C A N A D A
PROVINCE OF QUÉBEC
DISTRICT OF MONTRÉAL
No.: R-3842-2013

R É G I E D E L ' É N E R G I E

HYDRO-QUÉBEC, a public corporation constituted under the *Hydro-Québec Act* (R.S.Q., c. H-5), having its head office at 75 René-Lévesque Blvd. West, in the city and district of Montréal, province of Québec H2Z 1A4

APPLICATION FOR APPROVAL OF THE RETURN ON EQUITY RATES AND THE EARNINGS SHARING MECHANISM

[ss. 31(5), 32, 34, 48 and 49 of the *Act respecting the Régie de l'énergie* (R.S.Q., c. R-6.01)]

IN SUPPORT OF THEIR APPLICATION, THE TRANSMISSION PROVIDER AND DISTRIBUTOR RESPECTFULLY SUBMIT THE FOLLOWING:

I. OBJECT AND CONTEXT OF APPLICATION

1. Hydro-Québec is an enterprise whose electric power transmission activities (the "Transmission Provider") and electric power distribution activities (the "Distributor") fall within the purview of the Régie de l'énergie (the "Régie"), whose exclusive jurisdiction under the *Act respecting the Régie de l'énergie* (the "Act") extends to the setting or modification of rates and conditions under which electric power is transmitted or distributed.

2. In this joint application (the "Application"), the Transmission Provider and the Distributor (collectively the "Applicants") are requesting:

   (a) the determination of a reasonable return on equity rate for the purposes of setting rates as of January 1, 2014, provided the Régie renders a decision in due time;

   (b) the adoption of a mechanism for treating variances between the realized return on equity and the authorized return on equity (the "Variances"), also known as an earnings sharing mechanism (the "ESM");

   (c) the creation of variance accounts for the Transmission Provider and for the Distributor so that their customers may benefit from the implementation of the proposed ESM; and

   (d) the adoption of terms and conditions for updating the cost of debt and the prospective cost of capital.

3. It is important to emphasize that this Application:

   (a) follows and gives effect to the request that the Régie formulated in its D-2013-037 decision dated March 12, 2013 "[TRANSLATION] to act promptly so that the findings on the proposed earnings sharing mechanism and review of the method for fixing return on equity rates are taken into account in the 2014-2015 rate case";[1]

(b) follows in the wake of R-3777-2011[2] and R-3814-2012,[3] in which the Régie asked the Applicants to address the issue of earnings surpluses by accepting that the mechanism for treating Variances and the review of the method for determining returns on equity be examined in a separate joint matter;

(c) will be filed within the timeframe announced by the Applicants, namely "[TRANSLATION] early in the second quarter of 2013".[4]

4. Moreover, the Applicants maintain that the determination and update of their return on equity rate is an essential phase that is necessarily incidental to an ESM's approval.

5. Therefore, the object of the Application is defined by these decisions and positions, and this tribunal constitutes the appropriate forum for disposing of these topics coherently and in due time.

II. RETURN ON EQUITY RATE

6. When it sets electricity rates under the Act, the Régie must allow for a reasonable return based on the Applicants' rate base.

7. This return must cover the cost of the debt and allow the regulated enterprise to obtain a return on equity that is fair given the applicable regulatory standards and jurisprudential criteria.

8. The Régie adopted rules and principles that provide the framework within which to exercise its discretion, such as the principle of the regulated enterprise's independence[5] and a reasonable return standard that provides for the application of three defining criteria, namely the criteria of financial integrity, capital attraction and comparable earnings, which last criterion led to a study of the authorized return for other regulated enterprises operating within comparable areas of activity with comparable risks.

9. For over ten years, determining the Applicants' return on equity rate has been based on the application of a two-pronged methodology, namely the aggregate of a periodically-updated, risk-free rate and a fixed and implicit risk premium (the "Methodology").

10. Over the course of this period, an expert report submitted by Messrs. James M. Coyne and John P. Trogonoski from Concentric Energy Advisors, Inc., filed as Exhibit HQTD-2,

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1 R-3814-2012, decision D-2012-037, paragraph 58.

2 *Demande de modification des tarifs et conditions des services de transport d'Hydro-Québec à compter du 1er janvier 2012* (application to amend the rates and conditions of Hydro-Québec transmission services as of January 1, 2012). See decision D-2012-059, paragraph 154.

3 *Demande relative à l'établissement des tarifs d'électricité de l'année tarifaire* (application respecting the determination of electricity rates for the rate year). See D-2012-097 (paragraphs 19 and 20), D-2012-119 (paragraph 13) and D-2013-37 (paragraphs 31, 32, 38, 54, 55 and 58).

4 See the document entitled *Consultation sur la politique financière et les mécanismes de traitement des écarts* filed before the Régie as an administrative follow-up on decisions D-2012-024 and D-2012-059 dated September 2012.

5 The stand-alone principle.

Document 1, revealed that the application of the Methodology resulted in a return on equity rate being fixed that was not only far lower than the rates granted to regulated enterprises operating in comparable areas of activity in Canada and the United States, but that this unfavourable variance became greater over time.

11. It is obvious from this expert report that the return on equity rate determined using the Methodology does not comply with the reasonable returns standard, more specifically the comparable earning criterion.

