Financial, Rate and Regulatory Review of the
Waste Management and Drainage Service Utilities

Draft Final Report

June 2009

Prepared by:
HDR Engineering, Inc.
June 1, 2009

Ms. Lorna Rosen  
General Manager of Asset Management  
And Public Works Department  
City of Edmonton  
3rd Floor, Century Place  
9803 – 102A Avenue  
Edmonton, Alberta T5J 3A3

Subject: Draft Final Report on the Financial, Rate and Regulatory Review of the City’s Waste Management and Drainage Services Utilities

Dear Ms. Rosen:

HDR Engineering, Inc. (HDR) is pleased to present the draft final report on the financial, rate and regulatory review of the City’s Waste Management and Drainage Services Utilities. The main objective of this study is to review alternatives for the financial planning, rate setting, regulatory and governance structure of these utilities and provide recommendations to improve the overall process and the communication between the Utility Management and the City Council. This report outlines the review and research used within this study. We have provided a summary of our findings, conclusions and recommendations.

This report has utilized various documents and reports from each of the utilities. At the same time, as a part of this study HDR has interviewed a number of individuals from the City Council and the utility’s management team.

We appreciate the assistance provided by the utilities management and staff in the preparation of this study.

Sincerely yours,

HDR Engineering, Inc.

Tom Gould  
Project Manager and National Technical Director of Finance and Rates
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### City of Edmonton – Financial, Rate and Regulatory Review
Executive Summary

Introduction

HDR Engineering (HDR) was retained by the City of Edmonton to review the financial planning and rate setting process used by the City’s Waste Management and Drainage Services Utilities. As a part of this study, HDR also reviewed the governance structure and regulation of these utilities. The main objective of this study is to review alternatives for the financial planning and rate setting processes, along with the governance and regulatory structures utilized and provide recommendations to improve the overall process and communication between the Utility Management team and the City Council.

The City of Edmonton (City) owns and operates the Waste Management and Drainage Services Utilities. These utilities provide wastewater, solid waste and land drainage services for the City. One of the challenges of any utility is to be well-managed, financially self-sufficient and to have a governing body that provides clear policy guidance to allow management to operate and maintain each utility in the best interests of the City and the public it serves. Simply stated, these utilities are essentially multi-million dollar enterprises that should be run in a business-like manner. That statement implies that each utility is operated on a “stand-alone” basis and has adequate written financial and rate setting policies to guide management in their day-to-day operating decisions. At the same time, each utility must have a financial and rate setting framework in place to allow for the proper and adequate investment in infrastructure; be it replacement, growth or regulatory-related. Finally, each utility must have a governance and oversight “process” that is consistent in both timing and approach and results in prudent and rational decisions concerning each utility.

The City’s Need for This Study

From a governance and regulatory perspective, a municipal utility is particularly challenging for a City Council because the City Council is not solely focused on the policy issues associated with the utility, but instead the governance of the overall City. Often, the only time the management team of the utilities has an opportunity to update the City Council on the activities and status of the utilities is during the budgeting and rate setting process. Given the complexity of issues associated with these utilities, this limited and infrequent feedback is often inadequate; from the perspective of the utility management team and the City Council.

During the last budgeting and rate setting process, the utility management team was less than satisfied with the overall process. At the same time, in our interviews with City Council members there appeared to be a mutual recognition of the need for a better approach or process. A core theme heard during this study from both utility management and the City Council was the issue of communication and feedback and creating a better framework to
allow for the meaningful dialogue and policy discussion. With that in mind, HDR began to explore various alternative rate setting methodologies, along with regulatory and governance structures.

In conducting this review, three key areas were reviewed: establishment of fiscal policies, the financial/rate status of the Utilities, and the governance/regulatory structures of the City’s utilities. During the course of this study, HDR interviewed and discussed these issues with key utility management team members, the City Manager, and with certain City Council members. All City Council members were invited to be interviewed as a part of this study and seven City Council members and the Mayor accepted that invitation.

Strategic Plans of the Utilities

An important starting point for this study is simply understanding each of the utilities (sanitary, land drainage and solid waste) from a business and service level perspective. As noted in the previous section, utilities are typically multi-million dollar “businesses” and the City’s utilities are no exception to this observation. As multi-million dollar businesses, they need to be properly managed, regulated and governed in a manner that fits their overall size and complexity.

