Facing the Trade-offs:
The Proposed Transfer of Edmonton's Drainage Utility to EPCOR

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Executive Summary

The City of Edmonton's renewed deliberations over whether to transfer its Drainage Utility to EPCOR Utilities is an exercise in weighing trade-offs.

This report investigates whether Edmontonians are best served by having the Utility under control of the City or EPCOR. It lays out the factors that City Councillors and members of the public should consider at this critical decision point.

We believe there are two sets of factors that City Councillors must consider when weighing the pros and cons of the transfer. The first set of factors include the efficiencies claims made by EPCOR and the ability of the City to achieve these same efficiencies. The second set of factors include issues of transparency and accountability.

In its proposal to the City, EPCOR assumes that it can run the existing drainage utility more efficiently than the City. This claim forms the main basis of its proposal. However, we argue that if EPCOR fails to generate the efficiencies it claims, then the City risks earning significantly less compensation from the proposed transfer than it expects.

We demonstrate that it is highly possible for the City to generate a substantial portion of the efficiencies EPCOR proposes. This report estimates that the City could reasonably generate 93 per cent of the operational efficiencies that EPCOR implies only it can generate by taking control of the drainage utility. As such, based on the assumptions that EPCOR has proposed, turning the drainage utility over to EPCOR is an unnecessary gamble that should be rejected.

We also find that the City faces trade-offs with respect to transparency and accountability. These trade-offs directly relate to concerns over the public interest. By transferring the drainage utility to EPCOR, the City loses direct oversight over the operation of the drainage utility, which may impact service levels. Furthermore, the public clearly will have less access to information on the operation of their utility, since shareholder meetings between the City and EPCOR are not public and EPCOR is exempt from the Freedom of Information and Protection of Privacy Act.

Added to these concerns, Council's efforts to implement its City-Wide Flood Mitigation plan will make it even more difficult in the coming years to ensure the future welfare and safety of Edmontonians. If Edmontonians have no say or oversight into these critical decisions, it is doubtful that the public interest can be defended by our elected Councillors.

By weighing the benefits and costs of the proposed transfer to the City and Edmontonians, we submit that, overall, the proposed transfer would be a net loss to the City.

The key findings of this report are summarized as follows:

- The efficiencies claimed by EPCOR are fundamental to its estimations of dividends, and are a key determinant in the City's decision regarding the proposed transfer.

- If the City keeps the drainage utility and pursues cost savings itself, it could enjoy a greater level of guaranteed income at a relatively low level of risk when compared to the transfer.

- We estimate that the City could generate 93 per cent of the operational savings put forward by EPCOR.

- We also estimate that even if the City can realize only 59 per cent of the efficiencies put forward by EPCOR, there is no dividend amount offered in the deal that can compensate the City adequately for the income it will lose by handing over the drainage utility to EPCOR.

- By considering the risks and the loss of accountability and transparency implied, we find that the proposed transfer brings little benefit to Edmontonians and the City.

1. Introduction

The City of Edmonton's (the "City") deliberations over whether to transfer ("the Transfer") its Utility to EPCOR Utilities Inc. ("EPCOR") is an exercise in weighing trade-offs. This report investigates whether Edmontonians are best served by having its drainage utility ("the Utility") under City control, or under that of EPCOR. It lays out the factors that City Councillors and other observers should consider when making their decision. The report concludes that EPCOR's proposal should be rejected on several grounds.

A core theme in the topic of income involves efficiencies. As EPCOR's sole shareholder, the City receives annual dividends. EPCOR claims that by taking control of the Utility and implementing these efficiencies, it can earn more income from the Utility than the City currently can. The key assumption is that greater profit generated from the Utility would translate into greater dividends accruing to the City.

However, we believe it is completely feasible for the City to implement virtually all the same cost-saving measures that EPCOR assumes only it can achieve. Furthermore, we argue that if the City were to do so, it could earn even more income from the Utility than it would if the Transfer took place.

The City also faces a trade-off regarding transparency and accountability. By handing over the Utility to EPCOR in the hopes of achieving greater dividends, the City loses direct control and oversight over it. A direct consequence of this trade-off is that the City and Edmontonians will have less access to information about the performance and business activities of the Utility.

Issues around transparency and accountability are exceptionally pressing, given that the City will be undertaking major decisions around its flood mitigation plans. We are concerned that if Edmontonians cannot have input or oversight in these important decisions – directly due to EPCOR's involvement with the drainage Utility – the future safety of Edmontonians may be compromised.

By relinquishing public transparency, the transfer of the Utility to EPCOR exposes Edmontonians to the risk of having the Utility completely privatized by EPCOR later, without any of the meaningful public consultation that we current enjoy. As we know, this outcome has been seen before in the creation of Capital Power. In that case, the City sold Edmonton's power utility to EPCOR, and that utility was subsequently spun off as a private company.

Lastly, it is also unclear how the drive to realize some of the "efficiencies" forwarded by EPCOR may affect the service levels that Edmontonians have come to expect.

The evidence we present shows that transferring the Edmonton's drainage utility to EPCOR is an inherently risky proposition in which the dangers outweigh the benefits.

1.1 Our Approach

There have been several reports developed over the last few months that examine the potential costs and benefits of the proposed transfer. Grant Thornton LLP ("Grant Thornton") was commissioned by the City to prepare this documentation.

We primarily base our analysis on two documents prepared by Grant Thornton. The first is the "2016 EPCOR Proposal for Drainage Transfer Analysis," published on October 5, 2016 (the "October 2016 Report"). The second is the "2016 EPCOR Proposal for Drainage Transfer Analysis: Comparative Outlook on Rates," published on December 15, 2016 (the "December 2016 Report").

In our analysis, we have closely reviewed the October 2016 and December 2016 reports. We present the financial information in a format that enables City Council and Edmontonians to weight the trade-offs involved in the transfer. Throughout the report, we focus our analysis on the forecasted figures generated under the assumption that rates will increase by 3 per cent annually for the entire period. We believe this approach allow us to provide an "apples-to-apples" comparison between the income generated by the Utility under City management and that of the dividends the City could earn if the Transfer were to take place.

