STATE OF MAINE
PUBLIC UTILITIES COMMISSION
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January 3, 2006

The Honorable Phillip Bartlett II, Senate Chair
The Honorable Lawrence Bliss, House Chair
115 State House Station
Augusta, Maine 04333

Dear Senator Bartlett and Representative Bliss:

Title 35-A, section 3195 authorizes the Public Utilities Commission to adopt rate mechanisms that promote electric utility efficiency. Subsection 5 of that section directs the Commission to submit an annual report on its activities regarding alternative rate mechanisms to the Joint Standing Committee on Utilities and Energy. Enclosed please find the Commission's annual report.

The Commission looks forward to working with the Utilities and Energy Committee on this issue when necessary during the upcoming session. If you have any questions regarding the report, please contact the Commission.

Sincerely,

Kurt Adams JLP

Kurt Adams, Chairman,
Maine Public Utilities Commission

Stephen L. Diamond DLK

Stephen L. Diamond, Commissioner

Sharon Reishus CPS

Sharon M. Reishus, Commissioner

Encl.

cc: Utilities & Energy Committee Members
Lucia Nixon, Legislative Analyst

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2005 Annual Report by the Public Utilities Commission
To the Utilities and Energy Committee
On Electric Incentive Ratemaking and Actions Taken by the Commission
Pursuant to 35-A M.R.S.A. § 3195

35-A M.R.S.A. § 3195 authorizes the Public Utilities Commission (Commission) to adopt rate mechanisms that promote electric utility efficiency. Subsection 5 of § 3195 states:

> **Annual Report.** The Commission shall submit to the joint standing committee of the Legislature having jurisdiction over utilities matters an annual report detailing any actions taken or proposed to be taken by the Commission under this section, including actions on mechanisms for protecting ratepayers from the transfer of risks associated with rate-adjustment mechanisms. The report must be submitted by December 31st of each year.

This report provides background information about the use of alternative rate mechanisms in Maine and describes Commission actions taken during 2005 regarding mechanisms that promote electric efficiency through incentive rate plans.

I. BACKGROUND

Since 1995, several Maine utilities have operated under Alternative Rate Plans (ARPs). These plans replace traditional rate of return regulation[1] with a multi-year price cap approach that places an upper limit on the utility's rate increases, while allowing the utility to retain savings it accomplishes through improved efficiencies. ARPs, as a general matter, create rate predictability and stability, reduce regulatory costs, and provide stronger incentives for utilities to minimize their costs. However, if not properly structured, ARPs can disincentivize investment by utilities and undermine other goals of public policy, such as energy efficiency. At the present time, two of the state's investor-owned utilities, Central Maine Power Company (CMP) and Bangor Hydro-Electric Company (BHE), operate under ARPs.

A. CMP

On November 16, 2000, the Commission approved a second Alternative Rate Plan (ARP 2000) for CMP. With generation open to market competition, transmission service subject to Federal Energy Regulatory Commission (FERC) jurisdiction, and stranded costs being periodically adjusted in accordance with Maine law, ARP 2000 only applies to distribution rates and service. CMP's ARP 2000 is a seven-year plan scheduled to expire on December 31, 2007. The plan provides for

[1]Rate of return regulation is a regulatory approach in which the Commission examines all reasonable expenses a utility is likely to incur and establishes rates that will allow the utility, if operated efficiently, to recover those expenses and earn a reasonable return on its investments.

annual rate changes on July 1st of each year, which are based on a well-established formula of inflation minus a productivity offset, adjusted for mandated costs, earnings sharing and service quality index penalties. In comparison with CMP's previous ARP, ARP 2000 contains significantly stronger productivity incentives, allows only low-end earnings sharing, and increases the number of service and reliability indices that CMP must maintain. These changes responded in part to CMP's merger with Energy East, Inc. In our order approving that merger, we recognized that the rate conditions imposed in connection with our merger approval (ensuring that ratepayers receive a reasonable portion of the efficiency savings while allowing Energy East an opportunity to recover its acquisition premium) could best be accomplished through an incentive rate plan.[2]

