Régie de l'énergie
DOSSIER: R-3809-2012 PHASE 2
DÉPOSÉE EN AUDIENCE
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OC's Position and Recommendations on GM's 2013 Rate Case

Presented before the Régie de l'énergie

April 27, 2013

In R-3809-2012 Phase 2

Hearing Subjects

1. Operating Costs
2. 2013 Revenue Forecast
3. Affiliate Transactions
4. Sharing Mechanism
5. Debt "Transfer"/Reattribution
6. Rate Strategy and "Rate Vision"
7. TCPL Intervenor Costs
8. Costs Incurred for ROE Applications

1. Operating Costs – Salaries and Wages

- Salaries and Wages are forecast to increase by $4.9M or 4.5% between 2012 actuals and 2013 Budget (GM-12, Doc 12, B-0171 revised)
- GM maintains that this is due to various cost pressures such as:
  - Salary inflation (B-0171)
  - Filling vacant positions (B-0171)
  - New positions (B-0171)
  - Exponential increase in retirement and the difficulty hiring and training new staff (Panel 2)
  - Growth in activities (Panel 2)
  - Increased complexity/new norms (Panel 2)
- GM suggests a need to go beyond inflation and customer or volume growth as a good indicators for determining reasonable RR/O&M cost growth

1. Operating Costs – in the Context of Overall RR

- O&M costs/customer and O&M costs/volume are standard measurements for determining the reasonableness of O&M costs and their historic growth
- GM itself uses these indicators (B-171, pp. 5-6)
- Inflation is also a classic indicator for the determination of reasonable cost growth
- Under the IM, RR was subject to a CPI-X formula in which GM was expected to keep RR under inflation (i.e. 0.3% lower) by increasing productivity in order to get an incentive.

1. Operating Costs - Drivers of 2013 RR

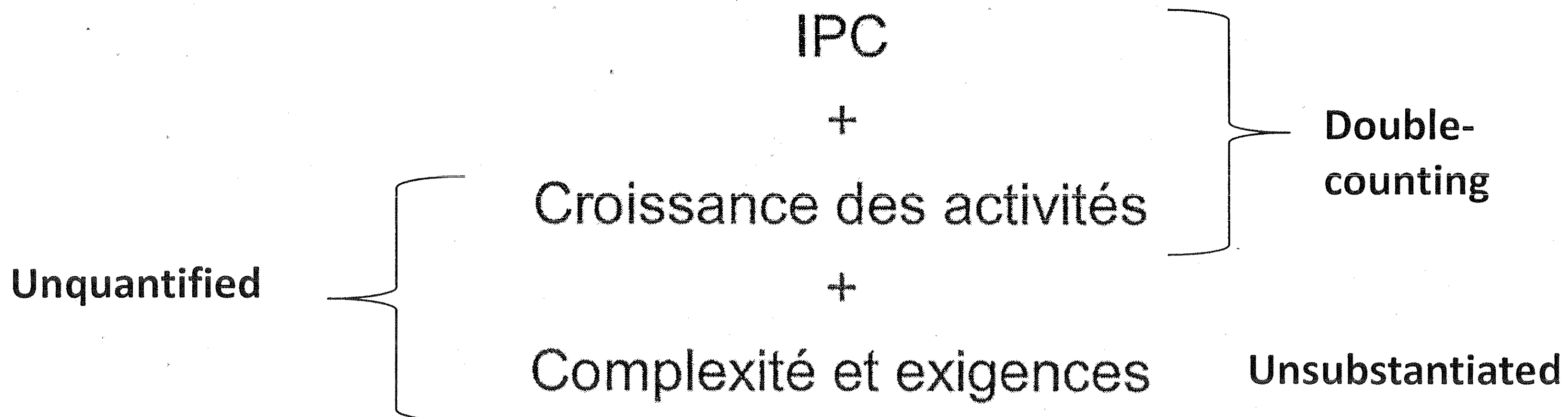
- GM justifies a 3.8% growth in RR (excluding exogenous/exclusions and pensions costs) (B-370, slide 4)
  - Based on CPI +Growth in activities + increased complexity/requirements

