EPCOR Water Services Inc.

Response to City of Edmonton PBR Review Reports

EWSI 2022-2024/2026 PBR Applications

June 18, 2021

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1.0 BACKGROUND

On February 22, 2021, Edmonton City Council, in its role as regulator of EPCOR Water Services Inc. (EWSI), approved the guiding objectives for Utility Committee and City Council to assess the EWSI's Performance Based Regulation (PBR) applications (Attachment 1 to City Administration's Report FCS00624). These guiding objectives have been in place since EWSI's PBR began in 2002 and have successfully balanced the interests of both ratepayers and the utility. In addition to these broad guiding objectives, EWSI also aims to follow well-accepted regulatory principles and practices followed by the Alberta Utilities Commission (AUC) and other provincial utility regulators.

The PBR framework has many benefits:

- customers receive stable and predictable rates that are competitive with other municipalities;
- EWSI, not its customers, bears the risk of potential cost and consumption variances;
- EWSI is allowed an opportunity to earn a reasonable return on its investment of capital;
- EWSI has strong incentives to continuously seek cost savings, which are then passed on to customers through lower rates in the subsequent PBR renewal period. In fact, EWSI's water and wastewater treatment operations achieved over $50 million in operating cost savings relative to forecast in the 2012-2016 PBR and another $32 million[1] to date for 2017-2021 PBR term. Permanent efficiencies found in these PBR terms benefit customers through lower operating cost forecasts and lower rates in subsequent PBR terms;
- performance metrics and penalties ensure that EWSI is required to meet high performance standards and that cost savings are not achieved by sacrificing service levels;
- administrative burden is reduced by having less frequent rate proceedings by filing a three to five-year PBR plan.

PBR regulation is recognized as best practice for utility regulation. Modeled after some of the successes of private water and wastewater utilities in the UK that are regulated through a PBR model by economic regulator Ofwat[2], EWSI is undertaking a new "Utility of the Future" initiative. The Utility of the Future initiative is intended to identify and drive further efficiencies by using data to proactively plan and respond to business needs. Without a PBR regulatory method in place, the incentives to seek these efficiencies are blunted. Introduction of deferral accounts and

[1] Excluding operating expense variances related to the negative corporate allocation NRA, green power costs and capitalization of valve casings and service box replacements in 2017-2020.

[2] https://www.ofwat.gov.uk/

various true-ups of cost forecasts to pass risk to customers will move the structure of regulation towards cost of service.

EWSI views any move towards cost of service regulation as a step backwards. Not only does it reduce incentives for the utility to innovate and find cost savings, it destabilizes rates for customers and requires more frequent regulation. Evidence of the cost savings achieved by incentives under the PBR framework is clearly demonstrated by a review of financial reporting over the past two PBR terms. As City Administration itself notes[3]: *EWSI was able to achieve earnings over the 2017-2019 timeframe comparable to amounts approved as part of the 2017-2021 PBR applications (PBR Progress Report), there were significant variances in two areas in particular, with unfavorable revenues due to lower water consumption being primarily offset by significant reductions in operating costs.* Because of the natural variations in revenues associated with lower water consumption, EWSI was strongly incented to find operating cost savings in order to maintain its earnings.

For all of these reasons, EWSI fails to see the benefits of moving towards cost of service and away from a PBR regulatory structure which has served to balance the needs of ratepayers and the utility since it was put in place in 2002 and was adopted for the Drainage utility because of its success. All three of the 2022-2024/2026 PBR Applications have been prepared under the current PBR framework. In EWSI's view, it is not appropriate to change the PBR framework in the middle of a proceeding. If there is interest in modifications to the PBR framework, that review process should be done in between applications so that the next application can be developed in alignment with the revised framework.

The 2022-2024/2026 PBR Applications present EWSI's evidence supporting a plan to invest over $1.35 billion in Edmonton's water cycle utilities. The benefits of this investment to Edmontonians are significant. They include reliable utility services; citywide flood mitigation; odour reduction; expansion of service to meet a growing customer base; operational efficiency improvements; and water quality and worker health and safety standards that meet or exceed changing regulatory requirements. EWSI has aligned the PBR plan for water, drainage and wastewater services with the City's vision and values (to belong, live, thrive, and preserve) in the new City Plan. The investments proposed over the next several years are significant but necessary to maintain reliable utility systems, continue a strong record of environmental performance, and improve Edmonton's flood resilience.

To fund these capital projects and programs while keeping rate changes within reasonable levels, EWSI constrained operating cost increases to less than 1% a year on average and targeted capital programs using risk-based assessments. Affordable and stable utility costs can be an important

[3] Page 9 of City Administration Report.

contributor to long-term economic recovery. To support its customers, EWSI is proposing to reduce the return on equity it has requested for the base Drainage operations from 9.95% to 6.61% for the 2022-2024 PBR term. This voluntary reduction in return will moderate rate increases and save ratepayers approximately $66 million.

1.1 EWSI's Business Risks and the Proposed Return on Equity

In the PBR Applications, EWSI presented a proposed approach for determining the return on equity. EWSI believes this approach has merit and should be accepted by Utility Committee because it is:

- simple and transparent and easily updatable for the next PBR term;
- hinges on the AUC's generic cost of capital (GCOC) of 8.5%, which is in accordance with Utility Committee's direction in the last PBR proceeding to determine a return on equity for EWSI based on the GCOC plus a risk premium;
- relies on a risk premium originally put forward by the City's own expert, Grant Thornton, based on its detailed cost of capital review in 2016 and which has been recently clarified at 1.77% in its latest report[4];
- reflects updated interest rates; and
- is clearly the only methodology put forward in this proceeding that is based on the GCOC with a risk premium provided by an independent expert that can be easily updated for subsequent PBR terms.

