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**PREAMBLE TO IR (IF ANY):**

In his evidence, Mr. Bowman states: “In light of the above, it is submitted that there is no empirical or sensible way to assess Hydro’s proposal absent some directional information about the long-term, particularly at the current levels of reserves.”

**QUESTION:1262**

- a) In Mr. Bowman’s view, is there a sufficient evidentiary record in this proceeding with respect to the long-term financial health of Manitoba Hydro to justify a rate increase in the test year?
- b) If the response to (a) is no, explain how Mr. Bowman’s recommendation of a 1.5% rate increase to transition rates higher to address Keeyask in-service costs is justified.

**RESPONSE:**

**(a) and (b)**

Please also see Coalition-MIPUG-4(a) and (b).

No. There is not a sufficient evidentiary record to support a rate increase in 2019/20 in either the short-term, or the long-term, with respect to the financial health of Manitoba Hydro.

In respect of the short-term, Hydro’s current rates and forecast other revenues are projected to fully cover the costs of all projected operating expenses (at the level forecast by Hydro, even without regard to whether these amounts are overforecast), all interest costs and payments to government related to current assets in service, depreciation on current assets in service, and fuel costs, and in addition to this to generate a net income in line with the best information

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available about the last reasonable target projection for 2019/20 coming out the last GRA (MH93, which included consideration of appropriate reserve targets tied to risks such as drought). This leads to the conclusion that no further rate increases are required for the purposes of Manitoba Hydro's financial condition in the short-term.

The PUB, in Order 1/19 directed that Manitoba Hydro's long-term financial forecast and financial plan were not in scope for this proceeding.<sup>1</sup> Nonetheless, there is a solid evidentiary basis to conclude that Hydro's long-term financial health is improved compared to MH93.

What does exist is an evidentiary record that a modest sub-inflationary rate increase may be in the interest of consumers, as part of long-term rate transitions. This should be considered only in light of regulatory precedent set previously by the PUB to transition rates for Bipole III in-service costs and factoring in long-term rate stability as a priority for rate setting. Given the threshold for rate increases above inflation should be high (see PUB/MIPUG-I-7), the PUB should use a level no greater than inflation as an allowable amount. This was used to guide Mr. Bowman's recommendation that any rate increase imposed should be within a range of 0% to 1.5%.

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<sup>1</sup> Order 1/19, January 2, 2019, page 12

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**PREAMBLE TO IR (IF ANY):**

Mr. Bowman takes issue with Manitoba Hydro’s decision to reclassify capitalized interest from an investing activity to an operating activity. Mr. Bowman states that providing readers of the Financial Statements with total interest paid by Manitoba Hydro regardless of whether interest is expensed or capitalized is not relevant for rate setting purposes nor for the regulatory ‘used and useful’ test as the calculation of capital coverage ratio continues to exclude capitalized interest in its determination.

**QUESTION:**

- a) Please explain how the reclassification of interest impacts the assessment of rate adequacy and how cash flows should be presented to best reflect the regulatory testing of rate adequacy
- b) For financial reporting to be consistent with the regulatory construct, should interest allocated to operating activities on the cash flow statement be limited to amounts related to assets that are providing service? Explain.

**RESPONSE:**

**(a)**

Mr. Bowman’s conclusions are based on 2 basic principles:

- 1) that capital investments require cash for all sorts of different purposes, be it construction costs, licencing costs, compensation, equipment, staff costs, etc. which are all investing activities. Interest paid for funds used during construction is no different – it is an investing activity. The costs would not exist but for the construction activity. The costs are incurred not to generate current period revenues, but to support long-term

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- investments. The costs will ultimately be capitalized as part of the project. There is no way in which interest costs are different or special on these facts compared to any other costs associated with construction, and as such should be recorded with investing costs.
- 2) The typical regulatory principle that only assets that are used and useful and providing service should be part of rates.

While rate regulation normally, and properly, focuses first and foremost on costs as reported on a utility's income statement, Manitoba Hydro has been increasingly justifying rate changes on cash-related tests to determine rate adequacy rather than traditional net income tests. This includes the discussion in the previous GRA about CFO:Capex ratios, and in the recent GRAs on the change in the interest coverage ratio to focus on eliminating some non-cash items from consideration such as depreciation and amortization.

