

February 26, 2010

TO INTERESTED PARTIES

## **RATE REGULATION INITIATIVE ROUND TABLE**

This letter is to advise that the Commission is beginning an initiative to reform utility rate regulation in Alberta and to invite interested parties to participate in a round table discussion to assist the Commission in determining scheduling and scope issues for the initial stages of the initiative.

The rate regulation initiative will begin with the reform of rate regulation for electricity and natural gas distribution services. Reform of rate regulation for electricity and natural gas transmission services will not be undertaken at this time for two reasons. The electricity transmission system is entering a period of significant change with substantial planned expansions while natural gas transportation rates are one subject of more extensive negotiations between the province's two largest regulated natural gas transportation service providers.

The regulatory framework for electricity and natural gas regulated retail rates offered under the *Regulated Rate Option Regulation* and *Default Gas Supply Regulation* will also not be considered as part of this initiative. Those regulations are the responsibility of the Minister of Energy.

There are two principal purposes of the Commission's rate regulation initiative. The first is to develop a regulatory framework that creates incentives for the regulated companies to improve their efficiency while ensuring that the gains from those improved efficiencies are shared with customers. The second purpose is to improve the efficiency of the regulatory framework and allow the Commission to focus more of its attention on both prices and quality of service important to customers.

This initiative proceeds from the assumption that rate-base rate of return regulation offers few incentives to improve efficiency, and produces incentives for regulated companies to maximize costs and inefficiently allocate resources. In addition, rate-base rate of return regulation is increasingly cumbersome in an environment where some companies offer both regulated and unregulated services and where operations that were formerly integrated have been separated into operating companies, some of which require their own rate and revenue requirement proceedings. These changes in the structure of the industry, occasioned by the introduction of competition in the retail and generation/production segments of the electricity and natural gas industries, have resulted in additional negative economic incentives for companies regulated under rate-base rate of return regulation. These conditions complicate the task for regulators who must critically analyze in detail management judgments and decisions that, in competitive

markets and under other forms of regulation, are made in response to market signals and economic incentives. The role of the regulator in this environment is limited to second guessing. Traditional rate-base rate of return regulation provides few opportunities to create meaningful positive economic incentives which would benefit both the companies and the customers. The Commission is seeking a better way to carry out its mandate so that the legitimate expectations of the regulated utilities and of customers are respected. Indeed, the Commission has already taken a first step to reforming rate regulation in Alberta.

On March 25, 2009, the Commission released Decision 2009-035,<sup>1</sup> the first Alberta formula based ratemaking decision for a distribution access service tariff and transmission tariff in Alberta. In this Decision, the Commission adopted a framework in which rates are adjusted annually by a formula that recognizes expected inflation and achievable productivity improvements. This framework will form the basis for the better alternative the Commission is seeking. Specifically, the Commission stated:

The Commission considers that there are potentially many benefits of a well crafted FBR regulatory regime. These include better economic incentives for the utility that more closely mimic the incentives in a competitive market, a reduction over time in the overall regulatory burden, and an opportunity for the utility to capture greater productivity, subsequently allowing for lower rates than would otherwise be enjoyed by consumers.<sup>2</sup>

This form of rate regulation has been referred to as both formula based regulation and performance based regulation, or PBR. Typically, PBR plans are initiated based on “going in” rates established in a traditional rate-base rate of return proceeding. Thereafter, those rates are adjusted annually by the formula adopted. This was the case for the ENMAX Power Corporation (ENMAX) plan approved in Decision 2009-035.

The Commission has surveyed the vintage of distribution service rates in effect today and the progress of distribution service rate cases currently before the Commission. Based on this survey, the Commission has determined that all companies offering distribution services have rates that have been approved or will soon be approved for a recent or current year making this an opportune time for the Commission to move distribution service rates to PBR regulation. It is the Commission’s intention to apply a PBR formula to distribution service rates beginning July 1, 2011 for a five-year term. July 1 is the date chosen for the annual PBR adjustment because the rates of inflation used in PBR formulas are typically actual rates of inflation from the previous year and are not published by Statistics Canada until April of each year.

The Commission recognizes that there are still some generic proceedings underway dealing with issues arising under rate-base rate of return regulation. The Commission has also signaled its intention to conduct additional generic proceedings to deal with other issues related to rate-base rate of return regulation. Current proceedings will continue and others will be scheduled during the five-year PBR term so that the Commission can ensure consistency of approach across all regulated companies employing rate-base rate of return regulation (including transmission companies) and so that these issues will have been settled by the time the PBR plan is to be reviewed. The Commission will initiate a proceeding during the first PBR term to consider how

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<sup>1</sup> Decision 2009-035: ENMAX Power Corporation 2007-2016 Formula Based Ratemaking, issued March 25, 2009.

<sup>2</sup> Decision 2009-035, page 12.

the success of the PBR plan should be judged and how it might be re-initiated, or rates “re-based,” at the end of the initial five-year term in a way that minimizes potential distortions to economic efficiency incentives.

The Commission will use the PBR plan approved for ENMAX in Decision 2009-035 as the model to be employed for adjusting the distribution service rates of both the electricity distribution companies and the natural gas distribution companies. The decision discusses the general principles of PBR plans and addresses each of the elements of the formula employed, including considerations in determining each one and how they are to be applied.

Nevertheless, the Commission recognizes that there are differences between the natural gas utilities and electricity utilities and there may be specific considerations that various companies and customers might ask the Commission to consider when implementing PBR plans. In particular, the Commission recognizes that the inflation factor and the productivity information used to develop the X factor in the ENMAX plan are specific to electric utilities. While the Commission is satisfied that the bases for the inflation and productivity factors in the ENMAX formula are acceptable for electric utilities, the inflation and productivity factors will need to be determined for the gas distribution utilities. The rate structures (fixed/variable charges), geographic territories served and sizes of the various companies may, for example, need to be considered in determining the values of various factors in the formula. In addition, there may be other matters specific to individual companies that will need to be considered before a PBR formula is determined and applied July 1, 2011.

In order to adjust distribution rates by a PBR formula on July 1, 2011, it will be necessary for the Commission to establish a process for submissions from the affected utility companies and from interested parties dealing with the issues mentioned above and other issues parties may wish to have considered. Therefore, before issuing a Bulletin to commence the proceeding leading to implementation of PBR, the Commission will conduct a round table discussion among utility companies and interested parties to set dates for submissions and a list of subject areas parties will be invited to address. Other process issues can be discussed at that time. The Commission will distribute an agenda prior to the meeting. Parties are welcome to add items to the agenda at the meeting or prior to the meeting.

The round table discussion will be held in the AUC’s Edmonton hearing room beginning at 10 o’clock a.m. on Thursday, March 25, 2010. The Commission asks parties to advise the Commission of their planned attendance at the round table, including the number of participants that are expected to attend, by March 10, 2010 so that alternate room arrangements can be made if necessary. Please email Terry Favaloro at [Terry.Favaloro@auc.ab.ca](mailto:Terry.Favaloro@auc.ab.ca).

Yours truly,

*(sent by email)*

Willie Grieve  
Chair  
Alberta Utilities Commission