Bylaw 15816 – EPCOR Water Services and Wastewater Treatment Bylaw
EWSI Comments on Grant Thornton Report -
("EPCOR Water Services Inc – Review of 2012-2016 PBR Renewal")

EPCOR Water Services Inc. (EWSI) has reviewed the Grant Thorton (GT) Report and provides the following comments on certain conclusions and recommendations outlined in the "Summary of findings" section of the report.

Water Consumption

GT Report Reference: Page 9 Subsection (b)

1. "Reduced average customer water consumption is assumed in the proposed rate structure. If such decreases do not materialize, then EWSI will generate revenue levels higher than those proposed without a corresponding increase in costs. Similarly, growth in customer count is assumed in the proposed rate structure. If growth exceeds the levels anticipated, then EWSI will generate revenue levels higher than those proposed. While costs are legitimately expected to increase, the marginal cost of servicing additional customers should not exceed the incremental revenues. We note that under the current PBR, no mechanisms are provided to ensure incremental revenues produced are held for the benefit of and/or redistributed to ratepayers."

EWSI Comments:

2. EWSI currently takes the risk on water consumption volumes as part of its Performance Based Regulation (PBR) framework. As noted by EWSI in its Rates Report, this risk is significant. Including a mechanism to pass this risk on to customers would significantly add to variability in customers rates on an annual basis and would reduce the rate predictability and stability provided under the current PBR structure.

3. There is as much risk of actual water consumption being lower than forecast as there is of it being higher. If such a mechanism is implemented, then both the benefit/cost of actual consumption being higher/lower than forecast would be passed on to EWSI's customers. It would not be appropriate to transfer the upside risk of consumption to customers with EWSI retaining the downside risk related to consumption. Water consumption is one of the many variables that determine EWSI's revenues and returns over the course of the 5-year PBR term. In the past, EWSI has achieved the approved returns by managing these variables.

4. Historical analysis of water demand has shown a long term continuous reduction in water use per customer. With the continued focus on water conservation in terms of education

program and rate structures, continued reduction in average water consumption is a reasonable expectation. A more significant risk would be that the new rate structure which promotes water conservation will result in even greater reduction in water use per customer than what has been forecasted in the PBR.

Capital Programs

GT Report Reference: Page 9 Subsection (c)

5. "By 2016, this level of capital spending will have increased the rate base for water operations by almost 32% when compared to the 2011 rate base based on total system. While a detailed analysis of the nature and relevance of individual capital project is beyond the scope of our engagement, best practices in other North American jurisdictions suggest that the City should participate in the investment appraisal process to ensure adequate financial regulatory oversight on capital spending, particularly to the extent such spending is in excess of amounts approved through this rate making process."

EWSI Comments:

6. As noted in Attachment 1 of the Rates Report, one of the benefits of PBR is that it provides an efficient regulatory framework by avoiding costly annual reviews inherent in cost of service regulation. While EWSI is open to providing further information to City Council and for the benefit of City Administration to support its annual PBR Progress Reports, EWSI would be concerned about introducing a process that reduces the regulatory efficiency of a PBR framework without a clear benefit of the additional time and cost required.

7. EWSI considers that the existing PBR framework has worked well to define both the return and performance standards, both of which have been met in the past by EWSI. The current PBR structure also includes a process for the City to approve non-routine adjustments (NRAs) in accordance with the criteria provided in the Bylaw. EWSI has historically used NRAs for major, unanticipated deviations from its capital plan. Review of the NRAs application also considers the projected return on equity of EWSI over the 5 year PBR term.

8. It is also important to note that EPCOR Utilities Inc. (EUI) has significant internal controls governing capital spending, including EUI Board approval, Financial Review Council and the Water Capital Steering Committee. These processes provide significant oversight of the capital spending by EWSI.

Cost of Capital

GT Report Reference: Page 10 Subsection (d)

9. "Compared to industry benchmarks, the cost of capital assumptions used by EWSI remain in the upper quartile. While EWSI is subject to commercial risks that may not be directly comparable to industry benchmarks, we note that the cost of capital assumptions used by EWSI continue to differ from the levels approved by the AUC for the RWCG."

