PERFORMANCE BASED REGULATION FILINGS FOR EDMONTON’S WATER CYCLE UTILITIES

Closing Comments to Edmonton City Council Utility Committee
July 9, 2021

Our presentation models the impacts of the straw dog motion items, and proposes two amendments

That Administration work with EPCOR to bring forward amendments to the applicable schedules to EPCOR Water Services Bylaw 19626 and EPCOR Drainage Services and Wastewater Treatment Bylaw 19627 to reflect the following:

1. The following adjustments, as noted by EWSI in its Response to City of Edmonton PBR Review Reports (page 6, Attachment 3 of FCS00627), be reflected in the Compliance Applications:
   a) $3.7 million for reduced debt costs; and
   b) $5.2 million to reimburse customers related to the capitalization of valve casings and service box replacements.
2. A deferral account for variable revenue for each of Water Services, Wastewater Treatment and Drainage Services, that would apply to revenue variances of $500,000 or more per year (either higher or lower).
3. A Return on Equity for Water Services for 2022-2026 and for Wastewater Treatment for 2022-2024 of 8.50% based on the Alberta Utilities Commission Generic Rate of Return (with no change to the requested Return on Equity for Drainage Services contained in the rates application)
4. An Efficiency Factor for Drainage Services for the 2022-2024 Performance Based Rates terms of 0.50%.

ROE level and continuation of the Drainage ROE discount

Consumption deferral accounts

Drainage efficiency factor

EPCOR

EPCOR has proposed or agreed to rate reductions totaling $77.2 million

PBR Capital and Operating Plans

−$66 million Temporary discount to Drainage ROE

−$8.9 million Agreed reductions to debt costs and reimbursement of previously capitalized items

−$1.7 million Reduction in ROE from 9.95% to 9.89%

−$0.6 million Drainage efficiency factor increase from 0.25% to 0.50% (EPCOR agrees)

EPCOR has agreed to reductions that total $77.2 million. These reductions lower EWSI's effective ROE to 8.44%.

EPCOR's proposed ROE equals 8.44%

9.89%		9.89%		6.6%		8.44%
Water ROE	+	Gold Bar ROE	+	Drainage Base ROE	=	Combined EWSI ROE
				(3-year average)		

Adoption of the straw dog motion would result in an unreasonably low ROE and a credit rating downgrade

EPCOR has agreed to rate reductions that total $77.2 million

−$9.6 million Additional reduction in ROE from 9.89% to 9.64% (0.25%) if consumption deferral accounts are introduced

−$41.9 million Impact if there is an additional reduction in ROE from 9.64% to 8.5%

−$9.4 million Higher debt costs to EWSI during the PBR period that are not recoverable from customers

