

Bylaw 15816 – EPCOR Water Services and Wastewater Treatment Bylaw

Review of Reasonableness

Recommendation:

That Utility Committee recommend to City Council:

That the September 1, 2011, Financial Services report 2011CA1232 be received for information.

Report Summary

This report outlines the results of a reasonableness review of EPCOR Water Services Inc. rates application, including proposed Bylaw 15816 – EPCOR Water Services and Wastewater Treatment Bylaw (to replace Bylaw 12585 – EPCOR Waterworks Bylaw). Proposed Bylaw 15816 includes an extension of the water Performance Based Regulation Plan to cover the period from April 1, 2012, to March 31, 2017, (2012-2016) and introduces rates for wastewater treatment as part of the Performance Based Regulation.

Previous Council Action

At the July 20, 2011, City Council meeting, the following motions were passed:

That Bylaw 15816 be given first reading.

That upon first reading of Bylaw 15816:

- a. Bylaw 15816 be referred to the City Manager and return to City Council, through Utility Committee, with a report as to the reasonableness of the rates application, and a summary of written submissions by interested parties.
- b. Utility Committee hold a non-statutory public hearing on Bylaw 15816, at the September 1, 2011, Utility Committee meeting.
- c. EPCOR carry out the necessary advertisement of the non-statutory public hearing, to be held at the September 1, 2011, Utility Committee meeting, in accordance with section 606 of the *Municipal Government Act*.
- d. Written submissions regarding material within EPCOR's Rates Notice and Rates Report from Councillors be provided to the Office of the City Clerk, no later than July 29, 2011, at 4:00 p.m., as per section 8(2) of Bylaw 12294 – EPCOR Rates Procedures Bylaw.

Report

The proposed 2012-2016 Performance Based Regulation application represents a five-year renewal of the second 2007-2011 Performance Based Regulation term. For the first time, wastewater treatment rates are proposed to be included through the Performance Based Regulation methodology, whereas these rates are currently levied through annual amendments to Bylaw 9675 – Sewers Use Bylaw.

Please retain this report for future meetings

As directed by Bylaw 12294 – EPCOR Rates Procedures Bylaw and City Council, the rates application is referred to the City Manager for a reasonableness review of the rates application in terms of the guiding objectives found in section 5 of the bylaw. The guiding objectives are provided in Attachment 1 of this report.

Administration has undertaken a reasonableness review of the proposed rates application, in part by engaging the services of an external consultant. The consultant, Grant Thornton LLP, is a global consulting firm with an extensive background in regulated utilities, and previous experiences working with the City's wastewater utility.

Advertisement of the September 1, 2011, Public Hearing was completed by EPCOR in accordance with Bylaw 12294 – EPCOR Rates Procedures Bylaw, on July 23, 2011, and July 30, 2011. The advertisements along with public submissions and Councillor questions are presented in the September 1, 2011, Financial Services Report 2011CA1233. Responses are to be provided for those public submissions received by August 10, 2011, as deemed appropriate by Administration, and for Councillor questions received by July 29, 2011. At the time of writing this report no written submissions have been received from the public.

Typically in a utility industry, customers and the utility make representation to an external regulator to adjudicate the rate setting process. The position of the customers and utility are considered,

with a decision ultimately rendered by the regulator.

City Council is in a unique situation of representing customers, as well as being the regulator and owner of the water and wastewater treatment utilities. As regulator, City Council is expected to balance the interests of the owner (ensuring a financially healthy utility that provides appropriate investment returns), with those of customers (high quality and reliable water and wastewater treatment services at a reasonable cost).

To assist Utility Committee in their review, this report provides background on the Performance Based Regulation methodology and summarizes the significant findings from the reasonableness review. Attachment 2 to this report includes a more complete list of recommendations and findings raised in the consultant report. The full external consultant's report on the reasonableness of the rates application is included as Attachment 3 to this report.

Background on Performance Based Regulation

A cost of service approach is the most commonly used approach in determining regulated utility rates, and under this approach, the regulator reviews the utility's rates every one to two years. The rates are set to recover actual costs, including costs of operations, maintenance, and capital investment required to provide the service, and allow the utility to earn a reasonable return on its investment (or return on equity). The return on equity

also compensates the utility for the risks inherent in operating the business.

