

**BACKGROUND AND ORIENTATIONS
OF THE DISTRIBUTOR'S RATE APPLICATION
2007-2008**

1. BACKGROUND	4
2. THE DISTRIBUTOR'S COST OF SERVICE	6
2.1 Supply Costs	7
2.2 The Transmission Bill	8
2.3 Distribution and Customer Service Costs	9
2.4 Evolution of 2007 Investments	10
2.5 Efficiency of the Distributor	10
3. RATE INCREASE AND IMPACTS	12
3.1 Level of the Increase	12
3.2 Rates	15
3.3 Rate Structures	16
3.4 Impact on Low-Income Customers	17

1. BACKGROUND

The Distributor appears before the Régie in order to initiate the process that will lead to the establishment of electricity rates applicable to Quebec customers as of April 1, 2007.

For the 2007 rate year, the rate increase necessary to allow the Distributor to recover its cost of service is 2.8%.

This application is strongly influenced by the current context.

Winter climate conditions and their impacts on the cost of service are among the important parameters in this file. In this respect, Winter 2006 was particularly mild. Indeed, during the months of January to April 2006, the impact of the weather conditions on the Distributor's energy requirements is evaluated at - 2.5TWh. In combination with these climate conditions, a more difficult economic situation for industrial customers, as well as higher-than-expected energy savings from the PGEÉ, have led the Distributor to revise its sales forecast of 4.3 TWh downwards with respect to its initial forecast. These volumes have an important direct impact on the purchase costs of electricity, as well as on the balance of the deferral account for post-heritage supply, authorized to capture the variances on the purchases of electricity.

Moreover, last April, the Régie approved the application of the Transmission Provider to increase the transmission service bill for the native load by an amount of \$170 million on an annual basis (D-2006-66). This increase is a direct result of increases in demand. Between 2001 and 2005, the transmission needs of the native load increased by 2,300 MW. This decision also authorizes the Transmission Provider to apply this increase retroactively to January 1, 2005.

With the exception of 2006, the growth in recent years related to new subscribers was much more significant than predicted. In combination with the cost freeze for day-to-day activities since 2003, this growth puts upward pressure on distribution and customer service costs. Thus, the Distributor notes that certain activities, though necessary in a normal context, had to be reduced or delayed in favour of a new connections.

Throughout this entire period, the Distributor has exercised a tight control on activities under its control and allowed important efforts in efficiency improvement. These actions have allowed the Distributor to contain the evolution of the indicators well below inflation with some indicators even showing an improvement. The cost pressures, which greatly exceed the potential of the efficiency gains, coupled with the imperative of offering customers an appropriate electricity service, call for an adjustment, as of 2007, to the level of operating costs, and to the system sustainability investment budget beyond the normal growth of activities.

Finally, in June 2006, Hydro-Québec filed its 2006-2010 Strategic Plan¹. This plan specifies the orientations as well as the objectives with respect to the improvement of the quality of service and efficiency that the Distributor plans to follow over the coming years. It also meets the expectations outlined in the Quebec Energy Strategy 2006-2015.² These directions will be reviewed in the current rate case.

¹ The Strategic Plan is filed as Exhibit HQD-1, Document 3 and is available in English at http://www.hydroquebec.com/publications/en/strategic_plan/2006-2010/pdf/complete.pdf.

² The Quebec Energy Strategy document is available in English at <http://www.mrnf.gouv.qc.ca/english/publications/energy/strategy/energy-strategy-2006-2015.pdf>.

2. THE DISTRIBUTOR'S COST OF SERVICE

Table 1 presents the Distributor's cost of service for the 2007 test year. The Distributor's cost of service totals \$10,251 million, up \$165 million from the Régie approved cost of service for 2006. The transmission bill and that of the distribution customer service costs increase by \$387 million. This increase is nonetheless compensated in large part by the important reduction of almost \$223 million in electricity purchases.

