NEWFOUNDLAND AND LABRADOR
BOARD OF COMMISSIONERS OF PUBLIC UTILITIES

REASONS FOR DECISION

ORDER NO. P. U. 31(2010)

IN THE MATTER OF the *Electrical Power Control Act*, *1994* SNL 1994, Chapter E-5.1 (the *"EPCA"*) and the *Public Utilities Act,* RSNL 1990, Chapter P-47 (the "*Act*") as amended, and regulations thereunder;

AND

IN THE MATTER OF a comprehensive proposal for the 2011 adoption of accrual accounting for other post employment benefit costs for Newfoundland Power Inc. ("Newfoundland Power")

Background

In Order No. P.U. 43(2009) the Board ordered that Newfoundland Power file, no later than June 30, 2010, a comprehensive proposal for adoption of the accrual method of accounting for other post employment benefits ("OPEBs") costs as of January 1, 2011. The proposal was required to include alternatives and recommendations in relation to (i) a deferral mechanism to capture annual variances arising from changes in the discount rate and other assumptions, and (ii) the recovery of the transitional balance associated with the adoption of accrual accounting for OPEBs costs. On June 30, 2010 Newfoundland Power filed an application (the "Application") together with the "Report on Other Post Employment Benefits". In the Application Newfoundland Power proposes that, effective January 1, 2011:

(i) it adopt, for regulatory purposes, the accrual method of accounting for OPEBs costs and income tax related to OPEBs;
(ii) the transitional balance associated with the adoption of the accrual method of accounting for OPEBs costs be recovered over a 15-year period using the Mortgage Method; and
(iii) it adopt an OPEBs Cost Variance Deferral Account to capture annual differences in OPEBs costs arising from changes in assumptions associated with the valuation of OPEBs obligations.

Newfoundland Power states that implementation of the proposals would result in an average increase in Newfoundland Power's base rates of approximately 1.0% effective January 1, 2011.

Newfoundland Power provided a copy of the Application to the Consumer Advocate and to Newfoundland and Labrador Hydro. The Consumer Advocate advised the Board on July 23, 2010 of his intention to participate in the proceeding. Newfoundland and Labrador Hydro advised the Board on August 10, 2010 that it had no comments on this matter.

The Board's financial consultants, Grant Thornton, reviewed the Application and filed a report on August 13, 2010 concluding that the base rate impacts had been calculated accurately in accordance with both International Financial Reporting Standards ("IFRS") and Canadian Generally Accepted Accounting Principles ("GAAP") .

Notice of the Application was published on September 11, 2010.

The Consumer Advocate filed eleven information requests on October 29, 2010. Newfoundland Power answered the information requests on November 5, 2010. Both parties filed written submissions with the Board on November 26, 2010. In its submission Newfoundland Power addresses three main issues in relation to its proposals:

i) the adoption of accrual method of accounting;
ii) the transitional balance; and
iii) the cost variance deferral account.

<u>Adoption of the Accrual Method of Accounting</u>

The issue of moving towards the accrual method of accounting for OPEBs costs was raised in Newfoundland Power's last three general rate applications. In Order No. P.U. 19(2003) the Board approved Newfoundland Power's proposal to continue using the cash basis for recognizing OPEBs costs for regulatory purposes. However the Board stated:

> *"The Board is concerned about the potential liability for employee future benefits and is of the view that NP should explore using the accrual method of accounting for these benefits. The Board recognizes that there are significant transitional obligations associated with this change in accounting policy but once the transitional obligation has been met these costs should decrease. NP should continue to monitor its obligations with respect to employee future benefits and corresponding regulatory practice. The Board will direct NP to propose a plan at its next general rate application for moving towards the accrual method of accounting for employee future benefits as recommended by the CICA. The Board emphasizes such a plan should be presented to the Board as an alternative to the existing method and should address the transitional impact with a view to fulfilling NP's obligation to its employees while at the same time moderating tis impact on rates. The Board will then be in a position to consider this alternative accrual method and its specific impacts at the next hearing."*

In its 2008 General Rate Application Newfoundland Power initially proposed to implement the accrual method of accounting for OPEBs costs but the settlement agreement provided that Newfoundland Power would continue using the cash basis of accounting for OPEBs costs.

