Summary

Gazifère Inc. ("Gazifère" or "the Company") has been successfully operating under Revenue Cap per Customer Comprehensive Performance Based Regulation (CPBR) since 2006. For Gazifère, which is a small utility with fewer than 40,000 customers, Revenue Cap per Customer model provides a fair and transparent regulatory framework that allows the Company to maintain a safe and reliable distribution system, satisfy customer service quality levels, and continue to attach new customers. The formula based distribution revenue requirement methodology combined with cost of service treatment of pass-through items (Y factors) and an earnings sharing mechanism adopts the best aspects of both cost of service and incentive based regulation.

The revenue requirement formula uses customer growth as a proxy for system growth. The discounted Consumer Price Index (CPI) revenue requirement escalator challenges the Company versus rate of inflation while encouraging productivity benefits for both ratepayers and shareholder. The Revenue Cap per Customer model allows for annual volume update which takes into account volumes gain or loss, average use decline, change in level of industrial demand as well as volumetric savings related to demand side management programs. This approach ensures that the allocation of revenue requirement by rate class, and consequently rate impacts, remain responsive to factors such as customer growth and volume gains or losses. Further, the annual update removes any disincentive to pursue energy conservation and demand side management.

In Gazifère's 2006 CPBR application R-3587-2005, interveners acknowledged in their submissions and the Régie de l'énergie ("the Régie") agreed that the Revenue Cap per Customer CPBR was appropriate for Gazifère because of the Company's size and the nature of its market. Also, the Régie in its decision D-2006-158 noted that Revenue Cap per Customer mechanism took into account the broad objectives of the incentive regulation which are to facilitate the improvement of business efficiency, customer needs satisfaction and to ensure fair redistribution of productivity gains between the distributor and the customers.

Under Revenue Cap per Customer CPBR, Gazifère continued to add new customers, met or even exceeded service quality levels to ratepayers, pursued energy conservation, and maintained a safe and reliable distribution network. The Company also generated over-earnings. The share of over-earnings for ratepayers was $66,600, $121,800, and $675,300 in 2006, 2007, and 2008 respectively.

The Revenue Cap per Customer framework provides for a simplified regulatory process, timely rate case submissions, efficient regulatory review, speedy hearing process, and timely implementation of rates on January 1st of each year. The Company believes that the objective of streamlining the regulatory process was reached during the first term of the CPBR formula and wishes to maintain this process in the future. Revenue Cap per Customer has good match with Gazifère's environment, meets the ratepayers', shareholder's, and regulator's needs, and continues to be the most suitable regulatory regime for the Company. Therefore, Gazifère proposes to continue with Revenue Cap per Customer CPBR model for another five year term (2011-2015).

The Company is requesting soft rebasing with no changes to the CPBR formula. The Company, however, is proposing to update values for productivity and discount factors, make a downward adjustment of base (2010) revenue requirement, determine an average revenue requirement treatment for Major Reinforcement Y factor capital expenditure, and make a one time revenue requirement adjustment for a change in depreciation rates.

Since Gazifère is proposing to continue with the existing CPBR model with minor changes, this evidence first discusses Gazifère's existing Revenue Cap per Customer CPBR model in detail, next is the discussion of the Company's performance under the Revenue Cap per Customer and lastly the evidence discusses Gazifère's proposal for the 2011-2015 CPBR term.

Introduction

Gazifère has been operating under Revenue Cap per Customer Comprehensive Performance Based Regulation (CPBR) since 2006. The Revenue Cap per Customer CPBR has been a success for the Company and its ratepayers through streamlined regulatory process, enhanced business efficiencies and service quality, as well as, earnings sharing. Hence, Gazifère is proposing to continue with Revenue Cap per Customer CPBR for the 2011-2015 term.

This evidence first outlines Gazifère's current Revenue Cap per Customer CPBR model, then it discusses the Company's performance in the 2006-2008 period, and lastly it sets out proposed minor updates and modifications to the model for the 2011-2015 term.

I. Background

Gazifère was under Cost of Service Regulation in the 1990s. From 2000 onwards the Company has been under some form of performance based regulation.

Targeted Performance based Regulation (TPBR) 2000-2004

Gazifère was under Targeted Performance Based Regulation from 2000 to 2004. During this TPBR period, O&M was subject to performance based targets. Gazifère generated combined savings of $1,251,933 during this five year period. These savings were subject to sharing with ratepayers on a 50/50 basis.

Transition to Comprehensive Performance Based Regulation (CPBR) 2005-2006

Gazifère 2006 CPBR Proposal

In 2005, satisfied with Gazifère's five year term (2000-2004) under TPBR, the Régie requested the Company to submit a proposal for a CPBR that covers all the aspects of Gazifère's operations.

Gazifère, after a thorough assessment, proposed Revenue Cap per Customer Regime. While the Company considered various CPBR models, features of Revenue Cap per Customer CPBR were the best fit with Gazifère's marketplace environment, customer base, and issues faced by the Company.

More than 90% of Gazifère's market comprises of residential customers and the Company's growth is mainly dependent on population growth. Given its regulated status and the nature of its market, Gazifère has limited opportunities for revenue growth through other product or service offerings.

