

**RÉPONSES D'HYDRO-QUÉBEC DISTRIBUTION
À LA DEMANDE DE RENSEIGNEMENTS N° 4
DE L'AQCIE-CIFQ**

Questions du Dr Booth adressées à Concentric Energy Advisors relativement à leur rapport produit comme pièce HQD-3 Document 3.1

First Topic: Regulatory and Financial Principles

Reference: Concentric Energy evidence pages 10 & sq.

Preamble:

Concentric discuss basic legal and economic principles

1.1 Would Concentric suggest that the balance in a deferral account constitutes “invested capital,” “capital investment” or a prudently acquired asset, necessary to provide service? If so please provide all supporting documentation for defining a deferral account as such.

Réponse de Concentric :

1 **Yes. Please refer to Concentric evidence at page 39, line 12 through page 40,**
2 **line 2. Deferral accounts with positive balances require capital investment by**
3 **the utilities, necessary to provide utility service. This is consistent with the**
4 **treatment of working capital as articulated by Mr. Bonbright (see HQD-3,**
5 **Document 3.1 - Concentric evidence, p. 14, line 13 through p. 15, line 2, B-**
6 **0150).**

7 **Further, Concentric finds the following passage relevant to the question**
8 **posed by AQCIE-CIFQ. Mr. Bonbright, in his widely recognized treatise,**
9 ***Principles of Public Utility Rates*, Second Edition, March 1988, p. 238 :**

10 **... The “prudent investment” or “new–investment” principle**
11 **seems now to be used interchangeably with the “original-cost”**
12 **principle despite earlier suggested distinctions.**

13 **“Prudent” imports the requirement that the investment, in order**
14 **to gain recognition in the rate base, must have been prudently**
15 **incurred in the light of foresight rather than of hindsight. (See**
16 **Justice Brandeis’s comment on this point in his concurring**
17 **opinion in the Southwestern Bell case, 1923). “Net” means net of**
18 **deductions either for capital investments already recouped from**
19 **revenues charged to depreciation or amortization, or else for**
20 **asset depreciation already sustained – an obvious ambiguity.**
21 **“Investment” refers to the capital funds contributed by the**

1 **company to the public service as distinct from the current values**
2 **of the assets acquired by these funds.**

1.2 Would Concentric agree that where “capital Investment” is referred to by the Supreme Court of Canada (page 10) in its definition of a fair rate of return it specifically states “(which will be net to the company)” and that this refers to the gross plant and equipment adjusted (or net) of accumulated depreciation? If not please explain what the passage in the quoted definition means.

Réponse de Concentric :

3 **Concentric believes the Supreme Court of Canada refers to net investment,**
4 **which may include assets subject to either amortization or depreciation.**
5 **Concentric agrees that a return is earned on the net asset balance (after**
6 **amortization or depreciation).**

1.3 Concentric quotes Bonbright (page 14) in terms of the requirement to include working capital in rate base:

a) Please confirm that by working capital Bonbright means “net working capital” that is current assets minus current liabilities. If not, please confirm that if the gross working capital is included in rate base it means that items like accounts payable need to be included in the WACC as financing with a cost rate of zero. If not please explain in detail.

Réponse de Concentric :

7 **Concentric confirms that by working capital Mr. Bonbright means “net**
8 **working capital”.**

b) Please confirm that with regulation using a forward test year it is the forecast (net) working capital required to provide service that should be included in rate base. If not why not?

Réponse de Concentric :

9 **Concentric confirms that when using a forward test year, the utility attempts**
10 **to estimate its level of working capital for the upcoming year. Its estimate is**
11 **included in rate base.**

- c) Please explain whether the balance in a deferral account represents any of the forecast working capital items referenced by Bonbright: inventory, petty cash balance; prepayments, minimum bank balances; or a cost of providing service.

