

EPCOR PBR Applications - Reasonableness Review by Administration

2022-2026 Water Services Application, 2022-2024 Wastewater Treatment and Drainage Services Applications

Recommendation

That Utility Committee recommend to the August 16, 2021, City Council meeting:
That the June 25, 2021, Financial and Corporate Services report FCS00624, be received for information.

Executive Summary

This report provides Administration's reasonableness review of the performance based rates applications submitted by EPCOR Water Services Inc. to establish new customer rates and terms and conditions of service for Water Services for the five year period April 1, 2022 to March 31, 2027, and for each of Wastewater Treatment and Drainage Services for the three year period April 1, 2022 to March 31, 2025. On an overall basis Administration considers the rates applications to be reasonable. Administration also considers that the performance based regulation framework continues to work as intended.

Notwithstanding this, Administration has highlighted certain areas that the Utility Committee and City Council may wish to consider further to determine if adjustments to the rates applications are warranted. Administration has also identified certain items that may also warrant a further review in advance of the next rates applications being submitted by EPCOR Water Services Inc. to establish new customer rates for Drainage Services and Wastewater Treatment effective April 1, 2025.

Report

In February 2021, EPCOR Water Services Inc. (EWSI) submitted performance based rates (PBR) applications and proposed bylaws for approval by City Council to establish customer rates for Water Services for the five year period April 1, 2022 to March 31, 2027 (proposed EPCOR Water Services Bylaw 19626), and for each of Wastewater Treatment and Drainage Services for the three year period April 1, 2022 to March 31, 2025 (proposed EPCOR Drainage Services and Wastewater Treatment Bylaw 19627). The regulatory process and guiding objectives for Utility Committee and City Council to assess the EWSI performance based rates applications were approved by Council on February 22, 2021 (Financial and Corporate Services report FCS00306), and are

included in Attachment 1 of this report. An overview of cost of service and performance based regulation is also provided in Attachment 2.

In accordance with the approved process, Administration has undertaken a reasonableness review of the three EWSI performance based rates applications (Attachment 3). Administration engaged an external consultant to assist with the review, with the scope of the engagement focussing on certain key technical regulatory aspects including the return on equity, inflation and efficiency factors, cost of service and rate design, and performance measures. The consultant, Grant Thornton LLP, is a global consulting firm with an extensive background in utility rate setting. Grant Thornton's report on its review of the EWSI rates applications is provided in Attachment 4.

Given the regulatory framework and assumptions are generally consistent among the Water Services, Wastewater Treatment and Drainage Services applications, Administration has summarized its review of all three collectively in Attachment 3. The summary includes:

- an assessment of the overall PBR framework and methodology in light of the current economic uncertainty and impacts of the COVID-19 pandemic;
- a review of the 2017-2021 PBR plans and financial results to confirm the PBR framework continues to work as intended and the costs incurred by EWSI were reasonable and prudent; and
- an analysis of each of the major components of the proposed 2022-2026 and 2022-2024 PBR plans, including revenue requirement, capital programs, cost of service and rate design, and performance measures.

On an overall basis, Administration considers the Water Services (2022-2026), Wastewater Treatment (2022-2024) and Drainage Services (2022-2024) rates applications to be reasonable.

The applications follow the Minimum Filing Requirements, which together with written responses to questions provided in report FCS00623, have resulted in a comprehensive level of information in support of the proposed rates under performance based regulation. EWSI has also provided a PBR Reader's Guide to further assist City Council, Administration and the public in understanding the customer rate impacts, operating and capital expenditures, and key initiatives included in the three applications.

As part of the assessment of the 2022-2026 and 2022-2024 rates applications, Administration also reviewed the financial performance, capital program and performance measures for the EWSI utilities over the 2017-2021 PBR term. Based on the review, Administration considers that the overall PBR framework continues to work

as intended, with EWSI earning a reasonable margin of profit (see Table 1 of Attachment 3 for return on equity), customers receiving safe and reliable utility services (see Table 2 of Attachment 3 for performance measures), and operating efficiencies realized by EWSI in the 2017-2021 PBR term being passed onto customers when rates are reset in the next PBR term.

