

## **Original: 2013-10-04 HQT-5, Document 4.3**

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### **Fifth Topic: Earnings Sharing mechanism**

Reference: Company evidence page 17

Preamble:

Hydro-Quebec seeks a 1.0% dead-band for HQD and 0.50% for HQT.

Question 5

5.1 Please confirm that Hydro Quebec is not seeking performance based regulation for either HQT or HQD?

Response:

The Petitioners are proposing that an earnings sharing mechanism be added to the current regulatory framework so as to meet the objectives of section 48.1 of the *Act respecting the Régie de l'énergie*.

## **HQT-5, Document 1**

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28. References:

- (i) Exhibit B-0020, p. 25 and 26 ;
- (ii) Exhibit B-0020, p. 32 ;
- (iii) Decision D-2012-024, case R-3776-2011, p 46 ;
- (iv) Decision D-2013-135, case R-3831-2012, p. 14 to16.

Preamble:

(i) “12.3 Indicate the regulatory framework in which the Régie will examine the overpayments and make adjustments, where applicable, under the MHEV.

R12.3

[...]

The Transmission Provider and the Distributor would like to submit the following elements.

In Exhibit HQT-1, document 1 (B-0004), pages 25 and 26, the divisions propose that the earnings sharing mechanism be managed as follows:

- findings of an actual earnings variance in the context of the annual report following the year-end;” [emphasis added]

(ii) “14.1 Please indicate what exclusions may be necessary when comparing the rates of return (ROR) that are authorized and realized as the starting point in the MHEV (ESM) of the Transmission Provider and Distributor.

#### R14.1

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.

(iii) “[143] The Régie has noted that the Distributor proceeded with these amendments in accordance with the GAAP in Canada, contrary to what was presented to and authorized by the Régie in the above matter. The Régie is of the opinion that the reviews of the useful life of poles and some existing software, the impact of which stands at \$13 million, were not approved in the 2010 rates. The Régie is asking that this topic be broached when the evidence that the Distributor proposes to submit in the next rate case is adduced in respect of a potential earnings sharing mechanism and variance management mechanism.”

#### (iv) “2.1.2 BIO-METHANE RELATED COSTS

[53] Gaz Métro states that operating costs were incurred in 2012 for all of its activities in the alternate energy department, which includes the project related to bio-methane, the costs of which have not been compiled separately. The greater portion of the expenses incurred went to wages and employee benefits.

[54] Gaz Métro specifies that a total of \$46.6 thousand, other than wages and employee benefits, were incurred to develop bio-methane, \$26.7 thousand of which went to professional services.

[55] According to Gaz Métro, studies were needed to understand the entire chain of production, processing, quality-control, hook-up to and injection of bio-methane into the gas network.

[56] However, in its decision D-2011-108, the Régie clearly decided that everything upstream of the injection point was non-regulated:

“[...]”.

[57] Decision D-2013-106 also mentioned that bio-methane-related costs must be part of the non-regulated activities (NRA). The Régie explicitly asked Gaz Métro to identify the wages and employee benefits related to bio-methane and to include them in the NRA as a recharge.

[58] The Régie believes that regardless what production process is used (bio-methane or other source), Gaz Métro’s responsibility where regulated activities are concerned is to ensure that gas

will be injected in its network in compliance with the standards established by TransCanada Pipelines Limited.

[59] However, the Régie notes that Gaz Métro has disregarded decision D-2011-108 by attributing the costs related to bio-methane to regulated activities.

[60] As a result, the Régie refuses the 2012 operating expenses related to bio-methane.

[61] The Régie orders Gaz Métro to attribute the 2012 bio-methane-related operating expenses to non-regulated activities, which includes an estimate of the expenses associated with wages and employee benefits. The Régie is also asking it to provide explanations regarding the estimates required to establish this amount.”

In reference (i), the Régie understands that the proposed mechanism (MHEV) seeks to examine the occurrence of overpayments in the context of the annual report and to make the necessary adjustments to reabsorb this overpayment.

In the context of the Petitioners’ proposal (ii), if the Régie were to find that an expense that occurred was included in the annual income statement despite not being authorized in the context of the rate process, that expense should be excluded from the amount to be shared.

In its decisions D-2012-024 (iii) and D-2013-135 (iv), the Régie noted the occurrence of unauthorized expenses affecting the year-end results.

**Request:**

28.1 After examining the Petitioners’ annual reports, if the Régie were to question or find that a portion or element of the overpayment recorded by one of the Petitioners resulted from an unauthorized expense, please specify when and under what regulatory framework the processing of that element should be carried out. Please elaborate using the two examples cited below.

**Response:**

The Petitioners have always undertaken to comply with the specific and global budgets, such as the operating expense budget and investment budget, which are recognized by the Régie. In the context of the proposed mechanism for handling earnings variances (“MHEV”), they will pursue this sound management of their budgets. Consequently, by efficiently and closely managing their costs, the Petitioners are ensuring, to the extent possible, that any unfavourable variances are compensated or mitigated by efforts at efficiency. The proposed MHEV will be an incentive for Petitioners to continue on this path.

