Newfoundland and Labrador Hydro
Hydro Place. 500 Columbus Drive
P.O. Box 12400. St. John's. NL
Canada A1B 4K7
t. 709.737.1400 I f. 709.737.1800
nlhydro.com

April 14, 2026

Board of Commissioners of Public Utilities
Prince Charles Building
120 Torbay Road, P.O. Box 21040
St. John's, NL A1A 5B2

Attention: Mike McNiven
Board Secretary

Re: Application for Approval of a Deferral Account for an Allowance for Funds Used During Construction

Enclosed is Newfoundland and Labrador Hydro's ("Hydro") application for approval of a deferral account for an allowance for funds used during construction.

Hydro's application, particularly Schedule 1 to the application, provides support for the proposed deferral account, the definition of which is included in Schedule 2.

Should you have any questions, please contact the undersigned.

Yours truly,

NEWFOUNDLAND AND LABRADOR HYDRO

Shirley A. Walsh
Senior Legal Counsel, Regulatory
SAW/mc

Encl.

ecc:

Board of Commissioners of Public Utilities
Jacqui H. Glynn
Ryan Oake
Board General

Consumer Advocate
Adrienne H.Y. Ding, O'Dea Earle
Justin W. King, O'Dea Earle

Linde Canada Inc.
Sheryl E. Nisenbaum
Peter Strong

Newfoundland Power Inc.
Dominic J. Foley
Douglas W. Wright
Regulatory Email

Teck Resources Limited
Shawn Kinsella

Island Industrial Customer Group
Paul L. Coxworthy, Stewart McKelvey
Denis J. Fleming, Cox & Palmer
Glen G. Seaborn, Poole Althouse

Approval of a Deferral Account for an Allowance for Funds Used During Construction

April 14, 2026

An application to the Board of Commissioners of Public Utilities

IN THE MATTER OF the *Electrical Power Control Act, 1994*, SNL 1994, Chapter E-5.1 ("*EPCA*") and the *Public Utilities Act*, RSNL 1990, Chapter P-47 ("*Act*"), and regulations thereunder; and

IN THE MATTER OF an application by Newfoundland and Labrador Hydro ("Hydro") pursuant to Section 58 of the *Act*, for the approval of a deferral account for an Allowance for Funds Used During Construction ("AFUDC").

To: The Board of Commissioners of Public Utilities ("Board")

THE APPLICATION OF HYDRO STATES THAT:

A. Background

1. Hydro is a corporation continued and existing under the *Hydro Corporation Act, 2024*, is a public utility within the meaning of the *Act*, and is subject to the provisions of the *EPCA*.

2. Under the *Act*, the Board has the general supervision of public utilities and requires that a public utility submit for the approval of the Board the rates, tolls, and charges for the service provided by the public utility and the rules and regulations which relate to that service.

3. Hydro adopted International Financial Reporting Standards ("IFRS") as of January 1, 2014, as approved in Board Order No. P.U. 13(2012). Prior to adopting IFRS, Hydro capitalized borrowing costs directly attributable to capital construction projects with a substantial duration based on its allowed rate of return.[1] This was aligned with regulatory accounting for capitalization of borrowing costs and referred to as AFUDC.

4. Upon adopting IFRS, Hydro must capitalize borrowing costs directly attributable to capital construction project with a substantial duration using Hydro's embedded cost of debt referred to as Interest During Construction ("IDC"). Unlike regulatory accounting, IFRS does not recognize the cost of equity in its calculation of capitalization of borrowing costs.

[1] Approved rate of return on average rate base.

5. The differences between the capitalization of borrowing costs under IFRS and regulatory accounting since Hydro's adoption of IFRS have been relatively small; however, as of 2026, the minimal nature of the differences is not expected to continue. With a number of longer-term, higher cost construction projects anticipated over the next number years, combined with a decreasing embedded cost of debt, Hydro is expecting significant increases in the differences between the two approaches. This is illustrated in Table 1 of Schedule 1 to this application.

6. In January 2026, Hydro engaged Christensen Associates Energy Consulting, LLC ("CA Energy Consulting") to perform a review of methods for recovering costs of financing capital projects, in particular the theory and practice of recovering financing costs on capital projects through AFUDC and IDC methodologies. CA Energy Consulting's report is attached to Schedule 1, Appendix A to this application.

7. As noted in Schedule 1, continued utilization of the IFRS methodology for capitalization of borrowing costs would be inconsistent with established principles of financial economics and the regulatory principle known as the Fair Return Standard.[2] AFUDC methodology aligns the recovery of capital financing costs with the principles of the Fair Return Standard by recognizing Hydro's full cost of capital, and not just interest expense.

8. As noted in Schedule 1, Appendix A, CA Energy Consulting recommends a weighted average cost of capital concept like AFUDC methodology be used for the purpose of setting Hydro's revenue requirement.

9. Hydro submits that it is appropriate for Hydro to capitalize borrowing costs based on its allowed rate of return. Hydro proposes to calculate the capitalization of borrowing costs using the AFUDC methodology which capitalizes directly attributable borrowing costs during asset construction using Hydro's allowed rate of return. This approach will align Hydro more accurately with accepted regulatory treatment of capital borrowing costs.

10. To facilitate this, Hydro proposes the creation of a new deferral account called the AFUDC Deferral Account, effective January 1, 2026, the definition of which is attached as Schedule 2 to this application. Any variances between the calculation of AFUDC and IDC, which will continue to

[2] The legal principle known as the Fair Return Standard in Canadian regulatory law was established in *Northwestern Utilities* (1929), 1929 CanLII 39 (SCC), [1929] SCR 186 and reaffirmed in *TransCanada PipeLines* (2004) [2004] F.C.A 149.

be used for IFRS reporting purposes, will be captured in the AFUDC Deferral Account on a monthly basis.

11. As discussed in Section 2.3 of Schedule 1, Hydro is also proposing to amortize the balance in the proposed deferral account using the composite depreciation rate derived from the most recent depreciation study accepted by the Board, commencing in the year after the variance transfers to the AFUDC Deferral Account.

12. The proposed AFUDC Deferral Account enables the deferral and recovery of variances between IFRS and AFUDC for capitalized borrowing costs over an amortization period consistent with capitalization.

B. Hydro's Requests

13. Hydro requests the Board approve:

(i) The proposed AFUDC Deferral Account, for which the account definition is provided in Schedule 2, to be effective as of January 1, 2026; and

(ii) Hydro's amortization of the balance in the AFUDC Deferral Account using the composite depreciation rate derived from the most recent depreciation study accepted by the Board, commencing in the year after the variance transfers to the AFUDC Deferral Account.

C. Communications

14. Communications with respect to this application should be forwarded to Shirley A. Walsh, Senior Legal Counsel, Regulatory for Hydro.

DATED at St. John's in the province of Newfoundland and Labrador on this 14th day of April 2026.