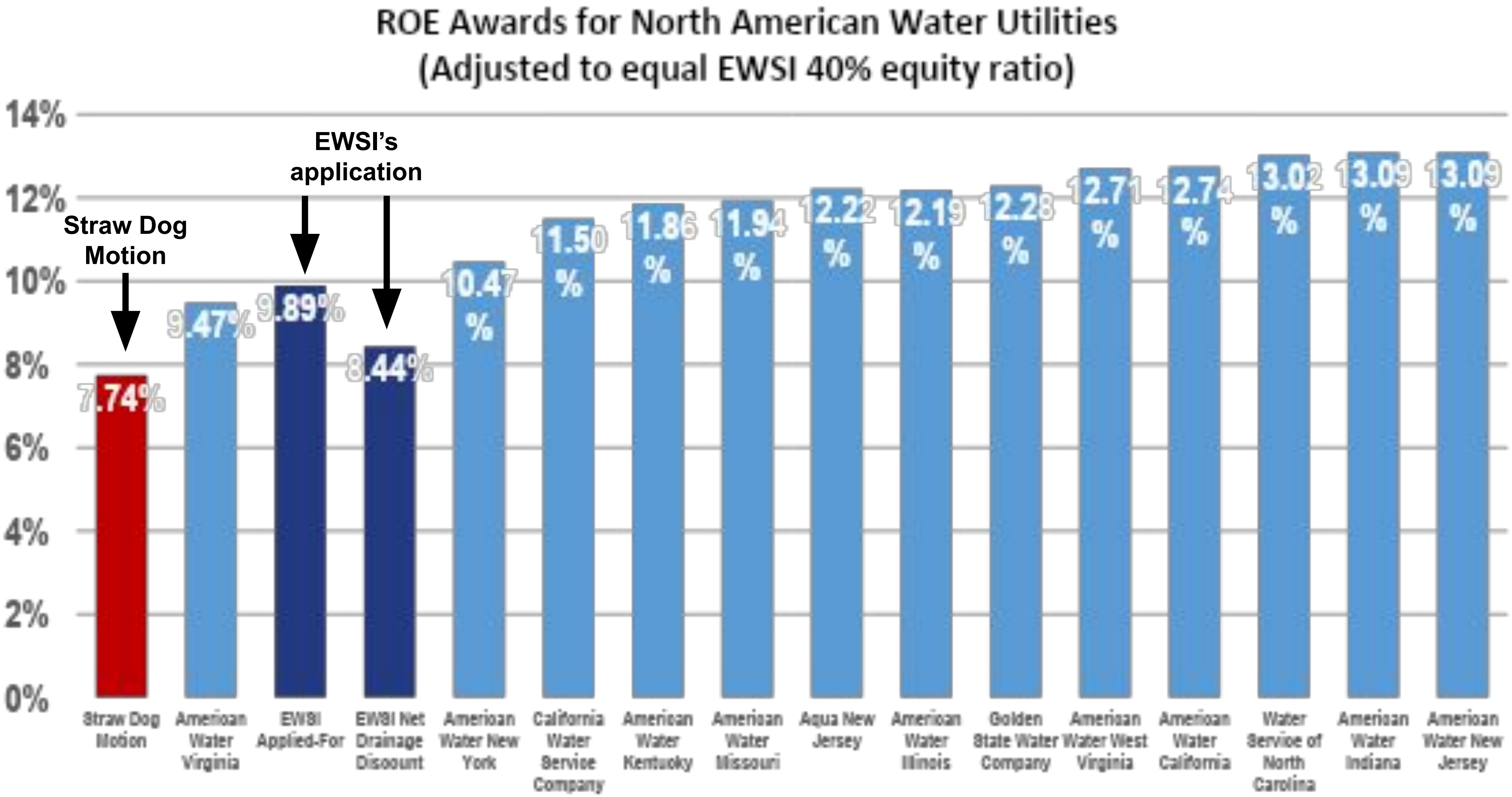
$138.2 million in total reductions if straw dog motion adopted.

Result: EWSI's ROE now 7.74%, and a credit rating downgrade.

