

**SUBMISSION BY**

**THE CONSUMERS' ASSOCIATION OF CANADA,  
SASKATCHEWAN BRANCH**

**TO**

**THE SASKATCHEWAN RATE REVIEW PANEL**

**IN THE MATTER OF**

**THE APPLICATION BY SASKENERGY TO ADJUST ITS  
DELIVERY FEES IN 2007**

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# 306 – 220 Third Avenue S. Saskatoon SK S7K 1M1  
Tel: 306-242-4909 FAX: 306-955-5810 Toll free: 1-888-395-5661  
Email: office.cacsk@sasktel.net

The Consumers' Association of Canada, Saskatchewan Branch, welcomes the opportunity to present its views on the rate application submitted by SaskEnergy on behalf of its Distribution Division.

We have reviewed the Rate Application Document in detail. We also found it necessary to review the 2005 Annual Report of SaskEnergy to fully understand the organizational structure of SaskEnergy and the operational responsibilities of each division within the corporation. Our presentation is based on the information contained in both documents.

SaskEnergy has the exclusive rights to transport and distribute natural gas within Saskatchewan. It sells natural gas to consumers in Saskatchewan but does not have the exclusive rights to do so. Consumers have the choice of buying gas from other suppliers though the Distribution Division of SaskEnergy acts as the carrier of the gas.

SaskEnergy has established a separate division, TransGas Limited, with responsibility for the transportation of natural gas within Saskatchewan. It operates gas storage facilities, compressor stations and is tied in with the Canadian pipe line system. The net earnings of this division were \$ 26.8 million in 2004 and \$ 21.4 million in 2005.

The delivery of gas from the national pipe line system to all consumers of natural gas within Saskatchewan is the responsibility of SaskEnergy's Distribution Division. The customers are charged a delivery fee for this service. For those consumers who purchase their gas from SaskEnergy the Division acts also as the vendor of gas and bills the purchasers accordingly. Finally, the Division collects franchise fees on behalf of all urban municipalities from urban customers connected to the Division's distribution system. Franchise fees in 2005 amounted to \$ 20.7 million. The net earnings of the Distribution Division excluding the commodity sales were \$ 21 million in 2004 and \$ 11.8 million in 2005. With the profits of the commodity sales included, the net earnings of the Distribution Division were \$ 55.9 million in 2004 and \$ 20.3 million in 2005.

The price of the gas sold (commodity sales) by the Distribution Division and the delivery fees (delivery revenue) are both subject to review by the Rate Review Panel. The current application is limited to the delivery fees only; the matter of the commodity prices was considered by the Review Panel in November 2006.

SaskEnergy on behalf of its Distribution Division is asking for an increase in the delivery fees to generate approximately \$ 8.7 million in additional annual earnings. The new fees, if approved, are scheduled to take effect on June 1, 2007.

This rate application has a narrow focus on a single activity of a single operational unit of SaskEnergy. The CAC/SK is concerned about rate reviews of this nature because they are designed to discourage questions and debates about important and substantive issues pertaining to the overall operations of SaskEnergy and the organizational structure that has emerged. How does SaskEnergy allocate its activities among the various unit divisions? How does it allocate assets and liabilities by units and appropriate rates of amortization for each unit? How does SaskEnergy verify that the organizational structure

it has chosen and the responsibilities it has assigned to each divisional unit offer the “best match”? Does SaskEnergy assign separate ROE targets for each division? How does SaskEnergy prorate its common expenditures among its unit divisions?

Review by outside regulatory bodies is an important aspect of SaskEnergy operations. By our count, the activities of SaskEnergy are subject to at least three separate regulatory bodies, the Saskatchewan Rate Review Panel, the Manitoba Public Utilities Board and the Nova Scotia Utility and Review Board. In addition, the Executive Council of Saskatchewan has the final authority to determine the rates for the Transportation Division. How much does SaskEnergy spend annually to prepare for and appear before regulatory agencies?