NEWFOUNDLAND AND LABRADOR HYDRO

Shirley A. Walsh
Counsel for the Applicant
Newfoundland and Labrador Hydro
500 Columbus Drive, P.O. Box 12400
St. John's, NL A1B 4K7
Telephone: (709) 685-4973

Schedule 1

Allowance for Funds Used During Construction

Contents

1.0 Background 1
2.0 Application 2
2.1 Justification 2
2.2 Capitalization of IDC versus AFUDC 6
2.3 Implementation Approach 6
3.0 Summary 7

List of Appendices

Appendix A: Capital Financing Review (AFUDC vs IDC)

1.0 Background

On April 30, 2020, the Board of Commissioners of Public Utilities ("Board") requested that Newfoundland Power Inc. ("Newfoundland Power") and Newfoundland and Labrador Hydro ("Hydro") each submit a report on the utilities' respective capitalization policies and guidelines.

Hydro's *Review of Capitalization Policies and Guidelines* ("Review") was submitted on August 14, 2020.[1] The Review included a discussion of Hydro's capitalization practices in the context of the results of a jurisdictional scan as well as a report from JT Browne Consulting on the topic of Hydro's capitalization and the differences between accounting and regulatory views of capitalization.

The capitalization of borrowing costs is one of the differences between accounting and regulatory capitalization highlighted in the JT Browne Consulting report. Prior to adopting IFRS,[2] Hydro capitalized borrowing costs directly attributable to capital construction projects with a substantial duration[3] based on its allowed rate of return.[4] This was aligned with regulatory accounting for capitalization of borrowing costs and referred to as AFUDC.[5] Upon adopting IFRS, Hydro capitalized borrowing costs directly attributable to capital construction projects with a substantial duration using Hydro's embedded cost of debt referred to as IDC.[6] Unlike AFUDC, IFRS doesn't recognize the cost of equity in its calculation of capitalization of borrowing costs.

The JT Browne Consulting report indicates that a major difference between Regulatory Accounting Principles and IFRS is the capitalization of borrowing costs. The JT Browne Consulting report noted that the allowed return on rate base that would be avoidable without the capital projects in aggregate should be capitalized and that this return recognizes both debt and equity. This is also consistent with the "regulatory framework" document prepared by the Board to describe the regulatory framework used by the Board in issuing its decisions, findings and subsequent Orders. That framework, attached as Appendix A to Board Order No. P.U. 8(2007), stated:

[1] "Review of Capitalization Policies and Guidelines," Newfoundland and Labrador Hydro, August 14, 2020. The JT Browne Consulting report can also be found in "Application for Approval of IFRS Deviations," Newfoundland and Labrador Hydro, February 24, 2021, sch. B, att. 1.
[2] International Financial Reporting Standards ("IFRS").
[3] Hydro considers substantial duration to be projects with a construction period greater than six months.
[4] Approved rate of return on average rate base.
[5] Allowance for Funds Used During Construction ("AFUDC") includes the cost of debt and equity financing.
[6] Interest During Construction ("IDC").

> Capital structure is the relative amounts of equity and debt, commonly referred to as the debt-to-equity ratio, which comprises a company's total invested capital. The total invested capital represents the funds invested in the public utility by shareholders (equity) and by bondholders and other long-term debt holders (debt). The just and reasonable rate of return allowed on rate base is equivalent to the cost of capital representing the sum of the weighted costs of both debt and equity in the capital structure.

JT Browne Consulting acknowledged that, at the time of the review in 2020, the differences between the capitalization of borrowing costs using IDC versus AFUDC, appeared to be immaterial based on historical calculations for the years 2015 through 2019. This is due to the comparability at that time between Hydro's allowed rate of return and its embedded cost of debt, as well as the smaller spend on projects of substantial duration upon which capitalization of borrowing costs would be applied. Therefore, Hydro concluded that, although AFUDC methodology would better align with regulatory principles, implementing one methodology versus the other would have little impact on customers and the exclusion of the cost of equity from capitalized borrowing costs would not materially impact cost recovery. For these reasons, Hydro continued to use the IDC methodology prescribed by IFRS and did not apply to the Board for a regulatory mechanism to apply AFUDC methodology.

Hydro is now expecting the differences between approaches to increase significantly, beginning in 2026, as a result of the increasing spend on projects of substantial duration over the next number of years, combined with a decreasing embedded cost of debt. These changes are resulting in less borrowing costs being capitalized under IFRS's IDC methodology than would be using AFUDC and have led Hydro to apply to the Board for a regulatory mechanism that would allow Hydro to apply AFUDC methodology.

Given the length of time that had passed since the last review of these concepts in 2020, in January 2026, Hydro engaged Christensen Associates Energy Consulting, LLC ("CA Energy Consulting") to perform a review of methods for recovering costs of financing capital projects, in particular the theory and practice of recovering financing costs on capital projects through AFUDC and IDC methodologies. CA Energy Consulting's report is attached to this schedule as Appendix A.

2.0 Application

2.1 Justification

Hydro currently accounts for its financing cost of capital using IDC methodology, which includes Hydro's cost of debt only. As noted above, Hydro has previously considered applying to the Board for a

regulatory mechanism to use AFUDC to account for its financing cost of capital; however, at the time, there was no material difference in the outcome of the two different approaches and therefore Hydro continued with IDC methodology. However, Hydro is forecasting this to change significantly as a result of an increase in major projects with longer construction schedules, combined with the divergence of Hydro's allowed rate of return and its embedded cost of debt. Hydro's embedded cost of debt has decreased since Hydro's review of these concepts in 2020.

Hydro is entering a period of transition in which its capital planning is no longer limited to the completion of routine annual capital projects. Hydro is forecasting several significant major capital initiatives in the near-term, including the Avalon Combustion Turbine, Bay d'Espoir Unit 8, Bay d'Espoir Penstock 3, and the Life Extension of Bay d'Espoir Unit 7. These initiatives represent large-scale, multi-year construction projects with substantial capital requirements. When major capital projects take years to construct, utilities are required to finance them long before they provide service.

The CA Energy Consulting report notes that regulators in different jurisdictions have adopted two approaches to the recovery of capital financing costs, including the capital work-in-progress in rate base as it is incurred, or using approaches such as AFUDC, to accrue financing costs during construction. The report indicates that AFUDC is the most common method, and that this may be due to efforts to maintain intergenerational equity as the AFUDC approach collects financing costs from customers over time; in comparison, adding construction work-in-progress to rate base collects financing costs from current customers.

CA Energy Consulting's report states that IDC methodology does not take into account the full cost of capital, being both the cost of debt and the cost of equity, making it inconsistent with established principles of financial economics and the Fair Return Standard.[7] AFUDC methodology aligns the recovery of capital financing costs with the Fair Return Standard by recognizing Hydro's full cost of capital, and not just interest expense.

