

SPEAKING NOTES July 11th, 2022

Dr. Roger Higgin

Sustainable Planning Associates Inc.

Presentation of Option Consommateurs Volet 2

For

CANADA
PROVINCE DE QUÉBEC
DISTRICT DE MONTRÉAL

No: R- 4167-2021

RÉGIE DE L'ÉNERGIE

Demande du Transporteur de modification
des tarifs et conditions des services de
transport pour les années 2021 et 2022;

HYDRO-QUÉBEC
Demanderesse

- et -

OPTION CONSOMMATEURS
Intervenante

Introduction - Revisions to OC Memoire (March 28, 2022)

Added References to OC Memoire - review of NERA Evidence

Page 4 : Following title Regulatory Lag- Dr. Makholm states **(page 10) :**

Footnote 6 B-0196 Question 7a)

Page 5 : Following the title NERA Comments on Positions of FCEI and AQCIE-CIFQ, NERA cites **(p.12)** the following extracts from a prior Régie decision:

Page 6: Following Title NERA Comments on Omissions in the Régie’s Framing of the DVA Issue
Dr. Makholm states **(p. 13 and14):**

Page 7 Dr. Makholm concludes as follows **(Page 15) :**

Footnote 14 NERA report, p.13

Errata

Page 9 delete ~~The Régie has established a \$15 million materiality threshold~~

Page 10 delete “~~taking into account the Régie approved materiality threshold of \$15 million”.~~

With regard to Errata.

Dr. Higgin made an error in stating that the Z-Factor Threshold of \$15 million revenue requirement for the MRI applied also to capital.

Dr. Higgin was mixing up Ontario with Quebec which does not have a threshold. So OC has filed a revised Memoire. The deletions are two lines on page 9 and page 10 of the original Memoire.

in the revised version the deletion is shown in “font -strikeout”

OC Presentation

Title Slide

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* Presentation of Option Consommateurs Volet 2

Dr. Roger Higgin
Sustainable Planning Associates Inc.

Slide 2

I. Capital Deferral and Variance Account (DVA/CER)

A. *Regulatory Deferral and Variance Accounts;*
B. *Regulatory Lag;*
C. *NERA Comments on FCEI and AQClE-CIFQ Evidence*
D. *OC Comments on NERA Evidence*
E. *Conclusions and Recommendation.*

OC Presentation Evidence-In-Chief 2

- Turning to the Power Point presentation, this is in two parts
- Part I. Capital Deferral and Variance Account (DVA) and
- Part II. Compensation Benchmark Study
- This slide is the outline of what Dr. Higgin plans to address regarding a Capital DVA.

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Slide 3

A. Regulatory Deferral and Variance Accounts- NERA Criteria:

- the cost is beyond the provider's control and can have a significant impact on revenues.
- criteria established by the Régie and used by HQT are no exception to the rule that is widely employed by North American regulators.
- Limits expense deferral accounting to cases where:
 - (1) the cost is material and extraordinary in nature, and
 - (2) the cost was incremental to what was allowed in rates.
- "deferral and variance accounts are not intended to be used for costs that are routine, nor those that are expected and easy to forecast. Rather, these accounts are used for those costs *that cannot reasonably be expected or may be out of the utilities control* as the above examples (NERA Table 2) show".

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- NERA sets out the criteria for DVAs as shown here:
- Deferral and Variance Accounts are commonly used by Regulators to deal with costs, that as NERA says, are material, extraordinary and difficult to forecast
- Examples of Capital DVAs are replacing meters, electric vehicle charging stations and perhaps storm restoration, as noted in NERA Table 2

The criteria are the same as for capital and OM&A DVAs
(Cost is material and unforeseen i.e. not easy to forecast.)