Straw dog motion ROE equals 7.74%

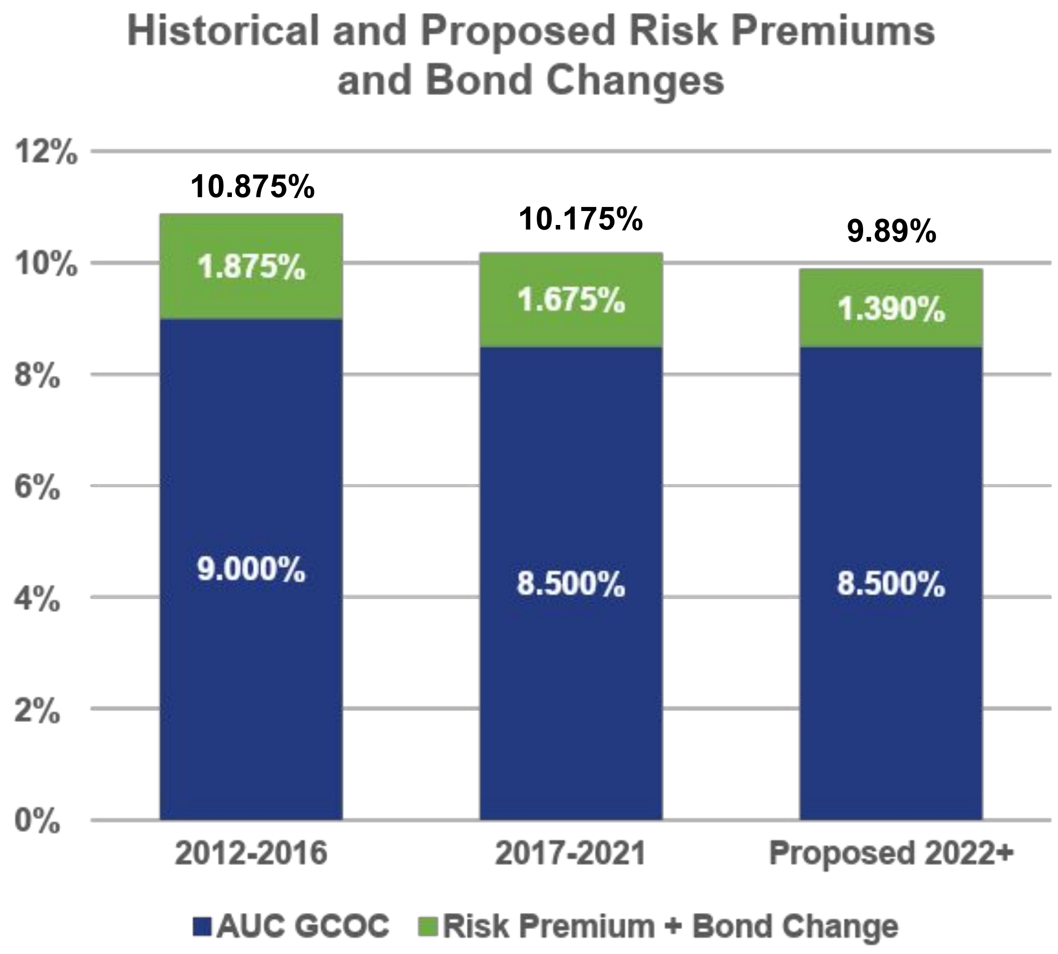
8.50% Water ROE	+	8.50% Gold Bar ROE	+	6.60% Drainage Base ROE (3-year average)	=	7.74% Combined EWSI ROE

EWSI's applied-for ROE is significantly lower than awards for competing North American water utilities



The 9.89% ROE award EPCOR applied for will actually be 8.44% because of the temporary Drainage ROE discount

The City of Edmonton has always included a risk premium when calculating ROE



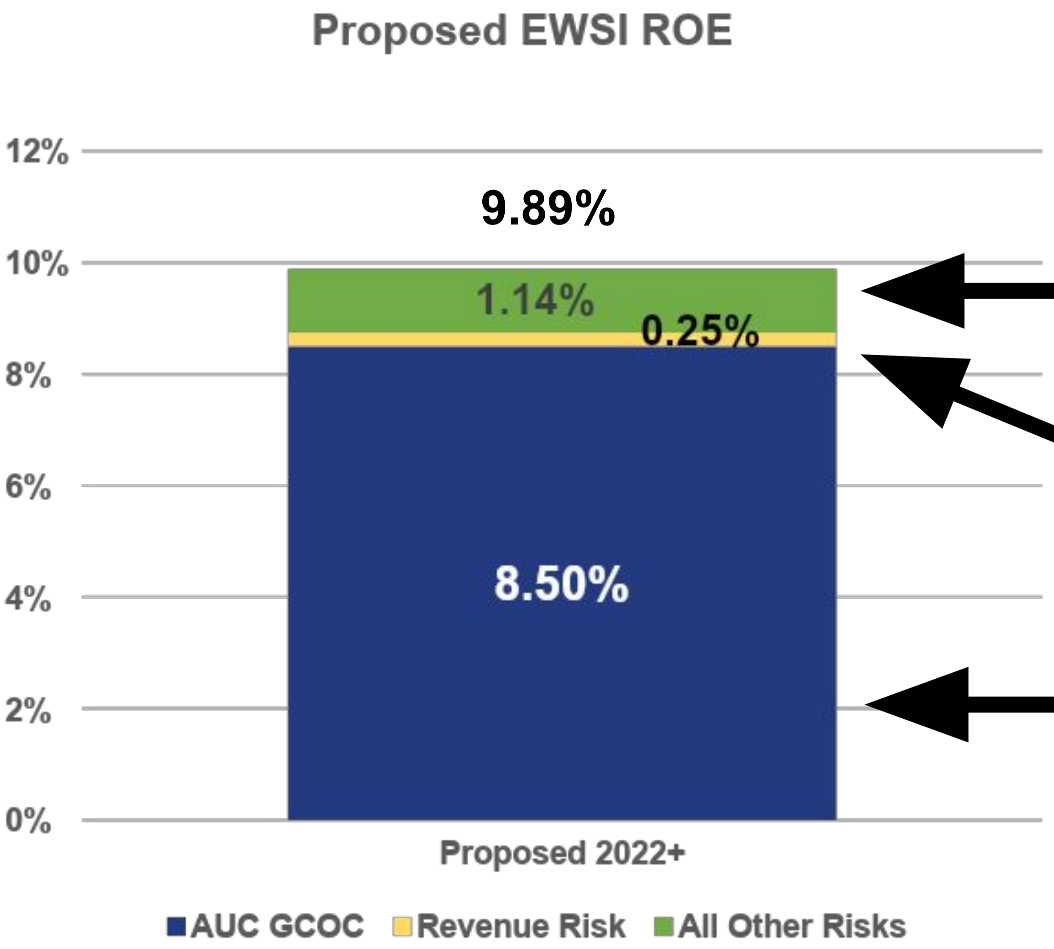
In 2012 and 2017, the City of Edmonton awarded a Risk Premium when calculating the ROE for the water utilities