The risk premium advanced by Grant Thornton is reasonable and recognizes that EWSI is exposed to materially greater business risks than the average electric and gas utility regulated by the AUC. It therefore follows that, all things equal, the appropriate common equity rate of return for EWSI is materially higher than the Commission's generic cost of capital. Four principal aspects of business risk support this conclusion.

First, water is a consumable product with health and environmental regulations. None of the electric and gas utilities produce consumables and face the complications and risks of dealing with health regulations. Differences in consumable product risk between EWSI and the electric and gas utilities apply primarily to the Water and Wastewater businesses.

Second, the proportion of contributed assets for EWSI is materially higher than the proportion of contributed assets for the electric and gas utilities. Contributed assets are not permitted to earn

[4] At page 43 of its 2021 Report, Grant Thornton clarified that its final common equity rate of return opinion from 2016 was a range of 10.12 – 10.42%. The midpoint of this range is 10.27%, and the associated EWSI risk premium is therefore 1.77% (= 10.27% less 8.50%). This adjusted risk premium is 0.06% lower than the 1.83% risk premium based on EWSI's original interpretation.

a return and yet the utility has the responsibility to operate and maintain contributed assets, thereby increasing the operating leverage risk to which the utility is exposed. Approximately 53% of EWSI's assets are contributed for which EWSI does not earn any return nor does it receive any compensation for the associated risks. In contrast, for the Alberta electric and gas utilities on average, only 15% of assets are contributed. The AUC has noted in its decisions that the contributed assets cause an increase in financial and operating leverage risk[5].

Third, the capital recovery risks faced by EWSI are greater than those of the electric and gas utilities as evidenced by the longer period over which Water utility capital is recovered. In financial markets, the connection between capital recovery periods and risk is readily-observable because investors typically demand higher yields on long-term bonds compared to medium- or short-term bonds of the same issuer. The average life of assets for electric and gas utilities is 33 years compared to EWSI's average asset life which almost twice as long at 57 years. To adjust EWSI's risk so that it is comparable to the Alberta electric and gas utilities would require depreciating EWSI's assets over 33 years, which would nearly double the current depreciation costs recovered from EWSI's customers.

Fourth, the lower the proportion of revenues arising from fixed charges, the greater the risk that forecast revenues will fail to materialize. EWSI has a lower percentage of its revenues from fixed charges than the electric and gas utilities. This difference is especially pronounced in the Water and Wastewater businesses. As noted in Appendix D to the PBR Applications, the average percentage of EWSI's revenues from fixed charges is 31.3%. This compares to an average of 72% from fixed charges for the Alberta electric and gas utilities. To adjust EWSI's risk so that it is comparable to the electric and gas utilities would require changing EWSI's rate structure to 72% fixed charges and 28% variable charges.

[5] Alberta Utilities Commission, *Decision 2011-474*, December 8, 2011, Paragraph 495, page 92.

2.0 INTRODUCTION

This report provides EWSI's reply to the following three reports (the "Reports") for the June 25, 2021 Utility Committee meeting:

- City Administration's report entitled "EPCOR PBR Applications Reasonableness Review by Administration" (FCS00624) (the "City Administration Report")
- Grant Thornton's report entitled "EPCOR Water Services Inc. – Performance Based Regulation Review" (FCS00624) (the "Grant Thornton Report")
- Utility Advisor's report entitled "EPCOR 2022 PBR Applications - Review by the Utilities Advisor" (FCS00625) (the "Utility Advisor Report")

EWSI appreciates the efforts taken by City Administration, Grant Thornton and the Utility Advisor to review EWSI's PBR applications and to provide their respective reports. EWSI agrees with some of the recommendations and is proposing to make the following adjustments in its compliance application for reasons further explained below:

- EWSI will reimburse customers $5.2 million related to the capitalization of valve casings and service box replacements;
- EWSI will reduce the return on equity from 9.95% to 9.89% for Water and Wastewater Treatment to reflect Grant Thornton's clarification of the recommended return on equity in its 2016 report; and
- as already identified in its IR response (COE-EWSI-1.b.iii), EWSI will reduce debt costs by approximately $3.7 million in total for Water and Wastewater Treatment.

These proposed adjustments are in addition to the voluntary $66 million reduction EWSI has proposed by reducing the Drainage utility return on equity to 6.61% for the PBR term.

EWSI respectfully disagrees with a number of other recommendations in the three Reports and provides its comments respecting those recommendations below. EWSI also notes the following general concerns with recommendations and comments in the Reports:

- **First, EWSI is concerned that a number of City Administration's recommendations appear to be unbalanced.** These recommendations do not reflect that the PBR framework should provide balance between areas of potential over-earning and under-earning. For example, after noting that the consumption forecast appears overly conservative[6], City Administration proposes a consumption deferral account which would require rate

[6] Page 30 of the City Administration Report.

increases/decreases to account for differences between actual and forecast consumption. Similarly, after noting a material decrease in the level of interest rates from the previous PBR term, City Administration recommends that an interest rate deferral account is not warranted[7]. The selective application of deferral accounts based on predicted outcomes is one of the dangers of departing from the PBR structure.

