Témoignage de The Brattle Group sur les mécanismes de traitement des surplus ou des manques à gagner cumulés du Transporteur et du Distributeur

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BEFORE THE
RÉGIE DE L'ÉNERGIE DU QUÉBEC

DIRECT TESTIMONY OF MR. TOM CHAPMAN, MR. ADAM WYONZEK, AND DR. METIN CELEBI

FOR

HYDRO-QUÉBEC IN ITS DISTRIBUTION ("HQD") AND TRANSMISSION ("HQT") ACTIVITIES

JUNE 23, 2026

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I. INTRODUCTION

Q. Mr. Chapman, please state your name and business address.

A. My name is Tom Chapman, and I am a Principal at Brattle, whose business address is 40 King Street West, Suite 3301, Toronto, Ontario, M5H 3Y2.

Q. Mr. Chapman, briefly describe your education and professional qualifications.

A. I am a senior member of Brattle's Electricity Practice, and I lead electricity work at Brattle's Canadian office in Toronto. As an energy economist, I have led projects across different practice areas and across different Canadian provinces, including regulatory economics, benefit-cost, benchmarking analysis, and rate and pricing analyses. I have also worked in the Canadian electricity industry for Ontario's Independent Electricity System Operator and with the Ontario Ministry of Energy, where, amongst other responsibilities, I was responsible for overseeing annual and quarterly financial reviews of Ontario Power Generation and Hydro One, the two largest electric utilities in Ontario.

I have been a lead witness and provided testimony and expert reports to Canadian regulators and policymakers on matters concerning electricity costs, regulatory charges, and energy policy. My testimony and expert reports have been presented before state regulatory commissions, the Ontario Energy Board, and legislative committees.

I hold an M.Sc. in Business Economics and a B.Sc. (Hons) in Economics, both from the University of Wales, Swansea (U.K.). I have completed executive programs at IVEY Business School and Queens Smith School of Business. I have also taught postgraduate courses on Electricity Markets at Toronto Metropolitan University. My curriculum vitae is provided in Exhibit A.

Q. Mr. Wyonzek, please state your name and business address.

A. My name is Adam Wyonzek, and I am an Associate at Brattle's Canadian office in Toronto.

Q. Mr. Wyonzek, briefly describe your education and professional qualifications.

A. My work focuses on regulatory economics of the energy and utilities industry. I have experience working on regulatory and litigation matters, including cost of capital and capital structure, business and financial risk assessment, utility and pipeline ratemaking (including cost of service, cost allocation, and rate design), performance-based regulation, and valuation for ad valorem tax disputes. I have previously submitted written testimony before The Board of Commissioners of the Public Utilities of Newfoundland and Labrador.

Before joining Brattle, I was employed as a regulatory economist at TC Energy. I received a Master of Financial Economics from the University of Toronto and a Bachelor of Arts (Honours) in Economics from the University of Calgary. My curriculum vitae is provided in Exhibit A.

Q. Dr. Celebi, please state your name and business address.

A. My name is Metin Celebi, and I am a Principal at The Brattle Group ("Brattle"), whose business address is One Beacon Street, Suite 2600, Boston, Massachusetts 02108.

Q. Dr. Celebi, briefly describe your education and professional qualifications.

A. I have been employed as a consultant in the electric power industry for more than 25 years. My expertise includes electricity markets, resource and transmission planning, ratemaking, valuation of generation plants, and evaluation of environmental and climate policies. I have provided expert testimony in a number of cases before the Supreme Court of the United

States, district courts, and federal and state energy regulatory agencies including Régie de l'énergie.

I hold a Ph.D. in Economics from Boston College, where my dissertation was on transmission investment, pricing, and power system modeling, a master's in economics from Bilkent University in Ankara, Turkey, and a Bachelor of Science in Industrial Engineering from Middle East Technical University in Ankara, Turkey. Further details regarding my background, publications, and prior expert testimony are provided in my résumé, which is included in Exhibit A.

II. PURPOSE OF TESTIMONY AND SUMMARY OF CONCLUSIONS

Q. What is the purpose of your testimony in this proceeding?

A. We have been asked by Hydro-Québec in its Distribution ("HQD") and Transmission ("HQT") activities (collectively, "HQTD") to present a recommendation to the Régie de l'énergie du Québec (the "Régie") for an Earnings Sharing Mechanism ("ESM") for HQD and HQT consistent with the language presented in Section 52.3 of the *Act respecting the Régie de l'énergie* as amended by in Bill 69, enacted as Law 24 ("Law 24"). Additionally, this ESM recommendation considers the nature and level of deferral and variance accounts ("DVAs") recommended for HQD and HQT to maintain and the proposed disposition of those accounts once the current three-year rate period is finished.

Q. Please summarize your findings and conclusions regarding your recommended ESM, DVA coverage and disposition, and service quality indicators for HQD and HQT.

A. Our testimony analysis is founded on established ESM design principles, a North American jurisdictional scan, and an assessment of HQD's and HQT's specific regulatory

circumstances (including the Régie's past decisions regarding ESM, and the requirements in Law 24's amendment to Section 52.3 of the *Act respecting the Régie de l'énergie*). For the reasons discussed below in our testimony, our principal recommendation is that HQD and HQT should adopt a symmetrical ESM and retain their existing DVAs consistent with a cost-of-service regulatory framework.

In reaching our conclusions, we considered the ESM design parameters: symmetry, deadbands, sharing percentages, and true-up timing. We reviewed Canadian and U.S. electric utilities with ESMs, including their DVA coverage and whether service quality indicators are linked to ESM recovery. Our jurisdictional scan found that most reviewed utilities use asymmetrical ESMs, 50%/50% sharing is common, and annual true-ups are typical. However, HQD and HQT differ from many peers because their rates are now set under a three-year forecast cost-of-service framework with limited ability to adjust rates during the period. As a result, ESM and DVA balances may accumulate over the full rate period resulting in incremental risk for HQD and HQT.

To address the unique regulatory circumstances and heightened risk faced by HQD and HQT, we recommend a symmetrical ESM that applies to both over-earnings and under-earnings relative to authorized ROE. This design is intended to protect customers from excess earnings while also protecting HQD and HQT from unexpected financial shortfalls, where earned ROE is materially less than authorized ROE. The proposed mechanism includes no upside deadband, a -100 basis point downside deadband for HQD reflecting heightened risk exposure, a -50 basis point downside deadband for HQT consistent with the typical deadband size for cost-of-service utilities we surveyed, and 50%/50% sharing between customers and the utility outside the applicable deadbands.

