EB-2013-0110

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, (Schedule B);

AND IN THE MATTER OF an application by Algoma Power Inc. for an order approving just and reasonable rates and other charges for electricity distribution to be effective January 1, 2014.

Algoma Power Inc.

Reply Submission

February 14, 2014

INTRODUCTION:

In accordance with Procedural Order #2 in this proceeding, this is the Reply Submission of Algoma Power Inc. ("API") in response to Board staff's submission dated January 31, 2014 (the "Staff Submission").

This submission has been organized such that, at the outset, API discusses its concerns with the following issues raised in the Staff Submission:

i. the offset argument;

ii. Board staff's understanding of the PEG model;

iii. the materiality argument;

iv. API's choice of rate-setting method;

v. API is recycling a failed argument; and

vi. the slippery slope argument.

Following these concerns, API has provided an explanation supported by evidence of why the stretch factor assignment produced by PEG's econometric model is inappropriate for API.

API'S CONCERNS ABOUT THE BOARD STAFF SUBMISSION:

I. THE OFFSET ARGUMENT

In Procedural Order #2, where the Board required Board staff to pose interrogatories on API's stretch factor assignment proposal, the Board wrote:

> *The Board panel is particularly interested in understanding the interaction, if any, between Algoma's eligibility for the Rural and Remote Rate Protection subsidy and the metrics used to assess Algoma's efficiency category. The Board expects Board staff to pursue this issue and for Algoma to present its case in a comprehensive manner to allow the Board to make a determination on the stretch factor.*

API, in response to Board staff's interrogatory #7 wrote that there is no interaction between API's eligibility for the RRRP subsidy and the metrics used to assess API's efficiency category. There is nothing in the PEG Report that would suggest otherwise, and Board staff has neither demonstrated nor argued that there is an interaction between API's RRRP eligibility and PEG's metrics. Rather, Board staff has questioned whether API's reduced business risk resulting from API not having to collect RRRP funding from its customers "offsets the incremental revenue of a change of assignment to Group III".[1] Based on the absence of discussion of an interaction between API's eligibility for the RRRP subsidy and PEG's metrics in the Staff Submission, API submits that the following conclusions can be drawn:

i. There is no interaction between API's eligibility for the RRRP subsidy and the metrics used to assess API's efficiency category.

ii. Board staff does not dispute that there is no interaction between API's eligibility for the RRRP subsidy and the metrics used to assess API's efficiency category.

iii. There is no evidence on the record to support the position that there is an interaction between API's eligibility for the RRRP subsidy and the metrics used to assess Algoma's efficiency category.

Despite the absence of any interaction between API's eligibility for the RRRP subsidy and the metrics used to assess API's efficiency category, Board staff in its submission has tenaciously

[1] Staff Submission, page 6.

reaffirmed its November 8, 2013 submission that API's reduced business risk resulting from API not having to collect RRRP funding from its customers "offsets the incremental revenue of a change of assignment to Group III". API submits that Board staff's "offset" position is troubling for the following reasons:

i. Board staff is unable to quantify the value of any incremental benefit arising from API not having to collect RRRP funding from its customers. Specifically, Board staff wrote, "Board staff does not know how to best quantify this, but submits 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 from higher revenues) is less persuasive than would have otherwise been the case."[2] API questions how or why Board staff would recommend that an offset be considered by the Board as justification for API's stretch factor assignment without any knowledge of or evidence to support the value of one of the two offsetting variables. In reality, the RRRP benefits the customer in as much as each dollar of RRRP funding displaces a dollar that would otherwise be collected from rates. API is held neutral by the RRRP since the sum of RRRP funding and revenue from rates is the allowed revenue requirement. Accordingly, API respectfully submits it would be inappropriate for the Board to even consider Board staff's suggestion.

ii. By suggesting that a reduced business risk benefit is "offset" by the detriment of a higher stretch factor assignment, Board staff is implicitly acknowledging that API's current stretch factor assignment is inappropriate. Another way of putting this is that Board staff is suggesting that reduced business risk will correct (i.e. "offset") a deficient stretch factor assignment, resulting in an equitable outcome for API. If API's stretch factor assignment were appropriate, why would there be any reason to even consider the principle of set-off?

iii. By suggesting that API's business risk is reduced by the RRRP, Board staff is in fact arguing that the risk premium included in API's ROE is too high (i.e. API is being compensated for risk that it doesn't face). We note that Board staff's interrogatory #3 asked API to provide its achieved ROE from 2008 to 2013. If the Board were to give any weight to Board staff's offset suggestion, API submits that doing so would

[2]Staff Submission, page 6.

amount to a decision by the Board that API's deemed ROE is inappropriate. Since this is an incentive rate-setting application, it would not be appropriate for either the substance of the Board's deemed ROE formula or its applicability to API to be raised.

iv. Ratemaking is a discipline that is grounded in legal, accounting and economic principles. The Board is required by law to set rates that are just and reasonable. API submits that an arbitrary approach of setting off an unsubstantiated and unquantified over-earning against an under-earning to correct the under-earning is not an appropriate method for setting just and reasonable rates. Rather, the Board should focus on the issue at hand, being what is the appropriate stretch factor assignment for API?