Réponse de Concentric :

1 **As Mr. Bonbright explains, “The working capital allowance is necessary to**
2 **bridge the gap between the time when costs are incurred in providing service**
3 **and the time the utility is paid for that service.” The balance in the deferral**
4 **account is entirely consistent with this definition. In the immediate case**
5 **Hydro-Québec Distribution’s balance includes power commodity costs**
6 **incurred at one time and recovered in another period, and were certainly a**
7 **“cost of providing service”.**

- 1.4 In the example on pages 17-18 please confirm that if a utility is deemed a 60:40 capital structure based on its underlying business risk and then unexpectedly acquires a significant lower risk short term asset then Concentric would agree that its business risk has declined and the regulator could respond by lowering the common equity ratio or allowed ROE? If not please explain in detail why the unexpected acquisition of a new lower risk asset has no impact on the risk of the utility.

Réponse de Concentric :

8 **If indeed, the asset had reduced the aggregate risk of the utility it would**
9 **appropriately be reflected in the utility weighted average cost of capital**
10 **(WACC), in terms of return on equity (ROE) or equity ratio. In this case,**
11 **however, a large balance that would otherwise be recoverable within one year**
12 **is being deferred to mitigate rate impact on customers. This delay disturbs the**
13 **earnings stream and cash flows of the utility, and has not lowered its risk.**

- 1.5 Please confirm that Concentric is aware of the Stores Block decision by the Supreme Court of Canada and the recent regulatory decision of the Alberta Utilities Commission Decision 214-297 where the AUC quotes its decision 2013-417 that

... [t]hat it is required to remove from rate base and customer rates assets that are not presently used, are not reasonably used and are unlikely to be used in the future to provide utility services. These assets may include obsolete property, property to be abandoned, overdeveloped property and facilities for future needs, and-property used for non-utility purposes and surplus land. These are examples of property that the Commission may exclude from rate base that the Alberta Court of Appeal has identified in the Carbon, Harvest Hills and Salt Caverns decisions. Indeed, in Salt Caverns, the Court of Appeal said in paragraph 31 that the “rate-

regulation process allows and compels the Commission to decide what is in rate base, i.e. what assets (still) are relevant utility investment” according to the used and required to be used test. In Harvest Hills the Court of Appeal stated in paragraph 14 that “once it was determined that there was surplus land, it should have been removed from rate base as no longer ‘required to be used’...” This implies that the Commission and the utility each have an obligation to remove assets from rate base (remove the costs from utility rates) when they cease to be “relevant utility investment.”

Réponse de Concentric :

1 **Concentric is aware of the Stores Block Decision and the AUC Decision**
2 **2014-297.**

1.6 Please indicate on what basis Concentric Energy judges that the balance in a deferral account reflecting past cost variances satisfies the “used and useful” test for an “asset” to remain in rate base and be allowed the WACC.

Réponse de Concentric :

3 **Concentric does not see the relevance of the Stores Block Decision to this**
4 **matter. The variance account is the result of purchased power used in utility**
5 **service to provide electricity to customers. Because the costs incurred were**
6 **for power used in providing utility service, the costs expended were for items**
7 **used and useful. When the Régie authorized Hydro-Québec Distribution’s**
8 **power pass through account for electricity purchases, the Régie did so**
9 **recognizing that these costs were incurred for service to ratepayers, and**
10 **Concentric is not aware of any challenges to the contrary. The Régie found in**
11 **Decision D-2006-34 [clarification added] :**

12 **“In previous decisions, the Régie has already authorized the**
13 **creation of these off-rate base [deferral variance accounts] DVA**
14 **accounts and their remuneration at the WACC. For purposes of**
15 **simplification and consistency without DVA accounts, the Board**
16 **allows the inclusion of DVA accounts in the rate base at the time**
17 **of disposal or amortization.**

18 **The Régie considers that the remuneration of these accounts at**
19 **the WACC is a reasonable and customary regulatory treatment**
20 **(...).”**

