

ACCOUNTING CONVENTIONS

1 In decision D-2003-93, the Régie accepts the main accounting conventions used
2 by the Distributor in the calculation of the costs of distribution, subject to certain
3 provisions, as these conventions are either in conformity with the GAAP, or with
4 the practices and methods generally recognized by regulators.

5

6 Section 1 is an overview of the ten accounting conventions accepted by the Régie.
7 Section 2 answers the inquiries of the Régie, which will allow the Régie to make a
8 decision on some outstanding accounting convention elements.

9

10 **1. MAIN ACCOUNTING CONVENTIONS**

11

12 **Capital Assets**

13 The capital assets are entered into the accounts at cost. This cost consists
14 essentially of materials, manpower and other expenses that directly contribute to
15 construction activities. It also includes the capitalized loan expenses during the
16 project's construction period. The cost of the capital assets in progress is then
17 transferred to the rate base when the facilities are put in service. Capital assets are
18 amortized using compound interest at a rate of 3%, except for materials used in
19 construction, operation and research, which are amortized according to straight
20 line depreciation.

21

22 The Régie accepts the Distributor's proposal to not include in the rate base the
23 cost of projects under construction, but rather at the time when the project comes
24 on line. In doing so, the Régie recognizes that the customer will have to support

1 the cost of these assets by the means of the rates only when these assets are able
2 to derive revenue from exploitation .

3

4 **Major Abandoned Projects**

5 The expenses incurred in the capital assets investment projects are periodically re-
6 evaluated. These costs are allocated to capital assets as long as they represent a
7 future benefit for the company. When they no longer present any future benefit,
8 they are transferred to losses.

9

10 At the time the major project is abandoned, the costs that are considered
11 irretrievable are deferred and written off over a period of 3 years according to the
12 linear method of depreciation, subject to Régie's decision, which are made on a
13 case by case basis.

14

15 **Deferred Expenses**

16 The expenses incurred as part of research and development activities are charged
17 to the financial year unless certain criteria are respected, in which case they are
18 deferred and written off over a period of 5 years, according to the linear
19 depreciation method.

20

21 The expenses related to commercial programs are amortized over a period not
22 exceeding 5 years, according to the linear depreciation method.

23

24 The cost of the reduction and renewal of manpower measures is deferred and
25 written off over a period of 5 years, according to the linear depreciation method,
26 as per the government of Quebec's decree 1626-96.

1 **Governmental Reimbursement Relating To the Ice Storm of 1998**

2 Refunds related to emergency measures obtained in 2001 are entered as a
3 reduction of operating costs and purchases of electricity for 1998 and 1999.

4
5 The reimbursement pertaining to network restoration in its initial state before the
6 disaster, paid in annual portions from 1998 to 2007, is entered into the account
7 over the remaining useful life span of the replaced assets. The equivalent
8 reimbursement at the non-amortized cost of withdrawn assets following the ice
9 storm is amortized over 10 years, using a compound interest rate of 3%.

10
11 The reimbursement pertaining to the annual financing linked to network
12 restoration is entered into the books in the financial year as a reduction in
13 financial expenses.

14
15 **Materials, Fuel and Supplies**

16 Materials, fuel and supplies are entered into the books at the least cost of the
17 average cost or the net construction value and also include a provision for
18 discontinued materials which is established and reviewed regularly.

19
20 **Long Term Debt**

21 Long term debt is entered into the books at face value, except for those
22 obligations with a zero coupon or a large expected discount/premium which are
23 entered into the books at their discounted value, and the rebates, premiums and
24 issuing costs which are deferred and amortized using the linear method over the
25 duration of the loans.

1

2 The amortization of the discount/premium is done using the real interest method.

3

4 **Foreign Currency Exchange and Currency Swaps**

5 The proceeds or expenses denominated in foreign currencies are converted into
6 Canadian dollars at the time of the transactions. The monetary elements of the
7 assets and liabilities are converted at the closing rate as of the date of the
8 statements. The non-monetary details are converted at the time of the transactions.

9

10 **Interest Rate SWAPS**

11 The interest rate SWAPS are brought closer to the interest expense pertaining to
12 the borrowings to which they are attached.

13

14 **Expenses Related To Guaranteed Loans**

15 Under the terms of the *Act on guarantee expenses pertaining to the loans of*
16 *government organizations*, Hydro Quebec provides the Quebec Minister of
17 Finance a guarantee fee equal to 0.5% of the balance, as of December 31 of the
18 previous exercise, of the loans guaranteed by the government of Quebec.

19

20 **Taxes**

21 The tax on the capital is calculated based on the method prescribed by the *Income*
22 *Tax Act*. Hydro Quebec facilities used for production, transportation and
23 distribution of electricity are not subjected to municipal taxes. In return, a 3%
24 gross revenue tax takes the place of property taxes, which is applicable to the

1 electricity revenues in Quebec from which one subtracts the purchases of
 2 electricity in Quebec.

