Q. Appendix A, page 3. Christensen states that the IDC methodology may result in an under-recovery of the opportunity cost incurred by Hydro and result in uncompensated risk by Hydro's shareholder, the Government of Newfoundland and Labrador.

**a)** Is the potential for uncompensated risk impacted by either the:

(i) payment of a debt guarantee by Hydro to the province; and

(ii) payment of the rural deficit by Newfoundland Power customers to recover revenue shortfall from Hydro's rural customers?

In the response, address whether the payments in (i) and (ii) and the approval of the use of the AFUDC methodology could result in the province being over compensated for risk.

**b)** Would the change in methodology from IDC to AFUDC require additional rate mitigation funding from the Government of Newfoundland and Labrador? If so, explain the impact of this additional funding requirement on the uncompensated risk to the Government of Newfoundland and Labrador?

A. *This response has been provided by Christensen Associates Energy Consulting, LLC.*

**a)** Hydro has requested to recover financing costs according to AFUDC rather than IDC in order to align the Company with accepted North American regulatory practice. This question asks how an alignment with standard regulatory practice on capital financing cost recovery interacts with the specific characteristics of Hydro's regulatory environment.

*Part (i):*

The payment of a debt guarantee by Hydro to the province does not mitigate uncompensated risk to the province associated with capital financing under IDC. Hydro pays the Government of Newfoundland and Labrador an annual fee to compensate the province for this debt guarantee. This payment does not compensate the province for equity risk.

Furthermore, the fee that Hydro pays to the province is not fully recovered from customers through rates. This means the equity shareholder (i.e., the province) faces a reduction to its dividend equal to the unrecovered portion of this fee payment. Arguably, Hydro's payment to the province increases the extent to which the Government's equity risk goes uncompensated.

To compensate Hydro for its capital financing costs, we recommend the adoption of AFUDC. AFUDC is the common approach used by utilities in North America to recover revenue associated with the financing costs of capital projects because it reflects the utility's weighted average cost of capital. In the case of Hydro, the weighted average cost of capital already incorporates the effect of Hydro's debt guarantee from the Government of Newfoundland in the form of a lower debt rate, arising from its relatively stronger credit rating. Therefore, an AFUDC carrying charge equal to the weighted average cost of capital is appropriate for Hydro in recovering its capital financing costs and would not overcompensate the province.

*Part (ii):*

The cost of capital financing is not affected by Newfoundland Power's payment to Hydro to recover revenue shortfalls from Hydro's rural customers. The rural deficit primarily reflects a transfer of cost recovery from rural customers to Newfoundland Power's customers, but this transfer payment does not change the risk associated with financing capital infrastructure projects.

As stated in the Christensen Associates report, "the cost of capital depends not on the source of financing but rather on the risk level of a given project." A subsidy of rural customers does not alter the risk of cost recovery of new capital projects, it is merely a transfer payment. The adoption of AFUDC would align Hydro's revenue recovery with the cost of capital financing with or without the transfer from Newfoundland Power customers to Hydro's rural customers.

**b)** The adoption of AFUDC could result in additional rate mitigation funding. In the absence of rate mitigation, it is possible that the adoption of AFUDC in lieu of IDC could require an upward adjustment to Hydro's rates.

Rate mitigation is funded by a reduction in Hydro's dividend payment to the Government of Newfoundland and Labrador. Therefore, to the extent that AFUDC requires a rate increase beyond the current limit of 2.25% in any given year, some portion of the government's equity risk will remain uncompensated.

It is possible that, given the current rate mitigation framework, the Government of Newfoundland and Labrador may continue to bear risk without full compensation, but the adoption of AFUDC will align the regulatory practice in the province more closely with the principles of financial economics and standard industry practice.