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Slide 4

B. Regulatory Lag

Dr. Makhholm states:

- “The source of the incentive on HQT to be efficient in pursuing needed new capital projects is *regulatory lag*; It permits regulated companies to earn returns against a pre-determined trajectory of rate control—driving those companies’ incentives to keep costs down”.
- “Regulatory lag is a subject integral to Canadian PBR generally. For example, from 2010 to 2012, the Alberta Utilities Commission (the AUC) held North America’s largest generic proceeding on how to re-implement *RPI minus X* regulation for its electric and gas utilities. *The AUC confirmed that its PBR regime was all about regulatory lag*”.
- “As NERA emphasized, this concept [of regulatory lag] corresponds to the underlying theory behind PBR plans in Canada and the United States: to permit regulated prices to change to reflect general price changes and industry productivity movements without the need for a base rate case. The effect is to lengthen regulatory lag and better expose regulated utilities to the type of incentives faced by competitive firms”.
- Dr. Makhholm cites regulatory lag as a major consideration for deferral accounts.
- He cites specifically, the late Dr. Alfred Kahn, Alfred E. Kahn, *Economics of Regulation, Vol. 2* (New York: John Wiley & Sons, 1971), page 48.

NERA Report Section IV
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- We have heard from HQT’s experts about “Regulatory Lag” as an incentive on the one hand and on the other hand ongoing concerns from AQCIE-CIFQ and FCEI about the impact on rates from inaccurate capital forecasts and in-service dates.
- What is Regulatory Lag? Regulation 101 says it occurs due to the fact that when rates are set, the costs, in this case, capital, may differ from forecast. In cost of service regulation the deviations (ecarts) usually go both ways and are reasonable. In multi-year rate plans, this also means the annual realized return on capital may differ from the approved amounts over the term of the plan. Regulatory Lag is a feature of all utility capital plans. Dr. Makhholm considers it to be an incentive mechanism, both in cost of service and indexed MRI rate plans
- It provides a productivity incentive for the utility to reduce its CAPEX or bring the assets in service early, thereby increasing its net income and return.
- In practice this can work and if there is a MTER/ESM ratepayers benefit. However, the fundamental issue that plagues this regulatory compact is inaccurate capital and in-service date (commissioning) forecasts.
- That’s when the regulatory compact breaks down and if the forecasts are asymmetrically wrong in favor of the utility, customers object to paying for assets that are not in-service and ask the regulator for **relief**.
- One type of relief is a Capital DVA. Others are ex-ante and ex-Post markdowns. These are already used by the Regie.
- DVAs are more commonly used for OM&A or revenue expenses. **NEXT SLIDE (5)**

Slide 5

B. Regulatory Lag (continued)

Dr. Makhholm also refers to Decision D-2020-041 and the reduction in capital made by the Regie. He concludes that:

“It would have been better, in framing the DVA issue, for the Régie to make a distinction between

(a) a more detailed review of business plans and

(b) after-the-fact comparisons that by themselves simply cannot answer the question of whether forecasts underlying such a PBR plan are reasonable”.

NERA Report Page 14
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- So what can the Regulator do?.
- I can only reference my experience as a regulator in Ontario.
- Dr. Makhholm criticizes the Regie’s decision in D- 2020-041 of an ex- post (after the fact) reduction.
- Certainly a post-ante reduction is a tool often used by regulators, including by myself in the past.
- Dr. Makhholm is critical of any after the fact adjustments that reduce the incentive related to regulatory lag. I agree with him to a point, except that historic performance informs future regulation.
- The question is what to do if the regulatory compact does not work. for example, if the utility is consistently over-forecasting capital costs and in service (commissioning) dates. The Regulator’s task is to ensure that over the longer term, the rates are just and reasonable.
- **NEXT SLIDE (6)**

Slide 6

C. NERA Comments on AQCIE-CIFQ Evidence

With regard to the position of AQCIE-CIFQ and FCEI, Dr. Makhholm concludes:

- “There should be a reasonable expectation that an incentive regulatory regime based on forecast test years will produce earnings for HQT (which are shared with consumers in an independent ESM-based sharing). The FCEI discussion of “median forecast,” mixing forward-looking forecasts and hind-sight-based actual expenditures, is inconsistent with that reasonable expectation”.
- “Neither FCEI nor PEG have offered any reasonable evidence, or any recommendation for obtaining evidence, to support their charges of bias, exaggeration, or a basis upon which any future “trimming” could occur. PEG does suggest a closer review of HQT’s “business plans.” If PEG means a further close-focus engineering review of HQT’s capital project forecasts at the time HQT makes them, it could be a useful suggestion. But the rest of PEG’s short discussion of the issue—particularly the comment on “trimming,” continues to suggest that PEG, like FCEI, mixes *forward-looking* forecasts with *hindsight-based* actual expenditures, which is a type of comparison that undercuts any incentive based in regulatory lag”.

