Engagement n^{o} 1 d'OC

Dossier R-3809-2012 Phase 1

Référence : (i) Notes sténographiques de l'audience du 11 mars 2013, volume 6, p. 157

(ii) Engagement n^{o} 1 de Gaz Métro, 12 mars 2013

(iii) Pièce A-108 « Transactions particulières considérées »

Question:

« Scénario de bonification en fonction des économies réalisées par rapport au tarif correspondant de TCPL pour les transactions identifiées à la référence ii (pièce A-108). La bonification serait basée sur un pourcentage des économies effectivement constatées au rapport annuel. Pour l'instant, ces économies seraient de l'ordre de vingt-six millions (26 M). Cependant, cette bonification serait conditionnelle à l'optimisation de la stratégie d'approvisionnement en gaz naturel de façon à ce qu'il y ait ni de FTLH inutilisés, ni revente des FTLH inutilisés, ni surplus de gaz à Empress ou Dawn, ni vente de transport au client GAC, gaz d'appoint concurrence, et on parle pour août, septembre et octobre, pour la période d'août, septembre et octobre. »

Réponse:

OC understands that this scenario presented by the Régie applies only to the rate year 2012-13 (Transcript from March 11 2013 hearing, volume 6, p. 152, para 123). The Régie's suggestion is of interest to OC and we appreciate that the Régie is considering another alternative to the Gas Procurement Incentive Mechanism (GPIM) proposed by Gaz Métro (GM). Our understanding of the Scenario is that we are being asked to comment on a targeted GPIM (Gas Procurement Incentive Mechanism) based on the optimization of transmission services (which is a subset of the optimization of operational transactions) for rate year 2012-13 only.

Our answer represents our current understanding of a complex question. We are attempting to provide a thoughtful answer to assist the Régie with feedback on an alternative incentive for the optimization of transaction costs in the current year. However, our answer must be somewhat preliminary and conditional. The time available to respond is very limited, and there is also now somewhat limited information available as to specifics for the targeted GPIM that could be implemented under the Scenario presented by the Régie. In particular, we are concerned that this targeted GPIM could create distortions that may not lead to the minimization of overall gas costs (among the various services and even with respect to the conditions set out by the Régie). But with the limited time and information now available, it is not possible to give sufficient consideration to how this targeted GPIM could create distortions, and whether and how these distortions could be mitigated.

Advantages

OC is impressed with the gains achieved by GM through the substitution of FTLH transportation with transportation swaps, as well as transmission purchases on the secondary markets (as recorded in A-108) and wishes to encourage GM to continue such activities for the remainder of the 2013 rate year and beyond.

In the absence of a global GPIM (the option favoured by OC and most parties in this case), OC has suggested to the Régie[1] that in the event of a delay in approval for a more global GPIM, the Régie may wish to explore a targeted GPIM for Transaction Services (such as the one used by Enbridge Gas Distribution in Ontario)[2].

The Scenario outlined by the Régie could be consistent with the OC suggestion in C-OC-0038 with respect the potential for an interim targeted GPIM for transaction optimization, inspired by an exploration of the incentives on Transaction Services in Ontario. However, if the Régie decides to implement this option, it will have to ensure that this targeted GPIM will not create potentially expensive distortions.

Disadvantages

OC see three main disadvantages to the Scenario:

1. Potential for the creation of distorted incentives

[1] In answer to Régie IR no 1(C-OC-0038) and in Ms. Rowan's direct testimony on March 12.
[2] 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.

2. Providing a reward on $26 M of savings on transactions that may have already been undertaken/confirmed, rather than rewarding future actions

3. Putting a GPIM in place that will only be in effect for six months - from the time of the Decision (April 2013 at the earliest) to September 2013. Considerable effort and regulatory oversight would be required to design a well-structured targeted mechanism that would avoid distortions and not reward already confirmed transactions.

1. Potential for the Creation of Distorted Incentives

Similar to our discussion in OC-0038 of the targeted GPIM suggestions contained in the Régie's IR, the suggested Scenario in this undertaking has the potential to create distorted or even perverse incentives for GM to shift costs across activities (and across time) in order to maximize its bonus, as oppose to its procurement performance.

OC is concerned about distorted 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 Scenario may have the potential to create such perverse incentives.

