

## **Réponse d'Option consommateurs (OC) à la Demande de renseignements no 1 de la Régie de l'énergie (la Régie) à OC**

### **Dossier R-3809-2012 Phase I**

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- 1. Référence :** (i) Pièce C-FCEI-0009, pages 7-8;  
(ii) Pièce C-ACIG-0016, page 3;  
(iii) Pièce C-OC-0019, page 20;  
(iv) Pièce C-UC-0014, page 12.

**Préambule:**

(i) « *Pour porter un jugement sur le niveau d'incitatif nécessaire pour encourager le comportement désiré chez Gaz Métro, il importe d'identifier la provenance des économies qui sont recherchées par ce mécanisme.* »

(ii) « *Que la bonification de Gaz Métro atteigne 3, 4 ou 5 million \$ dans l'intérim est sans importance dans la mesure où l'on puisse facilement identifier les sources importantes des réductions générées par les efforts de Gaz Métro comme, par exemple, le transport LH obtenu sur le marché secondaire.* »

(iii) « *Moreover, the Performance Indicator fails to deliver on the central objectives of most GPIMs: to provide true incentives for the achievement of lower short-term costs; and to reduce the regulatory burden. These flaws would result in the transfer of millions of dollars in unjustified awards from ratepayers (and mainly D1 customers) to Gaz Métro shareholders.* »

(iv) « *UC recommande à la Régie :de considérer l'établissement d'une formule de rémunération des transactions d'optimisation qui soit traitée distinctement du calcul de la variation du coût moyen d'approvisionnement.* »

Dans la perspective d'évaluer sommairement la faisabilité d'un mécanisme différent de celui proposé par Gaz Métro, la Régie énonce ci-après les grandes lignes d'une approche alternative :

- Plutôt que d'être constitué d'un seul indicateur incorporant tous les coûts de transport, d'équilibrage, de compression et, éventuellement, de

- fourniture, le mécanisme serait constitué à chaque année d'un certain nombre de volets.
- Les divers volets correspondraient à des activités d'approvisionnement en gaz naturel présentant une problématique spécifique d'optimisation qui met à contribution de façon importante l'expertise de Gaz Métro. À titre illustratif, les volets suivants pourraient être envisagés :
    - l'optimisation des quantités d'entreposage contractées de façon à minimiser les coûts totaux;
    - l'optimisation du coût des injections de gaz naturel et de la valeur des retraits de gaz naturel du site d'Union;
    - l'optimisation des outils mis en oeuvre pour minimiser, à fiabilité constante, le coût de la provision additionnelle;
    - l'optimisation des programmes annuels d'approvisionnement en gaz naturel : par exemple, rémunérer pour une performance lorsque les coûts d'approvisionnement en gaz naturel livré à Montréal sont inférieurs aux coûts d'un approvisionnement à Dawn livré à Montréal;
    - l'optimisation du coût de la structure d'approvisionnement par des transactions spéciales : contrats d'échange conclus à des tarifs inférieurs aux tarifs affichés par TCPL ou encore des contrats d'approvisionnement à moyen ou long terme conclus plus près des sources de production et acheminés ensuite à Dawn;
    - les transactions d'optimisation (financières et opérationnelles).
  - Les volets retenus pour une année donnée seraient établis au plus tard au plan d'approvisionnement approuvé par la Régie et la rémunération serait basée sur des résultats réels et les modalités de bonification retenues pour chacun des volets (indicateur à battre etc.).
  - La bonification de Gaz Métro serait tributaire de sa performance sur l'ensemble des volets; par exemple, Gaz Métro pourrait perdre sur certains volets et réduire ainsi la bonification qu'elle gagne sur d'autres volets.

- Au global, la bonification minimale pourrait être nulle.

**Demandes :**

- 1.1** Veuillez indiquer si ce type de mécanisme suscite votre intérêt.
- 1.2** Veuillez commenter les avantages et inconvénients d'une telle approche.

**Réponse à 1.1 et 1.2:**

Yes, the Régie's suggestion is of interest to OC. OC appreciates that the Régie is considering an alternative to the Gas Procurement Incentive Mechanism (GPIM) proposed by Gaz Métro (GM).

Advantages

The Régie suggests more fine-grained incentives tied to GM's specific short-term plans where GM can arguably apply expertise to reduce costs. Under the Régie's alternative approach, it appears that the benchmark would be more recent (i.e. from the latest Supply Plan) and thus potentially not as easy to beat as the 2010 benchmark proposed by Gaz Métro. As outlined in Section 3.2, p. 8 of Ms. Rowan's analyst report (C-OC-0019) ("the OC Report"):

2. The proposed 2010 benchmark is too easy to beat, such that Gaz Métro need not achieve superior performance to earn a bonus;
3. The proposed 2010 benchmark amounts to a retroactive reward for actions that have already been undertaken (and approved by the Régie) to optimize the supply structure (notably the actions put in place to displace the supply structure to Dawn, approved by the Régie in D-2012-158);

Disadvantages

*Contrary to Best Practices*

The Régie's alternative approach may create distorted or even perverse incentives for GM to shift costs over time and across activities in order to maximize its bonus, as oppose to its procurement performance. The Régie is proposing incentives around specific components (*volets*) and this mix of components could possibly vary from year to year.