Our testimony further recommends that both HQD and HQT maintain DVA coverage for all currently authorized DVAs as these are costs difficult to forecast accurately at the time rates are set and are outside of their direct control. Any other cost or revenue item variances should be addressed through the ESM to preserve cost-management incentives. Since DVA balances cannot generally be disposed of during the three-year rate period, we recommend disposing of accumulated ESM and DVA balances at the end of the period and amortizing them over the following three-year rate period to mitigate the potential for rate shock.

Finally, we recommend that service quality indicators reported by HQD and HQT should not be linked to ESM recovery under the current cost-of-service framework.

Q. How is the remainder of your testimony organized?

A. The remainder of our testimony is organized as follows. Section III explains what an ESM is and defines the typical characteristics and parameters that comprise an ESM framework. This section also provides the results of a jurisdictional scan of Canadian and U.S. utilities that have an ESM in place. Section IV outlines HQD's and HQT's unique regulatory circumstances that need to be considered when evaluating and proposing an ESM. Section V provides our recommended ESM key parameters taking into consideration regulatory principles and the specific circumstances in which HQTD conduct their business. Section VI provides our recommendation on DVA coverage and disposition of DVA balances. Section VII outlines whether service quality indicators should be linked to the recovery of ESM balances. Finally, Section VIII presents our overall conclusions.

Q. Are you sponsoring any exhibits to your direct testimony?

A. Yes, we are sponsoring and have attached the following exhibits.

- Exhibit A – *Curriculum vitae* of Mr. Chapman, Mr. Wyonzek, and Dr. Celebi
- Exhibit B – Jurisdictional Scan of Earnings Sharing Mechanisms
- Exhibit C – Jurisdictional Scan of Deferral and Variance Accounts
- Exhibit D – Jurisdictional Scan of Service Quality Indicators

III. EARNINGS SHARING MECHANISM

A. EARNINGS SHARING MECHANISM PRINCIPLES

Q. Please describe what an ESM is.

A. ESMs are an established regulatory arrangement that links the distribution of a utility's realized financial returns to a pre-defined benchmark, usually a target return on equity ("ROE"). An ESM is typically used together with other regulatory arrangements such as Deferral and Variance accounts ("DVAs") to provide a utility with a financial incentive to manage costs that are under its control. In practice, the ESM determines how actual utility earnings above or below an authorized level (typically, the authorized ROE) on an annual basis are allocated between customers and the utility.

During a given rate period any number of items that form a utility's revenue requirement may deviate from what assumptions were used to determine the rates. For example, HQD and HQT rate calculations are based on a forward-looking test year which require assumptions and forecasts for revenue, cost, and rate base items, all of which can deviate from forecast during the rate period. An ESM is a predetermined formula that determines how variations between *earned* and *authorized* ROE are split between customers and the utility.

A well-designed ESM can benefit ratepayers, the utility and its shareholders. Aligning financial incentives for the utility to reduce manageable costs during the rate period can result in operational efficiencies, lower costs and higher returns. Furthermore, ESMs can protect customers from unexpected financial windfalls for the utility, where earned ROE is materially greater than authorized ROE. Conversely, an ESM can protect the utility from unexpected financial shortfalls, where earned ROE is materially less than authorized ROE.

Q. Why are ESMs more relevant when rate periods are longer?

A. ESMs are more relevant as rate periods lengthen because the potential for deviations between the test year assumptions and actual operating conditions increases over time. Under certain conditions, deviations in multi-year rate plans can compound during the rate period, and the utility's earned ROE can move substantially away from the authorized ROE that supported the approved rates. The longer the period between rate cases, the greater the likelihood that actual results will diverge from forecasted results in a meaningful way.

An ESM that is trued up annually can help mitigate the impact of year-over-year ROE deviations by being an important balancing mechanism throughout longer rate periods. It can help maintain reasonable returns consistent with those authorized by the regulator. This type of ESM will limit the extent to which customers bear the cumulative financial consequences of over-earning and limit the extent to which the utility bears the cumulative financial consequences of under-earning. The extent to which an ESM can maintain balanced returns will depend on the specific design parameters.

Q. What are the main parameters in the design of an ESM?

A. The typical design parameters of an ESM include: 1) whether the ESM is symmetrical, 2) the size of the deadband above and below the authorized ROE, and 3) the applicable sharing percentages between customers and the utility outside the deadband. Symmetry refers to whether the mechanism applies only to earnings above the authorized level, or whether it applies on both the upside and the downside. A deadband defines the range around the authorized earnings level within which no sharing occurs, meaning any variation in the earned ROE are 100 percent to the account of the utility. The sharing parameter determines how earnings outside the deadband are allocated between the utility and customers.

Q. Please describe the difference between a symmetrical and an asymmetrical ESM.

A. A *symmetrical* ESM applies on both sides of the authorized ROE, meaning variation both above and below authorized ROE. If earned ROE exceeds or falls below the authorized level by more than the applicable deadband, the excess or shortfall is shared with customers according to the sharing percentages. A symmetrical design therefore treats upside and downside deviations as eligible for sharing.

An *asymmetrical* ESM, by contrast, applies only on one side of the ROE distribution, most commonly to earned ROE in excess of authorized. Meaning that any shortfalls in earned ROE are the responsibility of the utility.

Q. Please describe what a deadband is in the context of an ESM.

A. A deadband is the range around the authorized ROE within which no sharing occurs. The utility is responsible for 100 percent of any shortfalls or surpluses within the deadband. Deadbands are typically set as a specific amount of basis points around the authorized

ROE, for example ± 50 basis points from the authorized ROE in the context of a symmetrical ESM. It is also possible to design an ESM without any deadbands, such that any variation in earned ROE is shared between the utility and customer at the determined sharing parameters.

The purpose of the deadband is to recognize that utility earnings will naturally fluctuate to some degree because of ordinary business conditions. Deadbands on the downside of the authorized return will provide utilities incentives to manage costs during the rate period to avoid shortfalls. The upside deadbands incentivize the utility to seek operational efficiencies to retain surpluses. When evaluating the proper deadband size for a utility, these incentives are typically considered.