Due to energy conservation and associated average use declines, the Company's distribution volumes remained stagnant. In other words, while the Company has experienced system growth through extensions of its gas distribution network to new subdivisions, it has not experienced corresponding volume / throughput growth. The Revenue Cap per Customer CPBR is responsive to these issues, is easy to understand and implement, supports productivity improvements, facilitates meeting customers' service quality levels and is compatible with energy conservation interests.

Further, for a small company like Gazifère with less than 40,000 customers, Cost of Service regulation involved a long and resource intensive regulatory process. In fact, Gazifère, was subject to the same regulatory process as large distributors operating in Québec. The Revenue Cap per Customer CPBR, with its formula based revenue requirement determination, provides a mechanistic approach to rate setting, resulting in a simplified rate case process and reduced hearing time.

In response to Gazifère's proposal, the Régie authorized the formation of a working group to participate in a consultative process in order to establish a suitable incentive regulation mechanism. The working group was comprised of all the participants in that application process. The working group conducted its discussions from November 2005 to March 2006 and after this consultative process, Gazifère submitted a Revenue Cap per Customer proposal to the Régie incorporating some changes to reflect interveners' suggestions.

Intervener Position

The interveners supported the Revenue Cap per Customer regime. The Régie in its decision D-2006-158 highlighted that certain interveners considered the incentive mechanism proposed by Gazifère well adapted to the distributor's specific situation and the proposed revenue adjustment formula was straightforward to use. The Régie also added that other interveners supported the global mechanism proposed by Gazifère:

> "*L'ACIG et la FCEI considèrent que le projet de mécanisme incitatif présenté par Gazifère est bien adapté à la situation particulière du distributeur et que la formule d'ajustement des revenus proposée est simple*

> *dans son application. SÉ-AQLPA et l'UMQ appuient le mécanisme global proposé par Gazifère*." (see decision D-2006-158, page 9).

OC-ACEF de l'Outaouais argued against Gazifère's proposal and suggested that a mechanism should be developed through negotiations. The Régie, however, concluded that an incentive mechanism resulting from a formal negotiation process was not appropriate to Gazifère's situation as such a process would be too cumbersome for such a small business and would imply costs disproportionate to the following objectives: the streamlining of the regulatory process, simplicity and ease of application. Also, the Régie concluded that a mechanism based on volume, or on a rate cap would not be appropriate because of the nature of Gazifère's market, which is mostly residential:

> "*La Régie considère qu'un mécanisme incitatif qui découlerait d'un processus de négociation formelle n'est pas approprié dans le contexte de Gazifère. Elle est d'avis qu'un tel processus serait trop lourd pour une entreprise de petite taille et impliquerait des coûts disproportionnés par rapport aux objectifs recherchés, soit l'allègement du processus réglementaire, la simplicité et la facilité d'application. De plus, un mécanisme basé sur les volumes ou de type "plafonnement des prix" ne serait pas approprié en raison de la nature du marché de Gazifère, qui est principalement résidentiel."* (see decision D-2006-158, page 10).

Régie Decision on the CPBR model for 2006-2010

The Régie decided that the selection of a global incentive mechanism of the revenue cap type based on the growth of the average number of customers was appropriate in Gazifère's case, because of its size and the nature of its market. The Régie further noted that the Revenue Cap per Customer mechanism took into account the broad objectives of incentive regulation which are to facilitate the improvement of business efficiency and customer needs satisfaction and to ensure fair redistribution of efficiency gains between the distributor and the customers. Finally, the Régie noted that Gazifère's proposed mechanism underwent a consultation process in accordance with the Régie's request:

> "*Le choix d'un mécanisme incitatif global de type "plafonnement des revenus", basé sur la croissance du nombre moyen des clients, est approprié dans le cas de Gazifère, en raison de sa taille et de la nature de son marché. La Régie note que le mécanisme proposé tient compte des grands objectifs de la réglementation incitative soit, favoriser l'amélioration de l'efficacité de l'entreprise et la satisfaction des besoins des consommateurs et assurer une juste redistribution des gains en*

efficacité entre le distributeur et sa clientèle. Le mécanisme proposé a fait l'objet d'un processus de consultation conformément à la demande de la Régie." (see decision D-2009-158, page 10).

Based on this, the Régie approved the Revenue Cap per Customer CPBR for Gazifère for a five year term i.e. 2006-2010.

II. Characteristics of Gazifère's Current CPBR

Revenue Cap per Customer

Gazifère is a small company with less than 40,000 customers and a significant residential customer base. Gazifère's existing Revenue Cap per Customer regulatory regime is well matched with the Company's operating environment and its size. The formula based Revenue per Customer Cap regime ensures smooth rate case preparation and a streamlined regulatory process with Rates implemented on a timely basis. The Company experienced significant average use decline during and prior to approval of CPBR. The Revenue Cap per Customer model allows for annual volume update which takes into account volumes gain or loss, average use decline, change in level of industrial demand and volumetric savings related to demand side management programs.

The Formula

The formula and a discussion of its components are given below:

$$\mathbf{RR_T = [(RR_{T-1} / C_{T-1}) * (1 + d \times CPIQ_T) * C_T] + R + Y + Z - GAINS}$$

Where:

RR_t = Distribution revenue requirement for year t
RR_{t-1} = Distribution revenue requirement for year t-1
C_t = Average number of customers forecasted for year t
C_{t-1} = Average number of customers for year t-1
d = Discount coefficient
$CPIQ_t$ = Projected year t inflation rate, based on the Québec consumer price index
R = Adjustment for capital cost

Y = Revenue requirement for pass-through items
Z = Exogenous factors
GAINS = Productivity gains credited to customers

In the above formula, the distribution revenue requirement for the test year equals the revenue requirement for the previous year divided by the average number of customers for the previous year, multiplied by a portion of the projected test year inflation rate, multiplied by the average number of customers projected for the test year, plus or minus capital cost adjustment, pass-through items, exogenous factors and reduced by the productivity earnings credited to customers.