Under a Performance Based Regulation approach, as is the basis for this rates application, rates are determined for the first year of the Performance Based Regulation period based on the cost of service method with subsequent years' rates adjusted by a predefined formula for the term of the agreement – in this case, five years. The Performance Based Regulation approach is designed to provide customers with lower rates than under the conventional cost of service method, while the utility is allowed to earn higher returns to the extent efficiencies can be found. Generally the utility bears the risks of normal factors that could impact revenues and costs (e.g. weather, chemical costs, increases above normal inflation, etc.) with extraordinary or uncontrollable changes (e.g. legislative changes, major unexpected capital costs, etc.) being allowed to pass through to customers. In addition, performance targets ensure service levels are met. The customer expects the water and wastewater treatment service standards to be achieved along with predictable and stable rate increases.

Key Items for Considerations in Proposed Performance Based Regulation III

Administration has highlighted the following key items for Council consideration, including matters raised by the external consultant.

In reviewing the attachments, it is important to note that EPCOR provided an information package and other

supplementary information to Administration to support the rates proposed in Performance Based Regulation III and to facilitate the reasonableness review. This information was made available to the Utility Advisor and to the external consultants. Specific references within the external consultant report in some cases refer to the supplementary information.

Balance of Risks

- The Performance Based Regulation methodology is intended to balance risks between the service provider, the customer and the shareholder. The Performance Based Regulation includes non-routine and special rate adjustment mechanisms to adjust for non-controllable changes. The inflation adjustment picks up differences annually between forecast and actual inflation.
- Although the financial risks would seem to be balanced within the five year Performance Based Regulation period, the rebasing mechanism utilized between Performance Based Regulation arrangements allows cost levels above previous Performance Based Regulation forecasts to be built into the base for the subsequent Performance Based Regulation, resulting in increased rates.
- In some cases the rebased costs in Performance Based Regulation III would seem to reflect higher inflation-adjusted Performance Based Regulation II amounts as opposed to actual results, providing additional flexibility in the costing. Examples would be interest and depreciation expenses.
- Council may wish to consider the extent to which the proposed

Performance Based Regulation III rebased costs reflect the best estimates.

Performance Measures

- Proposed performance measures cover expected industry practices and promote system reliability and service quality.
- Performance targets for water have been based on 10 year actual averages achieved or 10 year averages plus a percentage. EPCOR should demonstrate that this basis for target setting leads to continuous improvement.
- Proposed performance measures are of an operational nature and do not include any financial measures to assess EPCOR’s performance relative to their Performance Based Regulation forecasts. Financial reporting on an annual basis is at a summary level.
- Council may want to consider including some measures that are more difficult to achieve in order to encourage improvements/efficiencies. Financial performance measures could be added to strengthen the review and evaluation function.
- The external consultant has recommended implementation of increased operating and capital expenditure oversight. If Council is supportive of that increased role, Administration would work with EPCOR to develop an appropriate process for Council consideration.

Return on Equity:

- The proposed Return on Equity of 10.875% for water operations is higher than industry standards and exceeds the recommended Alberta Utilities Commission generic return on equity of 9% for Alberta’s gas and

electric utilities in 2009 and 2010. The Alberta Utilities Commission is the regulator for regional water services provided by EPCOR.

- EPCOR takes the position that the premium of 1.875% built into their return on equity is acceptable due to increased business risk (refer to Pg. 39 of consultant report) and differing capital structures than regional customers, who were included in determining the Alberta Utilities Commission recommended 9% return on equity. A more detailed explanation should be provided by EPCOR to justify the 1.875% return on equity premium.
- An increase to the return on equity for wastewater treatment services is phased in over the term of the proposed Performance Based Regulation ramping up from a rate of 3.45% in 2012 to a rate of 10.875% in the final year, with an average expected return of 7.8%. The 2011 budget for the Gold Bar operations included a rate of return for 2011 of 4.79%. An explanation for this decline in return on equity from the 2011 budget to the 2012 projection should be provided by EPCOR.

