MARITIME ELECTRIC
A FORTIS COMPANY

September 25, 2015

Mr. Mark Lanigan
Regulatory Services
Island Regulatory and Appeals Commission
PO Box 577
501–134 Kent Street
Charlottetown PE C1A 7L1

Dear Mr. Lanigan:

2014 Depreciation Study Filing Docket UE21603
Response to Interrogatories from the Government of PEI

Please find attached the Company's response to the Interrogatories filed by the Government of PEI with respect to the 2014 Depreciation Study filing. An electronic copy will follow shortly.

Yours truly,

MARITIME ELECTRIC

Jason C. Roberts
Director, Regulatory & Financial Planning

JCR61
Enclosure

MARITIME ELECTRIC
A FORTIS COMPANY

September 25, 2015

Ms. Kim Horrelt
Chief Executive Officer
PEI Energy Corporation
PO Box 2000
Charlottetown PE C1A 7N8

Dear Ms. Horrelt:

2014 Depreciation Study Filing Docket UE21603
Response to Interrogatories

Please find attached the Company's response to the Interrogatories filed by the Government of PEI with respect to the 2014 Depreciation Study filing.

Yours truly,

MARITIME ELECTRIC

Jason C. Roberts
Director, Regulatory & Financial Planning

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1. **PEI Energy Corporation**

In testimony by Kathleen McShane, MECL's expert witness at the 2010 Island Regulatory and Appeals Commission (IRAC) hearing on rates, tolls and charges the following evidence was presented:

> ***"Business risks have both short-term and longer-term aspects. Short-term business risks relate primarily to year-to-year variability in earnings due to the combination of fundamental underlying economic factors and the existing regulatory framework. Long term risk are important because utility assets are long-lived. Long-term business risks comprise factors that may negatively impact the long-run viability of the utility and impair the ability of the shareholders to fully recover their invested capital and a compensatory return thereon. As utilities represent capital-intensive investments with very limited alternative uses, whose committed capital is recovered over an extended period of time, it is the long-term risks that are of primary concern to the investor."***
>
> ***"With respect to operating and supply risks, MECL's Island location exposes the Company to relatively high risk. MECL is dependent on NB Power for over 80% of its energy requirements. The remainder is largely supplied from wind turbines located on the island. The off Island energy supply is delivered from the mainland grid via two submarine cables. While MECL owns some generation of its own capacity of 150 MW) to serve as back up in case of supply interruption and in periods of peak demand, it is relatively high cost compared to off Island production. Generation assets, which inherently face higher operating and capital costs recovery risk than "wires" (distribution and transmission assets, comprise just under 25% of MECL's total net utility property, plant and equipment."***
>
> ***"In terms of total risk (business risk and financial risk). MECL is a higher risk utility than the typical Canadian utility. MECL's higher total risk translates into a higher overall cost of capital, which in turn, indicates that its allowed return should be higher than the average allowed return should be higher than the average allowed return of its Canadian peers."***

If the testimony of Ms. McShane in any way resulted in a higher than average allowed return for MECL (relative to its Canadian peers), would it not follow that the higher rate of return is at least in part intended to compensate shareholders for their higher total risk? If so, would it not also follow that the cost associated with stranded or overvalued assets be born by the shareholder and not the ratepayer?

1. **Response**:
   The establishment of a return on capital for a regulated utility in a cost of service environment is premised on the fair return standard which states that a fair or reasonable return on capital should:
   - Be comparable to the return of enterprise of like risk (the comparable investment standard);
   - Enable the financial integrity of the regulated entity to be maintained (the financial integrity standard); and
   - Permit incremental capital to be attracted to the enterprise on reasonable terms and conditions (the capital attraction standard).

   The Company faces a number of financial and business and operating risks which are discussed in Ms. McShane's evidence (2010) referenced in the question. While the return on capital among Canadian and U.S. utilities have considerable comparability (including that of Maritime Electric's) some variations in these established returns between utilities exist due to, among other things, specific business and operating risk circumstances. In the case of Maritime Electric such factors as MECL's integrated operation with responsibility for generation, transmission and distribution (not the case with several other investor owned utilities in other Canadian jurisdictions), relative lack of deferral accounts, small size of MECL relative to others (and relative ability to absorb the loss of major customers) and power supply risks (including cable interconnection management). As well, there are other factors referenced in the McShane 2010 evidence. These factors, as well as certain financial risks including a lower average debt rating than the utility peer group, have been recognized by the Commission, in past deliberations, in establishing a ROE for MECL.

   The 2010 ROE set for MECL (9.75% with an equity swath of 40% to 45%) compared to the 2009 ROE at Nova Scotia Power of (9.35% at 37.5% common equity / 3.8% preferred equity). Newfoundland Power - substantially a distribution only company (9.0% ROE with 45% equity), FortisBC (9.75%), Ontario Electric distribution (9.75%) and U.S. utility average of 10.30% (average 48.6% common equity).

