

1 capital required to carry out its role as provider of the Electricity Regulated Rate
2 Tariff (RRT) and the Gas Default Rate Tariff (DRT).
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4 **II. SUMMARY OF CONCLUSIONS**

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6 Q. What are you recommending to the Board?
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8 A. The returns that should be applied to DERS' RRT and DRT rate bases,
9 respectively, are ATCO Electric-Distribution's and ATCO Gas' allowed returns,
10 grossed up for the statutory tax rate, for the following reasons:
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- 12 ● The RRT and DRT services are, in fact, utility services, which should
13 attract a utility cost of capital.
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- 16 ● The ATCO Utilities' returns reflect the results of the EUB's Generic Cost
17 of Capital Decision, which resulted from an extensive review of the cost
18 of capital. There have been no substantive changes in either the capital
19 markets or utility risks since the decision that would cause a change in the
20 outcome. As a result, in light of the relatively small size of DERS' rate
21 base, the generic cost of capital decision findings should be applied to
22 DERS. This approach has previously been adopted by the Board in
23 Decision 2004-065 (August 13, 2004) for ENMAX Energy Corporation
24 (EEC).
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- 26 ● The ATCO Utilities file GTAs/GRAs regularly with the Board. Thus
27 findings in these proceedings will permit any changes in the various
28 components of the allowed costs of capital to flow through to the RRT and
29 DRT services without requiring, in future, additional evidence on the
30 appropriate cost of capital.
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1 **III. BACKGROUND**

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3 Q. Please summarize your understanding of the issue before the Board.

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5 A. DERS is ATCO Electric Ltd.'s authorized provider of the Electricity Regulated
6 Rate Tariff and ATCO Gas and Pipelines Ltd.'s authorized provider of the
7 Default Rate Tariff. Although both services provided by DERS are regulated by
8 the Board, DERS has no conventional utility rate base. It does, however, require
9 cash working capital to allow it to carry on its day-to-day operations.

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11 Q. What is the definition of cash working capital?

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13 A. In the utility context, cash working capital is typically defined as the average
14 amount of capital over and above the investment in plant and other specifically
15 measured rate base items to bridge the gap between the time expenditures are
16 made and the payment is received for service provided. As the Board indicated in
17 EUB Decision 2003-106 (December 18, 2003), the need for working capital
18 results from the lag between the rendition of service and receipt of payment
19 (Section 2.6, Cost of Working Capital).

20

21 Q. Please briefly summarize your understanding of the Board's findings with respect
22 to DERS' working capital in Decision 2003-106.

23

24 A. The key conclusions were as follows:

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26 1. The Board is required to fix a fair return on rate base, where rate base is
27 defined to include necessary working capital.

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29 2. DERS' rate base includes mainly working capital.

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1 3. The need for working capital is an ongoing requirement, and, thus, the
2 Board was not persuaded that it would be financed solely with short-term
3 debt. Nor was the Board persuaded that the traditional utility capital
4 structure, including only long-term debt and equity, was appropriate.

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6 4. The Board recognized that the relatively small amount of working capital
7 requirements did not justify the incurrence of significant regulatory costs
8 to establish a capital structure and rate of return on common equity for
9 DERS.

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11 5. The Board directed DERS to demonstrate at the time of its next
12 application what the cost of providing working capital would be if the
13 working capital were obtained through a financial institution, on a stand-
14 alone basis with a parental guarantee.

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16 Q. Are there any subsequent decisions of the Board that provide further views of the
17 Board on the issue of appropriate return on working capital for a retailer?

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19 A. Yes. In Decision 2004-065 for EEC, the Board agreed that it would not be cost
20 effective to undertake a detailed traditional cost of capital analysis, particularly
21 recognizing the relatively small amount of working capital. The Board noted that
22 the RRT remains the ultimate responsibility of the owner of the electricity
23 distribution system, and thus considered it to be reasonable to use the weighted
24 average cost of capital for the distributor (in that case ENMAX Power
25 Corporation) as the allowed carrying cost of working capital for EEC.

