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BY EMAIL

January 31, 2014

Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, 27th Floor
Toronto, ON M4P 1E4
BoardSec@ontarioenergyboard.ca

Dear Ms. Walli:

Re: Algoma Power Inc. ("API")
2014 IRM Distribution Rate Application
Board Staff Submission on Supplemental Evidence
Board File No. EB-2013-0110

In accordance with Procedural Order #2, please find attached Board staff's submission in the above noted proceeding. API has been copied on this filing.

API's reply submission is due on or before February 14, 2014.

Yours truly,

Original Signed By

Marc Abramovitz

Encl.

ONTARIO ENERGY BOARD

STAFF SUBMISSION

2014 ELECTRICITY DISTRIBUTION RATES

Algoma Power Inc.

EB-2013-0110

January 31, 2014

Board Staff Submission
Algoma Power Inc.
2014 Price Cap IR Rate Application
EB-2013-0110

Introduction

Algoma Power Inc. ("API") filed an application (the "Application") on August 16, 2013, seeking approval for changes to the rates that API charges for electricity distribution, to be effective January 1, 2014. The Application is based on the 2014 Price Cap Incentive Rate-Setting ("Price Cap IR") and also includes the impact of the rural and Remote Rate Protection funding, pursuant to Ontario Regulation 442/01.

On October 28, 2013, API filed supplemental evidence, as part of its responses to interrogatories, related to the assignment of the stretch factor used for its Price Cap IR calculation to adjust its 2014 rates. Following Board staff's submission, in which Board staff identified options for the Board to consider in addressing the supplemental evidence, API filed a Reply Submission and Notice of Motion (the "Motion") requesting that the Board make provision for further interrogatories and written submissions on API's supplemental evidence. API proposed that the Motion be heard orally. In Procedural Order #2, issued December 19, 2013, the Board granted the Motion but decided to proceed by way of written hearing.

The Board allowed for one additional round of written interrogatories and written submissions on the supplemental evidence regarding the stretch factor assignment. Board staff filed additional interrogatories on December 20, 2013. API filed interrogatory responses on January 17, 2014.

The purpose of this document is to provide the Board with the submissions of Board staff based on its review of the supplemental evidence and interrogatory responses submitted by API. While staff has reviewed the responses in detail, staff is of the view that much of the content of API's responses was in the form of a submission rather than actual evidence. More than one preamble to a response appears to be placing the onus on staff to justify why API should be assigned an "arbitrary" stretch factor of 0.6%. Board staff submits that the burden of proof that the stretch factor assigned to API is not appropriate is on the Applicant, not Board staff.

Board staff also submits that API's request raises issues that may also have implications for other distributors. Board staff notes that API is not the only distributor with geographic challenges to its operations. Accordingly, a thorough testing of the request was appropriate so that the Board has the information to assess whether API's request is in the public interest.

Board staff notes that this is API's second request to the Board to alter its assigned stretch factor. In its 2012 IRM application (EB-2011-0152) Algoma argued that it was appropriate to be assigned a stretch factor of 0.4% instead of the assigned 0.6%. In that proceeding API pointed to its characterization by the Board in a previous decision[1] as a "high cost" and "low revenue" distributor as indicative of its special circumstances when it comes to measures of productivity. API repeated its argument that a 0.4% stretch factor, being the mid-point between the high and low cohort levels, is the only just and reasonable one that should apply. The request was denied by the Board. In its Decision the Board stated:

> To award a stretch factor that is different from that set out in the letter would have the effect of providing incremental relief to the utility for those qualities that are already appropriately dealt with via the RRRP mechanism. No incremental arguments were provided that would justify a different stretch factor. In any event, an IRM application is not an appropriate venue in which a change in stretch factors should be considered.[2]

Board staff submits that arguments made by API in its 2012 application are of similar nature to those presented in its supplemental evidence.

Board staff makes detailed submissions on the following issues:

- The report entitled: Empirical Research in Support of Incentive Rate-Setting: Final Report to the Ontario Energy Board by Pacific Economics Group Research, LLC ("PEG", "PEG Report") issued November 21, 2013, as updated;
- Impacts arising from the implementation mechanism for Rural or Remote Electricity Rate Protection ("RRRP"); and
- Materiality.