Q. Please discuss the sharing parameter in the context of an ESM.

A. The sharing parameter determines how earnings above or below the authorized ROE are divided between customers and the utility. Once the utility's actual earnings move outside the applicable deadband, the sharing parameter specifies the percentage retained by the utility and the percentage credited or charged to customers. For example, under a 50%/50% sharing provision, each dollar of earnings above the threshold would be split equally between the utility and customers. The same concept can apply, in a symmetrical mechanism, to shortfalls in earnings.

The sharing parameter percentage directly impacts the incentives and risk allocation between customers and the utility. A lower utility sharing percentage provides greater protection for customers from utilities over-earning, but this weakens the incentives for utilities to manage costs during the rate period and find operational efficiencies. While

a higher utility sharing percentage increases the incentives for utilities to manage costs and find operational efficiencies, it also limits the refunds for customers. The sharing parameter can also be tiered, in a way that adjusts the sharing parameter as the earned ROE increases in variation from the authorized level. For example, the first tier may have a 50%/50% sharing parameter applicable for the first 100 basis points of variation from the authorized ROE and for any variation greater than 100 basis points those variations in ROE are split 70 percent to the customer and 30 percent to the utility. Regulators often have to balance between the objectives of limiting excessive earnings for utilities and providing effective incentives for them to manage costs and find operational efficiencies. Typically, the sharing parameters are considered in the context of other aspects of the ESM design.

Q. How are surpluses or losses typically distributed between the utility and customers?

A. The surpluses or losses that accumulate within ESM accounts under an ESM design are typically distributed through a periodic reconciliation, most often on an annual basis within each rate period. When the ESM results in a customer credit,[1] that amount is generally flowed back to customers through a rate adjustment or a direct reduction in the revenue requirement, such that rates in the next rate year reflect that accumulation of the ESM customer credit. Conversely, a similar process is followed when the ESM results in a utility credit.[2] An annual disposition of the ESM balance has become the established industry practice as it mitigates large ESM imbalances that may potentially accrue over time. In the case of ESM losses, large imbalances could result in future rate shocks in order to clear the accounts.

[1] Meaning earned ROE was in excess of authorized ROE and above any deadbands.

[2] Meaning earned ROE was below that of authorized ROE and below any deadbands.

B. JURISDICTIONAL SCAN

Q. Have you reviewed utilities that currently have an ESM in place?

A. Yes. We undertook a North American jurisdictional scan to review regulatory and industry practices for utilities that are currently subject to an ESM. The jurisdictional scan collected the following information from each of the utilities relating to their ESM: whether the ESM was symmetrical or asymmetrical, the size of any deadbands in the ESM, the customer sharing percentages and any tiered sharing, and the timing of the ESM true-up. Additionally, as explained further in Section VI and VII, the jurisdictional scan also reviewed the level of DVA coverage each utility had and if any utility linked their service quality indicators to the ESM.

Q. Which utilities did you review?

A. The objective of the jurisdictional scan was to identify utilities that are most comparable to HQTD. Considering that HQD and HQT are Canadian regulated utilities under cost-of-service ratemaking, we focused our jurisdictional scan on the following: 1) electric utilities within Canada subject to a regulator-approved ESM and 2) electric utilities within the United States that are regulated under a cost-of-service regulatory framework with an ESM. Figure 1 provides the utilities that were included in the jurisdictional scan.

FIGURE 1: LIST OF UTILITIES INCLUDED IN JURISDICTIONAL SCAN

Canadian Utilities		U.S. Utilities	
FortisBC Inc.*	Transmission + Distribution	Central Maine Power	Distribution
ATCO Electric*	Distribution	Idaho Power	Vertically Integrated
FortisAlberta*	Distribution	MidAmerican Energy	Distribution
ENMAX*	Distribution	Consolidated Edison	Distribution
EPCOR*	Distribution	New York State Electric and Gas	Distribution
Toronto Hydro*	Distribution	National Grid (Mohawk)	Distribution
Hydro One*	Transmission + Distribution	United Illuminating	Distribution
Hydro Ottawa*	Distribution	Dominion Energy Virginia	Vertically Integrated
Alectra Utilities*	Distribution	Appalachian Power Company	Vertically Integrated
Elexicon Energy Inc.*	Distribution		
Nova Scotia Power Inc.	Vertically Integrated		
Newfoundland Power	Generation + Distribution		
Newfoundland and Labrador Hydro	Vertically Integrated		

**Indicates the utility is under some form of performance-based regulation or incentive regulation plan.*

Q. What were the key findings from your jurisdictional scan?

A. The jurisdictional scan identified several common themes regarding how ESMs are designed and administered across different jurisdictions within North America which are summarized as follows:

1. All but one utility are subject to an asymmetrical ESM sharing design;
2. The median deadband size for the cost-of-service utilities is 50 basis points;
3. Tiered sharing is implemented in various jurisdictions, but no obvious pattern is displayed;
4. Every utility had the ability to true-up the balance of the ESM annually; and
5. No utility linked service quality indicators to the recovery of ESM balances.

We found that, with one exception, all utilities within the scan had an asymmetrical ESM design. Only upside variations in earned ROE were considered for sharing in the ESM and downside variations were 100 percent to the account of the utility. FortisBC Inc. ("FortisBC") was the sole utility that operates under a symmetric ESM.

As shown in Figure 1, a majority of the Canadian utilities within the scan are under some form of performance-based regulation ("PBR") or incentive rate plan.[3] These regulatory frameworks are built on expectations of efficiency improvements throughout the rate period. Therefore, we examined both the size of deadbands and the sharing parameters in the context of these two groups: PBR-regulated utilities and cost-of-service regulated utilities. Consistent with the implied goal of efficiency improvements within PBR, the larger deadbands serve as incentives for these utilities to internalize the benefits of efficiency gains during their rate period. In contrast, utilities regulated under a cost-of-service framework, as required under Law 24for HQD and HQT, are not subject to the same incentive structure as PBR. Cost-of-service regulation primarily provides for earnings stability for the utility. As a result, it is more typical for these utilities to have smaller deadbands, because it allows regulators to preserve earnings stability for the utility from earnings shortfalls, while also protecting rate pays from sustained excess earnings. The median deadband size for the cost-of-service utilities was 50 basis points.

