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Important AUC Decision on the Treatment of Customer Contributions: Getting the Price Signals Right

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Decision Commented On: AUC Decision 26061-D01-2021, Commission-Directed Examination of Distribution Facility Owner Payments under the Independent System Operator Tariff Customer Contribution Policy (23 April, 2021)

This decision has a long and complicated history arising most immediately out of Decision 22942-D02-2019 dealing with the Alberta Electric System Operator's (AESO) 2018 tariff (for ABlawg comment on some aspects of that decision see here) as well as the AUC's subsequent variance decision: Decision 24932-D01-2020.

This decision by the Alberta Utilities Commission (the Commission or the AUC) grapples with what are known in utility parlance as contributions in aid of construction (CIAC). Here is a straightforward example of a CIAC. Suppose that you live on an ordinary city block where the costs to tie in your house for utility service will be approximately the same for your house as would be for any other house on the block. You would not expect to pay extra to be tied in, and that this cost would simply be part of the utility's general rate base. But suppose that you live on an acreage and some distance from the main distribution lines (gas, electricity, or water). In that case, it is entirely possible that you may be asked for a CIAC representing the actual incremental cost of the tie-in (or perhaps that amount above the cost of a standard tie-in). This is fair to other utility customers since your tie-in costs are more than the average and might not make economic sense to the utility, and it avoids inappropriate cross- subsidization. Since you have covered the capital costs of the tie-in, these costs do not form part of the utility's rate base on which it is entitled to earn a return even if the utility owns that tie-in.

Now let us translate this straightforward example to an interconnected and unbundled electricity system in which we have a transmission network owned by transmission facility owners (TFOs), but where system access is under the exclusive control of the AESO (*Electric Utilities Act*, SA 2003, c E-5.1 (*EUA*)), and where most load connects to the electricity system through a distribution system that is owned and operated by Distribution Facility Owners (DFOs) (*EUA*, s 101(1)). In exceptional circumstances, load may be able to direct connect to the transmission system with the approval of the relevant DFO and the AESO (*EUA*, s 101(2)).

In Alberta, the general principle is that utilities are regulated monopolies and load (i.e., consumers) are responsible for all regulated utility costs, including transmission costs other than line loss costs (Transmission Regulation, Alta Reg 86/2007, s 31 (TReg)). But, for the most part, both the *EUA* and the TReg are silent with respect to CIAC. The one exception to both propositions is that s 29 of the TReg indicates that generation may be required to contribute to the costs of upgrades to the transmission system or for locating in areas where generation exceeds load.

In this proceeding, the Commission addressed three main questions about the treatment of transmission related to CIAC costs within this more complicated framework. (1) Is there legal authority for the AESO to establish and for the AUC to approve CIAC as part of the AESO tariff? (2) If there is such authority, should CIACs be applied to DFOs, and, if so, is there legal authority for the DFO to recover its CIACs as part of its approved tariff? And finally, (3) what principles should inform DFO recovery of any CIAC it has paid?

Is There Legal Authority for the AESO to Establish and for the AUC to Approve CIAC as Part of the AESO Tariff?

While the *EUA* is silent with respect to contributions by load in aid of construction, the AUC and its predecessors have long taken the view that the AESO can and indeed should provide for CIAC. It should do this as part of its statutory duty to establish a tariff that provides for the recovery of prudent costs "reasonably attributable to each class of system access service" provided by the AESO and sufficient to recover, *inter alia*, the amounts to be paid under a TFO's tariff (*EUA* s 30(2) and the decision at para 34). In giving effect to CIAC, the AUC and its predecessors have distinguished between costs directly related to a new local connection and the deep system costs of an expansion. Only the former costs properly fall within CIAC. "The deep system costs of expansion are properly the responsibility of all customers, form part of the utility's revenue requirement and should be recovered from all customers through rates" (at para 37 and quoting from an earlier decision of the AEUB). This distinction is captured by a maximum AESO investment level calculation for each project.

If There is Such Authority, Should CIACs be Applied to DFOs and, if so, is There Legal Authority for the DFO to Recover its CIACs as Part of its Approved Tariff?

