

**REQUEST FOR ADDITIONAL EVIDENCE FROM THE RÉGIE DE
L'ÉNERGIE (THE RÉGIE) IN RELATION TO THE APPLICATION SEEING
AUTHORIZATION OF A RETURN ON EQUITY AND AN
EQUITY SHARING MECHANISM**

RETURN ON EQUITY

- 1. Reference:** Exhibit B-0007, pages 26-27.

Preamble:

“Credit ratings are based on the utility's business risk profile (which includes an assessment of the regulatory environment in which the utility operates) and its financial risk profile. Companies with similar credit ratings have been determined by the rating agency to have similar levels of business and financial risk. This concept has been adopted by regulatory agencies, including the Federal Energy Regulatory Commission (“FERC”), which has found that “it is reasonable to use the proxy companies' corporate credit rating as a good measure of investment risk, since this rating considers both financial and business risk.

The basis for choosing proxy group companies with credit ratings of A- or higher is that absent the government debt guarantee, the credit rating for Hydro-Québec would be several notches lower.²⁹

²⁹ *In August 2012, Moody's Investors Service indicated that its Baseline Credit Assessment for Hydro-Quebec would be Baal (S&P equivalent BBB+) absent the government debt guarantee from the Province of Quebec. See Moody's credit report for Hydro-Québec, issued August 6, 2012, at page. 2.”*

Requests:

- 1.1 Please file a copy of the Moody's report for Hydro-Québec which refers to page 27 of the report by Concentric Energy Advisors (Concentric).

R1.1

Please see Request 1.1 Attachment 1.

- 1.2 Please file the Moody's Investors Service report dated August 2009, entitled "Regulated Electric and Gas Utilities" - Rating Methodology (34 pages).

R1.2

Please see Request 1.2 Attachment 1.

- 1.3 Please provide, in the form of an Excel file, the history of the rates of return, at a minimum on a monthly basis, for the last 25 years, for BBB- and A-rated corporate bonds for government-owned utilities, as well as the rates for 10- and 30-year bonds issued by the Government of Québec, the Government of Canada and the U.S. Treasury. Please provide this information for both Canadian and US markets.

R1.3

Please see Request 1.3 Attachment 1.

- 2. References:** (i) Exhibit B-0007, page 51;
(ii) Exhibit B-0007, Exhibit JMC-5, Appendix 1.

Preamble:

"Based on the lower equity ratios and the weaker credit metrics of HQD and HQT, Concentric concludes that these companies have greater financial risk than either the Canadian proxy group or the U.S. electric utility proxy group. Specifically, the actual credit metrics for HQD and HQT (as shown on Exhibit JMC-5) are not consistent with Hydro-Québec's current S&P rating of A+."

Request:

- 2.1 Please provide the data and source for each, and the detail calculations used to complete the table of Exhibit JMC 5, Appendix 1, of Exhibit 1-HQTD-2, Document 1.

R2.1

Please see Request 2.1 Attachment 1.

- 3. References:** (i) Exhibit B-0007, pages 89-90;
(ii) Exhibit B-0007, Exhibits JMC-9 to JMC-11.

Preamble:

"Yes, projected earnings growth rates are generally available. For example, analysts' five-year earnings growth rates are publicly available from Zacks' Investor Services for U.S. companies. Thomson First Call (as reported on Yahoo! Finance), which is a public source, and SNL Financial, a subscription-based service, publish earnings growth rates for both Canadian and U.S. companies. All of these services provide consensus estimates that compile projections of earnings growth from several analysts. Value Line, which is a subscription based publication, provides three-to-five-year projected earnings, dividend and book value growth rates based on the expectations of an individual analyst." [...]

"SNL Financial began compiling consensus earnings growth estimates for Canadian utility companies in February of 2012. In addition, Thomson First Call also provides long-term growth estimates for Canadian utilities."

Requests:

- 3.1 For the Canadian and U.S. proxy groups, please provide detailed growth estimates used including, for each source (Zacks, First Call, SNL and Value Line) the mean and median growth estimates, over one and five years, the highest value and the lowest estimate, as well as the number of analysts who provided estimates.

R3.1

Please see Request 3.1 Attachment 1 for the work papers that support the growth rates reported by Zacks, First Call, SNL and Value Line. Exhibit JMC-9 shows the five year growth rate estimates from each source, as well as the mean and median growth rates for the Canadian and U.S. proxy groups from each source. The work papers for First Call and SNL show the number of analysts surveyed to derive the consensus growth rate; Value Line's growth estimates are based on the projection of one analyst, and Zacks does not report the number of analysts that are surveyed in the consensus estimate.

The individual growth rate projections of each analyst that are included in the consensus growth rate for the company are not provided by Zacks, First Call, and SNL. Each of those three sources reports the consensus EPS growth rate for the company, but does not disclose analysts' individual growth rate projections. As noted above, Value Line's growth estimates are based on the projection of one analyst for a three-to-five year period.

In preparing this response, Concentric discovered that SNL discontinued coverage of Valener in July 2012. The SNL growth rate shown in the DCF calculation for Valener is for a different company (i.e., Vanguard Natural Resources) that has the same ticker (VNR) on the New York Stock Exchange as Valener has on the Toronto Stock Exchange. The growth rate estimate for VNR provided by SNL of 6.00% is not representative of Valener Inc., but rather Vanguard Natural Resources. The estimate provided by Yahoo of 8.00% is correct. Thus, the average growth rate used in the Constant Growth and Multi-Stage DCFs should be 8.00% instead of 7.00%. As a result of this change, the mean ROE results increase slightly :

Tableau R-3.1 – DCF Model Results

	Mean DCF Results	
Constant Growth	Old	New
30-Day	11.66%	11.83%
90-Day	11.76%	11.93%
180-Day	11.82%	11.99%
Multi-Stage	Old	New
30-Day	8.97%	9.04%
90-Day	9.10%	9.17%
180-Day	9.17%	9.24%

Concentric does not, however, change its recommended ROE, as we have placed principal reliance on the results of the U.S. proxy group, and this is a nominal change in the Canadian results.

- 3.2 Please provide Exhibit JMC-10, Appendix 4, for the Canadian proxy group.

R3.2

The calculation of the sustainable growth rate shown in Exhibit JMC-10, Schedule 4 is based on data from Value Line. It is not possible to perform this calculation for the companies in the Canadian proxy group because Value Line does not provide coverage of all of these companies.

4. **References:** (i) Exhibit B-0007, pages 27-28;
(ii) Exhibit B-0007, Exhibit JMC-1;
(iii) Exhibit B-0007, Exhibit JMC-3, Appendix 1;

- (iv) NEB decision respecting TransCanada Pipelines, RH-003-2011, pages 1, 3 and 16;
- (v) National Bank Financial's March 28, 2013 analytical report on Trans Canada Corporation.

Preamble:

(i) At pages 27-28, Concentric noted: "As shown on Exhibit JMC-1, in 2011, the average company in the Canadian utility proxy group derived approximately 61 percent of its operating income from regulated utility operations and 59 percent of its revenues from regulated utility service. Two companies, however, have substantial non-electric and/or unregulated operations, which have different business risks than the regulated electric transmission and distribution business."

The aforementioned two companies are Enbridge and TransCanada Corporation.

(ii) In Exhibit JMC-1, Concentric's table indicates that TransCanada has neither income nor revenues from the transmission or distribution of electricity, or other energy, on a cost-of- service basis.

2011 % Regulated Operating Income and Revenues			
	Utility	% Operating Income	% Revenues
	Consolidated Edison	98%	38%
	Northeast Utilities	101%	99%
	NextEra Energy	64%	69%
	Southern Co.	930%	95%
	Wisconsin Energy	61%	99%
	Xcel Energy	100%	99%
	U.S. Proxy Group Average	86%	92%
	Utility	% Operating Income	% Revenues
	Canadian Utilities Ltd.	60%	36%
	Emera. Inc.	94%	92%
	Enbridge Inc. (1)	22%	13%
	Fortis Inc.	91%	93%
	TransCanada Corp. (2)	0%	0%
	Valener	98%	97%
	Canadian Proxy Group Average	61%	59%
<p>Note: Percentage of operating income may exceed 100% due to losses at affiliates. (1) Does not include operating income or revenues from gas transmission. (2) TransCanada has no income or revenues from regulated utility service. Gas transmission income and revenue was not considered in our analysis.</p>			

(iii) Despite this fact, Concentric includes TransCanada in the Canadian proxy group of companies. The Régie notes that, in Exhibit JMC-3, Appendix 1, TransCanada has the highest authorized rate of return on equity (RROE) of the group, at 11.50%, and its inclusion raises the average RROE of the sample by 29 basis points, from 8.90% to 9.19%.

(iv) In its March 2013 decision respecting TransCanada PipeLines, the NEB stated: (page 1) "The Mainline is in an unprecedented position. No major NEB regulated natural gas transmission pipeline has ever been affected by market forces to the extent that the Mainline is now affected. Throughput on the Mainline has decreased significantly, and as a result, Mainline tolls have increased substantially over a short period of time.

The future of the Mainline depends on how TransCanada is able to respond to the changes to its business environment. The Mainline faces increasing competition for gas supply from intra-Alberta demand, other ex-Western Canada Sedimentary Basin (WCSB) pipelines and new markets for WCSB gas. The Mainline competes with pipelines from emerging shale and tight gas basins in the United States of America (U.S.), which deliver gas to eastern markets. The Mainline must adjust to this new environment because eastern consumers may not renew contracts for long-haul service and bypass infrastructure may be built.

Tolls cannot continue to increase each year in response to throughput decline. Costs associated with throughput variation have been passed to remaining Firm Transportation service (FT) shippers. Those shippers have borne all of the costs of, and the risk associated with, competition. If this were to continue, the Mainline's competitiveness could further erode and exacerbate the root cause of throughput declines.

Our decision

The multi-year fixed tolls approach we have adopted stops the toll increases. Our Decision sets the FT toll from Empress, Alberta to Dawn, Ontario at \$1.42/gigajoule (GJ), compared to the 2013 Status Quo toll of \$2.58/GJ. We expect this toll to remain in effect through 2017. Recognizing the increased business risk that the Mainline is facing, we have approved the Mainline's return on equity (ROE) at 11.5 per cent on a 40 per cent equity ratio. We have also approved an incentive mechanism that would further increase the Mainline's profits if annual net revenues are higher than forecast.

