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August 12, 2025

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

Attention: Jo-Anne Galarneau
Executive Director and Board Secretary

Re: Application for Approval of a Proposed General Expenses Capitalized Deferral Account

Enclosed is Newfoundland and Labrador Hydro's ("Hydro") application for approval of a deferral account to enable the deferral and recovery of capital-related general expenses, including the proposed methodology and capitalization rates.

In Board of Commissioners of Public Utilities ("Board") Order No. P.U. 16(2021), the Board agreed with Hydro's request to be permitted to capitalize overhead costs effective January 1, 2022, through the establishment of a deferral account, an International Financial Reporting Standards ("IFRS") deviation under IFRS 14.[1] However, the Board did not approve the proposed definition of the deferral account or the proposed interim capitalization rate. Hydro was directed to file the proposed deferral account definition along with evidence to support the proposed methodology and capitalization rate as part of Hydro's next general rate application ("GRA").

Due to delays in the filing of Hydro's GRA, a deferral account for the capitalization of general expenses was not established in 2022. In the interest of regulatory efficiency, Hydro is submitting an application in advance of its next GRA to establish the new General Expenses Capitalized Deferral Account, effective as of January 1, 2025.

Hydro's application, particularly Schedule 1 to the application, provides support for the methodology utilized in capitalizing general expenses and details with respect to the specific percentages to be applied to the operating labour costs in each department to determine the annual amount of capitalized general expenses that would be transferred to the deferral account. Schedule 2 to the application provides the definition of the proposed deferral account.

Should you have any questions, please contact the undersigned.

Yours truly,

NEWFOUNDLAND AND LABRADOR HYDRO

Shirley A. Walsh
Senior Legal Counsel, Regulatory
SAW/rr

[1] "Application for Approval of IFRS Deviations," Newfoundland and Labrador Hydro, February 24, 2021.

Encl.

ecc:

Board of Commissioners of Public Utilities
Jacqui H. Glynn
Ryan Oake
Board General

Consumer Advocate
Dennis M. Browne, KC, Browne Fitzgerald Morgan & Avis
Stephen F. Fitzgerald, KC, Browne Fitzgerald Morgan & Avis
Sarah G. Fitzgerald, Browne Fitzgerald Morgan & Avis
Bernice Bailey, Browne Fitzgerald Morgan & Avis

Labrador Interconnected Group
Senwung F. Luk, Olthuis Kleer Townshend LLP
Nicholas E. Kennedy, Olthuis Kleer Townshend LLP

Linde Canada Inc.
Sheryl E. Nisenbaum
Peter Strong

Newfoundland Power Inc.
Dominic J. Foley
Douglas W. Wright
Regulatory Email

Teck Resources Limited
Shawn Kinsella

Island Industrial Customer Group
Paul L. Coxworthy, Stewart McKelvey
Denis J. Fleming, Cox & Palmer
Glen G. Seaborn, Poole Althouse

Approval of a Proposed General Expenses Capitalized Deferral Account

August 12, 2025

An application to the Board of Commissioners of Public Utilities

newfoundland labrador hydro

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

IN THE MATTER OF an application by Newfoundland and Labrador Hydro ("Hydro") pursuant to Sections 58 and 80 of the *Act*, for the approval of a deferral account to enable the deferral and recovery of capital-related general expenses.

To: The Board of Commissioners of Public Utilities ("Board")

THE APPLICATION OF HYDRO STATES THAT:

A. Background

1. Hydro is a corporation continued and existing under the *Hydro Corporation Act, 2024*, is a public utility within the meaning of the *Act*, and is subject to the provisions of the *EPCA*.

2. On April 30, 2020, the Board requested that Newfoundland Power Inc. ("Newfoundland Power") and Hydro each submit a report on the utilities' respective capitalization policies and guidelines.

3. Hydro's *Review of Capitalization Policies and Guidelines* report was submitted on August 14, 2020 and is provided as Schedule 1, Appendix A to this application. That report, including a review of other Canadian utilities' capitalization practices, concluded the following:

   (i) In accordance with International Financial Reporting Standards ("IFRS"),[1] Hydro capitalizes costs that are directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

[1] The Board approved Hydro's adoption and use of IFRS for financial reporting for regulatory purposes in Order No. P.U. 13(2012), effective January 1, 2012, with certain exceptions. Hydro deferred adoption of IFRS until January 1, 2014. Hydro also elected to adopt IFRS 14 – *Regulatory Deferral Accounts*, which permitted Hydro to continue to account for regulatory deferral account balances in accordance with Canadian Generally Accepted Accounting Principles in its initial adoption of IFRS and subsequent financial statements.

(ii) Other non-direct costs, such as overhead costs associated with salary and benefits for individuals who work on capital projects generally but do not directly work on any individual capital project, are expensed by Hydro; Hydro capitalizes materially less in overhead costs than other utilities, including Newfoundland Power; and

(iii) Hydro's current practice of expensing capital-related overhead costs, while consistent with IFRS and least-cost in aggregate, results in a higher revenue requirement for customers in the short term. This approach is inconsistent with the principle of intergenerational equity, as current customers are paying for costs associated with capital assets which provide benefits to customers beyond a single year, as well as accepted utility practice among Canadian utilities.

4. Hydro's position was that it is appropriate for both Hydro and Newfoundland Power to have reasonably comparable approaches to the recovery of capital-related overhead costs.

5. On February 24, 2021, Hydro filed an application requesting approval to, among other things, deviate from IFRS to allow Hydro to establish a deferral account to enable the deferral and recovery of capital-related overhead costs effective January 1, 2022, and to apply an overhead capitalization rate of 2.3% on an interim basis in determining the annual transfers to the deferral account.

6. The Board, in Order No. P.U. 16(2021), agreed that Hydro should be permitted to capitalize overhead costs through the establishment of a deferral account, an IFRS deviation under IFRS 14. However, the Board did not approve the proposed definition of the deferral account or the proposed interim capitalization rate.

7. The Board directed Hydro to file the proposed deferral account definition along with evidence to support the proposed methodology and capitalization rate as part of Hydro's general rate application ("GRA").

8. Hydro experienced a number of delays in filing its GRA; as a result, no deferral account associated with capitalization of general expenses was established in 2022. Hydro's application herein requests approval of the deferral account and methodology regarding the capitalization rate of general expenses, effective January 1, 2025.

B. Application: General Expenses Capitalized Deferral Account

9. Hydro proposes the creation of a new deferral account called the General Expenses Capitalized Deferral Account, the definition of which is attached as Schedule 2 to this application.

10. Hydro intends to use the incremental method of capitalizing general expenses, capitalizing only those general expenses that are incremental to the utility as a result of its capital program. This approach will increase the comparability of Hydro and Newfoundland Power's capital-related overhead costs.

11. Hydro completed an assessment of its capital-related operating costs, and in doing so, determined whether a change in its capital program would result in a change in general expenses. This analysis enabled Hydro to estimate the amount of general expense in each department to be allocated to capital. Details of this analysis is provided in Schedule 1 to this application.

12. Hydro identified seven departments within which varying percentages of the operating labour costs should be capitalized for deferred recovery. Those departments and their respective percentages are discussed in Section 2 of Schedule 1 and listed in Table 1 of Schedule 1. The percentages range from 1% of the operating labour costs within Transmission and Rural Operations to 100% of operating labour costs within the Major Projects department.

13. Hydro has determined that through the implementation of the incremental method of capitalization of general expenses, 4.2% of Hydro's operating costs in 2025, and 4.4% of Hydro's 2026 operating costs should be deferred and effectively treated as capital costs. This would increase Hydro's overhead capitalization rate to approximately 4.8% in 2025 and 6.0% in 2026. Hydro would remain below both the Canadian industry average and Newfoundland Power's rate for general expenses capitalized.

14. Hydro is further proposing to amortize the annual transfer using the composite depreciation rate derived from the most recent depreciation study accepted by the Board, commencing the year after the transfer to the General Expenses Capitalized Deferral Account.

15. The composite annual rate derived from the 2016 Depreciation Study submitted in Hydro's 2017 GRA and approved in Board Order No. P.U. 16(2019) is 2.28%.

16. Approval of the deferral account and the proposed methodology would increase consistency with the principles of intergenerational equity and reduce disparities between Hydro and Newfoundland Power with respect to recovery of capital-related overhead costs. Hydro's proposed methodology is generally consistent with the Board's established regulatory principles and sound public utility practice.

C. Hydro's Requests

17. Hydro requests that the Board approve:

(i) The proposed General Expenses Capitalized Deferral Account, for which the account definition is provided in Schedule 2, to be effective as of January 1, 2025;

(ii) The following proposed transfers of annual labour costs by department to the General Expenses Capitalized Deferral Account:

Department	Capitalized Overhead Percentage (%)
Major Projects	100
Engineering Services	22
Regulatory Affairs	21
Supply Chain	16
Finance, Human Resources and Information Services	10
Production Operations	3
Transmission and Rural Operations	1

(iii) The proposed amortization at the composite rate derived from the most recent depreciation study accepted by the Board to apply to the annual transfer.

D. Communications

18. Communications with respect to this application should be forwarded to Shirley A. Walsh, Senior Legal Counsel, Regulatory for Hydro.

DATED at St. John's in the province of Newfoundland and Labrador on this 12th day of August, 2025.

NEWFOUNDLAND AND LABRADOR HYDRO

Shirley A. Walsh
Counsel for the Applicant
Newfoundland and Labrador Hydro
500 Columbus Drive, P.O. Box 12400
St. John's, NL A1B 4K7
Telephone: (709) 685-4973

Schedule 1

General Expenses Capitalized

Contents

List of Appendices

1.0 Background

Newfoundland and Labrador Hydro ("Hydro") capitalizes costs that are directly attributable to bringing an asset to the location and condition necessary for it to be capable of operating in the manner intended by management, in accordance with IFRS.[1] Other non-direct costs, such as general expenses associated with salaries and benefits for individuals who work on capital projects generally but do not directly work on any individual capital project, are currently expensed by Hydro.

Hydro's review of other Canadian utilities' capitalization practices determined that Hydro capitalizes materially less in general expenses than other utilities, including Newfoundland Power Inc. ("Newfoundland Power").[2] Hydro's *Review of Capitalization Policies and Guidelines* report, submitted to the Board on August 14, 2020, is contained in Appendix A to this report. Hydro's capitalization rate for 2019 was 2.9% according to the 2020 survey of Canadian utilities included within Appendix A. This rate put Hydro well below the Canadian industry average of an 8.1% capitalization rate. Hydro's review also indicated that its current practice of expensing capital-related general expenses, while least-cost in aggregate, results in a higher revenue requirement for customers in the short-term. Hydro's report further indicated that this approach is inconsistent with the principle of intergenerational equity, as current customers are paying for costs associated with capital assets which provide benefits to customers beyond a single year, and accepted utility practice among Canadian utilities.

Hydro believes it is appropriate for both Hydro and Newfoundland Power to have reasonably comparable approaches to the recovery of capital-related general expenses. To achieve this necessitated approval by the Board for Hydro to deviate from IFRS with respect to the capitalization to be used in regulatory accounting. The deviation enables the deferral and recovery of capital-related general expenses over an amortization period consistent with capitalization.