- The risk premium was based on an expert recommendation by Grant Thornton
- No subsequent studies have supported eliminating the risk premium
- The risk premium has been shrinking

It would be a fundamental change to utility regulation if the risk premium was eliminated

- Full financial consequences for the utilities and for customers have not been studied

EWSI's applied-for ROE is based on the AUC generic return plus a risk premium



Risks from how EWSI is different than energy distribution utilities

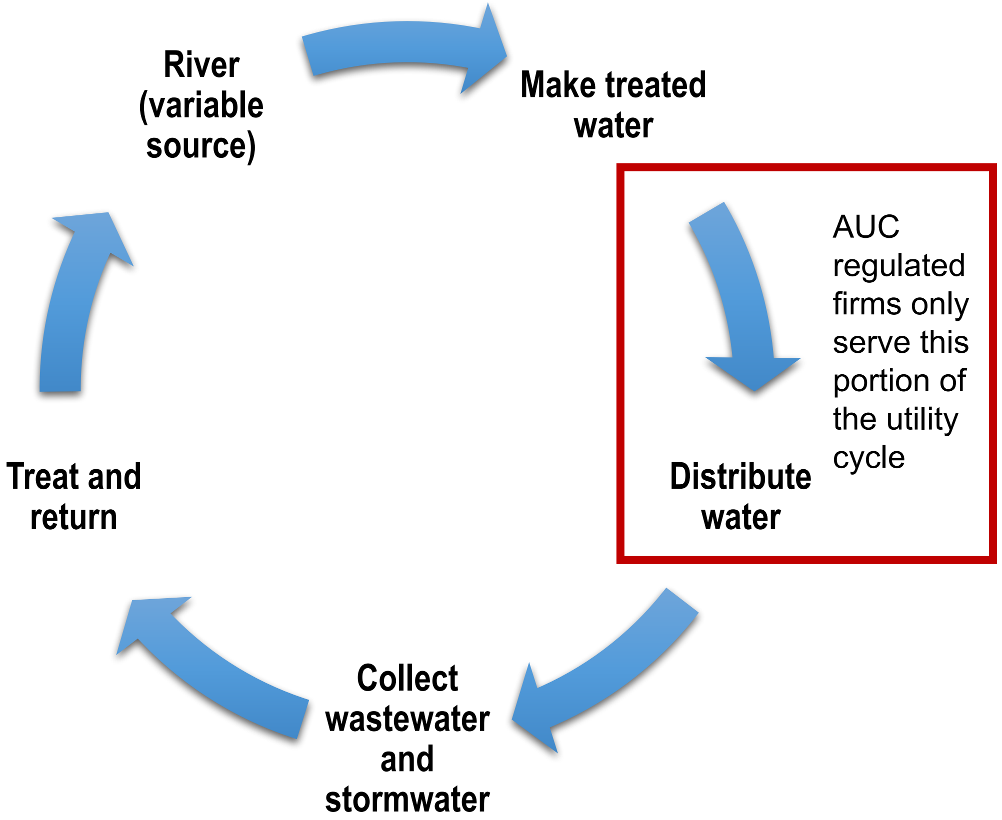
Administration estimate of revenue risks addressed by deferral account

