The Island Regulatory and Appeals Commission

Re: Maritime Electric Company, Limited
IRAC Docket UE20934

Review of Deferred Charges

December 27, 2004

Radchuck Associates Inc.
Suite 604, Sovereign Place
5121 Sackville Street
Halifax NS Canada B3J 1K1
Tel: (902) 474-7053
Fax: (902) 429-9791
bradchuck@eastlink.ca

Table of Contents

A. Introduction

1. Background

Maritime Electric Company, Limited ("MECL") applied to The Island Regulatory and Appeals Commission ("IRAC") in May and October 2004 for adjustments to its rates plus related amendments to the general rules and regulations. The application requested approvals on accounting for deferred charges and an energy cost adjustment mechanism ("ECAM"). IRAC decided to ask Radchuck Associates Inc. for independent advice on the nature of the deferred charges and the accounting methodology proposed by MECL compared to Generally Accepted Accounting Principles ("GAAP").

2. Terms of Reference

The summary terms of reference are: "Review of the deferred accounts set out in MECL's application – confirmation of the quantum of the deferred accounts associated with Section 47(4) of the Electric Power Act ("Act") and the appropriateness of MECL's proposals."

More specifically the terms of reference include:

- Review the provisions of Section 47(4) of the Act.
- Investigate and verify the components of the amount deferred ($20,783,600) under Section 47(4)(a)(i) and comment on MECL's proposal to recover this amount as a component of future rate revenues requirements.
- Investigate and verify the components of the amount deferred ($3,922,033) under Section 47(4)(a)(ii) and comment on MECL's proposal to recover this amount through future rate revenues.
- Investigate the purpose and appropriateness of accounting treatment for ECAM/deferred expenses incurred in 2004 and to be recovered with additional revenue requirements of $1,500,000 in 2005 and $3,500,000 in 2006.

3. Scope of Study

It is important to recognize that this study focused only upon the matters directly related to the amounts of the deferred expenses and the appropriate accounting methodologies to recover the deferred expenses. No calculations were made to determine the specific impacts of the amortization on the proposed rates although judgements were made to avoid (suspected) extraordinary impacts.

4. Purpose of this Report

The purpose of this report is to present the findings, conclusions and recommendations arising from the study.

It is understood that these recommendations will be considered by IRAC in its processes dealing with the MECL application.

B. Generally Accepted Accounting Principles

The Canadian Generally Accepted Accounting Principles ("GAAP") are established by the Canadian Institute of Chartered Accountants and provided in the Handbook plus accepted practices in industry over the years. In this Handbook, General Accounting, Section 1100.02(b), generally accepted accounting principles are defined as encompassing "broad principles and conventions of general application as well as rules and procedures that determine accepted accounting practices at a particular time."

In Section 1100.06: "No rule of general application can be phrased to suit all circumstances or combinations of circumstances that may arise." Hence, it is expected that some accounting policies will be based upon GAAP but developed through the exercise of professional judgement.

Accounting policies and methodologies established for rate-regulated operations by formal regulators are acknowledged and often take precedence over GAAP. Section 1100.36 states:

> Rate regulation exists when all of the following criteria are present:
>
> (a) The rates for regulated services or products provided to customers are established by or are subject to approval by a regulator or a governing body empowered by statute or contract to establish rates to be charged for services or products.
>
> (b) The regulated rates are designed to recover the cost of providing the services or products.
>
> (c) It is reasonable to assume that rates set at levels that will recover the cost can be charged to and collected from customers in view of the demand for the services or products and the level of direct and indirect competition.

Consequently, IRAC can determine or establish accounting policies and procedures, which although may not be in accordance with GAAP, will be recognized as required accounting policies for the regulated entity (MECL) by the CICA.

Later in the report, specific accounting principles will be referred to and acceptable deviations (subject to IRAC approvals) will be recommended.

