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ECONOMIC, FINANCIAL and STRATEGY CONSULTANTS

Summary of Direct Testimony of Paul Centolella

On behalf of Fédération canadienne de l'entreprise indépendante

Earnings Sharing Mechanisms

Purpose of Testimony

- **Purpose: Provide an independent ESM recommendation for the existing rate setting framework for HQ and the circumstances of this case**
  - Not a generic or theoretical ESM
  - Not asked to design an ESM for a multi-year PBR plan with substantial efficiency incentives
- **This case is different: With only a few exceptions, ESMs have been used in cases involving a utility's commitment to a multi-year rate plan**
  - In a multi-year plan, an ESM is used to mitigate the impacts of uncertainty that will not be addressed by reopening or initiating new rate proceedings
  - A multi-year rate plan can provide a strong efficiency incentive & an ESM provides a means to share cost savings with customers

Key Considerations

- **Important considerations:**
  - A history of earnings in excess of authorized returns
  - The use of annual rate cases based on the divisions' forecasted costs of providing service and sales
    - Permits the HQT & HQD to mitigate any downside earnings variances
    - Weakens the incentive to pursue efficiency improvements:
      - Only a subset potential efficiency opportunities are likely to have the possibility to contribute to earnings
      - This subset is likely to make only a limited contribution to earnings
      - For only a further sub-subset of these opportunities would the existence or structure of an ESM impact rational management decisions
  - Management's ability to manage earnings variances, including the additional flexibility to achieve earnings resulting from the lack of reliability and other service quality incentives
- **In this rate making structure, direct regulatory oversight of costs is the primary means of protecting customers**

Primary Function of an ESM in this Case

- **Address the impact of information asymmetry between the utility and the regulator**
  - With limited exceptions, a regulator is not in a position to observe many of the efficiency opportunities that may be available to the utility
  - Regulator not in a position make a timely observation of many of the opportunities available to the utility to generate a positive earnings variance
- **Reasonable response to a pattern of HQT and HQD earnings in excess of authorized levels**
- **Create a reasonable balance between protecting customers from excessive costs, while continuing to communicate to the utility that the regulator values the pursuit of efficiency improvements**

Primary Recommendations

- **Adopt an asymmetric ESMs that returns to customers a significant portion of actual earnings in excess of a reasonable authorized return on equity (ROE)**
- **No deadband**
- **For the first 50 basis points above a reasonable ROE, share excess earnings equally, 50% to the company and 50% to customers**
- **For any earnings in excess of 50 basis points above a reasonable ROE, share additional excess earnings at a ratio of 75% being returned to customers and 25% being retained by the utility**
- **Use of the same ESM structure for both HQT and HQD:**
    - Simple
    - Consistent with the historical pattern of HQT expenses deviating from forecasted levels by amounts exceeding the expense deviations for HQD
- **Do not act in this case to preclude any future review of the conformance of actual costs to applicable ratemaking principles and standards**

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