RP-2004-0188

ONTARIO ENERGY BOARD

IN THE MATTER OF

THE
2006 ELECTRICITY DISTRIBUTION RATE
HANDBOOK

WRITTEN EVIDENCE OF

M. GREG MATWICHUK

ON BEHALF OF

VULNERABLE ENERGY CONSUMERS COALITION

December 13, 2004

Q.1. Have you previously appeared before the OEB?

A. No.

Q.2. Briefly describe your background and expertise.

A. I am a partner in the firm of Stephen Johnson Chartered Accountants. I have worked in the field of regulated utilities for 20 years. I have testified before other regulatory tribunals and have advised clients on a number of topics regarding regulated utilities including electric, gas (LDC), pipeline and telecommunications matters. Often these issues deal with revenue requirement, the regulatory practices and underlying accounting treatment issues. Please see my Curriculum Vitae, Appendix 1, attached.

Q.3. Describe the nature and scope of this evidence.

A. I was asked by the Vulnerable Energy Consumers Coalition ("VECC") to conduct an independent review with advice and opinions regarding the following:

1) Review of regulatory practice in Canada with respect to allowed interest during construction ("IDC") and allowed interest on utility deferral and variance accounts;

2) Review the OEB Accounting Procedures Handbook[1] ("AP Handbook") for Ontario electric distribution utilities ("Electric LDCs")[2] to identify relevant accounts and ensure that the procedures for estimating carrying charges on construction balances or deferral accounts can be clearly documented;

3) Determine the options appropriate for allowed short term interest rate and which instruments are the basis of the options; and

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[1] Ontario Energy Board Accounting Procedures Handbook, Revised December 2001
[2] Electric Local Distribution Companies in Ontario

4) Review the Draft OEB Electricity Distribution Rate Handbook for 2006[3] ("EDR Handbook") to provide appropriate modifications to reflect my findings.

Q.4. What was the scope and context of your investigation?

A. The documents and information primarily relied on for this evidence were the AP Handbook, regulatory decisions in Ontario and other jurisdictions, various reports and procedural orders from OEB website, a sample of Electric LDC Terms and Conditions of Service, a sample of Electric LDC financial statements and Draft 1 of the 2006 EDR Handbook. In addition, I conducted an informal survey of regulatory practices in jurisdictions across Canada with respect to carrying charges as they related to Construction Work-in-Progress ("CWIP"), deferral and variance accounts. As well, I reviewed a sample of Electric LDCs audited financial statements.

I understand that the rate setting process for the Electric LDCs will be coming to the end of its initial PBR plan with the setting of rates for 2005, and for 2006, these utilities will, effectively, be regulated on an approved revenue requirement basis.

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Q.5. What are the underlying regulatory principles that are relevant to this analysis?

A. The prominent regulatory principles to be considered are as follows:

1) Cost – Rates ultimately charged to ratepayers should be set to recover the cost of providing service to those ratepayers. More specifically, ratepayers should pay no more than the cost incurred by a prudent utility. Further, an asset must be prudently acquired, be used and useful, and recorded at the cost when first devoted to public use to be included in rate base.

[3] Ontario Energy Board 2006 Electricity Distribution Rate Handbook, Draft 1, December 9, 2004

2) Matching – The revenues are to be matched to the costs incurred to assist in generating those revenues. Once the first principle is achieved the second becomes more a matter of timing (and inter-generational equity).

3) A regulated utility should have a reasonable opportunity to recover its costs.

Q.6. What is the conceptual impact of adopting a practice or policy with respect to carrying charges?

A. A regulated utility is entitled to recover its laid down capital (return of capital) and a reasonable opportunity to recover a fair return on that capital. In some circumstances the fair return would include an equity component and in others it would not. For costs that were prudently incurred pursuant to legislative fiat, regulator rulings, jurisprudence and relative to the circumstances, those costs are generally recoverable from ratepayers.

Regulators make judgments in terms of which cost items are authorized for inclusion in a utility's revenue requirement so that a utility can achieve the optimal rate of investment at the minimum price to ratepayers. Consistent with the cost principle, stated above, and as noted by renowned regulatory scholar James Bonbright, the cost will include all costs of operating the utility and the costs of capital including a capital attracting rate of profit[4].