It has also been the consistent practice of both the AUC and its predecessors to apply CIAC policy to both direct connect customers under s 102(2) of the *EUA* and to the system access requests of a DFO under s 34 of the *EUA.* Additionally, it has also been the custom to allow the DFO to recover those contributions through its own tariff, including its own CIAC policy (at paras 45 – 46). It follows that where a DFO pays a CIAC for a transmission facility, that CIAC amount is not included in the TFO's rate base (at para 33). As an aside, this has long been a source of contention for TFOs who have, for example, argued (unsuccessfully) that they should charge and receive a management fee for these CIAC contributions (at para 47).

The Commission confirmed the validity of these understandings and practices in the current proceedings and indeed concluded that "there is nothing legislatively that prevents the AESO from including a customer contribution policy (which encompasses contributions by DFOs and Direct Connect customers) within its tariff, and in fact, that its inclusion is supported by the overall policy objectives of the act to incent optimal behaviour" (at para 57). The Commission also confirmed that a DFO should be able to recover its CIAC costs from its customers through the DFO's approved tariff even though those costs represented an investment in the transmission system rather than the DFO's distribution system (at paras 90, 93). The Commission supported this interpretation by referencing s 122 of the *EUA* which deals with the costs and expenses that a DFO can recover as part of its tariff. The Commission was of the view that the language used in this section was broad enough to cover the recovery of a CIAC payment made by the DFO.

But what are the principles that should guide CIAC recovery within the DFO's tariff? Do the current rules create a perverse incentive for a DFO to pursue transmission solutions to distribution problems?

The Principles That Should Guide CIAC Recovery Within the DFO's Tariff

This is the most important part of the current decision. The Commission begins by detailing how DFO CIACs are treated for ratemaking purposes under both cost-of-service (COS) ratemaking (the basic model for DFOs prior to 2013) and under performance-based regulation (PBR), in effect from 2013 in two different phases, PBR 1, covering the period 2013 – 2017, and PBR 2, covering the current period, 2018 – 2022 (at paras 99 – 109).

The treatment of CIAC under COS ratemaking is very clear. Under that regime, CIAC payments were capitalized and then depreciated over future years. As such, they entered into the DFO's rate base and the DFO earned an approved rate of return on the undepreciated amount (at para 100). This was the case even though the CIAC was effectively an investment in a TFO's facility. While PBR adds all sorts of bells and whistles to this scheme to try and ensure greater scrutiny of new capital additions, neither PBR 1 with its "capital tracker scheme" (at para 103), nor PBR 2 with its type 1 and type 2 capital projects (at para 105), seem to have resulted in significant changes to the treatment of CIAC (at paras 107, 117).

But the more fundamental threshold question is this: do DFOs generally flow through their CIACs to the particular customers that imposed these costs, or do they generally recover those costs from all ratepayers? In answering this question, the Commission focused on Fortis as a pure-play DFO (i.e., a DFO without an affiliated transmission division, at para 119) and because the evidence showed that the amount of Fortis rate base represented by CIAC (in transmission facilities) had grown dramatically over the last number of years (at para 119). The question is crucial because if the DFO is recovering these CIAC costs from all ratepayers rather than flowing them through to particular customers, then CIAC is not imposing the same economic discipline on DFOs that it imposes on direct connect customers (at para 114).

Indeed, where the cost of a DFO's CIAC investments is included in its rate base, and where those costs are recovered over time from all customers, a DFO has a powerful (and perverse) incentive to seek transmission solutions to distribution problems. Dissenting opinions in several recent AUC decisions have commented on the lack of oversight of DFOs' requests for system access service (SASR) under s 34 of the *EUA*. (For references to and ABlawg commentary on those decisions see How Should We Assess Transmission Upgrades When They are Requested by the DFO?)

