R-3842-2013 October 9, 2013

Summary of Olivier Charest's evidence

The purpose of my report is fourfold:

(i) Serve as a factual basis regarding business risk for Dr. Laurence Booth's report on ROE;

(ii) If possible, show that HQT and HQD's risk are lower than they were last time the Régie did a full ROE examination in order to use the *Beta* determined then as a ceiling (which would not prevent Dr. Booth from determining a lower *Beta*);

(iii) If possible, show that HQT and HQD's risk are lower than Gaz Métro's – thus using GM's latest ROE (8.90%) as another ceiling (which would not prevent Dr. Booth from determining a lower ROE); and

(iv) Criticize HQ's and Concentric's respective risk analyses.

This Report is divided as follows:

1- General business risk analysis for HQT and HQD
2- Focus on changes since 2003-4
3- Comments on business risk analysis by HQ and expert.

1- GENERAL BUSINESS RISK ANALYSIS

1.1 HQT

I will address the following issues discussed at sections Q9 to Q28 of Zak El-Ramly's report in 2003, although in a different order and manner:

Q9-10: HQT's operating environment (monopoly) – *same, adding TCPL's "death spiral" as a counter-example*

~~Q11: FERC Order 2000~~

Q12: HQT'S business environment is unique – *same, adding new examples of government intervention in Régie affairs protecting its ROE*

Q13: No competitive pressure –*I will remove the reference to wheel-through. I will add that many parts of the grid serve as generator leads and will continue to be used as long as HQP runs its dams. Considering that HQ recently pushed up the useful life of its dams to 100-120 years (to be confirmed), connecting power lines will most likely not become*

useless tomorrow. I will also discuss geographical location: HQT grid is the gateway between sources (HQP's and Labrador's) and markets, and between markets. Although NL is now building a maritime link, it is for less than 1000MW. The Northern and Eastern Portions of HQT's grid therefore have a bright future. As for the rest of the grid, it is necessary to serve the Québec load. Here again, no risk.

Q14: Revenue requirement – *same*

Q15-16: Rate base uncertainty – *same, and add that HQT has a history of frequent rate cases as well as overearnings related to rate base. Remove the first paragraph of Q16 and change the last paragraph so as to not refer to Morin's report anymore. Also HQT has a deferral account for projects which have not yet been approved by the time the Régie approves the rates (thus allowing HQT to recoup them the following year)*

Q17: Capital costs – *same, without reference to Morin. Discuss previous over-earnings as well as proposed changes by HQTD (i.e. updating capital costs at the end of a rate case).*

Q18-19: O&M costs – *same, with a history of over-earnings*

~~Q20: 1998 Ice storm~~

Q21-22: Regulatory risk: - *This section will be modified to reflect HQT's longer regulatory history, constant over-earnings, frequent rate cases, etc. Reference to recent examples of government intervention in Régie matters. Regulatory lag is not an issue since HQT always gets interim rates.*

Q23: Revenue: *with its variance account for point-to-point service revenue HQT face no risk related to revenue.*

~~Q24: Increased competition~~

Q25: lack of client diversity: *same, minus comments on Morin*

~~Q26:passing on risk to HQ~~

Q27: Comparison with other utilities – *Replace these utilities by Gaz Métro's to use as benchmark (ceiling) for ROE*

Q28: Comparison with natural gas pipeline – *same, see comments above on TCPL's death spiral, which isn't likely here*

I would also add an admission from 2002 from HQT that their risk was minimal back then (and presumably still is today).

1.2 HQD

HQD's has slightly higher risk than HQT. Most of this additional risk is on revenue (for which HQT has no risk) and is basically short term, i.e. revenue shortfall from overestimating sales (thus rates too low). This risk, however, is minimal; this is proven by HQD itself who boasted the quality of their new forecast tools in the last rate case (I will try to find a good quote on this). HQD is also protected by a weather normalization account. Moreover, since HQD generally underestimates its weather-normalized net revenue (leading to over-earnings) it has a "cushion" to absorb such risks as plant closure, etc.

There is no "supply" risk since HQD has a variance account for supplies; it even has one for the diesel for its autonomous networks up North.

Much of the remaining short-term risk is the same as HQT's. Frequent cost of service rate cases offer a stable environment. Moreover, constant over-earnings on O&M costs (and even on amortization!) show that HQD has a "buffer" or "cushion" before it suffers a loss to ROE. We even have an admission from last year's rate case that they started the year at -40M$ (they forgot something in revenue requirement) and yet managed to over-earn by 111M$ (50% of their authorized ROE) by cutting on certain O&M expenses such as the non-capitalized energy efficiency expenses.

Risk is also lower now for both HQD and HQT since the government has been granted the ability to set the O&M at whatever level it sees fit (Bill 25).

There is no real long term risk. There is no "death spiral" looming for HQD : although gas might be more competitive than it was 10 years ago, we can't expect it to "steal" clients away from HQD. Machines and buildings will continue to require electricity and self-generation does not seem to be economically viable for a very long time. HQD may lose some energy volumes to Gaz Metro but this seems marginal; thus, although rates would rise, they probably would not rise by much; and considering that rates are already very low (the residential ones, at least), there is room for an increase without fear of losing (residential) clients.

Industry, though it represents a high % of sales, is not set to disappear, or at least not abruptly: major power consumers sometimes make 30-40 year capital investments, so they are not likely to all close down at the same time. Conversely, the government has just announced 50 TWh of new "special contracts" over 10 years, so we might actually see new industrial loads.

2- MAJOR CHANGES SINCE 2003

2.1 HQT

- Regulatory environment is more mature. I will look for a quote by HQT saying in 2003 that the relatively new regulatory environment was a risk factor for them back then.