"We recognize that throughput, cost and revenue forecasts may not be realized. We have compensated the Mainline through a higher allowed return for the increased variability risk it will face due to its cash flows being more dependent on the accuracy of its throughput forecast than in the past. [...]"

(page 3)

"If larger-than-forecast cost deferrals were to occur, they could represent a materialization of the Mainline's fundamental risk and costs could be disallowed. If costs were disallowed, it would not mean that TransCanada did not have a reasonable opportunity to recover costs, but rather that events did not turn out as forecast or that this opportunity was not seized by TransCanada. A potential outcome is that the Mainline would suffer a loss – just like any other business that faces competition." [Emphasis added]

At page 16 of the NEB decision, Table 2-1 clearly indicates the toll reductions decided by the Regulator, reductions that could reach 49% compared to the status quo.

**Table 2-1
Comparison of 2013 Tolls under the
Restructuring Proposal and Status Quo (S/GJ)**

Toll Path	2013 RP	2013 SQ
Sask./Man. Border to Dawn, Ontario (Union SWDA)	1.18	-
Sask./Man. Border to Toronto, Ontario (Enbridge CDA)	1.33	-
Alberta System to Dawn (Union SWDA)	1.47	2.74
Alberta System to Toronto (Enbridge CDA)	1.61	3.18
Alberta-Sask. Border (Empress, AB) to Dawn (Union SWDA)	1.52	2.58
Alberta-Sask. Border (Empress, AB) to Toronto (Enbridge CDA)	1.67	3.03

(v) TransCanada's Increased risk profile has not gone unnoticed by financial analysts, as evidenced in National Bank Financial's March 28, 2013 report concerning TransCanada Corporation entitled: "*NEB announces five-year Cnd Mainline decision: Fixed tolls = cash flow risk profile bumps up.*"

Requests:

4.1 Please file National Energy Board document: Reasons for Decision, TransCanada Pipelines Limited, NOVA Gas Transmission Ltd. and Foothills Pipe Lines Ltd. RH-003-2011, published in March 2013.

R4.1

Please see Request 4.1 Attachment 1.

4.2 Please file the National Bank Financial research report concerning TransCanada Corporation, dated March 28, 2013, entitled "*NEB announces five-year Cnd Mainline decision: Fixed tolls = cash flow risk profile bumps up.*"

R4.2

Please see Request 4.2 Attachment 1.

4.3 Given the foregoing observations, including the recent NEB decision, please explain why, in your view, TransCanada Corporation's level of risk is comparable to that of HQTd.

R4.3

As explained on pages 27-28 of Exhibit HQTd-2, document 1 (B-0007), two companies (Enbridge, Inc. and TransCanada Corporation) have substantial non-electric and/or unregulated operations, which have different business risks than the regulated electric transmission and distribution business. The significance of non-electric utility activities and non-regulated activities at

those two companies underscores the benefit of using a proxy group of U.S. electric utilities to estimate the cost of equity for the Transmission Provider and the Distributor, supplemented by the results of the Canadian proxy group.

Since the Régie has not previously found that it was appropriate to rely on U.S. regulated utilities to estimate the cost of equity for a Canadian company, Concentric selected a proxy group of Canadian utilities for analysis while noting the inherent concern that several of those companies are not comparable in terms of business risk to the Transmission Provider and the Distributor. For that reason, Concentric presented a similar analysis for a proxy group of U.S. electric utilities which were more risk comparable to the Transmission Provider and the Distributor.

- 4.4 More generally, please justify the inclusion of TransCanada Corporation in the Canadian electric utilities proxy group.

R4.4

Please refer to the response to Question 4.3.

- 5. References:**
- (i) Exhibit B-0007, pages 103-104;
 - (ii) Valener, *Results for the second quarter of its 2013 fiscal year*, Speaker's notes, page 3;
 - (iii) Valener, *Results for the second quarter of its 2013 fiscal year*, Slide 5;
 - (iv) Valener, 2012 Annual Report, pages 14, 168-169.

Preamble:

(i) *"Retention of earnings causes an increase in the book value per share and, other factors being equal, increases the amount of earnings that is generated per share of common stock. For example, a company that is expected to earn a return of 9 percent and retain 80 percent of its earnings might be expected to have a growth rate of 7.2 percent, computed as follows:*

$$0.80 \times 9\% = 7.2\%$$

On the other hand, another company that is also expected to earn 9 percent but only retains 20 percent of its earnings might be expected to have a growth rate of 1.8 percent, computed as follows:

$$0.20 \times 9\% = 1.8\%"$$

(ii) *"Turning to dividends, during the second quarter, Valener paid dividends of \$9.4 million to its common shareholders, either in cash or in shares for those who elected to take advantage of the dividend reinvestment plan. For the current quarter, Valener's Board maintains a dividend of \$0.25 per common share, payable next July 15. As planned, Valener will have paid to its shareholders an annualized dividend of \$1.00 per share for fiscal 2013.*

The distribution to be paid by Gaz Métro to Valener this coming July will be the last one to include the enhanced distribution established back in 2010, at the time of Gaz Métro's reorganization which saw the creation of Valener. The total amount of that enhanced distribution will have represented \$20 million over a three-year period ending next September 30th.

As communicated at the time of our reorganization, and as shown on page 5, the game plan is now to use the cash flows generated by phase I of the Seigneurie de Beaupré wind power projects to allow Valener to maintain its \$1 annual dividend over time. The 272 MW project is on time and on budget. The commissioning is expected to be in December 2013. Any timing difference would be covered by Valener's committed credit facility, which is currently largely unused. [Emphasis added]

Certain observations cannot not be readily reconciled with a dividend growth forecast of 7% per annum applied by Concentric in Exhibits JMC-11, Schedules 4 to 6:

- (a) Valener has not argued for an increase in its dividend of \$1.00 since its creation. Furthermore, Société en commandite Gaz Métro has not argued for an increase in its declared distribution per unit since 2003, the latter was even reduced from \$1.36 in 2003 to \$1.12 in 2012.
- (b) Valener has not covered its dividend for three years, both as regards net profits and cash flows from operating activities, and the shortfall for three years amounts to \$20 million. Furthermore, in its May 13, 2013 communication to analysts and investors (as in its previous communications), Valener management does not talk about increasing its dividend, but only maintaining it at the same level of \$1.00 "over time".
- (c) In slide 5 of the quarterly presentation of its results, Valener management indicates to investors that for the coming years (2014 and subsequent years) the \$1.00 dividend should be just covered (distribution rate of approximately 95%).
- (d) Return on shareholder equity realized by Valener in 2012 was only 4.4%, and at best its retention rate of expected earnings is 5% (1-95%) in 2014, which would give an imputed internal growth rate of 0.2% (4.4% * 5%).
- (e) Merely by including Valener in the Canadian proxy group, given the dividend growth assumptions used by Concentric, increases the group's average return on equity by over 50 basis points. For example, in Exhibit JMC-11, Appendix 5, the average return on equity would be 9.10% by including Valener, and 8.57% by excluding it.

Requests:

- 5.1 Please file a copy of the Valener speaker's notes for the teleconference held on May 13, 2013, following publication of the results for the second quarter of its 2013 fiscal year (available on the company's website).

R5.1

Please see Request 5.1 Attachment 1.

- 5.2 Please file a copy of the slides presented to investors during the teleconference held on May 13, 2013, following publication of their financial performance for the second quarter of fiscal 2013 (available on the company's website).

R5.2

Please see Request 5.2 Attachment 1.

- 5.3 Please file a copy of Valener's 2012 Annual Report.

R5.3

Please see Request 5.3 Attachment 1.

- 5.4 Considering the foregoing observations, please demonstrate how annual dividend growth in the order of 7% per year is possible for each of the next 5 years, as used in Exhibit JMC-11, Appendices 4 to 6.

R5.4

The growth rate in the DCF model is based on analysts' expectations for future growth in earnings per share. In other words, the DCF model uses market-based data to measure investors' return expectations. Since dividends are a function of earnings growth, it is entirely reasonable to use earnings growth as a surrogate for dividend growth. In this particular instance, the estimated growth rate for Valener is 7.0 percent (or 8.00% as indicated in response to Question 3.1). This growth rate represents the markets' consensus expectations for earnings and dividend growth for Valener over the next five years. We assume the analysts preparing these forecasts are aware of management's presentations and factor these into their growth rate estimates. Concentric notes that, although we have reported DCF results for the Canadian proxy group, we have given more weight to the DCF results for the U.S. electric utility proxy group and have used the Canadian DCF results and the Reconciled CAPM results to corroborate the reasonableness of our recommendation.

6. **Reference:** Exhibit B-0007, pages 92-95.

Preamble:

Page 92:

"Q. What is "optimism bias" in the earnings growth rate forecasts of security analysts, and how would it affect an estimate of the ROE?"

- A. *Optimism bias is related to the alleged tendency for analysts to forecast earnings growth rates that are higher than are actually achieved If optimism bias were present in analysts' earnings forecasts, it could create an upward bias in the estimated cost of capital that results from the DCF approach."*

Q. Is it reasonable to believe that analysts' earnings growth estimates currently may be overly optimistic or may represent a conflict of interest?

A. No. Several regulatory changes have been implemented that are designed to provide fair disclosure and eliminate analysts' bias. On August 15, 2000, the U.S. Securities and Exchange Commission ("SEC") adopted Regulation FD to address the selective disclosure of information by publicly traded companies and other issuers. Regulation FD provides that when an issuer discloses material information, the issuer must publicly disclose that information to all investors at the same time. In this way, the new rule aims to promote full and fair disclosure." [...]

Page 94:

"Q. Has any research been conducted to measure whether analyst forecast bias exists since the Global Settlement was implemented?

A. Yes. A 2010 article in Financial Analyst Journal found that analyst forecast bias has declined significantly or disappeared entirely since the Global Settlement:

Introduced in 2002, the Global Settlement and related regulations had an even bigger impact than Reg FD on analyst behavior. After the Global Settlement, the mean forecast bias declined significantly, whereas the median forecast bias essentially disappeared. Although disentangling the impact of the Global Settlement from that of related rules and regulations aimed at mitigating analysts' conflicts of interest is impossible, forecast bias clearly declined around the time the Global Settlement was announced. These results suggest that the recent efforts of regulators have helped neutralize analysts' conflicts of interest.^{112"}

Request:

6.1 Please file the article from the Financial Analyst Journal quoted in the answer at page 95 of the Concentric report.

R6.1

Please see Request 6.1 Attachment 1.

7. **Reference:** Exhibit B-0007, page 25.