[1] International Financial Reporting Standards ("IFRS").
[2] On April 30, 2020, the Board of Commissioners of Public Utilities ("Board") requested that Newfoundland Power and Hydro each submit a report on the utilities' respective capitalization policies and guidelines. The Board requested the reports include: the particular accounting standards being followed by the utility with respect to its capitalization policies and guidelines; a discussion of how the capitalization practices and/or guidelines are in accordance with sound public utilities practice and provide least-cost service to customers; any other alternatives that may be available to be used by the utility, with advantages and disadvantages with respect to sound public utility practice and the provision of least-cost service to customers; and a jurisdictional scan of other utilities in Canada with respect to their capitalization policies.

Approval of the IFRS deviation increases intergenerational equity for Hydro's customers, decrease Hydro's revenue requirement in the short-term, and provides comparability between Hydro and Newfoundland Power with respect to recovery of capital-related general expenses.

On February 24, 2021, Hydro filed an application to, among other matters, deviate from IFRS in order to defer capital-related general expenses beginning in the year 2022. In Board Order No. P.U. 16(2021), the Board approved Hydro's proposal to defer and recover capital-related general expenses beginning January 1, 2022 through the establishment of a deferral account under IFRS 14. However, the Board also directed Hydro to file, for approval, the proposed deferral account definition, including evidence to support the proposed methodology and capitalization rate, as part of its general rate application ("GRA"). Due the delays experienced in Hydro filing its GRA, no deferral account associated with capitalization of general expenses was established in 2022. Therefore, in the interest of regulatory efficiency, Hydro is submitting an application in advance of its next GRA to establish the new General Expenses Capitalized Deferral Account. Hydro's proposed deferral account definition and evidence on this matter is provided to support the general expenses capitalization rate effective January 1, 2025.

2.0 General Expenses Capitalization Rate

2.1 Methodology

Hydro proposes to use the incremental method of capitalizing general expenses. The incremental cost method capitalizes only those general expenses that are incremental to a utility as a result of its capital program. This approach will improve comparability between Hydro and Newfoundland Power's capitalization policies going forward.[3]

To implement the incremental method, Hydro has completed an assessment of its capital-related operating costs. This required Hydro to determine whether a change in its capital program would result in a change in general expenses. This analysis enabled Hydro to estimate the amount of general expense in each department to be allocated to capital.

[3] In Board Order No. P.U. 3(1995-96), the Board approved Newfoundland Power to convert to a methodology more consistent with the incremental method.

2.2 Incremental Cost Results

In summary, the implementation of Hydro's proposed general expenses capitalized methodology would result in a reduction in forecast operating costs of 4.2% in 2025 and 4.4% in 2026,[4] reflecting the transfer of these costs to a deferral account to be recovered on a basis aligned with the recovery of capital costs. The implementation of the proposed change would increase Hydro's current estimated overhead capitalization rate from 2.5%[5] (which reflects Hydro's direct billing methodology of vehicle charge outs and Hydro's interest during construction) to approximately 4.8% in 2025 and 6.0% in 2026. This would place Hydro below the Canadian industry average for general expenses capitalized of 8.1%[6] and Newfoundland Power's rate of 9%.[7]

The following sections provide the departmental breakdown applied to compute these amounts. A listing of relevant positions by department is included in Appendix B.

2.2.1 Major Projects

Major Projects is a department created for the planning, management and execution of major capital projects,[8] such as the Bay d'Espoir Unit 8 and Avalon Combustion Turbine projects. The Major Projects department includes roles which are not directly capitalized such as those associated with oversight, commercial, financial, stakeholder relations, quality, safety and administrative type activities.[9] Major Projects operating labour costs would not exist if it were not for major capital programs. As a result, all operating labour costs from this department are incremental and should be included in Hydro's general expenses capitalized.[10]

[4] Reduction of 4.2% in 2025 = $6.8 million General Expenses Capitalized / $160.5 million total budgeted Operating and Maintenance Expenses. Reduction of 4.4% in 2026 = $7.1 million General Expenses Capitalized / $160.3 million total current estimated Operating and Maintenance Expenses.
[5] Calculated using 2025 budget vehicle charge out of $1.8 million + budgeted interest during construction of $5.2 million / total budgeted capital spend of $282.2 million.
[6] Two utilities who responded N/A and the utility using the 'burden rate' methodology which had a rate of 26% were excluded from the average. Please refer to Appendix A, p. A-42, ((13.8 + 5.1 + 10.0 + 9.0 + 2.5+ 1.6 + 10.0 + 12.0 + 9.0)/9).
[7] Newfoundland Power's 2022–2023 GRA, Volume 2, Review of General Expenses Capitalized, p. 4 of 13.
[8] For the purposes of this document, the term 'Major Project' is generally used to describe regulated projects and programs with an anticipated cost of $50 million or greater under the accountability of Hydro's Major Projects department.
[9] Embedded contractors are used to fill certain roles in this department and are also considered incremental to the capital budget program and included in Hydro's General Expenses Capitalized deferral account.
[10] Employees and embedded contractors will charge directly to capital as applicable with the remainder of costs capitalized though GEC.

2.2.2 Engineering Services

If the capital program did not exist, it is estimated that the Engineering Services department would no longer require a total of seven employees who currently do not directly charge their time to capital jobs. These positions include Project Assistants, a Project Administrator, a Cost Analyst, a Capital Budget Coordinator and a Senior Manager of Project Execution. These positions are incremental and support the day-to-day coordination, documentation, financial oversight and execution of Hydro's capital program. This translates to 22% of the operating labour costs of this department.

2.2.3 Production Operations

This department contains 59 employees who work indirectly on the capital program . These positions include portions of time for a number of Office Clerks, Planners and Schedulers and Plant Operator positions along with various supervisory roles. Currently, Hydro employes approximately 30 Thermal Plant Operators in this department. If there was no capital program, Hydro could reduce its Thermal Plant Operators by the equivalent of three positions.[11] Overall for this department it is estimated that seven of its positions would no longer be needed without the capital program. These positions include an Office Clerk, a Planner, three Thermal Plant Operators and two Supervisors of various responsibilities. These positions are incremental and contribute to Hydro's capital program by managing processes like document control, including work orders, ordering parts and materials, holding permits and performing equipment isolations, scheduling work and commissioning of completed assets. This translates to a 3% reduction in operating labour costs for the Production Operations department.

2.2.4 Transmission and Rural Operations

Transmission and Rural Operations currently employs 12 Office Clerks who work on the capital program by completing document management processes and managing work orders. It is estimated that there could be a reduction of two of these positions if the capital program didn't exist. This department also employs two managers who contribute to the capital program by working with various project managers to assist in managing the capital projects including site visits and completing the necessary paperwork and management of crews who are working on the project. It is estimated that this could be reduced to

[11] Due to staffing requirements legislated within the *Boiler Pressure Vessel Act*, Holyrood Thermal Generating Station would require its full complement during the operating season; however, these reductions could be made during the major plant outage and are equivalent to 3 full-time equivalent's ("FTE").

one manager without the program. This represents an overall reduction of three FTE's, or 1% of operating labour costs for this department.

2.2.5 Supply Chain

The Supply Chain department includes 29 positions which support Hydro's regulated capital program through various procurement activities, including the issuance of tenders, requests for proposals and purchase orders, ensuring compliance with the *Public Procurement Act*, along with the tracking and receipt of materials associated with capital jobs. Supply Chain employs one Buyer and six Store Workers who are incremental and would no longer be required if the capital program did not exist. Therefore, this department would have an overall reduction of seven positions, or 16% of operating labour costs.

2.2.6 Regulatory Affairs

The Regulatory Affairs department currently employs 12 full time employees who work on the capital program. These positions include Regulatory Engineers, Project Managers, Regulatory Coordinators and various managerial positions. These roles draft, coordinate and file capital related applications for approval by the Board and related requirements for all capital proceedings. In addition, Hydro's regulatory engineering team works closely with Engineering Services on the annual capital budget, supplemental applications and five-year capital plan, and with the Major Projects department on its major capital works applications. It is estimated that there could be a reduction of three of these positions if the capital program didn't exist. This would represents 21% of operating labour costs for the Regulatory Affairs department.

2.2.7 Finance, Human Resources and Information Services

Hydro's requirements for Finance, Human Resources and Information Services would be lower if there was no capital program. This includes functions such as accounts payable, payroll, accounting and financial reporting, budget and forecasting, recruitment, human resource planning, training, information systems planning and upgrades, etc. However, because these departments provide a service to the entire company and do not devote a specific portion of their time or resources to the capital program, there is no way to pinpoint exactly how much of a reduction there would be in general expenses or number of employees in these areas if there was no capital program. In 1995, the Board suggested that Newfoundland Power use a nominal rate of 10% for areas of the business such as Finance and Human

Resources where this is the case.[12] Hydro is proposing to also capitalize 10% of operating labour costs, consistent with that approved for Newfoundland Power.

2.2.8 Small Parts, Tools and Safety Clothing

Hydro capitalizes tools as part of the capital programs. Small parts are capitalized as they are consumed part of capital jobs, as consumed and safety clothing is expensed as incurred, in accordance with IFRS.

2.2.9 Implementation Approach

For the annual calculation of general expenses capitalized for deferred recovery, Hydro proposes to apply the percentages to the operating labour costs in each department as summarized in Table 1.

Table 1: Proposed Transfers of Annual Operating Labour Costs to General Expenses Capitalized Deferral Account[13]

Department	Capitalized Overhead Percentage (%)
Major Projects	100
Engineering Services	22
Regulatory Affairs	21
Supply Chain	16
Finance, Human Resources and Information Services	10
Production Operations	3
Transmission and Rural Operations	1

Hydro is also proposing to amortize the balance in the deferral account using the composite depreciation rate derived from the most recent depreciation study accepted by the Board, commencing in the year after the transfer to the General Expenses Capitalized Deferral Account.[14] The composite annual rate derived from the 2016 Depreciation Study submitted in Hydro's 2017 General Rate Application and approved in Board Order No. P.U. 16(2019) is 2.28%, reflecting Hydro's average composite depreciation expense across all assets. Similar to depreciation expense, Hydro would be subject to a growth in amortization expense associated with general expenses capitalized deferral

[12] As per Board Order Nos. P.U. 36(1998-99) and P.U.3(2022) Amended.
[13] The annual operating labour costs for these departments exclude the operating labour cost of executives.
[14] Amortization of costs transferred to the General Expenses Capitalized Deferral Account during 2025 will commence in January 2026.

between test years. Table 2 provides and illustrative calculation of the amortization expense recovery for the first five years.

Table 2: Illustrative Amortization of Capitalized Overhead Deferral Account Balance

Year	Annual Deferred Cost (A) $	Annual Amortization Expense (B= A x Rate)[15] $	Cumulative Amortization Expense (C) $	Unamortized Balance $
2025	5,000,000	-	-	5,000,000
2026	5,100,000	114,000	114,000	9,986,000
2027	5,200,000	230,280	344,280	14,955,720
2028	5,300,000	348,840	693,120	19,906,880
2029	5,400,000	469,680	1,162,800	24,837,200

The proposed General Expenses Capitalized Deferral Account definition is provided as Schedule 2 to this Application.

3.0 Summary

In Board Order No. P.U. 16(2021), the Board approved Hydro's proposal to defer and recover capital-related general expenses through the establishment of a deferral account under IFRS 14 and that Hydro shall file, for approval, the proposed deferral account definition, including evidence to support the proposed methodology and capitalization rate, as part of GRA.

