

**Témoignage de
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de Concentric Energy Advisors sur les
caractéristiques du MRI du Transporteur
d'électricité**

Version amendée

PERFORMANCE BASED REGULATION RECOMMENDATIONS: REVISED

PREPARED FOR:
HYDRO-QUÉBEC TRANSÉNERGIE

R-3897-2014

BEFORE THE: RÉGIE DE L'ÉNERGIE

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PREFACE

Hydro-Québec TransÉnergie (“HQT”) submitted a proposed set of characteristics for Mécanisme de réglementation incitative (“MRI”) ¹, supported by evidence submitted by Concentric Energy Advisors (“Concentric”). ² This recommendation was subject to examination by the Régie de l’énergie (“Régie”) and intervenors through information requests and critique by intervenor experts, with Pacific Economics Group serving as the primary intervenor expert. HQT, with direction provided by a new management team, has subsequently reconsidered its initial recommendation, and has asked Concentric to evaluate alternative MRI models. HQT’s management also expressed its intentions to continue to improve and rely on the Modèle de gestion des actifs (“MGA”) because it enables an annual optimization between maintenance and capital expenses. From the perspective of HQT’s management, the MGA is a central component of HQT’s asset strategy and the MRI proposal should reinforce this approach to asset optimization.

This revised MRI approach takes into account comments expressed by stakeholders regarding the reliance on the “Building Block” approach with a three-year up-front forecast and their general preference for a mechanism that incorporates elements of an I-X approach. Stakeholders expressed concern over forecast variances for the 3-year term. ³ One stakeholder expressed the view that this proposal had the effect of HQT filing three annual rate cases at the same time, placing a burden on stakeholders to review the forecast. ⁴ However, while stakeholders expressed a preference for a formula that incorporates an X-factor, rather than reflecting efficiency gains within the forecast, there was disagreement as to whether the X-factor should be determined by conducting either a benchmarking or productivity study, or whether it should be determined by relying primarily on judgment that is informed by HQT facts and circumstances.

It is important to note that this revised proposal continues to meet the Article 48.1 requirements:

- 1) continuous improvement of performance and service quality;
- 2) cost reduction that is beneficial to both consumers and the distributor or carrier;
- 3) streamlining of the process by which the Régie fixes or modifies the rates the electric power carrier and electric power distributor charge consumers or a class of consumers.

¹ “Caractéristiques des MRI du Distributeur et du Transporteur d’électricité”, R-3897-2014, HQT-3, Document 1, November 9, 2015.

² “Performance Based Regulation Recommendations” prepared for: Hydro-Québec Distribution and Hydro-Québec TransÉnergie, R-3897-2014, HQT-2, Document 1, October 26, 2015, subsequently revised on February 10, 2016.

³ See for example, AHQ-ARQ response to HQ interrogatory 4, FCEI Evidence, p. 5.

⁴ Evidence submitted by FCEI, p. 20.



This submittal replaces Section 4, presented below, in Concentric’s initial report (Revised HQTD-2, Document 1) in its entirety. In all other respects, the content of the initial report remains applicable with the following exceptions:

- Delete Section 5A, first paragraph, last sentence;
- Delete Section 5B, first paragraph, first three sentences;
- Replace Section 7A and B for HQT by Section C of this amended testimony; and
- Delete Conclusions, third sentence of the first paragraph.



REVISED MRI CHARACTERISTICS FOR HQT

This section begins with a brief discussion of HQT’s current circumstances that have a bearing on the design of the MRI. Section B presents a Hybrid approach for HQT, with explanatory details, including the advantages of the Hybrid proposal over HQT’s current regulatory model and in relation to the initial Building Block proposal. The implementation details are presented in Section C.

