Direct Testimony on the 2014/15 & 2015/16 GRA Review Before the Manitoba Public Utilities Board

June 15, 2015

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1. INTRODUCTION

OVERVIEW AND SUMMARY OF RECOMMENDATIONS

1. Finalize 2014/15 increase at 2.75%
2. Grant 2015/16 increase
   - + Keep in line with inflation
   - + Reflects doubt over Hydro's near-term forecasts
     - × O&M costs higher than justified. Includes vacancy rate
     - × DSM projections that are inconsistent with (a) current market, and (b) expected program evolution to MB Government
   - + Supported by regulatory reporting approaches
     - × Do not expense the large range of capital costs suggested by IFRS
     - × Eliminate net salvage
     - × Retain ASL depreciation methods for rate setting
3. Hydro retain responsibility for industrial DSM
4. Do not cap the Curtailable Rates Program

WHY DOES HEARING MATTER?

- Two main concerns:
  1) Rates matter – A single 3.95% increase equals $60 million/year pulled out of Manitoba economy. Over 20% from large industry.
  2) Benefits of a Crown – Important aspects being lost in detail.
- Role of PUB critical to both issues.
- 3.95% is not a Fait Accompli

WHY DOES HEARING MATTER? (2)

- Can't ignore projections. Challenging situation, decade.
- But – there are many layers to numbers – picture is not always as portrayed by IFF.
  - Income (Interest Coverage) and Cash (Capital Coverage)
- Financial targets developed during limited major capital additions cannot be transferred directly to today.
- Fact is – given the context – Hydro doing spectacularly well, pushing too hard on rates, and hamstringing finances by unnecessary policy decisions.
- Still suggest approve previous 2.75%, plus for 2015/16:
  - Recommend in line with inflation potentially higher end (2-3%, $30-$45 million)
  - For one year, gives Hydro $15-$30M less revenue then requested
  - Decisions about future 3.95% still open if merited – room to do better

THIS HEARING

- Hearing completes 4 part process on many of the same issues.
  - 2010 Risk hearing/GRA; 2012 GRA; 2014 NFAT
- Still cleaning up on many recommendations
- We focused on this GRA primarily as short-term step (2 years).
  - Longer-term to be addressed after financial targets study and Cost of Service.
- Consistent with PUB re: no 2016/17 Test Year.

THIS HEARING (2)

- Heard in 2010 that Hydro annual risks not as large as had been reported (e.g., media, whistleblower, infrastructure)
- Heard in NFAT that despite a massive bulge in capital spending, Hydro financially positioned to handle Keeyask plus Conawapa.
  - + Credit rating agencies understand capital investment
  - + Long term investments pay off
- NFAT PUB Report showed concern over ratepayer impacts, Conawapa not justified, consider options to adjust financial targets, plus transfer DSM to government

THIS HEARING (3)

- Adherence to 3.95% regardless as to scenario
- Conawapa reduced capital met by major increase in sustaining capital, also Bipole increases, DSM increases
  - Pacing and prioritization?
  - Where was info at NFAT?
- New surprises to how much capital overhead to be expensed due to accounting changes
  - Why no reductions of $50-$60 million/year since IFF 11-2?
- DSM still in Hydro's spending – drives debt, hurts cash
- No proposals yet to ameliorate financial targets
- New heavy focus on cash – unusual
- No relief on proposed ELG aggressive depreciation method

WHAT LEARNED SINCE FILED EVIDENCE?

- On Sustaining Capital
  - Considerably more evidence on issues and individual department project – interesting, but not unexpected
  - Still not sufficiently address: (1) why not shared at NFAT ($1100M increase over 10 years), and (2) pacing and prioritization at senior level
- On ELG
  - More intransigent than expected
  - Major change from Warden in 2012 where only linked to IFRS, and a policy decision that could be reconsidered if IFRS allowed rate regulated accounting

NOTE - IMPORTANCE OF FUNCTIONS

- Utility basically does 3 functions:
  - Generation and Transmission – two functions sometimes grouped together as “bulk power”
  - Distribution – low voltage assets not relevant to many customers (e.g., industrials, also exports)
- The issue are often very different. Many jurisdictions do not blend – use 2 or 3 companies
- Caution is needed regarding statements being made that may relate mostly to one function.
- For example –
  - Net salvage may be still relevant for distribution (King St)
  - Distribution may offer enough units (e.g. poles) to closer match the ELG theory re: statistical data

2. FAIRNESS IN RATE SETTING DURING CAPITAL EXPANSION

CURRENT SITUATION

- Hydro had impressively good financial situation during late 1990s - 2000s
  - + Exceeding of financial targets (targets raised)
  - + Good overall water flows
  - + Fast recovery from 2004 drought
  - + Good export prices, domestic rate increases
  - + Embarrassment of riches on loads – EIIR target industry
  - + Limited capital investment
  - + Declining interest rates
- Extra pressure today from combining major expansion plus major existing system reinvestment, under more normal conditions
- In this situation, holding own on cash, and a reasonable return to positive net income after projects completed is a high test.

FINANCIAL "N" MINUS 5?

- Analogy to transmission planning, where look to "N-1" to protect against one severe impact and not lose normal operation.
- Financially, Hydro's proposal is to exceed N-5 standard
  - Finance and absorb Keeyask
  - Finance and absorb Bipole
  - Major reinvestment in existing assets
  - Invest in large DSM and absorb lost revenues it causes
  - Plus absorb impacts of major accounting changes
- All being achieved with:
  - No direct government support of projects (unusual) – pile on
  - Finance all ongoing operations over 10 years with operating cash flow (including absorbing Keeyask and Bipole annual effect), plus all Sustaining Capital investment
  - Keeping retained earnings levels near or above any estimate of 5 year drought (more protection than ever had in last 20 years)

CROWN UTILITY

- Critical big picture issue – what are we trying to do with a Crown utility
  - Public interest role in planning
  - Take on infrastructure that would not be possible if traditionally financed.
    - More than just debt guarantees – other approaches to financing, capitalizing assets
  - Lower overall costs by reduced returns/taxes
  - Reflect “patience” and risk mgmt. approach that would not be possible with private equity investor
- Most relevant to hydraulic generation and transmission
  - different economic profile than typical accounting assets. Crown can play a role in bridging.