II. BOARD STAFF'S UNDERSTANDING OF THE PEG MODEL

The Staff Submission did not refute the empirical evidence filed by API in support of departing from the stretch factor assignment produced by the PEG model. Rather, Board staff simply wrote that "API's analysis do not constitute an efficiency assessment that could reasonably support a Board determination that would assign API to Group III." In other words, Board staff is simply saying that API did not prove its case, without explaining *why* API did not prove its case. If Board staff disagrees with API's analysis or considers API's analysis incorrect, then presumably Board staff would have said so. Rather, Board staff fell back on its original position that PEG's benchmarking model accounts for API's unique circumstances. Although further submissions on the PEG model as it applies to API are set out below, API wanted to raise its concern that Board staff's lack of analysis may suggest that Board staff may not sufficiently understand the PEG model or API's empirical evidence as it applies to the PEG model.

III. THE MATERIALITY ARGUMENT

Board staff argued that the incremental impact of API's stretch factor assignment proposal is below the materiality threshold set out in the Board's Filing Requirements, and is therefore "an immaterial incremental impact". Board staff sounds very much like an intervenor in drawing this conclusion (i.e. as opposed to simply pointing out the materiality threshold for the Board's

consideration). In any event, API submits that the materiality threshold in the Board's Filing Requirements pertains to explanations that must be provided by an applicant (i.e. explanations for material variances, material expenditures, etc.). The materiality threshold does not preclude an applicant's eligibility to apply for the recovery of amounts below the materiality threshold in API's circumstance. The Board does consider materiality as a threshold issue for z-factor and ICM applications, but those thresholds do not apply to this circumstance.

The $60,000 incremental impact is significant for API. As well, this is not a one-time cost. The Board's decision on API's stretch factor assignment will impact API for years, resulting in a cumulative incremental impact well beyond API's materiality threshold.

IV. CHOICE OF RATE-SETTING METHOD

Board staff stated that "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." and "If the Price Cap IR option did not support API's business needs, other options were available."

Board staff seems to be under the impression that API chose the Price Cap IR option provided in the Board's October 18, 2012 report *A Renewed Regulatory Framework for Electricity Distributors: A Performance Based Approach*. If this is Board staff's impression, it is incorrect.

As part of API's last cost of service proceeding (EB-2009-0278), API entered into a settlement agreement on September 17, 2010, whereby API agreed to consult with intervenors prior to proposing any future IRM to set rates in non-rebasing years. The reason why this was an important issue for API and the intervenors was because the Board's IRM would not work for API since its residential customers' rate increases are, by law, required to be the average of all distributor rate increases in the prior year. API and the intervenors worked together to develop API's IRM mechanism that was approved by the Board and was used by API in EB-2011-0152, EB-2012-0104 and in this 2013 proceeding, EB-2013-0100. API does not have a choice to pursue an alternative option to "support API's business needs".

API raises this as a concern because it is important for the Board to understand that there is no other alternative for API to address its stretch factor assignment problem as suggested by Board staff.

V. API IS RECYCLING A FAILED ARGUMENT

At page 2 of the Staff Submission, Board staff submitted that, "the arguments made by API in its 2012 application (EB-2011-0152) are of similar nature to those presented in its supplemental evidence." In other words, Board staff is suggesting that API is trying to make the same argument that was rejected by the Board in API's 2012 rate application, and that therefore the issue has already been decided.

As pointed out in API's response to Board staff's interrogatory #1, the third generation IRM stretch factor assignment methodology used for API's 2012 application was different from the stretch factor methodology used in this 2014 application. Specifically, API wrote in response to interrogatory #1:

> *Board staff's interrogatory seems to place great emphasis on the Board's 2012 IRM Decision (EB-2011-0152) in regard to API's stretch factor assignment (the "2012 Decision"). It is important to note that the third generation IRM ("3GIRM") stretch factor methodology on which the 2012 Decision was based was different from the fourth generation IRM ("4GIRM") stretch factor assignment methodology applicable to API's current 2014 IRM application. Under 3GIRM, stretch factors were established based on OM&A costs relative to other LDCs. Under 4GIRM, stretch factors are established based on costs relative to each LDC's costs as predicted by an econometric model. As set out in API's response to interrogatory #7, API does not believe that the econometric model is responsive to API's unique attributes.*

The argument made by API in the 2012 proceeding was that API had uniquely high cost and low revenues, and should therefore not have had its stretch factors established based on a comparison of its OM&A cost to those of other LDCs. In this application, API is arguing that PEG's econometric model is not responsive to API's unique attributes. While API is seeking the same relief in this proceeding as it did in the 2012 proceeding, the basis for the relief sought is completely different from that in the 2012 proceeding as is the Board's methodology to assign stretch factors.