B. BHE

On June 11, 2002, we issued an order which approved a Stipulation, entered into by BHE, the OPA, and Georgia-Pacific Company, to establish an Alternative Rate Plan for BHE. The BHE ARP, as it was referred to in the Stipulation, took effect on the date of the Order and will also run through December 31, 2007. The Stipulation provides for annual rate changes commencing on July 1, 2003. The rate changes will occur in accordance with an Annual Percentage Price Change formula which is composed of Basic Rate Reductions, Mandated Costs, Net Capital Gains and Losses, Earnings Sharing and Service Quality Penalties. The first two Basic Rate Reductions in 2003 and 2004 were set at –2.50% and –2.75%. The rate changes in years four (2005) through six (2007) of the ARP depend on inflation. If inflation in the two years prior to the time of those rates changes averages less than 3%, as is currently projected, the Basic Rate Reductions for those years will be –2.75%, -2.00% and –2.00%.[3] Under the terms of the BHE ARP, BHE is required to submit specific information each year on March 15th to be used to compute the annual allowable price change to go into effect on July 1st of that year. The ARP Stipulation also establishes service reliability and customer service performance levels and subjects BHE to penalties of up to $840,000 if BHE's performance drops below the established levels.

C. Report to the Legislature on the Effect of Alternative Rate Plans on Grid Reliability

During its 2003 session, the Legislature passed an Act to Encourage Energy Efficiency and Security (Act).[4] The Act directed the Commission to investigate regulatory mechanisms and rate designs that provide incentives for transmission and distribution (T&D) utilities to promote energy efficiency and the security and robustness

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[2] *CMP Group, Inc. Et. Al., Request For Approval Of Reorganization And Of Affiliated Interest Transactions,* Docket No. 99-411, Order (Jan. 4, 2000).

[3] *Bangor Hydro-Electric Company, Request for Approval of Alternative Rate Plan,* Docket No. 2001-410, *Bangor Hydro-Electric Company, Proposed Rate Change to Increase Annual Revenues Approximately $6.4 Million,* Docket No. 2001-728, Order Approving Stipulation (June 11, 2002).

[4] P.L. 2003, ch. 219.

of the electric grid.[5] As required by the Act, the Commission submitted a report to the Joint Standing Committee on Utilities and Energy (Committee) on February 1, 2004 (February 1, 2004 Report). In the February 1, 2004 Report, the Commission stated that it believed that ensuring adequate service reliability through objective service quality metrics backed by meaningful penalties incorporated as part of a utility's alternative rate plan, along with the Commission's ability to use its traditional tools to ensure adequate service, was working well. Accordingly, the Commission recommended that no legislative changes be made in this area. The Commission stated that it would continue to monitor Maine's T&D utilities' service quality performance and refine the standards and penalty mechanisms in ways that improve their operation.

During the Commission's presentation of the February 1, 2004 Report, the Committee indicated that it was interested in the continued examination of certain issues associated with grid reliability and security. In a letter to the Commission dated February 23, 2004, the Committee requested that as part of this follow-up examination, the Commission specifically:

1. Quantify the safety margin of the grid system, including such indicators as maintenance activity, and analyze how the margin may have changed over time, particularly as the result of alternative rate plans and restructuring;

2. Assess the adequacy of grid security in light of the events of 9/11 and the blackout of 2003;

3. Examine issues of grid adequacy in remote areas, e.g., Washington County, including looping issues; and

4. Review relevant information including information from transmission and distribution utilities and reports on the blackout of 2003.

The Committee requested that the Commission submit a report with its findings and recommendations during the next legislative session.

On April 29, 2004, the Commission initiated an inquiry for the purpose of conducting the study requested by the Committee.[6] To assist our staff in conducting the study, the Commission retained the services of Liberty Consulting Group, which has extensive experience in reviewing and auditing the reliability of electric T&D services.

Following the initiation of the docket, the Commission's staff and consultants issued written data requests to CMP, BHE, Maine Public Service Company and Eastern Maine Electric Cooperative seeking information from each of the utilities concerning the utilities' processes, planning, performance data, maintenance activities

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[5] For purposes of that investigation, the Commission interpreted the term "security and robustness" to mean reliability of the system rather than protection against terrorist attacks.

[6] The Commission inquiry was docketed as *Maine Public Utilities Commission, Inquiry into the Adequacy of the Electric Grid in Maine,* Docket No. 2004-248.

and investments, as they related to the areas of investigation. Following receipt of the utilities' responses, the staff and consultants conducted interviews with utility personnel. To the extent that utility personnel were unable to provide responses to questions during the interviews, the staff requested that the utility provide the information in writing. On June 17, 2005, the Commission provided its Final Report to the Committee in response to its inquiry (June 17, 2005 Report).

