

VARIANCE ACCOUNTS - APPROPRIATENESS AND RETURN

Translation by
John Detre
Commissioned by
Association québécoise des consommateurs industriels d'électricité (AQCIE)
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Québec Forest Industry Council (QFIC)

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1. THE RÉGIE'S REQUEST

In decision D-2014-037,¹ the Régie announced that in the next rate case it would review the return on variance accounts and the appropriateness of keeping them, given their significant size. It also asked the Distributor to submit in-depth analyses of the issue for all such accounts and to file a survey of the approaches to return on variance accounts used by comparables in other jurisdictions.

The purpose of this document is to respond to the Régie's requests.

2. APPROPRIATENESS OF VARIANCE ACCOUNTS

As described in Exhibit HQD-9, Document 7, variance and deferral accounts (VDAs)² fall into two categories:

- accounts created to record costs that will be expensed in subsequent years;
- purely regulatory variance accounts created for later inclusion, in the revenue requirement, of costs incurred during a test year, the amounts of which were not anticipated when the distribution rates were set and of which the actual amounts differed from initial forecasts. The use of these variance accounts is therefore a mechanism for recovering costs through rates.

Theoretically, accounts in the second category are excluded from the rate base until inclusion of their balances in rates is warranted. A return is added to the costs recorded in variance accounts until these accounts are included in the rate base or factored into the revenue requirement. With respect to the amount of the return on these accounts, the Régie has authorized the use of the weighted average cost of capital (or the return on the rate base) for each of the Distributor's variance accounts, ensuring uniform regulatory treatment.

The variance accounts were authorized by the Régie in various rate cases after an exhaustive review of the advantages and disadvantages of each for the purpose of covering items with volatile, unpredictable or significant costs, or costs that are beyond the Distributor's control. Once recognized, these accounts are used as needed when differences arise in the covered items.

Table 1 shows the variance accounts authorized by the Régie and the main arguments in support of their creation.

¹ D-2014-037, paragraph 416.

² The acronym VDA covers both regulatory variance accounts and deferral accounts, which were combined under the heading "deferred charge accounts" before the adoption of IFRS.

Table 1:
Regulatory variance accounts authorized by the Régie

Account	Date authorized	Decision	Justifications
Variance account – transmission service for native load	2003	D-2003-93, p. 15-21	Factor beyond the Distributor's control - Potential discrepancy between the transmission rates recognized by the Régie and their inclusion in the revenue requirement Significant monetary issues
Pass-on account for electricity purchases	2005	D-2005-34, p. 36-50	Factor beyond the Distributor's control - Electricity price volatility - Climate conditions and fluctuations in demand - Other residual risks and uncertainties such as supplier equipment breakdown Significant monetary issues
Stabilization account for climate conditions	2006	D-2006-34, p. 19-21	Factor beyond the Distributor's control - Impact of climate conditions on transmission and distribution revenues
Variance account - fuel	2009	D-2009-016, p. 60-62	Factor beyond the Distributor's control - Price volatility
Variance account – load retention rate	2009	D-2010-022, p. 42-45	Factor beyond the Distributor's control - Impossibility of predicting use of rate by customers - Equitable treatment of all parties
Variance account – major outages	2009	D-2009-016, p.14-16 R-3644-2008, HQD-04-04	Impact of climate conditions on frequency and size of major outages Intergenerational equity Cost levelization Potentially significant monetary issues
Variance account – major projects	2010	D-2010-022, p. 45-47	Equitable treatment of all parties - Accelerating the inclusion of all project costs in the revenue requirement - Minimizing financing costs
Variance account – pension costs	2011	D-2011-028, p. 36-42	Factor beyond the Distributor's control - Unstable financial markets - Cost volatility (difficulty of forecasting factors such as the discount rate and return on assets) Significant monetary issues
Variance account - Bureau de l'efficacité et de l'innovation énergétiques (BEIE)	2013	D-2013-037, p. 74-77	Factor beyond the Distributor's control - Charge fixed by government decree Significant monetary issues
Variance account - Costs related to suspension of TCE deliveries	2014	D-2014-086 p.14	Intergenerational equity - Maintaining cost recognition on an annual basis

In view of the information in Table 1, the Distributor concludes that the reasons for which these accounts were created still apply. The majority of these accounts were created to record costs that were beyond the Distributor's control at the time, and it is clear that this remains the case. The absence of control is particularly significant given the large amounts in question. Finally, these accounts remain consistent with the general principles endorsed by the Régie in its decisions over the years, including intergenerational equity and rate stability.

