

Manitoba Hydro 2017/18 Interim Rate Increase Application – Submission of the Manitoba Industrial Power Users Group

This submission contains the outline of comments of the Manitoba Industrial Power Users Group (“MIPUG” or “Industrials”) in respect of Hydro’s proposed 7.9% rate increase for August 1, 2017. This outline reflects the June 9, 2017 letter from the Public Utilities Board (“Board”) indicating that the Board will only consider as rationale from Hydro “what has changed in its Integrated Financial Forecast since the Board issued Order 59/16 based on the Board mandated methodology for IFF15”.

Hydro has provided its response to this question:

“MIPUG and Coalition ask what has changed. Manitoba Hydro acknowledged at page 37 in Tab 2 of the Application that there is no longer a willingness to relax the equity ratio for an extended duration of fifteen years before recovering to its 25% minimum equity target.”¹

Hydro’s response is accurate – the fundamental change between IFF15 and IFF16 is attitudinal, not quantitative. It reflects a new Board of Directors, a new and unconventional perspective on Crown-owned public utilities, and judgment that is yet-to-be-tested regarding Hydro’s long-term financial plans; namely, whether Hydro’s longstanding plans for how to financially absorb and integrate major new assets should be thrown out in favour of more quickly building up equity and paying down debt. Such an assessment is not the proper territory for an interim rates review.

In keeping with the Board’s focus, for this submission the Industrials submit that for the purpose of assessing interim rates there are three fundamental questions that must be addressed:

1. Does IFF16 show a deterioration or improvement compared to IFF15, which would support a rate increase determination by the Board, applying consistent principles as in previous Hydro interim rates assessments?
2. If Hydro is not granted the requested 7.9% in August 2017, is the financial scenario into the future unduly worsened (recognizing that this rate change does not prejudice future rate determinations)?
3. If the first two questions suggest an interim rate increase is merited, does this outweigh Hydro’s failure to adhere to the Board conclusions and Directives in Order 59/16 regarding timing and the limited use of interim rates, which would strongly caution against providing any interim rate increase at this time?

¹ Manitoba Hydro June 20, 2017 submission, page 22.

This outline is organized into the following sections:

1. Summary of Conclusions
2. Key Regulatory Principles Relevant to Determining Interim Rates
3. Analysis of IFF16 compared to IFF15
 - 3.1. Framework for Analysis
 - 3.2. Comparison 2017/18 Expense Forecasts Under IFF16 Versus IFF15
 - 3.3. IFF16 Net Income
 - 3.4. IFF16 Cash Flows
 - 3.5. IFF16 Long-Term Cost Trajectory
 - 3.6. IFF16 Conservatism
 - 3.7. IFF16 Risk
 - 3.8. MH16 Updated (Appendix 3.6)
4. Implications of Awarding a 1.6% Rate Increase to Hydro
5. Overriding Policy Concerns and Cautions

1.0 SUMMARY OF CONCLUSIONS

The Industrial's submission of May 25, 2017 highlighted the position that Hydro merited no new increase in revenue for 2017/18, but that a rate increase of 1.6% on a go-forward basis was justified in the interests of ratepayers and predictable rate transitions, with all revenues from the added rates being targeted to the Bipole III deferral account to offset the cost impacts when Bipole III comes in-service. This position continues to be justified on the basis of review of Hydro's latest filings.

An overview of the Industrials' conclusions is set out below. This primarily relates to analysis of IFF16, with only limited consideration of MH16 (Updated) which was filed July 11, 2017:

- 1) IFF16 shows lower net costs in 2017/18 that must be paid by ratepayers than the projections in IFF15 (section 3.2)
- 2) IFF16 shows a positive Net Income in 2017/18 even without any interim revenue increase (which was one of the Board's test for interim rates in Decision 59/16). (section 3.3)
- 3) IFF16 shows a significant positive cash flow from Operating Activities even with the 1.6% proposed rate increase. The positive cash flow is more than sufficient to fund all capital expenditures for "normal" capital as well as the portion of the Major capital spending category that is tied to existing assets, and still yield over \$64 million that is able to be targeted to the truly new Major expansion projects or to debt retirement/sinking fund contributions. This does not reflect a cash constraint situation for Hydro meriting further increases to interim rates. (section 3.4)
- 4) Over the long-term, IFF16's forecast of net costs that must be recovered from domestic ratepayers (i.e. forecast operating expenses less forecast export revenue) is almost precisely equal to IFF15 – increases in costs in some areas are matched by decreases in costs in others. Further, the debt levels and equity levels achieved 11 years into the future are almost identical. (section 3.5)
- 5) In addition, this IFF16 scenario incorporates significant pessimistic assumptions that must be tested (such as amortizing restructuring costs largely over one year, including no dependability premium in forecasts of export prices, removing any assumption of potential future large industrial loads from the load forecast, etc.). These new forecasting methods have not been tested, and each appears to adversely affect IFF16 forecasts. As a result, the Board should not accept that IFF16 is a best estimate forecast, but rather appears as a pessimistic forecast of the next decade. (section 3.6)
- 6) Hydro's adoption of significantly reduced forecasts of export prices and domestic loads means that there is less potential downside in IFF16 than in IFF15. Also, the ongoing locking-in of new debt and of spending on major capital projects as time progresses continues to reduce the degree of potential variability in Hydro's forecast expenses – more

costs are now known. For this reason, IFF16 (from April 2017) has far less exposure to many forms of risk than IFF15 (from December 2015) during this intense period of major investment. (section 3.7)