This principle has also been recognized in the regulatory finance literature:

> Investors expect a fair opportunity to earn a rate of return on investments that is just equal to the cost of capital they supply.[5]

Without going into great detail, there is a long history of jurisprudence in this area and I will note two other principles of fairness and reasonableness regarding

[4] Bonbright, James, C., Albert L. Danielson and David R. Kamershcen *Principles of Public Utility Rates*, Second Edition Public Utilities Reports, Inc. 1988
[5] Kolbe, Lawrence A., William Tye and Stewart C. Myers *Regulatory Risk – Economic Principles and Applications to Natural Gas Pipelines and Other Industries*, Norwell, MA: Kluwer Academic Publishers, 1993

allowed return that arise from that history. Typically, regulators ensure that the allowed rate of return is sufficient to ensure a utility's financial health so as to maintain its credit worthiness and to be able to continue to attract funds on reasonable terms[6] (i.e. maintain financial integrity).

If a carrying cost is either excessive or is insufficient, there could be an impact on the reasonable opportunity to recover a fair return and maintain financial integrity. Essentially, the carrying cost allowed should be set to recover the cost a utility would incur to finance an asset, consistent with the cost principle, above. If an allowed carrying cost is excessive (greater than its cost of financing), this will allow a utility to potentially enhance its overall return on equity, above what is fair. Conversely, if the allowed carrying costs are insufficient (less than its cost of financing), it would potentially hinder that utility's opportunity to earn a fair return.

Q.7. Provide the historical and conceptual context for CWIP and its associated carrying cost.

CWIP is commonly considered as the costs incurred during the construction period of an asset up to the time where the asset becomes used and useful, and is then placed in rate base. Before being placed in rate base, there is a recognition that there is a financing cost to building new facilities. Consistent with the capital cost principle noted above, a regulated utility should be given a reasonable opportunity to recover the capital costs of its construction funds[7]. Historically, official recognition of that financing cost has evolved.

Prior to the 1970s Interest During Construction ("IDC") was commonly capitalized as the carrying cost of an asset while it was being constructed and before its transfer to rate base. Largely, beginning in the early part of that decade, IDC

[6] Morin, Roger A. *Utilities' Cost of Capital*, Arlington, VA: Public Utilities Reports, Inc. 1984. These matters are generally covered, in detail within a regulator's examination of cost of capital and are generally accepted by regulators in North America.
[7] Pomerantz, Lawrence S. and James E. Suelflow, *Allowance for Funds Used During Construction – Theory and Application*, East Lansing MI: Institute of Public Utilities, Michigan State University, 1975

was substituted by what is commonly referred to as Allowance for Funds Used During Construction ("AFUDC") in the case of investor owned utilities and implemented into the uniform system of accounts used in the U.S[8].

AFUDC provided recognition for a component of equity financing usually at the allowed rate of return on equity and is, generally, in the same proportions as the allowed capital structure. Essentially, the financing cost for CWIP became equivalent to the rate of return on rate base, but is a non-cash amount for utilities as that cost was capitalized. Typically, publicly owned or crown corporations continued with their use of IDC, given that they rarely had an equity component of a significant degree. More recently, however, a number of crown owned utilities are, indeed, financed by equity injections through shareholder arrangements with their owners, often municipalities. They have tended to adopt AFUDC treatment.

As IDC is purely interest, it is intended to reflect the interest financing cost alone. In the case of AFUDC, both the equity and debt components are to be representative of an investor owned financing, but part is recorded as current income and part as an offset to interest expense incurred. However, no cash payments are made by ratepayers for either the cost of debt or equity during construction.

In any event, the entire cost of constructing the plant, including the appropriate IDC or AFUDC, if approved, is added to rate base where it earns an allowed rate of return and is depreciated over its useful life – the costs that are recovered through revenue requirement in a ratepayer tariff.

In some cases CWIP is included in rate base, where it immediately begins to attract the allowed rate of return and is depreciated. This would typically be in a situation where there could be significant financial hardship or financing problems

[8] Phillips, Charles F. Jr. *The Regulation of Public Utilities*, Arlington, VA Public Utility Reports, Inc, 1988

during construction if it were not in rate base. However, this has been more the exception than the rule.

Q.8. Please summarize the results of your review of regulatory practice regarding carrying charges for CWIP.

