

Franchise Fee Update – December 2021

Franchise Fee Billing

The City's franchise fees are typically shown as the Local Access Fee (LAF) on electricity bills and as the Municipal Franchise Fee on natural gas bills.¹ Franchise fees are collected from customers paid and remitted to The City by the energy distribution utilities in return for three main benefits;

1. Payment in lieu of property taxes or charges payable to the municipality,
2. Use of the City's Rights-of-Way without lease payments and
3. For the granting of a monopoly to distribute either natural gas or electricity within Calgary.

The Municipal Government Act (MGA) specifies that the franchise fee may be calculated as a percentage of the cost of distribution alone or on the cost of distribution plus the deemed value of the cost of energy. The City uses the second alternative and includes both the cost of delivery and the cost of the energy in the calculation of its franchise fees.

The franchise fee is charged on the customer's utility bill. There are two components to the franchise fee being charged: the cost of the energy used (i.e., the natural gas and electricity) and the cost of the distribution infrastructure (i.e., wires and pipes) to deliver the energy. Franchise Fees are charged at a rate set so that the franchise fee represents 10 per cent of the total bill.²

For natural gas, the variable charge is based on the quantity of gas sold during the month multiplied by the Alberta Utilities Commission's (AUC) Gas Cost Flow-Through Rate (GCFR). For electricity, the variable charge is based on the quantity of electricity sold during the month multiplied by the AUC's Regulated Rate Option electricity price (RRO). The RRO is used to determine the City's Deemed Value of electricity. Since 2010 July 01, all the electricity purchased for the RRO is purchased on a month-by-month basis and therefore the rates vary monthly.

Utility customers pay different amounts for the energy that they consume. For example, some customers are on fixed rate contracts while others prefer the RRO/GCFR which is subject to change every month. To ensure that all customers are treated equally, the franchise fee uses the RRO/GCFR prices as the basis for the cost of energy for all customers when calculating the franchise fee. The MGA mandates municipalities use an AUC approved rates for the franchise fee calculation. The AUC has designated the RRO as the deemed value for electricity and the GCFR for natural gas.

Due to the volatile nature of energy prices, the franchise fee budget has traditionally been set conservatively to minimize the possibility of operational deficits.

¹ For instance, on a 2021 November *Energy and Utilities Statement* from ENMAX, the electricity franchise fee is collected as "Local access fee paid to CALGARY" and the natural gas franchise fee is collected as "Municipal franchise fee paid to CITY OF CALGARY."

² Mathematically, franchise fees are determined by multiplying the rest of the utility bill by 11.11%. This results in the franchise fee equaling 10% of the total bill. The energy component of the franchise fee is based on the month's RRO/GCFR, ergo, if a customer is on a fixed rate contract, their energy charge is based on their contracted rate (which may differ from the RRO/GCFR rate), and as a consequence, the energy component of the franchise fee paid (which is always calculated from the RRO/GCFR) may not necessarily amount to 10% of their total bill.

Benefits to the franchise fee methodology

- Captures changes in both Distribution/Transmission costs and commodity prices. Commodity prices generally follow the ups and downs of the Calgary economy.
- Using the same franchise fee methodology for electricity and natural gas provides a consistent and transparent policy for raising revenue for all utility distribution services.
- Provides a diversified source of revenue for The City

The City benefits from having diversified sources of revenue. Calgary's rate of growth is correlated to the economic wellbeing of the oil and gas industry, which in turn depends on the price of energy. When the price for energy is relatively high economic growth accelerates and the demand for infrastructure and municipal services correspondingly increases. Higher energy prices also increase the energy component of franchise fee revenues that help to pay for the rising demand. During periods when energy prices are falling Calgary's rate of growth is reduced, demand for additional infrastructure declines and revenue from franchise fees is correspondingly less. Conversely, the wires/infrastructure component of the franchise fee is not as dependent on commodity prices, and therefore provides stability when electricity and natural gas prices are volatile.

Having a source of revenue that correlates to a fundamental component of Calgary's growth is beneficial to The City's overall tax structure as follows;

