

16 August 2017

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Hi Guy,

Here is the proposal you requested for assistance to AQCIE, CIFQ, and other Quebec intervenors in Phase 3 of the Regie's deliberations to develop a "*mécanisme de réglementation incitative*" ("MRI") for Hydro-Quebec Distribution ("HQD").

Phase 3 MRI Issues and Concerns

On April 7 of this year, the Regie reached a decision on Phase 1 issues in proceeding R-3897-2014 to develop an MRI for HQD. D-2017-043 traced the broad outlines of this MRI and made final decisions on some important design issues. For example, the MRI will be a multiyear rate plan. Growth in the revenue requirement will be escalated by an $I - (X+s) + G$ formula, where I is measured inflation and G is 0.75 x growth in the number of HQD's customer accounts.

The X factor and the s factor in the revenue cap escalation formula will be decided by the Regie without the benefit of new, custom productivity studies.

[164] La Régie retient la méthode basée sur le jugement préconisée par le Distributeur pour déterminer la valeur du Facteur X à inclure dans la Formule d'indexation. À cette fin, le Distributeur devra mettre à la disposition des intervenants les études, analyses et rapports susceptibles d'éclairer la Régie quant à la détermination du Facteur X en phase 3.

HQD provided X factor evidence on June 29th in file R-3897-2014 Phase 1.¹ It included discussions of its own cost performance and commentary on productivity factors in North American regulation from its consultant Concentric Energy Advisors ("CEA").² HQD may file further X factor evidence at a later date:

¹ HQD, *Etudes, Analyses et Rapports pour la Détermination du Facteur X Déposés dans le Cadre de l'Établissement du Mécanisme de Réglementation Incitative du Distributeur*. June 2017.

² CEA, *Performance-Based Regulation: Productivity Factor for HQD*, 30 June 30 2017



« Dans le cadre de la phase 3B de l'établissement de son MRI, le Distributeur procédera à la mise à jour des études, analyses et rapports existants, le cas échéant, et présentera son positionnement quant à la détermination du Facteur X à utiliser pour son MRI.³ »

HQD filed for an increase to rates for the 2018-19 tariff year on 31 July 2017.⁴ The filing included a section on Phase 3 MRI issues. Only the Y and Z factor issues as well as the treatment of current deferral accounts were discussed in detail. HQD indicated that it will address other MRI issues in an Autumn 2017 filing.

On 9 August 2017, the Regie ruled in D-2017-086 that its hearings on HQD's rate application 2018-19 and Phase 3 MRI implementation issues for HQD will be consolidated. The Regie stated the following about requests for intervention on Phase 3 MRI issues:

« Toute personne intéressée doit indiquer les sujets de la demande tarifaire dont elle entend traiter, les conclusions qu'elle recherche ou les recommandations qu'elle propose, ainsi que la manière dont elle entend faire valoir sa position. Elle doit préciser, entre autres, si elle désire faire entendre des témoins et présenter une preuve d'expert. »⁵

AQCIE-CIFQ and other intervenors should participate actively in this proceeding, for several reasons.

1. HQD's recent submission on the X and s factors provides an unsatisfactory basis for the Regie to make a good decision on these issues, which are critically important to customers.
 - Independent benchmarking studies will not be funded under the Regie's guidelines, but HQD files extensive information about its cost performance in each rate case. Intervenors therefore need to appraise and, where necessary, challenge HQD's evidence on its cost performance. This is germane in setting the s factor.
 - The CEA's X factor discussion provides a distorted picture of the state of power distributor productivity research, suggesting that the multifactor productivity trend of distributors has recently been materially negative.
 - CEA's survey excludes important new results on productivity trends of power distributors.
 - CEA's discussion sheds no light on salient methodological issues that have recently caused a dispersion in the utility productivity results of different consultants. These issues include the capital cost treatment, changing accounting standards in Ontario, and the appropriate measure of output in a productivity study intended to help set the X factor in a revenue per customer cap like the Regie has chosen. When a commission simply takes the average value

³ HQD op cit. p. 12.

⁴ HQD, *Implantation d'un Mechanisme de Reglementation Incitative (MRI) – Phase 3*, 31 July 2017.

⁵ D-2017-086 p. 5.



from a range of productivity studies to set X, without commenting on their merit and relevance, it motivates utilities to choose consultants who produce studies with extreme values to influence the average. The Regie also needs more familiarization with methodological issues to provide guidance to HQD on its upcoming productivity study.

Note, finally, that HQD may provide further X factor evidence in the fall that requires rebuttal, including an unsolicited productivity study.

