Adopting a Quantity Only Model for Franchise Fees

PURPOSE

This report describes and recommends the Quantity Only methodology for calculating the electricity Local Access Fee (LAF). Primary considerations are greater stability in one of The City's most important revenue streams and greater predictability of charges for Calgarians.

PREVIOUS COUNCIL DIRECTION

On 2023 December 19, Council directed Administration (C2023-1180) to:

Postpone Confidential Report C2023-1180, Potential Changes to Local Access Fees – Budget Implications and Calgarian Impacts, C2023-1180, until The City of Calgary receives further clarity from the Government of Alberta about the future of the Regulated Rate Option (RRO)

1. If no clarity is received from the Government of Alberta with respect to Recommendation #1 above, resume Item 6.1.2, Potential Changes to Local Access Fees – Budget Implications and Calgarian Impacts C2023-1180, at the 2024 March 18 Strategic Meeting of Council;
2. Direct Administration to prepare a public release based on non-market sensitive information from the Confidential Attachments linked to Confidential Report Potential Changes to Local Access Fees – Budget Implications and Calgarian Impacts, C2023-1180;
3. Provide Administration with any further questions of clarification or requests for information on this item, with a 2024 January 19 deadline for those submissions;
4. Direct that the Closed Meeting Discussions, Confidential Report, and Confidential Attachments be held confidential pursuant to Section 24 (Advice from officials) of the *Freedom of Information and Protection of Privacy Act*, to be reviewed no later than 2026 December 31; and
5. Direct that, notwithstanding Recommendation 5, the Closed Meeting Discussions, Confidential Report, and Confidential Attachments be released to Corporate Planning and Performance, to be shared with Administration, only where required, to support next steps.

Background and previous Council direction is included as Attachment 1.

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RECOMMENDATION:

That Council:

1. Direct Administration to design and implement a revised methodology that aligns with the Quantity Only model, to transition The City in how it collects Local Access Fees from electricity and franchise fees from natural gas starting from 2027 January 01.
2. Direct Administration to seek all necessary approvals, including Alberta Utilities Commission (AUC) approvals, in order to implement a Quantity Only model for collecting franchise fees from electricity and natural gas.
3. Direct Administration to use the following design principles in designing a Quantity Only model:
    a. Build a model that will provide more stability and predictability than the current model in how much The City collects in revenue.
    b. Support affordability concerns of Calgarians and businesses.
    c. Minimize shifts in proportions across user classes with the intent of not materially shifting the financial responsibility from one user class to another.
    d. Maintain and improve The City's financial sustainability ensuring The City continues to collect at a minimum the currently budgeted Local Access Fee and Franchise Fee amounts from both electricity and natural gas.
    e. Build a model that will continue to support both The City's operating and capital budgets.
4. Continue advocacy efforts aimed at other orders of government to secure necessary funding for infrastructure and capital investments in The City.
5. Direct Administration to change the *Council Policy CFO003 Franchise Fee/MCAF Revenue Budgets and Variances* and develop a funding source, program and framework to support an annual amount of $10 million in 2025 and 2026 for Energy Poverty and Affordability initiatives with funding from a portion of any potential positive variance collected from the Local Access Fee operating budget.

CHIEF ADMINISTRATION OFFICER/GENERAL MANAGER COMMENTS

General Manager of Corporate Planning and Financial Services and Chief Financial Officer, Carla Male, concurs with this report. Council direction regarding reducing Franchise Fees volatility and positive benefits for Calgarians was considered in weighting the criteria to evaluate potential options and alternatives.

HIGHLIGHTS

- With the dramatic increase in the volatile monthly Regulated Rate Option (RRO) price for electricity in the last several years the revenue from the Local Access Fees (LAF) has increased significantly.
- The future of the RRO is uncertain as the province is planning to review it in the future.
- Transitioning to a quantity only model would provide greater stability in LAF revenue for The City and more predictability of charges for consumers.
- Council will have the ability to set an annual LAF rate (within regulated parameters) to target an LAF revenue figure based on forecasted electricity and/or natural gas consumption

figures. This will require annual review, have more administrative burdens, and be subject to public scrutiny. The risks of continuing with the current model, however, may outweigh the risks of transitioning to a quantity only model.

- Natural Gas Franchise Fees are subject to similar (albeit less) volatility and to be consistent both should be changed if directed by Council.
- Changing LAF methodologies would affect City planning and budgeting and would require changes to the ENMAX Franchise Fee and the Canadian Western Natural Gas Company (ATCO) agreements, which would need to be approved by the Alberta Utilities Commission (AUC).
- To allow time for design, approvals and implementation, the new methodology would take effect on 2027 January 01 which will align with the new budget cycle.