A. The review of regulatory practices involved canvassing regulators across Canada[9]. The treatment of carrying charges was generally consistent in respect of CWIP. Currently, where there is equity financing of rate base, CWIP is attracting carrying charges as AFUDC calculated using the rate of return on rate base. Where there is essentially no equity financing, as in the case of some crown owned utilities, the carrying charge associated with CWIP is IDC.

Q.9. Is there any guidance from Generally Accepted Accounting Principles ("GAAP") with respect to these carrying charges?

A. In regard to these matters GAAP is not prescriptive -- the appropriate regulatory treatment is not driven by GAAP. Rather, GAAP tends to obtain guidance from regulator directives. In respect of CWIP, the Canadian GAAP pronouncements permit the inclusion of AFUDC or IDC in the capitalized cost of construction, if so allowed by the regulator[10]. The U.S. view is similarly permissive[11].

There is no similar Canadian pronouncement with respect to deferral accounts. However, again, the U.S. perspective is that it is not a requirement nor a given,

[9] British Columbia Utilities Commission, Alberta Energy & Utilities Board, Saskatchewan Rate Review Panel, Manitoba Public Utilities Board, Ontario Energy Board, New Brunswick Board of Commissioners of Public Utilities, Nova Scotia Utility and Review Board, Island Regulatory and Appeals Commission, Newfoundland and Labrador Board of Commissioners of Public Utilities, Yukon Public Utilities Board and NWT Public Utilities Board. As at the date of submission data from Régie de l'énergie de Québec had not arrived,

[10] Canadian Institute of Chartered Accountants, *Handbook*, Section 3061, paragraph 23

[11] Financial Accounting Standards Board, Statement of Financial Accounting Standards 71 (FAS 71), paragraph 15

for financial statement purposes, that a deferral account have a carrying charge associated with it. But, it is allowed pursuant to regulatory decisions[12].

Q.10. Describe the nature of deferral accounts for regulatory purposes.

A. Deferral accounts are generally balance sheet accounts that are set up to record the difference between forecast and actual amounts for revenues or costs that are difficult to forecast and are not generally within the control of utility management. Deferral accounts, as such, tend to be a function of regulation since, except in few circumstances, GAAP does not allow such accounts.

Generally speaking deferral accounts are apparent in various types which generally represent the differences between costs incurred and those collected through rates. At times the industry distinguishes between deferral accounts and variance accounts. However, both operate in similar fashion in that they collect amounts (costs or revenues) not currently included in rates, and defer those amounts until the accounts can be disposed of in a systematically approved manner, usually by inclusion in rates over a prescribed period. For the purposes of this evidence I have defined the term deferral accounts to include variance accounts.

The essential reason for deferral is to collect prudent costs or revenues for which utility management was not reasonably able to forecast and so that the net balance can be collected from, or refunded to ratepayers over the appropriate period.

Deferral accounts are intended to ensure that there are no winners or losers as a result of uncontrollable revenues and costs. One result is generally a transfer of risk from utilities to ratepayers. The existence of deferral accounting has a direct impact on the business risk of a utility. Uncertainty of collection of prudently incurred costs is not considered an issue if the costs incurred are prudent, but

[12] Financial Accounting Standards Board, Statement of Financial Accounting Standards 71 (FAS 71), paragraph 20

becomes more of an issue of timing. Therefore, deferral and subsequent recovery provides reasonable assurance of high quality, safe and reliable assets, thereby reducing a significant component of utility business risk.

Deferral accounts can have either a short term or long term character. That will be discussed in further detail below.

Q.11. Please summarize the results of your review of regulatory practice regarding carrying charges for deferral accounts.

A. Based on my review of regulatory practice, there is a divergence with respect to carrying charges in respect of deferral accounts and variance accounts. Some utilities and jurisdictions treat deferral accounts as part of rate base. In those instances, rate of return on rate base is the carrying charge. Often these can be rate base related, in any event[13]. Others provide separate treatment outside of rate base. This appears largely to allow for separate monitoring. For non-rate base deferral accounts the carrying charges vary. Some use the rate of return on rate base, while others use the embedded cost of debt (similar to IDC), still others use short term rates of the utility and yet, still others use a prescribed rate that is not necessarily part of the utility's capital structure. Presumably, the last one arises out of some degree of administrative practicality, while still attempting to reflect a cost of borrowing.