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D. OC Comments on NERA Evidence

- OC notes that the issue is limited to whether a DVA (CER) for capital is appropriate, not if DVA’s for operating expenses or revenues are appropriate.
- OC notes that NERA was not aware of the Capital-In-Service Variation Account (CISVA) of Hydro One Transmission*.
- OC notes that NERA did not analyse the historic capital forecasts for HQT in its evidence and declined to provide this analysis as requested in OC DDR’s (B-0196, Q.5 and 6).
- OC suggests that the NERA evidence on the merits of regulatory lag as an incentive mechanism, is less pertinent to HQT under cost of service than it would be under a PBR scheme (including capital) or it would be under a multi-year capital plan.
- HQT capital forecasts for projects <\$65 million are reviewed under cost of service annually
- Regulatory Lag is reduced compared to multi-year rate plans. In addition, the ESM provides a buffer for HQT and ratepayers.
- OC also suggests that there is clear evidence that as shown by AQCIE and FCEI, (AQCIE-C-101 Table 1) there have been material deviations in both the capital forecast amounts and the in-service (commissioning) dates for projects <\$65 million.
- Larger Projects such as Michoua-Saguenay, which OC addressed in Volet 1, also often show large deviations between forecast and actual.
- OC accepts that recently, deviations may have been reduced somewhat for projects <\$65 m.
- OC suggests that both ex-ante and ex-post reviews of capital plans are normal regulatory tools.
- OC suggests the fundamental issue to be addressed is: are the rates just and reasonable?
- OC suggests materially excessive capital forecasts or incorrect in-service dates, do not result in just and reasonable rates. Ratepayers pay for assets that are not “used or useful”.

*OEB EB 2021-01-10 Hydro One Joint Rate Application Exhibit G Tab 1 Schedule 1 Section 3.14 Page 19 and Exhibit G Tab 1 Schedule 2 Section 4.3 Page 20 and Attachment 10

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- AQCIE-CIFQ and FCEI have raised legitimate concerns about HQT capital and in-service date forecasts. Dr. Makhholm has criticized their analysis and appears to contend that review of ex- ante forecasts is OK but post- ante reviews are not.
- Even in the former case, he indicates “trimming” reduces the incentive provided by regulatory lag. He also criticises the approach of an ex-ante (Before the Fact.) approach proposed by AQCIE-CIFQ and Pacific Economics Group.
- OC agrees with detailed ex-ante review of capital forecasts as the normal approach. Both intervenors and the regulator can review the forecasts and propose changes. That does not mean that post-ante review is not appropriate, especially if projects such as Micoua Saguenay, appear to go off the rails.
- Doing this ex-post review for projects under <\$65 million is perhaps not practical. However, a portfolio approach supported by Business Plans is appropriate.

Next Slide (7)

- Given this track record and NERA evidence that the regulatory compact requires regulatory lag productivity incentives for both cost of service and incentive regulation, OC has considered the options:
- First regulatory lag is not limited to capital. It occurs for expenses such as OM&A. regarding the use of DVAs is more common.
- OC notes that regulatory lag is weaker or annual cost of service capital regulation, due to annual reviews of capital forecasts.
- There has been a historic problem with HQT capital forecasts. And this occurs for the portfolio of projects under \$65 million and sometimes for larger projects such as Micoua- Saguenay.
- AQCIE-CIFQ Memoire Table 1 shows the impact on rates is material. Ratepayers have paid for assets that are not in service.
- HQT says its forecasts have improved.
- However Dr. Makhholm agreed that a \$25 million deviation is material. A \$25 million capital deviation still means ratepayers would have paid about \$2 million for assets not in service. This also increases the net Income of HQT, (apart from the MTER/ESM benefit in the overall return). NEXT SLIDE(8)

Slide 8

E. Conclusions and Recommendation

Options Considered by OC

- DVA(CER), similar to the Hydro One Transmission Capital In Service Variation Account (CISVA)
- An ex-ante markdown of capital for 2023 and 2024. The amount would be calculated based on recent 5 year historical difference between the Company's capital revenue and capital cost, on revenue requirement, for projects under \$65 million.
- Postpone consideration of a CER until the 2024 HQT cost of service rebasing and review of a Second Generation MRI. Monitor HQT Capital performance in 2022 and 2023.

