

IN THE MATTER OF the Alberta Electric System Operator 2009 Deferral Account Reconciliation Application (Application Number 1606095 and Proceeding ID 589) for Alberta Utilities Commission approval pursuant to sections 14, 30, and 119 of the *Electric Utilities Act*, S.A. 2003, c. E-5.1.

**Alberta Electric System Operator
2009 Deferral Account Reconciliation Application**

**AESO Reply Argument
November 12, 2010**



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1 INTRODUCTION

- 1 On November 5, 2010, the Alberta Electric System Operator (“AESO”) filed written argument on its 2009 Deferral Account Reconciliation Application (“Application”) with the Alberta Utilities Commission (“Commission”). Argument was also filed by the following three interveners:
 - the Industrial Power Consumers Association of Alberta (“IPCAA”);
 - TransCanada Energy (“TransCanada”); and
 - the Office of the Utilities Consumer Advocate (“UCA”).
- 2 IPCAA also filed confidential argument on the Revay and Associates unredacted *Cost Review Report* on the Kepphills-Ellerslie-Genesee (“KEG”) unit transformers conversion project. The report was provided on a confidential basis to the Commission and IPCAA during the course of the proceeding, as discussed in section 3.1 of the AESO’s argument.
- 3 The AESO provides the following reply argument in response to matters raised by interveners in argument. Where the AESO has already sufficiently addressed a matter in its argument, no further comments are provided. However, lack of response in this reply argument to any particular matter raised by an intervener in argument does not indicate agreement on that matter by the AESO.
- 4 The AESO has not found it necessary to refer to confidential information in this reply argument, and accordingly has not submitted a separate confidential version.

2 MATTERS RAISED IN ARGUMENT OF IPCAA

5 IPCAA filed argument on the AESO's recovery of costs for the KEG unit transformers conversion project arising from directions in Decision 2008-101. The AESO summarized its views on the matter in section 3.1 (pages 7-8) of its argument, and provides comments below on additional matters raised in argument by IPCAA.

6 IPCAA's argument, although extensive, focuses on three central concerns:

- the basis for and accuracy of the estimate approved in Decision 2008-101,
- the AESO's determination of prudence with respect to the costs incurred for the project, and
- the reasonableness of specific components of the actual costs incurred for the project.

7 In addition to its concerns related to the costs for the KEG project, IPCAA also submitted that the recovery of those costs should be varied from the approach proposed in the Application.

2.1 Basis for and Accuracy of Estimate

8 IPCAA raises several concerns that relate more properly to the basis for and accuracy of the project cost estimate originally reviewed in Decision 2008-101. Although the AESO does not consider IPCAA's concerns to be warranted, the AESO submits that the appropriate time to raise such concerns would have been in the proceeding that led to Decision 2008-101 when the estimate was first examined.

9 In particular, IPCAA expresses concern (page 9) that the estimate included "the application of a contingency to total project costs when there have already been significant expenditures incurred." IPCAA appears to be ignoring the nature of a contingency as "an event that may but is not certain to occur" (Merriam-Webster Online Dictionary). Although a contingency allowance is frequently estimated as a percentage of project costs, the nature or likelihood of a contingency may be unaffected when costs are incurred during the course of a project. In this case, the failure of the spare generator transformer may be considered a contingent event, and the incurrence of costs in the initial planning and engineering of the project would not affect the likelihood of that event occurring nor the costs associated with responding to that event. The AESO submits it would therefore be inappropriate to reduce the contingency allowance due to the incurrence of costs in the initial stages of the project.

10 IPCAA also provides various reinterpretations of the estimate, suggesting, "If the contingency of \$163,328 is divided by this estimate of future costs, the contingency level is now 22%" (page 10) and "If the 15% contingency was taken into consideration in stating the estimate range, it would be an accuracy of approximately +45%/-15%." (page 14) As explained above, IPCAA's reinterpretations ignore the nature of a contingency. IPCAA's reinterpretations also ignore the nature of the accuracy of the cost estimate provided for the project. Whether expressed as $\pm 30\%$ of the original cost estimate or +45%/-15% of IPCAA's reinterpreted estimate, the fact remains that the project was expected to cost between \$3,173,848 and \$5,894,288, and that this was the cost range described in Decision 2008-101 as \$4,534,068 with an accuracy of ± 30 percent.