Q.12. Please provide your understanding of the deferral accounts facing the Electric LDCs.

A. For the Electric LDCs, I understand these deferral accounts consist mostly of the following:

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[13] For example, if prescribed construction of certain assets is outside the control of utility management, a deferral account for these costs would be more related to rate base. Also, software development costs that are amortized over extended periods are sometimes placed in a deferral account which then gets placed in rate base.

1) Transition costs;

2) Pre-market opening cost of power variances; and

3) Post-market opening retail settlement variances.[14]

For financial statement purposes these are largely what has become known as "regulatory assets".

It is my understanding that Bill 210[15] in November 2002 generally deferred future rate increases until after May 1, 2006. Subsequently, with the introduction of Bill 4[16] in November 2003, the Ontario government announced that the Electric LDCs would be permitted to begin the recovery of regulatory assets commencing in 2004. Further, I understand that the Electric LDCs had the opportunity to possibly recover 25% of those costs in their respective 2004 rates. The remainder of those costs may be applied for recovery in 2005[17]. Also, I understand that the remaining regulatory assets are to be amortized over a period of 3 years.

Further, I understand that the deferral accounts in question, in aggregate, represent a ratio of approximately $550 million[18] to a collective rate base amount of approximately $9.2 billion[19] or 6.0% based on those amounts.

Q.13. Provide the criteria that should be considered to determine the short or long term financing character of a deferral account.

A. Based on my review the criteria that should be considered are as follows:

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[14] The specific accounts are separately itemized in the Uniform System of Accounts, Article 220 in the AP Handbook and at the OEB website at http://www.oeb.gov.on.ca/documents/cases/usoa/usoa_201201.pdf
[15] *The Electricity Pricing, Conservation and Supply Act, 2002*
[16] The Ontario Energy Board Amendment Act (Electricity Pricing), 2003
[17] With the exception of four of the largest Electric LDCs which received approval in 2004 for recovery.
[18] Measured at December 2002 found at OEB web site http://www.oeb.gov.on.ca/documents/regassets_200204.xls
[19] Measured at December 1999, Board staff prepared spreadsheet

1) Nature of the account – One time balance in a separate account to be amortized or an account balance that captures the ongoing changes that tend to create a blended balance.

2) Volatility – The more volatile, the more conducive to financing with floating rates and not long term capital but more towards bank lines. The less volatile, the more conducive to financing with fixed rate capital or permanent capital.

3) Duration or Amortization Period – For a short term duration of account there would be a tendency to use short term financing. For long term account one would tend to use permanent or long term capital for financing. The longer the amortization period, the general expectation is that the financing will require, at least, some permanent capital.

4) Administrative practicality – This consideration is a matter of the relative ease of setting and monitoring a single prescribed rate or allowing a range or actual rates.

Q.14. Comment on the deferral accounts in question in light of the above considerations.

A. Transition costs and pre-market costs have more an appearance of one-time costs, the balances of which have been, or will be, fixed and are more likely to be amortized over a period of three or four years. As a consequence there is no volatility. The deferral account that is capturing the ongoing retail settlement variances will vary as a result of day to day operations. Given its balance depends on volume and price differentials, its character will be more given to volatility. Both will be amortized over relatively short periods; perhaps three or four years.

Q.15. Comment on the duration of amortization and terms over which a deferral account would be financed.

A. I understand that existing deferral accounts are expected to be amortized over a period of three to four years. Generally speaking, one might consider that these are relatively short periods and would not be financed by long term capital. For example, it would not make business or economic sense to finance a three or four year declining balance asset with 30 year debt. Rather, it would be more prudent, in this case, to use short term financing.

Q.16. If a short term rate is to be used, what are the possibilities for short term rates.

A. The possibilities for short term rates include chartered bank prime, Banker's Acceptances, commercial paper, guaranteed investment certificates ("GICs"). All of these rates are readily accessible in business journals and web sites such as the Globe and Mail and the Bank of Canada.