Following is the discussion of various elements of the formula and other aspects of the Revenue Cap per Customer CPBR:

1. RR_T AND RR_{T-1}

In the above formula, RR stands for Revenue Requirement. The purpose of the formula is to generate distribution revenue requirement for the test year. The RR_t refers to revenue requirement for the test year whereas RR_{t-1} refers to revenue requirement for the previous year. Through a combination of adjustments and value updates, the above formula generates the revenue requirement for the test year, which Gazifère then collects from its ratepayers through rates.

2. C_T AND C_{T-1}

The customer growth is an indicator of system growth and is a key driver of the revenue requirement. Generally, utility costs increase with an increase in number of customers it serves. In the Revenue Cap per Customer revenue requirement formula, C_t and C_{t-1} represent the number of customers in test year and the previous year respectively. In its Decision D-2006-158, the Régie approved the use of per-customer revenue requirement as a basis for growth calculations. An increase in average customer number indicates system growth and results in an increase in test year revenue requirement and vice versa.

3. $CPIQ_T$

In the formula, $CPIQ_t$ represents Forecast Québec Consumer Price Index for the test year. In its 2006 CPBR application (R-3587-2005), Gazifère proposed and the Régie agreed that the Québec CPI should be used as an indicator for the inflation. Based on the Régie's decision, Gazifère's test year revenue requirement increases in relation to inflation. Under the existing CPBR revenue requirement calculation methodology, Gazifère uses the average of the Québec Consumer Price Index

(Québec CPI) forecasts set in August as inflation rate for the projected test year. The Company uses projections from Conference Board of Canada, Desjardins, Toronto Dominion Bank, CIBC World Markets and Nesbitt Burns, to determine the consensus forecast of Québec CPI inflation.

4. INFLATION DISCOUNT COEFFICIENT (D)

The Productivity is introduced in the revenue requirement formula through discount factor. For Gazifère, the discount factor is a combination of productivity factor (X) and a stretch factor imposed by the Régie to challenge the Company to do better than what it did in the past. In its 2006 decision, the Régie decided a productivity factor (X) of 0.2 and stretch factor of 0.2 for Gazifère. The productivity factor (X) was based on the productivity study conducted by Darryl J. Seal Consulting. The study used physical capital as input and customer numbers as output.

The inflation results in an increase in cost for the distributor. However, the discount factor allows Gazifère to increase its revenue requirement by only a portion of the inflation rate. For example, in 2006 the forecast inflation ($CPIQ_t$) growth rate was 1.8%. With a discount rate (D) of 0.78, the net growth rate was of 1.4% (1.8%x0.78). The calculations to derive the discount factor for 2006-2010 CPBR are given below:

CPI	=	Québec Consumer Price Index	=	1.80
X	=	Productivity Factor	=	0.2
SF	=	Stretch Factor	=	0.2
(X+SF)	=	Total Productivity Challenge	=	0.4
d(CPI)			=	1.40
d	=	Discount Factor	=	0.78

5. ADJUSTMENT FOR CAPITAL COST (R)

The Capital Cost adjustment accounts for factors which have a direct impact on annual capital costs and are out of the distributor's control. In its decision D-2006-158, the Régie approved Capital Cost Adjustment for Gazifère. The adjustment for capital cost is a cost of service modification; if cost of capital (debt and equity) increases, the cost of capital adjustment is a positive number, on the other hand if cost of capital declines, cost of capital adjustment is a negative deduction from the revenue requirement.

6. REVENUE REQUIREMENT FOR PASS-THROUGH ITEMS (Y)

The 2006-2010 CPBR formula approved by the Régie included pass-through items or Y factors which are items known in advance and have a direct impact on Gazifère's distribution costs. These pass-through items were calculated on a cost of service basis and were added to the revenue requirement separately. The items included in pass-through are:

- Deferred expenses including regulatory expenses and energy efficiency program expenses;
- The impact of the weather stabilization account;
- The impact of major investment projects over $450,000 and approved separately by the Régie, outside of the proposed incentive mechanism.

In its decision D-2006-158, the Régie noted that, in the context of incentive regulation, projects involving large capital expenditure and the resulting impact on the revenue requirement could discourage the distributor from investing in such projects. The Régie agreed that including such projects within the CPBR formula as a Y factor could be helpful in promoting prudent and reasonable investments by the distributor. The Régie decided that for projects with investment above $450,000, Gazifère is allowed to calculate the revenue requirement impact of such projects on a cost of service basis. However, the Company will require prior approval from the Régie to include that amount to distribution revenue requirement. An example of such a project from 2006-2010 CPBR term is the CIS project.

7. EXOGENOUS FACTORS (Z)

Exogenous factors refer to unpredictable events such as tax changes, natural disasters etc. that are out of the Company's control. In the decision D-2006-158, the Régie found that exogenous factors are clearly identifiable, one-time, unpredictable events not resulting from inflation and/or productivity changes. In the Gazifère CPBR formula, the objective of an exogenous factor is to quantify the marginal impact of the exogenous factor on distribution costs.

