

**Réponses du Transporteur et du Distributeur  
à la demande de renseignements numéro 1  
de la Fédération canadienne de l'entreprise  
indépendante  
(« FCEI »)  
Partie 2**



**DEMANDE D'APPROBATION DU TAUX DE RENDEMENT DES CAPITAUX PROPRES  
ET DU MÉCANISME DE TRAITEMENT DES ÉCARTS DE RENDEMENT**

**CAUSE R-3842-2013**

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**Question 1**

**Référence :**

(i) B0008(HQDT2, Document 2), p. 4

**Préambule :**

**"Q. What are some of the reasons why the realized ROE will differ from the authorized ROE?"**

A. The actual ROE will deviate from the authorized ROE for various reasons. For example, sales levels and associated revenues may be higher or lower than reflected in the calculation of rates due to changing economic conditions. Global economic conditions may impact a major regional industry in ways that had not been anticipated when the sales forecast was developed. The costs and commissioning of new transmission or distribution facilities may be affected by unanticipated changes in the costs of components or in the length of time required to complete construction. These unanticipated revenue and cost trends will impact the realized ROE to the extent that they are not covered by variance and deferral accounts. There are also opportunities for the utility to influence the level of costs by implementing initiatives that result in more efficient operations, and therefore increase earnings." (Nous soulignons)

**Questions :**

1.1 Veuillez indiquer s'il existe également des opportunités pour l'entreprise d'influencer le niveau des coûts par des initiatives qui ne résultent pas en davantage d'efficience.

**Réponse:**

**Utilities will incur expenses and make investments as necessary to fulfill their public service obligations. This would include connecting new customers and taking actions that improve the reliability of service. These expenses and investments are legitimate expenses incurred to provide regulated utility service and should be included in the calculation of earnings for purposes of applying the ESM.**

1.2 Dans l'affirmative, veuillez indiquer comment cette réalité est prise en compte dans la proposition de mécanisme de traitement des écarts de rendement (MTÉR) de M. Yardley.

**Réponse:**

**Please refer to response to Request 1.1.**

**Question 2 :**

**Référence :**

① B0008, p. 5

**Préambule :**

**Q. Why is the length of time that rates will be in effect relevant for purposes of implementing an ESM?**

A. One of the purposes of an ESM is to provide some protection against earnings variability to both customers (through an opportunity to share in earnings that exceed the authorized ROE) and the utility (to the extent that customers share in any earnings shortfall that is below the authorized ROE). Thus, an ESM provides protection to both customers and the utility against unanticipated earnings levels, and acts as a hedge against earnings variability. It is more likely that the realized ROE will deviate from the authorized ROE as the length of time that rates will be in effect increases in part because longer time periods increase the incentive that utilities have to pursue operating efficiencies. Although ESMs can be designed for a single rate plan year, they are more commonly associated with rates that are expected to be in place for two or more years.

ESMs are also a common element of incentive regulation plans. Incentive regulation plans can be quite complex but typically break the linkage between costs and rates after the initial year of the plan, with rates changing after the first year in accordance with an approved formula." (emphasis added)

**Questions:**

2.1 Considering the text cited above, can we conclude that the shorter the rate plan is, the more the "deadband" should be reduced?

**Réponse:**

**No. A shorter rate plan reduces the incentive to pursue efficiency gains, particularly those that require either an investment to be made or time to develop. If anything, a shorter rate plan should have a broader deadband to guard against this outcome.**

**Question 3:**

**Reference:**

- (i) B-0008, p. 13
- (ii) D-2013-106, paragraph 386
- (iii) B - 0 0 0 8 , p . 1 5

**Preamble:**

In reference (i) Mr. Yardley states:

**"Q. What is the potential impact of the current rate filing practice on the design of an ESM for HQD and HQT?"**

A. Annual rate filings based on cost-of-service principles act as a disincentive to pursue efficiency gains, although the evidence indicates that HQD and HQT have each been able to reduce Operating Expenses below the level that has been used to calculate rates over the past few years.

