



# MNP Assessment of Gazifère Corporate Services Cost Allocation

## MNP Presentation to the Régie de l'énergie



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# Presentation Agenda

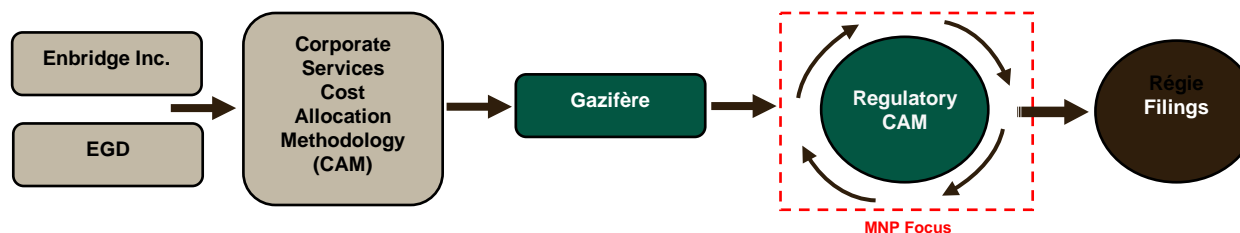
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# Background and Context

The purpose of MNP’s corporate services cost allocation review for Gazifère was to:

1. Provide an independent assessment of Gazifère’s received corporate services cost allocation against regulatory precedent and principles.
2. Support the development of a financial model (Regulatory Cost Allocation Model, or “RCAM”) for Gazifère to assess and treat Enbridge Inc. (Enbridge) and Enbridge Gas Distribution (EGD) allocations for prudence and reasonability under the regulatory regime.

## Flow of Corporate Services Information between Enbridge, EGD and Gazifère



## Breakdown of 2015 Corporate Services Costs Allocated to Gazifère

| Entity       | Total Allocated Costs (\$) | Total Allocated Costs (%) |
|--------------|----------------------------|---------------------------|
| Enbridge     | \$2,081,490                | 62%                       |
| EGD          | \$1,255,474                | 38%                       |
| <b>TOTAL</b> | <b>\$3,336,964</b>         | <b>100%</b>               |

# Enbridge and EGD Cost Allocation Methodology

- Enbridge utilizes a well-developed and robust internal Cost Allocation Methodology (“CAM”) to attribute all corporate shared services costs across the organization’s various business units.
- All Enbridge allocations are measured using fully burdened costs. Fully burdened costs are defined as all direct and indirect costs related to providing a corporate shared service.
- Enbridge’s policy is to charge direct costs wherever possible, defined as costs that can be specifically attributed to a cost object. However, in many situations direct cost charge outs are not possible and corporate shared services costs must be allocated using appropriate drivers. Allocation is the process of assigning a single cost to more than one cost object.
- EGD provides services directly to Gazifère on an as-needed basis. Similar to Enbridge, all costs incurred by EGD are fully burdened costs. Since services are provided on an as-needed basis, these are direct charges from EGD to Gazifère and no cost allocation is required or conducted.
- An Inter-Corporate Services Agreement formally outlines the services provided by EGD to Gazifère and this has been filed with the Régie de l’énergie (“the Régie”) in the past.

# Enbridge Cost Allocation Methodology

- Three types of cost allocations exist within Enbridge's CAM.
  1. Direct Costs – Costs that can be specifically attributed to a cost object.
  2. Indirect Costs – Costs that are directly related or proportional to direct costs.
  3. General and Administrative Costs – Costs that can be internal or external in nature, that support multiple business units, and must therefore be allocated on a basis that relates the cost to the cost driver.
- Each allocation is associated with a directly relevant cost driver. The corporate services allocators used to allocate costs between Enbridge and Gazifère are summarized below:
  1. Business Unit Full-Time Equivalent (FTE) – Number of FTEs at each business unit.
  2. Enterprise FTE – Percentage of FTEs at each business unit relative to total enterprise FTEs.
  3. Capital Employed – Percentage of capital employed at each business unit relative to the total enterprise capital employed.
  4. Blended Pro-Rata – Blended percentage based on the three other allocation drivers above.
- As part of its annual business cycle, Enbridge runs a comprehensive excel-based financial model to allocate the budgeted CAM costs for the following fiscal year.

# Need for Regulatory Cost Allocation Methodology

- Where transfer pricing (cost allocation) is required, at minimum, market prices should be applied.
- Where market prices cannot easily be determined, fully allocated costs must be applied.
- RCAM treats corporate cost allocations where corporate objectives and internal performance purposes may differ from the cost allocation principles of rate regulation.