As outlined by Costello and Wilson in the “NRRI GPIM Report,”<sup>1</sup> best practices suggest that it is generally better if an incentive mechanism operates globally on gas cost, rather than provide incentives around specific components or actions in specific years:

GPIMs that encompass as broad a scope of interdependent procurement-related costs and revenues as is feasible, within a single incentive calculation applicable to all costs, provide the best incentives. Incentive problems can arise when a GPIM creates unequal incentives for various types of procurement decisions; these potential problems are discussed in a later section of this paper. (p. 5)

[...]

#### **Some Common Pitfalls in GPIM Design and Structure (p. 8)**

[...]

##### **1. Different incentives (sharing percentages) applying to inter-related procurement actions**

One common GPIM design characteristic that can lead to incentive problems is the application of GPIM incentives only to certain cost components, or very different sharing percentages applying to different cost or revenue categories. This encourages the utility to increase its GPIM award by exercising any flexibility it may have to spend relatively more in areas where incentives do not apply or are weaker, to reduce other costs (or increase revenues) to which stronger incentives apply. This can be contrary to the customers' interests. (p. 9)

[...]

##### **10. Potential for gaming between consecutive GPIM accounting cycles**

Most GPIMs operate on an annual cycle (calculating the benchmark and actual costs, and applying sharing rules, to combined results over 12 months), while other GPIMs use a monthly or biannual cycle. Whatever the cycle, a GPIM can create opportunities and incentives for a utility to shift costs or revenues from one cycle to the next to maximize awards.

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<sup>1</sup> A Hard Look at Incentive Mechanisms for Natural Gas Procurement” by Ken Costello and James F. Wilson, the National Regulatory Research Institute, November 2006. [www.nrri.org/pubs/gas/06-15.pdf](http://www.nrri.org/pubs/gas/06-15.pdf) also filed in Appendix 1 of the OC Report.

For instance, if, near the end of a cycle, the utility anticipates that it cannot improve its award in the current cycle (perhaps due to hitting a cap, or results falling into a tolerance band), it would face an incentive to shift costs into, and revenues out of, the current cycle, to maximize its award in the next cycle. (p. 15)

*Perverse Incentives Lead to Over-Compensation for Inefficient Procurement*

As indicated above, the OC report expressed serious concerns about GM's selection of a benchmark that is too easy to beat and would provide disproportionate rewards to the company.<sup>2</sup> However we are equally, if not more, concerned about distorted or perverse incentives, which can lead to inefficient procurement and over-compensation of GM for behaviour that may result in cost increases not reductions. Depending on its design, the Régie's proposal has the potential to create such perverse incentives.

Without a detailed study and a more specific proposal for implementation of the Régie's alternative approach, it is difficult for OC to determine exactly how the interactions among the various components during any period, and also across time, might result in perverse incentives, but we are wary of this approach for the reasons outlined above.

*Perverse Incentives in Gas Procurement Can Be Very Expensive*

Moreover, gas procurement involves very large sums of money, so OC is particularly concerned that perverse incentives can result in very large costs for ratepayers.

*The Application of Incentives to Various Components May Increase Opportunities for Expensive Gaming and Need for Additional Regulatory Oversight*

Gas procurement is a highly interactive and complex process planned and operated by GM. GM is thus in a highly advantageous position in terms of control and access to information. In this context, applying various incentives to discrete components opens up the possibility of expensive gaming. This kind of expensive gaming is particularly challenging from the perspective of regulatory oversight.

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<sup>2</sup> A benchmark that is too easy to beat may still result in directionally correct procurement decisions, even if the company is over-compensated and does not have adequate incentive to improve performance.

*The Régie's Alternative Approach May Increase the Regulatory Burden*

This leads to another major disadvantage of the proposal: an increase in the regulatory burden. As mentioned above, additional oversight will be required to reduce the risk of gaming. Moreover, under the Régie's alternative approach, the mix of components included in the GPIM could possibly vary from year to year. This changing regime alone is unlikely to reduce the regulatory burden, which is a key objective of the Performance Indicator.

As indicated in the OC Report, Costello and Wilson have pointed out that poorly structured GPIMs characterized by distorted incentives and gaming opportunities, can increase regulatory burden (NRRI GPIM report, p. 1, our underlining):

Incentive mechanisms providing strong incentives properly aligned with customers' interests can reduce the need for detailed regulatory review of the procurement function, as a well-structured incentive mechanism's awards and penalties impose appropriate consequences for superior or inferior performance. However, to the extent a GPIM provides weak or no incentive for some aspects of procurement decision-making, a traditional review of these aspects remains appropriate. Moreover, to the extent an incentive mechanism provides distorted incentives and gaming opportunities, a more detailed and focused review would be needed to determine whether any abuse had occurred.