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IV. APPROACH TO RETURN ON WORKING CAPITAL

Q. Please explain the approach you took to arrive at a recommended return on working capital for DERS.

A. In arriving at a recommendation, I considered three major elements of the Board’s two decisions regarding the return on working capital:

1. Its directive to DERS in Decision 2003-106;
2. Its conclusion in Decision 2004-065 for EEC that the RRT remained the ultimate responsibility of the distributor; and,
3. Its conclusion in both decisions that the relatively small size of the working capital allowance did not warrant a detailed cost of capital analysis.

Q. What is your understanding of how DERS actually obtains its financing requirements?

A. DERS is effectively a division of Direct Energy Marketing Limited (DEML), which, in turn, is an indirect wholly-owned subsidiary of Centrica plc. Neither DERS nor DEML accesses the capital markets on a stand-alone basis. Instead, they obtain their financing requirements from Centrica, who assesses DERS a “use of capital” charge of 10% for inter-company advances.

Q. Do you have any comments on the Board’s directive to DERS in Decision 2003-106?

1 A. Yes. The Board directed DERS “to demonstrate at the time of its next DRT and
2 RRT non-energy applications what its cost of providing working capital would be
3 if it obtained its working capital through a financial institution, on a stand-alone
4 basis with a parental guarantee.”

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6 The stand-alone concept entails assessing the cost of capital for a firm on the basis
7 of its own business and financial risks, not those of its parent. The application of
8 the stand-alone approach recognizes the basic principle of finance that the cost of
9 capital, or required rate of return, of each division of a firm should reflect its own
10 business risk. The required rate of return of each division is not equal to the cost
11 of financing to the entity that is making, or has made, the investment in the
12 business. For a firm that is diversified across several lines of business, its
13 consolidated cost of capital is not necessarily the sum of the individual parts,
14 where each part has a different business risk profile.

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16 Adherence to the stand-alone principle (not only in the regulatory arena, but in
17 decision-making in any type of business) avoids confusion between the
18 investment decision and the financing decision. The investment decision entails
19 estimating the rate of return required in the business as a result of its risk. If an
20 evaluation of that business demonstrates that the achievable rate of return will be
21 lower than the rate of return required, the business will either not be acquired by
22 the investor, or if it has already been acquired, will be sold.

23
24 The choice of financing is a separate decision. For example, an individual may
25 decide to invest in real estate, from which he requires a rate of return of 12%. He
26 takes out a mortgage at a cost of 6% to do so. The analogy for a regulated
27 business is that the regulator should set the rate of return that reflects the rate of
28 return that investors require to commit capital to the business based on its
29 business risks (that is, the 12%), not the cost that an investor may incur in raising
30 financing for the business, that is, the 6% mortgage. Adherence to the stand-alone
31 principle in setting a regulated rate of return ensures that the allowed rate of return

1 represents the investor's required rate of return, not the happenstance of
2 ownership. More generally, adherence to the stand-alone principle by applying
3 the division's own business risk-related cost of capital avoids distortion of the
4 economics of that business when it is valued, and ensures, when capital is
5 committed, that scarce resources will be efficiently allocated to their best use.

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7 If a parent company provides a guarantee to a subsidiary, risk is transferred from
8 the subsidiary to the parent. That risk has a cost, for which the parent requires
9 compensation. In a regulated environment, the cost of the risk that is transferred
10 via the guarantee can be captured in one of two ways. In the first instance, the
11 parent provides the guarantee, but requires no guarantee fee. The parent's
12 guarantee has conferred on the subsidiary the ability to raise debt at the parent's
13 own cost. To ensure that the parent is compensated for the transferred risk, the
14 regulator must set a stand-alone capital structure and return on equity that are
15 consistent with the debt rating (and cost) that the parent's guarantee has
16 conferred.

