

EPCOR Proposal - Results of Independent Assessment

Recommendation:

That the November 8, 2016, Financial and Corporate Services report CR_3800, be received for information.

Report Summary

This report has been prepared in response to Council's direction for an independent assessment of EPCOR's proposal to transfer the Drainage Utility from the City of Edmonton to EPCOR Utilities Inc.

Previous Council/Committee Action

At the November 8, 2016, City Council meeting, the following motion was passed:

1. That the non-statutory public hearing for the EPCOR proposal be scheduled for the January 24, 2017, City Council meeting from 1:30 p.m. to 9:30 p.m.
2. That the November 8, 2016, Financial and Corporate Services report CR_3800, be referred to the January 24, 2017, City Council meeting, from 1:30 p.m. to 9:30 p.m., for the purposes of discussing the report and related matters.
3. That further clarification and information be brought to the non- statutory public hearing regarding:
 - provincial and federal grants and conversations with other orders of government regarding these grants and the order of magnitude of the investment in City owned assets that support flood mitigation,
 - analysis of the material differences between the EPCOR proposal and the proposal in 2005 referred to in the November 8, 2016, Financial and Corporate Services report CR_3800 (Gold Bar).
 - a comparative outlook on rates, longer term, assuming a ramp up (e.g. 50 years and twice the spend) of capital spending to deal with flood mitigation and adaptation. This should be based on current case policies, e.g. EPCOR ROE and the City using targets for debt to equity ratio and cash balance using the Utility fiscal policy approach.

At the June 14, 2016, City Council meeting, the following motion was passed:

That Administration complete an independent assessment of the EPCOR proposal, at their cost with full control by the City of Edmonton Administration, and return to the October 25, 2016, City Council meeting with a full report, with the analysis to include:

- review of EPCOR's eligibility for Federal and Provincial grant funding
- confirmation on asset transfer decision making (roles of Council or Shareholder)

EPCOR Proposal - Results of Independent Assessment

- how governance and responsibility around risk and liability, such as for flooding, climate change and other unpredictable factors would be managed
- implications of assets and liabilities reverting back to the City in the future
- comparison of EPCOR's proposal against known utility type transactions in the marketplace

and that Council hold a non-statutory public hearing (to be scheduled after the October 25, 2016, City Council meeting) on the EPCOR proposal before Council makes a decision on the proposal.

Please note that the City Council meeting date has been changed to November 8, 2016.

Report

Context

At the June 14, 2016, City Council meeting, EPCOR Utilities Inc. presented a Proposal for the transfer of the City of Edmonton's Drainage Utility to EPCOR - excluding some components of Drainage Planning. Council directed Administration to retain a third-party to provide an independent assessment of key financial and non-financial aspects of the Proposal and to return to present its findings to City Council.

As the timelines for responding to Council's direction were limited, Administration initiated a Negotiated Request for Proposal process. This process involved a limited number of potential vendors who had the expertise and capacity to complete the full scope of work within approximately an eight-week time period. Three companies were invited to submit proposals, Administration and EPCOR participated in a joint Question and Answer session. Administration reviewed submissions and selected Grant Thornton LLP (Grant Thornton) to provide an independent assessment of the Proposal and EPCOR was supportive of Administration's choice. As requested by Council, EPCOR has agreed to cover the full cost of this evaluation.

In developing the scope of the review, Administration remained committed to the overall project principles, which were cited in the June 14, 2016, Financial and Corporate Services report CR_3753 and are reiterated below. These principles are not in order of importance but rather listed as a set of eight equal considerations.