Cost of Service Study

- A cost of service study has yet to be finalized to allocate costs across the customer groups including the in-City customers and the fire protection services. Therefore the assumptions of the final Cost of Service methodology may differ from the methodology used in the proposed Performance Based Regulation III. If these differences are significant there may be a further impact to the in-city customer water rates.

- The Alberta Utilities Commission issued a June 28, 2011 decision with respect to regional water rates for 2004, 2005, 2006 and 2007 which has not been fully reflected in the proposed Performance Based Regulation assumptions.
- Once the final Cost of Service methodology has been determined and agreed to by all parties, EPCOR proposes to address any changes arising from the final Cost of Service methodology through the non-routine adjustment mechanism.
- At this point it is difficult to determine the full outcome of the cost of service study and its impacts on the proposed Performance Based Regulation III. However, City participation in the cost of service study finalization is critical to ensure City interests are represented and that the results are appropriately determined and implemented in Performance Based Regulation III.

Corporate Shared Service Costs

- EPCOR has experienced significant increases to corporate shared services costs over the history of the Performance Based Regulation process. EPCOR was not able to provide the cost allocation calculations to support the corporate shared service costs; therefore the consultant was unable to fully assess the reasonability of corporate shared service.
- Corporate shared service costs account for approximately 20% of the total operating costs for the term of proposed Performance Based Regulation III; therefore Council may consider having an oversight role in the allocation of these costs to water

and wastewater treatment revenue requirements.

Inflation Rate and Efficiency Factor

- The Performance Based Regulation rates are adjusted annually based on inflation factors.
- Performance Based Regulation III proposes two main changes to the inflation rate to be applied. The weighting on Alberta Consumer Price Index is shifted from 79% to 65%, and the weighting on the labour cost component is shifted from 21% to 35%, to acknowledge the personnel component of shared service costs.
- The proposed labour cost component used has changed from the percentage increase negotiated by bargaining units representing EPCOR's unionized employees to the Average Hourly Earnings for Alberta.
- Council may wish to get further clarification from EPCOR around the appropriateness of the Alberta Hourly Earnings for Alberta index in the proposed Performance Based Regulation.
- The consultant indicated that the efficiency factor of 0.25% is modest relative to industry standards. A higher efficiency factor could create a stronger incentive to reduce and control costs.

Policy

The information in this report is compliant with the *Municipal Government Act* and *Bylaw 12294 – EPCOR Rates Procedures Bylaw*

Corporate Outcomes

The information in this report is consistent with Council's strategic vision in terms of its conditions of success,

particularly related to sound management practices and processes.

Public Consultation

Utility Committee will hold a Non-Statutory Public Hearing on Bylaw 15816, at the September 1, 2011, Utility Committee meeting.

Attachments

1. Guiding Objectives - Bylaw 12294 – EPCOR Rates Procedures Bylaw
2. Summary of Consultant Recommendations & Findings - Grant Thornton Review of EPCOR 2012-2016 PBR Proposal
3. Grant Thornton Review of EPCOR 2012-2016 PBR Proposal

Others Reviewing this Report

- D.H. Edey, General Manager, Corporate Services
- M. Koziol, General Manager, Infrastructure Services

Guiding Objectives – Bylaw 12294 – EPCOR Rates Procedures Bylaw

The assessment of rates will reflect the following objectives:

- EPCOR is entitled to a reasonable margin of profit from operations in relation to the provision of utility services within the boundaries of the City of Edmonton;
- the citizens of the City of Edmonton must be provided with safe and reliable utility services;
- all customer charges will be based upon cost of service;
- rates will be sufficient to ensure continued development of utility infrastructure to reasonably ensure the satisfaction of the objectives of this section;
- utility services are to be provided in a manner that reflects reasonable environmental management in comparison to industry benchmarks;
- service levels and EPCOR performance will be assessed by reference to industry benchmarks; and
- the timing of a decision and the effective date for Rates approved pursuant to this Bylaw must reflect the financial needs of EPCOR and where applicable the regulatory requirements provided under the *Electric Utilities Act*.