-- Moreover, HQT is now able to have its rates reviewed annually which limits regulatory lag (whereas the first rate case took 5 years).

-The point-to –point revenue variance account takes a lot of risk away (I will try to find a quote by them in 2003 saying how risky this was).

- New deferral account related to investments for which approval by the Régie was pending when the Régie issued its decision on rate (therefore HQT can earn revenues to cover amortization and capital costs for a project during the year following that decision)

- (to be confirmed) Increased point-to-point activity: this has no short-term impact thanks to the variance account but demonstrates that demand for HQT's services is stronger than it was 10 years ago (interconnections are often congested, and clients such as NLH have brought lawsuits to the Régie and the courts in order to obtain access to HQT's grid). I could perhaps pull out interconnection flows measured on NYISO, NEPOOL and IESO to prove this.

2.2 HQD

- Regulatory environment is more mature. I will look for a quote by HQD saying in 2003 that the relatively new regulatory environment was a risk factor for them back then.

- Many new variance accounts:

--weather normalization (I will look for a quote saying that weather was a big risk in 2003);

--supply, although this mostly covers an increase in the underlying risk since 2003 when all of HQD's supply came from the Heritage Pool (which is an extremely flexible tool), thus not much "net" decrease in risk;

-- "maintien de la charge" (marginal impact)

-- pension costs – here again, it seems that the variance account covers something which was not an issue back then (although the risk did exist ...)

-- power outage costs

- Industrial load has decreased (assuming this is a risk factor, it is therefore less risky than in 2003).

3- COMMENTS ON BUSINESS RISK ANALYSIS BY HQ AND EXPERT.

3.1 HQ's analysis of HQT's risk (HQTD-1, Doc-1, pages 13-14)

HQ raises the following issues:

- Cost variability – *see above*
- No revenue related risk – *agreed*
- Grid size and complexity : high risk of equipment malfunction which can lead to costly repairs considering extreme climate - *This does not seem to have caused HQT to lose much money so far. It may cause their average O&M expenses to be higher, but this is not a "risk" insofar as rates are always set high enough.*
    - No protection against repeat of 1998 ice storm – *true. Not sure what to respond here.*
- Aging infrastructure – *Once again, this is not a risk, but a cost borne by customers.*
- Massive planned investment over next ten years which puts pressure on cash flows – *most likely true. not sure what to respond here, but not sure how this constitutes "risk". Couldn't HQT just hold more cash, thus increasing the rate base?*
- High degree of dependence on IT but no variance account for IT failures – *maybe true but quite hypothetical.*

It may be a good idea to say that HQ did not quantify any of these risks. How badly could these hypothetical situations cost it? We have no idea, but it seems the burden is upon them, no?

3.2 HQ's analysis of HQD's risk (pages 14-16)

- Revenue: limited protection; high industrial customer base (asymmetric risk since plant openings are known well in advance whereas plant closures arrive suddenly) – *as hinted in Dr. Booth's IR's, HQ would not be better off with less industrial customers. Diversity is good.*
- Supply risk: HQD mentions non-heritage pool supply as a source of risk because the Régie could disallow costs – *not sure the Régie ever disallowed costs retroactively. The Régie did reduce HQD's in last year's rate case because HQD was trying to incur unnecessary costs at HQP's advantage but this was done on a prospective basis, leaving time for HQD to adjust (decision rendered before April 1).*
- Grid size: similar to comments on HQT's risk. – *See above*
- Risk of customers defaulting on bill payment – *It's true that this has risen in recent years (2007-2012), but so has the amount included in rates to cover it. Moreover, the situation seems to have stabilized. This is therefore not a risk but increased cost for customers.*

3.3 Risk analysis by Concentric

Concentric's analysis is essentially as follows:

- Concentric identified 3 proxy groups: (1) Canadian companies (no criteria was used; these include TransCanada); (2) US companies (7 screening criteria were used); and (3) Canadian crown corporations (no specific screening criteria). These serve to benchmark the ROE it calculates for HQT and HQD. Some of these companies are holdings with more than one OpCo. *It is very questionable to compare HQT and HQD to TransCanada, especially in light of TCPL's recent troubles. As for the American companies, the screening criteria seem somewhat arbitrary.*
- Concentric identified 7 risk factors under which it compares HQT and HQD with proxy groups 1 and 2 (i.e. Canadian and US companies). As an eight factor, Concentric also discusses long term risk.
    - For the 7 risk factors, most of the analysis consists in verifying what percentage of each proxy group (weighted within each group as per the number of customers of each OpCo examined) faces a certain type of risk or has a certain protective measure. *In my view, there is something wrong in looking at protection measures instead of looking at the underlying risk is the same. Hurricane risk is not the same for HQ as it is in Louisiana. I also have specific comments on each of the 7 risk factors – see my IR's.*
- Concentric concludes that HQT and HQD face comparable risk to that of the Canadian proxy group but face higher long-term risk because of higher concentration in industrial clients (HQD) and because of capital expenditure in the coming decade (HQT). *Already discussed above.*
- Concentric also concludes that HQD faces higher long-term risk than 10 years ago because of competition from gas. *Discussed above.*
- Concentric also concludes that HQD faces risk comparable to the US companies since these face lower financial risk but face higher business risk because of regulated generation. *This seems to be quite arbitrary. Moreover, I'm not sure how a fictional capital structure (e.g. 35% equity for HQD) can be a risk factor and at the same time be used to account for difference in risk between HQD and HQT in order to grant them the same ROE.*
- Concentric also concludes that there are no fundamental differences in business risk between HQT and the US proxy group that would render comparisons inappropriate. *I think we're really comparing apples with oranges here. Moreover, HQ claimed in its evidence that HQT was unique – doesn't this contradict this conclusion?*