For purposes of designing an ESM in this proceeding, this implies that an understanding that the ESM will remain in place for a number of years, even if rates are to be reset more frequently will promote the pursuit of efficiency gains. It also implies that a meaningful deadband is appropriate to provide an incentive for HQD and HQT to pursue these efficiency gains."

In reference (ii), the Régie states:

"[386] The Régie considers that the sharing of earnings surpluses and shortfalls in the context of the cost-of-service principle consists in allocating the variances recorded at year end between the projections and actual data. Variances are inevitable when rates are determined using projected data. The Régie takes into considerable the characteristics inherent to the process, namely the asymmetry of the information and the presentation of conservative projections both for loads and sales volumes." (emphasis added)

In reference (iii), Mr. Yardley states:

**"Q. Please summarize your testimony with respect to the impact of HQD and HQT circumstances on the design of an ESM.**

A. The design of an ESM will need to reflect a balancing between the concern over earnings surpluses experienced by HQD and HQT in recent years and the need to mitigate the potential disincentives of an ESM for the pursuit of efficiency gains, a concern that is accentuated by the fact that rates may only be in effect for one year. It is also reasonable to incorporate an expected greater variation in earnings and ROE for HQD than HQT in the design of the ESM."

**Questions:**

3.1 In reference (i), Mr. Yardley indicates that the annual service cost acts as a disincentive to the pursuit of efficiency gains. Please provide references to economic literature in support of your affirmation.

**Response:**

**Mr. Yardley relied on his ratemaking experience and expertise, rather than on any particular article from economic literature. Utilities are allowed to benefit from efficiency gains until such time as rates are rebased. Thus, if rates are rebased every year, rather than after a longer period, this will reduce the incentive to pursue efficiency gains. Proponents of regulatory lag as a contributor to utility efficiencies essentially argue that the length of time between the realization of an efficiency gain and the rebasing of rates based on a lower cost of service that permanently reflects this gain acts as an incentive to pursue efficiencies.**

3.2 Are we to understand from the first paragraph of reference (i) that Mr. Yardley believes that the actual operating expenses of HQD and HQT were less than the projected expenses due to efficiency gains?

**Response:**

**Mr. Yardley is citing the fact that HQD and HQT have each been able to reduce Operating Expenses over the past few years as evidence of the fact that management has been able to achieve efficiencies that have contributed to these results. This does not imply that all of the lower-than-forecast operating expenses are attributable to efficiency gains. There may be other circumstances that allowed Hydro-Québec to spend less than forecast while still meeting its public service obligations.**

3.3 In reference (ii), the Régie believes that the presentation of conservative projections both for loads and sales volumes is inherent to the regulatory framework of the cost-of-service principle. Does Mr. Yardley know whether the Régie's affirmation is supported by economic literature? If it is, please provide references in support of your response.

**Response:**

**Mr. Yardley's experience as a regulator is the basis for his view that the outcome of the rate case process, whether the result of a fully litigated rate case or a multi-party settlement is a revenue requirement that is representative of the level of expenses, including a compensatory return, that is likely to occur during the first year that rates are in effect, assuming normal conditions. This is frequently lower than initially requested by the utility, but it is the end result of the rate case process that matters, not the initial request.**

**3.4 Does Mr. Yardley agree with the Régie's position?**

**Response :**

Mr. Yardley agrees with the position expressed by the Régie that variances are inevitable. This result is likely whether expenses are partially based on a forecast or based entirely on historical information. As noted in the response to Request 3.3, Mr. Yardley's experience indicates that the revenue requirement that results from a rate case is representative of the level of expenses that is likely to occur.

**3.5 To your knowledge, what does the economic literature say on the cost-of-service incentives to which regulated enterprises are subject when it comes to annual rate cases?**

**Response:**

Mr. Yardley's experience, including in his capacity as a regulator and as a consultant, supports his views. He does not rely on specific economic literature examples.

**3.6 Please explain what "this" refers to in the excerpt "this implies that an understanding that the ESM... "?**

**Response:**

In this context, "this" refers to annual rate filings based on cost-of-service principles.

