

# 2007 CAMPUT CONFERENCE

## **Regulatory Compact**

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### **Predictable Regulatory Outcomes and Efficient Process**

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### **Returns: Consequences and Impacts**

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Thank you very much Dr. Plourde (André), Panel Members, Steve and Sophie, Ladies and Gentlemen.

My objective today is to try and stimulate some discussion and further thinking around three topics:

### **Slide 1**

- (1) The Regulatory Compact
- (2) Predictable Regulatory Outcomes and Efficient Process
- (3) Returns: Consequences and Impacts

First, let's travel back a couple of decades.

### **Slide 2**

Prior to the mid 80's, in most jurisdictions, we had fully integrated utilities and regulatory life was pretty straightforward even though gas utilities produced and processed gas.

They also provided transmission, storage, distribution, sales to customers and billing.

Electric utilities developed, operated and maintained generating plants, entered into fuel contracts, provided transmission, distribution, billing and sales to customers.

These were very complex industries yet the regulatory environment of former times was quite benign. Everyone - policy makers, regulators and the utilities - knew and understood, and adhered to, the Regulatory Compact.

### Slide 3

Then in the mid 80's through the 90's, "Deregulation" came - first in gas. Many jurisdictions began to shed utility assets and services. Exploration and development of gas was now in the hands of non-regulated producers and a liquid and transparent gas market was developed. Non-utility companies were processing gas, developing storage and selling gas directly to industrial customers.

Then in the 90's, electricity deregulation began. Our policy makers were told that independent power generators (non-regulated) would be able to supply industrial customers with power at a lower cost. It was also felt that it would be worthwhile to offer choice to all residential and commercial customers. We would have market competition to put the "checks and balances" on supply and demand for all gas and electricity consumption.

As we all know, the result was, quite frankly, a bit of "a scramble" as governments - the policy makers, regulators and industry tried to find their way through new policy, new legislation, new concepts, new regulation and some very serious gaps as to how this should all come together.

### Slide 4

We all did our best to try and map out the direction we were supposed to be travelling in. But because all the road signs were not yet posted, we left ourselves open to a great deal of criticism. Customer intervention began to build in momentum and today we find a new sense of tension has broken out.

Most regulatory processes have become adversarial with customer interventions driving greater wedges between policy makers, regulators and utility companies.

### **Slide 6**

The result today is an environment that is unsustainable, unpredictable, inefficient, adversarial and in many instances unproductive, not the least of which might be the 500KV example in Alberta today, or our own Carbon Storage property rights issue, or the move away from the RCN-D principle of valuation for utility expropriation.

So the question is, “How do we resolve this unsustainable predicament we now find ourselves in?”

### **Slide 7**

It seems to me that we need to take a step back and look to our policy makers in consultation with our regulators to go back to basics and develop a clear, concise restatement of the Regulatory Compact based on principles. Principled regulation provides a clear description of the manner within which the regulator will make decisions.

Regulatory process benefits from the existence of precedents, just as in law, where decisions are consistent with previous decisions and where new issues are dealt with by referring to the cornerstone principles of regulation. In other words, the Regulatory Compact.

Regulators and regulated utilities have been faced with a significant number of new issues as a result of restructuring. This has led to divergent interpretations and rendered, almost impossible a common understanding of which regulatory principles are being applied to various decisions and further confusion is occurring as seemingly different principles are applied to gas versus electricity decisions.

### **Slide 8**

A reduction in regulatory predictability creates an adverse climate for not only the regulator but for the utility companies and the customer as well. Our concern is that, left unchecked, this will lead to an erosion of standards and respect for the Regulatory Compact.

With deregulation or restructuring, it was the belief, at least in Alberta, of the regulator and regulated utilities, that the regulatory process would become simpler and more efficient as our business was now streamlined to focus solely on “pipes and wires” - the simple job of transporting a commodity from one point to another. However, nothing could be further from our original expectation. Our applications are more onerous today than in the 80’s and 90’s.

### **Slide 9**

The involvement of intervenors and the attendant costs of intervention have increased dramatically and I would go so far as to say it is out of control despite the efforts of regulators and government to reduce duplicated customer intervention.

In Alberta, even though our regulator has a self-imposed 90-day deadline for decisions from the close of record, this recently evolved process has been characterized by a significant increase in applications for review and variance, leaves to appeal and incomplete decisions requiring time consuming, tedious, and unproductive compliance hearings.

It doesn't have to be this way - if we go back to basics and re-establish the meaning of the Regulatory Compact.

