



EPCOR Water Services Inc.

2008 Performance Based Regulation Progress Report

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Forward-looking Information

Certain information in this report is forward-looking and related to anticipated financial performance, events and strategies. When used in this context, words such as “will”, “anticipate”, “believe”, “plan”, “intend”, “target”, “expect” or similar words suggest future outcomes. By their nature, such statements are subject to significant risks and uncertainties, which could cause EPCOR’s actual results and experience to be materially different than the anticipated results. Such risks and uncertainties include, but are not limited to, operating performance, commodity prices and volumes, regulatory and government decisions, weather and economic conditions, competitive pressures, construction risks, obtaining financing and the performance of partners, contractors and suppliers.

Readers are cautioned not to place undue reliance on forward-looking statements as actual results could differ materially from the plans, expectations, estimates or intentions expressed in the forward-looking statements. Except as required by law, EPCOR disclaims any intention and assumes no obligation to update any forward-looking statement even if new information becomes available, as a result of future events or for any other reason..

Performance Based Regulation Progress Report¹

Highlights

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EPCOR Water Services Inc. (EPCOR Water) protects public health by providing a reliable supply of high quality water to over 200,000 residential, commercial and industrial customer accounts within the City of Edmonton. In 2006, Edmonton City Council approved the renewal of a five-year term covering the period April 1, 2007 to March 31, 2012 (2007-2011); to provide water services under the provisions of a performance based regulation (PBR) bylaw. This report serves as an update to the 2007 progress report issued in June 2008 and presented to City Council on July 9, 2008.

The PBR is intended to allow EPCOR Water to recover its costs and earn a fair rate of return while providing an incentive to manage its costs as annual increases to water rates are limited to less than inflation. Under the PBR model, EPCOR Water is required to meet operating performance standards in the areas of system reliability, water quality, customer service, environment and safety.

For customers in the Edmonton Region PBR delivers many benefits including:

- Assuring customers that their utility must meet performance standards
- Ensuring customers receive stable and predictable rates over the five year period
- Encouraging EPCOR to keep costs low and to find better and more efficient ways to operate the system
- Ensuring EPCOR is accountable for protecting customers from cost increases where possible

For the year ended December 31, 2008, the following highlights EPCOR Water's operating and financial performance under the PBR¹:

- EPCOR exceeded the operating performance standards established by City Council, achieving 103.3 points compared to the PBR target of 100 points.
- Under the provisions of PBR, 2008 actual net income was \$24.1 million compared to the PBR forecast net income of \$23.7 million.
- Completion of the E.L. Smith water treatment plant (WTP) upgrade increased overall system capacity by 25% while managing construction costs on budget during a challenging economic climate.
- Safety performance was significantly improved in 2008 resulting in a reduction of incidents by 91.5%, moving EPCOR towards a zero injury culture.

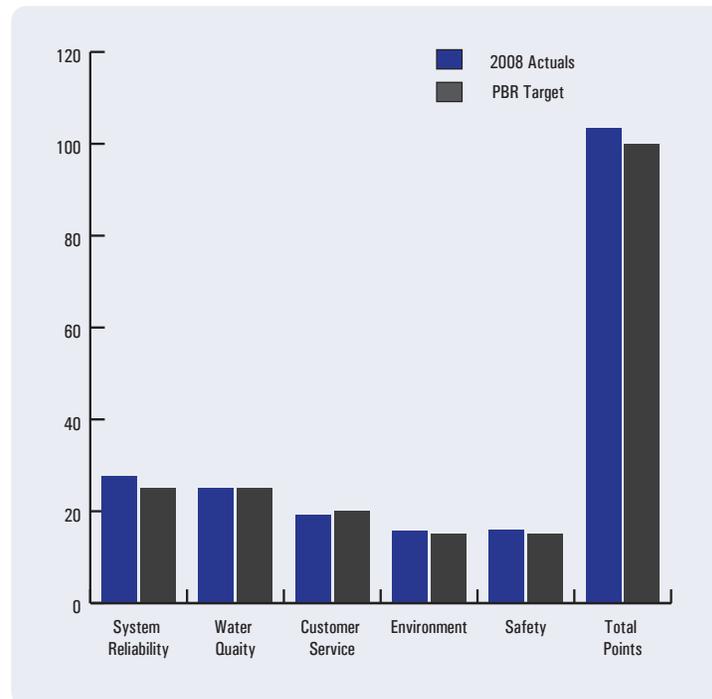
¹ For additional information relating to EPCOR Water's 2008 operating performance, refer to the "2008 Edmonton Water Performance Report" attached as information to this report and also available at www.epcor.ca.