**TABLE 1
COMPONENTS OF THE REVENUE REQUIREMENT (\$M)**

COMPOSANTES DU REVENU REQUIS (M\$)				
	Année historique	Année de base		Année témoin
	2005	R-3579-2005	2006 ¹	2007
COÛT DU SERVICE DU DISTRIBUTEUR	9 389	10 050	10 025	10 215
ACHATS	7 019	7 507	7 443	7 454
• Achats d'électricité	4 706	5 194	5 130	4 971
• Service de transport	2 313	2 313	2 313	2 483
COÛTS DE DISTRIBUTION & SERVICES À LA CLIENTÈLE	2 370	2 544	2 582	2 761
Charges d'exploitation	1 087	1 134	1 163	1 236
Autres charges	649	719	720	771
Coût du capital	635	691	700	754
RENDEMENT SUR LA BASE DE TARIFICATION	7,52%	7,75%	7,91%	7,99%
Structure du capital				
Capitaux empruntés	65%	65%	65%	65%
Capitaux propres	35%	35%	35%	35%
Taux				
Capitaux empruntés	7,52%	7,64%	7,89%	7,90%
Capitaux propres	7,51%	7,96%	7,96%	8,14%
Base de tarification (moyenne 13 mois)	8 447,0	8 919,1	8 843,6	9 445,8

¹ : Base de calcul : 4 mois réels, 8 mois projetés

Note (1): Calculated on 4 month actuals and 8 months projected

Translation of Column 1:
**DISTRIBUTOR'S COST OF SERVICE
PURCHASES**

- Purchases of Electricity
- Transmission Services

DISTRIBUTION COSTS AND CUSTOMER SERVICE

Operating Costs
Other Charges
Cost of Capital

RETURN ON THE RATE BASE

Capital Structure

Debt
Equity

Rates

Debt
Equity

Rate base (13-month average)

2.1 Supply Costs

The 2007 supply costs of \$4,971 million are down by almost \$223 million with respect to the amount approved in 2006. Two thirds of this reduction is attributable to the integration in 2007 of the pass-through account for post-heritage supply for the years 2005 and 2006. The remaining third is explained by a downward revision of the demand forecast (see HQD-2, Doc 1), combined with a reduction in the unit costs of supply (see HQD-2, Doc 2).

As authorized by the Régie³, since 2005, the Distributor accounts for all variances in price and volume between the actual and forecast supply costs in a deferral account (the pass-through account) and reflects them in the rates of the second subsequent rate year. Thus, \$36 million in additional supply costs related to purchase in the year 2005 were integrated in the supply costs in 2007. Moreover, milder weather conditions and a lower-than-predicted growth contribute to a \$182 million reduction in the forecast supply costs for the year 2006. Considering the significance of this reduction and the desire to better match costs with the appropriate customer generations, the Distributor proposes

³ Decisions D-2005-132 and D-2006-34

not to wait until the next rate case to reflect the reduction in its cost of service. For the benefit of the whole of the customer base, HQD is therefore integrating the credit balance in its cost of service as of 2007, and, consequently, asks the Régie to approve the new modalities associated with the pass-through account for the purchase of post-heritage electricity (see HQD-4, Doc 2).

2.2 The Transmission Bill

In April 2006, the Régie approved a new transmission rate for the native load of \$2,483 million. For the Distributor, this implies an increase of \$170 million in the bill for this service. In the same decision, the Régie authorized the Transmission Provider to retroactively apply the rates for the transmission service as of January 1, 2005. Therefore, HQD should integrate an additional \$340 million in its cost of service in 2007 due to this retroactivity. The overall transmission bill alone could drive a rate increase in the order of 5.6%.

However, given that the Régie has presented this as an exceptional measure, HQD believes that an exception may also be made for the integration of these amounts in order to avoid an important rate fluctuation for electricity consumers. As such, HQD proposes the integration, as of 2007, of the annual recently authorized transmission cost, but to spread the non-recovered balance for the years 2005 and 2006, that is, \$340 million plus interest, over a maximum of three years starting in 2008.

Given that the recovery will be made over a short period, HQD assesses that this approach offers both good predictability for costs, given that these costs are known, as well as a reasonable cost for rate stabilization.

HQD will propose a specific strategy with respect to the integration of the deferred transmission costs in its next rate case. It will also integrate if

necessary, the impact of the Régie's decision in the most recent application⁴ of the Transmission Provider to increase the cost of service for transmission of the native load by \$115 million, retroactive to 2007.