C. Point Lepreau Writedown

1. Nature of Deferred Expense

MECL has a participation agreement with New Brunswick Power Corporation ("NB Power") to obtain energy from the Point Lepreau Nuclear Generating Station ("Point Lepreau"). NB Power recorded an asset writedown of $450,000,000 in 1998 after the useful life of Point Lepreau was reduced from 2014 to 2008. In a study titled The Island Regulatory and Appeals Commission in the Matter of Maritime Electric Company, Limited and Its January 1, 2001 Tariff Filing, dated January 12, 2001 and prepared by Robert P. Radchuck, P.Eng., FCA ("January 2001 Study") (see Sections 4.1 and 4.2), the following was established:

- the useful life of Point Lepreau would end in 2008 rather than 2014 as originally designed for; and
- the amount of the writedown would be $450,000,000.

As part of the participation agreement with respect to Point Lepreau, MECL is required to pay 4.72% of all costs, capital and operating.

Accordingly, the portion of the writedown to be assumed by MECL as of April 1, 1998, is:

	Per Radchuck	Per MECL
Total writedown	$450,000,000	$450,000,000
Effective participation rate	4.72%	4.724%
Participation share:		
• Calculated	$21,240,000	$21,258,000
• Negotiated	$10,620,000	$10,629,000

MECL used a participation rate of 4.724% which has been the rate used over many years, while Radchuck used 4.72% as per the agreement. MECL negotiated the obligation to 50% of the calculated amount. The difference between the 4.72% and 4.724% was $9,000 which was deemed to be immaterial. Hence the MECL balance of $10,629,000 is accepted. Subsequently, MECL used 4.72% instead of 4.724% in its dealings with N.B. Power.

After adjusting for interest, the balance owing was $5,976,505 at January 1, 2001. MECL paid that amount to NB Power and recorded the amount paid as a deferred charge. The deferred charge was amortized over the useful life of Point Lepreau.

2. MECL Methodology for Amortization

MECL recorded the deferred charge of $5,976,505 as at January 1, 2001. MECL then decided to amortize this amount over the useful life of Point Lepreau, using equal annual amounts (straight line amortization method) until 2008. Subsequently, NB Power reassessed the useful life and revised the ending date from 2008 to 2010 – an additional two years. MECL revised the amortization period and the annual amortized amount accordingly.

The unamortized balance of the Deferred Charge as at December 31, 2003 was $3,922,033.

3. Findings and Conclusions

The following procedures were done to establish the accuracy of the original deferred charge:

1. The determination of the amount due was as follows:

Share of writedown	$10,629,000
Interest owing on the writedown	3,211,190
	$13,840,190
Deduct:	
Overpayment of capital charges	$ 6,927,002
Interest on overpayment	936,683
	$ 7,863,685
Net owing January 1, 2001	**$ 5,976,505**

2. The payment of $5,967,505 was traced to the bank remittance advice dated January 2, 2001, and the MECL bank account statement.
3. The Interest Owing on the writedown ($3,211,190) was recalculated and found to be correct.
4. The Overpayment of Capital Charges ($6,927,002) and Interest on Overpayment ($936,683) calculations were reviewed.

Based upon the above and work done in the January 2001 Study, the reported amount owing of $5,976,505 is accurate.

MECL concluded this payment is an expense that can be deferred since it is simply an acceleration of normal plant writedown precipitated by reducing the useful life from ending in 2014 to ending in 2010. This is reasonable.

These findings and conclusions relate to the amortization of the deferred amount:

1. MECL elected to amortize the $5,976,505 on a straight line basis (equal annual charges to operations) over the remaining useful life of Point Lepreau (to 2010). The NB Power audited financial statements disclosed in a note that the useful life of Point Lepreau was until 2010.
2. MECL calculated the equal annual amortization amounts and charged them to the annual operating expenses.
3. The annual amortization was calculated for the years 2001, 2002 and 2003 and deducted from the amount paid (per 2 above). The residual balance of the deferred charge as at December 31, 2003 was $3,922,033, which agreed with MECL's balance as reported in its audited financial statements and the amount in the application data.

4. GAAP Considerations

The participation agreement between MECL and NB Power includes capital expenditures and operating expenses. The $450,000,000 writedown that gave rise to the Deferred Charge can be described as property, plant and equipment reflecting a reduction in the original cost of Point Lepreau.