Preamble:

"Q. Did you also consider a third proxy group of government-owned electric utilities in Canada?

A. Yes. Since HQD and HQT are divisions of a government-owned crown corporation, Concentric also selected a group of municipal and provincial government-owned Canadian electric distribution and transmission utilities for purposes of comparing the authorized ROE of HQD and HQT to those entities.

That group consists of the following six companies:

- *British Columbia Hydro*
- *ENMAX Corp.*
- *EPCOR Utilities, Inc.*
- *Hydro One Networks*
- *Manitoba Hydro*
- *Saskatchewan Power"*

Request:

- 7.1 Please provide, for each of the above six companies, the authorized return on equity, the date the Regulator's decision concerning that return was rendered, the earned return on equity realized, as well as the proportion of equity accepted by the Regulator.

R7.1

Please see Request 7.1 Attachment 1.

8. **Reference:** Exhibit B-0007, pages 25-26.

Preamble:

In order to establish HQT D's American proxy group, Concentric proceeded as follows:

"As a starting point, Concentric utilized the 48 companies that Value Line classifies as Electric Utility Companies to ensure that the company is considered to be primarily engaged in electric utility operations. From that group, Concentric screened for companies that:

- *Have credit ratings from S&P of at least A-;*
- *Pay dividends;*
- *Have earnings growth rates from at least two utility industry analysts;*
- *Derived at least 60 percent of their revenue from regulated operations in the period from 2009-2011;*
- *Derived at least 60 percent of their regulated revenue from electric utility operations in the period from 2009-2011;*
- *Are not considered a small capitalization company; and,*
- *Are not involved in a merger or other transformative transaction that had a material effect on the company's stock price during the evaluation period.*

Q. What companies met those screening criteria?

A. The following six companies met those criteria:

- *Consolidated Edison Inc.*

- *Next Era Energy, Inc.*
- *Northeast Utilities.*
- *Southern Company.*
- *Wisconsin Energy Corp.*
- *Xcel Energy Inc."*

Requests:

- 8.1 Please file, in the form of electronic files, the Form 10-K reports filed with the United States Securities and Exchange Commission, for the last fiscal year of each company selected.

R8.1

Please see Request 8.1 Attachments 1 through 6.

- 8.2 Please file, in the form of electronic files, for each subsidiary in the suggested sample, the last decision concerning the return on equity for each company in the U.S. proxy group rendered by their respective regulators.

R8.2

Please see Request 8.2 Attachments 1 through 22.

VARIANCE ACCOUNTS

- 9. References:** (i) Exhibit B-0004, page 24;
(ii) Exhibit B-0007, pages A-21 and A-22.

Preamble:

(i) *"Furthermore, the Transmission Provider and the Distributor maintain the following variance accounts set up to ensure fair treatment of the parties and to cover significant factors beyond their control. These accounts are as follows:*

Transmission Provider

- *variance account for revenue from point-to-point transmission services;*
- *variance account for pension costs;;*

Distributor

- *"pass-on" account for the purchase of electricity;*
- *variance account for native-load transmission service;*
- *smoothing account for transmission and distribution revenue for weather conditions;*
- *variance account for fuel costs;*
- *variance account for load retention rates;*
- *variance account for pension costs;*
- *variance account for major outage costs;*
- *variance account for costs related to the Bureau de l'efficacité et de l'innovation énergétiques."*

(ii) *"[...] Table 13 summarizes the percentage of operating companies (based on number of customers) in the Canadian and U.S. proxy groups that has some form of cost recovery mechanism for each of these costs."*

Table 13: Cost Recovery Mechanisms				
Cost	HQD	HQT	Canadian Proxy Group	U.S. Proxy Group
Pension expenses	Yes	Yes	69%	36%
Bad Debt expenses	No	No	5%	13%
Storm Cost Recovery	Limited ¹⁴²	No	0%	79%
Interest Rate Change	No	No	9%	17%
Energy Efficiency/ DSM	No	N/A	81%	76%

Requests:

- 9.1 Please complete the summary presented in Table 13 (reference (ii)) in relation to all existing variance accounts of the Transmission Provider and Distributor (reference (i)).

R9.1

As discussed on pages A-3 through A-5 of Exhibit HQT D-2, document 1 (B-0007), and as shown on Exhibit JMC-4, Schedule 2, none of the companies in the Canadian or U.S. proxy group is at risk for variations in fuel or purchased power costs. As shown on Exhibit JMC-4, Schedule 3, Newfoundland Power and Gaz Metro have weather normalization adjustment mechanisms and Fortis BC Electric has a revenue decoupling mechanism that includes weather. Among the U.S. proxy group, Consolidated Edison of New York and Western Massachusetts Electric have weather normalization mechanisms and Alabama Power and Mississippi Power have formula rate plans that allow for annual rate adjustments for changes in volume/demand.

Concentric did not include other factors (i.e., variances in revenue from point-to-point transmission, variance account for native load transmission, and variance account for load retention rate) in our risk analysis. In our view, the cost recovery mechanisms shown on Table 13 pertain to the most important additional costs from the perspective of equity and debt investors. A discussion of our research and analysis of the risks associated with changes in demand/volume for electric transmission companies appears on pages A-7 through A-9 of Exhibit HQT D-2, document 1 (B-0007). Concentric's general conclusion, based on our research, is that the companies in the Canadian and U.S. proxy group are not exposed to meaningful cost recovery risk associated with changes in transmission demand/volume.

- 9.2 Considering the first three variance accounts (*pass-on*, native-load transmission and weather conditions) which alone affect approximately 70% of the Distributor's revenue requirements, please elaborate on the Distributor's level of risk.

R9.2

Concentric agrees that the Distributor has variance accounts that offer protection against risks associated with fuel supply, native load transmission, and changes in volume due to abnormal weather. For purposes of establishing a reasonable rate of return on equity, it is necessary to assess the relative business and financial risk of the Distributor (and the Transmission Provider) compared with the proxy groups of U.S. electric utility companies and Canadian utilities. As discussed on page 9 of Exhibit HQT D-2, document 1 (B-0007), both Canadian and U.S. regulators have provided the operating companies in the proxy groups with cost recovery and revenue stabilization mechanisms that mitigate many of the important business risks, such as fuel supply, fluctuations in volume/demand, capital investment costs, and operating costs that tend to fluctuate significantly from year to year.

Based on the business risks discussed in Exhibit HQT D-2, document 1 (B-0007), Concentric found that the only important difference is that a percentage of electric utilities in the U.S. proxy group (and in Canada) own some regulated generation, which suggests that those companies have somewhat more business risk than the Distributor (and the Transmission Provider). The ROE recommendation of 9.20 percent is at the low end of the DCF results for the U.S. proxy group, and is supported by the results of the reconciled CAPM. Our recommendation reflects our assessment that the

Distributor has relatively lower business risk than the U.S. electric utilities. However, Concentric did not make an adjustment to the ROE recommendation to reflect the fact that the Distributor has relatively higher financial risk than the U.S. and Canadian proxy groups.

- 9.3 Do the proposals pertaining to the cost of debt presented in Exhibit B-0004, page 26 and the creation of a variance account for "*Interest Rate Change*" presented in Table 13 (reference (ii)), have a similar impact on the Transmission Provider's level of risk and that of the Distributor? Please elaborate and quantify.

R9.3

The proposal to update the cost of debt forecasts in December or the introduction of a variance account for changes in interest related costs would have different impacts on the Transmission Provider and the Distributor risks. The introduction of a variance account for changes in interest related costs would eliminate the risks of under recovery of actual debt costs (other than the time required to clear the variance account), so it would be a nominally lower risk than the company proposal, which relies on a more current forecast. The company remains at risk for any differences between actual and forecast debt costs. However, neither of these mechanisms would have a material impact on the overall level of business or financial risk of the companies.

- 9.4 Please indicate if the new method for establishing expenses for bad debts presented in the Distributor's 2013 rate case (Matter No. R-3814-2012, Exhibit B-0024, page 39, Appendix E) and authorized by the Régie (Decision D-2013-037, page 81) has reduced the Distributor's risk, compared to the method used in previous rate cases.

R9.4

The method to establish the bad debt expense (BDE) presented in connection with the Distributor's File R-3814-2012 and authorized by the Régie in its Decision D-2013-037 consists in assessing the BDE in terms of projected sales. The BDE was previously assessed according to cost growth factors (according to the parametric formula) and specific elements.

This new method is further in line with the development of the economic context, the best indicator of which available to the Distributor is the volume of projected sales. This element thus proves to be a better driver to forecast the BDE than the progression of or change in operating costs, which, in the Distributor's opinion, will provide a better estimate of the BDE. This being the case, the fact of obtaining a more accurate BDE estimate does not impact the Distributor's risk. This risk is further tied to multiple factors that could have an upward or downward impact on the actual level of the BDE, such as the actual number of customers having moved without leaving any {forwarding} address, the specific aging of accounts receivable, the growing level of household debt or, there again, bankruptcies, and these factors remain unchanged.

This example indicates the efforts made to fine-tune the forecast models by including therein the latest and most pertinent data and knowledge in order to obtain the best possible forecasts.

EARNINGS SHARING MECHANISM (ESM)

- 10. References:** (i) Exhibit B-0004, page 22;
(ii) Follow ups-D-2012-024 and D-2012-059, Consultation on the financial policy and earnings sharing mechanism, page 10;
(iii) Exhibit B-0007, Exhibit JMC-4, Schedule 5.

Preamble:

(i) *"Robert C. Yardley, in his testimony produced in Exhibit HQT-D-2, Document 2, described the general principles of the ESM structure and the regulatory context in which they apply.*

The most common ESMs may include some or all of the following elements:

- *A definition of the ROE calculation, expressed as a percentage, for the purposes of applying the sharing formula and, specifically, the period to which the calculation applies (normally 12 months);*
- *Thresholds expressed as a percentage defining a deadband within which deviations are either fully absorbed or retained by the regulated enterprise; a number of ESMs observed do not have a deadband;*
- *For the portion of earnings deviations outside the deadband, a ratio establishes the percentage allotted to the regulated enterprise and the percentage allotted to customers;*
- *More complicated ESMs can be multi-tiered defined by several thresholds and various sharing ratios, for example, a first sharing threshold may have a sharing ratio of 75% for the regulated enterprise, a second threshold, a sharing ratio of 50% and a third, 25% or 0%;*
- *Methods for attributing earnings to customers in subsequent years.*

If the sharing thresholds and sharing ratios result in the same sharing percentage for a negative or positive deviation of the same size, the ESM is considered a symmetric ESM; otherwise it is an asymmetric ESM." [Emphasis added]

(ii) *"Hydro-Québec willing to facilitate discussions concerning ESMs using a benchmark study documenting the different variants adopted in other jurisdictions. The interested parties will be asked to comment on those approaches. Although the ESM concept is not per se complex, choices concerning an ESM's parameters can be complex and the subject of diverging points of view." [Emphasis added]*

(iii) The expert's evidence presented a table showing, for each company in the Canadian and U.S. Proxy group and for the Distributor and the Transmission Provider, a summary of the features of the respective rate regulation and the method for sharing overearnings. The Régie understands that the table is the result of a more exhaustive analysis of the ESMs or other mechanisms prevailing in the comparable companies.

