

1 Q. If “cost of service” (“COS”) pricing were applied in determining the power purchase
2 price, what would be the power purchase price paid by Hydro to Nalcor for Muskrat
3 Falls power and energy in the first full calendar year of supply?
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6 A. Nalcor has prepared an annual cost of service model in response to the question
7 posed. The financial parameters in this model were set to provide an internal rate
8 of return of 8.4% for the Muskrat Falls investment. On this basis, the cost of service
9 in year 1 would be \$214 /MWh declining with each year thereafter as the Island
10 sales base grows and the return on rate base declines.
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12 Nalcor notes that a cost of service pricing model will not be applied to determine
13 the power purchase price to be paid by Hydro and therefore the price provided
14 above is unrelated to the price of energy to be charged by Nalcor. As indicated in
15 Exhibit 36, a cost of service model has the following disadvantages:
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- 17 a) the revenue paid by ratepayers for Muskrat Falls is highest in the first year
18 (that is, when the undepreciated cost of the asset is at its maximum), and
19 declines thereafter, and
20 b) equity investors earn their regulated return each year; this return (in dollars)
21 is also highest in the first year.
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23 While the Island’s energy requirements increase over time in line with economic
24 growth, the early-year COS rate for MF power would be a significant burden for
25 ratepayers in those years, as the required COS revenue for MF would be at its
26 maximum and the power required by ratepayers would be at a minimum.

1 For these reasons, an alternative approach to MF power pricing was developed
2 which affords a number of advantages for ratepayers.

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4 An “escalating supply price” (that is, the price per MWh of power actually used by
5 ratepayers, expressed in real dollars subject to escalation at CPI) has been
6 established to recover all costs – operating costs over time, debt service costs for
7 the debt portion (as applicable) of the capital investment, and an equity return on
8 the equity portion of the capital investment at a defined Internal rate of Return
9 (“IRR”) over the life of the project.

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11 This escalating supply price is lower than would be indicated initially by the COS
12 framework. It escalates evenly over time, and is applied only to power actually used
13 by ratepayers – the early-year burden placed on ratepayers at that time is
14 minimized.

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16 Given the advantages of the escalating approach, Nalcor has selected it as the
17 pricing model to be used for the supply of Muskrat Falls energy to the Island.