Operating Performance

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In 2008, EPCOR Water exceeded the operating performance standards and this makes it the second consecutive year to record outstanding performance under the current five year renewal term of the PBR. The following graph summarizes EPCOR Water’s 2008 operating performance measures compared to the PBR target:

Graph 1: 2008 Operating performance measures vs. PBR targets



Refer to Appendix A for the detailed 2008 Water system service quality measures schedule. Further discussion of the 2008 results on each of the measures is provided below.

System Reliability Index

This index includes:

- a water main break factor to compare the number of actual breaks to the ten year rolling average in the bylaw;
- a water main break duration factor to ensure water main breaks are repaired within 24 hours from the time the water is shut off;
- a planned interruption factor which measures the extent to which customers are provided 48 hours advance notice;
- a water pressure factor to ensure no more than five incidents per year where water pressure is below 20 psi for two or more consecutive 15 minute periods; and
- a water loss factor to measure the amount of treated water that is unaccounted for within the waterworks system.

Operating Performance

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EPCOR Water performed very well on the system reliability index in 2008, earning the maximum points as it did in 2007. There are several factors, such as changes in temperature and soil conditions which can influence and create variability in the number of water main breaks in any given year. However, the 2008 results can be attributed to EPCOR Water's proactive approach to invest in preventive maintenance and water main replacement, focusing on those water mains that are most prone to break.

EPCOR Water recorded 583 main breaks in 2008, significantly lower than the PBR target of 630, although higher than the 2007 main breaks of 475 which was largely a result of extremely cold weather conditions early in 2008.

For 2008 PBR reporting purposes, the system water loss factor measured 3.57% compared to the PBR target of 4.9%, achieving maximum points for the reporting period.

Water Quality Index

This index is a summary of the percentage of the tests that EPCOR Water performs on drinking water quality in the City of Edmonton.

During the year, EPCOR Water performed 104,500 water quality tests, of which approximately 42,600 (for 97 substances) were conducted specifically on potable water - 99.8% met or exceeded the requirements. The remaining 61,900 tests were conducted in various parts of the treatment process and system. The water quality index target of 99.6% was surpassed in the face of raw water quality challenges during spring run off, significant rainfall events, and on-going maintenance of the distribution system. The water plant operations, distribution system operations and water quality assurance teams continued to meet strict internal water treatment and regulatory standards while meeting customer demands.

Operating Performance

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Customer Service Index

This index includes:

- a response time factor to measure the time that elapses from when EPCOR Water responds to a customer call to confirm a main break has occurred;
- a post service audit factor to measure customer satisfaction levels with those who rated their service experience “very satisfied” or “completely satisfied”; and
- a home sniffing factor to measure the percentage of volunteer community members who favorably assess the taste and odour of the drinking water during the spring run off season.

In 2008, EPCOR Water achieved 19.2 points for customer service, slightly below the targeted performance of 20 points. While the post service audit factor exceeded the target, the response time and home sniffing factors were below target. In 2008, the average response time factor of 25 minutes was slightly longer compared to the PBR target of 22 minutes. It is expected to remain above target for the remainder of the PBR period because of EPCOR’s safety policy requires field crew staff to pull over to a safe location before responding to a phone call.

Environmental Index

This index includes:

- emergency response training measured by the number of practice exercises undertaken in a year;
- regulatory reporting for completeness, timeliness and incidents; and
- supporting environmental initiatives measured by the water conservation factor (based on the average monthly water consumption per residential household) and a vehicle fuel efficiency measure to monitor litres/100 kilometers.

