Report to City Administration
Sep 23, 2022

EPCOR WATER SERVICES INC.

Response to July 9, 2021 Utility Committee Motions

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1.0 INTRODUCTION

1. The following two motions were issued at the July 9, 2021 Utility Committee meeting where the PBR Applications submitted by EPCOR Water Services Inc. (EWSI) for EPCOR Water Services, EPCOR Drainage Services and EPCOR Wastewater Treatment were reviewed.

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 adjustments noted by EPCOR Water Services Inc. in its response to the City of Edmonton PBR review reports (page 6, Attachment 3 of FCS00627) with respect to:*
   a) *reduced debt costs in the amount of $3.7 million; and*
   b) *the reimbursement to customers for the capitalization of valve casings and service box replacements in the amount of $5.2 million.*
2. *A deferral account for water consumption for each of Water Services, Wastewater Treatment and Drainage Services that would be accumulated during the 2022-2026 and 2022-2024 PBR terms and included in customer rates in each of the next PBR terms through a special rate adjustment.*
3. *A Return on Equity for Water Services for 2022-2026 and for Wastewater Treatment for 2022-2024 of 9.89% be reduced to 9.64% as a reflection of the risk reduction of the consumption deferral account (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 term of 0.50%.*
5. *That all non-routine adjustments applied for by Water Services, Wastewater Treatment and Drainage Services during the 2022-2026 and 2022-2024 Performance Based Rates terms be charged to the Adjustment Deferral Accounts. A two-step approach may be followed whereby EPCOR Water Services Inc. would receive interim approval and funding for the proposed adjustment with a final true up of funding being completed based on actual costs.*

And

That Administration work with EPCOR to bring forward reports prior to the next Performance Based Rates term for Drainage Services and Wastewater Treatment effective April 1, 2025, providing further background and the appropriate regulatory treatment for the following items:

1. *Improved disclosure of changes in accounting and capitalization policies and treatment;*
2. *Reporting the size of the workforce including actual and forecast full-time equivalents;*

3. *A review of how long-term debt interest rates are set for EPCOR Water Services Inc.;*
4. *A review of the performance measures to ensure they are increasingly stringent and challenging over time; and*
5. *A review of the deferral account and other adjustment mechanisms to deal with variations in usage.*

2. EWSI addressed the first motion in its "Compliance Application" submitted on July 27, 2021, which was subsequently approved by City Council on August 30, 2021. In addition, EWSI committed to review each of the items identified in the second motion and provide its recommendations to Utility Committee prior to the next PBR term.

3. This report provides EWSI's recommendations with respect to the following three items from the second motion:

1. *Improved disclosure of changes in accounting and capitalization policies and treatment;*
2. *Reporting the size of the workforce including actual and forecast full-time equivalents; and*
3. *A review of how long-term debt interest rates are set for EPCOR Water Services Inc.*

4. Recommendations for the fourth and fifth items from the second motion "*A review of the performance measures to ensure they are increasingly stringent and challenging over time" and "A review of the deferral account and other adjustment mechanisms to deal with variations in usage", respectively,* will be provided to Utility Committee in the Fall of 2023.

2.0 EPCOR'S RECOMMENDATION

5. EWSI's recommendations for addressing the first three items from the second motion are detailed in the appendices and summarized below.

1. **Appendix 1: Improved Disclosure of Accounting Changes**

   EWSI proposes to include a brief paper detailing material changes in accounting and capitalization policies along with appropriate regulatory treatment as part of its annual rate filings. In the event there are material impacts to EWSI's financial statements and to customer rates, EWSI proposes to utilize the Non-routine Adjustment (NRA) financial criteria as a measure to determine whether to apply for an update to rates during the PBR period. Refer to Appendix 1: Improved Disclosure of Accounting Changes for additional information.

2. **Appendix 2: Reporting the size of Workforce**

EWSI does not actively track FTE information for determining resource requirements or use FTE for its internal decision-making. As a result, EWSI undertook a process to compile FTE information for its Edmonton regulated utilities for informing this report and to compare it against readily available headcount information. The FTE and headcount comparisons confirmed that there are minimal differences between the two measures for EWSI's Edmonton regulated utilities. Given the minimal differences, EWSI proposes to provide readily available headcount information to inform the size of its workforce for its Edmonton regulated utilities in future PBR Applications. Refer to Appendix 2: Reporting the size of Workforce for additional analysis and information.