The public's interests must be a top priority.	There must be value for the taxpayers and ratepayers
Provide a net advantage to the City and maintain or enhance the City's long-term financial sustainability	EPCOR's existing electricity, water and other business operations will be maintained
City Council will remain as regulator of drainage rates through a Performance Based Regulation, similar to water	Utility customers must not be negatively impacted: EPCOR to maintain no more than the rate increases required to support the service and quality metrics in the current Drainage Services Utility plan
Ensure ongoing effective asset	All staff impacted by the proposal will be treated

EPCOR Proposal - Results of Independent Assessment

management practices and continued commitment to current Council priorities for flood mitigation	respectfully and their employment statuses will be maintained
--	---

In addition to the principles listed above, City Council indicated that there were other areas of concern that were to be addressed through the course of the independent assessment. The review completed by Grant Thornton, contained in Attachment 1, addresses the following issues in detail and a summary of the responses is included in Attachment 2 for ease of reference:

- review of EPCOR's eligibility for Federal and Provincial grant funding
- confirmation on asset transfer decision making (roles of Council or Shareholder)
- how governance and responsibility around risk and liability, such as for flooding, climate change and other unpredictable factors would be managed
- implications of assets and liabilities reverting back to the City in the future
- comparison of EPCOR's proposal against known utility type transactions in the marketplace

Administration's Process July - October 2016

Grant Thornton was awarded the contract for the independent assessment in July 2016. In August and September, Grant Thornton conducted a quantitative and qualitative assessment of the key financial and non-financial aspects of the Proposal.

The basis for the review included ten-year financial forecast models prepared by Administration and EPCOR, written Information Request responses developed by EPCOR that incorporate Administration's input and feedback. The results contained in Grant Thornton's report in Attachment 1 are based on comprehensive consultations with Administration and EPCOR subject matter experts and management. As such, Administration would like to acknowledge the magnitude of effort and collaboration required to support the analysis of the Proposal within a short timeframe.

Overview of the Analysis

The main quantitative findings that Grant Thornton identified were EPCOR's ability to:

- achieve improved operational and capital cost efficiencies for Drainage
- assume all Drainage-related debt while having additional capacity to manage the capital program forecasted, including an accelerated flood mitigation program
- maintain and improve the Drainage Utility's financial sustainability based on EPCOR's organizational and financial capacity, as well as its ability to provide equity injections to support capital growth
- hold the 3% increase in monthly Drainage rates between 2017 and 2021
- provide an annual incremental dividend to the City of at least \$20 million, sustained over the long term

As it relates to the quantitative aspects of the EPCOR Proposal, Grant Thornton has concluded that EPCOR's Proposal "has strong merit. Among all ownership alternatives

EPCOR Proposal - Results of Independent Assessment

analyzed, the EPCOR Proposal appears to have potential for the greatest positive impacts on the City, taxpayers, and ratepayers.”

The main qualitative findings that Grant Thornton identified include EPCOR’s ability to:

- Adhere to a corporatized, not privatized, structure in which the City is and will continue to be:
 1. the sole shareholder,
 2. the sole regulator of rates, performance measures, terms and conditions of service,
 3. the sole governing body of the Drainage Utility and City policy that impacts it.
- Consolidate the four major components of the water system (wastewater and stormwater collection, water treatment, wastewater treatment, and water distribution) to achieve capital and operational synergies and to qualify for new drainage-related business development opportunities
- Take on specific drainage planning responsibilities while working closely with the City’s Growth and Land Development Planning and Engineering section as it currently does for the water services

As it relates to the qualitative aspects of the EPCOR Proposal, Grant Thornton has concluded that EPCOR’s Proposal to transfer Drainage “has strong merit. While a number of next steps are identified in Section 6 of this Study, based on the information provided, we have not identified any major qualitative impediments to the proposed transfer.”

Overall, Grant Thornton has concluded:

“Based on the quantitative and qualitative analysis presented in this Study, EPCOR’s Proposal to transfer Drainage has potential to yield net benefits to the City, taxpayers, and ratepayers. While a number of next steps are included in this Study for consideration, it is recommended that the City further consider the merits of the EPCOR Proposal based on its own risk/reward parameters and the information presented in this Study.”

