| MANITOBA | Order No. 20/07 |
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| THE PUBLIC UTILITIES BOARD ACT | |
| THE MANITOBA HYDRO ACT | |
| THE CROWN CORPORATIONS PUBLIC REVIEW AND ACCOUNTABILITY ACT | February 28, 2007 |

Before: Graham Lane, C.A., Chairman
Robert Mayer, QC, Vice-Chairman
Len Evans, LLD (Hon.), Member

**MANITOBA HYDRO – INTERIM RATE INCREASE**
**EFFECTIVE MARCH 1, 2007**

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## 1.0 Executive Summary

By this Order, the Public Utilities Board (Board) approves Manitoba Hydro's (MH) application for a rate increase of 2.25%. The rate changes are to be implemented as of March 1, 2007, rather than February 1, 2007 as initially requested by MH. Concurrently, the Board varies MH's proposal and defers to the General Rate Application (GRA) hearing, anticipated for the fall of 2007, consideration of the potential consolidation of the residential customer class rate blocks.

The rates now established are interim, to be reviewed at the public hearing, then subject to either confirmation or amendment. In approving MH's application, the Board also:

a) pursuant to Order 117/06, accepts MH's proposal to freeze Area and Roadway class rates, at this time;
b) reaffirms Board Order 117/06's requirement for the filing of an amended Cost of Service Study (COSS) in advance of the General Rate Application;
c) reiterates past expressed concern with MH's low equity (retained earnings) position relative to its debt and business risks; and
d) reiterates other directions set out in Order 117/06.

With this interim rate increase, MH will remain below its equity target of 75:25, debt to retained earnings. MH's most recent financial projections reflect the interim rate increase of 2.25% and future forecast annual rate increases of 2.5%. Even these increases do not support the target debt:equity ratio of 75:25 being reached before March 31, 2017 -- five years beyond the MH's Board of Directors stated target of March 31, 2012.

Given the projected delay in reaching the debt:equity target, and the concurrent continuation of extant risks commensurate with the complexity and magnitude of Manitoba's largest utility, the Board finds its approval of the 2.25% interim rate increase to be in the public interest.

With respect to the deferral of the potential consolidation of energy rate blocks for residential customers, the Board acknowledges MH's proposal would have, if it had been accepted,

represented a step towards a rate design more consistent with the principles of *The Sustainable Development Act* (SDA). Order 117/06 directed MH to bring forward proposals to eliminate declining block rate schedules. However, the Board concludes that such a change should arise out of a GRA hearing whereat interested parties may discuss the change within a broader context, rather than by means of an Order focused on the provision of interim rate increases.

The elimination of declining rate blocks would best be part of a program towards achieving enhanced energy efficiency and conservation. Energy efficiency and conservation presents the potential for the creation of a virtuous circle, wherein lower domestic electricity consumption would result in reduced customer bills, and, concurrently, in higher net export revenue and overall net income. Improved energy efficiency in Manitoba would also, through exports of excess generation capacity, result in lower carbon emissions by MH's American export customers.

Accordingly, the Board reminds MH to provide supplemental information within the GRA with respect to marginal and environmental costs associated with domestic and exports sales. The Board intends to take into account this supplemental information, along with other factors, in evaluating future MH rate applications and differentiating increases among customer classes.

Within this Order, the Board also reiterates its previous requirements of MH for actions and filings covering a wide range of other matters. The Board acknowledges the time and effort that will be required of MH to meet the Board's directions prior to the GRA hearing; Board staff and Counsel will consult with MH and registered interveners to establish a reasonable timetable.

As suggested, the Board anticipates the GRA hearing will take place in late 2007, this to allow for potential further rate amendments to take effect in MH's 2007/08 fiscal year. Regulatory vigilance is required to ensure that the pursuit of low rates (the Manitoba Advantage) compromises neither environmentally-friendly actions nor the MH's financial strength. The utility requires an adequate balance sheet to move ahead with major capital expenditure plans to benefit future generations. .

## 2.0 Introduction

In January, MH filed its application for a rate increase of 2.25%, to be effective February 1. The Board employed a paper process to hear the application, involving:

a) circulation of MH's application and subsequent exchanges of information to and with past registered interveners;
b) filing Board information requests and receiving responses from MH;
c) filing information requests from Consumers Association of Canada and Manitoba Society of Seniors (CAC/MSOS), and receiving responses from MH;
d) consideration of intervener issues, submissions and positions;
e) consideration of submissions filed by other interested parties;
f) consideration of summary position of MH; and
g) Board general awareness of perspectives held by industry and the general public, made known through direct representation and media reports.

In addition, the Board reviewed past Board Orders, particularly Order 117/06. Material considered by the Board through its process may be accessed at the Board's Offices or, with respect to past Board Orders, found on the Board's website (www.pub.gov.mb.ca)

Ten interveners have represented various MH customer classes in recent MH-based proceedings, and, as indicated above, information related to the interim rate application was circulated to each of them. Three interveners provided detailed comments; CAC/MSOS also filed interrogatories, as did the Board. The three detailed interventions were from:

a) Consumers' Association of Canada (Manitoba) Inc. and Manitoba Society of Seniors (CAC/MSOS), which also filed interrogatories;
b) Manitoba Industrial Power Users Group (MIPUG); and
c) Resource Conservation Manitoba/Time to Respect Earth's Ecosystems Inc. (RCM/TREE).

Brief submissions were also received from Canadian Manufacturers & Exporters (CME), a past intervener, and Mr. Allan Ciekiewicz, a past presenter.

Complementing the assistance provided by interveners and Mr. Ciekiewicz, the Board was further assisted Board Counsel, Robert Peters of Fillmore Riley LLP, Larry Buhr of LAB Consulting, and Jean McClellan of PricewaterhouseCoopers LLP, as well as Board staff. LAB Consulting and PricewaterhouseCoopers are Board Advisors, familiar and experienced with MH and general utility matters.

To better understand this Order and its directions, a background outline is required. As well, it will be helpful to review the broader context in which MH operates, including the significance of MH to the Province and to Manitobans. Much of this understanding may be obtained by a review of past Board Orders 101/04, 143/04 (which resulted from MH's 2004/05 GRA hearing), and Order 117/06.

Because of the low-cost hydro generation that has resulted from Lake Winnipeg Regulation, the Churchill River Diversion, and, particularly, three Lower Nelson River Generating Stations and the High Voltage Direct Current Transmission infrastructure, MH has been able to export significant volumes of energy to the United States, and at various times to Ontario and Saskatchewan. Generation and transmission facilities built decades ago provide MH with low-cost energy, and this power has been sold at progressively higher export prices over the years.

