

**PRÉSENTATION DE
DE CONCENTRIC ENERGY ADVISORS SUR LES
CARACTÉRISTIQUES DU MRI DU
DISTRIBUTEUR D'ÉLECTRICITÉ**

Establishment of a Mécanisme de
Réglementation Incitative (MRI)
for
Hydro-Québec Distribution
Phase 1

Hearings before the Régie de l'énergie

September 19, 2016

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Concentric's Mandate

1. Assess HQD's specific characteristics and circumstances that could have a bearing on the selection of an appropriate MRI model;
2. Evaluate alternative MRI models in light of HQD specific characteristics and circumstances; and
3. Define, together with HQD, a model (the "HQD Proposal") that achieves the Article 48.1 objectives, consistent with HQD specific characteristics and circumstances.

Alternative MRI Models

Three basic models considered:

Option 1: Index-Based Revenue or Price Cap – revenues (or prices) are increased year over year based on an inflation index minus an estimate of efficiency gains (“I-X”).

Option 2: “Building Block” – Revenues (and prices) are adjusted each year based on a multi-year projection of costs that reflect an estimate of efficiency gains.

Option 3: “Hybrid” – Revenues (and prices) are adjusted each year based on a combination of approaches.

Attributes typically associated with each of these models:

- First-year revenue requirements are established by a rebasing that reflects cost-of-service.
- Provisions that address “exogenous” costs that are clearly beyond management’s control.
- Pre-defined off-ramps and performance indicators.