# MNP Shared Services Cost Assessment Methodology

- In performing this cost assessment, MNP noted that the OEB establishes the most clearly defined RCAM principles and assessment tools.
- Régie guidance and principles are defined and contained within previous Régie decisions, and demonstrate similarity across jurisdictions.
- MNP used the Ontario Energy Board's Three Prong Test<sup>1</sup>.
  1. Prong One: Cost Incurrence - Are the proposed charges prudently incurred by, or on behalf of, the companies for the provision of a service required by ratepayers?
  2. Prong Two: Cost Allocation - If properly incurred, are the proposed corporate centre charges allocated appropriately to the companies, based on the application of cost drivers/allocation factors supported by principles of cost causality?
  3. Prong Three: Cost Benefit - Do the benefits to the company's ratepayers equal or exceed the costs?

<sup>1</sup> Paragraph 5.5.14 and 5.5.17 EBRO 493/494 Decision with Reasons dated March 20, 1997.

## Prong 1 Test – Cost Incurrence (Prudence)

- 59 cost centres were charged by Enbridge to Gazifère for services provided to the organization. MNP assessed whether these charges should be incurred by, or on behalf of, Gazifère ratepayers.
- Through this analysis 10 of the 59 Enbridge cost centre items totalling \$152,409 were determined not prudent.
- A similar methodology was carried out to analyze the costs incurred by Gazifère from EGD.
- In order to better assess the prudence of these line items (and to evaluate Prong 2 – Allocation), a preliminary grouping of the costs (Service Categories) was developed (please see below).
  - Enterprise IT Systems & Support.
  - Operations & Engineering.
  - Compensation & Benefits.
  - Insurance.
  - Human Resources.
  - Regulatory Support.
  - Audit.
  - Common Stock-Based Compensation.
  - Direct Stock-Based Compensation.
  - Rent & Leases.
  - Executive Management.
  - Corporate Services.
  - Treasury & Accounting.
  - Legal Services.
  - Discretionary (Adjustment).
- MNP concluded that all services charged by EGD to Gazifère were prudent.



## Prong 2 Test – Cost Allocation (Causality)

- A total of \$3,184,555 was passed from Test #1 to Test #2, representing 95% of the total costs allocated by Enbridge and EGD.
- The objective of Prong Test #2 was to ensure that appropriate cost drivers were used by Enbridge and EGD. In this test, all line items comprising each Service Category were analyzed against their associated cost centre type and allocation basis.
- MNP found that 5 service line items were allocated with an inappropriate allocation basis. The allocation drivers used by Enbridge for these line items were not suitable, as a direct causality between the allocation basis and the costs incurred could not be established.
- Despite the lack of alignment between the cost and the driver, MNP did not adjust the allocation driver because the change in allocation driver would increase the amount of costs to be incurred within the RCAM. There were two reasons for this:
  1. MNP felt that it would be inappropriate for Gazifère to pay more than the ‘invoiced’ amount for a shared service provided by EI, especially given that rate payers would bear these increased costs.
  2. Changing the driver associated with an allocation to one Enbridge affiliate in isolation may not accurately capture the connected and dependent impacts to the change in allocated costs across all corporate entities.

## Prong 3 Test – Cost Benefit

- The purpose of this test is to assess if the benefits to Gazifère's ratepayers equal or exceed the costs of the services they receive.
- MNP established a materiality threshold of \$100,000 for the Prong 3 Test. If a Service Category exceeded the threshold, it was tested against comparable utilities. A total of \$2,780,395 or 87% of the costs that passed Prong 2 were considered material and underwent a quantitative assessment for Prong 3. This covered 7 of the 15 Service Categories in the RCAM. The other 8 Categories underwent a qualitative assessment.
- In order to accurately assess the Cost Benefit of the material Service Categories, MNP developed comparability measures for each of the categories. Calculations for each of the comparability measures were carried out for the comparative utilities. A low, high, and average price range for each of the utilities was derived based on the comparability measure, which was then used for the analysis of whether the costs incurred by Gazifère fall within the low and high range of industry comparable utilities.
- Upon first review, 5 of the 7 Material Service Categories fell between the MNP range developed through analyzing comparable utilities, and therefore passed Test #3.
- The Insurance Service Category that fell outside of the range was adjusted downward by \$114,475. The Common Stock-Based Compensation Service Category that fell outside of the range was also adjusted downward by \$68,850.