The benefits received from MH's export of excess generation to the United States have allowed domestic customer rates to remain well below marginal costs and North American and Canadian averages. MH reported that its rates, including the 2.25% interim rate, would compare to selected other jurisdictions, as follows:

| One Month Bill Calculations | | | | |
|---|---|---|---|---|
| **City** | **Residential 1,000 kW.h** | **GS Small 40 kW / 10,000 kW.h** | **GS Medium 300 kW / 120,000 kW.h** | **GS Large 5000 kW / 2,555,000 kW.h** |
| **Vancouver, BC** (BC Hydro) **February 1, 2007** | $66.49 | $727 | $6,064 | $121,070 |
| **Medicine Hat, AB**(Medicine Hat Elec) **January 1, 2007** | $100.69 | $911 | $10,870 | $168,536 |
| **Regina, SK** (SaskPower) **February 1, 2007** | $109.11 | $876 | $9,763 | $163,029 |
| **Winnipeg, MB** (Manitoba Hydro) **February 1, 2007** (proposed) | $64.34 | $634 | $5.865 | $100,145 |
| **Toronto, ON (**Toronto Hydro) **May 1, 2006** | $117.62 | $1,146 | $12,439 | $241,010 |
| **Montreal, PQ** (Hydro Quebec) **April 1, 2007** (proposed 2.8%) | $67.85 | $866 | $9,215 | $119,898 |
| **Moncton, NB** (NB Power) **July 1, 2006** | $109.56 | $1,106 | $11,578 | $168,146 |
| **Halifax, NS** (Nova Scotia Power) **February 2007** (preliminary) | $117.51 | $1,188 | $11,485 | $171,495 |
| **St. John's, NF** (Newfoundland Power) **January 1, 2007** (interim) | $104.94 | $1,136 | $10,404 | $187,922 |

MH rates are the lowest in Canada, with the largest positive spreads from the rates of other utilities being those charged General Service Large customers, where MH's "cost of service" rates are less than half the highest of the surveyed jurisdictions.

Considering MH's rates in comparison with other electrical utilities in Canada, it is apparent that rates could be increased substantially and still have MH competitive with the other utilities. The 2.25% interim rate increase granted herein and MH's projections of 2.5% annual increases thereafter would not affect the substance of this view; as the other utilities are increasing rates at or above the projected rate increases of MH. And, not all electricity utilities in Canada have the rate-setting and cost-based transparency found with the public hearings involving MH.

MH experienced favourable water flow conditions for hydraulic generation for domestic and export sale in four of the last six years; nine of the last eleven years; and thirteen of the last

sixteen years. Since the Limestone generating station came into service in 1990, MH has experienced only three years of significantly below median water conditions, including one drought, and, consequently, has been able to export on a net basis (exports less imports) substantial energy. Low water flow years result in increased imports and reduced exports, reducing the net value of exporting and placing pressure on domestic rates.

Ninety years of water flow history provides a good perspective on the potential for significant droughts. Drought results in drastically reduced exports and substantial energy imports, as well as the higher unit costs associated with MH natural gas electricity generation activity. Low water conditions occur on average one year in five, with a drought to be expected one year in ten. A severe drought (one lasting two or more years) has occurred at least three times in Manitoba's history; such a drought would now be very costly to MH, given its export commitments. The 2003-04 drought was MH's last, and it had a severe financial cost.

Drought remains one of the major risks faced by MH. In low water flow years, MH imports power and those imports come at a price that, in the past, has exceeded export prices.

In the absence of export profits, the annual revenue requirement of domestic customers would have to account for all domestic costs and, as well, provide a contribution to building MH's retained earnings. Without substantial net export revenues subsidizing customer class rates, these rates would be considerably higher. Yet, even without export profits to reduce rates below cost, MH's rates would still be below most other electricity utilities, due to MH's lower-cost historic-cost based hydro-electric generation.

Exports made possible by excess generation and transmission capacity provide MH the potential for significant profits in high water flow conditions, particularly, as was the case in 2005/06, high water levels are coincident with high natural gas prices. It is has been MH's recent policy and practice to make investments in generation and transmission with the export market in mind. Generation additions are advanced and capital and operating expenditures incurred to make the most of the export potential.

*Manitoba Hydro's Financial Position and Risks*

With respect to MH's retained earnings, Board Orders 101/04 and 143/04, followed by Order 117/06, expressed the Board's concerns with MH's present debt:equity ratio, while supporting the reaching of the 75:25 ratio target as soon as reasonably possible, and preferably without resorting to rate increases that exceed CPI. As elaborated on in Board Order 143/04 and, more recently, in Order 117/06, the risk of higher than CPI rate increases rest with a host of material risks, only one of them being the risk of drought.

According to a 2004 MH estimate, a five-year drought could result in an accumulated loss in the range of $2.2 billion, approximately twice MH's current retained earnings. And, of course, the incurring of a loss means retained earnings would fall, not increase, further setting back the projected date for achieving the 75:25 debt:equity ratio target.

Furthermore, there has been a growing expectation of severe weather fluctuations, and such fluctuations could include more frequent droughts.

Leaving aside droughts, other known and material risks include:

- foreign exchange fluctuations: the Canadian dollar has increased by 50% relative to the American dollar over the last five years. Energy exports are priced in American dollars, so the increased Canadian dollar restricts the rise in export revenue expressed in Canadian dollars. MH has held that its exchange risks are adequately hedged by U.S. dollar debt and sales in American dollars;

- the risk of rising construction costs and interest rates: rising rates affect financing costs, both for new generation, transmission, distribution and office building expenditures, to be largely funded by additional debt, and for existing debt on maturing and requiring refinancing;

- major infrastructure failure unable to be quickly restored, which would bring about the loss of export sales, the need for more expensive power generation and/ or imports, and the incurring of repair costs. MH largely self-insures for property damage and liability with respect to catastrophes;

- a disruption of domestic supply due to unforeseen damages to transmission lines;

- any market or regulatory caused disruption of MH's ability to export; and

- a decline in the average unit export price, whether due to weather, increased American reliance on relatively low cost coal or lower natural gas prices. Export prices are priced at the marginal cost of production for American utility counter-parties, and are constrained by American reliance on coal-fired generation.

The risk of an export price decline arises as a result of American utilities' concern with the risk of natural gas price bubbles. In response, American utilities may increasingly rely on coal for generation feedstock. Coal is attractive because of plentiful supplies, close proximity of supply to new generation and, relative to natural gas, stable pricing. Coincidentally, MH continues to employ its Brandon coal-fired generation, both to avoid importing power and to assist with export commitments; the plant not scheduled to close in the near future.

Since the natural gas price bubble of the winter of 2005/06, natural gas prices have fallen by 50%, driving down the marginal cost of peak electricity generation in the United States and thus affecting MH's opportunity export sales pricing in 2005/06. While the natural gas price decline may be temporary, it illustrates a risk difficult to quantify, that being that the marginal cost of production for American utilities, and hence MH's export prices, may not increase as forecast by MH. MH builds generation and transmission in advance of domestic load requirements, and the unit cost of the new energy may exceed the cost of production and transmission for the mid-term.

Interveners in the Board's MH hearings have generally accepted that MH's retained earnings should be sufficient to avoid the necessity of a large above-inflation rate-increase in the event of a major setback such as a drought. Past regulatory practice has defined rate shock as being a rate increase of 10% or more, implemented in one year.

Though MH has not built into its forecasts the full potential financial implications of a severe drought, it has forecast a need for annual 2.5% rate increases. Those forecast increases are more or less representative of the expected level of annual CPI.

As previously indicated, MH's objective, generally supported by interveners and the Board, is to bring its debt:equity ratio to the 75:25 target as quickly as is reasonably possible. To accomplish this, MH forecasts median water flow conditions and annual rate increases are required, though higher rate increases would allow the target ratio to be reached earlier than 2017. Yet, as MH increases its investment in plant and equipment at ever increasing incremental cost, and as its reliance on net export revenue expands, the utility's risk profile increases. This brings into question whether the existing debt:equity target is achievable, or adequate. The question of the adequacy of MH's retained earnings is underscored by a review of the composition of MH's assets. In Order 143/04, the Board noted that MH has a relatively higher level of deferred costs carried as assets on the balance sheet when compared to B.C. Hydro and Hydro-Quebec. And, the level of MH's deferred costs has since risen further. As well, there is the matter of MH's thermal natural gas generation assets, rarely operated and uneconomic at current natural gas prices.

