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SHARON M. REISHUS  
COMMISSIONER

January 2, 2007

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 M.R.S.A. § 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 you and your Committee on these issues during the upcoming session. If you have any questions or comments regarding the attached report, please contact us.

Sincerely,

Kurt Adams, Chairman  
Maine Public Utilities Commission

Sharon M. Reishus, Commissioner  
Maine Public Utilities Commission

Encl.

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



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**2006 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 31<sup>st</sup> of each year.

This report provides background information about the use of alternative rate mechanisms in Maine and describes Commission actions taken during 2006 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<sup>1</sup> 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 annual rate changes on July 1<sup>st</sup> of each year, which are based on a well-established formula of inflation minus a productivity offset, adjusted for mandated costs, earnings

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<sup>1</sup>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.

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.<sup>2</sup>

## **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 ARP 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 3.00%, as is currently projected, the Basic Rate Reductions for those years will be -2.75%, -2.00% and -2.00%.<sup>3</sup> Under the terms of the BHE ARP, BHE is required to submit specific information each year on March 15<sup>th</sup> to be used to compute the annual allowable price change to go into effect on July 1<sup>st</sup> 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.

## **II. 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).<sup>4</sup> 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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<sup>2</sup>*CMP Group, Inc. Et. Al., Request For Approval Of Reorganization And Of Affiliated Interest Transactions*, Docket No. 99-411, Order (Jan. 4, 2000).

<sup>3</sup>*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).

<sup>4</sup>P.L. 2003, ch. 219.

of the electric grid.<sup>5</sup> 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.<sup>6</sup> 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

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<sup>5</sup>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.

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

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 agreed that this was 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. 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 selected Williams Consulting, Inc. (WCI) 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.

As provided for in its contract with the Commission, WCI has examined the operation and maintenance of CMP's distribution system, the Company's distribution vegetation management program and conducted an evaluation of the condition of CMP's distribution facilities and equipment. The Commission expects that WCI will be submitting its final report to the Commission shortly after year's end. Upon its completion, the Commission will forward the WCI report to the Committee.

### **III. CMP ARP ACTIVITY IN 2006**

#### **A. CMP ARP Extension**

On December 7, 2005, the Office of the Public Advocate (OPA) filed a Stipulation entered into between the OPA and CMP to extend ARP 2000 by three years, or until December 31, 2010 (ARP Extension Stipulation). According to the letter filed with the Commission, the ARP Extension 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.<sup>7</sup>

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<sup>7</sup> The Industrial Energy Consumer Group (IECG) filed an executed signature page joining the Stipulation on January 5, 2006.

On April 28, 2006, the Commission's Advisory Staff filed its Bench Analysis in this matter. In its analysis, the Staff concluded that the overall result of the ARP Extension Stipulation was not reasonable, nor in the public interest, and that the rates which would result from the implementation of the Stipulation far exceeded those needed to provide CMP with a reasonable return on its investment and, thus, the Stipulation also failed to meet the criteria of 35-A M.R.S.A. § 3195. The Staff, therefore, recommended that the ARP Extension Stipulation be rejected by the Commission.

During the Commission's June 2, 2006 deliberative session, the Commission concluded that the ARP Extension Stipulation, as proposed, would not produce just and reasonable rates during the term of the ARP and, therefore, would not be in the public interest. Specifically, the Commission found that over the course of the extension period, the Stipulation would result in CMP over-earning in the range of \$20 million, accepting CMP's assumptions, to approximately \$80 million, accepting the Advisory Staff's assumptions which the Commission generally found to be reasonable. The Commission found particularly troubling the fact that the ARP Extension Stipulation, as proposed, would extend the ARP and the ARP's existing service quality protection provisions prior to the completion of the review currently being conducted of CMP's distribution system and maintenance practice and procedures in the current CMP grid study and would also provide a mechanism for the recovery of costs which result from implementing the grid study's results without knowing what the amount or cause of such costs are. Thus, while the ARP Extension Stipulation would produce a certain level of rate stability, which ordinarily can be seen as being beneficial to ratepayers, in this particular instance, this benefit would be achieved at too great a cost. The Commission stated that the other purported benefits of the ARP Extension Stipulation were either minimal or non-existent.

Rather than reject the ARP Extension Stipulation outright, the Commission proposed a set of conditions which, if accepted by the parties, would allow approval of the Stipulation. On June 7, 2006, the Stipulating Parties filed a request that this matter be dismissed without prejudice which was subsequently granted by the Commission.