The Distributor therefore proposes to maintain all the existing accounts to ensure equitable treatment of all parties.

The Distributor also notes that there is a link between the variance accounts and the risk assessment that was used to determine its return on equity. Creating or eliminating one or more variance accounts would affect the Distributor's risk and could necessitate a review of return on equity.

3. RETURN ON ACCOUNTS

In response to the Régie's request with respect to the return on variance accounts,³ the Distributor conducted a survey of the various rates approved by Canadian and U.S. regulatory authorities for various VDAs. The U.S. segment of the survey covered the companies selected as comparables in docket R-3842-2013.⁴

3.1. Survey of return in Canada

3.1.1. Québec

To the Distributor's knowledge, the Régie (like the old Régie du gaz naturel) has made no decision in principle on an across-the-board return on the VDAs recorded by the companies it regulates. However, it has systematically approved application of the weighted average cost of capital every time such an account was established.

The Régie issued its first opinion on the Distributor's VDAs in its decision D-2003-93⁵ in May 2003. The Distributor then asked the Régie to rule on the creation of deferred charge accounts for items related to supply costs for electricity, transmission costs and some operating expenses subject to acts of state. With respect to the transfer of supply costs and transmission costs, the Régie ruled that the cost differences would be recorded in a deferred charge account earning the Distributor's weighted average cost of capital.

In the 2006-2007 rate application,⁶ some intervenors opposed the inclusion of some accounts in the rate base and applying a return pegged to the weighted average cost of capital, as proposed by the Distributor. One intervenor even proposed that deferred charge accounts should earn the

³ D-2014-037, paragraph 417.

⁴ R-3842-2013, Application for approval of return on equity and the mechanism for treating differences in return. Joint application by Hydro-Québec when carrying on electric power transmission activities and distribution activities.

⁵ D-2003-93, Section 1.2, pages 15 to 22.

⁶ Docket R-3579-2005.

debt rate or another specific rate.

In its decision D-2006-34, the Régie recalled that it had previously authorized the creation of deferred charge accounts outside the rate base with a return pegged to the weighted average cost of capital. In the same decision, it also found that for such accounts to earn the average cost of capital was a customary and reasonable regulatory treatment, and it held that proposed return mechanisms had to be considered in relation to the regulated company's capital structure and business risk.

Since then, in the Distributor's subsequent applications to create new VDAs, the Régie has found, after review, that the terms and conditions of these accounts, including a return based on the weighted average cost of capital, were consistent with regulatory practice. However, since 2013, the Régie has shown some interest in revisiting the issue of the return on the various VDAs, as can be seen in its most recent decisions – including decision D-2013-106⁷ concerning Gaz Métro, decision D-2013-191⁸ concerning Gazifère, and decision D-2014-037 concerning the Distributor – in which it asked the companies it regulates to study the issue of the return on their variance and deferral accounts.

In the case of Gaz Métro, its response to an information request⁹ from the Régie indicates that historically it has always used the weighted average cost of capital to establish both rate base costs and the return on its deferred charge accounts outside the rate base. Gaz Métro also believes that acting otherwise would unduly penalize it since it financed regulatory assets in accordance with the stipulated structure, in good faith. Accordingly, it does not believe it necessary for the Régie to change the financing rate of these deferred charge accounts.

3.1.2. Alberta

In its most recent decision on the return on the variance accounts of gas distributor ATCO Gas (ATCO), the Alberta Utilities Commission (AUC) addressed the use of the weighted average cost of capital as the rate (2014-078¹⁰). The decision concerned the merging of two variance accounts for the cost of load balancing on ATCO's system, called LBDA North and South (for Load Balancing Deferral Account). These accounts are used to transfer the cumulative balance of load balancing costs to a natural gas distribution rate rider, subject to a triggering threshold. Creation of these accounts was authorized in 2008 and the weighted average cost of capital has been used since the outset. While its use has been challenged, the AUC has always upheld it.

In 2013, when ATCO applied for authorization for a rider for LBDA North, the return on the variance account was one of the issues discussed. The Consumers' Coalition of Alberta (CCA) opposed continued use of ATCO Gas' weighted average cost of capital, which was 8.4%,

⁷ Docket R-3809-2012, Phase 2, Gaz Métropolitain and Company, Limited Partnership, D-2013-106, paragraphs 518 and 519.

⁸ Docket R-3840-2013, Phase 3, Gazifère, D-2013-191, paragraph 70.

⁹ Docket R-3871-2013, response to question 21.3 in the Régie's information request no. 1 concerning the application for review of GMCLP's annual report for the fiscal year ended September 30, 2013.