In the event there was a small weight put on cash flow adequacy in determining the appropriate rate levels, Mr. Bowman's suggests a focus on cash flows as presented in the response to MIPUG/MH I-8(c) which shows positive operating cash flows of \$571 million in 2019/2020. On a forecast basis, Mr. Bowman suggests that it should be viewed as a positive characteristic for Hydro if this value exceeds the level of spending on sustaining capital, for forecast years. If this occurs, this means that internally generated cash is fully covering the costs of sustaining the system, and (to the extent this value is positive) further contributing to cash financing either debt reduction or investment in new growth assets. If this value did not exceed the level of sustaining capital, it means some debt is being secured to fund sustainment of the system, which is less ideal – this would not be a problem over some period of years, or during transient events like droughts, but further analysis would be required of other rate sufficiency metrics if this value were to remain negative over many forecast years under normal water flows. For example, this could be a sign that sustaining capital levels being proposed are excessive.

**(b)**

Though it is convenient when it occurs, financial reporting for IFRS purposes does not need to be consistent with the regulatory construct, as financial reporting for external auditing and to meet accounting standards serves a different purpose than financial forecasting to inform rate setting. Additionally, International Financial Reporting Standards (IFRS) allows for some limited differences in financial reporting for regulatory purposes on the basis of timing for collection of costs. Manitoba Hydro's financial reporting practises should be guided by these accounting standards in a manner its external auditors and staff deem appropriate.

For regulatory considerations, adjustments can and should be made to guide rate setting to ensure costs support the 'used and useful' test.

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Mr. Bowman also supports Hydro reflecting additional cash payments in the operating cash flows when they do not relate to projects still under construction. For example, as per MIPUG/MH-I-8(c), the annual payments to the City of Winnipeg tie to the acquisition of assets presently in service and delivering power to customers, and as such should not be reflected as Investing Activities regardless as to the IFRS interpretation (while also noting it is odd that IFRS requires this presentation given the definition of Investing Activities under IFRS per MIPUG/MH-I-8(b)).

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**PREAMBLE TO IR (IF ANY):**

Mr. Bowman states “For 2019 year to date (i.e. January and February 2019), all-in long-term rates are approximately 0.3% lower than Hydro’s latest forecast (3.27% compared to Hydro’s forecast of 3.60% for 30 year) and over 0.5% lower than Hydro’s forecast underpinning Exhibit MH-93. Starting April 1, 2019, Manitoba Hydro’s 30-year all-in forecast rate jumps up by over 0.6% from actuals as of February 28, 2019 (3.90% compared to 3.26% with MB spread).”

Mr. Bowman further states: “that it also is highly suggestive that long-term forecasts in MH-93 (beyond the five-year horizon) are likely very pessimistic compared to what is now known of Hydro’s borrowing costs for those years.”

**QUESTION:**

- a) Please provide a comparison and comment on the changes in forecasted 10 year and 30 year interest rates as of the end of March based on available forecasts from those provided in Manitoba Hydro’s February 14 update.
- b) Please comment on the potential saving in finance expense that may be achievable in 2019/20 given current interest rate conditions and those forecasted by Manitoba Hydro.
- c) Please discuss the longer-term financial implications of the existing interest rate environment on Manitoba Hydro.

