

**Before the**

**Alberta Energy and Utilities Board**

**in**

**THE DEFERRAL ACCOUNT BALANCES APPLICATIONS**

**Deferral Accounts Carrying Cost Evidence**

**of**

**William J. Demcoe  
Willbren & Co. Ltd.**

**John D. McCormick  
J. D. McCormick Financial  
Services, Inc.**

**Calgary, Alberta**

**June 2001**

## I INTRODUCTION AND SUMMARY

Q. Please state your names, addresses and occupations

A. My name is William J. Demcoe, and my address is 603 Parkridge Drive S.E., Calgary, Alberta. I am a strategic and financial consultant and President of Willbren & Co. Ltd. A description of my professional qualifications is found in Attachment 1.

My name is John D. McCormick, and my business address is Suite 2400, 645 7<sup>th</sup>. Avenue Southwest, Calgary, Alberta. I am a financial consultant. A description of my professional qualifications is found in Attachment 2.

Q. Are you aware of the purpose of this hearing?

A. The Notice of Hearing provides that the Board will, among other things, “determine the associated final 2001 carrying charges that are to be recovered from the Balancing Pool, pursuant to the Deferral Accounts Regulation.” The Board also wishes to determine “the timing of the collection of those balances from customers during the period January 1, 2002 to December 31, 2004.”

Q. Are you aware of the orders related to the deferral accounts that have already been made by the Board?

A. In a series of earlier decisions the Board authorized the Balancing Pool to pay an amount based on the Bank of Canada Rate plus 1.5% on the deferral amounts calculated by the various DISCOs. These decisions included:

Decision 2001-7	\$321.1 million for UtiliCorp Networks Canada (Alberta) Inc (“UtiliCorp” or “UNCA”),
Decision 2001-8	\$85.2 million for ATCO Electric (“ATCO”);
Decision 2001-10	\$77.6 million for EPCOR Distribution Inc (“EPCOR” or “EDI”);
Decision 2001-12	\$137.5 million for ENMAX (“ENMAX” or “EPC”);
Decision 2001-26	\$5.2 million for Red Deer, and
Decision 2001-27	\$5.4 million for Lethbridge,

In aggregate, the DISCO deferral accounts total \$632 million before any adjustments or offsets that may be ordered by the Board. We also understand that the Board in two recent decisions approved certain financings that might be relevant to determining the “prudent cost of financing” of the deferral amounts.

Q. Are you aware of the Board’s decision 2001-31?

A. In Decision 2001-31, the Board approved two \$25 million tranches of Debentures for ATCO Electric, the first being at 6.97% until June 2008, the second at 7.05% to June 2011.

Q. Are you aware of the Board’s decision 2001-47?

A. Yes, we are aware of the decision of the Board in respect of the issue of equity by UtiliCorp. That decision approved the issue of \$120 million of equity to UtiliCorp’s parent. From the decision it appears that UtiliCorp had been receiving “emergency financing” at an interest rate of 7.5% from its parent. As quoted in the decision, their application stated “Financing of UNCA’s outstanding deferral account exclusively with debt is not prudent and would put UNCA in violation of its existing financial covenants.” While the Board authorized the equity infusion, in its findings the Board provided that “The final amount of equity, if any, necessary to finance the deferral account will be determined by the findings of the Board following the Hearing.” Regretfully, at the time of preparing this evidence we had not had access to the application documents in decision 2001-47.

Q. Can you please describe the current interest rate environment?

A. Since we are focusing upon deferral amounts which are to be recaptured over a period of up to three years, beginning in about six months time, we have focused on shorter term rates. At the time this evidence was prepared the Bank of Canada rate was 4.75%. Rates for 1 and 3-month Bankers' Acceptances were approximately 4.50% as were the rates for 1 and 3-month commercial paper. Indicated rates for three-year instruments issued by "A" rated borrowers were approximately 6.00%. Yields on three-year instruments for "BBB" rated issuers which we considered relevant ranged from 6.20% to 6.80%.

Q. What is the purpose of your evidence at this proceeding?

A. The Alberta Energy and Utilities Board (the "Board") has requested that we provide an expert opinion on the potential prudent financial options available to the DISCOs. Specifically, the Board has requested that we, (a) explore, review and present various forms of financing for the Deferral Accounts available to the DISCOs, (b) address the relevance of including an equity component in the cost of financing of the Deferral Accounts, (c) present recommendations on the impact on the cost of financing for the DISCOs for other corporate purposes, (d) provide recommendations as to the forms of approvals that would be required from the Board in its Decisions in order that the DISCOs could access the most appropriate sources of financing while maintaining a prudent and reasonable financial structure for the DISCOs, and, (e) provide practical options and steps that would be required for the Balancing Pool to be able to access debt and use the proceeds to pay out the deferral accounts of the DISCOs. In preparing our submission we were to "[r]eview and analyse the applications that have been filed by the DISCOs in the Proceedings."

Q. Was the evidence prepared by you or under your direct supervision and control?

A. Yes.

Q. Please summarize your conclusions.

A. Our review of the financial options available to the DISCOs leads us to conclude that the options available to finance the 2000 deferral accounts, range from varying types and terms of debt, preferred and common equity through to some off balance sheet structures.

Our analysis of whether an equity component should be included in the cost of financing the 2000 deferral accounts and the determination of carrying costs indicates that for most DISCOs an equity component would not be required to be included in the financing cost of the 2000 deferral amounts. Prudent and cost effective debt alternatives exist.

Based on the information available to us, we have concluded that there should be no material effect on the cost of financing for ENMAX, EPCOR, ATCO and the cities of Lethbridge and Red Deer due to financing the 2000 deferral accounts with short-term debt. UNCA has raised issues with respect to their existing debt covenants.

The use of short term on balance sheet debt and off balance sheet financing structures will be enhanced with increased regulatory certainty and participation by parties such as the Balancing Pool.

## II DEFERRAL ACCOUNTS

Q. Can you give us a brief overview of how deferral accounts have been treated from a regulatory point of view?

A. We are aware of a broad range of treatment of deferral accounts including deferral accounts being repaid without an equity component.