- **Second, City Administration is recommending changing of PBR practices after approvals have been issued which is reflective of retro-active rate-making and a departure from accepted regulatory principles and practices.** Any proposed new treatment of the Non-Routine Adjustments (NRAs) and Special Rate Adjustments (SRAs) should have been provided in the NRA approvals or clarified in the Bylaw for the 2017-2021 PBR term so that EWSI can operate within a known framework.
- **Third, City Administration's recommendations do not follow established past practices for the PBR and are not applied consistently.** City Administration proposes a true-up to the Environmental Initiatives SRA for the difference between actual and forecast costs for the North Saskatchewan River Monitoring Program. Such a true-up to refund/collect under/overspending for SRA's has never been applied before and City Administration has not recommended that this approach be applied consistently to any other SRAs. Looking at all SRAs combined, there is a net overspending during 2017-2021, yet City Administration is not recommending that customers be charged. EWSI aims to forecast costs as accurately as possible under the PBR. As circumstances change and costs vary from approved amounts, the variances from approved amounts are expected to largely offset each other by the end of the PBR term.
- **Finally, none of the Reports give any consideration to EWSI's $66 million in voluntarily foregone returns.** EWSI has voluntarily mitigated rate increases for its customers by discounting the Drainage return on equity (ROE) for base operations over a five-year period, rather than the standard practice of applying for allowed rates of return beginning in 2022. Drainage's proposed ROE for the 2022-2024 PBR term is only 6.61% (for base Drainage operations excluding SIRP and CORe). This is far lower than even the 8.5% AUC generic rate of return, which as Grant Thornton presents in their Canadian regulatory review[8], is already the second lowest in the country. The Reports' recommendations on ROE do not appear to evaluate the overall fairness of the risk/reward equation within the PBR. The applied-for Drainage rate of return of 6.61% for base capital is already insufficient to satisfy the legal requirements for a fair return. The return set by the regulator should allow the utility to maintain its financial integrity, be able to attract capital on reasonable terms, and be compensated for the risks it takes on. The suggestion

[7] Page 20 of the City Administration Report.
[8] Page 47-48 of Grant Thornton Report.

that the already-insufficient rates of return should be made even more difficult to earn by doubling the Drainage efficiency factor does not account for EWSI's good faith effort to reduce rate shock to Drainage customers. Any further reductions would also place EWSI at risk of being unable to obtain debt financing on current A (low) terms causing an increase in EWSI's future cost of debt.

Based on EWSI's review of the Reports, EWSI has categorized its responses into two sections. Section 3.0 will addresses issues raised in the Reports that EWSI has identified as substantial changes to the PBR Framework, which EWSI views as out of scope for this 2022/2024-2026 PBR proceeding and should be considered by Utility Committee through a separate review process following customer consultations on these specific matters. Section 4.0 will provide EWSI's comments on issues that are considered within the scope of the 2022-2024/2026 PBR proceeding.

3.0 MATTERS OUT OF SCOPE FOR THE 2022-2024/2026 PBR PROCEEDING

Several key recommendations in the Reports would represent fundamental changes to the long-standing PBR framework. These recommendations include: (i) treatment of Special Rate Adjustments (SRAs) and Non-Routine Adjustments (NRAs); and (ii) the proposed implementation of a consumption deferral account. These recommendations would transfer to customers the forecast risk associated with expenditures that are part of SRAs and NRAs, and the risk associated with consumption forecasts. EWSI believes that these recommendations need to be carefully evaluated outside the scope of the current PBR proceeding and, therefore, would be more appropriately considered by the Utility Committee through a separate, more comprehensive review process, including customer consultations.

3.1 Introduction of Deferral Accounts

All three reports recommend consideration of a consumption deferral account. EWSI strongly urges the Utility Committee and Council to reject the use of deferral accounts. With the exception of the 90-Day Utility Bill Deferral Program to provide customers with relief during the early months of the pandemic, EWSI has not requested the use of **any** deferral accounts in the history of the PBR nor is it requesting a consumption deferral account at this time. EWSI has successfully managed the risk of cost and revenue fluctuations in order to provide stable and predictable rates to its customers. Section 4.5 discusses the consumption forecast in further detail, including improvements to the forecast methods and an assessment of the reasonableness of the proposed consumption forecast.

Implementation of deferral accounts will erode the benefits of the PBR framework which has been highly successful in balancing the interests of customers and utilities. EWSI submits that any consideration of implementing deferral accounts should be handled outside this current PBR proceeding. Although further analysis and review needs to be undertaken to understand the impacts of introducing deferral accounts on EWSI’s overall risk profile, the allowed return on equity, incentives and customer behaviours before any deferrals are considered, EWSI provides some general comments below. The restructuring of the PBR framework through the implementation of a deferral account for consumption variance will have consequences for:

- the utility’s incentive to manage costs,
- consumer incentives for water conservation,
- price signal distortion,
- rate volatility and unpredictability,
- bill complexity and
- utility earnings volatility.

Though not exhaustive, the following provides a high-level overview of some of the expected consequences of deferral accounts.

A consumption deferral account is not beneficial for customers as it breaks from the current PBR structure which provides rate stability and predictability. As the risk of consumption variances from forecast are shifted from the utility to EWSI's customers, future swings in revenues associated with consumption will require annual rate adjustments that may move rates higher or lower relative to prior years' rates. The forecast variance tends to be lowest in the first year of the PBR and highest in the final year of the PBR, as uncertainty increases with a longer forecast. This is likely to lead to a "snowball" effect, with significant bill impacts likely toward the latter years of a PBR term. Rate predictability and stability are important to EWSI's customers. This is especially true for sophisticated commercial customers, who rely on stable and predictable rates when developing their own business plans and forecasts. Rate stability and predictability is also an important principle of rate setting noted by the American Water Works Association and other rate setting guidelines (AWWA Principles of Water Rate Setting M1 Manual).[9]

A consumption deferral account reduces incentives for customers to conserve water. This is because when customers consume less water, rates would need to increase in the following period to adjust for the variance, essentially penalizing customers for conserving water and hardly a desirable result.