CROWN UTILITY – EXAMPLES OF ROLE

- Can have Government/citizens back debt (e.g. Muskrat Falls)
  - + Calm financial markets
- Different financial targets than private sector, and different than Crown when just in operating mode
- Forego charges on utility (e.g., no debt guarantee fee on Muskrat Falls, limited charges when LWR/CRD built)
- Provide for different financial structure for projects (e.g., AECL own and lease back on Bipoles I and II at negative lease rate)
  - + Net effect of AECL financing was almost total depreciation and financing relief
- Government investment dollars not need to be compensated for short-term risk like drought (e.g., Hydro-Quebec)
  - + Not relevant to MH, no Government investment

RATE SETTING

- GRA must deal with balancing and fairness.
- Key guides:

1. Public Utilities Board Act – what has changed?
2. Intergenerational Equity – what have we been left from previous ratepayers?
3. Interclass Equity (cost of service). Who uses/ requires which assets or costs? [next hearing]
4. Customer versus utility – Not the same issue with Crown as with private utilities. No investor. Not setting profit levels. Company and customers are "in this together", service focus.

3. FINANCIAL ISSUES FOR THIS HEARING

FINANCIAL PICTURE

- Financial issues fundamentally different between Income Statement and Cash Flow
  - + Income Statement, Interest Coverage
    - × Heavily burdened by expensing overhead costs related to capital
    - × IFRS makes worse – even larger impact than at last GRA
    - × DSM spending, adding sustaining capital matter, but takes time to build impact
  - + Cash Flow
    - × Holding our own during known heavy investment period
    - × Not IFRS issue. Not depreciation. Those are non-cash items.
    - × DSM spending, adding sustaining capital matter greatly
- Both affected by variables like O&M escalation, vacancy.
- Cash Flow is rarely a focus of regulatory reviews

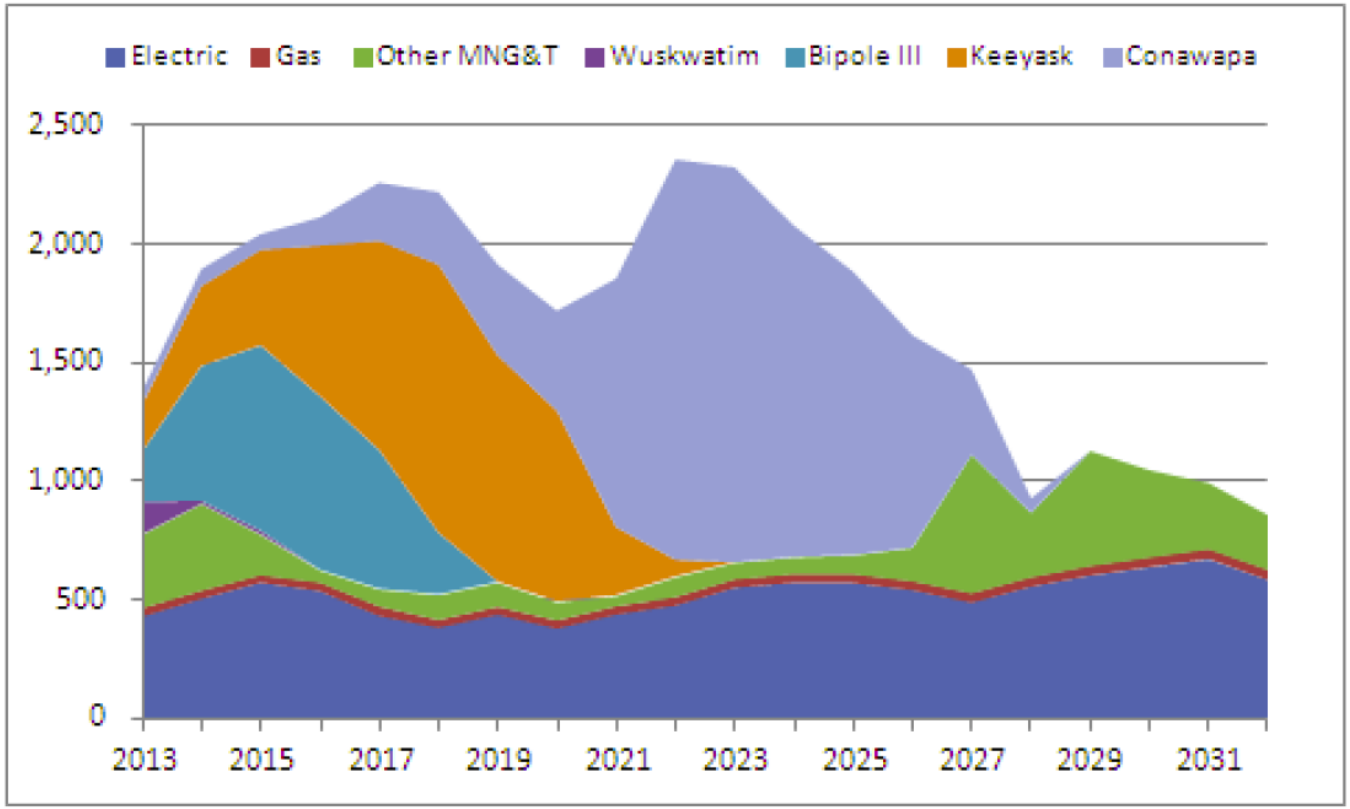
FINANCIAL TARGETS

- Addressed in 3 parts
  - Cash and Capital Spending
  - Net Income (including Accounting Changes)
  - Balance Sheet
- All 3 affected by the “bulge”
  - Guidance from longstanding regulatory literature – assets should not drive rates until “used and useful”.
    - Also assets should not drive rates if not “prudently acquired”

