ANALYST'S REPORT RESPECTING THE APPLICATION SEEKING AUTHORIZATION OF A RETURN ON EQUITY AND AN EQUITY SHARING MECHANISM

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1. Introduction

This document presents the facts that, according to the Canadian Federation of Independent Business "CFIB" are necessarily relevant for an analysis of the earnings sharing mechanism question. First, this document presents the relevant regulatory framework for the purpose of the question. It then examines the origin of the Distributor and Transmission Provider's earnings deviations. Lastly, it provides a typical timetable of the phases involved in the Distributor and Transmission Provider's annual reports and rate cases.

2. The regulatory framework

Hydro-Québec is regulated on a cost-of-service method basis both in its Distribution activities and in its Transmission activities. Almost without exception, the Distributor and the Transmission Provider file an annual rate application before the Régie. They are also required to file an annual report at the end of every fiscal year.

As part of the rate case, the Distributor and Transmission Provider present forecasts of their respective costs and revenues (12-month projections). To facilitate an assessment of theses forecasts, they are accompanied by actual data for the most recent year completed (12 actual months) and for the current year (4 actual months, 8 projected months).

After examining the evidence, the Régie first approves the earnings forecasts and costs. In a second phase, it authorizes rates adjusted so that projected earnings correspond to the authorized revenue requirement.

Hydro-Québec presents its operating results in its annual report. The shareholder bears the loss or earns the profits from all variations between costs and projected earnings as the case may be, except for items covered by an offsetting mechanism.

In the Distributor's case, these mechanisms cover the following items:

- The cost of fuel;
- Pension costs;
- BEIE-related costs;
- Electricity costs net of revenue from electricity sales;
- Power transmission costs;
- The cost of major breakdowns in excess of $16 million;
- The effect of weather on earnings;
- All income variations associated with the parameters of special contracts.

Thus, all other cost variations and the impact of variances in sales (other than those related to weather) on the distribution and transmission portions of earnings result in earnings deviations.

In the case of the Transmission Provider, the offset items are:

- All transmission earnings;
- Pension costs.

Thus, all cost variations other than pension costs result in earnings deviations.

3. Distributor's earnings deviations

The deviations are associated with the Distributor's and the Transmission Provider's budget years. In recent years, major deviations have been noted in the earnings and costs of both entities.

Table 1 presents the Distributor's deviations noted in the years 2007 to 2012. Actual costs generally lower than forecasts combined with actual earnings greater than forecasts have led to recurrent and often considerable overearnings over the entire period.

Table 1: Distributor's earnings deviations

	2007	2008	2009	2010	2011	2012
Electricity sales net of purchases	8.1	(18.8)	(4.1)	78.2	37.6	33.1
Other revenues	21.9	31.6	30.6	13.8	(8.3)	(7.1)
Operating expenses	(11.5)	(3.7)	(38.9)	(26.7)	(22.8)	(26.4)
Corporate costs	(3.5)	(4.6)	(9.8)	(12.5)	(8.3)	(3.5)
Other expenses	8.3	(6.6)	(1.3)	(24.8)	(28.3)	(31.9)
Cost of debt	27.3	1.1	(29.3)	(15.3)	(12.5)	(23.6)
Earnings deviation ($ millions)	9.4	26.6	105.8	171.4	101.2	111.4
Overearnings (%)	0.31%	0.90%	3.16%	4.94%	2.86%	3.32%

This finding raises questions regarding the source of these variances. Specifically, how did efficiency, forecasts and management practices contribute to those variances? In attempting to answer this question, it is useful to examine each item specifically.

Revenues net of purchases

By their very nature, revenue variances in electricity sales are exogenous and therefore not subject to efficiency. They are therefore due to forecast differences within the strict meaning of the term.

It is difficult to make a definitive judgment regarding whether the Distributor is conservative in its sales forecasts. We note that in the last three years, revenue variances net of purchases were positive, which means they increased the shareholder's actual return. The years 2006 and 2008 show relatively low variances and sales in 2008 were lower than forecast for an amount of $19 million. However, on average, the deviations were positive, i.e., close to $30 million per year. Globally, these results suggest conservative forecasts.

