

# **EPCOR Water Services Inc.**

## **Proposed Return on Equity (ROE) and Efficiency Factor 2022-2026 PBR Applications**

Utility Committee Meeting

December 4, 2020

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# Determining the EWSI ROE – 2017-2021 PBR

- The City's consultant (Grant Thornton) recognized that:
  - EWSI's business risks are greater than the average Alberta electric/gas utility
  - It is reasonable to add a risk premium to the AUC's Generic Cost of Capital (GCOC)
- Utility Committee suggested EWSI work with City Administration to address the following two directions:
  - *That the support to be provided for the rate of return and the productivity factor start as a baseline with the measures as determined by the Alberta Utilities Commission.*
  - *That Administration work with EPCOR on the following: Establish appropriate method to calculate the Efficiency Ratio prior to next Performance Based Rates.*

# Determining the EWSI ROE - Background

- Mid-2019
  - EWSI and City Admin discussions on a method to quantify the risk premium
  - formal RFI circulated to the consulting community
- January 2020
  - only two firms responded to the RFI
  - neither adequately defined a method to quantify the risk factors
  - no basis to adequately quantify and justify the risk factors
  - not an established industry practice
- EWSI concluded: attempting to quantify the risk factors to determine a risk premium is not the preferred course
- EWSI began to explore more traditional cost of capital approaches

# Should the impact of the Global Pandemic be reflected in ROE?

- Market data (financial ratios, interest rates) have been highly volatile during 2020 – making it **problematic to apply traditional methods** for estimating cost of capital.
  - investors' required rates of return in 2020 have increased
  - when will the economic impacts of the pandemic will end?
- To avoid reliance on capital cost estimates inflated by temporary pandemic conditions, we propose to assume a return to “normal” conditions by 2022
  - propose to use 2019 (pre-pandemic) data and/or *Consensus Economics* forecasts for 2022 (post-pandemic)
- Given the limitations with applying traditional methods during the pandemic, we propose a straightforward update of the Grant Thornton 2016 ROE analysis.

## Grant Thornton 2016 Review of EWSI's ROE for 2017-2021 PBR

- GT agreed to continue the 60% / 40% capital structure
- GT agreed EWSI's business risk is greater than average Alberta electric/gas utility
- GT applied an EWSI risk premium of 1.875% above the GCOC
- 2015 GCOC of 8.3% plus 1.875% results in the 10.175% approved ROE

	<u>2017 PBR</u>	<u>GT</u>	<u>Difference</u>
<b>Cost of equity</b>			
Adjust average U.S. proxy group indicated ROE to remove RPM results [1]	10.340%	9.680%	-0.660%
Adjust U.S. proxy group to remove ECAPM results [2]	10.450%	10.130%	-0.320%
Adjustment to reflect higher reduction in approved generic ROE's	10.500%	10.12% to 10.42%	-0.08% to -0.38%
Excessive risk premium over AUC generic rate	2.200%	1.875%	-0.325%

## Updating Grant Thornton's 2016 Analysis

EWSI has updated the GT 2016 analysis based on:

1. Most recent GCOC of 8.5%
2. EWSI risk premium of 1.875% (Grant Thornton 2016)
3. Changes in the long-term Government of Canada (GOC) bond yield from the 2018 AUC GCOC decision
4. Compression and expansion of equity risk premiums as bond yields vary

# Updating Grant Thornton's 2016 Analysis

## 1. GCOC

- AUC originally set 8.5% for 2018 and applied to 2019 and 2020
- Recently AUC extended 8.5% to 2021 on a final basis

## 2. EWSI Risk Premium

- GT 2016 Report concludes: appropriate risk premium for water and wastewater operations is 1.875%
- What about a Drainage?
  - Drainage business has higher business risk compared to Water
    - longer capital recovery period, far greater proportion of contributed assets and higher operating leverage
  - therefore, EWSI risk premium for Drainage should be **no less than 1.875%**