In addition to the regulatory process, the Petitioners are also subjected to a set of rules and guidelines that provides a framework for their decisions. Examples of these frameworks include the *Répertoire des pouvoirs de décision* (directory of decision-making powers), corporate governance rules and code of ethics.

In light of the above, the Petitioners therefore believe that all revenues and costs must be taken into consideration when calculating earnings variances, with the exception of those elements that were specifically refused by the Régie. The sharing of earnings variances must be carried out

using a global approach that is easy to apply. Since the Petitioners absorb 100% of the shortfalls, whether these stem from unrealized efficiency gains or projection variances, it seems fair to them that they receive part of the overpayment, without any distinction.

Finally, the Petitioners insist on repeating that after they file their annual reports, the Régie may ask for explanations or specifications on their revenues, which besides are subject to certain audit procedures. In the past, the Régie has always attested to the compliance of the Petitioners' annual reports.

29. References: (i) Exhibit B-0020, p. 26 ;

(ii) Exhibit B-0020, p. 20 and 21.

**Preamble:**

(i) “The annual reports of the Transmission Provider and the Distributor have been required by the Régie annually since 2001 pursuant to section 75 of the *Act respecting the Régie de l'énergie*. The annual reports already provide details on the regulated divisions' revenues, including financial and commercial revenues as well as performance indicators, pursuant to decision D-2002-175 issued by the Régie in R-3482-2002, as well as the subsequent decisions that have specified the Régie's requirements over time. The Régie has all of the latitude it needs to present any request for information to the divisions so that it can assess the compliance of these reports and declare itself satisfied therewith following its examination.

The divisions are of the opinion that this rigorous, time-tested regulatory framework is well adapted to providing an annual assessment of the earnings variances and determining whether or not any amounts are to be remitted to its clientele under the MHEV that will be approved.

The addition of the new step, such as a regulatory closing in the context of a public hearing, could potentially introduce new delays and make the revenue examination process we know today more cumbersome. What is more, the Transmission Provider and Distributor are of the opinion that the application of the MHEV, as it is proposed, does not require the addition of such a step.

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

[emphasis added]

(ii) “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.” [emphasis added]

**Requests:**

29.1 Please expand on the “latitude” the Régie would have were it to retain the method you propose for processing potential overpayments in the filing of annual reports as compares to the method that would result from an examination of the regulatory closing file by a panel of three commissioners.

**Response:**

The annual reports produced each year by the regulated divisions provide various information relating to the main budget items that are the source of these variances. The Régie has exclusive jurisdiction to assess the compliance of information provided by the Petitioners and the possibility of sending them requests for information for any clarification or additional information that may be necessary.

With all due respect, the Petitioners are of the opinion that an additional regulatory process would bring little added value in the context of the implementation of a mechanism that will, as of the next rate case, share all of the favourable variances regardless of their origin, even though the unfavourable variances will continue to be assumed only by them.

In addition to the practical considerations associated with the simple ability to introduce a new regulatory process in what is already a very loaded schedule, a regulatory closing could potentially have the effect of making the process unduly cumbersome and lead to additional delays in the sharing of variances due to the implementation of a separate file.

29.1 Please explain the role played by interveners in the MHEV as it is proposed by the Petitioners, and the consequences of not providing for their participation.

Please specify how the Régie will be able to consider the position of the interpreters in the proposed framework.

**Response:**

By participating in this case, the interveners have the opportunity to express their position on what they believe would be an appropriate mechanism for sharing earnings variances that would benefit all members that they represent. This way, the Régie will take their interventions into consideration when it weighs this proposal. However, once this mechanism is adopted, the Petitioners believe that the Régie and its technical staff have full jurisdiction over its application through its activities of monitoring the annual reports that they present.

This notwithstanding, the interveners play a key role in the rate cases of the Petitioners. The favourable earnings variances that will be shared stem from the variances between the revenues and the projected costs for the test year as well as between the revenues and actual costs. Each rate case provides interveners with a forum to examine, question and express their opinions on

the projections of the two divisions. The Petitioners argue that at this stage, the Régie once again has full jurisdiction as to whether or not it will take their concerns into consideration.

29.2 Please expand on the possibility that Petitioners will proceed with an examination of the annual revenues in a context analogous to the one described in (ii), namely a “compliance filing” accompanied by the possibility of comments on the part of the interested parties..

**Response:**

As the experts from CEA specify in (ii), a “compliance filing” is required in some US jurisdictions in order to proceed with the validation of variance sharing calculations.

The Petitioners respectfully repeat that their proposal to share all of the favourable variances and absorb 100% of the unfavourable variances, as well as to produce annual reports documenting the main sources of the variances and allowing the Régie to ensure that its decisions have been respected, are such that the implementation of a “compliance filing” would be useless. The Petitioners are of the opinion of the regulatory framework allows for the efficient and adequate handling of this type of case.