With regard to the sharing parameters, the most common approach across both the PBR and cost-of-service utilities was a 50%/50% sharing between the customers and the

[3] These utilities specifically utilize rate indexing by some form of RPI-X indexing within their rate periods to determine rates. Where RPI-X refers to retail price index (inflation) ("RPI") minus expected efficiency improvements ("X").

utility. Tiered sharing was implemented in various jurisdictions but no obvious pattern was displayed, other than as excess ROE variance increased the sharing parameter for customers increased as well.

Finally, we observed that every utility within the jurisdictional scan had the ability to true-up the balance of the ESM annually. This annual true-up was implemented by disposing of the ESM balance in the next rate year within the rate period by either directly impacting the utility's revenue requirement for that rate year or being disposed of through some rate adjustment mechanism. This annual true-up in other jurisdictions has allowed for regular and timely reconciliation of ESM account balances. The results of the jurisdictional scan can be found in Exhibit B.

Q. Do the results of the jurisdictional scan dictate an ESM design for HQD and HQT?

A. No. While the results of the jurisdictional scan are informative on North American ESM practices, we should not automatically assume common features are an appropriate ESM design for HQD and HQT. As described in more detail in Section IV, HQD and HQT operate under a unique business and regulatory environment that differentiates them from their peer utilities in the jurisdictional scan. It is clear from the jurisdictional scan that each utility ESM has been designed and implemented based on the specific legal and regulatory framework the utility operates in. For example, as previously stated, a majority of the Canadian utilities that are subject to an ESM are under some form of PBR. Inherit within PBR frameworks is the prioritization of efficiency gains throughout the rate period which is different from HQD and HQT cost-of-service regulation.

IV. UNIQUE CIRCUMSTANCES OF HQD AND HQT

Q. What are the key unique circumstances HQD and HQT exhibit compared to other utilities that may impact their ESM design?

A. While there are many aspects of HQD and HQT that potentially influence the design of an ESM, the following are three key factors that set HQTD apart from their peer utilities that are subject to an ESM:

- The language presented in Law 24 explicitly refers to "it [Régie] shall consider, according to the terms proposed by the electric power carrier or the electric power distributor, the ***surpluses or losses*** of revenue accumulated by the carrier or distributor during the rate years covered by the previous rate review"[4] (emphasis added)
- Law 24 requiring HQD and HQT to have limited ability to adjust rates during the three-year rate period, barring any extraordinary circumstances.[5]
- Law24 requiring the balances of the ESM account and DVA accounts to be accumulated over the full three-year rate period.[6]

Q. What is unique regarding the amendment to Section 52.3 of the Act respecting the Régie de l'énergie?

A. Section 52.3 of the *Act respecting the Régie de l'énergie* explicitly states:

> *When the Régie conducts a rate review in accordance with the first or third paragraph of section 48, it shall consider, according to the terms proposed by the electric power carrier or the electric power distributor, the* ***surpluses or losses*** *of revenue accumulated by the carrier or distributor during the rate years covered by the previous rate review. Those surpluses or losses of revenue, which may be estimated for the last rate year covered by the previous rate review, shall be established by the carrier or distributor, who shall inform the Régie not later than*

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4 *Act respecting the Régie de l'énergie*, CQLR c R-6.01, s. 52.3.

5 *Act respecting the Régie de l'énergie*, CQLR c R-6.01, s. 48.

6 *Act respecting the Régie de l'énergie*, CQLR c R-6.01, s. 48 and 52.3.

> *30 days before the beginning of the first rate year for which the required revenues are established.*[7] (emphasis added)

The language within Section 52.3 expressly states the Régie take into consideration "surpluses or losses" of revenues[8] accumulated by HQD and HQT during the rate period. This language contemplates that earnings variances may occur in either direction during the rate period. Accordingly, the design of the ESM should not be solely as a mechanism to account for excess earnings during the rate period but should also consider the sharing of utility's shortfall in earnings relative to authorized ROE.

Q. How are rates set for HQD and HQT during the three-year rate period?

A. As outlined in decisions D-2026-033 and D-2026-008 rendered for rates set during the 2026-2028 rate period, rates for HQD and HQT, respectively, are set through a three-year forecast cost-of-service framework without annual rebasing or rate adjustments throughout the rate period.[9] Additionally, as outlined in Law 24:

> *On the application of the electric power carrier or the electric power distributor made during the three rate years covered by a rate review conducted under the first paragraph,* ***in exceptional circumstances****, the Régie shall conduct a rate review referred to in that paragraph in the manner provided for in that paragraph.*[10] (emphasis added)

This means that both HQD and HQT enter the 2026–2028 period with rates established on a forward-looking, three-year basis, with limited ability to adjust rates

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[7] *Act respecting the Régie de l'énergie*, CQLR c R-6.01, s. 52.3.

[8] Our understanding is that the French language version refers to surpluses or earnings shortfalls which is generally consistent with our understanding of how other earnings sharing mechanisms are implemented.

[9] Decision D-2026-033, Docket R-4307-2025, Phase 1, March 13, 2026, and Decision D-2026-008, Docket R-4306-2025, February 5, 2026.

[10] *Act respecting the Régie de l'énergie*, CQLR c R-6.01, s. 48. Note section 48 of the *Act respecting the Régie de l'énergie* was amended by Law 24 article 37.

during the rate period.[11] This limits the opportunity for HQD and HQT to re-align rates during the rate period for any deviations in actual costs and revenues from the projections at the beginning of that three-year period.

Q. How should the method by which rates are set for HQD and HQT be considered when determining an ESM?

A. The limited ability of HQD and HQT to adjust rates during the three-year rate period is highly relevant because it increases the importance of the ESM as one of the principal tools available to address differences between forecasted and actual revenue and cost items results. If rates remain fixed during the rate period, then HQD and HQT will not have the opportunity to correct for forecast error, changing cost conditions, or other deviations through interim rate relief, riders, or surcharges. This could result in earnings differences that persist during the rate period and accumulate until the next rate case.

