CANADIAN FEDERATION OF INDEPENDENT BUSINESS (CFIB) BRIEF

APPLICATION REGARDING THE GENERIC MATTER BEARING ON THE ALLOCATION OF COSTS AND RATE STRUCTURE OF GAZ MÉTRO

Prepared as part of file
R-3867-2013 Phase 3
of the Régie de l'énergie (Québec)

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1. Introduction

As part of its 2016–2017 rate case, Gaz Métro proposed a methodology for the acceptance of expansion projects with an expectation of profitability. In its decision D-2016-090, the Régie deferred this issue to the next rate case. Subsequently, this case was postponed again, this time to file R-3867-2013. In the meantime, Gaz Métro has amended its proposal based on the concept of acceptable minimum profitability threshold with a new approach based on the profitability index. CFIB has analyzed this latest proposal based on recommendations regarding the role of the Régie, the process and decision criteria for investment choices, and the calculation of profitability per se.

2. Role of the Régie

In its application, Gaz Métro is asking the Régie "to note" the modified methodology for analyzing profitability and the criteria for accepting development projects.[1]

In response to a question, it also states that the Régie will be able to rule on the usefulness and prudence of the investments that Gaz Métro will have made under this methodology, as part of the examination of rate applications.[2]

Thus, the Gaz Métro application suggests that the Régie does not have to regulate the method and criteria used to accept or refuse development projects of less than $1.5 million, but simply the result of Gaz Métro's internal process.

In its decision D-2017-032, the Régie noted an ambiguity regarding the requirement imposed on Gaz Métro with respect to an investment decision. It wrote:

> *"[104] That said, as a result of this hearing, the review panel discovered an ambiguity as to whether an authorized methodology exists for investment projects under $1.5 million. Gaz Métro argues in the review case that it uses a methodology internally but that it does not result from an order issued by the Régie38. Yet in file R-3970-2016, Gaz Métro filed several pieces of evidence suggesting that it felt bound by a methodology that required the achievement of the PCC (prospective capital cost) for the projects in its Development Plan."*

CFIB disagrees with Gaz Métro that the network development policy does not require the approval of the Régie. It considers that the fact that a project is below the threshold of $1.5 million does not justify that it should not be submitted to the Régie for examination with the same rigour as larger projects.

According to CFIB, it is not at Gaz Métro's discretion to decide on the criteria that justify the customer connection and, in particular, the criteria for profitability. Connecting non-profitable customers

[1] B-0275, p. 4
[2] B-0253, answer 1.13

imposes a burden on all customers and the public interest arbitration in these circumstances must be the responsibility of the Régie and not the distributor.

CFIB believes that the Régie should not only take note of the proposal, it should set certain parameters within which Gaz Métro should be required to operate. In the absence of such an approach, CFIB submits that the Régie will not be able to ensure that investments are prudent. Unlike Gaz Métro, CFIB does not believe that it is possible for the Régie to draw such a conclusion in the context of rate cases unless it does a complete validation of the processes and criteria for each case.

In addition, the investments must be processed by the Régie as part of the annual report before being presented in the rate case. Thus, according to Gaz Métro's proposal, the Régie would establish an overpayment or loss of profit in the annual report before approving the rate base level.

According to the approach advocated by Gaz Métro, changes to processes could be put in place without the Régie being informed.

By setting the analytical framework and the criteria for accepting projects, the Régie would avoid having to carry out a systematic verification of the application of the processes and criteria.

Thus, according to CFIB, the Régie should not limit itself to acknowledging the process and criteria determined by Gaz Métro. It should set the criteria it deems appropriate and require Gaz Métro to secure approval of any changes to its method of evaluating profitability before implementing them.

3. Individual project profitability versus portfolio approach

In response to a question from the Régie on project acceptance criteria, Gaz Métro responded:

> *"Gaz Métro points out that in its evidence (R-3867, B-0277, Gaz Métro 7, Document 4), it submits to the Régie the criteria for accepting New Method development projects which will maximize the positive spinoffs for customers. Based on Black & Veatch's recommendations, Gaz Métro intends to use the profitability index approach used by Fortis BC, Union Gas Limited and Enbridge Gas Distribution. Thus, rather than referring to a minimum acceptable threshold ("MAT"), Gaz Métro uses a PI in the New Method.*
>
> *Essentially, there are two decision criteria related to PI.*
> *1- For individual projects with no densification potential, the PI target is greater than or equal to 1. If the project has no densification potential and this PI target is not reached, Gaz Métro may require a contribution from the customer in order to achieve a PI of 1.*
>
> *2- For individual development projects with densification potential, the PI target is greater than or equal to 0.8. If the PI is less than 0.8, but there is a potential for densification,*

Gaz Métro may require a contribution from the customer in order to reach a PI of 0.8.