The CICA Handbook states:

> "Property, plant and equipment is acquired to earn income or supply a service over its useful life. An item of property, plant and equipment, other than land that normally has an unlimited life, has a limited life. Its useful life is normally the shortest of its physical, technological, commercial and legal life. Amortization is the charge to income that recognizes that life is finite and that the cost less salvage value or residual value of an item of property, plant and equipment is allocated to the periods of service provided by the asset. Amortization may also be termed depreciation or depletion."

The Deferred Charge of $5,976,505 meets the criteria of being an asset to earn income over a useful life.

The CICA Handbook specifies:

> Amortization should be recognized in a rational and systematic manner appropriate to the nature of an item of property, plant and equipment with a limited life and its use by the enterprise. The amount of amortization that should be charged to income is the greater of:
>
> (a) the cost less salvage value over the life of the asset; and
>
> (b) the cost less residual value over the useful life of the asset.

The amortization methodology used by MECL meets these criteria.

5. Recommendation

The Deferred Charge and the amortization methodology meet generally accepted accounting principles.

> **It is recommended that IRAC accept the proposed Deferred Charge and the amortization methodology.**

D. Deferred Costs Recoverable

1. Nature of Deferred Costs

Until January 1, 2004, MECL was regulated under the Maritime Electric Limited Regulation Act ("Old Act"). In the Base Rate Adjustment Regulations, as provided under the Old Act, an energy cost adjustment mechanism was used to "smooth out" the energy costs. This mechanism was essentially a cost deferral method intended to mitigate against fluctuating energy costs. These deferred costs were to be recovered from future rates.

At December 31, 2003, the total of these recoverable costs was $20,783,600. The total amount is reported as a "cost recoverable from customers" in the audited MECL Non-Consolidated Financial Statements as at December 31, 2003. The same amount is also in Section 47(4)(a)(i) of the Act.

2. MECL Methodology

MECL calculated the Deferred Costs Recoverable of $20,783,600 using the methodology given in the Old Act. However, under the (new) Act, the proposed ECAM is operational beginning January 1, 2004 with no provision for recovering the deferred costs reported in the financial statements as of December 31, 2003.

In the Amended Notice of Application and Supplementary Evidence, October 5, 2004, the following statements are made:

(i) Paragraph 109: "Schedule 15 shows the composition of Deferred Costs Recoverable at December 31, 2003 calculated in accordance with the previous legislation." Schedule 15 is attached as Appendix A.

(ii) Paragraph 108: "Section 47(4)(a)(i) of the EPA provides for the recovery of these costs over such period of time and on such terms and conditions as the Commission considers just and reasonable…. It is expected that the $20,783,600 can be amortized over a period of 5 to 7 years."

However, MECL is requesting (referred to in paragraph 108) amortization amounts of $1,500,000 in 2004 and $2,500,000 in 2005. No indication is given of the annual amortized amounts after 2005 nor is there a commitment on the number of years over which the total $20,783,600 will be amortized.

3. Findings and Conclusions

The following procedures were done to establish the composition and amount of the $20,783,600:

1. The 2003 recoverable amount of $17,408,402 shown in Appendix A was calculated separately using the calculation schedule in Appendix E of the January 2001 Study referred to earlier in this report.
2. The other components in Appendix A were compared to prior fiscal period amounts and deemed to be reasonable.
3. The total was traced to the Audited Non-Consolidated Financial Statements for December 31, 2003 to which was appended the Auditors' Report from Ernst & Young LLP.

The conclusion is that the $20,783,600 was properly calculated.

The proposed amortization of $1,500,000 in 2004 and $2,500,000 in 2005 do not appear to be the result of a rational and systematic method. The only annual amounts disclosed are for 2004 and 2005 with no indication of future annual amounts other than the amounts may be amortized over a period of five to seven years (paragraph 108 referred to earlier).

An analysis was done on the significance of the Deferred Costs Recoverable and amortization. This is shown as Appendix B. The findings and conclusions are:

1. The total Deferred Costs Recoverable as a percent of the total expenses by year are:

2003	25.05%
2004	22.25%
2005	19.62%

   Using the actual in 2003 and the MECL proposals for 2004 and 2005, the unamortized deferred costs at the end of each year are very significant when compared to total expenses.