- 7) The MH16 Update has not been fully assessed, but on the surface it shows material improvements in 2017/18 and 2018/19 compared to IFF16, particularly in regard to cash flows (\$100 million in 2017/18 alone), as well as the positive impacts of what has been sustained high water reservoir levels into 2018/19 (assuming median inflows into the future²). This translates into improved Net Income in 2017/18 and 2018/19 in the MH16 Update than forecast in the original IFF16. (section 3.8)
- 8) Awarding a 1.6% interim rate increase today would not prejudice or fetter the Board's ability to later be convinced by Hydro that a more aggressive rate increase pathway is needed. If that were to occur, the Board could still put rates on a trajectory to achieve in excess of \$5 billion in retained earnings by 2027, or well above this level if 7.9% annual increases are deemed acceptable and carried forward³ into 2022/23. (section 4.0)

² This assumes Hydro has applied its typical water forecast methods to the MH16 Update.

³ Hydro could achieve well above this level if 7.9% increases were determined to be acceptable and were carried forward for 5 years starting 2018/19 rather than 4 years per the scenario analyzed.

2.0 KEY REGULATORY PRINCIPLES RELEVANT TO DETERMINING INTERIM RATES

The Industrials submit that there are a number of established regulatory principles that must be considered in any Board decision to award interim rates. Among these are the following:

- 1) **Certainty for ratepayers:** A regulated rate environment is intended to ensure that ratepayers, who are served by a monopoly, have protections that may otherwise not exist given the monopoly environment. This can include ensuring that rate charges are not unreasonable, but also that the ratepayer is not subject to other conditions such as uncertainty about what they will need to pay. Manitoba Hydro's long-term financial forecasts help with this principle. Interim rates are recognized as a "partial exception"⁴ to principles that guide normal utility ratemaking. For example, "...all rates should be for the future and known at the time that the consumer decides to consume some (or more) gas. Rates come into force only on the day they are announced (or a later day). ... On any given day, a consumer knows what rates apply."⁵ In contrast, interim rates lead to uncertainty for ratepayers. They can lead to Manitoba Hydro charging customers more than what may be ultimately granted on a final basis. As an example, customers are now being charged rates (since August 1, 2016) that include a 3.36% interim increase – by definition, it is possible that this increase will be adjusted upwards or downwards and ratepayers may face deferred bills or credits for past usage⁶. More specifically: the Alberta Court of Appeal noted: "If the Commission sets an interim rate which must be later adjusted and made final, then everything done in the meantime under that interim rate is tentative" and "... the utility company's accounts must be flagged to show that."⁷

For this reason, interim rates are an inferior form of ratemaking that should be avoided where possible, and minimized where not possible to be fully avoided.

- 2) **Ratepayers should experience stability of rates with a minimum of unexpected changes:** This principle of ratemaking is a main component of the frequently-cited *Bonbright criteria*, namely "Stability of the rates themselves, with a minimum of unexpected changes seriously adverse to existing customers."⁸ Further, Bonbright notes, in relation to the instability of rates that can arise with an over-focus on short-run costs that such pricing methods should not "deprive consumers of those expectations of reasonable continuity of rates on which they must rely in order to make rational advance preparations for the use of services"⁹.

⁴ ATCO Gas, paragraph 152 (*ATCO Gas*, [2010] 13 D.L.R. (4th) 615 (Alta CA))

⁵ ATCO Gas, paragraph 152

⁶ Though this has not occurred in Manitoba, it is an inherent possibility given the inherent definition of an "interim" rate.

⁷ ATCO Gas paragraph 163

⁸ As cited in Charles F. Phillips Jr. *The Regulation of Public Utilities* 3rd ed. Page 434

⁹ Bonbright, J.C., *Principles of Public Utility Rates*. 1960, Page 396-397.

The current interim rate proposal is indisputably a change that is seriously adverse to existing customers. Further, rate increase projections that customers have been provided since at least IFF07 have been in the range of 3% increase per year to no more than about 4%/year (including at the Needs For and Alternatives To hearing). An interim increase of 7.9% at August 1, 2017 would clearly qualify as an unexpected change or discontinuity. This is particularly true for industrial customers who make major capital investment decisions and commitments of facilities, staff, etc. for production over long periods of time and whose viability depends on careful financial planning. An increase of this magnitude cannot be absorbed by increases in revenue and will directly impact viability.