Gaz Métro emphasizes that these decision-making criteria are part of the internal governance rules that the company sets itself to frame the decision-making process regarding the authorization of new sales and new development projects. In addition, Gaz Métro will respect these decision points, except in very rare cases. Such cases would result from the fact that it is essential that Gaz Métro be able to enjoy operational flexibility and discretionary leeway in the business decisions it makes in the normal course of its operations. To that end, Gaz Métro must be able to acquire assets that are useful for the operation of its network, while acting in accordance with the standard of prudence. Consequently, in certain exceptional circumstances, Gaz Métro could carry out projects outside of these guidelines.

Lastly, this approach is also consistent and in accordance with the Conditions of Service and Tariff in effect on March 31, 2017. Article 4.3.4 stipulates that the distributor may, on entering into the contract, agree with the customer on a financial contribution payable by the customer. Please refer to the answer to question 1.10 of the Régie's RFI 10 (R-3867, Gaz Métro 9, Document 1), as well as the answer to question 3-7b of SE-AQLPA's RFI 3 (R-3867, Gaz Métro 9, Document 7)."[3]

In general, Gaz Métro's development approach involves a profitability analysis for each project. As a result, each of the authorized projects must have a positive expectation of profitability. In other words, a project without expectation of profitability would not be authorized on the pretext that the expected return of another project would exceed the break-even point and that, jointly, the two projects would be profitable.

However, despite this general rule, Gaz Métro mentions that it could carry out certain non-profitable projects on an exceptional basis.

CFIB supports the approach that the profitability of each project and the investment decision are assessed on an individual basis. According to CFIB, this approach maximizes the economic benefits of network development.

However, with respect to the execution of projects that are exceptionally non-profitable, Gaz Métro does not explain what these exceptional cases would be and why it would be essential that it have operational flexibility and discretionary leeway. CFIB reiterates that it is not at Gaz Métro's discretion to make non-profitable investments. Connecting non-profitable customers imposes a burden on all customers and the public interest arbitration in these circumstances must be the responsibility of the Régie and not a private stakeholder.

[3] 3 B-0281, answer 4.3

In the absence of satisfactory explanations, CFIB has difficulty understanding why Gaz Métro's operational leeway is so essential to the exercise of its mission. According to CFIB, Gaz Métro must explain more concretely the situations that would justify this discretionary need. In all cases, in the event that Gaz Métro carries out projects outside the project's individual profitability indicators, each of these projects should be presented in the annual report and the appropriate justifications should be given.

4. Governance process

Gaz Métro proposes the establishment of a governance process that, in its opinion, would better take into account all future benefits resulting from these development projects.

Under this process, projects for which the present value of the transaction cash flows for signed customers exceeds 80% of the initial investment (0.8 profitability index) [4] would go forward conditionally on the presence of a reasonable expectation of achieving a PI of 1 or expectation of profitability.

CFIB is in agreement with the consideration of all benefits and costs in the analysis of projects. However, it is concerned about the significant inaccuracy in the evaluation of the expectation of profitability.

To determine whether the expectation of profitability condition is met, Gaz Métro compares the number of additional customers theoretically required to reach the break-even point with the potential for adding customers that it evaluates. If it exceeds the theoretical threshold, it authorizes the project. Moreover, in addition to the number of customers, Gaz Métro indicates that it takes into consideration the volume in cubic metres for each gas application according to the type of building, the anticipated time of construction of the building, the market and the history of the customer's consumption, when available.

However, the way in which this additional information is concretely taken into account remains unclear. In addition, no such information appears in the sample project reports provided by Gaz Métro at CFIB's request.

For example, in the Senneville project report, assumptions about when unsigned connections or the volume of consumption used for densification customers are absent. In addition, no information is available on the actual penetration rate of natural gas at the time of the analysis, whereas this information seems useful for judging the realism of the forecasts.

The Cowansville project also raises questions. The case for this project indicates that 30 additional customers are required to ensure profitability out of a total potential of 39, of which 15 assume the addition of 100 m of additional pipelines. However, there is no indication of the type of customers considered in the sensitivity analysis. Potential customers can be either large single-family houses or row houses. In addition, the report contains no indication of the electricity penetration rate as of the

[4] 4 B-0298, p. 62

report date and, more generally, the probability of reaching the threshold of 30 additional customers. The report also does not indicate profitability if the extension of the 100 m pipeline does not occur. It is unclear to CFIB how a manager could conclude that the Cowansville project is more likely than not to break even on the basis of the information presented in the report.

In short, CFIB is concerned that the process presented by Gaz Métro does not appear to provide for a very rigorous comparison of the nature of the customers theoretically required to that of potential customers nor does it contain any information on the assumptions used for the purposes of a sensitivity analysis and the probability of breaking even. CFIB believes that the proposed process is too vague and is likely to lead to poor investment decisions.