3. Appendix 3: Setting of Long-term Debt Interest Rates

EPCOR recommends maintaining the stand-alone principle for calculating the cost of new long-term debt issued to EWSI. The stand-alone principle is an accepted regulatory principle and reflects the indicative credit rating for EWSI's Edmonton regulated operations and applies an indicative credit spread or risk premium based on available market information on the date debt is issued. In addition to consistency in calculating the cost of debt for all regulated utilities of EPCOR, this approach also follows the method approved by the AUC in its decision 24798-D01-2020.[1] In future PBR Applications, EWSI will provide supplemental information to further enhance the understanding of its cost methodology and the calculation of its long-term debt rates. In EWSI's view, the appropriate time and most efficient process to review the methodology and the calculation of debt cost is during the review and approval of its next PBR Applications. Refer to Appendix 3: Setting of Long-term Debt Interest Rates for additional analysis and information.

[1] Decision 24798-D01-2020, April 17, 2020, paragraphs 269-270 and 279.

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Appendix 1: Improved Disclosure of Accounting Changes

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1.0 INTRODUCTION

1. Several motions were issued at the July 9, 2021 Utility Committee meeting where the PBR Applications submitted by EPCOR Water Services Inc. (EWSI) for EPCOR Water Services, EPCOR Drainage Services and EPCOR Wastewater Treatment were reviewed.

2. The Utility Committee motions included "*That Administration work with EPCOR to bring forward reports prior to the next Performance Based Rates term for Drainage Services and Wastewater Treatment effective April 1, 2025, providing further background and the appropriate regulatory treatment for the following items:*

1. *Improved disclosure of changes in accounting and capitalization policies and treatment;*
2. *Reporting the size of the workforce including actual and forecast full-time equivalents;*
3. *A review of how long-term debt interest rates are set for EPCOR Water Services Inc.; and*
4. *A review of the performance measures to ensure they are increasingly stringent and challenging over time.*

3. City Administration in its reasonableness review of the 2022-2024/2026 PBR Applications noted that valve casing and service box replacement costs that were approved as operating costs in the 2017-2021 Water Services PBR Application were capitalized by EWSI beginning in 2020 due to a change in accounting treatment, in accordance with International Financial Reporting Standards (IFRS). City Administration recommended a regulatory adjustment to reimburse utility customers for the amounts included as operating costs in the 2020 and 2021 Water Services revenue requirements but capitalized for both financial statement and rate regulation purposes, resulting in the following motions:

- "The reimbursement to customers for the capitalization of valve casings and service box replacements in the amount of $5.2 million"; and

- "Improved disclosure of changes in accounting and capitalization policies and treatment", noted in paragraph 2 above.

4. Subsequently, EWSI reduced costs and revenue requirement for the 2022 – 2026 PBR term by $5.2 million to reflect customer reimbursements for the valve casings and service box replacements in its 2022 – 2026 PBR Compliance Application, which was approved by City Council on August 30, 2021.

5. This report provides EWSI's recommendations with respect to the motion "Improved disclosure of changes in accounting and capitalization policies and treatment".

2.0 BACKGROUND

6. EWSI is a wholly-owned subsidiary of its parent corporation EPCOR Utilities Inc. (“EUI” or “EPCOR”). Since January 1, 2011, EUI has prepared its corporate financial information in accordance with IFRS as required for Canadian publicly accountable enterprises. While EWSI has implemented IFRS to support the public external financial reporting requirements of its parent company, EUI, there are certain IFRS requirements which are not consistent with the accounting treatment historically applied for rate-making and rate-regulated reporting requirements (referred to herein as “regulated accounting” or “regulatory accounting”).

7. For regulated accounting purposes, EWSI records the value of its property, plant and equipment and associated expenses in accordance with EUI’s Regulatory Accounting Policies: RA-004 - Capitalization for Regulatory Accounting Purposes and RA-007 - Depreciation.

8. In 2009, the AUC issued Rule 026 “Rule Regarding Regulatory Account Procedures Pertaining to the Implementation of the International Financial Reporting Standards” (AUC Rule 026) to provide guidance to AUC-regulated utilities transitioning to IFRS. In preparing its regulatory applications, EWSI looks to existing regulatory accounting practices as well as guidance from AUC Rule 026 to assess IFRS requirements that may be applied for rate-making purposes.