# Updating Grant Thornton's 2016 Analysis

## 3. Change in Long Canada Bond Yields

- 2018 yield underlying the 8.5% GCOC is 2.3%
- 2019 (pre-pandemic) yield was 1.8%
- 2022 (*Consensus Economics*) forecast yield is also 1.8%
- Using either 2019 or 2022 yield results in a 0.5% reduction

## 4. Compression / Expansion Factor

- Equity risk premiums compress/expand as bond yields increase/decrease
- Historically, regulators assumed if bond yields increased/decreased by 1%, then common equity rates of return will tend to increase/decrease by 0.75%



# Updating Grant Thornton's 2016 Analysis

## PROPOSED ROE FOR EWSI 2022-2026 PBR (Tables 1 & 2 of EWSI Report)

2019 LT GOC Yield (or 2022 Consensus Economics Forecast)	1.80%
Less: LT GOC Yield underlying 2018 GCOC Decision	(2.30%)
Bond Yield Change	(0.50%)
X Compression / Expansion Factor	0.75
Change in Common Equity Rate of Return	(0.38%)
AUC 2019 (or 2021) GCOC	8.50%
Plus: GT 2016 EWSI Risk Premium	1.88%
Less: Change in Common Equity Rate of Return	(0.38%)
Proposed Equity Rate of Return for EWSI 2022-2026	10.00%

## Proposal to Moderate Drainage Rate Increases

- We are striving to improve service reliability and implementing the SIRP/CORE programs while NOT exposing customers to overly-aggressive rate increases.
- To moderate rate increases, we propose to ramp up ROE over a 5-year period for “Base” operations
- 2022-2026 consolidated ROE of 9.10% is well below the target ROE of 10%.

Year	Water	Wastewater	Drainage Base	SIRP + CORE	Drainage Consolidated*	EWSI Consolidated*
2022	10.00%	10.00%	5.50%	10.00%	5.97%	8.06%
2023	10.00%	10.00%	6.63%	10.00%	7.11%	8.56%
2024	10.00%	10.00%	7.75%	10.00%	8.16%	9.06%
2025	10.00%	10.00%	8.88%	10.00%	9.11%	9.53%
2026	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
2022-2026	10.00%	10.00%	7.86%	10.00%	8.25%	9.10%

\*weighting based on preliminary rate base forecasts

# Efficiency Factor Background

- The Efficiency Factor:
  - minimum amount the utility must improve efficiency to maintain its allowed ROE
  - usually declines over successive PBR terms to recognize the increasing difficulty in finding operational efficiencies
- EWSI had a declining efficiency factor until the 2007-2011 PBR term
- Efficiency factor for Water has been set at 0.25% since 2007
- EWSI's 2017-2021 PBR Efficiency Factor Evidence:
  - Dr. Kaufmann proposed negative 0.5% efficiency factor using industry established methods
  - EWSI proposed to maintain the positive 0.25% efficiency factor **even while** meeting higher regulatory, safety and environmental performance standards

## Proposed Efficiency Factor for the 2022-2026 PBR

- We are **not** planning to engage a consultant to recommend an efficiency factor
  - underlying industry parameters have not changed
  - a negative efficiency factor would likely be recommended by the consultant
  
- We propose to maintain the positive 0.25% efficiency factor
  - to continue our commitment to find operating cost savings across all businesses (Water, Wastewater Treatment and Drainage) and
  - to align with City of Edmonton goals

## Proposed Efficiency Factor – Drainage Considerations

- Aggressive efficiency targets already applied to Drainage operations – the 2017 Drainage Transfer commitments:
  - executing the City’s Drainage capital program at 10% lower costs; and
  - reducing Drainage operating costs by 5% below 2017 levels by 2021
- Drainage expects to meet these commitments by 2022
- Ramping the Drainage RoE **substantially** reduces Drainage’s return below a level that is commensurate with its risk
- Drainage business is **higher risk** compared to the Water, which increases EWSI’s overall business risk profile
- Increasing the efficiency factor above 0.25%, in combination with the ramped ROE, is seen as moving the risk/return profile beyond an acceptable level