- 3) **Customers should be afforded with an opportunity to fully test evidence:** MIPUG submits that section 48 of the *Public Utilities Board Act* is designed to give direction with respect to “an order involving any outlay, loss or deprivation to any ... person” and that with respect to this type of Order, “due notice and full opportunity to all parties concerned, to produce evidence and be heard at a public hearing of the board” are both necessary conditions, absent any determination of urgency. It is MIPUG’s submission that although due notice has been provided, the parties are not being afforded the full opportunity to be heard at a public hearing in respect of IFF16, and much less with respect to the MH16 updated forecast filed July 11, 2017. The concept of a full opportunity to be heard carries with it minimum procedural protections and rights such as pre-hearing discovery and the right to adduce evidence and test evidence through cross-examination.
- 4) **The concept of “used and useful” and a general aversion to pre-funding of capital projects:** Utility ratemaking is rooted in the concept of setting rates based on assets that are used and useful, based on a cost level that represents prudent acquisition of the asset. Assets that are not used and useful, or are recorded by a utility at a cost level that does not represent prudence in the acquisition, should not drive rates. For example, as far back as 1922, the New York Public Service Commission noted: “Consumers should not pay in rates for property not presently concerned in the service rendered, unless (1) Conditions exist pointing to its immediate future use; or (2) Unless the property is such that it should be maintained for reasonable emergency or substitute service; and in studying these two exceptions the economic factor should be carefully considered.”¹⁰ In the current situation, particularly for interim rates, caution should be applied in adopting Manitoba Hydro’s proposals founded fundamentally on building up with cash balances and/or equity tied to new major projects (particularly Keeyask but also Bipole III) which are not in service and are not scheduled to be within the next short while.
- 5) **Principles for Interim Rates used in other jurisdictions:** Perhaps the most clearly articulated principles for use of interim rates comes from the Alberta regulator, the Alberta

¹⁰ Elmira Water, Light & R.R., 1922D Pub. Util. Rep. (PUR) 231, 238.

Utilities Commission (formerly the Alberta Energy and Utilities Board) in Decision 2005-099 regarding interim rate applications¹¹. The decision sets out that the following two groups of factors may be employed to evaluate whether an interim rate application is justified. These factors may be given different weighting depending on the specific circumstances surrounding each application.

Quantum and Need Factors

Quantum and need factors relate to the specifics of the requested rate increase and include the following:

- The identified revenue deficiency should be probable and material.
- Is the increase required to preserve the financial integrity of the applicant or to avoid financial hardship to the applicant?
- Can the applicant continue safe utility operations without the interim adjustment?
- Contentious items may be excluded from the amount collected.

General Public Interest Factors

If all or a portion of the suggested rate increase appears appropriate after a consideration of the quantum and need factors, the Board must assess certain general public interest factors to determine if the interim rate increase is justified, including the following:

- Interim rates should promote rate stability and ease rate shock.
- Interim rates should maintain intergenerational equity.
- Interim rate increases may be required to provide appropriate price signals to customers.
- The use of carrying costs may be considered to avoid interim rate increases.
- It may be appropriate to apply the interim rider on an across-the-board basis.

Of the above factors, the following are of particular relevance to the current Manitoba Hydro application:

- “Is the increase required to preserve the financial integrity of the applicant or to avoid financial hardship to the applicant?” and “Can the applicant continue safe utility operations without the interim adjustment?”

Hydro’s application shows that under all scenarios the utility remains cash positive from Operating Activities, and has a positive net income in 2017/18 even without any revenue increases. There is no indication nor assertion from Hydro that it will become unable to pay its bills in 2017/18 absent an interim increase, nor that it will avoid undertaking operating or capital

¹¹ EUB Decision 2005-099(August 29, 2005) at page 7-8.

expenditures needed for safe and reliable service in the year due to cash constraints.

- “Contentious items may be excluded from the amount collected”

The principle at issue in this test is that items that are unfamiliar, previously unknown, or likely to be strongly debated at a full hearing, should generally not be included in the assessment of interim rates. Perhaps the most contentious items in Hydro’s current filing relate not to direct costs *per se*, which appear to have changed in largely offsetting ways, but to (i) the new desire to materially advance the target for increases in equity/reserves and (ii) the application of a new form of cash flow target (“CFO to Capex”). In respect of reserves, Hydro has determined, with no substantive support and no opportunity to test as yet, that waiting longer than 10 years to achieve 25% equity is an “untenable risk”¹² despite all previous IFFs and NFAT scenarios routinely taking longer than 10 years to reach the IFF target. While this is clearly a contentious change, it should be noted that at least this measure relates to previously debated financial targets for Hydro (a given debt:equity target achieved by a given year). With respect to cash flow and the new “CFO to Capex” citations, such a test is unheard of for regulating Hydro. Hydro has three longstanding financial targets (interest coverage, capital coverage, and debt:equity target). These targets were recently reviewed and updated as part of the as-yet untested KPMG report¹³. However, in its justifications for the interim rate increase in the June 20, 2017 submission, Hydro largely ignores these three financial targets and focuses on this new measure as a form of fourth target relying on CFO and Capex, both terms not previously used by Hydro in any financial target¹⁴. Such a citation readily qualifies as untested and contentious.

- Interim rates should promote rate stability and ease rate shock.

The new Hydro application seeks a doubling (or more) of the annual rate impacts compared to rate trajectories of 3-4%/year that have been reviewed over at least the last decade (and at times rejected in favour of lower increases). Unless and until this new reactionary agenda by Hydro is

¹² Hydro GRA filing, Tab 2 page 2.

¹³ Hydro GRA Appendix 4.1 and 4.2.

¹⁴ CFO is understood to be “Internally generated funds less portion of capitalized interest related to (Keeyask, MMTP & GNTL)” while Capex is “Total gross capital and deferred expenditures excluding Keeyask, Bipole III, MMTP & GNTL”. It is not clear why these definitions were adopted, including why Bipole III is excluded for the Capex measure, but not for the CFO measure. Definitions per Hydro GRA filing, Tab 2 page 20.

July 14, 2017

confirmed by the PUB, it would be a clear rate shock to award 7.9% increases on an interim basis.