9. Although EWSI’s utilities are not regulated by the AUC, EWSI considers AUC Rule 026 as a source for guidance on IFRS requirements for two reasons: 1) to ensure relative consistency in practice with other regulated utilities in Alberta and 2) to promote administrative efficiency and effectiveness. This supports minimization of the differences between regulatory accounting for In-City water services, drainage services and wastewater treatment; and regional water customers, who are regulated by the AUC on a complaint basis.

10. For EWSI, the most significant differences between IFRS and regulatory accounting relate to property, plant and equipment and associated accounts. Key differences between IFRS and regulatory accounting for EWSI are described in its PBR Applications. For example, Table 4.1-1 of the 2022-2024 Wastewater Treatment PBR Application summarizes the key differences, as detailed below for information.

Table 4.1-1
Regulatory vs. IFRS Accounting Treatment

	A **Accounting Policy Item**	B **IFRS Accounting Treatment**	C **Regulatory Accounting Treatment used by EWSI**
1	**Capitalized Interest** – this item relates to financing related charges which are included in the capital cost for projects during construction.	For IFRS accounting, EWSI uses Interest During Construction (IDC). IDC is charged to capital projects lasting longer than 6 months and only has a debt component to the charge.	For regulatory accounting EWSI uses Allowance for Funds Used During Construction (AFUDC). AFUDC is charged to capital projects lasting longer than 12 months and has both debt and equity components to the charge.
2	**Abandonments** – this item relates to the treatment of expenses incurred to abandon, demolish, or decommission an asset which is no longer in use.	For IFRS accounting, EWSI expenses abandonments as incurred.	For regulatory accounting, EWSI charges abandonment costs to capital as incurred.
3	**Retirements** – this relates to losses incurred when an asset with remaining net book value is taken out of service and proceeds when assets are sold.	For IFRS accounting, EWSI records gains and losses on retirement as net expense in the period the retirement occurs.	For regulatory accounting, depending on the nature of the transaction, EWSI may charge gains and losses on retirement to capital and amortize the gain/loss over the remaining life of the asset at the time of disposal.
4	**Leases** – this item relates to the use of assets held under rental or lease agreements where control of the asset for the lease term resides with the lessee	For IFRS accounting, unless the lease is a short term rental, EWSI records a right of use asset and a related obligation to the lessor and depreciates the right over the period of the lease term	For regulatory accounting, no right of use asset or obligation is recognized and the lease cost continues to be treated as an operating expense.

11. These regulatory to IFRS differences are consistent across the three utilities, Water Services, Drainage Services and Wastewater Treatment.

12. Similar details are located in Section 4.1 of the Water Services PBR Application and Section 5.1 of the Drainage Services PBR Application.

3.0 CHANGES IN ACCOUNTING AND CAPITALIZATION POLICIES AND TREATMENT

13. There are typically two reasons for accounting and capitalization policies and treatment changes.

14. Firstly, accounting policies and treatments change because of new IFRS guidance. In this situation, EUI and EWSI are obligated to amend its IFRS treatment in the required period in order to remain compliant for external financial reporting and audit purposes.

15. Secondly, EUI/EWSI may reassess its interpretation of the IFRS guidelines and in doing so determine a more appropriate approach to accounting and capitalization.

16. In both circumstances and when the impact is material, the accounting treatment update is reviewed and approved by EPCOR's corporate accounting group and the external auditors, KPMG.

17. Once approved, EWSI flows the accounting change through the regulatory records, meaning that the remaining differences are limited to those detailed above in paragraph 7.

18. EWSI acknowledges that the process of communicating changes in accounting policies and applicable regulatory treatment with City Council can be more transparent, and as such, offers a proposal in section 4.0 of this report.

4.0 EPCOR'S RECOMMENDATION

19. Each year, EWSI is required to submit Rate Filings to support and gain approval for the new rates, effective April 1.

20. EWSI proposes to include a brief paper detailing any material changes in accounting and capitalization policies and related regulatory treatment in its annual rate filings.

21. This proposed disclosure will provide better information to City Administration regarding any divergences, resulting from accounting changes, between the approved and forecast rate base and revenue requirement.

22. In the event of material impacts to EWSI's financial statements and to customer rates, EWSI proposes to utilize the Non-routine Adjustment (NRA) financial criteria as a measure to determine whether to apply for an update to rates during the PBR period.

23. Thus, any accounting and capitalization policies and treatment changes that result in a revenue requirement impact less than $500,000 annually would not be eligible for approval as an update to rates. Changes resulting in either an annual adjustment to EWSI's revenue requirement less than $3

million but either greater than $500,000 or greater than $1 million cumulatively would be eligible for consideration and approval by City Manager. Changes resulting in an annual adjustment to EWSI's revenue requirement equal to or greater than $3 million would be eligible for consideration and approval by City Council.

