Q. **a)** Provide the guidelines or policy that Hydro uses to determine when it is appropriate to capitalize the borrowing costs of a capital project.

b) In its report, Christensen notes that regulators generally require that AFUDC not be collected for certain periods of delay or deferment of construction activities and that the interest incurred during this period should not be capitalized. Does Hydro have a similar policy or apply a similar approach for capital projects that are delayed or deferred?

A. **a)** Newfoundland and Labrador Hydro ("Hydro") currently calculates and capitalizes borrowing costs in accordance with International Financial Reporting Standards – International Accounting Standard 23, *Borrowing Costs*. Below are the guidelines followed by Hydro with regards to capitalization of borrowing costs during a capital project.

Interest During Construction ("IDC")

Hydro shall include IDC as an element of the cost of a qualifying asset when borrowing costs are incurred to fund a capital project (prior to the asset being placed in service).

During the project's construction, the amount of IDC capitalized must be that portion of interest cost incurred by Hydro which could have been avoided if the expenditure for the project had not been made.

IDC related to a particular asset represents the cost of borrowing that the project is subject to during the construction phase. Only projects with durations greater than six months are subject to IDC.

When any of the following criteria is met, IDC is **NOT** incurred as part of a project's construction cost:

- The project is procurement-only (e.g., purchase of an asset such as vehicles, tools, capital spares);

- The project involves work on assets not owned by Hydro (e.g., Exploits, Star Lake, Natuashish);
- The project is fully funded, up front by third parties (contributions in aid of construction, grants, etc.);
- Programs that contain more than one project and multiple in-service dates (e.g., a circuit breaker program that contains multiple circuit breaker projects with varying in-service dates); and/or
- Projects with expected duration less than six months from the project commencement date to the date when substantially all the activities necessary to prepare the qualifying asset for its intended use are complete.

Once the project is in service, the interest capitalized is amortized as part of the cost of the asset over the service life of the asset(s).

Borrowing Costs Eligible for Capitalization

To the extent Hydro borrows funds specifically for the purpose of obtaining a qualifying asset, Hydro shall determine the amount of borrowing costs eligible for capitalization as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings (net interest expense).

To the extent that Hydro borrows funds generally and uses them for the purpose of obtaining a qualifying asset, Hydro shall determine the amount of borrowing costs eligible for capitalization by applying a capitalization rate to the expenditures on that asset. The capitalization rate shall be the weighted average of the borrowing costs applicable to Hydro's borrowings that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalized during a period shall not exceed the amount of borrowing costs incurred during that period.

Commencement of IDC Capitalization

Hydro begins capitalizing borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalization is the date when the project first meets all of the following conditions:

- Expenditures for the asset are being incurred;
- Borrowing costs are being incurred; and
- Activities that are necessary to prepare the asset for its intended use or sale are in progress.

Suspension of IDC Capitalization

Hydro suspends capitalization of borrowing costs during extended periods in which it suspends active development of a qualifying asset. An example would include when a capital project is ceased if Hydro is unsure whether progress on the project will continue. Such costs are costs of holding partially completed assets and do not qualify for capitalization.

However, during a period when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale, no suspension of IDC capitalization is required (i.e., IDC capitalization would continue during an extended period that the business delayed construction of an asset while it waited for a scheduled outage; managing scheduled outages is common during the construction season within the utility industry).

Whether a suspension period is considered to be extended is subject to professional judgment and is to be communicated to the Capital Accounting Team by the Project Manager.

Cessation of IDC Capitalization

Hydro ceases capitalizing borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

b) Please refer to Hydro's response to part a) for Hydro's guidelines for Suspension and Cessation of IDC Capitalization. Hydro will follow the same guidelines for the application of Allowance for Funds Used During Construction to capital projects.