In 2008 the City Council adopted the City’s Strategic Plan 2009 – 2018. The plan articulates the City’s vision, ten-year strategic goals and three-year priority goals to guide decision making throughout the City. The major ten-year goals of the City are as follows:

1. Preserve and Sustain Edmonton’s Environment
2. Improve Edmonton’s Livability
3. Transform Edmonton’s Urban Form
4. Shift Edmonton’s Transportation Modes
5. Ensure Edmonton’s Financial Sustainability
6. Diversify Edmonton’s Economy

The utilities have developed financial plans, budgets, business plans and policies that strive to meet the overall ten-year and three-year goals of the City. Each department has developed strategic plans in order to achieve the three-year goals and performance measures that will lead the City to accomplishing the overarching ten-year goals.

Comparing Public and Private Utilities

The City’s utilities are municipally owned and operated. There are two basic types of utilities in existence today – a publicly-owned municipal utility and a privately-owned utility. Most customers may not comprehend the distinction between these two types of utilities, but there are a number of distinct differences. These distinct differences are discussed in detail below.

Ownership – A public utility is owned by the municipality or the in-City customers of that utility. In contrast, a private utility is owned by shareholders who probably are not customers of the utility.

Financial/Business Objectives – A municipal utility is generally considered to be a not-for-profit enterprise. The business objective of the municipal utility is to provide the best quality service at the lowest reasonable cost. In contrast to this, a private utility is a “for profit” business
Understanding the differences between a public and private utility is important as it relates to this study. Edmonton’s utilities are not “purely” public or private and finding the proper balance between those two perspectives is an interesting challenge.

Methodology to Establish User Rates – The method around which the user rates are established for each of these types of utilities also varies. The primary difference in rate setting is that a municipal utility primarily focuses on the “cash needs” of the utility, absent any profit motive. In contrast to this, a private utility establishes their rates in order to earn a “fair” return on their investment.

Governance – Governance refers to the leadership and policy governance of the utilities. For a municipal utility, governance is typically provided by the City Council. However, there are exceptions to this where a municipal utility may have a Utility Board or other separate governing body. For a private utility, the governing body is typically an elected Board of Directors. The members of the Board of Directors are elected by the shareholders of the utility.

Regulation – Regulation refers to the regulatory oversight and establishment of rates and fees. Regulation is intended to balance the financial needs of the utility against the requirement for fair and equitable rates for customers. For a private utility with a profit motive, regulation and oversight is typically provided by a public utility commission, such as the Alberta Energy and Utilities Board (AEUB). In contrast to this, a municipal utility does not have a profit motive (per se) and is typically regulated by the City Council.

As can be seen, there are some significant differences in the ownership, financial/business motives, governance and regulation of a public and private utility. In the case of Edmonton and how the utilities are viewed, the line between a public utility and a private utility can become blurred. Provided below is an overview of HDR’s perception of the City’s utilities.

Ownership of Edmonton Utilities - Technically, Edmonton is a municipal utility and the utilities are owned by the citizens of Edmonton. However, the City views the ownership of the utilities much like a private utility in which the City is the sole owner of the “stock” in the utility.

Financial/Business Objectives of Edmonton’s Utilities – The financial/business objectives of the City’s utilities are again, a combination of public and private utility perspectives. The objective is to provide the highest quality service, while earning a “fair” return on its investment. This doesn’t produce the lowest possible rates, but rather, provides for “competitive” rates.

Governance of Edmonton’s Utilities – Policy governance is provided by the City Council.

Regulation of Edmonton’s Utilities – Regulation and establishment of rates and fees is provided by the City Council. When attempting to earn a “fair” return on investment, this does provide a “tension” in the balance between the financial needs of the utility/City and the rates paid by the City’s customers.

Understanding the differences between a public and private utility is important as it relates to this study. Edmonton’s
utilities are not “purely” public or private and finding the proper balance between those two perspectives is an interesting challenge.

Overview of the Utilities

A brief overview of the utilities and their operations may provide a better understanding of the complexity of these utilities.

Sanitary (Wastewater) Utility – The Sanitary Utility serves over 750,000 in population and is the largest utility within the Drainage Utility. This utility is responsible for all aspects of the collection and conveyance of sewage to the wastewater treatment plant (WWTP). The utility is organized around Planning, Operation, and Design and Construction.

Of the three sections within the utility, Design and Construction services are provided not only to the sanitary and land drainage utilities, but also to other City departments and to outside organizations, including EPCOR. In this way, the Design and Construction section generates revenue for the utility. More importantly, the Design and Construction section appears to be a “non-regulated” service. For a private utility regulated by a public utility commission, the utility’s “regulated” activities are the core services associated with the utility (e.g., collection and treatment of wastewater) and the “non-regulated” activities are those activities which may not be considered essential to the delivery of the core “regulated” activities. This is an important distinction in that “regulated” activities or services should not subsidize “non-regulated” activities or services.

