Q. [Sinking Fund] - Please provide all support and justification for the uses of the approved cost of capital as the interest rate used in the modified sinking fund calculation. Further, specifically address and substantiate why the discount rate used by Hydro for its ARO application is not an appropriate interest rate. Finally, to the extent Hydro believes the sinking fund interest rate and the ARO discount rate are for two different purposes, fully explain and justify such position.

A. In 1996, the Hydro Corporation Act was amended to subject Hydro to the provisions of the Public Utilities Act. Pursuant to that legislation, Hydro's rates are to be determined on the basis of a rate base/rate of return model. Hydro's rates were first set on a rate of return basis in 2002 as a result of the first General Rate Application subsequent to the legislative change. Prior to this, Hydro's revenue requirement was determined using an "interest coverage" model. At the time of the implementation of new rates, the approved weighted average cost of capital (WACC) began to be used as the financing rate used in Hydro for such items as the Rate Stabilization Plan, Allowance for Funds Used During Construction and Intercompany transactions as it was believed to be a rate more reflective of average financing costs within the company. At that time as well, the WACC began to be used as the interest rate in the modified sinking fund calculation. The financing rate used in the sinking fund calculation includes debt and equity components and is a weighted average cost of capital and is therefore more reflective of the financing cost for capital expenditures.

With regard to AROs, Hydro has not used WACC since IAS.37.47 provides specific guidance to determine a discount rate for the purpose of estimating AROs. The discount rate in this standard should be the pre-tax rate that reflects the time value of money and is consistent with the risks specific to the liability. Hydro views its own credit risk as a risk specific to the liability and as such included a credit risk adjustment in the discount rate used for the AROs.