Re: p. 31, lines 7-8

Dr. Vilbert states, “No, but if it is shown that ratepayers have provided the equity, that equity would be equivalent to the ‘no cost’ capital.”

(a) Please explain in detail what criteria Dr. Vilbert would use to evaluate whether ratepayers have provided the equity.

Response:

Dr. Vilbert has not studied the source of equity financing for either Crown Corporations in general or for Hydro in particular. For publicly traded companies, determining the equity holders is simple; equity holders are the investors who own the outstanding shares of common equity of the firm.

However, in principle, the issue for a Crown Corporation is the source of financing to purchase the assets used in the firm’s operations. Some assets are financed by debt, but the claim of the debt holders is limited to the promised interest and return of the principal. For Hydro, the source of the assets not financed by debt would have to be evaluated to determine whether they were provided by the Crown or by the rate payers in the form of retained earnings or a combination of both.

For a Crown corporation as for an investor-owned utility, retained earnings would ordinarily be part of the Crown’s assets, not the ratepayers’. Retained earnings are reinvested capital from equity holders. However, suppose a Crown corporation had raised capital for its operations not by contribution of tax monies or by retention of part of the return at or below the cost of capital, but by revenues from rates that provided an expected rate of return above the cost of capital. The money that the excess in the rate of return supplied would be ratepayers’ capital, not the Crown’s. An example for an investor owned utility in the U.S. is Accumulated Deferred Income Taxes (“ADIT”). Deferred Income Taxes are the difference in the taxes paid to the Government and the taxes upon which the revenue requirement is based. The excess of book income taxes over actual income taxes, if included in the revenue requirement (i.e., if not “flowed through” to customers directly), is often considered to be ratepayer provided funds. In this case, ADIT is subtracted from the rate base in setting rates, in accord with the view that ratepayers have provided these funds.

The analysis required to make an actual determination of the extent of ratepayer-supplied funds for Hydro would be quite involved and would require estimating the required return on Hydro’s equity over the life of the corporation and determining whether rates were set in excess of this cost. Dr. Vilbert understands that previously there was no required return on equity. Instead the cost of service was set with reference to a margin over debt costs that accrued to equity as opposed to determining the opportunity cost of capital. The margin allowed over debt would have to be compared to an estimate of the required return on equity. The effect, if any, of the previous regulatory regime on the required return on equity would also have to be evaluated as part of this calculation.

Re: p. 31, lines 7-8

(b) In Dr. Vilbert's opinion, do retained earnings constitute ratepayer-supported equity?

Response:

Please see the response to NLH-26 (a) above.