Utility Advisor Review of

EPCOR Water Services Inc.

2012-2016 PBR Proposal.

August 24, 2011

1.0 PURPOSE OF THIS REPORT

The Utility Advisor's (UA's) terms of reference were recently modified to include a review of the regulatory filings of EPCOR Water Services Inc. (EWSI). Pursuant to City of Edmonton Bylaw 12294 – EPCOR Rates Procedure Bylaw, Edmonton City Council acts as the regulator of EWSI regulated water operations and wastewater treatment services.

The UA review of EWSI rate applications is different from the review performed for the other city utilities (Waste Management, Surface and Sanitary Drainage). Under the provisions of Bylaw 12294, City Administration prepares an Administrative Report for Council, reviewing the EWSI applications. In this current application, an external consultant Grant Thornton (GT) was hired to provide the review of, and report on the application[1]. The UA review presented in this report is meant to assist the Utility Committee and Council in their assessment of the application, and to ensure consistent regulatory policies are applied where appropriate to all city-owned utilities for which Council has the final regulatory authority.

2.0 EXECUTIVE SUMMARY

- Utility Committee should develop a Minimum Filing Requirement for future EWSI rate applications.
- It is not clear to the UA on what basis EWSI believes it should earn a return on contributed assets associated with the transfer of GBWWTP from the City of Edmonton to EWSI. The basis for this claim should be substantiated.
- Capital expenditures during a PBR period are rolled into opening rate base at the start of each new PBR plan. Given the impact of capital spending on rates, additional scrutiny of the prudence of capital expenditures should be applied to each Annual PBR Progress Report.

[1] EPCOR Water Services Inc. Review of 2012-2016 PBR Proposal by Grant Thornton LLP

- Section 5.0 of Schedule 3 should be amended to require EWSI to include a section in its Annual PBR Progress Report containing a statement by the CEO and CFO of EWSI that all NRAs which would be to the benefit of customers have been requested.

- A special NRA should be considered if actual 2012 expenditures point out any over-forecasting of 2012 costs, given the absence of enough historical data on which to assess the reasonableness of forecasts.

- Additional work should be done to ensure utility customers are not funding 100% of employee bonuses awarded for the achievement of financial targets.

- The UA recommends that the issue of an appropriate return on equity be deferred until the results from proceeding 1606549 (2011 Generic Cost of Capital Proceeding) are available (currently expected in December of 2011). At that time a more reasoned determination of proposed return on equity will be possible.

- The UA recommends that EWSI be required to prepare a compliance filing incorporating all of the corrections noted during the Grant Thornton review, and the recommendations of Grant Thornton and the UA. The compliance filing should take the form of an amended Rates Notice and Rates Report, as well as amended Information Packages for both Water and Wastewater Rates. The compliance filing should also contain the replies to all Grant Thornton and UA Information Requests.

3.0 QUALTIY OF THE APPLICATION

The UA is disappointed in the quality of the EWSI application. While all regulatory applications should strive for high standards of quality and precision, Performance Based Regulation (PBR) applications should be held to the highest standards, since there is limited opportunity to correct errors over the term of a PBR. The UA concerns fall into two categories.

Firstly, the applications contained many errors. There are several references to these errors in the GT report which necessitated additional effort on the part of GT and the UA to understand the application.

Secondly, and more important (from the UA perspective) is the fact that EWSI did not provide sufficient historical information in their application to allow either GT or the UA to fully understand the derivation of the 2012 revenue requirement. Such an understanding is critical to evaluating the starting point of a multi-year PBR.

The UA asked GT in information request UA-5-GTLLP whether additional information might be required from EWSI to determine if the revenue requirements forecast are reasonable. GT replied that they were unable to address the drivers underlying the increase in Operating Costs and Capital Expenditures.