2. Overview of the Proposed Transfer

EPCOR proposes a transfer (the "Transfer") from the City several assets and responsibilities related to the Utility. The Transfer would include the City's Sanitary and Stormwater Systems. As of December

31, 2014, the book value of the Utility's consolidated assets was $2.6 billion.[1]

Under the proposed transfer, EPCOR would assume control and responsibility for several aspects of the Utility. It would take responsibility for all existing debt related to it, including responsibility for all new debt without recourse or credit support from the City.

The transfer would also involve the City's drainage operations and maintenance, as well as design and construction functions. In addition, all Approvals to Operate and key Licenses would be transferred to EPCOR, as well as responsibility for assigning major contracts. EPCOR would be responsible for all environmental liabilities and litigation arising after the transfer. Formal regulatory oversight and approval of all aspects of the drainage utility including design and planning criteria would remain with the City.[2] It is also notable that EPCOR has committed to offer employment to all City employees subject to the transfer (In 2016, staff capacity for these operations was 761 FTE).

2.1 Claimed City Benefits

In exchange of the Utility, EPCOR suggests there are a variety of benefits to the City. We will discuss the main proposed benefits in this section.

2.1.1 Dividends

EPCOR suggests that it can pay an additional $202M in dividends to the City over a ten-year period, assuming rates only increase by 3 per cent per year.[3] These dividends are directly attributable to the Utility, and do not depend on the performance of EPCOR's other business lines. This dividend value also assumes that EPCOR could achieve 5 and 10 per cent operational and capital cost-savings, respectively. Naturally enough, the dividend paid to the City should compensate the City for the income it could have earned from the Utility if it were to stay under City control.

However, If EPCOR is unable to generate any of the efficiencies it has promised, the City can expect to see only $137M in additional dividends.

Another factor to consider is that the total dividend paid by EPCOR depends on the overall financial health of EPCOR. As EPCOR's 2016 Annual Information Form States, "[d]ividends for each year will

[1] City of Edmonton. EPCOR Proposal for Drainage Transfer, 6.4.
[2] See page 74 of the October 2016 Report.
[3] See page 46 of the October 2016 Report.

be reviewed annually by the Board and the Shareholder and are subject to amendment in the event of significant change in EPCOR's business or financial condition."[4] Specifically, as the October 2016 Report states, "[City] Council has the ability to validate EPCOR's dividend by using EPCOR's dividend payout ratio (dividend as a per cent of net income) as an indicator."[5]

This evidence indicates that the dividend amount paid to the City depends on the financial health of EPCOR. For example, if EPCOR experiences losses in its other business ventures across North America, but earns income from the Utility, there may be a risk that Edmontonians will not receive dividends commensurate with the income generated from the Utility. Income from the Utility may also be used to fund EPCOR's other business activities, just as EPCOR's plans provide "equity injections" into the Utility using equity from its other business ventures.

Thus, the income the City receives from the Utility via dividends will become intrinsically tied to the health and activities of EPCOR. In this way, the Transfer will expose Edmontonians to the risks associated with the private market for utilities, whereas in the status quo scenario they are not.

2.1.2 Transition Payments

As the October 2016 Report states, EPCOR also commits to transition payments of up to $75M to compensate the City for "stranded costs." These costs are the efficiencies already generated by the City through shared services and other economies of scale. EPCOR recognizes that "the transfer of Drainage Services would likely result in some level of loss in efficiency within the City, which would be addressed through the transition fee EPCOR has proposed."[6]

2.1.3 Efficiencies

As already discussed, EPCOR's core claim is that it can generate efficiencies through superior business practices and synergies with its other business areas. As presented in the October 2016 report, EPCOR estimates that over a ten-year period it can generate 10 and 5 per cent savings for capital and operational costs, respectively.

These efficiencies are a key element in EPCOR's projected success with the Utility, as well as the purported value it brings to Edmontonians.

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[4] See page 16.
[5] See page 8.
[6] See page 88 of the October 2016 Report.

Specifically, if the Transfer were undertaken, the dividends attributable to the Utility would be intrinsically tied to the efficiencies EPCOR can generate.[7] As well, EPCOR's argument assumes that the City is unable to generate the same magnitude of cost savings if the Utility were under City control.

Our position is that the City could independently generate the vast majority of the efficiencies claimed by EPCOR. Thus, it is more prudent for the City to control the Utility and earn income directly from it, rather than transferring it to EPCOR.

Furthermore, compensation by dividend is riskier and costlier as the City would be tying its compensation to both the ability of EPCOR to achieve efficiencies and the overall business performance of the company. Furthermore, the dividend ratio, that is, the measure by which the dividend paid to the City is determined, ensures that the City will not receive dividends equal to the full amount of income generated from the Utility. However, by directly controlling the Utility and pursuing its own cost-saving measures, the City can generate comparable amounts of income from the Utility with less risk and cost.

2.1.4 Debt Capacity and Equity Injections

EPCOR also submits that taking on the debt associated with the Utility will free up additional self-liquidating debt capacity for the City. This self-liquidating debt is limited; it can only be used to finance capital expenditures for "activities or programs that are self-funded including utilities and Local improvements."[8]

EPCOR will then finance future capital projects itself by providing "equity injections," that is, taking on its own debt from private markets or using equity from its other business lines.[9] The Utility effectively would also be financed by the service fees charged by EPCOR in the other municipalities it serves.

3. EPCOR's Claimed Efficiencies

A key component of EPCOR's proposal is the assumption that it can achieve significate efficiencies by acquiring the Utility. It argues that these efficiencies would enable EPCOR to provide greater dividends directly attributable to the Utility over the next ten years.

[7] For more detail on the relationship between EPCOR's efficiencies and the incremental dividend, refer to the table on page 46 of the October 2016 Report.
[8] Page 50 of the October 2016 Report.
[9] See page 8 of the October 2016 Report.