## **B. Annual Filing Proceeding**

On March 20, 2006, CMP submitted its annual ARP 2000 filing. In its filing, CMP proposed an increase of 0.32% to its core distribution rates to take effect on July 1, 2006. A technical conference on CMP's annual ARP filing was held on April 6, 2006. On June 15, 2006, the Commission received a Stipulation entered into by CMP, the OPA and the IECG. On June 28, 2006 the Commission issued an Order Approving Stipulation. Under the terms of the Stipulation approved by the Commission, CMP's distribution rates were allowed to increase by 0.21% effective July 1, 2006. The following components comprise this year's annual price change: the basic price change of inflation (3.11%) minus productivity offset (2.75%) which yields an increase of 0.36%; on-going L.D. 665 PCB transformer costs of \$57,074; and the flow-through of the following one-time adjustments; DSM assessment over-collection \$46,863 (0.02%); Local Control Center distribution refunds of \$2.25 million (1.00%); and one-time L.D. 665 transformer costs of \$178,771 (0.08%). In addition, \$1,670,148 of one-time rate

reduction adjustments included in last year's price change have been removed prior to the application of this year's price index to rates. The overall result of those adjustments was a net price increase of 0.21% for distribution rates.

### **C. Resolution of Issues Related to PCB Transformer Replacement**

During its 1999 session, the Legislature enacted L.D. 665, "An Act to Protect the Environment by Phasing Out the Use of Old Transformers that are Potential Sources of PCB Pollution." 38 M.R.S.A. § 419-B (L.D. 665). L.D. 665 established voluntary goals for the removal of transformers owned by public utilities in the state that contain polychlorinated biphenyls (PCB) in concentrations at or above 50 parts per million. As part of CMP's last general rate case, the Commission approved a stipulation which authorized CMP to defer for recovery in a future rate case proceeding, the incremental costs of complying with L.D. 665. *Maine Public Utilities Commission, Investigation of Central Maine Power Company's Revenue Requirements and Rate Design (Phase II-B)*, Docket No. 97-580, Order Approving Stipulation (Feb. 24, 2000).

Since 2000, CMP has voluntarily undertaken a multi-year effort to remove PCB-contaminated equipment from its transmission and distribution system. CMP has removed all of its known PCB transformers and sources of PCB oil over 500 parts per million (PPM), as well as transformers suspected of being PCB-contaminated (50-499 ppm PCBs) near schools and waterways. CMP has used a statistical analysis to identify and remove transformers that are most likely to be PCB-contaminated. Transformers likely to be PCB-contaminated are identified by CMP as Priority A and Priority B based on the relative statistical likelihood of contamination.

On June 24, 2003, the Commission issued an Order Approving Stipulation in CMP's 2003 Annual ARP filing which required the parties to the proceeding to investigate further the incremental nature of certain costs associated with CMP's L.D. 665 program. *Central Maine Power Company, Review (Post-Merger) "ARP 2000,"* Docket No. 2003-179, Order Approving Stipulation (June 24, 2003). On June 23, 2004, the Commission issued an Order in the 2004 ARP proceeding, Docket No. 2004-167, requiring the parties to continue investigating the issues related to the incremental costs associated with CMP's PCB transformer replacement program finding that the record in the case did not provide enough information to determine if certain removal costs were in fact incremental and whether CMP was properly accounting for the effect of accumulated depreciation or declining rate base in its rate change proposals. The June 23, 2004 Order referred the issues back to the Examiner for further proceedings to address those questions.

Subsequent to the Commission's Order in Docket No. 2004-167, the parties and our Staff engaged in numerous technical and settlement conferences. On November 22, 2006, the Commission received a Stipulation, entered into by CMP, the OPA and the IECG, which resolved all pending PCB issues in Docket No. 2004-167 and in the Company's subsequent annual ARP cases, Docket Nos. 2005-82 and 2006-166. In its filing letter, which accompanied the Stipulation, CMP states that the Commission Staff was involved in the settlement phases and indicated to the signing parties its acceptance of the terms set forth in the Stipulation.



On December 22, 2006, the Commission issued an Order which approved the Stipulation. Under the provisions of the Stipulation, the parties agree as to what PCB-related costs should be considered incremental and, thus, recovered from CMP's ratepayers. As a result of the agreed-upon adjustments contained in the Stipulation, CMP will reduce its revenue requirements by \$553,321, effective July 1, 2007. In our Order Approving Stipulation, we concluded that the Stipulation's provisions, as well as the overall result of the Stipulation, were reasonable, consistent with all legislative mandates and in the public interest, finding that the Stipulation appropriately balanced the goals of the Legislature embodied in 38 M.R.S.A. § 419-B, the interests of CMP's shareholders and the interests of CMP's ratepayers.

#### **IV. BHE ARP ACTIVITY IN 2006**

On March 15, 2006, BHE submitted its annual filing pursuant to its ARP Stipulation. In its filing, BHE proposed to decrease core distribution rates by 1.37% as its Annual Percentage Price Change. On June 22, 2006, BHE and the OPA filed a Stipulation that proposed to resolve all issues raised in the proceeding and on July 5, 2006, the Commission issued an Order Approving Stipulation. Under the terms of the Stipulation approved by the Commission, BHE was ordered to reduce its core distribution rates by 1.83% on July 1, 2006. This 1.83% overall distribution rate decrease was comprised of three components: (1) the Basic Rate Reduction (inflation minus productivity offset) of 1.99%; (2) an increase of 0.19% associated with Low Income Program cost adjustments; and (3) a decrease of 0.03% associated with the reconciliation of Electric Space Heat revenues.