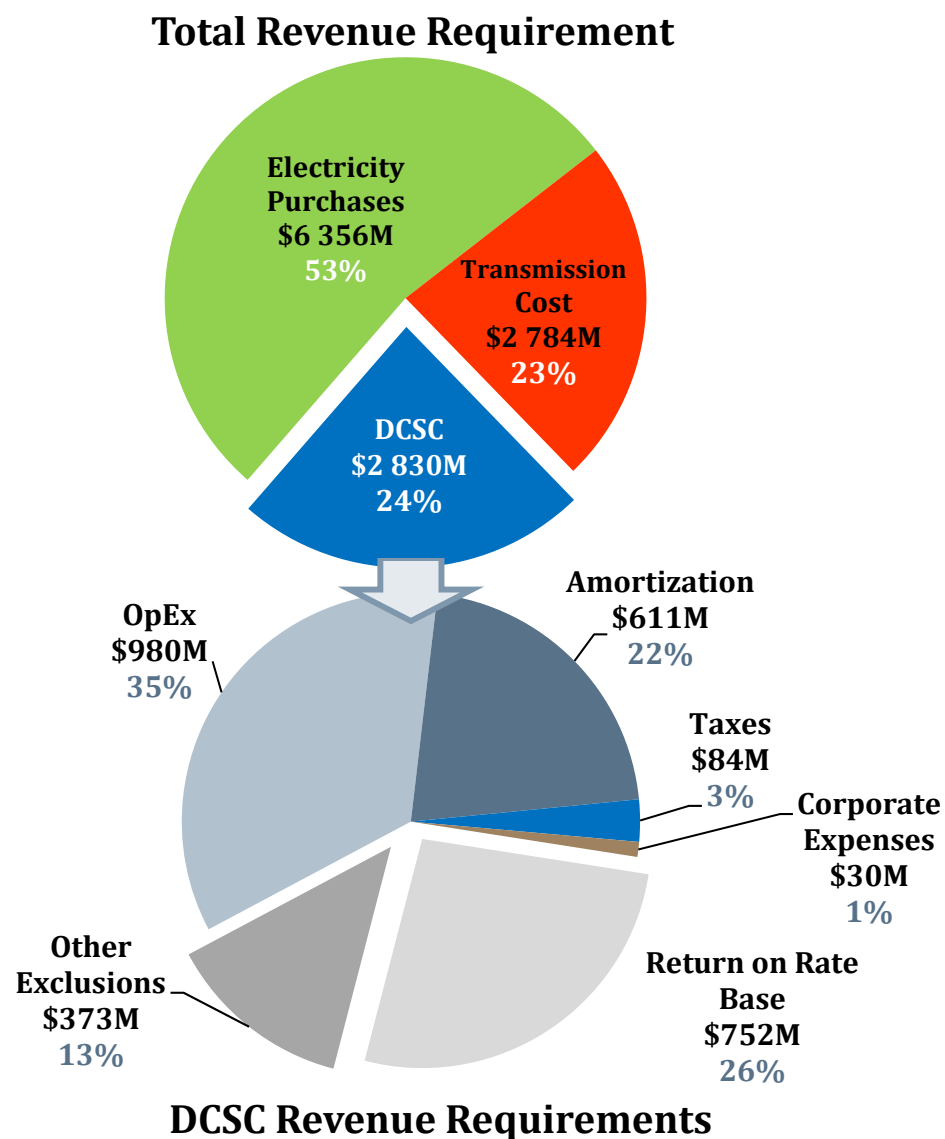
Rationale for a Hybrid MRI Model

HQD’s proposed Hybrid Model is a variation of Option 3 that reflects its revenue and cost drivers.

Revenue and Cost Drivers

- 76% of HQD’s 2016¹ revenue requirement is otherwise regulated (electricity purchases, transmission cost)
- Of the remaining 24% Distribution and Client Service Costs (DCSC), 60% would be subject to an I-X approach, as compared to 35% currently:
 - Inclusion of Amortization, Corporate Expenses, and Taxes
- CapEx treated as a “Y” Factor:
 - HQD’s CapEx are driven primarily by growth in number of customer accounts (46% of 2016 projected CapEx) and asset maintenance (42%) and do not track “I-X”.
 - Capital projects are authorized by the Régie pursuant to statute.

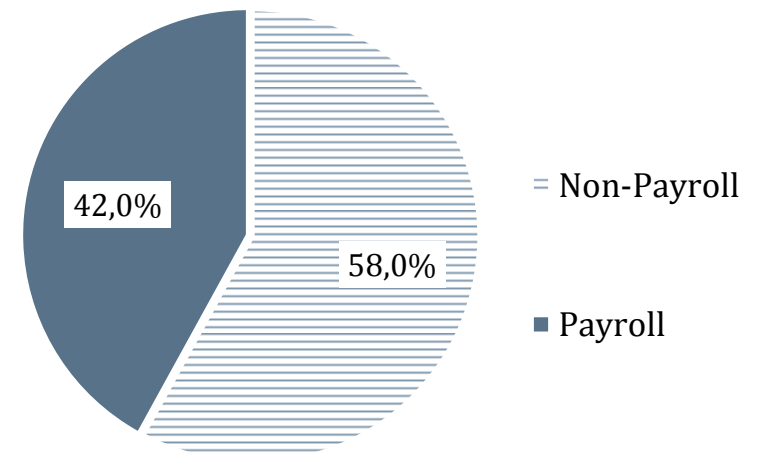
1. R-3933-2015, HQD-05-01



Inflation “I” Factor

- HQD I Factor Proposal is a composite of HQD labor inflation index and Canada CPI.
- Composite I-Factors are a common approach throughout Canada including Ontario, Alberta, and British Columbia, and in the U.S.
- An internal labor index provides greater confidence in its ability to accurately reflect HQD’s operating circumstances.