Currently, prime is posted as 4.25%[20]. Since January 1, 2004 prime has ranged from 3.75% to 4.50%

Banker's Acceptance rates are currently ranging from 2.56% to 2.57% for 1 to 3 month terms. Appropriate stamping fees would be added depending on the utility. Since January 1, 2004 those rates have ranged from 2.02% to 2.70% for 1 month and 2.04% to 2.74% for 3 months. Associated fees such as stamping fees for an A low and R1 rated company may be an additional 25 to 35 basis points.

Prime commercial paper rates are currently ranging from 2.58% to 2.63% for 1 and 3 month terms. Since January 1, 2004 those rates have ranged from 2.02% to 2.72% for 1 month and 2.03% to 2.76% for 3 months.

[20] Globe and Mail, December 11, 2004, page B23

Q.17. Please provide the short term financing rates permitted for deferral accounts that you discovered in your review of other jurisdictions.

A. Where they were explicitly shown, the short term rates used for deferral accounts ranged from prime less 0.5% to prime. Where deferral accounts were being amortized over long terms or where the nature of the accounts were more in the nature of rate base, longer term rates were used such as rate of return on rate base. However, even in some of the latter cases, the allowed carrying cost was a short term rate.

Q.18. Please provide the short term financing rates you ascertained from your review of financial statements of the Electric LDCs

A. From a review of the financial statements of the Electric LDCs the short term rates varied in instruments. Most often the rates were a function of the prime lending rate or Bankers Acceptances (inclusive of a stamping fee). From the survey of other jurisdictions those rates were consistent with those of the instruments in the financial statements reviewed. Generally, floating rates ranged from below prime to prime. Fixed rates were Banker's Acceptances plus 25 to 35 basis points and commercial paper. Based on current data the resulting short term rates would approximate a range of 2.80% for the larger companies and 3.50% to 4.25% for the smaller companies. The short term borrowing rate was not always apparent from the financial statements.

It is worthy of note that Enbridge Gas Distribution Inc., an Ontario based gas LDC, had a weighted average cost of short term borrowing ranging from 2.60% to 3.40% and averaging 2.98% based on commercial paper rates for the period. Over that same period, the average prime rate was 4.69% or 171 basis points greater than rate at which Enbridge was able to effect its short term borrowings.

Q.19. Do you have any other comments from your review of the financial statements?

A. Yes. I noted that, in some cases, Electric LDCs did not have full confidence in the ultimate recovery of their specific deferred costs. In those cases the financial statements either showed write-downs or associated allowances against the deferral account. No matter the reason for the write-down or allowance, essentially, the amounts required for financing is reduced in a commensurate magnitude. This may become an issue as to whether a utility is allowed carrying charges on the deferral account before or after the allowance (write-down).

Q.20. Please comment on these rates as they relate to deferral accounts.

A. A review of the financial statements indicates that utilities are able to finance their short term needs at rates well below the rates of their long term debt outstanding or the OEB deemed debt cost rate[21]. In consideration of the underlying cost principle discussed above, it is worthy to have regard for the actual financing costs available and, indeed, incurred.

Q.21. As a part of the review of these matters, please comment on security deposits and how the interest thereon compares to potential carrying charges for deferral accounts.

A. It is worthy to consider the status of customer security deposits. Often the rationale for utilities establishing an interest rate thereon is their assessment as to what rate the customers could get elsewhere, such as bank savings accounts or even GICs. However, in those terms of opportunity cost we should examine this more carefully. In the cases of residential customers who may be subject to proving their credit worthiness, it is instructive to recognize that, elsewhere, those customers may be required to pay down debt and even credit card debt at rates that could be as high as 20% or more. As such their opportunity cost may not be

[21] EDR Handbook, Draft 1, December 9, 2004, Section 5.2 "Debt Rate", pages 30 to 33

as simple as competitive rates for similar sized investments. For, larger customers, such as midsize commercial, the opportunity cost would likely be a business loan. For the large industrial customers, it would likely be similar to the short term financings discussed above.

The rates paid by utilities on security deposits cover a range using a number of benchmarks including Bank of Canada Bank rate, daily interest savings rate at a chartered bank, Canada Savings Bond rate, prime less 50 basis points and prime less 200 basis points. Based on my review, quantified, these rates range, from 1% to 2.75%. These rates, to compensate customers for deposits, are noticeably lower than the short term rates disclosed in the financial statements.