As discussed below, API has provided empirical evidence to demonstrate why PEG's econometric model is not responsive to API's unique attributes. API is troubled that Board staff did not seem to consider API's empirical evidence, and that Board staff has suggested that the

arguments made by API in this proceeding to be "of similar nature" to the arguments made in the 2012 proceeding.

VI. THE SLIPPERY SLOPE ARGUMENT

At page 2 of the Staff Submission, Board staff wrote:

> *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.*

This type of argument is commonly referred to as a "slippery slope" argument. In other words, if the Board accepts this argument for API, the door will be flung open for other distributors to come through. API questions why Board staff would even make this submission, given that:

i. API's stretch factor assignment proposal is based on more than just its geographic challenges; and

ii. no other distributor in Ontario (other than Hydro One Remotes) faces the same customer density issues that API faces.[3]

Further, API submits that Board staff should be more concerned about getting to the right outcome for API's stretch factor assignment than raising a concern about other distributors coming forward. This kind of argument has no place in setting just and reasonable rates.

API submits that instead of thoroughly testing API's proposal, Board staff has aggressively opposed it as though it has an interest in the outcome of this proceeding unrelated to setting rates that are just and reasonable. Further, the positions taken by Board staff addressed above are irrelevant to the issue at hand being; *what is the appropriate stretch factor assignment for API?*

[3] Please refer to API's response to interrogatory #4 for evidence to support this assertion.

WHAT IS THE APPROPRIATE STRETCH FACTOR ASSIGNMNENT FOR API?

At page 6 of the Staff Submission, Board staff concluded:

> *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.*

Board staff's conclusion raises the question: are API's unique circumstances factored into PEG's analysis?

Board staff seems to think so for the following reasons:

i. The PEG report describes a sensitivity analysis with respect to outliers (including API) 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. Specifically, at page 4 of the Staff Submission, Board staff wrote (under the heading Empirical Analysis 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.*

The Board should understand that this sensitivity analysis served the purpose of determining whether the outliers should be excluded from the development of a total factor productivity measure. It is not germane to the discussion of the stretch factor assignment. In fact, this reference serves no purpose other than to confuse two discreet matters; total factor productivity and stretch factor assignment. Simply stated, total factor productivity is a factor that measures the rate of growth of inputs against the rate of growth of output for the electricity distribution industry in Ontario as a whole. The stretch factor is derived from a measure of an individual LDC's estimated costs against its actual cost for a given time period.

API has not raised matters related to the development of total factor productivity. The focal point of API's position is that the "coefficients" or "cost drivers" developed by PEG are based on the industry average, and are not representative of API, which is an outlier in the Ontario distribution industry, and therefore do not accurately predict its cost.

In its report dated May 2013, *Empirical Research in Support of Incentive Rate Setting in Ontario: Report to the Ontario Energy Board*, PEG on page 76 under the heading Unit Cost Benchmarking and Stretch Factors, wrote:

> *This graph is presented in Chart One for all distributors except Algoma Power, Hydro One and Toronto Hydro. These distributors are not included because their service territories and output are so large compared with other distributors that including them would compress every other sample observation into a very small space, making it impossible to distinguish different output-service territory combinations within the Ontario electricity distribution sector.*

And in the footnote reference #33 on page 76, PEG explained the following;

> *We used the "median" rather than "mean" values to distinguish firms based on service territory because the territories for two distributors – Algoma Power and Hydro One Networks – were so much larger than every other Ontario distributor that they produce a distorted measure of "average" service territory in the Province. In fact, when the sample mean service territory is calculated, every firm but Hydro One and Algoma Power would have territories below the mean.*

In both of these references, it is evident that PEG, in its analysis, recognized that API's characteristics were significantly different than that of all other distributors in the province with the possible exception of Hydro One.