Summary of Consultant Recommendations & Findings - Grant Thornton Review of EPCOR 2012-2016 PBR Proposal

RECOMMENDATIONS & FINDINGS	Consultant Report Page Reference
Risks to Customers	
Recommendation - Consideration should be given to a mechanism to ensure incremental revenues produced through higher consumption are held for benefit of rate payers.	7
Finding - Proposed PBR does not focus on operational efficiencies and sharing savings with customers – a main objective of the PBR methodology.	13, 18
Finding - The consultant determined that revenues generated through the proposed wastewater rate structure exceeded the revenue requirements described in the wastewater information package by \$2.03 million over the term of PBR III. EPCOR opted to adjust its revenue requirement through an acceleration of the phasing of annual ROE increases, rather than reducing the revenues generated through the wastewater rate structure.	10
Finding - Over the term of PBR II, incremental revenues and savings in depreciation and interest are expected to be approximately \$53.2 million. These will be offset by increases in operating costs over forecasts by approximately the same amount although water volumes are inline with forecasts. Therefore, potential cost savings that should have been passed onto customers were eliminated by operating cost over runs.	23
Operating and Capital Oversight	
Recommendation - The transition from PBR II to PBR III enables EPCOR to reset its revenue requirements to match its current operating and capital related costs (depreciation and interest). This allows EPCOR to reset the rate structure to current cost levels, which emphasizes the importance of the City having an oversight or approval mechanism for capital expenditures in excess of levels approved through the rate making process.	24
Recommendation - Given the magnitude of increases in operating costs and their ultimate inclusion in the cost of service, it is important the City consider adding some form of oversight and approval for operating spending in excess of levels approved during the rate making process.	34, 46, 82, 89
Recommendation - Recommend that the City has appropriate approval oversight and review process for major capital projects. The Consultant noted that small projects under \$25 million accounted for approximately 25% of the 2012-2016 water services capital plan, therefore appropriate measures should be in place to review these as well.	38, 46
Finding - The 2011 forecast in PBR II is \$18.82 million lower than the 2011 forecast used to determine the 2012 revenue requirement in PBR	30

III. This increase in 2011 forecasts indicates EPCOR's operating costs clearly outpaced inflation. These increases above inflation are essentially passed onto the customer as proposed PBR III allows EPCOR to reset its revenue requirement to match its current operating costs without any operating oversight by the City	
Performance Measures	
Recommendation - The use of indices which are based on aggregate value of basket of individual measures dilutes the relative importance of each index and fails to properly account for the criticality of some measures. For selected measures of critical activities, consideration should be given to creating individual thresholds to ensure minimum performance is consistently achieved.	12
Recommendation - The Customer Service index includes a measure of number of meetings held, which may not result in a meaningful measure reflecting customer service nor provide an opportunity to monitor and track improvements. The City should consider implementing more meaningful measures should that can be monitored and tracked.	12
Recommendation - City should assess EPCOR financial performance in terms of actuals vs. forecast over the term of the PBR.	11
Recommendation - Given the relationship between the City's Drainage Branch and the Gold Bar wastewater treatment plant on biosolids management, it would appear that the development of performance measures around biosolids production and supernatant management would be warranted.	12
Finding - Weighting of different indices and available bonuses being aggregated in the final benchmark result could have a distortion effect	99-111
Finding - Performance targets are generally achievable since most are already reached or surpassed over the last number of years because of averaging and as a result the use of targets to stretch behavior is limited.	100
Cost of Service Study	
Finding - The application of the cost of service study to the proposed PBR III increases costs to in-city customers by 12.4% compared to PBR II.	50-53
Finding - Pending conclusion of the cost of service study, the total costs allocated to in-city customers may change. EPCOR has indicated that pending results and conclusions of the cost of service study, they may seek a non-routine adjustment to incorporate the findings from the cost of service study	54
Corporate Shared Service Costs	
Recommendation – Appropriate oversight and review process for corporate costs allocated to EPCOR for the term of PBR III, as they represent nearly 20% of the operating costs.	36
Inflation Rate and Efficiency Factor	
Recommendation - Higher efficiency factor can be justified to ensure	11, 77

strong incentive to reduce and control operating and capital costs.	
Finding - Lesser correlation in rate increases to CPI given the proposed weighting changes which increase the relative importance of labor costs.	11
Finding - ROE is in upper quartile for comparable entities	43, 84