Q. Can you give us an example of a large deferral account being repaid without an equity component included in the carrying charges?

A. Yes. We are familiar with three similar circumstances. In two of the cases Mr. Demcoe was the Chief Financial Officer of the companies involved. Both of these cases were with natural gas aggregating companies and involved large take-or-pay obligations. In one case the take-or-pay obligation was financed with commercial paper and the interest costs were included in the monthly cost of service. There was not, however, an equity return component in the Alberta cost of service for the take-or-pay balances. In the other case it involved an off-balance sheet financing by third parties of the take-or-pay liability and again the interest was charged in the monthly Alberta cost of service but there was no equity return component included on the balance of the take-or-pay liability.

Q. Are you aware of deferral accounts being repaid with an equity component included in the carrying charges?

A. Yes, a review of a number of regulatory decisions, including the August 1980 decision of the National Energy Board (the "NEB") in respect of TransCanada PipeLines Limited allowed certain amounts previously deferred to become part of the rate base and to be amortized through the cost of service earning the authorized rate of return on the rate base. In that decision, the National Energy Board also decided, "that the carrying charge on deferral accounts shall be calculated at the authorized annual rate of return on rate base." In that case, TransCanada had requested "that a carrying charge on the deferral accounts be allowed at a rate equivalent to the chartered bank prime rate plus one percent." In its decision the NEB referred to testimony in which it was adduced that the actual source of funds used to finance the deferral accounts could not be traced and TransCanada's short-term borrowing rate was prime.

Q. Are you aware of instances where a regulator refused amounts sought as deferral accounts?

A. Yes, a review of a number of regulatory decisions, including the June 1983 decision of the NEB in respect of TransCanada PipeLines Limited addressed several deferral account matters. In respect of a request by TransCanada for a deferral account for "lost and unaccounted gas and company use gas" the Board determined that approval of a deferral account would remove the financial incentive for TransCanada to continue to minimize those costs.

In the June 1983 decision, the NEB also did not approve a request in respect of an August 1982 revenue deficiency, citing a concern with the issue of retroactive ratemaking giving rise to a lack of jurisdiction.

Q. How would you differentiate between the deferral accounts that should be allowed to be financed with an equity component and those that should be afforded some other treatment?

A. Deferral accounts can arise for a number of reasons. One example would be an operating deferral account that may arise from time to time and could be either a debit or credit balance. In the long run these amounts should tend to offset each other and the net balances should not be significant over time. The balance, if allowed, would normally be amortized in the period following the determination. For this type of deferral account, the NEB determined, in RH-3-86, that allowing the carrying charges to be calculated at the approved return on rate base is reasonable.

Not all deferral amounts requested arise as a result of minor operating variances. Some arise as a result of special or non-recurring situations. The amounts can be significant and, as such, if allowed, may be recovered over a period longer than one year. These amounts, while material, are usually recovered over a

much shorter period than the average life of rate base assets. We believe that the superior methodology is to allow a cost of financing on this type of deferral account based on the likely method of financing that would be chosen by a prudent utility.

Q. Would you characterize the deferral amounts that are the subject of this proceeding as a special non-recurring situation?

A. In our view, the factors that brought about the deferral amount are not those of an operating deferral, but are a special situation that we understand is unlikely to continue. We understand that the potential for similar deferral accounts to arise for 2001 cannot be accurately estimated at this time, but that the clear intention of the deregulation program is that in a short period market rates will be passed through to customers.

### III REVIEW OF FINANCIAL OPTIONS

Q. How did you conduct your review of financial options?

A. We commenced our review with an analysis of each DISCO's application on the 2000 Deferral Accounts proceeding with specific regard to financing and carrying charges. We then commenced a review of financing options that may be available to the utilities in the current financial markets. In this review we had discussions with representatives of major banking institutions as to appropriate financing options, rates, market conditions, security and related matters.

Q. Would you summarize your review of the DISCOs applications regarding financing the deferral account balances and applicable carrying costs of same financing?

A. We will summarize the carrying costs proposed by the DISCOs first. Five of the six DISCO's proposed that they earn a WACC rate on the deferral account balances with the sixth, ENMAX proposing to utilize the Bank of Canada Bank Rate plus 1.5%. The proposed WACC rates and capital structures of the five DISCOs' are shown in Schedule 1 in Attachment 3. There is a range between 9.25% and 11.5% on requested after tax common equity returns and debt rates used in the WACC calculation range from a low of 6.45% to 9.32%. These indicate after tax WACC rates ranging from 8.44% to 8.47%. ATCO DISCO provided a before tax WACC calculation of 12.44% which has the equity return revenue requirement factored into the calculation. When an equity return revenue requirement is factored into the other applications for WACC the before tax rates are all estimated to be in excess of 11%.

EPC did not apply for a WACC based return on its carrying costs. Instead, it indicated it was appropriate to finance the deferral costs with all debt at the Bank of Canada Bank Rate plus 1.5%. EPC asserts that this closely approximates their cost of short-term debt for the relevant periods. We estimate this carrying charge rate at the time of this evidence to be approximately 6.25%.

The WACC applicants did not indicate the particular rates at which they have borrowed in any specific debt financing to fund the deferral accounts in their calculation of WACC rates. The cities of Lethbridge and Red Deer utilized a 7% cost of debt based upon a best commercially available lending rate of 6.75% plus a 25 basis points premium for "customer benefits". EPCOR used a debt rate of 6.65% derived from taking long Canada bonds at 6% and adding a 125 basis point credit risk premium and 5 basis points for financing cost allowance less 65 basis points due to the short term nature of the debt. UtiliCorp used a debt rate of 6.45% utilizing a similar methodology as EDI. It started with the 6% long Canada rate added a 105 basis point credit risk premium and 5 basis points financing cost allowance. ATCO used a 9.32% cost for debt based upon their forecasts.

Only one applicant, UNCA made reference to a need for incremental equity financing. UNCA indicated that it financed its deferral accounts on an interim basis with an emergency loan from a parent company at the rate of 7.5% and will refinance this emergency loan using an appropriate mix of debt and equity capital.

