November 22, 2006

Via Courier

Ms. G. Cheryl Blundon
Director of Corporate Services and Board Secretary
Board of Commissioners of Public Utilities
120 Torbay Road
P.O. Box 21040
St. John's, NL A1A 5B2

Ladies and Gentlemen:

Re: Newfoundland Power - 2007 Amortization and Cost Deferrals Application ("2007 ACDA")

By correspondence from the Board Secretary dated October 27, 2006, the parties were advised that the Board had decided to consider the 2007 ACDA in the context of a paper hearing. Accordingly, please accept the following as the Consumer Advocate's submissions to the Board of Commissioners of Public Utilities (the "Board") in relation to the matter.

This submission focuses on the following two issues as set out below:

<u>2007 Income Tax</u>

Newfoundland Power's 2007 ACDA states: "Newfoundland Power is proposing to amortize $2,714,000 of the 2005 Unbilled Revenue as revenue for regulatory purposes in 2007 to offset the increase in 2007 income tax expense attributable to the Tax Settlement" (2007 ACDA, 2:21-3:2) The Grant Thornton report on NP's 2007 ACDA ("GT 2007 ACDA Report") states:

> **According to the Company, the 2005 Unbilled Revenue was calculated to be $22,539,020. We have obtained support for this amount and found it reasonable and appropriate. Under the terms of the Tax Settlement, the Company is required to recognize for tax purposes one third of the 2005 Unbilled Revenue in each of 2006, 2007 and 2008. The portion to be**

recognized in 2007 will be $7,513,000 ($22,529,020/3) (sic), multiplying this by the Company's statutory income tax rate of 36.12% for 2007 results in an income tax expense of approximately $2,714,000.

The Consumer Advocate agrees with this calculation of the impact of the tax settlement in 2007. The Consumer Advocate notes, however, the amount of 2005 Unbilled Revenue that is appropriate to recognize for regulatory purposes in 2007 is $2,507,000 ($2,714,000 - $207,000), which is sufficient to provide an exact offset for the cumulative tax effect of the recognition of 2005 Unbilled Revenue to date.

The rationale for allowing for regulatory purposes an offset that is $207,000 less than the actual tax effect of the recognition of 2005 Unbilled Revenue as required by the tax settlement is based on the following calculation that appears in CA-5.0 NP, lines 18-26:

Forecast 2005 Unbilled Revenue for income tax purposes, 2006 APA	**24,262,000**
Actual 2005 Unbilled Revenue for income tax purposes, 2007 ACDA	**22,539,000**
Variance	**1,723,000**
Income Tax Rate	**36.12%**
Income taxes related to forecast variance	**622,000**
Portion of forecast variance related to 2006 (622,000/3)	**$ 207,000**

Put simply, because Newfoundland Power overestimated the 2005 Unbilled Revenue in the 2006 Accounting Policy Application ("2006 APA"), Newfoundland Power's estimate of the tax effect was overstated by $207,000. CA-3.0 NP indicates that the forecast error can be explained in part by unusual weather conditions. The response indicates that while the actual 2005 Unbilled Revenue was $22.5 million, the 2005 Unbilled Revenue based on normal weather would have been $23.6. Presumably the difference between the forecast 2005 Unbilled Revenue and the actual 2005 Unbilled Revenue based on normal weather was the result of other factors that caused a variance in the 2005 Unbilled Revenue.

Of course, Newfoundland Power's additional taxes pursuant to the Tax Settlement are based on the <u>actual</u> 2005 Unbilled Revenue. Hence, the <u>actual</u> tax effect of the recognition of 2005 Unbilled Revenue in each of the three years (2006, 2007 and 2008) is $2,714,000. Actual taxes paid are not based on the estimate of 2005 Unbilled Revenue that appeared in the 2006 APA, nor are they based on the 2005 Unbilled Revenue adjusted for normal weather.

It is therefore readily apparent that the cumulative tax effect of recognizing the 2005 Unbilled Revenue in 2006 and 2007 as required by the Tax Settlement will be $5,428,000 (that is,

$22,539,020 * 2/3 * 36.12%). Because the amount of the 2005 Unbilled Revenue recognized for regulatory purposes in 2006 as an offset to this tax effect was $2,921,000 the remaining balance that is needed in 2007 to offset the tax effect to date is the $2,507,000 that is recommended by the Consumer Advocate.

It should be noted that the Consumer Advocate is not recommending that the Board make a retroactive adjustment to last year's decision. Rather the proposal is that each year's accounting adjustment should reflect the amount needed to offset dollar-for-dollar the tax effect of recognizing the 2005 Unbilled Revenue as required by the Tax Settlement. The same principle should be applied in 2008.