- "growth in activities" and "increased complexity/requirements" are unquantified drivers
- There is no appropriate justification that there has been a step increase in complexity/requirements/norms between 2012 and 2013 therefore OC does not accept this as a driver of RR increase.
- Among quantifiable factors: IPC is 2.1%; growth in activities is generally related to customer growth (also 2.1%)
- Customer growth also brings revenue (to offset costs) so should not counted as a 1:1 driver of RR; and it would be "double-counting" to do so and "double-counting" to simply add IPC + customer growth (as the slide suggests)
- No offsetting efficiencies quantified in B-370 and only $600k eventually quantified in Undertaking no. 8 (much less than the productivity factor required under the IM)

Le mode coût de service (CS) pour établir le revenu requis (RR) de 2012-2013 (suite)

→ Après exogènes, exclusions et le coût des régimes de retraite

- $RR/CS_{réel2012}$ = 56 808M$ + 447 636 M$
- $RR_{projeté2013}$ = 82 657 M$ + 464 693 M$ (+3,8%)



GazMétro

1. Operating Costs – Reasonableness of 2013 Salary and Wages Budget

- OC's recommendations concerning Salary Costs remain the same as those of the OC report:
  - The $4.9M/4.5% increase is too high
    - Driven by salary increases plus a major increase in headcount (PMO) (68 or 64 non-ANR (as per OC cross on Panel 2))
    - We note that headcount increase from of 1251 in 2008 (B-370, p. 5) to 1285 in 2012 (as per OC cross) was 34 positions over 4 years: so the increase of 64 from 2012 to 2013 is **double** the increase between 2008-2012.
    - An increase in headcount of this magnitude in a rebasing year is not supported, and in our view too high.
  - Maximum increase of the 2013 Salary and Wages budget should be equal to projected inflation (2.1%)
  - GM should offset compensation costs with reductions in other components of controllable operating costs (e.g. efficiencies such as those quantified in Undertaking no. 8)

1. Operating Costs – 3% is Reasonable Growth Level for RR

- OC proposes that 3% growth in RR (excluding exogenous/exclusions and pensions costs) would be a more reasonable level for 2013
- Projected inflation is 2.1% and projected customer growth is 2.1%; but it is double-counting to simply add these together;
- Customer growth also brings revenue (to offset costs) so should not counted as a 1:1 driver of RR
- 3% growth in RR is based on CPI of 2.1% + 1% (to account for customer growth offset by revenues from new customers) less 0.1% (offsetting efficiencies)
- The 3% growth is generous since it requires a very low level of offsetting efficiencies
- Note Salary Costs can be held at Inflation because some of the other O&M Costs (e.g. non-pension benefits) are going up beyond inflation, so an overall 3% increase in the RR is achievable.

1. Operating Costs – Total Operating Costs for 2013 Relative to IM Years

- Pacific Economics Group's Updated Report indicates that O&M costs averages a 0.61% annual decline over the period of 2002-2011
- Historic gain in O&M productivity (for which GM was well-rewarded under the IM) supports our view that the 4.5% increase in Salaries and Wages is too high.
- The performance objective of an IM is defeated if the rebasing year following the IM significantly reverses the productivity gains of the IM.

1. Operating Costs – Benchmarking of Operating Costs Against Other Gas Distributors

- GM has not participated in a recent benchmarking of operating costs against other gas distributors.
- OC attempted to benchmark GM's operating costs against 3 other Canadian gas distributors (all under some form of incentive regulation) over the period of 2007-2012; but GM defines operating costs differently and our available data was not comparable.
- OC recommended that the Régie order GM to undertake a benchmarking exercise for its Rate Year 2014 application especially given that GM will be under COS until at least 2015 and possibly longer.
  - According to GM Response to IR 8.1 in B-0315, pp. 21-22, it would be impossible to file such a survey for either the 2013 or 2014 applications; as such we recommend that it be undertaken for the 2015 application at the very latest.