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4 **2. CAPITALIZATION OF THE FINANCIAL EXPENSES AT THE RATE**
 5 **OF THE COST OF CAPITAL**

6 In order to allow the Régie to reach a conclusion on the appropriate method, the
 7 Régie requires the Distributor to provide additional information on the
 8 capitalization of the financial expenses to capital assets under construction,
 9 including a comparison of the expenses capitalized according to the prospective
 10 rate and the average rate of the cost of capital

11

12 In this respect, the Distributor provides the following information:

	Simulation of the capitalized loan expenses (in M \$)			
	Exercise finished December 31			
	Historic years		Base year	Forecasted year
	2001	2002	2003	2004
Capital Costs				
Future rate	7.308%	7.342%	6.685%	7.061%
Average rate	9.790%	9.093%	8.390%	8.161%
Capitalized financial expense				
According to the prospective rate	4.7	7.9	6.7	14.6
According to average rate	6.3	9.8	8.5	16.8
% Differential between methods	-1.6	-1.9	-1.8	-2.2

13

1 **Comments on the Choice of a method**

2 The Distributor proposes the method of the average rate of the cost of capital to
3 capitalize the financial expense related to its fixed assets, and justifies its proposal
4 as follows:

- 5 • The method of the average rate of the cost of capital is in conformity with
6 the generally accepted accounting principles. Canadian accounting
7 standards permit the capitalization of a provision for the funds used
8 during the construction of tangible fixed assets relating to activities that
9 are subjected to regulated rates, when authorized by a regulatory
10 organization. It is also in keeping with the accounting principles
11 applicable to companies regulated on a cost of service basis;
- 12 • This method is also in conformity with the authorized principles used by
13 other regulatory organizations. Notably, in paragraph 3.17 the regulations
14 of the Federal Energy Regulatory Commission (FERC), present a formula
15 for computation applicable to Regulated Energy transmission companies
16 in the United States, whose application is comparable to the approach
17 recommended by the Distributor.
- 18 • The proposed method is in conformity and agreement with the method
19 used by the Transmission operator, which has been accepted by the Régie
20 in decision D-2002-95. According to the Régie, this rate is neutral, as to
21 the option to include or exclude the capital assets under construction in
22 the rate base. In fact, the capitalization of financial expenses at the
23 average rate of capital cost is equivalent to the treatment of the additions
24 when they are included in the rate base as soon as construction begins. It
25 then permits to enter into the accounts of capital assets under construction
26 that will be part of future rate base when put into service, the

1 return on the shareholders' equity that is used to finance these investments.

2 • Furthermore, in decision D-2002-95, the Régie allowed for the possibility
3 of a different treatment, making it possible to include certain important
4 capital assets under construction in the rate base that could otherwise
5 cause a rate shock at the time of implementation. This possibility
6 reinforces the importance to use a method that ensures rate neutrality
7 between the inclusion and the exclusion of the capital assets under
8 construction in the rate base.

9 • The “weighted average rate of debt” component included in the average
10 rate of capital cost, takes into account both the cost of the historic debt and
11 the cost of the new debt. It appears that the method suggested by the
12 Distributor already includes a future cost for the financing that
13 corresponds to the new debt.

14 • It is simple to understand and easy to verify and apply.

15 On the other hand, the Distributor opposes the use of the proposed method based
16 on the future rate of the cost of capital for the following reasons:

17 • The use of a future rate of the cost of capital is not in keeping with the
18 approach used by Hydro Quebec with regards to its financing activities.
19 Let us recall that Hydro Quebec uses an integrated approach with regards
20 to its financing activities, which implies that the debt issues of Hydro
21 Quebec are not specifically attributed to the Distributor. Furthermore,
22 Hydro Quebec doesn't match its borrowings with specific assets but rather
23 proceeds with an integrated debt management approach.

- 1 • This method assumes that the capital assets under construction are
2 financed 100% with external financing, whereas the financing of a portion
3 of these costs comes from the equity of the corporation.

4
5 In other respects, the Distributor points out that the majority of its investment
6 projects are completed in less than one year and that very few projects are the
7 subject of a capitalization of financial expenses. Thus, the difference between one
8 or the other method as observed for the years 2001 to 2004 is at most \$2.2 M, a
9 level not having any significant effect on the Distributor's required revenues and
10 on the return that it requests on its rate base. It is necessary to note that the
11 differences currently observed between the two methods are of a specific nature
12 and that on a continuous horizon, would be reversed (when the tendency is for
13 interest rates to rise) and even cancelled, according to economic and business
14 trends.

15
16 For all these reasons, the Distributor therefore asks the Régie to accept the
17 capitalization of the financial expenses applicable to the capital assets under
18 construction according to average rate of the cost of capital of the rate base and to
19 make this accounting convention applicable, from January 1st, 2003.