DISCUSSION

In this report, franchise fees are the general payment made by utilities to municipalities for access to rights-of-way and a franchise right to distribute energy within the municipality. The LAF refers specifically to the payment made by ENMAX to The City. The LAF is authorized under the *Municipal Government Act* (Section 360) and ENMAX's payment to The City is also a payment in lieu of property tax on distribution assets. This is not the case for most franchise fee agreements in the province where property tax is paid separately.

<u>Current Concerns</u>

High LAF Revenue with High Volatility

The RRO is the reference price used in the calculation of The City's LAF. The RRO has experienced increased volatility since mid-2021 reaching a high of 31.86 cents per kilowatt hour (kWh) in 2023 August. The RRO was normally at a small premium to the Power Pool price but in 2023 the spread between the RRO and the wholesale Power Pool price has widened. The RRO price has also been more volatile than the Power Pool price. The provincial government has committed to reviewing the RRO with the Affordability and Utilities Minister, Nathan Neudorf, and is considering possible discontinuance of the RRO.

Media reports have criticized the LAF and its formula saying that when the price of electricity is high the LAF compounds the affordability challenges facing Calgarians by adding to their utility bills. Critics have compared the LAF in Calgary to franchise fee payments in other municipalities showing that Calgary's LAF has increased faster over the past two years than municipalities using other franchise fee calculation methodologies.

<u>Current State</u>

The City initiated utility franchise fees for electricity and natural gas under the *Municipal Government Act* in 1956. This franchise fee, known as the LAF for the payment from ENMAX to The City, is calculated based on the customer's total utility bill (i.e., the cost of delivering the energy and the energy charge). Since 1974, the LAF rate has been 11.11 per cent of the total bill. To ensure that both electricity and natural gas are treated equally, The City has always had the same rate and methodology for both electricity and natural gas. Each time the methodology has been reviewed it has been affirmed as striking the proper balance between revenue generation and affordability.

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The City's LAF is authorized under Section 360 of the *Municipal Government Act* which permits a tax agreement between the utility and the municipality. The LAF is collected in lieu of property taxes on the utility's distribution network, compensates The City for the use of City rights-of-way and gives ENMAX a franchise to exclusively distribute electricity within Calgary.

Through the agreements with ENMAX and ATCO, the LAF on electricity and the natural gas franchise fee are important contributors to The City's revenue, totalling $376.7 million in 2023 (2023 budget of $175.3 million).

Following Council Policy CFO003: *Franchise Fee Revenue Budgets and Variances*, the electricity LAF budget is set using the lowest five-year forecast price from a survey of major forecasters of commodity prices. The budgeted amount for LAF is allocated to The City operating budget while positive variances become a one-time funding allocation to the Reserve for Future Capital, available to fund capital projects. Using the lowest five-year forecast price for electricity in the LAF budget mitigates the risk of an unfavourable variance in the operating budget and improves the likelihood that there will be positive variances available for capital purposes.

Critics of The City's current methodology frequently compare the amount raised to Edmonton's franchise fee on electricity. There are several concerns with this comparison. Calgary is a city with a larger population (Calgary's population of 1.442 million versus Edmonton's population of 1.253 million), so the comparison should be made on a per capita basis. Edmonton uses a different methodology to calculate franchise fees on natural gas than it uses for electricity and collects more on its natural gas franchise fee than from its franchise fee on electricity. Edmonton consistently collects more revenue from its natural gas franchise fee than Calgary. EPCOR must also pay property tax ($24 million in 2021) in addition to its franchise fee. All together, both the natural gas and electricity fees combined, in addition to property tax from EPCOR, form Edmonton's revenue strategy. Using one component of Edmonton's strategy with Calgary's strategy is only part of the comparison. Calgary uses the same methodology for both electricity and natural gas and collects more from the electricity LAF. In The City's franchise fee agreement with ENMAX, the LAF payment is in lieu of property taxes.

<u>Review of the Quantity Only methodology for LAF</u>

A more detailed analysis of the Quantity Only methodology is found in Attachment 2.

Electricity bills are split into two major components, the delivery charge (distribution and transmission costs along with AUC approved Rate Riders) and the electrical energy charge. The alternatives for calculating the LAF are:

1. applying the LAF rate to the total bill, including both the electrical charge and the cost of delivery,
2. the cost of delivering that electricity to the meter, or
3. to apply a LAF rate to either the charge for electricity used or a rate to the quantity of electricity used.