The annual investment in capital projects for this utility is significant even with WWTP operations being assumed by EPCOR. User rates are the largest single revenue source for the utility and in 2009 they are anticipated to be approximately $110 million.

Land Drainage Utility – The Land Drainage Utility is focused on storm and surface water management. The utility is focused on managing both quantity and quality of runoff. At approximately $24 million in revenue, the Land Drainage Utility is much smaller in size than the Sanitary Utility, but at the same time a “newer” utility. The Land Drainage Utility began charging user rates in January 2003. Prior to that point, these costs were being funded via property taxes. The utility serves residential, commercial, and industrial customers; all service is within the City limits. The average household pays approximately $60 per year, depending on lot size and land zoning. Billing is provided by EPCOR on the monthly water bills.

Waste Management Utility – The Waste Management Utility is a completely separate Branch from the Drainage Utilities, and is one of the four Branches in the Asset Management and Public Works Department. In January 2009, the utility converted to user rates from property taxes. This utility provides all garbage and recycling collection and disposal for approximately 320,000 residential households, including multi-family within the City. Non-residential customers have optional collection services available through contracted service with the City or other private entities. The utility disposes of solid waste and recycling materials collected within City limits at the Edmonton Waste Management Centre (EWMC). At this facility there is also an e-waste (electronic waste) facility. This utility has approximately $87 million in annual revenues from user fees/rates.

1 The transfer of the Gold Bar Wastewater Treatment Plant was being finalized during the course of this study.
Review of the City’s Fiscal Policies for the Utilities

In establishing user rates for a municipal utility, the establishment of a set of fiscal policies as they relate to the financial planning and rate setting process provides a significant benefit to management and the overall rate setting process. Absent a clear set of policies, utility management is left to presume or guess the City Council’s desired approach to the key parameters of the financial planning and rate setting process. As a part of this study, the City’s current fiscal policies for each utility were reviewed.

It is interesting to note that few municipal utilities have a strong or complete set of written financial and rate setting policies. To the City’s credit, the utilities do have fiscal policies which help guide the financial planning and rate setting process. Ultimately, financial policies provide a strong foundation for the long-term financial sustainability of the utilities and will provide the outside financial community with a better understanding of the City’s commitment to managing each of the utilities in a financially prudent manner.

The Government Finance Officers Association (GFOA) has established a framework for establishing these types of policies. The GFOA represents both Canadian and U.S. finance professionals and provides an important source for best management practices in this area.

In considering or reviewing fiscal policies, it should be noted that the basic framework should be consistent between utilities, but the actual policies related to a specific utility may vary based upon the unique characteristics and financial requirements of that utility (e.g., minimum reserve levels).

The City’s existing financial policies are found in Policy C304 B entitled Utility Fiscal Policy and Policy C203C entitled Debt Management Fiscal Policy. The City defines a utility as a self-funded operation providing a service to its customers, including a return on investment, at rates regulated by City Council.

The Sanitary and Land Drainage operations are considered utilities and the Utility Fiscal policy sets fiscal guidelines on debt service coverage, rate of return on investment, capital financing, dividend payments, cash reserves and local access fees. The intent of these policies is to maintain the financial health of the utilities and protect the City’s investment.

Overall, the City’s fiscal and debt policies are very comprehensive. In conducting our review, it was noted that the City is very reliant upon the dividend payment being made by the Sanitary Utility. In that respect, the dividend payment has moved from a “below the line” payment based upon “profitability” to a part of the Sanitary Utility’s cost of doing business.

The Land Drainage Utility has similar policies as the Sanitary Utility, but is exempt from the local access and dividend payments until 2014. The Utility will be reviewed at that time to determine the level of local access fees and dividend payments, as appropriate.

“The key for the City Council and management is to ensure the City adheres to sound financial policies and practices and the policies established represent utility management and City Council values and objectives.”
The Waste Management Utility needs to have policies developed that are similar in structure to the Sanitary and Land Drainage Utilities. The Waste Management Utility is currently exempt from paying dividends for ten years.

The City’s debt policies for the utilities are very thorough, but as an observation, the policies should provide some flexibility for the City to take into consideration issues such as the cost of debt, size of projects, and timing of issuance. The current policy appears fairly rigid, but in practice, the City may find this policy workable.