8. PRODUCTIVITY GAINS CREDITED TO CUSTOMERS (GAINS)

The "GAINS" represent ratepayers' share in the productivity gains. As Gazifère becomes more productive, the over-earnings are shared between the Company and ratepayers. In the Gazifère Revenue Cap per Customer formula, the gains are calculated based on ratepayers' share of earnings grossed up by nominal tax rate. Following are the details of the mechanism:

According to the Régie's decision D-2006-158, the earnings sharing formula is as follows:

- The first hundred (100) base points above authorized return will be shared 75-25 between the distributor and its ratepayers;
- The next two hundred fifty (250) base points will be shared 50-50 between the distributor and its ratepayers; and
- Gains beyond three hundred fifty (350) base points will be entirely credited to ratepayers.

The earnings sharing mechanism is asymmetrical as Gazifère bears the risk of a shortfall and the ratepayers do not see any impact in case of under-earnings. In case of over-earnings, earnings credited to customers will be used to reduce revenue requirements in the second year following approval of the amount in the closing of the books (i.e. 2008 earnings sharing are credited to the customers through 2010 revenue requirement calculations).

In its decision D-2006-158, the Régie noted that the distributor's efforts to continue improving its performance must be recognized and rewarded. Given the incentive to increase its rate of return and therefore the need to be more efficient, Gazifère has continued to improve its performance. As a result ratepayers also have seen increasing flows to them from the Company's over-earnings.

Other elements of the Comprehensive Performance based Regulation

9. SERVICE QUALITY INDICATORS

For the 2006-2010 CPBR term, the Régie required Gazifère to meet the following service quality parameters:

Quality Indicator	Measurement Parameter
Preventive maintenance	Compliance with preventive maintenance
Emergency response time	Response within minimum 35 minute delay
Frequency of meter readings	Percentage of meters read according to distributor's policy : ▪ Monthly, for industrial meters; ▪ Every second month for all other meters.
Call response time	Response to phone calls within 30 seconds or less.
Customer satisfaction (added in 2008 per decision D-2007-130)	Percentage of the level of customer satisfaction.
Overall performance	Arithmetic average

Each of the indicators has equal weight in performance calculation. Moreover, the earnings sharing are conditional upon achieving Service Quality levels given below:

- Gazifère's overall performance must be at least equal to 90% for earnings sharing to apply;
- If overall performance is between 80% and 90%, Gazifère could retain a percentage of earnings based on the following formula: actual overall performance multiplied by the earnings sharing formula;
- If overall performance falls below 80%, customers receive 100% of the over-earnings.

10. TERM AND RENEWAL

The Régie approved the term of the existing CPBR mechanism for an initial five years, i.e. from January 1, 2006 to December 31, 2010. The Régie also agreed with Gazifère's proposal that the Company would conduct an evaluation of the three year performance under the incentive mechanism and indicate whether it wishes to extend or renew the term of the current incentive mechanism.

11. REVISION FOR MAJOR EVENTS

In its decision D-2006-158, the Régie accepted Gazifère's proposal that the 2006-2010 CPBR term include the provision for the Company to revert back to cost of service or any other suitable arrangement, before the end of the term if major events beyond the Company's control threaten the viability of the Company. The

Régie in its decision also added that Gazifère, if applicable and when conditions warrant, shall submit detailed evidence of the circumstances that underlie its request to end the existing incentive mechanism and justify that a reversal to the traditional cost of service method is in the best interest of its customers and its shareholder.

12. RISK FACTORS AND REWARDS FOR PRODUCTIVITY

A. Risk Factors

While incentive regulation offers incentive to earn a higher return it has more risks also. Under Cost of Service, if costs increase faster than revenues, they will have an impact for one year due to annual cost based rate re-setting. However, under CPBR with a five year term, costs cannot increase faster than revenue due to downward impact on earnings. As Gazifère is unable to increase revenues as the revenues are determined as per the CPBR formula, the Company has to become more productive and reduce its costs. Examples of risk factors are given below:

a. Higher operating or capital costs: High unexpected inflation is a major risk as the revenue requirement is based on forecast inflation. A significant, unexpected rise in inflation and therefore increased costs could hurt Gazifère's profitability.

b. Lower than forecast demand due to an economic slowdown: The actual revenues depend on volumes and factors such as economic slow down or appreciation of Canadian dollar. Such factors could negatively impact gas consumption or could even result in closure of customer facilities and therefore have a negative impact on Gazifère's revenues.

c. High gas prices or high inflation: Factors like high gas prices or high general inflation could negatively impact gas consumption, etc.

Gazifère witnessed such problems in 2006, 2007, and 2008 as firm volumes were lower than budget in all three years (more significant in 2006 and 2007).

B. Rewards for Productivity

On the other hand as compared to cost of service, CPBR offers an opportunity to earn a higher than allowed return and be able to retain those higher earnings. However, to earn a higher return, the Company has to manage costs and be more productive throughout the period of the CPBR term. Opportunity for productivity

gains lies in managing O&M and rate base levels and composition. Based on the updated productivity analysis, Gazifère's productivity increased from 0.2 to 0.3 since the beginning of the first term of the CPBR formula. The ratepayers also benefited through earnings sharing.