The amount of LAF paid by a consumer will change depending on the methodology used to calculate the LAF. ENMAX's User Rate Classes are:

1. Residential
2. Small business
3. Medium Commercial

4. Large Commercial – Secondary
5. Large Commercial – Primary
6. Streetlights
7. Distributed Generation

Current – the Total Bill method using the RRO as the Reference Price

The strength of this methodology is primarily potency as this methodology has the best potential for raising funds. When the RRO reflects power market fundamentals (arguably the case up until mid-2021), the Total Bill method reflects both the production and delivery costs of electricity in Alberta. Its weakness is volatility because the formula includes the price of electricity. Arguments in favour note the ability to increase collections when energy costs are high.

The current methodology used by The City is the Total Bill method that applies a LAF rate to the total customer bill including both the energy charge and the delivery charge. The LAF rate has remained unchanged at 11.11 per cent since 1974.

A major attribute of the Total Bill methodology is its lack of distortion between user rate classes. On their utility invoice, residential and small business customers normally have a higher charge for delivery costs than for the energy charge because they use a relatively small amount of electricity, but their meters are spatially widely dispersed requiring an extensive network of wires for delivery. Large commercial consumers use large amounts of electricity but may have only a single meter, lowering their delivery costs. When the LAF is applied to the total bill the fee represents a charge on the full cost of providing the utility services consumed.

LAF revenue can be quite volatile under the Total Bill Methodology as evidenced by the large budgetary positive variance in 2022 and 2023. The surge in LAF revenue is primarily due to high Alberta electricity prices that are currently magnified by a very volatile RRO price. The RRO price rose to 31.86 cents per kWh in 2023 August but has fallen to 13.07 cents per kWh for 2024 March, this represents a 244 per cent reduction from the 2023 August price.

The risk of volatility is an example of using risk as an opportunity. As discussed in the Municipal Fiscal Gap (C2023-0960), The City has limited revenue tools available, however LAF and franchise fees are one of the few sources currently available. Property taxes are stable and predictable (based on factors within Council's decision-making authority) and provide operating and capital funding for Calgarians. LAF revenue is more volatile (based on some factors external to The City) and the Council approved policy mitigates some uncertainty in the total amount of revenue by assigning a conservative method for budgeting revenue for operating and leaving the majority of the risk in terms of the revenue contributed to capital. This valuable capital contribution is a significant and critical component of financial and infrastructure sustainability. It directly contributes to managing the size of The City's infrastructure gap. The capital funds are unrestricted to be spent on Council's highest priorities and contribute significantly to asset lifecycle investments (for which no other funding source is available). Without these funds available, asset conditions and availability of assets in The City would degrade.

Continuing use of the RRO as the reference price is a valid option. A large LAF positive budgetary variance is not anticipated for 2024. The Cascade 900MW powerplant near Edson Alberta has recently begun to generate electricity and sell in the Alberta inter-connected power market. This increased supply has helped drag wholesale power prices down significantly. The 30-day rolling average wholesale price was sitting at 8.0 cents/kWh as of 2024 March 1. The

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2024 March RRO price for ENMAX residential customers is 10.6 cents per kWh plus 2.5 cents per kWh for the electricity cap deferral account charge, for a total of 13.1 cents per kWh. This is a marked reduction from 2023 highs and is positive news for electricity ratepayers. The 10.6 cents per kWh RRO price (when the 2.5 cent deferral account charge is removed) is lower than the current ENMAX five-year bundled fixed price for electricity of 11.5 cents per kWh. The AUC is reviewing the RRO on behalf of the provincial government and may make revisions that allow the RRO to be less volatile and/or more reflective of wholesale prices.

Additionally, the Gas Cost Flow-Through Rate (GCFR) price has softened considerably with the 2024 March GCFR being $2.133. This comes during peak winter heating season and after the brutal polar vortex Alberta received in 2024 January which resulted in peak natural gas consumption for space heating.

These prices are indicative of the market (at least in the short term) being reflective of the strong supply dynamics which exist. It is likely that the additional electricity being produced by the Cascade powerplant has added enough baseload to minimize extreme power price spikes.

Recommended Alternative: Quantity Only model - based on per kWh consumed

The primary advantage of a Quantity Only methodology is stability and predictability for both the corporation and ratepayers. The weakness is that it is unresponsive to industry and market developments and is the most administratively burdensome option.

The City of Edmonton currently uses a Quantity Only methodology. Their electricity franchise fee calculation applies inflation and growth factors to the prior year franchise fee revenue to determine the current year franchise fee revenue. Inflation is defined as the Consumer Price Index for Edmonton. The growth factor is based on population growth that is estimated at 1.5 per cent although this may be adjusted.

