RÉPONSES D'HYDRO-QUÉBEC DISTRIBUTION À LA DEMANDE DE RENSEIGNEMENTS N° 2 DE L'AQCIE-CIFQ

DEMANDE DE RENSEIGNEMENTS DE L'ASSOCIATION QUÉBÉCOISE DES CONSOMMATEURS INDUSTRIELS D'ÉLECTRICITÉ (AQCIE) ET DU CONSEIL DE L'INDUSTRIE FORESTIÈRE DU QUÉBEC (CIFQ) DANS LE CADRE DE LA DEMANDE DU DISTRIBUTEUR RELATIVE À L'ÉTABLISSEMENT DES TARIFS D'ÉLECTRICITÉ POUR L'ANNÉE TARIFAIRE 2015-2016

Information Requests directed to Hydro Quebec R-3905-2014, HQD-3 English Translation

First Topic: Financing Principles

Reference: Company evidence page 5-7

Preamble:

The company discusses two main types of variance and deferral accounts

1.1 Does HQD accept the general principle of the fair rate of return on common equity as enunciated by the Supreme Court of Canada that adopted Mr. Justice Lamont's definition:

> "that the company will be allowed as large a return on the capital invested in the enterprise as it would receive if it were investing the same amount in other securities possessing an attractiveness, stability and certainty equal to that of the company's enterprise."

Réponse de Concentric :

Yes. However, when investing in the securities of a regulated utility, the return earned by the investor is a function of the company's full range of business activities. The investor, as suggested by Justice Lamont, is investing in the enterprise.

1.2 Does HQD accept that using the weighted average cost of capital for variance and deferral accounts includes both the deemed common equity ratio and fair ROE as set by the Regie, consistent with the above definition?

Réponse de Concentric :

Yes. Concentric accepts that the weighted average cost of capital (WACC) incorporates the risk of the enterprise by weighting the respective required returns on debt and equity in accordance with the Company's deemed capital structure. However, Concentric disagrees that investors consider the riskiness of certain accounts within the company. The risks associated with the deferral and variance accounts (DVA) are exposed to the same risks of cost recovery as the rest of Hydro-Québec's rate base.

1.3 Does HQD accept that "attractiveness, stability and certainty" essentially means the underlying business risk of the regulated entity? If not why not?

Réponse de Concentric :

Yes. Concentric agrees that "attractiveness, stability and certainty" equates to underlying business risk of the regulated entity.

1.4 Would HQD accept that business risk is normally defined as having a short run and a long run dimension with short run being the return on capital, that is, the ability to earn the allowed ROE, and long run being the return of capital, that is, the risk of stranded assets?

Réponse de Concentric :

Hydro-Québec Distribution and Concentric accept that business risk is often defined as having a short run and long run dimension, but disagree that the "short run risk" deals exclusively with "return on capital" and that "long run risk" deals exclusively with "return of capital" or the risk of stranded assets. Concentric finds that both risks deal with the "return on" and "return of" capital, but short run risks are expected to resolve satisfactorily within a year or two whereby the satisfactory resolution for long run risks may be uncertain and prolonged.

1.5 In terms of the maturity of financing would HQD also accept the matching principle that long run assets should generally be financed with long run financing, such as long term debt? If not please explain in detail why not?

Réponse de Concentric :

Concentric agrees that it is generally advisable to match the financing term to the life of the asset being financed. This is so the financing costs can be offset by the revenue stream generated by the asset. However, in utility regulation for rate setting purposes, utility assets are assumed to be financed in accordance with a deemed capital structure, i.e. a percentage allocation of debt, preferred equity and common equity. This simplifying assumption is generally applied to all capital assets financed by the utility such that the regulator (or the utility) is not required to specifically identify the individual financing costs associated with each asset.

It may also be assumed that deferred expenditures classified in DVA are often the result of unplanned and uncontrollable variances that are not reflected in utility rates until such time as recovery is allowed. In these cases, it is

arguably the equity in the utility operation that is financing such increased expenditures, unless the expenditures are of a magnitude to require special financing. If the expenditures were of a magnitude to require incremental financing, the costs of that financing would be reflected in the subsequent calculation of the WACC.

It is assumed for regulatory purposes that all assets are financed with the WACC and in doing so, there is an assumption that a portion of those assets will be shorter term in nature. Even long lived assets earn the WACC which attributes the entire range of debt costs in excess of one year. It is assumed when establishing rates that all prudently acquired assets will be financed in accordance with the deemed capital structure and will earn the allowed rate of return. If a greater portion of assets were financed with debt of a shorter duration, the WACC would incorporate a greater portion of shorter term debt into its calculation. To incorporate such shorter term debt costs into the WACC as Hydro-Québec does in its integrated debt cost, and then attribute a return other than the WACC for specific asset financing, denies the investor a reasonable opportunity to earn its allowed return.

1.6 Please provide the average depreciation rate for HQD's physical plant and equipment and the associated estimated useful life for the 2015 test year.