Primary Recommendation (per OC Memoire)

- Defer the Issue of a Capital CER to Rebasing in 2024 and consideration of a second-generation MRI, including Capital. In the interim, monitor HQT Capital forecasts.

New Primary OC Recommendation

- *Based on continued Cost Of Service for HQT capital for the next few years, consider a DVA similar to Hydro One Transmission CISVA Account (excluding verified productivity and 2% dead-band).*
- OC notes that the Next Generation MRI for Hydro One Transmission is being reviewed by the OEB this fall (EB-2021-0110) and there may be changes, including the CISVA DVA.

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- What are the solutions? OC suggests the evidence is that the HQT regulatory compact for capital is not working adequately and needs adjustments. Options include:
 - DVA
 - Rigorous ex-ante reviews and markdowns.
 - Post-ante reviews –perhaps not practical for <\$65 million multi project portfolio.
- Given the potential for improvement in accuracy of HQT forecasts, **in its Memoire, OC opted for postponement of a decision until the next second generation MRI in 2024.**
- However, given the new evidence on the HQT regulatory plan for capital cost of service, for several years, OC now supports a DVA.
- The remaining questions are how to structure the Capital Variance Account. Does the account record **both** the quantum and in-service date variations on the Test Year Revenue requirement? OR only commissioning date impacts, as suggested by FCEI.
- Should the account be symmetric or asymmetric?
- Asymmetric allows HQT to get the productivity incentive by beating its forecast, but protects ratepayers from overspending .
- What is the threshold that HQT should be required to meet?. The threshold for an OM&A Z-factor of a \$15 million impact on the revenue requirement is one option, (as also suggested by AQCIE-CIFQ.) Another is a percentage dead-band like the Hydro One Transmission DVA of 2%.

OC has provided the references for the Hydro One CISVA account. The illustrative example in EB-2021-0110 Exhibit G Tab1 Schedule 2 Attachment 10 page 2 shows how the CISVA works and how the CCA tax effects are addressed.

Hydro One is under custom incentive revenue cap rate plan with the capital amount determined by a Capital Factor.

An Asymmetrical Capital In-Service Variation Account, with reduction for productivity and 2% dead-band, like the Hydro One CISVA may/may not be appropriate for HQT. But OC would support an asymmetric DVA that covers deviations from forecasts for both the capital amount and in-service (commissioning) dates.

END OF PART I

PART II. Normandy-Beaudry Compensation Benchmark Study

Slide 9

II. HQ Compensation Benchmark Study

- A. Review of Normandin-Beaudry Expert Study
- B. Summary of OC Conclusions
- C. Recommendation

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Moving to Part II-The Normandin-Beaudry Compensation Benchmark Study B-0020 updated to B-0189

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Slide 10

A. Normandin-Beaudry Total Compensation Benchmark Study

- In Docket R-4167-2021 Volet 2, Hydro Quebec (“HQ”) filed a compensation benchmark study authored by Normandin-Beaudry (“N-B”) as exhibit B-0020.(Updated B-0189)
- This study was requested by the Régie de l’énergie (“Régie”) in D-2018-067 (HQD)¹ and D-2019-060 (HQT)².
- The N-B report benchmarks HQ total compensation to a selected peer group of 44 comparable companies, including 18 other energy companies.
- The selected benchmarked positions were 8 groups of employees, including managers, professionals, technicians and office staff.

1. D-2018-067 Paragraphs 280-285
2. D-2019-060 Paragraph 218

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- I have previously addressed the regulatory implications of such Benchmark Compensation Studies in several cases, including for Hydro One Networks, Toronto Hydro and Ottawa Hydro.
- The current Normandin-Beaudry benchmark is structured like most comparable studies.
- There are always issues regarding methodology (simulated method vs direct method), sample composition, position of employees within the salary scale and direct vs indirect remuneration. Collective bargaining is also a factor.
- These are matters for the experts to debate.