- 11 IPCAA appears to further suggest that the accuracy range of the total cost estimate also applies “by cost component” (page 10). However, there was no accuracy range provided for individual cost components of the estimate examined in the proceeding that led to Decision 2008-101. It is reasonable that the total cost estimate may have expected that variances could occur above and below the estimates for individual cost components, with offsetting impacts on the total cost estimate. The impact of offsetting variances in different components of a total cost has certainly been discussed in the context of AESO deferral account reconciliations, and was mentioned by the AESO in argument (page 12) in its discussion of future deferral account reconciliations. The accuracy range of a total cost estimate should not simply be assumed to apply to each individual cost component of that estimate.
- 12 The AESO submits that such reinterpretations and assumptions with respect to the project cost estimate originally reviewed in Decision 2008-101 are irrelevant to the matters in the current Application, and should be dismissed by the Commission.

2.2 Determination of Prudence

- 13 IPCAA includes (page 4), but generally ignores, the determination in Decision 2000-1 (page 46) on ESBI Alberta Ltd.’s 1999/2000 General Rate Application that “[t]he concept of prudence is used to determine whether, at a particular time in question, an arrangement is or was appropriate and reasonable given the circumstances known or which ought to have been known.” An essential component of the assessment of prudence is the reasonableness of an arrangement **at the time and in the circumstances under which it was made**, rather than at a later time with hindsight and the benefit of unhurried examination.
- 14 In the application for KEG project cost recovery (although not mentioned in Decision 2008-101), the AESO noted considerations related to coordinating the work with planned generator unit maintenance shutdowns and carrying out the work over the shortest possible timeframe to minimize risks to the reliability of the transmission system. The Revay and Associates *Cost Review Report* (page 7) also noted the schedule constraints under which the project was completed.
- 15 IPCAA expresses concern (page 11) that 57% of the total costs for the project were provided by a single vendor, ABB Canada Ltd. IPCAA apparently gives no consideration to the fact that those costs related to reconfiguration of the unit transformers (noted in the *Cost Review Report*, page 6) which constitutes work that would be impractical and inefficient to provide through multiple vendors. As further explained in the *Report* (page 7), three suppliers were approached for this aspect of the project, two of which declined to submit tenders. An assessment of prudence must recognize the reasonableness of decisions made in consideration of such circumstances.
- 16 IPCAA also ignores that at least 19 vendors were involved in the project overall (also noted in the *Cost Review Report*, page 6). The *Report* (page 8) explained that some services were from suppliers who were “the only ones capable of providing the service (transformer testing)” or were already on-site and therefore able to meet the project’s time constraints.

- 17 The AESO submits that IPCAA's concerns regarding prudence of some aspects of the KEG project work do not reflect the time at which and circumstances under which the work was arranged. As supported by the Revay and Associates *Cost Review Report*, the work completed by EPCOR was appropriate and reasonable given the circumstances at the time, and was accordingly prudent.
- 18 IPCAA also states (page 9) that "the AESO's test for prudence appears to be that the costs were 'consistent with those anticipated' which was apparently measured by being 'within the $\pm 30\%$ accuracy of the \$4.5 million cost estimate provided in the application.'" However, the quoted text was not referenced by the AESO as a test for prudence. As explained in the AESO's Application (page 54), "The AESO engaged a consultant to review the costs The review concluded that the costs invoiced to the AESO were the direct costs of carrying out the project and were prudent, accurate, and complete." The AESO's test for prudence accordingly relied on "a detailed examination of these costs" (*Cost Review Report*, page 3) carried out by an independent third party experienced in project audits.
- 19 IPCAA further suggests "that little, if any, weight can be assigned to the *Cost Review Report*" (page 16). IPCAA appears primarily concerned about the disclaimer on page 10 of the *Report*. In the AESO's experience, a disclaimer of this nature is common in such a report, and simply states that the work was done for a specific client (in this case, the AESO) and purpose, and cautions against use of the report by other parties for other purposes. The AESO submits that the disclaimer does not lessen the conclusion in the *Report* that the costs invoiced to the AESO were prudent, accurate, and complete.
- 20 IPCAA suggests the *Report* contains "other deficiencies" but in doing so generally ignores statements in the *Report* itself. For example, IPCAA suggests that a Revay and Associates criterion for its review was simply that procurement packages should follow EPCOR's procedures. However, Revay and Associates first reviewed the procedures themselves and ascertained that they contained "normal and sufficient safeguards against abuse regarding solicitation of single source suppliers and other non-competitive arrangements for major purchases." (*Cost Review Report*, page 7) IPCAA similarly suggests (page 16) that Revay and Associates "defined their own basis of the review", ignoring that the procedures used "were generally in accordance with General Accounting Standards for both financial and compliance audits." (*Cost Review Report*, page 5) Contrary to IPCAA's suggestions, the *Cost Review Report* was detailed, thorough, and complete.
- 21 In addition, IPCAA suggests (page 7) that the AESO unnecessarily requested confidentiality for the *Cost Review Report*, "rendering the review of the prudence of expenditures very difficult for intervenors, [which] undermines the whole regulated utility model." The AESO's request for confidential treatment of the *Report* was not unnecessary, however, as the Commission granted the request in its ruling of September 24, 2010, after reviewing the unredacted version of the *Report*. The AESO further cooperated with IPCAA by raising the confidentiality issue as soon as practical after receiving IPCAA's information request, and by providing a redacted version of the report and additional information in response to IPCAA's concern. Rather than creating difficulty for IPCAA, the AESO was attempting to be helpful while recognizing the financial and commercially sensitive information in the unredacted *Cost Review Report*.