However, we find that if the City were to generate at least 59 per cent of the efficiencies put forward by EPCOR, the City could earn more income by maintaining direct control of the Utility.

Thus, it is very important for City Council to distinguish between the efficiencies that the City could also reasonably obtain and those only attainable by EPCOR. For EPCOR to imply that the Transfer makes the Utility more efficient, it must prove that these efficiencies will only occur because of the Utility being transferred to EPCOR.

To be clear, when evaluating the Transfer, the efficiency must be directly attributable to EPCOR running the Utility if is to be to be considered for comparison purposes.

It is not valid to imply that the Transfer could generate net value of a 10 per cent reduction in capital costs and a 5 per cent reduction of operational costs compared to the City, if the City could undertake the same initiatives and achieve the same efficiencies. Furthermore, EPCOR does not provide compelling evidence to demonstrate that the City could not achieve the same efficiencies it has put forward. If the City can make these improvements itself without substantially compromising quality, then the Transfer will not unilaterally drive greater efficiency. Furthermore, the City may stand to earn even more income if it keeps the Utility and pursues these efficiencies itself.

Overall, we find that, in fact, 93 per cent of EPCOR's claimed operational efficiencies could also be generated if the Utility remained under City control. We also have reason to believe that a significant proportion of the claimed capital efficiencies could also be realized by the City, but we were unable to quantify these savings.

Furthermore, even if some of these efficiencies could be realized, it is not clear how they would affect service levels. In fact, we observe that there has been little discussion to date about how these efficiencies will affect service quality. Some of these efficiencies are merely cost-cutting measures, which may have major implications on infrastructure quality, service levels, issues related to transparency, or any such combination.

Lastly, simply listing potential efficiencies does not make them a reality. There is no guarantee that EPCOR will ever deliver on the efficiencies it has put forward. With multiple business interests and divergent interests, there is a high likelihood that EPCOR's priorities may shift elsewhere. As a for-profit enterprise, Edmonton's infrastructure is simply not a dominant priority for EPCOR when considering all the other systems for which it is responsible.

By contrast, having the Utility controlled by the City ensures that cost-saving measures will be pursued, as the City is beholden primarily to its rate payers.

The October 2016 Report does indicate specific operational and capital efficiencies that Grant Thornton believes the City could achieve. We address these efficiencies in the following sections.

3.1 Lost City Efficiencies

By transferring the Utility to EPCOR, the City will incur costs through the loss of synergies generated between the Utility and other City operations. The October 2016 report calls these efficiencies "stranded costs," and estimates their cumulative cost to be $29M.[10] As part of the proposal for the Transfer, EPCOR has offered up to $75M to compensate the City for such losses.

3.2 EPCOR Operational Efficiencies

The October 2016 Report indicates that EPCOR could reasonably reduce operational costs by 1 per cent each year for the first five years of the forecast, leading to a cumulative reduction of 5 per cent in year five. Beyond the fifth year, operational costs are projected to be 5 per cent lower than if the Utility remains under City control. The cumulative dollar value of these efficiencies over the 10-year forecast period is $44M.[11] We have assumed that these cost savings are on top of those the City is currently planning to undertake.[12]

Evidence shows that most of the operational efficiencies claimed by EPCOR are not unique to the Transfer. The October 2016 Report clearly indicates that many of these cost-saving initiatives could also be implemented by the City. The efficiencies listed in the October 2016 Report that could be pursued by the City are the following:

- Implementing support crews and area approach;
- Not filling new proposed positions in the 2016-2018 budget;
- Reduction in lost time incidents;
- Fleet fuel efficiency;
- Third party damage recoveries;
- and reduced absenteeism.

[10] See page 88 and page 36, Footnote 25 of the October 2016 Report.
[11] See page 36 of the October 2016 Report.
[12] For example, the City has reduced operational costs by 2 per cent annually for the last three years to generate total cost savings of 8 per cent (see page 36 of the October 2016 Report). We assume that the City's forecasts for the Utility, on which the October 2016 Report is based, account for continued costs savings associated with this cost-reduction endeavour.

The cumulative value of these efficiencies is between $1.2M and $5.4M, according to the October 2016 Report.[13]

The October 2016 Report also costed three efficiencies deemed likely only achievable if the Utility is transferred to EPCOR:

- Synergies with retiring employees,
- Enhance drainage commercial activities, and
- WCB rebates through improves safety performance.

Of these three efficiencies, we believe that only WCB rebates are relevant to the Transfer. We will discuss the remaining two efficiencies claimed to be unique to EPCOR in turn.

To capture Synergies with retiring employees, EPCOR plans to remove 30 technical and support positions through attrition. EPCOR would then "backfill" these positions. We are not convinced that only EPCOR can make these changes, as the City itself is currently undertaking a large reorganization initiative. If these employees are to retire, then the City could implement the same changes as part of its present rationalization initiatives. Lastly, it is not clear if EPCOR can feasibly reduce the number of staff and maintain the level of service that Edmontonians deserve and expect.

We also believe that EPCOR's "enhance drainage commercial activities" efficiency is not an efficiency relevant to the transfer because it does not reduce costs or increase service levels for users of the Utility. This claimed efficiency is simply an example of how EPCOR plans to use the know-how and assets of the Utility to expand its business offerings. Expanding into a new service line is not an efficiency but simply an expansion of EPCOR's services. This claimed efficiency does not directly address the core function of the Utility, which is to serve users of the Utility – that is, ratepayers.

If we consider only those claimed efficiencies that are genuine and unique to EPCOR, the net operational efficiencies generated by the Transfer are significantly less than the forecasts outlined in the October 2016 Report. The total value of the efficiencies that could be generated from the Transfer, based on the costs estimated in the October 2016 Report, would be approximately $300,000 annually, or $3M over the ten-year forecast period.[14] These cost savings are significantly less than the $44M in savings that EPCOR claims it can generate over the ten-year forecast period.

