

The Regulation of Government Owned Utilities: Why and How?



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PROVIDING MORE **EPCOR**

Outline

- Who is EPCOR?
- Utility Service Delivery
- Cost of Service Regulation
- Full Cost of Service Rates
- Government Services vs. Utility Services
- Private vs. Crown Vs. Government Department
- How do P3s Fit In?
- Concluding Observations

Who is EPCOR?

- Headquartered in Edmonton, Alberta
- Stand alone corporation; Jan 1, 1996
- 100% municipally-owned
- Fully independent Board of Directors - operates at arms length from Shareholder
- Raise own debt without credit support from City
 - A- (S&P) and A (low) (DBRS); report on SEDAR
- “Narrowly-held private company” with a strong commercial orientation



EPCOR Utility Operations

- Utility infrastructure developer / operator
- Electricity and Water
- Operations in Alberta, BC, Saskatchewan, Arizona and New Mexico
- 2,700 employees
- 2014 Asset Value \$5.7 billion
- 2014 Net Income \$191 million
- 2014 Dividend \$141 million



EPCOR's Utilities

Utility	Regulator	Method
Electricity Transmission	Alberta Utilities Commission	Fixed Forward Test Year
Electricity Distribution	Alberta Utilities Commission	PBR
Energy Services - RRO	Alberta Utilities Commission	Fixed Forward Test Year
Edmonton Water & Wastewater	City of Edmonton	PBR
Regional Water Customer Group	Alberta Utilities Commission	Actual Cost of Service (by complaint)
White Rock & French Creek Water	BC Water Comptroller	Fixed Forward Test Year
Arizona	Arizona Corporation Commission	Historic Test Year
New Mexico	New Mexico Public Regulation Commission	Historic Test Year

Utility Service Delivery

- Utility Infrastructure is typically characterized by significant “economies of scale” = “natural monopoly”
 - One entity can provide service at a lower cost than multiple providers
 - In recognition of this - utilities are typically granted an “exclusive franchise service area” and assume an “obligation to serve” all customers in that area
- Utility Services can be delivered in a number of ways
 - Government Department
 - Stand Alone government owned Crown Corporation
 - Private Corporation
- The Method of Regulation / Approach to Rate Setting can be very different depending on the governance / organizational structure of the utility

Deregulation vs. Privatization

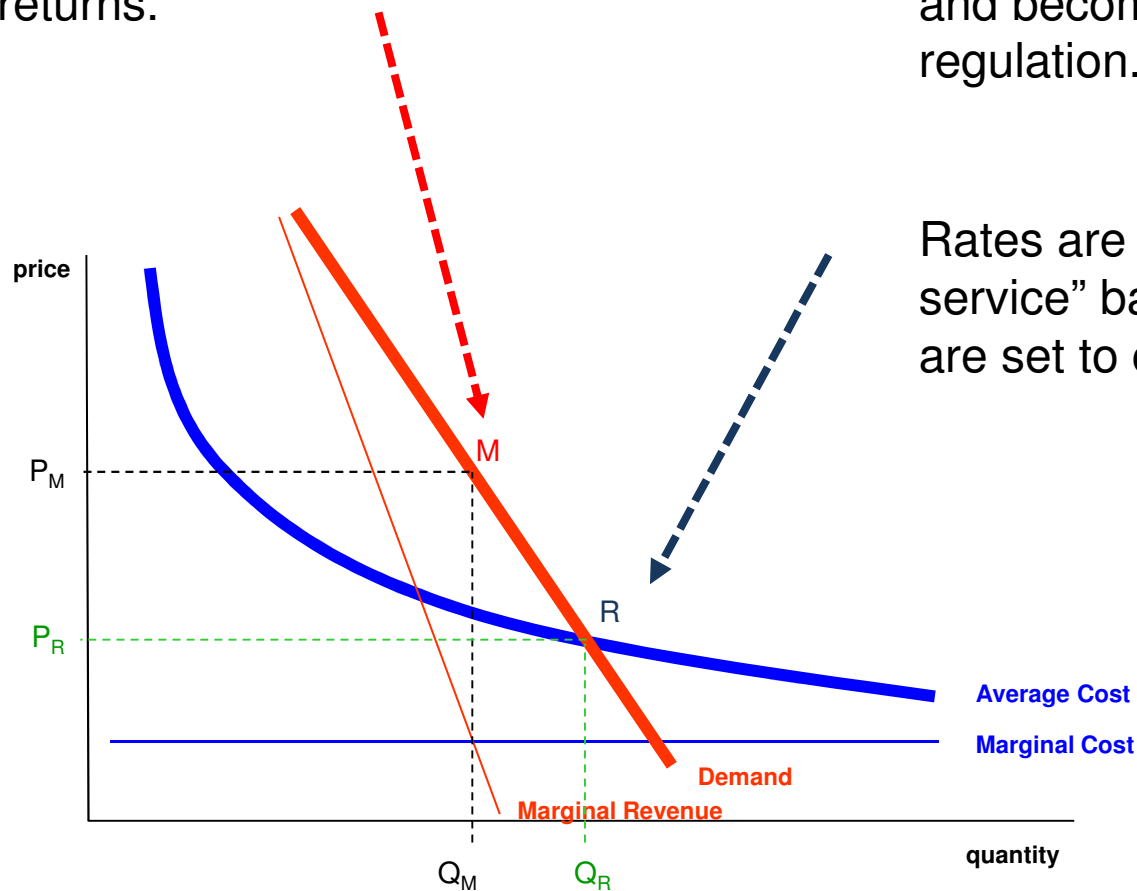
- De-regulation of an industry and Privatization of a government-owned business are different concepts that can get mixed together
 - The Decision to de-regulated an industry is related to industry characteristics – not ownership
 - Wireless, power generation, energy retailing
 - Privatization can be implemented for many reasons and can occur in a regulated or de-regulated industry
 - In a regulated setting - even-handed and predictable regulatory oversight is critical to investor confidence
 - In a de-regulated setting – level playing field concerns about fair competition by government owned entitles need to be addressed