EWSI Comments:

10. EWSI considers that the proposed ROE is required for EWSI to maintain its financial sustainability over the long term, to ensure continued investment in utility infrastructure and to maintain its operations and services for the benefit of its customers. A cost of capital expert determined the fair ROE for EWSI of 10.875% based on an evaluation of EWSI's business and financial risks compared to other utilities with similar risks and lines of business. These other utilities included a sample of US and Canadian gas, electric and water utilities.

11. While the proposed ROE is within the top quartile of allowed returns, EWSI considers this to be appropriate considering the risks associated with EWSI's particular PBR framework compared to the risks faced by comparable utilities, including:

- Under a five year PBR term, there is higher forecast risk compared to shorter (e.g. 1, 2 or 3 year) cost of service applications;
- There are no deferral accounts included to pass on actual incurred costs to its customers for highly variable costs, such as chemicals, which can vary significantly with changes in raw water quality. Deferral accounts, common in AUC rate applications, reduce this risk to the utility;
- Average per customer water consumption reflect a declining trend and there is forecast risk of underestimating this decline;
- EWSI collects the majority of its water and wastewater treatment revenue from a consumption-based charge (75%), whereas electric and gas utilities will typically collect a higher proportion of their revenue through a fixed charge. This amplifies consumption risk significantly.

12. The rate of return on EWSI's PBR is not directly comparable with that of the AUC approved rate of return established for the wholesale rates charged to EWSI's regional water customers group (RWCG). Water rates for the RWCG are determined annually based on a cost of service regulation and there is a lower level of risk for the utility compared to the risks in

EWSI's PBR plan noted above. This difference in risks, and the resulting difference in rates of return required, is acknowledged on page 40 of the Grant Thornton Report.

<u>Wastewater Revenues</u>

GT Report Reference: Page 10 Subsection (d)

13. "As part of our review, we identified that revenues generated through the proposed rate structure exceeded the revenue requirements described in the wastewater information package by $2.03 million over the term of PBR III. We understand that EWSI opted to adjust its revenue requirements through an acceleration of the phasing of annual ROE increases. While we emphasize this does not impact the proposed wastewater rate structure, we note that the adjustment could also have been implemented through a reduction in the wastewater rate structure."

EWSI Comments:

14. EWSI's had three objectives in determining the annual forecast level of returns for wastewater operations: (i) not to exceed annual rate increases of 8.0% per year in order to minimize the customer bill impact; (ii) to support a gradual increase in the ROE to 10.875% by the end of 2016 and (iii) to maintain the recommended capital structure of 60% debt and 40% equity. In meeting these three objectives, EWSI accepted a significantly lower average rate return on equity over the 5-year PBR term in comparison to the fair return.

15. As noted above, through the course of reviewing the revenue requirements, it was identified that a correction to EWSI's interest expense and equity return for wastewater operations was required to maintain the recommended capital structure of 60% debt and 40% equity. The correction required a downward adjustment to the forecast interest expenses and an upward adjustment to the equity returns for EWSI's wastewater operations in order to maintain its capital structure over the 5-year PBR term. The impact of these adjustments resulted in an update to EWSI's average annual return on equity to 7.8% compared to its original forecast of 6.6% for the 5-year PBR term.

16. With EWSI's average annual return on equity projected to be 7.8%, it still remains significantly below the recommended level of a fair return for the wastewater utility of 10.875%. Therefore, EWSI considers that its approach to this correction is reasonable and appropriate.

Inflation Adjustment

GT Report Reference: Page 11 Subsection (e)

17. “We note that the proposed changes to the annual inflation adjustment mechanism to the water and wastewater rate-structure will result in a more transparent rate adjustment mechanism based on the reliance towards independently verifiable data sources. We also note that over the term of PBR III and compared to the adjustment mechanism under PBR II, there will be a lesser correlation in rate increases to CPI given the proposed weighting changes which increase the relative importance of labour costs.”

EWSI Comments:

18. EWSI has proposed a rate of inflation measured by a weighted average of two components: (i) 65% based on the change in the Consumer Price Index for Alberta and (ii) 35% based on the change in the Average Hourly Earnings (AHE) for Alberta, Industrial Aggregate. The revised weighting of the CPI and Labour components reflects a determination that approximately 70% of corporate service cost allocations relate to salaries and benefits. Based on this, approximately 65% of operating costs are driven by general inflation and 35% are driven by wage and salary inflation. While the component of the inflation factor that is based on Alberta CPI has been reduced from 79% in PBR II to 65% in PBR III, EWSI considers this to be an appropriate reflection of the proportion of its labour costs and other costs.