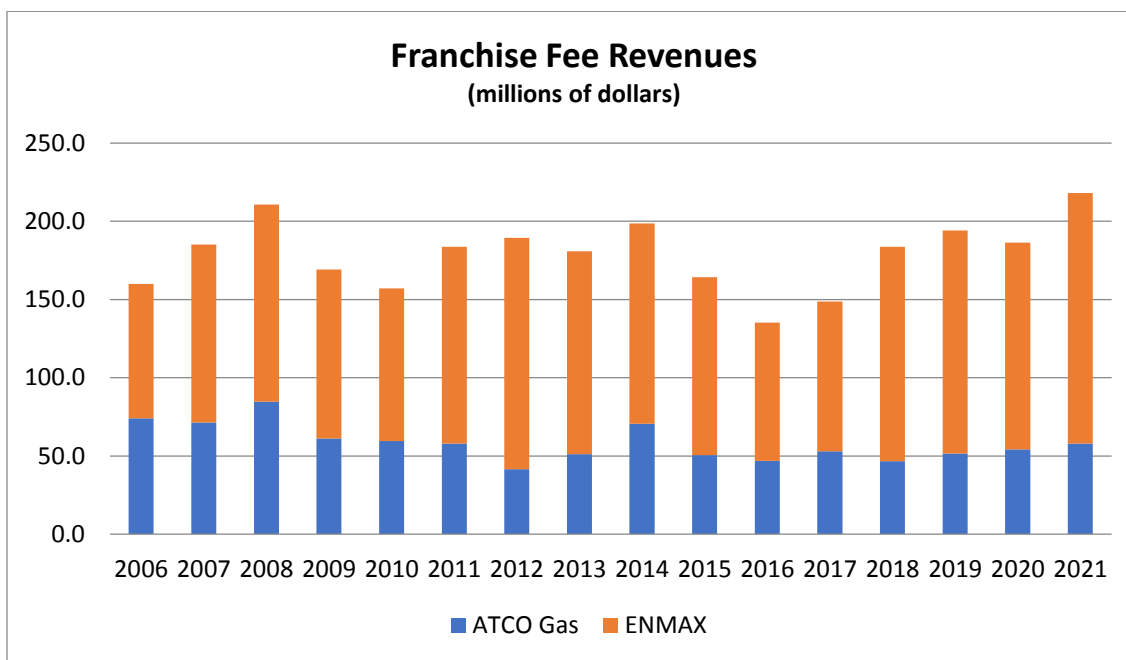
- Rising franchise fee revenue when the price of energy is increasing acts as a natural hedge to offset the increase in cost of utility services.
- Small customer bills are more heavily weighted to the distribution cost (i.e., more of their bill goes towards distribution charges), and large customer bills are more weighted to energy consumption (i.e., more of their bill goes towards energy charges). The current franchise fee methodology gives equal weighting to both the distribution and energy charges, capturing franchise fees indiscriminate of customer size.

Impact of variables in the franchise fee revenue

There are three variables that impact the revenue.

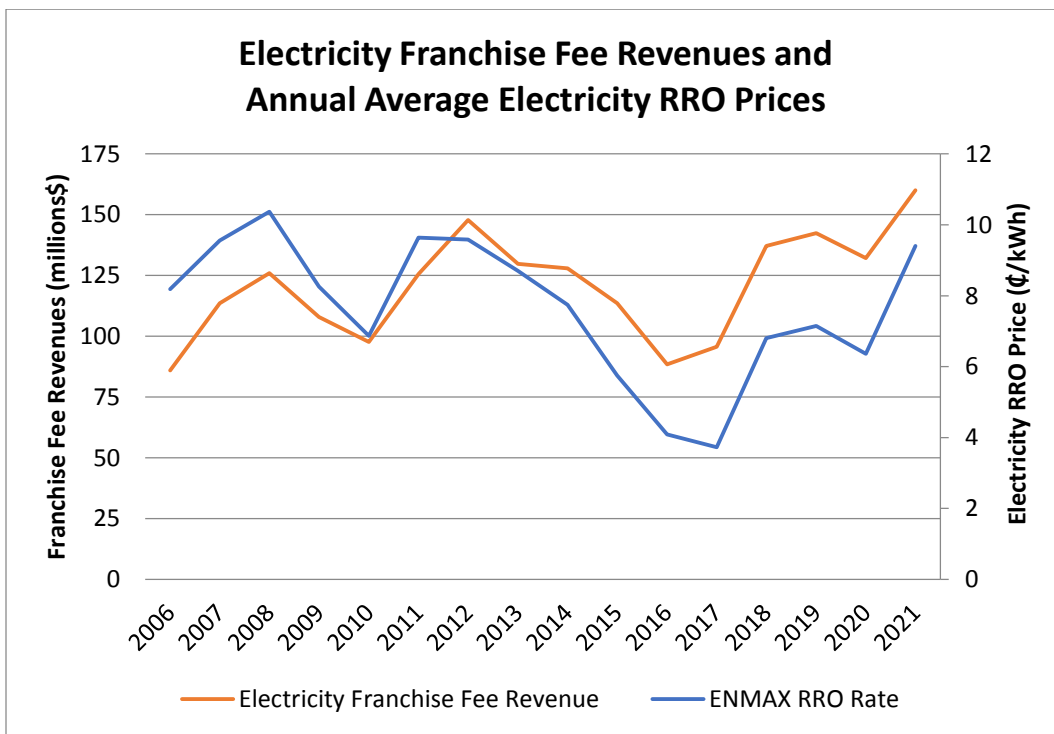
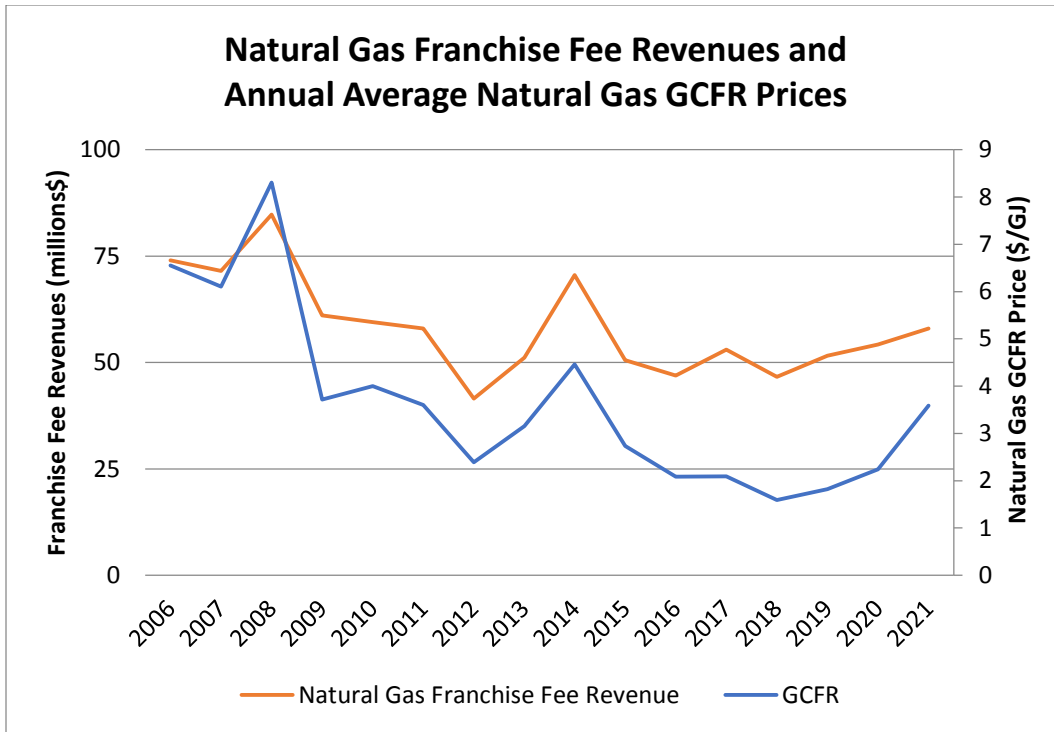
1. **Prices** - Higher or lower electricity and natural gas commodity prices. We are currently in a high price environment which is forecast to last into 2023. Increased environmental costs and the expected retirement of coal-fired generation in Alberta by the end of 2023 are expected to place upward pressures on electricity and natural gas prices in the near term. With the increased proliferation of natural gas fired power plants for baseload generation in Alberta, a stronger correlation can be expected between provincial electricity and natural gas prices. The market is bearish for both electricity and natural gas prices beginning in 2023 and further out.
2. **Volumes**- Volumes are both temperature and economically sensitive. Natural gas volumes can fluctuate by up to 10 per cent in a year. Major improvements in heating efficiencies have been made in the last 25 years which have significantly reduced per capita consumption of natural gas in Calgary. However, the average per capita consumption of natural gas seems to have leveled. Downtown vacancies have increased significantly, lowering consumption and the corresponding franchise fee collected.,