Q. Do you have a comment on the 9.32% cost of debt rate used by ATCO in their WACC application for carrying charges?

A. It does seem unusual that ATCO would use such a rate in this application when the last two financing rates approved by the Board were at 6.97% for 7.5 years and 7.05% for 10.5 years. These longer-term rates are also relatively high rates compared with the rates for terms that match the term of collection they propose for the deferral accounts. We would expect that ATCO would be able to finance for one year or under at rates under 6.0%.

Q. Does the *Deferral Accounts Deficiency Correction Regulation* require that the owner of an electrical distribution system receive its approved annual return on its rate base in respect of the deferral amount?

A. No, not as we read that regulation. We note in Paragraph 4(2) the Board may determine that the prudent cost of financing "may include debt financing, equity financing or a combination of debt and equity

financing.” On a literal reading, this paragraph allows the Board to determine that the prudent cost of financing includes only a debt component.

This literal reading is supported by Paragraphs 4(4) and 4(5)(a) which provide a relatively low interim financing rate and a refund by the owner of the amount paid to it on an interim basis which exceeded the prudent financing cost. Pursuant to Paragraph 4(4) the Board must allow owners, that apply for approval of a monthly payment in respect of the cost of financing, an amount determined at “the Bank of Canada bank rate plus 1.5%” based on the owner’s reasonable estimate of the amounts in its deferral accounts.

The Bank of Canada Bank Rate stood at 6% on January 1, 2001 and fell to 5.75% on January 23, 2001. It was further reduced on March 6, 2001 to 5.25% and on April 17, 2001 to 5.00%. On May 29, the Bank of Canada Bank Rate was reduced to 4.75%. The daily average of the Bank of Canada Bank Rate for the first five months of 2001 is approximately 5.4%. On July 17, 2001, the Bank of Canada Bank Rate was reduced once again to 4.50%. The interim financing cost allowed to an owner for the first five months of 2001, pursuant to Paragraph 4(4) of the *Deferral Accounts Deficiency Correction Regulation* would be approximately 6.9%.

For comparative purposes, the average of the month end rates for the first four months of 2001 for 3-month Bankers’ Acceptances as found in the Bank of Canada data series B14057 was 4.87%. The similar average for 1-month Bankers’ Acceptances as found in the Bank of Canada data series B14057 was 5.09%. The May 31, 2001 rates for 3-month and 1-month Bankers’ Acceptances were 4.47% and 4.52%, respectively. We would observe that the inverted slope of the yield on these two rates suggests that the market expects some further reduction in these rates in the near term.

Q. What maturity of debt obligation would you view as prudent in the financing of the deferral accounts?

A. We believe that it is prudent that the term of the debt obligation matches the term over which the deferral account is intended to be amortized.

By way of example, ATCO is applying to amortize the balance of the deferral accounts over a one-year term. Assuming that the amounts were to be recovered in 12 equal payments, we are of the view that the appropriate debt instruments would have an average life of approximately six months commencing on January 1, 2001 and would have individual maturities monthly throughout the year. In the case of UNCA, the amortization period applied for is three years. For UNCA, appropriate debt instruments would have an average life of approximately 18 months commencing on January 1, 2001 on a going forward basis and would have individual maturities throughout the three-year period.

Q. Why are you focusing on the remaining term for recovery of the deferral account amounts rather than the average life of the obligations that began to accrue in 2000, will remain outstanding throughout 2001 and will only be recovered in 2002 to 2004?

A. As you put the question the deferral amounts would have a 1.5 to 2.5 year average life. Although not set out in the various applications, each of the applicants has had to finance the deferral amounts from the beginning of 2000 until the date of the decision using its best judgment as to the appropriate financing structure. We observe that few applicants have increased their equity layer to finance these amounts. We therefore concluded that the growing deferral balances have been financed with short-term debt. As we have stated earlier, we believe for this type of deferral amount the actual type of financing used is a better result than a blended debt and equity or deemed capital structure.

This hearing will take place 18 months into the life of the obligation. The decision may not be released for several weeks. We believe that appropriate focus for the financing is the remaining term of the issue, which, if our securitization suggestion is implemented will be a going forward average life of 6 months to 18 months.

Q. Do you believe that the appropriate proxy for the cost of debt for financing the deferral accounts is 6.65%, as set out in the evidence of Dr. Evans for EPCOR?

- A. No. The going forward term of the deferral account obligations is between one and three years, and as such would have an average life of 6 to approximately 18 months. By focusing on bonds with a maturity of 1-3 years, Dr. Evans is using a sample where the average life is approximately 24 months. This average life is between 33% and 300% longer than the term of the deferral account obligation. In focusing on the 1-3 year term, Dr. Evans is excluding the rates paid for terms up to one year. These rates can be as low as 4.50% depending on credit worthiness.

Rather than adopt a methodology of taking a long-term Government of Canada rate, and adding the 24 year average yield difference between Canada bonds and BBB Utility bonds and the cost of financing, we prefer to look to the current market in which the yields on Bankers Acceptances (BAs) and bonds of up to 3 year maturities can be determined. We observe that BBB rated bonds of up to 3-year maturities are currently trading at yields of between 6.20% and 6.80%. Assuming the amortization of the deferral accounts equally over the 3-year term, the expected rate would be a blend of rates over the 1 month to 3-year term. On the basis of BAs and bond rates, we would recommend a cost of debt between 5.5% and 6%. On the basis of a securitization with high certainty of recovery, we believe the prudent financing rate is in the range of 5.10% to 5.60%.

- Q. What are your conclusions regarding the applications for financing of carrying costs of the deferral accounts?

- A. The DISCOs, with the exception of EPC, are all applying for the application of WACC to the deferral account balances. The WACC is normally applied to rate base assets that are characterized by their long term and integral nature in the operation of the core business of the utility. The cost of capital is usually comprised of the long-term capital of the utility whether actual or deemed, to finance the rate base.