¹⁰ AUC Decision 2014-078, ATCO Gas Application for Administration of a Province-wide Load Balancing Deferral Account, April 3, 2014.

suggesting that a 3% rate based on the short-term interest rate would be more appropriate since the rider's recovery period was less than one year.

ATCO Gas refuted the CCA's recommendation, arguing that the account could carry a balance for several years until the rider threshold was reached, and submitted that a long-term rate such as the weighted average cost of capital was appropriate.

In its decision 2013-106,¹¹ the AUC had approved the use of the weighted average cost of capital, which had been applied until that date to calculate the account balance, but ordered ATCO to produce an analysis of the merits of maintaining that practice by December 2013.

In the decision, the AUC recalled the reasons that had led it to use the weighted average cost of capital historically. It cited a decision rendered in 2010¹² which was based on a number of factors, including uncertainty about the balance, the fact that the balance could be either positive or negative, the materiality of the amount, and the fact that balances could persist for an extended time. The AUC noted that the account was established to be fair to both the distributor and its customers, with the anticipation that surpluses/deficits would be refunded to/recovered from customers. If there were an equal probability of positive and negative balances, ATCO should theoretically be indifferent to whether the carrying charge were an interest rate in accordance with AUC Rule 023¹³ respecting payment of interest or the weighted average cost of capital as approved in the AUC's previous decisions. However, the AUC notes that the account has consistently been in an account receivable position for ATCO since December 2010. In its 2013 decision, the AUC therefore took note of the CCA's arguments to the effect that approval of the rider could, in and of itself, alter the characteristics of the deferral account since the amount of the rider is known and its recovery period is less than 12 months. The AUC therefore asked ATCO to submit an analysis of this issue by December 2013 in order to determine whether, in the future, the return should be pegged to the weighted average cost of capital or to short-term interest rates in accordance with Rule 23, Rules Respecting Payment of Interest.

It also ordered ATCO to file an analysis of the appropriateness of combining the north and south LBDAs. The analysis filed by the gas distributor in response to the AUC's request shows how the criteria of uncertainty, variability, monetary materiality and longevity applied to the LBDA account by the AUC when it was created still hold, even if a rider is triggered, and warrant a return at the weighted average cost of capital. As indicated above, in its decision 2014-078¹⁴ concerning the combination of the north and south LBDA accounts into a single account, the AUC approved the creation of a new account and its conditions, and ordered ATCO to file, by June 1, 2014, an application to determine the balances of the north and south LBDA accounts and a proposed rate design for managing the new consolidated account. In that case, ATCO reiterated that the characteristics of the new account were consistent with the criteria set by the AUC for use of the weighted average cost of capital.

¹¹ AUC Decision 2013-106, ATCO Gas North Load Balancing Rate Rider, March 20, 2013.

¹² AUC Decision 2010-348, ATCO Gas North Retailer Service, North Load Balancing Deferral Account, North Load Balancing Rate Rider "L", July 23, 2010.

¹³ AUC Rule 023: Rules Respecting Payment of Interest, January 2, 2008.

¹⁴ AUC Decision 2014-078, ATCO Gas Application for Administration of a Province-wide Load Balancing Deferral Account, April 3, 2014.

3.1.3. British Columbia

In 2012, in decision G-77-12A¹⁵ concerning BC Hydro's rates for fiscal 2012 to 2014, the British Columbia Utilities Commission (BCUC) authorized an interest rate equal to the weighted average cost of the company's debt on the balances of deferred charge accounts and other regulatory accounts. However, this decision was made against the background of the provincial government's Direction No. 3, aimed at controlling BC Hydro's rate increases during that period.

In 2012, the BCUC also ruled on the issue in its decision G-110-12¹⁶ concerning the rates of electric power distributor FortisBC for 2012-2013. The BCUC decided that VDAs should not be included in the rate base or earn the weighted average cost of capital. Its view was that, if operating and other costs are deferred for purposes of rate smoothing instead of being recorded in current expenses, as would normally be the case, they do not become capital expenditures simply because they have been deferred, and that the most appropriate recovery mechanism is an interest rate of return. The BCUC ruled that the appropriate return on accounts that are amortized over more than one year is FortisBC's average cost of debt. The BCUC also decided that, for accounts amortized over one year, it would be more appropriate to use FortisBC's short-term interest rate.

3.1.4. Ontario

In 2006, the Ontario Energy Board (OEB) issued an administrative directive¹⁷ on the issue of interest rates on regulatory accounts. The directive applies to all gas and electric power distributors.

