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Fair Return on Deferral Balances

Professor Laurence Booth
CIT Chair in Structured Finance
Rotman School of Management

Supreme Court of Canada

Mr. Justice Lamont's definition of a fair rate of return in Northwestern Utilities (1929) was adopted in the BC. Electric Decision(1960)

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

BC Electric Statute

In BC Electric the Supreme Court of Canada had to interpret the following statute:

(a) The Commission shall consider all matters which it deems proper as affecting the rate:

(b) The Commission shall have due regard, among other things, to the protection of the public interest from rates that are excessive as being more than a fair and reasonable charge for services of the nature and quality furnished by the public utility; and to giving to the public utility *a fair and reasonable return upon the appraised value of the property of the public utility used, or prudently and reasonably acquired, to enable the public utility to furnish the service*

AUC Decision 2013-297

"that 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"***

Interpretation

- A fair and reasonable return
- Appraised value of the property
  - used or
  - prudently and reasonably acquired
- To enable the utility to provide service

Invested Capital

TABLE 20-1 Main Balance Sheet Accounts

Cash and marketable securities	Accruals
Accounts receivable	Accounts payable
Inventory	Short-term debt
Prepaid expenses	Current liabilities
Current assets	Long-term debt
Net fixed assets	Shareholders' equity
Total assets	Total liabilities and shareholders' equity

- Accruals and payables are spontaneous liabilities
  - arise as part of doing business, not "investment"
  - *invested capital* is total assets net of spontaneous liabilities: net fixed assets (NFA) plus net working capital (NWC)

Invested Capital

- Invested capital is NFA (and other long term assets) + NWC
  - includes *permanent* components of current assets: As one short term asset is retired it is replaced by another (like cars in Concentric's example)
  - temporary NWC is seasonal or other non-permanent components
    - year end is often set to minimise temporary NWC on year end balance sheet
    - banks often require a "clean-up" provision where there is no use of an operating line to make sure they are not financing permanent capital.
- WACC (weighted average cost of capital) is the cost of invested capital and includes financing permanent NWC

WACC

- Bears utility risk
  - Short term return *on* capital
  - Long term return *of* capital
- Utility witnesses normally emphasize long run risk as the most important: Dr. Paul Carpenter (on behalf of Gaz Metro, 2009)

"Q11. Why do you say that equity investors give greater weight to fundamental capital recovery risk?

A11. When investors buy a share of stock, they are buying a share of a long-term earnings stream. They are not buying only a month, or even a year's worth of performance. The time horizon of any equity investment is inherently long term. The short-term variability in the earnings of an equity investment is only a small part of the business risk picture. This is particularly important for utility investments that when "sunk" into the ground are difficult to redeploy to other valuable uses should their fundamental risks be realized."

- Short run deferral balances do not normally face this long run recovery risk

Financing Deferral Balances

- **Deferral balances are regulatory assets**
  - **unexpected revenues or costs carried forward from one test year to another**
  - **In this sense they not "used and useful" assets *necessary* to provide service in a *future* test year**
- **Normal balances**
  - **should zero out: zero average forecast errors**
    ***temporary* component of NWC**
  - **should be financed with a short term cost: *matching principle***
  - **Ontario Energy Board allows Bankers Acceptance (BA) rate plus 0.25%, but actual rate may not be material if they zero out on average**
- **Non-normal are any material balances amortised over future test years: "special" deferral accounts**

Non-normal Balances

- **Proposed regulatory asset of $380 million**
  - **Matching principle: financing based on amortisation of balance**
  - **Proposed 5 year amortisation is like a mortgage, and unlike a normal balloon payment on a bond**

Amortisation Table at WACC

	1	2	3	4	5
Principal	380 00	314 06	243 43	167 78	86.77
Interest	26 99	22 30	17.29	11.92	6.16
Payment	92 93	92.93	92 93	92.93	92 93
Close	314 06	243 43	167 78	86 77	0.00

Amortisation Table at BA + 0 25

	1	2	3	4	5
Principal	380 00	306.17	231 27	155 29	78 20
Interest	5 51	4 44	3 35	2 25	1 13
Payment	79 34	79 34	79 34	79 34	79 34
Close	306 17	231.27	155 29	78 20	0 00

  - **The weighted average maturity (duration) is much shorter than the term: just below 3 years**

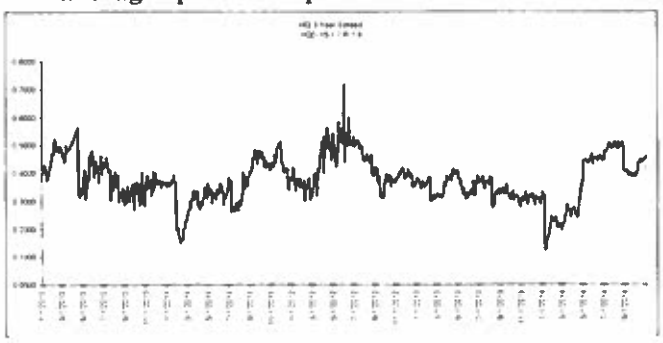
$380 million "Special" Deferral

- Approximate 3 year duration implies an approximate 3 year financing cost
- HQ (with provincial guarantee)
  - bond rating A+ to AA- (split rating)
  - commercial paper Dominion Bond Rating Service (DBRS) R-1 (mid) same as the banks
- Recommended rates:
  - short term spread is BA rate (22-24 bps over Treasury Bills) plus 25 bps for provincial guarantee
  - HQ (28 August, 2014) 5 year floating rate notes at CDOR + 0.14%; essentially overnight rate (1%) + 0.14%
- Long term spread
  - AA spread is currently approximately 0.60% over government of Canada bonds of the same maturity: 3 year is in between 0.14% and 0.60%

BOOTH HQD 2014

Recommended 3 year Rate

- I recommended 1.60%
- In HQD-15-1.7 R1.4, HQD provided the three year HQ and Canada rates:
  - latest 3 year HQ rate was 1.61%.
  - spread history since 2010 is in following graph: average spread 37 bps



BOOTH HQD 2014

Recommendation

- 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

- **No double counting the guarantee cost**
- **For the TransCanada Mainline (RH-3-2011) the NEB allowed the use of the WACC due to the extreme short term risk it felt the Mainline faced and the associated significant risk of non-recovery.**
- **Forecasts for 3 year rates are not available from Consensus Economics for the test year.**
- **Balance should be carried as a normal deferral balance until the Regie approves amortisation.**

Differences between Booth and Concentric

- **Concentric views the $380 million balance as being part of the normal operations of the utility that gets the WACC *and* that they were considered as such when the Regie set the allowed ROE and deemed common equity ratio**
- **If they were normal they should zero out and the cost may not be material**
- **I regard them as separate from the**

  "appraised value of the property of the public utility used, or prudently and reasonably acquired, to enable the public utility to furnish the service"
- **I regard them as a special regulatory asset apart from the assets *necessary to provide service* since some utilities operate perfectly fine without these deferral accounts**