Réponse :

Les durées moyennes d'amortissement des immobilisations en exploitation mises en services en 2015 sont les suivantes :

- **équipements de mesurage : 15 ans ;**
- **postes de distribution : 16 ans ;**
- **lignes aériennes de distribution : 40 ans ;**
- **lignes souterraines de distribution : 33 ans ;**
- **réseaux autonomes : entre 5 et 47 ans ;**
- **autres actifs de réseau : entre 31 et 43 ans ;**
- **actifs de soutien : entre 5 et 34 ans.**

1.7 Please provide the value weighted average maturity of HQD's debt outstanding as of the end of fiscal 2013 and the forecast for the 2015 test year.

Réponse :

À la fin de l'année 2013, la durée de vie moyenne de la dette d'Hydro-Québec était de 19 ans. À la fin de l'année 2015, celle-ci sera de 18 ans.

1.8 Please confirm that the first deferral account as defined on page 3 "normally" should balance out to zero, but due to the exceptional nature of the current balance it will be amortised over five years.

Réponse :

Le Distributeur comprend que l'intervenant fait référence au compte de *pass-on*. Il confirme donc que, compte tenu de l'importance des montants en cause, il propose de modifier de façon ponctuelle les modalités de disposition des soldes du compte de *pass-on* 2013 et 2014, de façon à les répartir sur cinq ans à compter de 2016 plutôt que d'en disposer intégralement dans les revenus requis de 2015 selon les modalités reconnues actuellement en vigueur.

1.9 Please explain in detail how financing a five year receivable with long term debt of the maturity given in 1.7 above satisfies the matching principle.

Réponse de Concentric :

The embedded debt cost reflected in the WACC includes the weighted average cost of all outstanding debt with maturities of greater than one year. Accordingly, the proportion of shorter term debt reflected in Hydro-Québec Distribution's WACC reflects the integrated financing it received from its parent. As indicated in the response to question 1.5 above, to assign recovery of a shorter term debt cost or medium term debt cost to an asset financed by utility investors deprives investors of a reasonable opportunity to earn their allowed return. Rate of return regulation assumes that every dollar of capital investment is financed in accordance with the firm's capital structure at the associated weighted average costs. The debt costs reflected in the WACC incorporates the embedded debt costs from a wide spectrum of debt maturities, including lower rates for shorter term financing. Applying the WACC to long term financing may incorporate a lower debt rate (since it includes shorter term maturities) than the costs actually incurred to finance a long term asset. To disregard the WACC for certain financing but to apply it for others undermines the overall regulatory financing assumptions upon which investors are compensated and denies investors a reasonable return on the capital they invested.

1.10 Please discuss in detail whether the five year deferral has an attractiveness, stability and certainty equal to the company's enterprise that is its physical plant and equipment.

Réponse de Concentric :

Yes. The five year deferral is integral to the risk of the utility, and accordingly should have the same attractiveness, stability and certainty equal to that of the enterprise. Investors in the enterprise are financing all of the utility's activities, short, mid, and long-term. The deemed capitals structure is designed to approximate how the utility is actually financed (or how the regulator wants to see the utility financed.). Within the utility's range of investments, are those of varying asset lives and risks. To pick and choose assets presumed to be of lower risk and suggest they had been financed with lower-cost shorter-term debt ignores the assets at the other end of the spectrum that are financed with longer term higher cost debt, but still earn only the WACC. A deemed capital structure and WACC is designed to compensate the utility and investors for the complete basket of risks across all capital assets in rate base.

The risk to the utility is very much impacted by the existence of large deferral balances. The account is integral to the utility and the risk it creates, i.e. the lag between investment and recovery is factored into the required return by investors. Deferral accounts impose greater risk on the utility by introducing an uncertain recovery period which must be reflected in the WACC. The resulting regulatory lag and the potential risk of non-recoverability is routinely monitored and evaluated by debt rating agencies as well as equity investors.

Second Topic: Specific regulatory decisions

Reference: Company Evidence, pages 7-15

Preamble:

The Company discusses various regulatory decisions awarding costs to accounts that HQD regards as comparable

2.1 For the ATCO Gas LBA please provide the average balances presented to the AUC when it rendered its 2013 decision, where ATCO Gas stated that the balance could be carried for several years.

Réponse de Concentric :

According to Schedule 9 of ATCO Gas's Annual Filing, the balance in the Load Balancing Deferral Account was $7.146 million as of December 31, 2013.

2.2 Please confirm that the AUC review is still outstanding, but that the key criteria were materiality of the account and its term (outstanding).

