BACKGROUND, OBJECTIVES AND ORIENTATIONS OF THE DISTRIBUTOR'S RATE APPLICATION 2008-2009

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1 BACKGROUND

Hydro-Québec Distribution 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, 2008.

For the 2008 rate year, the rate increase required to allow the Distributor to recover its cost of service is 2.9%. This consists of an increase of 1.3% needed to recover its additional distribution and customer services costs, and an increase of 1.6% equally divided between supply costs and transmission costs. Had it not been for the recovery of an amount of $166 million regarding deferred transmission costs for 2005 to 2007, the rate increase needed to cover all the additional revenue requirement would have been 1.3%, which is far lower than the anticipated inflation rate.

Each application reflects the background in which it is made. The most salient elements of this application are the following:

- Due to a strong decrease in sales to the industrial sector and the revision of weather normalization, a reduction of 1.5 TWh of forecast electricity demand in 2008 compared with 2007 is noted, which in principle reduces the pressure on supply costs. However, in 2008, as in 2007, the Distributor is faced with an important surplus of supply related to the deliveries expected in its long-term contracts (HQP and TCE), while the demand that had justified their signing has not completely materialized. The Distributor intends to lessen the economic impact of these surpluses by reselling them on the short-term markets.
- The last two decisions of the Régie pertaining to transmission rates have increased the annual transmission service bill for the native load from $2,313 million to $2,540 million, for a total of $567 million in additional costs since 2005. As of December 31, 2007, the deferral account for the transfer of transmission costs authorized by the Régie

will reach $344 million, including applicable interests. The recovery of this account must be done by striking a balance between two principles: intergenerational equity and rate stability.

- The year 2008, as in 2007, is characterized by major pressures on the Distributor's cost of service. This growth reflects, for the most part, a commitment to provide to its customers the services they expect to receive, and at the lowest cost. This is the case of the measures the Distributor will implement to ensure the harmonious deployment of the CIS project and the energy efficiency activities, of which an important part concerns low-income households. Moreover, the Distributor files in this rate case its integrated efficiency plan and lays out its commitments related to it.
- Finally, this rate case addresses several orientations formulated by the Government of Québec in its energy strategy, including those related to the rate structure. The Distributor's proposals reflect its willingness to change the rate structure in a way that is fair for all of its customers.

2 THE DISTRIBUTOR'S COST OF SERVICE

Table 1 presents the Distributor's cost of service for the 2008 test year. The Distributor's cost of service totals $10,542 million, an increase of close to $407 million compared with the costs approved by the Régie for the year 2007. All of the cost components contribute to this increase.

TABLE 1

COMPONENTS OF THE REVENUE REQUIREMENT ($M)				
	PREVIOUS YEAR 2006	2007 D-2007-12	2007 BASE YEAR	TEST YEAR 2008
DISTRIBUTOR'S COST OF SERVICE	9,859	10,135	10,239	10,542
PURCHASES	7,353	7,447	7,555	7,699
• **PURCHASES OF ELECTRICITY**	5,040	4,894	5,002	5,035
• **TRANSMISSION SERVICES**	2,313	2,553	2,553	2,665
DISTRIBUTION AND CUSTOMER SERVICE COSTS	2,505	2,688	2,684	2,843
OPERATING COSTS	1,151	1,213	1,208	1,252
OTHER CHARGES	725	740	740	801
COST OF CAPITAL	629	735	735	790
RETURN ON THE RATE BASE	7.09%	7.79%	7.82%	7.83%
CAPITAL STRUCTURE				
DEBT	**65%**	**65%**	**65%**	**65%**
EQUITY	**35%**	**35%**	**35%**	**35%**
RATES				
DEBT	**7.77%**	**7.90%**	**7.95%**	**7.84%**
EQUITY	**5.83%**	**7.57%**	**7.57%**	**7.80%**
RATE BASE (13-MONTH AVERAGE)	8,874.5	9,441.5	9,408.5	10,095.6

[1]: CALCULATED ON 4 MONTHS ACTUAL AND 8 MONTHS PROJECTED

2.1 Supply Costs

The 2008 supply costs total $5,035 million. This represents an increase of $141 million compared with the amount approved for 2007. The supply costs are increasing despite a decrease in forecast demand. This result is essentially due to the fact that in 2007, the supply costs benefited from a credit balance of $251 million from the pass-on account that ensued from the mild weather conditions and the not as strong as expected growth experienced in 2006. But the situation in 2008 is very different since the credit balance of the deferral account for the post-heritage supplies is only $11 million.

