SHORT-TERM DEBT METHODOLOGY

1.0 PURPOSE

This evidence provides an explanation of the methodology used to determine the short-term debt and associated cost for OPG’s regulated operations.

2.0 METHODOLOGY

OPG proposes that the short-term debt component of its capital structure reflect its forecast short-term borrowings, and that OPG’s cost of capital reflect its forecast short-term borrowing cost. OPG’s short-term debt proposals reflect a number of comments made by the OEB in its Report of the Board on Cost of Capital1 (OEB’s Cost of Capital Report). The following excerpts are taken from the OEB Report:

... as a general principle for ratemaking purposes, the Board believes that the term of the debt should be assumed to be similar to the life of the assets that are to be acquired with that debt. This suggests that, for an industry [utility] with long-lived assets [like OPG], the majority of debt should be long-term. However, in reality some short-term debt is a suitable tool to help meet fluctuations in working capital levels. Therefore, exclusion of some consideration for short-term debt in the distributors' capital structures going forward would not be appropriate.2 (parenthesis added)

... short-term debt is generally less expensive than long-term debt and generally provides greater financing flexibility3.

... although using a distributor’s actual short term debt component may seem to be a more accurate approach, it may be problematic. Short-term debt is optimally used as an interim solution for managing a firm’s financing requirements. It may fluctuate,

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1 Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario’s Electricity Distributors, Issued December 20, 2006 pursuant to EB-2006-0088 (Cost of Capital), EB-2006-0089 (2nd Generation Incentive Regulation Mechanism), and EB 2006-0087 Licence Amendment proceedings.
2 Ibid Page 10
3 Ibid Page 10
although generally within a limited range. Using a firm’s actual short-term debt component would be administratively challenging given the number of electricity distributors and the associated volume of data that would need to be reported and verified.  

As OPG’s rates are being determined on a utility-specific basis rather than via a generic proceeding, OPG has used the more accurate utility-specific approach to determine the short-term debt component in its capital structure.

The OEB’s Cost of Capital Report determined that recent historic short-term borrowing requirements of electricity distribution utilities was an appropriate basis upon which to establish the short-term debt component of their deemed capital structure. As electricity distribution utilities establish rates using a historic test year, the use of historic requirements is a suitable basis for establishing the short-term debt component of an electricity distribution utility’s capital structure. As OPG’s rates are established based on a forecast test year, the impact of changes in OPG’s short-term financing requirements have been included in its test year forecast short-term debt component.

The OEB’s Cost of Capital Report provided a generic methodology to be used when determining the short-term debt rate for all of Ontario’s electric distribution utilities. This approach is consistent with the OEB’s decision to use an industry average approach to determining a short-term debt component. As noted above, OPG proposes to use a utility-specific debt component, and therefore has used a forecast of the rate applicable to the debt sources used to meet its short-term financing requirements.

3.0 ALLOCATION TO REGULATED OPERATIONS
OPG must determine a basis of allocation for its regulated operations, as its short-term borrowing is on a company-wide basis. OPG uses short-term borrowing to finance its working capital requirements and to provide project financing until long-term financing arrangements are completed. Therefore, OPG has allocated short-term debt to its regulated

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4 Ibid, Page 11
operations based on the ratio of the construction work in progress and non-cash working
capital amounts (fuel inventory and materials/supplies) for OPG’s regulated operations to the
total construction work in progress and non-cash working capital amounts reported in OPG’s
last audited financial statements (December 31, 2007) approved by the Board of Directors
prior to the issuance of the OEB’s first payment order. OPG has used asset and liability
balances from its last audited financial statements as this approach is consistent with the
asset values that are readily available, the amounts are independently verified, and the
allocation ratio has been relatively consistent as reflected in Ex. C1-T1-S3 Table 1\(^5\).

OPG has not included cash working capital in this ratio as the lead/lag study used to
determine cash working capital for OPG’s regulated operations is not prepared on a
corporate basis. Alternative cash working capital approaches such as the balance sheet
method are not suitable in light of the more significant price and production variances
associated with OPG’s unregulated operations. As OPG’s cash working capital allowance is
relatively small in comparison to the combined construction work in progress and non-cash
working capital balance, it was excluded in determining the allocation of short-term debt to
OPG’s regulated operations.

The 2007 ratio of 57.1 percent, described in Ex. C1-T1-S3 Table 1, was applied to OPG’s
short-term debt amount determined above for the 2008, and 2009 periods.

\(^5\) The differences between 2005, 2006 and 2007 are less than two percent per Ex. C1-T1-S3 Table 1.