[7] The legal principle known as the Fair Return Standard Canadian regulatory law, was established in *Northwestern Utilities* (1929) and reaffirmed in *TransCanada PipeLines* (2004), as noted on page 4 of the CA Energy Report. This principle requires that a utility be granted a return that is commensurate with the risk of the enterprise, maintains its financial integrity, and allows it to attract capital on reasonable terms. Notably, section 80(1) of the Act states that a public utility is entitled to earn annually a just and reasonable return, which the Board has noted in Appendix A to Board Order No: P. U. 8(2007), is equivalent to the cost of capital representing the sum of the weighted costs of both debt and equity in the capital structure.

As noted in the report economic theory establishes that the cost of capital is determined by risk, not by how projects are financed. Increases in leverage linked to borrowings associated with capital projects increase risk for equity investors or shareholders, for which they should be compensated. Using IDC methodology recovers financing costs at the cost of debt only, even though capital projects impose risk on both debt and equity holders. Therefore, IDC methodology may result in uncompensated risk borne by the equity shareholder. Regardless of how a utility finances its capital projects, AFUDC methodology more appropriately reflects the true cost of capital by recognizing both debt and equity risk during the construction period. Hydro is proposing to use its most recently approved weighted average cost of capital ("WACC") to calculate capital financing costs under AFUDC methodology as WACC captures this risk relationship by weighting the cost of each source of capital in proportion to its contribution to the utility's overall capital structure.

CA Energy Consulting also notes that, through its review of decisions by regulators in other jurisdictions, IDC constitutes a financial reporting requirement or a method for accounting recognition of costs, and not necessarily a method for determining just and reasonable revenue or recovery. The report specifically notes certain regulators, such as the Alberta Utilities Commission, permit the recovery of financing costs using AFUDC even though utilities conduct financial reporting under IFRS.

The use of AFUDC methodology to recover capital financing costs is also consistent with Canadian regulatory practice, including among other Canadian utilities that report under IFRS as well as other Crown-owned utilities. The results of a jurisdictional survey completed by CA Energy Consulting, included in their attached report, indicates that AFUDC methodology is the most commonly used method among respondents. The respondents are evenly split between those who report under IFRS and those who report under US Generally Accepted Account Principles ("GAAP"). In this province, Newfoundland Power reports under US GAAP and uses AFUDC to recover capital financing costs calculated using the rate of return on average rate base. [8] Regulated utilities such as EPCOR and Hydro Quebec, who report under IFRS, use AFUDC for regulatory purposes, but IDC for financial reporting or for the purpose of calculating capital financing costs for non-regulated projects. NB Power, another crown utility, also uses AFUDC. CA Energy Consulting states:

[8] "2022/2023 General Rate Application," Newfoundland Power Inc., May 27, 2021, vol. 2, rpt. 6, att. 1, app. C.

> The findings from the survey indicate that AFUDC calculated using WACC is the predominant approach for capitalizing construction and other capital expenditures among Canadian utilities that responded. Even among Crown corporations, in which IFRS is commonly used for financial reporting purposes, AFUDC is still the most common method, with all but BC Hydro using AFUDC in some capacity.[9]

CA Energy Consulting recommends a WACC concept, like AFUDC methodology, be used for the purpose of setting Hydro's revenue requirement. Further information on the justification for the use of AFUDC for recovery purposes and the results of CA Energy Consulting's jurisdictional research can be found in Appendix A.

Hydro is a crown utility whose allowed rate of return on equity is linked to that of Newfoundland Power, an investor-owned utility since 2009, through direction issued by the Government of Newfoundland and Labrador.[10,11] In Board Order No. P.U. 49(2016) relating to Hydro's GRA for the 2014 and 2015 Test Years, the Board summarizes capital structure issues in the proceeding before ruling on the capital structure for Hydro. The Board noted Hydro's capital structure had improved and that protecting Hydro's capital structure going forward is important for financial stability and costs for rate payers. The Board accepted a common equity component not to exceed 45% for rate setting purposes. While Hydro has not proposed increasing its equity to 45% from the existing 25% target, adopting AFUDC based on changes to the level of capital expenditures and the change in the embedded cost of debt since adopting IFRS will help prevent erosion of equity during construction of major projects.

Hydro's status as a Crown utility, and the fact that its allowed return on equity is aligned with that of an investor-owned utility, are not considerations that are relevant in determining the appropriateness or calculation of AFUDC. AFUDC is a long-standing mechanism intended to recognize financing costs associated with capital under construction, regardless of ownership structure.

Hydro believes it is appropriate to capitalize financing costs based on its allowed rate of return. Hydro is proposing an AFUDC Deferral account, effective January 1, 2026, to capture the variance between the

[9] "Capital Financing Review (AFUDC vs IDC) for Newfoundland and Labrador Hydro," CA Energy Consulting, LLC**,** March 19, 2026, sch. 1, app. A, sec. 4.2, p. 13.

[10] Order in Council ("OC") OC2009–063, issued on March 17, 2009, directed the Board to adopt certain policies for all General Rate Application's ("GRA") by Hydro to follow, commencing with the first Hydro GRA filed after January 1, 2009. One of those policies involved the calculation of the return on rate base ("RORB"). The OC directed the Board to set the same target return on equity as was most recently set for Newfoundland Power through a GRA or through Newfoundland Power's Automatic Adjustment Mechanism.

[11] At the time this direction was received and for years after, Hydro's policy to recover capital financing costs utilized weighted average cost of capital until its adoption of IFRS as of January 1, 2014.

capitalization of borrowing costs under IFRS's IDC methodology and those capitalized under AFUDC methodology. Hydro is proposing the deferral account be amortized and recovered over a period consistent with capitalization, equal to the composite depreciation rate in Hydro's latest Board approved depreciation study.

Hydro's proposed AFUDC Deferral account definition is provided as Schedule 2 to this Application.

2.2 Capitalization of IDC versus AFUDC

Table 1 provides the comparison between the two capitalized borrowing cost calculations, AFUDC and IDC. The table includes actual IDC balances recorded by Hydro during the years 2015 to 2025, as well as forecasted[12] IDC for 2026 and 2027. The AFUDC balances are calculated using Hydro's allowed rate of return and applying it to the same qualifying capital construction costs used to calculate the IDC in each year.

Table 1: Comparison of Capitalized Financing Costs using AFUDC versus IDC[13]

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
AFUDC	3.3	3.6	10.7	2.9	2.2	1.7	1.8	1.0	2.1	2.2	3.8	10.0	19.9
IDC	3.4	4.0	10.6	2.7	2.0	1.5	1.6	0.9	1.9	2.0	3.5	7.9	16.5
Difference	**(0.1)**	**(0.3)**	**0.0**	**0.2**	**0.2**	**0.2**	**0.2**	**0.1**	**0.3**	**0.3**	**0.4**	**2.1**	**3.4**

As shown in the table the difference between IDC and AFUDC grows over time, beginning in 2026. This is as a result of decreasing cost of debt compared to the allowed rate of return and increasing capital spend on capital projects with substantial duration, such as the projects contained in Hydro's 2025 Build Application (Bay d'Espoir Unit 8 and the Avalon Combustion Turbine), Life Extension of Bay d'Espoir Unit 7, Bay d'Espoir Penstock 1 Life Extension Project, and Life Extension Projects for Penstocks 2 and 3.