Without taking into account these adjustments, the supply costs decrease by $99 million in 2008 mainly because of a reduced forecast demand in 2008 due to a revision of the weather normalization and a marked slow-down in the industrial sector. They also reflect the resale of close to 4 TWh on the market, allowing a reduction of $251 million in supply costs.

2.2 The Transmission Bill

In February 2007, decision D-2007-34 of the Régie approved a new transmission rate for the native load of $2,540 million, which amounts to $57 million more than that of the preceding year and of the amount the Distributor considered in its own 2007-2008 rate case. By virtue of decision D-2003-93, the Distributor has a deferral account for the transfer of transmission costs authorized by the Régie. Including the preceding amount, this account will be close to $344 million as of December 31, 2007 (of which $285 million correspond to the retroactivity of the transmission rates approved by the Régie for 2005 and 2006).

In its last rate decision (D-2007-12), the Régie decided that the Distributor's proposal of spreading the recovery of the additional transmission costs in 2005 and 2006 over a three-year period starting in 2008 was not in the interest of consumers. Instead, it invited the Distributor to recover as rapidly as possible the balance of the deferral account in the 2008 cost of service, including by applying any credit balance of the pass-on account to reduce the debit balance of the transmission costs deferral account. Moreover, in this same decision, the Régie required that the Distributor integrate in its cost of service for the test year, a provision reflecting the applicable transmission costs. This requirement is based on the principle of intergenerational equity. Finally, still in this same decision, the Régie required that the Distributor start amortizing this account in 2007, to an amount of $70 million "… in order to ensure a better cost approximation to the appropriate generation of customers, while at the same time aiming for rate stability,…" (D-2007-12, p. 20).

The Distributor subscribes to these two objectives. Therefore, the Distributor's proposal consists in:

- Recovering the entirety of the additional 2007 transmission costs resulting from Decision D-2007-34 ($57 million plus $2 million in interests);
- Reflecting entirely the reduction of the transmission costs of the native load forecast in the TransÉnergie rate application for 2008 including a $41.3 million credit, reflecting the Distributor's share regarding the balance forecast by the transmission provider in its variance account for point-to-point services income (Decision D-2007-08 of case R-3605-2006);
- Amortizing the 2005-2006 deferral account balance over a maximum 3-year period and recover in 2008 an amount of $107 million, limiting the increase in electricity rates to 2.9% in 2008.

Overall, in 2008, the Distributor will absorb $166 million of the transmission costs for the previous years. At the end of 2008, close to 50% of the deferral account will have been recovered and a residual balance of $178 million will remain to be amortized over the following two years. The current proposal to close the transmission costs deferral account includes an interest charge of $61 million over the 2006-2010 period (assuming a uniform distribution of the account balance between 2009 and 2010) compared with $79 million according to the scenario proposed last year.

2.3 Distribution and Customer Services Costs

Overall, in 2008, the distribution and customer service costs increase by $155 million, that is by 5.8% compared with the amount approved in 2007. This increase is mainly explained by the following elements:

- Additional costs of $108 million related to the implementation of the CIS project, of which $68 million are capital and amortization costs and $40 million are operating costs related to stabilization activities ($10 million) and other operating and maintenance costs ($30 million);

- Additional costs of $29 million related to energy efficiency activities.

The Distributor recalls that in the previous rate case, it announced that it had to spread over two years the implementation of L3, the last part of the CIS project, with some financial impacts. This decision is justified essentially by:

- the difficulties encountered during the deployment in 2006 of the parts of the project pertaining to business customers, which despite our efforts, caused an important deterioration of service to these customers;
- the willingness of the Distributor to make the required improvements in order to ensure that the commissioning of the last part of the project, which pertains to all of the residential customers, will be more efficient.

The increase in operation costs related to basic activities is only 1.1%. Given the 1% increase in the number of customers in 2008, an increase of 2.1% will be required to cover all of the Distributor's basic needs and growth needs. Including the specific elements, the increase of total operating costs is 3.2% compared with the approved amount for 2007.

In order to limit the impact on the rates of all these elements and in particular of the pressure exerted by the commissioning of CIS, the Distributor announced in June 2007 a tightening of its operating costs and of the process of filling or creating permanent and temporary positions. In addition, as presented in the next section, the Distributor expects to establish a series of courses of action to improve everyday management efficiency.

Overall, the tightening and efficiency measures that the Distributor intends to deploy in 2008 are valued at $40 million.