A. HQT CHARACTERISTICS

In addition to satisfying the requirements of Article 48.1, HQT’s recommended MRI model and associated characteristics must reflect its particular circumstances, and role in providing the backbone electric grid connecting Québec’s generating resources with both domestic and export customers. HQT operates the most extensive transmission system in North America with 15 interconnections to neighboring electric systems and nearly 34,000 km of transmission line. HQT’s tariff, approved by the Régie, is designed to provide non-discriminatory access to HQT’s system and ensure compliance with North American system reliability and security standards. HQT faces several challenges in maintaining the reliability of service and integrity of its network. The sheer geographic scale of its operations, location of traditional hydro resources and new wind generation at great distances from load centers, and challenging climatic conditions make HQT’s circumstances extraordinary as compared to other transmission companies. These factors combine to produce significant capital requirements necessary to maintain and extend HQT’s transmission facilities. These characteristics create a unique set of circumstances under which HQT is required to maintain the quality of service, within the context of an aging network and fulfill its public responsibility for maintaining the integrity of its network. These circumstances must be considered in the design of an MRI for HQT as they help identify factors within the control of HQT that impact either capital (“CAPEX”) or operating expenses (“OPEX”) and other residual items.

HQT’s business decisions are guided by its mission and fundamental priorities: to ensure public and employee safety, to ensure reliability of the network, to provide maximum availability of the network, and to achieve an optimal cost relationship between OPEX and CAPEX. HQT’s MRI must take into account these priorities and apply a long-term perspective that reflects the capital intensiveness of its business and the life cycle of the assets that make up its network. These characteristics differ substantially from typical distribution or integrated T&D utilities and are reflected in the composition of the annual revenue requirements, particularly the proportion of revenue requirements directly related to the return on (42.5%) and of capital (32.7%), as shown in the following table.



Figure 1: HQT 2016 Authorized Revenue Requirement (D-2016-046)

Revenue Requirement, 2016	\$Millions, CAD	%
Return on Rate Base	\$1,323.2	42.5%
Amortization	\$1,019.0	32.7%
Operating Expenses	\$691.1	22.2%
Taxes	\$100.1	3.2%
Corporate Expenses	\$32.1	1.0%
Purchase of Transport Service	\$18.5	0.6%
Electricity Purchased	\$15.1	0.5%
Total Revenue Requirement	\$3,112.6	

(R-3981-2016, HQT-05-01)

Taken together, the HQT depreciation and amortization expense, its return on rate base, and applicable taxes comprise 78.4% of the company's revenue requirements. This represents an imposing challenge for an MRI program because capital is typically the most difficult expense to accommodate under these programs. Transmission company CAPEX are "lumpy", and comprised of large projects that are built over many years. They are often dictated by system requirements beyond management's direct control, such as the integration of new generation. HQT's CAPEX are driven by a combination of: replacement of its aging infrastructure, growth in customer demand or integration of new generation resources, improvements in service quality, or external requirements (e.g., NERC or governmental regulations). Total CAPEX and related property, plant and equipment (PP&E) placed in service vary considerably from year-to-year, depending on the mix of projects.

HQT's OPEX have generally tracked below the rate of inflation over the past decade, but, this trend reversed in 2013, suggesting these efficiency gains may be more difficult to find in future years.⁵ As noted above, HQT has recently introduced a new MGA designed to more fully utilize transmission assets for their useful life.⁶ This model is still being refined but is causing HQT to spend more on maintenance in an effort to maximize the reliable use of existing transmission facilities over their entire service life, thus creating upward pressure on OPEX. It is Concentric's understanding that the MGA allows HQT to evaluate the probability and impact of potential equipment failures, and create optimized levels of asset maintenance expenditures and the lowest long-term cost for customers.

HQT customers have benefitted from significant cost reductions over the years under the existing regulatory regime, both from OPEX efficiency gains integrated into rates by HQT and CAPEX efficiency gains that reduce the amortized cost of PP&E placed in service. A new MRI program for HQT should recognize that future gains will be progressively more challenging as costs are rebased to reflect these prior gains and as opportunities for efficiency gains become less easily achievable. The combination of variability and magnitude of CAPEX, and

⁵ See HQT response to AHQ-ARQ interrogatory 3.1.

⁶ As discussed in: R-3823-2012; R-3903-2014; R-3934-2015; R-3981-2016.



recent trends in OPEX, require an MRI approach for HQT that can both accommodate these needs while providing the efficiency incentives envisioned in the goals of Article 48.1.