According to CFIB, rather than setting a threshold in terms of the number of customers and verifying the achievement of this threshold, it would be more appropriate to formulate a concrete forecast taking into account the densification potential and validating the profitability of this forecast as this was done in the past. Such an approach would force the establishment of accurate forecasts of customer additions on the basis of a concrete assumption that Gaz Métro should be able to defend taking into account the specific characteristics of the projects.

Gaz Métro also offers special conditions for street paving and industrial park projects. According to CFIB's understanding, projects of these two types having an expectation of profitability would be funded by a $1.5-million envelope even though their PI is less than 0.8. The contribution of this fund to the project would be equivalent to what is needed to bring the PI to 0.8.

Gaz Métro adds that "for road repaving, the only acceptable case with a profitability lower than the MAT is to aim for a potential project beyond the repaving work planned by the city. The costs associated with road repaving will be included in the potential project identified and will eventually demonstrate a profitability equal to or greater than the PCC."[5] (our underlining)

This statement is consistent with the agreement between Gaz Métro and the UMQ, which implies that, in any event, Gaz Métro would not be able to connect customers to the repaved portion within five years of repaving.

Gaz Métro also indicates that it will "prioritize the most promising projects in terms of densification potential in order to allocate the budget for industrial park and road repaving projects. Obviously, these projects will have to have a densification potential making it possible to achieve a profitability index of 1. In addition, another element to consider regarding the allocation of this budget is that the development plan must reach a profitability index greater than or equal to 1.1."[6] (our underlining)

[5] B-0298, p. 43
[6] B-0281, p. 10

Based on these statements, CFIB supports in principle the approach proposed for repaving and industrial park projects since the funded projects would presumably reach the break-even point. However, CFIB is still concerned about the application of the project analysis process, namely with respect to evaluating the potential for adding customers, particularly in the case of street repaving. Moreover, it is unclear how the amount of the contribution to the project would be established in cases where no customer is identified at the time of repaving or developing the industrial park.[7] CFIB's understanding is that a PI could not be calculated in such a situation since there would be no value in the numerator.

Therefore, in these cases as well, CFIB believes that it would be better to produce a complete profitability calculation that includes an accurate forecast of the densification potential.

5. Contribution applications

Gaz Métro proposes asking customers for contributions in the following two circumstances.

> *"1- For individual projects with no densification potential, the PI target is greater than or equal to 1. If the project has no densification potential and this PI target is not reached, Gaz Métro may require a contribution from the customer in order to achieve a PI of 1.*
>
> *2- For individual development projects with densification potential, the PI target is greater than or equal to 0.8. If the PI is less than 0.8, but there is a potential for densification, Gaz Métro may require a contribution from the customer in order to reach a PI of 0.8."*[8]

Although Gaz Métro uses conditions in the description of its criteria, CFIB understands that it would effectively require contributions in these circumstances because if it did not do so, the PI target would not be reached and the project would not go ahead.

CFIB's understanding of the proposed application in the first case is similar to the current practice and it agrees with this approach.

However, in the second case, CFIB understands that a contribution would sometimes be requested when profitability would not require it. For example, in a case where the PI would be 0.7 but the eventual PI would be 1.2, a contribution would still be required to bring the PI to 0.8. According to CFIB, this situation is unfair to affected customers. Of course, according to its proposal, Gaz Métro would not have an evaluation of the eventual PI and could not detect these situations. Nevertheless, unjustified contributions will inevitably be required if the qualitative approach proposed by Gaz Métro is retained.

CFIB submits that the search for greater equity in contribution requests supports a comprehensive profitability calculation that includes the densification potential as previously recommended.

[7] See for example, B-0298, answers 12.2 and 12.3.
[8] idem

6. Profitability analysis

Contractor overheads

Gaz Métro proposes two major changes to the profitability analysis with respect to projects, i.e. the withdrawal of the profitability calculation from corporate overheads and contractor overheads. Its costs would be maintained only with respect to the profitability analysis of the project portfolio as a whole.

In support of its position, Gaz Métro submits that these costs are fixed and do not depend on the number or nature of the projects carried out. It adds that these costs do not change over time depending on the size of the investments.