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Slide 11

Normandin-Beaudry Total Compensation Benchmark Study(continued)

Value of total compensation
The following equation was used by N-B to determine the value of total compensation for each organization:

Direct Remuneration = Non-unionized employees
Average base salary
+
Target incentive compensation
Unionized Employees
Average base salary (35 hours)
+
Target Incentive

Indirect Remuneration = Compensation Pension Plan Value
+
Value of Group Insurance Plans

Total Compensation = Direct Remuneration
+
Indirect Compensation

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- The components of total compensation/remuneration, under the simulated method used by Normandin-Beaudry are shown here for each group of employees:
 - Management excluded,
 - Union and other collective bargaining units.
 - It is important to note that salaries and wages are the main direct compensation, but indirect remuneration, Incentive pay and benefits can be important factors.
 - It is also relevant whether employees are in a defined benefit plan or defined contribution plan ; the employer/employee contribution ratios for Other Pensions and Benefits,(OPEBs).
- NEXT SLIDE (12)

Slide 12

OC Comparison of 2016 and 2021 Results (2015 and 2020 Data):

OC Table 1: Difference between HQ's total compensation and the market median

Employee Group	2016 Total Compensation	2021 Total Compensation
■ Middle management	-2%	3%
■ Managers	9%	2%
■ Professionals	7%	11%
■ Specialists*	5%	7%
■ Engineers*	3%	10%
■ Technologists*	11%	15%
■ Trades* (in French)	5%	-1%
■ Office*	9%	13%
Total	6%	7%

- The comparison of results of the 2016 and 2021 studies indicates that directionally, in aggregate terms, HQ has not moved closer towards market median total compensation.
- In addition, for all groups of employees except trades, the total compensation benchmark has moved to higher levels of total compensation than the market median.

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- This slide compares the total remuneration of HQ employees relative to the benchmark in 2016 and 2020.
 - The band of comparability, according to N-B, is $\pm 5\%$ relative to the peer group median benchmark.
 - The comparison shows that from 2016 to 2020 HQ Total Remuneration has moved away from the benchmark (higher) than the Peer Group in aggregate for all groups, except Trades.
 - In addition, except for Trades, all groups have moved to relatively higher levels compensation from 2016 to 2020
- NEXT SLIDE (13)

Slide 13

B. OC Conclusions

- The 2016 (2015 data) Normandin-Beaudry study found that HQ total compensation was 6% in aggregate, above their market median benchmark.
- In 2021(2020 data), N-B found that HQ total compensation was 7% in aggregate above their market median benchmark.
- In addition, 7 of 8 employee groups have moved to higher levels of relative benchmark compensation than in 2015. Trades are the exception to this.
- N-B states that an appropriate reasonable range is $\pm 5\%$ relative to market median.
- OC questions if this range is appropriate for each group of employees.
- Each group of HQ employees, except management, undertake separate collective bargaining.
- OC believes in principle, that it is not reasonable for HQ ratepayers to pay utility total compensation costs that are significantly above the market median.
- In the longer term, HQ, like many other regulated utilities, should target market median total compensation for all employees.
- OC has not undertaken any analysis, regarding whether employee and employer pension and benefits contribution ratios are in line with best practices, but suggests these should be reviewed by HQ in moving towards market median total compensation.
- When setting an appropriate amount of total compensation for 2022 and 2023, inflationary pressures apply to compensation across all sectors of the compensation market. HQ has not demonstrated that it is subject to unique inflationary pressures.

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- OC believes this result is not consistent with the Regie prior direction for HQ to move closer to the Total Compensation/Remuneration competitive band of $\pm 5\%$.
 - The N-B Finding is that HQ Total compensation/remuneration is at least 2% above the competitive band/range. The Optimum AC study result is that HQ at least 5% above the competitive range.
 - As noted earlier, except for Trades, all groups have moved to higher levels of relative compensation from 2016 to 2020
 - OC believes HQ should be in the competitive range, otherwise ratepayers are paying above market compensation costs in the OM&A envelope.
 - When considering Total Compensation for 2022 and 2023, the current inflationary factors apply across all sectors of the labour market and HQ has not demonstrated it is facing unique inflationary pressures, relative to the peer group.
- NEXT SLIDE (14)

Slide 14

C. Recommendation

OC Recommends that:

- The Régie reduce the HQT and HQD OM&A costs related to total compensation for 2023 and 2024 respectively to 5% above market median, in aggregate.
- The Régie should direct HQ to attain a market median total compensation benchmark for all employee groups as soon as possible.

Thank you for your attention

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- OC recommends that the Regie reduce the 2023 and 2024 HQT and HQD OM&A costs related to Total Compensation/Remuneration to 5% above the market median.
- END OF PART II

END OF DOCUMENT