The OEB's objectives were that the interest rate should reflect market rates and be responsive to changes in market conditions, and that the approach should be beneficial in an incentive regulatory regime where the review of interest rates for accounts is not undertaken as part of an annual rate application process.

The OEB decided that an interest rate equal to the three-month bankers' acceptance rate plus 25 basis points would apply to these accounts. The rate will be set each quarter and adjusted only if there is a change of more than 25 basis points.

3.1.5. New Brunswick

In 2012, the New Brunswick Power Distribution and Customer Service Corporation (NB Power) filed an application¹⁸ with the New Brunswick Energy and Utilities Board (NB EUB) relating to, among other things, the financing rate for the deferral account for the refurbishing of a nuclear

¹⁵ BCUC Order G-77-12A, BC Hydro and Power Authority - F2012 to F2014 Revenue Requirement Application, June 20, 2012.

¹⁶ BCUC Order G-110-12, FortisBC Inc. 2012-2013 Revenue Requirements and Review of 2012 Integrated System Plan, August 15, 2012.

¹⁷ OEB EB-2006-0117, Approval of Accounting Interest Rates Methodology for Regulatory Accounts, November 28, 2006.

¹⁸ NBPD Exhibit 27.01, Financing Costs and Amortization to be used in determining the amount required to be recovered by Disco, Matter 171: Lepreau Deferral Account Matter, May 28, 2013.

power plant. NB Power proposed that the financing rate be based on the total long-term debt portfolio and calculated on the average of the actual rate in the first year and the forecasted rate in the last year. NB Power also proposed that the setting of the financing rate be part of an annual filing with the Board. The forecasted financing rate for 2013-2014 was 4.62%.

A legislative change¹⁹ in October 2013 established a new regulatory framework for NB EUB under which it must set rates that allow for, among other things, a capitalization ratio of at least 20% and the lowest possible cost of service for the province's consumers.

NB EUB's decision on this issue,²⁰ rendered in January 2014, noted that while NB Power does plan on achieving the objective of a capital structure of at least 20% equity prescribed in legislation, it does not currently have a regulated return.

NB EUB noted that any adjustment to include equity would have required it to determine both an appropriate rate of return and an appropriate capital structure for NB Power, issues that were outside the scope of the case.

After considering the evidence, the Board accepted NB Power's proposed calculation method and authorized a 4.55% financing rate for the 2013-2014 fiscal year. It concluded by noting that the methodology could be reviewed in the future, as NB Power begins to build equity and a cost of equity can be reasonably calculated.

3.1.6. National Energy Board

In September 2011, TransCanada PipeLines Limited, NOVA Gas Transmission Ltd and Foothills Pipe Lines Ltd (collectively "TransCanada") asked the National Energy Board (NEB) for the necessary approvals to implement a service restructuring project on TransCanada's Mainline, as well as the Alberta and Foothills lines that it owns. TransCanada also asked for orders setting and approving the transmission rates it was entitled to charge for transmission services on the Mainline between January 2012 and December 2013.

In its application, TransCanada asked for, among other things, the maintenance of its variance and deferral accounts for the 2012 and 2013 rate years. TransCanada also asked that a TSA²¹ variance account be created and that it earn the weighted average cost of capital. The purpose of the TSA account is to stabilize rates and combine previously approved deferral accounts for firm service revenues, discretionary revenues, non-discretionary revenues, Union Dawn receipt point surcharge and interim revenue adjustment variance in place for 2010 and 2011. In support of its application, TransCanada argued that the use of a single revenue deferral account to capture the variance between actual revenue and the approved revenue requirement would simplify the revenue deferral calculation and related procedures for tracking and reporting revenue deferrals.

¹⁹ Electricity Act S.N.B 2013, c. 7, Section 68.

²⁰ NB EUB, Decision in the matter of the Point Lepreau Nuclear Generating Station Deferral Account and Section 143.1 of the Electricity Act (Matter No. 171), January 13, 2014.

²¹ Toll Stabilization Variance account ("TSA").

In its decision²² of March 2013, the NEB agreed with TransCanada that carrying charges for the TSA account should be pegged to the weighted average cost of capital, reflecting the overall cost of capital of the system. The NEB indicated that even if deferred revenues include a premium for the risks of the TSA, the TSA balance is exposed to the same level of cost recovery risk as the rest of the Mainline's rate base. It found that TransCanada should be compensated accordingly. The NEB also stated that it was not prepared to assume how TransCanada would finance the TSA and deemed the entirety of the Mainline's financing needs to be met with a 60% debt ratio, rather than deeming how individual accounts would be financed.