Hydro has conducted a review of the relationship of its capital program to its staffing requirements using an incremental cost approach and, based on this approach, is recommending that approximately 4.2% of its 2025 and 4.4% of its 2026 operating costs should be deferred and effectively treated as a capital cost. The implementation of the proposed change would increase Hydro's current estimated overhead capitalization rate from 2.5% (which reflects Hydro's direct billing methodology of vehicle charge outs and Hydro's interest during construction) to approximately 4.8% in 2025 and 6.0% in 2026. This would place Hydro below the Canadian industry average for general expenses capitalized of 8.1% and Newfoundland Power's rate of 9%.

[15] Rate equals the composite rate in the most recent Depreciation Study approved by the Board.

Table 3 illustrates the effect on Hydro's 2025 and 2026 revenue requirements associated with the proposed approach.

Table 3: Estimated Revenue Requirement Impacts of Proposed General Expenses Capitalized Approach

	2025 $	2026 $
Increase in Average Rate Base	3,375,997	10,237,570
Return on Rate Base (5.45%)	183,992	557,948
Increase to Depreciation	-	153,945
Reduction to O&M	(6,751,994)	(7,125,098)
Reduction to Revenue Requirement	(6,568,002)	(6,413,205)

Approval of the proposed approach would increase intergenerational equity for Hydro's customers, decrease Hydro's revenue requirement in the short-term, and provide comparability between Hydro and Newfoundland Power with respect to recovery of capital-related general expenses. Hydro's proposed methodology in dealing with the capitalization of general expenses is generally consistent with established regulatory principles of the Board and sound public utility practice.

Appendix A

Review of Capitalization Policies and Guidelines Report

newfoundland labrador hydro
a nalcor energy company

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August 14, 2020

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: Review of Capitalization Policies and Guidelines – Newfoundland and Labrador Hydro's Report

As per the Board of Commissioners of Public Utilities' request on April 30, 2020, attached is Newfoundland and Labrador Hydro's ("Hydro") report describing its capitalization practices and guidelines.

Also enclosed is a summary of the results of a jurisdictional scan of the capitalization practices of other Canadian utilities and a report from JT Browne Consulting. The consultant's report discusses Hydro's capitalization practices as including the differences between accounting and regulatory views of capitalization.

If you have any questions on the enclosed, please contact the undersigned.

Yours truly,

NEWFOUNDLAND AND LABRADOR HYDRO

Shirley A. Walsh
Senior Legal Counsel, Regulatory
SAW/kd

Encl.

ecc: **Board of Commissioners of Public Utilities**
Jacqui Glynn
PUB Official Email

Newfoundland Power
Gerard M. Hayes
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Denis J. Fleming, Cox & Palmer
Dean A. Porter, Poole Althouse

Praxair Canada Inc.
Sheryl E. Nisenbaum

Teck Resources Limited
Shawn Kinsella

Review of Capitalization Policies and Guidelines

August 14, 2020

A report to the Board of Commissioners of Public Utilities

newfoundland labrador hydro
a nalcor energy company

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List of Attachments

1.0 Background

On April 30, 2020, the Board of Commissioners of Public Utilities ("Board") requested that Newfoundland Power Inc. ("Newfoundland Power") and Newfoundland and Labrador Hydro ("Hydro") each submit a report on the utilities' respective capitalization policies and guidelines. The Board requested the reports include the following:

- The particular accounting standards being followed by the utility with respect to its capitalization policies and guidelines;
- A discussion of how the capitalization practices and/or guidelines are in accordance with sound public utilities practice and provide least-cost service to customers;
- Any other alternatives that may be available to be used by the utility, with advantages and disadvantages with respect to sound public utility practice and the provision of least-cost service to customers; and
- A jurisdictional scan of other utilities in Canada with respect to their capitalization policies.

This report provides Hydro's response to the Board's request, including a discussion of Hydro's capitalization practices in the context of the results of the jurisdictional scan. Hydro has also included a report from JT Browne Consulting in Attachment 1 on the topic of Hydro's capitalization, including differences between accounting and regulatory views of capitalization.

2.0 International Financial Reporting Standards

In accordance with Board Order No. P.U. 13(2012), Hydro adopted International Financial Reporting Standards ("IFRS") effective January 1, 2012. Hydro's capitalization policy is consistent with IFRS, and a detailed discussion surrounding accounting standards applicable to Hydro as well as direct, indirect, avoidable, non-avoidable and allocation of costs are found in Attachment 1 to this report.

Under IFRS, the capitalization of costs is addressed in International Accounting Standard ("IAS") 16: *Property, Plant and Equipment*. IAS 16.16 defines the cost of a capital asset as:

> The cost of an item of property, plant and equipment comprises:

a. Its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

b. Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

c. The initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

[Emphasis Added]

While the term "directly attributable" is not specifically defined in IAS 16, other IASs refer to directly attributable costs as those costs that otherwise "would have been avoided."[1] Hydro's application of this accounting standard follows this principle; therefore, only otherwise avoidable costs[2] that are directly attributable to capital projects are capitalized by Hydro (e.g., an employee's time directly coded to a capital project). Avoidable costs in aggregate, such as the salary and benefits associated with a manager who works on capital projects generally but does not directly work on any individual capital project directly, are expensed by Hydro.[3]

While IAS 16 provides guidance on the capitalization of costs, IFRS 14: *Regulatory Deferral Accounts* permits Hydro to recognize regulatory assets or liabilities following an order of the Board. Therefore, to the extent that Hydro capitalizes costs for regulatory purposes that would not normally be capitalized under IAS 16, the amounts can be recognized as a regulatory deferral. While regulatory assets are recorded differently than capital assets under IFRS, for revenue requirement purposes they are similar in that they reside in rate base, attract financing costs, and are recognized as an expense over time.

[1] "Newfoundland & Labrador Hydro Capitalization Policies," JT Browne Consulting, August 14, 2020, p. 6.
[2] "Newfoundland & Labrador Hydro Capitalization Policies," JT Browne Consulting, August 14, 2020, p. 2. states "An avoidable cost is a cost that would have been avoided (or will be avoided) if the cost object did not exist. For example, an employee may work exclusively on the construction of capital projects. Without the capital projects, there would be no need for the employee. As a result, the cost of the employee would be an avoidable cost of the capital projects. Direct costs would be avoidable costs."
[3] "Newfoundland & Labrador Hydro Capitalization Policies," JT Browne Consulting, August 14, 2020, p. 3. states "Whether a cost is avoidable or non-avoidable can depend on the scope of the cost object. For example, there may be a manager of capital projects: whether or not individual capital projects are undertaken, the cost of the manager will be the same; however, if there were no capital projects, there would be no need for the manager. Where the cost object is an individual capital project, the cost of the manager would be a non-avoidable cost; where the cost object is all capital projects, the cost of the manager would be an avoidable cost."

Increased levels of capitalization beyond that contemplated in IAS 16 are therefore permitted under IFRS 14, following an order of the Board. As noted in Hydro's expert report "…the primary purpose of GAAP is to support financial reporting, not pricing or rate setting decisions. As a result, regulators frequently deviate from GAAP where it is deemed appropriate in setting just and reasonable rates."[4]

Attachment 1 to this report includes a more detailed discussion of Hydro's accounting standards and current capitalization approach. Hydro's capitalization policy is consistent with IAS 16 and results in a lower level of capitalization than would occur if Hydro were to also capitalize avoidable costs in aggregate, as these costs are not permitted to be capitalized under IAS 16.

3.0 Public Utility Practice

Hydro, in conjunction with Newfoundland Power, conducted a survey of eleven utilities across Canada with respect to their capitalization practices. The results of this survey are included as Attachment 2 to this report.

In Hydro's view, the results of the survey indicate a general trend between Crown-owned utilities that have adopted IRFS (including Hydro), and investor-owned utilities that have adopted US GAAP[5] (including Newfoundland Power). A summary of the results are provided in Table 1.

Table 1: Analysis of Survey Results

Respondent	Ownership	Accounting	Capitalized Overhead	Internal Labour Capitalized	Total Labour Capitalized
Utility 2	Crown	IFRS	5.1%	16.3%	13.5%
Utility 5	Crown	IFRS	2.5%	17.0%	NA
Utility 7	Crown	IFRS	26.0%	36.0%	27.0%
Utility 10	Crown	IFRS	10.0%	22.4%	71.9%
Crown-owned Average[6]			**10.9%**	**22.9%**	**37.5%**
Investor-owned Average[7]			**7.7%**	**39.4%**	**42.1%**
Hydro	Crown	IFRS	2.9%	26.8%	37.1%
Newfoundland Power	Investor	US GAAP	11.7%	35.0%	43.0%

[4] "Newfoundland & Labrador Hydro Capitalization Policies," JT Browne Consulting, August 14, 2020, p. 5.
[5] Generally Accepted Accounting Principles ("GAAP").
[6] Excludes Hydro.
[7] Excludes Newfoundland Power.

The results in Table 1 show that Canadian Crown-owned utilities that have adopted IFRS capitalize less labour costs, on average, than their investor-owned counterparts that have adopted US GAAP. Capitalized overhead costs are more consistent across all utilities surveyed. By way of comparison, Hydro capitalizes significantly less relative to investor-owned utilities who have adopted US GAAP as well as Newfoundland Power. Comparing Hydro's results to Crown-owned utilities that have adopted IFRS, Hydro's capitalized overhead percentage is materially lower than average, while capitalized labour percentages are more consistent with the Crown/IFRS industry average.

In Hydro's view, the survey responses indicate that Hydro capitalizes less than Newfoundland Power and other investor owned utilities, and Hydro capitalizes less overhead when compared to utilities with the same ownership structure and accounting standards as Hydro.

4.0 Regulatory Principles

The *Electrical Power Control Act, 1994* states that the electrical system should be managed such that power is delivered to customers at the lowest possible cost consistent with reliable service. The policies of a utility which result in a cost being classified as either a capital or operating expense can have an impact on customer rates and the provision of least-cost service over the long-term.

For example, $100 in labour costs recorded as an operating expense will result in ratepayers contributing the same $100 in revenue requirement to be recovered in a single year. If a utility with the same weighted average cost of capital as Hydro capitalized $100 in labour costs towards an asset with a 30-year life, ratepayers would ultimately pay more than $180 in revenue requirement over the 30-year life of the asset.[8] In this respect, lower levels of capitalization result in lower costs for customers over the long term. However, in Hydro's opinion, consideration can be given to other regulatory principles in addition to least-cost when adopting policies and setting customer rates.

As noted in Hydro's expert evidence included as Attachment 1, the concepts of intergenerational equity, rate stability and predictability, and materiality are also important considerations in the determination of just and reasonable rates and the provision of reliable service at the lowest possible cost. As noted by Mr. Browne:

[8] WACC of 5.43%, useful life of 30 years, straight line depreciation.

The principle of intergenerational equity helps to determine when costs should be recovered. 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.

In the case of capital projects, the avoidable costs should be capitalized; these would be the costs that would be avoidable in relation to all capital projects, and not just the individual projects. These costs are incurred solely for the benefit of future customers and should be capitalized and recoverable from future customers, not current customers.

While Hydro's current approach to capitalization is consistent with accounting regulations and results in lower revenue requirements from its customers over the long term, the principle of intergenerational equity would support an increased level of capitalization to better match customer costs with the services provided in the current period. A summary of the differences in these principles with respect to capitalized overheads can be found in Table 2.