Q. How do DVA balances and how would ESM balances accumulate during the three-year rate period for HQD and HQT?

A. As a consequence of the limited ability to adjust rates during the three-year rate period, the balances of any DVAs and ESM accounts would accumulate during that three-year period. While it is typical of utilities to dispose of DVA and ESM balances annually, or once a certain rate impact threshold is met, HQD and HQT do not have this option during the rate period. Meaning that any balances accumulated in DVAs or the ESM account would accumulate over the entire three-year rate period. Given the limited ability for any interim adjustment of rates during the rate period, the structure of the ESM must serve as a backstop

[11] *Id.*

to preserve the balance between customer protection and utility incentives during the three-year term.

Q. How should the method by which DVA balances accumulate for HQD and HQT be considered when determining an ESM?

A. Given that balances of the DVAs and ESM would accumulate over the three-year rate period, the ESM is no longer addressing short-term annual earnings variation, rather the ESM has to consider cumulative impacts to earnings over the entire three-year rate period. This amplifies the effect of any forecast variation within the revenue requirement and any systematic persistent divergences in the items that determine the rates for HQD and HQT.

As further detailed below, this impacts the design of the ESM in various ways. The potential accumulation of large ESM and DVA balances during the rate period could potentially lead to rate shock during the subsequent rate case. It also requires that the ESM is designed specifically in mind with the level of DVA coverage for HQD and HQT. Further details on DVA coverage are discussed in Section VI.

Q. Have HQD and HQT had historical earnings variation?

A. Both HQD and HQT experienced variation in earned ROE. Since 2015, HQD's earned ROE was more variable than HQT's over the period reviewed.

Q. Do you expect that HQD would generally have greater variance in earned vs. authorized ROE compared to HQT?

A. Yes. We would generally expect HQD to experience greater variance between earned and authorized ROE compared to HQT. This is due to HQT being relatively insulated from variations in revenues, where a large portion of HQT's revenues are provided by HQD for

native load transmission service and any variance in the remaining point-to-point transmission revenues are subject to DVA coverage.

Q. How might this impact the design of the ESM?

A. As previously discussed, the intent of an ESM is to address variances between earned and authorized ROE by determining how earnings above or below authorized levels are treated. If there is an expectation that variation in earned ROE is greater for HQD compared to HQT that difference in expectation should be taken into account in the design of the ESM. For example, greater expected earnings variability for HQD may support a wider deadband, such that customer sharing begins only after a larger variance from authorized ROE than would apply for HQT. It is key to design the ESM to provide meaningful incentives for HQD and HQT to manage costs while pursuing operational efficiencies.

Q. Are there any additional circumstances to consider when designing an ESM for HQD and HQT?

A. Given the complex interaction between the ESM, DVAs, and the limited ability to adjust rates during the three-year rate period, we recommend that the ESM be relatively simple, transparent, and predictable. A simpler design will be beneficial to all parties to understand how the mechanism operates and what outcomes it is likely to produce. It will also reduce the risk of unnecessary complexity, overlap, or ambiguity in the treatment of earnings variances over rate period.

V. PROPOSED EARNINGS SHARING MECHANISM

Q. Present your recommendation for the ESM for HQD and HQT.

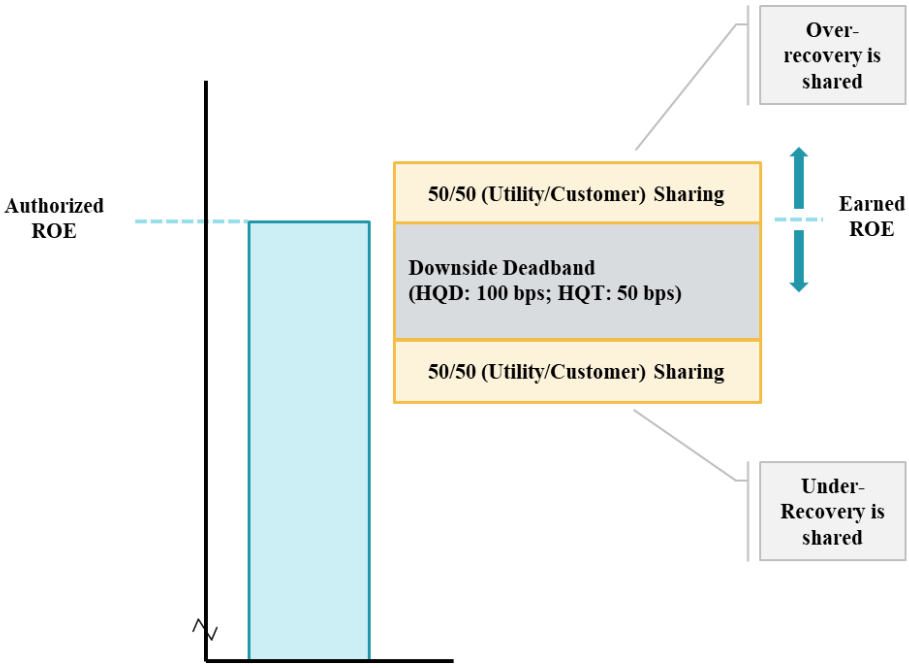
A. We recommend that HQD and HQT implement a symmetric ESM that accounts for variation in earned ROE on both the upside and downside. While this approach is atypical compared to peers reviewed in the jurisdictional scan, HQD and HQT must manage incremental risk associated with rates that are determined on a three-year forecasted cost-of-service basis with limited ability to adjust rates during the rate period. A symmetrical ESM will ensure that both the customers and the utility have appropriate protection from excessive surpluses or shortfalls during the rate period, while still providing a strong financial incentive to HQD and HQT to manage costs for which it is able to do so. Furthermore, as recognized in Section 52.3 of the *Act respecting the Régie de l'énergie,* the ESM should consider both surpluses or losses.

We recommend that HQD and HQT each have a deadband, but only on the downside. Specifically, for HQD we recommend a -100 basis point deadband and a -50 basis point deadband for HQT. The sizes of our recommended deadband are informed by our review of industry practices from our jurisdictional scan. As shown in Exhibit B, cost-of-service utilities typically have a deadband range below 100 basis points, with a median range of 50 basis points, which is consistent with these utilities not having the same incentive structure as utilities under a PBR framework. Therefore to be consistent with the range of deadbands for cost-of-service utilities we set HQD near the top end of the range with a -100 basis point deadband and HQT with 50 basis points, consistent with the median for cost-of service utilities we surveyed. As previously shown in **Erreur! Source du renvoi introuvable.**, the smaller deadband for HQT recognizes that historically HQT has

had less sensitivity to earnings variations compared to HQD. While sharing of both upside and downside risk will be symmetrical, we believe that HQD and HQT should only have a deadband for downside risk to incentivize them to control any manageable costs within the downside deadband. Even without an upside deadband, HQD and HQT will have incentives to find savings within manageable costs to gain additional earnings after any sharing with customers.