1. Operating Costs – Pension Costs

- The increase in Pension costs is driving about 40% of the RR increase (or 2.7% of the 6.7%)
- GM maintains that it has no control over the pension cost increase. OC does not fully agree.
    1. GM has some control over its investment strategy related to the Pension Fund
    2. GM has <u>considerable</u> control over the regulatory treatment of the pension costs.
- OC has chosen not to address the investment strategy related to the Pension fund since this would be a challenging undertaking, requiring an expert to evaluate how much control GM has over the performance of the Plan.

1. Operating Costs – Regulatory Treatment of Pension Costs

- HOWEVER, appropriate regulatory treatment of the pension costs (using common best practices) could considerably mitigate the rate impact of the $18.8M increase in Pension costs by:
  - Spreading the costs over a number of years;
  - Using more precise (actuarial) forecasting methods;
  - Ensuring that the variances between pension forecasts and actuals are properly and fairly accounted for.
- The OC understands that this treatment is currently under advisement (*en délibéré*) following D-2012- 141.
- GM maintained in the hearings that it could not presume to discuss any prospective treatment of the pension costs until after a Decision is rendered in R-3815-2012.
- GM also has maintained that in its application for an extension to use the Old Methods of treating pension fund that it did not consider the rate impact of using this Old Method (Panel 2)

1. Operating Costs – Regulatory Treatment of Pension Costs

- OC agrees that this is not the forum to discuss the precise details regarding implementation of a prospective treatment of pension costs.
- However, given the magnitude of the impact of the pension costs on rates and the fact that this issue is still under advisement, OC is proposing a *sursis* for consumers. We reiterate the recommendation from the OC Report for 2013:
  - the Régie should direct GM to mitigate the impact of the pension cost increase by the use of a placeholder comparable to the budgeted 2011-2012 pension cost increase (i.e. a $3.8 million increase vs. an $18.8M until the transition to USGAAP and the actuarial method).
  - When GM makes the transition to USGAAP, the deferred balance of the 2013 contribution could be trued-up (for example, using a 3 or 5-year rolling average). The deferred balance of the 2013 contribution will be accounted for in a Pension Cost True-Up Variance Account (similar to the one created for EGD) and calculated based on the actuarial method when an up-to-date actuarial report is available.
  - Also when GM moves to USGAAP, we believe that the Régie should direct that the transition costs be amortized over a longer period as has been done in other jurisdictions.

1. Operating Costs – Regulatory Treatment of Pension Costs

- Following the Régie's Decision in R-3815-2012, GM should be ordered to move as quickly as possible to implement USGAAP and the actuarial method (which the Régie has approved in D-2012-077):
  - consistent with best practices
  - provides more accurate matching between forecasts and actuals
  - mitigates potential rate shocks at time of volatility in pension plan performance.
- Like FCEI, OC is also very concerned that the variances between pension forecasts and actuals are properly and fairly accounted for going forward. As such, going forward, we have recommended Pension Cost True-Up Variance Account , such as the one used by EGD, to true up the forecast and the actual pension plan contributions based on the performance of the plan.

2. 2013 Revenue – Customer and Volume Forecasts for D1

- OC IRs demonstrate that GM does not use:
  - econometric models to estimate customer additions (unlike many Canadian gas distributors including EGD and Union)
  - models to estimate Normalized Average Use per Customer (NAC)
  - Average Use True-Up Variance Accounts for small volume classes.
- Between 1999-2012, there has been an average annual customer addition forecast error of about 1000 (as further explained in C-OC-0056, Response 1.1 to GM IR).
- Average use per customer is declining and this trend is expected to continue in 2013 (OC Report, p. 17)

2. 2013 Revenue – Customer and Volume Forecasts for D1: OC Recommendations

1. Develop econometric models to forecast customer additions and NAC for small-volume heat sensitive customers in D1 (particularly D1.1, which contains the majority of residential customers, and potentially D1.2 if it contains sufficient heat-sensitive customers).
   - These models would incorporate many of the variables already used in the GM forecast
   - Use together with existing methods to improve the accuracy of the forecast.
2. Use an Average Use True-Up Variance Account to protect both GM and ratepayers from differences in forecast vs. actual NAC for D1.