A consumption deferral account departs from the overarching goals of a PBR structure. The essence of "performance-based regulation" is that utilities assume the risks and should reap the rewards or suffer the losses for superior or inferior performance. Philosophically and practically, the use of deferral accounts blunts the very purpose and incentives for which PBR was created in the first place. The dangers in departing from these overarching goals and selectively instituting deferral accounts are: (i) parties to the regulatory process are then encouraged to "cherry pick" which costs to include in deferrals based on whether they believe that outcomes will benefit utilities or customers; and (ii) utilities will be encouraged to spend fewer resources on superior performance in areas where deferral accounts exist and focus instead on superior performance in areas where they are placed fully at risk. In short, the use of deferral accounts for all but the most extraordinary risks is philosophically antithetical to the goals and objectives of performance-based regulation. Selecting a single deferral for consumption ignores that there are some natural offsets to potentially higher than forecast consumption. These natural offsets include higher operating costs that vary with (power costs) and increases in interest rates that may come with economic recovery. Because of these natural offsets, imposing a deferral account on only one side of the equation may actually increase the risks to the utility..

[9] Response to Information Request COE-EWSI-1(d)(ii).

A consumption deferral account will blunt incentives for the utility to find cost savings. During the 2012-2016 PBR term, the Water and Wastewater Treatment operations achieved $52 million in operating cost savings relative to PBR forecasts; and, for the period 2017-2020, EWSI has already achieved an additional $32 million in operating cost savings[10]. During years where revenues are lower than forecast due to consumption variances, the significant pressures on net income have historically driven EWSI to respond by finding operating cost savings. This responsiveness to revenue swings is similar to a commercial environment, which a PBR structure is intended to simulate. Imposing a consumption deferral account would remove the revenue risk and erode the potential responsiveness of management to address the natural swings in revenues over time.

Introducing deferrals represents a fundamental change to the PBR structure which should be reviewed through a separate comprehensive process. The current PBR structure has no deferral accounts. If City Administration wishes to move away from a PBR and towards a cost-of-service form of regulation, this requires a more comprehensive review of all costs and risks similar consideration of other deferral accounts. More extensive modelling and scenario analysis is required in order for EWSI and City Administration to understand the potential unintended consequences of a consumption deferral account. Customers should also be consulted if the move toward deferrals and cost-of-service type regulation is being considered as there is considerable risk passed on to customers. Implementation of changes to the PBR structure without understanding the stakeholder perspective is not in the best interest of EWSI's customers. EPCOR's and the City's stakeholder consultation processes would require a stakeholder consultation process be completed in advance of making such changes to the PBR structure.

3.2 Treatment of Special Rate Adjustments (SRAs)

City Administration recommended the following:

A potential reduction to the Water Services 2022-2026 revenue requirements to carry forward differences between amounts approved ($4.1 million) and actual amounts incurred ($2.6 million) as part of the 2017-2021 Special Rate Adjustment for the North Saskatchewan River Monitoring project[11].

EWSI has the following concerns with this recommendation.

[10] Excluding operating expense variances related to the negative corporate allocation NRA, green power costs and capitalization of valve casings and service box replacements in 2017-2020.
[11] Page 5 of City Administration Report.

The recommendation reflects a fundamental shift from PBR regulatory framework towards cost of service. When EWSI applied for the SRA, the existing Bylaw did not contemplate any future true-up as part of the next PBR application. SRAs have never been adjusted in this manner in past PBR proceedings. This proposed change in the treatment of SRAs is a fundamental shift in the PBR structure which would pass cost forecast risks from the utility to the customer. As such, this matter should be fully evaluated to determine its merit in a fair and comprehensive manner outside the scope of this hearing.

Changing the treatment of SRAs (historical and future) will limit EWSI's future flexibility to manage costs in the most effective manner. As conditions change and as strategies evolve, the PBR has provided EWSI with flexibility to manage utility operations in the most cost-effective manner while ensuring customers consistently receive high quality services. EWSI and its customers benefit from the flexibility allowed under the PBR as EWSI has been effective in achieving the overall objectives of the programs under NRAs/SRAs while ensuring costs are within reasonable range of the forecast expenditures. If true-up processes for SRAs are required, EWSI will no longer be incented to maximize efficiencies for large programs under SRAs. This impact could be significant given the large SRAs included in the Drainage PBR including SIRP and CORe.

In EWSI's view, this is not a balanced recommendation. City Administration has only selected the one SRA where EWSI underspent by $1.5 million for a true-up adjustment, whereas other SRAs are not recommended for similar true-ups to forecast costs. There is no recognition in the City Administration Report that there are other areas where EWSI's costs have exceeded the forecasts, causing reductions in the achieved ROE for the 2017-2021 PBR term, yet it has no compensating mechanism. For the 2017-2021 PBR, EWSI is currently forecasting a net overspending. If this recommendation is accepted, then other SRAs should also be trued-up in the same manner.

3.3 Treatment of NRAs including Corrosion and Odour Mitigation Strategy

City Administration recommends potential adjustments to refund or carry forward differences between amounts approved and actual/forecast amounts incurred for NRAs during the 2017-2021 PBR term ($5.6 million in total, excluding any further potential amounts for the Corrosion and Odour (CORe) NRA)[12]. City Administration also recommends a further review of amounts included in the determination of the actual/forecast CORe NRA ($14.8 million) in comparison to the adjustment approved during the 2017-2021 PBR term ($10.8 million)[13]. EWSI has the following concerns with this recommendation.

[12] Page 5 of City Administration Report.
[13] Ibid.

Changing the treatment of NRAs after NRA approvals were received is retroactive rate-making and is inconsistent with standard regulatory practices followed by other regulators including the AUC. In the case of NRAs, City Administration has recommended new requirements to true-up NRAs to forecast amounts, even though this treatment was never contemplated in either the PBR Bylaws nor the 2019 NRA approvals by the City Manager and City Council.

