

**RÉGIE DE L'ÉNERGIE PRESENTATION  
AT THE INDUSTRIAL GAS USERS ASSOCIATION 2003  
CONFERENCE ON NATURAL GAS**

**SESSION 3: REGULATORY PERSPECTIVES**  
***“HOW ARE THE REGULATORY DECISIONS AND PROCESS CHANGES OVER THE PAST FIVE  
YEARS SHAPING AND DEFINING THE RULES OF THE GAME  
FOR QUÉBEC’S NATURAL GAS MARKET?”***

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**INTRODUCTION**

Ladies and Gentlemen:

I am very pleased to be here today on behalf of the Régie de l'énergie to talk to you about what is happening in natural gas regulation in Québec.

Much of the discussion here over the past two days has focused on issues of natural gas supply and pricing, and the changing structure of natural gas markets.

I will describe the existing regulatory framework for natural gas in Québec, how it has changed over the years in response to the changing market environment, and the challenges for the future.

## **REGULATORY FRAMEWORK**

As you know, competitive markets for natural gas exploration and production, and for the pricing of natural gas supplies, exist side-by-side with regulated markets for transmission, distribution and storage. Moreover, regulation of interprovincial transmission is a federal jurisdiction in Canada, while distribution and storage are under provincial jurisdiction.

Under Québec's regulatory framework, natural gas distributors are granted exclusive distribution rights within a given territory. Section 63 of the *Act respecting the Régie de l'énergie* stipulates that such rights entail the exclusive right to operate a distribution system and to transmit and deliver by pipeline natural gas intended for consumption.

In exchange for these exclusive rights, the distributors must submit their rates, commercial programs, supply plans and capital expenditure plans to the Régie for approval or authorization.

Another feature of Québec's regulatory framework is that, pursuant to section 77 of the Act, customers can buy natural gas from the supplier of their choice.

Every year, the Régie approves a rates schedule stipulating the various rate provisions and conditions of service that will apply to customers.

### **UNBUNDLING**

One of the major regulatory developments of recent years for customers of Gaz Métropolitain, the largest natural gas distributor in Québec, has been the unbundling of rates into five distinct services:

1. Gas supply
2. Compression fuel gas
3. Gas transmission, meaning the transportation of natural gas from the producing regions to the distributor's territory
4. Load balancing, for the daily management of the customer's gas supply
5. Gas distribution, within the territory in which the company holds exclusive distribution rights.

This new rate system has been in effect since October 1, 2001.

The watershed ruling that led to unbundling was Decision D-2001-232 of September 27, 2001, the product of a long and fruitful process involving the distributor, interveners and the Régie. The Industrial Gas Users Association (IGUA) was one of the interveners that was most active in this proceeding.

The new regulatory framework entailed radical changes in the range of choices available to customers and the applicable rate structures.

#### SYSTEM GAS AND FREE CHOICE OF SUPPLIER BY THE CUSTOMER

Under the Act, distributors are required to supply natural gas to anyone who requests it within the territory on which the distributor holds exclusive distribution rights. The distributor's gas supply service, commonly referred to as system gas, fulfils this obligation. The Act also stipulates that the customer may choose to buy gas from another supplier.

Since natural gas prices depend on market forces, the Régie had to find a way for regulated and unregulated supplies to co-exist without hindering the operation of the market, or hindering it as little as possible.

Under Québec's regulatory framework, the price of system gas is set and adjusted monthly on the basis of prices observed in the market.

Variance accounts are established on a monthly basis and automatically spread over the following 12 months.

The procedure in use since 1996 has yielded significant results. It has eliminated the need to use quarterly or annual variance accounts to clear the difference between the prices billed to consumers and the real cost of supply, based on the contracts negotiated with suppliers.

This regulatory framework is also very sensitive to the effect of market conditions on the rates billed to system gas customers and reflects market prices on a monthly basis. The reference price established by this method gives brokers and other suppliers a relatively transparent point of comparison.

The introduction of these procedures has also made it possible to streamline the regulatory process considerably, eliminating completely the need to hold hearings on these matters in recent years. The Régie monitors the implementation of decisions and the impact on the price of supply on a monthly basis.

The wide fluctuations in market prices have a significant impact on customers. The Régie allows the distributor to implement a risk management strategy by using financial derivatives within pre-authorized limits.