3. Affiliate Transactions: The Question of Synergies

1. One the key objectives of regulation is to ensure that costs and benefits of the Distributor's business are fairly allocated between ratepayers and shareholders, and thus the regulated and non-regulated sides on the business.
2. In hearings, GM representatives, including Mme. Brochu, discussed the fact that there are synergies between the regulated and unregulated parts of the business; and that regulated customers benefit from the experience of employees in the unregulated business.
3. OC has reviewed the Affiliate transactions (and the Debt "reattribution" issue) to ensure that the synergies are fairly distributed between regulated and non-regulated customers.

3. Affiliate Transactions: OC Recommendations

- OC believes that the provision of services by GM to affiliates has now reached a level that requires a fully allocated costing study to ensure ratepayers are not paying for the costs of affiliated organizations.
- In other jurisdictions, for example in Ontario, the OEB Affiliate Relationships Code for Gas Utilities includes provision for fully allocated costing of shared services (OEB ARC Revised 2010, Sections 2.3.1 and 2.3.11).
- OC recommends that the Régie should direct GM to produce a fully allocated costing study for affiliate relationships for the next rate case.
- Once the FA (full allocation) method is developed and approved it can be updated periodically by the Company and provide regulatory compliance into the future.
- Mme Brochu suggested that GM has an "intrinsic" Affiliate Relationships Code. For the sake of transparency, OC suggests that GM should be ordered to formalize this code in writing and file it for review in the next rate case.

4. Sharing Mechanism – GM's Risk has Changed

- Since the application was filed (December 12, 2012), several factors have reduced GM's risk:
- ROE (*taux de rendement*) is more advantageous
  - GM was granted an exemption for the automatic adjustment formula for its ROE for 2013: the ROE is now set at 8.9% vs. 7.92% (which the formula will yield) (D-2013-036)
  - It is likely that GM will also be exempt from the formula for 2014 as well and that the 8.9% will be in place for 2 years.
- Cost of Service for at least 2 years if not more
  - D-2013-063 postponed consideration of a new IM until after the Régie's renders its decision on proposed modifications to GM's rate structure as part of its "vision tarifaire";
  - given that the "vision" won't be complete in time for the 2014 rate case, it is likely that a decision won't be rendered on the proposed modifications to the rate structure until 2015 at the earliest.

4. Sharing Mechanism – Revised OC Proposal

- Likely the earliest an IM can be put in place will be 2016
- With an ROE above the formula and COS in place for at least two years, GM's risk has been reduced and the proposed Sharing Mechanism (SM) is now even less appropriate.
- In light of the risk reduction in GM's environment and the beginning of multi-year COS, OC amends its proposed sharing mechanism as follows:
  - 100% of the overearnings (TP) equivalent to the first fifty (50) basis points of variation with respect to the authorized base rate of return would be allocated to distributor;
  - TP equivalent to the subsequent 50 (i.e. 50-100) basis points of variation with respect to the authorized base rate of return would be shared equally (50/50) between the distributor and the customers;
  - TP from 100-250 basis points would be shared 75/25 between customers and the distributor;
  - 100% of the TP in excess of 250 basis points of variation with respect to the authorized base rate of return would be allocated to customers;
  - 100% of underearnings (MAG) would be allocated to the distributor.

4. Sharing Mechanism – OC's Proposal – Cont'd

- Under COS, ratepayers should not have to bear underearnings:
  - GM's risk is lower than under IM
  - GM has access to risk mitigation tools not available under IM (notably ability to use more conservative forecasting)
- Under COS the SM is typically asymmetric in favour of consumers due to GM's ability to use conservative forecasting
- OC's proposed sharing mechanism is almost identical to those used at EGD and Union (both currently under COS).

