



EWSI PBR APPLICATIONS REVIEW BY ADMINISTRATION

Utility Committee
June 25 , 2021

PRESENTATION OUTLINE

1. **Overall Conclusions** - Reasonableness of Applications
2. **EWSI Response to Administration Review**
3. **Key Issues (Reference to AUC Decisions)**
 - a. Non-routine Adjustments (Clarification of Treatment)
 - b. Water Consumption Forecast
 - c. Efficiency Factor ("X")
 - d. Return on Equity (Grant Thornton)
4. **Future Regulatory Considerations**

EWSI APPLICATIONS - OVERALL CONCLUSIONS

- **EWSI PBR Framework**
 - ✓ Continues to work as intended
 - ✓ Reasonable profit, safe & reliable service, operating efficiencies
 - ✓ Moderate regulatory oversight provides balance
- **EWSI 2022-2026 and 2022-2024 Rates Applications**
 - ✓ On an overall basis, applications reasonable
 - ✓ Comprehensive level of information (MFR, PBR Readers guide)
- **Number of Areas Highlighted for Consideration**

EWSI RESPONSE TO ADMINISTRATION REVIEW

- **EWSI Proposed Adjustments to Rates Applications**
 - ✓ Reduce debt costs by \$3.7 million (COE-EWSI-1.b.iii)
 - ✓ Reimburse customers \$5.2 million for valve casings
 - ✓ ROE decrease from 9.95% to 9.89% (similar to 9.80% COE)
- **Administration - Four Key Regulatory Issues Remain**
 - NRA's, Water Consumption, X Factor, ROE (risk)
 - *(Public submissions / funding for City-Initiated capital projects)*
- **Administration Recommendations Unbalanced?**
 - 3 large applications and compressed regulatory schedule
 - Focussed on main issues - **fair** to both customers & Utility

PERFORMANCE BASED REGULATION (I-X)

- **Basic PBR Formula:**

- **Rates** *(yr 1)* * **(1 + (I-X))** = **Rates** *(yr 2)*
 - **I = Inflation Factor**
 - **X = Efficiency Factor**

e.g. \$100/month * (1 + (2% - 0.25%)) = \$101.75/month

- **Non-Routine Adjustment (NRA) to PBR Formula**

- fair to Utility
- provides additional funding to EWSI outside of I-X formula
- unusual, significant in size, beyond EWSI's scope of control

AUC - Z FACTORS (e.g. Major Forest Fires)

- **AUC PBR Decision 2012-237 (Rates Inflated Annually I-X)**
 - Z Factor - funding for significant unforeseen events that are outside the ability of Utility to control (*par. 516*) (*i.e. NRA*)
 - Z factors must be carefully defined & limited in scope since are inconsistent with PBR objectives & lessen efficiency (*par. 21*)
- **Forecast vs Actual Costs (Deferral Accounts)**
 - Forecast costs provide incentive for additional efficiencies (I-X);
 - Actual costs used in limited situations (outside I-X formula)
 - Lessen efficiency incentives
 - Material items, outside control of Utility, not forecastable

AUC Z FACTORS (OUTSIDE OF I-X)

- **AUC Funding for Z Factor Is Based on Actual Costs**
 - all costs claimed must be prudently incurred (*par. 524*)
 - Utility recovers costs after they have been incurred & subsequently found by AUC to have been prudent (*par 519*)
- **Recovery of Z Factor a Two Step AUC Process** (*par. 540*)
 - notify AUC of proposed adjustment as soon as possible after the event is identified (i.e. step 1)
 - Z factor submitted as soon as possible after the costs associated have been incurred/ savings realized (i.e. step 2)

NRA'S - ADMINISTRATION RECOMMENDATION

- ❖ **Clarify 2022-26 NRA Regulatory Treatment and Process Based on Actual Costs (AUC)**
- ❖ **Clarify 2017-21 NRAs Based on Actual Costs or Remove Any Costs Included in 2022-26 Applications Already Funded by 2017-21 NRA's (Double Counting)**
 - 1) **Initial NRA approval** - to give regulatory certainty and interim funding to EWSI to proceed with NRA program (*e.g. lead mitigation*)
 - 2) **Final NRA approval** - to true up funding based on actual costs

