

**RESPONSES OF EXPERT PAUL L. CHERNICK  
TO REQUEST FOR INFORMATION NO. 1 OF  
SOCIÉTÉ EN COMMANDITE GAZ METRO ("GAZ METRO") (B-0326)  
REGARDING THE GENERIC MATTER BEARING ON THE ALLOCATION OF  
COSTS AND RATE STRUCTURE OF GAZ MÉTRO,  
R-3867-2013, PHASE 3, SUBJECT B**

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- 1. References :**
- i) Exhibit C-ROEE-0112, page 10
  - ii) Exhibit C-FCEI-0181, Gaz Metro's response to the Information Request no. 2 of Option consommateurs (OC), Gaz Métro-9, Document 12, response to question 8.1, page 13
  - iii) Exhibit C-FCEI-0185, Gaz Metro's response to the Information Request no. 3 of the Canadian Federation of Independent Business – Quebec Division (CFIB ), Gaz Métro-9, Document 11, response to question 2.10, page 9

**Preamble :**

- i) "Gaz Métro estimates that these costs amount to a 27.1% adder on top of the projected cost of the projects, so for every \$100,000 of contractor direct costs that Gaz Métro plans for the development year, Gaz Métro obligates itself to pay the contractor an average of \$27,100 in fixed overhead fees (B-0278, p. 26; B-0293, response to question 8.1)."
- ii) "In the methodology currently used by Gaz Métro to evaluate a development project's profitability, Gaz Métro allocates 27.1% to general contractor costs in the calculation of a project's cost. This specific allocation is used for the a priori evaluation of a development project's profitability in order to determine whether it will be approved or not.

Once the project is approved and carried out, there are no general contractor costs allocated to each of the development projects in Gaz Métro's accounts. The general contractor costs paid by Gaz Métro represent a fixed amount per contractor initially

established in the general agreement and are entirely capitalized regardless of the number of projects carried out.”

- iii) “The general contractor expenses are fixed in the General Contract between Gaz Métro and the contractors based on the contractors’ fixed costs, and pertain to their fixed operating expenses and wages. They are established in the context of the call for tenders for the General Contract and are part of the price schedule for which contractors are required to bid prices.”

**Request :**

- 1.1** Based on preamble ii) and iii), please confirm that, contrary to the statement in preamble i), fixed costs payable to contractors are not related to project investments?

**Response to request 1.1 :**

Not confirmed. If Gaz Métro ignores the scope of its capital plan in committing to fixed payments to contractors, the Régie should investigate whether Gaz Métro is imprudently committing to large fixed payments without considering whether it would need the contractor capacity reserved by those payments or whether it would be less expensive to pay for services on an as-needed basis.

- 2. Reference :** Exhibit C-ROEE-0112, page 15

**Preamble :**

“Second, Gaz Métro reports a posteriori results as a percentage increase in internal rate of return, or IRR, from the a priori to the a posteriori analyses; it is not clear how a change in IRR changes the profitability ratio.”

**Request :**

- 2.1** Please explain what you mean by “it is not clear how a change in IRR changes the profitability ratio”?

### **Response to request 2.1**

The IRR is the discount rate at which the net present value of projected revenues and costs is zero. The profitability ratio is the ratio of the present value of projected revenues to the present value of projected costs, at a fixed discount rate, such as Gaz Métro's cost of capital.

There is no simple relationship between the change in IRR (as a result of a change in cost or revenue stream) and the change in the profitability ratio. Hence, the Régie cannot easily convert a change in IRR (such as between a priori and a posteriori analyses) to a change in the profitability ratio.

### **3. Reference :** Exhibit C-ROEE-0112, page 20

#### **Preamble :**

“Based on the experience that Gaz Métro reports for the last three years, 30% to 35% of large customers would have left the system by then; if there are financial crises or economic downturns in the next 25 years, the business failure rate may be higher.”

#### **Request :**

**3.1** Please provide the evidences, references and calculations that support your statement in preamble i): “30% to 35% of large customers would have left the system by then; if there are financial crises or economic downturns in the next 25 years, the business failure rate may be higher”.

#### **Response to request 3.1 :**

The customer failure rates discussed by Mr. Chernick on page 19 (from B-0308, response 11.6) are 1.5% to 1.8%, implying that 98.2% to 98.5% of customers survive from one year to the next. After 25 years, assuming that the decay rate is constant, the survivors would  $0.98225 = 64\%$  to  $0.98525 = 69\%$ , so 31% to 36% of large customers would be expected to have shut down.

The failure rates that Gaz Métro provided were from a period of relative business stability (2014–2016). When a new financial crisis or cyclical economic downturn hits, the failure rate

would be expected to rise, especially among the heavy industries that would tend to operate as anchor customers for Gaz Métro's line extensions. The following graph summarizes this effect for the state of Wisconsin before, during and after the 2008/09 recession. (From [http://host.madison.com/wsj/business/plant-closings-plummet-statewide/article\\_7a20e972-0348-5abf-9a9b-370efa677486.html](http://host.madison.com/wsj/business/plant-closings-plummet-statewide/article_7a20e972-0348-5abf-9a9b-370efa677486.html) )