In 2008, EPCOR Water exceeded the target of 15 points to achieve 15.6 points for the environmental index. All measures either met or exceeded their targets. The vehicle fuel efficiency measure showed notable improvement over 2007 results, decreasing from 31.5 litres/100 km to 30.4 litres/100 km in 2008. The focus on education and training to increase awareness of vehicle fuel usage in 2007 contributed to the improved results in 2008.

Since 2005, EPCOR Water has gained 6% in vehicle fuel efficiency, resulting in a total savings of 30,400 litres of fuel.

Operating Performance

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Safety Index

EPCOR Water exceeded its performance on the safety index in 2008, achieving 15.9 points compared to the target of 15 points. This is a significant improvement over the 2007 results of 14.8 points and moves EPCOR towards its vision of a zero injury culture. The improvement reflects significant progress with no lost time incidents, no days lost to injury and is driven by the dedication and commitment by all EPCOR Water staff to conduct their work in a safe manner.

This index is measured by:

- training and monitoring through safety meetings, completing formal safe work plans, first aid training and work site inspections/observations; and
- lagging indicators including lost frequency rate, injury frequency rate and injury severity rate.

EPCOR Water places the highest priority on supporting a safe work environment and culture. In the 2007 PBR progress report, EPCOR Water indicated a continued emphasis in 2008 to achieve a zero injury culture through changes to safe work practices, linking of incentive pay to safety results, and the introduction of initiatives to refresh the focus on safety. New initiatives implemented in 2008 included the following:

- Hazardous energy isolation training at both plant facilities;
- Trench rescue procedures for all field staff;
- Introduction of hazard elimination procedures were introduced at the E.L. Smith WTP;
- Linking incident investigations, inspections, and observations to the hazard registry, and;
- Increased senior management accountability for safe work practices.

Financial Results

Economic Overview

In 2008, North American economies entered into a recession and some of this impact has been felt by EPCOR Water. Housing demand has declined and growth in the Edmonton area is expected to be modest over the short term. Although customer growth in the past three years has been significant, a decline in the water consumption per customer has offset growth in water sales. Increased availability of water efficient appliances and the adoption of conservation practices by consumers have contributed to the decline in water consumption.

Prior to the recent recession, operational, labour and materials costs had been rising, and EPCOR Water experienced the pressure of this movement upward in costs. With the shift into a recession in the latter part of 2008, declining costs and greater availability of labour and contractor resources alleviated some of this cost pressure into future PBR reporting periods.

Weather risk can have a significant impact on EPCOR Water's operations and financial results. Melting snow, freeze/thaw cycles and seasonal precipitation events in the North Saskatchewan River watershed affect the quality of water entering our water treatment plants and the resulting costs of purification.

As with most organizations, EPCOR Water is facing the demographic shift where a large number of employees are expected to retire over the next few years and the market for labour and management is extremely competitive. EPCOR Water and its parent company, EPCOR Utilities Inc. (EPCOR), continue to monitor and review our human resource strategies to ensure we attract and retain a strong supply of labour and management. In 2008, additional staff were hired in key operational areas to allow for training and development to achieve future succession plans.

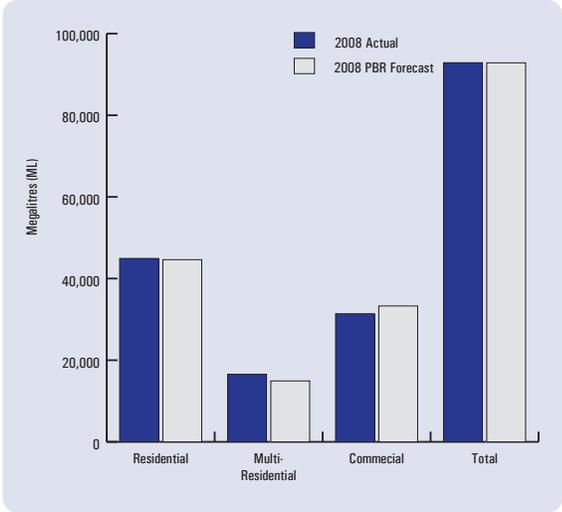
Annual Water Consumption

In 2008, actual water consumption within the City of Edmonton was 92,869 megalitres (ML) compared to the forecast of 92,839 ML. This chart breaks down consumption by customer group. Residential single family use continues to be 50% of total annual demand.