Table 2: Comparison of Capitalization Principles

	Regulatory Principles	IFRS	Hydro - Current
Overhead Capitalization[9]	Yes	No	No

Balancing against increased capitalization is the need for rate stability and predictability; to the extent that a utility capitalizes too much, operating costs could vary materially over time with the levels of capital projects. Such an approach could contribute to rate instability. Further, the concept of materiality is important to ensure the level of accuracy sought through increased levels of capitalization does not result in a significant increase in administration costs which would outweigh the benefit of improved accuracy.[10]

In summary, Hydro's current approach to capitalization is consistent with the principle of least cost service over the long-term; however, increased levels of capitalization could be appropriate with a view

[9] "Newfoundland & Labrador Hydro Capitalization Policies," JT Browne Consulting, August 14, 2020, Table 4, p. 17., Avoidable – Capital Projects in Aggregate Only. Excludes Avoidable – Specific Assets and Non-avoidable – Indirect.
[10] " Newfoundland & Labrador Hydro Capitalization Policies," JT Browne Consulting, August 14, 2020, p. 10., states "Attempting to achieve theoretical accuracy can be difficult and costly. For example, it is not always easy to identify the avoidable costs, especially where they are a small part of a cost category. In some cases, there is a significant cost to collect and report the information necessary for that accuracy."

towards improved intergenerational equity, as long as rate stability, predictability, and materiality are maintained and potential administrative burdens minimized.

5.0 Capitalization Alternatives

The Board's correspondence requested that Hydro identify any alternatives that may be available in the context of its capitalization policies, along with advantages and disadvantages of these alternatives. When examining alternatives Hydro considered the upcoming impact of Muskrat Falls on customer rates and the manner in which its capitalization policies could represent a small source of rate mitigation, provide better operating cost comparability with Newfoundland Power, and still adhere to sound regulatory principles.

On September 5, 2018 the Government of Newfoundland and Labrador requested that the Board undertake a review of electricity rate mitigation options and impacts in relation to the Muskrat Falls Project in accordance with the reference from the Lieutenant-Governor in Council under section 5 of the *Electrical Power Control Act, 1994*. As a part of this review, the Board engaged the Liberty Consulting Group ("Liberty"); Liberty issued its Final Report on Phase Two of Muskrat Falls Project Potential Rate Mitigation Opportunities on September 3, 2019.

In its report, Liberty noted there was a material difference in the rate mitigation opportunities that existed in the first 10 years of the in-service of Muskrat Falls versus the next 10 years.

> …insufficient revenue mitigation potential in the early years, keeps rates higher in the first decade following LCP operation than they can become in the second ten years. LCP financing requires significant payments (e.g., sinking fund payments) in that first decade. They add to revenue requirements. Figure I.3 shows the limits in the first decade, leaving a significant initial jump even after mitigation, followed by stability, and ending with a reduction as the Reference's 10-year period comes to a close.
>
> …
>
> Not surprisingly, as Figure I.4 shows, growing revenue requirements, as compared with the first decade mitigation sources available, limit rate-influencing ability through 2030.[11]

[11] "Final Report on Phase Two of Muskrat Falls Project Potential Rate Mitigation Opportunities," The Liberty Consulting Group, September 3, 2019, pp. 9–10.

One alternative to Hydro's current capitalization policy would be to begin capitalizing overheads, which are currently expensed, in aggregate under IFRS 14. This approach would increase Hydro's level of capitalization at the same time as increased revenue requirements associated with the Muskrat Falls project are coming into effect. The advantage of this alternative is that additional capitalization would increase Hydro's level of overhead capitalization to a level more consistent with the Crown/IFRS average, decrease Hydro's revenue requirement in the short term, contribute to rate mitigation efforts, increase intergenerational equity for Hydro's customers, and result in greater alignment between Newfoundland Power and Hydro with respect to their approaches to capitalization. More comparable capitalization approaches would result in better comparability of cost management practices.

The disadvantage of this approach is that the total revenue requirement paid by ratepayers would be greater over the long term than if these costs continued to be expensed under Hydro's existing capitalization approach. Further, there is risk that the level of administrative effort would significantly increase under this alternative as Hydro could potentially be required to maintain two sets of capital accounting records for regulatory and financial reporting purposes. However, Hydro believes that a simplified regulatory deferral which strikes the appropriate balance of costs and accuracy could be achieved.[12]

If it is determined that this alternative would be in the best interest of ratepayers, Hydro would undertake a detailed review of this proposed approach for inclusion in its next general rate application. While the results would be subject to the outcome of this detailed review, increasing Hydro's level of overhead capitalization more in line with the overall survey average of 7.7% would reduce Hydro's operations and maintenance expense by approximately $6.4 million (4.8%).[13]

Further, Hydro also suggests that if the Board was to provide such direction, it should also consider the inclusion of a requirement for re-evaluation of capitalization policies in this jurisdiction at regular intervals (e.g. every ten years) to ensure the utilities' capitalization policies are well understood and continue to be in the best interest of ratepayers.

[12] Hydro would likely propose to defer a percentage of operations and maintenance expense in a new regulatory deferral consistent with IFRS 14. This percentage would be based on an internal study of avoidable costs in aggregate, and would be amortized over the average useful life of Hydro's capital assets.
[13] Average of all survey responses to question 7.

6.0 Conclusion

Hydro's current approach to capitalization is in accordance with IFRS; however, survey results indicate that Hydro capitalizes less overhead than other Crown/IFRS utilities. The results of the utility survey also indicate that investor-owned utilities that have adopted US GAAP, including Newfoundland Power, capitalize more labour costs than their Crown-owned counterparts, including Hydro. Increased capitalization decreases revenue requirement in the short term but increases revenue requirement from customers over the long term when compared to expensing such costs.

While Hydro's current capitalization approach adheres to accounting guidelines, the primary purpose of accounting standards is to support financial reporting, not pricing or rate-setting decisions. As a result, as noted in the attached report from JT Browne Consulting, regulators frequently deviate from accounting standards where it is deemed appropriate in setting just and reasonable customer rates. As such, the Board may want to consider whether the ownership structure and accounting policy differences between utilities in this jurisdiction should be the sole reason for differing capitalization outcomes or if a deviation from standard accounting practices would be justified to better reflect regulatory principles in establishing just and reasonable rates.

Finally, an alternative to Hydro's current capitalization approach would be to capitalize more directly attributable costs in aggregate (overheads related to capital work); these costs are currently expensed. This approach would reduce revenue requirement in the short term and increase total costs to ratepayers over the long term; however, it would provide rate mitigation benefits, increase intergenerational equity for Hydro's customers, and bring Hydro's level of overhead capitalization more in line with other Canadian electric utilities. This approach would also improve comparability between Hydro and Newfoundland Power's operating and capital costs.

Attachment 1

Expert Report - JT Browne Consulting

JTBrowne Consulting

Newfoundland & Labrador Hydro

Capitalization Policies

August 14, 2020

Costing & Regulatory Consulting

TABLE OF CONTENTS

Appendices:

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INTRODUCTION

In a letter dated April 30, 2020, the Board of Commissioners of Public Utilities ("Board") requested that each of Newfoundland and Labrador Hydro ("Hydro") and Newfoundland Power Inc. ("NP")

> *… complete a report for the Board describing its capitalization policies and any guidelines relating to capital asset additions, including but not limited to, direct costs, indirect costs (example: overhead recoveries and AFUDC) and GEC.*

As part of the review, the utilities were requested to provide the following:

- *the particular accounting standards being followed by the utility with respect to its capitalization policies and guidelines;*
- *a discussion of how the capitalization practices and/or guidelines are in accordance with sound public utility practice and provide least-cost service to customers; and*
- *any other alternatives that may be available to be used by the utility in the development of capitalization policies and guidelines, along with advantages and disadvantages, with respect to the provision of sound utility practice and provide least-cost service to customers.*

To assist with the Board's request, Hydro has asked for my assistance as a CPA, CA and economist with experience in addressing regulatory issues.[1] In particular, Hydro has asked me to provide an opinion on the appropriate principles for capitalizing costs related to property plant and equipment from a regulatory perspective.

In developing my opinion, I have relied on information about Hydro that was provided to me by the Company. I was not asked to verify this information and did not undertake the work necessary to provide a professional opinion on the validity of the information.

The next three sections of this report address the relevant costing, financial reporting and regulatory principles. This is followed by a discussion of Hydro's capitalized costs and the application of the relevant principles to the capitalization of Hydro's costs. The final section sets out my conclusion.

[1] A copy of my resume has been attached as Appendix JTBC-1.

COSTING PRINCIPLES

Costing principles help to establish how costs should be determined and allocated to cost objects – i.e., whatever is being costed.

DIRECT / INDIRECT

In determining the costs of a cost object, costs are often divided into direct and indirect costs. A direct cost can be traced to a specific cost object whereas an indirect cost cannot, it is incurred for at least one other cost object. For example, in the Glossary for "Guide to Cost Estimating" produced by the Treasury Board, direct and indirect costs are defined as follows:

> *Costs are considered direct when they are incurred solely to support the initiative. Costs are considered indirect when they are incurred to support more than one initiative and are not attributed only to the initiative that is being costed.*[2]

An alternative division of costs is between avoidable and non-avoidable costs. Avoidable costs may also be referred to as incremental costs.

AVOIDABLE / NON-AVOIDABLE

An avoidable cost is a cost that would have been avoided (or will be avoided) if the cost object did not exist. For example, an employee may work exclusively on the construction of capital projects. Without the capital projects, there would be no need for the employee. As a result, the cost of the employee would be an avoidable cost of the capital projects. Direct costs would be avoidable costs.

A non-avoidable cost is a cost that would not have been avoided (or will not be avoided) if the cost object did not exist. Consider a payroll system that supports all the operations of a company, but contains small parts designed to meet the specific requirements of individual operations. Most of the costs of the payroll system would be a non-avoidable cost of the individual operations – without any one operation, the costs would still have been incurred. However, the cost of any portion of the system designed to meet the specific requirements of an individual operation would be an avoidable cost of that operation – i.e., without the operation, the cost of that portion of the system would have been avoided.

Whether indirect costs are completely non-avoidable or largely non-avoidable depends on how indirect costs are defined in practice. Using the example of the payroll system, if the

[2] Government of Canada; Government of Canada; Guide to Cost Estimating; Appendix A: Glossary; 2019-06-04; https://www.tbs-sct.gc.ca/pol/doc-eng.aspx?id=32600.

total cost is considered an indirect cost of individual operations, this indirect cost would contain both non-avoidable and avoidable costs. If only the cost that is required for at least two or more operations is considered as the indirect cost of individual operations (i.e., excludes costs that are avoidable in relation to individual operations), the entire indirect costs would be non-avoidable.

Whether a cost is avoidable or non-avoidable can depend on the scope of the cost object. For example, there may be a manager of capital projects: whether or not individual capital projects are undertaken, the cost of the manager would be the same; however, if there were no capital projects, there would be no need for the manager. Where the cost object is an individual capital project, the cost of the manager would be a non-avoidable cost; where the cost object is all capital projects, the cost of the manager would be an avoidable cost. At the level of the entire organization, all costs are avoidable.