   The suggestion in the question is that the MECL shareholder should incur some or all risk associated with a stranded cost or asset. It is assumed that the question is directed, at least in part toward the planned retirement of the CTGS and the Company's application proposing the adjustment of depreciation rates to reflect the planned retirement of the facility in 2021 and to ensure adequate depreciation is in place to ensure a minimal net book value, and a sufficient reserve for the cost of the removal of the asset, is in place upon retirement.

   The Company offers the following:
   a) Maritime Electric, like other utilities in a cost of service environment has an obligation to serve and therefore, can have little or no control in making investment decisions to ensure its obligations are met. Generation assets, including CTGS, needs

to be available to meet reliability needs and the Company is obligated to meet safety and environmental standards.

b) A principle in the historic cost of service regulatory framework throughout North America allows for prudently incurred costs to be fully recoverable by the utility. This includes stranded costs, if they should exist. The Company seeks preapproval by the Regulator of its capital expenditures to mitigate exposure to the risk of not incurring costs prudently. There are exposable risks inherent in owning and operating generation assets, which are relatively complicated assets to operate, including in the areas of environmental, safety and reliability.

c) The Company does not currently have a stranded cost or stranded asset. The CTGS is not scheduled for retirement until 2021 and remains an integral part of the Company's generation portfolio. In recognition of the planned retirement of CTGS the Company has prudently addressed the estimated remaining service life with respect to this facility in the 2014 Depreciation Study Application recommendations. The filing of depreciation studies, and the adjustment of depreciation rates to reflect ongoing changes in the estimated service life of assets, is an established practice in the North American regulatory environment.

d) The Company filed a depreciation study, as ordered, in 2006 after returning to a cost of service regulatory environment in 2004 and for the reasons outlined in Section 4.1 of the 2014 Depreciation Study the Company was ordered to maintain existing depreciation rates which the Company has done and continues to do. Therefore, the net book value of the Company's assets, including CTGS, reflects the utilization of Regulator approved depreciation rates.

2. **PEI Energy Corporation**

Given that MECL presented evidence to IRAC in 2006 stating that its assets were overvalued, can MECL quantify the excess return earned from that time to present by virtue of these assets not being written down to their realizable value at the point in time and also quantify the financial impact of not adjusting the useful lives of the identified assets on a go forward basis?

Response:

The Company, upon its return to a cost of service regulatory environment, in 2004, was ordered to file a depreciation study. The Company filed the 2005 Depreciation Study on August 31, 2006. The 2005 Study proposed depreciation rate changes that reflected, at the time, the estimated asset service lives and disposal costs, for each of the Company's asset categories. As outlined in Section 4.1 of the 2014 Depreciation Study evidence the Commission, based on the circumstances presented at the time, ordered (UE07-01) the Company to continue to utilize existing rates of depreciation. The Company has continued to comply with this Regulatory order and apply Regulator approved depreciation rates.

Because the Company has followed Regulator approved depreciation rates upon returning to the cost of service environment it cannot agree with the categorization of "excess" return earned. Depreciation is an allocation process that recovers the original cost of assets over their respective service lives. Accepted utility practice is to periodically engage an external expert to review estimated service lives and recommend changes if required. The Company recovers its debt and equity financing (which are required to service the net assets of the Company) through debt financing costs and return on equity costs being approved components of the Company's annual revenue requirement.

Based on the recommendations of external experts, depreciation rates are adjusted at intervals, as approved by the Regulator, to reflect changing service life patterns and other factors. The Company is required to follow Regulator approved depreciation rates. If it is argued that depreciation rates/expense is understated over a period of time for an asset and that Company returns are therefore higher than they would be if depreciation costs (and customer rates) were higher than correspondingly it could be argued that once depreciation rates/expense is adjusted upward to meet the latest end of service life estimate for the same asset the Company's returns moving forward would be lower than they otherwise would be.

3. **PEI Energy Corporation**

In the current application to establish depreciation rates for asset classes, MECL's focus is the adjusted service life and the accumulated reserve variance for the Charlottetown Thermal Generating Station. Since MECL is focused on this issue, why not address the 2015 variance for service life and accumulated reserve variance at the same time, rather than deferring this issue to 2019?

Response:

The Company recognizes that to fully adopt Gannett Fleming's recommendations would result in an even more significant increase in depreciation expense (the remaining amortization of the accumulated reserve variance not recommended by the Company to be acted upon at this time represents a further increase in depreciation expense of $1.555 million annually – or approximately .8% additional rate impact based on a $195 million pre-adjusted revenue requirement).

The proposed adjustment in depreciation rates made by the Company is proposed to maintain a reasonable balance between the rate impact on customers and the need to maintain good utility practice with respect to depreciation policy, with adjustments to depreciation rates over a reasonable and prudent period of time.

The need to address the accumulated reserve variance with respect to CTGS was seen as a high priority given the probable retirement date in the near term.