In 2008, Edmonton reported one of the lowest water usage rates for single family residential customers with an average of 237 litres per capita per day (l/c/d) compared to the average of 266 l/c/d for Canadian residential customers living in large metered communities.

In comparison with the 2008 PBR forecast, actual consumption reflects an increase in housing demand especially in mutli-residential dwellings, partially offset by lower consumption from the commercial customers to introduce water efficient initiatives into their operations.

Graph 2: Annual water consumption by customer class



Financial Results

Net Income

For the year ended December 31, 2008, the actual net income was \$24.1 million compared to the 2008 forecast of \$23.7 million, an increase of \$0.4 million. The increase is primarily due to higher revenue and lower depreciation and interest expense, offset by higher operating costs.

	(\$ in millions)	2008 PBR Forecast	2008 Actual
	Revenue	\$126.9	\$131.9
Less:	Operating Costs	\$55.3	\$63.5
	Franchise Fee	\$9.4	\$9.6
	Depreciation	\$15.6	\$13.5
	Interest Expense	\$22.9	\$21.2
	Net Income	\$ 23.7	\$ 24.1

In 2008, actual revenue of \$131.9 million represents an increase of \$5.0 million compared to the 2008 PBR forecast. The increase in revenue is attributable to the impact of higher than forecasted inflation rates on annual water rate increases and higher than forecast revenue from services such as temporary services, water permits and late payment penalties. Actual depreciation and interest expense were lower than forecast by \$2.1 million and \$1.8 million, respectively, primarily due to the delays in spending in the final phase of the multi-year E.L Smith WTP upgrade project and the impact of lower than forecast cost of debt (actual 6.41% vs. forecast 6.97%). The final phase of the \$140 million E.L. Smith WTP upgrade project was commissioned in June 2008 rather than late 2007 as originally anticipated in the PBR forecast.

Actual operating costs were \$63.5 million compared to PBR forecast of \$55.3 million, an increase of \$8.2 million. Inflation rates in 2008 were higher than the forecasted rates and contributed in part to the cost increases. In addition, increased staffing levels to support succession planning, and the impact of higher incidence of main breaks resulted in increased maintenance costs. In recent years, utilities such as EPCOR Water have experienced increasingly rigorous financial controls, financial reporting, and corporate governance controls. These trends have resulted in increased costs in 2008 associated with management and administrative support services provided by EPCOR. To manage these increasing demands and cost impacts, there has been a focus on updating corporately shared management tools and systems, corporate processes and organizational structure to identify opportunities for increased process efficiencies. In the short term, this has resulted in increased consultant costs in the areas of information systems and human resources to support future process improvements and efficiencies. These cost increases were partially offset by lower chemical costs and deferral of major maintenance and repair work to 2009.

In recent years, EPCOR Water has experienced a trend in industry towards operating in an environment with increasingly rigorous financial controls, financial reporting, and corporate governance controls.

Financial Results

Return on Equity

The rate of return on equity approved for the five-year term in the PBR plan (2007-2011) is 11.25%. It is expected the average rate of return on equity achieved over the five-year term will be close to the approved rate of return. Actual returns in any particular year can be higher or lower, depending on the actual operating and capital costs reported that year. In 2008, the rate of return on equity achieved was 12.28%, a decrease of 3.01% compared to 2007, reflecting the impact of the increased costs associated with the commissioning of the final phase of the E.L. Smith WTP upgrade project as well as impact of rising labour and material costs experienced during the year. Over the two year period (2007-2008), the average rate on equity achieved was 13.79%.

Capital Spending

Overall, in 2008 EPCOR Water invested \$58.7 million in capital additions compared to the 2008 PBR forecast of \$43.5 million.