24. If EWSI anticipates making a request for one or more rate updates related to changes in accounting and capitalization policies to take effect on April 1 of the current year, EWSI will on or before December 1 of the immediately preceding calendar year submit its request to the City Manager, and will include with such request sufficient information to enable the City Manager / City Council to evaluate the request. If after receiving the submission, the City Manager / City Council are satisfied that the rate update should be included in EWSI rates, the City Manager will issue a confirmation letter on or before January 31, confirming that the rate update will be included in EWSI rates to take effect on April 1st.

25. This proposal would enable the City Manager / City Council to better understand material changes in accounting policies that impact the regulated accounting records and resulting impact on customer rates, and enable EWSI to adjust rates once approved.

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Appendix 2: Reporting the Size of Workforce

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1.0 INTRODUCTION

1. Several motions were issued at the July 9, 2021 Utility Committee meeting where the PBR Applications submitted by EPCOR Water Services Inc. (EWSI) for EPCOR Water Services, EPCOR Drainage Services and EPCOR Wastewater Treatment were reviewed.

2. The Utility Committee motions included "*That Administration work with EPCOR to bring forward reports prior to the next Performance Based Rates term for Drainage Services and Wastewater Treatment effective April 1, 2025, providing further background and the appropriate regulatory treatment for the following items:*

1. *Improved disclosure of changes in accounting and capitalization policies and treatment;*
2. *Reporting the size of the workforce including actual and forecast full-time equivalents;*
3. *A review of how long-term debt interest rates are set for EPCOR Water Services Inc.; and*
4. *A review of the performance measures to ensure they are increasingly stringent and challenging over time.*

3. City Administration in its reasonableness review of the 2022-2024/2026 PBR Applications noted that EWSI realized significant operating cost reductions relative to the amounts approved in the past two PBR terms (2012-2016, 2017-2021), and acknowledged that the operating efficiencies and cost reductions realized by EWSI in prior years were passed on to customers and incorporated into EWSI's 2022 – 2026 PBR Applications by limiting cost increases to approximately 1% per year for the 2022 – 2026 PBR term. However, City Administration also identified a need to report the size of EWSI's workforce in its future rates applications, resulting in the second motion "*Reporting the size of the workforce including actual and forecast full-time equivalents*".

4. This report provides EWSI's recommendations with respect to reporting the size of EWSI's workforce.

2.0 BACKGROUND

5. EWSI's Edmonton utilities are regulated under Performance Based Regulation (PBR) by its regulator (Edmonton City Council). PBR provides incentive to a utility to find efficiencies and reduce costs while maintaining established performance levels. EWSI's PBR Applications sets standards in place to guide its performance, which is measured and reported on annually. Under the PBR framework, rates are set based on determining how much revenue or "revenue requirement" will be needed to pay for the cost of building, maintaining, operating, and financing the utility system over the next several years.

6. In preparing its PBR Applications, EWSI prepares a bottom-up forecast of its costs based on best available information in respect of expected work activity and cost levels for a given PBR term. This forecast is then used to determine the revenue requirement and rates for the PBR term. Regulated rates are set in accordance with generally accepted cost-based principles and methodologies established by the American Water Works Association (AWWA) and Water Environment Federation (WEF).

7. Under EWSI's PBR, rates are set annually during the PBR term using a formula of (i-x). The formula uses approved rates from prior year and then adjusts them by the forecast rate of inflation, an efficiency factor and any approved rate adjustments. The efficiency factor is applied as a reduction to the inflation factor to reduce customer rates. It represents the minimum amount by which EWSI must improve its operational efficiency to maintain its net income. The efficiency factor is applied to the overall cost of providing utility service including staff costs and benefits. EWSI bears the risk of cost increases beyond the (i-x) factor as a result of higher workforce requirements or other cost increases during the PBR term. This results in EWSI placing greater emphasis on finding cost efficiencies in order to achieve the approved efficiency factor and to maintain its net income. Efficiencies and cost reductions realized by EWSI are subsequently passed on to customers in future PBR terms. For example, efficiencies and cost reductions realized during the past two PBR terms (2012-2016, 2017-2021) were passed on to customers through reduced rates in the 2022 – 2026 PBR Applications. The efficiency factors approved in EWSI's 2022-2024/2026 PBR Applications were:

- Water and Wastewater Treatment - 0.25%; and
- Drainage Services - 0.5%.