Some integrated companies have operated under MRI plans, but notably, Concentric is not aware of any North American jurisdiction that has adopted an MRI program for a transmission-only entity, and this proposed program would be a first-of-its-kind in North America. FortisBC, for example, is a wholly owned subsidiary of FortisBC Holdings Inc. that generates, transmits and distributes electricity to approximately 163,000 direct and indirect customers including residential, commercial and industrial users. Its service territory is located in the southern interior of British Columbia. It currently operates under a PBR plan for the 2014-2019 period as an integrated electric company.⁷ In Ontario, which is on its 4th generation PBR plan for electric distributors, the OEB has recently indicated that it will not require existing transmitters to apply under its Custom IR or Revenue Cap index PBR frameworks for distributors, and have the ongoing option to file under one or two-year cost of service applications. The OEB expects transmitters to file enhanced reporting on customer engagement and to propose scorecards for measuring performance. The Board recognized that a transition period may be required to accommodate “the gradual entrenchment of Renewed Regulatory Framework for Electricity (“RRFE”) objectives and principles in transmission rate-setting over time”.⁸ Moving in this direction, among other requirements, the Board determined that transmitters should file a strategy to acquire benchmarking evidence for subsequent applications if not available at this time.⁹ These Ontario policies recognize the unique nature of transmission entities in comparison to distribution utilities.

⁷ FortisBC Inc., Multi-Year Performance Based Ratemaking Plan for 2014 Through 2018, BCUC Decision, September 15, 2014.

⁸ Ontario Energy Board, Filing Requirements for Electricity Transmission Applications, Chapter 2, Revenue Requirement Applications, February 11, 2016, p. 2.

⁹ *Ibid.*



B. REVISED MRI APPROACH FOR HQT

Based on these considerations and the stakeholder feedback received to date, Concentric is proposing a “Hybrid” model for HQT, with most OPEX¹⁰ adjusted each year based on an I-X formula, subject to certain adjustments, and using cost of service for all other components of the revenue requirements, including capital-related costs.

The recovery of capital expenses (amortization) and the return on capital (debt and equity) are based on the forecasted cost of service. Capital projects will be approved as they are under current filing procedures for large and small projects. The impact of HQT’s capital expenditures would be reflected in rates by adjusting corporate fees, amortization, taxes and the return on rate base to correspond to changes in Rate Base each year as the non-parametric nature of HQT’s CAPEX does not readily accommodate an I-X program.¹¹

HQT’s Revenue Requirement would be set according to the following formula:

$$\text{Revenue Requirement}_{t+1} = \text{OPEX}_{t+1} + \text{Other Components}_{t+1} + Z_{t+1}$$

Where:

$$\text{OPEX}_{t+1} = [\text{OPEX}_t - \text{Specifically Tracked Items}_t] * [1 + (\text{Inflation}_{t+1} - \text{Efficiency})] + \text{Growth}_{t+1} + \text{MGA}_{t+1} + \text{Adjustment for Recurring Activities}_{t+1} + \text{Specifically Tracked Items}_{t+1}$$

Other Components = Adjustment for expenses subject to variance and deferral accounts beyond management’s control, Capital Charges, and Other Residual Items,¹² where:

$$\text{Capital Charges} = \text{Amortization} + (\text{Return on Rate Base} * \text{Rate Base}) + \text{Taxes}$$

Z = Adjustment for costs resulting from unanticipated/exogenous events outside of management’s control.

The Hybrid approach, which applies an X-factor to OPEX in Years 2 and 3 of the MRI term, represents an appropriate extension of the current parametric formula. Under the Building Block approach, revenues were to be adjusted each year in accordance with a three-year forecast of total revenue requirements established at the beginning of the MRI. Efficiency gains were embedded within this three-year forecast. The updated Hybrid MRI provides a

¹⁰ For purposes of this MRI characteristics proposal, this term represents the “Charges nettes d’exploitation-CNE” component and the “Achats d’électricité” (Electricity purchases) item currently used to establish the revenue requirement.

¹¹ Pacific Economics Group (“PEG”) recognized this alternative in its report where it noted: “[s]hould an index-based escalator prove unsuitable for HQT, a hybrid approach to ARM design also merits consideration.”, Incentive Regulation for the Transmission & Distributor Services of Hydro-Québec, Pacific Economics Group, October 26, 2015, p. 101.