22 The AESO accordingly submits that its determination of prudence with respect to the costs incurred in the KEG unit transformers conversion project is appropriate and reasonable.

2.3 Reasonableness of Specific Costs

23 The AESO agrees with IPCAA (page 7) that the Commission is not constrained to a narrow definition of prudence when determining the prudence of expenditures and is empowered to examine the particular circumstances relative to the Commission's prudence standard. The AESO accordingly offers the following comments on some specific costs discussed by IPCAA with respect to the actual costs incurred in the project.

24 The AESO first observes that IPCAA has an extremely narrow view of possible causes of variances from an estimate, reflected in its statement (page 8) that "an over-expenditure variance on an original estimate can only stem from three sources – (a) the original estimate was under-stated (or poorly done), (b) the management of the expenditures was lax or (c) there was material and justifiable change in the scope (which includes schedule) of the project." IPCAA apparently allows for no uncertainty in a cost estimate when project scope and schedule do not change. The AESO submits that such a narrow view is unreasonable and ignores the uncertainty stated to apply to the estimate of costs for the KEG project.

25 IPCAA suggests (page 11) that "a material inconsistency [exists] in the AESO/EPCOR estimate of the effects of escalation in IPCAA.AESO-002." IPCAA is specifically referring to:

- an amount of \$54,443 included for inflation in the original project cost estimate, compared to
- a total of \$249,650 identified for escalation of labour costs in the actual costs recorded for the project.

26 The small amount of inflation included in the original estimate reflected the expected cost increase from when the estimate was prepared to when the work was expected to be done. The actual amount of escalation reflected the actual change in labour costs from when the estimate was prepared to when the work was actually done, including the impact of the delay attributable to the failure of the spare generator transformer. The AESO submits there is no inconsistency in the information provided to IPCAA.

27 IPCAA suggests (page 13) that the AESO provided an incomplete response to information request IPCAA.AESO-003 which sought relevant correspondence between the AESO and Capital Power and between the AESO and other parties. IPCAA stated its suspicion was warranted by a later statement in the information response where "the AESO notes that they were 'apprised throughout the project of scope and schedule changes'." Much of the coordination for the project was carried out verbally, usually by telephone. Additional coordination occurred through in-person and tele-conference meetings. Specific technical matters related to transmission system reliability, protection, and control were addressed through e-mail correspondence, but those items are not relevant to the project's costs. The AESO considers that the letters, invoices, and interim report discussed in the information response constitute the documents relevant to the costs of the project.