As discussed in the June 17, 2005 Report, the Commission found that, in most respects, the utilities were adequately operating and maintaining the grid. In certain respects, however, our examination revealed signs of potential shortcomings that warranted further and more in-depth review. In particular, we concluded that certain aspects of CMP's distribution system and operation and maintenance practices should be examined. On an overall basis, the Commission found that CMP was maintaining its distribution system to meet the requirements of ARP 2000 and therefore, on a system level, CMP's distribution system appeared to be adequate. However, the Commission was concerned by the disparity between CMP's worst performing circuits and its overall system performance and the nature and scope of CMP's improvement program. This concern was heightened by CMP's previous suspension of its distribution inspection program, the aging of CMP's plant, an increase in the number of outages, and what appeared to be inadequate record-keeping in CMP's distribution planning and maintenance operations.

The Commission and CMP have come to an agreement that now is an appropriate time to further review CMP's distribution system as a means of addressing the areas of concern raised during the Commission's general review, as well as to clarify any areas of misunderstanding between CMP and the Commission which may have arisen as a result of the general review. We also found that this further examination would not only shed light on CMP's maintenance practices but also might provide some indication of the efficacy of the performance standards in ARP 2000 and that such an examination would be especially timely with ARP 2000 scheduled to expire in 2007.

On September 1, 2005, the Commission issued a Request for Proposals for the purpose of selecting an independent party to conduct the further review discussed above. After an extensive evaluation process, which included input from CMP, the Commission has selected Williams Consulting Group to conduct the review. On December 13, 2005, the Commission initiated an inquiry, Docket No. 2005-705, to serve as the vehicle to conduct the further review. The review will examine the operation and maintenance of CMP's distribution system, including, but not limited to: CMP's distribution circuit inspection program; the loading of distribution circuits and planning to address or prevent overload situations; and the Company's distribution vegetation management program. The examination will also include an evaluation of the condition of CMP's distribution facilities and equipment and will determine the adequacy of operations and maintenance practices and procedures to meet current, as well as future, needs. The review will be conducted pursuant to the provisions of 35-A M.R.S.A. § 113. As such, the costs will be paid for by CMP and recovered from CMP's ratepayers.

II. CMP ARP 2000 ACTIVITY IN 2005

A. CMP Request for an Accounting Order

On October 14, 2004, CMP filed a request for an accounting order that would allow for the future recovery in rates of amounts it was unable to obtain from Enron Energy Services, Inc. (EESI) as a result of EESI's bankruptcy. In particular, CMP asked for accounting treatment that would allow it to recover $966,705, which is the amount that the United States Bankruptcy Court determined that CMP, in its role as a billing agent for EESI, had improperly recouped. CMP also asked the Commission to include in the accounting order incremental legal costs associated with claims related to the EESI bankruptcy.

The threshold question in the case was whether the costs, revenues and risks associated with CMP's billing, metering and settlement obligations fall within the provisions of ARP 2000. CMP's argument was that the unusual costs associated with the EESI bankruptcy do not fall within ARP 2000 and should be recovered outside its terms. CMP's position was based essentially on the rationale that the series of events that led to the costs were unanticipated and that neither the restructuring statutes nor the Commission rules contemplated that CMP would be at risk for such unanticipated events.

By Order dated February 2, 2005 in Docket No. 2004-709, we disagreed with CMP's position and found that the risks associated with billing, metering and settlement activities fall within ARP 2000. We found that T&D utilities in this State have the legal obligation to perform billing, metering and settlement functions to facilitate the operation of the competitive electricity markets and that there was no provision in the ARP 2000 agreement or otherwise that excluded these T&D activities from the ARP or suggested that their costs, revenues or risks should be subject to separate rate treatment. We concluded that in order to maintain the intended incentives and expectations of the parties, cost recovery outside the terms of ARP 2000 should only be considered in extreme circumstances in which some undue burden might exist. We therefore rejected CMP's request for an accounting order.

