

Overview of Cost of Service and Performance Based Regulation

As noted in Attachment 1 of Financial and Corporate Services report FCS00624, one of the guiding objectives in assessing EWSI's proposed rates is that "all customer charges will be based upon cost of service". A cost of service approach is the most commonly used approach in determining regulated utility rates. Under a traditional cost of service approach, rates are generally established by the regulator every one to two years through a two phase process.

In the first phase, the regulator determines the total amount of money (Revenue Requirement) required by the Utility to provide its regulated services in a year. The revenue requirement is comprised of the forecast prudently incurred costs required to operate, maintain and invest in the utility system plus a fair return on the Utility's investment (return on equity). The return on equity also compensates the Utility for the risks inherent in operating the business.

In the second phase, individual customer rates are established that will allow the Utility to recover the total annual revenue requirement. A Cost of Service Analysis is first completed to determine how much of the total revenue requirement should be equitably recovered from each customer class (e.g. residential, commercial). A Rate Design Analysis is then completed to determine how the individual customer rates should be designed and structured (e.g. fixed vs variable).

Under a Performance Based Regulation approach, customer rates are still determined for the first year of the Performance Based Regulation ("PBR") period based on the Cost of Service two phase approach described above. The customer rates are then adjusted in each subsequent year by a predefined formula for the term of the PBR plan - which in this case is five years (Annual Adjustments to Customer Rates).

The basic PBR formula adjusts customer rates annually by a rate of inflation ("I") that reflects the increased cost of labour and non-labour inputs the Utility uses, less an Efficiency Factor ("X") to reflect the productivity improvements the Utility can be expected to achieve during the PBR period. Generally the Utility bears the risk of normal factors that could impact revenues and costs above the Inflation and Efficiency Factors (I - X) (e.g. weather, consumption). However, extraordinary or uncontrollable factors that have a significant impact and are beyond the control of the Utility may be eligible for a "Non-Routine" customer rate adjustment and flowed through to customers (e.g. legislative changes).

Establishing customer rates under a PBR approach creates stronger incentives for the Utility to improve its efficiency through cost reductions and other measures since it is able to retain the increased profits from these measures for

a longer period than it would under a traditional cost of service two year approach. At the same time, customers automatically share in the expected efficiency gains because they are built into rates through the X factor regardless of the actual performance of the Utility. In addition, the actual cost reductions achieved by the Utility during the PBR term are then passed onto customers when customer rates are reset (“rebased”) for the next PBR term.

Other benefits of the PBR approach include customers receiving stable and predictable rates over the five year term and a reduction in the frequency and cost of regulatory applications being filed and approved.

While the I-X mechanism under PBR creates incentives for a Utility to find operating efficiencies, it does not create similar incentives for the Utility to maintain or enhance service quality. Therefore, under a PBR approach strong Service and Performance Measures must be established to ensure service levels are met. Customers expect the water and wastewater treatment service standards to be achieved along with predictable and stable rate increases.