5. Debt “Transfer”/Reattribution

- The complexity and confusion in the cross following Panel 3’s presentation of the Debt “Transfer” issue that an independent expert review is necessary for consumers or the Régie to ascertain that ratepayers are being held unharmed through this debt transfer.
- It is also misleading for Panel 3 to imply that what’s good for GM is good for the regulated customers; and to tell the regulator that in making a decision on the debt transfer, only GM’s overall balance was what was considered.
- As indicated above, one the key objectives of regulation is to ensure that costs and benefits of the Distributor’s business are fairly allocated between ratepayers and shareholders, and thus the regulated and non-regulated sides on the business. OC wishes to ensure that that the synergies are fairly distributed between regulated and non-regulated customers.

5. Debt "Transfer"/Reattribution – OC's Proposal

- The presentation of Panel 5 has reinforced the case for OC's proposal, as outlined in our Report and further elaborated on in Response to GM IR 4 (C-OC-0050, pp. 4-6). In summary:

  (i) we are not in a position to determine with certainty that ratepayers will in fact be held harmless and it may not be cost effective to submit the proposal for full review by a finance expert;

  (ii) there is a real possibility that ratepayers will be somewhat disadvantaged, at the very least in terms of increased complexity and regulatory oversight (undertaken in attempt to guarantee that ratepayers will be held harmless);

  (iii) GM will obtain considerable benefits from this proposal – benefits that GM valued at over $18 million.

- Given this situation, in order (a) protect ratepayers from the risk of increased costs; (b) share some of the synergies between ANR and daQ, we suggest that GM share a portion of the benefits with ratepayers.

5. Debt "Transfer"/Reattribution – OC's Proposal

- A reasonable sharing of the of the benefits could be in the order of $3M (see Response to GM IR 4.3 (C-OC-0050, p. 6 for further justification of this amount).
- Advantage: this proposal could be readily implemented absent an expert review and associated high transaction costs.
- Based on expert review, a different (and likely larger) sharing of the benefit might be found appropriate.
- OC agrees with the Régie's analogy of the debt transfer with the optimization of a financial transactions (for which the Régie recently determined a sharing of benefits of 90/10 in favour of ratepayers, D-2013-054, p. 9).
- Cost of the expert review should be borne by GM shareholders and not ratepayers since this transaction is being undertaken to benefit ANR.

5. Debt "Transfer"/Reattribution – OC's Proposal

- Even Mme. Brochu pointed out in her opening remarks that she's an economist and not a finance specialist, indicating that even the President is reluctant to venture an opinion on this issue absent a specialist; she points out though that the one who takes the risk should receive the benefits.
- In this case, a potential risk is being attributed to the ratepayers, who are not able to fully evaluate whether they are being held unharmed without a full review by a financial expert. AND GM is offering no offsetting benefit for the risk.
- If GM does not wish to share the benefits/synergies with ratepayers and offset their risks, we suggest that GM reattribute the debt back to those whom it is benefitting, the ANR.
- Ratepayers would then have the reassurance of being truly held harmless.

6. Rate Strategy and “Rate Vision”

- OC is concerned that GM’s rate proposal for 2013 is neither appropriate, nor sufficiently transparent. A “quasi-uniform” rate increase across all of the D1 rate blocks (“*paliers*”) will in fact change the level of cross-subsidization between small D1 and large D1 customers.
- By applying a uniform variation across D1, GM is in effect, averaging out the FEÉ credit across D1.
- The lack of transparency related to the 2013 rate proposal raises deeper concerns surrounding transparency in rate-making and the application of GM’s rate vision.

