Reference: Volume 2, Review of General Expenses Capitalized

Q. In Order No. P.U. 3(1995-96) the Board approved the change in Newfoundland Power's GEC methodology from the full cost method to the incremental method. According to Figure 1 on page 5 of 13 of the *"Review of General Expenses Capitalized"*, it appears that the amount of GEC in total capital expenditures decreased significantly after the change and phase-in period to incremental, which resulted in more of the general expenses being treated as operating costs and less as capital. It is noted that in response to the survey question 5 (b) on page 27 in Attachment 1, of the seven utilities that responded to the question, five used the full cost method and two used the incremental. Why does Newfoundland Power propose continuing with the incremental method when the full cost methodology appears to be a more common practice among the utilities surveyed?

A. As part of the *Review of General Expenses Capitalized* (the "GEC Review"), Newfoundland Power considered the appropriateness of continuing to apply the incremental cost method from 3 perspectives.

First, the Company considered the regulatory principle of customer rate stability.[1] Stability in GEC amounts is conducive to stability in customer rates. The incremental cost method results in reasonably stable GEC amounts on a year-over-year basis.[2] Annual GEC amounts were more variable under the full cost method.[3]

Second, Newfoundland Power considered the regulatory principle of intergenerational equity.[4] The full cost method capitalizes any general expenses incurred in connection with a capital program. The incremental cost method capitalizes only those general expenses that are incremental to a utility as a result of its capital program, with other costs expensed as incurred. This ensures costs are recovered only from customers who benefit from the service provided by capital assets.

Third, the Company considered the results of the *Survey of Capitalization Practices of Canadian Utilities*. Notably, Newfoundland Power considered the methodology used by the utilities as well as their overall capitalization rate.

1 The principle of customer rate stability establishes that rates and revenues should be stable and predictable from year to year, with a minimum of unexpected changes seriously adverse to either ratepayers or the utility. The principle of customer rate stability has been previously recognized by the Board. See, for example, Order No. P.U. 14 (2004), page 24.

2 From 2000 to 2020, GEC amounts ranged from approximately $2.1 million to $3.1 million annually using the incremental cost method, or from 2.6% to 5.0% of total capital expenditures.

3 From 1991 to 1995, GEC amounts ranged from approximately $8.3 million to $11.5 million annually using the full cost method, or from 23% to 31% of total capital expenditures.

4 The principle of intergenerational equity establishes that customers in a given period should pay only the costs necessary to provide them with service in that period. They should not be required to pay for costs incurred to provide service to customers in another period. The principle of intergenerational equity has been previously recognized by the Board. See, for example, Order No. P.U. 14 (2015), page 12.

The method used to determine capitalization rates varied among surveyed utilities.[5] Of the 11 respondents, 5 utilities use the full cost method, 2 utilities use the incremental cost method, 1 utility uses a burden rates method, while 3 utilities responded "N/A" to the question.

While the responses varied, the Company's use of the incremental method has resulted in its overall capitalization rate being comparable to that of the surveyed utilities. Excluding pension costs, Newfoundland Power's overall capitalization rate was approximately 9% in 2019 compared to an average of 10% of the surveyed utilities.[6] Ensuring capitalization amounts are comparable to other utilities is consistent with the Board's findings in Order No. P.U. 3 (1995-96).[7]

Based on this review, use of the incremental cost method to allocate general expenses to GEC continues to be appropriate.

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5 The types of overhead costs capitalized also varied among respondents.

6 See the *2022/2023 General Rate Application, Volume 2, Supporting Materials, Tab 6, Review of General Expenses Capitalized*, page 4.

7 In Order No. P.U. 3 (1995-96), the Board stated: *"It appears that while the full cost method is acceptable and theoretically sound, the manner in which it has been applied has resulted in an excessively high allocation of general expenses, particularly when compared with other utilities. Regulatory practice has seen a noticeable shift toward the incremental method. The risk of a method that capitalizes high amounts of overhead, would be to disadvantage future generations who would ultimately be asked to bear these costs."* See pages 12 and 13.