Notwithstanding the above, Administration and Grant Thornton have highlighted the following areas that Utility Committee and City Council may wish to consider further to determine if certain adjustments to the 2022-2026 and 2022-2024 rates applications are warranted:

- **Return on Equity** (i.e., forecast return that EWSI is allowed to earn on its investment in the utility) - a potential 0.15 percent decrease in the requested return on equity from 9.95 percent to 9.80 percent, as a result of updating the formula used by EWSI to calculate the requested 9.95 percent to be based on the final return on equity approved by Council for the 2017-2021 PBR term of 10.175 percent (10.175 percent - 0.38 percent change in bond yield = 9.80 percent);
- **Return on Equity** - a further potential 0.25 percent decrease in the requested return on equity given an evaluation of the risks for EWSI relative to the Alberta Utilities Commission (AUC) benchmark of 8.50 percent and the impact on EWSI's risk if a water consumption deferral account is implemented (along with a shift in customer rates to collect more revenue from fixed charges and less based on consumption charges);
- **Efficiency Factor** (i.e., the productivity improvements the utility can be expected to achieve during the PBR period) - a potential increase in the efficiency factor from 0.25 percent to 0.50 percent for Drainage Services based on the continued transition to performance based regulation following the transfer from the City of Edmonton in 2017;
- **Customer Rate Increases** - a potential smoothing of the customer rate increases over the five year PBR term (2022-2026) for Water Services and over the three year PBR term (2022-2024) for Wastewater Treatment and Drainage Services, consistent with the direction provided by the Utility Committee for the EWSI 2017-2021 rates applications;
- **Water Consumption Forecast** - a further assessment of the accuracy of the water consumption forecast based on the historic impact of weather and the added uncertainty due to COVID-19, and whether an annual update to the forecast or a deferral account should be implemented to adjust customer rates annually for the difference between the forecast and actual water consumption (similar to ATCO Gas);
- **Overall Capital Program** - confirmation of the overall capital program including a reduction in Reliability and Life Cycle Improvement capital expenditures for

Water Services in 2022-2026 based on a new risk based renewals program adopted by EWSI, and the continued scheduling and rollout in 2022-2024 for two key initiatives (Stormwater Integrated Resource Plan and Corrosion and Odour Reduction);

- **City-Initiated Capital Projects** - a potential increase in funding for City-Initiated Capital Projects to align the EWSI and City of Edmonton capital programs and work plans in the 2023-2026 budget cycle. Alternatively, a deferral account could be implemented to true up the difference between the forecast and actual capital expenditure costs incurred by EWSI to align its capital projects annually to the City of Edmonton's work plan;
- **Real Estate Consolidation Project** - a potential adjustment to the "in service date" for the Aurum property (Real Estate Consolidation project) to mid 2022 from January 1, 2022 based on employees moving into the facility in the 1st quarter of 2022, resulting in a reduction in depreciation expense, return on equity, and cost of debt in 2022;
- **2017-2021 Valve Casings and Service Box Replacements** - a potential adjustment to reimburse utility customers for amounts included as operating costs in the 2020 (\$2.9 million) and 2021 (\$3.0 million) Water Services revenue requirements but capitalized for both financial statement and regulatory accounting purposes beginning in 2020. The impact of the capitalization of costs without any further regulatory adjustments is that customers may pay twice for these costs through utility rates, once in 2017-2021 as an operating expense and then again in future years as the capitalized costs are depreciated and included in future revenue requirements;
- **2017-2021 Special Rate Adjustments for Environment Initiatives** - a potential reduction to the Water Services 2022-2026 revenue requirements to carry forward differences between amounts approved (\$4.1 million) and actual/forecast amounts incurred (\$2.6 million) as part of the 2017-2021 Special Rate Adjustment for the North Saskatchewan River Monitoring project;
- **2017-2021 Non-routine Adjustments** - potential adjustments to refund or carry forward differences between amounts approved and actual/forecast amounts incurred for non-routine adjustments during the 2017-2021 PBR term. The differences amount to \$5.6 million in total, excluding any further potential amounts for the Corrosion and Odour non-routine adjustment, as detailed in Table 6 of Attachment 3; and
- **2017-2021 Corrosion and Odour Non-Routine Adjustment** - a further review of amounts included in the determination of the actual/ forecast Corrosion and Odour non-routine adjustment (\$14.8 million) in comparison to the adjustment approved during the 2017-2021 PBR term (\$10.8 million). EWSI has included an additional \$66.5 million of capital costs related to EWSI's new CORe Large Trunk Rehabilitation Program in the non-routine adjustment calculation because

these projects target rehabilitation of large trunks with high levels of corrosion in emerging odour areas in the network (Table 7 of Attachment 3).