ALLOCATING COSTS

Avoidable costs are caused by their associated cost objects – i.e., without the cost object the cost could be avoided. These costs should be allocated to their associated cost object for all costing purposes.

In the case of non-avoidable costs, there is no causal relationship to individual cost objects – i.e., whether or not any one cost object existed, the cost could not be avoided. Without a causal relationship, there is no economic basis to support an allocation. However, there may be a need to allocate non-avoidable costs, such as in the case of cost-based pricing. In such cases, a reasonable basis must be found for allocating these costs.

Where non-avoidable costs do not benefit the provision of a cost object, they should not be allocated to the cost object. If the cost object was provided on its own, there would be no need for the costs, and they could be avoided. This leaves the non-avoidable costs that benefit the provision of a cost object.

In dealing with the non-avoidable costs that benefit the provision of a cost object, a possible fair and reasonable basis for allocating the costs is a measure of relative benefits received. For example, incurring the cost of the human resources department may benefit all departments in a company, but the cost is non-avoidable in relation to each department. Allocating the cost to cost objects on the basis of the number of employees may be viewed a fair and reasonable basis for allocating the costs on the basis of relative benefits received.

Even where a company develops a reasonable basis for allocating non-avoidable costs, it should be noted that these costs are not affected by the existence of individual cost objects. As a result, there is no economic basis to support the allocation; any allocation would be based on a subjective assessment of what was appropriate.

CONCLUSION

Avoidable cost are the costs that would have been avoided (or will be avoided) if a particular cost object did not exist, while non-avoidable costs are the costs that would not have been avoided (or will not be avoided). Whether a cost is avoidable or not depends on the scope of the cost object. As the scope expands, non-avoidable costs tend to become avoidable costs; for example, where the scope of the cost object is the entire organization, all costs are avoidable.

Avoidable costs are caused by the associate cost object and should be allocated to it. Non-avoidable costs would continue to be required if the cost object alone did not exist. As a result, whether or not the cost object existed, the non-avoidable costs would be the same, and there is no economic basis to support allocating the nonavoidable costs to the cost object.

Where non-avoidable costs must be allocated, they should only be allocated to cost objects that benefit from the incurrence of the costs – i.e., the cost objects for which in aggregate the cost would be avoidable. A possible fair and reasonable basis for allocating these costs is some measure of relative benefits received; however, any allocation will be based on subjective criteria.

FINANCIAL REPORTING PRINCIPLES

Financial reporting principles establish how a company should report its financial position and results of operations to outsiders, i.e., existing and potential investors, lenders and other creditors.

GAAP

Financial reporting is governed by generally accepted accounting principles ("GAAP"). In Canada, GAAP is established by the Accounting Standards Board and set out in the CPA Canada Handbook – Accounting ("Handbook"). For publicly accountable enterprises, Canadian GAAP generally consists of the International Financial Reporting Standards ("IFRS"); however, newly issued, amended or revised IFRS Standards are part of Canadian GAAP only after they are approved by the Accounting Standards Board.

The recognition of costs under GAAP is generally deemed appropriate for regulatory purposes. Also, differences between GAAP and regulatory accounting principles ("RAP") can add to the complexity and cost of a utility's accounting system. As a result, GAAP is usually the starting point for establishing the amount of costs, and the period in which they should be recognized for rate setting purposes. However, the primary purpose of GAAP is to support financial reporting, not pricing or rate setting decisions. As a result, regulators frequently deviate from GAAP where it is deemed appropriate in setting just and reasonable rates.

In regard to capitalizing costs, there are two GAAP standards that are particularly relevant: International Accounting Standard ("IAS") 16, Property, Plant and Equipment, and IFRS 14, Regulatory Deferral Accounts.

IAS 16, PROPERTY, PLANT AND EQUIPMENT

IAS 16, sets out the costs that should be capitalized as part of property, plant and equipment. In addition to the purchase price and the initial estimate of dismantling and removal costs:

> *The cost of an item of property, plant and equipment comprises:*
>
> *… (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. …*[3]

[3] Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IAS 16 Property, Plant and Equipment; para. 16.

The Handbook does not define "directly attributable." However, in describing borrowing costs that can be capitalized, the Handbook states:

> *The borrowing costs that are **directly attributable** to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. …*[4] (underlining added)

And in discussing the transaction costs of an equity transaction, the Handbook states:

> *… The transaction costs of an equity transaction are accounted for as a deduction from equity to the extent that they are incremental costs **directly attributable** to the equity transaction that otherwise would have been avoided. …*[5] (underlining added)

It therefore appears that GAAP requires that costs directly attributable to a property, plant or equipment asset should be capitalized as part of the cost of the asset, where the directly attributable costs are those that would been avoided without the asset – i.e., avoidable costs. However, only avoidable costs of each particular asset can be capitalized.

In addition to general direction, IAS also provides specific examples of costs that are "directly attributable." Among the examples of directly attributable costs are:

> *(a) costs of employee benefits (as defined in IAS 19 Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment; …*
>
> *(c) initial delivery and handling costs; …*[6]

It also identifies costs that are not directly attributable (i.e., should not be capitalized), including "administration and other general overhead costs."[7]

A major difference between RAP and GAAP is the recognition of the cost of equity: RAP recognizes it as a cost while GAAP does not. However, IAS 16 specifically allows for the capitalization of borrowing costs:

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[4] Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IAS 23 Borrowing Costs; para. 10.

[5] Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IAS 32 Financial Instruments; para. 37.

[6] Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IAS 16 Property, Plant and Equipment; para. 17.

[7] Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IAS 16 Property, Plant and Equipment; para. 19.

> *An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset.* [8]
>
> *To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset. The capitalisation rate shall be the weighted average of the borrowing costs applicable to all borrowings of the entity that are outstanding during the period. …*[9]

IFRS 14, REGULATORY DEFERRAL ACCOUNTS

Rate regulation can result in the creation of regulatory assets and liabilities, which the Handbook refers to as regulatory deferrals. These deferrals represent timing differences – i.e., the opportunity to recovery costs in a period other than the one in which the costs would normally be recognized under GAAP.

Under certain circumstances that usually apply to Hydro, the Handbook allows for the recognition of regulatory deferral accounts; however, it requires separate disclosure:

> *… the regulatory deferral account balances are recognised in the statement of financial position in addition to the assets and liabilities that are recognised in accordance with other Standards. These presentation requirements separate the impact of recognising regulatory deferral account balances from the financial reporting requirements of other Standards.*[10]
>
> *An entity shall present separate line items in the statement of financial position for:*
>
> *(a) the total of all regulatory deferral account debit balances; and*
>
> *(b) the total of all regulatory deferral account credit balances.*[11]

The impact of the regulatory deferrals must also be separately reported in the statement of profit and loss.[12]

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[8] Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IAS 23 Borrowing Costs; para. 8.

[9] Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IAS 23 Borrowing Costs; para. 14.

[10] Handbook; Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IFRS 14 Regulatory Deferral Accounts; para. 18.

[11] Handbook; Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IFRS 14 Regulatory Deferral Accounts; para. 20.

Therefore, to the extent that Hydro capitalizes costs for regulatory purposes that would not normally be capitalized under GAAP, the amounts can be recognized as a regulatory deferral account but must be reported separately with the other regulatory deferrals.

CONCLUSION

In the case of property, plant and equipment, GAAP requires Hydro to capitalize the avoidable costs "to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management." However, it can capitalize only the avoidable costs of the individual assets.

To the extent that the Board directs Hydro to capitalize costs that would not normally be capitalized under GAAP, it would have to account for them separately.

[12] Handbook; Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IFRS 14 Regulatory Deferral Accounts; para. 22 & 23.

REGULATORY PRINCIPLES

Regulatory principles help to establish how costs should be established for the purpose of setting regulated rates.

JUST & REASONABLE

The primary regulatory principle is that rates must be just and reasonable – where "just and reasonable" considers the legitimate interests of both customers and the regulated entity. Unfortunately, "just and reasonable" tends to be a vague concept and other regulatory principles help to establish what is "just and reasonable" in a particular situation.

In establishing just and reasonable, the most significant principle is the cost of service 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. The importance of this principle has been recognized by the Supreme Court of Canada:

> *… a key principle in Canadian regulatory law is that a regulated utility must have the opportunity to recover its operating and capital costs through rates …* [13]

The cost of service standard does not require that a regulated entity be guaranteed a fair return, only that it has an opportunity to earn it. In most cases, rates are set prospectively, based on estimated future costs. If the entity over-recovers, it normally keeps the excess; if it under-recovers, it bears the deficiency.

In the context of capitalizing costs, the issue is not whether costs should be recoverable in rates, but when.[14] To establish when costs should be recoverable, regulators frequently consider the principles of intergenerational equity, and rate stability and predictability. Also, they generally consider materiality in setting just and reasonable rates.

INTERGENERATIONAL EQUITY

The principle of intergenerational equity helps to determine when costs should be recovered. 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.

---

[13] ATCO Gas and Pipelines Ltd. v. Alberta (Utilities Commission); 2015; SCC 45; para. 61.

[14] Determining when costs will be recoverable will impact rates to the extent that a deferral impacts a utility's financing costs.

In the case of capital projects, the avoidable costs should be capitalized; these would be the costs that would be avoidable in relation to all capital projects in aggregate, and not just the individual assets. These costs are incurred solely for the benefit of future customers and should be capitalized and recoverable from future customers, not current customers.

The principle of intergenerational equity does not provide any direction in regards to costs that benefit capital projects, but are non-avoidable costs of capital projects – i.e., if the capital projects did not exist, the costs would still exist to support other operations. It might be argued that is fair that capital projects, and future customers, bear a share of the costs. However, whether or not the capital projects existed, the costs would have to be incurred to provide current operations. As a result, current customers do not bear any costs in addition to what they would have to bear if there were no capital projects. Similarly, whether or not the current operations existed, the costs would have to be incurred for the capital projects.

RATE STABILITY AND PREDICTABILITY

The principle of rate stability and predictability also helps to establish when costs should be recovered. It requires that rates remain stable and predictable – at least to the extent practical. It may, therefore, justify smoothing out changes in rates to avoid sharp rate increases or temporary fluctuations. This principle recognizes that it is usually easier for ratepayers to deal with gradual and predictable rate changes.

The intent of this principle is to establish only when costs are recovered, not the amounts actually recovered.

If any of the avoidable costs of capital projects in aggregate were charged to current operations, rather than being capitalized, costs charged to operations would tend to vary with the level of capital projects. If any non-avoidable costs in relation capital projects were capitalized, the amounts charged to operations would decrease and this reduction would tend to vary with the level of capital projects. In both cases this would tend to reduce rate stability and predictability. Therefore, capitalizing all avoidable costs in relation capital projects in aggregate, and only these costs, would tend to enhance rate stability and predictability.

MATERIALITY

Attempting to achieve theoretical accuracy can be difficult and costly. For example, it is not always easy to identify the avoidable costs, especially where they are a small part of a cost category. In some cases, there is a significant cost to collect and report the information necessary for that accuracy.

Where the pursuit of greater accuracy is difficult or costly, regulators will often weight the benefit of the improved accuracy against the cost. Especially where the impact of

improved accuracy has an immaterial impact on rates, regulators will generally not require it. It should be remembered that any additional costs would normally be passed onto customers through higher allowed rates.