It is also worthy of note that some portion of customer deposits are held for terms greater than one year and in some cases 5 and 7 years. Yet, there is no differentiation in rates that I could find, being paid for the longer terms.

If symmetry is a consideration, then one may wish to give regard to the interest rates customers receive for their money relative to the rates they are asked to pay for carrying charges on utility invested funds for deferral accounts.

Q.22. Provide the possibilities for long term rates.

A. Where it is determined that the deferral account recovery is of a long term nature and should have a long term carrying charge for regulatory purposes, there are choices. The Board could select among the following:

1) The allowed return on rate base or weighted average cost of capital ("WACC") inherent in a general rate application or deemed by the Board or similar rate to AFUDC.

2) Long term debt rate (regulatory) – The allowed long term debt rate either inherent in a general rate application or deemed debt cost rate.

3) Long term debt rates (financial statements) – The interest rates reported in the audited financial statements of the Electric LDCs or forecast in a rate case.

In both cases 1) and 2), the deemed rates, presumably, would be determined in accordance with the relevant sections of the EDR Handbook. To date, it would appear the ROE would be targeted at 9.61% and the deemed long term debt rate would range between 6.41% and 6.81%. Based on the sample calculation provided by Board staff, the WACC for a "medium-large" Electric LDC would derive 7.75%.

Deemed rates have administrative appeal in terms of simplicity and practical implementation. Should a utility consider itself aggrieved, presumably it can make an application to demonstrate its case.

In the case 3), the rates can vary significantly. These rates may result from credit facilities negotiated with third parties or they may result from debt issued to an affiliate. The latter may not reflect market conditions for credit facilities.

Q.23. Are rates paid to affiliates a reasonable guide?

A. No. Rates paid to affiliates, often for loans from a municipality to an Electric LDC, are not a realistic guide. There is little assurance that these debt arrangements would reflect market rates. In one case I reviewed, the rate paid on a debt instrument to an owner municipality was as high as 12%, thereby reflecting a component of equity character rather than exclusively debt (of a given risk profile and cost of debt).

In the past the OEB's general principle is that the total interest paid is no greater than would occur if the funds were borrowed by the entity itself[22].

Q.24. Please comment on the financial statements of Electric LDCs.

A. I reviewed a sample of 15 sets of financial statements. All made reference to regulatory assets in the context of deferral accounts. Most made reference to expected future recovery. However, a very few made reference to carrying

[22] OEB Decision with Reasons EBRO 464, page 16

charges associated with these accounts. Consequently, there was very little data available in terms of expectations of, or existing financing by the Electric LDCs in relation to the deferral accounts.

Q.25. Please comment on the deferral account for Conservation and Demand Management.

A. An OEB procedural order established deferral accounts for conservation and demand management activities. It appears that costs incurred prior to March 1, 2005 are to be recorded inclusive of a carrying charge of 5.75%[23]. That rate would appear to be approximately 175 basis points above the prime lending rate at the time of the order[24]. Based on a review of financial statements, it would appear that this rate would be in excess of the incurred cost by the Electrics to actually finance these costs – by as much as 300 basis points. I understand that there is no designated or associated carrying charge for expenditures of these types, post February 28, 2005[25].

Q.26. Please comment on this Board's general approach to carrying costs on deferral accounts.

A. The Board has used various rates for deferral accounts. As noted above, a specific rate was used for conservation and demand side management. For deferral accounts of similar nature to those currently facing the Electric LDCs, in

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[23] OEB Procedural Order, RP-2004-0166, October 5, 2004 and OEB Letter to All Local Distribution Companies regarding an amendment to the AP Handbook account 1565, October 29, 2004

[24] Chartered Bank prime business rate week of October 6, 2004 was 4.0%, source: Bank of Canada

[25] Attachment to OEB Letter of October 29, 2004, Re: Amendment to Accounting Procedures Handbook – Conservation and Demand Management Account 1565, Board File No. 2004-0203, paragraph 10 and Attachment, paragraph 24

a prior Consumers Gas case, the Board deemed that the appropriate rate is that which was approved for the applicant's short term debt[26].

Q.27. Please summarize your findings.

A. As contemplated in the EDR Handbook, there are two distinct alternatives for carrying charges associated with CWIP:

"Alternative 1: the embedded cost of debt (GAAP)"; and

"Alternative 2: some form of short-term debt rate"[27]

Based on the review in this evidence, there is a third alternative:

Alternative 3: AFUDC using the WACC or IDC using long term debt cost.