This budgeted revenue amount is converted into a rate per kWh based on an estimate of total kilowatt hours consumed in Edmonton for the year. Any differences between the actual franchise fee amounts estimated and what is collected are made up through an adjustment to the subsequent year's rate.

The major benefit of a Quantity Only methodology for consumers is the lack of volatility and, for The City of Edmonton, the predictability of revenue.

A new agreement would have to be entered into with ENMAX and ATCO for any change in the franchise fees. The City would need to terminate the existing agreement with ENMAX and enter into a new agreement restricted to the franchise payment and rights. The new ENMAX franchise-only agreement would not be subject to AUC approval because of the exemption in the Municipal Government Act. In the event that property taxes formed part of the franchise fee as they currently do, AUC approval is required for the tax component only. Any change to the franchise fee agreement with ATCO would require AUC approval. The different processes are due to the differences in ownership structure. Changing the last agreement that was signed with each company could be subject to review by ratepayers.

AUC Change Approval Matrix

	ENMAX	**ATCO**
Franchise rights and fee	AUC approval NOT required	AUC approval required
Tax Component	AUC approval required	AUC approval required

Changing to a Quantity Only methodology would mean that a significant source of capital dollars may no longer be available to support The City's capital plan. In the Quantity Only model there would be no budget surplus to transfer to the Reserve for Future Capital unless there is also a change to the Council Policy on Franchise Fee budgeting. Administration would address the required change(s) to this policy prior to adoption of the new methodology.

Evaluation of the existing and Quantity Only LAF models by 12 Criteria Used to Assess Revenue Tools

In the Municipal Fiscal Gap report (C2023-0960) 12 criteria were identified in the Framework and Assessment of the Net Benefit of New Revenue Tools.

	Current Methodology	**Quantity Only Option**
Strengths	• Fair • Potent • Adaptable • Reflects economic costs of energy and delivery	• (A more) predictable revenue source • Reliable • Would have resulted in less of a positive variance of LAF revenue over 2022/2023
Weaknesses	• Tied to RRO • Viewed as a windfall in 2022/2023 • Revenue is volatile/less predictable	• Larger customers pay greater share • Political – responsibility of Council to set (and take ownership of) annually • More administratively burdensome

The Path Forward

Adopting a new methodology will affect the amount of LAF revenue received and the volatility of that revenue.

Lowering the volatility of the LAF revenue could impact the planning and budgeting process. The LAF budgeted revenues support the operating budget. Currently the LAF budget is set using the most conservative energy price forecast to allow for greater certainty in the operating budget and to facilitate the transfer of positive budgetary variances to the Reserve for Future Capital.

Administration will internally find the necessary resources to prepare and process any change directed by Council to the LAF/franchise fee methodology.

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With lower volatility in LAF revenue, the budgeting process could be amended so that the LAF budget is the anticipated amount of LAF revenue to be collected for the year. With this process the amount of LAF budget allocated to the Reserve for Future Capital could be planned and budgeted for rather than having the capital portion as a budget positive variance. Lower budgetary surpluses would be less likely to attract media attention.

The recommendation is crafted to allow for certainty to the end of the cycle with the existing methodology while a new methodology is crafted and implemented, as well as offering certainty to the remainder of the 2023-2026 cycle. A recommendation regarding a change to policy CFO003 to allow for an affordability option when the RRO is extraordinarily high could embed initiatives for community resilience.

During the 2023 Adjustments, a one-time $10 million support package to provide emergency support to Calgarians experiencing vulnerabilities was approved for 2024. This investment was given to non-profits delivering programs to Calgarians experiencing vulnerabilities by contributing funding they can distribute directly to citizens requiring emergency support to meet their basic needs, while also supporting non-profits with their own increased operating costs.

EXTERNAL ENGAGEMENT AND COMMUNICATION

☒ Public engagement was undertaken

☐ Public/interested parties were informed

☒ Dialogue with interested parties was undertaken

☐ Public communication or engagement was not required

Dialogue and consultations were undertaken with ENMAX.

The Utilities Consumer Advocate (UCA) was also consulted on the use of alternatives to the RRO in the calculation of the LAF.

IMPLICATIONS

Social

Changing the LAF methodology would result in a change to the responsibility of payment of the LAF fee. If the Quantity Only method were to be adopted, then residential and small businesses would pay a smaller proportion of the overall fee and large commercial consumers would pay more. However, the actual change in real dollars would be insignificant.

Any change to the proportional share being paid the customer rate classes would very likely result in protest.