AUC Generic Cost of Capital for distribution utilities

Why there is a risk premium

The AUC Generic Cost of Capital does not reflect the risks inherent in operating water-cycle utilities

EWSI serves the full water cycle. It is fundamentally different than an energy distribution utility



- The AUC regulates large Electric/Natural Gas Distribution companies **that produce nothing**
- Energy distribution companies have no costs or risks related to energy production. **Customers pay for 100% of the cost of the energy** they distribute
- EWSI produces **all** of the drinking water, treats **all** of the wastewater, and bears risk for **all** the variable costs
    - Water is a consumable product, made from a variable source
    - Public health regulation risks (AEP, Environment Canada, Health Canada)

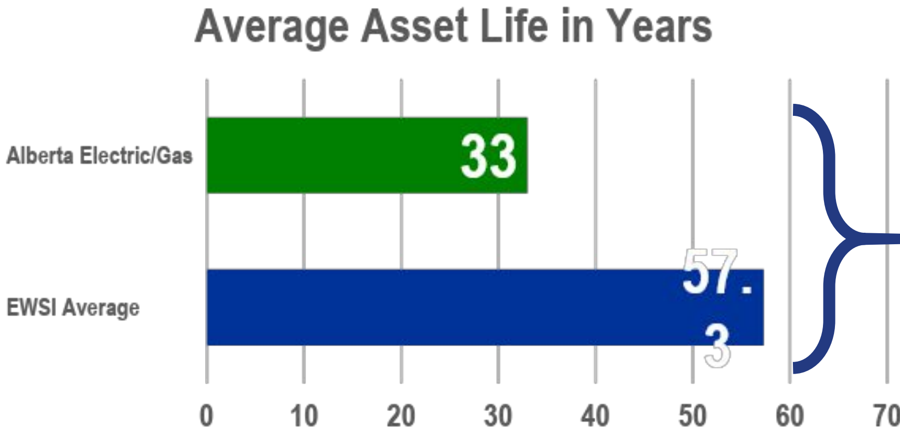
EWSI's longer asset lives and higher contributed assets increase risk and reduce utility earnings

Capital Recovery Risk

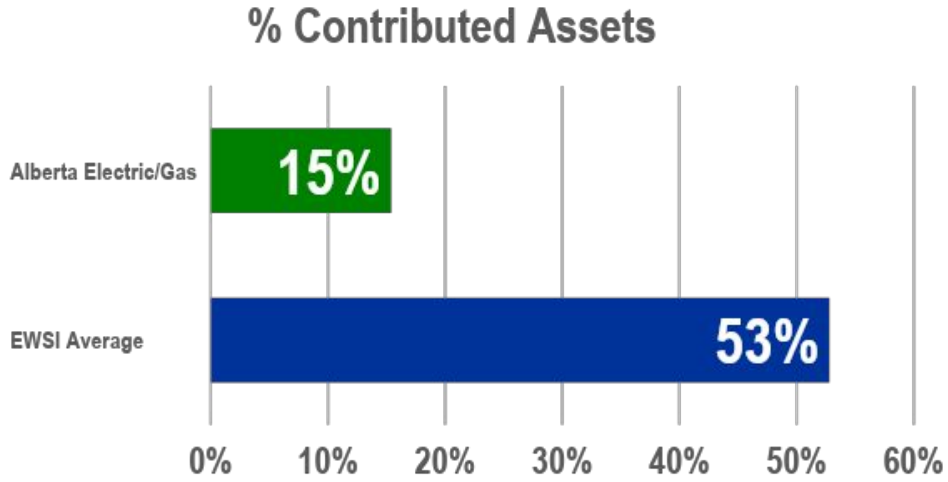
- Longer time period means higher risk that initial capital investment may not be recovered
- Higher risk of unexpected maintenance or replacement costs. (Under PBR, EWSI bears risk of operating and maintenance cost increases above i-x.)
- Lower annual cashflows mean lower credit quality