Finally, we recommend that HQD and HQT both have a 50%/50% sharing parameter between customers and the utility. This sharing parameter would apply to every dollar in excess of the authorized ROE and to every dollar after the specific HQD and HQT deadbands on any shortfalls. Again, this provides proper incentives for HQD and HQT to find efficiencies and control manageable costs, while providing protection for customers from excess earnings. This sharing parameter also achieves the goal of remaining simple and is also consistent with a majority of the utilities within the jurisdictional scan.

FIGURE 2: SUMMARY OF ESM DESIGN RECOMMENDATIONS FOR HQD AND HQT



Q. Has HQD and HQT previously had an ESM authorized by the Régie?

A. Yes. In Decision D-2014-034, the Régie authorized the use of an ESM for HQD and HQT (also referred hereafter as the "MTER"). This MTER included: 1) an asymmetric sharing mechanism under which HQD and HQT bore 100 percent of any earnings shortfall below the authorized ROE; 2) no deadband on the upside; and 3) a tiered sharing mechanism where the first 100 basis points above the authorized ROE were shared 50%/50%, while any earned ROE above the first 100 basis points would be shared as 75 percent returned to customers and 25 percent retained by HQD and HQT.[12]

[12] Decision D-2014-034, Docket R-3842-2013, March 4, 2014.

Q. Did you take into consideration the design of this previously authorized ESM when determining your recommendations for HQD and HQT?

A. While we examined the structure of the previously authorized ESM, as noted in Section IV, given the unique circumstances that HQT and HQD find themselves in under the regime established by Law 24, it is most appropriate to design the ESM to address the particular set of circumstances HQD and HQT currently face. The ESM authorized in Decision D-2014-034 was authorized in a different regulatory context than what HQD and HQT currently operate in and they did not face the same set of unique circumstances and risks. Specifically, at the time of the previously authorized ESM, HQD and HQT did not have: specific language present in Sections 48 and 52.3 of the *Act respecting the Régie de l'énergie* regarding an ESM; rates for HQD and HQT were not set under a three-year forecast cost-of-service framework with limited ability to adjust rates during the period; and ESM and DVA balances did not accumulate over a full three-year rate period. Given this, we found it most appropriate to recommend an ESM design to account for the specific unique circumstances HQD and HQT operate in.

VI. DEFERRAL AND VARIANCE ACCOUNT COVERAGE AND DISPOSITION

Q. Please describe what deferral and variance accounts are used for in utility regulation.

A. DVA accounts are generally used to track and defer differences between the costs or revenues reflected in authorized rates and the amounts that are actually incurred or realized during the period in which rates are implemented. Their purpose is to allow these variances in specific categories to be recorded and carried forward as deferral balances for later review and potential disposition resulting in a recovery from, or refund to, customers.

DVAs serve as a regulatory mechanism for addressing timing differences, forecast variances, and specific cost items that may be uncertain, volatile, and outside of the utility's direct control at the time rates are established. The disposition of the DVA balances can also help smooth rate impacts of unexpected and exceptional cost or revenues that might otherwise lead to sudden rate increases or financial strain.

Q. Describe the DVA accounts currently authorized for use by HQD.

A. The Régie recently recognized that the HQD DVAs presented in Figure 3 are once again operative as of January 1, 2026, with specific application and disposition of the DVAs to come at a later date. The Régie also approved the creation of an additional DVA.[13]

FIGURE 3: DVA ACCOUNTS AUTHORIZED FOR USE BY HQD

DVA
Domestic load (transmission service)
Pass-on for electricity supply costs
Balancing account (transmission and distribution revenues) for weather variations
Major outages
Costs related to energy efficiency (including solar panels) and demand-side management programs
Fuel cost
Pension cost
Contribution to MELCCFP
Unforeseeable events in autonomous systems
Load retention rate
Revenues from compliance units (CFR)

[13] Decision D-2026-033, Docket R-4307-2025, Phase 1, March 13, 2026.

Q. Describe the DVA accounts currently authorized for use by HQT.

A. The Régie recently recognized HQT's updated regulatory principles and accounting methods and practices, including updates that maintain certain DVAs presented in Figure 4 and deferred the determination of their disposition terms to a later proceeding.[14]

FIGURE 4: DVA ACCOUNTS AUTHORIZED FOR USE BY HQT

DVA
Point-to-point transmission services revenues
Pension cost
Commissioning timing differences

Q. How are DVAs and ESM related?

A. Both ESMs and DVAs are regulatory mechanisms used to address variances between assumptions and forecasts reflected in approved rates and the actual outcome of the cost or revenue items during the period in which the rates were active. DVAs track variations in accounts that relate to these specific cost or revenue items, while ESMs consider the aggregate variance of assumptions or forecasts reflected in rates through the utility's earned versus authorized ROE. The balances accumulated within the ESM account and DVAs are then disposed of at a later time.

The regulatory mechanisms are related because the treatment of specific items within the DVAs can affect the earned ROE within any given rate year, which is used in the determination of the ESM. To the extent that specific variances are captured in DVAs for later disposition, those amounts are typically excluded from, or otherwise adjusted in, the calculation of earned ROE for purposes of calculating the ESM. Simply put, any

[14] Decision D-2026-008, Docket R-4306-2025, February 5, 2026.

variance in costs or revenues that have DVA coverage will be excluded from the earned ROE calculation and will not be subject to the ESM formula. In this sense, ESMs and DVAs are inherently linked, and it is important to consider the level of DVA coverage a utility has when evaluating the design of an ESM.

Q. Did you also examine levels of DVA coverage for comparable utilities to HQD and HQT in your jurisdictional scan?

A. Yes. As part of the jurisdictional scan, we also reviewed the level of DVA coverage for each utility. We examined whether the companies had some form of DVA coverage for a variety of general DVA categories including: load forecast, power supply variances, pensions, electrification and policy driven factors, additional network revenues, taxes, and major outages/storms. The intent was to better understand the extent to which the comparable utilities within the jurisdictional scan addressed variances from approved rates, either through the use of DVAs or addressed more broadly in the context of their ESM design. The results of the DVA related jurisdictional scan can be seen in more detail in Exhibit C.