3.0 ANALYSIS OF IFF16 AS COMPARED TO IFF15

3.1 Framework for Analysis

For the purposes of an interim rate review, the Board made clear in Order 59/16 that it will consider two standards in the awarding of interim rate increases:

- 1) On a short-term basis, would the utility show a positive net income absent the interim rate increase¹⁵; and
- 2) A need to "...look beyond the test years and mitigate potential rate shock to consumers ..."¹⁶

On the basis of these two tests, the Board in Order 59/16 concluded that Hydro merited no increase in revenue from its review of IFF15, and that ratepayers would benefit from imposing a 3.36% rate increase with all funds flowing to the deferred Bipole III account.

For the currently proposed increase, the Board has made it clear that it intends to focus on "what has changed" from IFF15¹⁷. For this reason, this outline focuses on both the short-term and the longer-term forecasts comparing a **baseline** of IFF15 to the **current outlook** in IFF16.

First – it is necessary to define what scenarios define the "baseline" and the "current outlook". The Industrials have concluded that the best comparators are the following:

1. **IFF15 baseline**, as set out in Attachment 46 from the 2016/17 Interim Rate Increase, specifically pages 9 to 14 (MFR #1 - Scenario 1 - Alternate Scenario).

This scenario includes the 3.36%/year rate increase that was ultimately approved by the Board on an interim basis, and includes the Board-approved accounting methodologies where any deferred amounts are amortized to income in a manner that flows to net income¹⁸.

2. **IFF16 current outlook**, as set out in PUB MFR-73 pages 2 to 7.

This scenario offers the IFF16 financial forecast including accounting for deferred costs in a manner largely consistent with the Board approved method. This scenario also provides a long-term rate increase trajectory of 3.44%/year, the closest rate increase scenario that the Industrials could locate to that used in the benchmark IFF15 noted above (with equal annual rate increases of 3.36%/year –

¹⁵ Order 59/16, page 4

¹⁶ Order 59/16, page 12

¹⁷ Board letter of June 9, 2017, page 2.

¹⁸ The approach where amortization of these deferred amounts does not flow to net income is shown at pages 3-8 of the same document, however Hydro criticized this approach as improperly including the amortization in Other Comprehensive Income rather than Net Income, and the Industrials tend to agree that Hydro's concerns in this regard are valid. These concerns are fully addressed by using pages 9-13 instead of pages 3-8.

the differences are not expected to be material for drawing conclusions on comparisons between financial forecasts).

A further scenario, MH16 Updated (Appendix 3.6 in its GRA filing), was provided much later in the process (July 11, 2017). Given the late date of its filing, and the fact that only one rate increase scenario was provided (7.9% per year), it has not been directly included in this analysis. A short list of comments on MH16 Updated is provided in section 3.8 comparing it to the original IFF16 (the appropriate benchmark for comparison as it uses the same rate increase assumptions). It should be noted that, overall, the changes in MH16 Updated further support the Industrial's conclusions in this outline.

3.2 Comparison of 2017/18 Expense Forecasts Under IFF16 Versus IFF15

Looking to the specific 2017/18 year, the comparison of expenses and export revenues is provided in Table 1 below:

Table 1: Comparison of Expenses and Export Revenues in IFF16¹⁹ versus IFF15²⁰

	2017/18		
	IFF15	IFF16	change
Ongoing Expenses			
Operating and Administrative	537	518	-19
Finance Expense (net of Finance Income)	580	558	-22
Depreciation and Amortization and Other Expenses (incl reg deferral)	423	392	-31
Water Rentals and Assessments	113	124	11
Fuel and Power Purchased	182	135	-47
Capital and Other Taxes	137	132	-5
Corporate Allocation	8	8	0
Ongoing Expenses	1980	1867	-113
One-time Corporate Restructuring Costs		50	50
Total Expenses	1980	1917	-63
less: Non Controlling Interest	-4	-9	-5
less: Extraprovincial and other income	-477	-484	-7
Net Costs allocated to Domestic customers	1499	1424	-75

¹⁹ IFF16 scenario used above has 3.44%/year rate increases, which lowers cash generation from domestic rates compared to the original IFF16 scenario, resulting in somewhat higher interest costs.

²⁰ The IFF15 scenario used above has 3.36% increases, consistent with the scenario adopted by the Board in Order 59/16.

Table 1 reflects values taken directly from the cited IFF scenarios prepared by Hydro²¹, supplemented by background detail contained in Tab 6 of the GRA filing, particularly Figure 6.26 re: restructuring costs. The structure of Table 1 illustrates forecast operating expenses less external revenues (exports and other income) to derive a residual “net costs allocated to domestic customers”. In this manner Table 1 simplifies the presentation of the different Hydro financial results as it avoids the need to apply any definitions related to net income and level of reserves – the focus is merely on net costs, the largest component of Hydro’s annual revenue requirement (the other component being transfers to reserves). Additionally, it helps avoid confusion caused by changes to the load forecast between IFF15 and IFF16 that has not had the chance to be properly tested (discussed more in section 3.6). In this manner, Table 1 can be assessed under any desired target net income or reserve level and load forecast method.