1.7 Further please confirm that Concentric is aware of the following passage from AUC Decision 2013-417

In order to give effect to the court's guidance that the "rate-regulation process allows and compels the Commission to decide what is in the rate base, i.e. what assets (still) are relevant utility investment on which the rates should give the company a return," the Commission directs each of the utilities to review its rate base and confirm in its next revenue requirement filing that all assets in rate base continue to be used or required to be used (presently used, reasonably used or likely to be used in the future) to provide utility services. Accordingly, the utilities are required to confirm that there is no surplus land in rate base and that there are no depreciable assets in rate base which should be treated as extraordinary retirements and removed because they are obsolete property, property to be abandoned, overdeveloped property and more facilities than necessary for future needs, property used for non-utility purposes, property that should be removed because of circumstances including unusual casualties (fire, storm, flood, etc.), sudden and complete obsolescence, or un-expected and permanent shutdown of an entire operating assembly or plant. As stated above, these types of assets must be retired (removed from rate base) and moved to a non-utility account because they have become no longer used or required to be used as the result of causes that were not reasonably assumed to have been anticipated or contemplated in prior depreciation or amortization provisions. Each utility will also describe those assets that have been removed from rate base as a result of this exercise. At this time, the Commission will not require the utilities to make additional filings to verify the continued operational purpose of utility assets.¹⁰

Réponse de Concentric :

1 **Concentric confirms.**

- 1.8 Please indicate whether Concentric agrees with the AUC's interpretation of the Supreme Court of Canada's Stores Block decision that assets that are no longer used and useful due to damage caused by "fire, storm or flood" should be removed from rate base and are for the shareholder's account, not that of the rate payers. If not please explain why not.

Réponse de Concentric :

2 **Concentric sees no relevance of the AUC's interpretation of the Supreme**
3 **Court of Canada Stores Block Decision to its evidence filed in this proceeding**
4 **before the Régie.**

- 1.9 Please confirm that Dr. Booth (contrary to the statement on page20) only refers to the fair rate of return on the balance in the deferral account and not HQD's WACC. If not please

reference any passages in Dr. Booth's testimony where he comments on HQD's WACC or the relevant embedded cost of debt to be included in HQD's rates.

Réponse de Concentric :

See Dr. Booth testimony p. 5, where it is stated :

“For the \$380 million deferral account I would suggest the Regie 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 Regie 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.”

- 1.10 Please indicate and provide details on any discussions Concentric Energy has had with any financial institution about selling the \$380M special treatment deferral account to either a financial institution or a receivables backed commercial paper conduit to confirm the statements made at the bottom of page 20 and the top of page 21.

Réponse de Concentric :

Concentric has had no discussions with financial institutions on this matter. However, Concentric has observed in the market that there are costs associated with the type of transactions suggested by AQCIE-CIFQ in this question. As Dr. Booth indicates in the excerpt below, there is not dollar for dollar financing for accounts receivable balances, and there must be either an anticipated equity contribution of 25 % to 30 %, or the secured accounts receivable would have to exceed the loan balance by 25 % to 30 %. Further, this short term financing is not appropriate for a 6-year asset.

Excerpt from Dr. Booth's testimony, page 12, is below :

“Most of these assets have a high degree of “moneyness”, in that they turn into cash within a year, which is why they are referred to as current assets. As such they are prime candidates for security under a bank loan. A rule of thumb is that a bank will finance 100% of cash, 70-75% of a firm's good receivables and 50% of inventory. Normally this would be under an operating line so that as the current assets turn into cash they are replaced with new ones to support the debt.”

Second Topic: Regulatory Decisions

Reference: Concentric Energy evidence pages 24 & sq.

Preamble:

Concentric discusses certain regulatory decisions

- 2.1 With reference to the TransCanada Mainline decision can Concentric confirm the following passage from RH-3-2011:

“The Mainline is in an unprecedented position. No major NEB regulated natural gas transmission pipeline has ever been affected by market forces to the extent that the Mainline is now affected. Throughput on the Mainline has decreased significantly, and as a result, Mainline tolls have increased substantially over a short period of time.

The future of the Mainline depends on how TransCanada is able to respond to the changes to its business environment. The Mainline faces increasing competition for gas supply from intra-Alberta demand, other ex-Western Canada Sedimentary Basin (WCSB) pipelines and new markets for WCSB gas. The Mainline competes with pipelines from emerging shale and tight gas basins in the United States of America (U.S.), which deliver gas to eastern markets. The Mainline must adjust to this new environment because eastern consumers may not renew contracts for long-haul service and bypass infrastructure may be built.”