2. The proposed amortization of $1,500,000 in 2004 and $2,500,000 in 2005 represent 1.29% and 2.02% of total revenues respectively. These amounts are not unreasonable.

3. Although Point 2 above indicates the proposed amortization amounts for 2004 and 2005 are reasonable when calculated as a percent of revenues, Section B of Appendix B addresses the years after 2005. The opening balance in 2006 is:

Deferred cost	$20,783,600
Less amounts amortized	
2004	(1,500,000)
2005	(2,500,000)
Opening balance 2006	**$16,783,600**

The annual amortized amount for each of the suggested periods (five and seven years):

	Annual Amount	
	2006 to 2008	2006 to 2010
Amount	$5,594,533	$3,356,720
Percent of 2005 revenues	4.67%	2.80%

If the revenues in future years were equal to the 2005 revenues ($119,769,100), the increases in annual revenues just to amortize the Deferred Costs Recoverable would be 4.67% in 2006 for the five-year period and 2.80% in 2006 for the seven-year period.

This analysis illustrates the impact of the proposed methodology where smaller amounts of amortization were used in 2004 and 2005. The required increases in 2006 onwards are much higher whether using the five-year or the seven-year option.

4. Section C of Appendix B calculates the annual impacts on 2004 and 2005 if the deferred costs are recovered in equal annual amortized amounts over seven years. The annual amount is $2,969,086 for the years 2004 to 2010. As shown in Appendix B, Section C, this represents about 2.56% of revenues in 2004 and 2.48% of revenues in 2005 or increases of 1.27% (2.56% minus 1.29%) in 2004 and 0.39% (2.48% minus 2.09%) in 2005 above the currently proposed rates.

5. Section D is similar to Section C except the impacts are calculated using equal annual amortized amounts over five years beginning in 2004. The annual amortized amount is $4,156,720. Additional revenues of $2,656,720 ($4,156,720 less $1,500,000) in 2004 and $1,656,720 ($4,156,720 less $2,500,000) in 2005 would be needed to recover the additional amortization.

6. A similar calculation to Section D of Appendix B using a period of three years was done to amortize the deferred costs. The annual amortized amount increased to about 8% of total operating expenses. This was viewed as too much of an impact if all of it were to be recovered from increased rates.

7. The other non-financial factors, which must be considered, include:

   (a) Deferred costs, although shown as an asset on the MECL balance sheet, have no future benefit to the electrical service customers. In fact, the benefit was received by the customers in the prior years whose rates were not high enough to recover all operating costs. Hence, one could conclude that in accounting methodology, the future useful life of the deferred costs is zero.

   (b) The proposed amortization method, with only the amounts in 2004 and 2005 defined and the useful life suggested at five or seven years, does not meet GAAP.

   (c) The customers that received the benefit of lower rates in the past are likely to be the same customers who will be required to pay for these costs in the future. The assumption here is that the customer base is relatively stable.

4. Relevant GAAP

If the useful future life, in strict accounting principle terms, is zero, then the entire amount should be taken into expense in the year 2004. However, professional judgement (when all factors are considered, especially the relative quantum of the deferred costs) would dictate that is not a reasonable alternative.

If the amortization period between five years and seven years is considered to be the reasonable range, then the term should be shorter rather than longer.

5. Recommendation

Although not completely in accordance with GAAP:

> **It is recommended that IRAC approve the deferral and the Deferred Costs Recoverable of $20,783,600 should be amortized over a period of five years in equal annual instalments.**

E. Energy Cost Adjustment Mechanism

In Section 3.1 of the May 2004 Rate Case Evidence, MECL describes the challenges of developing rates using fluctuating costs. Selected quotes are:

> "Costs for energy purchases vary by contract and by fuel source. While some of these costs are stable and therefore predictable, many are not, making it difficult to predict with accuracy the cost of purchased energy."
>
> "Costs for fuel, labour and maintenance at the Company's generation plants on PEI are difficult to forecast with accuracy."
>
> "…[T]he introduction of a mechanism of this nature (ECAM), which was in place prior to 1994, provides stability in the Company's earnings and eliminates the need for frequent and costly hearings to adjust rates in response to changes in energy costs…."