Contributed Asset Risk

- No return earned on these assets
- EWSI bears risk associated with unexpected maintenance costs and liabilities
- **AUC: "*CIAC-funded [contributed] assets contribute to business risk*"** (*Decision 2011-474)*



EWSI cash flow approx. $50M/year lower as a result



AUC regulated energy distribution utilities benefit from multiple de-risking tools

Broader approach to consumption risk
- Higher fixed charges
- Weather deferral account
- Revenue cap

Interest rate deferral account
- Annual updates to pass on actual interest costs

Additional operating cost protections
- EWSI equivalent would include chemical cost flow through

Externally driven projects
- AESO directed projects funded separately
- EWSI equivalent would be protection for costs related to City and Developer driven projects

Generic cost of capital protection
- Annual updates to pass on actual GCOC costs

These tools would not address EWSI's additional financial risks
- Higher contributed assets in EWSI
- Longer-lived EWSI assets

EPCOR

The EWSI ROE should fall within the range of the expert recommendations

9.80%	9.89%	9.95%	9.74% to 10.04%
City Administration recommendation	EPCOR's revised proposal	EPCOR's original filing, based on Grant Thornton expert study	Grant Thornton expert methodology

- **City Administration and Grant Thornton agree that a risk premium is warranted** because the EWSI utilities are higher-risk than AUC-regulated energy distribution utilities

- There is no evidence to support an award of 8.5% with no risk premium. An 8.5% ROE award would result in EWSI earning 7.74%, which is below a fair return

- De-risking the EWSI utilities to be similar to energy distribution utilities would require fundamental changes to the PBR regulatory model and restructuring of the utility businesses

Customer and utility consequences from a credit rating downgrade

EWSI Level Impacts

Borrowing costs increase for Water customers

30-year debt: reduced access and more expensive

$138 million less cash available to invest in utility infrastructure

$49 million extra in borrowing costs for debt issued during this PBR period

+

Additional Impacts to Parent Company

EPCOR

There would be limited ways to prevent a credit rating downgrade

To maintain its A(low) rating, credit rating agencies would require EWSI to improve its cash flow

1. **Revise the PBR filing to cut the amount of capital investment in the next PBR cycle**
   - Size of cut would be determined by credit rating agency metrics, not by operational requirements
   - Increased risk of asset failures and longer implementation times for flood prevention
2. **Eliminate the temporary $66 million discount to Drainage rates**

- *Additional implications for parent company, separate from EWSI*

EPCOR

A consumption deferral account is a guarantee given by customers to the utility…

If customers use more water than forecast, *the utility refunds* ‘extra’ revenue so that **customers only pay for their forecast consumption.** The extra water is free for customers. The utility still has to pay for its higher production costs.

