

1 Q. Schedule 1, page 6, lines 20-21. Hydro is proposing that the AFUDC Deferral Account be included
2 in rate base.

3 a) Explain whether specific Board approval is required for the AFUDC deferral account to
4 be included in rate base.

5 b) Confirm the date that Hydro is proposing the deferral account to be included in rate
6 base and explain how Hydro will determine when the monthly transfers to the deferral
7 account for each capital project will be included in rate base, addressing how Hydro will
8 treat capital projects that are not yet completed.

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11 A. a) Capitalization of Interest During Construction ("IDC") allows certain financing costs incurred
12 during construction to be included in the total project cost ultimately included in rate base,
13 in lieu of annual cost recovery. IDC typically reflects only the interest expense on borrowed
14 funds. Allowance for Funds Used During Construction ("AFUDC") generally includes both
15 debt and equity.

16 Upon adopting International Financial Reporting Standards ("IFRS"), Newfoundland and
17 Labrador Hydro ("Hydro") capitalized borrowing costs directly attributable to capital
18 construction projects with a substantial duration using Hydro's embedded cost of debt (i.e.,
19 IDC).

20 At the time of the JT Browne Consulting review in 2020, the differences between the
21 capitalization of borrowing costs using IDC versus AFUDC appeared to be immaterial based
22 on historical calculations, but Hydro is now expecting the differences between approaches
23 to increase significantly beginning in 2026, resulting in less borrowing costs being capitalized
24 under IFRS's IDC methodology than would be using AFUDC.

25 Hydro believes it is appropriate to capitalize financing costs based on its allowed rate of
26 return and is proposing an AFUDC Deferral account, effective January 1, 2026, to capture
27 the variance between the capitalization of borrowing costs under IFRS's IDC methodology

1 and those capitalized under AFUDC methodology. Hydro is proposing the deferral account
2 be amortized and recovered over a period consistent with capitalization, equal to the
3 composite depreciation rate in Hydro's latest Board of Commissioners of Public Utilities
4 ("Board")-approved depreciation study. Hydro believes that to ensure that the variance is
5 recoverable and recovered, Board approval with respect to the inclusion of the deferred
6 amounts in rate base is necessary to provide that certainty.

7 **b)** It is Hydro's intent to capture the variances between the calculation of AFUDC and IDC on
8 capital construction in progress in the AFUDC Deferral Account on a monthly basis. Hydro
9 currently calculates IDC on its construction in progress for projects for which it has received
10 approval from the Board under Section 41(3) of the *Public Utilities Act* on a monthly basis,
11 and this will be an addition to that process. The calculation of AFUDC on a construction
12 project will cease once the project assets are placed in service. The AFUDC Deferral Account
13 balance will be included in rate base effective January 1, 2026, with amortization of the
14 balance commencing the year after the transfer of the cost to the AFUDC Deferral Account.

15 Hydro acknowledges that inclusion of the AFUDC Deferral Account balance in rate base is
16 not directly linked to the timing of the individual assets being placed into service. However,
17 the account records only the difference between AFUDC and IDC rather than the underlying
18 construction expenditures themselves. Given the administrative effort of tracking the in-
19 service dates of, on average, 140 active projects each fiscal year, Hydro believes this is a
20 more administratively appropriate method of implementation.

21 Hydro has provided additional details on the breakdown of AFUDC versus IDC impacts of
22 Major Projects and Hydro's other annual capital projects for the years 2026 to 2032. Please
23 refer to PUB-NLH-003, Attachment 1, for further details. The most significant potential
24 impact relates to balances associated with Hydro's major capital projects.

25 Hydro notes that the potential customer impact associated with the inclusion of AFUDC
26 Deferral Account balances in rate base in its 2027 Test Year, prior to certain major project

1 assets being placed into service, is not expected to be material.¹ In addition, Hydro does not
2 currently anticipate capital expenditures on major projects beyond 2031 to be at the same
3 level as those forecast during the 2028 to 2031 period.

4 Hydro considers the proposed approach to be a practical and cost-effective method of
5 administering the account while providing an appropriate opportunity to recover financing
6 costs associated with prudently incurred capital investments.

¹ $(\$1,500,000 + \$2,900,000) / 2 * 2027 \text{ Test Year Weighted Average Cost of Capital of } 4.88\% = \$107,360$. Hydro notes that a portion of this balance relates to Penstock 3, which is forecast to be placed into service during 2027. This example is for illustrative purposes only.

Table 1: Comparison of Capital Financing Costs using AFUDC¹ versus IDC^{2,3} showing Impact of Major Projects⁴

Major Projects	2026	2027	2028	2029	2030	2031	2032
AFUDC	7.2	16.8	37.3	57.1	36.8	44.5	2.7
IDC	5.7	13.9	32.5	47.9	30.5	36.1	2.4
Difference	1.5	2.9	4.8	9.2	6.3	8.4	0.3
Other Projects	2026	2027	2028	2029	2030	2031	2032
AFUDC	2.8	5.6	6.6	9.1	5.5	1.6	1.5
IDC	2.2	4.6	5.8	7.6	4.5	1.3	1.3
Difference	0.5	1.0	0.9	1.5	0.9	0.3	0.2

¹ Allowance for Funds Used During Construction ("AFUDC").

² Interest During Construction ("IDC").

³ Forecasted balances for 2028 through 2032 are based on the latest forecast information available at this time.

⁴ For the purpose of this analysis, Major Projects are defined as regulated projects with an anticipated cost of \$50 million or greater and are under the accountability of Newfoundland and Labrador Hydro's Major Projects Department.