3. **Rates** - Utility distribution/transmission rates also impact franchise fee revenue. These have tended to be more predictable. Rate stability is a key consideration of the AUC in its rate setting function



The chart above shows annual franchise revenue back to 2006, with actuals for 2006 to 2020 (inclusive) and a preliminary estimate for 2021. The majority of the volatility in both is due to commodity price changes.

Below are charts depicting total annual franchise fee revenue along with an annual average of the corresponding underlying GCFR/RRO rate. Please note that the 2021 franchise fee revenues are forecasts, whereas the 2021 GCFR/RRO rates are actuals.



For 2021 the forecast estimates recently provided are \$58M and \$160M for ATCO Gas and ENMAX respectively. These amounts are greater than recent history and largely due to commodity prices rising throughout 2021. The 2021 full year GCFR for natural gas is \$3.59/GJ and the RRO for electricity is 9.402 ¢/kWh. These higher natural gas and electricity prices are forecast to continue into at least the first half of 2022.

2021 Volatility in Natural Gas and Electricity Markets

Natural gas prices are at their highest monthly levels since early 2014 due to multiple factors, including a decrease in North American natural gas production following shut-ins in 2020, rising liquified natural gas exports, and colder-than-normal weather depleting reserves to keep North American natural gas inventories low.

Likewise, the Alberta electricity market has been at multi-year highs in 2021, with the annual average wholesale price set to be the highest since 2000. Year-over-year, significantly higher electricity prices have been seen in Alberta because of increased demand, higher generator offer prices, tighter environmental legislation, additional generator outages, and strong natural gas prices. With the rapid retirement and replacement of coal fired generation with natural gas-fired (combined cycle) generation, there have been additional coal unit outages this year, and many of them are being converted into natural gas-fired units. As such, natural gas prices are expected to become a more important factor in determining Alberta electricity prices.

While the general market consensus is that there is will be some strength in natural gas prices in the near term, Alberta electricity prices (based on industry forecasts and historical trends) are unlikely to remain at their present elevated levels in 2022-2023. As such, care must be taken when interpreting 2021 natural gas and electricity prices (and subsequently, franchise fee revenue collected), as 2021 may be an anomalous year with respect to Alberta natural gas and electricity prices.