As indicated earlier we have reviewed the 2005 annual statement of SaskEnergy, the net earnings of the various operational divisions and units and the distribution of the total corporate assets and liabilities by divisions.

We noted previously that net earnings of the Distribution Division in 2005 (excluding commodity sales) were \$ 11.8 million. It was \$ 1.3 million in 2001, \$ 3.8 million in 2002, \$ 19.2 million in 2003, and \$ 21 million in 2004. The corresponding Rates of Return on Equity (ROE) will be equally volatile and it is unlikely the suggested target rate of 9 % for the Distribution Division can be met on a year-to-year basis.

A review of the consolidated net earnings of SaskEnergy between 2001 and 2005 shows the same volatile pattern. Net consolidated earnings were \$ (15.4 million) in 2001, \$ 6.9 million in 2002, \$ 41.0 million in 2003, \$ 107.8 million in 2004, and \$ 76.7 million in 2005. When we look at the ratio of the net earnings of the Distribution Division to the consolidated net earnings of SaskEnergy we find it ranged from a low of 2.8 in 2001 to a high of 30.0 in 2004. In 2005 it was 18.0.

**It is clear SaskEnergy has been able to adjust to volatile net distribution earnings in the past; it is not clear why SaskEnergy believes it should no longer continue to do so and has requested permission to increase its delivery fees.**

We have reviewed carefully the documentation submitted in support of the rate changes.

Based on that review we can conclude that SaskEnergy must possess the most extensive gas distribution network of all gas utility companies in Canada with 66,000 kilometres of gas distribution pipe lines. It is not surprising therefore to note that it averages only 5 customers per kilometre of pipe line. That is well below the norm for the industry. Some relevant comparisons of customers per kilometre of distribution gas pipe line are offered on Page 12 of the application. That evidence shows an average ranging from a high of 57 to a low of 19 customers per kilometre. The average of the “average” for the comparators listed in the brief is 33 customers per kilometre.

A gas distribution network as extensive as SaskEnergy’s and with relatively few “average customers” per kilometre is not likely to emerge if it is to be based on normal commercial

calculations requiring ROE of 9 per cent and governed by marginal cost and revenue calculations to determine the optimum level of additional investments in gas distribution pipe lines.

CAC/SK accepts that decisions to make natural gas available to customers throughout Saskatchewan have been made by the provincial legislature and that SaskEnergy was directed to fulfill that task. And it has; 66,000 kilometres of gas distribution pipe lines is the record of that accomplishment.

The franchise area served by SaskEnergy is vast by industry standards and comprises large sections that cannot be characterized as being densely settled. SaskEnergy obviously has made significant investments in its distribution network. The size of the assets assigned by SaskEnergy to the Distribution Division reflects this investment. We note it lists total assets of \$ 753 million in 2005. That represents 54.9% of SaskEnergy's assets in 2005. On the liability side its current liabilities and debt amount to \$ 558.9 million in 2005. That represents 57.2 % of SaskEnergy's total current liabilities and debts in 2005. Interest and amortization expenses assigned to the Distribution Division in 2005 to service that debt load amounted to \$ 40.7 million out of normal operating expenses of \$ 155 million after an adjustment for the municipal franchise fees.

To reduce the present costs of its investment in the gas distribution network SaskEnergy has chosen to amortize this investment over 40 years. That is a very long time period for commercial purposes and seldom employed in the determination of the economic feasibility of an investment project. The investments undertaken by SaskEnergy to extend the distribution network have also triggered an increase in variable costs to service new customers as it notes in its application. It projects that these variable costs will continue to increase over time.

The normal problems resulting from a legislative decision to serve the collective good arise from decisions how these services should be financed. The two standard options are either to use general tax revenues of the province or to make the financing of this expansion the responsibility of SaskEnergy. We gather the legislature favoured the second option and SaskEnergy has had to decide how it can fulfill the decision of the legislature to make gas generally available in Saskatchewan and at same time finance this expansion.

