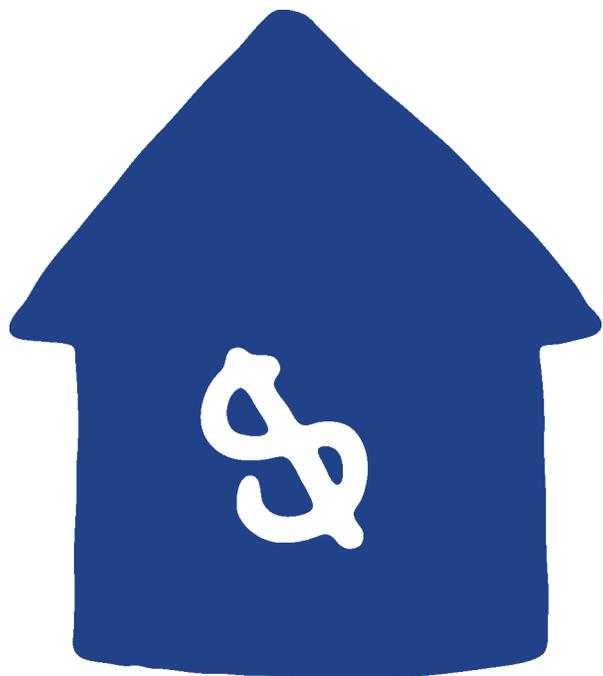


# Guide to Utility Ratemaking



## Guide to Utility Ratemaking Contents

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presented by



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## Introduction

This booklet explains how natural gas rates are determined and explains the process ENSTAR Natural Gas Company follows when seeking a rate adjustment.



In Alaska, utility rates are set by the Regulatory Commission of Alaska (RCA). This commission is responsible for ensuring that consumers receive adequate and reliable utility services at a reasonable rate. At the same time, the RCA must allow ENSTAR an opportunity to earn a profit that fairly compensates the utility's investors and enables the company to maintain financial stability and to attract the capital necessary to provide satisfactory future service.

This booklet includes three sections:

- A description of ENSTAR's regulatory environment
- A description of the two types of rate cases ENSTAR files
- An explanation of the rate case process.

**General Rate Case** – These rate filings address ENSTAR's distribution non-gas costs, or the cost to operate and maintain the distribution system across Southcentral Alaska. General rate cases have two functions: 1) to review ENSTAR's distribution non-gas costs and establish rates that fairly reflect those costs, and 2) to approve the method by which these costs are divided among customers.

**Gas Cost Balance Account** – Also called the balancing account, is used to balance actual gas costs against revenue collected from customers to cover those costs. The balance of this account shows whether revenues from current rates are more or less than actual costs. If the balance shows a surplus, rates are reduced the following year; if it shows a deficit, rates are increased the next year.

**Allowed Return on Investment** – Also called the "allowed rate of return," this is the return, or profit, a utility is allowed to earn. It's calculated as a percentage of the utility's rate base.

**Test Year** – A 12-month period used to calculate the revenue required to cover the company's distribution non-gas costs. The test year should reflect, as closely as possible, the conditions the utility will face when the rates being established will be in effect.

**Rate Design** – The process that determines how ENSTAR's distribution of non-gas costs are divided among different types of customers, and how revenue will be collected (through customer charges, minimum bills, charges per CCF used or a combination of those methods).

**Interim Rate Relief** – Rates allowed by the RCA to be put into effect on a temporary basis, usually subject to a refund, while a rate case is pending RCA decision.

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## Terms

**Gas Costs** – the amount ENSTAR Natural Gas Company pays for the gas it resells to customers (with no additional markup).

**Distribution Non-Gas Costs** – The cost of operating and maintaining ENSTAR's distribution system.

**Purchased Gas Adjustment** – A type of rate filing that allows ENSTAR to adjust its rates to reflect changes in gas costs. These filings are also called "pass-on" filings because ENSTAR is just passing on the gas cost to customers with no markup.

**Rate Base** – The utility's investment in its facilities and the cash or "working capital," necessary to operate on a day-to-day basis.