EWSI, as a subsidiary of EPCOR Utilities Inc. should be familiar with standard filing requirements for regulated utilities, as EPCOR Distribution and Transmission Inc. is subject to such requirements when they file applications with the Alberta Utilities Commission. The following table is an extract from a recent EPCOR Distribution and Transmission Inc. 2010-2011 rate application:

EPCOR Distribution & Transmission Inc.
2010 - 2011 Phase I DTA & TFO TA
Summary of Transmission Revenues and Costs
($ Millions)

Line No.	Description	Cross Reference	2007 Decision	2007 Actual	2008 Decision	2008 Actual	2009 Decision	2009 Updated Fcst	2010 Forecast	2011 Forecast
1	**Revenues**									
2	Transmission Tariffs		34.75	35.26	44.28	43.78	52.15	52.15	55.95	60.88
3	**Total Revenues**		**34.75**	**35.26**	**44.28**	**43.78**	**52.15**	**52.15**	**55.95**	**60.88**
4										
5	**Costs**									
6	Fuel	S. 4-1	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
7	Operating Costs	S. 5-1	16.10	15.85	18.46	18.57	20.19	19.61	22.08	23.56
8	Depreciation	S. 6-1	7.80	8.05	9.47	9.65	11.15	10.83	11.72	12.51
9	Return on Rate Base	S. 9-1	11.95	11.77	16.43	16.42	21.01	20.13	22.73	23.89
10	Income Tax Expense	S. 7-1	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
11	Revenue Offsets	S. 8-1	(0.68)	(0.89)	(0.74)	(1.60)	(0.86)	(0.79)	(0.25)	(0.23)
12	Deferral & Reserve Accounts		(0.90)	0.00	0.14	0.05	0.14	1.80	(1.16)	0.17
14	**Total Costs**		**34.26**	**34.78**	**43.76**	**43.08**	**51.63**	**51.58**	**55.12**	**59.90**
15										
16										
17	Transmission Tariffs		34.75	35.26	44.28	43.78	52.15	52.15	55.95	60.88
18										
19	Revenue at Existing Rates		36.85	36.85	34.75	35.26	44.28	43.78	52.15	55.95
20										
21	Increase		(2.09)	0.00	9.53	8.52	7.87	8.37	3.80	4.93
22										
23	% Increase		-5.68%	0.00%	27.41%	24.18%	17.77%	19.12%	7.29%	8.81%

This 2010-2011 application (for rates covering two years) contains historical data and the then current year updated forecast going back 3 years. The EWSI contains significantly less historical data, where a PBR application should actually contain more historical data (the UA recommends 5 years).

The UA is unable to identify any previous effort to develop a Minimum Filing Requirement for EWSI. The UA recommends that the Utility Committee develop a Minimum Filing Requirement for future EWSI PBR applications, and that EWSI be required to meet such requirements before future Administration Reports and UA reviews begin.

With regard to this particular application, the UA recommends that EWSI be required to provide detailed information on actual 2012 operating and capital expenditures in a format similar to the Information Packages provided in support of this application. This material should be reviewed by the Utility Committee shortly after it is prepared to identify any areas where the 2012 revenue requirement forecast may have been over-estimated.

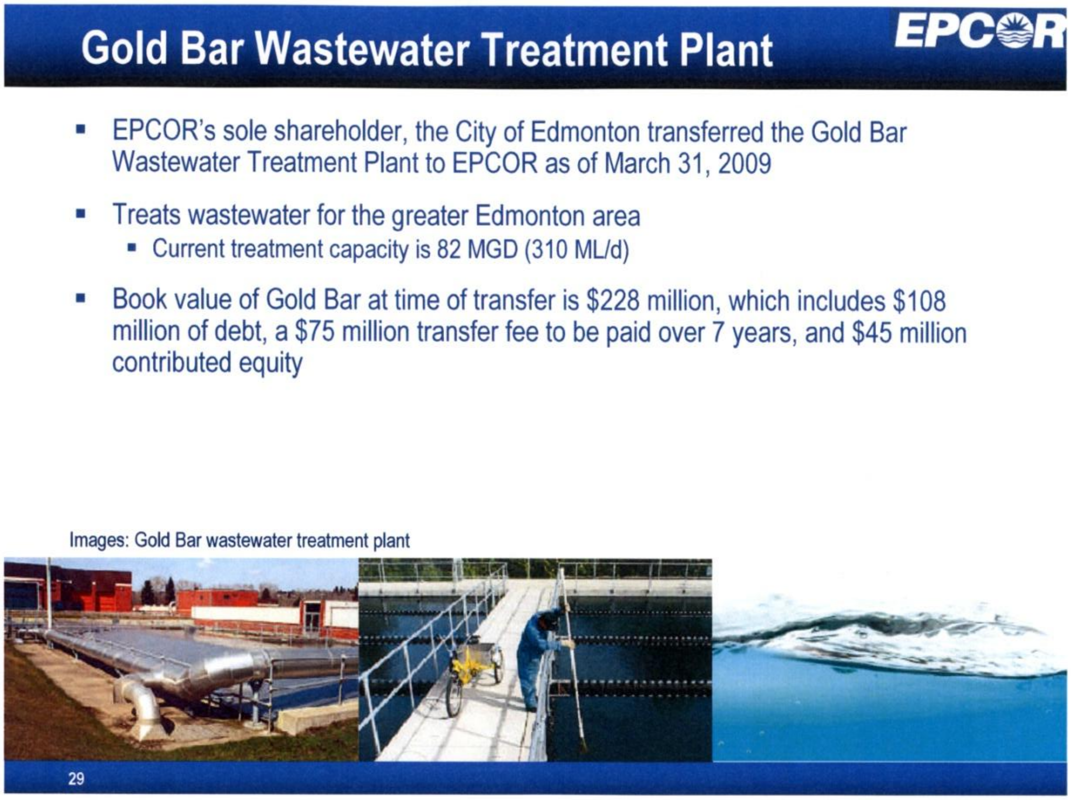
Schedule 3 of the Rates Report sets out the PBR Plan, and includes provisions for Non-Routine Adjustments and Off-Ramps. In subsequent sections of this report, the UA recommends changes to these provisions which would allow City Council to react if necessary if the actual 2012 expenditures are significantly less than those forecast. While not a standard provision of PBR, such action is necessary given the errors and non-adherence to Minimum Filing Requirements contained in this application.