Environmental

The existing and Quantity Only LAF methodologies apply the fee to the energy component of the utility bill, and this acts as a disincentive to consume electricity. Shifting fees away from electricity would provide an incentive for electrification, which is currently the most feasible way to decarbonize the environment if the Alberta generation mix were to change. Currently most of the electricity is generated from baseload natural gas units.

Decreasing the fees in general from residential customers would help increase energy equity and meet the goals for the energy equity pathway in the Climate Strategy.

Economic

The LAF is broadly based, inclusive of all developed properties in Calgary including those exempt from paying property taxes, thus diversifying The City's revenue base. The LAF supports a balance between property taxes and other revenues, one of The City's fiscal objectives. Under the current methodology the positive variance of LAF contributed to the Reserve for Future Capital supports municipal infrastructure and service provision, and The City's long-term financial and infrastructure sustainability and resilience. Under the recommended Quantity Only option there would be no positive variance and no further contributions to the Reserve for Future Capital program.

Service and Financial Implications

Decrease in rates or fees

2023 was an unusual year with very high electricity prices and an unusually high differential between wholesale prices and the RRO, so the reduction in LAF revenue would likely be significant in future years. If the Quantity Only methodology was designed to generate at minimum the current budgeted LAF, there would be no impact on the operating budget. However, the potential funding available for future unbudgeted capital projects would be greatly reduced.

Using the Quantity Only methodology for electricity, Council would be able to set the amount of revenue to be collected. The City's rate per kWh consumed would be higher than Edmonton's, depending on the LAF revenue chosen, possibly resulting in ratepayer intervention and difficulty getting AUC approval.

RISK

Regulatory Risks – If The City determines that it will change to the Quantity-Only methodology it may be challenging to obtain approval from the regulator to return to the current methodology. The City's current methodology was approved by The City's former Electric Utility Regulatory Committee. The AUC has not conducted a thorough review of The City's current methodology because it was approved by a previous regulator. The City would be able to adjust the franchise-only agreement with ENMAX without an AUC approval process. Any change to the proportion of the fees being paid by a rate class could be met with significant pushback by ratepayers.

Reputational Risks – Large LAF budgetary positive variances when electricity prices are high and citizens have affordability concerns, have precipitated critical media articles and citizen complaints.

Financial and Infrastructure Sustainability Risk – If the Quantity Only LAF methodology results in lower LAF revenue there will be less money for capital expenditures. This will also create demand for higher revenues from other existing revenue sources, require new revenue channels or expenditure reductions. In addition, we should note that the current capital funding levels are not meeting the need, so decreasing funding will increase the fiscal gap.

Market Risk – When the price of electricity is included in the LAF formula then the amount of LAF collected depends partially on the overall price of electricity. Market prices are volatile and when prices are low the amount of LAF collected is less and the amount available for the

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Reserve for Future Capital is less. From 2015-2017 the LAF amounts collected were under budget primarily due to low commodity prices

Social Risk – If electricity and LAF charges remain high, there could be health and safety concerns if people are making unsafe decisions to avoid using energy. Vulnerable populations will be disproportionately affected.

Timing risks – the Provincial Government is currently reviewing the RRO and when/if the RRO will be replaced or updated is uncertain.

Political Risk – Having Council set the franchise fee amount annually would result in “ownership” of the amount collected. Even a small increase in the amount collected could be viewed as another Council driven tax increase by various parties. The current methodology puts the political risk on the Alberta Utilities Commission as it approves the RRO rate monthly.

Overall, the reputation and financial risks due to volatility in the current model are more significant than the risks of a quantity only model, and this assessment forms the basis of Administration’s recommendation.

ATTACHMENTS

1. Background and Previous Council Direction
2. At-a-glance: Comparison of Local Access Fee Methodologies
3. Adopting a Quantity Only Model for Franchise Fees - Presentation

Department Circulation

General Manager/Director	Department/Business unit	Approve/Consult/ Inform
David Duckworth, Chief Administrative Officer	Chief Administrator’s Office	Inform
Carla Male, Chief Financial Officer and General Manager	Corporate Planning & Financial Services	Approve
Stuart Dalgleish, Chief Operating Officer	Chief Operating Office	Inform
Chris Stewart, Director	Corporate Planning & Performance	Approve
Chris Arthurs, General Manager	People, Innovation & Collaboration Services	Inform
Katie Black, General Manager	Community Services	Inform
Debra Hamilton, Acting General Manager	Planning and Development Services	Inform
Jill Floen, City Solicitor and General Counsel	Law, Legislative Services & Security	Consult
Doug Morgan, General Manager	Operational Services	Inform
Michael Thompson, General Manager	Infrastructure Services	Inform

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