- 28 IPCAA suggests (page 14) that the AESO has not met “[t]he responsibility of an Applicant to provide complete and comprehensive support for all of the expenditures in a project”. With respect, the AESO considers that the *Cost Review Report* provides detailed, thorough, and complete support for the KEG project cost. In addition, the use of an independent third party experienced in project audits to review the costs goes beyond the normal responsibility of an applicant, and provides further support for the KEG project cost. There is no basis to suggest the AESO has not fully satisfied all reasonable responsibilities of an applicant.
- 29 IPCAA expresses concern (page 15) that “the AESO has relieved EPCOR of normal reporting requirements under ISO Rules 9.1.3.1 to 9.1.3.6 on the grounds that the Cost Review Report could be a substitute for those reports.” As explained in information response IPCAA.AESO-003, the AESO did not require monthly reporting by Capital Power as is generally required under ISO Rule 9.1.3.1. However, the AESO considers that the ISO Rules 9.1.3.2 and 9.1.3.3 requirements to notify the AESO of schedule and scope changes, with reasons, was accomplished through the verbal coordination discussed above. Similarly, the AESO considered that the project change proposal and review required by ISO Rules 9.1.3.4 and 9.1.3.5 were not necessary considering the detailed coordination required during the project. As already explained in the information response, the AESO considered that the *Cost Review Report* made a final cost report under ISO Rule 9.1.3.6 unnecessary. In summary, the AESO did not relieve Capital Power of the reporting requirements under ISO Rule 9.1.3, and instead submits that the intent of those reporting requirements was satisfactorily met through other means during the course of the project.
- 30 Having consideration for all of the above, the AESO submits there is no basis, and certainly no substantial or material basis, for IPCAA’s request (page 19) that the Commission “should deny all or a significant portion of the \$1 million cost overrun” for the KEG unit transformers conversion project.
- 31 The AESO also submits that, through its Application, the *Cost Review Report*, and information responses, it has provided substantial and complete information that constitutes “acceptable documentation to validate the quantum” of “actual direct costs” as required by Decision 2008-101, and that such information demonstrates the prudence of those costs. Accordingly, the AESO submits there is no justification for IPCAA’s request (page 19) that the AESO be required to respond to the eight additional information requests attached as Appendix A to IPCAA’s argument.

2.4 Recovery of KEG Project Costs

- 32 IPCAA suggests (page 18) that it is inappropriate to recover the KEG project cost as an adjustment attributed to the 2008 production year in the AESO’s deferral account reconciliation.
- 33 However, Decision 2008-101 noted (page 1) that the AESO’s application for cost recovery included a request “that the actual costs of the conversion of unit transformers, as determined by the Commission to be recoverable under the AESO’s tariff, would be subject to necessary deferral treatment consistent with such treatment generally accorded by the Commission concerning the AESO’s forecast revenue requirement.” In its decision, the

Commission accordingly ordered (page 8) that “[t]he AESO include these direct costs in its next Deferral Account application.” The AESO consequently included the majority of the cost of the project in its 2008 deferral account reconciliation application that was approved on a final basis in Decision 2009-191, and has included the remaining cost in the current Application.

- 34 The AESO notes that the \$5.5 million cost of the KEG unit transformers conversion represents only about 0.6% of the \$880.2 million total revenue requirement subject to deferral account reconciliation for 2008, as determined from Table 4-1 in the Application (pages 51-53). As noted in Decision 2008-101 (page 7), the AESO’s application for cost recovery was also unique based on the facts and circumstances of the situation.
- 35 The AESO further notes that it does not amortize other expenditures for capital costs of other parties. As well, the AESO’s tariff includes amortized costs only for facilities of regulated owners of transmission and distribution facilities, which are subject to regular review by the Commission in tariff applications by those parties. The AESO considers that amortizing the KEG project cost would add unnecessary complexity to the cost recovery.
- 36 Accordingly, in consideration of the small amount of the AESO’s revenue requirement represented by the KEG project costs and the uniqueness of the cost recovery, and for reasons of simplicity, the AESO submits that the KEG project cost should continue to be treated as part of the AESO’s 2008 revenue requirement in its deferral account reconciliation, as originally ordered in Decision 2008-101.

3 MATTERS RAISED IN ARGUMENT OF TRANSCANADA

- 37 TransCanada submitted argument supporting (pages 1-2) the AESO's proposed process for future deferral account applications, stating that the accuracy of the reconciliations is important to TransCanada.
- 38 In argument (page 13), the AESO withdrew the specific requests supported by TransCanada. The AESO had initially requested approval of its proposed approach for its 2010 deferral account reconciliation application, and explained that the extension of the regulatory review of the current Application raised concerns that the resulting decision could impact and delay the 2010 application. The AESO noted that it "instead intends to prepare and file its 2010 deferral account reconciliation in the same manner as its 2009 application." The AESO considers that this approach will satisfy TransCanada's concern for accuracy.
- 39 The AESO also suggested in argument (page 13) that "the Commission may want to consider further discussion with stakeholders to review alternative proposals related to the deferral account reconciliation application process, before directing material changes to the current approach." The AESO notes TransCanada also supports (page 2) further discussion on the matter.

4 MATTERS RAISED IN ARGUMENT OF UCA

40 UCA raised two concerns in argument:

- “the continual re-reconciliation of years” (page 2, para. 2) and
- “that the AESO may not be accurately interpreting or applying Commission Decisions” (page 5, para. 12).

