Q. In reply to PUB-NLH-377, Hydro indicates that $1.2 million in operations and maintenance costs associated with the Labrador-Island Link are included in the 2015 Test Year. Hydro has stated at p. 2.52 of its evidence that "the Board may want to consider the deferral of these costs for future recovery upon the in-service of the Labrador Island Link." What regulatory principles would support the deferral of these costs versus their inclusion in the test year?

A. In 2002, John T. Browne presented evidence on behalf of Newfoundland Power with respect to the relevant regulatory principles to consider on issues concerning cost recovery.[1] Exhibit JTB-3 entitled "Regulatory Principles" was filed with the Board in 2002; this exhibit has been provided as CA-NLH-356 Attachment 1.

Hydro believes the following are the key regulatory principles that apply in considering whether a deferral account should be created to deal with current costs being incurred to ensure reliable system operations after the completion of the Labrador-Island interconnection.

Cost of Service Standard: A regulated utility should be provided with a reasonable opportunity to recover its costs of providing regulated service, including a fair return.

Hydro has included $1.2 million in the 2015 Test Year operations and maintenance costs associated with the preparation for the future operation and integration of the Labrador-Island Link and Muskrat Falls Generating Station within the provincial

[1] Source: Exhibit JTB-3 of report entitled "Newfoundland Power, Accounting and Regulatory Issues Related to Future Employee Benefits and the Hydro Production Equalization Reserve" dated October 11, 2002.

electricity system. There will be additional annual costs incurred in 2016 and 2017 beyond the $1.2 million in the 2015 Test Year necessary for ensuring adequate workforce and system preparedness in advance of completion of the project commissioning in 2018.

The provision of a deferral account to recover the incremental costs incurred by Hydro in preparing for the Labrador-Island Interconnection would provide Hydro a reasonable opportunity to recover its costs incurred in 2016 and 2017.

Intergenerational Equity: Customers in a given period should pay only the costs necessary to provide them with service in that period. Combined with the Cost of Service standard, this principle requires that the rates in each period should recover the costs of providing service in that period.

The $1.2 million in costs referred to in the request relates to additional costs being incurred in 2015 to ensure reliable system operations after the completion of the Labrador-Island interconnection. These costs are not required for the provision of service to current customers. Reflecting these costs in the 2015 Test Year effectively requires customers to pay for the current costs of providing service concurrently with future costs of providing service. The deferral of these costs for future recovery from customers who will benefit from the Labrador-Island interconnection provides a better matching of the recovery of costs with the timing of the benefits being provided. Approval of a deferral account to deal with additional costs incurred by Hydro in preparation of the Labrador-Island interconnection is consistent with the practice, for example, of recording financing costs for a capital project while it is under construction and recovering those costs through rates subsequent to project completion.

REGULATORY PRINCIPLES

In the context of the issues on which NP has requested an opinion, the following principles are relevant: just and reasonable, cost of service standard, prudence standard, intergenerational equity, and rate stability and predictability.

Just & Reasonable

The primary regulatory principle, and the one most likely to be incorporated into regulatory legislation, is that rates should be just and reasonable. "Just and reasonable" applies to both customers and regulated entities. It requires a weighting of the legitimate interests of both parties. Unfortunately, "just and reasonable" is a vague and subjective concept. It provides an overall direction to regulators but little specific guidance.

This principle is consistent with the declared policy of the Province of Newfoundland and Labrador. For example, paragraph 3 of the "Electric Power Control Act, 1994" states that it is the declared policy of the province that the rates to be charged, either generally or under specific contracts, for the supply of power within the province should be reasonable and not unjustly discriminatory.

Cost Of Service Standard

At the heart of rate regulation is the cost of service standard, sometimes referred to as the revenue requirement standard.

Under this standard, a regulated entity is permitted to set rates that allow it the opportunity to recover its costs for regulated operations, including a fair rate of return on its investment devoted to regulated operations – no more, no less.

It's important to note that this standard only gives the entity the opportunity to earn a fair return; it does not guarantee it. In most cases, rates are set prospectively, based on anticipated future costs. If the entity over-recovers, it keeps the excess. If it under-recovers, it bears the deficiency.

This standard reflects fairness and the necessity to offer adequate incentives for providing regulated services.

- In fairness, an entity's investors should have the opportunity to recover their costs, including a fair return, just as they would if they were to invest in a non-regulated entity of similar risk. However, customers should not have to provide investors with the opportunity to earn more than they could expect from investing in non-regulated operations.

- From an incentive viewpoint, unless investors have a reasonable opportunity to recover their costs, it will be difficult to attract the investment necessary to provide regulated operations. The opportunity to recover costs, including a fair return, should provide an adequate incentive to attract those funds.

The cost of service standard is applicable to all regulatory methodologies, including performance-based methods such as price cap regulation. A regulated utility may earn more or less than a fair return, and performance based methods increase the possibility of realized earnings deviating from a fair return. However, the issue is that a regulated entity should have a reasonable opportunity to earn a fair return, which implies that the possibility of under and over earning is offsetting[1].

The cost of service standard is consistent with what is expected to occur in a competitive market, where the price of services tends towards the cost of providing them, including a fair return.