19. The Alberta AHE Industrial Aggregate series is comprised of multi-industries across Alberta and includes the oil and gas industry as well as several other industries of substantial size (i.e. health care). Therefore, the AHE index is broadly based and is not overly influenced by any particular industry. EWSI competes for talent across a number of industries and therefore, a broadly based index such as the AHE index is appropriate for use as the salary escalation factor for the 2012-2016 PBR. AHE is readily available and verifiable and reflects the geographic market that EWSI is primarily drawing its resources from.

Efficiency Factor

GT Report Reference: Page 11 Subsection (e)

20. “We note that the proposed annual rate adjustment calculation continues to feature a proposed efficiency factor of 0.25%. We echo the conclusions from the independent review of PBR II that the proposed factor is modest in comparison to the industry. Given the prior year increases in operating costs as well as the extent of the capital program contemplated under PBR

III, a higher efficiency factor could be justified to ensure a strong incentive to reduce and control operating and capital costs."

EWSI Comments:

21. EWSI considers that its proposed 0.25% efficiency factor is appropriate given this is the third renewal of its PBR. With each successive 5-year term, it becomes increasingly difficult for utilities to find additional cost savings beyond those already achieved in prior PBR periods. Under the Bylaw, if the actual inflation rate is 1.75% or lower, no efficiency factor will be applied.

22. EWSI's PBR structure is based on prices for chemicals, power and other inputs increasing at the level of inflation. If prices for these inputs increase at levels greater than inflation, EWSI will need to find additional cost savings to offset these price increases and still maintain its proposed rate of return. Refer to EWSI's further comments below on the "Incentives to Innovate".

23. EWSI retained an independent expert, Dr. David Ryan, a Professor with the University of Alberta's Economics Department, to recommend a productivity factor for EWSI's 2012-2016 PBR. Dr. Ryan's analysis and conclusions were provided to Grant Thornton. In Dr. Ryan's report, he concludes "that the most reasonable forecast of productivity growth in the utility industry in Alberta for the next several years is that it will be zero". However, to demonstrate a continuing commitment to its customers to increase operational efficiencies, EWSI proposes to continue to with an efficiency factor of 0.25% for the 2012-2016 PBR.

Operating Costs

GT Report Reference: Page 11 Subsection (e)

24. "Consistent with our finding with respect to capital projects, we note that the City, as regulator, should contemplate an enhanced level of disclosure by EWSI over the term of PBR III with respect to its financial performance with a detailed analysis of variances between actual and forecasted values. As a further step to mitigate future cost increases, the City should contemplate mechanisms which would require prior approval of incremental expenditures before they get aggregated in the revenue requirements."

EWSI Comments:

25. The recommendations to provide "…enhanced level of disclosure over the term with respect to financial performance…" and "…mechanisms which would require prior approval of incremental expenditures before they get aggregated..." suggest a move back to cost of service regulation. As noted in its comments above regarding "Capital Programs" oversight process, EWSI is concerned about eroding the benefits of a PBR mechanism by introducing processes that reduce regulatory efficiency. EWSI is submitting for City Council approval its plan as part of its 5-year PBR Bylaw; having additional process for approvals during the five year term could create duplication of effort and process. EWSI considers that a PBR framework should allow the utility the ability to make operating cost decisions to balance off performance standards and return on equity considerations. The test as to whether EWSI's operating decisions are appropriate lies in past performance history, the returns achieved and the resulting water rates which are reasonable relative to other comparable cities.

Performance Indices

GT Report Reference: Page 11 Subsection (f)

26. The use of indices which are based on the aggregated value of a basket of individual measures dilutes the relative importance of each index and fails to properly account for the criticality of some measures. This is especially relevant in the context where not all measures share the same relative importance and where performance on individual measures are mitigated or averaged. For selected measures that impact critical activities, consideration should be given to creating individual thresholds to ensure minimum performance is consistently achieved.

EWSI Comments:

27. EWSI considers all the performance measures – system reliability, water quality, customer service, environmental and safety performance – to be of comparable importance to ensure a well functioning water and wastewater system. Therefore, energy and attention is applied to all of these five areas as a matter of sound utility management. Further, the existing performance measures have served the City well, as indicated by the relatively positive customer survey results. As a result, EWSI does not see the need to have additional individual measures added to the performance measures.