(\$ in millions)	2008 PBR Forecast	2008 Actual
Capital Additions excluding EL Smith WTP Upgrade	\$43.5	\$48.1
EL Smith WTP Upgrade	\$ -	\$10.6
Total Capital Additions	\$43.5	\$58.7

The increase is primarily due to carryover spending for the E.L. Smith WTP upgrade project of \$10.6 million as delays in the project resulted in capital spending originally planned for 2007 to be shifted to 2008. The final phase of the E.L. Smith WTP upgrade project was completed and commissioned in June 2008. The upgrade reuses existing infrastructure and increases the Capital Region's water supply capacity by 25%. The design also includes an award winning environmentally-friendly water disinfection system and a water intake system that diverts and returns fish safely downstream preserving aquatic life in the North Saskatchewan River. Other capital additions for 2008 were \$48.1 million compared to the forecast of \$43.5 million, an increase of \$4.6 million primarily due to higher than forecast projects carried over from 2007.

EPCOR Water's capital program for 2008 includes projects for upgrades and replacement of the waterworks infrastructure, as well as projects to support customer growth driven expansion of the system and changes in regulatory requirements.

In 2008 EPCOR Water completed the upgrades to its E.L. Smith Water Treatment facility and the innovative design of this plant was recognized with an Emerald Award for environmental leadership.

Financial Results

Major capital projects in 2008 included:

- Cast iron renewals (\$17.7 million) - replacing an average of 15 km per year of pipe. Cumulatively, EPCOR Water has replaced 60% of its cast iron pipe over the past 30 years,
- EL Smith dechlorination (\$4.6 million) - enhancing the aquatic environment of the North Saskatchewan River,
- South light rail train (LRT) water pipe network modifications (\$2.1 million); and
- Meter purchases and changeouts (\$1.9 million); to improve efficiency of reading and customer service support capability.

Rates Comparison with Surrounding Communities and Other Regions

Edmonton residents enjoy water rates competitive or lower than City of Calgary rates.

The comparative 2008 water rate information is based on the surveyed water utilities of Calgary, Vancouver, Winnipeg and Alberta Capital Region represented by communities surrounding Edmonton including St. Albert, Fort Saskatchewan, County of Strathcona and the City of Leduc. The rate comparisons are based on the total cost to the customer and included fixed charges, consumption charges plus any surcharges.

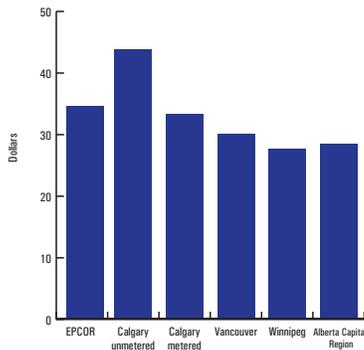
The residential water comparisons are based upon a consumption of 19 cubic metres per month (m³/month). This is representative of the average monthly consumption of an EPCOR Water residential customer. Comparisons are not made for the multi-residential customer class as many jurisdictions do not have similar rate class. Comparisons are provided for three types of commercial customers:

- i) small commercial business representative of a typical restaurant;
- ii) medium commercial business representative of a hotel or large shopping centre; and
- iii) large commercial customer representative of a large-scale commercial enterprise, like a brewery or food processing plant.

Financial Results

Residential Water Monthly Bill Comparison

(based on an average monthly consumption of 19 m³)



Despite Edmonton having a challenging water source, treating water to higher standards and completion of major facility upgrades, residential customers of EPCOR Water pay much less than an unmetered Calgary resident and are comparable to the metered residents of Calgary. Vancouver and Winnipeg reflect lower rates as both cities only disinfects water with chlorine resulting in lower water treatment costs. The Alberta Capital Region's lower water bills reflect the lower costs associated with maintaining a newer distribution system compared to the EPCOR waterworks system.

Commercial Water Bill Comparison

Overall in the commercial water segment, EPCOR Water's charges are competitive compared to the other surveyed utilities as demonstrated in the table below:

	Small	Medium	Large
Commercial Business	Restaurant	Hotel / Hospital	Brewery / Processing Plant
Average Monthly Consumption (m³)	325	6,000	20,000
EPCOR Water	\$344	\$4,897	\$14,084
Calgary	\$396	\$5,375	\$13,836
Vancouver	\$212	\$3,707	\$12,368
Winnipeg	\$391	\$5,790	\$18,106
Alberta Capital Region	\$393	\$7,135	\$26,183

Future Plans and Challenges

Water industry trends over the PBR period will include the following challenges for all water utilities:

- impacts of economic recession,
- increased stakeholder expectations,
- climate and environmental changes,
- moderate population growth, and
- shortages of skilled labour forces.