Future Regulatory Considerations

Given the compressed schedule for the regulatory review and approval of the three EWSI comprehensive rates applications, Administration and Grant Thornton also identified certain areas that may warrant a further review in advance of the next rates applications being submitted by EWSI to establish new customer rates for Drainage Services and Wastewater Treatment effective April 1, 2025. Administration recommends that EPCOR and Administration work together to bring forward reports providing further background and context and the appropriate regulatory treatment for the following items:

- **Accounting and Capitalization Policies** - further consideration should be given to additional reporting of changes in accounting policies and accounting treatment (including capitalized overhead) in future EWSI rates applications, and whether regulatory adjustments should be made to ensure customers only pay once for significant costs through utility rates;
- **Full-Time Equivalents** - a review should be completed for the need and format of reporting full-time equivalents (FTEs) in future EWSI rates applications. Providing a breakdown of actual and forecast FTEs is a typical information request in regulatory proceedings to properly assess the size and composition of the workforce;
- **Cost of Debt** - a further review should be completed of how debt costs are calculated for EWSI. EPCOR Utilities Inc. calculates the debt rate for EWSI based on market conditions rather than flowing through (or mirroring) the actual cost of debt issued by EPCOR Utilities Inc.; and
- **Performance Measures** - a further review should be completed of the methodology used to establish performance measures including the use of bonus points and ensuring standards are increasingly stringent over time.

Next Steps

In advance of City Council's consideration of the rates applications and proposed bylaws in August 2021, EWSI will prepare "Compliance Filings" (updated rates applications) that incorporate directions received from the Utility Committee on June 25, 2021, in addition to any other adjustments identified for the Water, Wastewater Treatment and Drainage Services rates applications.

These adjustments will include EWSI reducing the debt costs included in the rates applications by \$0.5 million per year in 2022-2026 for Water Services and by \$0.4 million per year in 2022-2024 for Wastewater Treatment. In responding to Administration's question (COE-EWSI-1.b.iii) regarding how the debt rates for EWSI

are calculated and flowed through from EPCOR Utilities Inc., EWSI noted that it had inadvertently calculated the actual interest rates for EWSI based on a standalone credit rating of BBB+ rather than A (low).

Corporate Outcomes and Performance Management

Corporate Outcome(s):The City of Edmonton has sustainable and accessible infrastructure.			
Outcome(s)	Measure(s)	Result(s)	Target(s)
Oversight and transparency of EPCOR water, wastewater and drainage services.	Annual and periodic reporting to Utility Committee of financial performance, operating and capital programs, and service quality levels.	Annual Progress Report - Water, Wastewater, Drainage (Fall 2020) Annual Operational Plan (Feb 2021) Performance Based Rates Applications (Feb 2021)	Annual Progress Report - Water, Wastewater, Drainage (June) Annual Operational Plan (Q1)

Attachments

1. EWSI PBR Applications - Regulatory Schedule and Guiding Objectives
2. Overview of Cost of Service and Performance Based Regulation
3. Reasonableness Review by Administration of EWSI PBR Applications
4. Grant Thornton Report on EWSI PBR Applications

Others Reviewing this Report

- C. Owen, Deputy City Manager, Communications and Engagement
- G. Cebryk, Deputy City Manager, City Operations
- A. Laughlin, Deputy City Manager, Integrated Infrastructure Services
- R. Smyth, Deputy City Manager, Citizen Services
- S. McCabe, Deputy City Manager, Urban Planning and Economy
- K. Fallis-Howell, Acting City Solicitor