This finding is supported by the analysis of the economic parameters used for the sales forecast. For the purpose of its sales forecast, the Distributor systematically uses a GDP growth and construction starts lower than the consensus average. The variance in construction starts increased as of 2009.

Table 1: Comparisons of Hydro-Québec economic parameter forecasts and consensus averages.

	Consensus average	Hydro-Québec	Difference
GDP (growth over 2 years)			
2007 RC	**4.8%**	**4.4%**	**0.4%**
2008 RC	**4.3%**	**3.6%**	**- 0.7%**
2009 RC	**3.6%**	**2.8%**	**- 0.8%**
2010 RC	**0.2%**	**-1.5%**	**- 1.7%**
2011 RC	**5.3%**	**4.9%**	**- 0.4%**
2012 RC	**4.6%**	**3.6%**	**- 1.0%**
2013 RC	**3.7%**	**3.0%**	**- 0.7%**
2014 RC	**3.4%**	**2.6%**	**- 0.8%**
Construction starts (2 years)			
2007 RC	**83,400**	**82,000**	**-,1,400**
2008 RC	**79,200**	**80,000**	**800**
2009 RC	**85,800**	**81,000**	**-4,800**
2010 RC	**76,700**	**72,000**	**-4,700**
2011 RC	**87,500**	**83,000**	**-4,500**
2012 RC	**88,300**	**83,000**	**-5,300**

Other income

The variations in other income stem from variances in intersegment / external customers.

Table 2: Other income

Source of the variance	2007	2008	2009	2010	2011	2012
Other income*	21.9	31.6	30.6	13.8	(8.3)	(7.1)
External customers and other units	21.0	21.3	18.8	9.9	(11.3)	(9.3)
Intersegment customer expenses	0.9	10.3	11.7	3.7	2.5	2.2

* Excluding Cost-recovery expenses

A review of the Distributor's annual reports indicates that external customer variations are explained primarily by variances related to administrative costs and by a breach-of-contract penalty in 2007.

Administrative costs are related to receivables, which in turn are largely affected by economic conditions. Therefore, variances in administrative costs react to exogenous factors. However, the Distributor states that it can reduce such costs by more restrictive recovery practices.[1] However, because the Distributor's actions in this regard reduce administrative costs, they also tend to reduce

[1] 2011 AR, HQD-2, Document 3, p.15

positive earnings deviations. They thus cannot participate in generating overearnings. Therefore, it can be asserted that efficiency does not contribute to external customer overearnings.

Furthermore, administrative costs have been the subject of recurring positive variances from 2007 to 2010, which suggests conservative forecasts. However, this trend appears to have reversed since 2011. As of the 2010 reference year, a new model for forecasting administrative costs was implemented. [2] At present there is no indication that this model produces conservative forecasts.

Compared to external customers, intersegment customer variations are smaller in absolute terms. Because intersegment customers depend on demands from other Hydro-Québec divisions, we can assume that the earnings therewith are largely beyond the Distributor's control. Despite this, variances noted from 2007 to 2012 are all favourable to the shareholder. This suggests that the Distributor is conservative in its forecasts for this income category.

Operating expenses

Table 3: Variances – Operating expenses ($ millions)

Source of the variance	2007	2008	2009	2010	2011	2012
Operating expenses *	(11.5)	(3.7)	(38.9)	(26.7)	(22.8)	(26.4)
Pension costs	1.5	(33.7)	(31.5)	(37.2)		
Operating expenses net of pension costs	(13.0)	30.0	(7.4)	10.5	(22.8)	(26.4)

*Including third-party recovery costs and excluding corporate costs

There are many reasons for variations in operating expenses. In a number of cases, it can be readily concluded that a cost variation is independent of efficiency (pension costs; deferred or abandoned IT projects, vegetation control or other projects [3]; reduction in level of service [4], unanticipated capitalization; early retirements, less than expected energy efficiency activities, impact of the economic context on bad debts). In other cases, the distinction is less clear. That being said, excluding the impact of variations in fuel and pension costs, we note negative variances in operating expenses hardly occurred before 2011. Thus, there does not appear to have been any marked gains in efficiency in those years.