In its 2010 General Rate Application Newfoundland Power again proposed the implementation of the accrual method of accounting for OPEBs costs. In Order No. P.U. 43(2009) the Board ordered Newfoundland Power to file a comprehensive proposal for the adoption of the accrual method of accounting for OPEBs costs as of January 1, 2011.

In its August 13, 2010 report Grant Thornton notes that accounting for OPEBs costs using accrual accounting is consistent both with Newfoundland Power's treatment of pension costs and with Newfoundland and Labrador Hydro's treatment of OPEBs costs. The proposal to adopt the accrual method of accounting for OPEBs costs is also consistent with current Canadian regulatory practice and is in accordance with both Canadian Generally Accepted Accounting Principles (GAAP) and with International Financial Reporting Standards (IFRS).

The Consumer Advocate did not raise any concerns or issues which would suggest that the move to the accrual method of accounting for OPEBs costs should not proceed.

The Board is satisfied that as of January 1, 2011 Newfoundland Power should use the accrual method of accounting for OPEBs costs and income tax related to OPEBs.

<u>OPEBs Transitional Balance</u>

The move to the accrual method of accounting for OPEBs costs will result in a transitional obligation. Grant Thornton states at page 7 of its report that:

> *"Transitional obligations typically arise on the adoption of the accrual method of accounting for employee future benefits. The obligation represents the cumulative difference between accounting treatments up to the implementation date of the accrual method."*

Newfoundland Power's OPEBs transitional balance is estimated to be approximately $52.4 million by the end of 2010.

Newfoundland Power submits that the primary matters for regulatory judgement by the Board in relation to the transitional balance are the amortization method and the amortization term.

(i) Amortization Method

Two alternative methods were considered by Newfoundland Power for the amortization of the transitional balance. The first was amortization on a simple straight-line basis (the "Straight-Line Method"). This method amortizes the regulatory asset in equal amounts in each year. This, in effect, stabilizes recovery of the balance over time.

The second method proposed was amortization on a basis that offsets recovery of the regulatory asset with rate base effects associated with adoption of the accrual method for OPEBs costs (the "Mortgage Method"). According to Newfoundland Power this method amortizes the balance by a varying amount in each year to achieve consistency in the annual recovery of costs related to past service, effectively stabilizing recovery of net OPEBs costs over time. Under this method the amortization amount increases each year with the increasing amortization amounts offset by rate base effects.

Newfoundland Power recommends the use of the Mortgage Method to amortize the transitional balance. While both methods meet the cost of service standard as both methods permit an opportunity to recover costs, Newfoundland Power claims that the Mortgage Method would result in a fairer treatment with respect to intergenerational equity as the overall OPEBs cost recovery would be spread evenly over the amortization term. The Mortgage Method also provides better rate stability as it results in a more stable annual recovery of net OPEBs costs.

The Consumer Advocate supports the adoption of the Mortgage Method as this approach minimizes the year to year impact of the recovery of the transitional obligation on rates.

At page 9 of its report Grant Thornton states:

> *"While we agree with the Company's comments regarding the regulatory principles it is important to note that the methodology used under the Mortgage Method is not typically applied in Canadian GAAP or IFRS. The method is a type of smoothing mechanism, similar to the sinking fund depreciation method, which is generally inconsistent with accepted accounting treatments. In addition, CICA Handbook Section 3461 notes that past service costs must be amortized on a straight-line basis. However, as the Company's financial consultant, JT Browne, has pointed out in Appendix G to the application, there can be a difference between regulatory accounting policies and GAAP due to differing objectives. We also note that in the past amortization of regulatory assets and liabilities have typically been dealt with on a straight-line basis, for example, P.U. 32 (2007) provided for the straight-line amortization of various regulatory account balances. The company has noted that it is not aware of past practice from any rate regulated entity to amortize regulatory assets in this manner."*