The key finding of this review is that utilities within the jurisdictional scan that operate under some form of PBR typically have less extensive DVA coverage compared to the utilities operating under a cost-of-service regulatory framework. In other words, those utilities under a PBR framework had greater reliance on their ESM design to address variances in costs and revenues.

DVA categories such as taxes, pensions, power supply costs, and electrification or other policy-driven initiatives were common among the utilities within the jurisdictional

scan. We also observed that nearly half of the utilities had some form of DVA or adjustment mechanism related to load forecast.

Q. What criteria did you use to determine what DVA coverage was appropriate for HQD and HQT?

A. We considered the underlying purpose of DVAs within utility regulation and the types of variances they are intended to address. We considered whether specific cost or revenue items are difficult to forecast accurately at the time rates are set and whether those items are largely outside the control of the utility. DVA treatment is most appropriate where there is a reasonable basis to conclude that particular variances cannot be reasonably managed by the utility in the ordinary course, especially where those variances are material and arise from factors that are difficult to predict accurately in advance. Another consideration is that DVAs allow certain exceptional or non-routine costs or revenues to be recorded for later disposition, which can help avoid abrupt rate changes for customers or undue financial strain on the utility from a single-year variance.

In reviewing which DVA accounts were most appropriate for HQD and HQT to retain, we first considered whether a particular item was sufficiently outside the control of HQD and HQT. Items that are partially or fully manageable by HQD and HQT are more appropriately addressed through an ESM. The ESM allows the utility to bear some of the risk associated with forecasts of cost and revenues and, importantly, provides a financial incentive for the utility to find efficiencies.

Q. Considering the ESM design recommended for HQD, what DVA accounts do you recommend they maintain?

A. We recommend that HQD maintain all currently approved DVA accounts. These DVA accounts were authorized by the Régie while HQD was under periods of cost-of-service regulation, and recently recognized as once again operating under cost-of-service regulation as of January 1, 2026 (under Law 24), and are intended to address cost or revenue variances that are material, difficult to forecast, and largely outside HQD's control.[15] Maintaining these DVAs is appropriate because they help isolate significant uncontrollable variances from the earned ROE calculation, while allowing the ESM to address the remaining differences between earned and authorized ROE. In our view, continuing the currently approved DVA coverage is consistent with the recommended ESM design because it preserves protection for material uncontrollable items while maintaining incentives for HQD to manage costs and pursue operational efficiencies for items within its control. Additionally, as outlined in the jurisdictional scan, many of these DVA categories are consistent with DVA coverage within Canada and the U.S.

Q. Considering the ESM design recommended for HQT, what DVA accounts do you recommend they maintain?

A. We recommend that HQT maintain all currently approved DVA accounts. These categories should maintain DVA coverage due to them largely being outside the control of HQT and can be difficult to forecast accurately at the time rates are set for the entire rate period.[16] In

[15] *See* for example, Decisions: D-2003-93, at 21; D-2005-34, at 49; D-2006-34, at 20-21; D-2009-016, at 62; D-2009-016, at 14-16; D-2011-028, at para. 148; D-2013-037, at para. 282; D-2019-088, at para. 478; and D-2026-033, at para. 581.

[16] *See* for example, Decisions: D-2007-08, at 82; D-2011-039, at para. 39-40; and D-2025-022, at para. 331.

addition, as outlined in the jurisdictional scan, DVAs related to pension costs are typical among Canadian and U.S. utilities.[17]

Q. How are ESM and DVA balances typically disposed of for recovery or refund?

A. ESM and DVA balances are typically disposed of either on a regular periodic basis, most commonly through annual true-ups during the rate period, or when the balance in the account reaches a specified threshold. Allowing for disposition of the accounts during the rate period ensures regular and timely reconciliation of the balances for both the utility and customers.

Q. Was this consistent with the findings in the jurisdictional scan?

A. Yes. As part of the jurisdictional scan, we reviewed the disposition treatment of ESM and DVA balances. Typically, utilities used two disposition methods for these balances. The first, and most common method, was a true-up of the balances on an annual basis. Annual proceedings would be issued where regulators review the balances of the ESM and DVAs and adjust rates to recover or refund the balances in the next rate year.[18] This method allows timely reconciliation of the balances and does not allow them to accumulate over multiple years. The second method, most typically used by Ontario Energy Board ("OEB") regulated utilities, is to dispose of DVA balances once they reach a rate impact threshold, specifically for the OEB this threshold is 0.001/kWh. Typically, this rate impact threshold

[17] While utilities within the jurisdictional scan may not specifically have DVAs related to variances in point to point revenues, it is very common that any revenues associate with "off-system sales", which are electric sales made to parties outside a utility's native retail customer system, go to directly reduce the revenue requirement of the native retail customers. Thereby providing very similar results to having DVA coverage for this category.

[18] As discussed below, there are incidences where the recovery or refund of ESM and DVA balances are spread over multiple years.

is determined during an annual rate review proceeding. This method also allows for timely reconciliation of ESM and DVA balances, while only triggering disposition of the balances if there are material impacts to rates. Further details on the ESM and DVA disposition treatment of the jurisdictional scan can be found in Exhibit C.

Q. Do HQD and HQT have the ability to dispose of ESM and DVA balances during the rate period?

A. No. Barring extraordinary circumstances, HQD and HQT do not have ability to adjust their rates during the 2026-2028 rate period. As previously discussed, Law 24 requires ESM or DVAs to accumulate over the entire three-year rate period, at which point their entire balances will have to be disposed of. In contrast, all utilities within the jurisdictional scan have annual true-ups or rate impact thresholds to dispose of these balances. Our view is that the unique circumstance of HQD and HQT needs to be taken into consideration when designing the disposition treatment for the balances of the ESM and DVAs.

Q. What is your recommendation regarding the disposition treatment of the ESM and DVA balances for HQD and HQT?

A. Given that HQD and HQT do not have the ability to dispose of ESM or DVA balances during a three-year rate period, our recommendation is that these balances of the ESM and DVAs be disposed of at the end of the three-year rate period and amortized over the subsequent three-year rate period, rather than through immediate disposition in a single rate year. Our recommendation is consistent with the language in section 48 of the *Act respecting the Régie de l'énergie* ("The Régie may, in the manner it determines, spread out the rate increase for one or more of the years covered by the review over those three years").