Water consumption is forecast for the next five years

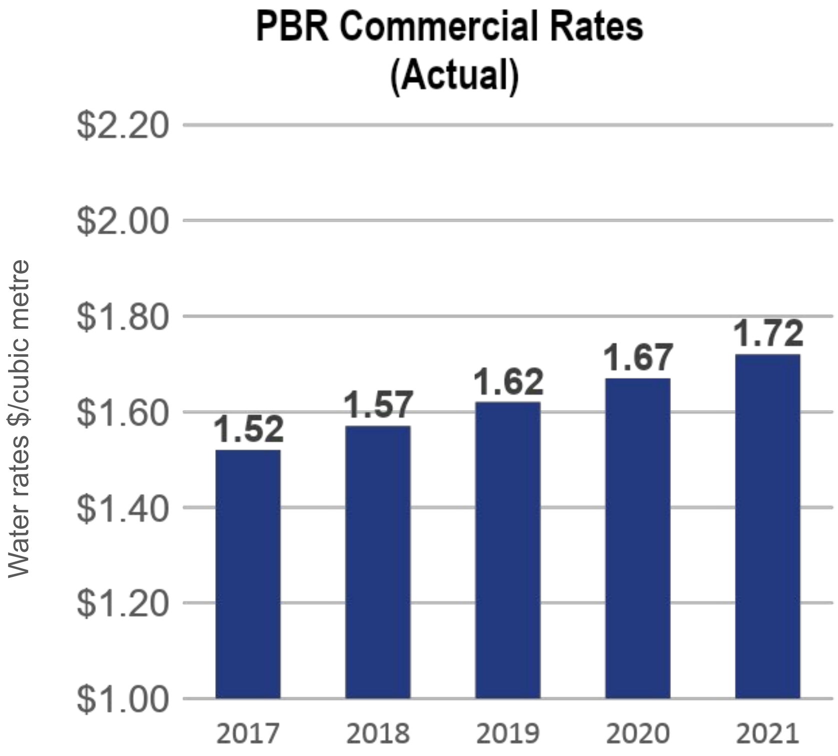
Every year, rates are changed to make up for any difference between forecast and actual

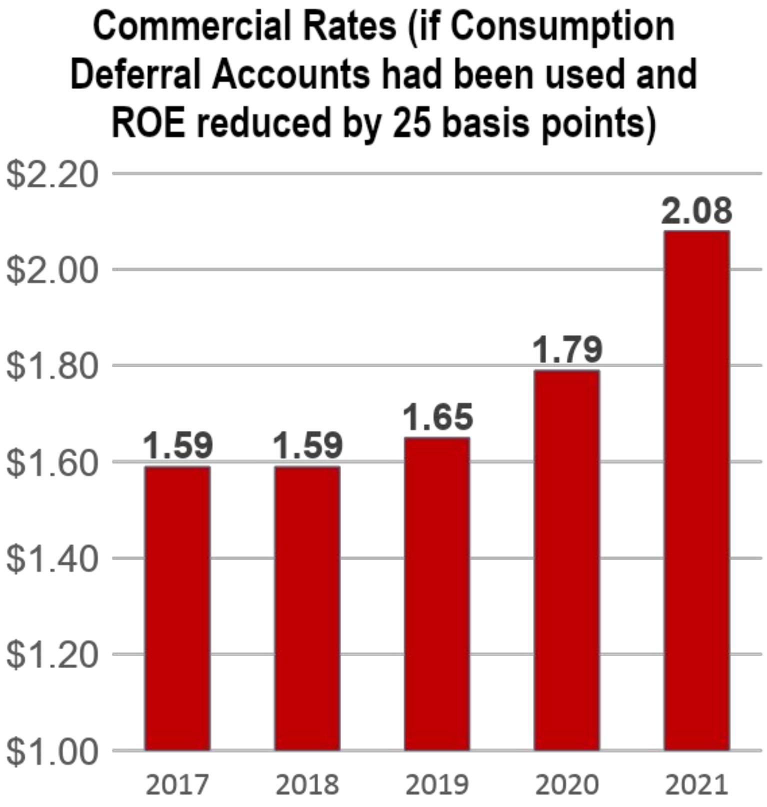
If customers use less water than forecast, ***they owe the utility money*** for the water they didn’t consume.
An extra rate increase the next year collects the money customers owe for water they didn’t use.

Historical analysis

Consumption deferral account results in real life

The PBR structure delivers predictable, stable rates that make it easier to plan business and investment decisions. Consumption deferral accounts make utility rates unpredictable and volatile…





In 2021, businesses struggling with pandemic recovery would have been hit with rates 21% higher than those provided by the PBR.

EPCOR

Consumption deferral accounts shift risk to customers and undermine conservation goals

- Consumption deferral accounts undermine water conservation goals
- Rates go from being predictable and stable, to being unpredictable and volatile
- Low income customers, small businesses, and large commercial and institutional water users are at the greatest risk
- The utility incurs additional expenses for water production if consumption is high (revenues are fixed, but variable costs jump and

If consumption deferral accounts are introduced, Administration and Grant Thornton recommend reducing EWSI's ROE by 25 basis points

EPCOR recommends public engagement before introducing consumption deferral accounts

Consumption deferral accounts would be a major transfer of risk from the utilities to customers.