Where possible the Board strives to ensure consistency as well as compliance with Canadian GAAP in the accounting methods of the utilities. The Board also notes that when IFRS is formally implemented many of the regulatory assets established by the utilities will have to be reassessed under IFRS compliance standards. The Board is reluctant to approve a method that would be inconsistent with IFRS at this time. To maintain consistency among amortization accounts and to be compliant with Canadian GAAP and IFRS the Board will require that the transitional balance for OPEBs expenses be amortized using the Straight-Line Method.

(ii) Amortization Term

Newfoundland Power considered 10-year, 15-year and 20-year amortization terms for recovery of the transitional balance. The following table provides the rate impacts of the various alternatives reviewed by Newfoundland Power:

Pro Forma 2011 Rate Impacts
OPEBs Regulatory Asset Amortization Alternatives[1]
(%)

	10-Year	15-Year	20-Year
Straight-Line Method	1.75	1.43	1.26
Mortgage Method	1.33	0.99	0.84

Newfoundland Power recommends a 15-year term for amortization of the transitional balance as the term provides an adequate balance between the rate impact on customers and the duration of the impact.

Grant Thornton suggested that Newfoundland Power could consider using a 14-year term, which aligns with the Expected Average Remaining Service Life for Newfoundland Power's employees.

The Consumer Advocate stated that a 14-year term had some merit.

The Board finds that the proposed 15-year term is reasonable as it approximates the Expected Average Remaining Service Life for Newfoundland Power's employees and therefore will accept Newfoundland Power's recommendation of a 15-year amortization term.

OPEBs Cost Variance Deferral Account

Newfoundland Power proposes the creation of an OPEBs Cost Variance Deferral Account to capture future changes in OPEBs costs from those included in rates. The Consumer Advocate supports the creation of this account provided that it is implemented in a manner that is consistent with the adoption of the Pension Expense Variance Deferral Account.

Grant Thornton concludes that the use of the OPEBs Cost Variance Deferral Account will limit the variability of the OPEBs costs due to changing assumptions, such as discount rates, as well as changes related to rate base effects. Grant Thornton notes however that the proposed account addresses "net OPEBs cost" which includes rate base effects whereas the Pension Expense Variance Deferral Account only addresses actual pension expense.

Newfoundland Power states that the proposed deferral account is similar to the Pension Expense Variance Deferral Account. Newfoundland Power submits that it included rate base effects as part of its comprehensive proposal to fully reflect the customer benefits of reduced financing requirements and that the OPEB's Cost Variance Deferral Account should be approved as filed.

1 Newfoundland Power's written submissions, November 26, 2010, Table 1, Page 9

The Board notes that an inclusion of rate base effects in the deferral account definition allows for the possibility that the account could be impacted by factors other than those specific to OPEBs assumptions. To be consistent the OPEBs Cost Variance Deferral Account should operate in the same manner as the existing Pension Expense Variance Deferral Account approved by the Board in Order No. P.U. 43(2009), which does not include rate base effects. The Board is satisfied that the rate base effects should not be included in the OPEBs Cost Variance Deferral Account.

In addition Newfoundland Power will be required to file an annual report on the operation of the OPEBs Cost Variance Deferral Account. This report will allow the Board to monitor the account and ensure that it is meeting its intended purpose.

DATED at St. John's, Newfoundland and Labrador, this 14th day of January, 2011.

Andy Wells
Chair & Chief Executive Officer

Darlene Whalen, P.Eng.
Vice-Chair

Dwanda Newman, LL.B.
Commissioner

James Oxford
Commissioner

Cheryl Blundon
Board Secretary