III. Gazifère's Results under the 2006-2010 CPBR

In its decision D-2006-158, the Régie noted that the broad objectives of incentive regulation are to facilitate the improvement of business efficiency, customer needs satisfaction, and fair redistribution of efficiency gains between the distributor and the customers. As Gazifère completed four years of the five-year CPBR term, the Company believes that the three objectives for selecting the Revenue Cap per Customer as noted by the Régie in its decision have been met. This success is despite the continued price volatility and other risks discussed above. Following is a short description of these three objectives met by Gazifère.

1) Customer Needs Satisfaction

Gazifère aims to provide highest level of service to its customers. The Company has been meeting and exceeding the Service Quality levels (above 90%) required by the Régie. Also, the Company has been adding new customers and therefore it is giving more customers in its franchise area the access to natural gas. As a result of its customer growth efforts, Gazifère added more than 6,000 customers during the 2006-2010 CPBR term. This growth represents a 21% increase in customer numbers (Dec 31, 2010 forecasted number of customers, 37,038, versus Dec 31, 2005 actual number of customers, 30,683).

2) Business Efficiency

The Revenue Cap per Customer regulation with its streamlined regulatory process incented the Company to be more productive to earn a higher than the Régie's authorized rate of return while maintaining high quality of customer service. As Gazifère has been operating under performance based regulation since 2000, the easiest gains in productivity had already been reached during its first targeted PBR plan (2000-2004). However, under the CPBR, the Company continued to realize further improvement.

a) Productivity Improvement

An updated Total Factor Productivity (TFP) study indicates that Gazifère improved its productivity under the CPBR term. The Company updated the (TFP) study to include the Company's performance during the latest five years (2004-

2008). The TFP study which was based on the same methodology as approved by the Régie for the 2006-2010 CPBR term compared inputs (Labor "Salaries & Benefits", Materials "Supplies & other O&M", Capital "Depreciation, Interest, Plant etc.") with outputs (Customers served) to determine the productivity. The results of the updated study indicate that the productivity factor for 2004-2008 period is 0.3%, as compared to 0.2% for 2001-2005 period. (Please see report with updated productivity analysis, exhibit GI-2, document 2). The improvement in productivity factor highlights the power of incentive regulation and is an indication that the Régie's incentives have resulted in desired behavior from Gazifère.

b) Distribution Revenues and Costs

The Revenue Cap per Customer formula determined the annual distribution revenue requirement envelope under the CPBR. This formula based revenue requirement served as a target against which the Company managed its costs and operations. The Table 1 below shows Gazifère's actual distribution revenues. The table also shows Gazifère's actual distribution revenues minus 100% of the over-earnings which correspond to the actual level of costs in that year at authorized return. As can be seen in Table 1, Gazifère was able to control its costs with success as distribution cost per customer (adjusted for inflation) are lower in 2008 at a level of $544.07 per customer compared to $555.84 per customer in 2006. As a result of this cost management, Gazifère was able to exceed its authorized rate of return and generate over-earnings.

Table 1: Distribution Revenues and Costs during the CPBR Term

		Closing of the Books 2006	Closing of the Books 2007	Closing of the Books 2008
Distribution revenues ($)		17,646,963	18,584,408	20,486,930
Distribution revenues minus 100% of the over-earnings which correspond to distribution costs at authorized return ($)		17,380,662	18,135,168	19,120,188
Average number of customers		31,269	32,562	33,889
Distribution revenues per customer (in current $)	($/customer)	564.36	570.74	604.53
Distribution revenues per customer (in constant 2006 $)	($/customer)	564.36	561.75	582.96
Distribution costs per customer (in current $)	($/customer)	555.84	556.94	564.20
Distribution costs per customer (in constant 2006 $)	($/customer)	555.84	548.17	544.07
Actual inflation rate (December 31)		1.7%	1.6%	2.1%

3) Redistribution of efficiency gains (Earnings Sharing)

The Table 2 below shows a summary of the Régie Approved Revenue against actual Gross Revenue and Net Earnings. As can be seen in Table 2, the Company managed to increase its earnings (2006 & 2007) even when actual revenue was lower than budget due to lower actual (firm) volumes. As a result of over-earnings, the ratepayers received their share through the earnings sharing mechanism.

Table 2: Board Approved Versus Actual Revenue			
($ 000)	**2006**	**2007**	**2008**
Board Approved Revenue	18,351.0	18,793.0	20,187.0
Actual Revenue	17,647.0	18,584.4	20,486.9
Above/(Below) Approved	(704.0)	(208.6)	299.9
Net Earnings	2,622.3	2,711.6	2,999.2
Earnings Sharing before Tax	66.6	121.8	675.3

Year over year as the Company improved productivity, the earnings sharing increased for ratepayers. Table 2 shows Earnings Sharing with ratepayers during the CPBR term. As can be seen in Table 2, the before tax share of over-earnings for ratepayers was $66,600, $121,800, and $675,300 respectively.

CPBR's Other Stakeholder Benefits

- The CPBR provided a streamlined regulatory process with short and efficient rate case hearings.
- Timely implementation of rates on January 1st of every year.
- The Company continued to provide quality service by meeting or exceeding the Service Quality Indicators mandated by the Régie.
- Gazifère invested in system expansion and provided access to natural gas for new customers in Gazifère's franchise area.