The request for such a mechanism is reasonable. However, it is important to properly establish at the outset, the costs to be included and the methodology of the ECAM. It is understood that IRAC has engaged an independent expert to evaluate the ECAM proposed by MECL. Based upon the findings and conclusions of the January 2001 Study and the approach proposed by MECL, it is possible that the costs being used may include costs not commonly permitted in cost adjustment mechanisms. The independent study will provide IRAC with that analysis.

Consequently any conclusions and recommendations on categories or types of costs to be used in the ECAM should come from the independent expert referred to above. If there are costs included in the proposed ECAM that are not so recommended, these costs must be reported in the fiscal year in which the costs are incurred if they are to meet GAAP. Or, more specifically:

> **Costs excluded from the ECAM methodology should be accounted for under GAAP and reported as annual operating expenditures.**

F. Other Considerations

GAAP represent accounting theory and practice that apply to enterprises in general. Due to the unique nature of some industries (e.g. utilities), certain principles and practices which apply to businesses in general are inadequate or inappropriate. In some cases, the accounting regulatory bodies have developed accounting principles for specific industries which become part of the GAAP for that industry.

For regulated industries, the accounting regulatory bodies have provided for and recognized that the regulators can, and do, prescribe special accounting practices. In general, the regulator's objective is to maintain smooth and stable rates for customers considering the financial status and needs of the utility. This objective is commonly achieved with deferrals of large or volatile expenditures by a regulated utility (for example, ECAM).

The scope of this review and the resulting recommendations did not include any calculated determination of the impact(s) on the rates required to recover the allowable deferred costs or amortization expenses in 2004 and 2005. This is an important factor when moving to a new regulatory framework.

For example, the Deferred Costs Recoverable ($20,783,600) impacts of the proposed and recommended amortization are as follows:

	2004	2005
Recommended annual amortization	$4,156,720	$4,156,720
Proposed annual amortization by MECL	1,500,000	2,500,000
Difference – increase	**$2,656,720**	**$1,656,720**

The increases are substantial and may not be prudent to meet the objective of "smooth rate changes." Similarly, the ECAM study outcome is uncertain. Non-ECAM costs could increase the allowable expenses in 2004 and 2005 requiring high rate increases.

The general objective of IRAC should be to require MECL to meet GAAP as closely as possible but not to the extent that the objective of just and reasonable rates is significantly impaired. Consequently:

> **IRAC should determine the impacts of the recommendations on customer rates and consider the impacts of the move to a new regulatory framework before acting on the recommendations in this report.**

SCHEDULE 15
Deferred Costs Recoverable December 31, 2003

A. Energy Cost Adjustment Mechanism (ECAM)	
Purchased Energy Costs	$43,187,072
Lepreau Energy Costs	10,565,071
Dalhousie Energy Costs	10,593,469
Generation Costs – PEI Plants	6,434,034
Amortization – Point Lepreau Deferred Charge	560,291
Total 2003 ECAM Eligible Energy Costs	$71,339,937
Net 2003 Purchased & Produced Energy – kWh (NPP)	1,039,945,319
Base Rate /kWh – Per Regulations	$0.05
Base Energy Costs	$51,997,266
Difference Between Actual & Base Energy Costs	$19,342,671
Pass-through Rate	90%
Amount Recoverable – 2003	$17,408,404
General Ledger Opening Balance January 1, 2003	$20,713,379
Additions – 2003	14,408,404
Collected from Ratepayers – 2003	(16,476,223)
General Ledger Closing Balance December 31, 2003	**(A) $21,645,560**
B. Cost of Capital Adjustment (COC)	
General Ledger Opening Balance January 1, 2003	($647,792)
Accrued Refundable COC to Ratepayer – 2003	(653,636)
Returned to Ratepayers – 2003	439,468
General Ledger Closing Balance December 31, 2003	**(B) ($861,960)**
C. Deferred Costs Recoverable (A + B)	**$20,783,600**