2. Many issues in the design of the MRI for HQD are unresolved. In addition to the X and s factors, these include the following:
 - Choice of inflation measures (alternatives to IPC^{Quebec} should be considered)
 - Methodology for HQD's Post Phase 3 productivity study (e.g. what sample is appropriate, what scale variable is correct, should alternative capital cost treatments be considered?)
 - Full list of costs that are eligible for Y factoring (e.g. energy efficiency expenses)
 - Details of the rate of return Y factor mechanism
 - Materiality thresholds for the Y and X factors
 - Service quality performance incentive mechanisms
3. The Regie did not provide rulings in D – 2017 -043 on a few notable issues. Most importantly, it chose a revenue cap for HQD without expressly deciding whether to complement it with revenue *decoupling*. Revenue decoupling has many merits, including its ability to encourage peak load management and to reduce controversy over future billing determinants in ratesetting. It has been combined with revenue caps in numerous MRIs around the world. Even were the Regie to rule against decoupling, it must decide how revenue requirement growth translates into rate growth.

The decision also skirts the issue of incentives for peak load management. This is a key consideration in Phase 3 since HQD can influence peak loads that drive transmission costs but these costs have been Y factored, reducing HQD's incentive to contain them. The regulatory system for HQT is as yet unknown. There is little gain from amortizing peak load management expenditures since they tend to be modest. Incentives for utilities to consider non-wire alternatives to transmission and distribution capital spending have recently been adopted in several U.S. jurisdictions.

PEG's Budget

PEG proposes to work on a time and materials basis subject to a cap of **CAD 135,000** for Phase 3 issues in the development of an MRI for HQD. A spreadsheet with a budget estimate is attached. In preparing this estimate, hourly billing rates have been escalated by 1.0278 from those we charged in Phase 1 of the HQD proceeding. The escalation is based on the cumulative 2.78% inflation in the US Gross Domestic Product Price index which occurred between the second quarters of 2015 and 2017.



These hourly rates constitute good value for the services of highly qualified U.S. consultants, due in part to the currently weak value of Canada's dollar. PEG continues to be North America's leading MRI consultancy, with large projects in Calendar 2017 for the Ontario Energy Board ("OEB"), Green Mountain Power, and Xcel Energy. We were active in the Alberta MRI proceeding that CEA discusses in its X factor report, and an expert on Ontario power distributor productivity trends. We recently completed a new study of U.S. power distributor productivity for Lawrence Berkeley National Laboratory. We are currently undertaking a multinational power distribution cost benchmarking study for Alberta's Utility Consumer Advocate which includes Alberta, Ontario, and U.S. data. PEG is nonetheless prepared to charge low rates in Quebec because our work there is in the public interest and we have a long term commitment to advance the cause of MRI. Private ownership of our firm makes pricing flexibility to reflect such considerations possible.

The itemization of the tasks, and the hours we propose for each task, reflect our knowledge of how much work was involved in Phase 1 of this proceeding. Economies were possible for several reasons.

- The scope of issues has been greatly reduced by the Phase I proceeding.
- There is little need for PEG to do further background research on Quebec regulation or HQD.
- PEG Staff members Matt Makos, Dave Hovde, and Kaja Rebane played important roles in the Phase 1 proceeding and are thus able to "hit the ground running".
- The cost of our work is also reduced by our good reading knowledge of French.

The cost of an effective program of work for ACQIE in Phase 3 is nevertheless substantial, for several reasons.

- As was the case for Phase 1 of case R-3897-2014, we stand ready to continue to act on behalf of not only ACQIE and CIFQ but also on behalf of *all* intervenors in the proceeding and would take the time to provide a draft of our testimony to them and solicit their comments.
- It will be necessary to read extensive evidence and prepare information requests and responses to such requests.
- It is desirable to examine some precedents from other jurisdictions on some of the plan design issues (e.g. Y factors and clauses de sortie) which haven't been resolved.
- We would review HQ's cost performance evidence with the eye of a consultant who has prepared benchmarking studies for many MRI proceedings.
- We would elucidate key issues in the measurement of power distribution productivity.
- We would update our simple calculations on the historical and expected future cost per customer trends of HQD.
- We would like to retain the services of Jean-Paul Chavas for a few hours to appraise some key issues in recent power distributor productivity debates. Dr. Chavas is a distinguished production economist of French origin and a chaired professor of Applied Economics at the



University of Wisconsin. A fellow of the Agricultural and Applied Economics Association, he has received many awards for his research. This is a great chance to involve him in Quebec regulation, which may increasingly rely on production economics, at low cost.

- Oral testimony will still require quite a bit of time for preparation, attendance, and travel.

Our budget may require adjustment when HQD files its evidence this fall.

Conclusions

I hope you appreciate the high quality of the team we have assembled to help the Regie establish an MRI for HQD and comply with provincial regulatory law. The cost is reasonable and necessary to help the Regie get the details of a novel multi-year regulatory system right. Thanks for the chance to continue our enjoyable and important work for all Quebec intervenors.

Sincerely,

Mark Newton Lowry, PhD

President, PEG Research LLC