The following paragraphs provide the Commissions' damning assessment of what had been happening (and indeed, what the Commission had allowed to happen):

121. … [T]he Commission considers that there is a general incentive for DFOs to increase the amount of AESO customer contributions to grow rate base, and that *this incentive is exacerbated by the fact that a DFO has a degree of influence on transmission project requirements, associated costs, and therefore AESO customer contribution amounts*. As noted above, it is the responsibility of the DFO to work with its customers to identify distribution connection capabilities. When the distribution system access is inadequate to meet capacity or reliability requirements and a transmission solution is the preferred alternative, the DFO files a system access service request (SASR) with the AESO on behalf of the DFO or its customer.

122. AltaLink cited the AESO's testimony from the 2018 ISO tariff proceeding that distribution planning is beyond the AESO's mandate, and that it is "primarily relying" on the DFO's assessment of need for transmission facilities. In Decision 21538-D01-2017, the Commission observed that the DTS contract capacity increment assigned to each transmission project, which was determined by Fortis, was a key driver of the maximum investment level set for each project and affected the amount of the contribution required to be funded by Fortis. *The Commission observed that the AESO customer contribution amounts incurred may reflect decisions within a greater degree of Fortis's control than may have been recognized in prior proceedings, where the Commission had relied primarily on evidence that the contributions were driven by, and involved decisions made by third parties, namely the AESO and AltaLink*.

123. The Commission considers that the amount of the AESO customer contributions related to specific projects included in a DFO's rate base can be reduced by flowing through all, or a portion of, the contribution amount, to the end-use customers driving the need for the project (assuming the presence of one or more identifiable end-use customers). *However, in Decision 21538-D01-2017, the Commission noted that Fortis confirmed that it has not received, nor did it expect to receive, any customer contribution amounts from its end-use customers served through the transmission facilities.*

124. In Decision 21538-D01-2017, the Commission stated its concern that AESO customer contributions were not being flowed through to some large customers, resulting in a potential for substantial stranded investments in new or upgraded transmission connection facilities which would be borne by customer classes that did not require additional capacity. The Commission considered that the transfer of transmission investment risk from Fortis's larger capacity customers to smaller customers could potentially be mitigated by flowing through some or all of the AESO customer contributions to the end-use customers that may be the primary drivers of transmission investments.

125. *Based on this analysis, the Commission finds that the current DFO tariff recovery mechanism applicable to AESO customer contribution amounts fails to provide effective price signals intended to incent the end-use customers to choose the most economical connection solution*. (emphasis added, references omitted)

The Commission expanded on this conclusion as follows:

> 126. First, the DFO is not generally flowing the costs of the AESO customer contribution amounts to the end-use customers that trigger the need for new connection assets. As a result, the costs of the AESO customer contributions associated with the connections are socialized across all DFO customers. This mutes the price signal on siting decisions since the customer or customers that caused the need for a new connection do not directly pay their share of the AESO customer contribution associated with the assets ultimately built. Conversely, when the AESO customer contributions are passed-through to an end-use customer of a DFO or are paid by a Direct Connect customer, the intended price signal to impose economic discipline on siting decisions operates properly.
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> 127. Second, the DFO is able to earn a return on its invested AESO customer contribution amounts. As a result, the intended price signal is at best distorted or muted and is likely absent. In fact, what was intended to be a price signal is converted to a revenue signal to a DFO. The Commission considers that the tariff recovery mechanism applicable to AESO customer contributions could creates [*sic*] an incentive for Fortis, as a pure-play DFO, to prefer a transmission solution over a distribution solution, because it would need to manage and operate the assets associated with a distribution solution and bear all of the attendant ownership risks, when it receives the same rate of return on the investment in either case.

Having identified the problem, the Commission turned to identify the best solution(s). The first step was to remove the incentive to DFOs, like Fortis, to prefer transmission solutions. The Commission proposed to do this by denying the DFO the opportunity to earn a return on CIAC. The Commission recognized that this might mean that CIAC would no longer be eligible for inclusion in a DFO's rate base and that therefore some creative accounting solutions (such as a contributions reserve account) might be required to ensure that the CIAC costs could be spread over a number of years (at para 134). Considering that it did not have enough information before it to take a specific ruling, the Commission decided to establish an additional process to examine "the tariff mechanism for the recovery of future AESO customer contributions within the DFO tariff" (at para 136). The Commission gave the following directions to guide the development of DFO proposals:

> - An evaluation of whether it is appropriate to recover AESO customer contributions as an expense item in the year they are made, similar to other operating expenses.
> - The use of a reserve account or similar mechanism if it is determined that DFO AESO customer contribution amounts are too large to be fully recovered in the year they are made. If a reserve account is required, the proposal(s) should consider the appropriate amortization period for recovery of the contribution amounts and of how the debt-only financing costs associated with the reserve account should be calculated and recovered.
> - A proposal for greater cost accountability for the customers that drive the SASR [System Access Service Request] and the CIAC required for the new facilities connection.

- The impact of the revised accounting treatment proposal(s) on each DFO.
- Any risks associated with the proposal(s), the likelihood of the risks arising and the consequences of the risks should they occur. (at para 139)

Second (although logically perhaps this should be the first step), the AUC directed that DFOs should, where possible, flow through CIAC "to the specific customers that require the connection and, therefore, the additional investment, the price signal is imposed on the customer, in terms of decisions both with respect to siting and to the nature and size of facilities required" (at para 133). It would appear that the Commission proposes to address this issue through the same additional process insofar as the Commission is asking for submissions dealing with, *inter alia,* "greater cost accountability for the customers that drive the SASR [System Access Service Request] and the CIAC required for the new facilities connection" (at para 139).

The final issue that the Commission had to resolve in this proceeding was the effective date of these changes to the treatment of DFO CIAC. The Commission had directed in an earlier proceeding that any order would be prospective – see [Decision 24932-D01-2020]() (review and variance of the Commission's decision on the AESO 2018 tariff application), at para 183 that "[i]f a new policy is approved, the commencement date would be on a prospective basis."

While some participants advocated postponing any implementation of this changed treatment of CIAC, either to the commencement of the next PBR period (i.e., PBR 3 in 2023) or upon the outcome of the AUC's consideration of the AESO's upcoming contribution policy review (at para 141), the AUC directed that the change should come into effect immediately (at para 142) with respect to all new AESO customer contribution payments. For clarity "[t]he tariff recovery mechanism currently in effect for AESO customer contributions made prior to the date of this decision shall continue to be in effect until these costs are fully depreciated" (at para 142).

Conclusions

The concept of contributions in aid of construction should be a useful tool to discipline a utility's investment in new capital infrastructure and to limit the degree of inappropriate cross-subsidization across consumer classes. It is a relatively easy and intuitive concept to apply in the context of, say, a water utility. (Which is one of a number of reasons why I used to use an AUC water rates decision when teaching basic aspects of utility regulation in an energy law course!) But it is more difficult to apply in the context of an unbundled electricity system in which transmission and distribution are separate functions, and within which system one set of owners, the TFOs, are subject to greater supervision and direction by the AESO than another set of owners, DFOs. This is further complicated by the fact that TFOs continue to be regulated on a cost of service basis with frequent tariff filings while DFOs have subject to PBR as noted above since 2013 and hence subject to less regulatory scrutiny of their costs and hence rates.

What this decision shows is that DFO CIAC's may be used quite perversely such that they actually incent new transmission investments rather than the reverse, and at the same time may permit inappropriate cross-subsidization. That this has happened appears to be due, at least in part, to the information asymmetry between the DFOs and the AUC, and because the AESO does not subject DFO SASR requests to the same degree of scrutiny as other types of transmission investments. The decision also demonstrates how long it takes to bring about change within a system of utility regulation even though the practice of allowing DFOs to recover a return on CIAC has been under scrutiny for some time.

The decision will correct the current price signal and incentive that stand-alone DFOs have to encourage new transmission investments involving CIAC. This is a welcome development, but I would have liked to have seen more discussion about the decision to confine the analysis to the prospective application of the treatment of CIAC. That decision was perhaps motivated by a concern that the AUC should not engage in retrospective ratemaking, but I think that the possibility of denying DFOs the right to continue to earn a return on CIAC on a go forward basis for existing projects merited some consideration.

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