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April 8, 2024

Medicine Hat Utilities Ratepayer Association
Via Email: sounantha1@hotmail.com

Attention: Sounantha Boss

I received your inquiry on Wednesday, March 27, 2024, as a follow-up to my March 15, 2024 Response Letter (which was provided in response to your March 8, 2024 letter inquiry). I will summarize the following questions/concerns that you have noted as:

1. MCAF elimination; Energy Business Review scope as it relates to MCAF
2. Cost-plus rate design not in scope for KPMG
3. Cost-plus rate methodology
4. Stakeholder feedback
5. Allocation of energy and utility earnings

For simplicity, I will respond to the concerns, in order, below.

1. MCAF elimination; Energy Business review scope as it relates to MCAF

The MCAF was originally introduced in 2019 to offset a portion of the then current $23 million annual municipal shortfall (triggered by reduced commodity prices). I will note that we have been unable to locate any record that indicates Council had a plan to eliminate the charge, rather, the plan introduced the charge with increases to occur over the 4-year budget forecast period. As with any plan, revisits and review are prudent. The MCAF is currently used to fund municipal purposes (programs, services and operations) as directed and approved by Council.

In setting the fee assumptions for the 2023/2024 municipal budget, benchmarking showed that Medicine Hat MCAF fees are still low and competitive compared to other Alberta jurisdictions that have instituted this fee. Refer to Attachment 1 for most recent benchmark data. Importantly, Calgary's MCAF design is fundamentally different than the design used locally, and the current interest from the Province in Calgary's MCAF is specific to Calgary's design.

As previously shared publicly, a local shift from MCAF to property taxes would result in an approximate 7% increase to property taxes (municipal tax revenue for 2024 as approved by Council is approx. $89M, so a shift or increase of $6M = approx. 7% increase).

Regarding Energy Business Review scope, refer to item #1 in my prior Response Letter. The priority of the review is to revisit the overall philosophy of approach for the respective business units – philosophical approaches around ownership, governance, financial structure, and more, that will logically impact all other design choices. It is not practical or cost effective to have clarity of all detailed design considerations (e.g. MCAF specifics) across all philosophy/model scenarios before Council decides on the philosophy/model scenario we wish to proceed with for the respective business units. KPMG may offer specifics as part of their recommendation, but it remains possible that a second work effort may be required to determine detailed design considerations after Council confirms the desired philosophy/model combination. Thus, our expectation that the KPMG review is expected to at least inform future MCAF fee setting.

2. Cost plus rate design not in scope for KPMG.

Refer to item # 1 in my Response Letter.

While cost-plus rate design for our distribution businesses is out of scope for the KPMG review (by assumption that an alternative rate design philosophy wasn't relevant for those business units), the City did request that KPMG provide commentary regarding the cost plus assumption for the distribution business units, together with any improvement considerations related to how that approach is operationalized.

For clarity, cost-plus rate design is in scope for our commodity business units.

3. **Cost-plus rate methodology.**

You asked a number of detailed questions in your March 27th letter, and I will look to address them more wholistically from a governance perspective.

As I understand it, performance-based regulation is a form of cost of service or 'cost-plus', with efficiency / performance targets being applied to drive productive service delivery behaviours with a *share* of the resulting savings going to the customers in the form of lower rates (and the service provider retaining the remaining savings). That approach is thought to mitigate the risk of service providers not paying enough attention to costs (which flow through to the customer) because they may chase the 'plus' / return… the higher the capital costs, the higher the return. That unintended 'chasing' is the primary reason for regulatory review and oversight. Use of a performance-based approach, as a tweak to a cost-plus approach, reduces the frequency of regulatory oversight for the service providers.

Medicine Hat's distribution rates are not regulated by the province, but Council reviews them annually, with an aim of ensuring rate increases to our customers are minimized for the benefit of our customers. We know affordability is a challenge, so it is our responsibility to find the balance between rate increases and business (operating and reinvestment) sustainability requirements. When reviewing the asks from the business units, we are aided by extensive budget reviews for the inputs, benchmarking for the relative impact to customers, and knowledge of periodic third-party utility rate design reviews (and related adjustments). In the City's case, sharing of upside savings doesn't occur like it would in performance-based rate setting; rather, *all* benefits of productive improvements flow through to the customer. Refer to Attachment 2 for recent distribution benchmarking.