	Regulated	De-Regulated
Government Owned	<ul style="list-style-type: none">• Prov. electric utilities• Municipal water & wastewater	<ul style="list-style-type: none">• Electric Generation
Privately Owned	<ul style="list-style-type: none">• Natural Gas• Electric T&D utilities	<ul style="list-style-type: none">• Electric Generation

Cost of Service Regulation

Left unchecked, firms characterized by natural monopoly could increase rates resulting in excessive returns.

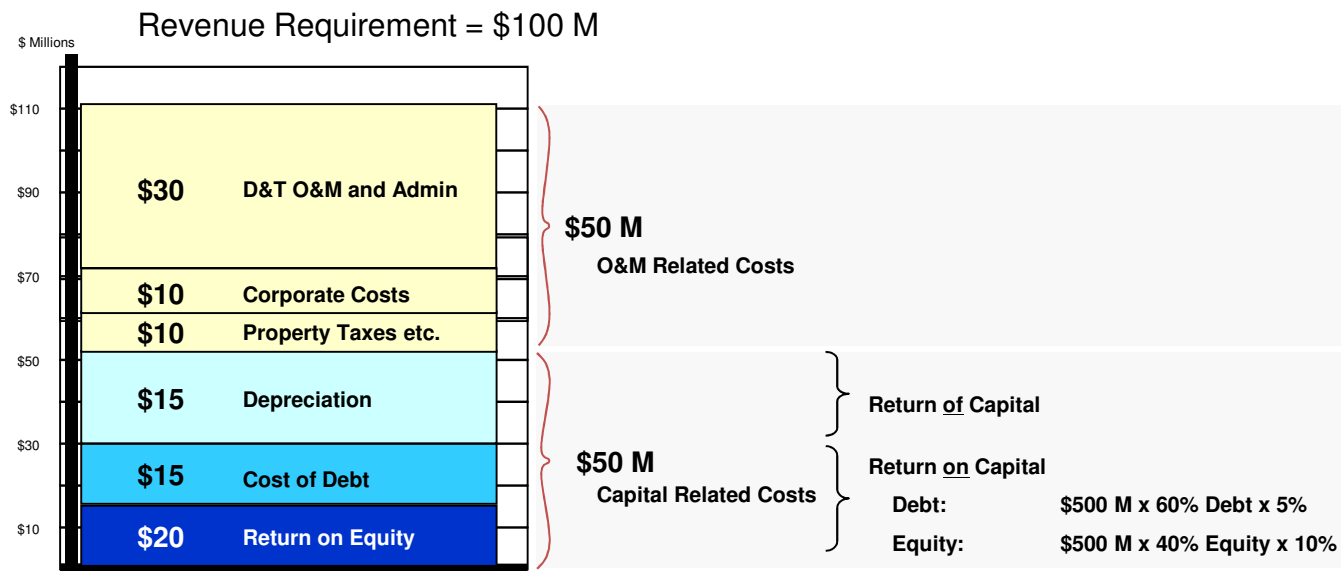
In return for the grant of an exclusive franchise service area, utilities assume an obligation to serve all customers within that area and become subject to rate regulation.