2.4 Efficiency of the Distributor

In its last rate decision, the Régie expressed the desire of having an integrated efficiency improvement plan detailing the targeted strategies and objectives in a timetable of several years. Exhibit HQD-3, document 1, answers this request.

The Distributor recalls that the implementation of efficiency measures must respect certain conditions such as maintaining the quality of the electric service and customer satisfaction, and at the same time take into account evolving business needs.

For 2008, the efficiency gains relate mainly to actions aimed at everyday management, which result in a budget decrease of the order of $10 million, or about 1% of the operating costs budget. For the following years, the Distributor has identified several structuring courses of action that will be added to the deployment of the CIS project, in order to help limit the increase of its cost of service. These different courses of action emanate from its analysis of best practices of successful companies. They will be rigorously evaluated in order to verify their adaptability to the Distributor's environment and maximise potential gains.

Moreover, Table 2 shows the evolution of 8 indicators used as reference points to synthetically appreciate the Distributor's performance as regards efficiency. At the request of the Régie, these indicators also cover the 2003-2008 five-year period.

TABLE 2: EFFICIENCY INDICATORS OF THE DISTRIBUTOR

DESCRIPTION	YEARS ENDED DECEMBER				AVERAGE YEARLY		
	HISTORICAL		D-2007-	TES YEA			
	200	200	200	200	2001-	2003-	2007-
OVERALL INDICATORS FOR THE DISTRIBUTOR							
1 – TOTAL COST OF DISTRIBUTION AND CS ($) PER SUBSCRIPTION	**532**	**499**	**548**	**567**	**0.9%**	**2.6%**	**3.6%**
2 – TOTAL COST DISTRIBUTION AND CS (¢) PER NORMALIZED KWH	**1.22**	**1.10**	**1.21**	**1.28**	**0.6%**	**3.1%**	**5.5%**
3 – NOC OF DISTRIBUTION AND CS ($) PER SUBSCRIPTION	**264**	**266**	**276**	**284**	**1.1%**	**1.3%**	**2.9%**
4 - CIM ($) PER	**281**	**246**	**254**	**268**	**-0.7%**	**1.7%**	**5.3%**
CUSTOMER SERVICE PROCESS INDICATORS							
5 – TOTAL COST OF CUSTOMER SERVICE ($) PER SUBSCRIPTION	**107**	**104**	**107**	**117**	**1.2%**	**2.3%**	**8.7%**
6 – NOC OF CUSTOMER SERVICE ($) PER SUBSCRIPTION	**100**	**103**	**105**	**110**	**1.4%**	**1.3%**	**4.5%**
DISTRIBUTION PROCESS INDICATORS							
7 – TOTAL COST OF DISTRIBUTION ($) PER	**422**	**393**	**428**	**436**	**0.5%**	**2.1%**	**1.9%**
8 – NET OPERATING COST OF DISTRIBUTION ($) PER SUBSCRIPTION	**163**	**162**	**170**	**173**	**0.9%**	**1.3%**	**1.8%**

(1) **: THE COMPONENTS OF THE EFFICIENCY INDICATORS ARE DEFINED IN APPENDIX 1.**

Taking into account the implementation of the CIS project in 2008, several indicators show significant growth in 2008, as expected. However, most of the indicators are close to the inflation rate for the period 2003-2008. In an environment in which the true measure of the Distributor's performance must be estimated on a longer period, the different efficiency indicators demonstrate that from 2001 to 2008, their growth rate has been far lower than the inflation rate.

2.5 Energy Efficiency Activities

Generally, the energy efficiency activities contribute to cutting the consumers' electricity bill through a reduction of the supplies required at market price. The Distributor maintains its target of saving 4.7 TWh through energy efficiency by 2010. Almost 60% of this objective, 2.8 TWh, will be reached at the end of 2008 through additional investments of $252 million, a similar amount as in 2007.

In its last rate decision, the Régie encouraged the Distributor to continue its efforts to support low-income households and, more specifically, increase the accessibility of the customer programs. Following the conclusions of a committee made up of various interest groups that are active with this customer segment, about twenty courses of action were identified in the field of responsibilities of the Distributor and the Agence de l'efficacité énergétique. These must be developed using an integrated approach and be articulated around three main orientations:

- Ensure the accessibility of low-income households to electricity and services;
- Make electricity and the services affordable for all low-income households; and
- Optimize the electricity savings of low-income households and improve their comfort at the same time.