With respect to CWIP the issue is fairly straightforward. Given the regulatory principles, history and generally accepted regulatory practice, the appropriate carrying charge for CWIP would be AFUDC (using rate of return on rate base) in the case of utility whose capital structure includes an equity component and IDC for a utility that is essentially financed by debt. Short term debt rates are not typically employed in the context construction assets. Based on my analysis, I recommend **Alternative 3**.

The less definitive issue is whether deferral accounts should attract short term financing. In the alternative they would receive a long term debt rate or even rate base like treatments. There are no hard and fast rules to determine the appropriate treatment. However, as outlined above I set out a number of considerations and criteria with respect to an assessment.

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[26] OEB Decision with Reasons, EBRO 464, page 57
[27] EDR Handbook, Draft 1, December 9, 2004, Section 4.4 "Interest on Deferral Accounts and Construction Work in Progress (CWIP)", page 25

First, consider the 3 alternatives contemplated in the EDR Handbook for deferral accounts:

"Alternative 1: the embedded cost of debt (GAAP)";

"Alternative 2: some form of short-term debt rate"; and

"Alternative 3: deemed debt rate (5- to 10-year rate)"[28].

The following sections contain a discussion of the relative merits of each alternative followed by a recommended approach.

If the Board determines that it views deferral accounts as being financed by short term capital, then it should ascribe a short term rate. However, if the Board concludes that the deferral accounts are financed by permanent capital or have more attributes like rate base then it should assign a long term debt rate or the rate of return on rate base.

Based on the data presented, my review of these accounts and the practices in various jurisdictions, it is more likely that these accounts have attributes that would attract short term financing. While an account such as the transition cost deferral may be a one time balance to be amortized over a period of years, that period is very short which would be more amenable to short term financing. Deferral accounts, such as the ongoing retail settlement variances appear to be of a blended nature over time and where one would expect some volatility, would be better accommodated by short term debt instruments. Given a utility's ability, in general, to actually carry out short term financing for these balances, awarding a long term debt rate or a rate of return on rate base would likely provide an opportunity to earn an excessive return on equity. Historically, this Board has implemented different interest rates for carrying charges on deferral accounts, including short term debt.

[28] EDR Handbook, Draft 1, December 9, 2004, Section 4.4 "Interest on Deferral Accounts and Construction Work in Progress (CWIP)", page 25

Based on the foregoing, it would appear that a short term rate would generally better lend itself as a reasonable cost associated with financing the deferred costs in question (i.e. **Alternative 2**). In contrast, the embedded cost of debt contemplates debt as long as 30 years and would, therefore, not be reflective of the amortization period being considered for the deferral costs. I will deal with Alternative 3 in Q&A #30, below.

Q.28. In your view, what options are appropriate for allowed (deemed or actual) short term interest rate and which instruments are the appropriate base of those options.

A. The Board could 1) deem a quantified rate that it determines is reflective of short term borrowing or 2) it could deem a benchmark. I note that with respect to long term debt, the Board is considering allowing a deemed rate for the Electric LDCs based on size[29]. In either of the above two cases, a similar approach could be adopted for short term debt. In so doing, the Board could approve either a specified rate or an instrument as a benchmark for the "Large" Electric LDCs and then allow increments above that benchmark for the successively smaller Electric LDCs.

Alternatively, while it may be possible to use the actual short term instrument inherent in a utility's capital structure, that is likely more cumbersome to administer with respect to 90+ utilities and may have only a minimal improvement in precision.

Setting one specified rate would have the greatest appeal from an administrative point of view. However, it may be somewhat challenging to predict an appropriate specific rate for an entire year beginning a number of months from the time of a Board decision in this matter for all the utilities. Given that market rates for short term debt instruments may fluctuate, it may be more advisable to

[29] EDR Handbook, Draft 1, December 9, 2004, Section 5.2 "Debt Rate", Table 5.1, page 31

use a benchmark instrument in a similar fashion used in the draft EDR Handbook with respect to long term debt.

Q.29. What would you recommend as a benchmark for a short term debt rate?

