RÉGIE DE L' ÉNERGIE - R-3867-2013 (PHASE 3B)

SUMMARY

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POINTS IN COMMON WITH ÉNERGIR:

- **Separate and less stringent evaluations for individual projects than development plan**
- 0.8 with densification, 1.0 without densification
- Special treatment of street paving and industrial parks
- **More stringent evaluation of development plan**
- Include common costs (corporate and contractor overheads, future capacity)
- Higher profitability index
- Allowance for inactive meters (5% residential, 15% non-residential), recognizing that gas use is less than expected amounts when premises are empty (between occupants, under rehabilitation, etc.)

KEY DIFFERENCE

- **Profitability Index for the Portfolio**
- *Énergir claims that a Profitability Index of 1.1 for the portfolio adequately reflects risk and uncertainty.*
- **Two major asymmetrical risks left out** – that tend to reduce profitability
- 1. Potential for reduced project life due to electrification to reduce greenhouse gases as presented by ROEÉ
- 2. Current cost of capital is at historic lows and is likely to increase
- **RAISING PROFITABILITY INDEX TO 1.3 ADDRESSES THESE RISKS.**

ADDITIONAL DIFFERENCES IN EVALUATION

- The Company includes residential, commercial, and VGE projects (both new construction and load increases ("ajouts de charge") to construct its portfolio.
- A portfolio of new residential and commercial connections (PMD) needs to be adequately profitable (PI of 1.3).
  - e.g, projects in A-0167, Column 7 (Total PMD, Nouveaux Clients).
- VGE projects should be evaluated separately from residential and commercial.
  - Should be adequately profitable (PI of 1.3), not subsidize others and not be subsidized by others.
  - e.g., projects in A-0167, Column 10.
- Low-cost "ajouts de charge" should be analyzed separately, rather than increasing portfolio profitability relative to more expensive new connections.
  - e.g., projects in A-0167, columns 8 and 11.

COST DIFFERENCES

- Most costs and financial parameters either are not controversial or were decided in Phase 3A.
- Five Remaining Cost Issues in My Evidence
  - Need for meter reinvestment within 40-year evaluation period
  - Two types of OPEX overhead costs (working capital and human resources)
  - Incremental capacity reinforcements (both capital and O&M)

NEW METER REINVESTMENT

- Meters have much shorter depreciable life (durée de vie) – 18 years – relative to mains and services.
- Likely to need a new meter once during a 40-year evaluation period.
- 40 years may be average engineering life, but, unlike mains and services, meters will be needed in the middle of the evaluation period.
- For reference, average meter cost is $283 (page 12 of my report), but calculation needs to be specific to the project, as larger commercial and industrial projects have more expensive meters.
- Terminal value for life beyond 40 years should not be considered for mains and services because of uncertainty regarding useful life identified above.

TWO OVERHEAD COSTS

- **Working Capital (Fonds de Roulement)**
- Distributor must pay its bills for operating expenses before it receives money from ratepayers. 0.4% of all OPEX (page 10 of my evidence)
- **Human Resources Department Overhead**
- Not included in corporate overheads for capital.
- Long-run incremental cost of human resources department would vary with number of workers.
- Use salaries and benefits as proxy - 4.6% of company labor.
- Use 2.3% of OPEX to reflect that many OPEX costs are not labor (page 11 of my evidence)

NEW CAPACITY REINFORCEMENTS (CAPITAL AND O&M)

- Énergir and intervenors agree that some amount of capacity reinforcements is needed.
- Two different methods of calculation of capital – by Énergir (routine reinforcements under $1.5 million), and Mr. Chernick (cost per unit of peak demand over longer period of time). (Experts' Report line 33)
- **O&M required for new capacity reinforcements** (regardless of method)
- These indirect O&M costs couldn't possibly have been considered in Phase 3A, because the treatment of reinforcements was not in Phase 3A.
- Apply Phase 3A costs of inspections and corrective maintenance to metres of new main reinforcements – calculated as 0.25% of capital cost per year. (pages 13-14 of my evidence)

DIFFERENCES IN RECOMMENDED <u>EX POST</u> EVALUATION OF PROJECTS

- Énergir suggests aggregate analysis of projects with PI of 0.8 to 1, but more information is needed:
- **Project Specific Data (pages 14-15 of my evidence)**
    - Use to determine if changes need to be made in the future to profitability parameters or forecasting methods.
    - Use to determine if there systematic issues in forecasting costs or revenues from types or locations of projects.
    - Specific analysis of special projects (repaving and industrial parks) is necessary to determine if the parameters for these projects are reasonable for continued use. (page 8)
- **<u>Not</u>** trying to second-guess utility's past decisions and disallow projects.

CONCLUSIONS

- **Portfolio P. I. of 1.1 does not adequately reflect uncertainty**
  - Potential shorter economic life of projects
  - Historically low cost of capital
- **Use Portfolio P. I. of 1.3 to cover off additional risks**
- Evaluate VGE and "ajouts de charge" separately to focus on profitability of new residential and commercial development.
- Include cost of meter reinvestment and several other indirect cost elements not identified in Phase 3A.
- Provide additional information for ex post project evaluation.

DISCOUNT RATE (TAUX D'ACTUALISATION)

- In the Experts' Report, all parties supported the mixed discount rate (**5.28%**), as proposed in GM's evidence (B-0277, p 14, line 11).
- ***Énergir recently changed its position***. Energir now proposes to use the after tax discount rate (**4.87%**) according to an answer to a Régie IR (B-0405, Réponse 2.1)
- The after tax discount rate measures profitability from the perspective of shareholders.
- The mixed discount rate measures the profitability from the perspective of ratepayers, who must pay grossed-up income taxes and do not receive the benefit of the tax deduction on bond interest.
- The right way for a regulator to measure profitability is from the perspective of **ratepayers**.
- A project that just breaks even at the after-tax discount rate will be unprofitable to ratepayers and will raise rates.