REPORT

A Report to the Minister of Energy Concerning the Decision by the New Brunswick Power Distribution and Customer Service Corporation to Increase its Rates by 3% on April 1, 2008.

Submitted by the New Brunswick Energy and Utilities Board.

June 26, 2008

NEW BRUNSWICK ENERGY AND UTILITIES BOARD

EXECUTIVE SUMMARY

On March 5, 2008, the Minister of Energy directed the Board to investigate and report upon the forecast of the costs and revenues DISCO used to support the necessity for the 3% increase.

The Board expected its investigation to be reasonably straight-forward as it had recently completed a detailed examination of DISCO's finances in connection with a public review of rates for 2007/2008.

The Board anticipated that for 2008/2009 DISCO would have followed the rules of the PPAs, continued to use a mechanistic approach to determine its costs for fuel and purchased power and then base its decision on DISCO specific information.

The investigation was considerably more challenging than the Board had anticipated because DISCO based its decision to increase rates by 3% on the consolidated information for the NB Power Group of Companies and not on its own forecast of revenues and costs.

The forecast for the fuel and purchased power expense for each of the 2006/2007 and 2007/2008 years had been developed on the basis of the PPA rules and maximized cost certainty concerning the acquisition of fuel and purchased power.

The forecast that DISCO used for 2008/2009 included external purchases of energy that were not based on firm contracts. This was a marked departure from past practice.

The 2008/2009 forecast for fuel and purchased power assumed that the PPA rules would be changed despite the fact that these changes had not occurred at the time that the forecast was developed.

The result of these changes was a forecast for the cost of fuel and purchased power for 2008/2009 which was almost $100 million lower than if the forecast had been done using the traditional rules.

The Board believes that if DISCO had prepared its revenue requirement for 2008/2009 in a manner consistent with previous years, there is no doubt that such information would have supported the decision to increase rates by 3% on April 1, 2008, particularly in light of rising fuel costs.

DISCO did not prepare its revenue requirement in a manner consistent with previous years and stated that much of the DISCO specific information was of "limited usefulness".

The Board therefore cannot state conclusively that the 3% increase of April 1, 2008, was necessary based solely on the DISCO information.

The reasonableness of the consolidated NB Power financial results forecast is dependent upon the reasonableness of the operating costs and net earnings for GENCO and NUCLEARCO.

The Board does not regulate GENCO or NUCLEARCO and therefore it would be inappropriate for it to comment on the reasonableness of the operating costs and net earnings of GENCO and NUCLEARCO.

The Board therefore cannot determine if there was a necessity for DISCO to implement its rate increase based upon the HOLDCO information.

The Board, as a result of this investigation, concludes that the NB Power Group of Companies does, in fact, operate as a single vertically integrated utility as it did prior to restructuring. This conclusion is based on the fact that the April 1, 2008, 3% increase in rates was based on the financial outlook of HOLDCO and not on the financial outlook for DISCO.

The result of our investigation highlights a very serious problem in the current regulatory structure. It would appear that by using DISCO figures alone, an increase of substantially more than 3% could be shown to be "needed". On the other hand, by using NB Power's consolidated figures, the increase of 3% may or may not be needed depending upon what is determined to be reasonable operating costs and net earnings for GENCO and NUCLEARCO. Given that DISCO's rates this year have, in fact, been set using the consolidated figures for the NB Power Group, any future regulation of rates using DISCO only information would likely lack credibility.

Future hearings, under the current regulatory structure, would not be able to properly examine, in an open and transparent manner, all of the costs that customers in New Brunswick would be asked to pay.

The current regulatory structure does not match the actual operations of the NB Power Group of Companies resulting in significant impediments to effective and credible setting of electricity rates.

It has been made clear in this investigation that the NB Power Group of Companies operates as a single entity with respect to determining the rates for electricity in New Brunswick. As such, all of the relevant costs should be examined before rates are increased.