As well and as previously noted, MH's net income forecasts are dependent on export sales, net export revenue and the continuation of favourable water levels as experienced in the past. In the absence of large net export revenues, which could fall for one of a number of reasons, domestic rates would need to rise by far more than MH's current forecast of annual 2.5% rate increases for the 75:25 debt:equity target to be achieved.

This question of the adequacy of MH's retained earnings is further highlighted by evidence indicating that both B.C. Hydro and Hydro-Quebec have arguably stronger balance sheets than MH. These public utilities have equity balances that are higher on both an absolute and percentage basis than MH. These Crown Corporations have higher equity balances despite the fact that both pay annual dividends to their provincial governments, rather than crediting back to their domestic customers a share of their annual net export revenue as MH does.

For all of these reasons and concerns, Order 117/06 provided MH direction that it should consider future domestic rate increases greater than the 2.5% annual increases to expedite reaching the debt:equity target sooner rather than later.

*Low Cost-Based Electricity Rates*

Electricity is a vital commodity, and Manitoba's economy relies on secure, adequate and affordable power. Some large industrial firms located in Manitoba and expanded with "low-cost based" electricity as one of the factors in their decision, a primary factor for some. Recently, MH has recognized that industry may draw power that could be more profitably sold on the export market, and MH is engaged in research and consultations towards the consideration of a new rate class for new large industry.

Significant changes have taken place in MH's environment that have affected MH's domestic pricing over the last 15 years including:

a) the acquisition of Winnipeg Hydro, which brought MH new revenues, costs, assets, liabilities and borrowings, along with increased responsibilities, opportunities, risks and challenges;

b) a three-fold increase in average unit export price between 1996 and 2006, which have recently fallen back, driven in large part by increased commodity prices (most relevant, natural gas and coal), leading to higher input costs for American non-hydro generation.

Higher marginal generation costs for American non-hydro generation improved the prospects for MH's electricity export prices;

c) changes in the structure and nature of the export market, brought about mainly through the development of the MAPP/MISO trading market and Ontario's growing energy requirements (MH can export excess generation at the marginal costs of American utilities, as defined by MISO rules, limited only by transmission capacity and economic considerations);

d) increased recognition of the value of energy efficiency measures, which reduce domestic consumption and provide for increased export sales. Effective demand side management (DSM) is profitable for MH when the present value associated with the marginal benefit of export sales over domestic sales exceeds the net costs of implementing DSM;

e) environmental concerns are now "front and center", not only with the public and in the media but also as a focus of government attention. Manitoba enacted the SDA, Canada signed the Kyoto pact (although the latter's status is presently uncertain with respect to the federal government's intentions) and Manitoba remains committed to addressing the causes and deleterious affects of climate change;

f) increased loss projections for sustained droughts, demonstrating the importance of MH's export relationships (low water flow year losses may exceed gains in high water flow years – in short, the "worst" scenario overwhelms the "best" when drought and high water flows are compared);

g) planned major new generation and transmission: 99 MW of wind generation has been installed, Wuskwatim has received First Nation approval, and other generation plans are on the drawing board. These projects, which in total involve billions of dollars of additional debt, will impact MH's risk profile and debt:equity ratio, while also increasing generation and transmission capacity with positive expectations for future export revenue;

h) despite significantly improved average and high net income years experienced over the last 15 years with very favourable average water supply conditions, MH's debt:equity ratio remains below the Board-approved target of 75:25 and is forecast to improve only slowly over the next decade – the projected improvement is vulnerable to further deterioration under a number of risk realization scenarios (export market prices fall, rate increases are not implemented, drought, etc.); and

i) identification of a risk associated with large energy-dependent multi-national firms with high-energy use/low employment ratios seeking out jurisdictions with low electricity rates, Manitoba reportedly being the lowest electricity rate jurisdiction in North America. MH has expressed a concern that such new or expanded high-energy dependent industries will lead to rate increases, or, in the absence of higher rates, lower aggregate revenues and net income and a higher debt:equity ratio (through the displacement of export sales at higher rates and possible new generation requirements for industry paying lower rates).

*Last Rate Increases, Forecasts*

The last MH rate application was heard by way of public hearing in the summer of 2004, following the end of the 2003/04 drought. The hearing resulted in Board-directed rate increases and other directives. The rate directives included a 5% firm across-the-board rate increase (implemented August 1, 2004) and two 2.25% conditional rate increases (only the first was implemented, that in early 2005), and provision for further research into inverted rates.

Until January 2007 and MH's recent application, the subject of this Order, MH did not pursue the second conditional rate increase, then-citing record net income forecasts for 2005/06 and a good outlook for 2006/07. After recovering in 2004/05 from a $400 million plus drought-induced loss in fiscal 2003/04, MH's net income for 2005/06 exceeded $400 million, the highest net income recorded in MH's history. Then, with water conditions still favourable, in the fall of 2006 MH publicly projected a Net Income of approximately $200 million for fiscal 2006/07, now reduced to a projection of $102 million, due to a deteriorated water situation.

MH forecasts in its IFF, regular annual rate increases of 2.5%. Yet, the rate increases projected in succeeding forecasts over the past ten years were often neither sought nor implemented, as net export revenues increased due to a succession of years of favourable water levels and export prices. Leaving rates unchanged year after year until 2004 resulted in low electricity rates for domestic customers, but, unfortunately, an inadequate capital base for a utility facing increased risks.

*Manitoba Hydro's Importance to Manitoba*

MH, Manitoba's largest and oldest provincial Crown Corporation, is an integrated energy company providing electricity to approximately 500,000 customers and natural gas to 250,000 of those customers through Centra Gas Manitoba Inc.. MH's consolidated annual revenue approaches $2 billion, with the majority provided by Manitoba's residential, commercial and industrial electricity customers. MH's assets approximate $10 billion, with a further $10 billion on the drawing board. MH is one of Manitoba's largest employers with a personnel complement approaching 6,000 employees.

MH operates fourteen hydroelectric, two thermal and four remote diesel generating stations, purchases 99 MW of wind generation, and has plans for additional hydroelectric and wind generation and transmission assets. Within the past ten years, MH has acquired Centra Gas Manitoba Inc. and Winnipeg Hydro, and integrated these operations with those of its pre-existing electric operations. MH is also involved in and, from a financial and operating perspective, benefits from the export and import of power.

MH is administered through a Board of Directors appointed by the Lieutenant Governor-in-Council, and is financed not only by revenue from electricity and natural gas sales but also from borrowings guaranteed by the Province. The borrowings are intended to enhance future profitability through the making of additional infrastructure investments in generation and transmission assets. MH's generation and transmission capacity is required to provide reliable

service to the Corporation's Manitoba customers, as well as to take advantage of export opportunities as surplus capacity allows.

Because MH is a capital intensive utility, many of its costs derive from the amortization and financing of plant costs with medium to long term service horizons. This is the case both with respect to electric and natural gas operations.

Consistent with the importance of MH to Manitoba, the Corporation's debt represents more than half of the Province's overall borrowings. MH is subject to the direction and/or oversight of the legislature, the Government of Manitoba, its Board of Directors, Crown Corporations Council and the Public Utilities Board.