[13] See page 37.
[14] *ibid.*

For context, in Table 1 we compare the net efficiencies of the Transfer with the 10-year forecast of operational expenditures, which is provided on page 36 of the October 2016 Report. We assume that the efficiencies related to WCB rebates can be realized immediately. Our findings indicate that the City could realistically generate 93 per cent of the operational efficiencies claimed by EPCOR.

	Total	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
City OPEX	1,069,059	96,279	98,500	101,143	103,433	105,697	108,132	110,649	112,909	115,271	117,046
EPCOR Claimed Efficiencies ($)	43,590	963	1,970	3,034	4,137	5,285	5,407	5,532	5,645	5,764	5,852
Net Efficiencies ($)	3,000	300	300	300	300	300	300	300	300	300	300
October 2016 Efficiencies (%)		1.00%	2.00%	3.00%	4.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%
Actual Efficiencies (%)		0.31%	0.30%	0.30%	0.29%	0.28%	0.28%	0.28%	0.28%	0.28%	0.28%

Table 1: Claimed, Revised, and Net Operational Efficiencies Forecast ($000's)

EPCOR also claims that, even if the City could achieve some of these efficiencies itself, EPCOR could gain them faster because of its exclusive focus on utilities and its experience with other utility systems. However, we should recognize that the City also has extensive experience operating utilities; it is unclear how EPCOR's experience is plainly superior to that of the City's.

Secondly, EPCOR's experience is not a guarantee that it will achieve its claimed efficiencies in a timely manner. EPCOR has suggested a timeline for realizing these efficiencies in its forecasts, but has not, to our knowledge, put forward an explicit time commitment or contractual agreement to solidify these promises.

3.3 Capital Efficiencies

EPCOR plans to achieve several capital efficiencies by gaining ownership of the Utility. As with the previous discussion, we are not convinced that these efficiencies are unique to EPCOR. EPCOR has claimed capital efficiencies of $193M over a ten-year period.[15]

It seems very likely that many of these efficiencies could be achieved by the City. There is very little evidence in the October 2016 Report to suggest that the City could or would not undertake these measures itself. Furthermore, given that the City is currently undertaking its own reorganization and cost-saving initiative, it seems very likely that the City could implement many of the capital efficiencies put forward by EPCOR.

For example, we question the claim that the practice of hosting "value engineering" sessions with contractors to find ways to reduce construction costs is an efficiency unique to EPCOR (capital efficiency no. 5). We understand that value engineering sessions are simply a common practice when undertaking large construction projects. Indeed, the October 2016 Report indicates that the City already hosts value engineering sessions for its significant projects. It is not clear how EPCOR can claim this capital efficiency is unique.

The City also may be practicing some of the capital efficiencies measures presented by EPCOR in its other divisions or utilities. There is likely precedent within the City's other business units for using master service agreements with pre-agreed unit pricing (capital efficiency no. 4). If the City already has master service agreements with fixed unit pricing in its other business areas, it seems reasonable that the City could carry forward this practice into the Utility, if it has not already done so.

As with the claimed operational efficiencies, EPCOR also argues that even if the City does implement some of these efficiencies itself, EPCOR could make these improvements faster. Specifically, the October 2016 Report claims that the City could establish master service agreements with a limited number of contractors (capital efficiency no. 2). However, one must also consider the likelihood that EPCOR will devote the resources necessary to achieve these efficiencies given the variety of other stakeholders EPCOR is accountable to, including the inherent volatility it faces as a private-sector enterprise. It also seems likely that the City can pursue this capital efficiency in a timely manner.

It is also not clear that the City may even want to undertake some of the cost-saving initiatives presented by EPCOR. These initiatives

[15] See page 41 of the October 2016 Report. This figure excludes the additional $500M in capital spending for the Flood Mitigation program, which was explored as a hypothetical in the December 2016 Report.

may have negative implications on the quality of capital projects. For example, we find EPCOR's claim that it uses "Master Service Agreements with No Contractor Contingencies [which] Results in Lower Realized Contractor Costs" perplexing (capital efficiency no. 3). This claim implies that EPCOR does not account for, or only accounts for to a limited extent, potential risks in projects when negotiating pricing. We would be interested in having City council explore the implication of this practice on actual project costs and the quality of infrastructure built.

Lastly, the October 2016 Report also suggests that EPCOR could reduce the cost of routine engineering projects (capital efficiency no. 1). We would like to reiterate the point made in the October 2016 Report that water drainage engineering projects tend not to be routine. As such, "[w]hile there will likely be cost savings with greater use of internal engineering by EPCOR, these may not be as large as projected."[16]

Based on the information provided in the October 2016 Report and its appendices, our view is that the October 2016 Report overestimates the capital cost savings EPCOR could realistically obtain, relative to the City. Due to limited information, in the rest of our analysis, we entertain the possibility of EPCOR generating capital efficiencies between 0 and 10 per cent greater than what the City could generate, while recognizing that the achieved efficiencies are certainly well short of 10 per cent.

3.4 Summary

The total sum of efficiencies EPCOR claims is $237M ($44M are derived from operational efficiencies and $193M from capital efficiencies). We believe that the true value of efficiencies arising from the Transfer is significantly less because the clear majority of these efficiencies are not unique to EPCOR.

Specifically, we believe that the City can generate 93 per cent of the operational efficiencies that EPCOR has claimed it can achieve. Without more information regarding the feasibility of implementing EPCOR's capital cost-saving measures at the City, and the implications of these measures on infrastructure quality, we are unable to provide an accurate revision of the October 2016 Report capital cost savings estimate. However, it is apparent that the City could generate a sizable portion of the capital efficiencies claimed by EPCOR.

[16] Page 41. Emphasis added.

We submit that the true operational efficiencies directly attributable to the Transfer would be approximately $3M over the ten-year period. Although we do not have an exact estimate for capital efficiencies, we are confident that the true capital efficiencies unique to EPCOR are significantly less than the $193M claimed. The Transfer will also see the City lose efficiencies of about $29M, which would be compensated for by EPCOR's transition payment.