¹² Such as corporate fees (“frais corporatifs”), transmission service purchases (“achats de services de transports”), internal billing (“autres revenus de facturation interne”), and external revenue (“facturation externe”).



reasonable degree of simplicity and rate stability that is appropriate in this first generation MRI. The Hybrid model is comprehensive and addresses all of HQT's revenue requirements.¹³

The hybrid approach continues to rely on the Régie's approval for both major capital projects and aggregated capital spending for smaller projects which are the major driver of costs to customers. This approach recognizes that most MRI programs include some form of recognition for capital investments that do not track well with a pure I-X formulation. Infrastructure systems age at varying rates, and there is no reason to expect that investments and cost recovery for a system as large and complex as HQT's would correspond with a smooth I-X trend. This challenge is dealt with by policymakers in one of several ways in an MRI context. Capital related expenditures may be recovered under a cost of service standard, as proposed here for HQT both with respect to the return on capital and the return of capital (i.e., amortization). This approach reflects the fact that HQT's capital expenditures can vary significantly from year to year, with corresponding fluctuations for both return and amortization. Capital trackers have been used to isolate the rate effects of certain types of expenditures, such as replacements for leak-prone pipe by gas distributors. Large capital projects may be separately tracked while smaller projects rolled into an I-X framework. Or, the utility may be allowed to apply for "K-factor" treatment for projects deemed out of the ordinary course of business and beyond management's direct control. These latter examples are all derived from electric T&D or integrated utilities, or gas distributors in North America; none have been applied to a transmission specific entity.

In practice, the majority of MRI models are of a hybrid form, utilizing both cost of service and performance-based regulation principles. Concentric's proposal retains the cost of service recovery for HQT's capital investments, and introduces a formulaic approach for OPEX that realistically applies performance-based regulation where it will be most effective and appropriate for HQT.

¹³ The hybrid MRI proposal is also consistent with Elenchus observations expressed in its report: "Regulators also observed that while a revenue cap provided an incentive for utilities to use their existing infrastructure more efficiently, a revenue cap was not appropriate in cases where major new capital investments were need to maintain or enhance the company's infrastructure. Consequently, some regulators adopted revenue cap models that included mechanism for increasing the allowed revenue to reflect major capital investments that could not be accommodated by the basic cap. This approach was more appropriate than adopting a price cap in situations where the cost driver did not relate to load or customer growth." Elenchus Research Associates, Inc., Op. Cit, January 2015, p. 81.



The broad parameters of the proposed framework are outlined below:

Figure 2: HQT Updated MRI Characteristics

Plan Feature	Revised MRI Proposal*
Revenue Requirement Determination	Hybrid: I-X Formula and Cost of Service (COS)
Term	3 years
I-X Coverage	OPEX ¹⁴
COS Coverage	Other Components: return on rate base; amortization; taxes; transmission service purchases; corporate fees; deferral and variance accounts currently recognized by the Régie; and other residual items of revenue requirement
Investments	Maintain annual authorization of investments < \$25M and project-specific authorization of investments > \$25M
Inflation Factor (I)	Weighted combination of HQT's labor inflation and Canada's general inflation to be applied to OPEX ¹⁰
Productivity Factor (X)	To be applied to OPEX ¹⁰ based on the Régie's informed judgment
Annual Updates	Inflation factor, adjustments for growth, MGA maintenance, recurring activities, specifically tracked items, Other Components and demand for transmission services
One-time Adjustments (Z)	Unforeseen or exogenous events (extreme climatic events, major outages, unscheduled customer requests, governmental decrees, decisions from the Régie, statutory and regulatory requirements (government and regulatory agencies), etc.
Earnings Sharing	Adjustments to ESM to be determined following the establishment of the MRI
Off-Ramp	Possibility of review or interruption of the plan if earnings are +/- a certain number of basis points of allowed ROE
Service Quality Thresholds	Limited number of service quality indicators to be linked to the ESM

* Some other features, such as a carry-over mechanism, could be evaluated and incorporated in a subsequent term of HQT MRI.

The revised MRI proposal reflects two principle changes from the original building block proposal: (1) OPEX is based on a multi-year I-X formula and (2) all other components of the revenue requirements are based on COS as currently used by HQT.

This Hybrid MRI proposal meets each objective of Article 48.1. The three-year MRI term will provide an incentive for HQT to identify and implement continuous improvements in its operations and performance, fulfilling the first objective. The cost reduction objective will be realized by using a fixed X factor for OPEX throughout the MRI term, optimizing costs using the MGA and explicitly sharing the earnings surpluses through the ESM; the achievement of performance targets will also be rewarded through the ESM. The streamlining objective will be achieved by replacing two cost-of-service rate filings with targeted annual updates for data required to establish HQT rates. While HQT's Building Block proposal achieved these same objectives, the Hybrid MRI provides greater transparency with respect to the efficiency that was embedded within the forecasts that serve as the benchmark under a three-year Building Block proposal.