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18 To illustrate, assume that a utility can only access the debt markets without a
19 parent guarantee at a cost consistent with a BBB rating. However, with a parent
20 guarantee, the utility can now raise debt at a cost that reflects an A rating. To
21 ensure proper compensation to the parent, the utility's combined allowed capital
22 structure and return on equity need to be set so as to provide the basis for a stand-
23 alone A rating. Through the regulator's application of the stand-alone principle,
24 the parent to whom the financial risk was transferred via the guarantee is
25 compensated. If, on the other hand, the regulator allows customers to benefit
26 from the lower debt cost achieved via the guarantee without reflecting the benefit
27 in the utility's allowed capital structure and return, a cross-subsidy from the
28 parent company to the utility's customers has been created.

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30 The second approach is for a guarantee to be obtained at an explicit fee. In
31 principle, a guarantee could be obtained from either a parent or a third-party. The

1 overall cost of capital of the business does not change as a result of explicitly
2 paying the guarantee fee. Instead, the cost of capital is “carved up” differently, so
3 that there are three stakeholders being compensated for the risks they bear, the
4 debt investors, the equity investors, and the guarantor. Since some of the
5 financial risks have been transferred to the guarantor, the debt investors will
6 require a lower rate of return. However, the overall cost of capital of the business,
7 reflecting its business risk, will still be equivalent to its stand-alone cost of
8 capital. Consequently, for the purpose of determining the rate of return to be
9 applied to DERS’ rate base, estimating the stand-alone cost of capital for the
10 DERS operations fulfills the Board’s directive.

11

12 Q. Are there any constraints on DERS’ ability to comply with the Board’s directive
13 as a result of the manner in which DERS actually obtains financing for its
14 operations?

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16 A. Since neither DERS nor DEML actually obtains financing in Canada, its ability to
17 obtain a considered view on the stand-alone cost of capital without incurring
18 significant fees (e.g., hypothetical debt ratings) is limited. In essence, DERS is
19 seeking advice from financial institutions that are relatively unfamiliar with its
20 operations. Since DERS has no intention of engaging that firm to provide any
21 actual financing, neither a financial institution, such as an investment banking
22 firm, nor a debt rating agency has much incentive to provide detailed advice on
23 how DERS should finance its operations and at what cost.

24

25 Q. Please explain your understanding of how DERS complied with the Board’s
26 directive to demonstrate what the cost of working capital would be if the working
27 capital were obtained through a financial institution on a stand-alone basis with a
28 parent guarantee.

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30 A. DERS sought the financial advice of The Toronto Dominion Bank (TD Bank),
31 providing them with the specifics of the Board’s directive and the necessary

1 background to that directive. TD Bank was selected due to their banking
2 relationship with DEML and knowledge of DEML's operations.

3

4 Q. Please summarize your understanding of TD Bank's conclusions.

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6 A. TD Bank concluded that:

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8 a) It would not provide financing for DERS' working capital on a stand-
9 alone basis, based on the financial statements of the relevant businesses.

10 b) In order to provide financing for the working capital requirements, TD
11 Bank would require the inter-company shareholder loan to be converted to
12 equity or a subordinate loan.¹

13 c) The conversion of debt to equity would then allow DERS to obtain
14 financing for the working capital at a cost of 105 basis points (a Bankers'
15 Acceptance Fee of 85 basis points per annum plus a Stand-by Fee of 25
16 basis points).

17 d) The total cost of capital for DERS would need to include the cost of equity
18 or the cost of the subordinated loan.

19

20 The letter obtained from TD Bank is attached to this testimony as Appendix A.

21

22 Q. What are your comments on TD Bank's letter?

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24 A. TD Bank's letter states, in sum, that there is no stand-alone cost of financing for
25 working capital independent of the overall cost of capital of the business. Further,
26 in order for DERS to actually obtain a financing facility on a stand-alone basis, it
27 would have to have equity (or equity-like securities) in its capital structure.² The
28 cost of that equity would have to be determined in order to estimate DERS'
29 overall cost of capital.