4. Transaction Valuations

The October 2016 Report presents a series of valuations of the Utility based on different ownership arrangements and user-rate policies. These valuations consider several different elements of EPCOR's proposal. However, we believe these valuations do not accurately present the trade-offs the City faces in its decision to transfer the Utility to EPCOR.

The valuation analysis presented in the October 2016 Report is not an entirely accurate method of assessing the pros and cons of the Transfer. It is unclear how an increase in the value of the Utility, as estimated in the case where EPCOR holds the asset, provides direct benefit to taxpayers and the City.

Value for taxpayers is measured by the quality of service provided by the Utility for a given price. If the Utility, through the transfer, can provide a better quality of service to Edmontonians at a lower cost, then the transfer should be deemed as a benefit to ratepayers.

The increase in the Utility's value would only be useful to taxpayers if it generated income to the City that could then be used to improve the quality of life of Edmontonians.

There are two ways that the City could earn income from the Utility under EPCOR control. First, the increase in value would be relevant if it translated into a guaranteed dividend. However, we expect the dividend directly attributable to the Utility to decrease over time, even if all the claimed efficiencies are achieved.[17] It is also not clear that even if EPCOR were to achieve these efficiencies it would pay a dividend; this is because the dividend policy of EPCOR can be changed subject to a "significant change in EPCOR's business or financial condition."[18]

[17] For example, see the table on page 46 of the October 2016 Report.
[18] EPCOR Utilities Inc. *2016 Annual information Form*, page 16.

Secondly, the Utility, under EPCOR control, could generate a one-time increase in income to the City if it was sold to a third-party at a price equal to its market value. The proceeds from that sale could be paid to EPCOR, and then, possibly, be transferred to the City via a dividend. However, there are two major problems with this series of events. Firstly, we believe that a sale of this nature would be unacceptable because it compromises public oversight over this critical public infrastructure. Secondly, it is not guaranteed that a dividend would be paid to the City if the Utility were to be sold for the reasons stated above.

Regardless, the notion that an increase in the value of the Utility provides value to taxpayers is flawed. There is no direct, guaranteed correlation between the value of the Utility and the level of service provided to ratepayers.

5. Business Risk

The forecasts presented in the October 2016 and December 2016 reports do not explicitly consider business risk. Risk is a critical factor to consider and is directly relevant to EPCOR's claims related to efficiency, the likelihood of getting a dividend, and rate stability.

Although we are presently unable to quantify the risks associated with the Transfer, we believe that transferring the Utility to EPCOR will clearly expose the City and Edmontonians to greater risk. These risks stem from the fact that EPCOR is a private enterprise with several business interests across North America.

For example, the dividend amount paid to the City depends on the financial health of EPCOR. If EPCOR experiences losses in its other business ventures across North America, but earns income from the Utility, there may be a risk that Edmontonians will not receive dividends commensurate with the income generated from the Utility. As such, EPCOR operates in a more volatile environment, as volatility is a key part of markets.

We urge the City to more thoroughly examine the risks associated with EPCOR attaining control of the Utility. The City should not only assess whether the Utility could generate profits to support an increase to the incremental dividend, as the October 2016 Report has done. The City should also examine the likelihood that the claimed efficiencies would be achieved by EPCOR, including the likelihood that EPCOR would be able to pay a dividend given both the financial health and risks associated with its other business ventures.

6. Benefits and Drawbacks of the Transfer

The following section outlines two core themes of the Transfer: monetary gains and losses, and losses of transparency and accountability.

6.1 Monetary gains and losses of the City and taxpayers

Given that we do not have information that quantifies the risks associated with the Transfer and its purported benefits, we now explore the costs and benefits of the Transfer under several different scenarios.

We believe that to best understand the pros and cons of the Transfer, the City should examine the net effect of the Transfer over the ten-year forecast period. To examine the net effect is to compare the unique benefits and drawbacks of the Transfer, and exclude those elements that would remain the same if the Utility was controlled by the City or EPCOR. For example, we have excluded stranded costs from the analysis because EPCOR has offered to fully compensate the City for these costs if they were to arise. We have also excluded figures related to rate increases, as both the City and EPCOR could choose to increase rates. As such, all our figures assume that both the City and EPCOR will increase rates by 3 per cent annually.

Additionally, we have also excluded a discussion of the tax implications of the Transfer because, to date, we have limited information that quantifies them.[19]

To estimate the net effect of the transfer, we have established two scenarios, one in which the Utility is transferred to EPCOR, and one in which it is not. In Scenario 1, the City keeps control of the Utility and directly receives the Utility's income. In Scenario 2, the Utility is transferred to EPCOR, and the City receives dividends from EPCOR. In this scenario, the City also gains additional debt capacity, which EPCOR has presented as another benefit of the Transfer.

[19] As well, for the sake of simplicity, we have not recalculated any of the dividend or efficiency figures to remove the "cost-savings" related to the operational efficiency "Enhance Drainage Commercial Activities." As previously mentioned, we do not view this efficiency as such, but rather as an example of the business activities EPCOR wishes to expand into if it acquires the Utility. However, given the small monetary value associated with this activity (at most $4M over ten years), and the relative complexity associated with removing it from the dividend figures, we have not pursued any recalculations.

In Table 2 below, we have summarized the benefits the City stands to earn under the two scenarios over the ten-year forecast period presented in the October 2016 Report.

Scenario 1 (City Control) Benefits	Scenario 2 (EPCOR Control) Benefits
Net benefit of $295M to $532M	• Dividends ranging from $20M, to $137M, to $202M. • Additional self-liquidating debt capacity of $232M. Net benefit of $252M, to $369M, to $434M

Table 2: Benefits Derived from Scenario 1 (City control) and Scenario 2 (EPCOR Control)

If the City retains control over the Utility, it could earn between $295M and $532M. The lower range is the sum of all the projected income over the ten-year forecast period, as presented in the October 2016 Report.[20] The upper range figure assumes that the City could generate all the efficiencies claimed by EPCOR that are not unique to EPCOR.[21] The upper range is a rough estimate used for illustrative purposes.[22]

If the City hands the Utility over to EPCOR, it can expect to earn additional dividends from EPCOR, and it will attain additional self-liquidating debt capacity of $232M, which can be applied to other City business activities.

