

March 18, 2014

Board of Commissioners of Public Utilities
Prince Charles Building
120 Torbay Road, P.O. Box 21040
St. John's, NL
A1A 5B2

ATTENTION: Ms. Cheryl Blundon
Director of Corporate Services & Board Secretary

Dear Ms. Blundon:

Re: An amended application by Newfoundland and Labrador Hydro pursuant to Section 70 and 75 of the Public Utilities Act, for the approval of customer electricity rates for 2014 on an interim basis or, in the alternative, for a deferral and recovery mechanism.

Following is Hydro's reply to the parties' submissions with regard to the above noted application.

1.0 Application Background

On July 30, 2013, Newfoundland and Labrador Hydro (Hydro) filed its General Rate Application (GRA) to adjust rates effective January 1, 2014. The GRA process is ongoing with the hearing scheduled to begin in July and rates anticipated to be implemented in the fall.

The implementation of proposed 2013 Test Year rates effective January 1, 2014 would have provided, on average, approximately \$7.0 million additional revenue per month to better match the cost of providing service to customers. Delayed implementation of customer rates until October 1, 2014 would result in a forecast 2014 revenue shortfall to be recovered from customers of more than \$55 million.¹ This is approximately 10% of the forecast cost of providing service for the 2013 Test Year.²

¹ The response to Request for Information IR-NP-NLH-036, Attachment 1 provides the projected revenue shortfall by month from Newfoundland Power. There is also forecast revenue shortfall for Hydro Rural Customers and Island Industrial Customers.

² The forecast 2013 Test Year Cost of Service is approximately \$568 million. See Exhibit 13, page 1 of 109, line 23.

To provide an opportunity for recovery of the forecast cost to serve, Hydro filed an Interim Rates Application with the Board on November 18, 2013 for approval of either (i) a schedule of proposed rates, tolls and charges on an interim basis effective January 1, 2014 or (ii) a deferral and recovery mechanism whereby Hydro would defer any revenue shortfall that results from delayed implementation of rates proposed in the GRA for recovery commencing at the time of the new rate implementation. The Interim Rates Application also proposed implementation of Island Industrial Customer rates in compliance with Government directives.

The requests for information submitted by Newfoundland Power indicated a concern with changing the Utility Rate and its customer rates in advance of the Board completing the GRA process. In Order No. P.U. 40(2013), the Board stated that the “the proposals in the Interim Rates Application raise complex and comprehensive issues which in the Board’s view should be addressed before interim rates are established”.

To address the concerns with the Interim Rate Application, Hydro filed an amended Interim Rates Application (the “Amended Interim Application”) on February 11, 2014.

2.0 Application Proposals

The Amended Interim Application effectively proposes to: (i) make existing rates interim for all customers except the Island Industrial Customers; (ii) implement proposed 2013 Test Year rates for Industrial Customers on an interim basis effective January 1, 2014; (iii) re-activate the Rate Stabilization Plan (RSP) rules for setting Island Industrial Customer rates effective January 1, 2014; and (iv) implement a deferral and recovery account to provide for recovery of the 2014 revenue shortfall upon approval of final customer rates.

Hydro’s Amended Interim Application provides a reasonable approach to deal with delayed implementation of final rates by giving balanced consideration to both the impact on customers and the opportunity for reasonable cost recovery by the provider of service.

2.1 Proposed Customer Rates and the RSP

Hydro’s Amended Interim Application avoids implementing a GRA rate change for Newfoundland Power and retail customers until final rates are approved but requires a modification to the values used in operation of the RSP for the period while the interim rates

are in effect.³ Hydro is proposing to use proposed 2013 Test Year values for the operation of the RSP under interim rates and to update the RSP balances when the final test year values are approved. The proposed approach provides a consistent test year basis for computation of monthly RSP balances and is consistent with the rates and costs reflected in the computation of the 2014 revenue shortfall.

Hydro is proposing that the 2014 RSP recovery related to the current fuel rider of 1.634¢ be held separately from the current RSP balance to reduce the amount of the 2014 revenue shortfall that would need to be recovered through a future rate adjustment. This approach provides a better matching of customer rates and costs during 2014 and minimizes the customer rate impact of having to recover the full amount of the 2014 revenue shortfall subsequent to a final rate order.⁴

Hydro's proposal provides for the phase-in of cost-based rates for the Island Industrial Customers including the application of RSP adjustments effective January 1, 2014.⁵ The average customer rate impact as a result of implementing the RSP adjustment effective January 1, 2014 is approximately 1.0% for all Industrial Customers.