3.2. Survey of recovery in the U.S.

For the U.S. component of this survey, the Distributor looked at the various VDA recovery methods used by the U.S. comparables described in the risk analysis produced for docket R-3842-2013.

This survey is based on the annual reports of the U.S. comparables, their 10-K filings with the Security Exchange Commission, and decisions made by their regulators. An exhaustive analysis of these companies was not produced, the objective being to provide an overview of the regulatory treatment of VDAs for each.

3.2.1. Consolidated Edison

The Consolidated Edison Company of New York (CECONY), part of the Consolidated Edison group, earns a return at the rate set annually by the Public Service Commission.²³ In November 2013, it was set at 3%²⁴ for all regulatory assets and liabilities that provided or used cash flows, except FAS-109 accounts and the Metropolitan Transit Authority tax deferral account, which are exempt from interest charges. CECONY's 10-K filing states that its operating companies are credited with a return on all regulatory assets for which a cash outflow has been made, and pay a return on all regulatory liabilities for which a cash inflow has been received. The regulatory assets and liabilities will be recovered from customers, or applied for customer benefit, in accordance with the rate provisions approved by the applicable regulatory body.²⁵ CECONY's last rate application stated, with respect to VDAs, that the company is required to record on its books the various amounts to be charged or refunded to customers. Unless the Commission decides otherwise, CECONY applies carrying charges at the rate set by the Commission to the amounts on the books, less federal and state income taxes.

²² NEB RH-003-2011, Reasons for Decision, TransCanada PipeLines Limited, NOVA Gas Transmission Ltd, and Foothills Pipe Lines Ltd, March 2013, page 236.

²³ This rate, originally called "Other Customer Provided Capital Rate," is an interest rate set by the regulator based on unadjusted composite bond yields for investor-owned utilities and municipal utilities. This interest rate is paid to gas suppliers, for example.

²⁴ NY DPS, Memo, November 14, 2013, Subject: Case 13-M-0463 - Customer Deposits Interest Rates Effective January 1, 2014, page 1.

²⁵ Con Ed 2013 10-K, page 42.

3.2.2. NextEra Energy

Florida Power and Light (FP&L), part of the NextEra Energy group, earns a return on all its regulatory assets and liabilities. NextEra Energy's 10-K filing states²⁶ that FP&L's regulatory assets and liabilities represent probable future revenues that will be recovered from or refunded to customers through the ratemaking process. Regulatory assets and liabilities are included in rate base or otherwise earn (pay) a return on investment during the recovery period. With respect to cost recovery clauses, the 10-K filing states that they are designed to permit full recovery of certain costs,²⁷ including fuel, purchased power and interchange costs, certain construction-related costs for new nuclear power plants planned by FP&L and for FP&L's solar generation facilities, and certain environment-related costs, and to provide a return on certain variance and deferral accounts. The company has had storm recovery funds since 2007. These costs are treated separately as a special entity rather than being included in the rate base.²⁸

3.2.3. Northeast Utilities

The companies in the Northeast Utilities group²⁹ earn different rates on their VDAs. The Massachusetts companies (NSTAR and WMECO) have, for some accounts, carrying charges at the customer deposit rate, which is pegged to the prime interest rate.³⁰ Other accounts, such as the storm recovery fund, earn the weighted average cost of capital. PSNH's accounts are included in its rate base and bear interest at the weighted average cost of capital.³¹

3.2.4. Southern Company

The Southern Company's four main companies³² generally have carrying charges on their VDAs. Variance accounts such as those for fuel cost recovery or revenue recovery are generally amortized over less than one year. At two of the companies, Gulf Power and Georgia Power, these accounts earn the weighted average cost of capital authorized by the Commission.³³ Georgia Power has also established distinct rates and revenue requirements,³⁴ including the weighted average cost of capital authorized by the Commission, for the recovery of environmental costs and energy efficiency costs. According to the surveyed documents (10-K filings and recent rate applications) all regulatory assets and liabilities are authorized to earn the current weighted average cost of capital, except in the specific case of regulatory asset accounts that are offset by deferred liabilities.

²⁶ FPL 2013 10-K page 65.

²⁷ FPL 2013 10-K page 81.

²⁸ FPL 2013 10-K page 85.

²⁹ Connecticut Light and Power (CL&P), NSTAR Electric (NSTAR), Public Service Company of New Hampshire (PSNH) et Western Massachusetts Electric (WMECO).