CFIB is not convinced by Gaz Métro's explanations regarding contractor overheads. First, the analysis of the nature of several entrepreneur cost items suggests that these cost should vary with the scale of the investments. Gaz Métro describes contractor overheads as follows:

> *"The Contractor shall not provide any amount related to the fixed costs in the Service Records provided for the performance of the Work (price schedule submitted during the call for tenders based on the nature of the work). Contractor overheads provided for in the General Contract, and invoiced quarterly, consist of two main categories, namely operating expenses and salaries.*
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> *In the case of fixed operating expenses, they are detailed as follows:*
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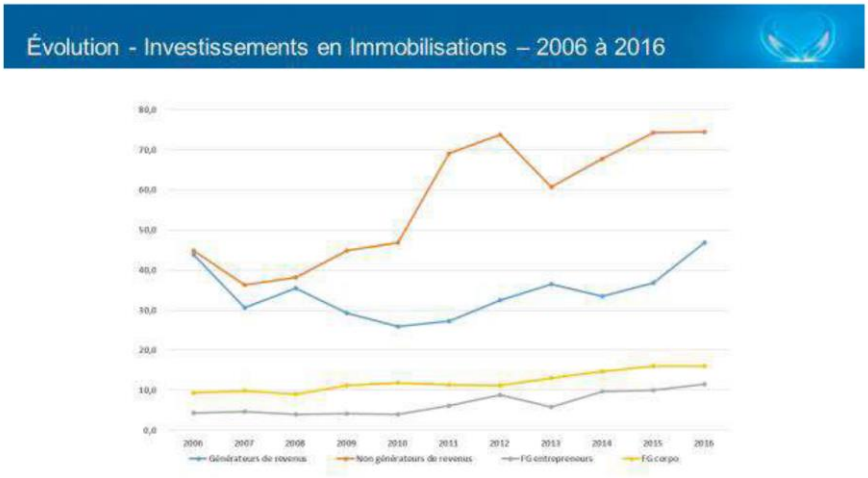
> - *Contractor expenses relative to the place of business (rent, electricity, heating, maintenance, insurance, property taxes, telephony, information technology, etc.);*
> - *Costs related to storage areas;*
> - *Depreciation (buildings, computer equipment, rolling stock (trucks),*
> - *specialized equipment, etc.);*
> - *Lease of long-term equipment (rolling stock);*
> - *Costs relating to training workers in gas activities.*
>
> *In the case of fixed wages, there are four categories:*
>
> - *Management salaries (president, VP, operations directors, project managers, others);*
> - *Field operations salaries (superintendent, general foreman, pipefitter foreman, project managers, planner, health and safety coordinator);*
> - *Office employee salaries (clerk, accounting, billing, measurement, quality plan, ISO);*
> - *Yard employee salaries (dispatcher, stock keeper, yard workers)."*[9]

[9] B-0286, answer 2.6

By their nature, it seems that many of these cost items should vary with the magnitude of the anticipated work. For example, equipment rental, the number of employees trained in gas activities, and the number of employees in field operations will depend on the contractor's expectations regarding the amount of future work it will have to perform, particularly in relation to Gaz Métro's projects.

In addition, if a contractor works with several customers, it may allocate a larger portion of its fixed costs to Gaz Métro if it anticipates an increase in the portion of its activities attributable to Gaz Métro. Thus, the fact that certain costs are fixed does not imply that the portion supported by Gaz Métro is.

In addition, the visual analysis of the evolution of the level of investments and contractor overheads[10] suggests a certain correlation.



The above graph shows that several significant variations in the level of investments are associated with important variations in the same direction for contractor overheads. Based on an evaluation of the values presented in the graph, CFIB calculates a correlation greater than 80% between contractor overheads and the level of investments.

It is important to note that even though contractor overheads are set at the beginning of the year, this does not imply that they are not influenced by the scale of the investments if this magnitude can be anticipated in a reasonably reliable manner. In other words, the mere fact that the general contract occurs before the execution of the investment work is not sufficient to conclude that the work has no influence on the contractor overheads.

Based on the information available, CFIB submits that contractor overheads should be maintained in the project profitability analysis. CFIB considers that it would be useful for Gaz Métro to produce the figures of the curves in answer 2.3 of Exhibit B-0286.

[10] B-0286, answer 2.3

7. Summary of recommendations

- **CFIB submits that it is up to the Régie and not Gaz Métro to define the method and criteria used in the analysis of investment projects of less than $1.5 million.**

- **CFIB recommends that the Régie require criteria that ensure the individual profitability of each project in general. Flexibility may be allowed so that exceptionally non-profitable projects are carried out; however these projects should be presented and justified as part of the annual report cases.**

- **The methodology for analyzing project profitability should be based on an accurate projection of customer additions taking into account project and customer characteristics rather than a qualitative approach comparing a theoretical number of required customers and a potential number of customers.** This approach would have the advantage of avoiding any discrepancy between the characteristics of customers considered in the sensitivity analysis and those of potential customers. It would also require Gaz Métro to formulate concrete hypotheses regarding the addition of anticipated customers, which should be documented. Lastly, an accurate calculation would avoid the imposition of an unfair contribution on certain customers.

- **Contractor overheads should be maintained in the profitability analysis for individual projects.**