This report provides suggestions for additional fiscal or rate setting policies. These may include a description of the methodology to be used to establish rates for each utility, establishment of policies and plans for asset acquisition, maintenance, replacements and retirements, and policies to guide the design of programs and services.

Overall, the City has strong fiscal and debt policies for the Utilities. The policies should be routinely reviewed by the City Council to assure that they still meet the overall goals, objectives and vision of the City Council for the Utilities. These policies help provide guidance (governance) to the Utilities as they develop their financial plans and proposed rates.

Review of the Financial and Rate Status of the Utilities

A review of a variety of aspects of the financial and rate status of each Utility was undertaken. The primary objective of this review was to determine whether the Utilities are adequately funded.

Budgeting/Rate Setting Process - The regulatory process to establish budgets and rates is a part of the City’s overall general government budgeting process. Based upon interviews conducted as a part of this study, there is general consensus from those interviewed that the current budgeting and rate setting process is inadequate and needs to be revised. The current approach does not provide adequate time to review the issues, challenges and concerns that the City Council may have with the proposed budgets and rates. It was noted that a separate budget and rate setting process from the City’s general government budgeting process should be considered.

Reporting - Like all municipal utilities, the City Council typically does not have expertise in utility rate setting and is therefore required to make decisions concerning utility rates with limited technical knowledge. The City Council and Mayor would like to be better informed about the status of the Utilities, their performance and overall efficiency. In response to the City Council’s concerns the Utilities need to be cognizant of this issue and provide the City Council and Mayor with a better process of reviewing strategic plans, budgets and rates. Only through greater communication can the City Council have greater comfort that the rates being proposed are “fair and equitable.” To help achieve this overall objective, the Utilities will need to improve their financial and performance measurement reporting.

Rate Setting Methodology – Public utilities typically use a methodology to establish rates based upon their “cash needs.” In contrast to this, a private utility typically utilizes a methodology that includes a “fair” return on investment. The City’s rate setting methodology more closely conforms to that which would be used by a private utility. Provided below in Figure ES-1 is an overview of the general methodology used by the City to establish the rates, particularly for the Sanitary and Land Drainage Utilities.
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Review of the Utilities’ Rate Models – Each utility has developed a financial planning and rate model. The City’s fiscal policies, for the most part, “drive” the results of these models. It was noted that the City has in recent years deviated from their established fiscal policies, particularly as it relates to the planned amount of dividend payments. Deviating from the City’s fiscal policy as it relates to dividend payments (i.e. greater dividend payments than planned) may have substantial long-term negative impacts if the City Council continues this practice. The result will be such that the Utilities will either have substantial deferred capital projects or be heavily in debt having debt financed the capital projects with the potential of rates not remaining competitive. In that respect, the City Council must be cognizant of the impacts of their decisions.

Under the current methodology of earning a return on investment, the City Council must find the delicate balance between ensuring rates are reasonable over time, while attempting to maximize return on investment within the utilities. The other concern highlighted by our review is the debt financing policy of attempting to finance 70% of capital improvements through

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**Capital Program**

+ Capital Projects
  - Outside Funding Sources (e.g., Developer contributions, etc.)
  = Total Capital Program “Internally” Financed

**Rate (Revenue Requirement) Calculation**

**Sources of Funds**

+ Rate Revenues at Current Rate Levels
+ Assumed or Needed Rate Adjustment
+ Miscellaneous Revenue Sources
= Total Revenues

**Application of Funds**

- Operation and Maintenance Expenses
- Local Access (Tax)
- Interest on Debt
- Depreciation Expense
= Net Income (Return Component)

**Fiscal Policies**

✓ Return on Equity – 6% to 10%?
✓ Dividends 30% of Net Income?
✓ Adequate Reserve Levels?

**Fiscal Policy on Capital Financing**

30% Cash Financed 70% Debt Financed Maximum

**Debt Schedules**

Existing & New Debt
✓ Principal Payments
✓ Interest Payments

**Rates Are Adequate and Meet Costs and Fiscal Policies**

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The utilities should examine this policy and consider whether it is or is not a long-term sustainable approach.

In reviewing the Sanitary Utility, it was noted that the Design and Construction activities are not a “core” service of the utility. In essence, the Design and Construction services are intended to generate greater revenue for the utility and ultimately pay greater dividends to the City. In that respect, the Design and Construction activities appear to be a “non-regulated” service. The City should separately account for “regulated” and “non-regulated activities as separate line items in the total revenues derived within the Sanitary Utility Fund. By accounting separately for “non-regulated” activities the City can assure that “regulated” services are not subsidizing these “non-regulated” activities. In establishing rates for the core “regulated” services, the utility’s “non-regulated” activities should be clearly identified within the analysis to demonstrate the benefit to ratepayers in undertaking these “non-regulated” activities.