Any change adopted to make NRAs subject to a true-up process must be symmetrical. The estimated over-collection is based on EWSI's forecasts prepared in 2020 and may change significantly by the end of 2021. By the end of the current PBR term, the over-collection may be reduced or may become an under-collection by the end of 2021 when actual results are known. In the latter case, the only fair approach would be to charge customers for the under-collected amounts. Furthermore, if EWSI is required to adjust 2022 rates for these forecast differences, it would create a need for further adjustments to update rates in the future when actual amounts are known. This adds further administrative burden for both the City and EWSI.

Changing the treatment of NRAs will limit EWSI's future flexibility to manage costs in the most effective manner. As conditions change and as strategies evolve, the PBR has provided EWSI with flexibility to manage its operations in the most cost effective manner while ensuring customers consistently receive high quality services. As noted above, with the introduction of deferral accounts or true-up processes for NRAs/SRAs, utilities are encouraged to spend fewer resources on superior performance in these areas.

EWSI should not be penalized for refining CORe in a manner that better facilitates efficient management of the program. With respect to the CORe NRA, EWSI 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. CORe is a new program which has evolved based on EWSI's further understanding of the Drainage system. In EWSI's view, it is entirely appropriate to move the CORe Large Trunk Rehabilitation Program into CORe as the program is focused on addressing both corrosion and odour. The approach under PBR to NRAs, as EWSI understood, is on a forecast basis with EWSI bearing the risk of cost forecast variances in NRAs - no differently than other cost forecasts. This treatment allows EWSI the flexibility to manage its programs in the most efficient and effective manner. In the CORe NRA Application, EWSI noted that it would learn more about the requirements to address corrosion and odour once inspections were completed. With the knowledge gained from these inspections, EWSI has adjusted the program appropriately.

This proposed change in the treatment of NRAs is a fundamental shift in the PBR towards a cost-of-service regulation and passes the cost forecast risks from the utility to the customer. As such, this matter is more appropriately considered in a fair and comprehensive manner outside the scope of this hearing to better understand the impact a change like this will have on the risk profile of the utility and potential impact to customers.

4.0 MATTERS WITHIN SCOPE FOR THE 2022-2024/2026 PBR PROCEEDING

In addition to matters which should be handled through a separate review process, EWSI respectfully submits the following reply comments for Utility Committee's consideration on specific recommendations in the three reports.

4.1 Return on Equity Adjustment: 0.15% decrease

City Administration has recommended an update to the return on equity formula based on the final return on equity approved by Council for the 2017-2021 PBR term of 10.175% less 0.38% change in bond yield = 9.80%. EWSI has the following concerns with this recommendation.

City Administration proposal departs from setting the return on equity based on the AUC's generic cost of capital (GCOC). City Administration's proposed method does not align with the direction from Utility Committee in the 2017-2021 PBR proceeding to establish a method for determining the ROE for EWSI that uses the AUC GCOC as a starting point. Instead of using the most recent AUC approved GCOC, City Administration's proposal relies on City Council's approved ROE for 2017-2021 as the basis for determining the ROE for the upcoming PBR term. The use of a regulator's past awarded or approved rate of return as the point of departure for determining what that regulator's current awarded rate of return should be is widely-regarded as a circular exercise. Thus, City's recommended 0.15% reduction in the ROE suffers from circular reasoning and is therefore less reliable and independent than a proposed risk premium which is derived from Grant Thornton's independent studies. The problem of circularity and excerpts from decisions of the AUC, the National Energy Board, the U. S. Federal Power Commission and a prominent regulation textbook are set out in the Response to Information Request COE-EWSI-2(ii).

EWSI's proposed method relies on the most recent AUC GCOC as a starting point, consistent with Utility Committee direction, and a risk premium derived from Grant Thornton's recommended return on equity in the last PBR proceeding. The EWSI risk premium above the GCOC is based on Grant Thornton's risk premium of 1.83% from the 2017-2021 PBR proceeding. As such, there is **no circularity** inherent in EWSI's proposed method for establishing a reasonable ROE. EWSI's proposed method also adjusts for changes in bond rates. Based on Grant Thornton's clarification that the recommended return on equity for the 2017-2021 PBR should be 10.12% - 10.40%[14], an adjusted risk premium can be derived. The mid-point of this range is 10.27%. Deducting the 8.5% GCOC approved at the time of the decision, establishes a revised risk premium of 1.77% (0.06% lower than the 1.83% risk premium based on EWSI's original

[14] Page 43 of the Grant Thornton Report.

interpretation). Based on this clarification from Grant Thornton, any ambiguity respecting the 2016 starting point risk premium is clearly resolved. With this clarification, EWSI recommends that the proposed common equity rate of return for the 2022 – 2024/2026 PBR terms be fixed at 9.89% which is independently derived from the 8.50% AUC GCOC plus Grant Thornton's 1.77% risk premium less the 0.38% decrease in long-term bond yields.

4.2 Return on Equity Adjustment: 0.25% decrease

City Administration recommended that the proposed ROE be decreased by 0.25% if a water consumption deferral account is implemented and to account for EWSI's proposed shift in the fixed/variable charges.[15] Grant Thornton also recommended that the proposed be decreased by 0.25% if a water consumption deferral account is implemented and to account for EWSI's proposed shift in the fixed/variable charges and the three-year term of the PBR period (for Wastewater Treatment and Drainage)[16].

EWSI has five concerns with these recommended reductions in the ROE:

First, there is no analytical basis for the 25 basis points. When EWSI was asked to quantify the impact of a possible debt cost deferral account, an extensive analysis was provided in the Response to Information Request COE-EWSI-1(d)(v). In contrast, there is no analysis which supports the 25 basis points. There is only the statement that this potential adjustment reflects an unspecified basket of "…items which are reducing EWSI's risk profile, *such as* the shift to fixed charges, deferral accounts, the term of the PBR period proposed."[17] (Emphasis supplied.)