2.3 Distribution and Customer Service Costs

Overall, in 2007, the distribution and customer service costs increase by \$217 million, that is by 8.6% with respect to the amount approved in 2006. This increase is mainly explained by the following elements:

- Cost of capital: the cost of capital grew by almost \$63 million, going from \$691 million to \$754 million. Two factors contribute to this increase:
 - the increase in the rate base of 6% contributes to two thirds of the increase. The PGEÉ, the CIS project and the deferral account for the BT rate are the main factors explaining this increase;
 - the increase in the rate of return on the rate base which went from 7.75% to 7.99% accounts for the other third of the increase;
- the amortization costs are up by \$42 million. Among the specific elements driving this increase, we note the amortization of the PGEÉ, the CIS project, the deferral account for the BT rate and the overhead and underground lines necessary for the growth of demand in recent years;
- the increase in direct pension costs of \$19 million, to which an amount of \$7 million has been added for the pension costs of the supply units;
- additional costs planned to maintain the distribution system, with more emphasis on maintenance (\$14 million) and vegetation control (\$10 million) for an overall amount of \$24 million. These efforts will increase over the coming years in order to obtain the optimal level with respect to operations and service continuity. Indicators allow the follow-up of specific gains from the improvement measures for system reliability;

⁴ Application R-3605-2006 – July 2006

- additional costs of \$8 million for the CIS: the technical implementation of the CIS project continues successfully, and within the budget authorized by the Régie. However, the integration of the project in the day-to-day management of activities is characterized by greater difficulties than forecast, and at the dawn of the implementation of the residential portion, it is important that stabilization actions be put in place for the benefit of the customers.

2.4 Evolution of 2007 Investments

In relation to the additional efforts dedicated in order to avoid a significant deterioration of the quality and reliability of the service, the Distributor must undertake an adjustment of investment budgets for system sustainability, supported by a new study demonstrating the grounds⁵ for this adjustment.

2.5 Efficiency of the Distributor

The cost budget conveys an efficiency improvement for the Distributor (see to this effect Exhibit HQD-3, Doc 1), but HQD's anticipated gains cannot completely absorb the increase in costs.

Table 2 illustrates the evolution of the six indicators which serve as reference points to evaluate in a concrete manner the Distributor's performance with respect to cost control. Over the period of 2001-2007, the growth of these indicators was below inflation. The Distributor therefore met the objective that it has set, that of containing the average annual change in the six indicators below inflation. Moreover, the evaluation of the evolution of the indicators in 2007 must take into consideration the integration of the structural adjustments to the cost

⁵ See Exhibit HQD-14, Doc 1, Appendix 1.

and investment budgets that are being added to the current activities of the Distributor.

TABLE 2

Description	Exercices terminés le 31 décembre							Croissance annuelle moyenne	
	Années historiques				Année de base			Année témoin	
	2001		2003	2005	2006		2007	2001-2007	2001-2005
	AS	NS	AS	AS	AS	NS	NS	NS	AS
Indicateurs globaux du Distributeur									
G1- Coût total Distribution et SALC (\$) par abonnement	566	566	531	539	567	567	597	0,9%	-1,2%
G2- CEN Distribution et SALC (\$) par abonnement	251	251	251	243	251	251	266	1,0%	-0,8%
G3- IEN (\$) par abonnement	1 986	1 986	1 981	1 947	1 957	1 957	2 092	0,9%	-0,5%
G4- Coût total Distribution et SALC (¢) par kWh normalisé	1,30	1,30	1,17	1,19	1,26	1,26	1,32	0,2%	-2,2%
C1- Coût total du processus SALC (\$) par abonnement	157	113	152	142	152	110	124	1,6%	-2,3%
R1- Coût total du processus Distribution (\$) par abonnement	409	451	375	386	406	449	458	0,3%	-1,4%
Taux de croissance de l'inflation - IPC Canada			2,8%	2,2%	2,0%	2,0%	2,0%	2,2%	2,3%

AS = Ancienne structure NS = Nouvelle structure

Note: AS = Old structure; NS = New structure

Translation of Column 1:

Description

Overall indicators for the Distributor

G1 - Total cost of Distribution and Customer Service (\$) per subscription

G2 - Net operating costs for Distribution and Customer Service per subscription

G3 - Net capital assets in operation (\$) per subscription

G4 - Total cost of Distribution and Customer Service (\$) per normalized kWh

C1 - Total cost of Customer Service process (\$) per subscription

R1 - Total cost of Distribution process (\$) per subscription

The process of efficiency improvement put in place by the Distributor is progressing well. Several potential improvement solutions have already been identified, amounting to \$20 million, of which several will be deployed as of 2006. These potential solutions cover a wide range of activities, which target both customer services and distribution activities.

It is important that sustained efforts be dedicated to the improvement of efficiency and that the best business practices be implemented at HQD. To this effect, a

committee was established specifically to closely guide the management of activities in this area. The Distributor wishes to have available a portfolio of long-term actions and to exercise a rigorous monitoring of the actions put in place, as well as monitoring of the expected gains.