8. Headcount is generally defined as the total number of full time, part time, and temporary workers employed by an organization at any given point in time.

9. Full Time Equivalent (FTE) is a calculated unit of measure, which represents all workers employed by an organization as comparable full time employees. It is generally determined based on paid regular hours divided by the standard hours of work for a position.

10. Historically, EWSI has not provided staffing levels on either a headcount or full time equivalent basis as part of its PBR applications. The rationale for this approach is that total staffing costs, not number of staff, are a central determinant of customer rates.

3.0 WORKFORCE INFORMATION

11. EWSI's primary focus is on delivering safe and reliable utility services while providing value to its shareholder and ratepayers by managing its costs and finding efficiencies. EWSI utilizes a time tracking system to facilitate appropriate cost tracking, monitoring and reporting for its business units. To determine rates for its PBR Applications, EWSI first develops a forecast of its revenue requirement for the total regulated Edmonton water system. The forecast revenue requirement is prepared using a bottom-up forecast of EWSI's costs based on the expected work activity to deliver safe and reliable utility services. Rates are then determined based on the forecast revenue requirement and escalated annually during the PBR term using the (i-x) factor described above in paragraph 7.

12. Each year, EWSI also prepares a detailed bottom-up budget and quarterly forecast of its costs based on the expected levels of work activity for that year to enable management oversight, effective decision-making and prudent cost management. Personnel costs are budgeted based on headcount and the level of work activity necessary to meet the objectives for the year. Headcount information in addition to costs from EPCOR's enterprise systems are used on a regular basis for monitoring performance and decision-making.

13. EWSI does not actively track FTE information for determining resource requirements or use FTE for its internal decision-making. Instead, the type and level of resource requirements are determined based on the activities required to be completed to accomplish planned objectives for a given year. Emphasis is placed on delivering planned objectives in the most cost efficient manner possible.

14. Since FTE information is not actively tracked and used internally, EWSI undertook a process to compile FTE information for its Edmonton regulated utilities for informing this report and to compare it against readily available headcount information. EWSI's FTE's have been determined based on paid regular hours divided by the standard hours of work for each position. Table 3.0-1 to Table 3.0-3 provides a summary of annual average FTE's for Water, Wastewater Treatment and Drainage Services. FTE information presented below is broken down and summarized by the different operational functions used to deliver utility services, similar to the functional costs presented in EWSI's PBR Applications. For example, Table 5.2-1 of Water Services 2022 – 2026 PBR Application summarizes operating costs by the operational functional areas.

Table 3.0-1
Water Services Annual Average FTE's

Operational Function	**2017**	**2018**	**2019**	**2020**	**2021**
Water Treatment Plant	133	138	141	152	150
Water Distribution and Transmission	227	224	221	211	204
Billing, Meters and Customer Service	81	74	73	68	62
Operational Support Services	81	78	76	59	57
EWSI Shared Services	7	7	7	7	6
Total FTE's	**529**	**521**	**518**	**497**	**479**

Table 3.0-2
Wastewater Treatment Annual Average FTE's

Operational Function	**2017**	**2018**	**2019**	**2020**	**2021**
Wastewater Treatment Plant	125	126	125	123	126
Operational Support Services	47	52	52	50	48
EWSI Shared Services	1	1	1	1	1
Total FTE's	**173**	**179**	**178**	**174**	**175**

Table 3.0-3
Drainage Services Annual Average FTE's

Operational Function	**2017**	**2018**	**2019**	**2020**	**2021**
Drainage Operations	223	221	226	228	239
One Water Planning and Project Support	363	343	323	351	351
Operational Support Services	65	75	77	19	11
Drainage Services Administration	51	60	64	55	57
Total FTE's	**702**	**699**	**690**	**653**	**658**

15. Table 3.0-4 to Table 3.0-6 provides a summary of EWSI's readily available headcount information and compares it against the FTE information summarized above.