2.3 Implementation Approach

In calculating the capitalization of borrowing costs using AFUDC, any variances between the calculation of AFUDC and IDC for IFRS reporting purposes will be captured in the AFUDC Deferral Account on a monthly basis. Hydro is proposing the deferral account be effective January 1, 2026, and be included in Hydro's rate base.

[12] Forecasted 2026 and 2027 based on the latest budget information available at this time.
[13] Numbers may not add due to rounding.

Hydro is also proposing to amortize the balance in the deferral account using the composite depreciation rate derived from the most recent depreciation study accepted by the Board, commencing in the year after the variance transfers to the AFUDC Deferral Account.[14] The composite annual rate derived from the 2016 Depreciation Study is 2.28%,[15] reflecting Hydro's average composite depreciation expense across all assets. Similar to depreciation expense, the risk of growth in amortization expense associated with the AFUDC Deferral Account between test years would be borne by Hydro.

Table 2 provides an illustrative calculation of the amortization expense recovery for the first two years.

Table 2: Illustrative Amortization of AFUDC Deferral Account Balance

Year	Annual Deferred Cost (A) $	Annual Amortization Expense (B= D x Rate[16]) $	Cumulative Amortization Expense (C) $	Unamortized Balance (D) $
2026	2,079,432			2,079,432
2027	3,371,976	47,411	47,411	5,403,997

The proposed AFUDC Deferral Account definition is provided as Schedule 2 to this application.

3.0 Summary

Hydro submits that recovery of capital financing costs using AFUDC, calculated on a WACC basis, is consistent with the Fair Return Standard and the *Act*. As demonstrated in the CA Energy Consulting report, IDC, while appropriate for financial reporting under IFRS, systematically under-recovers the cost of capital incurred during multi-year construction periods. AFUDC is consistent with established principles of financial economics and with prevailing Canadian utility practice.

Hydro has compared the impacts of calculating the capitalization of borrowing costs using IDC and AFUDC and, based on the results, is recommending that Hydro be permitted to use the AFUDC methodology to capitalize borrowing costs. This methodology better captures the cost of borrowing associated with Hydro's capital projects and allows for the recovery of all financing costs associated with these capital assets from customers. Hydro is proposing that any variance between the calculation of

[14] Amortization of variances transferred to the AFUDC Deferral Account during 2026 will commence in January 2027.
[15] As approved in Board Order No. P.U. 16(2019).
[16] Rate equals the composite rate in the most recent Depreciation Study approved by the Board.

IDC and AFUDC should be deferred in the proposed AFUDC Deferral Account, effective January 1, 2026, and recovered from customers over a period consistent with capitalization, and therefore effectively treated the same as a capital cost. Implementation of the use of AFUDC would increase Hydro's current estimated capitalization rate from 4.7%[17] to approximately 6.3% in 2026. Hydro's capitalization rate would continue to be below the Canadian industry average of 8.1% and Newfoundland Power's rate of 9%.[18]

The proposed approach is consistent with regulatory precedent.

[17] Includes Hydro's direct billing methodology of vehicle charge outs and capital related general expenses.
[18] "Approval of a Proposed General Expenses Capitalized Deferral Account," Newfoundland and Labrador Hydro, sch. 1, app. A, sec 2.2.

Schedule 1, Appendix A

Capital Financing Review (AFUDC vs IDC)

Capital Financing Review (AFUDC vs IDC)

for
Newfoundland and Labrador Hydro

By

Nicholas Crowley, CFA
Corey Goodrich

March 19, 2026

Table of Contents

1. INTRODUCTION 3
1.1 Report Summary and Approach 3
1.2 Project Background 3
2. DEFINITIONS 4
2.1 The Fair Return Standard 4
2.2 Construction Work in Progress (CWIP) 4
2.3 Allowed Funds Used During Construction (AFUDC) 5
2.4 Interest During Construction (IDC) 7
3. ECONOMIC THEORY OF FINANCING COST RECOVERY 8
3.1 The Effect of Debt Financing on Equity Risk 8
3.2 The Cost of Capital for Major Projects 9
3.3 Financing Cost Recovery: Considerations for NL Hydro 9
4. SURVEY 10
4.1 Survey Results 11
4.2 Survey Summary 13
5. CONCLUSIONS 13

1. INTRODUCTION

1.1 Report Summary and Approach

Christensen Associates Energy Consulting ("CA Energy Consulting") was asked by Newfoundland and Labrador Hydro ("NL Hydro") to produce a report containing a review of methods for recovering the costs of financing capital projects. In particular, CA Energy Consulting was asked to review the theory and practice of recovering investment costs on Construction Work in Progress ("CWIP") through Allowance for Funds Used During Construction ("AFUDC") and Interest During Construction ("IDC").

This report draws upon landmark legal and regulatory decisions from the United States and Canada to define terms. For the theoretical discussion, we cite foundational publications from the field of financial economics to establish the prevailing academic perspective. Our practical research consists of a survey we administered to major Canadian utilities in the first quarter of 2026. We present a summary of the methods of financing cost recovery used by respondents to our survey.

We conclude with a summary of the research. We comment on the connection between theory and practice regarding AFUDC and IDC among Canadian utilities and offer recommendations regarding the recovery of financing costs by NL Hydro.

1.2 Project Background

NL Hydro is the primary generator of electricity in the province of Newfoundland and Labrador. The system includes hydroelectric facilities, one oil-fired plant, gas/combustion turbines, remote diesel plants as well as transmission and distribution assets. This system requires upgrades and expansion that involves major capital investment.

For example, on March 21, 2025, Hydro filed an application with the Board of Commissioners of Public Utilities ("the Board") for the purchase and installation of Bay d'Espoir ("BDE") Unit 8 and Avalon Combustion Turbine. NL Hydro requested approval of an authorized budget of $1.08 billion for BDE Unit 8, with anticipated completion in 2031 and $891 million for the Avalon Combustion Turbine, with anticipated completion in 2029.[1]

The debt incurred for sustaining capital and system expansion imposes financial pressure on NL Hydro. Under the current IDC financing approach, the Company recovers an allowed return on financing costs equal to the cost of debt rather than the utility's weighted average cost of capital. For reasons discussed in this report, this may result in an under-recovery of the opportunity cost incurred by the company and result in uncompensated risk by NL Hydro's shareholder, the province of Newfoundland and Labrador.