Hydro's rate proposals balance customer impacts, regulatory efficiency and customer acceptance by limiting the number of rate changes required to implement new test year rates. The proposed approach provides a smooth transition from existing rates to final 2013 rates while limiting the amount of current costs to be recovered in future rates through the deferral account.

Newfoundland Power submitted that the effect on customer rates of Hydro's RSP proposals is unclear and should "only be considered when Hydro provides a clear explanation of the manner in which the RSP is proposed to operate". Hydro acknowledges the complexity of the RSP proposal and is prepared to address the concerns of Newfoundland Power prior to proposing a revised RSP adjustment to become effective July 1st, 2014. One option to

³ The RSP balances are computed based upon variances from test year forecast. The proposed interim rates on the Island Interconnected System will be based upon 2013 Test Year for Island Industrial Customers and 2007 Test Year for customers whose rates are based upon the rates of Newfoundland Power. The use of a single test year is required in computing RSP balances.

⁴ The 2013 Test Year fuel costs reflect a forecast fuel price of approximately \$109 per barrel and the fuel cost currently recovered in Island Interconnected retail rates is approximately \$106 per barrel. The \$106 per barrel is recovered through a combination of base rates (i.e., approximately \$55 per barrel) and the RSP fuel rider of 1.634¢ (approximately \$50 per barrel). The funds collected through the fuel rider of 1.634¢ do not accrue to revenue to Hydro but to the RSP balance.

⁵ The additional revenue from the phase-in of cost-based rates for Island Industrial Customers is being recovered from the Industrial RSP Surplus.

address the concern of Newfoundland Power would be to defer the RSP update scheduled for July 1st until final rates are approved in the fall of 2014. This would result in a single rate change in 2014 rather than a rate change in July and another rate change a few months later.

Counsel for the Towns of Labrador City, Wabush, Happy Valley-Goose Bay, Northwest River (LWHN)) has argued that interim rates are not required at this time with respect to Labrador Interconnected Customers just as they were not required when Hydro made its November 2013 original application for interim rates. With respect, Hydro submits that there are two important differences in the circumstances: (i) in the November 2013 application Hydro was seeking rates to go into effect immediately without an opportunity for the Board and intervenors to test and consider relatively large proportional changes in rates, whereas in the present amended application, Hydro is seeking a deferral account method of recovery with rate changes that will not go into effect until the final order; and (ii) it is now certain that a final order will not be made until well into the second half of 2014 which is later than Hydro was anticipating when it filed its original application for interim rates in November 2013. As a result, the revenue shortfall from not having rates in place is therefore larger and has a greater impact on Hydro's earnings.

2.2 Proposed Deferral Account

Hydro is requesting the Board approve a deferral account in advance of conclusion of the GRA to provide certainty to Hydro that it will have an opportunity to earn a just and reasonable return on its rate base for 2014. The proposed Revenue Shortfall Account provides for the difference between the revenues from interim rates and revenues based upon approved final rates be charged to the account.

Approval of the proposed Revenue Shortfall Account will provide Hydro with the opportunity to earn a reasonable return on rate base for 2014 and a return on equity for Hydro that reasonably reflects the Government directive for use in establishing customer rates.

2.2.1 Financial Performance and Reporting

Hydro earned a return on equity of only 0.14% in 2013. If final rates for 2014 are approved effective September 1, 2014 without approval of the proposed deferral account, the forecast return on equity for 2014 is 3.14%⁶. Given the current GRA schedule provides for the hearing to start in July, it is more likely that final rates may not be in effect until October or November further reducing the forecast return on equity for 2014. Without approval of a deferral account to provide rate relief for 2014, it is entirely possible that Hydro will incur financial losses in 2014.

It is important that the Board approve the proposed deferral account to enable Hydro to signal to lenders and other stakeholders that it will not be financially disadvantaged by the duration of the GRA process and have an opportunity to earn a reasonable return in 2014.

2.2.2 Legislative Provisions and Regulatory Practice

Section 75 of the *Public Utilities Act* permits the Board to approve electricity rates on an interim basis until a final order is made. Implementation of customer rate changes through interim rates is common among regulators in Canada and the United States.⁷

Hydro is proposing to implement new interim rates for Island Industrial Customers in its Amended Interim Application. Industrial Customers, including Vale, generally acknowledge that they are prepared to accept the interim rates requested by Hydro. Implementation of Island Industrial Customer rates on an interim basis is in accordance with Government directive OC2013-089, as amended.

The existing rates to Newfoundland Power and Island Industrial Customers are currently approved on an interim basis. In its Amended Interim Application, Hydro is requesting the Board approve the existing rates of Hydro Rural Customers also be made interim to recognize that additional revenue recovery for 2014 may be required in the future once final 2014 revenue requirement has been approved.