Second, this suggestion should not apply to the Drainage business inasmuch as EWSI is already applying for an average 2022 – 2026 Drainage rate of return that is materially below even the AUC's generic cost of capital.[18] It would be unreasonable to impose an additional 0.25% reduction on the Drainage rate of return given that EWSI is already voluntarily proposing to reduce the Drainage rate of return to 6.61%, which is clearly less than a reasonable rate of return, for the purpose of moderating rate increases to customers. Any further reductions would also place EWSI at risk of being unable to obtain debt financing on current A (low) terms.

Third, introduction of a consumption deferral account is out of scope for this proceeding and should be considered through a separate review process. As such, the return on equity for the

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[15] Page 4 of the City Administration Report.
[16] Page 49 of the Grant Thornton Report.
[17] Page 49 of the Grant Thornton Report.
[18] As noted in Table 17 on page 42 of the Grant Thornton Report, the average 2022 – 2026 applied-for Drainage rate of return is 8.19%.

2022-2024/2026 PBR term should not be adjusted downward for any risk factor associated with a consumption deferral account.

Fourth, there is no proposal to increase the proportion of revenues recovered through fixed charges in either the Wastewater Treatment or Drainage businesses. Thus, at least one of the risks referenced by City Administration and Grant Thornton is inapplicable to these businesses, casting further doubt on the appropriateness of a 0.25% reduction for Wastewater Treatment and Drainage.

Fifth, the 3-year PBR term does not apply to the Water business. Thus, the reduced risks referenced by City Administration and Grant Thornton associated with a 3-year PBR term are not applicable to the Water business.

EWSI wishes to emphasize that it has <u>not</u> requested an increase in ROE due to risks associated with the COVID pandemic, nor has it attempted to pass on these risks to customers through deferral accounts. EWSI is proposing to continue to manage the risks associated with the pandemic just as it has effectively managed other forecast risks within the current PBR structure. In fact, despite the increase in risk, EWSI has proactively reduced its applied-for ROE by $66 million for the Drainage operations to further protect customers from rate increases during a difficult economic period. None of the Reports appear to acknowledge this voluntary decrease in the return on equity in combination with the increase in risk of EWSI's operations.

4.3 Increase to Drainage Efficiency Factor

Both City Administration and Grant Thornton recommend an increase in the efficiency factor from 0.25% to 0.50% for Drainage Services based on the continued transition to performance based regulation following the transfer from the City of Edmonton in 2017.

EWSI has five concerns with this recommendation.

First, EWSI's ROE for the Drainage utility is already well below any reasonable level. To minimize rate increases to its customers for the 2022-2024 PBR term, EWSI has voluntarily proposed a $66 million decrease in the ROE that it will earn for the Drainage utility. The impact of the reduced ROE for Drainage does not appear to be taken into account in City Administration's or in Grant Thornton's recommendations. One of City Council's guiding objectives in approving the PBR Bylaws is that ***EPCOR is entitled to a reasonable margin of profit from operations*****.** Moreover, the applied-for Drainage rate of return is already insufficient to satisfy the legal requirements for a fair return as articulated by the Supreme Court of Canada in Northwestern Utilities Ltd. V. City of Edmonton:

> *The duty of the Board was to fix fair and reasonable rates; rates which, under the circumstances, would be fair to the consumer on the one hand, and which, on the other*

> *hand, would secure to the company a fair return for the capital invested. By a fair return is meant that the company will be allowed as large a return on the capital invested in its enterprise (which will be net to the company) as it would receive if it were investing the same amount in other securities possessing an attractiveness, stability and certainty equal to that of the company's enterprise. In fixing this net return the Board should take into consideration the rate of interest which the company is obliged to pay upon its bonds as a result of having to sell them at a time when the rate of interest payable thereon exceeded that payable on bonds issued at the time of the hearing. To properly fix a fair return the Board must necessarily be informed of the rate of return which money would yield in other fields of investment. Having gone into the matter fully in 1922, and having fixed 10% as a fair return under the conditions then existing, all the Board needed to know, in order to fix a proper return in 1927, was whether or not the conditions of the money market had altered, and, if so, in what direction, and to what extent.*[19]

The suggestion that these already-insufficient rates of return should be made even more difficult to earn by doubling the Drainage efficiency factor is an unreasonable position particularly given EWSI's good faith effort to reduce rates for Drainage customers by voluntarily reducing its return on equity.

Second, the Drainage utility is already strongly incented to find operating cost savings under the current PBR structure in order to maintain a reasonable return. A higher efficiency factor is not necessary for EWSI to continuously identify opportunities for cost improvement. To limit its cost increases to inflation less 0.25% is already a very challenging target for EWSI. It requires that EWSI find cost savings to offset certain external costs which are expected to rise faster than inflation. The incentives to improve efficiency under performance-based regulation are generated by the form of regulation, not the value of the productivity factor per se. Under PBR, utilities have incentives to find efficiencies that reduce their costs because their allowed prices are decoupled from their costs while the PBR plan is in effect. Price changes under PBR are linked to industry input price inflation and productivity trends that are "external" to the utility, rather than the utility's own costs, as under cost of service regulation. Severing the link between price and cost changes allows utilities to profit from efficiency gains under PBR, and it is this feature of PBR rather than the value of the productivity factor, that generates improved performance incentives.