*The Régie's Alternative Approach May Be Asymmetric*

Our reading of the Régie's alternative approach is that the minimum bonus could be zero for GM, which implies that this approach is asymmetric in favour of the company. Section 3.2.1 (pp. 9-11) of the OC report outlines the problems with asymmetric incentives. In summary, when the proposed sharing rules provide asymmetric awards and penalties, such asymmetry is inequitable towards consumers and provides a distorted incentive for risk-taking on the part of the Distributor. Moreover, asymmetric sharing rules violate the recommended GPIM Design Principles set out by the NRRI Report (p. 17).

*Unclear How the Benchmarks for the Régie's Approach Would Be Established*

Under the Régie's alternative approach, it appears that the benchmarks for each component would be more recent (i.e. from the latest Supply Plan) than the 2010 benchmark set out by GM. However, if these benchmarks are based on the Supply Plan, they would then change every year and be based on forecast data.

This has the potential to lead to gaming and distorted, and even perverse incentives. It may also increase the regulatory burden.

**Demande :**

**1.3** Veuillez formuler des améliorations qui permettraient de bonifier cette approche alternative ou la rendre opérationnelle.

**Réponse :**

In light of the answer in 1.2, OC believes that the alternative approach is too problematic to be implemented.

According to the Recommended GPIM Design Principles and Characteristics set out in the NRRI Report (p. 17):

**7. Meanwhile, Try To Keep It Simple:** A less complex approach will be less costly to monitor and may reduce the chance of misunderstandings, disputes and unintended incentives.

We reiterate the finding above from the NRRI Report that best practices suggest that it is generally better if an incentive mechanism operates globally on gas cost, rather than provide incentives around specific components or actions in specific years. So in fact, if a GPIM is required at all (and this is a subject of debate), OC believes that it is preferable to put a simple and more global GPIM in place in order to encourage better performance while reducing gaming and the regulatory burden.

However, as outlined in Section 4.1 of the OC Report (pp. 19-20), Gaz Métro's Proposals in the current filing should be rejected for the following reasons:

[W]e strongly recommend that the Régie reject both (a) the Performance Indicator (proposed for 2014-2018); and (b) the extension of the provisions of the recently expired Incentive Mechanism relative to the optimization of financial transactions (proposed for 2013). Gaz Métro has failed to meet its burden of proof to demonstrate that the proposals are well-structured incentive mechanisms that will lead to superior performance while lightening the regulatory burden, thus providing benefits to both customers and the Distributor.

Furthermore in Section 4.2.1 (pp. 20-21), OC goes on to suggest that the Régie should consider delaying the implementation of a GPIM until after the displacement of the Supply Structure to Dawn:

The Régie may wish to apply a Cost of Service regime for supply until conditions stabilize and the displacement to Dawn has been completed. Since 2016 is the first year of the displacement to Dawn, Gaz Métro may want to consider setting a benchmark of 2016 and starting the application of the Performance Indicator in 2017. Alternatively, it may be possible to create a benchmark prior to 2016, which reflects the optimization of the purchase locations (i.e. the displacement of the supply structure to Dawn), but this may be overly complex in the absence of real data reflecting the shift to Dawn.

In conclusion, in light of the above considerations, OC is convinced that GM has failed to meet its burden of proof and that the Régie's alternative approach is not a viable substitute for GM's flawed proposal. Given that it is highly challenging to suggest a simple and global GPIM until after the displacement of the structure to Dawn, OC suggests that GM be denied a global GPIM until conditions stabilize and the displacement to Dawn has been completed.

We note that in Ontario, Enbridge Gas Distribution and Union Gas do not receive incentives for gas procurement with the exception of a sharing mechanism for Transaction Services (TS) related to storage and transportation, which include exchanges, swaps, loans, etc. There is usually a "floor" forecast of revenue from TS in rates and above that floor, there is a TS Sharing Methodology with different ratios for storage and transportation. The TS Sharing Methodology for TS-related transportation revenue is **25% shareholder and 75% ratepayers**. For underearnings (below the revenue floor), shareholders bear the entire risk; for overearnings (above the revenue floor), sharing is 75% ratepayers and 25% shareholders.

For TS-related storage revenue, the TS Sharing Methodology is **10% shareholder and 90% ratepayers**. For underearnings (below the revenue floor), shareholders bear the entire risk; for overearnings (above the revenue floor), sharing is 90% ratepayers and 10% shareholders.<sup>3</sup>

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<sup>3</sup> EB-2011-354, Exhibit C1, Tab 4, Schedule 1, pp. 1-5 (see in particular pp. 4-5 for TS Sharing Methodology), 2012-01-31.



Our understanding is that the TS are similar to GM's financial and operational transactions. Although, the sharing is asymmetrical in favour of the consumers, given the specific attributes of the TS, the actual risk-sharing is more symmetrical.

Prior to the implementation of a global GPIM, should the Régie wish to explore a targeted sharing mechanism to optimize these financial and operational transactions with a sharing mechanism similar to that of Ontario, OC would be open to this possibility.