MH's annual revenue requirement and rates are subject to the approval by the Public Utilities Board. With respect to its electricity operations, MH has a significant involvement in and reliance on export energy sales, with all classes of Manitoba consumers' rates benefiting from actual and expected export profitability.

## 3.0 Interventions and Submissions

As previously indicated, the views of past interveners and other submissions pertaining to this Order, together with the evidence reviewed by Board, can be accessed at the Board's office. This reportage of intervener positions and other submissions focuses on major issues, and omits some of recommendations and positions put forward; all were considered.

RCM/TREE

RCM/TREE noted MH's projected net income for 2006/07 had dropped from $217 million to $102 million between October and January, and that the decline in expectation was attributable by MH, in part, to energy imports required because of lower than expected hydraulic energy. RCM/TREE also noted MH's report that export prices were lower than expected; in combination

representing a major set-back though *"… not an emergency at the scale of 2003/04"* (the drought year, which resulted in a loss of over $400 million).

Though agreeing with MIPUG that the deterioration was not as serious as the drought year, RCM/TREE suggested

> *"… the problem is the continuing pre-emergency risk of excessive debt and insufficient retained earnings and the further postponement to 2017 of the projected reduction of debt to 75%. That target-achievement date is now five years later than the MH board-approved target of 75:25 debt/equity by 2012."*

RCM/TREE recalled that the Board, "…with the support of MIPUG and RCM/TREE, has repeatedly encouraged the timely achievement of the 75:25 benchmark…", quoting Board Order 101/04:

> *"In summary, meeting this target (debt:equity ratio of 75:25) within a reasonable period of time would reduce long-term pressure on domestic electricity rates, better assure bondholders and thus constrain financial charges and provide a hedge against a future drought (which is certain from a statistical probability perspective)."*

RCM/TREE also reminded the Board of the Board's position enunciated in Order 117/06. The Board then-proposed that MH consider higher-than-inflation annual rate increases to expedite the achievement of the 75:25 target, noting that MH's failure to meet the target in a timely fashion may, in part, be attributed to MH's failure to initiate rate increase applications over the course of a decade. RCM/TREE recommended an interim rate increase in the range of 5%, effective March 1, 2007, noting that while such an increase would be more than MH's requested 2.25%, it would be less than the approximate 6% rate increases required on an annual basis to achieve the target debt:equity ratio by March 31, 2012.

RCM/TREE opined *"… customers should not be experiencing declining real rates (rate increase less inflation) while the debt risk hangs overhead."* They further state:

> *"…holding rates constant for another year increases the gap and the rate increments required to achieve the debt target and, in the meantime, keeps customers oblivious to the true costs of their consumption of electricity. Continually putting off the target date prolongs the condition of continuing risk and pushes the burden of debt repayment onto future customers. Manitoba Hydro's income is subject to sometimes dramatic variability owing to swings in the underlying and interacting determinants of water flows, market prices, and temperatures. It is a challenge to translate that into a stable pattern of rates. Following a policy of foregoing increments in the good years only to be rescued by dramatic hikes when there is a downturn is a formula for rate instability."*

RCM/TREE concluded

> *"…while the current application is incomplete in detail, it does reflect broad directions recommended previously by the Board and will be subject to examination with further information within the year (at a public hearing to follow MH's expected GRA application). We recommend that an increment approximating the cumulative CPI for the last two years be approved on an interim ex parte basis for reasons of intergenerational equity, rate stability, and sending appropriate price signals to consumers."*

<u>MIPUG</u>

MIPUG noted that the Board's *Rules of Practice and Procedure* provide broad discretion to the Board in interpreting the circumstances appropriate for an interim *ex-parte* order (the Board provides interim rate increases herein, and has employed a paper process involving past interveners rather than proceeding by way of an Ex Parte process).

MIPUG suggested criteria for the Board to be applied when considering an interim rate application, the criteria based on Decision 2005-099 of the Alberta Energy and Utility Board

(EUB). Those criteria include general public interest factors of rate stability, the avoidance of rate shock, intergenerational equity, and the provision of appropriate price signals for customers. In providing this guidance, MIPUG noted EUB's indication that in proceeding with the award of an interim increase the reflection of contentious items may be omitted.

MIPUG held that the projected deterioration in Net Income results cited by MH as supporting its application for interim rate increases was insufficient to justify the Board providing interim rate increases. MIPUG opined that the revised Net Income projection of $102 million did not represent an "emergency" condition that would warrant proceeding with an interim rate increase ahead of a GRA hearing. MIPUG noted that MH's supported its request by a reference to a conditional rate increase previously awarded by the Board that was not sought by MH, and held that the circumstances that surrounded the Board's providing of the conditional rate increase are no longer present.

MIPUG suggested that the Board's provision of conditional rate increases followed recognition of the effects of a drought, and that MH had since recovered from that drought, having recorded record earnings in 2005/06 and, now, projecting Net Income of $102 million for 2006/07. MIPUG cited as critical certain outstanding matters yet to be reviewed in a public hearing, these being:

a) amended COSS methodology, as directed by Order 117/06 (COSS is one of the mechanisms employed in rate setting);
b) continuing concerns regarding substantial increases in MH's operating and capital expenditures; and
c) the filing of a GRA.

MIPUG held that a thorough review of these and other GRA-related matters should be required, prior to establishing amended rates, as there was no "emergency" requiring an interim rate increase ahead of a GRA hearing.

\CAC/MSOS

CAC/MSOS provided as its preferred outcome a recommendation that the Board reject MH's application for an interim rate increase and defer the consideration of a rate increase to the full review associated with a GRA. Preferring early notice and reasonable time lines to deal with a proposed rate increase, CAC/MSOS portrayed MH's application as being rushed, a "surprise", and lacking the detail normally required to support an increase.

CAC/MSOS expressed concern as to the negative effect rate increases would have on families with fixed or low income. In the alternative, CAC/MSOS recommended that any increase approved by the Board should be clearly denoted as interim, to be reviewed and possibly amended through a GRA hearing to follow in 2007. CAC/MSOS also held that any increase granted should not be retroactive, and that increases should always be on a prospective basis.

CAC/MSOS also recommended that the Board "challenge MH to take more responsibility for managing the financial impact of the lower precipitation levels experienced last fall through increased vigilance and cost control."

CAC/MSOS questioned the seriousness of MH's reduced expectation of profitability for 2006/07, and noted that MH "*did not mention that its progress towards achieving its financial targets is being impeded by material increases in operating, maintenance and administrative costs (O&A costs), as well as in capital spending.*" CAC/MSOS cited MH's forecasts of O&A expenses per customer, noting that the projection called for an increase from 2005/06's $600 to $664 for 2007/08 and $716 by 2013/14, representing annual increases well above projected inflation. Suggesting MH should demonstrate increased cost control, CAC/MSOS claimed "*... the only parties being asked to make any sacrifice to address the (low water conditions) of the fall of 2006 are Manitoba consumers.*"

This intervener raised reservations with respect to the target date set for MH to reach the debt:equity target of 75:25. Suggesting a need to reconsider whether a 75:25 debt:equity ratio is required to address MH's risks, CAC/MSOS recommended:

> *"As part of its next GRA, the Board should direct MH to file a study reviewing the appropriateness of its current financial targets (i.e. both level and target date) in light of increased capital spending and timing delays for Wuskwatim."*

CAC/MSOS proposed that the Board require MH to file its GRA and all related materials in support thereof "well in advance of any future request for rate increases", seeking increased assurance of the ability of the Board's process to fully test MH's contentions and support for further rate increases.