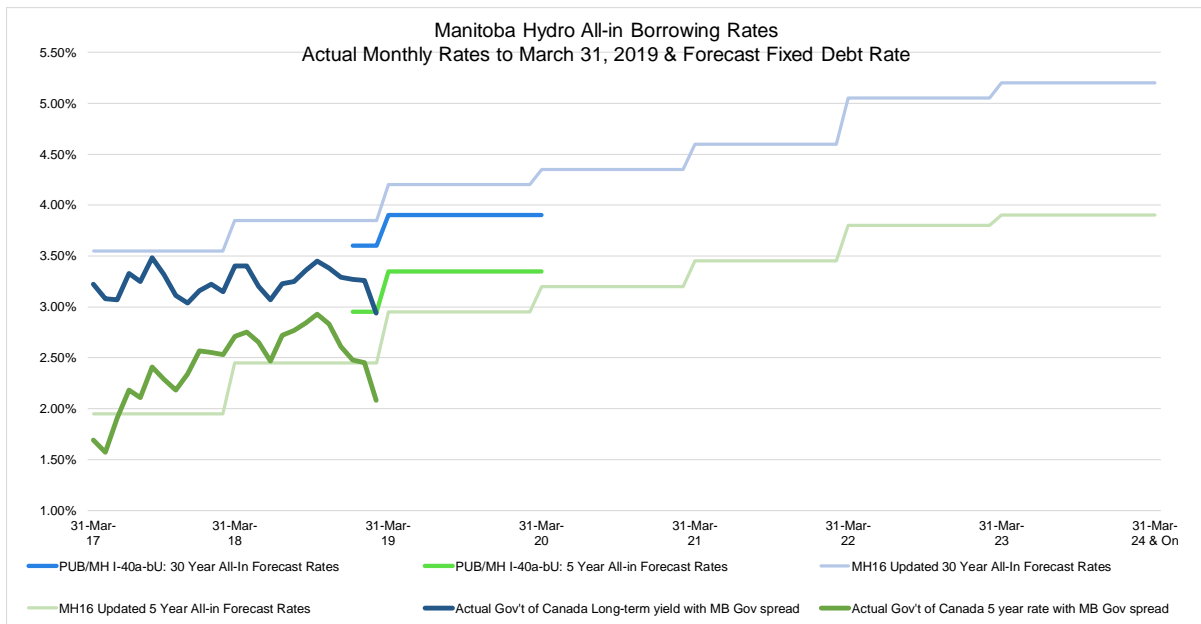
**RESPONSE:**

(a)

Mr. Bowman notes that Manitoba Hydro is in the best position to update interest rates as they apply to Hydro borrowings, due to both availability of information (e.g., Bloomberg output) and specific ongoing updated forecast information that is generally only reported on after the fact by such entities as the Bank of Canada.

The 30 year and 5 year rates were updated in Mr. Bowman’s evidence at page 16, but even in the time since the evidence was prepared significant further reductions in rates continue to occur, as shown in Figure 1 below:

**Figure 1: Manitoba Hydro All-in Borrowing Rates Actual Monthly Rates to March 31, 2019 & Forecast Fixed Debt Rate<sup>2</sup>**



Government of Canada long-term benchmark bond yields for March, 2019 are 1.84% (down from 2.16% in February) and for 5-year for March, 2019 is 1.43% (down from 1.80% in

<sup>2</sup> MH16 Updated 30 Year & 5 Year All-In Forecast Rates as of MH-68 in the 2017/18 and 2018/19 GRA, slide 64; Current 30 Year & 5 Year All-In Forecast Rates as of PUB/MH I-40(a-b) Updated; Actual monthly rates as per PUB/MH I-40 and extended for January to March 2019 from Bank of Canada Benchmark bond yields long-term (V122544) and 5 year (V122540) with added Province of Manitoba spreads as provided for those months in PUB/MH I-40(a-b) Updated.

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February). Comparatively Manitoba Hydro's forecast includes 2.50% for long-term yield and 2.30% for 5-year yield for January to March 2019.<sup>3</sup>

Note also that the above figure corrects the labels as compared to Figure 4 in Mr. Bowman's pre-filed testimony, which erroneously indicates the values include the Debt Guarantee Fee. A corrected version of Figure 4 will be prepared before the oral portion of the hearing commences.

**(b) and (c)**

The potential for interest rate savings during 2019/20 is significant. Mr. Bowman cannot fully quantify the impact given lack of specific information about the specific monthly borrowings assumed, the relative mix of debt maturities, and the fact that interest cost savings will be split between the income statement and the capitalized interest expense.

As a rough measure, Hydro is presently borrowing at 0.5% or more lower than forecast since about February 2019. Hydro is presently borrowing approximately \$250 million per month (per PUB/MH-I-8(c) updated, proceeds from long-term debt total approximately \$6 billion over 2018/19 and 2019/20). About 1/3 of debt is related to new capital (per PUB/MH-I-8(b) work in progress averages approximately \$7 billion over 2018/19 to 2019/20, out of approximately \$21 billion in long-term debt) so for each month that passes with 0.5% lower than forecast interest rates, Hydro's secures almost \$1 million per year in savings that will reflect on the income statement (0.5% times \$250 million times 2/3) with additional savings that will accrue in the Keeyask and MMTP projects. This \$1 million per year benefit that arises for each month interest rates stay at the current level (0.5% below forecast) is a long-term savings tied to the full WATM of new debt (e.g., savings every year for 20 years).