Requests:

Questions 10.1 to 10.3 are also addressed to Robert C. Yardley

10.1 Please file the benchmark study of ESMs for companies in the Canadian and U.S. proxy groups. Please indicate for each company:

- A description of the authorized ESM;
- Indication of the regulatory framework: Cost of service or Incentive Mechanism;
- The authorized rate of return;
- Whether or not the ESM is conditional on the achievement of certain performance indicators, if so, identify them;
- If the ESM is associated with a regulatory closing of books process;
- Other relevant information.

R10.1

Request 10.1, Attachment 1 presents a summary of rate plans for the Canadian and U.S. Proxy Groups. Request 10.1, Attachment 2 presents a summary of rate plans for selected electric utilities that have ESMs but are not part of the Proxy Groups. Rate plans do not always fit neatly into either the “cost of service” or “incentive mechanism” classifications so further information is provided under this category.

A few comments are appropriate with respect to the Proxy Group. Three of the utilities that have recently been subject to an incentive mechanism are now operating under alternative approaches. Gaz Métro is operating under cost of service-based regulation during a transition period and the plan includes an ESM. Both the prior plan and the current plan are summarized in the table. Two companies merged in 2012 (Northeast Utilities and NSTAR) and reached multi-year rate agreements as part of merger approvals in Connecticut and Massachusetts. These plans do not include ESMs.

Two general conclusions can be drawn from these two Attachments:

- **Explicit tying of ESMs to performance metrics appears to be rare. Only two members of the Proxy Group (Gaz Métro and Mississippi Power) have such an arrangement.**
- **Some regulatory closing of the books (often called “Compliance Filings” in the U.S.) is required to document the calculation of earnings sharing, although efforts are made to minimize the potential regulatory burden on all parties. Stakeholders receive a copy of the compliance filing and have an opportunity to submit comments to the regulator on whether the calculations are consistent with the intent of the regulator’s decision. The regulator will formally acknowledge the final change in rates before they are implemented by the utility, but a formal regulatory proceeding is not required.**

10.2 Please explain and comment on the mechanisms observed that do not have a deadband (reference (i)).

R10.2

Only two utilities in the Proxy Groups have ESMs with sharing that begins with the first dollar of earnings above the allowed ROE (e.g., no upside deadband). These are Gaz Métro's former and current rate plans, and Public Service Company of Colorado. In the latter case, it is important to note that the ESM was one element of a comprehensive rate case settlement agreement reached among the parties. It is difficult to comment on the appropriateness of a single parameter in a comprehensive settlement that most likely involved trade-offs among several parameters by the parties.

- 10.3 Considering that overearnings can be explained by forecast errors and efficiency gains, please comment on the likelihood of a 50% /50% overearnings sharing mechanism without a deadband, for the Transmission Provider and the Distributor and their customers.

R10.3

As stated in Mr. Yardley's testimony, the design of an ESM reflects (1) a desire to constrain earnings variability, and (2) a desire to pursue operating efficiencies. The Transmission Provider's and the Distributor's proposals each strike a proper balance between these two objectives and also balances the risk and return between the Transmission Provider and the Distributor and their respective customers. The deadband serves a critical role in achieving both objectives.

As implied by the question, earnings variations are caused by forecast differences (factors largely beyond the control of the Transmission Provider and the Distributor) and by efficiency improvements that are the result of management action. Rate case forecasts reflect four months of actual data and the remaining eight months are based on an analysis of historical data and the end result is also evaluated in some cases (e.g., net operating expenses) by the application of a parametric formula. They are also scrutinized by the Régie and by stakeholders through requests for information and cross-examination at hearings before a decision is ultimately made regarding the forecast values to be used to calculate rates. Despite these considerable efforts, forecasts of revenues and costs will differ from actual results and contribute to earnings volatility, to the extent that they are not addressed by variance accounts. These forecast differences are part of the normal ebb and flow of the utility business and are a source of risk. the Transmission Provider and the Distributor have experienced both positive and negative variances over the past decade.

The deadband recognizes forecast differences in three ways. First, it recognizes the fact that there is earnings volatility that merely reflects the

normal ebb and flow of the business. Second, it provides an opportunity for the Transmission Provider and Distributor to retain a modest level of earnings above the authorized ROE to fairly balance and compensate the utility for absorbing all of the down-side risk, as is proposed by the Transmission Provider and the Distributor. They have proposed relatively narrow deadbands that are approximately one-half of the earnings variability that has been experienced by the Transmission Provider and Distributor. Third, the deadband provides a cushion within which it is not necessary to change customer rates, thus limiting the regulatory burden associated with rate changes.

In summary, the Transmission Provider's and the Distributor's ESMs address the concerns that created the interest in an ESM proposal (earnings variability), do so in a manner that fairly balances the risks that are assumed by the Transmission Provider and the Distributor, and maintain an adequate incentive to pursue operating efficiencies.

11. Reference: Exhibit B-0004, page 24.

Preamble:

"The existence of a deadband, within which positive deviations are fully retained by the Transmission Provider and the Distributor, is for them fundamental in order to maintain sufficient incentive to achieve efficiency gains. As regards the sharing percentage of 50% for any greater deviation, the Transmission Provider and the Distributor are of the view that this is a reasonable sharing in order to achieve the objectives of fairness, maintenance of efficiency incentives and simplicity of application. It also takes into account that they will fully absorb negative deviations.

The proposed asymmetric ESM would reduce the regulatory burden by avoiding contestations of management decisions when the mechanism is applied in negative deviation situations. Dealing with positive deviations globally without distinguishing the factors that contributed to such deviations, irrespective of whether or not they are within the control of the regulated divisions, would also streamline the process." [Emphasis added]

Request:

11.1 Please comment on the fact that the deadband within which positive deviations are fully retained by the Transmission Provider and the Distributor also includes forecasts differences that are not the result of gains in efficiency.

R11.1

The Transmission Provider's and the Distributor's ESM proposals are designed to address earnings variability that is attributable to either forecast differences or efficiency improvements.

This approach responds to the fact that actual earnings variances will reflect both efficiency gains that result from specific Transmission Provider and Distributor actions as well as the consequence of forecast differences that are

beyond the control of the respective utility and that are not addressed by variance and deferral accounts. Mr. Yardley described some of these circumstances in his testimony, including the fact that sales levels and associated revenues may be higher or lower than reflected in the calculation of rates due to changing economic conditions. These unanticipated revenue and cost outcomes will impact earnings and contribute to the financial risks of the business.

To address these risks, the Transmission Provider and the Distributor have each proposed an asymmetric deadband for both the Transmission Provider and Distributor, under which they will continue to absorb 100 percent of the risks of negative variances. Under these circumstances, it is a reasonable balancing of risk for the Transmission Provider and Distributor to be allowed to retain positive variances up to a reasonable upper bound before beginning to share the benefits of positive variances (whether attributable to circumstances beyond their control or as a result of efficiencies) with customers.

12. Reference: Exhibit B-0004, page 25.

Preamble:

"However, the Transmission Provider and the Distributor propose that the current process for reviewing their respective costs of service and performance be maintained. This regular review process, implemented by the Régie in their rate applications, allows for yearly monitoring of changes in costs as well as efficiency and quality-of-service indicators for each division respecting many variables." [Emphasis added]

Requests:

12.1 Please comment on the possibility of the ESM being conditional on the achievement of certain performance indicators. If yes, identify them.

R12.1

It is possible to condition the realization of the utility portion of earnings sharing on the achievement of minimally acceptable (in contrast to stretch goals) performance standards, particularly if there is a legitimate concern that pursuit of efficiency gains could have an impact on certain performance indicators.

There is no evidence that it has been the case for both the Transmission Provider and the Distributor. Mr. Yardley has nevertheless identified several practical challenges that would need to be addressed before any formal linking of performance results to financial outcomes. Also, it is worth noting that only two of the companies among the Proxy Group explicitly tie the sharing under the ESM to the performance results.

The Transmission Provider and the Distributor wish to add the following additional information:

The regulatory regime currently in place already includes a set of performance and quality of service indicators. The monitoring of these indicators provides, among other things, assurances that these

performance measures are not implemented to the detriment of the quality of the service.

In this respect, the Transmission Provider's performance indicators are concerned with customer satisfaction, the reliability of the service, cost behaviour and environmental indicators.

In its rate applications, the Transmission Provider presents the analysis of the indicators retained by the Régie, according to requirements expressed by it in its decisions. A history of the results is also presented.

With regard to the Distributor's performance indicators, they deal with customer satisfaction, the reliability of the electrical service, the quality of the service and safety.

Like the Transmission Provider, the Distributor provides a detailed follow-up of each of its performance indicators in its annual reports and their progression over a five-year period in each of its rate files.

Globally, the results in recent years for the Transmission Provider and the Distributor show that the performance of the two divisions does not constitute an issue.

Moreover, during this period, the divisions posted significant recurring efficiency gains, directly taken into account in the determination of the required revenue and thus fully transferred to the customer base.

The concern according to which such gains can be realized to the detriment of the quality of the rendered service, does not rest on any factual data. The Transmission Provider and the Distributor reiterate and underscore that the ESM is basically intended to respond to the Régie's request to deal with performance variances. Thus, in the opinion of the divisions, it is not justified to make the ESM conditional upon the achievement of performance targets.

It is, in fact, accepted that the quality of the service and the search for efficiency are not the subject of any arbitration for the government-owned crown corporation, i.e., Hydro-Québec. For the Transmission Provider and the Distributor, achieving performance and efficiency targets that benefit all their customers is indisputable. All decisions on efficiency actions are already made from this perspective and they are intended to include the mean annual growth of costs while globally maintaining the same quality of service and reliability.