6. Rate Strategy and "Rate Vision" – Recommendations Re. D1 Uniform Rate Increase

- Because of the importance of properly allocating the FEÉ credit by rate class, and OC's more general interest related to transparency in rate-making, Régie should order GM to redo its rate proposal (including B-202, GM-15, Doc 8, Grilles actuelle et proposées and B-203, GM-15, Doc 9) using as input the rate allocation that reflects a differentiated FEÉ credit by rate class (i.e. col (1), Table 1, B-0280, p. 12) instead of the uniform variation proposed (i.e. col (2) of the same Table).

6. Rate Strategy and "Rate Vision" – OC's Overall Recommendations

- OC supports the more rigorous and transparent process for rate-making set out by TCE in its IR13 (B-0264, GM-18, Doc 7, Reference A, p. 52 and Preamble pp. 53-54).
- We agree with TCE that the current and future rate proposals should present the underlying cost data in a clear and transparent manner and that any modifications from underlying costs should be explicitly presented and justified.
- The rate allocation table, the rate schedule and other elements of the rate proposal should provide sufficient information for the Régie and intervenors to easily follow the rate-making process.

6. Usefulness and Treatment of the NEB Costs Claimed for ACIG

- The request to grant ACIG intervenor funding for its participation in a case before another regulator (NEB), where ACIG is not eligible for such funding, is unusual.
- However, because of the high quality of the work done by ACIG and GM before the NEB in the recent case concerning the TCPL Mainline tolls, OC will not oppose the granting of ACIG's NEB Costs. The NEB case was important for GM and its ratepayers, and the outcome was positive for consumers, including residential consumers.
- We wish to emphasize that this is an exceptional circumstance and should not set a precedent.

6. Usefulness and Treatment of TCPL's NEB Costs

- Given that Mme. Brochu has expressed concerns about having sufficient firm capacity to ensure reliability of supply and has promised us that the TCPL is an « avant-première » (presumably for other TCPL-related cases), OC wishes to make some clear recommendations for intervenor participation going forward:
  - If GM wishes to strengthen its case by obtaining guidance and input from the perspective of stakeholders who represent the public interest, GM should consult and fairly compensate all intervenors representing consumer groups;
  - The parameters of such participation should be well-defined in advance.
  - Request for intervenor funding for the ACIG and other consumer groups should not be post-facto, but should instead be made in advance to the Régie (as is the usual practice in regulatory cases).

7. Costs Incurred for ROE Applications

- During the four rate cases that examined ROE since 2007 with the assistance of external experts (this excludes CT 2009 and 2011 but includes the present case):

  the average amount per year spent on the ROE portion of the case has been about $1M.

- ($909k according to data from B-0242, GM-18, Doc 10, Response to OC IR 1.1, pp. 1-2; and 916k with updated data from Undertaking No. 7 to include full legal fees; however the above estimates are low because GM was not able to provide all the costs)

7. Costs Incurred for ROE Applications

- In the current filing, while GM was supposed to be under an automatic adjustment formula for ROE, and without any advance approval from the Régie, these costs have already amounted to almost $500k ($462k according to Undertaking No. 7 and this excludes intervenors' fees).
- GM ratepayers pay twice: about $1M/year for the ROE postion of the cases and then for the result of the increase in the ROE itself.
- Currently GM has every incentive to continue to push for increases in its ROE: if it wins, the regulatory costs are borne by the ratepayer and GM shareholders benefit from an increased ROE; if it loses, regulatory costs are still borne by the ratepayers and GM can (and does) revisit the issue to develop and present a new ROE strategy for the following year's rate proceeding.

7. Costs Incurred for ROE Applications – OC Recommendations

- In light of the above, GM's costs for the ROE portion of its 2013 application (estimated at $462k as per Engagement no. 7) should be disallowed.
- Going forward, GM's regulatory costs associated with the ROE portion of the application should be disallowed for a period of at least 3 years, following a rate proceeding when costs associated with an ROE are allowed by the Régie.
- OC understands that it is an accepted part of the regulatory process to allow GM and intervenors to collect their regulatory costs in COS via the rates. But after spending over $3.7M since 2007, it is fair to say that GM has abused this privilege with regard to the repeated applications, which are not in the public interest.