[1] "Application for Capital Expenditures for the Purchase and Installation of Bay d'Espoir Unit 8 and Avalon Combustion Turbine – Redacted." March 21, 2025, before the Board of Commissioners of Public Utilities. (http://www.pub.nl.ca/applications/NLH2025AvalonCombustionMarch/index.php)

2. DEFINITIONS

2.1 The Fair Return Standard

Canadian regulatory law, as established in *Northwestern Utilities* (1929)[2] and reaffirmed in *TransCanada PipeLines* (2004),[3] requires that a utility be granted a return that is commensurate with the risk of the enterprise, maintains its financial integrity, and allows it to attract capital on reasonable terms. This legal principle is known as the Fair Return Standard.

When establishing the components of a revenue requirement, the Fair Return concept typically applies to the utility's allowed return on rate base. A utility recovers its cost of capital through an allowed return on debt costs and an allowed return on equity, weighted according to the proportion of debt and equity within total capital found on the utility's balance sheet. The utility calculates the return component of its revenue requirement by multiplying the allowed return (a percentage) by rate base, or the net dollar value of the utility's productive assets plus working capital.

However, rate base generally does not include capital assets currently under construction, as such assets are not yet considered used and useful. For major projects, constructed over the course of multiple years and requiring investment capital, a utility will incur financing costs that cannot be recovered through the productive use of the asset until the asset begins generating output and earning revenue. Thus, a question arises regarding the treatment of financing costs vis-à-vis the Fair Return Standard. Without the ability to recover financing costs for projects under construction, the utility may be unable to earn a fair return.

Regulators in different jurisdictions have adopted two approaches to providing utilities with the ability to recover capital financing costs: (1) the rate base, or, CWIP method; and (2) a set of approaches that accrue financing costs during construction (such as AFUDC or IDC). Under the CWIP method, the utility places the cost of unfinished projects directly into rate base to begin earning a rate of return. Under the AFUDC or IDC approaches, assets are only placed into rate base when they are deemed used and useful, but financing costs are capitalized and included in the value of the asset once it is placed into rate base. We describe these methods in more detail below.

2.2 Construction Work in Progress (CWIP)

Utilities generally finance major capital investments with debt, equity, or a combination of both. This financial capital must be obtained from investors that require compensation for the use of their capital by the payment of interest and dividends. The money used to pay investors interest and dividends must be obtained from the company's customers. A simple way to recover these costs is by placing a portion of investment capital, i.e., the value of CWIP, into rate base prior to the completion of construction projects.

Consider the following example. Under the CWIP method, if a utility spent $200 million on a construction project in a given year, that $200 million of CWIP would be included in the rate base

[2] Northwestern Utilities Ltd. v. Edmonton (City), 1929 CanLII 39 (SCC), [1929] SCR 186.
[3] TransCanada PipeLines Limited v. National Energy Board et al. [2004] F.C.A 149. Para. 6.

along with other operating assets. The utility would then be allowed to earn its authorized rate of return on the total rate base, including the CWIP balance. The return associated with CWIP would generate current cash flow which would then be used to pay the interest and provide a return to equity investors financing the construction.[4]

While this approach offers simplicity, our research indicates that most utilities do not include CWIP in rate base. This may be due to the requirement by statute or regulatory precedent to require rate base to include only assets that are used and useful. As a result, approaches that allow for the capitalization of financing costs, of which AFUDC is the most common method, are more prevalent.[5] However, the Federal Energy Regulatory Commission has allowed the placement of CWIP into rate base for transmission projects to promote transmission investment.[6]

2.3 Allowed Funds Used During Construction (AFUDC)

AFUDC is an accounting approach to recovering the cost of financing capital investments that does not require CWIP to be placed into the rate base. Using AFUDC, utilities capitalize the cost of financing construction projects by adding those financing costs to the total cost of the asset, typically through an offset to interest expense.[7] When the asset is placed into service and deemed used and useful, the total construction cost plus accumulated AFUDC is added to the rate base and earns a rate of return based on the utility's weighted average cost of capital. Thus, at least in theory, the AFUDC approach and the CWIP approach produce the same revenue recovery for financing costs on a net present value basis.

AFUDC cannot be recorded if CWIP is already included in rate base, since the utility is already earning a return on the carrying cost of those funds.[8] Table 2.1 presents the methodology used by the US Federal Energy Regulatory Commission ("FERC") to calculate AFUDC.

[4] Brigham, Eugene F., *The Treatment of CWIP.* Working Paper for the Florida Public Service Commission. July 1980.

[5] The prevalence of AFUDC cost recovery (rather than placing CWIP into rate base) may arise from efforts to maintain intergenerational equity: the AFUDC approach collects revenue from customers over the useful life of the asset, whereas adding CWIP to rate base collects financing costs from current customers before the asset begins providing value to customers.

[6] *Promoting Transmission Investment through Pricing Reform*, Order No. 679, 116 FERC ¶ 61,057 (2006).

[7] Aliff, Gregory E., and Robert L. Hahn. 2015. *Accounting for Public Utilities*. New York: LexisNexis/Matthew Bender.

[8] One exception is the "mirror CWIP" approach. Under this method when plant is placed in service, a decreasing portion of CWIP is excluded from the rate base each year, "mirroring" the pattern in which the construction costs were originally included. (See: PwC, "18.4 Construction work in progress in Rate Base," Chapter 18 Regulated Operations, https://viewpoint.pwc.com/dt/us/en/pwc/accounting_guides/utilities_and_power_/utilities_and_power__US/chapter_18_regulated_US/184_construction_wor_US.html.)

Table 2.1: FERC Calculation of AFUDC

Components of AFUDC Income
The mechanics of computing AFUDC may vary between jurisdictions. Below, we present the formula used by the US Federal Energy Regulatory Commission to calculate AFUDC.[9] The cost rate for common equity (c) "shall be the rate granted on common equity in the last rate proceeding before the ratemaking body having primary rate jurisdiction." The formula assumes that a utility's short-term debt is the first source of funds used for financing construction. If the entire project is funded by short term debt, (1-S/W) would equal zero, removing the inclusion of a long-term debt rate and the cost of equity from the calculation. If some portion of the project is financed by funds other than short term debt, both the cost of equity and the cost of long-term debt are included in the AFUDC calculation. The AFUDC rate is the sum of A_i and A_e, as calculated below. $$A_i = s\left(\frac{S}{w}\right) + d\left(\frac{D}{D+P+C}\right)\left(1-\frac{S}{W}\right)$$ $$A_e = \left(1-\frac{S}{W}\right)\left[p\left(\frac{p}{D+P+C}\right) + c\left(\frac{c}{D+P+C}\right)\right]$$ A_i = Gross allowance for borrowed funds used during construction rate. A_e = Allowance for other funds used during construction rate. S = Average short-term debt. s = Short-term debt interest rate. D = Long-term debt. d = Long-term debt interest rate. P = Preferred stock. p = Preferred stock cost rate. C = Common equity. c = Common equity cost rate. W = Average balance in construction work in progress less asset retirement costs (See General Instruction 24) related to plant under construction.