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## ENSTAR's Regulatory Environment

ENSTAR Natural Gas Company provides natural gas service to residential and commercial customers in Southcentral Alaska. The Regulatory Commission of Alaska (RCA) sets appropriate rates for these services. ENSTAR does not have direct competition from providers of the same service, so rate regulation is provided by the RCA, as a substitute for direct competition. The RCA is charged with ensuring that rates are just, reasonable and in the public interest.

The RCA does not guarantee ENSTAR's earnings. They simply set rates and provide a reasonable opportunity to achieve an allowed rate of return. The five members of the RCA are appointed by the Governor. The RCA also has a staff of attorneys, auditors and other employees.

Industry representatives and other special interest groups often participate in RCA proceedings. The RCA also can conduct public hearings during rate case hearings to allow individuals the opportunity to express their opinions and provide information concerning utility rates. (The general public also is able to comment in writing).



These costs are considered in different types of rate cases:

- Purchased-gas adjustment cases, that allow ENSTAR to adjust its rates to reflect changes in gas costs; or
- General rate cases, which cover the company's distribution non-gas costs and the way in which these costs are divided among various customers.

Any changes to ENSTAR's rules and regulations are also submitted to the RCA. These types of filings are generally independent of rate cases.

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## Purchased Gas Adjustments

Purchased-gas adjustments reflecting changes in ENSTAR costs were historically filed annually. However, beginning in 2011, purchased gas adjustments will be filed quarterly.



Gas costs are passed through to customers on a dollar-for-dollar basis, so purchased-gas adjustment filings have no impact on ENSTAR earnings. These rate cases are commonly referred to as "pass-through" cases. Gas costs are collected from all customers using the same rate per hundred cubic feet (Ccf) consumed.

ENSTAR uses "balancing" accounts to balance its actual gas costs against the revenues collected from customers to cover those costs. The balance of this account shows whether revenues from current rates are more or less than actual costs. If the balance shows a surplus, the surplus is returned to customers over a 12-month period as a rate reduction. If the balance shows a deficit, it is recovered over a 12-month period through a gas cost rate increase.

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## Types of Rate Cases

ENSTAR rates have two components that reflect different kinds of costs:

- Gas costs, or the amount ENSTAR pays for the gas it turns around and resells to customers
- Distribution non-gas costs, or the costs of operating and maintaining the company's natural gas distribution system.

While the equation may vary, depending on changes in various costs, in recent years, gas costs have accounted for about 80 percent of rates for residential customers, while distribution non-gas costs have accounted for about 20 percent.

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## General Rate Cases

General rate cases reflect changes in distribution non-gas costs, or the costs of operating and maintaining ENSTAR's distribution system. These costs include things like employee wages, pipeline maintenance costs, vehicles and equipment, taxes paid by the company and the cost of capital needed to finance the company. Prior to 2009, ENSTAR had not requested an increase in these rates since 1986.

General rate cases require more time to complete than purchased-gas adjustment cases – often many months or years. The proceedings typically include several weeks of hearings, preceded by months of research and thorough audit of the company's books. A typical General Rate case looks at five areas:

- size and composition of the utility's rate base
- amount and treatment of expenses
- sales levels and revenues for the test year under consideration
- return on investment to be allowed
- rate design

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## Rate Base

ENSTAR's rate base includes its investment in facilities (pipelines, vehicles, buildings, etc.) and the operating funds or "working capital," necessary for day-to-day operations.



Rate base is computed on the basis of a 12-month period, called a test year. The company is allowed to include in its test year expenses a "return on rate base," which is determined by multiplying the calculated rate base by the allowed return on investment.

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## Expenses

Expenses include what ENSTAR spends to operate and maintain its distribution system across Southcentral Alaska. Other expenses include employee wages and benefits, costs of materials and supplies, interest on company debt, federal, state and local taxes and the costs of other direct business expenses.



The RCA allows appropriate operating expenses to be recovered in rates. However, they can disallow recovery of an expense if they feel it is not necessary to carry out the utility's service. When that happens, the utility absorbs the disallowed expense out of what otherwise would be profit, or shareholder's return on investment.