In 2011, the Distributor stated that it saved $7.1 million through improved operational performance further to staff reductions.[5] The other main variations in expenses are explained by factors other than efficiency.

In 2012, the Distributor reported a $25.4 million comprehensive efficiency effort. That effort was triggered by an unexpected increase in the contribution to the BEIE. The Distributor notes two sources of efficiency: abandonment and deferral of projects and works and higher than expected retirement levels, which allowed for optimization of its activities. Although retirement may result in efficiency gains, strictly speaking abandoned or deferred projects are not strictly speaking gains in

[2] R-3708-2009, HQD-9, Document 2, p. 4.
[3] 2009 AR, HQD-10, Document 1, p. 5.
[4] 2009 AR, HQD-10, Document 1, p. 5.
[5] 2011 AR, HQD-2, Document 3, p. 11.

efficiency despite a resulting reduction in costs. It seems that most of that efficiency effort stemmed from abandoned and deferred projects, given that there were actually 57 more retirements than anticipated in 2012.[6] At $100,000 per retirement, staff reductions resulted in savings of under $6 million. Therefore, close to $20 million of the cost-reduction effort stemmed from abandoned and deferred activities.

The Distributor also noted $11.7 million in efficiency gains from its Real Estate Management, Material Management, and Transportation Services divisions. Such efficiency gains are *a priori* surprising given that the actual costs in those areas in 2012 totaled $140.1 million, i.e., more or less the budget of previous years ($140.5 million in 2011 and $137.4 million in 2010). In addition, volumes invoiced are rather stable (slight drop) between 2011 and 2012 except for warehouse transactions that dropped more markedly, reflected in a $2 million drop in actual costs.

However, the Distributor stated that the Shared Services Center carried out unplanned environmental projects for $4.1 million in 2012. Because the budget did not increase accordingly, efficiency gains in the Shared Services Centers cannot be ruled out.

Table 4: Changes in Shared Services Centre costs

Actual costs ($ millions)						
	2007	**2008**	**2009**	**2010**	**2011**	**2012**
Real Estate Management	63.2	61.1	57.8	58.9	60.6	63.9
Material Management	35.2	36.9	35.8	34.8	34.7	32.7
Transportation Services	42.1	41.0	42.4	43.7	45.2	43.5
Total	**140.5**	**139**	**136**	**137.4**	**140.5**	**140.1**
Forecast costs ($ millions)						
	2007	**2008**	**2009**	**2010**	**2011**	**2012**
Real Estate Management	59	64.7	63.6	65.8	61.8	67.0
Material Management	35.9	35.9	38.0	37.3	37.7	36.7
Transportation Services	40.5	38.8	40.0	41.5	46.9	46.9
Total	**135.4**	**139.4**	**141.6**	**144.6**	**146.4**	**150.6**
Total variance	**-5.1**	**0.4**	**5.6**	**7.2**	**5.9**	**10.5**

Generally, it could be said that the positive variances in operating expenses in 2011 and 2012 are partially the result of efficiency gains. However, efficiency only explains a fraction of the variances noted.