Most regulators have established rules related to the capitalization of financing costs under AFUDC. For example, FERC requires that the capitalization period of AFUDC can only begin and continue so long as these two conditions are met:[10]

1. Capital expenditures for the project have been incurred, and
2. Activities that are necessary to get the project ready for its intended use are in progress.

Brief, routine pauses that are inherent in the construction or acquisition process do not require capitalization to stop. However, regulators generally require that AFUDC is not collected for periods when a utility intentionally defers or suspends construction activities, or when delays are externally imposed but can reasonably be resolved and the utility elects not to do so. Interest incurred during such periods is considered holding costs rather than acquisition costs and should

[9] Uniform System of Accounts Prescribed for Natural Gas Companies Subject to the Provisions of the Natural Gas Act, 18 C.F.R. pt. 201 (1960).

[10] Federal Energy Regulatory Commission, *Accounting for Allowance for Funds Used During Construction*, Docket No. AI11-1-000 (Feb. 16, 2011).

not be capitalized. If a project is not expected to be completed in the future, or if the existing costs do not benefit the future asset, then the costs should be written off as an expense. Table 2.2 summarizes these rules.

Table 2.2: Impact of Construction Status on AFUDC[11]

Construction Status	Impact on AFUDC
Completion of the plant and recovery of all construction costs is probable.	Capitalize AFUDC if recovery of AFUDC is probable.
Completion of the plant is reasonably possible but no longer probable.	Cease capitalization AFUDC because recovery is no longer probable. No adjustment to previously capitalized AFUDC; AFUDC should not be written off until disallowance of plant costs is probable.
Disallowance of plant costs is reasonably possible.	Identify range of possible disallowance and cease accruing AFUDC on the costs equal to the maximum amount in the range, because recovery is no longer probable.
Plant is probable of being abandoned or all or a portion being disallowed.	Cease capitalizing AFUDC and apply abandonment of disallowance guidance for existing amounts as applicable.

Under 18 C.F.R Part 101,[12] AFUDC represents the cost of financing construction, including the net cost of borrowed funds and a reasonable return on other funds used for construction, subject to commission approval. AFUDC is not recorded for projects that are abandoned. The rates used in calculated AFUDC are determined annually. For long-term debt, preferred stock, and common equity, the balances are based on actual book values at the end of the prior year. The cost rates for long-term debt and preferred stock are the weighted average actual cost, while the cost rate for common equity is generally the allowed ROE granted in the last rate proceeding. If that is not available, the average rate earned over the previous three years may be used.

When only part of a plant or project is completed and ready for service while the rest of the project remains under construction, the completed portion is treated as plant in service, and AFUDC for that portion ceases. AFUDC continues to be recorded on the incomplete portion until it is placed in service. For example, suppose a utility is building a generating unit. If half of the unit is completed and begins operating while the rest is still under construction, AFUDC stops accruing on the operating portion but continues to be calculated on the remaining unfinished portion. Once the entire unit is in service, no further AFUDC is recorded.

2.4 Interest During Construction (IDC)

IDC reflects the cost of debt financing incurred for construction projects that are in progress. Like AFUDC, IDC is capitalized as part of the construction cost of the asset and ceases once the asset is placed in service. However, unlike AFUDC, which generally includes both debt and equity costs, IDC typically reflects only the interest expense on borrowed funds. Capitalization of IDC allows certain financing costs incurred during construction to be included in the total project cost ultimately included in rate base, in lieu of annual cost recovery. Once the asset is in service, the

[11] PwC, "18.3 Allowance for Funds Used During Construction," Chapter 18 Regulated Operations, https://viewpoint.pwc.com/dt/us/en/pwc/accounting_guides/utilities_and_power_/utilities_and_power__US/chapter_18_regulated_US/183_allowance_for_fu_US.html.

[12] U.S. Federal Energy Regulatory Commission, 18 C.F.R. Part 101: Uniform System of Accounts Prescribed for Public Utilities and Licensees Subject to the Provisions of the Federal Power Act, Electronic Code of Federal Regulations, https://www.ecfr.gov/current/title-18/chapter-I/subchapter-C/part-101

interest is no longer capitalized, and the utility begins recovery of the total construction cost through depreciation and return on rate base.

Under International Financial Reporting Standards ("IFRS"), utilities are required to use IDC in the development of balance sheet information.[13] However, IFRS defines *reporting* standards and does not establish rules about setting a utility's revenue requirement. As such, IAS 23 does not require that a utility establish its revenue requirement according to IDC accounting. Some regulators have provided guidance regarding the reconciliation of IAS 23 for financial reporting purposes and AFUDC for regulatory purposes.[14] As we present in Section 4, many utilities in Canada that report financial statements according to IFRS recover capital financing costs using AFUDC.

3. ECONOMIC THEORY OF FINANCING COST RECOVERY

3.1 The Effect of Debt Financing on Equity Risk

A company may finance capital projects using debt, equity, or a combination of both. Financing projects with debt affects equity holders by increasing a company's overall risk. We consider two components of this risk: (1) the opportunity cost of forgoing alternative projects that could be necessary in the future; and (2) financial risk associated with the payment of interest.

In both regulated and competitive industries, new projects impose an opportunity cost. A company does not have the ability to borrow indefinitely, which means that financing a project with debt draws down the company's capacity to borrow additional debt for any other potential project. A company with lower *debt capacity* has less ability to borrow to pay for other expenditures like emergencies or unforeseen repairs.[15] A major project financed by debt constitutes an opportunity cost because it reduces the company's flexibility to finance other critical projects. This increases the company's risk, which affects shareholders.

Debt financing also affects shareholders through financial risk. As a company adds debt to its balance sheet, the risk to the equity holders increases because the company now has a higher fixed payment obligation, in the form of an interest expense.[16] Shareholders must be compensated for this increased risk. Thus, the cost of equity increases as leverage increases. Empirical studies have supported this theoretical conclusion.[17]

[13] International Accounting Standards Board. (2007). *Borrowing costs* (IAS 23). IFRS Foundation.

[14] See for example: Alberta Utilities Commission Rule 026: Rule Regarding Regulatory Accounting Procedures Pertaining to the Implementation of IFRS.

[15] Brealey, R. A., Myers, S. C., & Allen, F. (2006). *Principles of Corporate Finance* (8th ed.). McGraw-Hill/Irwin.

[16] Modigliani, F., & Miller, M. H. (1958). *The Cost of Capital, Corporation Finance and the Theory of Investment.* The American Economic Review

[17] See, for example: Hamada, R. S. (1972). "The effect of the firm's capital structure on the systematic risk of common stocks." *The Journal of Finance*, *27*(2), 435–452.