Reviewing Table 1, Hydro’s 2017/18 forecast year is projected to be materially better off than contemplated in the IFF15 scenario. Expenses, before one-time restructuring costs, are down by \$113 million. Restructuring expenses are material, at \$50 million, but this is being taken into expenses almost entirely at one time²² with no amortization or matching of the costs with the long-term benefit of the expenditure. Note that Operating and Administrative expenses have decreased due to restructuring in 2017/18, but also continue to fall in 2018/19, indicating that taking all \$50 million of expenses in 2017/18 overstates the benefits to 2017/18 and a portion of the benefit in fact accrues to 2018/19 (and future years). Despite this pessimistic assumption that effectively records all restructuring costs to 2017/18 income, overall expenses in IFF16 remain \$63 million below that forecast in IFF15 (i.e. a benefit to net income of \$63 million). Including corresponding changes in export revenue and non-controlling interest, IFF16 is improved compared to IFF15 by \$75 million. This improvement is larger in magnitude than the financial impact of a 3.36% rate increase for the 2017/18 year.

In short, if Hydro remained focused on retaining the path that the Board established in Order 59/16, there would be no basis for granting a revenue increase in 2017/18. This is because Hydro’s finances already benefit by at least \$75 million compared to the accepted IFF15 forecasts, whereas a 3.4% increase would only have generated \$38 million in increased revenue.

²¹ Table 1 merges Depreciation and Amortization with Other Expenses and Net Movement in Regulatory Deferral Accounts, as these categories have been reclassified between IFF15 and IFF16, but combined they represent largely the same subset of items.

²² Hydro indicates that \$55 million in restructuring charges will be taken into income “over the next three years” in Tab 2 page 51. However, in Figure 6.26 of Tab 6 the values show that \$50.4 million of restructuring charges are being taken to income in 2017/18 and only \$2.2 million in 2018/19. No values are shown for 2019/20.

3.3 IFF16 Net Income

Turning to the standard for review set out by the Board in Order 59/16, the Order noted that “The Board has concluded that Manitoba Hydro’s financial situation for the 2016/17 fiscal year has improved and Manitoba Hydro does not require additional revenues from a rate increase to obtain a positive net income for 2016/17.” On the basis of that finding, the Board granted Hydro no additional revenue in Order 59/16 (all added revenue from the interim rate increase went to the Bipole III deferral account).

Applying this same standard to the IFF16 and the 2017/18 test year would give rise to the same conclusion, as shown in Table 2:

Table 2: Test Year Net Income With and Without New Revenues from Rates

	IFF15 2016/17 test year	IFF16 2017/18 test year
Net Income with rate increase proposed	59	65
less: rate increase proposed	52	38
Net Income with no new revenue from rates	7	27

Table 2 sets out that when the Board made its decision on the 2016/17 test year interim rate, the Board decided that no new revenue should flow to Hydro due to a forecast positive net income (in that case \$7 million) absent any new revenue. In the current situation, applying the same analysis would yield a net income of \$27 million absent any new revenue from a rate increase. On this basis, the conclusions from the 2016/17 test year should be similarly applied to interim rates conclusions in the 2017/18 Test Year. Note also that the \$27 million in Net Income absent a rate increase is after Hydro elects to expense \$50 million in restructuring costs in one year – if this were spread over at least 2-3 years (the minimum that would be supported given the distribution of benefits), the forecast net income for 2017/18 would exceed \$50 million with no new revenues.

3.4 IFF16 Cash Flows

Looking to Hydro’s reporting of cash flows, it is important to note that the material filed by Hydro on June 20 indicates that ongoing Operating Activities are forecast to generate \$601 million in cash in 2017/18 if no rate increase were granted, and \$619 million if 1.6% were granted as per the Industrials’ recommendation²³. This stands in stark contrast to Hydro’s assertion that

²³ Manitoba Hydro June 20, 2017 filing, Attachment 1, pages 5 and 11

“Manitoba Hydro has a fundamental cash problem and without the proposed rate increases Manitoba Hydro is borrowing to fund core operations.”²⁴ Looking further into cash activities, the following is noted:

- \$619 million in cash is generated from Operating Activities with a 1.6% rate increase as recommended by the Industrials.
- Electric Business “Operating” (i.e., Normal) Capital Spending is forecast to total \$525.8 million²⁵. This means Operating Activities can fully fund, in cash, all operations as well as all normal capital spending under the long-standing definitions, with a cash surplus of \$94 million.
- Hydro has indicated that the Corporation now takes issue with its own long-standing definitions of what qualifies as “Major New Generation and Transmission”²⁶. Hydro asserts that improvements to existing facilities should not be excluded from cash flow tests. If Hydro’s redefinition were adopted, in 2017/18 this would likely apply to 5 projects totalling \$30.3 million²⁷. In short, this would still indicate \$64 million in surplus cash in 2017/18.
- This scale of surplus cash allows some portion of major new capital and/or debt repayment (via retirement or via funding sinking fund balances) to be internally funded. This is far from any urgent or emergency cash shortfall status.

It is important to understand why the above numbers are materially different than Hydro’s figures in its June 20, 2017 submission. That Hydro submission indicated that cash flows from operations have deteriorated to the point where 2017/18 is asserted to show a “\$264 million deficiency”²⁸. This swing in net cash, of over \$300 million, primarily relates to Hydro’s calculation including capitalized interest from Major New Generation and Transmission projects – interest costs related to spending on capital assets that are not yet in service. Hydro’s calculation is therefore not compliant with any normal regulatory construct for determining a revenue requirement, as these assets are not yet “used and useful” nor providing any service to ratepayers in the test years in

²⁴ Manitoba Hydro June 20, 2017 filing, page 1.