41 The AESO acknowledges the amount of information and detail included in the AESO’s deferral account reconciliation applications. UCA appears to be concerned (pages 4-5, para. 11) with the efficiency of the reconciliation process for small deferral account balances.

42 The AESO does not understand how the efficiency of the reconciliation process would be materially improved by an alternate treatment of small deferral account balances. The AESO observes that, excluding the current year (2009), balances exceeded \$3 million for two of the remaining five years in the Application, was \$1.5 million for one year, and were less than \$0.5 million for two years. The AESO considers that the larger amounts need to be reconciled to satisfy concerns of accuracy, as expressed by TransCanada in argument and by other participants in the AESO’s consultation on deferral account reconciliations (as mentioned in information response AUC.AESO-001). It may have been possible, by implementing an alternate process, to remove two or three years from the 2009 deferral account reconciliation, but three to four years would remain to be reconciled. The AESO doubts that removing two or three years would provide any appreciable improvements in the efficiency of the reconciliation process, while its accuracy and transparency could decrease.

43 UCA’s concern regarding re-reconciliations also appears to relate (page 4, para. 10) to the fact that distribution utilities recover deferral account balances on a prospective basis using the current consumption of each customer. The AESO again does not understand how the reconciliation of its own deferral accounts relates to the distribution utilities’ recovery of their deferral account balances. The AESO’s deferral accounts have been reconciled retrospectively for several years, and have not affected the approach used by distribution utilities. The AESO expects that if it implemented an alternative approach to reconciling its own deferral accounts, it similarly would not affect the approach used by distribution utilities.

44 The AESO suggests that UCA’s concern may reflect the relative stability of the proportion of the AESO’s deferral account balances allocated to distribution utilities and the resulting minimal impact that alternative approaches may have. The AESO understands that individual industrial market participants like TransCanada may be more materially impacted by different approaches, resulting in their greater concern for the accuracy of the reconciliation.

45 With respect to the interpretation or application of Commission decisions, UCA cites (page 5, paras. 12-13) the AESO’s reliance on Decision 2007-104 for the allocation of a \$16.1 million refund from ATCO Electric in compliance with a direction to transition to a flow-through tax method. The direction responded to by ATCO Electric and approved in Decision 2007-104 (page 16) included a requirement to refund “any future income taxes that AE has currently collected from customers”. The refund from ATCO Electric to the AESO included a

year-by-year calculation of the future income taxes that had been collected by ATCO Electric as part of its transmission facility owner tariff in prior years. The AESO accordingly allocated those amounts to the relevant production years in its deferral account reconciliation. The AESO understands that ATCO Electric did not treat the amounts as part of its current year transmission revenue requirement, but rather as adjustments originating in prior years.

- 46 The AESO considers the appropriate test of the AESO's interpretation and application of Commission decisions is the Commission's approval of that interpretation and application in AESO deferral account reconciliation proceedings. The AESO identifies, in reasonable detail, the variances arising from Commission decisions, including the years to which amounts are attributed and usually noting significant multi-year impacts (such as that which resulted from Decision 2007-104 as discussed above). The AESO expects that any misinterpretation or misapplication of Commission decisions would have been noted by the Commission (or its predecessor, the Alberta Energy and Utilities Board) with appropriate directions to correct the misinterpretation or misapplication. Having received no such directions in recent deferral account reconciliation decisions, the AESO concludes that it has correctly interpreted and applied the relevant Commission decisions.
- 47 Notwithstanding the above, and consistent with consultation on the current Application as well as prior applications, the AESO will continue to consult with stakeholders on its deferral account reconciliations and expects to explore alternatives to improve the efficiency of the process during future consultation.
- 48 Based on the foregoing, the AESO does not consider that UCA's comments warrant any correction or revision to the deferral account reconciliations included in the AESO's Application, nor any specific direction from the Commission at this time.



5 CONCLUSION

- 49 The AESO submits that no party has raised in their argument a sufficient or reasonable basis that would warrant correction or revision to the proposals included in the AESO's 2009 deferral account reconciliation application.
- 50 The AESO therefore reiterates, as it earlier submitted in argument, that its Application should be approved as filed and that the relief requested in section 1.4 (pages 9-10) of the Application should be granted in full, with the exception of the process changes that had been initially proposed with respect to the AESO's upcoming 2010 deferral account reconciliation application and for which the AESO no longer requests approval.
- 51 The AESO also reiterates its submission that the distribution of the deferral account balances approved on an interim basis in Decision 2010-209 should be confirmed as final.