¹ At the end of 2004, the inter-company shareholder loan accounted for 100% of DERS' permanent capital.

² A subordinate loan of this type is typically viewed by the capital markets as having equity-like features.

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The TD Bank letter essentially is saying, and I agree, that the working capital is an integral part of the business; there is no separate “working capital” business. The working capital requirement arises as a result of the overall operations, and is financed as a part of those operations.

As a consequence, from a real world perspective, financing is not done on the basis of individual assets, but on the basis of the business in which the firm operates. Thus, in order to obtain financing for working capital, the firm needs to have an appropriate capital structure, including an equity component. As suggested by TD Bank’s letter, in order to estimate the overall cost of capital for DERS, one would need to estimate the required return on equity. This exercise, in turn, would entail finding comparators in the energy retailing business whose cost of equity would be a proxy for DERS’ cost of equity. However, since the cost of equity for any comparator in the energy retailing business would reflect the composite of their regulated and unregulated services, their cost of equity would, in principle, represent the upper end of a reasonable range of the return applicable to DERS’ regulated rate base. Moreover, finding “pure-play” Canadian³ comparators with data is problematic. In my opinion, the amount of analytic effort require to produce a reliable estimate of the return requirement is not justified by the size of the DERS’ regulated rate base.

Q. Is there any other approach that would produce a reasonable estimate of the return that should be applied to DERS’ rate base?

A. Yes. As indicated by the EUB in Decision 2004-065, the allowed return of the distribution utilities that retain the ultimate responsibility for providing the RRT and DRT services is a reasonable proxy for the cost of capital and hence the allowed return to be applied to those utilities’ authorized provider(s) of RRT and DRT services.

³ Adapting data for non-Canadian comparators to the Canadian environment would add further complexity.

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Q. Please explain why you agree that the Board’s conclusion in December 2004-065 is reasonable.

A. The RRT and DRT services can be viewed as simply two of the various types of regulated services that are offered by a utility. For each type of service offered by a utility (e.g., gas utility services, such as interruptible gas sales or gas storage services, or electricity delivery services, such as irrigation pumping), the rate is based on an allocated cost of service that includes a return component. The return component is based on the overall cost of capital that is incurred by the utility when it invests in the assets required to deliver a full slate of regulated services.

There is no attempt by the utility or the regulator to trace dollars of financing to specific assets. There is no attempt to distinguish among the types of services on the basis of different levels of risk or on the basis of different types of assets being utilized. The same return is assigned to each service. To attempt to assign different costs of capital to different services would be arbitrary, as each service makes a contribution to the overall operations of the firm. Thus, the overall cost of capital is applied to the composite of the assets used to deliver regulated utility services (that is, to the rate base). Those assets include an allowance for working capital.

The application of the same cost of capital to each utility service makes logical sense, since the utility is financing a business that is a going-concern; it is not simply financing a collection of assets. Regulatory practice sets the quantum of return to be recovered in a utility’s rates by applying the utility’s overall cost of capital to the rate base. The cost of capital, in turn, is determined in the capital markets; that cost of capital is a function of the totality of the utility business.

For an integrated utility that provides standard electric or gas service options, there is no separate RRT or DRT “business”. Those service options, would be,

1 from the investors' perspective, no different from the other services offered by a
2 utility, that is, they would be an integral part of the utility's business.
3 Consequently, there is no tracing of dollars of financing to specific assets or
4 services.

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6 While the concept of a "functionalized" or "unbundled" cost of capital has been
7 applied in a few regulatory jurisdictions, including Alberta, it has generally been
8 restricted to those utility functions that could be, or actually have been, financed
9 on a stand-alone basis (e.g., pure-play distribution utilities). The RRT and DRT
10 services, in this context, would be considered to be an integral part of the
11 distribution function.