Canadian Manufacturers and Exporters, Manitoba (CME)

CME provided a submission opposed to MH's application, which opined:

> *" a rate increase… will have a negative impact on … already strained industry. Electricity is a key input for all manufacturers in the province and one of the only advantages Manitoba based companies enjoy over other locations in Canada and the United States. Low electricity rates help to offset higher input costs such as labour (versus low cost US locations) and higher taxes including payroll taxes not paid by competing jurisdictions."*

CME advised

> *"… manufacturing in Canada is under tremendous pressure from increasing Canadian currency, foreign competition particularly China and India and the slow down in our main market the US. Manufacturers cannot control these pressures and will only be further hurt by rate increases in a key input such as electricity."*

With respect to the confluence of the debt:equity target shortfall and MH's proposed rate increase, CME advised the Board:

> *"If improving the debt ratio at Manitoba Hydro is the goal why has little or no emphasis been put on the corporation's internal cost structure. The granting of price increases*

> *clearly puts all the burden of debt ratio improvement on the backs of the ratepayers. ... Hydro be forced to improve its internal efficiency through a mandated cost reduction program..."*

CME recommended MH be provided half of the 2.25% increase applied for, and be obliged to "*…find savings to generate the remaining earnings*".

Mr. Allan Ciekiewicz

This presenter at the MH GRA hearing of 2004 provided a submission in opposition of MH's request for a 2.25% rate increase, citing the existing level of retained earnings as being adequate to meet the reported concern of a condition of low water flows affecting hydro generation.

Mr. Ciekiewicz's opposition focused on MH's debt:equity ratio. His submission considered MH's latest forecast of Net Income for 2006/07, that being $102 million, as being adequate and not requiring a rate increase. He also indicated substantial concern with MH's export contracts, particularly with respect to firm and long-term power commitments; the meeting of these commitments, for Mr. Ciekiewicz represented undue risk. And, Mr. Ciekiewicz reviewed the performance and use of MH's thermal coal and natural gas generating plants, suggesting a need for a better understanding of their operations given export sales commitments and the plants' economics.

Mr. Ciekiewicz suggested that considerably more information than was available through MH's application was required before a proper assessment could be made of the rate proposal, and suggested a case could be made for a decrease in rates rather than an increase.

General Comments

MH's capital structure and its debt:equity ratio has been a focus of attention at Board proceedings related to the utility for many years, as the significance of the ratio is understood by the utility, parties appearing at Board hearings into MH rate applications, and MH's external lenders.

In the public hearing that resulted in Order 117/06, CAC/MSOS opined that the legislation governing MH does not "contemplate" MH recording a profit "over and above all costs." Yet, the intervener accepted retained earnings should be held as a reserve against the actualization of a major risk.

In that hearing, MH, supported by RCM/TREE, suggested that the current legislation "contemplates that MH's revenues will exceed its expenses for purposes beyond normal operating expenses, interest and other charges." MH also noted that its legislation allows for funds "not immediately required for corporate purposes" to be retained as a reserve.

## 4.0 **Board Findings**

Following considerable review and deliberation, and with a primary concern related to MH's financial strength, that being a cornerstone of the process of establishing just and reasonable rates in the public interest, the Board will approve MH's application for interim rate increases. However, the Board will defer until the GRA hearing consideration of the consolidation of existing rate blocks. While the Board called for the consolidation by way of Order 117/06, it prefers such a consolidation occur following a GRA hearing, wherein the implications can be fully considered and the positions of interested parties heard.

The Board accepts MH's proposal not to increase Area and Roadway Lighting class rates at this time, and awaits revisiting the adequacy of these rates at the GRA hearing, expecting to have received an updated COSS ahead of the hearing.

The Board shares some of the concerns raised by interested parties commenting on MH's application, particularly with respect to increases reported in MH's O&A costs.. There is a need for a more detailed examination of MH's costs prior to finalizing the rates that are now set on an interim basis. While the Board recognizes the desirability of long lead times and scheduled rate reviews, and the avoidance of "surprises" such as MH's current application, which was presented

ahead of an expected GRA, the Board also shares MH's view as to the importance of the utility having and preserving an appropriate capital structure.

Adequate retained earnings are required for purposes of meeting unexpected negative events, assuring bondholders of the security of their funds, and meeting this generation's responsibility for providing a sound electricity utility to future generations.

Thus, when the utility is not at its agreed-upon financial target for a suitable debt:equity ratio, and when its immediate financial prospects are in doubt ahead of a new fiscal year that may hold even greater risk, the Board favours an interim rate increase. Given the long lead times associated with a full GRA public hearing, if the Board refused an interim rate increase, by the time the GRA is held and a rate increase, if then warranted, implemented, many more months would have gone by, and MH's situation may well have deteriorated.

Preserving MH's financial strength through rate changes is the jurisdiction available to the Board with respect to MH's financial prudence. It is important to note that the Board has no jurisdiction over MH's capital expenditures; those expenditures are undertaken with the approvals of government and the MH Board. As capital expenditures result in the major costs of MH's operations (those being the amortization of capital investments, financing costs associated with capital assets, and the required operating costs associated with capital assets), the Board's jurisdiction is significantly restricted.

In short, the Board's primary mandate with respect to MH concerns the establishment of rates that are just and reasonable and reflective of the public interest. And, in recent years, particularly with the passage of the SDA, the Board must also take into account environmental objectives in establishing rates. The SDA will continue to be a major area of attention in future rate hearings.

With respect to environmental objectives, the Board notes the seeming inherent conflict between at least short to mid-term economic and environmental objectives. On the one hand, establishing

rates consistent with the past practice and the current ongoing understanding that MH offers the lowest rates in the country would continue to assist residents and business.

On the other hand, recognizing environmental precepts that suggest rates need to be higher to produce price signals to recognize environmental costs not currently recognized in MH's Cost of Service Studies and *" that would promote conservation and energy efficiency, would drive rates up"*.

The dichotomy between these two positions may be illustrated by MH's continued operation of its thermal plants- coal and natural gas. While MH's goals include the phasing out of the coal plant, gas generation capacity may always be required to ensure peak load requirements are met; thermal operations are now generating power to, in part, avoid more expensive imports, this during a period of low water.

While MH's hydro-generated power may displace coal and gas fired generation for its American utility customers, currently, MH's thermal operations are continuing in lieu of relying on American coal and gas generated imports. When economics and environmental principles clash and are unresolved, it suggests, as the Board perceives, more time and discussion is required to develop a societal consensus on which set of principles should prevail, or what balance of interests is to be implemented.

At the anticipated fall 2007 GRA hearing, the Board will continue its examination of this matter, while considering reports to be filed by MH, as directed in Order 117/06. These filings relate to energy conservation and efficiency matters, including consideration of environmental costs in the pricing of Manitoba electricity sold to Manitobans.

In establishing rates, the Board must and has been taking into account the reality of capital expenditures made and planned, and the impact of those decisions on debt, financing and other costs. If rates are too low to produce annual Net Income adequate to satisfy financing and operating requirements, or the expectations of debt markets that provide MH's financing, major

problems can arise for MH, its only shareholder, the Province of Manitoba, and the public served by both.