Third, EWSI has already reflected further operating cost savings of approximately $3 million per year for the 2022-2024 PBR forecast. These operating cost savings, which are related to the Real Estate Consolidation Project and AMI Metering Project[20], are incorporated into the Drainage

[19] Page 192-193, Northwestern Utilities Ltd. v. Edmonton, [1929] SCR 186. 1929 CanLII 39 (SCC) | Northwestern Utilities Ltd. v. Edmonton (City) | CanLII

[20] Section 6.2, Drainage PBR Application.

revenue requirements for 2022-2024. These operating cost savings have not been accounted for in City Administration's report and therefore would need to be removed if the efficiency factor was increased to 0.5%. Furthermore, for the first PBR term for Drainage (2018-2021), EWSI had already committed to significant operating cost savings of 1% per year and believes it has demonstrated having achieved those savings.[21] As such, increasing the efficiency factor would only penalize the Drainage utility and further reduce the allowed return below a reasonable level.

Fourth, the 0.5% efficiency factor recommendation is an arbitrary determination with no formal study completed or justifiable basis. Normal regulatory practice would be to establish an efficiency factor based on expert evidence using an industry study.

Finally, City Administration's argument that the efficiency factor should decline over successive PBR terms has not been applied consistently. If this argument is accepted, then there is no basis for continuing to maintain a Water efficiency factor at 0.25% for an additional 5 years when it has been at that rate for the past 15 years (three PBR terms).

4.4 Smoothing of Customer Rates

City Administration recommends 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.

EWSI notes that the initial rate increases in the first year of the PBR term primarily reflect one-time events including: (i) the impact of collecting fire protection costs through water rates; (ii) the transfer of the Biosolids Management function from Drainage to Wastewater Treatment; and (iii) collection of the 90 Day Deferral Program. As shown in Table 4.4-1, a significant portion of the increase in the first year of the PBR relates to the impact of collecting fire protection costs through water rates. EWSI understands that the offsetting City of Edmonton tax decreases associated with moving fire protection costs into water rates would be applied in 2022 as a single year adjustment. As such, applying additional smoothing to the water rate increases over the five-year period does not appear to be consistent with the offsetting tax reductions.

[21] Section 2.3.8, Drainage PBR Application.

Table 4.4-1
Average Residential Bill
(Combined Bill for Water, Wastewater Treatment, Sanitary and Stormwater)
($ per month)

		A **2021**	B **2022**	C **2023**	D **2024**
1	Monthly Bill before Fire Protection	101.86	106.01	108.65	113.59
2	**Change in Bill - %**		**4.1%**	**2.5%**	**4.5%**
3	SRA – Fire Protection	-	2.59	2.64	2.70
4	Monthly Bill including Fire Protection	101.86	108.60	111.29	116.29
5	**Change in Bill - %**		**6.6%**	**2.5%**	**4.5%**

4.5 Consumption Forecast

Grant Thornton recognizes the use of judgement in developing the forecast of commercial consumption, but notes that there may be implications regarding potential under-forecasting. City Administration states that it is "*unable to gain a sufficient level of comfort as to the reasonableness of the water consumption forecast*"[22]. Both parties recommend the considerations of either: (i) a consumption deferral account; or (ii) annual updates to the forecast to address this uncertainty.

EWSI submits the following comments in response.

EWSI has improved its ability to forecast consumption trends. Although historically, EWSI has tended to over estimate residential water consumption, more recently EWSI has used neighbourhood data to better understand trends in consumption declines associated with new water-efficient fixtures and appliances. This is illustrated by the variance of only 0.7% from forecast for the residential consumption per customer for the 2017-2020 period. For the upcoming PBR term, EWSI has implemented further refinements to its method for forecasting commercial and multi-residential consumption.

EWSI is effectively managing consumption forecast risk on behalf of customers. The COVID-19 pandemic has introduced new risks to utilities. The Grant Thornton report concludes "It is unreasonable for utilities to expect both an increased equity return and have the financial consequences of the associated risk eliminated"[23]. In fact, EWSI has requested neither an increase in return nor elimination of risk. Rather, EWSI has responded to the downturn by offering a $66 million discount to customers, which effectively reduces Drainage's ROE for the 2022-2024 PBR term to just 6.61%. EWSI has effectively managed COVID-19 risks thus far over

[22] Page 30 of the City Administration Report.
[23] Section 8.2 of the Grant Thornton Report.

the 2017-2021 PBR term by looking for operating cost savings in 2020 and 2021, and has effectively managed weather-related risk in prior PBR terms.

EWSI's consumption forecast is aligned with other third-party forecasts in terms of the timing of COVID-19 recovery. EWSI developed its assumptions for the commercial consumption forecast based on third-party forecasts by the City of Edmonton, Government of Alberta and ATB Financial. All three now predict a return to normal for general output (GDP) levels for 2023 and a return to normal unemployment rates for 2024[24]. This aligns with the recovery timing assumptions imbedded in EWSI's consumption forecast, which predicts a full return to the pre-pandemic trend line by full-year 2023 for all variables except commercial consumption per customer. The proposed forecast assumes lingering consumption effects in some sectors in 2023, supported by the expectations of the City of Edmonton of a prolonged recovery in certain sectors. EWSI's forecast of commercial consumption per customer in 2020 came in higher than forecast (89.9 m^3/month as opposed to the 85.1 m^3/month forecast). However, actual results for January to April 2021 are lower than forecast (79.9 m^3/month), confirming the overall reasonableness of the forecast.

