RÉPONSES DE L'AQCIE/CIFQ
À LA DEMANDE DE RENSEIGNEMENTS #1
DU DISTRIBUTEUR

Le 20 novembre 2014

RÉPONSES DE L'AQCIE/CIFQ À LA DEMANDE DE RENSEIGNEMENTS N° 1 DU DISTRIBUTEUR

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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?

Réponses:

a) Correct, as far as Dr. Booth was aware there was no discussion of any significant deferral accounts or short term assets in TQM's rate base. Note that TQM's revenue requirement was automatically included in that of the TransCanada Mainline as a TBO.

b) Dr. Booth assumes that the NEB included footnote 38 since the Canadian Association of Petroleum Producers recommended a conventional approach to rate making and the NEB wanted to provide consistency with other recommendations. Note that the TQM case was unique in that TQM had very little debt outstanding and there was no need to deal with the problem of the embedded cost of debt versus the current market cost in the ATWACC. Also the NEB precedent in TQM was not followed in subsequent NEB decisions, notably that for the TransCanada Mainline (RH3-2011).

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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?

Réponses:

- **a) In accounting Dr. Booth agrees that current assets and liabilities are generally those that have a high degree of moneyness in converting to cash within a year and mainly for that reason are recorded separately in a company's balance sheet. In finance the terms are not as precise, long term, for example, does not refer to greater than one year. Medium term notes (MTNs) include debt with a maturity out to 20+ years and yet conventionally we refer to paper, notes and bonds where notes refer to obligations with between a one and 5 year maturity.**
- **b) No. Dr. Booth's understanding is that HQD has put forward a proposed revenue requirement that would treat the regulatory asset as part of rate base proposed to be financed with debt and equity. Any proposed average debt cost only includes part of the regulatory asset.**

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3. Preamble :
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   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.

Réponses:

a) Yes, but the maturity of debt shortens through time to match the depreciation of the asset to which it is matched.

b) Of course; all averages reflect values that are both higher and lower than the average.

c) No, since the assets that the long lived debt finances also gets shorter each year, that is, HQD follows a matching philosophy so that as the asset life gets shorter so too does the maturity of the debt.

d) The length may affect the risk of recovering a deferral account balance, but it depends on the business risk of the utility. As Dr. Booth discusses on page 16 the National Energy Board regarded a medium term toll stabilisation account proposed by the Canadian Association of

Petroleum Producers to be as risky as other TransCanada Mainline assets. This was because the anticipated balance was to be recovered in the medium term from shippers where there was a significant risk that the Mainline's throughput would not recover. For HQD Dr. Booth does not consider the difference between the proposed special deferral account and normal accounts to be material, since there is very little short run risk of non-recovery from electricity users in Quebec.

e) The question needs to be more specific. Regulatory lag in terms of the frequency of regulation can increase or decrease risk depending on the state of the economy. For example, when there was significant inflation regulatory lag imposed significant risk for historic cost utilities. With deflation or constant prices, it would be Dr. Booth's judgment that in many cases regulatory lag is to the utilities benefit.

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?

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Réponses:

a) That is Dr. Booth's understanding. In the referenced passage Dr. Booth is referring to new in the sense of HQD's proposal to convert a substantial balance in a deferral account into a longer term receivable.

b) Yes, as Dr. Booth generally recommends the use of deferral accounts to control for variances beyond the control of management.

c) Dr. Booth would agree that DBRS and others refer to deferral accounts as supportive of credit ratings, since they smooth out earnings. However, he would note that neither Enbridge Gas Distribution Inc (EGDI) nor Union Gas have weather deferral accounts and even when EGDI was "shut out" of the long term bond market due to poor weather and low temporary earnings DBRS did not view it as a credit event. Further EGDI did not propose a weather deferral account to remove this risk. Dr. Booth has not seen any evidence of lower debt costs due to the existence of deferral accounts and would judge it incredibly difficult to empirically test such a proposition. He would note that for many Canadian utilities their S&P bond rating is a flow through of their parent's bond rating, so it is unlikely to change even were they to be granted a material increase in deferral accounts.

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?

Réponses:

a) As Dr. Booth has frequently pointed out Canadian regulators use normal deferral accounts to pass on unanticipated risks to ratepayers, which may allow a lower overall cost of capital. This would be the case with normal deferral accounts, where the balance fluctuates around zero with recovery the following year. By definition this does not apply to the $380 million in question.

b) A five year capital investment recovered through normal depreciation is part of the normal capital investment of a utility and reflected in its cost of capital. This asset would be part of the average life of the utility's assets and by the matching principle the average life of the utility's debt. Special treatment of a deferral account, such as that proposed, is unusual and reflects the acquisition of a new low risk asset.

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?

Réponse:

a) Correct. There is always some shorter term debt as the debt remains outstanding, but until recently there was no ability to issue debt with a maturity longer than 30 years so by definition the average life of the debt was shorter than 30 years. For example long term Government of Canada debt was normally an average of about 18 year debt. Now we see utilities raising 40 and 50 year debt so the average maturity can be lengthened to closer to the average life of rate base assets. However, the yield curve beyond about 20 years is pretty flat so the cost of 20 versus 30 or 50 year debt is quite similar.

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?

Réponses:

a) Correct, the point of this passage was that Dr. Booth was highlighting the very large cost involved, the long time period over which those costs would be incurred and the even longer time period over which they would be recovered.

b) Yes.

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.

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Réponses:

a) **If a capital asset has a $380 million value, a five year useful life and the Regie approves its inclusion in rate base then it would be included in capital investment and earn the weighted average cost of capital. This asset would then be necessary to provide service and be part of the weighted average life of the utility assets and by the matching principle a factor in the average life of the utility debt. This asset would then bear the normal business risk of the utility earning its allowed ROE. In contrast the $380 million balance is not a capital investment as normally determined and not necessary to provide service. It is a regulatory asset and different for the reasons cited by Dr. Booth in his tesitmony on pages 6-10.**

b) **The five year capital investment would earn the weighted average cost of capital unless HQD decides to lease the assets from a third party.**