For all these elements, in addition to those raised in Exhibit HQTD-2, Document 2 (B-0008), page 17, the Transmission Provider and the Distributor estimate that an application of the ESM conditional upon the achievement of performance targets is neither useful nor appropriate.

- 12.2 Please comment on the possibility, in the annual review process concerning the respective costs and performance of the Transmission Provider and the

Distributor, of considering the use of certain existing indicators to determine the annual deadband applied in the ESM.

R12.2

The structure of the ESM (including the deadband and sharing percentages) should be based on a fair allocation of financial risks and the value of maintaining an adequate incentive for the Transmission Provider and Distributor to pursue efficiencies. Concerns regarding performance can be addressed outside of the ESM through a separate review.

The Transmission Provider and the Distributor wish to assert the following additional elements.

The ESM proposed by the Transmission Provider and the Distributor, the purpose of which is to respond to the Régie's request to deal with performance variances, tallies, among other things, with an objective of the straightforwardness of regulatory enforcement and relief to deal with this question. Its structure, of which the deadband forms part, was developed to strike and maintain a fair balance in terms of the risk assumed by the divisions, while promoting the pursuit of efficiency gains.

However, the divisions are of the opinion that the yearly determination of the deadband in terms of various variables, including the results of the performance indicators, would not fail to give rise to debates that would be counter to the referred regulatory straightforwardness and relief, in addition to introducing a considerable issue of continuity regarding the application of the ESM from one year to the next.

Consequently, the Transmission Provider and the Distributor feel that it is not desirable to complicate the application of the ESM by a yearly re-evaluation of its parameters in terms of the results of the performance indicators.

Lastly, the Transmission Provider and the Distributor refer the Régie to the answer to Request 12.1 on the appropriateness and difficulties of linking the sharing mechanism to performance indicators.

- 12.3 Please indicate the regulatory framework in which the Régie will examine overearnings and make adjustments, as the case may be, for the purpose of the ESM.

12.3

It is not necessary to create a new administrative burden in order to implement the ESM. This can be achieved using financial results of the prior year, including all supporting results and calculations in a format that can be easily reviewed by the Régie. The customer sharing can be scheduled to occur at the same time as the next change in base rates if this contributes to administrative efficiency and minimizes customer confusion. It is apparent from reviewing other ESMs that an effort is made to minimize any potential administrative burden from filings that reflect a regulatory closing of the books. In some cases, stakeholders are provided with copies of the filing and can ask questions but a formal regulatory proceeding is not required.

The Transmission Provider and the Distributor wish to assert the following additional elements.

In Exhibit HQTD-1, Document 1 (B-0004), pages 25 and 26, the divisions propose a management of performance variances as follows:

- the recognition of the actual performance variance in connection with the annual year-end report;
- the payment of the variance noted in a non-rate base variance account in the rate file;
- the treatment in a subsequent year's rate application.

Pursuant to Section 75 of the Act respecting the Régie de l'Énergie, the Régie has required annual reports from the Transmission Provider and the Distributor annually since 2001.

The annual reports already set out the detailed financial and commercial results of the regulated divisions as well as the performance indicators, in accordance with Decision D-2002-175 rendered by the Régie in File R-3482-2002 as well as in subsequent decisions stipulating its requirements over time. Furthermore, the Régie has all the leeway needed to send any request for information to the divisions enabling it to determine the compliance of these reports in order to declare its satisfaction therewith pursuant to its review.

The divisions are of the opinion that this tried and tested strict regulatory framework is adapted to draw up the annual statement of performance variances and determine the amounts that must or must not be remitted to the customer base pursuant to the ESM that will be approved.

The addition of a new phase, such as a regulatory closing in the course of a public hearing, would potentially introduce new delays and would weigh down the process to review the annual results as currently ongoing. In addition, the Transmission Provider and the Distributor are of the opinion that the application of the ESM as proposed does not require the addition of any such phase.

For these reasons, the Transmission Provider and the Distributor do not favour the application of a regulatory closing to analyze the performance variances noted each year.

- 12.4 In addition to lightening the regulatory burden, please indicate the advantages and disadvantages of implementing a regulatory closing of books associated with the ESM.

R12.4

Besides the advantages associated with the regulatory relief, the Transmission Provider and the Distributor point out the lack of need to foresee such a phase given the proposed simple variance processing mechanism. Also see the answer to Request 12.3.

- 12.5 Please indicate what the Transmission Provider and Distributor's position would be regarding a review of the overearnings pertaining to the ESM in a regulatory closing of books.

R12.5

See the answers to Requests 12.3 and 12.4.

- 13. References:**
- (i) Transmission Provider's 2007-2012 Annual Reports, Exhibit HQT-2, Document 1.1;
 - (ii) Distributor's 2007-2012 Annual Reports, Exhibit HQD-2, Document 3.

Preamble:

- (i) In its 2007-2012 annual reports filed under section 75, the Transmission Provider presented a comparison of recognized regulatory performance and revenue requirements, and explained the main differences.

The Régie has prepared the following table based on information in the Transmission Provider's 2007-2012 annual reports:

Table 13.1
Source of the Transmission Provider's 2007-2012 earnings deviations (in \$M)

	AR 2012	AR 2011	AR 2010	AR 2009	AR 2008	AR 2007
REVENUE						
Transmission	-0.1	0.0	0.0	0.0	0.0	0.0
EXPENSES						
Net operating expenses	-46.6	-50.5	-58.1	-40.0	-21.5	22.3
Direct gross expenses	-46.0	-32.2	-46.6	-31.1		
Shared service expenses	-11.4	-14.7	1.9	11.5		
Capitalized costs	10.7	-11.9	-24.3	-23.1		
Intersegment customer expenses	0.1	-2.9	0.9	2.7		
Régie Decision		11.2	10.0	0.0		
Other expenses	-49.0	7.3	-3.6	14.9	-2.4	7.3
Power transmission purchases	-4.0	-4.3	-6.4	5.8	-1.0	-1.4
Depreciation and amortization	-45.2	14.9	13.6	15.1	-6.9	11.1
Taxes	-1.9	-4.1	-10.6	-7.2	4.3	-2.4
Other intersegment customer expenses	2.1	0.8	-0.2	1.2	1.2	
VA – pension expenses	-1.0	16.8				
External customers and other units	-6.7	-10.9	-11.5	-10.2	-5.1	-0.8
Accretion expense	0.3					
Cost of debt	-49.1	-29.6	-14.7	-48.3	-2.7	34.6
Total expenses	-152.1	-66.9	-87.9	-83.6	-31.7	63.4
Earnings deviations	152.0	66.9	87.9	83.6	31.7	-63.4

AR: Annual report

(ii) In its 2007-2012 annual reports filed under section 75, the Distributor presented a comparison of recognized regulatory performance and revenue requirements, and explained the main deviations.

The Régie has prepared the following table based on information in the Distributor's 2007-2012 annual reports.

Table 13.2
Source of Distributor's 2007-2012 earnings deviations (in \$M)

	AR 2012	AR 2011	AR 2010	AR 2009	AR 2008	AR 2007
REVENUE						
Electricity sales net of electricity purchases	33.1	37.6	78.3	-4.1	-18.7	8.1
Revenues other than sales of electricity	-7.1	-8.3	13.8	30.5	31.6	21.9
External customers	-9.3	-11.3	9.9	18.8	21.3	21.0
Intersegment customers	2.2	2.5	3.7	11.7	10.3	0.9
Interest credit – Gov't. refund	0.0	0.5	0.2	0.0	0.0	0.0
Total revenues	26.0	29.3	92.1	26.4	12.9	30.0
EXPENSES						
Operating expenses	-26.4	-22.8	-26.7	-38.9	-3.6	-11.5
Direct gross expenses	-22.6	-7.3	-85.2	-85.4	-1.2	-0.3
Shared service expenses	-20.5	-7.2	54.1	40.9	-2.5	-1.9
Capitalized costs	42.9	6.9	11.5	10.1	11.2	-0.6
Revenue-Cost recovery (1)	-26.2	-15.2	-7.1	-4.5	-11.1	-8.7
Corporate costs	-3.5	-8.3	-12.5	-9.8	-4.6	-3.5
Other expenses	-31.9	-28.3	-24.8	-1.3	-6.6	8.3
Depreciation and amortization	-24.9	-25.4	-19.7	2.3	0.1	18.1
DEA – Major Projects	-5.6	-0.1				1
Taxes	-1.4	-2.8	-5.1	-3.6	-1.4	-2.5
Fuel purchases	0.0	0.0	0.0	0.0	-5.3	-7.3
Accretion expense	-0.1					
Cost of debt	-23.5	-12.5	-15.3	-29.3	-1.1	27.3
Total expenses	-85.4	-71.9	-79.3	-79.3	-13.7	20.6
Earnings deviations	111.4	101.2	171.4	105.7	26.6	9.4

Note 1: Reclassified as per the presentation requested in rate case 2013 (R-3814-2012) and authorized in D-2013-037.

AR: Annual report

Requests:

- 13.1 Please confirm or complete, as the case may be, the information on earnings deviations for 2007-2012 period of the Transmission Provider and Distributor respectively, presented in references (i) and (ii).

R13.1

The Transmission Provider validated table 13.1 and confirms that the performance variance data for the 2007-2012 period is correct.

The Distributor validated table 13.2 and confirms that the performance variance data for the 2007-2012 period is correct.

- 13.2 Please indicate if the source of variances in the Transmission Provider's and Distributor's operating expenses is attributable to efficiency gains and/or forecast variances. Please quantify.

R13.2

The variances relating to operating costs stem in all cases from variances between forecasts and actual costs noted for a given year. However, some of these variances stem from unexpected efficiency gains, but are difficult, even impossible in certain cases, to distinguish from forecast variances.

In fact, the Transmission Provider and the Distributor make decisions on a daily basis and globally and dynamically manage their costs while respecting the budget established according to a parametric method and recognized by the Régie. In this context, expenses over and above the amount allotted for certain budgetary items must be offset by cost-cutting in other budgetary items.

The Transmission Provider and the Distributor present a global change analysis of their operating costs in their respective annual reports for 2007 to 2012 .

- 13.3 Please indicate if the Transmission Provider's and the Distributor's depreciation and amortization variances derive primarily from commissioning lead times, and if so, indicate if the variances are attributable to efficiency gains or forecast differences. Please explain.

R13.3

Depreciation variances are mainly attributable to the following elements:

- Value of commissioned capital assets;
- Commissioning delays;
- Useful life review;
- Value of net costs related to the disposal of fixed assets and intangible assets.