The deferral accounts have been recognized as short term in the regulation governing the term of their recovery and in the applications through the identification of the collection periods proposed being one to three years that yield an average life on the financings of 6 to 18 months. On page 8 of Dr. Evans' evidence in respect of EPCOR and on page 7 of his evidence in respect of UNCA, he observes that "the period of recovery of the amounts included in the deferral accounts is considerably shorter than the period for recovery of distribution wires assets." It was also recognized in evidence in the UNCA and EDI applications regarding the risks and adjustments to debt rates. EPC states in BR.ENMAX PC DISCO-11 "EPC selected the Bank of Canada Bank Rate plus 1.5% as the basis for its financing costs, since this rate closely reflects EPC's cost of short term debt for the relevant period".

We note that there are three different rates of return on common equity utilized by the five utilities proposing WACC as the carrying charge rate for the deferral accounts. The cities of Lethbridge and Red Deer utilize 9.75% being identified as the rate "recently tested by the Board for owners of Transmission Facilities in Board Decisions for ATCO Electric Ltd. (2000-65), TransAlta Utilities Corporation (2001-04) and EPCOR Transmission Inc. (2001-05)." We note with interest that ATCO (DISCO) used 9.25% and EDI used 11.5%, as did UNCA, using evidence provided by Dr. Evans in their applications. The Board has determined the rate of return on the DISCOs' common equity and, should WACC be used in the carrying costs for the deferral accounts, it would be logical to continue utilizing the rates in force until changed by the Board.

We concur with EPC that, as the deferral account obligations are short term, the appropriate financing should also be short term. The conventional use of WACC is with long-term rate base assets. If it is determined that the problem that gave rise to the deferral accounts is not short term, and if it is determined that a new material tangible equity support component is necessary to support the financing of the deferral accounts we support the use of a WACC. If this were so determined, the conventional WACC calculations would need to be adjusted to reflect the -term of the debt incurred by the utilities or deemed to be incurred by the utilities. We also note that return on common equity is normally priced in reference to long-term equity premiums. The use of WACC to determine carrying costs on shorter term obligations would raise the question whether shorter or equivalent term Canada debt should be utilized as the base for determining return on equity (180 day T-bills or government debt with 18 month maturities).

There is a material difference in carrying costs rates when one compares the EPC submission of approximately 6.25% and the WACC applications in excess of 11% when equity revenue requirements are

factored in. The difference in carrying cost rates of greater than 4.75% on over \$630 million dollars is a material amount.

Q. What options are available to corporate issuers seeking to raise funds?

A. Generally, financing options are broadly divided between debt and equity options and can vary in respect to term of commitment by the purchaser. There are a range of ways issuers can access the market for debt, depending on their credit standing and the term for which they require the capital. No list would be complete, but on the debt side banks are available capital sources with a range of loan products, in addition to the commercial paper markets and longer-term debt markets. At the other end of the spectrum we have common equity, which is the most subordinated and permanent capital layer. In between common equity and debt you would find preferred shares appropriate for some issuers. Cost of preferred shares for the same company would be less than common equity. Preferred shares can also be issued for particular terms matching capital requirements.

Q. What prudent financial options are available to the utilities to finance the deferral account balances?

A. The availability and prudence of each option is dependent upon the market conditions at the time and the individual circumstances of the utility.

In the context of prudent options for the utilities in financing the deferral accounts the options available will be dependent upon the credit standing of the issuer, security backing the financing, term of the financing and rates applicable to the offering. The financing must be rate competitive and match the characteristics of the underlying security of the assets being financed. It is a general principle of corporate financial management that one would not fund short-term assets with long term capital. It is, however, normal and prudent to finance short-term assets with short-term obligations. There are organizations that finance longer-term assets with shorter-term debt and are willing to take a variability risk in rates over time.

Q. How have the DISCOs been affected by the deferral amounts?

A. While it is hard to get a clear picture of the impact of the DISCO deferrals on each company owing to the other activities that may effect their financial statements, we were able to review the consolidated financial statements for the year ended December 31, 2000 of ENMAX, EPCOR Utilities Inc. and ATCO. The deferral accounts of ENMAX, EPCOR Utilities Inc. and ATCO, referred to respectively on their Balance Sheets as "Deregulation adjustment rider receivable," "Deferred amounts receivable" and "Deferred electricity costs," are disclosed to be \$140 million, \$102 million and \$85 million, respectively. We have summarized some indicative ratios of these companies below

	ENMAX	EPCOR Utilities Inc.	ATCO
Deferral Account as a % of equity	41%	11%	9%
Deferral Account as a % of assets	12%	3%	4%
Deferral Account as a % of revenue	19%	7%	12%
Current ratio 1999	1.59 to 1	0.35 to 1	1.31 to 1
Current ratio 2000	0.52 to 1	0.35 to 1	0.91 to 1
Working capital 1999 \$MM	\$ 50	\$ (296)	\$ 38
Working capital 2000 \$MM	\$ (207)	\$ (620)	\$ (27)

Q. What are your observations regarding the deferral accounts of these companies?

A. Our first observation is that these financial ratios may not be exclusively related to the DISCO operations. The current ratios and changes in working capital of each company indicate changes in their liquidity. The effects are most significant for ENMAX where both liquidity indicators have been changed dramatically.

In their case they went from a ratio of 1.59 to 1 to a ratio of nearly 0.5 to 1. Working capital decreased by over \$250 million. The deferral accounts for ENMAX are much more significant in proportion to key items on their Balance Sheet than they are to the other two companies. This is a factor of the relative size of each company and the size of the deferral accounts. EPCOR and ATCO are approximately three and two times larger, respectively, and their deferral accounts are 0.72 and 0.61, respectively, the size of those of ENMAX.

UNCA states in its application that the deferral account is approximately 60% of rate base and greater than the sum of long-term debt at December 31, 2000.

Q. Can you discuss the financing option that EPC appears to have selected in relation to their balance sheet and income statement?

A. Briefly, EPC is the sole applicant that sought only short term debt suggesting that it would finance its deferral amount in that manner. On its December 31, 2000 Balance Sheet the Deregulation Adjustment Rider was shown at \$140 million representing 41% of the Total Equity. The Deregulation Adjustment Rider was 12.4% of Total Assets. When compared to 2000 revenue the Deregulation Adjustment Rider was 18.6% of that amount. As a result of a number of significant changes in the past year including the deferral issues and the power purchase arrangements that it acquired, EPC's current ratio fell from 1.59 to 1 in 1999 to 0.52 to 1 at the end of the year 2000. EPC's working capital also fell from a \$50 million surplus to a \$207 million deficit.