IV. Proposal for the next CPBR (2011-2015)

Gazifère proposes to continue with the Revenue Cap per Customer CPBR regime without any changes to the formula and applies for another five-year term (2011-2015) under the Revenue Cap per Customer CPBR. Gazifère is also proposing that

there should be no cost of service rebasing of the base year revenue requirement for next CPBR term.

A. Revenue Cap per Customer for the 2011-2015 Term

Gazifère believes that Revenue Cap per Customer CPBR is a good fit with the Company's situation/environment. The CPBR adopts a performance based indexing formula and combines it with the best features of cost of service to meet Gazifère's needs and satisfy the ratepayers' and the Régie's requirements. The CPBR offers a clear and easily understood rate adjustment mechanism and an efficient and transparent regulatory process. The CPBR encourages operational efficiency while maintaining customer service standards. The Revenue Cap per Customer CPBR regime encourages system expansion while providing incentives to maintain service quality and safety and reliability. The Revenue Cap per Customer CPBR removes the disincentive for the utility to pursue demand side management and also maintains a fair balance between Gazifère's financial viability and ratepayers' interest.

Given the above factors, Gazifère believes that Revenue Cap per Customer regulatory regime continues to be the most suitable regulatory regime for the Company.

B. Soft Rebasing

For the 2011-2015 CPBR term, Gazifère is proposing soft rebasing without reversion to a hard rebasing. In Gazifère's opinion 'hard' rebasing means using full cost of service revenue requirement as base year revenue requirement. Whereas 'soft' rebasing refers to using some variant of CPBR formula based revenue requirement as base year revenue requirement. The Company proposes to use 2010 CPBR revenue requirement as the base revenue requirement with a one time downward adjustment. The Company proposes to reduce the base year revenue requirement by $600,000. This one time downward adjustment more than off-sets the proposed Depreciation expense increase ($368,600) and the Reinforcement project revenue requirement ($224,976) to be included in the 2011 revenue requirement as outlined in the Exceptional Adjustments section, on pages 22 and 23.

Other elements of the CPBR formula such as Y Factors, Earnings Sharing, R factor, and Z factor etc. will be treated as usual without any consideration to one time revenue requirement adjustment.

The Company believes that rebasing to a cost of service revenue requirement would be inappropriate because of the features of Gazifère's existing CPBR framework given the reasons below:

i. Gazifère has and will share benefits of efficiency gains with ratepayers

The primary purpose of the rebasing is to share all or a portion of the productivity gains with the ratepayers. Gazifère shares the benefits of incentive regulation efficiencies in multiple forms:

a. The ratepayers have been benefiting from lower rates due to earnings sharing;
b. The 2011-2015 productivity factor is higher than the 2006-2010 CPBR productivity factor;
c. Gazifère is proposing base year revenue requirement drop through permanent reduction of the base year revenue requirement (⇓$600,000). The proposed $600,000 reduction more than off-sets the exceptional adjustments proposed for 2011.

The incentive regulation should be focused on long term operating model. A hard rebasing while temporarily more beneficial for ratepayers may serve as a disincentive for the distributor to find sustainable productivity improvements.

ii. Gazifère's operations reflect an incentive based organization

Gazifère has been operating under some form of incentive regulation since 2000. During 2000-2004 targeted PBR period, Gazifère optimized its O&M expenses to respond to the sharing incentives offered by the Régie. As a result, Gazifère was able to generate O&M savings of $1,251,933. Moreover, since 2006, Gazifère has been operating under Revenue Cap per Customer. While the O&M was already optimized, the Company continued to keep a check on its operating expenses and also made efforts to optimize its rate base.

The Cost of Service regulatory regime focuses on costs and budgets. Therefore the organizational structure is setup accordingly with cost and budget orientation. Under incentive regulation, organizational structure and strategic and operational structure is focused on customer growth and performance management. With ten

years under some form of Performance Based Regulation, Gazifère's O&M, rate base and other elements of cost of service actually reflect a performance based organization operating with incentive based mind set. Going back to Cost of Service even for one year would be a step back. Therefore, Cost of Service would be an inappropriate frame of reference for the Company and therefore should not be applied for Gazifère's rebasing.

C. Proposed Incentive Mechanism

1. REVENUE DISTRIBUTION ADJUSTMENT FORMULA

No change. As mentioned above, the Company is applying for the Revenue Cap per Customer regulatory regime without any changes to the formula.

$$\mathbf{RR_T = [(RR_{T-1} / C_{T-1}) * (1 + d \times CPIQ_T) * C_T] + R + Y + Z - GAINS}$$

The detailed discussion of Gazifère's renewal application for 2011-2015 term and Gazifère's proposal for each of the elements of the Revenue Cap per Customer revenue requirement formula is as follows:

2. BASE YEAR

In 2010 the Company is operating under the Revenue Cap per Customer and Gazifère's 2010 revenue requirement has been calculated under the same CPBR formula. Under the Revenue Cap per Customer CPBR regime, Gazifère submits its rate case every year for the review of the Régie and the stakeholders. This review is meant to scrutinize the rate case filing to ensure that rates are acceptable. For each of the five years during the 2006-2010 CPBR term, the Régie has thoroughly reviewed the rates and found them just and reasonable. Therefore, in Gazifère's opinion, 2010 approved revenue requirement constitutes a valid reference year for the next five-year CPBR term.