²⁵ IFF16 page 55

²⁶ In particular, in the GRA filing at page 15-16 of Tab 2, Hydro notes “- Compounding the above, actual sustainment capital needs of the operations have historically been understated in debt service and capital coverage metrics by ascribing “Major New Generation and Transmission” status to certain projects due to their individual size. However, most of these projects are essentially for system renewal or reliability in that they are replacing failing or at-capacity infrastructure or supporting ongoing operations and are not, once finished, contributing to any material increase in revenue.” It would appear reasonable to consider this comment applicable to the following projects which are addressing assets already in service, and are not primarily linked to new transmission or generation assets: Wuskwatim – Generation; Pointe du Bois Spillway Replacement; Kelsey Improvements and Upgrades; Kettle Improvements and Upgrades; and, Pointe du Bois Transmission. The remainder are either properly major new assets (e.g., Keeyask or Bipole) or projects closely linked to the new assets or commitments Hydro made as part of committing to the new assets (e.g., Gillam redevelopment, or fish hatchery expansion).

²⁷ IFF16, page 51 – all projects related to Wuskwatim, Pointe du Bois, Kelsey, or Kettle.

²⁸ Hydro June 20, 2017 submission, page 18

question. Obviously, the interest costs noted are a draw on cash – just as any other expense related to Keeyask or Bipole III is a draw on cash. Further, the standard being challenged by Hydro is not just a regulatory standard - all relevant accounting standards (including IFRS) similarly are based on interest being capitalized for projects that require long lead times to construct.

3.5 IFF16 Long-Term Cost Trajectory

The other question that has been used to guide the Board in interim rate decisions focuses on the long-term. This can be assessed by looking at the 11 year period 2017-2027²⁹, as shown in Table 3 below:

Table 3: 2016/2017 to 2026/2027 Net Income Comparison in IFF16 versus IFF15

	2017-2027 (11 year period)		
	IFF15	IFF16	change
Ongoing Expenses			
Operating and Administrative	6473	5899	-574
Finance Expense (net of Finance Income)	10995	9756	-1239
Depreciation and Amortization and Other Expenses (incl reg deferral)	7072	7884	812
Water Rentals and Assessments	1369	1359	-10
Fuel and Power Purchased	2292	1564	-728
Capital and Other Taxes	1690	1744	54
Corporate Allocation	88	88	0
Ongoing Expenses	29979	28294	-1685
One-time Corporate Restructuring Costs		50	50
Total Expenses	29979	28344	-1635
less: Non Controlling Interest	-3	-9	-6
less: Extraprovincial and other income	-9007	-7320	1687
Net Costs allocated to Domestic customers	20969	21015	46

Table 3 sets out that with a long-term scenario of rate increases on the order of 3.4% (3.36% for IFF15 and 3.44% for IFF16), the costs allocated to domestic customers over the next 11 years are expected to be almost precisely the same in the IFF16 underlying forecasts versus the IFF15 scenarios. It is important to note that this is not because there are few changes – there are significant changes across many categories, but the net effect is small. Further, for this degree of difference, it is entirely reasonable to assume that there would be many opportunities to adjust

²⁹ This is the same period analysis approach as Hydro adopted in Tab 3, page 8.

rates as necessary over the 11 year period, and the need for urgent action in 2017 is therefore limited.

As a final comparison of the long-term scenarios, it is important to recognize that the baseline IFF15 (with 3.36% rate increases each year over this timeframe) provided a trajectory towards \$3.1 billion in retained earnings and \$24.3 billion in long-term debt by 2027. The IFF16 scenario in question (with 3.44% rate increases) achieves \$3.0 billion in retained earnings (\$0.1 billion lower) and \$24.6 billion in debt (\$0.3 billion higher). Given this is 11 years into the future, these small differences are not significant changes. In short, on the numbers themselves, IFF16 has not shown a long-term deterioration from IFF15.

3.6 IFF16 Conservatism

Beyond the pure numbers of IFF16, the following are also important considerations:

- 1) **IFF16 uses conservative forecasting methods:** IFF16 is cited to be conservative compared to past Hydro IFFs in many respects. Examples include:
 - a. The load forecast for each respective IFF that Hydro prepares is usually based on the most recent Electric Load Forecast. In this case, that would be the 2016 Electric Load Forecast. However, in preparing IFF16, Hydro adjusted downwards the domestic loads in the 2016 Electric Load Forecast citing updated actuals and proposed new forecasting methods that the Corporation intends to apply in the future³⁰. The scenario used is not just a small variation – compared to the official 2016 Electric Load Forecast, the load forecast used in IFF16 represents just the 24th percentile of what would be expected as the likely future outcomes as of 20 years in the future³¹.
 - b. The presence of Potential Large Industrial Loads has been removed from the load projections. Traditionally Hydro assumes some measure of presently unknown large industrial load will locate in the province in the coming years. The IFF16 adjusted forecast is said to exclude such load assumptions. This not only hampers Hydro's forecast revenue, it also reduces the loads on which future Hydro rate increases are assumed to be applied, making the requirement for rate increase percentages appear larger than under Hydro's previous revenue forecast method.
 - c. The forecast of export prices has been reduced by two factors, present in previous export revenue forecasts, that Hydro has now eliminated from the forecasting methodology in IFF16. First, Hydro indicates that the "premium that has historically been applied to the long-term dependable forecast prices has been removed"³².