Note that starting April 1, 2019, Hydro forecasts rates to rise 0.4% to 0.5%. If rates do not in fact rise to this degree immediately, the savings noted above could increase materially.

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<sup>3</sup> PUB/MH I-40a-b Updated



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**PREAMBLE TO IR (IF ANY):**

**QUESTION:**

- a) How does the 1.5% inflationary rate increase compare to the Manitoba CPI rate?
- b) What is the basis for selecting Bank of Canada inflation for rate setting purposes rather than using Manitoba CPI?

**RESPONSE:**

**(a) & (b)**

The February 2019 year-over-year Total CPI (v41690914) per the Bank of Canada is 1.5%.

As of the date when this portion of the evidence was prepared, the most recent year-over-year CPI value for Manitoba posted by the Manitoba Bureau of Statistics was 1.4% (the January report, published February 27, 2019). The February report now available from MBS indicates 2.0% (dated March 22, 2019).

Mr. Bowman is not explicitly recommending the Bank of Canada inflation rate as the rate increase benchmark, but rather the general principle that a rate increase should not exceed CPI except in the face of substantial evidence no other alternative is available. The intent of a principle of this type is to set an envelope to guide ratemaking, not to push rate increases to the limit of the highest CPI reference that can be located.

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**PREAMBLE TO IR (IF ANY):**

Mr. Bowman states: “Of the remaining project costs, a material portion is interest during construction, which is less likely to change than direct project expenditures.”

**QUESTION:**

- a) Provide further justification for the statement in the Preamble, and comment whether this statement remains true if Keeyask is delayed.

**RESPONSE:**

(a)

Please see PUB/MH-I-4(c) which shows the Keeyask total expenditures by construction year and the proportion of this cost made up of Interest During Construction. For fiscal 2017/18, IDC made up 12.1% of costs (\$151 million out of \$1,244 million total), for 2018/19 the ratio is 15.6% and for 2019/20 the ratio of 22.7%. This percentage will keep growing as the project construction continues. The interest each year is largely locked in based on past expenditures and mostly past borrowings (as adjusted for incremental new borrowings added each year).

If Keeyask is delayed, all project costs are subject to increase, including such items as camp operation, equipment charges, site maintenance, etc. However, the evidence is that Keeyask schedule certainty has improved as compared to the previous GRA, not become more uncertain.

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**PREAMBLE TO IR (IF ANY):**

Mr. Bowman states: “While pre-funding of future capital projects can be problematic from a regulatory perspective, the Board created this mechanism at the time to address future rate pressures, with the end result helping to smooth the transition of Bipole III now that it is in-service.”

**QUESTION:**

- a) Explain why pre-funding future capital projects can be problematic for a utility regulated on a modified cost of service basis such as Manitoba Hydro and whether the use of a deferred revenue account addresses these problems.

**RESPONSE:**

(a)

Pre-funding of capital is problematic as it violates the regulatory principle that only used and useful assets are considered to set rates. This principle is not inviolate – there are instances where some assets that are not used and useful are included partially in rates (such as the Bipole III deferral account, or recent experiences by some regulators to include the AFUDC portion of project costs in rates prior to a project being put into service, due to specific finance metrics otherwise being unmet) and of projects that are used and useful not being included in rates (such as deferral accounts for large new additions in years prior to these assets being fully loaded, or to aid in rate smoothing).

In a modified cost-of-service approach, the principle of not pre-funding assets and of maintaining the used and useful test should still, to the degree possible, be recognized. Decisions to yield on this principle can be addressed in part by ensuring that any revenues that arise from the pre-funding of projects in rates do not become available to the utility as Net Income, or as a source to fund expansions of O&M expense, for example. The use of an account such as the Bipole III deferral account can assist in this regard.