Gazifère is proposing to use the Régie approved 2010 formula based distribution revenue requirement as base year revenue requirement without reversion to Cost of Service for the 2010-2015 CPBR term and with a one time downward adjustment. The authorized 2010 distribution revenue requirement adjusted for the deferral accounts, CIS and the customers' share of the 2008 over-earnings amounts to $21,235,200. The Company proposes to reduce this amount corresponding to the base year (2010) revenue requirement by $600,000. After this one time irreversible adjustment to the 2010 revenue requirement, the base

revenue requirement will be $20,635,200. This base revenue requirement will be used as RR_{T-1} in 2011 revenue requirement formula.

3. GROWTH

No change. The Company does not propose any changes to the growth measure and methodology approved by the Régie in its decision D-2006-158.

4. INFLATION

No change. Gazifère proposes to continue to use the existing methodology and process without any changes for inflation factor determination.

5. PRODUCTIVITY FACTOR

Gazifère has updated the study developed by Darryl J. Consulting in the 2006 CPBR application by adding the results of 2006 to 2008 time period. While following the same methodology the productivity factor (X) was updated and is now equal to 0.3. Therefore, Gazifère proposes to use a productivity factor (X) of 0.3, which is based on input and output for the 2004 to 2008 period.

6. STRETCH FACTOR

For 2006-1010 CPBR term, the Régie imposed a stretch factor of 0.2 on Gazifère. As discussed under productivity factor, Gazifère's proposed productivity factor of 0.3 for the 2011-2015 term is higher than the Company's productivity factor of 0.2 for the 2006-2010 CPBR period. Moreover, additional stretch is reflected in Gazifère's proposal through the downward adjustment of $600,000 to the base year revenue requirement. The Company therefore proposes that the Régie not impose any stretch factor for the 2011-2015 term and the Inflation Discount Factor be calculated based on a Productivity Factor of 0.3 only.

7. INFLATION DISCOUNT COEFFICIENT

Based on the updated productivity factor of 0.3 and using a forecasted CPI of 1.9%, Gazifère proposes an inflation discount coefficient (d) for the next CPBR term 2011-2015 of 0.84. The calculations to derive the discount factor are given below:

CPI	= Québec Consumer Price Index	=	1.90
X	= Productivity Factor	=	0.3
d(CPI)		=	1.60
d	= Discount Factor	=	0.84

8. CAPITAL COST ADJUSTMENT

Gazifère proposes the continuation of the annual capital cost adjustment and its continued treatment as variable R in the formula. During the current CPBR term, the ratepayers received the benefit of this adjustment when forecast for cost of capital fell. On the other hand, the shareholder received the protection when the Cost of Capital rose. Gazifère requests the approval of cost of capital adjustment for the next term of CPBR with one minor change i.e. the use of the nominal income tax rate in the cost of capital adjustment rather than the forecasted effective income tax rate as was used during the 2006-2010 CPBR term. (Please see detailed evidence in exhibit GI-2, document 3, pages 3 to 5).

9. PASS-THROUGH ITEMS

No change. Gazifère requests that the Régie allow the treatment of these items as pass-throughs for the purposes of calculating the revenue requirement without any changes. Gazifère also adds that any additions to Y factors will continue to be subject to approval by the Régie and will require the Company to justify their inclusion during an annual rate case.

(a) DEFERRAL ACCOUNTS (I.E. REGULATORY EXPENSES, ENERGY EFFICIENCY PROGRAM EXPENSES, AEÉ DUES)

No change. Gazifère proposes the same treatment of the deferral accounts during the next CPBR term and requests the Régie for its authorization.

(b) INVESTMENT PROJECTS OVER $450,000

No change. Gazifère does not propose any changes to this Y factor provision and requests for the future continuation of the Cost of Service treatment of projects above $450,000 subject to the Régie approval. Exceptionally at the beginning of the next CPBR term, Gazifère is proposing a special treatment for the Major Reinforcement project. The details of this proposal are discussed at the end of the evidence in the Exceptional Adjustments section, on pages 22 and 23.

(c) WEATHER STABILIZATION ACCOUNT

No change. Like 2006-2010 CPBR, Gazifère requests the approval to incorporate as a Y factor the impact of the variation of the weather stabilization account included in rate base, for the next CPBR term.

10. EXOGENOUS FACTORS

No change. The Company is not requesting any changes in the exogenous factor definitions, requirements, criteria, or calculation methodology for the next term.

The Régie has requested Gazifère to address the issue of nominal versus effective tax rates for Earnings sharing calculations. The company's detailed response with examples has been included in this evidence in exhibit GI-2, documents 3 and 3.1.

11. EARNING SHARINGS MECHANISM

No change. Gazifère does not propose any changes to the existing earnings sharing arrangement.

12. SERVICE QUALITY INDICATORS

No change. Gazifère proposes to continue with the existing service quality indicators and their current weights and thresholds for earnings sharing at this time.

13. TERM AND RENEWAL

Gazifère proposes a five-year term for the next CPBR mechanism i.e. from January 1, 2011 to December 31, 2015. The Company proposes to conduct an evaluation of the performance of the incentive mechanism for its renewal in early 2014 based on the results of the first three years. Gazifère will then submit an evaluation report that will indicate whether it wishes to extend or renew the term of the current incentive mechanism.