EPCOR Water continues to monitor these trends to assess the impact to our business.

Our long term focus on maintaining and rehabilitating distribution networks and plant facilities places us ahead of the curve in managing Edmonton's water infrastructure.

Housing demand has been slowing and growth in the City's population is expected to be modest over the short term. Although customer growth has been significant in recent years, a slowing of growth was noted in the latter part of 2008 and this trend is expected to continue in 2009. Sales growth has also been affected by the increased availability of water efficient appliances (ie. low flush toilets, front loading washing machines) and conservation initiatives. EPCOR also advocates the importance of wise water use. A small annual increase in base demand over previous years is expected. However, weather-dependent water sales will always remain significant but difficult to predict.

Major projects like the Anthony Henday and LRT projects are resulting in requirements to relocate water transmission mains that have exceeded the level anticipated in the PBR forecast. EPCOR Water is working with the City and the Province of Alberta to minimize these impacts through utility alignment reviews early in the design phase. The increase in main breaks in the early part of 2009 will escalate the number of water mains qualifying for renewal. EPCOR Water is reviewing its 2009 program to determine whether more use of water main lining and other protection methods may reduce the number of breaks and resulting impacts to customers.

A continuing focus on process improvement will allow us to manage operational costs. EPCOR Water will continue to manage its power costs by optimizing reservoir operations and pump scheduling, training operators on energy efficient procedures, and by replacing equipment as needed with energy efficiency in mind. EPCOR Water will also continue to effectively manage its power costs by monitoring time of use and limiting exposure to pool prices. These efforts will become of increasing importance as our existing power contracts expire over upcoming years.

While price increases for water treatment chemicals are expected in 2009, the impact will likely be mitigated through chemical use optimization strategies. Other process improvement and efficiency initiatives include continued efforts towards improving vehicle fuel efficiency, and utilizing existing staff strategically to complete capital projects that also allow for succession planning.

Future Plans and Challenges

Of significance in the area of operational excellence, 2009 will be the first full year of implementation of a process redesign effort, which involved redesigning core operating processes for EPCOR's water treatment plants. The addition of staff to support work scheduling, prioritization and maintenance oversight as well as other improvements are expected to generate increased productivity and efficiencies.

EPCOR Water will continue its proactive approach to ensuring that it exceeds current and proposed environmental standards as well as meet the needs of its stakeholders. In 2009, EPCOR Water Services will continue developing plans to minimize the impact of treatment plant residuals on the environment. This involves dechlorination of residuals currently being tested at the E.L. Smith WTP plant and under design at the Rosssdale plant. EPCOR Water will also continue the lead sampling program it launched in 2008 to offer free tap water testing and filters to 5,000 customer homes built before 1950 that receive their water through lead service lines. The remaining 50% of homes not visited in 2008 will be tested and be provided the option to replace the service line. EPCOR Water will fund the portion of the pipe leading up to the property line and the customer will be responsible for the cost to replace pipe on their property.

EPCOR Water continued work on the Cost of Service study that is expected to be completed in the third quarter of 2009. The study ensures the costs associated with the operations and maintenance of the water infrastructure system and treatment and distribution of potable water are fairly and appropriately allocated to the various customer groups. Stakeholders, including the City of Edmonton, have been engaged in this process to obtain feedback and keep them informed on issues impacting them. Study results will be used to determine whether the rates that are charged to various customer classes are covering the costs of water treatment and delivery to those classes

In addition to the internal programs driving change and efficiency, EPCOR Water is responsive to external initiatives that will shape future operations. The Province of Alberta, through the Alberta Water Council and its Water for Life strategy, is advocating conservation planning for all water-use sectors, including municipalities. In 2009, the Alberta Urban Municipalities Association (AUMA) is developing the Sector Conservation plan for municipalities, after which each municipality will develop its own plan based on the AUMA template along with its own unique priorities. It is anticipated the template will focus on promoting efficient fixtures and water loss minimization over the next 10 to 20 years as well as establishing a future target for per capita use in municipalities.