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**PREAMBLE TO IR (IF ANY):**

Mr. Bowman states: “Such a rate increase of approximately 1.5% in 2019 could be viewed as being consistent with principles of rate stability and predictability, given there is a known need to transition to a new higher rate level at some point in the future to address the costs of Keeyask and potentially MMTP coming in-service.”

And “Since an assessment of the net impacts to customers was not undertaken as part of this review, and the current proceeding is not interim but final in nature, the PUB should consider a maximum level of rate increase no higher than inflation, currently estimated by the Bank of Canada at 1.5%.”

**QUESTION:**

- a) Explain why the maximum level of rate increase should be held to no higher than inflation.
- b) If a transition to a higher rate level at some point in the future is necessary to address the in-service costs of Keeyask and MMTP, explain why the test year rate increase should be limited to only an inflationary level, as inflation may have only a limited relationship to the expected in-service costs.

**RESPONSE:**

(a) And (b)

Mr. Bowman’s view, as part of the MIPUG panel for the previous GRA, was set out as part of testimony that emphasized that the threshold for rate increases above inflation should be quite high. The specific discussion that best addressed this concept was under cross-examination by Board Counsel at pages 6424 to 6426 of the transcript from the previous GRA (spoken to by the MIPUG expert witness Mr. Osler).

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In general, for a utility that has little fuel price exposure and a very large capital asset base (i.e., a large fixed cost), which produces power at a relatively constant cost over many decades, there is little reason to expect that rate increases above inflation will be a common feature. Regulation focused on rate stability should include the objective that even when material rate shifts are said to be required in certain instances (such as during a drought) the regulatory model can accommodate the financial requirements with measured changes over time, including rate changes below inflation to the degree possible.

In this proceeding, with the paltry record of where long-term rate trajectories must unfold, the evidentiary base does not exist to justify a rate increase above inflation.

The presumption of a need, at any time as part of the Keeyask phase-in, for rate increases above inflation is also now in doubt. With lower costs for Bipole III, lower long-term borrowing costs, sensible investment in DSM tied to marginal costs, continued O&M cost control, ongoing favourable resolution of Keeyask project execution risks, and a re-think of the need for reserves that far exceed the role to provide rate stability (including the PUB's direction that reserves should not be set aside to deal with export price or interest rate risk, for example), it is credible that a long-term scenario of rate increases at or below inflation could sustain a sufficient financial performance for Hydro for the long-term. In the absence of a long-term forecast from Hydro, to assume any other outcome would appear premature. Indeed, the expectation should be on Hydro's management and the MHEB that the comprehensive review of Hydro's operations and finances should set this as an objective, and if it cannot be met, the threshold for showing why it cannot be met should be quite high.

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**PREAMBLE TO IR (IF ANY):**

Mr. Bowman appears to be of the view that the levels of demand-side management activity ultimately undertaken by Efficiency Manitoba will not achieve the legislated targets of 1.5% net savings, as this level of savings is no longer economic based on the updated marginal value presented at the 2017/18 & 2018/19 GRA.

**QUESTION:**

- a) Confirm whether the premise in the Preamble reflects Mr. Bowman’s view. If not confirmed, adjust the premise to reflect his view.
- b) Provide more basis or support for why Efficiency Manitoba would not try, or receive approval for a plan, to achieve the energy savings specified by the legislated target.

**RESPONSE:**

**(a) and (b)**

Not fully confirmed.

Mr. Bowman is of the view that based on current facts, the DSM portfolio previously established proposed by Hydro suggests issues in this area. This is because the program was both so large as to include programs that would not be justified based on updated marginal cost metrics, and too small to actually achieve the 1.5% target set in the Efficiency Manitoba Act.

This does not mean that these two objectives cannot be simultaneously met. For example, if Efficiency Manitoba is able to achieve more energy savings than Hydro expected (so as to meet the 1.5% target) at a cost less than assumed by Hydro (so as to maintain the cost-effectiveness of the DSM program within the range supported by updated marginal cost values), Efficiency Manitoba can meet both objectives.