Future regulation would therefore be more effective and have more relevance for customers if GENCO and NUCLEARCO were regulated in the same manner as DISCO and TRANSCO.

MINISTER of ENERGY'S DIRECTIVE

On February 29, 2008, the New Brunswick Power Distribution and Customer Service Corporation (DISCO) notified the New Brunswick Energy and Utilities Board (the Board) that DISCO's Board of Directors had approved an across-the-board 3 percent rate increase, effective April 1, 2008, as permitted by the Electricity Act (the Act).

The Act allows DISCO to increase its rates without the approval of the Board as long as the increase does not exceed the greater of 3 percent or the percentage change in the average consumer price index. DISCO, in doing so, does not have to provide any information to the Board concerning the necessity of such an increase.

The Minister of Energy wrote to the Chair of the Board on March 5, 2008, directing the Board to make an investigation and report on a review of the forecast of the costs and revenues that DISCO used to support the necessity for an increase in rates.

PROCESS

This is the first time that such an investigation has occurred. The legislation provides no specific direction but allows the Board to establish the process that would be used. As part of the process the Board ordered:

1. The filing of information by DISCO;
2. The registration of interested participants;
3. The provision by DISCO of answers to written questions;
4. An examination of certain specific items by a consultant; and
5. A Public Hearing.

The Board panel for the public hearing was Raymond Gorman, Chairman; Cyril Johnston, Vice-Chairman; and members Edward McLean, Constance Morrison and Robert Radford. At the hearing on May 28, 2008, the following witnesses testified on behalf of DISCO:

- Angela Leaman, Finance Director for DISCO;
- Lori Clark, Managing Director of Finance for the New Brunswick Power Holding Corporation (HOLDCO); and
- Jeff Good, Finance Director for the New Brunswick Power Generation Corporation (GENCO).

The Board acknowledges the following participants for their valuable contributions during the review:

- Voice of Real Poverty Inc. (Real Poverty)
- Canadian Federation of Independent Business (CFIB)
- Canadian Manufacturers and Exporters Association (CME)
- Flakeboard Company Limited (Flakeboard)

- Gary Lawson (Lawson)
- J.D. Irving Pulp & Paper Group (JDI)
- Kurt Peacock (Peacock)

Not all of the concerns expressed by the participants fall directly within the scope of this investigation but the Board believes that they should be brought to the Minister's attention. A summary of their comments and recommendations is provided in Appendix A.

The Board retained the services of Mr. Andrew Logan, CA, of Teed Saunders Doyle, as a consultant to examine the following four specific items:

1. Forecasted Purchased Power Expense
2. Pt. Lepreau Refurbishment Deferral Account
3. PDVSA (Orimulsion) Settlement Deferral Account
4. Budget Process Review

Mr. Logan provided a report of his findings to the Board and copies were provided to DISCO and the participants in advance of the hearing. Mr. Logan attended the public hearing to answer questions on his report. No participant took issue with his report. The main conclusions of Mr. Logan's report are provided in Appendix B.

BOARD'S EXPECTATIONS

The Board was directed by the Minister of Energy to review the forecast of the costs and revenues that DISCO used to support the necessity for an increase of 3% in its rates on April 1, 2008.

The Board expected its investigation to be a reasonably straight-forward task as only a few months ago the Board had completed a detailed examination of DISCO's revenue requirement for 2007/2008. The Board expected to be in an excellent position to analyze DISCO's revenue requirement for 2008/2009 and determine if the April 1, 2008, increase had been necessary.

DISCO had previously applied for approval by the Board of changes to its rates for the 2006-2007 and 2007-2008 fiscal years. These applications were based on evidence specific to DISCO's forecast of its revenues and costs as well as comparable figures for prior years. Parties during those hearings argued that the costs of generation should be reviewed to determine whether they were fair and reasonable because they are the underlying costs that flowed through the power purchase agreements (the PPAs). However, the Act requires the Board to consider DISCO's forecast of costs and revenues and not the combined forecast of costs and revenues of HOLDCO. The Board could not therefore examine the costs or efficiencies of GENCO or the New Brunswick Power Nuclear Corporation (NUCLEARCO).