Future Plans and Challenges

The Canadian Institute of Chartered Accountants (CICA) confirmed plans to converge Canadian Generally Accepted Accounting Principles (GAAP) with International Financial Reporting Standards (IFRS) for Canadian reporting issuers effective January 1, 2011, including comparative figures for the prior year. EPCOR has established a core team to develop a plan which will result in EPCOR's first interim report for 2011 being in compliance with IFRS. EPCOR Water, as a subsidiary of EPCOR, is participating in this IFRS convergence project.

Based on analysis thus far, the most significant differences between Canadian GAAP and IFRS for EPCOR Water will be in the areas of property, plant and equipment, and regulatory accounting. Differences in the area of regulatory accounting between current Canadian GAAP and IFRS may necessitate reporting financial information for external reporting purposes under IFRS differently than what is required for regulatory purposes. However, regulatory accounting standards under IFRS are still under review by the International Accounting Standards Board. As further work is done on IFRS convergence, EPCOR Water will advise the City of any issues impacting them in their role as regulator of EPCOR Water.

The current term of EPCOR Water's PBR plan will expire in March 2012. EPCOR Water would like to solicit input from City Council and Administration on possible new performance criteria that would be included in the renewal of PBR, expected to occur in 2011.

EPCOR Water experienced excellent operating and financial performance in 2008. With the E.L. Smith WTP Upgrades complete, water quality and reliability standards maintained and exceeded, along with a strong focus on environment, safety and customer satisfaction, EPCOR Water is well positioned to continue this performance in 2009.

EPCOR Water considers that PBR has been beneficial for citizens, City Administration, and EPCOR since 2001.

Appendix A: 2008 Water System Service Quality Measures Schedule

Description	Standard Performance	Actual Performance	Points Earned
System Reliability Index			
Water Main Break Factor	630	583	5.4
Water Main Break Repair Duration Factor	93.6%	89.1%	4.8
Planned Interruption Factor	95.0%	96%	5.1
Water Pressure Factor	5	0	6.0
Water Loss Factor ^[3]	4.9%	3.57%	6.4
System Reliability Index			27.5^[1]
Water Quality Index			25.1
Customer Service Index			
Post Service Audit Factor	72.6%	74.5%	6.8
Response Time Factor	22	25	5.8
Home Sniffing Factor	93.4%	92.6%	6.6
Customer Service Index			19.2
Environmental Index			
Emergency Response Training	3	5	4.5
Completeness of Reporting	100%	100%	1.9
Timeliness of Reporting	100%	100%	1.9
Environment Incident Reporting	0	0	3.7
Water Conservation	20	19.6	1.5
Vehicle Fuel Efficiency	30.08	30.44	2.1
Environmental Index			15.6
Safety Index			
Emergency Response Training	40	42	1.5
Formal Safe Work Plans	3486	2932	3.1
First Aid Training	33%	47%	3.0
Work Site Inspections/Observations	800	847	3.0
Lost Time Frequency Rate	.59	0	1.1
Injury Frequency Rate	2.4	.29	2.1
Injury Severity Rate	8.92	0	2.1
Safety Index			15.9
Aggregate Points Earned (sum of all indices)			103.3
Points Required at Performance Standard			100.0
Points Above / (Below) Performance Standard			3.3
Water System Service Quality Penalty, If Any			\$0.00 ^[2]

[1] Maximum points achieved for System Reliability Index.

[2] In accordance with Schedule 3 Section 3.0 Water System Service Quality of Waterworks Bylaw No. 12585, there is no water system quality penalty to be assessed as the points earned are above 100.

[3] Water Loss Factor standard and actual performance reported above does not reflect a recently revised measurement methodology utilized for other reporting purposes. The methodology used to determine the standard performance measure in Waterworks Bylaw No 12585, as amended, has been retained in calculating the actual performance to allow for comparability to the performance standard.

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