**3.7 Please justify the following affirmation: "It also implies that a meaningful deadband is appropriate to provide an incentive for HQD and HQT to pursue these efficiency gains".**

**Response:**

The utility retains 100% of all efficiency gains and absorbs 100% of all cost increases that result from inefficiencies within the deadband. Therefore, a broader deadband provides greater incentives to pursue efficiencies and avoid inefficiencies. Annual rate filings based on cost-of-service principles provide an inherent disincentive to pursue efficiency gains and thus it is particularly important under these circumstances to implement a meaningful deadband to avoid further reducing this incentive. Nonetheless, Mr. Yardley is of the opinion that he has proposed relatively modest deadbands that are at the lower end of the range that might be considered to be "meaningful".



3.8 In terms of reference (iii), please reconcile the objective of not creating an efficiency disincentive with the implementation of an "ESM", in a context where the starting point at which the ESM applies already, in and of itself, constitutes an efficiency disincentive (as mentioned in reference (i)).

**Response:**

**These circumstances are not in conflict. A narrow deadband will reduce the incentive to pursue efficiency gains, particularly as compared to the situation without an ESM in which the utility absorbs all earnings variations. Annual rate filings based on cost-of-service principles will reduce the incentive to pursue efficiency gains. Under these circumstances, Mr. Yardley believes that it is important to provide a meaningful incentive for the utility to pursue efficiency gains through the design of the ESM (i.e., both through the size of the deadband and sharing percentages outside of the deadband).**

3.9 How is the starting point of the efficiency incentive taken into consideration in the search for balance between the concern over earnings surpluses and the need to limit disincentives? Would a different initial incentive level have led to a different recommendation?

**Response:**

**The balancing of concerns is a matter of judgment. Mr. Yardley's proposal is intended to maintain an incentive to pursue efficiency gains that is meaningful, while still addressing the concerns that have been expressed by the Régie regarding the level of Hydro-Québec's recent earnings.**

**Question 4 :**

**Référence :**

① B0008, p. 15

**Préambule :**

À la référence (i) M. Yardley indique: "A. As this is the initial ESM for HQD and HQT, I would recommend that a relatively simple approach be adopted. This will provide experience with ESMs for all stakeholders."

**Questions :**

4.1 Quelle approche recommanderiez-vous si HQD et HQT n'en étaient pas à leur premier ESM? Veuillez justifier votre recommandation.

**Réponse :**

**It is not possible to answer this question in the abstract. Mr. Yardley cited the fact that it is the first ESM as support for a mechanism that is relatively simple, and in particular, does not have a tiered sharing formula when earnings are outside the deadband.**

**Question 5 :**

**Référence :**

① B0020 (HQDT3, Document 1), p. 21

**Préambule :**

À la référence (i) M. Yardley indique: "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 downside 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. "

**Question :**

5.1 Considérant que les Demanderesses soumettent annuellement des dossiers tarifaires, voyez indiquer en quoi un "deadband" plus restreint augmenterait le fardeau réglementaire lorsque vous affirmez: " the deadband provides a cushion within which it is not necessary to change customer rates, thus limiting the regulatory burden associated with rate change"?

Réponse :

**Mr. Yardley acknowledges that the "cushion" element in the context of reducing regulatory burden is not applicable when rates are adjusted on an annual basis if the timing of the new rates after a rate case coincides with the implementation of rate changes that reflect the ESM. Absent a rate an annual rate filling the deadband would serve this purpose.**

5.2 Selon M. Yardley, devrait-on s'attendre à ce que, avec l'application du mécanisme proposé, l'espérance mathématique du rendement réel soit inférieure au rendement autorisé, égale au rendement autorisé ou supérieur au rendement autorisé? Veuillez expliquer votre réponse.

Réponse :

**The realized return will depend on HQD's and HQT's performance and other factors that are beyond its control. Mr. Yardleys' proposal is designed to address the Régie's concerns regarding the level of earnings experienced in recent years as well as the benefits to customers from retaining an adequate incentive for HQD and HQT to pursue efficiency gains. Pursuit of the former objective will dampen HQD and HQT's realized return; the latter objective will contribute to a higher realized return.**

5.3 Selon M. Yardley, le mécanisme proposé répond à l'objectif qui a motivé la mise en place du MTÉR « in a manner that fairly balances the risks that are assumed by the Transmission Provider and the Distributor ». Veuillez indiquer quels sont les risques supportés par le Transporteur et le Distributeur.