Various actions will be established over the next four years to materialize these orientations. In 2008, about $3 million will be allocated for these actions. The Distributor expects to spend an average annual amount of the order of $5.5 million from 2008 to 2011 to adapt its commercial offer to the needs of this special customer segment. Moreover, an annual amount of about $3.5 million will be used to alleviate the financial burden of low-income households, in particular through bill payment support for customers in very difficult situations.

As for the energy efficiency measures, together with the Agence de l'efficacité énergétique in the case of certain programs, an amount of $30 million has been allocated in the Distributor's 2008 budget, representing 26% of the forecast budget for residential customers.

3 RATE STRATEGY

3.1 Level of the increase

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

TABLE 3

Evaluation of the Shortfall and the Rate Increase at April 1, 2008 ($	
	Application R-3644-
2008 Sales Revenues (without rate increase)	**10,170.**
Revenues other than those from Electricity Sales	**157.2**
Adjustment – Regulatory Provision for 2007	**-54.0**
Total Revenues for the Calculation of Additional Revenue Requirements	**10,273.**
Revenue Requirement	
Purchases	
Purchases of Electricity	5,034.5
Transmission Services	2,664.6
Distribution Costs and Customer Service	
Operating Costs	1,251.6
Other Charges	800.9
Return on the Rate Base	790.3
Revenue Requirement	**10,542.**
Additional Revenue Requirement at April 1	**-**
Sales Revenues before the Increase, excluding Special Contracts	**9,268.**
Increase Requested - April 1, 2008	**2.90**
Revenues Generated in 2008 by the Requested Increase	**184.**
Regulatory Provision for 2008 Recovered in 2009	**84.**

The variance between the revenues on the basis of the current rates and the revenue requirement resulting from the cost of service is $268.8 million in 2008, which justifies an overall increase of 2.9% for all of the electricity rates. The regulatory provision for the year 2008 recovered in 2009, as per Régie decision D-2005-34, amounts to $84.2 million. Moreover, revenues of $184.6 million are anticipated by this increase over the period of April 1 to December 31, 2008.

3.2 Rate Structures

In the context of high marginal costs of supply, it is important to ensure that the price signal sent to customers encourage a more efficient use of electricity. In this respect, the government of Québec, in its new 2006-2015 energy strategy, as well as the Régie, in its last decision D-2007-12, invited the Distributor to intensify its rate structure reform in order in particular to better reflect this environment.

In 2008, the Distributor plans to continue with the differentiated increase of the rate components in order to target the elements for which demand is the most elastic. Thus, for residential customers, the Distributor proposes a greater increase in the price of the 2nd energy block as well as the power premium in winter; for customers charged general rates (G, M and L); it proposes to increase even more the energy component of these rates.

Starting in 2009, the Distributor proposes to go further in its search for a better price signal and at the same time simplify its commercial offer and implement a reform of its rates of which the main points are the following:

- Eliminate the energy price degressivity in rates G and M, with the aim of eventually eliminating the second block;
- Apply the same power billing rules to all of its customers (except for rate L customers) to encourage better management of customer demand.

The elements of this new reform would be implemented as soon as 2009 according to a timetable that will be submitted to the Régie in the next rate case and that will be aimed at their harmonious commercial integration.

3.3 Time-based pricing

In its recent energy strategy, the government of Québec expressed the desire that the Distributor implement progressively in Québec a rate structure that varies according to the season and time of use, inviting it to submit an application to this effect to the Régie de l'énergie as soon as 2007. Moreover, the government also expressed its wish that such a rate structure not produce an increased overall bill of the customer base.

At the present time, the Distributor has been unable to identify a strategy that would allow the participating customers and at the same time all of the customers to take advantage of such a rate structure. Among the main pitfalls encountered, we note the cost of meters, and especially of communication links, the low differentiation between peak and off-peak prices, and the constraints related to load displacement in winter. Nevertheless, in order to apply this orientation of the government of Québec, which was supported by the Régie in its last decision, the Distributor proposes the execution of a pilot project to acquire more detailed data in order to better estimate the costs and benefits, for the customer as well as for the Distributor, of the implementation of time-based pricing in Québec.

3.4 Differentiated Increases

In its last rate decision, the Régie re-examined the principle of maintaining interfinancing established in its law. Under its new interpretation, the Distributor can propose differentiated rate adjustments by customer category in order to reflect the cost of service variation of this category. For 2008, the application of this principle would mean a major increase for the residential category and a lower increase for all other customer categories. While subscribing to the concerns the Régie formulated in its decision, that is to ensure real costs and fairness between the customer categories, the Distributor considers that the application of differentiated rate adjustments remains an issue of public interest, and that it is best to let the Régie arbitrate it.