CONCLUSION

Regulatory principles would require the capitalization of the avoidable costs of capital projects in aggregate, not just the avoidable costs of individual assets. It might be fair to also allocate a "fair" share of the costs that benefit capital projects but are not avoidable in relation to capital projects in aggregate; however, such an allocation is not required. Moreover, such an allocation would tend to reduce rate stability and predictability since the level of operating expenses would vary with the level of capital activity.

Where the impact of a deviation from what is normally required by regulatory principles has an immaterial impact on rates, especially where there is a cost or it is difficult to achieving greater accuracy, such deviations are normally allowed by regulators.

HYDRO'S CAPITALIZED COSTS

The costs that Hydro capitalizes as part of the cost of property plant and equipment are determined by the requirements of "IAS 16 - Property, Plant and Equipment" – this is for both financial reporting and regulatory purposes.

IMPLICATIONS OF FOLLOWING IAS 16

In accordance with IAS 16, Hydro recognizes the directly attributable costs of bringing an asset to the location and condition required for use in its operations. The directly attributable costs are those that would be avoided if the specific asset were not acquired or constructed. However, it recognizes only the directly attributable costs of specific assets; it does not recognize costs that are directly attributable to capital projects in aggregate, but not individual assets.

A more extensive discussion of IAS 16 was provided in the section "Financial Reporting Principles".

ADOPTION OF IFRS STANDARDS

In a 2012 Order and Decision, the Commission accepted Hydro's proposal to modify its capital expenditure methodology to align it with IFRS requirements. These changes are set out in Appendix 2 and resulted in an increase to the amount of costs capitalized (at least in 2012).

Prior to adopting IFRS, Hydro followed Auditing Guideline 19 "Disclosures by Entities Subject to Rate Regulation" ("AcG 19") in pre-IFRS GAAP. Under AcG 19, separate disclosure of regulatory deferrals was required only when a separate asset or liability was recognized solely because of the effects of rate regulation. As a result, where an amount was recognized as a regulatory deferral under GAAP and capitalized as part of property plant and equipment, there was no need for separate disclosure; and no need to separately track and account for the regulatory deferral on an ongoing basis.

As previously discussed, differences between RAP and GAAP can be recognized as a regulatory deferral under IFRS; however, the aggregate amount of regulatory deferrals must be separately reported on a company's financial statements. As a result, a regulatory deferral capitalized as part of property plant and equipment would have to be tracked and accounted for separately, as would the amount amortized in any period.

Hydro maintained that differences between its capitalization policies for regulatory purposes and those required by IFRS would require keeping two sets of records, resulting in an increase in regulatory burden and costs. As summarized by the Board in the 2012 Order and Decision:

> *… Hydro explains that the primary rationale to use the relevant IFRS requirements in its capital expenditures relates to transparency and the administrative burden required to maintain duplicate asset records. Hydro states that calculating separate capital costs and the resulting depreciation variances and reconciling the two sets of records for the foreseeable future would require additional investment in both personnel and systems.*[15]

In accepting Hydro's proposal, the Commission stated:

> *The Board accepts Hydro's evidence in relation to the administrative burden and costs associated with maintaining regulatory reporting differences. The Board also agrees that moving to IFRS will enhance transparency. Hydro's proposed changes have been fully reviewed by Grant Thorton (sic). The Board will approve Hydro's proposed IFRS related changes to its capital expenditure methodology.*[16]

SIGNIFICANCE OF CAPITALIZED COSTS

Capitalized costs represent a significant proportion of Hydro's total costs. Over the most recent five years, on average, these costs have equaled 34% of its annual expenses and 141% of its operating costs.

Table 1

CAPITALIZED EXPENDITURES RELATIVE TO						
	2015	2016	2017	2018	2019	AVERAGE
Annual Expense[17]	22%	38%	64%	29%	22%	34%
Operating Costs	83%	165%	262%	115%	95%	141%

[15] Newfoundland and Labrador Board of Commissioners of Public Utilities; Order No. P. U. 2(2012); January 24, 2012; pg. 3.

[16] Newfoundland and Labrador Board of Commissioners of Public Utilities; Order No. P. U. 2(2012); January 24, 2012; pg. 4.

[17] Annual expense consists of operating costs, other income and expense, fuel, purchased power, amortization and interest.

COSTS CAPITALIZED

The following are the major components of Hydro's capitalized costs.

Paid to 3rd Parties

These costs include payments to third parties for raw materials, contract materials, contract labour and consultants. There are no loadings added to these payments.

Hydro Allocation -Labour:

These costs consist of the cost of Hydro and inter-company employee time allocated to specific capital assets on the basis of time records. This includes both regular and overtime costs.

Hydro's internal and inter-company labour includes a loading factor bill rate that is applied to regular labour to reflect the cost of vacation, employee benefits, other benefits and employer taxes. The bill rate is calculated annually and updated accordingly. Hydro's current bill rate is 68%. The bill rate does not contain a profit component and it is not included on overtime hours.

Hydro Allocation – Materials

These costs consist of the cost of material that has been inventoried and then used for a specific asset. No loadings are applied to these costs.

Hydro Allocation – Borrowing (IDC)

These are the borrowing costs applied to specific assets. Interest during construction ("IDC") is charged to projects estimated to be of a substantial duration (e.g., greater than six months). The IDC rate is based upon Hydro's cost of debt. The rate is reviewed on a quarterly basis and is updated accordingly.

Hydro Allocation – Other

These costs consist mainly of travel, equipment rentals and direct vehicle and equipment billings. The vehicle bill rates are based upon the type of vehicle or equipment utilized. The rate is calculated by multiplying the usage time by the daily hourly rental rate for the applicable vehicle or equipment. The rates are reviewed annually and updated accordingly.

Table 2

CAPITALIZED COSTS ($millions)							
	2015	**2016**	**2017**	**2018**	**2019**	**AVERAGE $**	**%**
Paid to 3rd Parties	69	114	258	98	64	121	63.2
Hydro Allocation - Labour	23	30	28	26	29	27	14.3
Hydro Allocation - Materials	28	53	40	27	27	35	18.3
Hydro Allocation – Borrowing (IDC)	3	3	10	2	2	4	2.1
Hydro Allocation - Other	2	4	5	4	5	4	2.1
Total	**$125**	**$204**	**$341**	**$157**	**$127**	**$191**	**100.0%**

FINANCING COSTS

GAAP does not recognize the cost of equity. Consistent with this view, IAS 16 only allows a capitalization of directly attributable borrowing costs – i.e., interest during construction or IDC.

Prior to adopting IFRS, Hydro capitalized financing costs based on its allowed rate of return. This amount was referred to as the allowance for funds used during construction ("AFUDC").

With Hydro's low equity ratio, its allowed rate of return tends to be close to its borrowing rate and the period over which financing costs are capitalized tends to be relative short, As a result, the difference between IDC and AFUDC tends to be relatively small.

Table 3

Capitalized Financing Costs ($ millions)						
	2015	2016	2017	2018	2019	Average
IDC	3.4	4.0	10.6	2.7	2.0	4.5
AFUDC	3.3	3.6	10.7	2.9	2.2	4.5
Difference	0.1	0.4	(0.1)	(0.2)	(0.2)	0.0

DIRECTLY ATTRIBUTABLE COSTS EXCLUDED

Consistent with IAS 16, Hydro capitalizes only the directly attributable costs of individual assets. Costs that are directly attributable to capital projects in aggregate, but not directly attributable to individual assets, are not capitalized but expensed in the current period.

Hydro does not track the costs that are avoidable only at the level of capital projects in aggregate and was not able to provide an estimate of these costs. To provide an estimate of costs that are avoidable only at the level of capital projects in aggregate, Hydro has stated that it would need to complete an in-depth analysis, including a detailed review of Hydro's departments with interviews of key personnel.

NON-AVOIDABLE INDIRECT COSTS

Hydro does not track non-avoidable indirect costs – i.e., costs that benefit capital projects but would not be avoided if Hydro did not have any capital projects. To provide an estimate of non-avoidable indirect costs, Hydro has stated that it would need to complete an in-depth analysis, including a detailed review of Hydro's departments with interviews of key personnel.

CONCLUSION

Hydro's capitalized costs are significant. The Company capitalizes the avoidable costs of specific assets; however, it does not capitalize, or even track, costs that are avoidable only at the level of capital projects in aggregate, or any non-avoidable indirect costs.

APPLICATION OF PRINCIPLES

Considering only regulatory principles, the avoidable costs of capital projects in aggregate should be capitalized; while there is no clear direction as to whether non-avoidable indirect costs should be capitalized. Considering only financial reporting principles, the avoidable costs of specific assets should be capitalized - i.e., the costs that would be avoided if the specific capital projects did not exist, but only these costs. A summary of these principles is provided in Table 4.

Table 4

COSTS CAPITALIZED			
	REGULATORY REPORTING	**FINANCIAL REPORTING**	**HYDRO (Currently)**
Avoidable – Specific Assets	**YES**	**YES**	**YES**
Avoidable – Capital Projects in Aggregate Only	**YES**	**NO**	**NO**
Non-avoidable - Indirect	DEPENDS	**NO**	**NO**

AVOIDABLE COSTS – INDIVIDUAL CAPITAL PROJECTS

The avoidable costs of individual capital assets should be capitalized as part of the cost of those assets. This is required by the principle of intergenerational equity.

Hydro is currently capitalizing these costs for financial reporting purposes. As a result, capitalizing these costs for regulatory purposes does not impose any additional accounting and reporting costs.

AVOIDABLE COSTS – CAPITAL PROJECTS IN AGGREGATE

As required by the principle of intergenerational equity, all of the avoidable costs of the capital projects in aggregate should be capitalized, even where they are non-avoidable costs in relation to individual assets.

This raises the issue of how to allocate these costs to individual assets. There is no economic basis for such an allocation: if any individual project did not exist, the costs would still have to be incurred for other projects. However, a "fair" basis might be some measure of relative benefits received. For example, consider the costs of the manager for capital projects where these costs are non-avoidable costs of individual capital projects. The dollar value of each project as a percent of the total, or the number of labour hours allocated to each project as a percent of the total, might be a reasonable measure of the relative benefits that each project receives.

A problem with allocating these costs, is that such allocations would not be in accordance with Hydro's financial reporting. As a result, Hydro would have to maintain separate records to account for the capitalization and amortization of these costs separately. As discussed in the previous section, this was a major reason (if not the most significant reason) the Board allowed Hydro to modify its capitalization polices to be consistent with the requirements of IFRS.

As noted in the previous section, Hydro does not have an estimate of these costs. As a result, it is not possible to determine the materiality of these costs.

NON-AVOIDABLE COSTS – INDIRECT

Costs that benefit capital projects but are non-avoidable in relation to capital projects in aggregate – i.e., non-avoidable indirect costs, do not have to be capitalized under the principle of intergenerational equity. Whether or not the capital projects existed, these costs would still have had to be incurred for current operations. As a result, current operations would not be required to bear any additional costs as a result of the capital projects.

It might be argued that it is "fair" that a portion of these costs be capitalized and borne by future customers rather than current customers. This would not be inconsistent with the principle of intergenerational equity. Both current operations and capital projects would not the allocated any more costs than what they would have to bear if they were provided alone.

As in the previous situation, there is no economic basis for allocating these costs to individual projects: if the capital projects did not exist, the costs would still have to be incurred for the current operations; if the current operations did not exist, the costs would still have to be incurred for the capital projects. As in the previous situation, a "fair" basis for allocating these costs between capital projects and current operations might be some measure of relative benefits received.