DISCO agued that the PPAs were developed by a team of experts and were designed to provide protection to the electricity customers in New Brunswick while providing a fair recovery of costs for GENCO and NUCLEARCO. DISCO said the PPA rules must be followed.

Mr. David Hay, President of HOLDCO, on November 26, 2007, testified:

> *And the attitude that we take is the rules are the rules. And we must live by those rules. And so we have filed on that basis for the distribution company in order to obtain the revenue requirement for DISCO."*

This position was supported by Ms. Sharon MacFarlane, Vice-President of Finance for HOLDCO, who on November 29, 2007, testified:

> *"But nonetheless we have the structure. We have the PPAs. They do have a certain set of principles behind them. And we do take the approach that those are the rules we are to live with.*
> *Any amendments that we have made to the PPAs, we have not in any way violated the objectives, the intent, the underlying structure."*

DISCO had also used a mechanistic approach to hedging whereby its cost for fuel and purchased power for the upcoming year was based on firm contracts. This maximized cost certainty and allowed DISCO to fix its revenue requirement for the upcoming year using a firm price for fuel and purchased power that was determined each year on October 1. The forecast for the fuel and purchased power expense for each of the 2006/2007 and 2007/2008 years was developed on the basis of the PPA rules and maximized cost certainty concerning the acquisition of fuel and purchased power.

The Board anticipated that for 2008/2009 DISCO would have followed the rules of the PPAs, continued to use a mechanistic approach to determine its costs for fuel and purchased power and then base its decision on DISCO specific information.

HOW DISCO ACTUALLY DECIDED ON THE 3% INCREASE

The investigation was considerably more challenging than what the Board had anticipated because DISCO based its decision to increase its rates by 3% on April 1, 2008, on the consolidated forecast of revenues and costs for the NB Power Group of Companies and not on its own forecast of revenues and costs. This caused the knowledge base and experience that the Board has built up relating to DISCO's finances to be much less useful.

In September, 2007, DISCO prepared a forecast of its fuel and purchased power expense for 2008/2009 in the normal manner. DISCO, however, did not rely on this forecast when deciding to implement the 3% rate increase on April 1, 2008. DISCO did not provide any details on this forecast as part of the information submitted to the Board in connection with this review.

The forecast for fuel and purchased power expense that DISCO actually used was the forecast that was used to develop the HOLDCO consolidated budget for 2008/2009, which was approved on December 12, 2007, by the HOLDCO Board of Directors. This forecast was developed in the fall of 2007 and differed significantly from the forecast prepared in September.

The difference was due primarily to two factors. The first was a reduction in the amount of energy that DISCO would require in 2008/2009. The second factor was a decision that more energy would be obtained by way of purchases and a consequent reduction in the amount of energy from in-province generation. In addition, in a marked departure from its policy of seeking cost certainty, HOLDCO made a decision to include purchases of energy for which no contracts existed at the time of preparing the forecast. This decision was based on the assumption that power purchases would be available at lower cost than if the power was produced by GENCO.

The result of lowering the amount of energy required together with increasing purchases of energy was a reduction of almost $100 million in the forecast of the fuel and purchased power expense. These adjustments are a significant departure from past practice as understood by the Board and will require amendments to the PPAs. Such amendments had not occurred at the time that the revised forecast was being developed.

The Board notes that the decision to make these adjustments for 2008/2009 occurred in the same period of time that a public hearing was taking place to consider an application by DISCO to increase its rates for 2007/2008. At that hearing, DISCO made statements, as noted above, about the need to follow the PPA rules.

Despite those statements, adjustments were made to the forecast of fuel and purchased power expense for 2008/2009 without making the appropriate amendments to the PPAs. Mr. Logan's report identifies that, at the HOLDCO consolidated level, the overall result of these adjustments was a reduction of $99.6 million for this expense for 2008/2009.