Payroll -
Percent of Operating Expenses
2016



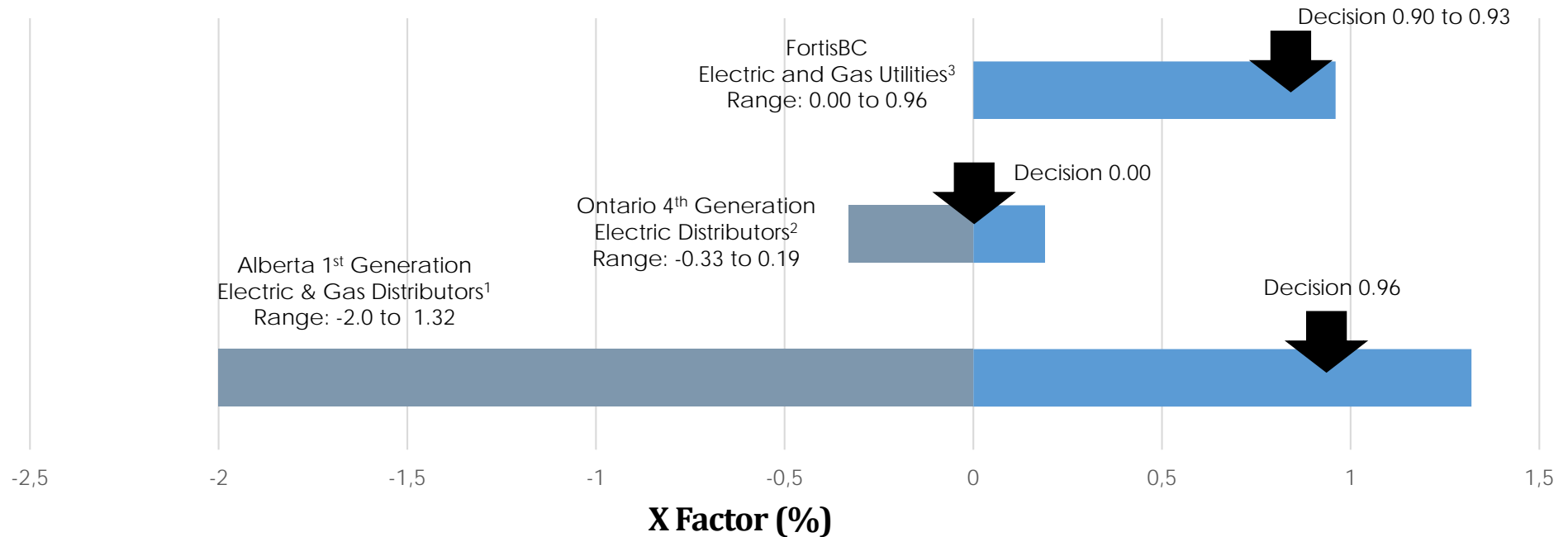
Productivity “X” Factor

- Regulatory agency “judgment” is the primary factor in establishing the X-factor, which may be informed by productivity studies and/or benchmarking studies, by recent X-factors derived in other jurisdictions, or by company-specific evidence – we refer to this as informed judgment.
- To the extent that productivity or benchmarking studies are considered, it is imperative to recognize their many controversies:
 - Determining the specific methodology, e.g., Total Factor Productivity or Partial Factor Productivity studies and specific algorithms to estimate X;
 - Identifying a valid comparison group, including distribution utilities from the United States to achieve a desirable sample size;
 - Determining the appropriate study period;
 - Assessing the comparability of input data that reflects varying regulatory and accounting policies among jurisdictions; and
 - The need to specify numerous assumptions not well understood by stakeholders and regulatory staff.
- The reliance on informed judgment is particularly necessary to both:
 - Address these shortcomings of TFP studies, and
 - Reflect prior HQD efficiency gains and other relevant HQD-specific circumstances that determine HQD’s ability to achieve efficiency gains over the term of the MRI plan.
- Establishing an X-factor that is overly aggressive could adversely impact customer service; an overly conservative target will dampen efficiency incentives.

Productivity “X” Factor: Recent MRI Proceedings in Canada

- A range of methods, samples, and time periods studied yield varying analytical results requiring regulatory judgement in setting productivity factors

RANGE OF EXPERT RECOMMENDED PRODUCTIVITY FACTORS AND COMMISSION DECISIONS



1. Plus 0.2% stretch factor (D2012-237, Sept. 12, 2012).
2. Plus 0.0 to 0.6% stretch factor (EB-2010-0379, December 4, 2013).
3. Plus 0.1% to 0.2% stretch factors (BCUC Decisions, September 15, 2014).