Table 3.0-4
Water Services Annual Average Headcount vs FTE's

Operational Function	**2017**	**2018**	**2019**	**2020**	**2021**
Water Treatment Plant	134	140	143	153	150
Water Distribution and Transmission	226	225	218	212	199
Billing, Meters and Customer Service	80	74	72	68	62
Operational Support Services	82	79	76	59	58
EWSI Shared Services	7	7	7	7	6
Total Headcount	**529**	**525**	**516**	**499**	**475**

Total FTE's (from Table 3.0-1)	529	521	518	497	479
Difference (FTE minus Headcount)	-	(4)	2	(2)	4

Table 3.0-5

Wastewater Treatment Annual Average Headcount vs FTE's

Operational Function	**2017**	**2018**	**2019**	**2020**	**2021**
Wastewater Treatment Plant	125	126	125	123	126
Operational Support Services	48	52	52	50	48
EWSI Shared Services	1	1	1	1	1
Total Headcount	**174**	**179**	**178**	**174**	**175**
Total FTE's (from Table 3.0-2)	173	179	178	174	175
Difference (FTE minus Headcount)	(1)	-	-	-	-

Table 3.0-6

Drainage Services Annual Average Headcount vs FTE's

Operational Function	**2017**	**2018**	**2019**	**2020**	**2021**
Drainage Operations	218	221	225	228	238
One Water Planning and Project Support	363	340	318	350	349
Operational Support Services	65	76	77	19	12
Drainage Services Administration	52	60	65	55	58
Total Headcount	**698**	**697**	**685**	**652**	**657**
Total FTE's (from Table 3.0-3)	702	699	690	653	658
Difference (FTE minus Headcount)	4	2	5	1	1

16. The summary comparisons presented above confirm that there are minimal differences between headcount and FTE for the Edmonton regulated utilities.

17. Table 3.0-7 below provides a summary of staff costs for EWSI's Edmonton regulated utilities over the 2017 – 2021 PBR term. The total staff cost increase for Water and Wastewater over the 2017 – 2021 PBR term was $3.4 million, an increase of 5.4%. In contrast, labour inflation over the same period was 6.9% indicating that EWSI delivered value to its shareholder and ratepayers by managing its costs through efficiencies, despite customer growth of 6.8% over the 2017 – 2021 PBR term. The increase in Drainage Services staff costs from 2018 to 2019 reflects differences in accounting policy between the City and EPCOR related to capitalization of staff time. As demonstrated in Table 3.0-6, there were reductions in headcount and FTE over the same period. The cost increases from 2019 to 2021 reflects labour inflation as well as additional resources necessary to support Drainage projects approved as part of the Non-Routine Adjustments.

Table 3.0-7
2017 – 2021 Staff Cost
($ millions)

Segment	2017	2018	2019	2020	2021
Water	$ 48.8	$ 49.2	$ 49.4	$ 49.4	$ 48.8
Wastewater	$ 14.5	$ 16.0	$ 15.6	$ 18.4	$ 17.9
Total Water and Wastewater	**$ 63.3**	**$ 65.2**	**$ 64.0**	**$ 67.8**	**$ 66.7**
Drainage *	NA	$ 44.1	$ 52.2	$ 54.0	$ 57.9
Total Staff Costs	**$ 63.3**	**$ 109.3**	**$ 116.2**	**$ 121.8**	**$ 124.6**

* Drainage Services was transferred to EPCOR on September 1, 2017, as a result 2017 costs are not presented.

4.0 EWSI RECOMMENDATION

18. EWSI adds value to its shareholder and ratepayers by prudently managing costs and by finding efficient ways of delivering safe and reliable utility services. As demonstrated in Table 3.0-7, EWSI has successfully managed its staff costs below inflation despite increased customer growth. In addition, the FTE and headcount comparisons confirm that there are minimal differences between the two measures for EWSI's Edmonton regulated utilities. Given the minimal differences, EWSI proposes to provide readily available headcount information to inform the size of its workforce for its Edmonton regulated utilities in future PBR Applications. EWSI believes the overriding consideration is total staff costs and staff counts are of limited value.

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Appendix 3: Setting of Long-term Debt Interest Rates

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1.0 INTRODUCTION

1. Several motions were issued at the July 9, 2021 Utility Committee meeting where the PBR Applications submitted by EPCOR Water Services Inc. (EWSI) for EPCOR Water Services, EPCOR Drainage Services and EPCOR Wastewater Treatment were reviewed.