Should SaskEnergy decide to let the customers who will benefit from the expansion pay for the expansion it may find that the costs of becoming a new customer will deter them from becoming customers. In that case, the directives of the legislature will not have been met.

Alternatively, SaskEnergy can decide that the costs of expansion should be shared by all existing and new customers in order to attract new customers and make gas available to the maximum number of potential customers. The dilemma facing SaskEnergy under this scenario is that it must devise a pricing structure that will cover the expansion costs, fully knowing that this will likely involve cross-subsidization across and within its customer

rating groups. The resulting levels of cross-subsidization will depend on how SaskEnergy distributes these costs among its customers. By and large the regulatory agencies and the utility companies themselves attempt to minimize levels of cross-subsidization because excessive amounts undermine the fundamental rules of fairness in utility pricing.

The impact of space and customer densities on gas utilities is illustrated in the evidence introduced by SaskEnergy to compare its operations with other gas utility companies in Canada. Centra Gas in Manitoba owned by Hydro Manitoba is a Crown public utility similar to the Distribution Division of SaskEnergy. It averages 40 gas customers per kilometre of gas distribution pipe line. Centra Gas and the other gas distributors therefore face significantly different distribution costs in supplying their customers with gas. They serve smaller areas with higher population densities by choice or decree. Consequently, they do not bother to levy differential distance costs as part of their distribution charges, nor is it likely the regulatory agencies responsible for their fee levels would allow them to impose such fees without proof of significant cost increases to justify the higher fees.

The pricing policy that has emerged under these circumstances is called the “postage stamp” pricing policy. It simply means the supplier will not take account of the costs associated with the distance involved in supplying the product to the customers within the given franchise area. The average number of customers per kilometre is sufficiently high that it is not worth the effort to establish the marginal cost of adding another customer to the existing distribution network.

Expansion of the franchise area and the construction of a new gas distribution network is an entirely different proposition and normally call for determination of proper service fees. It is therefore surprising to learn that SaskEnergy has adopted the “postage stamp” pricing policy of the other gas utilities in setting its delivery rates despite the great distances involved with its distribution network and the relatively low numbers of average customers per kilometre of pipe line.

The CAC/SK believes this decision by SaskEnergy may have given rise to significant amounts of cross-subsidization within and across each rate class and cannot be ignored in assessing the claims of fairness in the current rate determination procedures.

The current issue before the Rate Review Panel arises from SaskEnergy’s claim that its Distribution Division is now experiencing declining volumes of gas being distributed in the face of relatively high debt servicing costs and increasing variable costs. To address this problem, it is applying for permission to increase the price of its delivery services to offset the reduced quantity demanded.

The structure of SaskEnergy’s gas delivery price is the same for all of its customers. The price consists of two parts, a fixed fee and a variable fee. SaskEnergy has approximately 326,000 customers classified by 5 different groups with different fixed rates and variable rates applicable to each group. Hence all customers within each group face the same fixed and variable fee rates but customers in different customer groups face different fixed and variable fee rates for the delivery of gas.

The distribution of customers by rate classes and the current and proposed fee rates for each rate class are spelled in great detail in the application document and need not be repeated in full in this presentation.

CAC/SK has focused on assessing the distributional consequences of the proposed fee increase by different rate classes and within rate classes. In doing so we are responding to the challenge issued by SaskEnergy to itself in the following statement found on Page 24 of the Rate Application:

*“The challenge in rate design is to recover all costs fairly, both among the various rate classes as well as within each rate class. Various rate design principles can conflict with one another”*

We begin by looking at the impact of the rate increase on each rate class. Table 1 presents the results.