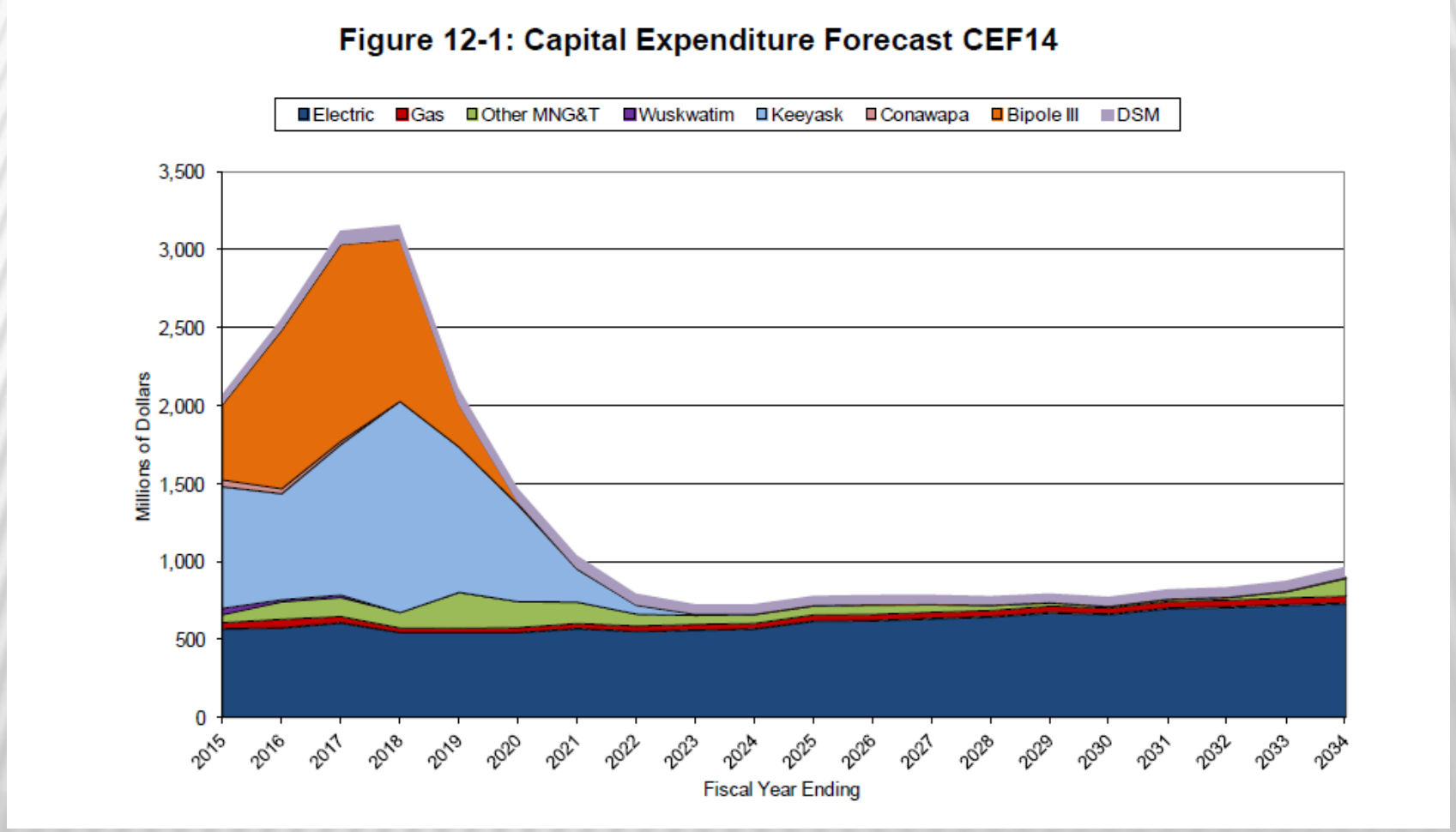
FINANCIAL ISSUES – CASH FLOW

IFF12 EXPECTED 15 YEARS OF BULGE

Figure 3-1: Capital Expenditure Forecast CEF12



IFF14 – NO CONAWAPA - BULGE HIGHER/SHORTER



CHANGE SINCE CEF13

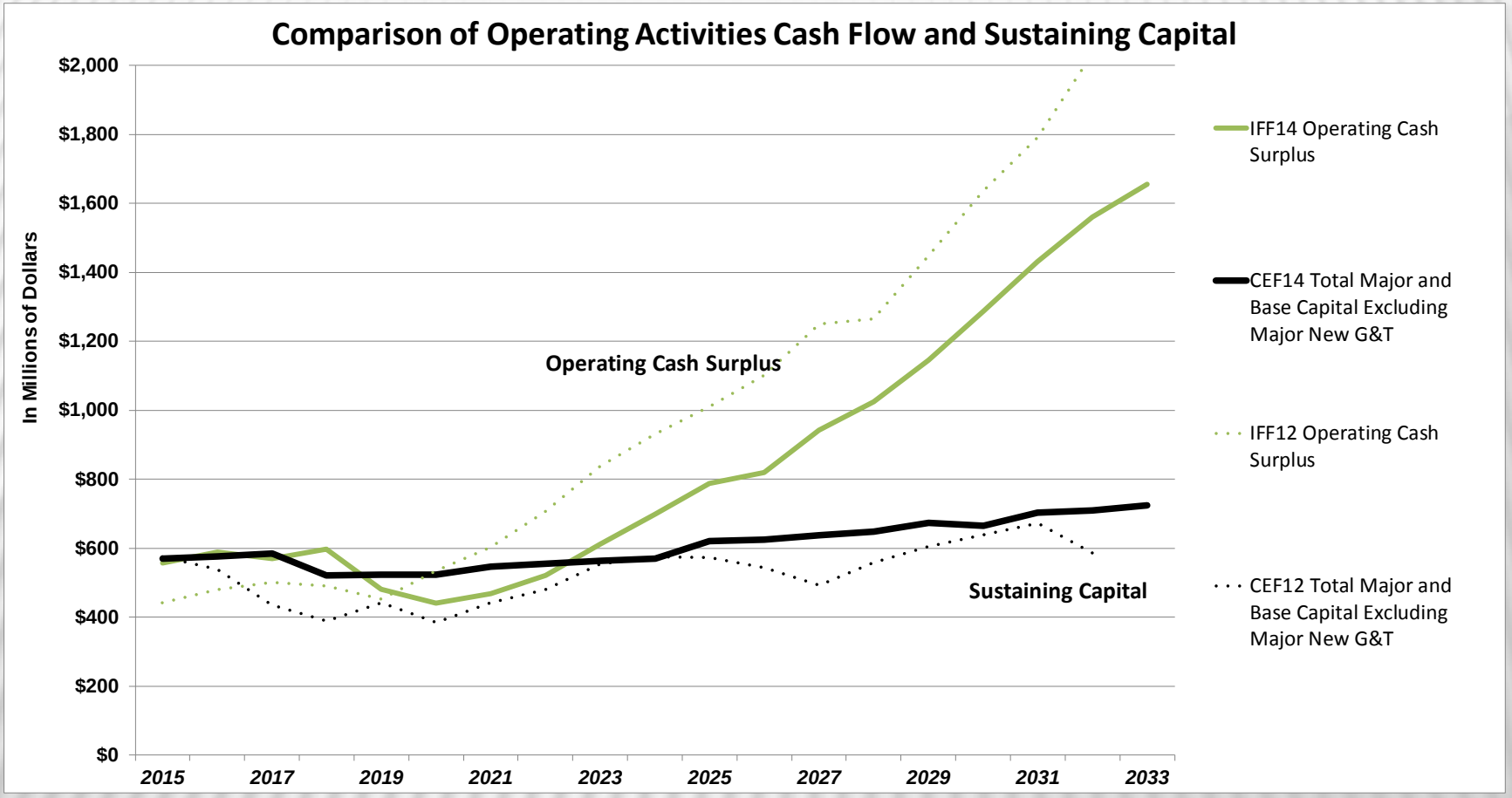
CEF14 compared with CEF13 ($ billion)

	1st 10 yr	2nd yr	Total
Conawapa	-6.1	-4.0	-10.1
Pointe du Bois Rebuild	0.0	-1.5	-1.5
Sub total	-6.1	-5.5	-11.5
Bipole III	1.3		1.3
Keeyask	0.3		0.3
DSM	0.5	0.3	0.8
Sustaining Capital	0.4	1.6	2.0
Sub total	2.6	1.9	4.4
All other Electric & Gas	0.1	-0.5	-0.4
Overall Change	-3.4	-4.1	-7.5

SUSTAINING CAPITAL

- Extremely difficult topic for regulators and intervenors
- Very difficult to parse information from utility
  - Large number of adjectives – potentially all valid
  - Often information focused on staff level – why this project versus that chosen within the budget limit – rather than executive level about how the budget limit determined.
- Regulatory onus key to managing the issue
  - Newfoundland PUB situation, can't manage utility
- OEB report highlights some approaches (categorization, prioritization, performance reporting, reliability metrics)
- Many overlapping issues. E.g.:
  - More fuel switching and natural gas conversion can help address rural transmission/distribution loads
  - Rate designs to help address load timing (Time of Use)