MH is highly leveraged, that is, its investments in capital plant (generation, transmission, distribution and administrative infrastructure) are largely financed by debt, loans issued to MH by its bondholders. Without access to debt markets, MH would have to finance its capital investments in new or upgraded infrastructure through earnings alone, and would require massive rate increases. Or, if capital markets are willing to lend money to MH, but, being dissatisfied with MH's capital structure and perceiving a repayment risk, require higher interest rates, there would also be an impact on rates.

There are no major utilities in North America that, to the Board's knowledge, operate either without debt or are able to ignore the concerns of the capital markets.

MH's debt is guaranteed by the Province, and represents over fifty percent of the Province's total debt; and MH's share of the Province's total debt is expected to continue to increase and the Province's non-MH debt is being retired over a lengthy amortization period. Given this, if debt holders are not satisfied with MH's capital structure and situation, it can have implications for the Province overall.

It has been generally accepted that a suitable mix of debt and retained earnings in the case of MH would have debt representing no more than 75% of MH's capital, with retained earnings supplying the other 25%, at minimum. Currently, MH's debt is approximately 80% of its capital, retained earnings only 20%, which for MH, interested parties and the Board is not a satisfactory situation. If water conditions were to remain low into 2007/08, the present debt:equity ratio could worsen further. While an interim rate increase will provide only modest protection, it will show needed commitment to debt markets while reducing the risk of a large rate increase being required later.

In past Orders, the Board has called for quicker progress towards MH's 75:25 debt:equity target than forecast by MH. Reviewing MH's forecasts, the Board notes that with the 2.25% increase

granted as of March 1, 2007 followed by a further 2.5% each year from 2007/08 on (upon Board approval and contingent upon the outcome of a public hearing), and if median water flows occur from 2007/08 and all other MH operating and financial assumptions are realized as now stated, the debt:equity target of 75:25 would still not be reached until March 31, 2017. This would be five years later than the target established at the 2002 Status Update hearing, that being March 31, 2012.

The Board notes that the debt:equity ratio forecasts reported and projected by MH are based on a continuation of current accounting policies, which provide for increasing deferred costs and construction in progress being excluded from the debt:equity ratio calculation.

MH's most recent Net Income forecast for 2006/07 of $102 million is less than one half of MH's forecast prepared in October 2006, at which time MH publicly forecast a Net Income for the current fiscal year of $217 million. While this reduced Net Income forecast is of concern, the Board notes MH's final sub mission assertion that the results for 2006/07 may be "somewhat better" than its forecast of $102 million. The Board's greater concern is that the new forecast through 2007/08 may be optimistic. Given the recent water flow situation could extend into fiscal 2007/08, the prospects for 2007/08 may include the risk of Net Income well below the level now projected. The current forecast for 2007/08 is based on median water flow, which may or may not be realized. As well, the Board is concerned about MH's definition of "median water", and that changes made in that definition may risk overstated Net Income forecasts.

As Board Order 117/06 observed, MH's earnings over the fifteen years prior to fiscal 2006/07 were assisted by 13 of 15 near median or better water and improving export price years; both of these positive factors are now challenged.

Order 117/06 reviewed MH's operating and financial risks, initially set out in Orders 101/04 and 143/04, and these risks are continued, if not intensified. It is the Board's understanding that export prices in 2006/07 have been considerably lower than realized in 2004/05 record, and even

lower than 2005/06 because of lower natural gas prices, increased MISO market partners' reliance on coal and less export sales in peak periods.

In fact, the Board notes that MH has been importing far more electricity than has been the case since the drought year of 2003/04. From the start of calendar year 2007, imports have been a regular feature of MH operations and import prices have at times been higher than the unit prices earned by MH from either exports or domestic sales. As a result of reduced water flow and the high winter peak power requirements of Manitoba, MH has been operating its thermal plants, both coal and gas generation.

MH is not operating in a status quo mode. Major capital expenditures are planned, and as these projects are developed and completed additional debt will be added. When completed and amortization, financing and operating costs for the new facilities are taken into account, short to mid-term pressure may be expected on rate levels. Wuskwatim, wind and Conawapa, all these new announced generation projects will be accompanied by per kilowatt hour unit costs that will be far higher than existing generation unit costs. Winnipeg River generation was constructed over fifty years ago, and northern generation two to four decades ago, when construction and equipment costs were, in nominal dollar terms, fractions of present levels.

Deferring the rate increase sought by MH, given the water and export/import situation and immediate prospects, may well only risk later higher rate increases than are currently contemplated.

In an immediate and concrete sense, deferring MH's interim rate increase of 2.25% for possible implementation following a later GRA hearing would reduce MH's revenue by an estimated $4 million a month for each of February and March (both heating-season months) and $2 million a month until implemented thereafter. Then, if the deferred increase was simply added to the increase now projected to be sought as early as of August 1, 2007, an increase of 4.75%, perhaps higher would be needed to reflect the lost income between March and August 2007.

Ahead of this interim rate application, MH rates had not changed since the first of the two 2.25% conditional rate increases provided by Board Order 101/05 were applied (March 2005); some of the other surveyed utilities have raised rates more frequently and in larger amounts. And, while general price inflation in the economy continues to be in the 2%-3% range each year, MH's residential rates have experienced lengthy periods during which no increases occurred.

General Observations and Discussion

From 1980/81 through to and including 2006/07, and including the interim increase provided herein, the average annual increase in CPI was 3.45% as compared to the average annual increase in MH residential rates of 2.57%. This stands in stark and positive contrast to consumers' experience with other energy sources – natural gas, fuel oil, gasoline, diesel, propane- and industrial and utility companies' experience with coal, natural gas and uranium feedstock prices.

It is interesting to note that the lion's share of the residential rate increases, in number and in percentage terms, implemented by MH from 1980/81 took place in years marked by lower than median water flow (1980-1991). Between 1980/81 and 1991/92, MH's residential rates rose by an accumulated 69%. Since then, from 1991/92 to the current fiscal year, the aggregate residential rate increase was only 15%, an average annual increase in MH residential rates of less than 1% a year.

The average increase in rates since 1991 has been well below the average increase in CPI – with most of that aggregate increase occurring since the drought year of 2003/04. In short, past history of the last twenty-five years suggest that residential rate increases follow or accompany lower than median flow water conditions; such is the present case. Inflation is forecast to continue in the annual range of 2-3%, and MH's forecast of future annual rate increases are also in that range, now projected at 2.5% each year.

The Board recognizes that there was no public notice, though there were several newspaper reports. Nonetheless, very limited public opposition has been represented in the media or written

communications to the Board since MH's application was filed. There has been support for much higher rates from some observers, such as the Frontier Institute, environmentalists and some academic economists, though for different reasons.

Assuming median water flow conditions going forward, MH data suggests that ahead of major generation increases ten and more years out in time, the expectation would be for annual returns in the range of $100-$200 million a year, given annual rate increases at the rate of inflation level. While such levels of earnings may appear to be substantial, if MH's assets were valued at current replacement costs, they would not so appear.

As matters now stand, with MH's unit costs largely based on historic capital costs, and with rates projected to increase annually by 2.5%, the debt:equity target of 75:25 would, according to MH's forecasts, still not be reached until 2017, and then only by continuing the practice whereby construction-in-progress and related debt are excluded from the calculation of the ratio.