Bylaw 17698/18100 "Where a non-routine adjustment is very significant in size, it may be charged to an Adjustment Deferral Account"

2017-2021 PBR PLAN - NRA's

| Revenue Requirement \$mm | | 2017-21 PBR Approved | 2017-21 Actual/Forecast | Variance |
|-------------------------------|---------------------------------|----------------------|-------------------------|---------------|
| Water (2017-2021) | Corporate Cost Reduction Refund | (\$11.40) | (\$12.60) | \$1.20 |
| | Lead Mitigation Strategy | \$3.40 | \$1.50 | \$1.90 |
| | LRT Relocations | \$1.50 | \$1.60 | (\$0.10) |
| | Leduc County Annexation | \$2.20 | \$1.60 | \$0.60 |
| Wastewater (2017-2021) | Corporate Cost Reduction Refund | (\$4.20) | (\$3.80) | (\$0.40) |
| Drainage (2017-2021) | LRT Relocations | \$5.30 | \$3.20 | \$2.10 |
| | SIRP | \$8.30 | \$8.00 | \$0.30 |
| NRA's - Excluding CORE | | | | \$5.60 |

- *Potential 2017-21 NRA's subject to deferral account treatment*
 - *Variance > \$500k annually or \$1 million cumulative*
 - *Would decrease 2022-2026 rate increases by \$5.2 million*

WATER CONSUMPTION FORECAST

- **Unable to Confirm 2022-26 EWSI Forecast is Reasonable**
 - significant historical variances due to weather / increased EWSI judgement for 2022-26 due to COVID-19
- **Potential Alternative Approach (Deferral Account)**
 - ATCO Gas Weather Deferral Account Under PBR (2012-237 per. 680)
 - *protects ATCO Gas in years when earnings would otherwise be negatively impacted by warmer than normal weather;*
 - *also protects customers in years when colder than normal weather would require them to pay higher utility bills;*
 - *ATCO Gas directed to use a separate rider outside of the PBR formula to settle balances with customers;*
 - *reduction to ATCO Gas risk for weather deferral*

WATER CONSUMPTION FORECAST - ADMINISTRATION RECOMMENDATION

❖ EWSI Water Consumption Deferral Account

- 1) Customer rates for 2022-26 are initially set to recover revenue requirement based on EWSI PBR forecast consumption
- 2) EWSI will over/under collect revenue each year from 2022-2026 based on actual consumption
- 3) EWSI settles over/undercollection in next year's rates (annual rate filing submitted to COE Administration)

X FACTOR - ADMINISTRATION RECOMMENDATION

❖ Increase X Factor for Drainage Services to 0.5%

- **EWSI X Factor**

- 0.5% 2002-2006; 0.25% thereafter (Water Services)
- EWSI 2022-26 and 2022-24 Rate Applications
 - ✓ 0.25% for Water and Wastewater reasonable
 - 0.5% for Drainage Services more appropriate**
 - Drainage transitioning to PBR (e.g. Water in 2002-06)

2017-21 EWSI PBR Proceeding - ability for Utility to find efficiencies decreases over time. However, still an expectation for Utility to find efficiencies.

RETURN ON EQUITY (GRANT THORNTON)

Overview:

- GT has undertaken a broader scope of work, we focused our presentation on the cost of capital matters
- EWSI did not provide a formal cost of capital study in their current application instead they have updated the 2016 analysis as they considered that the most straightforward approach.
- It's important to note that GT did not complete a formal cost of capital study.
- Our role is to help the Utility Committee and the Utility Advisor assess the EWSI cost of capital submission as opposed to set precedent.