By means of that strategy, the distributor is able to mitigate the price fluctuations. For industrial customers that do business with other suppliers, similar services are available in the marketplace.

On September 26, 2003, the Régie issued Decision D-2003-180, in which it approved a fixed-price supply service for customers consuming between 7,500 and 1,168,000 cubic meters per year. The decision met customers' expectations while preserving the role of brokers.

#### TRANSPORTATION SERVICE AND LOAD BALANCING SERVICE

For these two services, specific and complementary solutions have been adopted that take into account the characteristics of the Québec market and the options available to customers and to the distributor.

The price of the transportation service is based on the distributor's acquisition costs and is billed separately in cents per cubic meter. The price is the same for

all, irrespective of the type of service, interruptible or firm, and regardless of the customer's load factor. The transportation service is optional, except for interruptible customers. In the current year, four customers have taken advantage of this option, two of them by means of a permanent assignment of transportation capacity.

However, interruptible customers receive a credit on their bills equal to the value of the interruption of the service to the distributor.

The load balancing service is also priced according to the costs incurred by the distributor. However, the rate allows for each customer's consumption profile and load factor to be taken into account.

One of the practical advantages of this system is that if a customer manages its consumption profile effectively, the resulting savings are deducted directly from the customer's bill.

The load balancing service is optional for all customers.

## DISTRIBUTION SERVICE

The distribution service is the only one that is compulsory for all customers.

The rate structures were established and have changed over the years on the basis of the distributors' proposals and interveners' observations. Various options are available to allow for the customer's consumption profile.

### Gazifère Inc.

Gazifère also provides various options to its customers. Those options are derived from those offered by Enbridge in Ontario, which are under the supervision of the Ontario Energy Board. Customers can choose various supply options, T-Service, interruptible service, etc... .

## INCENTIVE REGULATION IN QUÉBEC

I would now like to turn to the introduction of incentive regulation in Québec and the procedural approach the Régie adopted for the purpose.



In 2000, the Régie initiated proceedings to introduce incentive regulation for the two natural gas distributors, Gaz Métropolitain and Gazifère.

Section 49 of the Act stipulates that, when setting rates, the Régie must, among other things,

- favour measures or incentives to improve distributor performance and the satisfaction of consumer needs.

In the case of Gazifère, the Régie held a public hearing using a traditional process, with evidence and arguments from interested parties.

A cost escalation system similar to the one in use in many other jurisdictions was established.

$$\text{Charges}_{t+1} = \text{charges}_t (1 + \text{growth} - \text{productivity}) (1 + \text{inflation}) \pm Z$$

This cost indexing formula is accompanied by the sharing of productivity gains between customers and the shareholder, as well as the surplus earnings at the end of the year.

For Gaz Métropolitain, a much more elaborate system was established and a streamlined procedural framework was set up to govern the process.

First, the Régie authorized the creation of a task force in which all interested parties were represented and approved guidelines for a Negotiated Settlement Process (NSP). The Régie also determined what matters could be dealt with through this process.

In this type of process, the distributor and recognized stakeholders can work constructively, through frank and open discussion, to find solutions that address the concerns of all parties, and try to arrive at a consensus on a proposal to submit to the Régie.

The process produced a unanimous agreement, which was subsequently studied by the Régie at a public hearing.

In Decision D-2000-183, the Régie approved an incentive mechanism for Gaz Métropolitain and it has been in effect since October 1, 2000. This mechanism is innovative from several points of view. Its main features are:

- rates are set using a hybrid cost of service/price cap system;

- productivity gains exceeding those measured on the basis of unit distribution costs over the previous ten years, are shared, as are any surplus earnings or shortfall at the end of the financial year;
- if the actual return exceeds the authorized return by 400 basis points or more for two consecutive years, or if there is a shortfall greater than 1.5% of the rate base, a review is mandatory;
- service quality indicators are established and the company must meet a certain standard in order to be entitled to its share of productivity gains;
- an energy efficiency fund, funded from the customers' share of productivity gains, has been created;
- the mechanism applies for a five year term,
- there is a process for updating the mechanism before it expires.

Under the mechanism, rate proposals are prepared annually on the basis of negotiated settlements reached by a task force including all interested parties recognized by the Régie.