With below median water flows, past historical MH experience suggests a considerable risk of actual Net Loss years, given that at times imports carry higher per kilowatt hour price tags than the export opposite. As well, historically and as may be expected with future experience, adding new generation, transmission and distribution investment produces per kW.h unit cost pressures – new capital investments carry associated unit costs that are multiples of in-place assets, while export pricing and results are limited by:

a) the marginal costs of generation for the MISO market;
b) increasing domestic load reducing export potential; and
c) strategies of American MISO partners when MH is importing.

For new generation, years of revenues based on unit prices per kW.h basis below the new cost of generation and transmission are, based on historical experience, likely. This, though long-term prospects suggest new investment in renewable electricity supply should pay off and is beneficial for future generations (as was Limestone, Winnipeg River plants, etc.).

The development of an "East-West" Canadian grid, with opportunities for MH to export renewable power to Ontario and Saskatchewan (both provinces dependent on non-renewable resources), is generally perceived as providing a major and profitable inter-provincial export market opportunity for MH. While the Board's present understanding is that this may well be true, there may be short-term cost/revenue issues associated with the investment in transmission and new generation to serve such an expanded grid that would arise.

These short-term issues include:

a) time to recognize the value of renewable energy relative to non-renewable based energy (climate change matters);
b) the transition to higher prices affecting the initial years' profitability of the required investment in new transmission and generation; and, as well
c) at least some risk of coal-generated electricity being developed to "feed into" such a grid at lower cost than new hydro-electric power, to affect east-west grid market pricing.

With respect to investments in wind energy, while of particular benefit to the environment and perhaps of considerable additional price value in future years, in the short to mid-term higher per kW.h unit costs, transmission capacity and reliability issues limit potential immediate profitability from investments in wind power. Wind power requires back-up generation, and this also limits the immediate profitability of such investments.

As previously indicated, MH has numerous other risks to future profitability and the achievement of the target debt:equity ratio, these include drought or series of years of below-median water flow (such as were experienced in the 1980-1991 time period); disruption to generation or transmission; access to market problems; First Nations relations and arrangements; interest rate changes; and foreign exchange.

The Board plans to consider all of these at a 2007 GRA hearing to determine whether the goal of 75:25 should be the minimal capital ratio requirement for MH, and that target should be reached no later than 2017, that being five years later than earlier envisioned. Private utilities are

expected to have a 60:40 debt:equity ratio or better to be able to access debt market; MH being a Crown Corporation with its debt guaranteed by the Province is generally accepted to be able to operate more highly leveraged, allowing for a 75:25 target.

Manitoba, though having a well-diversified economy that has served its residents well for many decades, lacks the non-renewable energy store of its neighboring provinces to the west. That means that provincial governments' budget balances are more difficult to ensure than these other provinces, as the needs of the residents are no less than other province's populations.

In recent years, it has become evident that annual Province of Manitoba's positive consolidated results depend in part on MH financial performance. And, with MH having more than 50% of overall Province of Manitoba debt, the Province and MH's debt ratings are integrally linked.

MH generates significant revenue and or assistance for the Province by means of:

a) capital taxes, water rental fees and debt guarantee charges – aggregating approximately $250 million per year;
b) in addition to the those fees and taxes, the Province and/or municipal governments receive major annual revenue from or related to MH from the following additional sources: payroll taxes, grants-in-lieu of taxes,
c) income and corporate taxes on employee and agent salaries and payments/purchases, retail sales taxes, electricity taxes;
d) assistance to ameliorating First Nations conditions while meeting responsibilities with respect to shared resources and impact of generation and transmission facilities in the north;
e) contributions to environmental objectives, general economic development (Manitoba advantage electricity rates for industry) and research and development and assistance to low-income with respect to DSM efforts; and
f) assistance to development of City of Winnipeg (new head office building and contributions to the City's energy efficiency initiatives).

The current generation of MH's customers enjoys low electricity prices because of investments made in prior years in generation, transmission and distribution. Ahead of a more intensive consideration, there is no reason to believe that the earlier investments came with less risk attached than those that are projected to lie ahead for MH. To be able to borrow at good rates and to have the confidence to make substantial investments in infrastructure now to mainly benefit future generations requires a utility that despite its relative low rates is considered by the public, industry, government and lenders as sound.

A test of that soundness is MH's debt:equity ratio. A target for that ratio has been long-established as being 75:25, but MH has yet to reach that target. With the extant risks ahead, the Board concludes it is prudent for the long-term public interest to provide further assurance that the 75:25 debt:equity ratio will be reached, and within a reasonable period of time.

While granting the interim rate increase of 2.25% is but one step on that road, it is a step and provides a degree of assurance that targets are meaningful. This should provide assurances to the public and to lenders that MH can confront its future and the investments being contemplated without jeopardizing the overall benefits to Manitoba associated with MH.

Consideration (and rejection) of Other Options

In reaching its conclusion to approve the rate increases sought by MH, the Board not only considered MH's situation and prospects and formed the rationale supporting approval, but also considered options and contrary support to that action. Firstly, the Board considered declining MH's application for interim rate increases, and instead, deferring rate considerations to a GRA public hearing.

MIPUG suggested there was no compelling reason to do other than wait for the GRA application and hearing. The intervener noted that the second conditional rate increase provided for by the Board in Order 101/04 was not sought by MH, and opined there was just cause for MH not then proceeding. The firm and conditional rate increases provided in Order 101/04 followed a major

loss associated with a drought. In declining to seek the second of the two conditional rate increases, MIPUG concludes that MH properly took into account then-projected, and later realized, positive results for 2005/06 and expectations for continued profitability.

MIPUG held that:

a) MH's current projection for this fiscal year, 2006/07, represents a reasonable result, that expected to be in the range of $100 million (note, MH's final argument submission which suggested actual results for 2007/08 may be "somewhat better" than most recently projected);
b) consideration of a rate increase should await MH's filing of an amended COSS model, ordered by the Board by Order 117/06; an amended COSS would allow for a different distribution of a rate increase than across-the-board; and
c) MH is experiencing excessively high annual rates of increase for its operating and administrative expenses.

This intervener suggested it would be prudent for the Board to defer consideration of any rate increase. Deferral would await MH's filing of a GRA, and the holding of a public hearing wherein evidence can be received and tested to confirm or contradict MH's projected rate needs.

The Board rejects deferral of the application for all of the reasons stated previously. That said, the Board accepts MIPUG and CAC/MSOS's concerns, especially concerning increasing O&A expenses, as being of value and will consider them at the hearing of MH's 2007 GRA.

An interim rate increase is exactly that, interim. If a different structuring of the rate increase now provided, or even a consideration of the overall effect, is required, then the Board can amend the interim rate decision now made. The Board anticipates receiving a GRA application as early as August 1, 2007, though given the lead times associated with a GRA, the 2007 hearing that will follow may well not occur until the fall.

When the hearing does occur and rates are revisited, the finalization of the interim rate increase provided herein will be one matter to be considered, and adjustments can be made if considered appropriate.

The Board considered deferring the rate application until the GRA hearing because MH has yet to file either COSS amendment required by Order 117/06 or the report on a potential new industrial class, for consideration of applying marginal cost pricing to that class. If these reports had been filed, it could have led the Board to allocate the rate increase sought by MH now differently. However, the reports are not before the Board, and, even if it were, the Board would be reluctant to rely on them in differentiating rate changes between customer classes without a full examination and discussion of a GRA hearing, at which interveners would participate.