Furthermore, the Distributor states that it manages it operations in compliance with its operating budget. At several points, it testified regarding its mode of management of its operating expenses, but also as regards its global envelope. Inter alia, in reply to a question in this case, it made the following joint statement with Transmission Provider:

> "The Transmission Provider and the Distributor make day-to-day decisions and manage their expenses on a comprehensive and dynamic basis while aiming to comply with the envelope established according to a parametric method recognized by the Régie. Expenses exceeding

[6] 457 actual start-ups (R-3854-2013 HQD7, Document 2, p. 9) versus 400 projected start-ups (R-3776-2011 HQD7, Document 3, p. 10)

> the amount recognized for certain budget items must therefore be offset by cost reductions in other budget items."[7]

More concretely, in its 2012 annual report, the Distributor stated as follows:

[Translation:]

> "The Distributor and Transmission Provider manage their expenses on a comprehensive and dynamic basis while aiming to comply with the envelope allowed by the Régie.
>
> Thus, to comply with the expenses envelope allowed by the Régie for 2012, the Distributor had to make certain decisions at the beginning of the year to offset a negative variance of $52.6 million, an amount corresponding to the BEIE assessment for the year and which, no longer qualifying as an intangible asset according to IAS 38, was charged to expenses in accordance with Decision D-2012-021. […] The efforts to offset such unplanned costs pertaining to the BEIE are translated, inter alia, by the following:
>
> - Abandonment or deferral of certain projects and work allowing for the generation of a positive variance in external services and other expenditures;
> - More retirements than expected at the time the rate case was prepared; such departures allowed the Distributor to further optimize the organization of its activities."[8]

Similarly, in its 2009 annual report, it stated:

[Translation:]

> "Furthermore, as part of integrated management of its operating expenses and based on its business context and compliance with its comprehensive budget envelope, various additional costs noted early in 2009 led the Distributor to implement ad hoc and temporary measures to mitigate their impacts."[9]

Thus, the Distributor states that it is conservative in its operational management. Because, such a practice considerably reduces the risk of negative variances and, on the contrary, fosters positive variances, it is, in a way, equivalent to making conservative forecasts.

One evident sign of this practice is that the Distributor enjoyed overearnings from operating expenses every year between 2007 and 2012. Firstly through pension costs when they were not offset by a variance account, and then by other cost items.

Corporate costs

Corporate costs have contributed to the Distributor's overearnings every year since 2007 for amounts variant from $3.5 to $12.5 million. It seems obvious that most of the variances can stem only from forecast differences. Such unanticipated efficiency levels (between 9% and 30% of the budget) for six consecutive years are not realistic.

[7] HQDT-3, Document 1, p. 29, R13.2.
[8] 2012 Annual Report, HQD-2, Document 3, p.11.
[9] 2009 Annual Report, HQD-2, Document 3, p.6.

Table 5: Variances – Corporate costs ($ millions)

Source of the variance	2007	2008	2009	2010	2011	2012
Corporate costs - Projected	39.5	40.9	41.9	43.9	39	33.4
Corporate costs – Actual	36	36.3	32.1	31.4	30.7	29.9
Variance	(3.5)	(4.6)	(9.8)	(12.5)	(8.3)	(3.5)
Variance (%)	(9)	(11)	(23)	(28)	(21)	(10)
% increase versus actual costs (t-2)			16%	21%	21%	6%

Furthermore, all indications are that such forecast differences are the result of conservative forecasts made by the Distributor. In that respect, we note that forecasts are systematically higher than the most recent factual data at the time they were made. For example, 2010 budget forecasts of $43.9 million represented an increase of 21% compared to the actual 2008 budget, which figures were known at the time. Despite this, actual costs for 2010 were substantially lower than those of 2008.

It is highly improbable that such sizeable forecast differences that systematically favour the shareholder are arbitrary, especially given the low volatility of corporate costs. In these assorted annual reports, the Distributor specifically explains these variances by hiring delays and postponed activities. However, these delays and postponements are not at any time reflected in increased actual costs for a subsequent year.

In other words, the variances are explained primarily by conservative forecasts, and efficiency is at best only marginal.