Q. Do you believe the deferral account balances will negatively affect the ability of these companies to finance their operations and other projects?

A. The effects of the deferral accounts on EPCOR's and ATCO's financial condition are significantly less than on ENMAX. In both of these companies the accounts make up significantly smaller portion of the total assets and equity. With such strong coverage we believe that there would be no material effect on their ability to finance. We note that ATCO has recently had two new debt issues approved by the Board.

It is important to note that ENMAX submits that it will finance their deferral account with short-term debt. One can conclude that in their judgment their ability to finance is not impaired. We do note, however, that our belief in these companies ability to continue to finance with these deferral account balances is based upon the balances and financial statements as at December 31, 2000. Should the financial condition of these companies change due to new large deferral account balances we would have to reconsider this view.

It would be naive to say that on the scale of financeability that each of these utilities would have the same ease of accessing financing the deferral accounts. The materiality of the deferral accounts to the revenue, asset and equity base of the utility is a significant consideration. The greater the materiality of the deferral account to each of these items will affect both the availability and cost of financing of both the deferral accounts and other financings.

Q. Do you believe the deferral account balances will negatively affect the ability of these Lethbridge and Red Deer to finance their operations and other projects?

A. Similar to our view of the corporates, we do not see an impairment of the financial position of these parties as a result of these amounts that are intended to be recovered over a short time.

Q. Have you been able to form an opinion as to whether an amount of equity was necessary to finance the deferral accounts of UtiliCorp?

A. No. In our review of their material for this application, we did not have complete ~~any~~ information as to the covenants that they were in risk of breaching, nor any information as to the steps that they undertook to obtain temporary waivers of the covenants. Regretfully, at the time of preparing this evidence we had not had access to the application documents in decision 2001-47.

Q. Would you expand on market conditions as variable?

A. The capital markets are made up of highly dynamic suppliers and demanders of capital. Both suppliers and demanders of capital have different needs or appetites as to amount, term, risk and rates. At any given time there may or may not be a strong supply of funds with a particular term, risk and return package. The demanders of capital must adjust their packages of risk and return to meet current market appetite or enhance their package (increase returns, reduce risks or change the time frame) to attract supply. If you are a demander of capital (issuer of debt or equity securities) and there is no appetite for your offering from the suppliers of capital then you must offer a package that will attract. In some markets and in some time periods, only the best issuers can attract capital.

Q. If the deferral accounts of a utility are significant relative to the rate base of the utility, such as they are to UNCA, are there factors which can mitigate the negative effects on the availability and costs of financing?

A. There are three primary factors that may mitigate the negative effects. The first of these are the regulatory decisions related to accounts in question. If there is clarity and certainty created by the decisions on the collection of the principal and carrying costs of the accounts then the negative effects will be somewhat minimized. Second, the quality of the underlying customer base of the DISCO can provide some mitigation. The timing of the recovery period of the deferral account is the third factor. The shorter the recovery period the greater certainty of recovery. This reduces the risks of other factors negatively affecting the recovery of the accounts and provides some mitigation.

Another mitigating factor would be the presence of a significant shareholder or shareholders. Shareholder comfort letters have been known to provide sufficient assurance to the lenders in order that large financings of this type can be done at highly competitive rates with no direct equity support.

Q. UNCA points out that incremental debt necessary to finance the deferral accounts would put them in violation of covenants in its current debt facility. What options are there for a company to deal with the anticipated violation of its existing debt covenants?

A. UNCA indicates that it will refinance, in part, with equity that one assumes will remedy the violations. Not having access to the covenants at issue, we are unsure whether a waiver request, or some other subordinated bridging mechanism would have provided an alternative remedy.

Covenant violations, if they are not long-term impairments on the ability to repay the debt, can in many instances be temporarily waived through negotiation and mitigating actions. As stated earlier the regulatory certainty of collection of the debt and carrying charges incurred for financing the deferral accounts will be an important consideration of current debt holders. Assurance and comfort from the major shareholders also are factors that may determine whether the violations will be waived. During a period of technical default on some covenants it is also not unusual have credit enhancement or some number of basis points added to the rate of existing debt. These penalties would normally be removed when the covenant violations are remedied. One would expect that the regulator under these circumstances would approve recovery of credit enhancement costs on existing debt.

Another possible option is financing the deferral accounts with some form of off balance sheet financing. Again the strength of the regulatory decision has a significant impact on both the availability and cost effectiveness of this option.

Q. Are there other factors that will affect the ability to finance the deferral accounts?

A. Yes, an important consideration will be the risk of large deferral accounts being created in the future by circumstances similar to those in 2000. The accretion of new large deferral account balances on top of existing deferral balances can in a relatively short period of time start to impair even the strongest balance sheet and company. This would have to be dealt with by the addition of permanent equity and debt capital in the companies and the ability to earn a return on that capital.

Q. Have you identified specific prudent financial options that may be available to the utilities to finance the deferral accounts?

A. Yes. We believe that the utilities, with appropriate regulatory authorities and assurances, could prudently finance the deferral accounts predominantly with short-term on balance sheet debt. Each utility has different credit characteristics and financing capacity that would vary the costs of financing and other factors involved in each case. Available options would involve bank financing, Bankers Acceptances, and Commercial Paper. The current commercial bank prime rate in Canada is 6.5%, and Bankers Acceptances rates range from 4.50% for the 1-month maturity through 4.46% for the 3 months maturity to 4.40% for the 6 months maturity. Commercial Paper rates are currently in the range of 4.53% for 1-month maturities and 4.48% for 3-month maturities. These rates were indicative during the week of May 28-June 1, 2001. Each utility would have different access to each market and would pay varying risk premiums in terms of added basis points over the Bankers Acceptances and Commercial Paper rates. Regulatory authority to collect the deferral accounts and applicable carrying charges would provide security for the securities. It may also be necessary for certain firms to have credit enhancement built into their particular program. Enhancements may include full or partial guarantees from parent or affiliated companies. It would be expected that these would be compensated for in the rate rider.