Issues, Risks and Mitigation Strategies

Grant Thornton explored potential issues, risks, concerns and gaps throughout the analysis. While most issues, risks and associated mitigation strategies are detailed in the report, Administration is providing additional context by highlighting the following issues, risks and mitigation strategies for Council’s further consideration.

Grant Funding Eligibility

Many federal and provincial grant funding program parameters are unclear or silent regarding municipal corporations receiving either grant funding or ownership of municipal infrastructure constructed using grant funds. The Alberta Community

EPCOR Proposal - Results of Independent Assessment

Resilience Program guidelines indicate that funding is directed at municipalities only. The City is aware and expects that there are grant programs for climate change that will be part of federal and provincial programs, however, it is unclear whether EPCOR would be considered in the context of grant funding for flood mitigation. The City and EPCOR would need to work with grant providers to ensure that future grant programs directed at flood mitigation that the City applies for can be fully accessible by EPCOR or the City (for city-owned drainage related assets such as future dry ponds).

Flood Mitigation Strategy Approach

The current Drainage Capital Plan totals approximately \$2 billion over the next ten years or \$200 million per year. Of this, \$530 million has been earmarked for flood mitigation or \$53 million per year. While Administration is working on an accelerated flood mitigation strategy, EPCOR has reviewed the flood mapping work and has developed a strategy to address how it would manage the flood mitigation program if a drainage transfer were to occur. EPCOR's Stormwater Integrated Resource Plan would outline options for accelerating the flood mitigation plan implementation along with associated rate impacts. Administration is providing EPCOR's Flood Mitigation Approach in Attachment 3 for Council's information.

Shared Services Impacts

Administration has conducted an initial estimate of the potential stranded costs resulting from a potential transfer of the Drainage Utility. These are costs mainly associated to shared services that would remain in the City and would no longer be recovered through Drainage Utility rates and would require a transition period to eliminate, reduce or absorb through other growth in the City. The current estimate of potential stranded costs to the City is approximated at a net present value of \$29 million. To mitigate the risk of the stranded costs, EPCOR has proposed a transition payment of up to \$75 million to the City as a provision to cover the potential for stranded costs. If a transfer moves ahead, more work will be required to fully implement the transition strategy.

Employees' Questions

In the spirit of the Working Relationship Agreement, CUPE Local 30 provided Administration with results from a survey it had conducted with its members about EPCOR's proposal for Drainage transfer. CUPE indicated that it received 119 members' responses to the survey (of approximately 200 members). The majority of survey responses were not in favour of Drainage being transferred to EPCOR. However, CUPE Local 30 acknowledged that at the time of the survey being conducted, July/August 2016, there was little information available about EPCOR's proposal and/or results of the independent assessment. The intention of conducting the survey was to bring forward its members' concerns and questions related to the proposal. Through discussions with Administration, CUPE Local 30 management agreed to provide the list of fundamental questions from its members to which EPCOR would provide answers. CUPE Local 30 management feels that Grant Thornton's independent assessment report along with EPCOR's answers to member questions will provide its members with a better understanding of the proposal. CUPE Local 30 management indicated that following the Council meeting, there may be the opportunity to conduct a follow-up

EPCOR Proposal - Results of Independent Assessment

survey with its union members. Administration is providing the question and answer document in Attachment 4 for Council's information.

Consideration by Council

While it is noted that Grant Thornton provided specific Observations and Recommendations in Section 6 of Attachment 1, Administration is not recommending acceptance or rejection of the key recommendations found within Grant Thornton's report.

Administration has prepared this report to facilitate the presentation of the Grant Thornton findings to City Council on November 8, 2016. At the November 8, 2016, City Council meeting, Grant Thornton will provide a presentation to Council, EPCOR will provide a verbal presentation, and Administration and EPCOR will be available to answer Council's questions. A copy of this report will be provided to Council's Utility Advisor and he will also be available to answer questions from Council.