A significant change for the Sanitary Utility is the transfer of the Gold Bar Wastewater Treatment Plant to EPCOR. At this point, it is unclear how EPCOR will charge the Sanitary Utility for treatment services and how that may impact the Utility’s rates. However, in the end, it would seem that the City’s Sanitary Utility customers should essentially be held harmless from this transaction.

Interestingly, the Waste Management Utility employs an approach more in line with a public utility (i.e. a “cash needs” approach). While the Utility is currently exempt from local access fees and dividend payments, at some point, the Utility will need to consider the rate setting methodology to take those payments into account.

Overall, it appeared that the Utilities were adequately funded and that a good financial planning and rate setting process was in place.

Review of Governance/Regulation of the Utilities

Governance and regulation are at the core of a utility. As a public (municipal) utility, the City has the responsibility to operate the Utilities in the best interest of the citizens. At the same time, from a regulatory perspective, the City has the responsibility to establish equitable and cost-based rates. As a part of this study, the governance and regulatory structures of the Utilities were reviewed.

Governance and regulation are two separate and different activities undertaken by the City Council. Governance, by definition, is a set of policies, roles, responsibilities, and processes established to guide and control how an organization accomplishes its business goals. In other words, this is the leadership provided to the organization or agency. In contrast to this, regulation is in part the control of certain behaviors in a monopolistic situation (e.g. price gouging, etc.). Regulations are put in place to control the behavior of utilities and to protect the public interest. Absent regulation, the service and pricing of these services may look entirely different and likely not balanced between the utility and the customers.

City’s Current Governance and Regulatory Structure – The City of Edmonton utilizes a similar governance and regulatory structure for the sanitary, land drainage, and waste management utilities when it comes to budgeting and rate setting. The City’s current governance and regulatory structure certainly is not significantly different than a traditional municipal utility. That is, the City Council provides policy direction and establishes the City’s rates and fees. One
unique aspect of the City is the issue of the level of dividend payments, but the City Council appears to be cognizant of the issue in relation to the level of the rates and the competitiveness of the rates.

In discussions with both Utility Management and the City Council members, there is universal agreement that the current schedule and process for reviewing the utilities’ budget and rates is flawed. In all cases, when HDR discussed this issue with Utility Management and City Council members there was agreement that the utility budgeting and rate setting process should be segregated from the City’s general government budgeting process.

The Utilities work with the Transportation and Public Works Committee. This committee is made up of City Council members. The historical role of the Transportation and Public Works Committee is fairly limited and it has not historically reviewed strategic plans, budgets or rate proposals for the Utilities. As a result, a utility item will go before the full City Council with limited or no vetting process. When the item does reach the full City Council, there may be frustration on the part of the City Council in their limited opportunity to discuss and refine a proposal. A City Council meeting is simply a difficult forum to discuss, address or refine the technical details of a report or proposal in such a limited time frame.

Concerns With the Current Governance and Regulatory Structure - Conceptually, the City’s governance and regulatory structure would seem to be appropriate. However, based upon interviews conducted by HDR with Utility Management and certain City Council members it appears that the governance and regulatory structure or process is not functioning at a level that is likely needed to properly guide and regulate these Utilities. Access to the City Council and lack of sufficient time to discuss topics were common concerns and issues cited. While the City utilizes committees to address certain issues, it also appears that the Transportation and Public Works Committee is not as effective as it could or should be. The City’s Council members of this committee rotate each year, thus negating the Utilities’ efforts to educate the Committee members to the issues and challenges facing the Utilities.

In summary, it appears that two key issues surfaced during the course of this study – access and communication/feedback. The Utilities need greater access to inform and educate the City Council (or alternative governing/regulatory body) and the Transportation and Public Works Committee. At the same time, the Utilities, Transportation and Public Works Committee, and the City Council desire a greater level of communication and feedback.

Review of Alternative Governance Structures – Research was provided on three alternative governance and regulatory structures. These included a Utility Committee structure, a Utility Advisory Committee and an Independent Utility Board structure. Each of these structures has varying roles, levels of responsibility and authority. From that review of alternatives, HDR concluded that the City should consider the following alternatives for governance and regulation:

- **Option 1: Create a Utilities Committee Comprised Entirely of City Council Members** – Under this option, the Transportation and Public Works Committee would be segregated into two committees with a new Utilities Committee being formed. The Utilities Committee would solely address utility issues. The Utilities Committee would be charged with reviewing all comprehensive (master) plans, budgets, audits and any rate or fee proposals. The intent is to make the Utilities Committee a sounding board for any items that would eventually go before the full City Council. The number of committee members
could be similar to the current approach used by the City for other committees. Ideally, for this committee the City would prefer to create greater stability and would potentially consider two-year terms with staggered membership. The City Council would retain regulatory authority under this structure.