Q. Are there other prudent financing options available to the utilities?

A. Yes, we have concluded that for the larger deferral account balances that off balance sheet financing is available to the utilities at attractive rates. This would involve a securitization of the accounts and could involve one or more of the utilities. We address securitization of all or most of the deferral accounts in detail below.

#### IV RELEVANCE OF EQUITY COMPONENT

Q. Are you of the opinion that the deferral accounts in question at this proceeding should be treated as rate base assets and attract WACC rates of return?

A. We are of the opinion that these deferral accounts should not be treated as a rate base asset that would attract WACC returns. Although these accounts are material in amount to some of the utilities involved, we understand they are not expected to be a recurring material issue in the future. The short term characteristics, recovery prospects and the attractive rates on short term debt as opposed to longer term debt or WACC rates leads us to prefer a financing structure that is either off-balance sheet, or with a substantially larger short-term debt component.

Q. If a WACC was deemed appropriate for the deferral accounts should it be calculated to reflect the short-term nature of the deferral accounts?

A. This question raises interesting issues about determining appropriate rates for both debt and equity components. If our understanding is correct that the deferral accounts are a short term and non-recurring then the appropriate financing would match the expected term of the deferral accounts to debt instruments similar to the recovery period. Determining an appropriate rate of return on common equity raises questions on the use of conventional methodologies that have a long-term focus. We believe it is more appropriate to use a shorter equity instrument, such as redeemable preferred shares. The use of redeemable preferred shares or adjusting the returns on common equity to reflect the short term nature of the accounts being financed deserves consideration as the well as the amount of equity typically needed to underpin short term debt financing.

Q. Does the size of the deferral account balances relative to UNCA's \$471.3 million forecast rate base enter into your recommendation for financing structure?

A. Yes, the size of the deferral account balances is an important factor in considering the financing options available to UNCA. The deferral account balances of UNCA total over \$321 million. To amortize these amounts over a single year might create a hardship for UNCA's customers. The size of the deferral account balance also in some ways increases the flexibility we have in dealing with its funding. With an amount of this size we are motivated to identify any prospective cost savings that may exist in a special financing structure, and the size of the prospective financing makes it more attractive for investment dealers to allocate resources in hope of earning a larger fee and prospective purchasers to consider the purchase of a new name or structure.

Q. Do you agree with the evidence of Dr. Evans that it is not possible for UNCA to finance all the deferred costs with debt?

A. We would view the statement that such a financing is "not possible" as a little strong. This is not dissimilar from the Alberta & Southern Natural Gas Company Ltd. ("A&S") financing of their take-or-pay balances of over \$150 million that were underpinned with no assets other than its parent's obligations to purchase natural gas, the natural gas supply contracts and assurances from the parent company. The rate base assets of A&S were immaterial relative to the take-or-pay obligation.

We believe, that with the right regulatory environment, a decision mandating the recovery of the deferred costs and their carrying charges through an effective levy on the current and future customers, and, minor credit support from UNCA, an alternative financing structure could be created.

Q. Has anything like what you propose been done before?

A. Yes. In the late 1970's and early 1980's TransCanada PipeLines faced a major problem with its obligations under take-or-pay contracts.

Q. What was the size of that take-or-pay liability relative to TransCanada's rate base and total capitalization?

A. By December 1982, the Topgas syndicate had financed \$2.3 billion in deferrals. For the test year ended July 31, 1993, the NEB approved a total capitalization of TransCanada's utility business of \$2.7 billion, of which \$746 million was common equity and \$346 million was preferred share capital, leaving the balance of \$1,570 million as debt.

Q. What sort of debt rates were being paid by Topgas in the last three years of the program?

A. The offering memorandum filed March 14, 1990 at the Alberta Securities Commission for Topgas Holdings Limited and Topgas Two Inc. (collectively the "Topgas companies") shows a pricing of 0.35% spread over Bankers' Acceptances for the December 20, 1990 maturity, 0.40% spread for maturities in January through April 1991, 0.45% spread for maturities in December 1991 through April 1992, and 0.55% spread for maturities in December 1992 through March 1993. In aggregate, the principal amount of Debentures covered by the offering memorandum was \$632 million.

Q. At what level have Bankers' Acceptance rates been in recent months?

A. The average of the month end rates for the first four months of 2001 for 3-month Bankers' Acceptances as found in the Bank of Canada data series B14057 was 4.87%.

Q. In addition to the spread, would there be any other costs attached to such a financing?

A. Yes. We would anticipate that in addition to the spread there would be a credit enhancement fee and a stamping fee.

Q. What is your conclusion regarding the necessity of including an equity component in the carry charges on the deferral accounts?

A. It is our conclusion that new material tangible equity support is not necessary for the financing of most utilities deferral accounts. It is more likely that with the appropriate regulatory authorities and in some cases credit enhancement mechanisms the deferral accounts can be prudently financed with all short-term on balance sheet debt.

Q. What do you conclude about the impact of deferral account financing on the cost of financing for other corporate purposes of the utilities or their parents?

A. We conclude that there will be little if any effect on the cost of financing if off balance sheet financing, either done directly or through the Balancing Pool, is utilized to finance the deferral accounts. The financing risks are segregated out of the utility in the securitization and would have negligible effects if any on the cost of financing for other corporate purposes.

If the utilities finance the deferral accounts utilizing WACC or short-term debt there will be increased debt on the consolidated balance sheets of the utilities and their parent companies. Depending on the materiality of the deferral account financing in the overall capital structure it may have a negative effect on the cost of financing for other corporate purposes. The significance of the effect will depend on the term of the deferral account collection and the regulatory certainty present regarding the collection. The greater the regulatory certainty the lesser the effect on the cost of financing

**V OPTIONS FOR ALTERNATIVE FINANCING**

Q. Are there other options for financing the deferral accounts of all the DISCOs?

A. Yes, there are a number of other options available to finance these deferral amounts. The Topgas structure is one precedent. Variations on that theme are limited only by the ingenuity of the parties involved. Since the time the Topgas structure was created the complexity of the financial markets has increased. There have been a large number of structured financings and asset securitizations completed.

