P. U. 40(2004)

IN THE MATTER OF the *Electrical Power Control Act* R.S.N.1994, c.E-5.1 (the "*EPCA*") and *the Public Utilities Act*, R.S.N. 1990, c.P-47 (the "*Act*") and their subordinate regulations;

AND IN THE MATTER OF an application by Newfoundland and Labrador Hydro ("Hydro") for approval of rates to be charged its customers and resulting Order Nos. P.U. 14(2004), P.U. 17(2004), P.U. 24(2004) and P.U. 25(2004);

AND IN THE MATTER OF a proposal from Hydro for a range of return on rate base pursuant to Order No. P.U. 14(2004).

On May 4th, 2004 the Board issued Order No. P.U. 14(2004) arising from Hydro's 2003 general rate application. In this Order the Board found, *inter alia*, that implementation of a range of rate of return on rate base and an excess earnings account for Hydro was appropriate. Hydro was ordered as follows:

> *"As part of its revised filing of rate base and rate of return on rate base NLH shall file for the approval of the Board:*
>
> *i. a proposal for a range of return on rate base including an analysis of several alternate ranges with impacts; and*
>
> *ii. a definition of an "excess earnings" account to be included in the company's system of accounts to which earnings above the maximum of the allowed range of return on rate base will be credited."*

On June 1, 2004 Hydro filed with the Board a proposal with respect to a recommended range of return on rate base and a definition of an "excess earnings" account. In its proposal Hydro recommended that its range of return on rate base be set at 48 basis points (plus or minus 24 basis points on the approved rate of return on rate base), effective January 1, 2005. Hydro stated that this range would provide sufficient flexibility in absolute dollar terms to accommodate the variations in earnings that can occur over time due to circumstances outside Hydro's direct control, and which cannot be addressed through future applications for revised rates. Hydro also stated that this range would provide further incentive for Hydro to contain costs and build the regulated equity portion of the capital structure.

In a submission filed on June 9, 2004 with respect to Hydro's proposed range of rate of return on rate base the then Consumer Advocate ("CA"), Mr. Dennis Browne, cautioned the Board that there is a lack of evidence linking directly an expanded range and operating efficiencies, stating that "such a link has been assumed; it is a theory which remains unproven." The CA submitted:

> *"Newfoundland and Labrador Hydro has no basis for putting forward a proposal to expand the range on rate base to 48 basis points, with the Board having just rejected Newfoundland Power's application to increase its range by 50 basis points. If the Board decides to allow any range at all, such a range should be conservative for this newly regulated Utility. 24 basis points annually, that is one-half of what is proposed, would be the maximum that should be considered for this newly regulated Utility."*

With respect to Hydro's proposed definition of an excess earnings account the CA submitted that the account should be calculated on a range of no more than 24 basis points annually. The CA filed a further submission on July 13th, referencing the CA's previous submission and provided additional comment on the magnitude of the range proposed by Hydro. The CA reiterated his position that the use of range of return on rate base does not provide an incentive mechanism for utilities to improve productivity and that there is no benefit whatsoever to ratepayers by allowing a range of return. According to the CA *"utilities which are properly managed and which provide legitimate forecasts do not need any further incentive in terms of range of return."* The CA submitted that the application by Hydro for a range of return of 48 basis points should be rejected.

The Board's financial consultants Grant Thornton reviewed Hydro's proposal and filed a report on June 29, 2004 with comments and findings, including a confirmation of the data and calculations provided by Hydro. Grant Thornton offered comments for the Board's consideration with respect to the magnitude of the potential earnings fluctuations and interest rate variations raised by Hydro and also with respect to the issue of the use of range of return on rate base as an incentive mechanism. Grant Thornton also stated that the difference between the two utilities as described in Hydro's submission suggests that the size of the range of return should be based on the individual circumstances. With regard to Hydro's proposed definition of the excess earnings account Grant Thornton concluded that it is appropriate, subject to the Board's final determination as to the upper limit of the rate of return on rate base.

In its submission of July 13, 2004 the Industrial Customers ("IC") stated:

> *"…we see no value for a range of return for Newfoundland and Labrador Hydro. The rate of return set by the Board must be accepted by all parties as the minimum rate required by Hydro to maintain its financial integrity and the maximum rate necessary for that purpose. To allow Hydro to recover any more that that rate represents the unlawful imposition of additional cost on customers."*

With respect to the excess earnings account, the IC submitted that Hydro should be required to establish an excess earnings account which should be based upon the rate of return approved by the Board.

On July 19, 2004 Hydro filed a response to Grant Thornton's review. This submission clarified certain issues and also provided additional comment on Grant Thornton's position with respect to potential earnings variations and the use of an expanded range to protect Hydro from such variations. Hydro stated that it *"would not characterize its request in establishing a range 'as a mechanism to protect against earnings fluctuations' but rather would state that a range should be established which would accommodate the significant fluctuations in return which can occur in the normal course of business."* Hydro goes further to state that "*…a band which is too narrow would not be symmetrical and would expose Hydro to a higher probability of under-earning than over-earning."* Hydro also reiterated its position that a broader range for Hydro as compared to Newfoundland Power ("NP") is warranted, based on its financial comparison.

NP did not file a submission on Hydro's proposal for a range of return on rate base or Hydro's proposed definition of an excess earnings account.