The change in the value of commissioned capital assets can be explained by efficiency gains and forecast variances. However, even with reasonable effort, the Transmission Provider and the Distributor cannot differentiate these two types of variances.

The variances due to commissioning delays, useful life review and the value of net costs related to the disposal of fixed assets and intangible assets are attributable to forecast variances.

An analysis of the depreciation expense change is presented in Exhibit HQD-2, Document 3, and in Exhibit HQT-2, Document 1.1, of the Transmission Provider's and the Distributor's annual reports for 2007 to 2012.

- 13.4 Please indicate if the cost-of-debt variances for the Transmission Provider and Distributor would be reduced if the Régie accepted the update as proposed by the applicants during the rate case.

R13.4

The goal of this proposal is, in point of fact, to reduce the variances relating to the costs of borrowed capital. This update is, if you will, a re-evaluation of the projected debt cost by taking into account the debt existing on a more recent date and by updating the assumptions regarding expected loans and interest rates. Moreover, this update will allow for an incorporation of the most recent financing completed during the reference year. This new evaluation would take rate and volume changes into account in the numerator and denominator of the cost of the debt.

While established for the purpose of reducing the variances relating to the costs of borrowed capital, the new cost obtained would remain a projection and would not eliminate all the variances with the actual debt cost.

Currently, when the financial policy is filed, the evaluation of the cost of the debt takes into account the debt existing as at April 30 of the reference year, new expected loans, as established on such same date, and the economic variables obtained from Consensus Forecasts published in May.

The proposal to update the cost of the debt would take into account the debt existing as at October 31 of the reference year, thus incorporating the new financing completed during the months of May to October. Likewise, any other financial transaction carried out during this period, in connection with the management of the debt, would be considered. Thus, considering these recent transactions as well as market developments, a new projection of the loans would be drawn up and used in the revised calculation of the cost of the debt. Lastly, the rates would be established based on Consensus Forecasts for November. For the rate forecasts applicable to Hydro-Québec, the methodology in effect in previous rate files would be applied.

This proposal is in keeping with a context where the update should be submitted to the Régie de l'énergie and to the intervening parties. Also, as the information request period would be over at the time of its filing, the Transmission Provider and the Distributor propose that the topic be discussed at the later hearing, namely the Distributor's, usually held in December. A subsequent update would not enable the Régie and the intervening parties to question the Distributor and the Transmission Provider on this review of the costs of the borrowed capital. Lastly, a simultaneous update would allow the Transmission Provider and the Distributor to submit the same revised borrowed capital costs knowing that they will obtain the same actual debt cost. In addition, to update on just one date would simplify the process.

- 13.5 Please comment on the causes of the Distributor's variances pertaining to sales of electricity net of purchases of electricity, specifically respecting growth in the number of accounts resulting from forecasted housing starts, the increase in electric heating customers, and increased production by industrial customers. Please indicate the extent to which they are attributable to efficiency gains or to forecast differentials.

R13.5

The volume variances in electricity sales to the residential customer base (Rate D) are, among other things, due to an unexpected growth in the number of subscribers, including the increase in the number of residential customers using electric heating. It results, in particular, from variances between actual and planned housing starts that varied between 5,400 and 16,400 per year over the 2007 – 2012 period.

The sales variances relating to the big business customer base (Rate L) are caused by industrial customer production cuts in 2007, 2008 and 2009. Weak world-wide demand, increased competition by emerging economies and the economic slowdown in 2008 followed by the recession in 2009 account for the drop in sales greater than expected, in particular, in the pulp and paper sector. Moreover, the economic recovery in 2010 as well as the temporary Rate L contract awarded to the Rio Tinto Alcan customer over the 2010-2011 period, to make up for the low flow coefficient in its reservoirs, basically account for the positive forecast variances notwithstanding the rationalizations in the pulp and paper sector.

As the Distributor mentioned in rate file R-3814-2012 of Exhibit HQD-13, Document 7, in response to question 1 by the CFIB, additional forecasting tools consisting in multiple linear regression models were developed for each consumer sector in order to improve precision forecasts. These models directly integrate economic and demographic variables like housing starts, employee compensation or economic statistics relating to industrial sectors, like pulp and paper, mines, metal processing and other manufacturing sectors.

(...)

TESTIMONY OF ROBERT C. YARDLEY OF CEA CONCERNING ESMs

The following questions are addressed to Mr. Robert C. Yardley:

14. Reference: Exhibit B-0008, pages 5 and 6.

Preamble:

"Q. What are the key parameters of an ESM?"

A. The ESM begins with the calculation of realized earnings for a preceding twelve-month period and this calculation is typically performed for each year of a multi year rate plan. Some adjustments could be necessary (such as the exclusion of revenue, cost, or plant items) to ensure a valid comparison between the authorized and realized ROE.

Using this comparison as a starting point, ESMs are defined by two key parameters (1) the size of a "deadband" around the authorized ROE, and (2) the "customer sharing percentage" or the sharing of earnings with customers that applies when realized earnings fall outside of the deadband."

Request:

14.1 Please indicate what exclusions could be necessary in the comparison of the authorized and realized rates of return (*ROE*) as the point of departure in the ESM of the Transmission Provider and that of the Distributor.

R14.1

The earnings sharing mechanism is intended to reflect earnings from regulated utility operations in a manner that is consistent with the establishment of revenue requirements in the rate decision. The need for exclusions will depend on the income statement that is used to calculate ROE for earnings sharing purposes. Thus, it should include impact on utility earnings of forecast differences and efficiency gains. However, any revenues and expenses that are not associated with regulated utility service should be excluded from the calculation if they were also excluded from the calculation of the revenue requirement used to establish rates in the rate case. There may be revenues and/or expenses that are associated with one or more unregulated services that are provided by the utility but are excluded from the rate case revenue requirement. These are sometimes referred to as "below-the-line" items. For consistency purposes, they should also be excluded from the calculation of the actual ROE that will be compared to the allowed ROE for purposes of calculating earnings sharing.

A second example of an expense that would be excluded from the earnings sharing calculation is a specific expense item that had been reviewed by the regulator and excluded from the revenue requirements used to establish rates. It would be inconsistent with the rate case determination to include that same expense item in the calculation of the actual ROE for earnings sharing purposes.

15. Reference: Exhibit B-0008, page 6.

Preamble:

"One of the purposes of having a deadband is to reflect the normal ebb and flow of the business and provide an incentive for the utility to manage costs throughout its operations. A second, but related purpose is to provide an incentive for the utility to implement initiatives that are designed to achieve operating efficiencies. These factors contribute to the evaluation of the size of the deadband."

Requests:

- 15.1 Please explain and discuss what factors would be taken into account respecting the deadband to reflect the normal ebb and flow of the business of both the Distributor and the Transmission Provider.

R15.1

There are many factors beyond the control of the utility that will affect either revenues (e.g., sales levels) or costs (e.g., costs of major inputs) and therefore affect earnings. When there is no ESM, the utility absorbs the risk that earnings will be higher or lower than the authorized return due in part to these factors. These circumstances are what Mr. Yardley refers to as the "normal ebb and flow of the business." They include forecast differences that are attributable to the differences between the volume of sales included in the design of rates and the actual sales that occur during the rate year. They also include the differences between the level of costs reflected in the design of rates and actual cost levels for cost items that are not addressed through variance and deferral accounts. The imposition of an ESM with a deadband preserves this allocation of risk attributable to the normal ebb and flow to the utility just as that faced by the utility before the implementation of an ESM.

- 15.2 Please explain, separately for the Transmission Provider and the Distributor, the nature and form of the incentive presented by having a deadband in the ESM. Please explain how that deadband would induce the Transmission Provider and Distributor to initiate projects oriented towards achieving greater or further efficiency gains.

R15.2

The utility retains 100% of efficiency gains as long as earnings fall within the deadband. The ability to retain 100% of efficiency gains, even if capped, provides management with the incentive to aggressively pursue opportunities to operate more efficiently. This will increase the likelihood and amount of customer sharing under the formula, and contribute to efficiencies that continue after rates are rebased. Management will not know until after the year is complete whether they are within the deadband or not and will maintain a persistent focus on achieving efficiency gains.

15.3 Please explain the relationship between the factors discussed in 15.1 and the size of the deadbands attributed to the Transmission Provider (50 basis points) and au Distributor (100 basis points) in the joint proposal that has been presented.

R15.3

Mr. Yardley recommended a wider deadband for the Distributor than the Transmission Provider to reflect the greater sensitivity of the Distributor's earnings to variations in revenues and operating expenses. This greater earnings sensitivity is attributable to the fundamental differences in cost structures between the two businesses. Using the most recent year for which data is available, the Distributor had operating expenses of \$1,270.9 million (excluding electricity purchases and transmission services) and a rate base of \$9,895.7 million. This contrasts with the Transmission Provider that had operating expenses that were nearly half as large (\$633.2 million) and a rate base that was approximately 70% higher (\$16,894.1). A 2.5% increase in operating expenses excluding "specific elements" will result in a 0.80% decrease in the ROE for the Distributor compared to a 0.31% decrease in the ROE for the Transmission Provider. The sensitivity of ROE to variations in operating expenses is the same irrespective of whether they result from forecast differences or efficiency programs. These calculations are shown in Table R-15.3A.