DISCO provided details on its revenue requirement for 2008/2009 but this information was based on the lower cost for fuel and purchased power that was used to develop the HOLDCO budget approved on December 12, 2007. This information shows that even with the 3% rate increase that occurred on April 1, 2008, DISCO is still forecasting a loss of $16 million for 2008/2009.

The reduction of $99.6 million referred to above would have been included in DISCO's forecast of fuel and purchased power expense for 2008/2009 had that expense been calculated in a manner consistent with previous years. This would have increased DISCO's forecasted loss for 2008/2009 to $115.6 million.

The Board believes that had DISCO developed its revenue requirement for 2008/2009 in a manner consistent with the way it did for 2006/2007 and 2007/2008 there is no doubt that such information would have supported the decision to increase rates by 3% on April 1, 2008, particularly in light of rising fuel costs.

DISCO, however, did not make such an application and further, in its response to written questions, stated that many of the details provided concerning its revenue requirement for 2008/2009 have "limited usefulness" in this review. This is because the decision to increase rates on April 1, 2008, was made on the basis of the combined NB Power financial results. DISCO further stated that the existing PPAs are inconsistent with the view of self-sustaining and "break-even", and will require change to support the self-sustaining view at an operating company level.

DISCO also said that given the current PPA structure, a three per cent rate would not provide sufficient net earnings for DISCO and that the 2008/2009 budget was based on the assumption that certain PPA changes would be made. The PPA legal wording changes are still under development and will be submitted to the appropriate NB Power Boards of Directors for approval once complete. DISCO did not provide any information on the details of the proposed changes to the PPAs or on the policy considerations that led to the need for such changes.

Given the above, the Board is unable to state conclusively whether or not there was a necessity for DISCO to increase its rates by 3% on April 1, 2008, based solely on an examination of the DISCO specific information. Adjustments were made, at the HOLDCO level, that lowered DISCO's costs for 2008/2009 by $99.6 million. It is certainly possible, given the way

DISCO's costs were determined, that further adjustments could have been made that would have resulted in a need for an increase of less than 3%.

The information on which the decision was made to increase DISCO's rates by 3% on April 1, 2008, was the consolidated budget information of HOLDCO. This information, as provided by DISCO, shows a surplus of revenues over expenses for 2008/2009 for HOLDCO of $69 million and an interest coverage ratio of 1.27 times. The Board notes that the 3% rate increase of April 1, 2008 will provide approximately $37 million in 2008/2009. HOLDCO therefore would have had a forecast surplus for 2008/2009 of $32 million without the April 1, 2008 increase.

Certain participants raised concerns, at the public hearing, that the forecasted surplus of $69 million was too high. The $69 million represents the operating results for DISCO, TRANSCO, GENCO and NUCLEARCO all taken together. To determine if the $69 million is reasonable, the Board would need to examine the operating costs and net earnings for each of the four companies.

The Board does review the operating costs and net earnings for DISCO and TRANSCO. However, the reasonableness of HOLDCO's financial results forecast is also dependent upon the reasonableness of the operating costs and net earnings for GENCO and NUCLEARCO. As discussed above, the Board does not regulate GENCO or NUCLEARCO and therefore has not previously examined their specific information. Further, there was no information on the reasonableness of the operating costs or the net earnings for either GENCO or NUCLEARCO in evidence as part of this review.

In order for the Board to properly determine what are reasonable costs of operations and net earnings for both GENCO and NUCLEARCO it would be necessary to hold a full public review. At such a hearing, GENCO, NUCLEARCO and other interested parties would provide evidence on the appropriate policies, operating costs, capital structure and return on equity. This information would be examined by the Board to determine if the companies were operating efficiently and if the proposed costs were prudent. The Board would also review the evidence on the appropriate capital structure and rate of return on equity in order to determine the proper level of net earnings.

