Board of Commissioners of Public Utilities

Newfoundland Power Inc.

2007 Amortization and Cost Deferrals

Grant Thornton

Contents

Introduction and Scope

On September 13, 2006, Newfoundland Power Inc. (the "Company") filed an application for approval of the amortization and deferral of various costs until their next general rate hearing. According to the Company, the approval of this application would allow the Company to defer a rate increase until its next scheduled rate application and adjust customer rates effective for 2008. It is the Company's position that a general rate application in 2007 would allow Newfoundland Power sufficient time to incorporate the results of Newfoundland and Labrador Hydro's 2006 general rate hearing.

The Board of Commissioners of Public Utilities (the "Board") has requested that we review the information in the Company's submission with a view to assessing the appropriateness of the information and the proposed treatment as well as the accuracy of the calculations. Specifically, the items presented for deferral and amortization include the following:

1. the treatment of 2007 Income Tax Costs related to the 2005 tax settlement with the Canada Revenue Agency;

2. the deferral of increased costs relating to the conclusion of a depreciation true-up; and

3. the deferral of forecast 2007 replacement energy costs attributable to the proposed 2007 refurbishment of Rattling Brook.

The Board has also requested that we review the forecast values for rate base and invested capital for use in the automatic adjustment formula for 2007.

Observations and Findings

We have conducted our review in accordance with the scope described above and our findings and comments with regards to the Application and related proposals are contained in the sections of the report which follow.

<u>Amortization of the 2005 Unbilled Revenue for 2007 Income Tax Costs</u>

For the 2007 fiscal year, the Company is requesting that $2,714,000 of the 2005 Unbilled Revenue be amortized as revenue for regulatory purposes to offset the additional income tax costs that will be incurred in 2007 as a result of the Tax Settlement between the Company and the Canada Revenue Agency in 2005.

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 to be 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), 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.

This request is consistent with the treatment previously approved by the Board in P.U. 40 (2005). In this particular Order, the Company was approved to recognize $3,086,000 of the 2005 Unbilled Revenue to offset the estimated 2006 income tax expense attributable to the Tax Settlement.

Based our review, we find that the treatment proposed by the Company for amortization of $2,714,000 of the 2005 Unbilled Revenue to offset the 2007 income tax costs is consistent with the treatment approved in P.U. 40 (2005) and therefore we consider it appropriate in the circumstances.

<u>2007 Depreciation True-Up Deferral</u>

In P.U. 19 (2003), the Board approved the amortization of an accumulated depreciation reserve variance ("true up") of $17.2 million over a three year period commencing in 2003. This annual amortization of $5,793,000 concluded at the end of 2005. Consequently, beginning in 2006 the Company will incur annually an additional $5,793,000 in depreciation expense equal to the annual true-up adjustment.

In P.U. 40 (2005), the Board ordered that it "will allow the Company to recover in future rates by use of a deferral account the increased depreciation expense of $5,793,000 related to the amortization of the depreciation true-up." This treatment offsets the increase in depreciation expense on the Company's statement of income.

In this Application, the Company is proposing that the 2007 effect of the conclusion of the depreciation true up ($5,793,000) be treated in the same manner as approved in P.U. 40 (2005) and be deferred until a further Order from the Board.

Based on our review, we find that the proposal put forward by the Company in this Application is consistent with the treatment approved by the Board in P.U. 40 (2005).

<u>Deferral of Forecast 2007 Replacement Energy Costs</u>

In its 2007 Capital Budget Application, the Company included a refurbishment of the Rattling Brook hydroelectric plant. This project has been approved by the Board in P.U. 30 (2006). The Rattling Brook hydroelectric plant is Newfoundland Power's largest generating facility. According to the Company, the annual production from this facility accounts for approximately 17% of its total annual hydroelectric production.

In the Company's pre-filed evidence, it has noted that during the period of refurbishment, it will have to purchase replacement energy from Hydro to replace the normal production from this hydroelectric facility. The Company has forecast that the spill associated with this project would result in a loss of 38.2 GWh of energy production in 2007.

The estimated cost of the additional energy purchases is $1,795,000. This has been calculated using the Company's purchase power cost from Hydro at 4.7 cents per kWh, (38,200,000 kWh * $0.47). Since this cost is deductible for income tax purposes, the net impact to Newfoundland Power as a result of these additional purchases is estimated to be $1,147,000, the details of this calculation are provided by the Company in Table 2, page 11 of its pre-filed evidence.