2. The Utility Committee motions included "*That Administration work with EPCOR to bring forward reports prior to the next Performance Based Rates term for Drainage Services and Wastewater Treatment effective April 1, 2025, providing further background and the appropriate regulatory treatment for the following items:*

1. *Improved disclosure of changes in accounting and capitalization policies and treatment;*
2. *Reporting the size of the workforce including actual and forecast full-time equivalents;*
3. *A review of how long-term debt interest rates are set for EPCOR Water Services Inc.; and*
4. *A review of the performance measures to ensure they are increasingly stringent and challenging over time.*

3. In the 2022 – 2024/2026 PBR Applications, EWSI inadvertently calculated its actual interest rate based on a stand-alone credit rating of BBB+ instead of A (low). Since 2012, the forecast cost of debt in EWSI's PBR applications has been based on an indicative credit rating for EWSI's regulated Canadian operations from DBRS of A (low). In responding to information request as part of the 2022-2024/26 applications, EWSI found that although interest rates on intercompany notes issued to EWSI in 2012 and 2013 were based on an A- credit rating (equivalent to A (low)), commencing in 2014, interest rates on new long-term debt issuances have reflected a BBB+ credit rating. The difference in credit rating has arisen because EUI issues long-term debt to the EWSI legal entity, rather than to EWSI's regulated Canadian operations. Besides its regulated Canadian operations in the regulated business units, the EWSI legal entity includes commercial operations, which, because of their higher business risk, results in an indicative credit rating for the EWSI legal entity of BBB+. EWSI notified City Administration and corrected this error in its "Compliance Application" by reducing debt costs by $3.7 million, which was subsequently approved by City Council on August 30, 2021.

3. City Administration in its reasonableness review of the 2022-2024/2026 PBR Applications noted that EWSI's debt issuances and rates are not subject to ongoing regulatory review and recommended a further review of how EWSI's debt costs are calculated, resulting in the third motion "a *review of how long-term debt interest rates are set for EPCOR Water Services Inc.*".

4. This report provides EWSI's recommendations with respect to the long-term debt interest rates motion.

2.0 BACKGROUND

5. Consistent with the standard approach followed in previous PBR terms, EWSI'S forecast cost of new long-term debt issuances for the 2022-2026 PBR term are set once and held throughout the five-year PBR term at the 2022 forecast debt rate of 3.50%. This reflects a 1.32% decline in EWSI's approved cost of debt of 4.82% relative to the 2017-2021 PBR term. EWSI bears the risk of interest rate fluctuations during the PBR term and this risk is not passed on to its customers. Acceptance of this risk is one of the many factors that differentiates EWSI's PBR approach from the AUC PBR approach, resulting in a higher risk premium and allowing EWSI to maintain stable, predictable rates. Under the AUC PBR, Alberta electric and gas utilities pass on interest rate risk to their customers through rate adjustments.

6. EWSI is a wholly-owned subsidiary of its parent corporation EPCOR Utilities Inc. ("EUI" or "EPCOR") and obtains corporate services from its parent. Corporate services are comprised of activities that are centrally managed within the EPCOR group due to their nature, and for the purposes of realizing economies of scale and greater effectiveness. Services associated with maintaining appropriate credit ratings and raising capital, primarily through the issuance of debt in the public and private markets are centrally managed within EPCOR's Treasury department.

7. EWSI funds its annual capital expenditures and working capital requirements by entering into short-term and long-term loan arrangements (intercompany debt) with its parent. EWSI requires regular, annual long-term debt issuances to fund its annual capital program. Short-term borrowings are utilized throughout the fiscal year whereas long-term debt is typically issued later in the year in order to align the financing cost with the lifespan of its long-lived assets.

8. EUI's debt issuances are governed by its Financial Exposure Management Policy (FEMP), which defines the framework and policy limits for managing various financial exposures such as interest rate, liquidity and credit risks in order to minimize volatility on cash flows, earnings and to provide value to its shareholder and customers.

9. EUI's long-term debt issuance in any given year is dependent on the combined funding requirements of all EUI subsidiaries and the overall cash position of EUI. As such, EUI may not require issuance of new long-term debt in the public or private markets to fund its subsidiaries depending on the availability of cash on hand. For example, from 2013 to 2016, the Capital Power Corporation transaction allowed EUI to fund EWSI's long-term debt requirements through available cash. In addition, EUI and EWSI have different requirements and timelines for issuing debt. This results in each

entity issuing debt at different times. As market interest rates fluctuate, the timing of EUI and EWSI debt issuances affects the interest rates received by each entity.

10. The long-term debt interest rate calculation methodology and process followed by EWSI is consistent with the processes followed by EUI's other utilities regulated by the Alberta Utilities Commission (AUC).

