Q. **Reference: Volume I, Section 5.7.6; Board Order No. P.U. 33(2021)**

Hydro proposes that financing charges on the LT SCVDA be calculated at the approved weighted average cost of capital ("WACC") (4.88%), whereas Board Order No. P.U. 33(2021) directed short-term borrowing costs for the existing SCVDA.

**a)** Given the use of WACC in computing the financing costs in the LT SCVDA could increase rate mitigation funding requirements, explain the rationale for this proposal.

**b)** Explain how the actual financing of account balances corresponds to a WACC-based financing charge.

**c)** Did Hydro consider a hybrid approach under which balances expected to be collected within one year accrue interest at short-term rates, with either the embedded cost of debt or WACC applied to balances carried longer?

A. **a)** The proposal to use Weighted Average Cost of Capital ("WACC") is based on what Newfoundland and Labrador Hydro ("Hydro") considers to be the appropriate rate to accrue interest on deferral account balances, whether or not rates are being mitigated. The potential that WACC could increase rate mitigation funding should not be a reason to deviate from current regulatory practice in Newfoundland and Labrador.[1] The Rate Stabilization Plan ("RSP"), which was essentially replaced by the Supply Cost Variance Deferral Account ('SCVDA") accrued interest at WACC, and the Electrification Cost Deferral Account approved in Board of Commissioners of Public Utilities ("Board") Order No. P.U. 33(2023) was approved to accrue interest at WACC. As well, all deferral accounts included in rate base earn a return based on WACC.

[1] "2025/2026 General Rate Application," Newfoundland Power Inc., December 12, 2023, vol. 1, sch. A, p. 16 of 20 defines the calculation of interest on the Rate Stabilization Account using the mid-point of the Company's allowed rate of return on rate base.

Short-term interest rates can vary and may not always be lower than Hydro's WACC. For instance, in 2023, the interest rate applied to the SCVDA, based on the short-term borrowing rate, was 5.72%, which was higher than the approved WACC of 5.43%.

**b)** The actual financing of account balances corresponds to a WACC-based financing charge since the account balances are financed with a combination of debt and equity funds that are not traceable to a single source. The use of WACC to accrue interest on the deferral account balances compensates Hydro for the use of funding from both debt and equity sources.

Unlike the existing SCVDA at the time of Board Order No. P.U. 33(2021), the Long-Term SCVDA is intended to operate as an ongoing long-term deferral mechanism, and balances may remain outstanding for extended periods. The balance in the account under rate mitigation takes in excess of a year to fully settle, and in the absence of rate mitigation, could take in excess of two years to fully settle. Accordingly, Hydro does not consider the account to be analogous to a short-term borrowing requirement.

Recovery of Long-Term SCVDA balances remains subject to Board review and approval in accordance with the terms and operation of the account. However, Hydro's proposal to apply WACC is not based on a quantified prudence, forecast, or non-recovery risk comparable to the risks associated with capital investments included in rate base. Rather, Hydro considers WACC to be the appropriate financing charge for an ongoing long-term regulatory deferral account that is financed through Hydro's overall capital structure, as it is consistent with the treatment of similar long-term deferral accounts in Newfoundland and Labrador.

**c)** Hydro did not consider a hybrid approach, since a hybrid approach is not consistent with regulatory practice in Newfoundland and Labrador for similar deferral account balances.

In Board Order No. P.U. 33(2021), the Board approved short-term borrowing costs for the calculation of finance charges in the SCVDA given that Hydro planned to finance the balances using short-term debt in the near term. In the proceeding, Newfoundland Power Inc. ("Newfoundland Power") submitted that short-term financing costs be used until the long-term approach is determined through Hydro's next general rate application. Newfoundland Power also commented that while Hydro's RSP historically attracted finance charges at WACC on a monthly basis, the RSP is a long-standing regulatory mechanism that provided recovery of supply costs from customers on an annual basis and is proposed to be continued. The Long-Term SCVDA is Hydro's proposed long-term deferral account to record annual supply variances on the Island Interconnected System, both during and after rate mitigation, and should accrue interest at WACC similar to the RSP.