Without such a review, it would not be appropriate for the Board to comment on the reasonableness of the operating costs and net earnings for GENCO and NUCLEARCO. The Board therefore cannot determine if there was a necessity for DISCO to implement its rate increase based upon the HOLDCO information.

The Board is therefore unable to determine if the 3% increase in DISCO's rates that occurred on April 1, 2008, was necessary. This is due to the fact that the decision to increase rates was done on the basis of HOLDCO's financial position and not based on the financial forecast for DISCO. To the extent that DISCO's financial outlook for 2008/2009 was in any way a factor, it must be noted that this information was developed based on the assumption that changes would be made to the PPAs.

At previous hearings, DISCO has argued that the PPAs are legally binding contracts and that it is obligated to pay the costs arising from those contracts. DISCO's purchased power expense is its single largest cost and is determined by the PPAs.

For 2008/2009 it has been established that assumptions were made regarding changes to the PPAs. The result of such adjustments to the way that DISCO would normally forecast its fuel and purchased power expense for 2008/2009 was a reduction of approximately $100 million.

IMPLICATIONS

As a result of the manner in which the decision was made to increase rates on April 1, 2008, the Board believes it is helpful to provide a brief history of the restructuring of NB Power.

Legislative changes occurred in the fall of 2004 that significantly altered the way the provision of electricity is regulated in New Brunswick. The New Brunswick Power Corporation had previously operated as a vertically integrated utility providing generation, transmission and distribution services.

On October 1, 2004, the New Brunswick Power Corporation was continued as HOLDCO. HOLDCO subsequently created GENCO, NUCLEARCO, TRANSCO and DISCO as legally separate operating corporations. HOLDCO and its four subsidiaries are referred to as the NB Power Group of Companies or the NB Power Group.

The assets and liabilities were distributed among the new corporations. The terms governing the provision of inter-company services were stipulated in a series of power purchase and service level agreements. DISCO and TRANSCO are subject to regulation by the Board but GENCO, NUCLEARCO and HOLDCO are not.

DISCO was the subsidiary created to provide distribution services to in-province customers. It is the only company legally able to increase rates for customers in New Brunswick.

At previous hearings, parties have expressed the view that assessing the reasonableness of a DISCO request for an increase in its rates was very difficult because, in their opinion, the NB Power Group of Companies operated as a vertically integrated utility. The Board, as a result of this investigation, concludes that the NB Power Group of Companies does, in fact, operate as a single vertically integrated utility as it did prior to restructuring. This conclusion is based on the fact that the April 1, 2008, 3% increase in rates was based on the financial outlook of HOLDCO and not on the financial outlook for DISCO.

The result of our investigation highlights a very serious problem in the current regulatory structure. It would appear that by using DISCO figures alone, an increase of substantially more than 3% could be shown to be "needed". On the other hand, by using NB Power's consolidated figures, the increase of 3% may or may not be needed depending upon what is determined to be reasonable operating costs and net earnings for GENCO and NUCLEARCO. Given that DISCO's rates this year have, in fact, been set using the consolidated figures for the NB Power Group, any future regulation of rates using DISCO only information would likely lack credibility.

This is because significant changes to DISCO's forecast of its cost for fuel and purchased power can occur at the discretion of HOLDCO. The fuel and purchased power expense represents over 80% of DISCO's costs and the forecast for this expense would be based on the forecast of operating costs and net earnings for GENCO and NUCLEARCO.

In order to determine if the cost for fuel and purchased power that customers in New Brunswick were being asked to pay was reasonable, it would be necessary to determine if the operating costs and net earnings of GENCO and NUCLEARCO are reasonable. In other words, it would be necessary to review the costs of generating the power that is sold to customers in New Brunswick.

However, the Board does not regulate GENCO or NUCLEARCO and therefore does not have the jurisdiction to review their costs. This means that, in future DISCO rate hearings, the Board would be presented with a forecast for a major expense item for DISCO and have no way to determine if that expense was reasonable. As a result, under the current regulatory structure, future hearings would not be able to properly examine, in an open and transparent manner, all of the costs that customers in New Brunswick would be asked to pay.