An illustrative example of a potential distortion created by this Scenario could be to encourage GM to release too much firm transportation, which could then impede its ability to then purchase additional supply at a lower cost upstream of the firm transportation path. By holding firm transportation, GM pays a fixed cost but then faces only very low variable transportation tolls to purchase additional supply upstream of the firm transportation path. If the firm transportation is released, some revenue is received from that transaction, but GM could then face higher interruptible tolls for the path, or must otherwise purchase transportation to make additional purchases. Some upstream supply purchase opportunities that are cost-effective given the low variable charges available with a firm transportation arrangement might not be cost-effective if firm transportation is no longer held. Thus, an opportunity to minimize overall gas supply costs could be lost if the targeted GPIM encourages GM to release too much firm transportation. The objective of a well-designed GPIM would be to minimize the overall costs of gas procurement and potential distortions from the proposed Scenario could be contrary to this objective.

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 a targeted incentive to a discrete component (such as the optimization of transmission services) could open up the possibility of significant distortion. This kind of distortion is particularly challenging from the perspective of regulatory oversight.

Without a detailed study and a more specific proposal for implementation of the Scenario, it is difficult for OC to determine exactly how the interactions among the various components might result in perverse incentives, but we have concerns about the creation of distortions for the reasons outlined above.

2. Providing a reward on $26 M of savings on transactions that may already be confirmed rather than rewarding future actions

OC has repeatedly emphasized in this case that a GPIM should award GM for strong performance going forward. It would appear as if the $26M of savings on transactions could already be largely confirmed and thus a targeted GPIM for the six remaining months of the rate year may reward past performance rather than future performance.

3. Putting a GPIM in place for only six months (the remainder of rate year 2013)

As mentioned in C-0038, for targeted GPIMs, additional oversight will be required to reduce the risk of creating distortions that do not minimize overall gas costs. It may be <u>possible</u> to design and implement a well-structured targeted mechanism that would avoid distortions and not reward confirmed transactions. However, even if this were the case, OC questions whether it would be <u>worthwhile</u> to commit potentially quite substantial regulatory effort and oversight for a targeted GPIM that will only be in place for 6 months.

<u>Recommendation</u>

The Scenario outlined by the Régie could be consistent with the OC suggestion in C-OC-0038 with respect the potential for an interim targeted GPIM for transaction optimization, inspired by an exploration of the incentives on Transaction Services in Ontario. However, if the Régie decides to implement this option, it will have to ensure that this targeted GPIM will not create potentially expensive distortions. In this event, OC highly encourages the Régie to research how potential distortions have been addressed in the Enbridge Gas Distribution Transaction Services Incentive Mechanism.

In the design of a targeted GPIM, the Régie would also have to bear in mind to what extent it is rewarding past performance (i.e. to what extent are the $26M in savings already confirmed) rather than future performance. A GPIM should award GM for strong performance going forward.

OC is open to a targeted GPIM as outlined in the Scenario, if the Régie were convinced that (a) potentially expensive distortions could be mitigated quickly and easily; (b) the targeted GPIM rewards strong performance going forward; and (c) there is not an undue regulatory burden associated with the implementation and oversight of this scenario,. OC would be even more supportive of such a Scenario if a global GPIM were deferred until 2015 or beyond. However, if the Régie plans to put in place a global GPIM in 2014, there would only be 6 months remaining in rate year 2013 in which to apply the Scenario. OC questions whether the design and implementation of the Scenario (to mitigate the disadvantages described above) might incur too high regulatory burden for too short a period.

If the Régie decides to implement the Scenario, even for 6 months, OC suggests the potential distortions could be mitigated by decreasing the sharing proportion such that there would be less incentive for the inefficient switching of costs between activities, while still providing a reward for transaction optimization. The usual sharing proportion for such targeted IMs varies between 90:10 and 75:25 in favour of ratepayers. OC suggests that GM's rewards be on the low side (10%). Moreover, EGD in Ontario has a floor of $6M with all revenues below the floor going to ratepayers before the sharing begins (see footnote 1 and OC-0038). If the $26 M in savings is already mainly confirmed, the floor for this targeted GPIM should be at least $10-$20M, in order to focus the rewards to GM on savings going forward and to encourage strong performance for the remainder of 2013. To quantify this suggestion, a 90:10 sharing with a floor of $10-$20M would provide GM with a $600k-$1.6M bonus for 2013 if savings of $26M were achieved.