12
13 While DERS is the ATCO Utilities' authorized provider of the RRT and DRT
14 services, the ATCO Utilities retain the obligation to render these services. As
15 such, the services do indeed remain an integral part of the ATCO Utilities'
16 distribution businesses. Implicitly, the ATCO distribution utilities' cost of capital
17 and allowed returns continue to recognize that obligation. Consequently, it would
18 follow logically that the rate base underpinning the RRT and DRT services should
19 attract the same cost of capital of the utility to which the final obligation belongs,
20 that is, the corresponding ATCO utility's cost of capital. In effect, the rate base
21 (i.e., the working capital) devoted to the RRT and DRT services can be
22 characterized as the portion of the utility rate base allocable to specific utility
23 services now delivered by DERS, by authorization of the ATCO Utilities.

24
25 In sum, whether the RRT and DRT services, and the corresponding costs, reside
26 within DERS or within the ATCO Utilities, they remain an integral part of the
27 utility business. They would, as part of a stand-alone utility, attract a utility cost
28 of capital. Since, in this case, the ultimate obligation to provide the RRT and
29 DRT service remains with ATCO Electric-Distribution and ATCO Gas
30 respectively, it is reasonable to apply those utilities' allowed returns to the rate
31 base (working capital) that is required to offer these specific services.

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Q. What are the costs of capital that would then apply to DERS' working capital?

A. The applicable costs of capital are the weighted average costs of capital determined for ATCO Electric-Distribution and ATCO Gas in accordance with the findings in the Generic Cost of Capital Decision 2004-052, as updated for changes in the allowed return on equity as required by the Board's automatic adjustment mechanism. The ATCO Electric-Distribution cost of capital would be applied to the RRT rate base and the ATCO Gas cost of capital would be applied to the DRT rate base.

The applicable costs of capital as per the most recent publicly-available data would be:

<u>RRT</u> <u>(ATCO Electric-Distribution)</u>	<u>DRT</u> <u>(ATCO Gas)</u>
7.87%	8.32%

Source: Schedule 1.

The components of the costs of capital can be found on Schedule 1.

Q. Do the costs of capital above include an allowance for income taxes?

A. No. The indicated costs are allowed returns on rate base, which include the after-tax returns on equity. In order for DERS to have an opportunity to earn the after-tax return on the equity components of the weighted average cost of capital, the equity components need to be grossed up for income taxes. The corresponding pre-tax costs of capital, using the current statutory combined federal/provincial income tax rate of 32.5%, would be:

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	RRT (<u>ATCO Electric-Distribution</u>)	DRT (<u>ATCO Gas</u>)
	9.7%	10.2%

Source: Schedule 1.

The calculations are shown on Schedule 1.

- Q. What, then, are you recommending to the Board?
- A. I recommend that the Board apply to the RRT and DRT rate base, respectively, ATCO Electric-Distribution’s and ATCO Gas’ allowed returns, grossed up for the statutory tax rate, for the following reasons:
1. The RRT and DRT services are, in fact, utility services, which should attract a utility cost of capital. DEML’s stand-alone cost of capital is for a business that also includes unregulated energy-related services.
 2. The Board has recently undertaken an extensive review of the utilities’ cost of capital in the generic cost of capital proceeding, from which it arrived at a decision that, in the absence of material changes in the capital markets or the utilities’ risk profiles, will apply for a period of at least five years. There have been no substantive changes in either the capital markets or utility risks since the Board’s decision in July 2004 that would likely lead to a different decision at this juncture. That conclusion, in conjunction with the relatively small size of DERS’ rate base, support application of the generic cost of capital decision findings to DERS.
 3. The approach has previously been adopted by the Board in Decision 2004-065.

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4. The ATCO Utilities file GTAs/GRAs regularly with the Board. The findings in these proceedings will allow any changes in the various components of the allowed costs of capital to flow through to the RRT and DRT services without requiring, in future, additional evidence on the appropriate cost of capital. Thus, not only does this approach produce a reasonable estimate of the relevant cost of capital, but given the relatively small size of the RRT/DRT rate base, it provides a pragmatic solution without excessive costs of evaluation.

Q. Does this complete your testimony?

A. Yes.