3.2 The Cost of Capital for Major Projects

The appropriate measure of a company's opportunity cost is its weighted average cost of capital.[18] This is true regardless of the funding source of a particular project.[19] For this reason, financial analysts assess the economic value of new projects on the basis of net present value using a discount rate equal to the weighted average cost of capital. A project financed entirely by debt will still have a cost of capital set according to the risk of the project, not the source of the funding.[20]

If a company issues substantial debt to undertake capital projects, but the regulator permitted only the recovery of the cost of debt—and not the cost of capital of the project—equity holders would earn zero return for the risk associated with taking on this enhanced debt. This would cause utility financial conditions to deteriorate over time, as equity investors would eventually liquidate equity holdings as a result in a decline in economic value. This could result in intergenerational equity issues, as current ratepayers would experience artificially lower costs while future ratepayers would experience a spike in costs associated with an increase in the company's total cost of capital.

The opportunity cost of capital must also be examined. Consider a scenario in which a utility has two investment options: (1) investment in a capital project that could be completed and placed into service in a single year; and (2) investment in a project that would take multiple years. Under Project 1, the plant-in-service earns a rate of return based on the utility's weighted average cost of capital (and recovers a depreciation expense) following year 1. Under Project 2, the investor must wait additional years to begin earning a return. To provide an investor with sufficient recovery of the opportunity cost of the multi-year project, rather than the single year project, the investor must be compensated according to the weighted average cost of capital—because that is the return the investor has forgone in selecting Project 2.[21] Otherwise, management investment decisions will be biased in favor of short term projects.

For these reasons, the AFUDC calculation presented in Table 2.1 includes the cost of short-term debt, long-term debt, *and* equity. The AFUDC approach to financing cost recovery incorporates these principles of financial economics to properly account for the true cost of capital associated with new projects.

3.3 Financing Cost Recovery: Considerations for NL Hydro

NL Hydro currently recovers financing costs according to IDC. This means that the Company's revenue requirement contains a provision for recovering financing costs equal to the cost of debt rather than the project (or Company) cost of capital. This regulatory treatment of financing costs

[18] Koller, T., Goedhart, M., & Wessels, D. (2020). *Valuation: Measuring and Managing the Value of Companies* (7th ed.). John Wiley & Sons.

[19] "The cost of capital is the minimum rate of return that must be earned on assets to justify their acquisition, and the regulator must set the allowed return so that optimal investment rates are obtained, and that no other investment rate would result in a higher share price." Morin, Roger, *New Regulatory Finance* (2006), p. 23.

[20] Brealey, R. A., Myers, S. C., & Allen, F. (2006). *Principles of Corporate Finance* (8th ed.). McGraw-Hill/Irwin, p. 217.

[21] Pomerantz, Lawrence S., and James E. Suelflow. *Allowance for Funds Used During Construction: Theory and Application*. MSU Public Utilities Studies. East Lansing: Michigan State University, 1975.

follows from the Company's requirement to issue its financial statements in accordance with IFRS.

This approach to cost recovery does not conform to the established principles of financial economics. We have shown that increases in leverage affect equity investors by increasing risk, which must be compensated (see Section 3.1). We have also established that the required return on investment is not a function of the specific funding source, but is instead governed by the intrinsic risk profile of each capital project (see Section 3.2). We also understand, from the review of decisions by regulators in other jurisdictions, that IDC constitutes a financial reporting requirement, and not necessarily a method for setting a utility's revenue requirement.

For these reasons, we recommend a weighted average cost of capital concept like AFUDC for the purpose of setting NL Hydro's revenue requirement.

4. SURVEY

CA Energy Consulting contacted 17 Canadian electric and gas utilities, including five Crown Corporations, to gather information regarding the methodology used to capitalize construction costs across the nation. Initial survey emails were sent on February 3, 2025, with follow-up emails sent on February 11, 2025, to non-respondents. Surveys were due by February 13, 2025. Each utility was asked to respond to the following five survey questions:

1. Does your utility operate under IFRS or U.S. GAAP?

2. Which method does your utility use to calculate financing costs during construction:
    - Allowance for Funds Used During Construction (AFUDC)
    - Interest During Construction (IDC)
    - Other

3. If financing costs are recovered through AFUDC, which methodology is used to determine AFUDC?
    - Most recently authorized weighted average cost of capital (WACC)
    - Current capital structure and cost rates
    - Other

4. Has your utility requested from your regulator a change from IDC to AFUDC financing recovery? If so, could you provide an explanation of the outcome and relevant documentation?

5. If your utility is a Crown Corporation, does the utility recover a return on equity (ROE)? If so, how is the ROE calculated and approved by the regulator? (e.g., through a cost of capital study filed as part of a rate case; through regulatory judgement; based on province funding needs.)

Of the 17 utilities contacts, responses were received from 11. Table 4.1 summarizes the utilities contacted and if they responded.

Table 4.1: Summary of Engagement[22]

Stakeholders	Crown Utility	Responded
Alectra Utilities		
ATCO Electric		X
BC Hydro	X	X
District of Summerland		
Enbridge Gas		X
EPCOR		X
Fortis BC		X
Hydro One		
Hydro Ottawa		
Hydro Quebec	X	X
Manitoba Hydro	X	
Maritime Electric		X
NB Power	X	X
Nova Scotia Power		X
SaskPower	X	X
Toronto Hydro		

4.1 Survey Results

This section presents the survey results. We have removed the response of one utility that wished to remain anonymous. Table 4.2 summarizes the results from Question 1, which asked whether the utility operates under IFRS or U.S. GAAP. Of the eleven respondents, ten use either IFRS or U.S. GAPP, while one utility follows the "Canadian Accounting Standards for Private Enterprises." Among the ten utilities using the two primary accounting frameworks, the distribution is relatively even: five utilities use IFRS (including three of the four Crown utilities), and the remaining use U.S. GAAP.

Table 4.2: IFRS or U.S. GAAP

Stakeholders	IFRS	U.S. GAAP	Other
ATCO Electric	X		
BC Hydro	X		
Enbridge Gas		X	
EPCOR	X		
Fortis BC		X	
Hydro Quebec		X	
Maritime Electric			X
NB Power	X		
Nova Scotia Power		X	
SaskPower	X		

[22] One respondent requested that its survey responses be treated as confidential and, therefore, are not include in a publicly available version of this report.

The results indicate that AFUDC is the most commonly used method for recovering financing costs among respondents. The three utilities that do not use AFUDC are Enbridge Gas, BC Hydro, and SaskPower, all of which use IDC.

Table 4.3 presents the findings from Question 2, which asked utilities about their approach to capitalizing financing costs (specifically whether the utility recovered financing costs using AFUDC or IDC). Among the respondents using AFUDC, there is a mix of practices regarding financial reporting and the revenue requirement calculation. Some utilities use AFUDC for both purposes, while others use a combination: AFUDC for regulatory accounting and IDC for financial reporting. For example, ATCO and EPCOR use IDC for financial reporting purposes under IFRS but applies AFUDC for regulatory reporting. Similarly, Hydro-Québec applies AFUDC for its rate-regulated activities and IDC for non-regulated generation projects. These responses align with our reading of regulatory documents from provinces like Alberta, where the Alberta Utilities Commission permits the recovery of financing costs using AFUDC, even though utilities conduct financial reporting under IFRS.