Exclusions: “Y” and “Z” Factors

- Y and Z factors are typically incorporated in MRI programs
- Y Factor Exclusions: known expense categories but deemed beyond management’s direct control, for example:
 - Electricity purchases
 - Transmission costs
 - Return on rate base
 - Variance or deferral accounts already recognized by the regulatory agency, *i.e.* weather normalization account, etc.
- Z Factor Exclusions: unknown expenses arising due to unforeseen circumstances and beyond management’s direct control, for example:
 - Extreme weather events
 - Significant equipment failure
 - Change in law or tax code
 - Government decrees; regulatory agency decisions

Electricity Supply and Transmission Costs

- The HQD Proposal maintains the existing policy of passing supply and transmission costs through to HQD's customers.
 - This practice is common across the utility industry and reflects the fact that these costs are flow-through items approved by the Régie.
 - This approach is also consistent with PEG's recommendation.²
- With respect to supply costs, the existing regulatory and statutory regimes provide active oversight of both HQD's contracting decisions and the dispatch of supply resources:
 - HQD files a 10-year supply plan every three years - reviewed and approved by the Régie, with annual updates;
 - HQD's execution of the approved supply plan and recovery of supply costs is addressed in rate cases; and
 - The dispatch of Heritage Pool supplies is mandated by law and all of HQD's supply strategies are approved by the Régie.
- With respect to transmission costs, HQD has very limited ability to influence transmission costs, and virtually no impact within the term of an MRI. Transmission costs are addressed in HQT's MRI.
- The Régie reviews and approves HQD's conservation and demand management programs which have the potential to influence supply and transmission costs over the short-term (supply costs) and long-term (transmission costs).

² PEG Evidence, p. 101, where PEG suggests these costs should be Y-factored.

Return on, and of, Capital

- The HQD Proposal excludes rate base and return on rate base from formula.
 - Rate base is more properly addressed through a review of capital projects to ensure that desired investments continue to be made when required
- Fair and accurate treatment of return on rate base benefits both customers and shareholder:
 - The cost of debt and the cost of equity are beyond the control of management
 - ROE set by the Régie; factors in bond yields and other capital market inputs
 - Cost of debt determined through corporate HQ financing
 - Without control, incentives tied to these costs create risk for both customers and HQD, without the expectation of productivity gains
 - I Factor does not accurately represent changes in these costs
 - There is considerable precedent in Canada for the pass-through of Return on Rate Base
 - Québec – Gaz Métro, Gazifère
 - British Columbia – FBC, FEI
 - Ontario – Enbridge
- Amortization is the direct result of capital projects, but nonetheless appears manageable under the formula for HQD.

Advantages of a Revenue Cap over a Price Cap Model

- Both Revenue Cap and Price Cap models provide strong incentives to pursue efficiencies during the term of the plan.
- The Revenue Cap approach, as proposed for HQD, adjusts revenues to accommodate the annual change in number of customers, a key driver of costs (consistent with PEG's proposed approach).¹
- The Revenue Cap approach incorporates annual changes in forecasted sales (increases or decreases) when adjusting rates each year.
- The Price Cap approach to industrial customers (under PEG's proposal) would either:
 1. Shift the fixed cost recovery risk attributable to discounting to industrial customers to other customers within the industrial class or to customers in other customer classes, or
 2. Result in an under-recovery of fixed costs by HQD as an MRI design element.
- Unlike the Price Cap model, the Revenue Cap proposal protects other customers and HQD from cost shifts and cost under-recovery.

¹ PEG Evidence, p. 98.

Service Quality Indicators

- Article 48.1 Objective #1: ongoing improvement in performance and service quality
 - Ensure efficiency gains are not pursued at the expense of service quality
 - Metrics focus on quality, not costs; cost incentives are captured by the MRI formula
- Criteria for identifying specific Service Quality Indicators
 - A limited number of metrics
 - Under the control of HQD
 - Reflective of HQD's core mission (customer satisfaction, quality of service, reliability and security)
 - Easy to measure
- Composite indicator: averaging of performance across indicators
 - Similar approach to that of Gazifère
 - Composite indicator moderates concerns that specific metric targets may be too low or too high, as performance is weighted across composite index
 - Composite indicator able to measure service quality evolution through time
- Phase 3 Item: Directly Link Service Quality to ESM
 - MTER design to be revisited to ensure alignment with HQD's MRI, before it can be linked to metrics