Rate base

Table 6: Rate base variances ($ millions)

Source of the variance	2007	2008	2009	2010	2011	2012
Total variance including:	(28.4)	(163.8)	(84.8)	(55.0)	(82.0)	(167.3)
Underground distribution lines	(14.0)	29.9	12.6	(6.8)	(14.7)	(26.3)
Off-grid systems	(16.3)	(26.0)	(31.7)	(33.60	(12.3)	2.7
Support assets	(45.2)	(65.1)	4.7	(31.5)	(11.4)	(24.7)
Software	(19.5)	2.4	(11.7)	(17.4)	(20.0)	(46.5)
EEP	(25.6)	(38.1)	(9.2)	(12.1)	(47.0)	(53.8)
ABA	(45.3)	15.6	47.8	(33.3)	(0.3)	0.0
Contribution to connection projects	73.9	(24.8)	(6.6)	0.3	0.1	3.3

Table 6 presents the variances between the projected and actual rate bases for the years 2007 to 2012. The first thing we note from Table 6 is that the actual rate base is always lower than forecast every year. This tendency is further reflected in certain asset classes such as off-grid system fixed assets, the support assets, software or the EEP also tend to be lower than forecast.

As in the case of expenses, there is reason to wonder about the contribution of efficiency efforts to these variances. Table 6 presents the asset classes in which substantial negative variances were noted at some point. Some of these categories (ABA and contributions to connection projects) do not lend

themselves to efficiency. The cause of variances in the other asset classes is analyzed in the following paragraphs.

Underground distribution lines

To properly understand the source of variances, it is useful to compare projected and actual opening balances and start-ups. In the case of underground distribution line, we note that the average rate base variance is in large part attributable to the opening balance variance. As rate case forecasts are made on the basis of 4 actual and 8 projected months, opening balance variances must therefore stem from changes that occur in the eight months remaining in the reference year. Given the short time between preparation of the rate case and the end of the reference year, it seems fairly unrealistic that a significant part of opening balance variances is the result of efficiency efforts. This would imply that in eight months, unanticipated sources of efficiency were identified, operationalized and implemented. Considering the nature of the projects in question, that period seems insufficient for such changes to be made.

Table 7: Variances between projected and actual data for the average rate base, opening balance and start-ups – underground distribution lines

Source of the variance	2007	2008	2009	2010	2011	2012
Average rate base	(14.0)	29.9	12.6	(6.8)	(14.7)	(26.3)
Opening balance	(7.3)	30.4	10.3	3.0	(26.1)	(19.4)
Start-ups	(11.8)	22.8	1.7	(31.3)	11.0	(54.2)

Because efficiency gains do not explain opening balance variances and because those variances are important in average rate base variances, it can reasonably be assumed that efficiency plays a marginal role in average rate base variances. Furthermore, start-up variances in 2012 and 2013 represent respectively 20% and 30% of forecast start-ups. Such variances necessarily imply that fewer projects than were forecast were carried. Therefore, the average rate base variance is largely the result of factors other than efficiency.

Off-grid systems

Like underground distribution lines, the major part of average rate base variances of off-grid system fixed assets stem from the variance in opening balances. Once again, it seems highly improbable that the variance in opening balances includes significant efficiency gains. Furthermore, between 2007 and 2012, actual off-grid system start-ups were systematically lower than forecast by large margins. Over that period, the variance in start-ups represented between 49% to 76% of projected start-ups six years out of seven and 18% in the other year. By virtue of their magnitude and recurrence, it is clear that most variances cannot stem from efficiency gains. Thus, efficiency most likely did not play a major role in average rate base variances in off-grid systems.

Thus, the recurring negative variances strongly suggest that the Distributor is conservative in its forecasts.

Table 8: Variances between forecast and actual data for the average rate base, the opening balance and start-ups – Off-grid systems ($ millions)

Source of the variance	2007	2008	2009	2010	2011	2012
Average rate base	(16.3)	(26.0)	(31.7)	(33.6)	(12.3)	2.7
Opening balance	(13.7)	(11.6)	(22.7)	(16.8)	(10.9)	13.4
Variance in start-ups	(14.4)	(28.1)	(14.7)	(48.3)	(28.3)	(5.0)
Variance in start-ups (%)	(52)	(55)	(54)	(49)	(70)	(18)

Support assets

Like the preceding asset classes, a major part of the average rate base variances in support assets stems from opening balance variances. Again, efficiency hardly explains opening balance variances.