And, with respect to the potential for a new industry class, Board Order 117/06 has suggested that a separate class be reserved for new major industry, and such a prospect is not immediately present to the Board's knowledge. As well, with respect to existing large industry, decreased export prices and exports may limit the potentially negative implications on MH's revenue arising out of current price schedule sales to large industry.

The Board also considered deferring the rate application or varying it to reduce the increase for reasons raised by interveners with respect to MH's cost growth in O&A expenses, the rate of increase being above both inflation and the rate of rate increase proposed. O&A costs on a per customer account are now past the $600 "benchmark" and rising towards $640. The Board grants that MH's response to interrogatories filed by the Board and interveners with respect to O&A cost growth are not sufficient to eliminate concern. That said, the Board notes its premise for the interim rate increase is based mainly on concerns related to water levels, power imports and the long-term effect on debt:equity ratio.

Notwithstanding this, the Board expects to fully explore the growth of O&A expenses at the GRA.

The Board serves notice to MH that at the upcoming GRA hearing the Board will seek a detailed understanding of the reasons for the rate of increase in O&A costs. In addition, the Board will seek the benchmarking of MH's O&A expense experience and projections against the experience of other Canadian utilities. While each utility is unique, the Board expects relevant comparisons can be made to provide needed "light" on this contentious issue.

In taking this stance at this time, the Board also relies on MH's Board of Directors and senior management to continuously strive to operate the utility efficiently and incur no material costs that are not warranted from the perspective of sound business practices.

As presented to the Board's paper process for MH's interim rate application, CME suggested half of the 2.25% rate increase be withheld because of the O&A concern, and that MH be tasked to reduce such costs. CAC/MSOS and MIPUG have similar concerns. That known, and with the rationale understandable, the Board is reluctant to direct operating changes without having a full understanding of cost drivers and comparative performance, and the implications associated with forced reductions.

**Concluding Comments**

The Board confirms that based on its public interest mandate, it will provide directions to MH based on the Board's perspective of the public interest. The Board is concerned not only with the financial interest of consumers but also the health of the utility and intergenerational equity, both goals furthered by a properly financed MH.

To reiterate Board Order 117/06:

a) the environment, emissions and climate change (Order 117/06 directed, among other matters, that MH file a report providing its rationale for its plans to continue to operate the coal plant -- MH's generation from the Brandon coal plant for export sale appears to reinforce the impression that coal energy is cheaper than natural gas and competitive with hydro-electric generation, and that economics trumps environmental concerns);

b) fairness for First Nations communities including those relying on diesel generation;

c) fairness for industrial customers having made substantial investments in the Province;

d) attention to the interests of low-income customers, unable to afford energy efficiency upgrades; and

e) the advisability of consumers having a solid and comprehensive understanding of MH's situation, plans and prospects.

All of these matters will be thoroughly tested and reviewed following MH's filing of the GRA required by this and prior Orders. At this time, the Board will provide interim rate direction, while reiterating an expectation for the upcoming pubic hearing. As to that GRA, the Board directs MH to file the application as soon as possible, so as to ensure that a hearing can be held in 2007.

## 5.0 IT IS THEREFORE ORDERED THAT:

1. Manitoba Hydro's application for a 2.25% interim rate increase BE AND IS HEREBY APPROVED, subject to the following:
   a) the increase and related changes be implemented as of March 1, 2007;
   b) the residential declining rate block structure is to remain in place, to be considered at a General Rate Application hearing in the fall of 2007;
   c) new rate schedules are to be filed with the Public Utilities Board reflecting the above; and
   d) these rate increases shall remain in force until December 31, 2007, or until a further Order of the Board.

2. Manitoba Hydro is to re-file PCOSS-06, updated to reflect the above decisions and methodology changes as set out in Order 117/06 together with explanatory commentary. The filing is to also include a preliminary outline of the supplemental information to be filed related to marginal and environment costs.

3. Manitoba Hydro shall, as directed by Order 117/06, file with the Board the following information and reports by no later than April 30, 2007:
   a) a report and recommendations with respect to establishing a new energy-intensive industry class, including criteria developed after broad consultation with industry and government, and rate design recommendations;
   b) a report and recommendations to phase out or eliminate the declining block rate schedules;
   c) a report and recommendations with respect to rebalancing demand and energy charges;
   d) a report and recommendations to introduce inverted rates for large volume consumption customers, including winter ratchet considerations;

e) a report and recommendations to establish time of use rates for non-residential customer classes, particularly large volume customers;

f) a report with respect to consultations with the City of Winnipeg concerning customer counts and overall cost allocations to the street lighting customer class;

g) a report with respect to Manitoba Hydro's plans concerning the Brandon coal-fired generation plant, and the rationale for continued operations of that plant in light of the Sustainable Development Act;

h) a report on consultations with MKO and the federal government with respect to MKO's proposal for an additional sharing of net export revenue and its suggestion that rates charged such communities should be reduced on an ongoing basis to reflect the removal of the cost responsibility for certain mitigation costs;

i) a risk analysis report that analyses and quantifies MH's $2.2B loss estimate for a five year drought, including marketing, operational and financial risks and the potential impact of drought shortfall import costs such as those experienced in 2003/04; and

j) a report and recommendations with respect to customer class consolidation options and appropriate rate differentials for various customer sub-classes.

4. Manitoba Hydro shall file no later than May 1, 2007 a status update of the Settlement Agreement with the Government of Canada with respect to Diesel generation.

5. Manitoba Hydro shall file a General Rate Application for the fiscal years 2007/08 and 2008/09 by no later than August 1, 2007 which shall include the following information:

a) updated Cost of Service information reflecting the revised methodologies pursuant to directions set out in Order 117/06;

b) u current forecast as of May 31, 2007 of prospects for Net Income for the 2006/07, 2007/08 and 2008/09 fiscal years, based on water flow and other conditions as of May 31, 2007;

c) consideration of future general consumer rate increases greater than the 2.5% annual increases set out in the IFF, to reflect the concerns expressed by the Board and others with respect to expediting achievement of the financial targets;

d) detailed discussion, information and support with respect to accounting policies related to capitalization and deferral of expenses, including planning studies, DSM costs, capitalization of overheads, mitigation costs, and accounting for plant costs related to uneconomic generation with limited expected remaining life (such as the Brandon and Selkirk generation plants);

e) detailed discussion and information with respect to financial forecasting methodologies used in preparation of the IFF, including preparation of load forecasts, utilization of water flow scenarios, methodologies for forecasting export prices and revenue, and information as to how the effects of drought, including purchased power costs, are reflected in the financial forecasts;

f) an updated power resource plan including the proposed role of wind and Wuskwatim Generating Station, and depicting the potential role of Gull and Conawapa;

g) a detailed review of cost causation for Operating and Administrative Expenses, related to the current 2007/08 fiscal year in comparison with fiscal 2004/05, 2005/06 and 2006/07, and projections for 2008/09 and 2009/2010; and

h) comparisons of MH Operating and Administrative Expense experience for fiscal 2004/05 and 2005/06 with BC Hydro, Quebec Hydro and Saskatchewan Power, providing explanation and analysis of differences.

THE PUBLIC UTILITIES BOARD

"GRAHAM F. J. LANE, C.A."
Chairman

"GERRY GAUDREAU, CMA"
Secretary

Certified a true copy of Order No. 20/07 issued by
The Public Utilities Board

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Secretary