Some of the choices in rate design involve allocation of costs to the rate-base (the utility rate payers) or to the individual customer (customer contribution). Cost-causation is a key principle that drives rate design – if it is a common good asset (e.g. a substation) that benefit many, those costs are borne by the rate base. It the asset more exclusively benefits a customer, and that customer is asking for the infrastructure upgrade, then the customer typically pays the cost for the upgrade directly (e.g. industrial customers with dedicated feeder lines and/or substations). Council revisits these allocations as needed to ensure the rate burden is fair. For instance, Council may have an opportunity to revisit the allocation of costs for residential transformer upgrades later this year – an example where, today, an upgrade is paid by the customer because the customer wishes to add electrical load (e.g. hot tub / solar panels), but the asset upgrade can benefit a handful of others once built so there is arguably more discretion on whether these types of upgrades should be borne by the rate base or by the individual customer.

4. **Stakeholder feedback.**

Refer to item #2 in my Response Letter.

5. **Allocation of energy and utility earnings.**

Council is aware and sympathetic of the current affordability challenges that are impacting communities across Canada. That was the driver behind Council's support for the 2023 cost-pressure relief program, providing an unplanned $33.2 million in relief payments to our community.

We were able to do that because of unplanned earnings from our commodity business, but we also need to be mindful that the City is still trying to balance our municipal budget (without ongoing reliance on the unpredictable and higher risk energy business, and/or while otherwise meeting our corporate wide financial health metrics); we are also expecting energy transition obligations that will require material and likely unprecedented capital investments to sustain our energy business units, be compliant with pending Federal carbon regulations, and be ready for consumer based electrification.

An important note is that during COVID, the Council of the day voted to eliminate a planned 4% tax increase in each of two years which was a setback to the City's goal of reaching a self-sustaining municipal budget - but is testament (as is the recent cost-pressure relief) to the City's ability and willingness to change course in the best interest of our community.

I will invite you to review the City's tri-annual report that has now gone through Audit Committee and will be available in the April 22, 2024, City Council agenda package. It provides information on how business earnings have most recently been allocated, consistent with the City's dividend policy (with the proceeds also helping to reduce tax-payer burden). I would also encourage you to follow the development of the City's 2025-2026 budget as these topics will be discussed at length, starting with the Council Committee of the Whole meeting on April 23, 2024.

Finally, I'd like to close by asserting that 2024 is an important year for our energy business units. We are anticipating greater clarity on Federal decarbonization expectations, we hope to advance early decisions around local efforts towards decarbonization, we will develop and deliver a budget for 2025 and 2026 including utility rate levels (subject to bylaw approval), and we expect to see the energy business review recommendations from KPMG. This combined activity has the potential to see fundamental changes to our energy business and Council is staying focused at the strategic level to ensure our decisions are prudent for the business units while ensuring ongoing value to our community now and into the long term. I appreciate that MHURA has similar objectives of ensuring community value and I ask that you consider these shifting dynamics in any future queries, as much of what you are asking may not be relevant depending on the course of 2024.

Sincerely,

Councillor Darren Hirsch
Chair, Energy, Land & Environment Committee

Attachments: #1 - Budget MCAF Benchmark
#2 - Distribution Benchmarks

copy: Medicine Hat City Council Members
Ms. Ann Mitchell, City Manager, City of Medicine Hat
Ms. Rochelle Pancoast, Managing Director, Energy, Land & Environment, City of Medicine Hat

Attachment #1: Budget MCAF Benchmark

- The data below represents the average residential customer bill in 2023 as it pertains to MCAF. 'Average' normalizes the consumption levels across the cities by using the average consumption level of Medicine Hat residents.

January 2023 to December 2023						
	Lethbridge	Red Deer	Calgary	Edmonton	Average	Medicine Hat
MCAF	$ 293.84	$ 288.21	$ 310.06	$ 290.52	**$ 295.66**	**$ 130.91**

Attachment #2: Distribution Benchmarks

- This data is DRAFT in preparation for the 2025/2026 budget planning process.
- Note the purple and dark blue (almost black) gas and electric distribution fees for the City of Medicine Hat compared to the other locations. It is those fees that are based on the cost-plus methodology used by our distribution business units.
- 'Average' normalizes the consumption levels across the cities by using the average consumption level of Medicine Hat residents.
- MCAF charges are embedded; consumer carbon levies are excluded as that charge is not a City imposed charge and it does not differ across the communities.