¹⁴ See footnote 10.



The Hybrid MRI changes OPEX in years 2 and 3 by I-X with the inflation factor (I) calculated as an average of two indices: HQT's labor inflation index and Canada's general inflation rate. For reasons described in Section 5 of Concentric's Initial Report (HQT-D-2, Document 1), the productivity or "X" factor should be established by the Régie with judgment being a major, if not primary, determinant. This is particularly appropriate for HQT as there appears to be an insufficient number of "comparable" transmitters upon which to produce a statistically valid productivity or benchmarking study.

The incentive to pursue sustainable efficiency improvements throughout HQT's operations is a principal objective of the MRI and recognized in HQT's proposal. The parameters of the ESM must, therefore, preserve the ability of HQT to retain a meaningful portion of the savings that are generated by efficiency improvements, particularly for efficiency gains that require an up-front investment. A strong incentive will encourage HQT to pursue efficiency gains in all areas of its OPEX including payroll (salaries and overtime), benefits, and fees for external services.

In addition, the integration of the MGA as part of the MRI proposal is explicitly designed to optimize HQT's expenditures on maintenance when there are asset management decisions to be made with respect to whether to maintain the useful life of a facility through a maintenance solution or whether it would be better for HQT's customers to address facility condition through a capital investment solution (or a combination of both). The MGA, by design and through its application, will yield efficient outcomes that impact both OPEX and CAPEX. The OPEX efficiency incentives and MGA each contribute to an alignment of customer and HQT shareholder interests.

The Hybrid MRI approach maintains the visibility and review of HQT's capital program for the Régie, as specified by statute. Thus, projects greater than \$25 million are subject to a project-specific review and approval, and smaller projects are grouped together and submitted with HQT's annual investment budget. While this may not be an incremental advantage of the Hybrid MRI relative to the existing ratemaking model, it nonetheless represents an integral element of the overall proposal. It is particularly important with respect to HQT because of the contribution of the return of and on capital to the overall revenue requirement. These reviews provide an opportunity to review proposed capital projects at a critical phase in their development. HQT's annual MRI filings will include rate base updates that are consistent with the annual capital expenditure filings and based a forecast of plant to be placed in service during the rate year.

One feature common to the existing model and all three MRI approaches (i.e., the I-X, the Building Block, and the Hybrid MRI) is the exclusion of certain items that are beyond HQT's control from the incentive mechanism. These items, which include pension costs, point-to-point transmission service revenues, costs related to projects pending approval by the Régie, and penalty revenues related to ancillary services are currently subject to variance accounts and will be trued up on an annual basis. Exclusion from the incentive mechanism ensures that neither HQT nor its customers will be exposed to a financial penalty or reward for circumstances that are beyond their control.



Under the proposed approach, HQT updates the return on capital each year to reflect the change in rate base and any change in the cost of debt as updated in December of each year for the upcoming year. The ROE is established from time-to-time by the Régie.¹⁵ The return of capital (amortization expenses) and taxes are also treated on a cost of service basis, recognizing that annual changes in amortization expenses and taxes are a direct function of the annual change in rate base. HQT's capital program is dominated by large projects spanning multiple years thus providing limited ability to influence amortization and tax expenses.

Considered as an integrated package, the updated proposal continues to provide a reasonable degree of simplicity and rate stability that is appropriate in this first generation MRI.

¹⁵ The capital structure would also be updated should the Régie approve a new capital structure during the term of the MRI.



C. IMPLEMENTATION

Implementation of the Hybrid MRI model requires the establishment of initial rates for year one based on cost-of-service principles, to be followed by annual rate filings that calculate a new set of rates for years two and three based on the required updates to components of the Hybrid MRI mechanism as indicated in Figure 2. The following components contribute to updated revenue requirements:

Operating Expenses

- Application of I-X to previous year's OPEX (minus previous year's specifically tracked items).
- Application of the forecasted growth factor, with accompanying explanations and supporting calculations.
- Adjustment to maintenance expenses based on the output of the MGA and other costs related to recurring activities.
- Adjustments to reflect elements of Operating Expenses that are specifically tracked, including any that are subject to variance accounts.
- The inflation factor will be based on the average of the HQT labor cost index and the Canadian inflation rate.
- The X-factor will remain fixed throughout the term of the MRI and will be based on the Régie's informed judgment.