Although capitalizing a "fair" portion of these costs would not be inconsistent with the intergenerational equity, it would tend to reduce rate stability and predictability. Since these costs are not affected by the level of capital activity, the amount recognized in current operations would tend to vary with the level of capital projects under construction.

Again, there would be issue that the capitalization of these costs would not be in accordance with Hydro's financial reporting. As a result, Hydro would have to maintain separate records to account for the capitalization and amortization of these costs separately.

COST OF CAPITAL

The allowed return on rate base that would be avoidable without the capital projects in aggregate should be capitalized. This return recognizes both the cost of debt and equity. However, GAAP only recognizes the cost of debt and Hydro has been following GAAP for both financial reporting and regulatory purposes.

As discussed in the previous section, the difference between IDC and AFUDC appears to be immaterial.

CONCLUSION

Based on the discussion in this report, Hydro should continue to capitalize the avoidable costs of specific assets, and where significant, it should also capitalize the costs that are avoidable only at the level of capital projects in aggregate.

Ignoring the practical issue of the cost and complexity it would impose, all of the avoidable costs (i.e., directly attributable costs) of capital projects in aggregate should be capitalized:

- The avoidable costs of specific assets should be capitalized as part of the cost of the related assets.

- The costs that are only avoidable at the level of capital projects in aggregate should be allocated to specific assets on some measure of relative benefits received.

However, where the costs that are avoidable only at the level of capital projects in aggregate are not significant, especially where the cost of tracking and accounting for the costs is significant, it would be acceptable to expense the costs.

In the case of non-avoidable indirect costs (i.e., costs that are non-avoidable in relation to capital projects in aggregate but benefit those projects), it would be consistent with the principle of intergenerational equity to either capitalize or not capitalize these costs. However, capitalizing these costs would tend to reduce rate stability and predictability; would require Hydro to maintain separate records for the amounts capitalized leading to higher costs; and there would be no economic basis to support any allocation.

Since it is unlikely that there would be a significant difference between IDC and AFUDC, Hydro should continue to capitalize IDC rather than AFUDC so as to avoid the cost of separately tracking and accounting for the difference.

JT BROWNE CONSULTING Appendix JTBC-1
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RESUME - JOHN T. BROWNE

Summary: John Browne has been assisting clients in applying regulatory principles and resolving financial, accounting and costing issues related to rate regulation for over 30 years. Prior to establishing his own practice 20 years ago, he was a consultant with Deloitte and Touche LLP, the last seven years as a partner.

He has directed and worked on a wide range of studies for rate-regulated entities that have dealt with accounting and cost allocation principles, the determination of rate base, cost of service determination, product costing/pricing, rate of return, capital structure, and methods of regulation.

He has appeared as an expert witness on accounting, costing and financial issues before the following regulatory tribunals: Canadian Radio-television and Telecommunications Commission, Canadian Transport Commission, the Alberta Public Utilities Board / the Alberta Energy and Utilities Board, the Manitoba Public Utilities Board, Newfoundland and Labrador Board of Commissioners of Public Utilities and the Nova Scotia Board of Commissioners of Public Utilities.

Education / Professional Qualifications:

- Bachelor of Commerce - Queen's University
- Master of Arts (Economics) - Queen's University
- Chartered Professional Accountant, Chartered Accountant

Committees/ Publications Mr. Browne was Chairman of the Canadian Institute of Chartered Accountants ("CICA") Study Group that produced the CICA research report "Financial Reporting By Rate Regulated Enterprises."

He authored or co-authored the CA Magazine articles "A Matter Of Principles - Part I" "A Matter Of Principles - Part II" and "Regulatory Assets." These articles dealt with accounting by rate-regulated enterprises.

He co-authored the Deloitte & Touche publication "Basics of Canadian Rate Regulation" and authored the Deloitte & Touche monograph "The Contractual Pitfalls of Relying on GAAP." He has also authored a number of papers for distribution to clients and potential clients such as "Fundamentals of Rate Regulation" (an update of "Basics of Canadian Rate Regulation") and "Comments on Deferral Accounts to Deal With Uncertainty."

Key Clients: Mr. Browne's major clients have included: Newfoundland Power Inc., Nova Scotia Power Inc., New Brunswick Power Corporation, Hydro Quebec, Ontario Hydro, Manitoba Hydro, SaskPower, Edmonton Power, Ottawa Hydro, Canadian Electricity Association, Ontario Energy Board, Atco Gas, Enbridge, Newfoundland Telephone Company Ltd., Bell Canada, Manitoba Telephone System, Saskatchewan Telecommunications, AGT/TELUS, Teleglobe, Telesat Canada, Southwestern Bell Telephone Company, New York Telephone, The Telecommunication Authority of Singapore and Dhiraagu (Maldives).

Selected Assignments:

- Completed a survey of Canadian regulators to determine what they viewed as their objectives and how they interpreted those objectives.
- Assisted Ontario Hydro Services Company (currently Hydro One), one of the successor companies of Ontario Hydro, in understanding its regulatory options by researching and providing advice on a number of regulatory issues related to transfer pricing, structural organization, accounting for income taxes, relationships with affiliated companies, performance-based regulation, etc.
- Participated in the in the OEB consultation process dealing with the transition to IFRS. As part of this participation, made a presentation on proposed principles to guide the development and maintenance of regulatory accounting policies (RAP) and a framework for evaluating proposed changes in RAP.
- Advised the Canadian Electricity Association in the preparation of a paper dealing with the recognition of regulatory assets and liabilities. The assistance included organizing and drafting the report and advising on issues covered in the paper.
- Prepared a draft for the framework and principles section of a utility's cost manual.
- Researched and analysed the issue of a deferral plan for the introduction of a new plant into rate base. Prepared evidence on the issue for Nova Scotia Power and appeared as an expert witness. Subsequently prepared evidence and appeared as an expert witness on changes to the deferral of the costs on the plant due to changes in circumstances.

- Researched and analysed the issues of phase-in and risk sharing for Edmonton Power's Genesee plant and prepared a recommendation that was submitted to the utility's regulator. Expert testimony was also provided.

- Researched, analysed and presented a recommendation that an electric utility should be allowed to defer tax costs so that the utility could avoid a rate increase followed by a rate decrease.

- Provided a written opinion for Nova Scotia Power on its regulatory treatment of amounts related to an income tax dispute. The report dealt with past taxes that had not been recovered in allowed rates, future taxes that may not be payable, and the use of deferral accounts.

- Prepared a report for Nova Scotia Power Inc. that addressed the utility's plan to use market-related value in determining its pension expense. This plan would result in smoothing the impact of pension expense on rates. The report provided an opinion on whether the plan was consistent with generally accepted accounting principles and established regulatory principles.

- Provided a written opinion for Newfoundland Power on accounting and regulatory issues related to future employee benefits and the company's Hydro production equalization reserve. The opinion was included in the company's rate submission.

- Advised New Brunswick Power Distribution and Customer Service Corporation on regulatory issues related to a proposed fuel deferral account.

- Prepared two reports for NSPI: the reports addressed the recovery of unrecovered costs of a retired generating station. The utility's proposal included the recognition of a deferral account for both the unrecovered costs and the related capitalized financing costs.

- Provided a written opinion on a proposal by a not-for-profit electric system operator to deal with surpluses and deficits. In preparing the opinion, the treatment of surpluses and deficits by other not-for-profit independent electric system operators was reviewed.

- Analysed the issue of the appropriate accounting and regulatory treatment of Nova Scotia Power's defeasance program. Prepared evidence and appeared as an expert witness on the issue.

CHANGES IN CAPITALIZATION POLICY DUE TO ADOPTION OF IFRS

As set out in a 2012 Decision and Order, Hydro proposed the following changes to its capitalization policy as a result of the adoption of IFRS. The Board accepted all of the changes:

> *Hydro explains further in its 2012 Capital Projects Overview that the five areas of the 2012 Capital Budget Application that are affected by the move to IFRS are:*
>
> *i. Major Overhauls and Inspections - Hydro believes that it is appropriate to capitalize these costs in certain conditions as they represent benefits that will last over periods greater than one year and including these costs in a year could result in volatility in operating costs. Hydro sets out the policies and guidelines that it has adopted in this regard.*
>
> *ii. Training Costs – IFRS no longer allows the capitalization of training costs and Hydro proposes that such costs be included in operating rather than civil expenditures. Hydro submits that the exclusion of training costs in projects does not represent a material change.*
>
> *iii. Capital Labour Overheads – Hydro, in accordance with IFRS, no longer includes an allocation for Engineering Managers and Supervisors in the cost of property, plant and equipment. Hydro reports that it is now able to more accurately capture the hours of all engineers that work on capital as a result of the re-alignment of the Project Execution and Technical Services group, and proposes that hours directly charged to a capital project be included in the project's capital costs.*
>
> *iv. Corporate Overhead Allocation – Hydro, in accordance with IFRS, no longer includes an allocation for time for support business units.*
>
> *v. AFUDC vs. IDC – According to Hydro using Interest During Construction ("IDC") rather than Allowance for Funds Used During Construction ("AFUDC") as required by IFRS does not result in a material change.*[1]

[1] Newfoundland and Labrador Board of Commissioners of Public Utilities; Order No. P. U. 2(2012); January 24, 2012; pg. 3.

Attachment 2

Utility Survey Results

Jurisdictional Scan Results

General

1. What is the primary focus of your organization? For example, is your organization primarily Generation, Transmission, Distribution or some combination?
2. What accounting standards does your organization follow (i.e. US GAAP, IFRS, Private Entity GAAP, etc.)?
3. What form of rate regulation is your organization subject to for rate-setting purposes (eg. Cost of service methodology, performance based, etc.)?
4. Does your organization have any capitalization policies that are approved by your regulator which may be an exception to current accounting standards? If yes, please provide details.

	Ownership	Q1	Q2	Q3	Q4
Utility 1	Investor	Generation, Transmission & Distribution	US GAAP	Performance Based	No
Utility 2	Crown	Generation, Transmission & Distribution	IFRS	Cost of Service	No
Utility 3	Investor	Transmission	IFRS (translate to US GAAP)	Cost of Service	AFUDC, ELG, ARO
Utility 4	Investor	Distribution	US GAAP	Performance Based	No
Utility 5	Crown	Generation & Transmission (Some Distribution)	IFRS	Cost of Service	Regulatory Assets
Utility 6	Investor	Distribution (Some Transmission & Generation)	ASPE (translate to US GAAP)	Cost of Service	IAS 16[1]
Utility 7	Crown	Distribution	IFRS	Custom Incentive Rate-Setting	No
Utility 8	Investor	Transmission & Distribution (Some Generation)	ASPE (translate to US GAAP)	Cost of Service	No
Utility 9	[Redacted]	[Redacted]	[Redacted]	[Redacted]	No
Utility 10	Crown	Generation, Transmission & Distribution	IFRS	Cost of Service	No
Utility 11	Investor	Generation, Transmission & Distribution	US GAAP	Cost of Service	Training
Newfoundland Power	Investor	Distribution, Transmission (Some Generation)	US GAAP	Cost of Service	No
Hydro	Crown	Generation, Transmission & Distribution	IFRS	Cost of Service	No

[1] Utility 6 reports under US GAAP but follows IAS-16, *Property, Plant, and Equipment* with respect to capitalization.