Autonomous Networks

- HQD Proposal: Integrate Autonomous Networks within the HQD's MRI
 - Autonomous networks account for a relatively small percentage of HQD's operations:
 - 0.3 % of sales
 - 0.5% of customer accounts
 - 2.0 % of total HQD Revenue Requirements
 - It would be challenging and burdensome to design and implement an MRI that would address the unique circumstances of autonomous networks.
 - For example, it would be impossible to establish a valid I or X factor that applies to all autonomous networks.
 - Integrating autonomous networks within the comprehensive HQD MRI provides an incentive for HQD to pursue cost efficiencies, even though it is not targeted to the particular circumstances of the various autonomous networks.
 - This proposal aligns with objective #3 of Article 48.1: Regulatory Streamlining

Regulatory Process and Annual Reporting

- Regulatory Process:
 - A single “compliance” filing that presents the new rates and all supporting calculations using a pre-defined template as directed by the Régie in this proceeding
- Annual Reporting:
 - Full Closing of the Books serves no purpose and would be costly and inefficient:
 - Increase in time and costs of implementation
 - Potentially requires two hearings each year
 - Costs are an offset to efficiency gains and would reduce HQD’s incentives
 - Contrary to the objectives of Article 48.1, particularly the streamlining objective
- First Generation MRI should be simple and easy to administer

Section 13

Responsive to Stakeholder Concerns

Concern		HQD Proposal
1	HQD should have a greater incentive to operate efficiently	The HQD proposal significantly expands the costs subject to the current parametric formula (60% of service & distribution costs vs. 35% currently).
2	The term of the rate plan should be at least four years	A Three-year term is appropriate, particularly since rates are currently rebased every year.
3	The HQD proposal does not provide a sufficient incentive to control capital costs	Rate base additions are conditional upon the Régie's prior authorization and thus already thoroughly reviewed. The HQD proposal includes amortization within the I-X formula providing a sufficient incentive.
4	The HQD proposal does not provide an incentive to control supply costs	HQD exerts little or no control over supply costs, which are subject to scrutiny by the Régie through a separate regulatory process. The current variance account treatment, triennial reviews of supply plans, and annual reviews of supply management and costs is an appropriate regulatory approach.
5	HQD should have a stronger Incentive to reduce peak demand.	HQD offers conservation and demand management programs that target energy usage and demand during peak hours. These programs reduce supply costs in the near-term and capital costs over the long-term.
6	HQD should include Decoupling and/or Time Varying Rates (TVR)	The design and implementation of either decoupling or TVR are not responsive to Article 48.1, too complex, and in fact not required if, as proposed, current exclusions for Energy efficiency measures are maintained.
7	A price cap, at least for industrial customers, is appropriate	As proposed, the price cap would likely result in a shift of cost responsibility to other customer classes or an under-recovery of fixed costs by HQD, which goes against the principle of uniform treatment for all customers. .

Section 14

Summary: HQD Proposal Achieves Objectives

MRI Objective	Assessment
1 Meet Section 48.1 objectives	
Ongoing improvement in performance and service quality	Expansion of costs subject to MRI formula; 3-Year term provides time to identify and implement efficiencies; quality metrics to ensure efficiency gains are not pursued at the expense of service quality.
Cost reduction that is beneficial to both consumers and the distributor	HQD will have a financial incentive to strive to beat the “I-X” formula for covered items. Ex-ante (X-Factor) and ex-post (ESM) sharing of efficiency gains with customers.
Streamlining of the regulatory process	Avoids annual hearings, relies on pre-defined compliance filing based on actual results, and avoids separate treatment of autonomous networks.
2 Reflect HQD’s specific characteristics and circumstances, including operations, business, and regulatory aspects	Depends largely on parameters to be established in Phase 3 including X-factor that reflects up-front efficiencies, ESM parameters (current MTÉR to be aligned with MRI parameters).
3 “First-generation” MRIs should be relatively straight-forward in their design and implementation	Defers consideration of certain complexities including efficiency carry-over mechanism. Three years provides valuable learning opportunity.