³⁰ MA DPU, National Grid Decoupling Order, November 30, 2009, pages 87-88.

³¹ PSNH Witness, Baumann Exhibit, Docket No. DE 09-035, Schedule 3, pages 1 and 2.

³² Alabama Power, Georgia Power, Gulf Power and Mississippi Power.

³³ Gulf Power Stipulation and Settlement Agreement, Docket No. 130140-EI (November 22, 2013) page 3, and Georgia Power Smith Direct Testimony Exhibit RCS-2, Schedule A, page 1, Staff Revenue Requirements Witness, Docket 36989, pages 17 and 26 (October 2013); and Smith Schedule Exhibit RCS-2, Schedule B page 1 of 4, Staff Revenue Requirements Witness, Docket 36989.

³⁴ Smith Direct Testimony, Staff Revenue Requirements Witness, Docket 36989, pages 17 and 26 (October 22, 2013) and Smith Schedule Exhibit RCS-2, Schedule B, page 1 of 4.

3.2.5. Wisconsin Energy

Wisconsin Electric Power, part of the Wisconsin Energy group, has variance and deferral accounts. While a small percentage of regulatory assets earn no return, the vast majority earn a return based on short-term interest rates.³⁵ From 2002 to 2013, the regulator allowed the variance account for transmission costs in excess of those embedded in the rates to earn a return based on the weighted average cost of capital. Since 2013, however, this account has earned the short-term interest rate.³⁶

3.2.6. Xcel Energy

Xcel Energy companies³⁷ generally receive a return on their regulatory assets and liabilities.

At Northern States Power – Minnesota, the only major accounts that earn no return are those relating to the Prairie Island nuclear power plant and to energy adjustment mechanisms.³⁸ The other accounts earn the authorized weighted average cost of capital. In some cases, however, refunds of customer overpayments bear interest at the prime interest rate.³⁹

In the case of Northern States Power – Wisconsin, while some accounts, such as those for natural gas and electricity costs, earn no return, most regulatory assets earn a return pegged to short-term interest rates.⁴⁰

At Public Service of Colorado, most regulatory asset balances transferred to the rate base earn a return pegged to the authorized weighted average cost of capital.⁴¹ However, some regulatory assets are outside the rate base and earn no return, such as those used to recognize expenses related to renewable resources and environmental initiatives.⁴²

Finally, in its most recent rate application, Southwestern Public Service excluded from its rate base some significant regulatory accounts that did not qualify for a return. In general, these accounts relate to renewable resources and environmental initiatives.⁴³ The company's other variance accounts are included in the rate base and earn the authorized weighted average cost of capital.

³⁵ Wisconsin Electric Power 2013 10-K page 75.

³⁶ Wisconsin Electric Power 2013 10-K page 54.

³⁷ Northern States Power – MN (NSP-MN), Northern States Power – WI (NSP-WI), Public Service of Colorado (PSCo) and Southwestern Public Service (SPS).

³⁸ NSP-MN 2013 10-K pages 94-95.

³⁹ Minnesota PUC Order, NSP-MN Docket No. E-002/GR-12-961 (Sept 3, 2013) page 39.

⁴⁰ NSP-WI 2013 10-K page 65 and 71.

⁴¹ PUC of Colorado Decision No. C12-0494, Docket No. 11AL-947E, Order Approving Settlement Agreement, May 9, 2012, Adopted Date: April 26, 2012 page 17.

⁴² PSCo 2013 10-K page 80.

⁴³ SPS 2013 10-K page 68.

4. DISTRIBUTOR'S POSITION

It is clear from the survey that return on VDAs is not uniform across North America. Many jurisdictions use the weighted average cost of capital, while others use a rate based on the average cost of debt or the short-term interest rate. Therefore, this survey does not show any clear trend with respect to return on VDAs. It must be noted, however, that in many jurisdictions the return methodology is tailored to the specific characteristics of each utility regulated by the jurisdiction and the nature of the various VDAs.

In considering the return on VDAs, therefore, certain specific features of the Distributor's situation, such as the relatively high amounts recorded in the VDAs, which can have a significant impact on the Distributor's capital structure, and the company's integrated debt financing policy, must be taken into account. The Distributor therefore believes that the weighted average cost of capital should be used to calculate the return on its VDAs, for the reasons set out below.

First of all, the Distributor believes it relevant to review, with respect to these two points, namely its capital structure and the company's integrated debt financing policy, the regulatory context in which it operates.