I believe we should start with the concept of monopoly. When it is in the public interest that a company be granted a monopoly to supply a public service then that company gives up its rights to set price, or discriminate against customers or geographies and agrees to submit to the authority of the regulator.

### **Slide 10**

It is incumbent upon the regulator then, to act as a proxy for competition and in doing so, as stated in *The Public Utilities Act*, the regulator is charged with setting "just and reasonable rates which are not unduly discriminatory and which are in the public interest."

In plain and simple English, this means just and reasonable rates that don't discriminate against either the utility or its rate payers. Rates that are in the public interest must also mean rates that don't cause harm or impairment to the utility which would not be in the public's interest.

## Slide 11

This brings me to my third and final topic of *Returns*. Regulated companies (whether investor owned or government owned) employ shareowner capital and incur debt to provide the necessary facilities. As in any enterprise, debt holders expect to be repaid with interest and they establish guidelines in determining the risk of not being repaid. Shareowners expect to receive a fair return of and on their capital.

Return of capital is accomplished through a depreciation allowance which attempts to match the return of capital to the life of the asset. For the return on capital, the regulator, as the proxy for competition, is charged with determining a fair return on the equity employed.

While most regulators and utilities agree there is lower risk in regulated businesses, the current impact of prescriptive vs. prospective regulation, the micro management of operating methodologies, and cost disallowances occurring in light of overwhelming customer intervention, has added, in my opinion, an opaque layer of risk to utility shareowners and debt holders which is not reflected in the current returns. Nor is there the reflection of a premium offered to a utility if it is outperforming its peers.

Prudency in capital needs and costs must be determined while taking into account the economic, environmental and geopolitical nature of the jurisdiction within which the utility is operating.

It is not enough to simply approve a capital structure and return that pressures the utility to no longer having the ability to raise funds at a reasonable rate. For one thing, the

vagaries of financial markets make this a moving target and secondly, capital is not attracted to underperforming assets long term.

I truly believe the predetermined capital structure and ROE formula now implemented will have negative consequences on the health and viability of utility companies in the short term as well as creating the possibility of severe impairment for utilities in the long term.

ATCO Group has set as a self-imposed tenet, and means of differentiating itself, the principle of maintaining a healthy balance sheet to provide for adverse or unpredictable times.

Our utilities are forecasting we will be required to invest \$2.1 billion over the next 36 months.

However, the impact on our utilities which are ring fenced in CU Inc. through covenants prescribed by our debt holders so that our non-regulated businesses cannot be subsidized or financed by the utilities, is one of a downward spiral.

### **Interest Coverage Ratio**

As you can see, on this slide, beginning in 2003, as a direct result of the ROE formula as it tracks 10-year Canada bonds, our utilities interest coverage ratio has fallen from the "A" credit rating we have strived so diligently to maintain to BBB status in just three years and given the new return set in November 2006 we will drop below the BBB

standard just as we have to approach the investment community to raise almost \$1.4 billion of new debt.

### **Slide 12 Five-Year Average Financing Spread**

The five-year average financing spread on 30-year bonds is as much as 62 basis points if we or any company goes from an “A” rating to BBB; however, as you saw on the previous slide, the 8.51% ROE takes us below a standard BBB to negative or BB.

### **Slide 14 Consumer-Paid Borrowing Costs**

The higher the risk an investor perceives in the borrower, the higher the cost. In ATCO’s case, without any new debt raised, the difference on rate payers from an “A” to BBB+ is over \$12 million/year and the cost at or below investment grade will be higher.

But it’s not as simple as that. As a below investment grade enterprise, your counterparty risk to suppliers goes up meaning you will have to post bonds, letters of credit or put up some form of collateral to order equipment, or possibly even pay your rent.

Your ability to attract and retain people is impacted and most importantly your ability to manage through unpredictable situations is diminished.

In Alberta with inflation at 6.5% and rising against 8.5% return and possibly declining and no monetary tools to counteract the high inflation in Alberta, coupled with cost disallowances and the unpredictable nature of what should be relatively simple outcomes puts our utilities in a higher risk category than the 8.5% ROE belies.

## **Slide 15 Leadership**

This is not a one-sided problem. It is my and our companies' belief that it can be resolved - it will take strong leadership from our regulators – it will take vision and foresight – it will take a just and reasonable perspective.

It will require us to go back to the basics of what our Regulatory Compact means and apply it in a way that provides for efficient and predictable outcomes.