

Alternative Approaches to Canadian Regulation

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Introduction

Canada is today the scene of constructive regulatory ferment

Many regulators are now practitioners of performance based regulation (“PBR”)

BC

Alberta

Federal (CRTC, NEB)

Ontario

Quebec

Others are pondering departures from traditional regulation

This presentation considers some pros and cons of making the transition

Plan of Presentation

Defining Terms

Criteria for Choosing Regulatory Systems

PBR: Potential

PBR: Contemporary Realities

The Earnings Sharing Controversy

Conclusions

I. Defining Terms

A. Cost of Service Regulation (COSR)

Rates designed to recover prudent cost of service

Base rates typically adjusted periodically via rate cases

Revenue Requirement = Prudent Cost of Service

1-3 year regulatory lag

Flow-through of energy costs may be faster

B. Incentive (Alternative) Regulation

Weaken link between company's rates and cost

Alternative decoupling mechanisms

Reduce rate case frequency via

- rate freeze
- external rate adjustment
(*e.g.* price cap index tracks industry unit cost trend)

Statistical benchmarking

Negotiated settlements

C. Performance Based Regulation

Calibrate incentive plan terms to share benefits fairly

- *Inferior* return for *inferior* performance
- *Superior* return for *superior* performance

Benefit sharing mechanisms

- Real-time sharing (*e.g.* earnings sharing)
- Initial rate discounts
- Favorable rate trajectory (*e.g.* rate freeze, stretch factor)

>>> PBR encompasses a wide range of regulatory systems

Major Regulatory Options

Cost of Service Regulation

Incentive (Alternative) Regulation

Performance-Based Regulation (PBR)

Other Incentive Regulation

II. Criteria for Choosing Regulatory System

Utility operating efficiency

- Cost containment
- Marketing

Efficient regulation

Share benefits fairly

III. PBR: Ideal

Better utility performance

Stronger performance incentives

Greater operating flexibility

(e.g. light-handed regulation of optional rates & services)

Share plan benefits fairly

Better use of regulatory resources

>>> Win-win situation for companies and customers

IV. PBR: Contemporary Realities

A. General Performance Incentives

General performance incentives depend on PBR plan details

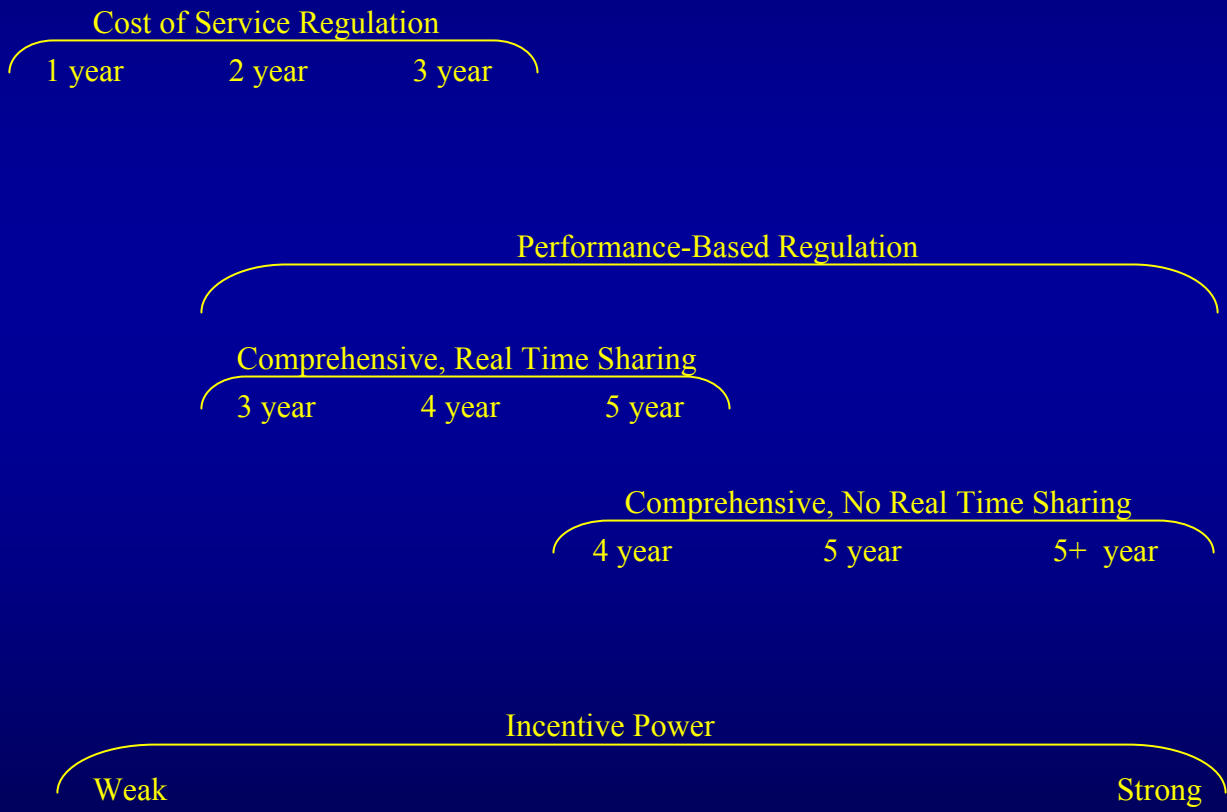
Not always stronger than traditional COSR due to

- Short plan term
- Real-time sharing (*e.g.* earnings sharing)

Meanwhile, COSR can be fine tuned to improve effectiveness

- Increase regulatory lag
- Strengthen staff
- Improve operating practices

Cost Containment Incentive Spectrum



B. Service Quality

Strong cost containment incentives under PBR can weaken service quality (“SQ”) incentives

Design of SQ provisions still in infancy

Several examples of SQ declines under PBR

- US West (OR)
- Ameritech (WI)
- Railtrak (UK)

Greater concern for power than for gas

C. Declining Productivity

Conventional North American approaches to PBR not designed to handle situations of declining productivity

Declining productivity can occur in well managed utilities

- Cyclical Investment Patterns (*e.g.* Transmission)
- Major replacement investments
- Slow volume growth (*e.g.* due to DSM, regional recession)

Conventional solutions: exclude major capital investments
ignore problem

British approach to PBR (*e.g.* five year rate case) has merits
in this context

V. The Earnings Sharing Controversy

Controversy over earnings and other real-time sharing mechanisms highlights “growth pains” of PBR

These mechanisms have advantages in PBR plan design

- Transparent sharing of benefits
- Benefits shared *as realized*
- Reduces chance for extreme earnings outcomes

Advantages especially valued in first generation PBR

>>> Common in North American energy PBR

V. Earnings Sharing Controversy (cont'd)

These advantages come at a cost

- Weaker performance incentives
- Less operating flexibility
- Higher regulatory cost

Disadvantages discourage use

- Many newer plans don't have ESMS (*e.g.* AmerenUE)
- Rarely used for energy utilities overseas
- Rarely used for telecom worldwide (*e.g.* CRTC)

VI. Conclusions

Canada's regulators have a wealth of alternative regulatory systems to choose from today

No single "best system" for all applications

COSR and PBR both have their places

Wide range of PBR plans merit consideration

Devil as always is in the details

Canada's tradition of PBR innovation should (and doubtless will) continue