Council has directed that a non-statutory public hearing be held at a time to be determined after the November 8, 2016, City Council discussion on this item. If Council wishes to continue exploring consideration of EPCOR's proposal, it is recommended that Council set a date for that meeting either at Committee or Council. The City Clerk has advised the following options or possible non-statutory public hearings:

- Option 1 - Executive Committee on November 22, 2016, following the November 29, 2016, City Council meeting
- Option 2 - City Council meeting on November 29, 2016

If Council does not wish to continue discussion of the EPCOR proposal, it is recommended that the report be received for information and the City Clerk will be advised not to schedule a public hearing.

Budget/Financial Implications

Financial implications of the study are limited other than staff time as EPCOR is covering the consultant's costs.

If Council does not pursue the proposal, there would not be any financial implications as the Drainage Utility would remain within direct City operations.

Financial implications of accepting the proposal include the transfer of approximately \$1.1 billion in non-contributed tangible capital assets, \$609.3 million in long-term debt, and \$530 million in equity, increased value of EPCOR, incremental dividend of at least \$20 million on an annual basis, up to \$75 million as a transition payment to the City to cover stranded costs. The financial information here is based on current information available.

While transferring responsibility for all future Drainage debt would give the City a long-term increase in the amount of total debt servicing capacity available, the ability to use

this additional capacity is limited under the *City's Debt Management Fiscal Policy*. As the City's tax-supported debt is limited by policy to 15% of Tax Levy Revenue, the additional capacity gained through the transfer of responsibility in the long term would be limited to self-liquidating debt. To benefit from the increased capacity, the City would have to amend the *Debt Management Fiscal Policy* to remove or amend the tax-supported debt restriction to utilize the increase in debt servicing capacity as a result of a transfer of Drainage to EPCOR for tax-supported projects.

Legal Implications

Should a transfer occur, the City would continue to be responsible for legal liabilities arising prior to the transfer and EPCOR would assume responsibility for liabilities for operations assumed by them occurring post-transfer. It is suggested that the same liability protection available to the City under the *Municipal Government Act* could be granted to EPCOR through a bylaw amendment. However, the power to pass a bylaw is solely within the jurisdiction of City Council and cannot be fettered. Further analysis of the legal ramifications would be required.

Under the current *Municipal Government Act*, certain specified property types owned by specified owners are exempt from municipal assessment or non-assessable, and accordingly are also exempt from property taxation. It is expected that the assessment on the Drainage works (pipes, lift stations etc.) would be difficult to ascertain and may remain exempt, but service centre buildings would become subject to property taxes as they are today for EPCOR Water service centres and administration buildings.

The City uses local improvement financing on a number of utility capital projects including both Drainage and EPCOR Water projects today. Local improvement financing should not be impacted by EPCOR ownership of assets, but this particular issue has not been tested in the courts. Administration will continue to complete the required local improvement processes, bylaws and defend any challenges to these local improvements as they do today.

Pursuant to section 47.1 of the *Municipal Government Act*, City Council could continue to regulate the Drainage Utility following the transfer so long as the Drainage Utility is owned or operated by EPCOR Water Services Inc.

Metrics, Targets and Outcomes

Drainage Utility's 2017-18 business plan measures - which are aligned to the 2015-24 Aspirational Drainage Master Plan - are included in Attachment 5.

Attachments

1. Grant Thornton – City of Edmonton - 2016 EPCOR Proposal for Drainage Transfer Analysis
2. Answers to June 14, 2016, Council Motion
3. EPCOR's Approach to Flood Mitigation Strategy
4. EPCOR's Responses to CUPE Local 30 Employees Questions

5. Drainage Utility Performance Measures from the 2017 Utility Rate Filing

Others Reviewing this Report

- D. Jones, Deputy City Manager, City Operations
- R. G. Klassen, Deputy City Manager, Sustainable Development
- A. Laughlin, Deputy City Manager, Integrated Infrastructure Services
- C. Campbell, Deputy City Manager, Communications and Public Engagement