- **Option 2: Create a Utilities Committee Comprised of City Council Members Plus Utility Experts** – This option is similar to the prior option, but adds outside utility experts to the Committee (e.g., two additional members). This has the added advantage of individuals on the Committee that bring actual utility expertise and knowledge to the decision-making process. All other elements of the Committee as described in Option 1 above would still be considered.

- **Option 3: Create an Independent Utilities Board** – The City would create an Independent Utilities Board (similar to the EPCOR model). The Utilities Board would have full responsibility and authority for the governance and regulation of the utilities.

In HDR’s discussion with the Mayor and various City Council members, the establishment of an Independent Board did not appear to have sufficient support at this time. Options 1 and 2 are very similar with the exception that Option 2 adds outside expertise to the Committee. For that reason, HDR would recommend the City consider Option 2 for a committee structure. Under this option, the City Council ultimately maintains governance and regulation over the Utilities, but would hopefully rely upon the Committee to provide the needed policy guidance. As the Utilities Committee begins to function properly it should provide the City Council with greater confidence that the issues, proposals and recommendations before the full City Council are in the best interests of each Utility, the City and the ratepayers.

**Recommended Budgeting and Rate Setting Approach**

This report identifies that the budgeting and rate setting process should be segregated from the City’s general government budgeting process. Two approaches were reviewed; reviewing utility budgets and rates before or after the general government budget process. It was concluded that the City should consider reviewing the Utilities’ budgets and rates before the City’s general government budgeting process. The timing and approach for that process may be similar to the example shown in Figure ES-2. The process identified in Figure ES-2 is an iterative process in that the impact to rates is taken into consideration throughout the budgeting process. If the impact to rates is too significant, a readjustment of the budget may take place to better balance the impact. Once the budget is adopted, the rates can then be analyzed, formally presented, and adopted.

**Figure ES-2**

*Overview of an Alternative for Utility Budgeting and Rate Setting*

<table>
<thead>
<tr>
<th>Establish Utility Budgets and Rates Before the City Budgeting Process</th>
</tr>
</thead>
<tbody>
<tr>
<td>Utility Establishes Operating and Capital Budgets</td>
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</table>
Utilities’ Overall Rate Setting Methodology - Our review indicates that the methodologies being used for the utilities fall within the range of “generally accepted” methodologies. At the same time, it appears that the fiscal policy which specifies a return on equity does not seem to indicate excessive returns. Certain fiscal policies could certainly be clarified and potentially simplified to better explain the relationship between the fiscal policy and the resulting rates. However, in the end, HDR is of the opinion that there is not a significant issue with the rate setting methodology. Rather, the issue may be in communicating the methodology in simple and easy to understand terms.

Performance-Based Rate Making - One approach to establishing rates which has been suggested is performance-based ratemaking (PBR). Under a PBR, the City develops a number of performance criteria and there are certain “rewards” or “penalties” for achieving those performance levels. EPCOR's retail water rates setting process currently utilizes a PBR approach. In the opinion of HDR, the City should not focus on using PBR as a method of performing annual adjustments to the utilities’ rates. It would appear to be difficult and challenging to establish “meaningful” performance measures the City would use to regulate the Utilities' rates.

Performance Measurement - The City Council and Mayor would like to better understand the overall efficiencies of these utilities and the services they are providing. Utility Management should work with the Utilities Committee (assuming it is formed) to establish a set of performance measures for each utility that would demonstrate and communicate to the City Council the overall efficiency and effectiveness of each Utility. The performance measures would not directly relate to rate making like the PBR process, but to identify the efficiency of the utility.

Fiscal Policy and Dividend Payments - As was noted in Figure ES-1, these dividend payments are a function of the utility’s net income. That simply implies that dividends are to be “earned” and not “taken.” Historically, the City Council has worked within the fiscal policy that was established. However, in recent years, due to budget pressures, the City Council has taken dividends that were greater than anticipated. The City Council should carefully watch this trend and always attempt to remain in conformance with their established fiscal policies.