14. REVISION FOR MAJOR EVENTS

No change. Gazifère proposes that the next CPBR mechanism entail the provision for the Company to revert back to Cost of Service or any other suitable arrangement, before the end of the term if major events beyond the Company's control threaten the viability of the Company. Should the extraordinary circumstances arrive, the Company proposes to submit detailed evidence to support its request.

15. EXCEPTIONAL ADJUSTMENTS FOR 2011

Gazifère proposes to make certain exceptional adjustments to the 2011 revenue requirement. These adjustments relate to (a) increase in depreciation expense which is not a part of 2010 distribution revenue requirement and (b) revenue requirement related to special projects i.e. major reinforcement. The details of the two items are discussed below:

(a) DEPRECIATION EXPENSE INCREASE

In 2009, the Company conducted a depreciation assessment to determine if depreciation rates for various asset classes are reasonable. As a result of this review, Gazifère must make a one-time adjustment to the revenue requirement in the formula in order to recover in its rates the full amount of the depreciation expense for 2011 and coming years. The amount for adjustment is $368,600 (see exhibit GI-3, document 2).

(b) SPECIAL PROJECTS – MAJOR REINFORCEMENT

As discussed earlier, in its decision D-2006-158, the Régie allowed Gazifère to add the impact of major projects with investment exceeding $450,000 (subject to the Régie's approval) on a cost of service basis. During the 2006-2010 term, Gazifère, undertook two projects i.e. CIS and Major Reinforcement involving capital expenditure over $450,000. The CIS was approved by the Régie and was added to the rate base in 2009 whereas the major reinforcement is expected to be in operations during the winter season of 2010-2011. A leave-to-construct application on the reinforcement project was filed to the Régie in February 2010.

Unlike the CIS project where asset life is relatively short, the Reinforcement project has an estimated life of over 40 years. Continued Y factor treatment of such an asset will increase the regulatory burden for the Company and the regulator. As one of the objectives of the CPBR is to streamline the regulatory process and reduce the distributor's record keeping burden to a minimum, the Company proposes to include the cost of service revenue requirement of the reinforcement project in the 2011 distribution revenue requirement.

Gazifère is proposing to calculate the five year average revenue requirement for the reinforcement project of the years 2011 to 2015 and add that amount to the 2011 revenue requirement on a one-time basis. From that point onwards the revenue requirement for the reinforcement project will be a part of formula based revenue requirement. This request is conditional to the Régie's approval of the leave-to-construct application on the reinforcement project filed in February 2010.

The estimated average annual revenue requirement for the reinforcement project is $224,976. Including the Major Reinforcement project in 2011 revenue requirement on an average basis will simplify the annual rate case

process and will reduce the regulatory review burden for the interveners and the Régie. Please see exhibit GI-2, document 1.1, for the detailed average revenue requirement calculations for the Major Reinforcement project.

As for the CIS project, Gazifère will continue to calculate the cost of service impact on a yearly basis until the end of the asset life.

Recommendation

Gazifère recommends that the Régie adopt the CPBR framework proposed by Gazifère for the next five year (2011-2015) term. Table 3 below provides a summary comparison of Gazifère's proposal versus the existing CPBR model.

Table 3: Comparison of 2006-2010 and 2011-2015 CPBR Regimes

	2006-2010	2011-2015 Proposal	Change
Regulatory Regime	Revenue Cap per Customer	Revenue Cap per Customer	No Change
Items subject to Incentives	O&M, Capital except Y and Z Factors	O&M, Capital except Y and Z Factors	No Change
Base Year	2005	2010	Permanent reduction of the 2010 base year amount of $600,000
Business Growth Factor	Average Customer Number	Average Customer Number	No Change
Inflation Benchmark	Québec CPI	Québec CPI	No Change
Productivity Factor - X	0.2	0.3	Updated
Stretch Factor	0.2	0.0	Not proposed
Discount Coefficient	0.78	0.84	Updated
Capital Cost Adjustment	Yes	Yes	No Change except for use of nominal income tax rate
Y Factors (Cost of Service Items)	Deferral accounts, Capital above $450K, Weather Stabilization	Deferral accounts, Capital above $450K, Weather Stabilization	No Change
Exogenous Factors	To be determined by the Régie through Annual IR Application	To be determined by the Régie through Annual IR Application	No Change
Earnings Sharing	Over-earnings Sharing: Distributor : Ratepayers 1-100 bp 75:25 101-350 bp 50:50 above 350 bp 0:100	Over-earnings Sharing: Distributor : Ratepayers 1-100 bp 75:25 101-350 bp 50:50 above 350 bp 0:100	No Change
Service Quality Indicators	Required for Earnings Sharing: (i) Preventive Maintenance (ii) Emergency Response Time, (iii) Frequency of Meter Reading, (iv) Call Response Time, (v) Customer satisfaction	Required for Earnings Sharing: (i) Preventive Maintenance (ii) Emergency Response Time, (iii) Frequency of Meter Reading, (iv) Call Response Time, (v) Customer satisfaction	No Change
Term and Renewal	Five year Term with Annual IR Application	Five year Term with Annual IR Application	No Change
Revision For Major Events	Yes	Yes	No Change
Exceptional Adjustments	Envision, Incentive Regulation Development Cost, Rent Increase, Moving Expenses, Depreciation Increase, Reinforcement Project	Depreciation Increase, Reinforcement Project	(1) Average Revenue Requirement - Reinf Project (2) Higher Depreciation Rates