In the PBR engagement process:

- Stakeholders supported investing more in infrastructure reliability, within the existing rate structure
- No customers requested that risks be transferred to them from the utility
- **Large water customers identified *predictability* as one of the most important things** they wanted from their water-cycle utilities
- Unpredictable rates may deter businesses from expanding in or moving to Edmonton

Customer and public engagement is essential prior to a change of this magnitude

EPCOR

Amendments to the straw dog motion will preserve the customer benefits in the PBR

Quality service at a reasonable rate	Rate stability and predictability	Financial viability of utility, and credit rating
Water conservation	Ability to plan and fund capital investment	Low administrative burden

EPCOR

EPCOR recommends a motion directing a study of deferral accounts and other adjustment mechanisms

RECOMMENDED MOTION

That Administration work with EPCOR to study potential adjustment mechanisms, deferral accounts, ROE risk premiums, or other mechanisms as determined during investigation, prior to the renewal of the Drainage and Wastewater Treatment Performance Based Rates in 2024. The investigation to include:

- The impact to the utility and to the customers;
- Stakeholder consultation;
- The following risk factors: Consumption Risk; Interest Rate Risk; Public Health/Environmental Regulatory Risk; City-Driven and Developer-Driven Projects Risk; Capital Recovery Risk; Contributed Asset Risk; and other risks as determined during the investigation.

Amendment 1: Deferral Accounts

- Consumption deferral accounts transfer risk to customers, result in rate volatility, and deter water conservation
- There has been no public or customer engagement on this topic
- If consumption deferral accounts had been used in the 2017-21 PBR, current rates would be 21% higher
- **Recommendation: Delete clause 2 in the straw dog motion, and make a separate motion directing Administration and EPCOR to undertake a study of risks and risk mitigation options**
- *Note*: A 0.25% reduction in EWSI's ROE is recommended by Administration and Grant Thornton if consumption deferral accounts are added

EPCOR

EPCOR recommends amending the ROE in the straw dog motion….

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4. An Efficiency Factor for Drainage Services for the 2022-2024 Performance Based Rates terms of 0.50%.

Amendment 2: ROE Level

- **Recommendation: Set the EWSI ROE at 9.89%, based on the Grant Thornton risk premium**
- Continue with the inclusion of the temporary Drainage ROE discount
- An ROE of 9.89% + the temporary Drainage discount, results in an **actual ROE of 8.44%**
- Because the Drainage discount is temporary, we expect EWSI to maintain its credit rating
- **Any ROE award should fall within the range recommended by the expert studies** (9.74% to 10.04%)

EPCOR

Customers will benefit from an efficiently run utility with strong performance standards

- ✔ Stable and predictable rates
- ✔ Efficiently run utilities (operating cost changes are less than 1%)
- ✔ More than $77 million in reductions to customer utility rates, without impacting utility credit ratings
- ✔ Customer service, reliability, quality, environment, and safety performance standards
- ✔ Risks are borne by the utilities, not by customers

Average residential bill for continuing utility service:

2021: $100
2022: $101
2023: $103
2024: $105

EPCOR

Investments in flood prevention and infrastructure will make Edmonton a more resilient city

- ✔ Keeping pace on the 20-year plan to invest in in citywide flood prevention (SIRP)
- ✔ Addressing corrosion and odour issues in Edmonton's drainage infrastructure (CORe)
- ✔ Targeting investment to reduce the risk of asset failures
- ✔ Building a more climate resilient city
- ✔ Jobs and economic benefits from $1.35 billion in capital investment during the next PBR period

Average residential bill with SIRP + CORe programs

2021: $100 +$2 = $102
2022: $101 +$5 = $106
2023: $103 +$6 = $109
2024: $106 +$9 = $116

EPCOR

QUESTIONS?

In addition to the speakers, a range of subject matter experts are registered and available to provide information