

IEC

BEFORE THE RÉGIE DE L'ÉNERGIE

IN THE MATTER OF:  
HYDRO QUÉBEC DISTRIBUTION

Demande du Distributeur relative à  
l'établissement des tarifs  
d'électricité pour l'année tarifaire  
2011-2012

DOSSIER R-3740-2010

10 December 2010

Régie de l'énergie
DOSSIER: R-3740-2010
DÉPOSÉE EN AUDIENCE
Date: 10 décembre 2010
Pièces n°: C-4.17 AQCIE/CIFQ

prepared on behalf of:

l'Association québécoise des consommateurs

industriels d'électricité (AQCIE)

Conseil de l'industrie forestière du Québec (CIFQ)

Opening Statement of:

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**INTRODUCTION**

1 Good morning Madame Chair and members of the panel.

2 I would like to briefly summarize my pre-filed evidence in this proceeding in two areas:  
3 first, the regulatory treatment of pension cost variances and second, the tariff interface  
4 between Rate M and Rate L.

**PENSION  
COSTS**

5 Let me start with pension costs, and let me move directly to the question: Is deferral  
6 account treatment appropriate for HQD's pension costs? In my view and in my  
7 experience, deferral accounts are a reasonable regulatory tool when (i) the costs involved  
8 are not under the control of the utility, (ii) the costs are difficult to forecast, and (iii) the  
9 costs are material.

10 Let me examine the costs associated with defined benefit pension plans with those criteria  
11 in mind, starting with the first. To a certain extent, defined benefit pension plan costs are  
12 related to the nature of the benefits package and to employee salaries. Both of these are  
13 under the control of the utility. Therefore, establishing a pension cost requirement on a  
14 forecast test year basis will create an incentive for the utility to try to minimize costs,  
15 thereby providing a longer term benefit to ratepayers.

16 However, there are two other aspects of pension cost determination that militate against  
17 test year forecast treatment of pension costs. First, some significant aspects of pension  
18 costs are beyond the control of the utility. Of note, past returns on the pension fund can  
19 have a significant effect on pension costs. Second, the pension costs actually incurred for  
20 any particular year are based on a set of assumptions, including expected future returns  
21 on plan assets, inflation, and discount rate values for future benefits.

22 In thinking about these assumptions however, it is important to recognize that the long  
23 run costs of operating a defined benefit pension plan is not based on the actuarial  
24 assumptions – it is based on what actually happens. Therefore, while changing a  
25 particular assumption in a particular year can and will change the accounting expense in  
26 that year, it will not affect the long-run need to fully fund the pension plan. It is therefore  
27 not correct to assume that because a utility has control over the actuarial assumptions for  
28 any one year that it has control over the real long-run pension costs.

29 Thus, in considering whether a deferral account is appropriate for HQD, I encourage the  
30 Régie to consider whether the historical variances between forecast and actual pension  
31 costs are due to differences in factors that are under the control of HQD (such as salaries  
32 and eligibility requirements), or whether the variances result from changes in actuarial  
33 assumptions about factors over which HQD has no control (such as future returns on plan  
34 assets and benefit discount rates). Based on my understanding of HQD's responses to  
35 discovery in this proceeding, I believe that the variances in the past few years have  
36 resulted more from changes in assumptions for factors beyond HQD's control.

37 Regarding the second criterion, I conclude that HQD's pension costs have proven to be  
38 difficult to forecast. The variation from year to year in overall pension costs is  
39 substantial, as is the variance between forecast test year and actual costs. Over the past  
40 seven years, actual pension costs have exceeded authorized costs by more than a factor of

1 2, and authorized pension costs have exceeded actual pension costs by more than a factor  
2 of 2. Moreover, over the last two complete years, the authorized pension costs exceeded  
3 actual pension costs by nearly \$60 million.

4 Regarding the third criterion, materiality, I admit that I am sympathetic to a regulator's  
5 desire to limit the proliferation of deferral accounts. However, HQD's pension costs are  
6 significant, ranging from \$50 to \$100 million per year over the past five years. In light of  
7 the fact that HQD has little control over the factors which have caused these costs to both  
8 gyrate wildly, I believe deferral account treatment is warranted.

9 Because the net variance between actual and forecast pension costs through 2009 is just  
10 about in balance, I recommend that deferral account treatment begin in 2010.

11 One final note: In my evidence, I suggest that the Board may consider alternatives, such  
12 as minimum cash contribution requirements to the plan. Based on my review of HQD's  
13 responses to IRs that were not available to me at the time the evidence was drafted, and  
14 recognizing that HQD appears before the Régie on an annual basis, I conclude that  
15 attempting to establish minimum cash contributions for the integrated Hydro Québec  
16 pension plan would be far too complex a solution to this issue, and that simply  
17 establishing a deferral account would be a preferable solution.

RATE M - RATE L  
INTERFACE

18 Let me turn now to the issue of the Rate M -- Rate L tariff interface. To the extent  
19 practicable, utilities establish rate classes based on homogeneous groupings of customers  
20 with similar cost-to-serve characteristics. Typically, rate classes are segregated by size of  
21 customer and type of service. With respect to size distinctions, however, there will  
22 always be some customers that fall near the borderline between two rate classes. In order  
23 to avoid creating perverse incentives for customers, utilities often try to design rates such  
24 that there is a relatively smooth transition between rate classes. Declining block rates,  
25 either for demand or energy charges, are one such mechanism which achieves that end.

26 Over the past several years, HQD has been modifying its Rate M and Rate L tariff  
27 structures in such a way that the potential for customer "gamesmanship" is increasing.  
28 Specifically, larger Rate M customers may increasingly be able to reduce their bills by  
29 raising their contract demand, lowering their load factor, and "trading up" to Rate L.

30 The tariff design characteristics and trends which cause this change are as follows:

- 31 • As a starting point, the Rate M cross-subsidy is higher than the Rate L cross-  
32 subsidy. While there is little that HQD can do about this legislated mandate,  
33 it is a factor that should be considered in rate design.
- 34 • HQD has been assigning disproportionate increases to the Rate M energy  
35 charges relative to the demand charges. While this policy may encourage  
36 energy conservation, it will discourage efficient use of capacity by reducing  
37 the incentive to hold down peak demands.
- 38 • HQD has been assigning disproportionate increases to the Rate M tail block  
39 charges relative to the first block energy charge. This policy increases costs  
40 for larger Rate M customers, making Rate L conversion more attractive.

1           • HQD has been assigning disproportionate increases to the Rate L energy  
2           charge relative to the demand charge. This policy also discourages efficient  
3           use of capacity, and therefore increases the incentive for Rate M customers to  
4           reduce their billing load factor and trade up to Rate L.

5   As I explain in my evidence, none of the rate design policies are demonstrably consistent  
6   with the results of HQD's cost allocation study.

7   Because HQD proposes no changes to tariff design in this proceeding, I make no specific  
8   rate recommendations in my evidence. However, I recommend that the Régie direct  
9   HQD to review the tariff design trends that I listed earlier, with an eye toward retaining a  
10   smooth transition between the Rate M and Rate L tariffs. HQD should also consider  
11   whether tariff modifications, such as a declining block tariff for Rate L, would reasonably  
12   mitigate the perverse incentives for inefficiency that the current policy is creating. In  
13   addition, HQD should continue to monitor any and all customer transitions between Rate  
14   M and Rate L. I suggest that HQD report back on the results of its analysis in its next  
15   general rate application.

16   Thank you for your attention. I look forward to answering any questions that you may  
17   have.