# Summary of RCAM Assessment Results

| Service Category  | Total Allocated Costs | MNP Adjustment for Test #1 | Total Costs Passing Test #1 | MNP Adjustment for Test #2 | Total Costs Passing Test #2 | MNP Adjustment for Test #3 | Total Costs Passing Test #3 |
|---|-----------------------|----------------------------|-----------------------------|----------------------------|-----------------------------|----------------------------|-----------------------------|
| Audit   | \$ 105,213            | (\$ 5,960)                 | \$ 99,253                   | \$ 0                       | \$ 99,253                   | \$ 0                       | \$ 99,253                   |
| Compensation & Benefits                                 | \$ 296,518            | \$ 0                       | \$ 296,518                  | \$ 0                       | \$ 296,518                  | \$ 0                       | \$ 296,518                  |
| Corporate Services                                      | \$ 173,583            | (\$ 77,513)                | \$ 96,070                   | \$ 0                       | \$ 96,070                   | \$ 0                       | \$ 96,070                   |
| Common Stock-Based Compensation (See Recommendation #3) | \$ 187,341            | \$ 0                       | \$ 187,341                  | \$ 0                       | \$ 187,341                  | (\$ 68,850)                | \$ 118,491                  |
| Discretionary (Adjustment)                              | (\$ 43,000)           | \$ 0                       | (\$ 43,000)                 | \$ 0                       | (\$ 43,000)                 | \$ 0                       | (\$ 43,000)                 |
| Enterprise IT Systems & Support                         | \$ 1,380,587          | (\$ 66,946)                | \$ 1,313,641                | \$ 0                       | \$ 1,313,641                | \$ 0                       | \$ 1,313,641                |
| Executive Management                                    | \$ 51,727             | \$ 0                       | \$ 51,727                   | \$ 0                       | \$ 51,727                   | \$ 0                       | \$ 51,727                   |
| Human Resources   | \$ 137,919            | (\$ 1,990)                 | \$ 135,929                  | \$ 0                       | \$ 135,929                  | \$ 0                       | \$ 135,929                  |
| Insurance   | \$ 281,236            | \$ 0                       | \$ 281,236                  | \$ 0                       | \$ 281,236                  | (\$ 114,475)               | \$ 141,761                  |
| Legal Services  | \$ 9,222              | \$ 0                       | \$ 9,222                    | \$ 0                       | \$ 9,222                    | \$ 0                       | \$ 9,222                    |
| Operations & Engineering                                | \$ 441,839            | \$ 0                       | \$ 441,839                  | \$ 0                       | \$ 441,839                  | \$ 0                       | \$ 441,839                  |
| Regulatory Support                                      | \$ 123,892            | \$ 0                       | \$ 123,892                  | \$ 0                       | \$ 123,892                  | \$ 0                       | \$ 123,892                  |
| Rent & Leases   | \$ 64,986             | \$ 0                       | \$ 64,986                   | \$ 0                       | \$ 64,986                   | \$ 0                       | \$ 64,986                   |
| Direct Stock-Based Compensation                         | \$ 94,443             | \$ 0                       | \$ 94,443                   | \$ 0                       | \$ 94,443                   | \$ 0                       | \$ 94,443                   |
| Treasury & Accounting                                   | \$ 31,458             | \$ 0                       | \$ 31,458                   | \$ 0                       | \$ 31,458                   | \$ 0                       | \$ 31,458                   |
| <b>TOTAL</b>  | <b>\$ 3,336,964</b>   | <b>(\$ 152,409)</b>        | <b>\$ 3,184,555</b>         | <b>\$ 0</b>                | <b>\$ 3,184,555</b>         | <b>(\$ 183,325)</b>        | <b>\$ 3,001,230</b>         |

# Recommendations for Gazifère

- 1. DEVELOP INTERNAL COST ALLOCATION DRIVERS** – MNP recommends that Gazifère develop a set of specified internal cost allocation drivers for inclusion in the RCAM. This is similar practice to EGD’s RCAM, which involves a number of internal studies to establish reliable cost drivers that clearly demonstrate the principle of causality where it is not already clear. Adjustments to cost allocation drivers would be made in Test #2.
- 2. SERVICE-LEVEL AGREEMENT WITH ENBRIDGE** – MNP recommends that Gazifère develop a formal Service-Level Agreement (SLA) with Enbridge. The SLA should outline the nature of the corporate services provided by Enbridge to Gazifère and the policies for allocating costs under this arrangement. The SLA should be submitted to the Régie for regulatory approval as part of Gazifère’s future rate applications.
- 3. INTERNAL STUDIES ON COMMON STOCK-BASED COMPENSATION** – MNP recommends that Gazifère work with Enbridge to implement an alternative mechanism to allocate costs appropriately and in alignment with the principles of cost allocation established through regulatory proceeding. Greater precision in the allocation of these costs will enhance the value of Enbridge’s shared services to Gazifère.