The Consumer Advocate notes that the Board's view on this matter when addressed in the 2006 APA appears in Order No. P.U. 40(2005) at page 14:25-26 of the Order:

> **The Board will accept NP's proposal to recognize $3,086,000 of the 2005 Unbilled Revenue in 2006 to offset the income tax effects associated with the tax settlement.**

In the Consumer Advocate's view, the words "the income tax effects" reflect an intent to hold the company whole with respect to the income tax effects. The intent is not to allow Newfoundland Power to gain and customers lose, or vice versa, due to any variance between the forecast and actual 2005 Unbilled Revenue.

While it may be the case, as Newfoundland Power suggests in CA-7.0 NP, that it would not be appropriate to make a retroactive adjustment to Order No. P.U. 40(2005) to reduce the amount of 2005 Unbilled Revenue recognized in 2006, the Board's discretion in establishing an appropriate amount of 2005 Unbilled Revenue to recognize in 2007 is fettered only by considerations of the fair treatment of both Newfoundland Power and its customers. The Consumer Advocate submits that fairness to both parties can be achieved by ensuring that the cumulative amount of 2005 Unbilled Revenue recognized as an offset to the tax effect of Newfoundland Power's recognition of the 2005 Unbilled Revenue for tax purposes is precisely equal to the actual tax effect over the three-year recognition period.

<u>2007 Replacement Energy Cost Deferral</u>

CA-16.0 NP posed the following question:

> **Is it the view of NP if there are any cost savings expected during the construction phase in 2007, those cost savings should offset the forecast replacement energy cost that is subject to the deferred recovery proposed by NP? If not, please explain the Company's position.**

Newfoundland Power provided a four page response defending its position as stated in the conclusion of its response:

> **Newfoundland Power has examined its 2007 hydro plant operating costs and determined no cost savings will result from the Rattling Brook refurbishment to offset the forecast energy replacement cost.**

Nowhere in the response does Newfoundland Power address the question that was asked. The Consumer Advocate therefore concludes that Newfoundland Power does not disagree with the principle embedded in the question that "if there are any cost savings expected during the construction phase in 2007, those cost savings should offset the forecast replacement energy cost that is subject to the deferred recovery proposed by NP."

It may well be that case that Newfoundland Power will not undertake any measures to reduce its operating costs during the Rattling Brook refurbishment although its generation capacity will be significantly reduced. As the Company states in its response "Newfoundland Power will assign staff to operating maintenance projects at other locations." After all, the company has little incentive to seek out cost savings to offset the cost of replacement energy - if the cost savings are used to offset the Replacement Energy Cost. Newfoundland Power's return on equity will not benefit from the reduction in operating costs.

The Consumer Advocate submits, however, that the important issue for the Board is not whether Newfoundland Power plans to aggressively seek cost savings to offset partially the Replacement Energy Cost that Newfoundland Power proposes to capture in a deferral account and recover from ratepayers in the future. The important issue is whether the Company should be expected to seek ways to reduce its costs so as to partly offset the expected $1.8 million Replacement Energy Cost.

The Board has a history of directing the electrical utilities it regulates to achieve unspecified cost savings in cases where such cost savings were appropriate in the circumstances. For instance, in P.U. 7 (2002-2003) the Board required a reduction of $2,000,000 on Hydro's "other costs" for the 2002 test year to reflect a productivity allowance. The Board also applied a productivity allowance in the 1996 general rate hearing for Newfoundland Power.

In each of these cases, the Board determined that it was appropriate for the Company to review its budget and reduce its costs below the forecast level. When directed to do so, it is left to the Company to determine the best way to realize the savings that the Board expects to achieve.

It must be observed that the Rattling Brook facility is the largest generating station operated by Newfoundland Power. The normal annual plant production is approximately 69.8 Gwh of energy, or about 16.6% of Newfoundland Power's total hydroelectric generation (NP 2007 CBA, Vol 2, p. 1). The Consumer Advocate submits that it is entirely reasonable for the Board to expect and direct that the Company should seek ways to reduce its costs so as to partly offset the expected Replacement Energy Cost in circumstances where the Company's largest generating facility is forecast to be out of service for a projected 35 weeks from early April to the end of November, 2007 (NP 2007 CBA, Vol 2, p. 9).

Newfoundland Power observes at CA-16.0 NP, lines 21-22 that "Over the period 2005 to 2007 total annual hydro plant operating costs are expected to vary by only approximately 3%." This magnitude of fluctuation in costs is therefore entirely normal.

The Consumer Advocate submits that it would be reasonable for the Board to place an expectation on Newfoundland Power that it will save roughly 5% of its 2007 Hydro Plant Operating Costs ($2,288,000), or $100,000 as an offset to the Cost of Replacement Power. To achieve this end, the Consumer Advocate recommends that the Board direct Newfoundland Power to reduce its Net Cost of Replacement Energy by $100,000 when it seeks recovery of the deferred costs to reflect required operating cost savings to offset the Cost of Replacement Energy during the refurbishment.

We trust the foregoing is found to be in order.

Yours very truly,

O'DEA, EARLE

THOMAS JOHNSON

TJ/cel

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