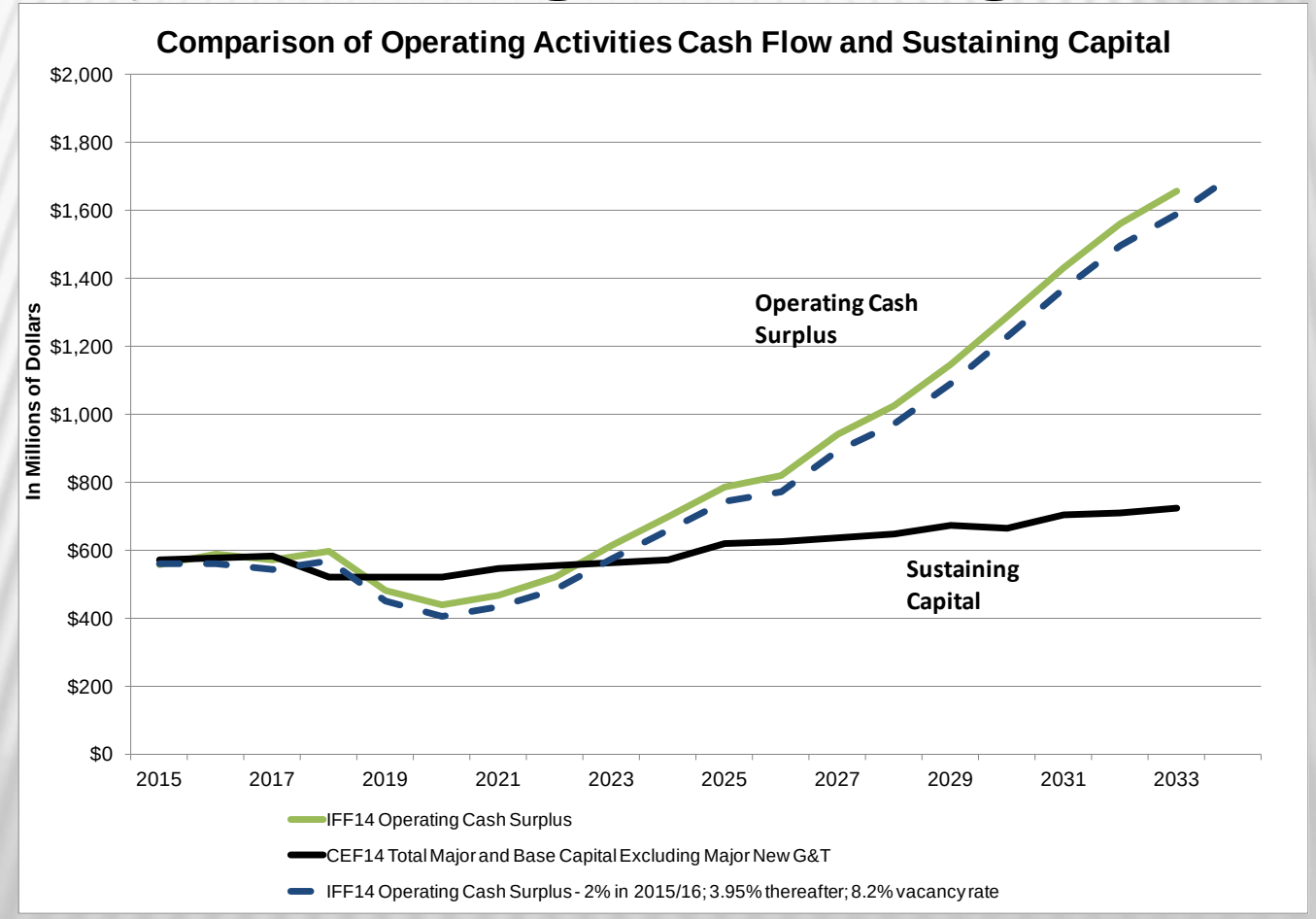
OPERATING CASH SURPLUS & SUSTAINING CAPITAL



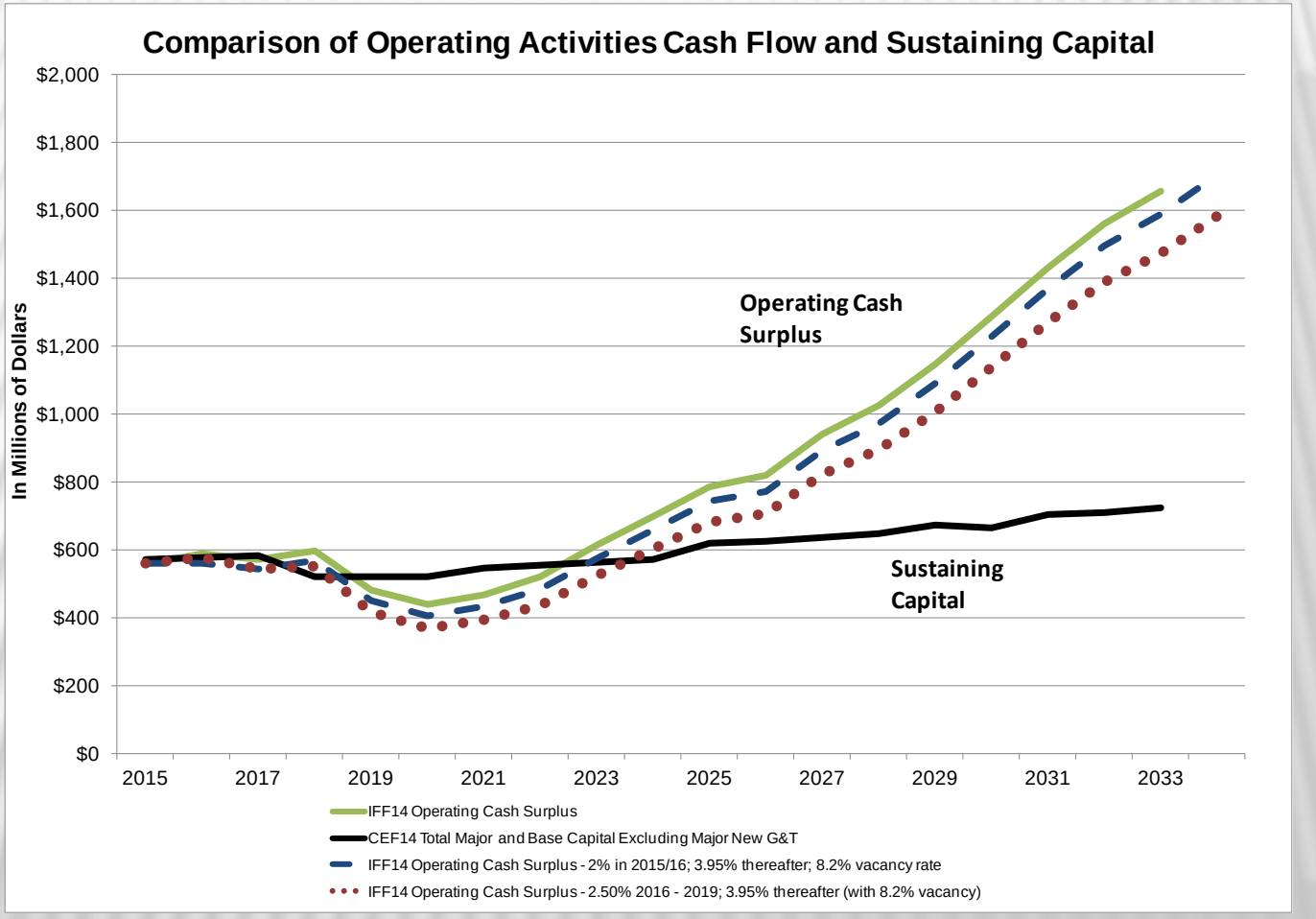
Not borrowing to operate (green line always positive) – also fully absorbs operating cash impacts of $275M/year Bipole, and $80M/year shortfall for Keeyask (cash cost less export revenues)

WHAT IF GRANT 2% TODAY

Change 2015/16 rate increase to 2% and adjust vacancy rate to long-term average



WHAT IF GRANT 2.5% TODAY AND SUSTAIN FOR 4 YEARS?