Table 9: Variances between forecast and actual data for the average rate base, the opening balance and start-ups – Support assets ($ millions)

Source of the variance	2007	2008	2009	2010	2011	2012
Average rate base	(45.2)	(65.1)	4.7	(31.5)	(11.4)	(24.7)
Opening balance	(20.6)	(67.8)	7.9	(24.2)	(15.1)	(20.6)
Start-ups	(67.2)	(5.3)	(19.2)	(26.7)	12.1	(11.0)
Start-ups (%)	(53)	(5)	(22)	(24)	15	(13)

Excluding 2011, start-ups were lower than forecast every year. Except maybe for 2008, the size of the variances lets us exclude efficiency as a main explanatory factor. Thus, it can be stated that efficiency did not play a major role in the average rate base variances in off-grid systems.

Thus, the recurring negative variances strongly suggest that the Distributor is conservative in its forecasts.

Software

The general findings are the same for the software asset class. Opening balances and start-ups are generally over-valued. Opening balance variances explain a sizeable percentage of the average rate base variances. The magnitude of start-up variances excludes efficiency as a main factor contributing to those variances.

Table 10: Variances between forecast and actual data for the average rate base, the opening balance and start-ups – Software ($ millions)

Source of the variance	2007	2008	2009	2010	2011	2012
Average rate base	(19.5)	2.4	(11.7)	(17.4)	(20.0)	(46.5)
Opening balance	(18.8)	4.9	(12.3)	4.4	(7.8)	(18.2)
Start-ups	(21.5)	(18.3)	0.3	(35.0)	(35.9)	(56.0)
Start-ups (%)	(36)	(4)	(1)	(58)	(67)	(48)

In that respect, the Distributor cites revised business priorities concerning investments in information technology to explain a depreciation and amortization expense lower than forecast in 2010[10]. In 2011,

[10] 2010 Annual Report, HQD-2, Document 3, p.7.

it mentions a reduction in IT development and innovation projects.[11] In 2012, it notes that IT development and innovation projects that were not carried out or that were initially forecast in expenses were capitalized.[12]

Thus, recurring negative variances in start-ups strongly suggest that the Distributor is conservative in its forecasts.

EEP

Table 11: Variances between forecast and actual data for the average rate base, the opening balance and start-ups – EEP ($ millions)

Source of the variance	2007	2008	2009	2010	2011	2012
Average rate base	(25.6)	(38.1)	(9.2)	(12.1)	(47.0)	(53.8)
Opening balance	(21.1)	(35.9)	(6.4)	(7.4)	(42.5)	(54.1)
Start-ups	(71.6)	(51.9)	(41.4)	(65.4)	(158.4)	(36.9)
Start-ups (%)	(29)	(29)	(21)	(16)	(48)	(20)

EEP findings are as follows. Opening balances and start-ups are systematically largely overvalued. Opening balance variances explain a major portion of average rate base variances. The magnitude of the variances in start-ups excludes efficiency as a main factor contributing to those variances.

Furthermore, examination of EEP follow-ups presented in the annual reports reveal recurring causes for those variances: level of participation in programs lower than forecast, unexpected program interruption, delay in program launch, evaluation reports, reduction in communication efforts, non-use of the contingency budget. All these causes are independent of the Distributor's efficiency efforts. Optimization of evaluations, follow-ups and communication activities are also cited in 2011. However, they represent a modest part of start-ups. Moreover, as the actual evaluation expenditure was $4 million rather than the projected $8 million, it is very likely that fewer projects than forecast were completed.

We find that most of all rate base variances are independent of efficiency and that the Distributor is conservative in establishing its start-up forecasts.