[1] EB-2007-0744 Decision and Order dated October 30, 2008, p.3.
[2] *Algoma Power Inc.* EB-2011-0152

The PEG Report

In its supplementary evidence to the Application, API requested to be reassigned from the last stretch factor group (Group V) to the middle group (Group III) for 2014 rates. API reasoned that PEG's econometric model does not accurately assess and compare the efficiency of API within the general operating environment of distributors in Ontario.

Board staff asked API to identify other factors that the Board should consider to justify assigning a distributor like API to an alternative stretch factor group than that resulting from the benchmarking analysis completed by PEG. In response, API noted that PEG's estimated cost drivers used in its analyses are understating API's predicted costs. Specifically, in Table 16 of the PEG Report, API takes the position that the coefficients are not valid in API's circumstance and are unreliable as cost drivers to predict costs for API. Furthermore, API labeled itself as an extreme outlier within the data set used by PEG to determine its coefficients.

In its response to interrogatory #6, API noted that its starting point in the Price Cap IR cycle should be a stretch factor of 0.3% and, if it is able to reduce its controllable costs on a go forward basis, then the onus would be on API to present evidence as to why its stretch factor should be decreased. Furthermore, if costs increase, API would present evidence as to why its stretch factor should not be raised. Board staff notes that in response to the same interrogatory, API acknowledged that they can incorporate efficiencies to lower distribution costs.

<u>Background</u>

On October 18, 2012, the Board issued its *Report of the Board: A Renewed Regulatory Framework for Electricity Distributors: A Performance Based Approach*. In that report, amongst other matters, the Board established three rate-setting methods to provide choices suitable for distributors with varying capital requirements, while ensuring continued productivity improvement. Furthermore, the Board determined that regardless of the rate-setting plan under which a distributor's rates are set, the distributor will continue to be included in the Board's benchmarking analyses.

In its November 21, 2013 Report of the Board entitled R*ate Setting Parameters and Benchmarking under the Renewed Regulatory Framework* (the "Board Report") the Board sets out the 2014 stretch factor assignments for Ontario's electricity distributors.

In the Board Report, the Board determined that under Price Cap IR distributors will be assigned to one of five groups with stretch factors based on their efficiency. In the Board Report, the Board also states that, “unless otherwise determined by the Board, all distributors will be included in the Board’s total cost benchmarking analyses”.

The Board made these assignments based on the cost evaluation ranking determined through econometric total cost benchmarking analysis completed by PEG. The results were set out in Table 17 of the PEG Report.

Board staff makes two observations with respect to the applicability of the PEG analysis to API.

Choice of Rate-setting Method

Of the three rate-setting methods available, API applied to the Board for rates to be set for 2014 under the Price Cap IR method. Consistent with the Board Report, the Board assigned API to Group V with a resulting stretch factor value of 0.6%. This, in conjunction with the Board-approved inflation factor of 1.7% and the productivity factor of zero, would result in API’s 2014 price cap index adjustment amount to be +1.1% [1.7% - (zero + 0.6%)]. If the Price Cap IR option did not support API’s business needs, other options were available.

Empirical Analyses for Benchmarking

With respect to outliers, Board staff notes that the PEG Report describes a sensitivity analysis that it carried out with respect to specific outliers (eg: Algoma Power, Canadian Niagara Power, Greater Sudbury Hydro, Innisfil Hydro, and PUC Distribution) but did not find that the results were sufficiently influential to recommend that the Board exclude any of them from the industry total factor productivity analysis.

With respect to total cost benchmarking, the Board determined in the Board Report that PEG’s econometric model will be used for benchmarking distributor cost performance. PEG’s model is described in the PEG Report. PEG notes that it used its recommended cost model to generate econometric evaluations of the cost performance of Ontario electricity distributors. This was done by inserting values for each distributor’s output and business condition variables into a cost model that is “fitted” with the coefficients. This process yielded a value for the predicted (or expected) costs for each distributor in the sample given the exact business condition variables faced by that distributor. PEG then compared each distributor's actual total cost to the model's cost prediction. This comparison was made for each distributor's average value of cost in 2010-2012.