B. Annual Filing Proceeding

On March 15, 2005, CMP submitted its fifth annual ARP 2000 filing for rates to go into effect on July 1, 2005. Several technical conferences were held on CMP's proposal and on June 17, 2005, the Commission received a stipulation entered into by CMP, the Office of the Public Advocate (OPA) and the Industrial Energy Consumer Group (IECG). On June 30, 2005, the Commission issued an Order Approving Stipulation.

Under the terms of our Order Approving Stipulation, CMP's distribution delivery rates decreased by .58% effective July 1, 2005. This decrease was comprised of the following components: (1) the basic price change of inflation (2.37%) minus the 2005 productivity offset (2.75%) totaling –0.38%; (2) flow-through items consisting of Establishment of Service Fee Rate increase reconciliations; (3) DSM over-collection;

Electric Lifeline Program (ELP) over-collection; (4) ELP rate adjustment; (6) PCB transformer replacement costs; and (7) the removal of one-year adjustments from the 2004 price change of 0.97%. The price change agreed to in the Stipulation contained no amounts for mandated costs. The parties also agreed that in 2004, CMP met or exceeded all of the indicators contained in ARP 2000's Service Quality Index (SQI) and therefore, no penalties under the SQI mechanism were applicable. Finally, the parties also agreed not to decide the issue of whether certain costs incurred by CMP from the implementation of L.D. 665, "An Act To Protect The Environment By Phasing Out The Use Of The Old Transformers That Are Potential Sources Of PCB Pollution" (codified at 38 M.R.S.A. § 419-B) were in fact incremental and, thus, properly included in rates, but rather to consider these issues in another proceeding (Docket No. 2004-167) prior to CMP's next scheduled ARP filing on March 15, 2006.

C. Stipulation to Extend the ARP

On December 7, 2005, the OPA filed a stipulation signed by the OPA and CMP that would extend CMP's current ARP by three years, or until December 31, 2010 (December 7, 2005 Stipulation). According to the cover letter filed with the Commission, the December 7, 2005 Stipulation was the result of bilateral negotiations between CMP and the OPA and was the end product of discussions that began on October 14, 2005.

As set forth in cover letter, the December 7, 2005 Stipulation would continue CMP's current ARP with the following four significant additions: (1) an additional productivity offset of 0.5 percentage points for July 2006 with productivity offsets averaging 2% for 2008, 2009 and 2010; (2) limitations on CMP's promotion of the consumption of electricity at or near its winter and summer peak demand periods, as well as collaboration with Efficiency Maine in order to help with its efficiency efforts; (3) an increase in available funding for the low-income Electric Lifeline Program for CMP's customers from $4.0 million to $6.2 million annually; and (4) the commitment by CMP to invest an incremental $25 million through 2010 in its distribution system in order to provide greater assurance of reliable electric service.

On December 9, 2005, the Commission issued a Notice of Proceeding which provided interested persons with an opportunity to intervene in this matter. The Commission will next be establishing a process to adjudicate the December 7, 2005 Stipulation. The OPA and CMP have requested expedited review of the Stipulation with Commission approval by January 31, 2006.

IV. BHE ARP ACTIVITY IN 2005

On March 15, 2005, BHE submitted its third annual filing under its ARP which was assigned Docket No. 2005-179. Following two technical conferences on BHE's filing, the parties and the Commission's Staff engaged in a number of settlement conferences. On June 16, 2005, BHE filed a stipulation signed by BHE, the OPA and the IECG, which proposed to resolve all issues in this matter (June 16, 2005 Stipulation). The Commission approved the June 16, 2005 Stipulation by Order dated September 23, 2005.

Under the terms of the June 16, 2005 Stipulation, BHE's core distribution rates were reduced by 2.44% effective July 1, 2005. This overall rate reduction was comprised of the Basic Rate Reduction of 2.75%, a reduction of 0.96% associated with low-income program costs adjustments, and an increase of 1.27% associated with the recovery of Electric Space Heat revenue deferrals over a four-year period. The parties agreed that the reduction in rates would not apply to BHE's unbundled conservation rates, the tailblock of BHE's Residential Low Income Rates, or the Space Heat Tail-Block Rate.

As part of the June 16, 2005 Stipulation, the parties also agreed that effective October 2005, the total delivery rate (transmission, distribution, and stranded costs) to BHE's three Electric Space Heat categories would be increased to 5.4¢ per kWh and as of the end of July 2005, BHE would cease deferring Electric Space Heat revenues previously approved by the Commission in Docket No. 2000-435.