EWSI considers its 2022-2026 consumption forecast to be reasonable and balanced. EWSI prepares its best estimates of consumption based on the information currently available. EWSI is predicting a return to the long-term trend line for commercial consumption per customer by full-year 2024. However, that trend line is based on the long term decline in consumption per customer, which is flatter than the decline observed over the last four years prior to 2020. As businesses implement efficiency measures to manage costs during the economic downturn as well as to meet climate goals, this steeper decline in commercial consumption per customer may continue. EWSI determined that it would be speculative to incorporate a steeper decline at this time, however this presents downside risk to the forecast. The forecast currently predicts a fairly smooth recovery from the pandemic. However, a number of downside risks remain. Statistics Canada data shows that fewer businesses have closed over the past year than historically[25], likely

[24] City of Edmonton Spring 2021 Update provided to EWSI:
https://www.edmonton.ca/business_economy/economic_data/quarterly-economic-update.aspx
ATB June 2021 Economic Outlook:
https://www.atb.com/siteassets/pdf/company/insights/outlook/alberta-economic-outlook-june-2021.pdf
Alberta Government Budget 2021 Economic Outlook:
https://www.alberta.ca/economic-outlook.aspx#:~:text=The%20Alberta%20economy%20is%20expected,rebound%20by%204.8%25%20this%20year

[25] https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3310027001&pickMembers%5B0%5D=1.40&pickMembers%5B1%5D=2.1&cubeTimeFrame.startMonth=09&cubeTimeFrame.startYear=2015&cubeTimeFrame.endMonth=01&cubeTimeFrame.endYear=2021&referencePeriods=20150901%2C20210101

due to reliance on government assistance to pay wages and supplement sales revenue. An increase in bankruptcies and closures may therefore be observed once government supports for businesses end. The evolution of COVID-19 variants and the effectiveness of vaccines against those variants is another looming uncertainty. Similarly, there are upside risks that the economy and commercial consumption could recover faster than expected.

Annual updates to the forecast are not practical to implement. During stable periods with no economic downturn or structural changes to the data, it may be possible to implement formulaic updates to the forecast. However, there will be PBR terms in which pre-determined, formulaic updates to the forecast are inappropriate and will in fact reduce the accuracy of the forecast. For example, a sudden drop in commercial consumption per customer could be caused by a general downturn in the economy or by the sudden loss of one of EWSI's largest customers. The former would require a rebound in future years, while the latter would constitute a permanent reduction in average consumption per customer. Thus, it is EWSI's understanding that an annual approval process by City Council would be required in order to develop a revised forecast each year as any revised forecast would have impacts on rates. This would place administrative burden on both EWSI and its regulator.

4.6 Review of Neighbourhood Renewal / City-Initiated Capital Plan

City Administration recommends to confirm the 2022-2026 overall capital program including a reduction in renewal capital expenditures for Water Services based on the new risk assessment method adopted by EWSI, and the continued scheduling and rollout for two key initiatives (SIRP and CORe) [26]. City Administration further recommends an 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 or to include a deferral account (that would be flowed-through to customer rates) to true up the difference between the forecast.

EWSI considers that its planned capital programs are prudent and appropriate given that they are based on comprehensive asset reviews and risk assessments of potential failure. This approach enables EWSI to prioritize and address the most critical assets while leaving less critical assets with a lower chance of failure in place. A non-risk based approach would replace all assets meeting a defined criteria (age, replacement of road, etc.) irrespective of the actual condition of the assets. The risk-based approach has enabled EWSI to maintain reasonable rate increases and reliable utility service.

EWSI makes its best efforts to ensure its capital forecasts included in the PBR Applications are aligned with City-Initiated capital projects. EWSI updates its work plans and internal forecasts

[26] Page 4, City Administration Report.

annually based on the latest information provided by the City through a number of channels. First, every year, EWSI sends an email request to the City requesting notice of potential work to be completed in the following year. The City then responds with projects in the following year that require EWSI infrastructure to be relocated. The City and EWSI discuss potential relocation requirements at conceptual design meetings. Finally, EWSI, along with other departments at EPCOR, meet with the City monthly as the Capital Working Group, which is a venue for both parties to share information regarding projects that may be funded in the next budget cycle.

EWSI has been able to successfully manage the risk of variances in City Driven projects. EWSI considers that there is flexibility within EWSI's capital programs to address changing requirements while ensuring that it can meet the City's and its customers' service requirements. One specific advantage of the PBR structure is that specific projects within a given program can be reprioritized to address changing priorities, provided that the criteria for the program is maintained. In the event that capital requests exceed what can be accommodated within the various programs, EWSI bears the risk on any variations from these capital expenditure forecasts. In other words, if capital expenditures on City-Driven projects are higher than forecast, EWSI's net income for the PBR term will be reduced below the approved amount and if capital expenditures are lower than forecast, EWSI's net income for the PBR term will be higher than forecast. This process increases risk to EWSI. Lastly, if there is a significant variance in City initiated work that meets the NRA threshold, it would qualify for recovery through the NRA process.

4.7 Adjustment to Aurum Facility In-Service Date

City Administration recommends an 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, ROE, and cost of debt in 2022.

Construction is scheduled for completion in 2021, with moves beginning as soon as possible thereafter and move completion projected in the 1st quarter of 2022. Thus, the new facility will be used and useful prior to January 1, 2022. As such, the "in service date" of January 1, 2022 is set appropriately. This is consistent with guidance from IFRS (IAS 16) which states that depreciation of an asset begins when it is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

4.8 Adjustment for Change in Accounting

City Administration recommends an adjustment to reimburse utility customers for valve casings and service box replacements 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.

EWSI accepts this recommendation to reimburse customers. In its PBR Compliance Application EWSI will reimburse customers $5.2 million related to the capitalization of valve casings and service box replacements. The $5.2 million is calculated based on the $5.9 million of operating costs in 2020 and 2021, less $0.7 million for the revenue requirement (deprecation and return) generated in 2020 and 2021 by the additional capitalization.

EWSI notes that City Administration has given no consideration in its report to the changes to Drainage capitalization policies needed to conform to IFRS that, unlike Water's changes, have decreased capital and increased operating expenses by up to $10 million in each year of the 2018-2021 PBR term. EWSI submits that consideration for these increased operating costs be accounted for and on this basis Utility Committee should accept EWSI's proposed 0.25% efficiency factor for Drainage.