APPENDIX B

MARITIME ELECTRIC COMPANY LIMITED

Old ECAM / Deferred Expenses Amortization

Evaluation of Materiality - December 31			2003	Est 2004	Est 2005	Balance of Term
Deferred costs recoverable at year end			**$20,783,600**	**$19,283,600**	**$16,783,600**	
Total operating expenses for the fiscal year (before ECAM)			**$82,961,289**	**$86,660,000**	**$85,524,000**	
Total operating revenues			**$96,269,939**	**$116,045,000**	**$119,769,100**	
Deferred cost as a percent of total operating expenses			25.05%	22.25%	19.62%	

Impact of amortization on annual expenses

				2003	Est 2004	Est 2005	Balance of Term
A	**Proposed by MECL**						
	Annual amount				$1,500,000	$2,500,000	
	Percent of total expenses				1.73%	2.92%	
	Percent of total revenues (revenue increase needed)				1.29%	2.09%	
B	**Annual impacts after 2005 (MECL suggested 5 and 7 year terms less 2 years - 2004 and 2005)**						
	(assumes starting balance of $16,783,600)						
	Annual amount on remaining term	5	Years				$3,356,720
		3	Years				$5,594,533
	Percent of expenses (2005)	5	Years				3.92%
		3	Years				6.54%
	Percent of revenues (2005)	5	Years				2.80%
		3	Years				4.67%
C	**Assume deferred costs amortized over**	**7**	**years**				
	Annual amount			$2,969,086	$2,969,086	$2,969,086	
	Percent of total expenses				3.43%	3.47%	
	Percent of total revenues (revenue increase needed)				2.56%	2.48%	
D	**Assume deferred costs amortized over**	**5**	**years**				
	Annual amount			$4,156,720	$4,156,720	$4,156,720	
	Percent of total expenses				4.80%	4.86%	
	Percent of total revenues (revenue increase needed)				3.58%	3.47%	

Appendix C

MARITIME ELECTRIC COMPANY, LIMITED

Maritime Electric Company Limited Regulation Act
Base Rate Adjustment Regulations

Calculation Schedule

	2003	2002	2001
Data Inputs			
Average Common Equity	$73,852,441	$70,610,717	$63,142,908
Billed Revenue	$94,546,374	$91,136,047	$92,551,495
Other Revenues	$2,377,201	$1,198,505	$1,599,800
Total ECAM Expenses	$71,339,935	$70,093,949	$68,006,655
Base ECAM Cost (per kWh)	$0.05	$0.05	$0.05
Other Expenses	$29,705,404	$27,273,531	$28,537,081
Tax Rate	42.80%	44.35%	43.73%
Rate of Energy Costs Recoverable	90.00%	90.00%	90.00%
Net Purchased and Produced (kWh)	1,039,945,319	1,019,875,649	1,066,886,739
Target Return on Equity	11.00%	11.00%	11.00%

Per Section 4(2) of the Maritime Electric Company Limited Regulation Act,
The Energy Cost Adjustment Mechanism is calculated as follows:

Section				2003	2002	2001
4(2)(a)	Determine total cost of energy purchased and produced					
	Cost of Energy			$71,339,935	$70,093,949	$68,006,655
4(2)(b)	Determine the total amount (in the preceding year) of the net kilowatt-hours produced and purchased;					
	Purchased and Produced Energy			1,039,945,319	1,019,875,649	1,066,886,739
	Total			1,039,945,319	1,019,875,649	1,066,886,739
4(2)(c)	Calculate the Base energy cost by multiplying the energy purchased and produced (above) by the Base ECAM cost ($0.05)			$51,997,266	$50,993,782	$53,344,337
4(2)(d)	Deduct the Base ECAM Cost from the Total Actual Cost to calculate the excess (deficiency):					
	Total actual cost	Section 4(2)(a) above		$71,339,935	$70,093,949	$68,006,655
	Base cost	Section 4(2)(c) above		$51,997,266	$50,993,782	$53,344,337
	Amount of excess (deficiency)			$19,342,669	$19,100,167	$14,662,318
4(2)(e)	Calculate the recoverable amount of the difference in Section 4(2)(d) above:					
	Recoverable per Legislation		90.0%	**$17,408,402**	**$17,190,150**	**$13,196,086**