Réponse de Concentric :

Not confirmed. The AUC issued its decision on this matter on September 17, 2014 (Decision 2014-268). In its final Decision, the AUC recalled the following suggested criteria for evaluating the use of a deferral account :

- **Materiality of the forecast amount.**
- **Uncertainty regarding the accuracy and ability to forecast the amount.**
- **Whether or not the factors affecting the forecast are beyond the utility's control.**
- **Whether or not the utility is typically at risk with respect to the forecast amount.**
- **The deferral account should provide a degree of protection to both the company and the customers from circumstances beyond their control, symmetry must exist between the costs and benefits for the both the company and its customers.**
- **Should be applied in a consistent and fair manner in both test years and non-test years.**

The AUC has continued to allow ATCO Gas to earn the WACC on its unamortized LBDA balances. The utility was also instructed to provide further analysis, with respect to LBDA monthly activity, balance reversals, carrying charges, and any associated capital recovery risks in its next Rider L Application.

2.3 Please compare the materiality of the ATCO Gas LBA with the HQD requested deferral account (% of rate base over the five year period)

Réponse de Concentric :

As of December 31, 2013, ATCO Gas's Load Balancing Deferral Account of $7.146 million, represented 0.4 % of mid-year 2013 rate base of $1,860.3 million.

In Hydro-Québec Distribution's present Application, the balance of deferral and variance accounts is around $ 359.3 million and rate base is $1 0,729.8 million, such that the DVA balance represents 3.3 % of rate base.

2.4 For the NB Power rate discussed on page 11 please indicate the time period (and estimated term) of the nuclear refurbishment account referred to and discuss whether this has more similarities with a standard allowance for funds used during construction (AFUDC) account than the deferral accounts discussed on page 3.

Réponse de Concentric :

Per the Board's Order in that proceeding, the deferral account balance of $1.036 billion will be recovered over the operating life of the refurbished Point Lepreau nuclear generation station (27 years). The refurbishment period extended from March 2008 to November 2013. The regulatory treatment of the refurbishment costs appears to be the result of several factors that are balanced to arrive at the allowed treatment. Concentric agrees that because of the magnitude of the deferral and the duration of both the refurbishment and the recovery period over the life of the asset, that the financing and associated costs would tend towards longer term, higher cost debt and equity similar to an Allowance for Funds Used During Construction (AFUDC) rate earned on significant Capex. However, because the refurbished costs are not planned to be included in rate base, it is actually very different from AFUDC, since AFUDC costs are capitalized (earn a return) and are depreciated over the life of the asset. The carrying charges allowed by the NB EUB for Point Lepreau will not be capitalized.

The recovery proposed for the Point Lepreau is recovery of capital with a debt return only. The Board found this treatment appropriate since NB Power did not have equity in its capital structure or an allowed equity return. The Board noted that the carrying cost methodology may be reviewed in the future as NB Power begins to build equity to the newly-legislated minimum level of 20 %, and its cost of equity could reasonably be calculated.

2.5 Please indicate whether HQD is aware that the Toll Stabilisation Account (TSA) was established by the NEB so that the TransCanada Mainline could charge rates less than its cost of service due to persistent load losses. Further can HQD confirm that the Mainline argued that the recovery of the balance in the TSA was highly uncertain and contingent on a recovery of its throughput?

Réponse de Concentric :

Concentric and Hydro-Québec Distribution are aware that the TSA was established by the NEB to capture revenue and cost variances due to the Board's setting of Mainline tolls for 2014 through 2017 below the Mainline's cost of service. Concentric is also aware that the uncertainty associated with recovery based on throughput was one aspect of the Mainline's argument.

Third Topic: HQD's Position

Reference: Company Evidence pages 15-19

Preamble: The company lays out its positon justifying the use of the cost of capital for its deferral accounts

3.1 Please confirm that whenever a regulated entity finances an asset currently not included in rate base then its common equity ratio may deviate from that deemed for assets in the rate base. How much it deviates depends on how the asset is financed.

Réponse de Concentric :

Agreed. The equity ratio will diverge from the deemed equity ratio when incremental debt or new equity financing is arranged for the increase in assets out of rate base. The amount of change would depend on the amount of the financing.

3.2 Please confirm that deemed common equity ratios, such as HQD's 35% ratio, are based on underlying business risk, not short term issues.

Réponse de Concentric :

The deemed common equity ratio is based on underlying business risk, both short and long-term. Business risk reflects the aggregate of all factors impacting the firm and cannot be segregated to exclusively pertain to long term risks.

3.3 Please confirm that HQD's funded debt ratio would stay at 65% were it to finance short term deferrals with commercial paper at the rate set by the Ontario Energy Board for similar variance accounts.

Réponse de Concentric :

Concentric confirms that commercial paper is not reflected in the deemed debt ratio of 65 %. This incremental financing, however, may impact outstanding debt, and therefore Concentric cannot conclude that the debt ratio would stay at 65 %.

3.4 Please provide any excerpt from any bond indenture or rating agency reports that indicate that HQD's ability to issue long term debt would be adversely affected by financing a short term deferral with unfunded short term debt.

Réponse :

Le Distributeur ne comprend pas la question.

3.5 Please discuss whether HQD has considered securitising or factoring its short term variance/deferral accounts and if not why not.

Réponse :

Hydro-Québec n'a pas envisagé d'effectuer une « securitisation » de ses comptes d'écarts et de report.