**TABLE 1**  
**ANNUAL FIXED FEE INCREASE BY RATE CLASS**

<b>Rate Class</b>	<b>Current Fixed Fees</b>	<b>Proposed Increase</b>	<b>Percentage Increase</b>
	\$/Year	\$/Year	
Residential	126.00	24.00	19.04
Farm	138.60	30.00	21.64
General Service II	204.00	43.80	21.47
General Service III	447.00	75.00	16.78
Small Industrial	2400.00	192.00	8.00

The information in Table 1 does not provide much insight about the fairness of the rate request across rate classes. The percentage increases are high for all classes except one. We note the rate application document suggests the proposed fee increases should be viewed in the context of the sum of the fixed and flexible fees. On that basis the percentage increases will appear to be more reasonable. That is an accurate observation but also quite irrelevant. The issue before this Panel is an assessment of SaskEnergy’s request to increase the fixed portion of its delivery fees. CAC/SK is here to express its concerns about what is being proposed.

The information in Table 1 speaks much more forcefully about the need to review the distributional consequences of the fee request within each rate class.

CAC/SK can speak with some authority about the Residential Rate Class customers. We all know that the typical or the “average” residential customer identified in the rate application document is a statistical concept. The residential class contains 267,000 customers across Saskatchewan. The residential housing stock in Saskatchewan ranges

from the small homes of less than 1000 sq. feet to large homes in excess of 5000 sq. feet. The size of the housing stock in Canada and in Saskatchewan has been increasing steadily since the end of WW II. Recent studies report the move to larger homes is accelerating.

The residential class of customers is large and is not homogenous. CAC/SK constructed Table 2 to capture the impact of the proposed fee increase on different gas customers within that class. We do not have information about the residential consumers by location, size or volume of the homes they occupy and we had to use the volume of annual gas consumption as a proxy for size. We are informed on Page 23 of the rate application document that the “average home” in Saskatchewan uses 3078 m<sup>3</sup> of gas annually. We are using that “consumer class number” as a benchmark in Table 2. In the absence of information of the median usage of the residential consumer class, we have constructed two residential customer class sizes below and two above the benchmark number used by SaskEnergy.

**TABLE 2**

**IMPACT OF FEE INCREASE BY RESIDENTIAL CLASS CUSTOMER SIZE**

	<b>1000</b>	<b>2000</b>	<b>Bench Mark 3078</b>	<b>4000</b>	<b>5000</b>
	(Measured in m <sup>3</sup> of annual gas consumption)				
Fixed \$	126.00	126.00	126.00	126.00	126.00
Flexible \$	<u>71.90</u>	<u>143.80</u>	<u>218.50</u>	<u>287.60</u>	<u>359.50</u>
Total \$	<u>197.90</u>	<u>269.80</u>	<u>344.50</u>	<u>413.60</u>	<u>485.50</u>
<i>Fixed as % of total</i>	63.7	46.7	36.6	30.5	25.5
Fixed Fee Increase \$	24.00	24.00	24.00	24.00	24.00
New Total \$	<u>221.90</u>	<u>293.80</u>	<u>368.50</u>	<u>437.60</u>	<u>509.50</u>
<i>New Fixed as % of total</i>	67.6	51.1	40.7	34.3	29.4
<b>Percentage increase in Total Fees</b>	<b>12.1</b>	<b>8.9</b>	<b>7.0</b>	<b>5.8</b>	<b>4.8</b>

The last row of Table 2 tells the story about the distribution of the fixed fee increases sought by SaskEnergy. Our analysis shows the smallest consumer in the residential rate class will be hit with a fee increase of 12.1 %, the largest consumer will suffer a fee increase of 4.8 % and, the “average bench mark consumer” of SaskEnergy will experience a 7 % increase. We therefore conclude that the current fixed fee proposal will shift the burden of the gas distribution fees to the smallest consumer groups and the occupants of homes who use the least amount of gas.

It has long been accepted that flat taxes are incompatible with equity and fairness because of the regressive end results. CAC/SK is at loss to comprehend why SaskEnergy would propose a flat fee increase and at the same time claim that its fee request is consistent with fairness.