The Company has also indicated in its pre-filed evidence that Newfoundland Power's estimate of normal energy production from its hydroelectric generating facilities is adjusted, when necessary, to reflect physical changes and schedule plant availability. Consequently for 2007, the estimate for normal energy production for use in the Hydro Production Equalization Reserve will have to be reduced by the 38.2 GWh to reflect the unavailability of the Rattling Brook plant during the refurbishment period.

As part of this Application, Newfoundland Power has indicated that since the impact of replacement energy costs in 2007 associated with this project are not reflected in its current customer rates and the fact that the Company's general rate application will not be filed until 2007, it is proposing that the Board defer the recovery of this additional cost until a further Order of the Board. Essentially, the Company would like to use a deferral account and recover these additional costs in future rates.

Based on our discussions with the Company, there are no cost savings expected during the construction phase in 2007 to offset the forecast replacement energy costs that will have to be incurred.

<u>2007 Forecast Average Rate Base</u>

The Company is requesting approval of its 2007 forecast value for rate base of $785,271,000 (Exhibit NP-1 of the Company's Application), subject to the Board's approval of the Company's 2007 Capital Budget Application. This forecast rate base would be used in the automatic adjustment formula for calculating the Company's 2007 rate of return on rate base. It is our understanding that the Board approved the capital projects submitted by Newfoundland Power in its Capital Budget Application in P.U. 30 (2006).

The 2007 forecast rate base presented by the Company in Exhibit NP-1 of the Application is calculated with the assumption that the Board will approve the three previous proposals discussed in this report. The outcome of these proposals will impact the calculation of the average 2005 Unbilled Revenue and the average deferred charges in the calculation of the rate base.

The average deferred charges, including the Weather Normalization Reserve that were to be included in the forecast rate base were previously reviewed by us as part of the Capital Budget Application. It is important to note, that the Company has updated the average deferred pension costs and the Weather Normalization Reserve to reflect actual results up to July 31, 2006 in this Application. We have reviewed the revised numbers and obtained support and explanations for the changes where appropriate.

The approval of the three proposals set out in this Application would result in an increase in the 2007 average rate base of $4,827,000. The average deferred charges would increase by $3,470,000 and the average 2005 Unbilled Revenue would be reduced by $1,357,000.

Based on our review of the information provided by Newfoundland Power, we did not note any discrepancies in the calculation of the forecast average rate base, and therefore conclude that the 2007 forecast average rate base of $785,271,000 included in the Company’s Application is calculated correctly and in accordance with P.U. 36 (1998-99), P.U. 19(2003) and P.U.40 (2005). Our conclusion with respect to the forecast average rate base for 2007 is based on the assumption that the Board approves the proposals requested in this Application.

<u>2007 Forecast Average Invested Capital</u>

The Company is requesting approval of its 2007 forecast average invested capital of $787,990,000 (Exhibit NP-2 of the Company’s Application). This forecast average invested capital would be used in the automatic adjustment formula for calculating the Company’s 2007 rate of return on rate base.

The 2007 forecast average invested capital presented by the Company in Exhibit NP-2 of the Application is also calculated with the assumption that the Board will approve the three previous proposals discussed in this report. The outcome of these proposals will increase the forecast average invested capital by $4,827,000 in comparison to the average invested capital without these proposals. The details of this calculation are provided by the Company in Exhibit NP-3 of the Company’s Application. The approval of the proposals would result in an increase in net earnings attributable to common shares of $9,654,000; the average would be $4,827,000 ($9.654 million / 2).

Based on our review of the information provided by Newfoundland Power, we confirm that the calculation of the 2007 forecast average invested capital of $787,990,000 (Exhibit NP-2 of the Company’s Application) is calculated correctly and in accordance with P.U. 36 (1998-99), P.U. 19(2003) and P.U.40 (2005). Our conclusion with respect to the forecast average invested capital for 2007 is based on the assumption that the Board approves the proposals requested in this Application.

Conclusion

Based on the results of our review of the information included in the Application we conclude that the proposed treatments requested by the Company are an appropriate means of dealing with these outstanding issues and the calculations provided by the Company are accurate.

Grant Thornton LLP

St. John's, Newfoundland
October 23, 2006

Chartered Accountants