Q. Are there limitations on this market?

A. Yes. There are many factors that must be considered which would affect the decision to establish a new financing structure. Costs and the expected repayment term are very important. As a new off balance sheet structure would have a number of fixed set up costs, a relatively small balance to be financed for a relatively short period would erode the potential rate savings that would otherwise accrue. The deferral account balances of Lethbridge or Red Deer, each being approximately \$5 million, and likely to be recovered over a short period of time, would not provide a large enough base for the cost savings of a new structure to be realized. It is for that reason that we believe that for most of the DISCOs, acting individually, on balance sheet short-term debt financing to recover the deferral account balances in a relatively short period of time would be more prudent than attempting to establish an off balance sheet structure. If some of the DISCOs were to act collectively, there would likely be cost savings in a new financing structure.

Q. Are there any other limitations on accessing this market?

A. Yes. The asset securitization market collects obligations that intermediaries repackage in such a way so as to attract the highest debt and commercial paper ratings. Many of the structures have “AAA” or “R-1” ratings on the notes or commercial paper that they offer to the market. The structures often obtain a higher rating than the issuer providing the underlying asset or obligation because, the risk of the assets transferred is often lower than the risk of the business as a whole, the structure may provide a degree of over-collateralization, and, there may be material credit enhancement by third parties. To participate in this market, both the rating agencies and any prospective buyer of notes or commercial paper must be able to see a clear path to their repayment. In that concept there can be no compromise. Outside that fundamental principle there are often a number of different ways to achieve the same result.

For there to be certainty of collection, there must first of all be a right or entitlement. To allow a securitization, that right must be able to be assigned or transferred as a property right. To have a clear path to repayment, the right must not be subject to variation or prejudicial amendment, or in other terms, it must be an irrevocable rider with a right to transfer the entitlement that will survive the unlikely event of a bankruptcy of the utility.

The certainty of collection is also enhanced with provisions that assure that the rider is not open to circumvention either by not applying to new customers or by customers that would seek to switch to alternative service providers. In short, the rider should be non-bypassable. We observe that ATCO Electric proposes on page 16 of their application that, “customers who benefited from the pool price deferral in 2000 should meet their obligation to pay for these benefits starting in 2002 should the nature of their operations change. ... In such cases, ATCO Electric is requesting a one time payment equal to that customer’s share of the deferral account.” We would support such a provision on the basis that it would assist financing the obligation.

The certainty of collection is further enhanced if the rider provides for the costs of collection and a “true up” provision that would allow for adjustments to assure that unanticipated changes would not imperil the collection of adequate funds to repay the financing. We observe that ATCO Electric proposes on page 17 of their application that “Should a rate class be under-collecting its share of the deferral rider due to lower than forecast energy use, the rider will be adjusted such that the allocated amount is collected within the 12 month period.” We would support such a provision on the basis that it would assist financing the obligation.

Q. Are there any technical issues that would affect an off balance sheet financing that you would like to draw to our attention?

A. Yes. The rider must be adequate to provide for the collection of the financing costs and collection costs. Unlike a mortgage or credit card securitization, where the obligation requires an interest payment, the future rider payments by customers are not yet due. As such they do not come with an imbedded interest entitlement. For that reason the rider must allow for the collection of both the deferral amount and the financing costs. In many securitizations, until an event of default, the original owner of the obligation, who acts in the capacity of collection agent for the entity managing the securitization, handles the day-to-day collections of the monies. In the unlikely event of bankruptcy, the entity managing the securitization could be faced with the task of operating the collection of the rider from a large number of utility customers. To assist an off balance sheet financing, the rider should allow for the recovery of collection costs and therefore encourage the proper collection of the deferral amount in all events.

In a securitization there are a number of reporting obligations and administrative issues related to the handling of funds by the collection agent that are addressed in the purchase arrangement. In administering a securitization there is often a degree mismatching of the dates of payment by obligors and the underlying financing. An estimate of the costs of any hedging or backstop facilities would need to be incorporated into the rider.

Q. Can you describe the circumstances that gave rise to TransCanada's take-or-pay obligations and the off balance sheet financings that were ultimately employed to fund those obligations in 1982 and thereafter?

A. Yes. Briefly, at that time gas purchase contracts contained fixed contract obligations that required the purchaser to make payments when it was unable to request specified minimum quantities of gas for delivery. Changing markets caused contracted supply to exceed demand in a period beginning in 1977, making "take-or-pay" payments a substantial and increasing problem for TransCanada and other pipeline companies. By the end of 1981, TransCanada had paid to gas producers \$1.013 billion financed with \$733 million of term loans and \$280 million of preferred shares. Interest and dividends were recovered by TransCanada through its Alberta cost of service.

A syndicate of banks stepped in and created Topgas companies to make advances to producers between October 1982 and March 1983, of the amount of take-or-payments previously made by TransCanada and certain additional amounts that TransCanada had deferred. These advances, which totaled approximately \$2.3 billion, and the interest costs of the program, were to be recovered through the delivery of prepaid gas and a levy on gas delivered in future years. The recovery of prepaid gas was postponed until November 1984. TransCanada supported the Topgas program with an indemnity as to its interest costs and a \$300 million indemnity for producers' failure to deliver. The province of Alberta passed enabling legislation to support the Topgas program that, among other things, had the effect of levying a charge on producers that have elected not to participate in take-or-pay.

As mentioned above, the offering memorandum filed March 14, 1990 at the Alberta Securities Commission for the Topgas companies shows pricing for the December 20, 1990 maturity at a spread of 0.35% over Bankers' Acceptances, for maturities in January through April 1991 a spread of 0.40% over BAs, for maturities in December 1991 through April 1992 a spread of 0.45% over BAs, and a spread of 0.55% over BAs for maturities from December 1992 through March 1993. Presented another way the spread for a term of up to 1 year was 0.40% or less, and for terms up to 3 years ranged as high as 0.55%. In aggregate, the principal amount of Debentures covered by the offering memorandum was \$632 million.