SUMMARY CASH FLOW – NEXT 10 YEARS

- 2015 year-end net debt - $11.7 Billion
- 2024 year-end net debt - $23.2 Billion
- Growth in debt- $11.5 Billion *($11.6-$11.8B other scenarios)*
- On what – long-term assets:
  - Keeyask - $6.5 Billion
  - Bipole - $4.7 Billion
  - MMTP - $0.3 Billion
  - DSM - $0.7 Billion (only spending - not incl. revenue hit on cash)
  - Total - $12.2 Billion
- Outside of 4 long-term projects, any of 3 rate increase scenario:
  - All operating costs and interest covered by cash from operations
  - Keeyask and Bipole early year losses absorbed
  - All normal capital over 10 years is financed by cash flow
  - PLUS old debt is paid down (by $0.7B with 3.95%; $0.4-$0.6B under scenarios).
    - Occurs despite present context – large increases in Bipole costs, heavy sustaining capital reinvestment, low gas/export prices, opportunity for low interest rates.

CASH FLOW CONCLUSION

- Some challenges, but entirely as expected during major phase of build out of new assets, overlapping with major reinvestment in old assets.
- Picture is not bleak – for the most part cash is tracking sustaining capital.
  - Where it is not tracking is the first few years of Keeyask and Bipole III
- Even if it was not tracking well, this is to be expected during the current investment period.
- Cash flow over this period would benefit if DSM was reduced, interest rates remain lower than forecast, higher vacancy rates than forecast, or better O&M cost control. Also any government charge relief.

FINANCE ISSUES – INCOME STATEMENT

INCOME STATEMENT SUMMARY

- The income statement shows known and expected issues as major projects are brought into service.
- Net losses based on Hydro projections show 8 years of losses totalling $980 million.
  - $400 million - Overhead capitalization since IFF11-2 totals $50 million/year (PUB/MIPUG-11)
    - Not include changes made before IFF11-2 under CGAAP
  - $400-$560 million - ELG $50-$70 million/year (rebuttal page 33)
  - $100-$160 million - vacancy overestimation $12-$20 million/year
  - $280 Million in new DSM amortization at 10 year rate [only DSM in IFF14 but not in IFF13] – not include net lost revenue
- Up to $1.2B to $1.4B over the key 8 year period.
- Offset by some amortization of the above amounts if deferred; i.e., net income absent some of the above items could be very small loss or even positive.

FINANCIAL ISSUES – INCOME STATEMENT OVERHEAD

OVERHEAD CAPITALIZATION

- Relates to IFRS accounting standards for what common costs are to be capitalized (e.g., stores)
- 2 important considerations:
  - PUB must adopt method that is fair to ratepayers
    - No change in PUB legislation in last 6 years when these changes occurred
    - Large impacts compared to last hearing ($120M/yr vs $57M/yr)
    - $120M is 8% on rates. Not just accounting detail, versus a fundamental change to balancing/rate fairness
  - New facts re: IFRS accepting regulatory deferrals
    - If PUB does require new methods for regulatory reporting, Hydro can apply same to IFRS books and not have divergence.
    - CAMPUT letter supports IFRS standard for this reason – not “2 sets of books” but one set driven by PUB’s needs.

PUB CONCLUSION IN LAST GRA

- At last GRA, PUB indicated:
  - "In the Board's view, Manitoba Hydro's proposed accounting changes are appropriate for the test years. The Board will direct Manitoba Hydro to file an International Financial Reporting Standards status update at the next General Rate Application. Until such time, the Board expects Manitoba Hydro not to make any further accounting changes for rate-setting purposes." (Order 43-13)
- At that time $57.6 million in accounting changes under CGAAP. None due specifically to IFRS.
- IFRS rate regulated accounting was not permitted.

ACCOUNTING CHANGES - OVERHEADS

- Even if only deal with IFRS driven changes (leave CGAAP changes per last PUB decision), still very material ($55-$60 million/year.
- Key is options here that did not exist as of last GRA:
  - Hydro previously stated : “Including amounts allowed by the regulator in the cost of [PPE] appropriately reflects the economic substance of regulated operations and the basis upon which rates are set … In addition, this exception promotes consistency in financial statement presentation for a significant aspect of a rate regulated utility’s operations which will assist the users of the financial statements upon the transition to IFRS.” [PUB/MIPUG-9 quoting attachment to CAC/MH-I-22e from 2012 GRA]

OVERHEAD TREATMENT

- 2 options today - lead to same outcome: (PUB-MIPUG-9)
  - (1) Retain consistent reporting before PUB (not adopt changes otherwise proposed under IFRS).
  - (2) Adopt new regulatory overhead rate to capitalize costs consistent with full cost accounting
    - At least cover on the order of $60 million/year (per PUB I-73(a)) a range of about 2-5% overhead rate, perhaps more.
- Move towards PUB-driven verification, e.g., OEB
- In either case Hydro (with its auditors) can elect to also make IFRS statements consistent.
  - IFRS should remain secondary consideration for PUB
  - Risk if miss window under IFRS14 (re “continue”)

FINANCIAL ISSUES – INCOME STATEMENT
FIXED ASSETS AND NET SALVAGE

FIXED ASSET ACCOUNTING PRACTICES

Hydro proposes a “package” of matters related to the cost of assets. But factually not a package:

1) Change live estimates – routine and necessary – gives large reserve imbalance

2) Eliminate net salvage – sensible and principled proposal - common regulatory practice - doesn’t fit for MB generation and transmission - also fits with IFRS

+ Both these are easy and necessary things

3) Change to Equal Life Group (ELG) depreciation

+ Been made a complicated issue

CURRENT STATUS

- Existing methods – surplus of $470M due to lengthening lives.
- Plus Net Salvage reserve of $530M
- Total surplus if get rid of Net Salvage - $1 billion

- Then – proposed change to ELG – calculates needed to have amortized an additional $400M in the past – surplus drops to $600M.