The principle is also consistent with the Newfoundland and Labrador Public Utilities Act. For example, paragraph 80 states:

> *(1) A public utility is entitled to earn annually a just and reasonable return as determined by the board on the rate base as fixed and determined by the board ...*
>
> *(2) The return shall be in addition to those expenses that the board may allow as reasonable and prudent and properly chargeable to operating account, and to all just allowances made by the board according to this Act and the rules and regulations of the board.*
>
> *(3) Reasonable payments each year to former employees of a public utility who have retired and are receiving payments of supplemental income from the public utility are expenses that the board may allow as reasonable and prudent and properly chargeable to the operating account of the public utility. ...*

Prudence Standard

The prudence standard modifies the cost of service standard. Under this standard, customers should be charged only for prudently incurred costs. This recognizes the fact that regulated entities have a responsibility to manage themselves in a prudent manner.

Deciding what is prudent is done by determining what a reasonable person would have done in a similar situation. This should not be done in hindsight. A regulated entity's management can be expected to rely only on information reasonably available to it when it makes its decision.

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[1] The expected rate of return should equal a fair rate of return where the expected rate of return is equal to the average of the possible rates of return weighted by the probability of their occurrence.

It's generally assumed that management has acted prudently unless evidence exists to the contrary.

Intergenerational Equity

Under this principle, customers in a given period should pay only the costs necessary to provide them with service in that period. They should not have to pay for any costs incurred to provide service to customers in another period. This principle is consistent with setting just and reasonable rates within each period.

For example, a regulated entity is usually not allowed to earn a return on projects under construction. It's incurring this cost to provide service to future customers, not customers in the current period. Instead, the return is capitalized and recovered through depreciation over the period in which the assets are used to provide service.

Combined with the cost of service standard, the principle of intergenerational equity requires that rates within a period should cover the costs of providing service in that period.

This principle's importance depends on the periods involved. Customers in one year tend to be the same as those in the next and an individual's usage generally doesn't vary that much from one year to the next. Having customers in one year pay more as a result of costs incurred to provide service in the previous year would not be as serious a breach of this principle as it would be if they had to pay more because of service provided to customers 10 years earlier. If costs can't be recovered in the period for which they were incurred, it's generally best to recover them in a period as close as possible to the one for which they were incurred.

Under the accounting principle of conservatism, where there is uncertainty concerning the future economic benefit of an expenditure, it should be reported as an expense rather than an asset. This tends to create a bias toward expensing rather than capitalizing expenditures, though the principle does not justify deliberately underestimating income or assets. The regulatory principle of intergenerational equity requires a more equal weighting between periods to treat customers of different periods fairly.

Under the principle of intergenerational equity, costs that might be expensed in one period under normal accounting principles could be deferred for regulatory purposes and recovered from customers in a future period.

Rate Stability And Predictability

This principle requires rates to remain stable and predictable – at least to the extent practical. It may, therefore, justify smoothing out changes in rates to avoid sharp rate climbs or temporary fluctuations.

The principle's intent is to establish only when costs are recovered, not the amount actually recovered. In practice, it does affect the amounts recovered because the timing of cost recovery affects financing costs. Where costs are deferred, the deferred amount must be financed, and regulated entities are entitled to recover the additional financing costs under the cost of service standard.

The principle of rate stability and predictability may require costs to be collected from customers in periods other than those for which they were incurred. Therefore, it is inconsistent with the principle of intergenerational equity. Despite that, it's justified because it recognizes the adverse impact where customers must adjust to significant rate increases or short-term rate fluctuations.

As time passes, the makeup and usage of a customer group changes. Therefore, the longer the period that costs are deferred, the more serious the breach of the intergenerational equity principle. As a result, when the principle of rate stability and predictability is applied, cost deficiencies should be recovered over as short a period as is reasonable, so the customer group that eventually pays for the costs is similar to the one benefiting from the costs. Similarly, if, to avoid a sharp rate increase, costs are recovered before a period for which they will be incurred, the intervening period should also be as short as reasonably possible.

COMPONENTS INCLUDED IN PENSION EXPENSE

Section 3461 of the CICA Handbook sets out the components of pension expense for both a defined benefit plan and a defined contribution plan.

DEFINED BENEFIT PLAN

In paragraph 070, Section 3461 sets out the potential components of the pension expense associated with a defined benefit plan. All of the components may not be applicable to a given plan in a given year:

(a) the current service cost;

(b) the interest cost on the accrued benefit obligation;

(c) the expected return on plan assets;

(d) the amortization of past service costs arising from a plan initiation or amendment;

(e) the amortization of a net actuarial gain or loss;

(f) the amount recognized as a result of a temporary deviation from the plan;

(g) the increase or decrease in a valuation allowance against the carrying amount of an accrued benefit asset;

(h) the gain or loss on a settlement or curtailment;

(i) the expense recognized for a termination benefit;

(j) the amortization of a transitional asset or transitional obligation; and

(k) the amortization of an amount carried forward arising on the initial application of the Recommendations of this Section related to the limit on the carrying amount of an accrued benefit asset.

DEFINED CONTRIBUTION PLAN

In paragraph 015, Section 3461 sets out the potential components of the pension expense associated with a defined contribution plan. All of the components may not be applicable to a given plan in a given year:

(a) the current service cost for the period;

(b) the interest cost for the period on the estimated present value of any contributions required in future periods related to employee services rendered during the current period or past periods;

(c) the amortization for the period of past service costs; and

(d) a reduction for the interest income for the period on any unallocated plan surplus.