Q. Generally, what did the *Take-Or-Pay Cost Sharing Act* do?

A. The *Take-Or-Pay Cost Sharing Act*, assented to September 18, 1986, provided for a levy payable on gas upon its delivery to two pipeline companies and created a fund under the administration of the Alberta Petroleum Marketing Commission. The Act provided that avoidance of the levies was improper but not otherwise illegal or unlawful. The levy was recoverable against any payor and the Commission was empowered to issue an order stopping gas shipments if a payor was in default for more than 30 days. The Act also provided that, except as permitted by regulations, no deduction was permitted to be made in paying the levy.

Q. What ratings were granted to the Topgas securities?

A. The Dominion Bond Rating Service report dated November 24, 1989, rated the Senior Serial Debentures as "A" and the Commercial Paper as "R-1 (low)." The rating report noted that TransCanada only needed to ship 15% of its capacity to satisfy the Topgas obligations and that a "FIFO" system of recovery helped to ensure repayment. That report also found satisfaction in the quality of the customers that were to supply gas to TransCanada, noting that 20 highly creditworthy companies would supply 78% of the gas to be recovered. The risks enumerated in the report were described as having "been overcome or are not very significant." The risks considered in the report included producer credit risk, reserve recovery risk, pricing risk, changes in regulation and bypassing.

Q. Can the Balancing Pool access debt and use the proceeds to pay out the deferral accounts of the DISCOs?

A. Having the Balancing Pool acquire the deferral accounts of the DISCOs would simplify any structured financing to the degree that the financial intermediaries would only have one party with which to deal. We are advised that Balancing Pool is empowered to borrow and give security for certain purposes and may make investments of certain types. While we express no opinion as to whether the Balancing Pool would be able to invest, in developing a model of one of many possible structures for a securitization we assumed that the Balancing Pool might choose to invest in a manner which would assist the over-collateralization of the off balance sheet financing. We believe were the Balancing Pool to make such an investment that it would facilitate the prudent and cost effective financing of the DISCOs' deferral accounts through a securitization of the deferral account balances.

The Balancing Pool is also structured in a manner that is in some ways similar to the characteristics required to provide the certainty of collection of the underlying asset that security purchasers prefer when they lend. The Balancing Pool has the ability, in some circumstances, to require that a balancing pool charge would be paid by customers.

Q. Please describe the financing structure that you feel would be the most prudent for the deferral accounts?

A. We believe that the most prudent financing structure for the deferral account amounts is generally short-term debt. In addition, we believe that an off-balance sheet securitization of these receivables is possible and prudent.

Q. In aggregate, the deferral account balances of all applicants total \$632 million. Are there any prospective purchasers for this size and type of offering?

A. Yes. In general terms the market for securitization securities is very large. We understand that there are in excess of \$70 billion in various securitizations.

Q. What level of regulatory assurance will result in the most beneficial rate?

A. In our analysis, the practical result is more important than the packaging. The lowest rates are available to borrowers that provide the highest assurance that their obligations will be repaid. In considering the financing there are several features that we believe are necessary to obtain the best rates. There include certainty of collection, or in other terms, an irrevocable rider with a right to transfer the entitlement that will survive the unlikely event of a bankruptcy of the utility. The certainty of collection is also enhanced with provisions that assure that the rider is not open to circumvention either by not applying to new customers or by customers that would seek to switch to alternative service providers. The certainty of collection is further enhanced if the rider provides for the costs of collection and a "true up" provision that would allow for adjustments to assure that changes unanticipated would imperil the collection of adequate funds to repay the financing.

Q. Can a satisfactory level of assurance be provided in a decision of the Board?

A. In many ways this is a strictly legal question related to the jurisdiction of the Board, and outside the scope of our assignment. A decision of the Board is clearly adequate for the recovery of deferral amounts in a conventional short-term on balance sheet financing. Utilities have been able to raise debt and equity for

years based upon the expectation of recovering their operating costs and earning a return on the rate base contained in decisions of regulators.

**VI RECOMMENDATIONS ON APPROVALS**

Q. With respect to the narrowest question before the Board, what recommendation would you make on the prudent financing costs incurred in 2001 for the 2000 deferral account balances?

A. We would recommend that the Board require that the DISCOs to advise the Board of the current rates at which they are borrowing money on a short term basis and approve those short-term rates.

We would also recommend that the Board structure its approvals to provide the maximum clarity and certainty so that, should the DISCOs wish to pursue a structured off balance sheet financing or securitization, any regulatory issues within the Board's jurisdiction would be resolved.

## VII CONCLUSIONS

Q. Please review your conclusions.

A. We believe that these short-term obligations can and prudent financial managers would generally finance them on a basis that matches the anticipated recovery period. For most of the DISCOs, the use of short-term on balance sheet debt to finance the deferral amounts should be a prudent financing option. The short-term financing of this type of unusual expense will offer Alberta ratepayers a substantial saving over the costs of financing if the deferral amount is thought to require a substantial equity component.

Q. Is this also true for UNCA?

A. As we have not had access to the document which gives rise to the covenants that they were in danger of breaching, we are not in a position determine whether a brief waiver or some alternative measure would have allowed UNCA to use on balance sheet debt. We do observe that a preferred share alternative could lower the cost of capital and that prudent financial managers would consider this alternative prior to a common equity infusion. In the event that the use of short-term on balance sheet debt to finance the deferral amounts would impair their balance sheet, owing to the significant size of their deferral accounts, and, in the right regulatory environment, those deferral accounts could support an off balance sheet solution. The off balance sheet solution for this type of unusual expense could offer Alberta ratepayers a substantial saving over the costs of financing if the deferral amount is thought to require a substantial equity component.

Q. Would it be prudent for the other DISCOs to participate in an off balance sheet financing structure for these obligations?

A. We believe that with the appropriate level of clarity in the regulatory environment, these deferral accounts can be financed on an off balance sheet basis in conjunction with UNCA's resulting in substantial savings to Alberta ratepayers. Prudent financial managers in a large number of Canadian companies have used similar arrangements. The most beneficial rates will be available with the greatest regulatory certainty. As the uncertainty as to the risk or timing of collection increases, the rates which will be required for the structured financing will increase.

Q. Does this conclude your evidence?

A. Yes.