The amount of dividend that the City can expect to receive, directly attributable to the Utility, is between $20M and $202M. Ideally, EPCOR will be able to achieve all the efficiencies it has put forward, and be in a financial position to fully transfer that income to the City via a dividend. In this case, the City could earn $202M in dividends. However, if EPCOR is unable to generate any efficiencies, but is still in a financial position to pay a dividend, the City would earn $137M in

[20] See page 34.

[21] In our discussion on operational efficiencies, we established that the City could not achieve the WBC efficiencies claimed by EPCOR. The value of this efficiencies has been omitted from the total value of cost-savings we expect the City could also pursue.

[22] This figure may not consider other factors such as differences in interest rates incurred by the City versus EPCOR, or the equity injections EPCOR could offer to offset the need for more debt. Furthermore, we assume that cost-saving measures undertaken by the City to flow through to the Utility's net income on one-to-one basis.

dividends. Finally, in the worst case, EPCOR reneges on its promise to pay any dividend attributable to the income it earned from the Utility due to its general “business or financial condition.” In this case, we assume the City will receive only $20M in dividends since it has committed to an $20M increase in the dividend in the first year after the Transfer.

Table 2 does not consider the probability of achieving any of the benefits in either scenario. Therefore, we expand on our analysis by accounting for the possibility that efficiencies may not be maximized by the City, or that EPCOR may not pay any additional dividends beyond the guaranteed $20M because it cannot achieve efficiencies and/or faces other business risks. We present the full analysis in the appendix, but will summarize our findings here.

If EPCOR does not pay a dividend beyond the guaranteed $20M, the Transfer would be a net loss to the City of $43M. However, if EPCOR pays the full dividend attributable to the Utility, but generates zero efficiencies, the net benefit to the City would be $74M over the ten-year forecast period.

In fact, if the City can generate just 59 per cent of the efficiencies put forward by EPCOR, we find that there is no reasonable dividend in this case that would make up for the City’s lost income, if the Transfer were to occur.

The October 2016 Report indicates that the City is undertaking its own cost-savings measures in the Utility that, to date, have provided a cumulative cost savings of 8 per cent of operational expenses.[23] If this trend were to continue, and if the City could adopt some of the capital spending cost-saving practices put forward by EPCOR as efficiencies, it is very possible that the City could generate 59 per cent of the cost savings proposed by EPCOR. We have already identified that the City could generate 93 per cent of the operational efficiencies put forward by EPCOR, which translates into approximately 17 per cent of $237M of total efficiencies claimed by EPCOR.

Another way to view the trade-off between keeping the Utility and transferring it to EPCOR is to consider the dividend payout ratio, which is the metric by which dividends are determined. The ratio is the total dividend paid as a percentage of net income. As the October

[23] See page 36.

2016 Report indicates, a standard dividend payout ratio for the industry is between 40 and 60 per cent.[24]

Consider a case where the dividend payout ratio is set at 60 per cent, and EPCOR generates $100M in net income from the Utility due to its cost-saving measures. It follows that the City will only receive $60M of the $100M of the additional income generated, and the remainder will be held in EPCOR as retained earnings. However, if the City can generate the same increase in net income, it can have full access to the full $100M it has earned.

In effect, a divided payout ratio of 60 per cent would see EPCOR charge a 40 per cent “margin” on the income it generates for the City. To put it another way, the City would be paying EPCOR a commission, of sorts, to manage the Utility. EPCOR would then likely use its retained earnings fund other business activities. This scenario raises the question of whether the fees paid by Edmontonians ought to be funding EPCOR’s business activities, rather than being directly reinvested into the community by the City.

If the City can keep the Utility’s operations under its control, it can circumvent the costs of outsourcing the Utility’s management to EPCOR, and instead invest this money in Edmontonians through better funding of City programs and services.

6.2 Transparency and accountability

Past transfers of City utilities to EPCOR have brought to the forefront concerns regarding transparency and accountability. The transfer of the Utility of EPCOR raises concerns about formal accessibility of information and accountability mechanisms regarding the Utility for the City and Edmontonians. Overall, there are two key problems related to transparency that will arise if the Transfer takes place: loss of direct City oversight, and loss of information accessibility to Edmontonians.

Transparency and accountability issues will be even more important in the coming years, as the City works to implement its flood mitigation plan. Decisions pertaining to flood mitigation will be critical in ensuring the future welfare and safety of Edmontonians. If Edmontonians have no say or oversight into these critical decisions, the public interest will surely be compromised.

[24] See footnote 1 of page 8.

6.2.1 Loss of direct city oversight

By transferring control of the Utility to EPCOR, Council loses direct control and oversight over the Utility. The Utility would no longer answer directly to the City for operational decisions.[25] The City's auditor would lose the ability both to review the business activities of the Utility and report these results publicly. As the sole shareholder of EPCOR, the Council appoints the Board of EPCOR. However, Councillors do not sit on EPCOR's board and thus the City cannot participate in the management of EPCOR if the Utility were to be transferred.

If the Utility were transferred, the City may have some limited ability to attain information. As the sole shareholder of EPCOR, the City would likely have some powers as stipulated in EPCOR's Unanimous Shareholder Agreement (the "Shareholder Agreement"). For example, as part of the Shareholder Agreement, we know that EPCOR meets with the City on a quarterly basis (although these meetings are not open to the public). However, it is not clear what powers are awarded to the City through the Agreement, as this document is not publicly available.

We contend that the inaccessibility of the Shareholder Agreement is a concrete example of how transfers of this nature reduce transparency.

The reduced ability for the City to oversee the operations of the Utility has several negative consequences.