RETURN ON EQUITY (GRANT THORNTON)

Background ROE relative to AUC approved rates:

- The following table summarizes the background of the EWSI ROE relative to the AUC return on equity:

| | EWSI 2017-2021 Submission (June 2016) | AUC Rate Increase (October 2016) | COE Approved ROE (October 2016) | EWSI 2021 PBR (February 2021) | EWSI Rebuttal to City concern over premium calculation | Impact of 25 bps reduction |
|---------|---------------------------------------|----------------------------------|---------------------------------|-------------------------------|--|----------------------------|
| AUC | 8.3% | 8.5% | 8.5% | 8.5% | 8.5% | 8.5% |
| Premium | 2.2% | n/a | 1.675% | 1.45% | 1.39% | 1.14% |
| ROE | 10.5% | n/a | 10.175% | 9.95% | 9.89% | 9.64% |

- As a water, wastewater and drainage utility, EWSI has a higher risk profile than the electric and gas utilities that the AUC approved return on equity is predominately intended to regulate. Overall, GT agrees with this position, but does have differing positions relative to specific risks.

RETURN ON EQUITY (GRANT THORNTON)

Understanding the risk differential between EWSI and AUC:

| Incremental risk per EWSI | Grant Thornton Position |
|---|-------------------------|
| Water is a consumable product | GT agrees |
| Health and environmental | GT agrees |
| Revenue – demand volatility / decline risk | GT partially agrees |
| Capital Recovery – longer amortization periods reduce internal cash generated and increasing inflation risk | GT does not agree |
| Level of contributed assets that do not attract return on rate base but require operation and maintenance | GT does not agree |
| Return on equity – locked in for 3-5 year PBR periods as opposed more frequently updated AUC ROE | GT does not agree |
| Debt – interest rate risk borne by EWSI as opposed to passed on to customers. | GT agrees |

RETURN ON EQUITY (GRANT THORNTON)

Understanding the levers:

- EWSI is proposing a premium in comparison to the AUC's in two ways:
 - 40% equity vs the AUC approved 37% equity
 - EWSI has proposed a premium ROE vs the AUC approved ROE
- These are the “two levers” that the Utility Committee needs to consider when assessing the incremental risk relative to the AUC.
- Illustrative example of impact on utility earnings:
 - For every \$1,000 of rate base, the earnings generated by EWSI based on a capital structure with 40% equity and a 9.95% ROE would be \$39.8 per year.
 - For every \$1,000 of rate base, the earnings generated by EWSI using the AUC approved capital structure with 37% equity and the AUC approved 8.5% ROE would be \$31.45.
 - This is a reduction in earnings per \$1,000 of rate of \$8.35, or a decline of 18.9% in earnings.

RETURN ON EQUITY (GRANT THORNTON)

Conclusions:

- **Higher Risk Profile:** GT recognizes that EWSI has a higher risk profile than the predominantly gas and electric utilities that the AUC ROE is based upon.
- **EWSI risk premium relative to AUC:** GT sees the merit of moving towards reducing the risk premium between the EWSI ROE and the AUC ROE, as additional risk mitigators can be implemented.
- **Importance of maintaining a stable regulatory environment:** GT would caution that there is real value to ratepayers of maintaining a stable regulatory environment.
- **Caution:** Therefore, we would recommend that care is taken in the pace at which the Utility Committee moves the EWSI ROE towards the AUC ROE.
- **Adjusting ROE:** The City could consider a reduction of the proposed ROE to account for items which are reducing EWSI's risk profile, such as the shift to fixed charges, deferral accounts, the term of the PBR period proposed.

FUTURE REGULATORY CONSIDERATIONS - ADMINISTRATION RECOMMENDATIONS

- ❖ **Accounting and Capitalization Policies**
 - improved disclosure of accounting changes
- ❖ **Full-Time Equivalents**
 - reporting on actual and forecast workforce
- ❖ **Cost of Debt**
 - review of calculation of interest rates (calculated by EUI)
- ❖ **Performance Measures**
 - need for increasingly stringent and challenging targets

Thank you.