

**Utilities Advisor Review of
Bylaw 15816 - EPCOR Water Services and
Wastewater Treatment Bylaw - A Bylaw to
Replace Bylaw 12585 - EPCOR Waterworks
Bylaw**

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1.0 PURPOSE OF THIS REPORT

The Utilities Advisor'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 Utilities Advisor 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 application¹. The Utilities Advisor review presented in this report is meant to assist 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

All substantive issues related to the Utilities Advisor review of this proposal were addressed at the September 1, 2011 Utility Committee meeting, with the exception of the proposed rate of return. In the absence of credible expert testimony to balance the testimony of the single expert commissioned by EWSI to propose the rate of return included in their application, the Utilities Advisor suggests caution in accepting their proposal for a five year term. An alternative exists which will yield a fair rate of return, and which will not prejudice EWSI.

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

3.0 CONCERN WITH PROPOSED 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%. It is clearly understood by all participants to EWSI's PBR proposal that the business risk of EWSI for in-city customers is higher than the risk considered in Decision 2011-281. EWSI deals with retail customers in the city (as opposed to wholesale sales outside the city), and a 5 year Performance Based Regulation regulatory regime is undoubtedly more risky than the 1 year regime for which the generic formula established in Decision 2004-052 was developed.

Grant Thornton (the consultant hired by administration to prepare administration's review of this application) responded to the Utilities Advisor's Information Request Utilities Advisor-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.

The Utilities Advisor regards the argument that generic rates of return developed for utilities under the regulatory authority of the AUC are not comparable to the appropriate rate of return for a water and wastewater treatment utility as spurious. The stated objective of the AUC in developing their generic rate of return was to develop a rate of return which could be applied to the widest possible population of utilities. While it is true that a water and wastewater utility faces different risks and business issues than an electric utility, it is also true that an electric utility faces different risks and business issues than a gas utility, but the generic rate of return is equally applicable to both the gas and electric utilities, and can, by extension, be applied to a water and wastewater treatment utility.

The best evidence of the above statement is to look at EWSI's consultant's evidence in this proceeding, and similar proceedings which are currently before the AUC. In this proceeding, the consultant has recommended an ROE of 10.875%, to be set for the period of the PBR. In proceedings now before the AUC, the same consultant has recommended an ROE of 10.375% as a generic rate of return suitable for a one-year regulatory regime, and an additional 0.500% as appropriate compensation for increasing the risk to the utility through a 5 year PBR. When the same expert makes the same recommendation for AUC-regulated utilities and for City of Edmonton-regulated utilities, it is clear that she has determined that the elements which go into making up a recommended rate of return are very similar.

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 Utilities Advisor 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 Utilities Advisor 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. Since the EWSI rates are not scheduled to come into effect until after December, this proposal does not prejudice EWSI, and it does protect the interests of the customers of EWSI.

The Utilities Advisor 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.