Cost-of-Service Related Expenses Other than Operating Expenses, including:

- Plant placed in service during the prior, base and test years as necessary to calculate rate base.
- Debt costs and any changes to the authorized ROE or capital structure that may have been approved by the Régie.
- Amortization, taxes, corporate expenses, and any other cost of service items.
- Z-factor adjustments to reflect the revenue requirement impact of unanticipated events.

Earnings Sharing

- Application of the ESM to the most recent historical year's financial earnings and performance indicator results.

Billing Determinants

- Forecast of demand for transmission services that are relied upon to calculate new rates.



The required annual filing should be relatively efficient. Most importantly, it should be possible to achieve streamlining as contemplated in Concentric's initial proposal by implementing a set of generally accepted regulatory practices:

- 1) A single annual "compliance" filing that presents the new rates, including the impact of updates to reflect changes in the OPEX subject to the I-X formula coverage and to all other items subject to the COS coverage;
- 2) The filing is based on financial and service quality results for the prior year that are routinely reported by HQT;
- 3) All calculations are presented in the filing;
- 4) The precise form of the filing is determined by the Régie in this proceeding;
- 5) The new rates take effect after a short period that allows the Staff of the Régie to confirm the calculations; and
- 6) The Régie indicates its approval through a decision.

These filings would be managed through a written consultation. They are required in order to fulfill objective 3 under Article 48.1, a streamlining of the process by which the Régie fixes or modifies the rates of HQT. This regulatory process will still result in streamlining as compared to annual rate case filings. The ability to deliver on the streamlining objective is achieved by agreeing to the form of the annual rate change filing and avoiding unnecessary discovery and hearings to "litigate" the compliance filing.

In addition, and as noted in the initial report, having MRIs' initial term start in alternate years for HQD and HQT would further streamline the regulatory process for a particular year.

At the conclusion of the first generation MRI, Concentric would expect HQT to file for a rebasing of rates based on standard cost of service principles. A rebasing is fairly common at the end of MRI plans. Based on an assessment of the results of the plan, HQT could ask the Régie for the extension of the plan or propose modifications to the parameters or to the characteristics of the existing MRI.



D. CONCLUSIONS AND RECOMMENDATIONS

The hybrid approach recognizes HQT's specific and unique circumstances as the initial proposal, the Building Block approach, did. As Concentric mentioned in response to the Régie's 9.2 information request,¹⁶ the hybrid approach can accommodate the stair-step trajectory of HQT's CAPEX and related costs. Under this updated proposal, HQT would have OPEX subject to an I-X formula. The Régie will continue to review the HQT's capital plans on an annual basis for smaller investments, and a project specific basis for larger investments. Concentric does not recommend that "X" be established for HQT through the development of a productivity study because there are so few comparable transmission companies. Rather, Concentric recommends reliance on informed judgment which may include results from other utility productivity studies and HQT's actual productivity trends to determine the prospects for future efficiency gains. This approach avoids the many shortcomings of these studies and is in line with the third objective of Article 48.1.

Concentric proposes a rebasing of rates, followed by a two-year MRI term for HQT. Concentric proposes that the specific Service Quality Indicators (SQI) plan be developed in a subsequent phase, including metric definitions and targets. The ESM should also be established at that time because it must be aligned with the overall MRI mechanism, including its parameters.

These recommendations address the first two objectives of Article 48.1. The third objective, regulatory streamlining, is addressed under the Hybrid MRI through the avoidance of two comprehensive annual rate cases, through the choice of defining elements and parameters and through a series of recommendations that relate to the annual filings that will be required to adjust HQT rates. They also consider some preferences expressed by stakeholders in their testimonies.

In summary, Concentric believes that these recommendations comply with the letter and intent of Article 48.1, provide a strong incentive for HQT to pursue efficiency gains and improvements in service quality, and provide for regulatory streamlining. This proposed framework represents an appropriate first generation MRI for HQT.

¹⁶ HQT-4, Document 1, p. 20.