In the PEG Report titled "*Productivity and Benchmarking Research in Support of Incentive Rate Setting in Ontario: Final Report to the Ontario Energy Board"* dated November 2013 (Issued on November 21, 2013 and as corrected on December 19, 2013), PEG makes several relevant observations. Beginning on page 54 of the report, PEG states, *"Distribution cost is therefore sensitive to the circumstances of the territories in which they provide service"*, and; *"The spatial distribution of customers will therefore have implications for network costs".* Both of these statements are significant when considering the stretch factor assignment for API, for which the spatial distribution of customers is so significantly different than for other Ontario LDCs; a fact recognized by PEG in these previous two references.

ii. With respect to the predicted costs used to determine the stretch factor assignment, Board staff wrote:

> *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.*

API's contention is that the "coefficients" or "cost drivers" used by PEG to predict API's costs, not the methodology more generally, are not appropriate when applied to API, which, as has been demonstrated, is an extreme outlier in terms of the business conditions and output levels that drive cost. These "coefficients" or "cost drivers" were developed from data representing the total distribution of Ontario LDCs, and therefore assume that an average or typical relationship between the cost driver and the business condition or output will be achievable by all LDCs given appropriate internal programs to drive efficiencies. The term 'fitted" does not suggest the coefficients themselves were altered or modified to suit each individual LDC but rather applied to an equation containing outputs unique to each individual LDC in order to predict that LDC's cost. API has presented irrefutable evidence that its data is not represented by "average" data of Ontario LDCs. This was acknowledged by in the Staff Submission when they wrote:

> *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.*

PEG, in their analysis, and noted in the foregoing, acknowledges that API's business conditions are such that they are not comparable (to the extent that inclusion of API data dwarfs the measure of all other LDCs) to the remainder of LDCs in Ontario, except Hydro One.

In its response to Board staff interrogatory # 4, API provided statistical evidence as to why the coefficients or cost drivers developed by PEG will consistently under-estimate API's costs in the stretch factor assignment.

Actual LDC activities were cited to illustrate how the coefficient developed on industry averages will understate API's predicted costs. A clear and irrefutable illustration is the costs associated with adding new customers. One of the cost drivers selected by PEG is the percent of customers added in the last 10 years, and for this cost driver (NG) PEG determined that the appropriate coefficient is 0.0165; that is to say that a 1% increase in this variable increased distributor costs by 0.017%.

In its response to Board staff interrogatory #4, API pointed out the number of customers connected per installed distribution transformer as a real cost of connecting new customers. Whereas the average Ontario distributor has the potential to connect 5 to 7 residential customers to a centrally located 25 kVA distribution transformer (a 25 kVA distribution transformer is the standard minimum commercially available size available), API will normally be able to connect at most two residential customers to one distribution transformer; a 2:1 ratio. This means API will have purchased and installed a 25 kVA distribution transformer and have made all necessary line modifications associated with the transformer installation for every two

new residential customers added. This is three times the average LDC's cost for the same activity. Clearly, this coefficient does not work for API and in fact will under estimate API's cost.

API's customer density in terms of customers per kilometer of distribution line also impacts the applicability of this cost driver to API's real costs of connecting new customers. API has the lowest density of customers per kilometer of distribution line of any LDC at only 6.28. This is clear evidence that, on average, API will install more poles and wire than any other LDC in Ontario to add a new customer to its distribution system. Again, this is a real cost that proves that this coefficient does not work for API and in fact will under estimate API's cost.

A second cost driver (L) the average line length was determine by PEG to be 0.283. A 1% increase in the average circuit kilometers raised the costs by 0.29%. Again, it is easily recognizable that with API being an extreme outlier in terms of the size of its service territory and customer density in terms of customers per square kilometer, a fact noted and discussed in PEG analysis, this cost driver is not representative of API's own costs. To access, construct and maintain each incremental length of distribution line, API will drive further, consume more fuel, use more specialized all-terrain vehicles, cut more trees and require more person-hours of labour than any other LDC in Ontario, with the possible exception of Hydro One.

Based on all the evidence presented by API in this matter, there is no doubt that a set of "coefficients" or "cost drivers" developed from a data set representing all LDCs in Ontario is not representative of API's actual costs. API, in its response to interrogatory #4, presented some specific instances in which an output (such as a customer) drives significantly more added costs than would be typical across the industry in Ontario. These cost levels must be incurred in order to provide acceptable service levels to customers. Therefore, a model using the average of cost drivers would consistently underestimate API's cost.

CONCLUSION

For the reasons set out above, API submits that API has established that the stretch factor assignment of 0.6% generated by the PEG model would be inappropriate for API. In the absence of a reliable prediction of API's costs, the reasonable compromise in this proceeding would be to start API at the mid-point stretch factor of 0.3%.

API believes that it be would be more appropriate, given its uniqueness, to assess future efficiencies and inefficiencies against its own actual costs. Should API be able to reduce its controllable costs on a go forward basis, then the onus ought to be on API to present evidence as to why its stretch factor should be decreased from 0.3%. Likewise, if these same costs increase than the onus should be on API to present evidence as to why its stretch factor ought not to be raised. API's annual scorecard will provide sufficient information to inform the Board.

All of which is respectfully submitted. February 14, 2014

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