⁶ See response to Request for Information IR-PUB-NLH-052.

⁷ The evidence of Mr. Larry Brockman filed with the Board on February 24, 2014 regarding the RSP Surplus disposition includes a number of instances where rate increases were implemented on an interim basis. Canadian jurisdictions include Saskatchewan, New Brunswick and FortisBC in British Columbia. In the United States, rate increases were implemented on an interim basis in Alaska, Connecticut, Delaware, Hawaii, Kentucky, Louisiana, Michigan, Minnesota, Montana, North Dakota and South Dakota. In all these cases, when final rates were approved the interim rates were determined to be too high and rebates or rate adjustments resulted.

Hydro is proposing the Board approve a deferral account rather than implement new rates on an interim basis for Newfoundland Power and retail customers. Deferral accounts are a common regulatory tool used by the Board to ensure rates are reasonable and provide the utility the opportunity to earn a just and reasonable rate of return.⁸

The approval of the proposed deferral account avoids the need to implement a customer rate change to provide for recovery of 2014 costs until the Board has adequate time to deal with the GRA application. This will allow for a full understanding of the rate design and cost of service implications and provide all parties the opportunity for input prior to the final decision of the Board.

Newfoundland Power and the Consumer Advocate have submitted that the Board should conclude the GRA in advance of determining if a deferral account should be approved. This was the approach followed by the Board in Newfoundland Power's 2013 GRA. The revenue shortfall for Newfoundland Power resulting from delayed rate implementation was approximately \$4 million. The forecast revenue shortfall for Hydro based upon October 1st rate implementation is more than \$55 million. These revenue shortfalls clearly differ in their orders of magnitude. The position put forth by Newfoundland Power is of little relevance to the present situation.

Hydro submits that the approval of the proposed deferral account does not require the completion of the GRA process as implied by Newfoundland Power. The magnitude of the forecast revenue shortfall for 2014 combined with Hydro's 2013 financial results and 2014 forecast financial results, in the absence of the proposed deferral account, provides adequate support for approval of the proposed deferral account.

It is important to recognize that no customers are disadvantaged by the Board's approval of the proposed deferral account. The approval of the proposed deferral account simply provides certainty to Hydro that it will be provided an opportunity to earn a reasonable return in 2014.

⁸ Deferral accounts are specifically addressed in the June 19, 2012 Court of Appeal decision in the Industrial RSP Surplus Case, paragraphs 114 et seq. (2012 NLCA 38).

3.0 Summary

Hydro's rate proposals balance customer impacts, regulatory efficiency and customer acceptance by limiting the number of rate changes required to implement new test year rates.

Hydro earned a return on equity of only 0.14% in 2013. Delayed implementation of customer rates until October 1, 2014 would result in a forecast 2014 revenue shortfall of more than \$55 million. The magnitude of this shortfall justifies the approval of the proposed deferral account to provide Hydro certainty of an opportunity to earn a just and reasonable return on rate base in 2014.

The approval the proposed deferral account will enable Hydro to signal to lenders and other stakeholders that it will not be financially disadvantaged by the duration of the GRA process and have an opportunity to earn a reasonable return in 2014.

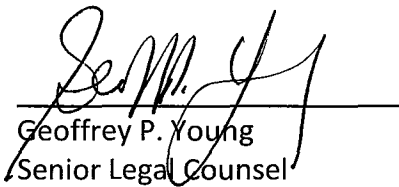
Hydro submits that the evidence before the Board justifies:

- (i) approval of current rates for all Hydro Rural Customers on an interim basis;
- (ii) approval of proposed 2013 Test Year rates for Industrial Customers on an interim basis effective January 1, 2014;
- (iii) approval to re-activate the RSP rules for setting Island Industrial Customer rates effective January 1, 2014;
- (iv) approval of the proposed deferral account for the difference between the revenues received by Hydro from January 1, 2014 (or such later date that rates are made interim for the respective class) until such time that final rates are approved;
- (v) approval of changes to the RSP Rules to use the Proposed 2013 Test Year values for RSP purposes; and
- (vi) approval that the amounts collected by Hydro through Newfoundland Power's current Fuel Price Projection rider of 1.634 cents/kWh be segregated within the RSP until a further order of the Board on the matter.

Please contact the undersigned should you have any questions.

Yours truly,

NEWFOUNDLAND AND LABRADOR HYDRO



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Senior Legal Counsel

GPY/jc

cc: Gerard Hayes – Newfoundland Power
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