4.0 RATE BASE

Rate base is a significant driver of utility rates. It is very important to ensure that utility opening rate base at the start of a regulatory period is correct.

In the case of GBWWTP, the determination of opening rate base is complicated by the nature of the transaction which transferred GBWWTP from the City to EWSI. The following slide is taken from the EPCOR website.[2]

[2] http://www.epcor.ca/en-ca/about-epcor/investor-information/InvestorPresentations/Documents/EUI-Investor-Presentation-Sept09.pdf



Since 2009, the book value of GBWWTP has increased, as set out in the Rates Report. However, at the time this slide was prepared, the equity component of GBWWTP was $120 million. However, EWSI did not pay $120 million. The UA understands that EWSI committed to pay $75 million over 7 years, and received a contribution from the City of $45 million. The UA asked for additional information on the treatment of this transaction from GT in Information Request UA-8-GTLLP. GT received additional information from EWSI stating that all regulated assets in-service on the transfer date of Gold Bar to EWSI were recorded at the City's book value.

It is a standard regulatory principle that a utility is only allowed to obtain a return on assets in which the utility has invested. Assets used by a utility to provide utility service in which the utility has not invested are treated as contributions, and the utility does not earn a return on contributed assets. In the case of GBWWTP, it appears to the UA that the outstanding component of the $75 million transfer fee, and the $45 million contributed equity do not represent investments by EWSI, and therefore should not be included in EWSI Rate Base. It would be helpful if EWSI could address this issue during the non-statutory public hearing scheduled for September 1, 2011.

EWSI provides the process by which capital projects are forecast and approved by EWSI management in section 3.2.2 of the Water PBR Information Package. The process described by EWSI properly places the onus for determining the necessary capital investment in the utilities on EWSI and EUI management. However, it remains the responsibility of the regulator to ensure that the resulting rate impacts of the capital expenditures represent prudent actions on the part of management. The opportunity for doing so appears to be upon review of each year's Annual PBR Progress Report. Given the impact of capital expenditures on rates, it would be appropriate to ensure that these Annual PBR reports receive the scrutiny necessary to ensure prudent actions on the part of management.

5.0 PBR STRUCTURE

The UA notes some aspects of the proposed PBR structure with interest. It appears that the intent of Non-Routine Adjustments is to allow for symmetrical adjustments, but that the onus for identifying such adjustments rests solely with EWSI. The UA asked GT about this in UA-4-GTLLP. GT replied that the current PBR framework enables EWSI to request NRA to the rate structure for events beyond the scope of control of EWSI. While an NRA to the benefit of EWSI customers is allowed conceptually, GT noted that the current drafting of Section 5.0 of Schedule 3 to the proposed bylaw is geared towards incremental costs, and that to GT's knowledge EWSI has not sought such an NRA that would result in lower costs to its customers over the term of PBR II.