When the Régie approved this incentive mechanism, it explicitly reserved the possibility of studying, through an appropriate hearing process, various issues of strategic interest that may arise over the years.

The results produced by this approach since 2000 speak for themselves:

- the Régie has rendered four rate decisions on this basis;
- the length of hearings has been reduced significantly;
- rates have been adopted in a timely manner;
- interveners' costs awards have been reduced;
- interveners' concerns have been dealt with in task force groups rather than in adversarial debates before the Régie.

The Régie has however held conventional public hearings on issues such as:

- introduction of the first Energy Efficiency Program;
- approval of the distributor's supply plans;
- the process for using financial derivatives;
- provision of a fixed-price supply service, etc.

### **ISSUES FOR NATURAL GAS REGULATION IN QUÉBEC**

### Price volatility and high prices for natural gas

Like fuel oil, natural gas is expected to experience greater price volatility and higher prices than in the 1990s.

Fixed-price service options and financial derivatives can help shield customers from these eventualities, at least in part. The Régie will be attentive to the needs that may be expressed in this respect.

### Supply strategies

The Régie pays special attention to supply strategies in order to make sure that supply security and reliability are preserved in the short, medium and long term. The content of the supply plans that distributors must submit, and their frequency, are stipulated by regulation. Because of ongoing changes in the marketplace, supply strategies must be adapted to ensure they are optimal.

### Updating the incentive mechanism

As provided for under the current incentive mechanism, the Régie opened a proceeding in 2002, in response to a proposal from Gaz Métropolitain, to update the existing mechanism.

The procedural framework was similar to the one used in 2000 for the first proceeding.

In the first stages of the process, the task group submitted to the Régie an assessment of the mechanism that has been in effect since 2000 and a proposal concerning areas that could be improved.

In February 2003, the Régie accepted the conclusions of that first report and authorized participants to enter into a negotiated settlement process in order to update the mechanism, while asking them to take a number of concerns into account.

This process has also yielded results. The Régie just received this week a unanimous agreement. The main characteristics of the proposed incentive mechanism are in continuity with the one that has been in effect for three years. The new mechanism would be in force for five years.

It is too early to say whether this proposal will be accepted as is. The Régie will announce shortly the hearing procedure that will be used to complete the review of the proposal.

I should also mention that the Régie intends to launch a proceeding at the end of 2003 to determine whether a more comprehensive incentive mechanism should also be introduced for Gazifère.

### Sustainable development

In this day and age, the question of sustainable development cannot be neglected in decision-making.

Under the Act, the Régie is required to promote the satisfaction of energy needs through sustainable development and with due regard for individual and collective equity.

So the Régie must take the environment into account and consider the impact of its decisions on future generations. Over the past three years, the Régie has taken concrete action to promote sustainable development and has incorporated into the regulatory framework various measures to support energy efficiency and the replacement of more polluting energy sources. In its decision of September

28, 2003, the Régie extended Gaz Métropolitain's Energy Efficiency Program to industrial customers. The program includes the following components:

- studies and support for the implementation of energy efficiency measures (PE 211)
- efficient boilers (PE 213)
- customer education (VGE 214)

### Regulatory Process streamlining

More flexible processes such as task force, negotiated settlement processes and others have been tested successfully in natural gas regulation in recent years. The Régie intends to continue along this path.

The Régie also plans to examine the possibility of using conciliation to deal with consumer complaints, as many civil tribunals are now doing. The purpose of conciliation is to resolve disputes using a process that is better suited to the needs of the parties involved and more able to take all the relevant facts into account.

### **CONCLUSION**



In summary, the recent regulatory proceedings in front of the Régie, that involved all interested parties, including your Association, have changed profoundly the regulatory framework in Québec.

This regulatory framework rests on solid foundations as well as on innovative approaches.

This framework has reached, over the last few years, an interesting level of maturity and stability.

This framework is also flexible enough to be adjusted and adapted to the constant change of markets and to respond to customers needs.

The Régie has relied upon light handed approaches, when circumstances were adequate, and this has contributed positively to the quality of the proceedings.

The Régie will be listening to your needs and to those of all interested groups as your implication and that of all others are essential ingredients for ensuring high quality regulation. The Régie must always ensure the effective conciliation of interests of all parties.