In Order No. P.U. 14(2004) the Board found that it was appropriate to establish a range of return on rate base and a corresponding definition of an excess earnings account for Hydro. This finding would ensure a consistent approach by the Board in regulating both Hydro and NP in the future. The Board also acknowledged in Order No. P.U. 14(2004) that the determination of an appropriate range for Hydro must be made within the context of Hydro's financial parameters and also within the context of the Board's other findings in the Decision and Order.

With regard to the submission of the IC and the CA, the Board determined in Order No. P.U. 14(2004) that a range of return on rate base should be established, and outlined its reasons for this finding. The Board will not consider further the matter of whether the establishment of a range on return on rate base is justified. The question before the Board is one of what is the appropriate range, given the operating and financial parameters of Hydro. To this end the Board has examined Hydro's proposed alternate ranges and the associated impacts of the various ranges considered.

In Order No. P.U. 19(2003) the Board expressed its view that the range of return on rate base can act as an incentive to encourage a utility (NP in this case) to seek efficiencies between rate hearings, which can then be passed on to customers in the form of lower rates into the future. This principle applies equally to NP and Hydro in terms of the incentive to manage costs.

In setting an appropriate range of return on rate base for Hydro the Board is cognizant of its obligation to strike a balance between the interests of the utility and the consumer. Hydro is entitled to a fair and reasonable return and customers should be charged rates that recover Hydro's costs, including a fair and reasonable return. As recognized in the Stated Case (paragraph 66), the setting of a range of return recognizes that the determination of a fair and reasonable return cannot be done with the precision of a simple mathematical calculation but that, realistically the balance can only be struck within a reasonable range. If Hydro earns within the upper limit of the range as set by the Board, Hydro is entitled to those earnings. Hydro is not entitled to any earnings in excess of the upper limit of the range; these earnings are required to be put into an "excess earnings" account and dealt with by the Board as it deems appropriate. In dealing with the disposition of these excess earnings the Board may consider the facts and circumstances giving rise to the excess earnings and take these factors into account.

Hydro has submitted that any approved range of return on Hydro's earnings should be considered relative to the various risks to which those earnings are exposed. Hydro provided examples of business risks that could affect its earnings, such as interest rate variations, the impact of a potential shutdown at one of its Industrial Customers, the demand-energy rate to be implemented for Newfoundland Power, variations in efficiency at Holyrood that are dependent on precipitation and reservoir inflows, variations in the cost of diesel fuel, and costs arising from unplanned breakdown or corrective maintenance. While the Board acknowledges that these are all risks that could negatively affect Hydro's earnings, the Board has in fact already considered the level of Hydro's risk exposure when it considered the appropriate return on equity for rate setting purposes in Order No. P.U. 14(2004). The fact that these risks are present for Hydro however does not justify the setting of a specific range. There are indeed other factors that may materialize which could offset these downside risks, such as higher sales revenues and increased efficiencies at Holyrood. The Board also notes that Hydro has the right to make an application to the Board for interim rate relief should unanticipated factors arise outside its control which lead to increased costs.

The use of a range of return is intended to, in part, capture the uncertainty in forecasting the actual operating conditions in which a utility may find itself and allow for some financial flexibility in responding to those uncertainties. At the same time the range may also provide an incentive mechanism for Hydro's management to contain costs by improving productivity, and hence benefiting ratepayers in the long term. In Order No. P.U. 7(2002-2003), Hydro's first Order as a fully regulated utility, as well as in Order No. P.U. 14(2004), the Board established appropriate regulatory oversight for Hydro which is anchored in sound planning, including performance measurement and enhanced regulatory reporting. The Board sees the incentive provided through an appropriate range of return on rate base as a useful and appropriate tool in this regulatory oversight. The Board also notes Hydro's position that its proposed range would provide further incentive for Hydro to build the regulated equity portion of its capital structure, a concern expressed by the Board in Order No. P.U. 14(2004).

Having examined Hydro's analysis of the financial impacts of various ranges of return on rate base, the Board finds that a range of 30 basis points (plus or minus 15 basis points on the approved rate of return on rate base of 7.466%) is reasonable. This range will, in the Board's view, allow Hydro to operate within a range of return on rate base that will provide meaningful financial incentive for management to improve productivity and reduce costs to consumers in the long term. The range will be ordered to be effective as of January 1, 2005 in recognition of the fact that approved rates resulting from Order No. P.U. 14(2004) will not be in effect for all of 2004.

The Board accepts Hydro's definition of excess earnings, modified to account for the Board's finding of an appropriate range of return on rate base of 30 basis points.

IT IS THEREFORE ORDERED THAT:

1. The allowed range of rate of return on rate base for Hydro shall be 30 basis points (±15 basis points), effective January 1, 2005 unless otherwise ordered by the Board.
2. The definition of excess earnings shall be as set out below, with any balance greater than zero as of December 31 of each year, commencing January 1, 2005, to be recorded in Hydro's excess earnings account as a liability and reported to the Board as part of its annual financial report.

   Definition of Excess Earnings

   Excess earnings shall be defined as the greater of A-(B x C) and 0 where:

   A = Actual return on rate base, calculated as net interest expense, including debt guarantee fee, plus net income

   B = Actual average rate base, December 31

   C = Upper limit of return on rate base, defined as Test Year Return on Rate Base + 15 basis points

Dated at St. John’s, Newfoundland and Labrador this 27th day of October, 2004.

Robert Noseworthy,
Chair & Chief Executive Officer.

Darlene Whalen, P.Eng.,
Vice-Chair

G. Fred Saunders,
Commissioner.

G. Cheryl Blundon,
Board Secretary.