Board staff reiterates that the Board determined that all distributors will be included in the Board's total cost benchmarking analyses. Board staff notes that API does not take issue with its data in the benchmarking, but rather PEG's benchmarking analyses themselves. API has not provided compelling evidence (e.g., from an independent expert) that PEG's econometric benchmarking analyses are flawed with respect to API. Board staff submits that PEG's benchmarking model, which predicts a distributor's costs based on its historical actual data, has been calibrated for all distributors, not just for API. Board staff is of the view that changing the results of the PEG Report, which have been accepted by the Board, to fit API's request would not be compatible with the Board's policy direction.

API describes the assignment of the 0.6% stretch factor as "arbitrary", yet has provided no evidence to substantiate the selection of the 0.3% group as its proper "starting point".

Impacts arising from the implementation mechanism for the RRRP

In the preamble to interrogatory #7, Board staff set out the manner in which the RRRP mechanism has been established. Staff observed that the mechanism established by the Board guarantees API a substantial portion of its revenue requirement because it is not load dependent. For the 2014 year, this portion will likely be more than 50% of API's revenue requirement. With all things being equal, this mechanism reduces API's business risk. Board staff asked API to explain why the benefits associated with a reduction in business risk are not sufficient to address or offset API's high costs as a result of having a profile of a low density/low revenue distributor.

API stated that there is no interaction between API's eligibility for the RRRP subsidy and the metrics used to assess API's efficiency category. API appeared to concede that there is reduced risk of collecting revenue resulting from the RRRP but took the position that this is artificial justification for disputing the stretch factor proposed by API.

API also took the position that by using the benefit of a reduced risk of collecting revenue to justify an inappropriate stretch factor for API, Board staff is suggesting that the Board's ROE formula does not work in API's case. API also noted the following:

> API does not believe that it is appropriate for Board staff to attempt to indirectly adjust API's ROE through the stretch factor. API's ROE was approved by the Board in its last cost of service rate application. Further, the Board does not adjust distributors' ROE during the IRM period. Finally, the ROE formula is applied generically to all distributors and is not subject to adjustment (either directly or indirectly) in this proceeding.

Board staff is not advocating for a change to API’s Board approved ROE, but questions whether the reduced business risk offsets in any way the incremental revenue of a change of assignment to Group III. Board staff does not know how to best quantify this, but submits that if the Board finds that there is indeed an incremental benefit of some kind arising from the mechanism established to implement the RRRP subsidy, then the Board may wish to consider that API’s argument about commencing the Price Cap IR cycle with a lower stretch factor (resulting in higher revenues) is less persuasive than would have otherwise been the case.

Materiality

In response to Board staff interrogatory #5, API quantified the incremental impact between applying a stretch factor of 0.6% versus that of 0.3%. API responded that the incremental impact is $60,238.

Board staff notes that as per Chapter 2 of the Board’s *Filing Requirements for Electricity Distribution Rate Applications* issued July 17, 2013, the Board established materiality thresholds for costs being reviewed in a rate application. For API the materiality threshold is 0.5% of distribution revenue requirement. API’s 2013 Board-approved revenue requirement is approximately $21.2 million resulting in a materiality threshold of approximately $106,000. Board staff notes that API’s request to be placed in Group III results in an immaterial incremental impact. Furthermore, API would have to demonstrate that it should be in Group I with a stretch factor of 0.0% in order to reach a materiality threshold of 0.5% of its distribution revenue requirement.

Conclusion

Based on the Board’s policies, Board staff is not persuaded that the analyses provided by API supports its requested stretch factor assignment. Staff further submits that API’s analyses do not constitute an efficiency assessment that could reasonably support a Board determination that would assign API to Group III. Board staff does not disagree with API that it is a different distributor from the majority of electricity distributors in

Ontario on account of its geography, number of customers and the collection of the RRRP. However, Board staff notes that PEG's benchmarking model predicts a distributor's costs based on its historical actual data and the business condition variables faced by that distributor. Therefore API's unique circumstances are factored into PEG's analysis.

Furthermore, Board staff notes the reduced business risk due to the RRRP, the other rate setting options (e.g., Custom IR) that API could have chosen to support its business needs, and the fact that the impact of the move from Group V to Group III is below the materiality threshold set forth in the Board's filing requirements.

Under Price Cap IR, API has not demonstrated total cost performance commensurate with that of the distributors assigned to Group III.

All of which is respectfully submitted