Other expenses

Table 12: Variances - Other expenses ($ millions)

Source of the variance	2007	2008	2009	2010	2011	2012
Other expenses	8.3	(6.6)	(1.3)	(24.8)	(28.3)	(31.9)
Depreciation and amortization	18.1	0.1	2.3	(19.7)	(25.4)	(24.9)
Asset removal	0.9	0.6	4.6	(1.0)	(16.3)	(12.7)

[11] 2011 Annual Report, HQD-2, Document 3, p.12.
[12] 2012 Annual Report, HQD-2, Document 3, p.13.

Table 12 presents the variances associated with other expenses. We note that most of the variances stem from depreciation and amortization, comprised in large part by asset removal in 2011 and 2012.

In reply to a question from the Régie, the plaintiffs attribute variances in depreciation and amortization to four main factors: the value of the assets commissioned, the time required for commissioning, the review of useful lives and net costs related to retirement of property, plant and equipment and intangible assets.[13] The plaintiffs also stated that the variances related to the last three factors are attributable to forecast differences rather than to efficiency. As regards the value of the assets commissioned, they state that they are unable to distinguish the impact of forecast differences from that of efficiency gains.

The foregoing analysis of variances related to the average rate base allows for the finding that efficiency plays a minor role. Because the depreciation or amortization expense is a direct result of the rate base, the same is true for that expense**.** Thus, we can conclude that most of the variances related to depreciation and amortization are unrelated to efficiency.

In short, there have been significant positive variances in depreciation and amortization expenses since 2010. These variances suggest conservative forecasts by the Distributor. Moreover, efficiency affects such variances only slightly or not at all.

Cost of debt

Table 13: Variances – Cost of debt ($ millions)

Source of the variance	2007	2008	2009	2010	2011	2012
Cost of debt including:	27.3	1.1	(29.3)	(15.3)	(12.5)	(23.6)
Interest rate on the indebtedness	29.0	9.0	(25.0)	(13.0)	(9.0)	(16.0)
Rate base	(2.0)	(8.0)	(4.0)	(3.0)	(4.0)	(8.0)

Variances in the cost of debt are the result of variances in the cost of the indebtedness that are beyond the Distributor's control. Nor can the Distributor exercise control over forecasts of interest rate on the debt.

Systematically negative variances in the impact of the rate base reflect the conservative nature of the Distributor's average rate base forecasts.

Conclusion respecting the Distributor's earnings deviations

The Distributor earned considerable overearnings between 2007 and 2012. However, a detailed analysis of the source of the variances indicates that in most cases, efficiency contributed little or nothing to these variances except potentially as regards 2011 and 2012 operating expenses.

[13] HQTD-3, Document 1.

Also, everything suggests that the Distributor is conservative in its budget forecasts and it has stated that it is conservative in its operational management. This conservatism is the primary explanation for the overearnings noted in recent years.

4. Transmission Provider's earnings deviations

Table 14: Transmission Provider's earnings deviations

	2007	2008	2009	2010	2011	2012
Net operating expenses	22.3	-21.5	-40	-58.1	-50.5	-46.6
Other expenses	7.3	-2.4	14.9	-3.6	7.3	-49
Pension costs variance account					16.8	-1
External invoicing and others	-0.8	-5.1	-10.2	-11.5	-10.9	-6.7
Cost of debt	34.6	-2.7	-48.3	-14.7	-29.6	-49.1
Accretion expense						0.3
Earnings deviation ($ millions)	-63.4	31.7	83.6	87.9	66.9	151.9
Overearnings (%)	-1.28%	0.85%	1.77%	1.69%	1.44%	3.15%

Table 14 presents the Transmission Provider's cost variances observed from 2007 to 2012. We note that the sizeable overearnings stem basically from positive variances in net operating expenses, **external** invoicing and others] and the cost of debt.