A. A benchmark for a short term rate could be considered in context with the benchmarks that are common in regulatory formulae for rates of return on common equity. That is, a benchmark is determined for the low risk entities in a population and then the higher risk entities are awarded graduated rates associated with their incremental risk.

Generally speaking, when one compares various short term rates that would be available to the larger entities in the population of the Electric LDCs, it is apparent that their short term borrowing can and does take place at or at the rough equivalent of prime less 175 basis points. This rate is approximately equivalent to other instruments such as Banker's Acceptances and commercial paper, as discussed above (See Q&A #16). The smaller entities in the population appear to be able to access short term borrowing at prime.

If a proxy of prime less 175 basis points were used for the large companies, then other short term rates could be determined for the smaller sizes of utilities in a similar fashion to that ascribed in the EDR Handbook. See Table 1 below which uses that format.

Q.30. Are there possible exceptions to using the short term debt rate?

A. Yes. There are two exceptions that are apparent. First, I understand that the deferral accounts, in some cases, may be so large that it may be difficult for a utility to obtain the types of short term financing discussed above. The relative size of the deferrals may be compared to the utility's rate base. Where the deferral account balance, as a ratio, exceeds 10% of rate base, it would be an indicator that the utility may be constrained in obtaining short term debt for exclusive financing of the deferral accounts. In those cases, the Board may choose to allow the utility to use a 5 to 10 debt rate or the rate of return on rate base or WACC for the calculation of carrying charges. See Table 1 for that accommodation.

It is worthy to note that current 5 year debt rates would likely approximate the prime rate. So there may be little to be gained by this stratification. However, the 10 year debt rates are approximately 50 to 75 basis points above prime and that may be a worthy consideration under the circumstance where there is a relatively high ratio of outstanding deferral accounts to rate base. One caution is that a 10 year rate is not necessarily an appropriate timing match to the amortization period. However, it may provide a reasonable bottom end range in these circumstances. As such, a derivative of **Alternative 3** may be considered for the lower end of the range.

Second, I understand that there is a proposed allowance for Electric LDCs that can demonstrate financial distress under a "Tier 2 Adjustment"[30]. That adjustment could also be applicable, under similar conditions, for financing the deferral accounts. If such financial distress can be demonstrated[31], the Board may choose to allow the utility to use the WACC for the calculation of carrying charges associated with deferral accounts. See Table 1, below, for that accommodation, as well.

To borrow a format from the EDR Handbook, the short term debt rates applicable to the Electric LDCs for 2006 might look like the following Table 1:

[30] EDR Handbook, 3.1.2 "Test Year Adjustments", "Option 2: Tier 2 Adjustments", pages 15 to 17
[31] My understanding is that there would be an ongoing annual requirement to demonstrate financial distress to merit Tier 2 treatment.

TABLE 1

Size-Related Debt Rate Formula				
Utility Size	**Rate Base**	**Deemed ST Rate**	**Deferred Accounts Aggregate Balance Greater than 10% of Rate Base**	**Financial Distress**
Large	> $1.0 billion	Prime less 1.75%	10 year debt rate to WACC	WACC
Medium-Large	$250 million - $1.0 billion	Prime less 1.00%	10 year debt rate to WACC	WACC
Medium-Small	$100 million to $250 million	Prime less 0.50%	10 year debt rate to WACC	WACC
Small	< $100 million	Prime	10 year debt rate to WACC	WACC

The approach in Table 1 would likely result in a reasonable approximation of the cost incurred by a utility to finance the deferral accounts. It has the added benefits of accessibility, transparency, administrative simplicity and, thereby consistent with the approach being proposed for long term debt costs.

Q.31. What accounts would you suggest be considered for the use of short term and long term rates?

A. I have not completed a thorough review of the uniform system of accounts, but it is apparent that the short term rates should be applied, in accordance with Table 1, to the deferral accounts associated with transition costs, pre-market opening cost of power variances and post-market opening retail settlement variances, as outlined in Q&A 12 above. A discussed above, long term rates, under the concepts of IDC or AFUDC would be appropriate for use with CWIP. Further, a range of 10 year debt rates and WACC, would be appropriate for carrying charges where certain conditions are met, with respect to deferral accounts, as outlined in Q&A 30.

Q.32. Does this conclude your evidence?

A. Yes, at this time.