The corporate structure put in place for NB Power in 2004 anticipated significant changes in the energy market. Those changes have not taken place. There is a consensus of opinion that the current structure is not working. Mr. David Hay expressed this consensus clearly during his testimony on November 26, 2007, as follows:

> *"The structure is proving to be a difficult one. It was put in place in October 1, '04. And I'm sure everyone in the room would understand and agree with that statement. And there have been various statements by the government, that the government intends to look at the structure with the potential to make some modifications. To date there are no changes."*

CONCLUSION

The current regulatory structure does not match the actual operations of the NB Power Group of Companies resulting in significant impediments to effective and credible setting of electricity rates.

Regulation of electricity rates has posed challenges for all concerned. In some cases, there has been a considerable period of time between rate applications. The result is that a substantial amount of effort was required for the parties to become familiar with the situation that existed at the time of a particular application.

In addition, with the restructuring of NB Power, the scope of information that could be examined was limited to DISCO specific information. The costs of generation, that are responsible for over 80% of the cost of electricity, were not subject to any detailed review.

It has been made clear in this investigation that the NB Power Group of Companies operates as a single entity with respect to determining the rates for electricity in New Brunswick. As such, all of the relevant costs should be examined before rates are increased.

Future regulation would therefore be more effective and have more relevance for customers if GENCO and NUCLEARCO were regulated in the same manner as DISCO and TRANSCO.

Dated at the City of Saint John, New Brunswick this 26th Day of June, 2008.

Raymond Gorman, Q.C., Chairman

Cyril W. Johnston, Vice-Chairman

Edward McLean, Member

Constance Morrison, Member

Robert Radford, Member

APPENDIX A

Real Poverty:

1. The three per cent increase should not be enforced on low income people;
2. Provide a special electricity rate for low income people; and
3. The HST on electricity bills should be removed for low income people.

CFIB:

1. No rate increases be permitted when NB Power posts a profit or forecasts a surplus;
2. Increase accountability on rate increases by having all rate recommendations examined through public hearings;
3. Introduce a reasonable time frame for bringing all rate classes within the 0.95 to 1.05 revenue cost ratio; and
4. Provide permanent representation for small business at energy rate hearings through a small business advocate.

Flakeboard:

1. A formal benchmarking study be filed annually with the Board to allow ratepayers to understand how well NB Power is performing in relation to its peers; and
2. That further investigation be undertaken to investigate longer range purchase contracts for energy that would replace higher cost NB Power generation.

Lawson:

1. The 3 percent threshold for a rate increase without a hearing is a significant amount of money for people living in poverty and the large industrial customers and large customers;
2. It appears that the only direction from Government for NB Power was to break even; and
3. Full disclosure of all of NB Power's information that the rate increase was based upon may signal an opportunity to review the substantial costs associated with NUCLEARCO and its refurbishment.

JDI:

1. Annual costs resulting from the Pt. Lepreau deferral account and additional amortization would increase the revenue requirement by an additional $55 million plus interest on the new debt;
2. Change the budget process and only finalize the budget two months before year-end;
3. A cost allocation hearing is necessary due to changes in the load factor;
4. Current budget earnings should not exceed $53 million; and
5. NB Power provide quarterly consolidated financial reports on a timely basis.

APPENDIX B

1. A second forecast for the fuel and purchased power expense was done in the fall of 2007. This was done in addition to the forecast done in September and would not have occurred in the normal course of events. In preparing the second forecast, NB Power made a decision to include non-firm external purchases of energy which was also a departure from past practice.

2. The fuel and purchased power forecast contained in the consolidated financial statements appears reasonable.

3. NB Power has complied with the intent of the Act concerning the Pt. Lepreau Refurbishment Deferral Account.

4. Adjustments to the PDVSA Settlement Deferral Account generate an additional income of $1.9 million for 2008/2009.