³⁰ Hydro GRA, Tab 7, page 2

³¹ Hydro GRA Tab 7, page 2

³² Hydro GRA, Tab 3, page 14

There has not been time to fully understand this removal, but it is well-known that an aspect of Hydro's export value comes from a dependability premium. Second, the current export price forecast is said to have "removed capacity value from the pricing of potential future uncommitted export sales from surplus dependable energy". Combined, these two assumptions reflect a worst-case forecast in that they appear to ascribe no value to products that traditionally had at least some value in export markets, and in some forecasts had significant value into the future.

- 2) **IFF16 may not fully incorporate current high water:** IFF16 was prepared in a period leading up to April 2017. During that time, Hydro was experiencing record high storage volumes³³. However, Hydro's forecasting methodology assumes inflows from that time forward would be at median flow levels. Instead, Hydro's filing indicates that for at least March, April and May 2017 (a period of actuals that may have not been captured in the April dated IFF), water flows continued to be above the flows of last year for each point of measurement except the May measurement for the Winnipeg River, and materially above for the critical Saskatchewan River basin³⁴. In general, rate setting should not be focused on up-to-the-moment water flow conditions; however, in consideration of a short-term (partial year) interim rate increase, such conditions can mute the need for this form of rate relief. Further, it should be noted that it is a near certainty that if the reverse situation arose and water conditions were below normal, Hydro would be citing this fact in its argument for rate relief.
- 3) **IFF16 also includes more flexibility via a larger Bipole III Deferral Account balance:** The comparison of the above IFF16 versus IFF15 scenarios shows that IFF16 is not worse off than IFF15 in terms of the 2017/18 forecasts, and is in fact better off on overall costs and on net income. It is important to also note that IFF16 achieves this concurrent with a larger deferral revenue balance related to Bipole III. In other words, IFF16 achieves a better net income even though it is concurrently deferring more revenue to the future than IFF15 assumed. In the case of year-end 2017 balances, IFF15 forecast only \$238 million in the deferred Bipole III account, while IFF16 reflects \$312 million as of this same date.

3.7 IFF16 Risk

Finally, with respect to risk, the Industrials submit that the long-term risks facing a utility are not generally a relevant consideration for an interim rate review. Long-term risks should be fully canvassed and assessed in the context of a full, open, and timely General Rate Application. Nonetheless, it is important to address Hydro's comments regarding risk in its June 20, 2017 submission. In short, Hydro's comments focus on two fundamental points:

³³ Appendix 7.4, page 2.

³⁴ Appendix 7.4 page 4.

- 1) Hydro has changed its forecast methodologies for many factors to be more conservative (e.g., export prices, domestic load), and this is somehow a contributor to risk; and
- 2) Hydro has locked in more debt at fixed rates, and has increased the amount of actual known spending on the major projects (therefore decreasing the remaining unknown spending), but asserts it is “naïve”³⁵ to think that this has in any way reduced Hydro’s risk, since large amounts of spending have not yet been locked in.

Both points are patently absurd. In the first citation, risk would be exacerbated by maintaining a high domestic load forecast, or a high export price scenario, and asserting that these forecasts must be met to achieve a positive financial path. This is not what has occurred. In each example Hydro has reduced the relevant forecast and incorporated these reduced outlooks into IFF16, and in this manner set a lower bar that must be met to achieve the financial projections. There is no way that such a move to a more conservative forecast could be said to increase the risk of Hydro’s forecasts. Similar considerations apply to increases in Keeyask and Bipole III capital budgets.

On the second citation, the Board must remain aware that Hydro brought forward at the Needs For and Alternatives To review a Preferred Development Plan, asking ratepayers to support a plan that required \$24 billion in new debt by 2026. This debt was entirely subject to unknown future interest rates. The Board did not support the plan, and instead recommended a plan (ultimately adopted by the Minister) that projected over \$16 billion in new borrowings by 2026, again entirely subject to unknown future interest rates. By the end of this year, Hydro will be exposed to interest rate risk on \$11 billion in future borrowings (under the 3.44% rate increase scenario - only \$8 billion under the Hydro IFF scenario). These are significant numbers, but they are well below the bounds of what has been repeatedly recognized to be part of Hydro’s ongoing scenarios. This is not a new risk, and it is not an increased risk – with each passing day the amounts outstanding and not yet locked-in shrink and consequently the risk and variability in future forecasts declines.

3.8 MH16 Updated (Appendix 3.6)

While there has been limited time to review and test IFF16, and the financial forecast variants that have been provided, there has been even less time to consider the MH16 Updated filed on July 11, 2017. For this reason, MIPUG only highlights for the Board’s consideration a short number of key elements that arise in IFF16 updated:

- 1) Cash flow in 2017/18 is improved compared to IFF16. Net cash from Operating Activities is up almost \$100 million (from \$689 million to \$785 million)³⁶.

³⁵ Hydro’s June 20, 2017 filing, page 20.

³⁶ This comparison is using the same rate increase assumptions as IFF16 – namely 7.9%. If the 7.9% were not granted, but rather the 1.6% as proposed by MIPUG, cash from Operating Activities would be reduced, but by equal amounts in each scenario (IFF16 forecasts as well as IFF16 Updated forecasts).