The rationale for our recommended approach is the potential for significant balances to accumulate during the three-year rate period. While there is a potential that these DVA balances may partially offset one another over the course of the rate period, we nonetheless consider a three-year amortization period to be appropriate in order to mitigate potential rate shock in the next rate period and provide a gradual recovery from, or refund to, customers.

Q. Are there additional matters you recommend the Régie consider regarding the disposition of the ESM and DVA balances?

A. Yes. Additionally, we recommend that HQD and HQT provide annual reporting on the aggregate balances of their DVA accounts in order to maintain transparency for all stakeholders regarding the amounts accumulating over the rate period. At the time of disposition for the ESM and DVA balances, the Régie may also consider a cumulative threshold for the entire balances of the ESM and all DVAs. If the balance of the ESM and all DVAs exceeds this cumulative threshold which could be determined as a balance that could reasonably be expected to create undue rate impacts if disposed of over a single subsequent rate period, HQTD would be permitted to amortize that balance over two rate periods, or six years in total. In our view, this additional flexibility would provide an appropriate safeguard to mitigate rate impacts of unusually large ESM and DVA balances.

This approach is consistent with the disposition treatment for ESM and DVA balances for various utilities within the jurisdictional scan. While the utilities within the scan all dispose of the account balance annually or after a rate impact threshold is met, there have been incidences where particularly large ESM or DVA balances are amortized

over a longer period. For example, to mitigate single year rate impacts, as part of its annual rate adjustment filing Hydro Ottawa was approved by the OEB to amortize the disposition of its ESM and DVA accounts over a three-year period as opposed to the typically disposition treatment that happens over one subsequent rate year.[19] There are also various examples of U.S. utilities amortizing or securitizing DVA balances over multi-year period to avoid rate shock, due to unexpected and unpredictably large DVA balances.[20]

Q. At this time, do you recommend a specific cumulative threshold for amortizing ESM and DVA balances for longer than the next three-year rate period?

A. No. We do not currently recommend a specific cumulative threshold above which ESM and DVA balances should be amortized over a period longer than the next three-year rate period. In our view, it is preferable for the Régie to retain flexibility to determine, at the time rates are set for the subsequent rate period, whether the magnitude and circumstances of the accumulated ESM and DVA balances warrant a longer amortization period. Accordingly, rather than prescribing a fixed cumulative threshold at this time, we recommend that the Régie assess the appropriateness of any extended amortization period based on the facts and circumstances present at the time of disposition of the ESM and DVA balances.

[19] Decision and Rate Order EB-2022-0042, Hydro Ottawa Limited, Application for rates and other charges to be effective January 1, 2023, December 8, 2022, at 17.

[20] For example, see New York Public Service Commission, Cases 15-E-0283 et al., Order Approving Electric and Gas Rate Plans in Accord with Joint Proposal, issued June 15, 2016, at 28-29 and Virginia State Corporation Commission, Case No. PUR-2023-00112, Financing Order, November 3, 2023, at 4 and 11.

VII. LINKING SERVICE QUALITY INDICATORS TO THE ESM

Q. Is the explicit linking of receiving ESM recovery and a utilities service quality indicators typical?

A. No. We reviewed the Canadian utilities within the jurisdictional scan to determine whether their ESM were explicitly linked to any service quality indicators. We found that no utilities had this explicit link, regardless of whether they were regulated under a PBR or cost-of-service framework. Instead, these utilities are required to report their service quality indicators to their regulator on a regular basis. If the reported service quality indicators do not meet the thresholds outlined by the regulators, then these utilities could be found in non-compliance of their performance measures. In this case, the regulators have a range of potential actions available to it, including imposing penalties to the utility. However, it is important to note that these penalties are determined independently and outside of the scope of any specific sharing within the utilities ESM. Additional detail on the review of Canadian service quality indicators can be found in Exhibit D.

Q. What are your recommendations regarding HQD and HQT providing service quality indicators and whether they should be linked to the ESM?

A. We recommend that service quality indicators for HQD and HQT are not linked to the ESM, but rather that HQD and HQT continue to report their service quality indicators to the Régie. These indicators are similar to those reported by other Canadian utilities, and the continued reporting of those measures would allow the Régie to monitor whether HQD and HQT are maintaining appropriate levels of service quality. If the reported indicators indicate a reduction in service quality below the Régie's applicable standards, then they

would have the ability to provide specific direction to HQD and HQT to improve service quality, including potential penalties.

VIII. CONCLUSION

Q. What is your conclusion?

A. Our central conclusion is that HQD and HQT require an ESM design tailored to their specific regulatory circumstances rather than a mechanical replication of peer-utility approaches. A symmetrical ESM with downside only deadbands, 50%/50% sharing, continued use of existing DVAs, multi-year disposition of accumulated balances, and continued performance reporting (not linked to the ESM) provides a balanced framework for customer protection, utility financial stability, cost-management incentives, and rate stability during and after the 2026–2028 rate period.

Q. Will your recommended ESM provide an incentive to improve HQT and HQD's performance and the satisfaction of their clients under Section 49, paragraph 4, of the *Act respecting the Régie de l'énergie*?[21]

A. Yes. Our recommended ESM design is responsive to the Régie's request because it provides incentives for HQD and HQT to manage costs efficiently. In our view, the ESM should work alongside reported service quality indicators in order to support improved performance and customer satisfaction. Our recommended ESM design and the DVA coverage improves performance by the ESM creating a balanced framework for sharing earnings surpluses and shortfalls between the utility and customers, and encouraging HQD and HQT to manage their costs and find operational efficiencies, while the recommended

[21] Decision D-2025-098, at 57 and *Act respecting the Régie de l'énergie*

DVAs avoiding the utilities to be inefficiently incentivized for reducing the quality of service during periods of unexpectedly higher costs that are largely outside their control. At the same time, customer interests remain protected because the ESM can operate alongside the continued reporting of service quality indicators and, as consistent with other regulatory jurisdictions, would allow the Régie to monitor whether HQD and HQT are maintaining appropriate levels of service quality without linking them to recovery of the ESM.

Q. Does this conclude your direct testimony?

A. Yes.