Since decision D-2003-93,⁴⁴ the Distributor's VDAs have all earned the weighted average cost of capital. This weighted average cost is calculated using a deemed equity ratio of 35%, the cost of which for 2015 is 8.2%, and a deemed debt ratio of 65%. With respect to the cost of debt, given that Hydro-Québec manages its debt financing programs in a comprehensive, integrated manner, which means that there is no financing specifically for any of its operating segments (i.e. generation, transmission and distribution) or related specifically to a particular asset, the company's integrated cost of debt has been used to calculate the cost of debt for its regulated divisions since decision D-2002-95.⁴⁵ Since 2003, the Régie has used Hydro-Québec's integrated cost of debt to estimate the Distributor's deemed cost of debt and the weighted average cost of capital for the purpose of determining regulatory net income. On this basis, the projected regulatory cost of debt for 2015 is 6.511%⁴⁶ and the weighted average cost of capital is 7.102%.

As described in section 2, VDAs derive from differences between a forecasted revenue or expense and the amount actually recorded by the Distributor, or from multi-year averaging of the costs of certain programs or projects.

Therefore, if the Distributor must spend more than originally budgeted for an operating expense, the difference must be financed pending recovery of the amount through rates in subsequent years. This difference between the expenditure and its recovery in revenues gives rise to an account receivable, i.e. a regulatory asset. Conversely, if in connection with a VDA the Distributor collects amounts which it must later refund to customers, this advancement of revenues provides a source of financing pending the refund and gives rise to an account

⁴⁴ D-2003-93, page 57.

⁴⁵ D-2002-95, page 147.

⁴⁶ The 6.511% regulatory cost of debt is based on actual (4 months) and forecasted (8 months) figures for the 2014 base year and figures for the 2014-2015 borrowing program.

payable, i.e. a regulatory liability. The cash deficits and surpluses associated with the assets and liabilities generated by the VDAs are included in consolidated cash flows provided by operating activities of Hydro-Québec and therefore factored into Hydro-Québec's capital requirement. As Hydro-Québec establishes and manages its financing program in an integrated manner, it is not possible to connect the cash deficits and surpluses associated with the VDAs to a specific source of financing.

Among the factors Hydro-Québec considers in determining its optimal financing program, the capitalization ratio is important because, as with any business, lenders expect it to advance a portion of the funds required to finance its assets.

VDA-linked assets, like the Distributor's other assets, are therefore financed by Hydro-Québec by means of a mix of equity and debt. This applies to both long-term assets and current assets, the term of which may be similar to that of the VDAs, such as vehicles and accounts receivable arising from billed electricity sales.

The composition of Hydro-Québec's borrowings, in terms of debt maturities and the mix of fixed-rate and floating-rate debt, takes into account projected capital needs, on a consolidated basis, including all the characteristics of the various units' cash flows and hence the characteristics of the cash flows associated with the Distributor's VDAs. But, as noted above, it is not possible to connect a particular asset to a specific form of debt financing.

This is why the Régie accepted the proposition that, to realize the benefits of integrated management and enable Hydro-Québec to recover an appropriate share of the financing costs associated with the regulated units, the concept of deemed capital structure should be applied and Hydro-Québec's average cost of debt should be used.

Ascribing a specific form of financing to the Distributor's VDAs, such as financing composed of 100% short-term debt, would be incompatible with the Distributor's deemed capital structure.

Taking a hypothetical case in which the balance of the VDAs totals \$400 million and is deemed to be financed entirely by the issuance of debt in the same amount, the Distributor's capital structure would be materially altered. The Distributor's equity ratio would decrease from 35% to 33.7%, and its debt ratio would increase from 65% to 66.3%, thereby creating a substantial departure from the capital structure authorized by the Régie.

With respect to the cost of debt, given the fact that the company's integrated cost of debt reflects the actual financial charges that the company must recover, any decrease in the return on VDAs that leads to debt cost recovery lower than the average cost of consolidated debt (which is 6.511% for 2015) would be offset by an increase in the average cost of consolidated debt applied to the other assets in the Distributor's rate base. This is a communicating vessels effect. Returning to the hypothetical case described above, the effect would be seen with the portion of the \$400 million that is already included in the integrated cost of debt, i.e. 65% of the total. Table 2 shows a hypothetical case in which a financing rate based on short-term interest rates is used, without any change to the capital structure, to finance 65% of the \$400 million.