- 2) Water flows continue to improve, as can be seen by the estimated water rentals (which are directly linked to the amounts generated by Hydro). In IFF16, the water rentals were forecast to be \$124 million in 2017/18, while MH16 Updated forecasts \$130 million.
- 3) MH16 Updated now includes the impacts of current high reservoir levels lingering into 2018/19, as would be expected. This is a large part driving the 2018/19 improvement of \$55 million in Net Income and \$73 million improvement in Net Cash from Operating Activities³⁷.
- 4) Over the longer-term, changes are somewhat adverse, indicating the achievement of benchmark retained earnings levels are delayed by about one year (\$6 billion by 2026/27 rather than 2025/26; \$10 billion by 2033/34 rather than 2032/33). As noted above, such considerations should not be the primary focus of an interim rates application.

³⁷ As above, the underlying values would change with a different rate increase scenario, but the directional improvement would remain of the same magnitude between the two forecasts.

4.0 IMPLICATIONS OF AWARDING A 1.6% RATE INCREASE TO HYDRO

A further question that should be considered in determining interim rates is whether approving a given interim rate exposes Hydro to an adverse long-term scenario. To support this assessment, the Industrials have relied upon the Manitoba Hydro June 20, 2017 filing, pages 7-12 of Attachment 1. These are projections under IFF16 using the Industrials' recommended 1.6% rate increase in 2017/18, followed by Hydro 7.9% increases for the following four years. As such, this scenario provides the best indication of the interim rate implications without assuming any fettering of the Board's future discretion to support Hydro's proposals.

Comparing this scenario to the long-term IFF15 scenario as used by the PUB in Hydro's last interim rates decision (which projected rate increases of 3.36% annually), the following are noted:

- The current IFF16 forecast with 1.6%/7.9% rate increases shows no years of negative forecast net income, and one year showing record net income for Hydro more than \$100 million higher than the previous record net income³⁸.
- The previous IFF15 scenario that the Board was relying upon showed 5 of the next 10 years with modest negative net income (which was more than offset by 5 years of positive net income). No years targeted record net income.
- Comparatively IFF14, which underpinned the rate increases requested in the 2015/16 GRA, forecast 8 consecutive years of negative net income over the forecast period, and was considered reasonable given the level of investment and increased costs with Keeyask and Bipole III coming in service.
- By 2027, Hydro would achieve \$5.2 billion in retained earnings under the IFF16 scenario. Under the IFF15 scenario only \$3.1 billion in retained earnings were achieved in this time frame (which is still a record high for Hydro).

In short, electing a 1.6% interim rate increase today does not preclude the Board from adopting a rate increase scenario going forward that is far more aggressive than the Board last saw as valid. No insurmountable "hangover effect" will be created to prevent achieving or even materially exceeding the accepted IFF15 scenario.

³⁸ Hydro's previous record net income was \$415 million in 2006; this scenario has \$519 million net income for 2021/22.

5.0 OVERRIDING POLICY CONCERNS AND CAUTIONS

In the environment of regulated rates, a characteristic of significant importance is regulatory consistency. This is true for all stakeholders of the utility – e.g., ratepayers and bondholders alike. MIPUG previously noted that: “The Board must provide consistency and predictability to ratepayers, and comprehensively continue with the overall trajectory of regulatory oversight and financial plans that have been put in place since before the NFAT review.”³⁹

In respect of interim rates, the same principles in favour of consistency apply. The current review does not take place in a vacuum. The Coalition submission of May 26, 2017 fully summarized the excessive use of interim rates by Manitoba Hydro in recent years (after such interim rates were unheard of for over two decades of regulation). In response, Order 59/16 was extremely clear in respect of putting very tight constraints on Hydro’s ability to use interim rates after 2016/17. In particular, the PUB, at page 4 of Order 59/16, made it known to Manitoba Hydro that interim rates should only be used for “unforeseen or emergency situations”. This should reflect two complementary requirements:

- 1) that interim rates not be granted without the noted conditions (unforeseen, emergency); and,
- 2) that once interim rates are granted, they should quickly proceed to being tested and confirmed in a full proceeding.

There is no credible basis to argue that Hydro has or will be in an unforeseen or emergent situation from April 2016 through well into 2018 when a final GRA Order may be issued. MIPUG also notes that Manitoba Hydro has not complied with the following directive of the PUB at page 4 of that same Order:

By this Order, the Board accordingly directs Manitoba Hydro to file a General Rate Application for the 2016/17 and 2017/18 years by no later than December 1, 2016. A December 2016 filing would allow for the adjustment of consumer rates for August 1, 2017. Should Manitoba Hydro wish an earlier date for rate adjustments they need to file their Application earlier and allow approximately six months for the for the Board’s review of a General Rate Application.

Hydro has failed to comply with the timing for filing the current GRA. Hydro has failed to comply with the directive that rate changes should be filed six months in advance of when they are to occur. Hydro has failed to comply with the directive that interim rates should only be used for unforeseen or emergency circumstances. Granting an interim remedy in the face of non-compliance would send a message to Manitoba Hydro that it can ignore PUB directives without consequence. Not only does this risk unintended messages to Hydro, it also risks undermining

³⁹ June 9, 2017 Pre-Hearing Conference filing

the long-term reputation of Manitoba as a jurisdiction which values regulatory consistency, long-term planning, adherence to consistent principles and PUB Orders which stand the test of time.