First, by relinquishing direct control over the Utility, the City reduces its ability to address emergencies and other exceptional situations related to the Utility. Currently, the City may be able to redeploy resources from other utilities or divisions within the City, if the need arose. In the case where the Utility was held by EPCOR and additional resources were required, the City may have to appeal directly to EPCOR, pursuant to a contractual agreement. Addressing emergencies in the way may increase administrative burden and bureaucracy.

Furthermore, as a for-profit enterprise, EPCOR may have less interest in addressing pressing issues related to the Utility, as these activities represent a cost, and are not a profit-generating activity. Simply put, EPCOR's priorities do not lie directly in service quality, but in maximizing profit. However, under direct ownership of the City,

[25] Gibson, Diana. *EPCOR: A Study of Ownership, Accountability and the Public Interest*. Parkland Institute. September, 2005.

the Utility is more likely to have resources and motivation to address exceptional circumstances as they arise.

Secondly, by handing off the Utility to EPCOR, the City's role becomes primarily one of a regulator. This arrangement incurs many additional costs to the City. In the October 2016 Report, Grant Thornton states the following:

> *As regulator, Council regulates [EPCOR] through its approval of […] water and wastewater treatment rates as well as regulated performance measures over a five year period. Additionally, non-routine adjustments outside of the approved PBR are reviewed and recommended by Administration and approved by the Utility Committee (UC; a committee comprised of Council members). EPCOR also provides an annual PBR report to the UC for information.*[26]

However, regulation itself is a costly practice. If the City transfers the Utility to EPCOR, it must devote additional resources to expand its capacity to monitor and regulate EPCOR. Conversely, by directly managing the Utility itself, the City can more efficiently ensure Utility standards are met because it will have direct access to the information it needs, and it will not have to operate within bureaucratic processes outlined in its contractual agreement with EPCOR or other legal frameworks.

6.2.2 Loss of information accessibility

As a private corporation, EPCOR has an interest in not disclosing commercially sensitive information that could harm its competitive position in the market for privately-run utility services. This reality would generate a great harm to the fair and democratic oversight and governance of the Utility. Public access to information about the Utility's operations would be limited pursuant to the formal governance agreement between the City and EPCOR. If the Transfer takes place, access to information would be far more limited than what is currently available to Edmontonians.

Currently, Edmontonians can obtain specific information about the Utility from Council, including information provided publicly on the City's website. The City is also subject to the Freedom of Information and Protection of Privacy Act, which allows citizens to "FOIP" the City to obtain the information about the Utility.

[26] Page 72 of the October 2016 Report.

To counteract concerns about information accessability, EPCOR claims in the October 2016 Report that it works with "open data" with restrictions imposed due to "privacy" and "terrorism" concerns.[27] However, it does not make clear what is meant by "open data," given these restrictions. It also claims that "[d]ata around operational matters such as power outages and water main breaks are reported on EPCOR's website,"[28] but makes no comment about other measures related to service.

What is clear is that citizens would lose significant oversight over the Utility. They would not be able to attend the quarterly shareholder meetings between the City and EPCOR to gain information about the current operation of the Utility. Furthermore, as a 2005 report by the Parkland Institute states: "The public, through its elected Mayor or a Councillor, can no longer require the utilities to answer detailed questions in a City Council Meeting."[29]

Specifically, the public would lose the power to compel information pursuant to the Freedom of Information and Protection of Privacy Act because EPCOR is exempt from this Act due to the fact it is not a "local government body" as explicitly defined in the Act.[30] Lastly, Edmontonians would also have less access over general information on the quality of service provided; complaints about the Utility would be submitted directly to EPCOR, not the City.

It if evident that the business decisions of EPCOR are less likely to be made public if the Transfer takes place. For example, in 2009, lack of transparency allowed EPCOR to hive off and privatize the City's power generation assets in a closed-door shareholder meeting with no public consultation or input.

Overall, we expect to see significant harms related to transparency and accountably arising from the proposed Transfer.

7. Conclusions

In theory, the Transfer could be in the interest of the City and ratepayers. However, the evidence shows that this is not the case.

Even if the City could generate 59 per cent of the efficiencies that EPCOR claims it can, then there is no dividend amount presented in

[27] Page 77 of the October 2016 Report.
[28] *ibid*
[29] Gibson, Diana. *EPCOR: A Study of Ownership, Accountability and the Public Interest*. Parkland Institute. September, 2005. Page 15.
[30] See *Freedom of Information and Protection of Privacy Act.* Section 1.i.xii.

the October 2016 Report that would fully compensate the City for its lost income (assuming rates increase by 3 per cent annually).

The amount of compensation necessary for the Transfer to be a benefit to the City depends on the efficiencies that the City can generate relative to EPCOR. In the forecasts presented in the October 2016 Report, Grant Thornton assumes that the City could generate none of the efficiencies cited by EPCOR. By doing so, the October 2016 Report mischaracterizes the costs and benefits of the Transfer for the City.

In fact, we have determined that the City can generate nearly all of the operational efficiencies claimed by EPCOR. We also have reason to believe that the City can generate most of the capital efficiencies presented in the October 2016 Report.

Since the City could realistically pursue some of the cost-saving measures suggested by EPCOR, the City could keep the Utility, and earn additional income directly, rather than depend on a dividend from EPCOR. By accepting the Transfer, the City would be attaching a significant source of income to the business outcomes of a private corporation, making the Transfer to be an unnecessary and risky gamble with a valued public asset.

The City and Edmontonians would lose direct oversight over the Utility, reducing the amount of transparency and accountability that Edmontonians can expect.

We also question how the Transfer will ensure that the City and EPCOR are held to account as the City faces significant decisions about its flood mitigation plan – decisions that will deeply impact the health and safety of Edmontonians. Without proper public oversight, we fear that decisions about this important infrastructure will not be subject to public consultation and scrutiny.