**CAC/SK believes that SaskEnergy’s request for increases in fixed fees is unfair, inequitable and will have unavoidable regressive consequences.**

CAC/SK has not attempted a similar analysis for the other rate classes because we were not able to identify suitable benchmark customers. We are, however, satisfied that similar patterns will occur of shifting the burden of the distribution fees to small farmers in the Farm Rate Class with 22,316 customers and to small businesses in the General Service II Class with 35,271 customers. With numbers like these in each class one would expect to find a wide distribution of customers from small to large by usage of gas. We are less confident about the heterogeneity of the two remaining rate classes and therefore hesitant to suggest that our conclusions about the residential rate class analysis can be extended to these classes without further analysis.

Table 3 shows the distribution of the total fee increase of \$ 8.7 million by each rate class. We estimated the total fee increase by using the size of each class as reported in the rate application document and multiplied those numbers with the proposed fees increases for each class. We then calculated the percentage distribution of the total fee increase.

**TABLE 3**

**DISTRIBUTION OF TOTAL FIXED FEE INCREASE BY RATE CLASSES**

<b>RateClass</b>	<b>Class Size</b>	<b>Total Class Fee Increase ( \$ millions)</b>	<b>Percentage Distribution</b>
Residential	267,535	6.421	73.5
Farm	22,316	0.669	7.6
General Service II	35,271	1.545	17.7
General Service III	1,243	.092	.1
Small Industrial	15	.003	.02
<b>TOTALS</b>		<b>8.700</b>	<b>100.00</b>

Note: The percentage distribution may not add up to 100 due to rounding errors.

CAC/SK is not surprised to see that the Residential Rate Class is scheduled to absorb close to three quarters of the requested fee increase. That is inevitable given the structure of the rate proposal and the rate class system employed by SaskEnergy.

**These results have encouraged CAC/SK to ask itself if there are other methods available to SaskEnergy to distribute the burden of a fee increase across its established rate classes and which could at the same time address our concerns about unacceptable fee distributions within certain rate classes.**

We began by looking at what would happen if the fee increases were in some ways related to usage of gas by each rate class. We focused on the total gas consumption of each class. We had to rely on information published on Page 5 of the 2005 Annual Report of SaskEnergy. Under the heading of Operating Statistics gas consumption is measured in Petajoules by customer classes. Unfortunately the classes do not correspond exactly with classes listed in the fee application document. We suspect the Commercial grouping includes both General Service classes and wonder if the Industrial grouping is identical to the Small Industrial Class in the rate application document. We assume the residential and farm groups in the Annual Report correspond to the same rate classes in the other document. We have not attempted to convert Petajoule consumption into cubic metres of gas. We believe the Petajoule measure is probably as good as the other measure at the aggregate class level. The results are presented in Table 4.

**TABLE 4**

**TOTAL ANNUAL GAS CONSUMPTION IN 2005 BY CUSTOMER CLASSES  
(In Petajoules)**

Customer Groups	Distribution Volumes	Percentage Distribution
Residential	30	24.30
Commercial	28	21.80
Farm	4	3.00
Industrial	66	51.50
Totals	128	100.00

In terms of usage the Residential group accounts for about one quarter of the total gas supplied by SaskEnergy and yet the current fee request would like that rate class to carry close to three quarters of the total fee increase.

**WHY ?**

**CONCLUSIONS:**

**CAC/SK believes the current fee application is flawed in many ways and encourages the Rate Review Panel to reject it in its current form. The results of our review and analysis of the fee rate increase show unreasonable and unfair consequences in terms of distribution within rate classes and across rate classes.**

**We do not believe that SaskEnergy has met the test it set for itself on Page 24 of the Rate Application which we quoted earlier.**

**We suspect that any fee application proposing a fee increase without reference to the quantity of gas used will always give rise to troublesome questions about cross-subsidization and fairness. The applicant's claim to fairness and desire to address the issue of fairness will be met invariably with a healthy dose of skepticism because we are asked to accept an application which we have judged to be unfair in order for it to correct a fee structure which the applicant alleges is even more unfair.**

**To accept the applicant's claim of fairness, CAC/SK believes the applicant must show evidence of levels of cross-subsidization in the current fee structure and demonstrate how its current application will reduce cross-subsidization and increase fairness within and across current rate classes.**