Table 4.3: AFUDC or IDC To Account for Financing Costs

Stakeholders	AFUDC	IDC
ATCO Electric	X	X
BC Hydro		X
Enbridge Gas		X
EPCOR	X	X
Fortis BC	X	
Hydro Quebec	X	X
Maritime Electric	X	
NB Power	X	X
Nova Scotia Power	X	
SaskPower		X

Question 3 asked utilities that use AFUDC to describe the methodology they apply to determine AFUDC cost rates. All but one of the respondents that use AFUDC calculate their allowance based on the company's WACC. The single exception is ATCO, which determines AFUDC using its approved capital structure and cost rates, rather than a formal weighted average cost of capital calculation. (We note that this difference exists because the utilities in Alberta operate under a deemed capital structure and a uniform allowed ROE that applies to all distributors.[23])

Question 4 asked whether the utility has requested a change from IDC to AFUDC. Enbridge, one of the three utilities in the survey that exclusively uses IDC, has not made a direct request to the Ontario Energy Board ("OEB") for such a change. However, a consultant filed testimony on behalf of Enbridge that recommended adopting a WACC/AFUDC approach to determine the carrying cost on CWIP as part of the OEB's Generic Cost of Capital and Other Matters proceeding.[24]

[23] Alberta Utilities Commission. (2023). *2024 Generic Cost of Capital* (Decision 27084-D02-2023). https://www.auc.ab.ca

[24] The OEB, however, disagreed with this recommendation. (Ontario Energy board. *EB-2024-0063 Decision and Order*. Case No. EB-2024-0063, March 27, 2025. https://www.oeb.ca/node/5097)

Question 5 asked Crown Corporations whether they recover an ROE and, if so, how it was calculated. We summarize the responses as follows:

- Hydro-Québec recovers a regulated ROE, which was established at 8.2% in 2015 as part of a rate case and has been maintained since then.
- SaskPower has a ROE of 8.5% where SaskPower's ROE is approved annually by the Crown Investments Corporation.
- NB Power stated that the regulator does not establish an allowed ROE value, though there is a net income component included in the revenue requirement.
- BC Hydro collects an ROE such that "…sufficient revenue in each fiscal year [be collected] to enable the authority to achieve an annual rate of return on deemed equity that would yield a distributable surplus of $712 million."[25]

4.2 Survey Summary

The findings from the survey indicate that AFUDC calculated using WACC is the predominant approach for capitalizing construction and other capital expenditures among Canadian utilities that responded. Even among Crown corporations, in which IFRS is commonly used for financial reporting purposes, AFUDC is still the most common method, with all but BC Hydro using AFUDC in some capacity. Variations exist, however, in the methods used by individual utilities to determine AFUDC cost rates.

In addition, we have found that state-level regulators in the United States have allowed returns on capital financing costs above the cost of debt since the 1940s.[26]

5. CONCLUSIONS

Our review of the principles of financial economics and the responses to our survey of Canadian utilities suggests that an alternative approach to recovering capital financing costs may be warranted for NL Hydro. Currently, NL Hydro recovers the cost of capital financing only equal to the cost of debt. This practice is a function of NL Hydro's adherence to IFRS accounting practices, which require the use of IDC for financial reporting purposes.

Our findings suggest that IDC, as an approach to financial reporting under IFRS, is not required for the purpose of setting a utility's allowed revenue. As explained in Section 3, the required return on investment is not a function of the specific funding source, but is instead determined by the risk profile of capital projects. A revenue requirement that relies only on the cost of debt to recover capital financing costs is likely to under-recover the true cost of capital and, therefore, impose uncompensated risks on equity shareholders.

The results of our survey suggest that most major Canadian utility respondents use AFUDC for regulatory purposes. Crown Corporations are less likely to use AFUDC. However, since the cost of

[25] B.C. Reg 236/2024, *Utilities Commission Act Direction No.8 to the British Columbia Utilities Commission,* July 15, 2025. https://www.bclaws.gov.bc.ca/civix/document/id/complete/statreg/24_2019#section3
[26] Pomerantz, Lawrence S., and James E. Suelflow. *Allowance for Funds Used During Construction: Theory and Application*. MSU Public Utilities Studies. East Lansing: Michigan State University, 1975.

capital depends not on the source of financing but rather on the risk level of a given project, the ownership of a utility does not determine its cost of capital. An attenuated return on capital financing costs might therefore be considered a subsidy made by the equity shareholder (the Province).

For these reasons, we recommend a weighted average cost of capital concept like AFUDC for the purpose of setting NL Hydro's revenue requirement.

Schedule 2

Allowance for Funds Used During Construction Deferral Account – Definition

Newfoundland and Labrador Hydro
Allowance for Funds Used During Construction Deferral Account – Definition

This account shall be charged monthly with the difference between the calculation of Allowance for Funds Used During Construction ("AFUDC") and Interest During Construction ("IDC") on capital projects that attract interest based on Newfoundland and Labrador Hydro's ("Hydro") Capitalization Guidelines. This account will be charged at the conclusion of each calendar month based upon the following formula:

Monthly Transfer = AFUDC - IDC

Where:

AFUDC is calculated using Hydro's approved rate of return on average rate base; and

IDC is calculated using Hydro's embedded cost of debt in accordance with International Financial Reporting Standards ("IFRS").

Disposition of any Balance in this Account

The balance in this account will be amortized using the composite depreciation rate in the latest depreciation study approved by the Board of Commissioners of Public Utilities, commencing the year after the transfer of the cost to the AFUDC Deferral Account.

Affidavit

IN THE MATTER OF the *Electrical Power Control Act, 1994*, SNL 1994, Chapter E-5.1 ("*EPCA*") and the *Public Utilities Act*, RSNL 1990, Chapter P-47 ("*Act*"), and regulations thereunder; and

IN THE MATTER OF an application by Newfoundland and Labrador Hydro ("Hydro") pursuant to Section 58 of the *Act*, for the approval of a deferral account for an Allowance for Funds Used During Construction ("AFUDC").

AFFIDAVIT

I, Dana Pope, of St. John's in the province of Newfoundland and Labrador, make oath and say as follows:

1) I am Vice President, Regulatory Affairs and Stakeholder Relations, Newfoundland and Labrador Hydro, the applicant named in the attached application.
2) I have read and understand the foregoing application.
3) To the best of my knowledge, information, and belief, all of the matters, facts, and things set out in this application are true.

SWORN at St. John's in the province of Newfoundland and Labrador this 14th day of April 2026, before me:

Michelle Compton
Commissioner for Oaths, Newfoundland and Labrador

Pope
Dana Pope, CPA (CA), MBA

MICHELLE COMPTON
A Commissioner for Oaths in and for
the Province of Newfoundland and Labrador.
My commission expires on December 31, 2030