Summary Conclusions
In the course of our review HDR was able to reach a number of conclusions regarding the Utilities. Our conclusions are not utility specific, but rather combined as an overall observation of the Utilities as a whole. Provided below are HDR’s conclusions based upon our review of the City’s Waste Management and Drainage Services Utilities.

The Utilities are Well Operated and Managed – HDR was impressed during our overall review of the three utilities. They appear to be well operated and managed. They also appear to be more proactive than reactive and have developed strategic plans and other planning documents that provide an impressive view of their future. Organizationally, HDR did not witness or perceive any tension or discord within the management of the utilities. The Public Works organization seems clearly focused on the delivery of high quality services.

2 The September 2008 issue of Public Utilities Fortnightly indicates that current authorized returns on equity for private utilities average approximately 10.5%. (P. 94)
The Utilities do not have a Management Level Financial Professional – At the present time, the Utilities do not have a management position for a financial professional. While there are financial and budgeting individuals within the organization, there does not appear to be an individual responsible for the financial planning and rate activities of the Utilities. The Utilities are multi-million dollar enterprises and there needs to be an individual to plan, analyze and manage the key financial decisions that occur within these Utilities.

The City’s Perspective and Objectives Regarding the Utilities is Unique for a Municipality – This report highlights the difference between a public and private utility. The City’s Utilities do not appear to be purely “public” or “private” enterprises. The objective of the City’s utilities is to provide the highest quality service at a competitive rate while providing (compensating) the City with Local Access Fees and Dividends. At the same time, the City has an entrepreneurial spirit with its utilities and seeks opportunities to provide an expanded service and supplement the utilities revenues (e.g., Design and Construction).

“Regulated” Activities Should be Financially Segregated From “Non-Regulated” Activities – Similar to a private utility, there generally is a regulatory requirement to financially segregate “regulated” activities from “non-regulated” activities. “Regulated” activities are the core services associated with the utilities (e.g., collection and treatment of wastewater) and “non-regulated” activities are those activities which may not be considered essential to the “core” regulated activities. Regulated activities should not subsidize the non-regulated activities. From an accounting perspective, Design and Construction activities could be defined as a non-regulated activity and should be financially segregated within the Sanitary Utility.

Similar to Other Municipalities, the City Council is Responsible for Both Governance and Rate Regulation of the Utilities – Most City Councils wear two hats; those of the governing/policy body and the regulator. In that respect, the City’s utilities are not unusual from other municipal utilities. However, the City’s overall utility financial objectives, along with the payment of dividends, certainly complicate the equation. However, the citizens of Edmonton provide the balance to the City Council concerning the level of the rates and any over-reliance upon dividend payments.

The Utilities’ Fiscal Policies Appear to Provide a Good Foundation for the Rate Making Process – The City has established a solid foundation of fiscal policies for the Utilities. It is refreshing to see a municipal utility with the foresight to establish these fiscal policies. The policies can certainly be refined and expanded, but they provide a good policy direction for Utility Management.

The Focus of the Fiscal Policies Appears to be on the Dividend Payment – HDR’s impression of the fiscal policies is that they operate from a “bottom-up” perspective. That is, the focus is on meeting a specific return on average equity to allow for the payment of the dividend. The City needs to be very careful to not become over-reliant upon these dividend payments or the City’s utility rates may become uncompetitive or unaffordable.

The Utilities’ Fiscal Policies are Technically Solid, but may be too Complicated for Policy Makers to Understand – The fiscal policies are technically detailed and intertwined. For a City Council member, the challenge of understanding the interrelationships between the fiscal policies and the resulting rate impacts may be somewhat daunting. The City may

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3 This conclusion should not be interpreted to mean that there are not individuals responsible for the financial performance of their utility areas, but that there is not a position in place for a financial professional to oversee the financial planning, budgeting and rate setting process for all the Utilities.
consider attempting to simplify the policies while at the same time recognizing that conditions change and allow for more flexibility within the policy statements (e.g., not be strict or absolute in the fiscal policy of using 70% debt financing for capital improvements).

- **The Combined Process of Establishing the Utilities’ Budgets and Rates Creates Issues for the City Council and the Utilities** – The process of establishing and adopting a budget, while at the same time reviewing a rate proposal, seems to be the crux of much of the discussion around the Utilities. The City’s budgeting process, taken alone, is extensive and exhausting. When a utility rate process is essentially added on top of the budgeting process, it is no surprise there is a feeling the process in inadequate. However, the more troubling aspect of the combined budget and rate process is any change in a utility’s budget does not allow sufficient time for adjustment with the rate proposal. As a result, the Utilities may be left short-changed due to these last minute budget modifications. Finally, when the Utilities’ budgets and rates are reviewed at the same time as the City’s general government budgeting process, the Utilities do not receive adequate review or discussion.