Tolls cannot continue to increase each year in response to throughput decline. Costs associated with throughput variation have been passed to remaining Firm Transportation service (FT) shippers. Those shippers have borne all of the costs of, and the risk associated with, competition. If this were to continue, the Mainline’s competitiveness could further erode and exacerbate the root cause of throughput declines.

Réponse de Concentric :

- 1 **Concentric confirms.**

- 2.2 Can Concentric confirm that during that hearing some parties felt that the risks faced by the Mainline were so severe that the assets in the Northern Ontario Line (NOL) were no longer used and useful and should be written down to zero and further that TransCanada itself wanted to reallocate accumulated depreciation to the NOL to

dramatically reduce its book value? If not please explain why the NEB decision and example would be put forward to justify treatment of an HQD deferral account.

Réponse de Concentric :

1 **Concentric recognizes the extreme circumstances that the TransCanada**
2 **Mainline was operating under at the time of the NEB's Decision. However,**
3 **these circumstances do not render the NEB Decision incomparable. The NEB**
4 **indicated, with respect to its Toll Stabilization Account ("TSA"), on page 236**
5 **of its Decision, RH-003-2011, that "the carrying charges on the TSA should be**
6 **the same as the rate of return on rate base, reflecting the overall cost of**
7 **capital of the Mainline." The point is that the account is not segregated from**
8 **the rest of the utility, that it is an integral part and accordingly should earn the**
9 **same return as the other assets in the utility. Further, the NEB indicated that**
10 **the account would be presumed to be financed in accordance with the utility's**
11 **capital structure "rather than determining how individual accounts are**
12 **financed."**

2.3 Please indicate whether in Concentric's judgment, and like the Mainline, HQD is in an "unprecedented position" and is now affected by market forces to a degree that no other utility regulated by the Regie has ever been, and that the throughput (use) of HQD's facilities has decreased significantly causing a substantial increase in HQD's rates over a short period of time. If Concentric cannot so confirm, please explain what relevance the NEB decision has to the situation faced by HQD.

Réponse de Concentric :

13 **Concentric does not confirm. See Concentric response to question 2.2 above.**
14 **Further, Concentric notes that AQCIE-CIFQ also referenced the same**
15 **TransCanada Decision as support for its recommendation for Hydro-Québec**
16 **Distribution on page 16 of Dr. Booth's testimony. Concentric also notes that**
17 **the NEB rejected Dr. Booth's recommendation for a specific debt rate**
18 **equivalent to a medium term note in that proceeding.**

Third Topic: Response to Intervenor evidence

Reference: Concentric Energy evidence page 31

Preamble:

Concentric discusses AQCIE-CIFQ evidence

- 3.1 Please indicate where in Dr. Booth's evidence he suggests any of the treatments in the example created by Concentric in Figure 1. Please be specific in referencing passages in Dr. Booth's testimony.

Réponse de Concentric :

1 **On page 5, Dr. Booth writes the following :**

2 **“For the \$380 million deferral account I would suggest the**
3 **Regie think of this in terms of a newly acquired asset as in the**
4 **prior example. Existing assets earn the normal WACC, but by**
5 **definition this is a special or unusual deferral account, since it**
6 **does not zero out in the normal way. As a result HQD can now**
7 **be considered as a combination of its normal rate base earning**
8 **the WACC 7 and this newly acquired asset. The Regie can then**
9 **either lower the overall WACC of this new entity, since HQD's**
10 **risk is now marginally lower, or simply allow a fair return on**
11 **this new \$380 million acquired asset that reflects its**
12 **“attractiveness, stability and certainty.”**