Table R-15.3A

	HQ - Distribution			HQ - Transmission		
	2012	Sensitivity		2012	Sensitivity	
Revenues						
Electricity sales	10,366.8	10,366.8		2,991.5	2,991.5	
Other revenues	173.9	173.9				
	10,540.7	10,540.7				
Expenses						
Supply:						
Electricity Purchases	4,895.9					
Transmission Services	2,583.9					
Subtotal Supply	7,479.8	7,479.8				
Distribution Operating Expenses:						
OpEx - Excluding Specific Elements	1,101.9	1,129.4	2.5%	633.2	649.0	2.5%
OpEx - Specific Elements	169.0	169.0		0.0	0.0	
Subtotal OpEx	1,270.9	1,298.4		633.2	649.0	
Other Dist Charges	1,016.6	1,016.6				
Subtotal Distribution OpEx	2,287.5	2,315.0				
Total Expenses	9,767.3	9,794.8				
Financing Costs	437.9	437.9				
Total Expenses	10,205.2	10,232.7				
Total Returns	335.5	306.0				
Earned Return on Rate Base	77.3,4	745.9				
Rate Base (13-months average)	9,895.7	9,895.7				
Earned Return on Rate Base - %	7.80%	7.52%				
Earned ROE	9.69%	8.89%	0.80%	9.54%	9.23%	0.31%
Based On:						
Capital Structure:						
Debt	65.0%	65.0%		70.0%	70.0%	
Equity	35.0%	35.0%		30.0%	30.0%	
Cost of Debt:	6.78%	6.78%		6.779%	6.779%	
Expenses						
Transmission Operating Expenses:						
Other OpEx - Excluding Specific Elements				633.2	649.0	2.5%
OpEx - Specific Elements				0.0	0.0	
Subtotal OpEx				633.2	649.0	
Other Transmission Charges				1,072.9	1,072.9	
Subtotal Transmission OpEx				1,706.1	1,721.9	
Financing Costs				802.0	802.0	
Total Expenses				2,508.1	2,523.9	
Total Returns				483.4	467.6	
Earned Return on Rate Base				1,285.4	1,269.6	
Rate Base (13-months average)				16,894.1	16,894.1	
Earned Return on Rate Base - %				7.61%	7.51%	
Earned ROE				9.54%	9.23%	0.31%
Based On:						
Capital Structure:						
Debt				70.0%	70.0%	
Equity				30.0%	30.0%	
Cost of Debt:				6.779%	6.779%	

Considered in this light, it should not be surprising that the Distributor has experienced greater earnings variances in recent years as the normal ebb and flow of the business includes variations in operating expenses as well as in sales revenues, which also tend to experience greater variations for the Distributor than for the Transmission Provider. One measure of the risks inherent in the “normal ebb and flow of business” is the average of the absolute ROE variances. However, it is necessary to first correct the data for changes in variance and deferral accounts to produce a consistent measure of earnings volatility over the historical period as these accounts affect earnings volatility. This has been accomplished by assuming that the variance accounts in place in 2012, have been in place throughout the historical period. Over the five-year 2008-2012 period, this average absolute ROE variance is 2.4% for the Distributor as compared to 1.5% for the Transmission Provider. The difference for the 2007-2011 period is 1.8% vs. 1.2%, the period for which data was available when Mr. Yardley prepared his testimony. A period of five years is more appropriate for this purpose than focusing on a single year.

A second measure of the risks inherent in the business is the standard deviation of observed ROE values. Applying this measure to the 2007-2011 period, the Distributor has a standard deviation of ROE variances of 1.6% as compared to 1.2% for the Transmission Provider, again supporting a larger deadband for the Distributor. This relationship is similar when considering the 2008-2012 period, as the Distributor has a standard deviation of ROE variances of 1.4% and Transmission Provider has a standard deviations of 1.0%. These calculations are presented in Table R-15.3B.

Table R-15.3B

HQ Distribution - Revenue Requirements, Expenses and Return						
	2007	2008	2009	2010	2011	2012
ROE Variance M\$	9.4	26.6	105.7	171.4	101.2	111.4
ROE variance %	0.31%	0.90%	3.16%	4.94%	2.86%	3.32%
Adjustments for retroactive application of all Variance Accounts since 2004+ yearly allowance for major breakdowns						
Patrimonial and Post-Patrimonial IE	n/a	n/a	n/a	n/a	n/a	n/a
Transmission Services	n/a	n/a	n/a	n/a	n/a	n/a
Weather Normalization Account	n/a	n/a	n/a	n/a	n/a	n/a
Fuel Purchases	-7.3	-5.3	n/a	n/a	n/a	n/a
Load Support Tariff Account	n/a	n/a	n/a	n/a	n/a	n/a
Pension Costs	0.7	-3.2	-31.5	-37.2	n/a	n/a
Major Breakdowns	0	5.7	n/a	n/a	n/a	n/a
Allowance for major breakdowns	8	8	n/a	n/a	n/a	n/a
Total Variance Accounts	1.4	-28.6	-31.5	-37.2	0	0
Adjusted ROE Variance M\$	10.8	3.0	74.2	134.2	101.2	111.4
Adjusted ROE Variance %	0.3%	0.1%	2.2%	3.8%	2.8%	3.2%
Absolute Value ROE Variance %	0.3%	0.1%	2.2%	3.8%	2.8%	3.2%
Standard deviation of adjusted ROE Variance						
2007-2011	1.6%					
2008-2012	1.4%					

5-Year Mean Values		
2007-2011	2008-2012	
1.8%	2.4%	

HQ Transmission - Revenue Requirements, Expenses and Return						
	2007	2008	2009	2010	2011	2012
ROE Variance M\$	-63.4	31.7	83.6	88.0	66.9	152.0
ROE variance %	-1.28%	0.85%	1.77%	1.69%	1.44%	3.15%
Adjustment for retroactive application before 2011 of pension cost variance account						
Pension Costs account M\$	-2.6	-16.9	-14.2	-19.2	n/a	n/a
Adjusted ROE Variance M\$	-66.0	14.8	69.4	68.8	66.9	152.0
Adjusted ROE Variance %	-1.5%	0.3%	1.4%	1.4%	1.3%	3.0%
Absolute Value ROE Variance %	1.5%	0.3%	1.4%	1.4%	1.3%	3.0%
Standard deviation of adjusted ROE Variance						
2007-2011	1.2%					
2008-2012	1.0%					

5-Year Mean Values		
2007-2011	2008-2012	
1.2%	1.5%	

Mr. Yardley's recommendation fairly reflects all of these factors, as well as the fact that the Transmission Provider and the Distributor have each proposed to accept all of the downside risk. The size of the deadband, in particular, incorporates a proposed upper bound for both the Distributor (1.0%) and Transmission Provider (0.5%) that is considerably lower than the historical experience. This reflects an effort to balance the concerns of the Régie regarding earning variances, and the importance of pursuing operating efficiencies for management because these efficiency gains benefit customers in subsequent years.

- 15.4 Please comment on the fact that the deadband within which positive variances are fully retained by the Transmission Provider and the Distributor also include forecast variances that are not the result of efficiency gains.

R15.4

As described in the response to 10.3, the deadband addresses both forecast differences and the need to promote efficiency gains. The deadband recognizes the fact that there is earnings volatility from forecast differences that merely reflects the normal ebb and flow of the business. The deadband provides an opportunity for the Transmission Provider and Distributor to retain a modest level of earnings above the authorized ROE to fairly balance and compensate the utility for absorbing all of the down-side risk, as is proposed by the Transmission Provider and the Distributor.

It is worth noting that ESMs do not distinguish among the sources of variances, whether they are attributable to circumstances within or beyond the company's control, or whether they are attributable to forecast differences. The ESM proposal is responsive to the expressed concern of the Régie that the Transmission Provider and the Distributor have been experiencing earnings variances. It would be extremely challenging to design such an approach, costly to prepare and review such an analysis and the results would still likely be subject to controversy.

16. Reference: Exhibit B-0008, page 11.

Preamble:

"Q. Are there any circumstances that are unique to either HQD or HQT (or both) that might affect the design of an ESM?"

A. There are several circumstances that are relevant for purposes of designing an ESM for HQD and HQT. These include:

- the recent earnings experience;*
- the practice of filing annual rate cases based on cost-of-service principles; and*
- the presence of variance and deferral accounts."*

Requests:

16.1 Please explain if the recurrence of forecast variances due to conservative forecasts are part of the circumstances that are unique to the Transmission Provider and the Distributor. Please discuss if such variances are included in the design of the Transmission Provider's and Distributor's ESM as proposed.

R16.1

Mr. Yardley has not reviewed the Transmission Provider's and the Distributor's forecast methodology other than to note that the forecast values that relied on to calculate rates are subject to considerable scrutiny by the Régie and other stakeholders before a final decision is reached. Thus, in preparing his ESM

recommendation, Mr. Yardley assumed that the revenue requirements forecast, including a compensatory return on equity, are objective, unbiased, and reflect the best available information when they are approved. The recommendation is designed to specifically address (1) the concerns of the Régie regarding historical earnings variances by proposing a deadband that is relatively small (approximately one-half the size) compared to the average of recent variances and (2) the importance of pursuing operating efficiencies for management because these efficiency gains benefit customers in subsequent years.

16.2 For the other regulated companies in the Canadian and U.S. reference groups please discuss the treatment by their regulatory authorities of forecast variances observed in their respective ESMs.

R16.2

Mr. Yardley has reviewed the relevant orders and did not see any discussion of the impact of forecast differences on the design of an ESM. Thus, the impact of forecast differences is not distinguished from the impact of efficiency gains for purposes of designing the ESM. However, it is apparent from the recent Gaz Métro rate decision that this is an area of particular concern to the Régie.

17. Reference: Exhibit B-0008, pages 11 and 12.

Preamble:

"As presented in Table 1, HQD and HQT have each been able to earn in excess of their authorized ROE over the past five years, with the exception of HQT in 2007."

Table 1		
Realized v. Authorized ROE		
	HQT	HQD
2007	-1.28%	+0.31%
2008	+0.85%	+0.90%
2009	+1.77%	+3.16%
2010	+1.69%	+4.94%
2011	+1.44%	+2.80%

Requests:

17.1 For illustration purposes, please complete table 1 in the Preamble indicating the information presented in the 2012 annual report filed recently by the Transmission Provider and the Distributor and provide details of the ESM proposed by the applicants, applicable as of 2007, for each year (basis point of the shortfall, of the deadband, of the 50% attributed to the applicants and of the 50% attributed to customers).