28. Although EWSI's individual performance measures are grouped for penalty calculations they are reported on individually to City Council and specific initiatives to address missed

performance are followed up on with new initiatives and reported back to City Council in the annual PBR Progress Reports.

Wastewater Customer Service

GT Report Reference: Page 12 Subsection (f)

29. Under the customer services index for wastewater treatment, the measure of number of meetings held may not result in a meaningful measure which reflects customer service nor provide an opportunity to monitor and track improvements. A possible variation to this index could be to measure the ratio of "number of open items during the meetings over the number of items closed within the targeted period". So independently of the number of meetings, EWSI would measure the pro-activeness in responding to the community liaison committee open issues. Other variations to this measure could also be considered.

EWSI Comments:

30. The intent of this measure is to ensure that Gold Bar Wastewater Treatment plant management continues to engage with the Gold Bar community, as has been the case since the plant was owned by the City. Because of major changes to Gold Bar's operations (e.g. Enhanced Primary Treatment) and the lack of historical data with both the new operational configuration and operation of the plant by EWSI, a simple engagement measure was deemed appropriate. Having said that, EWSI will consider alternatives to this measure for discussion with the City.

Biosolids and Supernatant Management

GT Report Reference: Page 12 Subsection (f)

31. "Furthermore, 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."

EWSI Comments:

32. A mechanism already exists for direct and collaborative interface between Gold Bar Wastewater Treatment Plant and the City's Drainage Branch, in the form of the Gold Bar Management Committee. This Committee, which includes both senior EWSI and City staff, has mandate to jointly manage the interface points between the Wastewater Treatment Plant and the

Drainage Branch. This structure also includes a subcommittee, the Edmonton Biosolids Regional Partnership responsible for the biosolids and supernatant management activities.

<u>Incentive to Innovate</u>

GT Report Reference: Page 12 Subsection (g)

33. "From a financial perspective there is limited incentive for EPCOR to innovate and thus reduce the cost of service delivery to rate payers. The current model is effectively a blend of PBR for service quality related elements and traditional return on rate base for the financial component. To create a full PBR system and incent cost reduction for ratepayers, there has to be an incentive (for EWSI) to innovate and drive down the cost of service delivery. The current efficiency factor is not an incentive for EPCOR to be innovative and more efficient. Based on the current regulatory model, we have made recommendations above to create greater oversight in financial decision making regarding capital and operating matters. Should the rate structure evolve towards more of a full PBR model with incentives for reducing costs to ratepayers, then these oversight mechanisms can be withdrawn."

EWSI Comments:

34. EWSI notes that there are several ways, other than through the efficiency factor, in which EWSI is incented to innovate and find cost savings. These other incentives stem from PBR III revenue requirement and rates which reflect forecast increases in its input prices held at the level of inflation.

35. While EWSI's forecast revenue requirement for 2012-2016 reflects increases in certain costs above inflation, these are only related to higher volume/activity levels (driven by regulatory, reliability, City of Edmonton requirements, etc.) and all input prices are assumed to increase based on the inflation rate (as measured by CPI and AHE). Therefore, EWSI retains the risk associated with input prices for capital and operating costs rising above inflation and is driven to find cost savings to offset any increases in input prices above inflation.

36. EWSI considers that there is a high probability of certain key input prices rising above inflation which will result in strong incentives to find offsetting cost savings, for instance:

- Chemical prices
- Power prices – Under PBR III, power prices are forecast to increase at CPI. However, EWSI has a power price contract for the next five years based on power prices increasing at rates much higher than forecast CPI.

- Interest rates – Under PBR III, the cost of new debt is forecast to be 5.89%, which is based on the 2012 forecast held constant for the 5-year period. EWSI will need to mitigate the impacts of higher than forecast interest rates.
- Construction materials costs – If Alberta faces another construction boom in the next 5-year period, EWSI could face rapidly increasing materials costs at level above CPI.

37. Another way EWSI is incented to find cost savings is if there is a significant reduction in water consumption compared to EWSI's forecast. This occurred during PBR II and caused EWSI to have to manage a significant reduction in revenues relative to forecast.