13 **Also see page 15, where Dr. Booth writes :**

14 **“Normally the balance in deferral accounts should net out to**
15 **zero, so the balance is essentially temporary working capital.**
16 **However, occasionally there are special cases where the**
17 **balance becomes so large it cannot be allocated to rates for the**
18 **following year, instead it is amortized over several years. This**
19 **is the case with the \$380 million balance in the deferral account**
20 **in question. In these cases, instead of using the BA +0.25% rate**
21 **I would recommend using the rate equal to the average**
22 **maturity expected of the deferral balance. In the case of the**
23 **\$380 million balance with an average maturity of about 3 years,**
24 **I would recommend a three year rate. The current yield on the**
25 **three year Government of Canada benchmark bond is 1.13%.**
26 **To this I would add 0.45% to bring it to an HQD rate of 1.58% or**
27 **rounding up 1.60%.”**

28 **Concentric has modeled the scenario, where the account is**
29 **subject to a relatively short-term debt rate as recommended by**
30 **Dr. Booth in the second passage above. The point of the**
31 **example is to show that if an asset is removed from rate base**
32 **and designated a specific return, the utility will not earn its**
33 **allowed return unless the asset's financing is also removed**

1 from the embedded debt costs, due to the double counting of
2 the financing associated with the asset. This is illustrated in
3 Scenario 3 of Figure 1.

- 3.2 On page 35 Concentric indicates that Dr. Booth states that the balance “did not result from and were not necessary to provide service.” Please confirm that this is not a direct quote and that Dr. Booth states that it is “not necessary to provide service.” Is it Concentric’s view that the balance in the deferral account is necessary to provide future service, that is, that a regulatory asset is used and useful in the same sense as a physical asset in providing future service? If the answer is yes please explain how a cost variance in the past affects the provision of future service?

Réponse de Concentric :

4 **Concentric confirms. The passage cited by AQCIE-CIFQ was not a direct**
5 **quote. The relevant passage is below, from Dr. Booth’s responses to Hydro-**
6 **Québec Distribution 8.a.-b. (November 20, 2014) :**

7 “If a capital asset has a \$380 million value, a five year useful life
8 and the Regie approves its inclusion in rate base then it would
9 be included in capital investment and earn the weighted average
10 cost of capital. This asset would then be necessary to provide
11 service and be part of the weighted average life of the utility
12 assets and by the matching principle a factor in the average life
13 of the utility debt. This asset would then bear the normal
14 business risk of the utility earning its allowed ROE. In contrast
15 the \$380 million balance is not a capital investment as normally
16 determined and not necessary to provide service. It is a
17 regulatory asset and different for the reasons cited by Dr. Booth
18 in his testimony on pages 6-10.” [emphasis added]

19 It is Concentric’s view that the balance in the deferral account constitutes an
20 investment, i.e. capital funds contributed by the company, prudently incurred
21 in carrying out utility service. This investment is integral to the company in
22 the sense that its impact on the risk profile of the company is reflected in the
23 company’s earnings stream and is subject to the same risk of recovery as
24 other invested capital in the utility. Concentric takes issue with Dr. Booth’s
25 assertion that the power costs captured in the deferral account were “not
26 necessary to provide service.”

- 3.3 Further to 3.2 above, is it Concentrics’ view that utilities that do not operate with the range of deferral accounts available to HQD cannot offer appropriate service?

Réponse de Concentric :

1 **No. A utility with no deferral and variance accounts will continue to offer**
2 **appropriate utility service, but its cash flow and earnings stream will be less**
3 **certain. That is a matter for investors to consider when and if they decide to**
4 **contribute capital to the utility.**

3.4 Is Concentric aware that Enbridge Gas Distribution Inc (EGDI) and Union Gas operate without weather deferral counts? In Concentric's view if particularly bad weather caused significant losses to either EGNB or Union would the inability to pass these losses to a deferral account to be passed on to future rate payers impair their ability to provide service? Please explain in detail how this can happen.

Réponse de Concentric :

5 **This would depend on the magnitude of the loss. However the presence or**
6 **lack of deferral accounts does impact the utility's risk profile and accordingly**
7 **the return investors' require. Concentric notes that Enbridge and Union have**
8 **allowed ROEs of 9.36 % and 8.93 % on 36 % equity, while Hydro-Quebec**
9 **Distribution is allowed 8.20 % on 35 % equity, reflecting the regulators'**
10 **decisions on their relative risk profiles.**