The full explanation of Mr. Bowman's views on the Efficiency Manitoba status was provided in the pre-filed testimony from the previous GRA (section 6.3.3), which is quoted below:

The *Efficiency Manitoba Act* is one part of the Government of Manitoba's response to the PUB's NFAT report. That response included both a specified intent to implement IRP, and an intent to establish a new arm's length agency.<sup>4</sup> The *Efficiency Manitoba Act* makes specific reference to a "savings target"<sup>5</sup> that, at least at the outset, is fixed at a given value regardless as to the facts of the Resource Plan. There are two ways to consider the target:

- 1) The *Efficiency Manitoba Act* is a rejection of Integrated Resource Planning, and intends to achieve the cited 1.5%/year savings target notwithstanding any evidence received from time-to-time in regards to the appropriateness and cost effectiveness of the target; or,
- 2) the *Efficiency Manitoba Act* is intended to operate within an Integrated Resource Planning framework, and the target is simply a starting point that is intended to be adjusted to reflect the facts as they are updated.

On balance, it appears the second reading is appropriate, for the following reasons:

- 1) The Act was accepted as an idea at the same time as the concept of IRP was endorsed by the Minister.
- 2) The Act specifically notes that the intent is to achieve a cost-effective result, including sections 9(f) regarding the need to indicate the cost effectiveness of the plan, 11(4)(b) the requirement for the PUB to

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<sup>4</sup> Mandate letter to the Minister of Crown Services, May 3, 2016, page 2. Available online: [https://www.gov.mb.ca/asset\\_library/en/executivecouncil/mandate/hon\\_ron\\_schuler.pdf](https://www.gov.mb.ca/asset_library/en/executivecouncil/mandate/hon_ron_schuler.pdf)

<sup>5</sup> Efficiency Manitoba Act, Bill 19, Part 3, available online: <https://web2.gov.mb.ca/bills/41-2/b019e.php>

consider the cost-effectiveness of the plan, and 16(1)(b) regarding the need to have an independent assessor confirm the cost-effectiveness of the plan as carried out.

3) The Act specifically notes that the long-term purpose of Efficiency Manitoba is to achieve rate benefits for Manitobans, as per the Mandate section of the Act, section 4(1)(c): “The mandate of Efficiency Manitoba is to ... mitigate the impact of rate increases and delay the point at which capital investments in major new generation and transmission projects will be required by Manitoba Hydro to serve the needs of Manitobans.” At this time, there is no prospect of rate increases tied to future capital investment for bulk power to be avoided.

4) The Act also specifically notes that Manitoba Hydro should be heard and make submissions on a review of an efficiency plan, presumably to reflect Hydro’s knowledge and plans for future capital investment that could be deferred.

5) The explanatory notes to the Act when it was first introduced as Bill 19 specifically note: “In recognition of the benefits received by Manitoba Hydro from the efforts of Efficiency Manitoba, Manitoba Hydro is responsible for funding Efficiency Manitoba's operations.”<sup>6</sup> The benefits to Manitoba Hydro clearly only arise to the extent that the DSM program being delivered is providing net benefits to the utility accounts, financial results and net revenues.

6) While the Act specifies a pre-determined value as the “savings target” in section 2, the Act also specifically notes that the target is not in practice fixed, as follows.<sup>7</sup>

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<sup>6</sup> Efficiency Manitoba Act, Bill 19, available online: <https://web2.gov.mb.ca/bills/41-2/b019e.php>

<sup>7</sup> Efficiency Manitoba Act, Bill 19, available online: <https://web2.gov.mb.ca/bills/41-2/b019e.php>



- a. Section 4(2)(b)(i) notes that the agency should provide advice to the government and to Hydro regarding "...the appropriateness of the savings target..."
- b. Section 11(5)(b) provides that the PUB can recommend "a decrease in a savings target if it is reasonably satisfied that the existing savings target is not in the public interest".
- c. Section 38(1) notes that the Lieutenant Governor in Council may, by regulation, adjust the savings target.

In short, the above structure suggests that any savings plan from Efficiency Manitoba should be viewed from an IRP context, tied to the ability of DSM to achieve economic benefits (including rate benefits) from export sales or deferring new major generation and transmission. Where such benefits do not exist, or do not exist to the degree needed to support a 1.5%/year savings target, such a target should not be assumed to be the default level to pursue.

Manitoba Hydro's DSM forecasts do not appear to align with the purpose and intention of Efficiency Manitoba, nor are the full expenditures likely to be undertaken in the 2019/20 year.