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## Sales Levels and Revenues

Revenue generated from test-year sales is compared to the total cost of providing natural gas service for the test year. The difference is the rate of deficiency. While rates are based on the sales levels included in the test-year information, many factors affect actual sales levels. These factors include weather, general economic conditions and customer growth. For example, the test-year sales levels are based on "normal" weather. When actual weather conditions vary from what is considered normal, there is a significant impact on what ENSTAR earns.



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## Return on Investment

In order to maintain the quality of its service and to provide for the needs of a growing service area, a utility must raise money for new facilities. This money is obtained by the utility through the sale of stock or issuance of long-term debt. Attracting this capital depends on the utility's ability to earn a return on investment (commonly called rate of return) that is sufficient to cover the cost of this capital – to pay interest on debt, and provide retained earnings. Retained earnings are reinvested in the company.

In Alaska, utilities are allowed an opportunity to earn a return on their investment in their facilities through the rates they charge their customers. The RCA determines a utility's "allowed return on investment." This allowed return on investment is just that – an allowed, not guaranteed, return. The utility must effectively manage its operations in order to achieve its allowed return on investment.

ENSTAR annually files financial statements with the RCA. If ENSTAR expects to earn less than its allowed rate of return, it can file a rate increase with the RCA. ENSTAR realizes, however, that an increase in rates can hinder the company's ability to compete with other energy sources. In addition, when rates increase, customers generally use less gas, so a rate increase doesn't necessarily increase earnings.

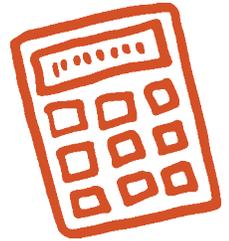
If ENSTAR's financial statements show earnings above the allowed rate of return, or if the RCA believes earnings may exceed the allowed return in the future, it may ask the company to justify its rates. If the RCA believes the utility's earnings will continue to exceed its allowed rate of return, it can reduce the utility's rates.



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## Rate Design

Once ENSTAR's rate base, operating expenses and other costs and a reasonable allowed return on investment are established, the company's total cost of providing service is calculated.



The process of dividing this total cost of providing service among various types of customers is called rate design. ENSTAR customers fall into one of four general service rate classes, which are based on the individual customer's meter set. Other customers include Municipal Light & Power, large volume transport clients and Fairbanks Natural Gas.

ENSTAR presents recommendations to the RCA on how costs should be divided among rate classes. These recommendations are based on the cost of providing service to each rate class. Other parties also present their opinions based on their special interests. Then, the RCA determines the rate design that will be used.

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## How Rate Cases Are Processed

General rate cases and purchased-gas adjustment cases are handled in generally the same manner.

ENSTAR files a request with the RCA, including information needed to support the request. The request is studied by the RCA. Other interested parties that file with the RCA as intervenors in the case, such as industrial customers or private consumer organizations, also may study the request. Typically, additional information is requested from ENSTAR. These groups can file testimony with the RCA in response to ENSTAR's request. Filing testimony and evidence prior to the hearing process allows all parties to adequately prepare so the RCA's time can be spent productively during the hearings and review of evidence.

Individuals can provide information and express their opinions during public testimony periods. Public witnesses are not required to file testimony in advance. In a typical hearing, witnesses for each party testify then all parties have an opportunity to present rebuttal witnesses and evidence. After public hearings, briefs may be filed by the involved parties, and then the RCA considers its ruling or decision in the matter.

In general rate cases, ENSTAR has the option to seek interim relief. This means that ENSTAR may ask the RCA to allow the company to implement all or part of the requested increase on an interim basis while the case is being settled (a process that can take many months). Interim relief is designed to prevent the company from suffering unfair losses due to inflation and other factors that can negatively affect it during the course of rate case proceedings. Interim rates are generally subject to refund, pending the RCA's final order in the case.

Purchased-gas adjustment cases generally are processed more quickly than general rate cases.

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## Conclusion

Judgments about the quality of regulation can be made on the basis of the answers to three questions:

- Are the rates customers pay just and reasonable for the level of service they receive?
- Is the quality of the service adequate?
- Is the allowed return on investment adequate to fairly compensate owners for committing capital to the utility?

When these three questions can be answered "yes," utility regulators and utilities are meeting their responsibilities to the public they serve.