Réponse:

**Under Mr. Yardley's asymmetric ESM proposal, the Transmission Provider and Distributor absorb all of the downside risks that are associated with the business including those that lead to lower revenues and those that result in higher expenses, for revenues and expenses not covered by variance accounts.**

5.4 Pour chaque risque identifié à la question précédente, veuillez indiquer si, selon M. Yardley, celui-ci une distribution de probabilité symétrique autour des valeurs prévues au dossier tarifaire. Le cas échéant, veuillez produire les analyses supportant votre réponse.

Réponse:

**The basis for Mr. Yardley's recommendation is contained within his prepared Testimony. He has not performed, nor did he rely upon a probability distribution analysis of individual risks or outcomes.**

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### Groupe technologie

#### **Question 6 :**

#### **Référence :**

Ø B.0020, p. 38

#### **Préambule :**

"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."

#### **Questions :**

6.1 Veuillez confirmer que « compensatory return on equity » réfère au rendement autorisé par la Régie.

#### **Réponse :**

**The term "compensatory return on equity" as used in this context refers to the ROE level that will provide HQD and HQT with an opportunity to earn a "fair" return on their invested capital. Application of this standard by the Régie in establishing the authorized return on equity will produce a compensatory return on equity.**

6.2 Selon M. Yardley, est-ce que la citation en référence implique que l'espérance mathématique du rendement réel est égale au rendement autorisé? Sinon, veuillez expliquer votre réponse.

#### **Réponse:**

**Mr. Yardley has not performed an analysis of the "expected value of the actual return." It is possible that such an analysis would produce an expected value that is higher or lower than the authorized return.**

6.3 Est-ce que la recommandation de M. Yardley repose sur l'hypothèse que l'espérance mathématique du rendement réel est égale au rendement autorisé?

#### **Réponse :**

**Mr. Yardley's recommendation is based on the assumption that the authorized return on equity is the fair compensatory return on equity.**

**Question 7 :**

**Référence :**

Ø B-0009

**Questions :**

7.1 Le cas échéant, veuillez fournir une copie de tous les rapports d'expertise de M. Yardley traitant de « ESM ».

**Réponse:**

**Mr. Yardley was a co-author of an April 20, 2012 report prepared for the Ontario Energy Board entitled, "Incentive Regulation Options for Ontario Power Generation's Prescribed Generation Assets" that addressed the role of Earnings Sharing Mechanisms. Please see Request 7.1, Attachment 1.**

7.2 Le cas échéant, veuillez fournir une copie de toutes les décisions rendues par M. Yardley traitant de « ESM ».

**Réponse:**

**Mr. Yardley does not recall that any of his rate case decisions involved an ESM.**

7.3 Veuillez fournir une copie du rapport d'expertise soumis par M. Yardley dans le cadre du dossier suivant : docket 99-04-18 of the Connecticut Department of Public Utility Control.

**Réponse:**

**A copy of Mr. Yardley's prefiled direct testimony in Docket No. 99-04-18 submitted to the Connecticut Department of Public Utility Control is attached. Please see Request 7.3, Attachment 1.**

**Question 8 :**

**Référence :**

- (i) B-0020, p. 27
- (ii) B - 0 0 2 0 , p . 2 9

**Préambule :**

A la référence (i), la Régie compile le tableau 13.1

A la référence (ii), le Transporteur confirme que les données du tableau 13.1 compilé par la Régie sont exactes.

**Questions :**

8.1 Veuillez pour chacune des années expliquer la ou les causes des écarts de coûts capitalisés.

**Réponse:**

**Une analyse de la variation des charges nettes d'exploitation est présentée à la pièce HQT-2, Document 1.1 des rapports annuels des années 2007 à 2012 du Transporteur.**

8.2 Veuillez pour chacune des années expliquer la ou les causes des écarts d'amortissement.

**Réponse:**

**Une analyse de la variation de la dépense d'amortissement est présentée à la pièce HQT-2, Document 1.1 des rapports annuels des années 2007 à 2012 du Transporteur.**