R17.1

**Tableau R-17.1A
Detail of the ESM for HQT (in %)**

	2007	2008	2009	2010	2011	2012
Authorized Earnings	7,50%	7,85%	7,63%	7,59%	7,14%	6,39%
Realized Earnings - No Sharing	6,22%	8,69%	9,40%	9,28%	8,58%	9,54%
Earning Variances - No Sharing	-1,28%	0,85%	1,77%	1,69%	1,44%	3,15%
Amount - Under-earnings	-1,28%	-	-	-	-	-
Amount - Deadband	-	0,50%	0,50%	0,50%	0,50%	0,50%
Amount - 50% HQT	-	0,17%	0,64%	0,59%	0,47%	1,32%
Amount - 50% Customers	-	0,17%	0,64%	0,59%	0,47%	1,32%
Realized Earnings - With Sharing	6,22%	8,52%	8,77%	8,68%	8,11%	8,21%
Earning Variances - With Sharing	-1,28%	0,67%	1,14%	1,09%	0,97%	1,82%

**Tableau R-17.1B
Detail of the ESM for HQD (in %)**

	2007	2008	2009	2010	2011	2012
Authorized Earnings	7,57%	7,74%	6,99%	7,85%	7,32%	6,37%
Realized Earnings - No Sharing	7,88%	8,64%	10,15%	12,79%	10,18%	9,69%
Earning Variances - No Sharing	0,31%	0,90%	3,16%	4,94%	2,86%	3,32%
Amount - Under-earnings	-	-	-	-	-	-
Amount - Deadband	0,31%	0,90%	1,00%	1,00%	1,00%	1,00%
Amount - 50% HQD	-	-	1,08%	1,97%	0,93%	1,16%
Amount - 50% Customers	-	-	1,08%	1,97%	0,93%	1,16%
Realized Earnings - With Sharing	7,88%	8,64%	9,07%	10,82%	9,25%	8,53%
Earning Variances - With Sharing	0,31%	0,90%	2,08%	2,97%	1,93%	2,16%

17.2 For illustration purposes, please provide a table in \$M for the Transmission Provider and the Distributor for each year for the period 2007-2012, indicating the following information:

- Authorized regulated profit;
- Realized profits (as presented in the annual report);
- Earnings deviations in \$M;
- Detail of the ESM proposed by the applicants, applicable as of 2007, for each year (amount of shortfall, of the deadband, of the 50% attributed to the applicants and the 50% attributed to customers).

R17.2

**Tableau R-17.2A
Detail of the ESM for HQT (in M\$)**

	2007	2008	2009	2010	2011	2012
Authorized Earnings	337,1	369,0	367,3	379,3	361,3	323,9
Realized Earnings - No Sharing	279,7	408,8	452,5	463,7	434,2	483,4
Earning Variances - No Sharing	(57,4)	39,8	85,2	84,4	72,9	159,5
Amount - Under-earnings	(57,4)	-	-	-	-	-
Amount - Deadband	-	23,5	24,1	25,0	25,3	25,3
Amount - 50% HQT	-	8,1	30,6	29,7	23,8	67,1
Amount - 50% Customers	-	8,1	30,6	29,7	23,8	67,1
Realized Earnings - With Sharing	279,7	400,6	421,9	434,1	410,4	416,3
Earning Variances - With Sharing	(57,4)	31,7	54,6	54,7	49,1	92,4

**Tableau R-17.2B
Detail of the ESM for HQD (in M\$)**

	2007	2008	2009	2010	2011	2012
Authorized Earnings	249,6	267,1	238,2	274,5	264,0	220,6
Realized Earnings - No Sharing	259,7	298,2	345,9	447,3	367,3	335,5
Earning Variances - No Sharing	10,1	31,1	107,7	172,8	103,3	114,9
Amount - Under-earnings	-	-	-	-	-	-
Amount - Deadband	10,1	31,1	34,1	35,0	36,1	34,6
Amount - 50% HQD	-	-	36,8	68,9	33,6	40,1
Amount - 50% Customers	-	-	36,8	68,9	33,6	40,1
Realized Earnings - With Sharing	259,7	298,2	309,1	378,4	333,7	295,4
Earning Variances - With Sharing	10,1	31,1	70,9	103,9	69,7	74,8

Note: For purposes of the hypothetical demonstration of how the ESM formula would have been applied historically in these tables, we are calculating the earnings under the authorized ROE based on the realized rate base.

- 18. References:** (i) Exhibit B-0008, page 16;
(ii) Exhibit B-0008, pages 12 and 13;
(iii) Tables 13.1 and 13.2 presented in the Régie's question 13.

Preamble:

"Third, I recommend that the ESMs for HQD and HQT each have a deadband before upside sharing begins. Specifically, I recommend a +100 basis point deadband for HQD and a +50 basis point deadband for HQT. The wider deadband for HQD reflects the greater sensitivity of HQD's earnings to variations in revenues and Operating Expenses. I believe that a meaningful upside deadband is appropriate in recognition that HQD and HQT will be absorbing all of the downside risk. At the same time, my proposed deadband is responsive to the earnings variability concerns expressed by the Régie and interested parties while maintaining an adequate incentive to achieve efficiency gains that will benefit customers in the future."

"Q. Are there any reasons why HQD might have experienced greater earnings variability than HQT?

A. There are at least two reasons why HQD has experienced greater earnings variability than HQT over the past five years.

First, HQT is relatively insulated from variations in revenues. Approximately 90% of HQT's revenues are provided by HQD (native load transmission service) and are fixed on an annual basis. The remaining 10% of HQT revenues (point-to-point transmission services) are subject to a variance account. HQD experiences variances from sales levels that are either higher or lower than the sales levels relied upon to calculate rates.

Second, a much larger proportion of HQD's net revenues (i.e., net of supply costs) derive from Operating Expenses. As a result, HQD's earnings are more sensitive to percentage changes in Operating Expenses."

(iii) The Régie prepared the following Table based on the Distributor's and Transmission Provider's 2007-2012 annual reports.

Table 18.1
Distributor and Transmission Provider's 2007-2012 earnings deviations
excluding variations in revenues (in \$M)

	AR 2012	AR 2011	AR 2010	AR 2009	AR 2008	AR 2007	2007-2012 Average
HQD overearnings	111.4	101.2	171.4	105.7	26.6	9.4	87.6
Variances for sales of electricity net of electricity purchases	33.1	37.6	78.3	-4.0	-18.8	8.1	22.4
	78.3	63.6	93.1	109.7	45.4	1.3	65.2
HQT overearnings	152.0	66.9	87.9	83.6	31.7	-63.4	59.8
Variances for transmission revenues	-1.0	0.0	0.0	0.0	0.0	0.0	-0.2
	153.0	66.9	87.9	83.6	31.7	-63.4	60.0

AR: Annual report

The Régie notes that had it not been for the earnings deviations, the Distributor's and Transmission Provider's overearnings are comparable, except for 2012.

Requests:

18.1 Please confirm that 100 basis points for the Transmission Provider represents approximately \$50 M, and for the Distributor, approximately \$35 M.

R18.1

This statement is confirmed. Based on the Transmission Provider 2012 rate base of \$16,894.1 million, each 100 basis points in ROE represents \$50.7 million in earnings. Based on the Distributor 2012 rate base of \$9,895.7 million, each 100 basis points in ROE represents \$34.6 million in earnings.

18.2 Considering the Transmission Provider and Distributor's 2012 overearnings, please explain if the different deadband for the Transmission Provider and the

Distributor, namely 50 basis points and 100 basis points respectively, remains relevant.

R18.2

Please refer to the response to 15.3. As noted in that response, the 2012 experience does not affect Mr. Yardley's recommendation. While it might support a deadband for the Transmission Provider that is closer to the size of the Distributor, Mr. Yardley believes that the overall evidence supports maintaining a distinction between the two businesses to reflect the relative sensitivity of ROE to variations in operating expenses and revenues.

18.3 Considering the information presented in reference (iii), please justify the different deadband for the Transmission Provider and the Distributor, namely 50 basis points and 100 basis points respectively.

R18.3

Please refer to the response to Question 15.3.

- 19. References:** (i) Exhibit B-0008, page 17;
(ii) Transmission Provider's 2012 Annual Report, Exhibit HQT-2, Document 11;
(iii) Distributor's 2012 Annual Report, Exhibit HQD-9, Document 2;
(iv) Matter No. R-3777-2012, Exhibit B-0010;
(v) Matter No. R-3814-2012, Exhibit B-0025.

Preamble:

(i) "Q. Have you considered whether it is appropriate to implement a more formalized set of operational performance measures or "service quality plan" to accompany the implementation of an ESM for HQD and HQT?"

A. Operational performance measures serve a critical role for utilities in identifying potential areas of improvement and in driving internal performance. They also serve as indicators to regulators that there may be an area of the utility business that merits further scrutiny. However, taking the next step by formally linking performance to financial results by including a set of penalties and rewards requires careful consideration. Establishing such a linkage is not a trivial exercise. They require agreement on the performance to be measured, development of a penalty and/or reward structure and reporting requirements, and the specific measurement calculation to be applied to each measure. For new measures, the utility will have to implement new business and information processes to capture the necessary data, at a cost to ratepayers. Establishing the proper benchmark is perhaps the most challenging aspect as it often depends on utility-specific circumstances. Establishing a benchmark that is too rigorous may unfairly penalize the utility or provide an incentive to over-invest to meet the benchmark and then recover these costs from customers.

This effort may be justified for multi year rate plans where the regulator may not have an opportunity to raise service quality concerns in an annual rate case, as is possible with respect to HQD and HQT." [Emphasis added]

(ii) In its 2012 annual report filed under section 75, the Transmission Provider presented its performance measure results.

(iii) In its 2012 annual report filed under section 75, the Distributor presented its performance measure results.

In its 2012 rate case, the Transmission Provider presented the change in its performance measures.

(v) In its 2013 rate case, the Distributor presented the changes in its efficiency and performance measures.

Requests:

19.1 Considering that the Transmission Provider and the Distributor have presented changes in their performance measures via their annual reports and their rate cases, and apart from the difficulties that such an exercise may present both as regards measures and results sought, please indicate why the applicants' ESM would not be conditional on the achievement of certain performance measures.

R19.1

As noted in the response to question 12.1, it is possible to condition the realization of the utility portion of earnings sharing on the achievement of minimally acceptable (in contrast to stretch goals) performance standards, particularly if there is a legitimate concern that pursuit of efficiency gains could have an impact on certain performance indicators. As implied by the content of the question, Mr. Yardley has identified several implementation challenges. These challenges and the administrative burden of conditioning ESM sharing on achieving performance indicators should be balanced against the fact that there has been little or no indication that this has been a concern, as both the Transmission Provider and Distributor have demonstrated that significant efficiency gains that each has realized in prior years have been achieved without compromising quality performance. To the contrary, performance has either been maintained or improved over the past years while simultaneously realizing efficiency gains that are passed on to customers.

19.2 Please indicate which existing or new performance measures the Transmission Provider and the Distributor would use in an ESM.

R19.2

Without commenting on the specific measures to be included, a question which Mr. Yardley has not studied, Mr. Yardley believes that they should reflect only the most important measures of service quality that can be objectively measured (e.g., reliability of service) and avoid reliance on metrics that rely on judgment and perceptions (e.g., customer satisfaction surveys).

Please refer to the response to Questions 12.1 and 19.1. As also indicated in the response to Question 10.1, an explicit tying of ESMs to performance metrics is rare.