- **The Utilities’ Rate Setting Methodology is Unique for a Municipality, but Within the Range of “Generally Accepted” Methodologies** – The rate setting methodology for the City’s utilities is not purely a “public” or “private” utility approach. Rather, it is something of a combined approach between the utilities. The problems encountered in the past over the establishment of rates does not necessarily appear to be a function of the methodology (although it may be), but rather a function of time and communication. The Utilities need more time to communicate with the governing body or designated committee to address any issues and concerns they may have.

- **The Utilities Appear to be Adequately Funded for O&M and Capital Infrastructure** – The Utilities appear to be adequately funded to support O&M and capital infrastructure activities. The franchise fee and dividend payment made to the City do not seem to impose a significant detriment to the Utilities’ O&M and capital infrastructure activities.

- **Performance Based Ratemaking is Not a Solution** – There was some initial thinking that performance-based ratemaking (PBR), similar to the approach EPCOR uses, would be a potential rate setting methodology for the utilities. In discussions with certain City Council members it appeared that a number of those interviewed did not fully understand or accept performance-based ratemaking (PBR).

- **Performance Measures Should be Retained** – While performance-based ratemaking may not be a solution to the rate setting process, the Utilities should continue to develop performance measures for the utilities. These performance measures and the continual reporting of those measures will help assure the Mayor and City Council of the efficiency of the utilities. The challenge for the City and the Utilities will be developing “meaningful” performance measures for each utility.

- **The Transportation and Public Works Committee is Not Functioning at a Level Such That Issues can be Adequately Addressed and Resolved** – Both Public Works/Utility Management and City Council members acknowledged that the Committee approach, as historically assembled, has been ineffective at dealing with the utilities’ issues. In particular, the annual rotation of members creates challenges for both the Utilities and those City Council members on the Committee. At the same time, the Committee has historically not been a key “stopping point” to review budget and rate proposals. The Committee or some other body should be a forum to answer and address many of the City Council questions and concerns before the budget or proposal reaches the full City Council.
A Forum or Approach Needs to be Developed to Allow for Adequate Review and Communication Regarding the Utilities – Either the Transportation and Public Works Committee needs to be significantly changed or an alternative approach developed to allow for adequate review and communication concerning utility issues.

Given the above observations and conclusions, HDR has developed a set of recommendations which are presented below.

Summary Recommendations

The following recommendations are being made at this time. HDR believes it is important for the City to focus on a few key recommendations from this study. While there certainly are more recommendations contained within this report, HDR believes the following recommendations are the most important and should hold the highest priority.

- **Segregate the Utility Budget/Rate Setting Process from the City's General Government Budgeting Process** – Two options were presented to either develop utility budgets and rates either before or after the City's general government budgeting process. It is recommended that the Utilities' budgeting and rate setting process occur before the City’s general government budgeting process.

- **Segregate the Utilities' Budget Process from the Rate Setting Process** – The Utilities' budgeting process should be segregated from the rate setting process. Once the Utilities' operating and capital budgets are drafted or adopted, they then provide the foundation for establishing cost-based rates.

- **Establish a Utilities Committee** – The City should establish a Utilities Committee to focus exclusively on utility issues. The Utility Committee would be separate and distinct from the existing Transportation and Public Works Committee. The Utility Committee should be composed of five City Council members and two outside utility experts. For purposes of continuity, the City Council should consider establishing two-year staggered terms for the City Council members.

- **Add Utility Financial/Budget Expertise to the City** – The City should add a position for a financial professional to work with the Utilities. This position would be responsible for the financial aspects of the Utilities (e.g., budgeting, financial planning, rate making, etc.)

- **Financially Segregate the Design and Construction Services** – Design and Construction Services should be accounted for separately within the Sanitary Utility. These services appear to be “non-regulated” services and as such should be accounted for separately to assure the services are profitable and that ratepayers are not subsidizing these “non-regulated” activities.

- **Review the Fiscal Policies to Potentially Simplify, Clarify and/or Amend** – The City has a very strong set of fiscal policies. It would appear that they could possibly be simplified, clarified or amended to provide more flexibility under changing conditions.

This concludes the key recommendations from this study. Additional recommendations are included in the more detailed report.
Summary

This study has reviewed the budgeting and rate setting process of the City’s utilities. At the same time, the governance and regulation of these utilities were reviewed. The recommendations resulting from this study should enable the City to better manage, govern and regulate the City’s Utilities.