3.0 EUI LONG-TERM DEBT INTEREST RATES

11. EUI's interest rate for long-term debt issuance is based on the relevant market data for the Government of Canada bond yield for the term of the debt being issued plus a credit spread (or risk premium) attributable to EUI for the same term. EUI's credit spread is highly dependant on its credit ratings, which are currently A (low) from Dominion Bond Rating Service (DBRS) and A- from S&P, and these are considered to be equivalent ratings.

12. EUI's long-term debt interest rates are based on existing market conditions at the time the debt is issued. The underlying Government of Canada bond yield for an EUI debt issuance is based on market information at the time the debt is issued. The credit spread applied to an EUI debt issuance is based on expected pricing provided to investors who then decide whether they will participate in the debt issuance or not. EUI's credit spread pricing expectations are primarily based on EPCOR's bank's observations of secondary trading of previously issued long-term debt as well as indicative pricing comparisons to issuers with similar credit ratings to EUI.

4.0 EWSI LONG-TERM DEBT INTEREST RATES

13. Similar to other regulated utilities of EUI, EWSI follows the stand-alone principle for calculating the cost of long-term debt, where the cost of debt for regulatory purposes reflects the credit rating for EWSI's regulated Edmonton operations (i.e. a combined rating for Water, Wastewater and Drainage Services), rather than the credit rating for the legal entity EWSI, which includes both regulated and non-regulated operations. This principle is intended to ensure that ratepayers have cost responsibility commensurate with the risks of the utility.

14. EWSI's interest rate for long-term debt issuances are determined based on obtaining relevant market information from banks for 30-year Government of Canada bond yields and EUI's current indicative credit spread for 30-year long-term debt as of the date of issuance of long-term debt to EWSI, and adding a 5 basis point transaction cost. Thus, the relevant interest rate for EWSI's long-term debt issuance will be based on the prevailing market conditions at the time of issuing long-term debt financing to EWSI. The 30-year term most closely matches the average asset lives for which debt

financing is used. This stand-alone principle and process of issuing new long-term debt for EWSI is consistent with the processes followed by AUC regulated utilities of EPCOR.

5.0 EPCOR'S RECOMMENDATION FOR SETTING LONG-TERM DEBT RATES

15. EPCOR recommends maintaining the stand-alone principle for calculating the cost of new long-term debt issued to EWSI. The stand-alone principle is an accepted regulatory principle and reflects the indicative credit rating for EWSI's Edmonton regulated operations and applies an indicative credit spread or risk premium based on available market information on the date debt is issued. In addition to consistency in calculating the cost of debt for all regulated utilities of EPCOR, this approach also follows the method approved by the AUC in its decision 24798-D01-2020.[1]

16. City Administration in its reasonableness review of the 2022-2024/2026 PBR Applications concluded that the forecast cost of debt applied in EWSI's 2022-2024/2026 PBR Applications were reasonable based on EWSI's stand alone debt rating of A (low) and based on current and forecast Government of Canada debt rates, see Financial and Corporate Services report FCS00624 - Attachment 3 (Cost of Debt, page 20). Administration also concluded that a deferral account was not warranted to adjust customer rates for the difference between forecast and actual debt rates given the significant decrease in the forecast cost of new debt issuances in the 2022-2024/2026 PBR Applications and due to the potential negative impact a deferral account may have on the incentive for EUI to continue to access the financial markets for the most favourable terms/rates.

17. In order to continue to maintain stable and predictable rates, EWSI does not recommend to pass the interest rate risk to customers and maintains that it is reasonable for EWSI to continue to bear the risk of interest rate fluctuations, as currently designed in EWSI's PBR.

18. In its future PBR Applications, EWSI will provide supplemental information to further enhance the understanding of its cost methodology and the calculation of its long-term debt rates. In EWSI's view, an appropriate time and efficient process to review the methodology and the calculation of debt cost is during the review and approval of its next PBR Applications.

19. Lastly, EWSI does not recommend introducing a process to review new debt issuances during the PBR term as it further complicates the rate-making process, increases administrative and regulatory overhead associated with such review, impacts efficient delivery of utility services, and further burdens customer rates. EWSI follows AUC approved method for calculating its cost of debt and requires regular, annual long-term debt issuances to fund its annual capital program and support activities that will be used in the efficient delivery of public utility services. Introducing a debt issuance

[1] Decision 24798-D01-2020, April 17, 2020, paragraphs 269-270 and 279.

review process during the PBR term could delay the implementation of key capital renewal and growth programs that require debt financing and therefore affect the efficiency with which EWSI delivers its services.