Net operating expenses

Table 15: Variances – Net operating expenses ($ millions)

Source of the variance	2007	2008	2009	2010	2011	2012
Net operating expenses	22.3	-21.5	-40.0	-58.1	-50.5	-46.6
Pension costs					16.8	-1
Operating expenses net of pension costs	22.3	-21.5	-40.0	-58.1	-33.7	-47.6

Like the Distributor, the Transmission Provider's operating expenses show sizeable recurring positive variances. The explanations provided in the Transmission Provider's various annual reports do not mention efficiency as a reason for the variances except after 2011 with $15 million in efficiency gains. The rest of the variation is apparently due to pension costs and capitalization. In 2012, the Transmission Provider mentioned $48 million in efficiency gains. However, it states that it is unable to identify the sources of those efficiency gains. Nevertheless, it proposes to maintain that cost reduction in the 2013 and 2014 rate cases.

Efficiency therefore seems to be irrelevant in earnings deviations prior to 2011. After 2011, available information shows marked cost reductions that could be due to gains in efficiency.

However, the recurring negative variances suggest generally conservative forecasts.

Other expenses

The impact of other expenses on earnings deviations is generally low. Also, sometimes it is positive, and sometimes it is negative. Thus, such expenses generally do not contribute to the Transmission Provider's overearnings. However, in 2012 we see a positive variance in the order of $49 million. The Transmission Provider explains this variance as being mainly the result of deferring the commissioning of projects. Thus, it is not a reflection of the Transmission Provider's efficiency efforts.

External customers and other units

Variances observed in external customers and other units are largely the result of the variance in corporate costs.

Table 16: Variances – External customers and other units

Source of the variance	2007	2008	2009	2010	2011	2012
External customers and other units including:	-0.8	-5.1	-10.2	-11.5	-10.9	-6.7
Corporate costs	0.4	-2.2	-8.7	-10.7	-10	-4

As regards corporate costs, the findings regarding costs invoiced to the Distributor also apply here. The conclusion is that, in all likelihood, variances in corporate costs are explained primarily by conservative forecasts, and efficiency is at best only marginal.

Cost of debt

Table 17: Variances – Cost of debt ($ millions)

Source of the variance	2007	2008	2009	2010	2011	2012
Cost of debt including:	34.6	-2.7	-48.3	-14.7	-29.6	-49.1
Rate of interest on debt	50.0	16.0	-44.0	-23.0	-16.0	-30.0
Impact of the rate base	-15.0	-19.0	-4.0	8.0	-14.0	-19.0
Average rate base variance ($ millions)	-266.3	-344.5	-70.9	156.5	-279.8	- 393.4

As indicated in Table 14, variances in the cost of debt significantly affect overall overearnings. These variances stem from variances in interest rates on the debt and from variances in the rate base.

Interest rate variances are beyond the control of the Transmission Provider, who does not exercise control over the forecasting and apparently very little over its actual debt rate.

Recurring negative variances in rate base levels suggest conservative forecasts by the Transmission Provider in that regard. Moreover, the Transmission Provider explains these variances by opening

balances below forecasts and by delayed pushed forward (2010) commissioning dates. For all intents and purposes, efficiency has no impact on these variances.

Conclusion respecting the Transmission Provider's earnings deviations

An analysis of the Transmission Provider's forecast differences leads to much the same conclusions for the Distributor; namely major and recurring overearnings from 2007 to 2012 due basically to conservative forecasts and conservative management. In most cases, efficiency appears to have contributed little or nothing to such overearnings except potentially as regards 2011 and 2012 operating expenses.

5. HQD and HQT annual report and rate case timetable

Table 18 presents the typical sequence of stages in HQD and HQT annual reports and rate cases.

Table 18: Typical annual report and rate case timetable

	HQD/HQT annual reports	**HQD/HQT rate cases**
End of May	Tabling of HQD and HQT annual reports	
Mid-July	Answers to Régie questions	
End of July		Filing of the case
End of August		Applications to intervene
Mid-Septembre/beginning of October		HQT/HQD requests for information
End of October	Completion of AR review	
End of October/beginning of November		Evidence from intervenants HQT/HQD
December		Hearing
March		Decision