EWSI must be equally motivated to seek NRAs whether the benefit is to the EWSI shareowners or EWSI customers. In the case of increased costs, EWSI is clearly motivated by a desire to protect its return. However, when a decrease in costs can occur, EWSI is giving up increased returns by requesting an NRA. Section 5.0 of Schedule 3 should be amended to require EWSI to include a section in its Annual PBR Progress Report containing a statement by the CEO and CFO of EWSI that all NRAs which would be to the benefit of customers have been requested.

As discussed in sections above, a special NRA should be considered if actual 2012 expenditures point out any over-forecasting of 2012 costs, given the absence of enough historical data on which to assess the reasonableness of forecasts.

Many utility regulators, including the Alberta Utilities Committee watch incentive compensation plans for utility employees carefully, particularly when it comes to bonuses based on achieving financial targets. Reasoning that achieving financial targets results in a reward to the company through higher earnings, these regulators do not believe that utility customers should pay 100% of any bonuses based on achieving such targets. The UA asked GT through UA-GTLLP-7 about this issue. GT advised that additional work would be necessary to answer this question. The UA recommends that this additional work be done.

6.0 RATE OF RETURN

Based on the recommendations of its consultant, EWSI is proposing a return on equity of 10.875%, with a common equity ratio of 40%.

Decision 2011-281 of the Alberta Utilities Commission (Rates for Water Supplied by EPCOR Water Services Inc. to RWCG for 2004, 2005, 2006 and 2007) the Commission determined that the generic formula established in Decision 2004-052 should be employed for purposes of the return on equity on an annual basis for the period 2004-2007. As well, the Commission determined that an appropriate common equity ratio would be 30%.

GT responded to the UA's Information Request UA-6-GTLLP requesting whether or not GT had reviewed and could summarize the evidence of other experts in the Alberta Utilities Commission 2011 Generic Cost of Capital Proceeding in the affirmative, however they did not summarize the evidence of the other experts. GT also noted that the AUC proceeding is focussed on electric and gas utilities. GT further reported that they understand from EWSI that there are two fundamental differences between the EWSI PBR application and the AUC decision on EWSI's RWCG decision, being the multi-year nature of PBR, and the increased risk associated with in-city retail customers versus RWCG wholesale transactions.

The UA is not convinced that findings from the Alberta Utilities Commission Proceeding into a generic cost of capital cannot be incorporated into the decision on EWSI's PBR application. It is interesting to note that EWSI's expert witness is recommending 10.375% ROE in the AUC proceeding, and in another application before the Commission (dealing with PBR), has recommended an adder of 0.5% for the additional risk associated with multi-year PBR. Clearly the recommendations of this expert can be applied to water utilities.

In making this proposal, EWSI has relied on an expert witness who generally appears on behalf of regulated utilities, rather than customer groups. As evidenced in current proceedings before the Alberta Utilities Commission, there are a number of expert witnesses, generally appearing on behalf of customer groups who convincingly argue for significantly lower rates of return. Commissions invest hundreds of hours of staff and hearing time, and millions of dollars weighing this conflicting evidence, and do so with skill and experience.

The UA cannot recommend approval of the applied for return on equity. Relying on a single expert, commissioned by utility management is not good regulatory practice. Duplicating proceedings that are currently underway is also not good regulatory practice.

The UA recommends that the issue of an appropriate return on equity be deferred until the results from proceeding 1606549 (2011 Generic Cost of Capital Proceeding) are available (currently expected in December of 2011). At that time a more reasoned determination of proposed return on equity will be possible.

As a starting point, the UA believes that the 2011 Generic Cost of Capital determined as a result of proceeding 1606549, increased by 0.5% for a PBR scheme, with a common equity ratio of 40% would be reasonable. 40% common equity ratio is quite high for regulated utilities in Alberta, and represents significant compensation for the risks identified.

7.0 CONCLUSION

Both the Grant Thornton report, and this Utility Advisor report include recommendations to Council. With the implementation of the recommendations, the proposed bylaw can be approved.

The UA recommends that EWSI be required to prepare a compliance filing incorporating all of the corrections noted during the Grant Thornton review, and the recommendations of Grant Thornton and the UA. The compliance filing should take the form of an amended Rates Notice and Rates Report, as well as amended Information Packages for both Water and Wastewater Rates. The compliance filing should also contain the replies to all Grant Thornton and UA Information Requests.