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Appendix

Schedule A: Net Benefits and Loses Incurred by the City if it Transfers the Utility Over the 10-year Forecast Period

Scenario 2 (EPCOR Control)

Scenario 1 (City Control)

Efficiencies (%)	Dividend **Total Benefit**	20 **252**	31 **263**	42 **274**	52 **284**	63 **295**	74 **306**	85 **317**	95 **327**	106 **338**	117 **349**	128 **360**	137 **369**	138 **370**	149 **381**	160 **392**	171 **403**	181 **413**	192 **424**	202 **434**
0.0%	**295**	43	32	22	11	0	11	22	32	43	54	65	74	75	86	97	108	118	129	139
4.7%	**306**	54	43	32	22	11	0	11	22	32	43	54	63	65	75	86	97	108	118	128
9.4%	**317**	65	54	43	32	22	11	0	11	22	32	43	53	54	65	75	86	97	108	118
14.1%	**327**	75	65	54	43	32	22	11	0	11	22	32	42	43	54	65	75	86	97	107
18.8%	**338**	86	75	65	54	43	32	22	11	0	11	22	31	32	43	54	65	75	86	96
23.5%	**349**	97	86	75	65	54	43	32	22	11	0	11	20	22	32	43	54	65	75	85
28.2%	**360**	108	97	86	75	65	54	43	32	22	11	0	10	11	22	32	43	54	65	75
32.3%	**369**	117	106	96	85	74	63	53	42	31	20	10	0	1	12	23	34	44	55	65
32.9%	**370**	118	108	97	86	75	65	54	43	32	22	11	1	0	11	22	32	43	54	64
37.6%	**381**	129	118	108	97	86	75	65	54	43	32	22	12	11	0	11	22	32	43	53
42.2%	**392**	140	129	118	108	97	86	75	65	54	43	32	23	22	11	0	11	22	32	42
46.9%	**403**	151	140	129	118	108	97	86	75	65	54	43	34	32	22	11	0	11	22	32
51.6%	**413**	161	151	140	129	118	108	97	86	75	65	54	44	43	32	22	11	0	11	21
56.3%	**424**	172	161	151	140	129	118	108	97	86	75	65	55	54	43	32	22	11	0	10
60.7%	**434**	182	171	161	150	139	128	118	107	96	85	75	65	64	53	42	32	21	10	0

65.4%	**445**	193	182	171	161	150	139	128	118	107	96	85	76	75	64	53	42	32	21	11
70.1%	**456**	204	193	182	171	161	150	139	128	118	107	96	87	85	75	64	53	42	32	22
74.8%	**466**	214	204	193	182	171	161	150	139	128	118	107	97	96	85	75	64	53	42	32
79.5%	**477**	225	214	204	193	182	171	161	150	139	128	118	108	107	96	85	75	64	53	43
84.2%	**488**	236	225	214	204	193	182	171	161	150	139	128	119	118	107	96	85	75	64	54
88.9%	**499**	247	236	225	214	204	193	182	171	161	150	139	130	128	118	107	96	85	75	65
93.6%	**509**	257	247	236	225	214	204	193	182	171	161	150	140	139	128	118	107	96	85	75
98.7%	**521**	269	258	248	237	226	215	205	194	183	172	162	152	151	140	129	119	108	97	87
100.0%	**532**	280	269	259	248	237	226	216	205	194	183	173	163	162	151	140	130	119	108	98

Schedule A compares various combinations of City income derived from the Utility and various levels of incremental dividend paid to the City by EPCOR.

The left-most column of bolded figures represents the net income the City stands to make if it does not transfer the Utility (Scenario 1). The increasing values represent the increase in income the City stands to make if it can achieve some of the efficiencies presented by EPCOR. The October 2016 Report projects the City's income from the Utility over the ten-year forecast period, assuming rates increase by 3% annually, to be $295M. We assume that if the City could generate most of the efficiencies put forward by EPCOR, it may be able to earn an additional $237M in net income over that period. This is a rough estimate for illustrative purposes. For more information, see the foot notes 18 to 21.

The "Efficiencies (%)" column indicates percentage of efficiencies that corresponds with the net income of the same row.

The bolded values at the top of the chart represent the value the City could make if the Utility was transferred to EPCOR (Scenario 2) under a variety of possible dividend values. The City is guaranteed to gain $232M in self-liquidating debt capacity and a one-time $20M dividend, totaling a value of $252M. The City could also earn up to $202M in additional income via incremental dividends, generating a total possible value of $434M.

Above the bolded values are the dividends corresponding to each of the bolded values. Each dividend level infers a level of efficiency generated by EPCOR under the Transfer. For more information on the dividends and their corresponding efficiency, see the table on page 46 of the October 2016 Report.

The figures in the body of the chart indicate if the benefits of Scenario 1 (City control) outweigh the benefits of Scenario 2 (EPCOR control), and vice versa, for a specific level of EPCOR dividend and City efficiency. The value in each cell is the benefit derived in *Scenario 2 (EPCOR Control) minus Scenario 1 (City control)*. The red figures represent a loss to the City if the Transfer is undertaken, and the black figures a gain.

The zeros in the table show the amount of dividend EPCOR would have to provide for the City to "break even" for a certain level of city efficiency or EPCOR dividend. The step pattern of the zeros shows that as the amount of efficiency the City expects it could generate increases, the greater the dividend must be for the City to be fully compensated for the forgone revenue of the Utility.

The zero in the last column of the schedule represents the point at which no dividend, in this analysis, can be realistically provided to the City such that the City comes out ahead from the Transfer.

Be believe that these results are generalizable to other scenarios where the Transfer is evaluated under different user-rates and debt level assumptions. Efficiencies are the key driver of EPCOR's claims regarding lower rates and less debt under its management. This exercise expands the analysis done by Grant Thornton to include the possibility that the City could generate efficiencies like that of EPCOR, which we have argued is possible. If the City, too, can achieve greater efficiency, it follows that their costs will decrease, and they would be better positioned to offer lower rates in the case where rates are set according to ROE.