Maritime Electric (MECL) 2016 Rate Application (UE20942) – Comments to IRAC

Summary of the Application

The 300 page document can be summarized as seeking approval for three primary topics: 2016 single year rate increases, continuation of a high Return on Equity (ROE) and the start of cost allocation changes across the customer class set.

1) 2016 Single Year Rate Changes: With a small correction in the base rate, basic rate increases sought in the application are driven by the inclusion of increased annual capital depreciation as documented in a yet-to-be -approved, separate IRAC application. Following the rate stability and consumer confidence set in place over the last five years of the Energy Accord, it is extremely disappointing to witness MECL returning to iterative planning and the pre-2010 period of annual rate applications. The Accord demonstrated that with a longer term Power Purchase Agreement (PPA) in place, MECL has the skills and data to accurately forecast customer rates over a number of years. Any financial risk for MECL was eliminated by publishing the "Input Factors" or assumptions upon which these forecasts were based and having the provision that rate changes might be required if these input factors changed. MECL does have a PPA for 2016 to 2019.

2) Rate of Return/Net Profit: Approval for a (high) 9.7% Return on Equity (ROE) within a proposed range of 9.5% to 9.9% is sought. The actual history of financial risks for MECL resulting from unplanned operating, contractual or financial events, does not align with the risk rating reported by the rating organizations cited by MECL in the application. By example, the following is a list of recent major cost events:

   a) 2010 Pointe Lepreau refurbishment in excess of $80M
   b) 2011 Dalhousie Plant closure - $12M
   c) 2012 mainland cable repair in excess of $3M
   d) 2016 Capital Depreciation corrections - $5M per year
   e) From 1991: Long term debt issues ranging from $12M to $60M and set for 25 to 50 years duration. Each has a committed interest payment in the range of 4.5% to 11.5%.

   The costs arising from the above events have all been assigned to the customer base; none have affected the financial position of MECL or shareholder return. When requested through interrogatory questions, MECL declined to provide counter data. By definition, the "Cost of Service" regulatory model under which MECL operates allows all costs to be assigned to the customer base and therefore sets the parameters for setting a risk free "reasonable and guaranteed" financial return. This currently is not 9.7%!

3) Cost of Service/Cost Allocation Adjustments: Resulting from a 2014 study, the application recommends that changes between rate classes start in 2016 but be fully implemented over a period of time. The “Revenue to Cost” ratios documented are calculated by considering both energy and demand costs for each customer class but this calculation does not separate the individual class revenues into revenue from energy and revenue from demand. Further, there are two important factors relating to the cost of meeting peak demand power that are not factored in the 2014 study. These are:
a) the relative timing of all the individual demands across the distribution and transmission systems drives the capacity requirement of these systems.
b) nearly 100% of annual capital expansion in both the distribution and transmission systems is driven by the incremental increase in coincident peak demand power.

After many years of delay in addressing “Cost of Service” equity and not having an effective Demand Side Management program it is vitally important that the aspect of “On-Peak” and “Off Peak” demand delivery costs be included in the re-design of customer tariffs, beyond any differentiation (or not) in the PPA. The first “cost of service” adjustment proposed in the application is setting the monthly target second block for the Residential class to be the same as the General Service class (5000KWh). By bringing some equity between these two classes it follows that consideration should also be given to introducing a demand measurement and tariff element for the Residential class.

Interrogatories Questions Commentary

1) Topic – 2016 Rate Changes: Referencing schedules 16-2 to 16-4, MECL declined a request to clarify the elements of the “basic energy charge” entry. This new term could easily be confused with the “Basic Rates” as documented but it is in fact a subset number which excludes ECAM adjustment, recovered provincial costs, cable contingency contribution and a RORA offset. Notwithstanding the confusion of terms used, of concern here is that without the temporary RORA offset, the 2016 rate increase cited could have been 2 times, e.g. from 2.5% to 5.6% for the average Residential class customer. This is a prime example of why rate forecasts should be extended to 2019 so that consumer uncertainty beyond 2016 is avoided.
2) Topic – Continuation of a high ROE: For Questions #13 and #14 MECL declined to provide any examples of past costs assigned to shareholders or past costs affecting equity value or equity dividends. Risks described by rating agencies as documented in the application apparently could arise from many potential sources yet MECL was unable to cite any examples where operating, financial, regulatory or legislative actions have affected the financial standing of MECL. No tangible, actual past experience evidence exists to support the current ROE.
3) Topic – Increase in Long Term Debt: The proposed conversion of a portion of the available $55M short-term debt to an increased long-term debt ($167M to $195M) with a new $40M/30-year loan issue is based upon maturing debt and future borrowing conditions for 2016. A summary of the future economic reasons and/or consumer benefits beyond 2016 was not provided.
4) Topic – Application: Errors in Schedule 8-1 and the RORA account were identified and presumably will be corrected in the revised application.

Conclusions:

1) This annual rate application should not be approved until it is synchronized with the current PPA to March 2019. A 2016 revised application to include 2017 and 2018 proposed rates should be directed.

2) The 9.7% ROE and the 7.64% Return on Rate Base requests should be denied.

3) The planned updated/extended Cost Allocation Study should include a more rigorous analysis of the revenue and costs elements of demand power especially the daily/monthly coincident patterns of demand peaks.

Application (UE#20942) Approval Suggestions:

I propose an application approval scenario as follows:

1) Approve the Depreciation Application (UE#21603) but delay the approval of this rate application (UE#20942) until it has been extended to include 2017 and 2018 costs and subsequent rate changes. Application corrections as noted and DSM cost adjustments will be required.
2) By spanning 2016 to 2018 in the revised application, the planned increases for the Residential second block, the reductions in General Service basic rates, three years of depreciation correction and impacts of increasing the long term debt will all be complete and documented.
3) Direct that the ROE target should be 7%, achieved by setting 2016 at 9%, 2017 at 8% and 2018 at 7%. The approximate reduction in annual net (regulated) profit will be from the $13M in 2015 to $11M spread over the three years.
4) Apply the RORA account to fund the delay (if any) in implementing the rate changes for 2016.
5) Having avoided the time and cost entailed with future annual rate applications for 2017 and 2018, direct MECL management to prepare an accelerated schedule in seeking IRAC approval for:
    a. A revised DSM plan
    b. A 2016 debt retirement and refresh application
    c. An updated/extended Cost Allocation Study earlier than June 2018
    d. A completed Depreciation Study
    e. The CTGS decommissioning study. Urgency is required for determining whether the CTGS upside salvage value is $8M or the estimated cost -$6.2M.
    f. The Pointe Lepreau costs allocation study
    g. The Farmers tariff proposals
    h. An Integrated Resource Plan (IRP) for the period 2017 to 2027