3. RATE INCREASE AND IMPACTS

3.1 Level of the Increase

Table 3 below summarizes the rate increase being requested and the rate strategy being implemented, based on the Distributor's cost of service.

TABLE 3
EVALUATION OF THE SHORTFALL AND THE RATE INCREASE
AT APRIL 1, 2007 (\$ million)

Évaluation du déficit et de la hausse au 1er avril 2007	
(M\$)	
Demande R-3610-2006	
Revenus des ventes 2007 (sans hausse de tarif)	9 947,4
Revenus autres que ventes d'électricité	153,2
Ajustement - Provision réglementaire 2006	-141,4
Revenus totaux aux fins du calcul du revenu additionnel requis	9 959,2
Revenus requis	
Achats	
Achats d'électricité	4 971,1
Service de transport	2 483,0
Coûts de distribution & services à la clientèle	
Charges d'exploitation	1 235,8
Autres charges	770,6
Rendement sur la base de tarification	754,3
Revenus requis	10 214,8
Revenus additionnels requis au 1er avril	-255,6
Revenus des ventes avant hausse, excluant contrats spéciaux	9 127,6
Hausse demandée - 1er avril 2007	2,80%
Revenus générés en 2007 par la hausse demandée	177,0
Provision réglementaire 2007 récupérée en 2008	78,6

Translation of Column 1:

**2007 Sales Revenues (without rate increase)
Revenues other than those from Electricity Sales
Adjustment – Regulatory Provision for 2006
Total Revenues for the Calculation of Additional Revenue Requirement**

Revenue Requirement

Purchases

Purchases of Electricity (including deferral account for Rate BT)
Transmission Services

Distribution Costs and Customer Service

Operating Costs
Other Charges
Return on the Rate Base

Revenue Requirement

Additional Revenue Requirement on April 1

Sales Revenues before the increase, excluding special contracts

Required Increase

Increase Requested - April 1, 2007

Revenues generated in 2007 by the required Increase

Regulatory Provision for 2007 Recovered in 2008

The variance between the revenues on the basis of the current rates and the revenue requirement resulting from the cost of service is \$255.6 million in 2007, which justifies an overall increase of 2.8% for all of the electricity rates. The regulatory provision for the year 2007 recovered in 2008, as per the Régie decision D-2005-34, amounts to \$78.6 million. Moreover, the revenues of \$177 million are anticipated by this increase over the period of April 1 to December 31, 2007.

3.2 Rates

Even with the increase of 2.8%, the Distributor will continue to rank among the North American companies offering the lowest rates. Indeed, among the cities ranked in an annual price comparison carried out by the Distributor and as indicated in the following table, Hydro-Québec offers, along with Manitoba Hydro and BC Hydro, residential rates that are clearly more competitive than those of other North American distributors as of April 1 2006.⁶

TABLE 5 (SIC)
COMPARATIVE INDICES FOR NORTH AMERICAN ELECTRICITY PRICES
(APRIL 2006)

INDICES COMPARATIFS DES PRIX DE L'ÉLECTRICITÉ EN AMÉRIQUE DU NORD
(AVRIL 2006)

	Clients résidentiels (1 000 kWh)	Clients de petite puissance (40 kW - 10 000 kWh)	Clients de moyenne puissance (1 000 kW - 400 000 kWh)	Clients de grande puissance (5 000 kW - 3 060 000 kWh)
Villes canadiennes				
- Montréal	100	100	100	100
- Toronto	169	128	138	181
- Winnipeg	95	73	70	78
- Moncton	154	128	135	127
- Edmonton	155	117	119	143
- Vancouver	97	83	73	94
Villes américaines				
- New York	291	239	246	303
- Chicago	139	135	128	154
- Détroit	198	146	140	166
- Portland	119	88	81	103
- Seattle	124	82	96	143