12. It also appears from the expert report[6] and the analysis therein, the recognized assessment methods, the risks specific to the Applicants and the authorized return on equity rates authorized for a comparable proxy group of Canadian and American regulated enterprises, that a 9.2% return on equity rate for the Transmission Provider and Distributor constitutes a fair return in light of all of the facts and relevant circumstances.

13. A 9.2% return on equity rate is at the lower end of the return rate collars authorized for these other regulated enterprises.

14. The Applicants are requesting the approval of a 9.2% return on equity rate applicable as of January 1, 2014, provided that the Régie renders a decision in due time, as appears from Exhibit HQTD-1, Document 1.

15. Moreover, in addition to the authorized return's mandatory compliance with the reasonable return standard that the Régie has recognized and applies to its other subject enterprises, the determination of a fair return is necessarily incidental to the Régie's adoption of an ESM that is fair and equitable for the Transmission Provider, the Distributor and their customers.

III. EARNINGS SHARING MECHANISM

16. The Applicants submitted to the Régie for approval the ESM described in Exhibit HQTD-1, Document 1, and this for the reasons stipulated therein, as will be factually explained and legally supported during the hearing and arguments.

17. The said ESM consists of the following:

(a) for Overearnings:

i) the creation of a deadband not exceeding 50 basis points above the fair return authorized for the Transmission Provider;

ii) the creation of a deadband not exceeding 100 basis points above the fair return authorized for the Distributor;

iii) the equal sharing of any portion of Overearnings exceeding 50 basis points between the Transmission Provider and its customers, and the equal sharing of any portion of Overearnings exceeding 100 basis points between the Distributor and its customers, as the case may be;

(b) for Earning Shortfalls:

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6 HQTD-2, Document 1.

i) any Earning Shortfalls will be absorbed by the Transmission Provider or the Distributor, as the case may be.

18. In the opinion of the Applicants and their experts, the proposed ESM is fair and equitable and fully meets the previous applications of the Régie, in that it:

(a) ensures that Overearnings are shared fairly between the Applicants and their customers;

(b) constitutes an incentive for reducing costs and improving the Applicants' operating efficiencies;

(c) introduces a mechanism that is easy to apply and in keeping with the concept of reducing the regulatory burden;

The whole as appears at greater length from Exhibit HQTD-1, Document 1, as well as the expert report prepared by Mr. Robert C. Yardley, Jr. from the firm Concentric Energy Advisors, Inc., filed as Exhibit HQTD-2, Document 2.

IV. VARIANCE ACCOUNTS

19. So that their customers may benefit from the implementation of the proposed ESM, the Applicants have submitted to the Régie for approval an application to create variance accounts bearing interest at the rate authorized on the rate base in order to reflect the Overearnings.

20. These accounts would be governed by the variance conditions described in Exhibit HQTD-1, Document 1.

21. The grounds for supporting the creation of such accounts are set forth in the evidence,[7] as will be factually explained and legally supported during the hearing and the arguments.

V. COST OF DEBT AND PROSPECTIVE COST OF CAPITAL

22. The Applicants have submitted to the Régie for approval an application to adopt conditions for updating the cost of debt and the prospective cost of capital while the rate records are processed.

23. These terms and conditions, described at greater length in Exhibit HQTD-1, Document 1, can be described as an update of the borrowing volumes and interest rates using more recent data for the purpose of recognizing a more contemporary forecast of the rate year that will more accurately reflect the actual results.

24. The grounds for supporting these terms and conditions are specified in the evidence, as will be factually explained and legally supported during the hearing and the arguments.

VI. CONCLUSIONS

25. The application to approve the 9.2% return on equity rate, the terms and conditions for updating the cost of debt and the prospective cost of capital as well as the proposed

[7] HQTD-1, Document 1.

ESM are fully justified in light of the evidence and expert reports on record, the applicable regulatory standards and the relevant case law precedents.

26. The Application is just and reasonable, and the Régie is well founded in approving the Application within the exercise of its powers under the Act, as well as in light of the considerations set forth in section 5 of the Act.

FOR THESE REASONS, MAY IT PLEASE THE RÉGIE TO:

ALLOW this Application;

APPROVE, for the Transmission Provider, a return on equity rate of 9.2%, applicable as of January 1, 2014, provided that the Régie renders a decision in due time;

APPROVE, for the Distributor, a return on equity rate of 9.2% applicable as of January 1, 2014, provided that the Régie renders a decision in due time;

APPROVE the ESM proposed by the Transmission Provider and the Distributor as of January 1, 2014, provided that the Régie renders a decision in due time;

AUTHORIZE the Transmission Provider and the Distributor to create variance accounts for the earnings variances, bearing interest at the authorized rate on the rate base, governed by the conditions described in evidence;

APPROVE the terms and conditions for updating the cost of debt and the prospective cost of capital applicable as of January 1, 2014, provided that the Régie renders a decision in due time;

ALLOW the Transmission Provider and the Distributor to reflect the conclusions of this Application in any tariff case underway or pending following the decision rendered in this case.

THE WHOLE RESPECTFULLY SUBMITTED.

Montreal, April 19, 2013

(s) *Hydro-Québec*

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