DEMANDE DE RENSEIGNEMENTS D'HYDRO-QUÉBEC DISTRIBUTION À AQCIE-CIFQ

DEMANDE DE RENSEIGNEMENT N° 1 DU DISTRIBUTEUR À AQCIE-CIFQ RELATIVE À L'ÉTABLISSEMENT DES TARIFS D'ÉLECTRICITÉ 2015-2016

QUESTIONS DU DR. COYNE AU DR. BOOTH

1. **Preamble :**
   C-AQCIE-CIFQ-0021
   Dr. Booth Testimony, p. 3

   "By convention most Canadian regulators allow debt investors their embedded cost and then determine a fair ROE (Return on Equity) to the stock holders taking into account any financing risk imposed by the debt. The National Energy Board was an exception to this general principle in its TQM decision (RH-1-2008) where it allowed an overall after tax weighted average cost of capital of 6.4% and left the financing of its rate base to TQM. In footnote 38 to that decision the NEB noted that its award amounted to a 9.7% ROE on a 40% common equity ratio, an 11.2% ROE on a 32% common equity ratio or an 8.46% ROE on a 50.5% common equity ratio.

   The important implication of the NEB's decision is to confirm that a regulator can award an overall return on capital or divide the financing up into "slices" and then award a fair rate of return on the different slices."

   a. **Please confirm that the NEB, in its TQM Decision RH-1-2008, allowed an ATWACC on rate base for TQM, and made no attempt to distinguish between long and short-term asset lives and their associated risks.**

   b. **Please confirm that footnote 38 in the NEB Decision was necessary because the NEB indeed did <u>not</u> divide the financing up into slices by establishing a capital structure, or the respective returns for each component, but rather established a single cost of capital to be used for determination of return on rate base?**

2. **Preamble**
   C-AQCIE-CIFQ-0021
   Booth Testimony, p. 4

   "However, there is no logical reason why the debt financing slice cannot be further divided into long term debt and short term debt. Indeed the major utilities in Ontario, for example, routinely finance with short term debt and recover that financing cost separately from long term debt. There is no reason therefore why the Regie cannot

allow HQD a short term debt component to finance a deferral account, as well as long term debt and common equity components to finance the normal rate base."

a. Does Dr. Booth confirm that in corporate finance and accounting, short-term applies to balances outstanding for less than one year, and long-term applies to balances outstanding for greater than one year? If not, why not?

b. Would Dr. Booth agree that the debt cost included in HQD's weighted average cost of capital already incorporates an estimate of financing costs for the upcoming year, including that which is necessary to fund the known cash shortfall associated with deferral of operating expenses beyond one year? If not, why not?

3. Preamble :
C-AQCIE-CIFQ-0021
Booth Testimony, p. 4

"As a result, the utility claims it still needs the 10% return allowed its original assets, regardless of the lower risk and lower fair return on its new asset. In this instance I think it is obvious to anyone that the above arguments are false and that consistent with the opportunity cost principle the regulator has to allow a fair return consistent with the lower risk of the newly acquired assets."

a. Is it Dr. Booth's understanding that HQD's weighted average cost of debt incorporates all outstanding long-term debt maturities, some of which may be outstanding for one to five years? If not, why not?

b. Would Dr. Booth accept that HQD's weighted average debt might also include longer- term debt financed at rates higher than that reflected in HQD's average cost of debt? If not, why not.

c. Does Dr. Booth believe HQD should propose a separate and higher cost of capital for long-lived assets? Please explain.

d. Does Dr. Booth believe that the risk of a variance account balance that is recovered through rates in 1 year possesses the same risk as a variance account balance that is recovered over 5 years or longer? Please explain.

e. **Would Dr. Booth confirm that all else being equal, increased regulatory lag results in increased business risk? If not, why not.**

4. **Preamble :**
   C-AQCIE-CIFQ-0021
   Dr. Booth Testimony, p. 5

“For the $380 million deferral account I would suggest the Régie think of this in terms of a newly acquired asset as in the prior example. Existing assets earn the normal WACC, but by definition this is a special or unusual deferral account, since it does not zero out in the normal way. As a result HQD can now be considered as a combination of its normal rate base earning the WACC and this newly acquired asset. The Régie can then either lower the overall WACC of this new entity, since HQD’s risk is now marginally lower, or simply allow a fair return on this new $380 million acquired asset that reflects its “attractiveness, stability and certainty.”