Table 2:
Example of return based on the cost of short-term debt,
with no change in capital structure

Current return, pegged to weighted average cost of capital (WACC)					Return on VDAs pegged to cost of short-term debt, with no change in deemed capital structure				
Parameters	Debt Equity Weighted average cost of capital	Rate	Capital structure	Weighted rate	Debt ¹ Equity Weighted average cost of capital Short-term debt	Rate	Capital structure	Weighted rate	
		6.511%	65%	4.232%		6.676%	65%	4.339%	
		8.200%	35%	2.870%		8.200%	35%	2.870%	
		7.102%				7.209%			
						2.107%			
Return	Return-earning assets	Asset value in \$ million	WACC	Return in \$ million	Return-earning assets	Asset value in \$ million		Return in \$ million	
	Rate base (non-VDA)	10,700	7.102%	759.9	Rate base (non-VDA)	10,700	7.209%	771.4	
	100% of VDAs	400	7.102%	28.4	65% of VDAs	260	2.107%	5.5	
					35% of VDAs	140	8.200%	11.5	
		Total		788.3	Total	Total		788.3	
1. Recalculation of cost of debt for cost recovery:									
	Distributor's share	Minus: VDA share							
Numerator	470	5.5	464						
Denominator	7215	260	6955						
Cost of debt	6.511%		6.676%						
2. 65% of the denominator of the Distributor's share is financed by borrowed capital.									

Table 3 shows the situation with a financing rate based on short-term interest rates and the capital structure changed to fully finance the \$400 million balance of the VDAs, which would be deemed to be financed by debt in its entirety. As can be seen, the average cost of capital would change and the Distributor would be adversely affected by the change in the capitalization ratio as it would no longer earn the return on equity to which it is entitled.

Table 3:
Example of return based entirely on the cost of short-term debt,
with full recovery of the Distributor's share of the cost of integrated debt

Current return, pegged to weighted average cost of capital (WACC)					Return on VDAs pegged to cost of short-term debt				
Parameters	Debt Equity Weighted average cost of capital	Rate	Capital structure	Weighted rate	Debt ¹ Equity Weighted average cost of capital Short-term debt	Rate	Capital structure	Weighted rate	
		6.511%	65%	4.232%		6.764%	65%	4.397%	
		8.200%	35%	2.870%		8.200%	35%	2.870%	
		7.102%				7.267% 2.107%			
Return	Return-earning assets	Asset value in \$ million	WACC	Return in \$ million	Return-earning assets	Asset value in \$ million		Return in \$ million	
	Rate base (non-VDA)	10,700	7.102%	759.9	Rate base (non-VDA)	10,700	7.267%	777.5	
	100% of VDAs	400	7.102%	28.4	100% of VDAs	400	2.107%	8.4	
		Total		788.3	Total	Total		786.0	
1. Recalculation of cost of debt for cost recovery:									
Minus:									
Distributor's VDA									
share share									
Numerator	479	8.4	470						
Denominator	7355 ²	400	6955						
Cost of debt	6.511%		6.764%						
2. 66.3% of the denominator of the Distributor's share is financed by borrowed capital.									

From a regulatory point of view, a scenario in which VDAs are specifically financed by debt, in their entirety, without recognizing the communicating vessels effect with the cost of debt for the rate base, would violate the principle that ratemaking must allow a company to fully recover its costs. Moreover, as the example in Table 3 shows, even in the hypothesis where the difference in the cost of debt is recovered through the offsetting effect described above, there would still remain a shortfall with respect to the 35% equity component of this structure, which would not be offset. Therefore, the Distributor would not realize the return on equity authorized by the Régie, violating the principle of a reasonable return for shareholders.

In addition to penalizing the Distributor, applying different rates would introduce additional complexity into the tracking and management of the various VDAs. Returning to the previous example, regular adjustments would be required to follow up on the Distributor's specific cost of debt. As well, since VDAs may generate either accounts receivable or accounts payable over time, the amount and amortization period of which may vary widely, differential treatment would mean that the Distributor's effective capitalization ratio would vary over time independently of funds. In fact, the Distributor would be penalized when the VDAs are in an asset position (accounts receivable) and rewarded when they are in a liability position (accounts payable).

For all the above-mentioned reasons, the Distributor believes that the weighted average cost of capital, calculated for the rate year for which the rate is being set, is the most appropriate rate for

determining the return on VDA balances. It reflects the reality of Hydro-Québec's integrated financing and is consistent with comprehensive management of that financing. It is a simple method for establishing the return on VDAs that guarantees uniform treatment for the company's accounts receivable from customers and its accounts payable. It should be borne in mind that VDAs apply to differences beyond the company's control that may be either positive or negative. Finally, a calculation methodology based on the use of variance accounts financed exclusively by debt would have an adverse impact on shareholders.