Capitalized Overheads

5. Does your organization capitalize overheads as a component of construction costs? If so:
    a. What types of overhead costs do you capitalize (eg. administration, finance labour, parts, interest, training, pension etc.);
    b. Does your organization follow an established methodology such as the Full Cost or Incremental methods, or another methodology relating to capitalized overhead construction costs?
6. How are the capitalized overhead construction costs allocated amongst the various classes of assets in your organization?
7. Expressed as percentage, what were your overhead construction costs in relation to your total capital expenditures in 2019? Has this ratio changed materially (i.e. >3%) in comparison to your average?

	Q5. a	Q5. b	Q6	Q7
Utility 1	Departmental Costs	Full Cost	Based on asset additions	13.8%
Utility 2	Labour, Meals, Travel Related, Vehicles, IDC	Full Cost	Based on project spend	5.1%
Utility 3	Facility, HR, Finance, Head Office	N/A	Based on monthly CAPEX	10.0%
Utility 4	Departmental Costs	Full Cost	Prescribed percentages	9.0%
Utility 5	AFUDC	N/A	Monthly WIP balance	2.5%
Utility 6	No	N/A	N/A	N/A
Utility 7	2/3 direct labour - Supervision, Engineering, and Supply Chain burden rates. 1/3 vehicle and burdens	Burden Rates	Based on time spent	26.0%
Utility 8	Administration, Finance, 90% Stores Inventory Operating costs, AFUDC	Full Cost	Based on annual CAPEX	1.6%
Utility 9	All directly attributable to projects. Overhead departments charged to O&M	Incremental	Directly charged	N/A[2]
Utility 10	Salaries & Benefits, Administrative where directly attributable, Cost of Energy	Incremental	Prescribed percentages	10.0%
Utility 11	Administration, Labour, Office Supplies, Contracts, Rent, Membership Dues, Materials and proportionate amount of current service pension cost	Full Cost	Based on project spend	12.0%
Newfoundland Power	Construction and Non-Construction Activities, Pension, AFUDC, Inventory, Vehicle	Incremental	Proportionately based on asset additions	11.7%[3]
Hydro	No overhead. Hydro does capitalize Vehicle/Equipment, IDC directly	N/A	N/A for overhead. Time sheet for vehicle/Equip & proportionately based on project spend for IDC	0% overhead. 2.9% direct for vehicle & int.

[2] Not separately identifiable from percentages in Q9.
[3] If the capitalized overhead was adjusted to remove the impact of pension, the percentage of capitalized overhead for 2019 decreases to 9.0%. Capitalized overhead for Newfoundland Power includes GEC, AFUDC, and vehicle and inventory overheads.

Capitalized Internal Labour

8. Does your organization have a loading applied to base salaries for capital asset additions? If so:
    a. what is included in the labour loader (i.e. benefits, vacation, pension, etc.)?
    b. how is it allocated to capital assets (through an hourly charge or some other method)?
9. What percentage of your total internal labour costs (regular and overtime, excluding overheads from question #6) were capitalized in 2019 (i.e. total capitalized internal labour divided by total labour costs)? Has this ratio changed materially (i.e. >3%) in comparison to your average?
10. What percentage of your total labour costs (contract labour, regular and overtime, excluding overheads from question #6) were capitalized in 2019 (i.e. total capitalized internal labour divided by total labour costs)? Has this ratio changed materially (i.e. >3%) in comparison to your average?
11. Does your organization have any other method of allocating labour costs to capital assets; for example, loading labour costs on inventory and/or meter replacement? If so, please provide details below.

	Q8. a	Q8. b	Q9	Q10	Q11
Utility 1	Health Benefits, Leave, Incentives, Pension	Time Entry	50.2%	50.2%	Inventory
Utility 2	Allowances, Absences, Payroll Benefits, Severance, Vehicle	Time Entry	16.3%	13.5%	No
Utility 3	Benefits, Pension	Time Entry	58.0%	58.0%	No
Utility 4	Pension, Medical & Dental, CPP, EI	Time Entry	31.1%	14.0%	Inventory Loader
Utility 5	Benefits, Leave, Pension	Time Entry	17.0%	N/A	No
Utility 6	Vacation, Benefits, Pension, Professional Dues, Education, Protective Equipment, Vehicle	Time Entry	35.0%	N/A	No
Utility 7	Pension, CPP, EI, Health & Dental, Safety Uniforms, Tools, Vacation	Time Entry	36.0%	27.0%	No
Utility 8	Benefits, Vacation, Pension	Time Entry	37.0%	46.0%	No
Utility 9	Allowances and Burden (such as Pension and Dental)	Time Entry	14.0%	N/A	No
Utility 10	Benefits (Health, insurance, dental, life, CPP, EI, Workers Comp., Pension)	Time Entry	22.4%	71.9%	No
Utility 11	Employer payroll costs, benefits (health, dental, life & ADD) and DC/DB Pension	Time Entry	25%	N/A	No
Newfoundland Power	Health Benefits, Payroll, Vacation, Leave	Time Entry	35.0%[4]	43.0%[5]	Inventory Loader
Hydro	Benefits, CPP, EI, Pension, Vacation	Time Entry	26.8%	37.1%	No

[4] Adjusting Newfoundland Power's capitalized internal labour to account for pension increases the percentage to 37.5%.
[5] Adjusting Newfoundland Power's capitalized total labour to account for pension increases the percentage to 44.8%.

Appendix B

List of Relevant Positions by Department

Department	Positions Supporting Capital Program[1]	Positions within Department	Incremental Positions	Description
Major Projects[2]	Manager, Quality	1	1	The Major Projects department is responsible for the oversight, planning, and execution of Hydro's major capital works, typically those projects with budgets exceeding $50 million. The Project Management team support the entire portfolio of projects that the department has accountability for, including oversight of project governance activities, risk management, project reporting, capital planning, budgeting and forecasting, execution of safety and contracting plans, and engagement of stakeholders and government.
	Program Manager	1	1	
	Project Manager, Feasibility Studies	1	1	
	Lead, Safety	1	1	
	Project Coordinator	1	1	
	Lead, Stakeholder Relations	1	1	
	Senior Financial Analyst	1	1	
	Cost Controller, Commercial	1	1	
	Senior Manager, Commercial	1	1	
	Director	1	1	
Engineering Services	Project Assistant	3	3	The Engineering Services department is responsible for the oversight, planning, and execution of Hydro's capital works, typically those projects with budgets under $50 million. The Capital Planning and Project Execution teams within Engineering Services support the entire portfolio of projects that the department has accountability for, including oversight of project governance activities, risk management, project reporting, capital planning, and budgeting and forecasting.
	Project Administrator	1	1	
	Cost Analyst	1	1	
	Engineer, Capital Budget Coordinator	1	1	
	Senior Manager, Project Execution	1	1	
Production Operations	Office Clerk	4	1	The Production Operations department is responsible for overseeing scopes of capital work performed on Hydro's hydraulic and thermal generating assets. Supervisory roles provide direct oversight of personnel responsible for the operations and maintenance of those assets, as well as the execution of applicable capital work. The applicable operations team provides support to the capital program through completion of permitting and equipment isolations, performing commissioning activities and providing professional guidance on assets. Administrative staff are responsible for the coordination and completion of relevant documentation required for capital work. Planning staff are responsible for interface between engineering and operations team to ensure work is planned appropriately, coordinated with the other asset activities and executed in a timely fashion.
	Planner	6	1	
	Thermal Plant Operator	30	3	
	Various Supervisory Positions	19	2	
Transmission & Rural Operations	Office Clerk	12	2	The Transmission and Rural Operations department is responsible for overseeing scopes of capital work performed on Hydro's transmission distribution and rural generating assets. Management and supervisory roles provide direct oversight of personnel responsible for the operations and maintenance of those assets, as well as the execution of applicable capital work. Administrative staff are responsible for the coordination and completion of relevant documentation required for capital work.
	Manager	2	1	
Supply Chain	Buyer	7	1	The Supply Chain department supports Hydro's capital program through various procurement activities, including the issuance of tenders, requests for proposals and purchase orders, ensuring compliance with the Public Procurement Act, along with the tracking and receipt of materials associated with capital jobs.
	Store Worker	16	6	
	Purchasing Clerk	3	-	
	Team Lead, Procurement	1	-	
	Advisor, Contract Management	1	-	
	Supply Chain Analyst	1	-	
Regulatory Affairs	Regulatory Coordinator	3	1	The Regulatory Affairs department is responsible for overseeing the approval of capital work performed on Hydro's assets. Regulatory Engineers support the short-term and long-term capital planning process for the annual capital budget application, supplemental capital and Major Projects applications. Administrative staff are responsible for the coordination and compilation of the necessary documentation required for the approval of the Board of Commissioners of Public Utilities in accordance with guidelines.
	Regulatory Engineer	3	2	
	Project Manager	2	-	
	Manager, Regulatory Compliance	1	-	
	Manager, Reguatory Engineering	1	-	
	Sr. Advisor, Regulatory Compliance	1	-	
	Sr. Manager, Regulatory Affairs	1	-	

[1] Listing of positions is based on 2025 structure and does not include future positions to be added to Major Projects or within other departments supporting Major Projects.

[2] Some of the incremental positions listed within the Major Projects Department directly captialize a portion of their time under IFRS and will continue to do so. As the department itself is incremental, the remainder will be capitalized under General Expenses Capitalized.

Schedule 2

General Expenses Capitalized Deferral Account – Definition

Newfoundland and Labrador Hydro
General Expenses Capitalized Deferral Account

This account shall be charged with the approved portion of Newfoundland and Labrador Hydro's ("Hydro") Operating and Maintenance ("O&M") Labour expenses which are directly attributable to Hydro's capital program but cannot, from their general nature, be assigned to a specific capital project. This account will be charged at the conclusion of each calendar month based upon the following formula:

Monthly Transfer = Actual Monthly O&M Labour Expenses * X

Where:

Actual Monthly O&M Labour Expenses = actual operating and maintenance Labour expenses incurred in each of the applicable Department; and

X = capitalized overhead percentages for each applicable Department as approved by the Board of Commissioners of Public Utilities

Disposition of any Balance in this Account

The balance in this account will be amortized using the composite depreciation rate in the latest depreciation study approved by the Board, commencing the year after the transfer of the cost to the General Expenses Capitalized Deferral Account.

Affidavit

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

IN THE MATTER OF an application by Newfoundland and Labrador Hydro ("Hydro") pursuant to Sections 58 and 80 of the *Act*, for the approval of a deferral account to enable the deferral and recovery of capital-related general expenses.

AFFIDAVIT

I, Lisa Hutchens, Vice President, Chief Financial Officer, of St. John's in the province of Newfoundland and Labrador, make oath and say as follows:

1) I am the Vice President, Chief Financial Officer, for Newfoundland and Labrador Hydro, the applicant named in the attached application.
2) I have read and understand the foregoing application.
3) To the best of my knowledge, information, and belief, all of the matters, facts, and things set out in this application are true.

SWORN at St. John's in the province of Newfoundland and Labrador this 12th day of August 2025, before me:

Commissioner for Oaths, Newfoundland and Labrador

AMANDA HURLEY
A Commissioner for Oaths
in and for the Province of
Newfoundland and Labrador
My Commission expires on December 31, 2028

Lisa Hutchens, Vice President, Chief Financial Officer, CPA