a. **Does Dr. Booth agree that the utility shareholder is already assured recovery of variances due to weather and power since the time these accounts were originally established, and that these accounts are indeed not “new”? If not, why not?**

b. **Would Dr. Booth agree that the risk reducing attributes of deferral and variance accounts are factored into the Régie’s determination of a just and reasonable equity return for HQD?**

c. **Would Dr. Booth agree that ratings agencies recognize deferral and variance accounts as supportive of credit quality and consider such accounts favorably in making ratings determinations, which could result in lower debt costs? If not, why not?**

5. **Preamble :**
   C-AQCIE-CIFQ-0021
   Dr. Booth Testimony, pp. 9 – 10

“I mention these business risk excerpts to emphasise the difference in the risk assessment of the overall company over an indefinite future to the risk involved in recovering unexpected expenses in a short term deferral account. It is these overall risks that are reflected in the utility’s deemed common equity ratio, fair ROE and weighted average cost of capital. As HQD and Concentric agree when asked whether they accept Mr. Justice Lamont’s definition of a fair return they state (ACQCIE-CIFQ IR # 1.2), that

> *"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."*[9]

In my judgment the WACC, as confirmed by HQ and Concentric, reflects all the risks that a utility is faced with. In contrast, a short term deferral account does not reflect these enterprise risks. As such, the use of the WACC as a return on a deferral account is not generally acceptable.

a. **Would Dr. Booth agree when he states that "the WACC reflects all the risks that a utility is faced with", that this includes the risk-reducing properties of deferral and variance accounts?**

b. **Could Dr. Booth explain how recovery of deferral account balances through amortization differs from recovery of a 5-year capital investment through normal depreciation practices?**

6. **Preamble :**
C-AQCIE-CIFQ-0021
Dr. Booth Testimony, p. 11

"In ACQCIE-CIFQ-IR 1.6 HQD was asked to provide the average useful life of its major equipment classes and except for measuring equipment and distribution posts these ran out to 33 to 40 years. In answer to ACQCIE-CIFQ 1.7 HQD then estimated the weighted average life of its debt as 18-19 years. Consistent with the matching principle HQD has funded long term assets with long term debt. Further on its web page HQ states as part of its financing strategy

"Plan bond issuance-in particular, series maturing in 2035, 2040, 2045, and 2055- in order to increase market liquidity.

-these long term bonds are in line with the service life of our property, plant and equipment."

a. **Would Dr. Booth accept that there is shorter term debt in HQD's debt portfolio to bring the average debt maturity down to 18 or 19 years compared to the average life of rate base assets (approximately 27 years)? If not, why not?**

7. **Preamble :**
   C-AQCIE-CIFQ-0021
   Dr. Booth Testimony, pp. 16-17

"In the same light the New Brunswick Power deferral account referred to by the company (HQD-3 Document 3, page 11) and (ACQCIE-CIFQ IR 2.4) refers to a $1.036 billion recovery incurred over a six year period from 2008-2013 that extends the useful life of the Point LePreu nuclear power plant. I would have thought it obvious that such expenditures bear the same risk as the business risk of the nuclear plant and would have recommended the utility cost of capital and not a BA +0.25% rate.[18]

[18] Note the NB EUB allowed the recovery of a debt return, since it is a publicly owned."

   a. **Would Dr. Booth accept that the reason the NB EUB allowed the recovery of a debt return is that there was no equity in the utility's capital structure? If not, please explain.**

   b. **Would Dr. Booth confirm that NB EUB stated that they would revisit the recovery of the WACD return on the referenced deferral account as New Brunswick Power added equity to its capital structure?**

8. **Preamble :**
   C-AQCIE-CIFQ-0021
   Dr. Booth Testimony, pp. 17

"Consequently, I would recommend the following:

- *Normal deferral accounts be allowed BA+0.25%*
- *Special deferral accounts be allowed a return that reflects:*
  - *The expected term of the account*
  - *The risk of non-recovery*
  - *What has given rise to the account*
  - *Materiality of the account"*

   a. **For each of the "special deferral account" return criteria listed above, please compare and contrast 1) the purchase of a capital asset with a 5-year useful life, such as a vehicle or computer, with 2) the pass-on account for electricity purchases balance of $380 million. Please provide justification for your response.**

b. With respect to the comparison provided in part a. above, please indicate i) the current return earned on the asset listed; and ii) the return you would recommend for each asset. Please provide a detailed explanation for your answer.