NET SALVAGE BACKGROUND

- Needs to be a principled decision – not about accounting changes.
  - Agree with Mr. Kennedy - If it's appropriate to keep in rates, then do that. Don't be forced by IFRS
  - Disagree with Mr. Kennedy as to whether it is appropriate today.
- Significant evolution on the issue in last 10+ years
- Only exists today as regulatory liability. Hydro claims this PUB wanted the account.
- Others moved in same direction to get rid of salvage accumulation – BC Hydro and BCUC (also Yukon, NWT).

WHY GET RID OF NET SALVAGE?

- Same principled decision as other Crowns.
- In Manitoba, net salvage not fit well with generation and transmission assets.
  - In most cases sites will be redeveloped
  - There will be more value to the site left to next generation than costs for removing residual assets
  - Transactions (market test) support this conclusion, such as hydro plant sales at end of life.
- IFRS clarifies can include removal costs in replacement asset (not determinative, but simplifies application)

DEPRECIATION – EQUAL LIFE GROUP

- Many layered topic – technical, theory, practice, realities, regulatory implications.
- Summary of Issue:
  - Hydro is outlier. All other Crown utilities using ASL
  - ELG higher cost with no crossover. Not more intergeneration fairness.
  - Hydro selling false precision of ELG as they propose to apply it.

PAT LEE DIRECT

ELG VERSUS ASL RECONCILIATION

- Hydro's business is to sell power in a regulated market – IFRS catching up to reflecting that principle (IFRS14)
- Hydro can run whatever statements this Board requires.
- If there's an issue, it's for IFRS reporting (CAMPUT letter)
- Hydro's rebuttal runs backward reconciliation scenario (page 23). Exhibit shows different alternative of same analysis. (Ex. 97).
  - Analysis based on view that MH convert to ELG, but pretend to use ASL for the PUB and effectively loan ratepayers the difference
  - Fallacious example. Suggests decision becomes about when the loan comes due (10 years, 40 years) which is incorrect.
- Proper approach is to apply "ASL No Salvage" rates as per MIPUG/MH-I-22b. *[Hydro noted this in previous GRA – see quotes at final slide]*

FINANCIAL ISSUES VACANCY AND DSM

VACANCY RATES

- In the last GRA, Hydro projected 6.2% vacancy for 2012/13. MIPUG concluded 8% based on past years
- Actual from this GRA:

Manitoba Hydro
Actual and Forecast Vacancy Factor

Vacancy Factor	2009/10	2010/11	2011/12	2012/13	2013/14
Actual	9.3%	7.4%	7.8%	8.5%	8.1%
Forecast	6.6%	5.7%	6.3%	6.2%	5.5%

- Hydro now projecting 4.5%.
- If the same 7.4%-9.3% repeats as per recent history, savings of $9 - 15 million/year in salaries, plus benefits (add'l 35%). Total $12 - 20 million/year
- Larger savings in cash (due to capitalized portion)
  + $20 – 30 million/year

DSM FINANCIAL IMPACTS

- Significant increase in spending and amortization since previous GRA
- Adverse impact on cash given low export revenues to replace lost domestic revenue
  - Positive DSM metrics indicate program can pay for itself over long periods. Not necessarily in first 2, 5, 10 years
- Even if spending stays at this level, unlikely to remain as capital spending and debt carried by Hydro if new government entity is to deliver DSM.
- Amortize over 10 years when benefit calculated over up to 30 years depending on the program

FINANCIAL ISSUES – BALANCE SHEET

BALANCE SHEET

- Pre-filed testimony notes drought not as large a cost risk as in past – same conclusion as at NFAT
- Retained earnings throughout IFF consistently above the 5 year drought cost forecast ($1.2 billion per Bowman snapshot, $1.7 billion per Hydro scenario)
  - Retained earnings remain above $1.9 Billion at 3.95%
  - $50 to $300 million lower under other rate scenarios.
- 25 years of PUB Hearings based on building Hydro's reserves up - first to 2 year drought, then to early debt:equity targets, and finally to a level that closely tracked a 5 year drought cost – understandable
- The projections that maintain reserves near or above 5 year drought cost during major building phase is very favourable.
  - Better if find improvements in capital pacing and prioritization.

DEBT:EQUITY

- Based on a rote 75:25 target, by 2034 need over $5 billion in retained earnings.
- More work needed if Hydro is to justify this level of reserve targets – not for this GRA.
- Today debt:equity near 75:25. Absolute levels highest in history.
- Also $1 billion depreciation surplus, which is benefit.
  - If depreciation study concluded assets were $1 billion underdepreciated, it would be a caveat against the debt:equity. Not 1:1 issue, but a notable footnote.

4. OTHER ISSUES FOR THIS HEARING

DSM APPROACH AND TESTS

- DSM tests must take into account lost revenue. It is inherent economic aspect of reducing loads.
  - Without taking into account lost revenue, DSM programs can lead to higher rates to others, and severe cross-subsidization.
  - Only test applied by Hydro that does this is RIM test. This test is a ratio, which is helpful but can be less informative as it gives no idea of scale or of dollars.
  - Tests based on the net cost of DSM, including lost revenue, on a cents/kW.h basis can also be relevant.
- Industrial DSM is best managed by Hydro
  - Already part of close relationship with utility – efficiencies
  - Customer confidentiality of information
  - Integral to the Hydro/customer relationship – i.e., DSM can be more about sizing feeders or curtailable service, etc. Cannot be managed by 3rd party.