Rates are typically set on a “cost-of-service” basis meaning that rates are set to cover average costs.

Full Cost of Service Rates

- Utility rates are typically set on a full cost of service basis – meaning that all costs necessary to provide service are reflected in rates. This facilitates efficient resource allocation – not too high or too low.
- The Cost of Capital (Cost of Debt and Equity) should be priced to reflect the risks that are inherent with the investment in the utility.
 - This should be done by looking at the utility on a **stand-alone** basis. Failure to set rates in this manner risks cross-subsidy.
 - The utility should be capitalized with sufficient equity to support debt issuance without recourse to another entity / parent.
 - This ensures that the utility is financially self sufficient – entirely supported by cash flow from rates.



Government Services vs. Utility Services

- Governments are uniquely positioned to provide a range of services that have “public good” characteristics (emergency services, education, roads, transit, parks) etc.
 - Most of these government services are funded through general revenues because it is not practical or socially desirable to fund them through user fees
 - Toll road examples
 - Transit is often a mix of fare box and general revenue
 - Street lighting has utility characteristics but is not measureable – often funded from general revenue

Government Services vs. Utility Services

- Utilities services are different – the service is generally measurable and amenable to being fully funded through rates. Examples include:
 - Natural gas distribution
 - Long history of being provided by private firms
 - Electricity generation, transmission, distribution and retailing
 - Mix of crown corporations and private firm (power generation and retailing deregulated in some markets)
 - Water treatment and distribution and wastewater collection and treatment
 - Mostly municipal departments – some crown corporations and private forms

Private Vs. Crown Vs. Gov. Departments

- Private firms and Crown corporations can look and operate very similarly
 - Governance overseen by an independent board of directors
 - Looking for a fair return on their equity investment
 - Typically paying a cash dividend of 40% - 60% of earnings – may or may not have a commercial growth mandate
 - Typically raising debt on a stand alone basis – no recourse to parent / government
 - Independently regulated – provincial regulator - full cost of service rates
 - Use of Crowns to backstop large infrastructure projects (hydro generation) may be socially desirable in certain circumstances - but likely incompatible with a competitive / deregulated market structure

Private Vs. Crown Vs. Gov. Departments

- Utilities provided by a Government Department are different
 - Utility property may not be segregated in government books
 - Rates set through government budgeting process
 - Rates may only cover O&M costs – no allocation of corporate / indirect costs
 - Rates typically too low – not full cost of service – likely partially funded / subsidized by general revenues – sends an incorrect price signal about the value / scarcity of resources (water)
 - Capital funded from general revenue – or a cash reserve generated from a rate rider
 - Large capex funded by borrowing government on balance sheet
 - Large capex often is funded through grants from a higher order of government – creates significant uncertainty in meeting obligation to serve

How do P3s fit in?

- Used extensively by federal government and some provinces to fund / deliver social infrastructure – roads, bridges, LRT, hospitals, schools, courthouses, hospitals
- Produces a very low cost of capital
 - 90% debt capital structures with good credit ratings
- Facilitates life cycle risk transfer to project sponsor – instills market discipline
- Uses in some utility applications
 - For the East Ft. McMurray Transmission Line
 - For Evan Thomas Kananaskis water and WW treatment plant
 - For City of Regina WW Treatment Plant
 - To award power generation projects in managed markets
- P3 is a way to fund / deliver large plant builds for government utility departments that have not taken the step to organize as stand alone utilities
 - Provincial / federal grant funding may not otherwise be available
 - Municipal balance sheet may have insufficient room to fund needed capital
 - Promotes full cost of service rates (as it relates to infrastructure build)

Concluding Observations

- Utility Services are very amenable to being provided on a stand alone basis
 - Can be privately or publically owned
 - Best if governance is overseen through a fully independent board of directors
 - Best if utility is financial separate from shareholders – raises own capital without backstop
 - Best if rates are set by a capable independent regulator
 - Best if rates are set to cover full cost of service
- P3 is an alternative for large builds
 - Ownership can be retained by government
 - Life Cycle Risk can be transferred to proponent