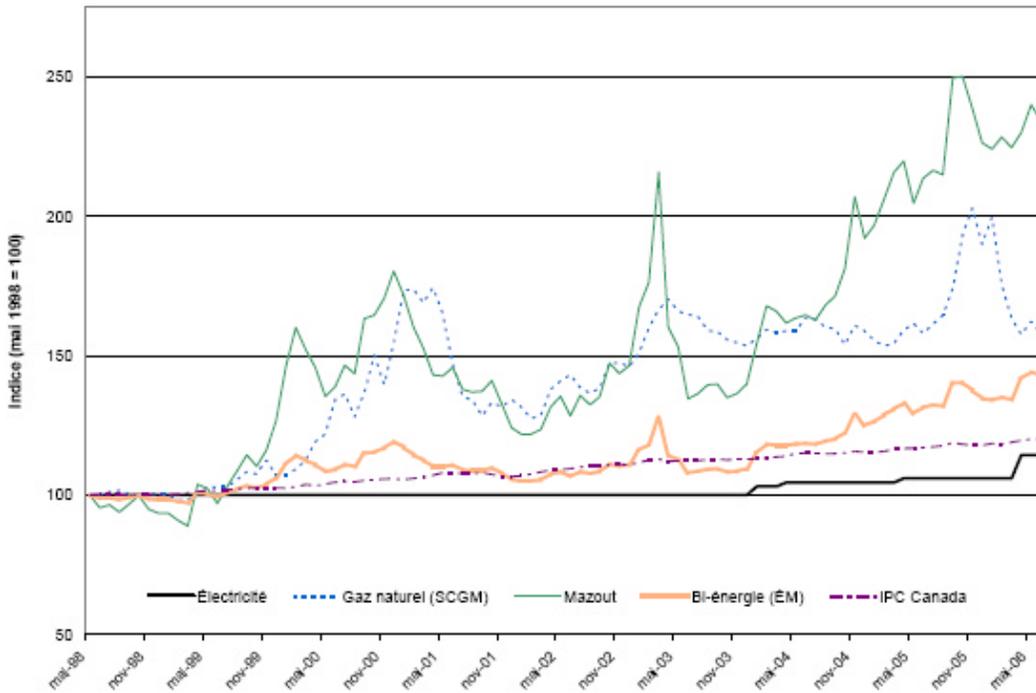
Note (1): Prices calculated in Canadian dollars and excluding sales tax

Moreover, as shown in the following figure, HQD's customers have benefited from stable electricity prices during a period in which the price of diesel and

⁶ Source: Price comparison of major North-American cities (April 2006). The electronic version will be available shortly on Hydro-Québec's website.

natural gas have been characterized by important increases and great volatility. The Distributor's domestic customers will continue to take advantage of the most stable source of energy for heating. Thus, between May 1, 1998 and April 1, 2006, the energy bill for an average 158 m² house, heated by electricity, increased by 14.4%, while the bill for the same house, heated by diesel or natural gas, increased by 130% and 58%, respectively.

FIGURE 1
ANNUAL GROWTH OF ENERGY COSTS FOR SPACE HEATING
AVERAGE SINGLE FAMILY HOME IN MONTREAL



3.3 Rate Structures

In the context of high marginal costs of supply, it is important to ensure that the price signal sent to customers encourages a more efficient use of electricity.

In continuity with the recent Régie decisions, the Distributor plans to continue with the differentiated increase of the rate components, which has already started, and which targets the more elastic elements of the rate. Thus, for residential customers, HQD proposes a greater increase of the price of the 2nd energy block. This orientation better reflects the marginal costs, accentuates the price signal received by the customer, and encourages energy savings.

For the general rates (G, M and L), this orientation is expressed by more important increases in the energy component of these rates.

3.4 Impact on Low-Income Customers

It is important that all consumers of electricity receive their fair share of the cost of service of electricity and receive access to tools that allow them to manage their bill.

Due to the differentiated rate increases, the requested adjustment of 2.8% has less of an impact, on average, on low-income households, where consumption is concentrated more in the first energy block of rate D.

Moreover, the Distributor proposes an increase of \$71.7 million in the 2007 Energy Efficiency Plan (PGEÉ) budget compared to the forecast presented in the R-3584-2005 application, to bring the budget to \$245 million for the year 2007, thus aiming to generate additional energy savings of 110 GWh for a total of 661 GWh in 2007. To favour a greater access to the PGEÉ for low-income consumers, HQD provides special assistance and programs adapted to their needs. The intensification of energy efficiency efforts for these customers is reflected by a \$19 million budget in 2007, which is 18% of the total investments for the residential market.

Finally, HQD wishes to examine different means that could be developed in order to assist customers with payment difficulties, using an integrated approach, which would specifically cover consumption reduction measures.

To date, the Distributor has implemented over recent years various improvements in the recovery services offered to lower-income consumers. In particular, in collaboration with various consumer associations, HQD has developed the concept of custom payment agreements. In order to further advance its interventions with low-income households experiencing payment difficulties, HQD will put in place a committee, which will bring together interest groups who are active with this customer segment.