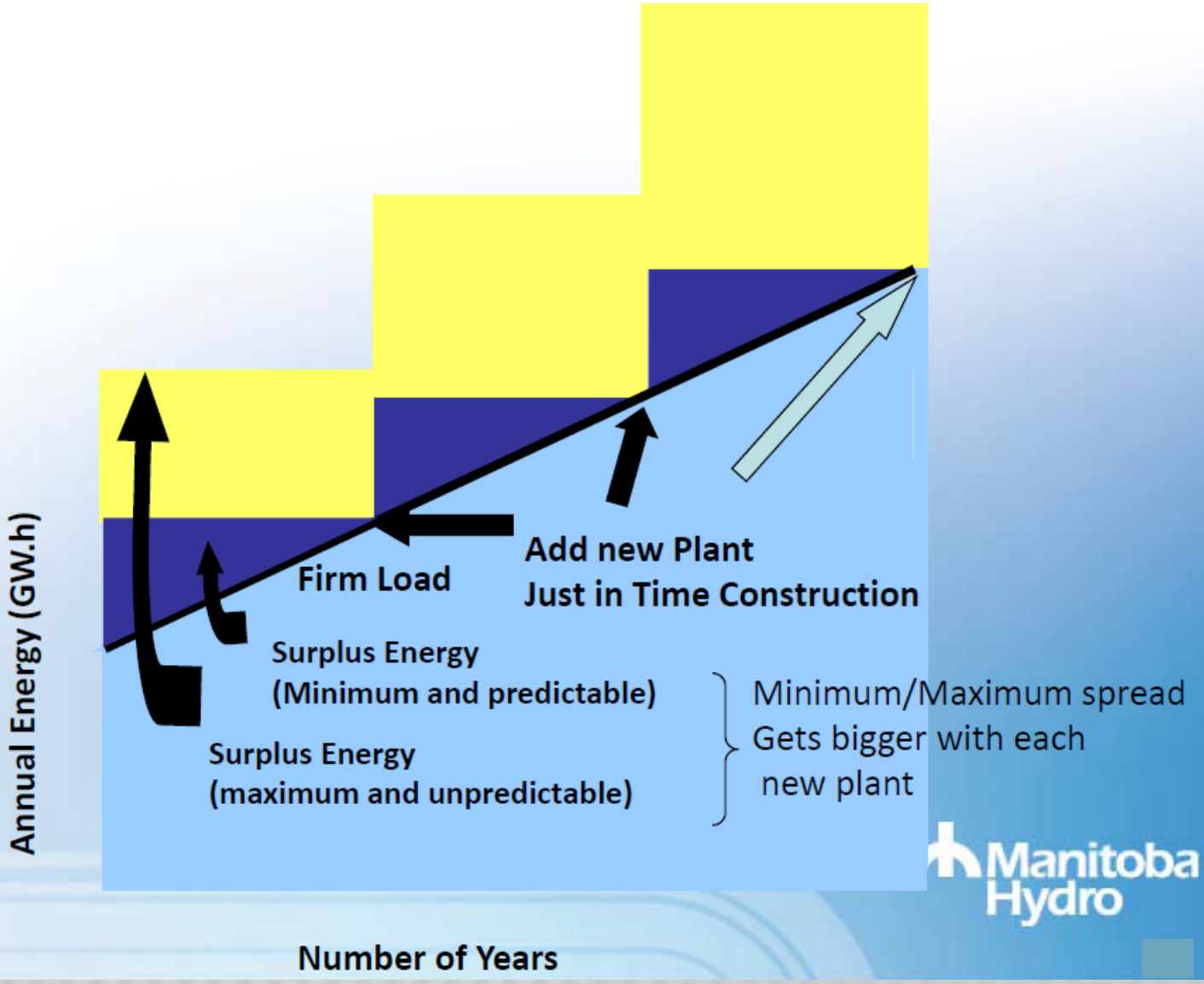
CURTAILABLE

- Most important aspect is to protect value of program to participants. Caps can help achieve this.
- Recommend retain caps at level prior to last GRA (not the new interim lower level).
  - Option A at 230 MW
  - Option R at 100 MW
- If Option C (1 hour notice) not of value then eliminate.
- Important to ensure Hydro reflects the full value of Curtailable in its assessments. Two parts presently missing:
  - Long term value even if no guaranteed long-term contract – can rely on record of customer participation – much like other DSM
  - Also reflect value on other system issues – for example, regional transmission getting increasingly constrained to near limits.

SUPPORTING MATERIALS

Manitoba Hydro System Overview – NFAT Pre-Hearing Conference, May 15&17, 2013, slide 23

Surplus Energy - By Design



HYDRO POLICY VIEWS ON ELG AT 2012 GRA

Mr. V. Warden (Senior VP of Finance & Administration and CFO) in 2012:

"If rate regulated accounting were approved, or some form of rate regulated accounting by international board, then we would – at that point it would be a policy decision as to whether or not we wanted to continue to include net salvage value. We would also perhaps reconsider ELG as well." (T:1650)

"Mr. Peters, given the situation we have with IFRS at this particular time, there's some uncertainty as to whether or not we'll move to ELG. In the interim period we are still using ASL. And, if we proceed down this path and IFRS continues to be deferred, we will continue to use ASL. And if we take it to the next depreciation study in five (5) years from now, in fact, we will be adding more componentization in order for ASL rates to be compliant. So we may very well get there anyway, but it would probably not be a worthwhile exercise at this juncture." (T: 1712-1713)