Alberta Electric System Operator
2010-2011 Deferral Account Reconciliation
Reply Argument

Date: July 31, 2012
Prepared by: Alberta Electric System Operator
Prepared for: Alberta Utilities Commission
Application No. 1608444, Proceeding ID No. 1878
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1 Introduction

The Alberta Electric System Operator (AESO) provides the following reply argument on its 2010-2011 Deferral Account Reconciliation Application (Application) filed with the Alberta Utilities Commission (Commission) on May 11, 2012 as Application No. 1608444 and Proceeding ID No. 1878.

Only one party other than the AESO filed argument on the Application. In its argument, the Consumers’ Coalition of Alberta (CCA) raised several matters primarily respecting certain items of the AESO’s 2011 general and administrative costs, including the AESO’s 2011 capital costs. The AESO responds to those matters in this reply argument.
2 Reply to Consumers’ Coalition of Alberta

In its argument, CCA raised several questions and made several recommendations related to:

- the AESO’s 2011 recorded staff and benefits costs (pages 1-4, paragraphs 3-14),
- the AESO’s 2011 recorded contract services and consultants costs (pages 4-7, paragraphs 15-27), and
- the AESO’s 2011 capital costs (pages 7-10, paragraphs 28-36).

CCA also commented in support of the AESO’s proposed approach to refining Rider C (page 10, paragraphs 37-40). The AESO acknowledges CCA’s support for its proposed approach and notes that no other party submitted argument on it. The AESO accordingly submits its proposed approach to refining Rider C should be approved as filed.

The balance of this section addresses the questions and recommendations of CCA with respect to the AESO’s general and administrative costs and capital costs as identified above. The AESO first provides background on the matters raised by CCA and then addresses CCA’s specific questions and recommendations in more detail.

2.1 AESO Budgets and AESO Board Approvals

CCA’s recommendations on the above matters included changes to the AESO’s budget process (page 4, paragraph 14, and page 7, paragraph 27) and changes to the AESO Board approval process (page 9, paragraph 35). The AESO provides the following summary of the AESO budget and AESO Board approval processes to establish context for replies to CCA’s recommendations.

The AESO’s current budget review and approval process was initially developed in consultation with stakeholders in 2005 and 2006. The AESO has continued to work with stakeholders since then to refine and improve the process in accordance with practices established under sections 2 and 3 of the Transmission Regulation. Those practices are summarized in section 3.1 of the Application (pages 28-29, paragraphs 128-132) and are also described in the “Governance Practices” section of the AESO’s 2011 Annual Report (pages 20-21) provided as Appendix C-1 of the Application. The Annual Report describes the process as follows.

As a part of the AESO’s development of its business priorities, budgets and forecast costs, the AESO undertakes a consultation process with stakeholders that is referred to as the Budget Review Process (BRP).

The BRP is an open and transparent process that allows stakeholders the opportunity to provide input into the AESO’s business priorities, budgets and forecast costs. The BRP’s primary objective is to work with stakeholders to develop a comprehensive business planning document that provides a common understanding of expected deliverables and related costs. Stakeholder input can be provided in a number of ways including submitting written comments on the proposed business priorities, budgets and forecast costs, and meeting with the AESO Board to further explain those comments. At the conclusion of the process, the AESO Board issues a decision on the AESO’s business priorities, budgets and forecast costs. [page 20]

The AESO notes that the Budget Review Process is focused on the AESO’s business priorities and plans. Budgets and forecast costs are developed with input from stakeholders to support those priorities and plans. The AESO must also meet its legislated duties, responsibilities, and functions as established in the Electric Utilities Act and the Transmission Regulation. The AESO notes that CCA has not formally participated in the Budget Review Process and to date has never submitted comments on any of the material posted during the Budget Review Processes conducted by the AESO for 2011 or any prior year.
Despite the best efforts of the AESO, budgets and forecast costs occasionally do not fully accommodate the actual costs needed to accomplish the established business priorities and plans and to continue to meet the AESO’s legislated mandate. At such times, the AESO has controls and procedures in place to determine appropriate actions, which may include approving additional expenditures to accomplish specific business priorities or meet its mandate, or managing the timing or reducing the scope of other business priorities to remain within budget.

The Budget Review Process includes an agreed-upon practice when estimated costs are expected to exceed budgeted amounts. Variances up to 10% above budgeted general and administrative expenditures and up to 20% above budgeted general capital expenditures may be approved by the AESO Board and subsequently communicated to stakeholders. Variances above those thresholds are reviewed with stakeholders in advance of a request for AESO Board approval.

The AESO budget controls and procedures are further discussed in the “Governance Practices” section of the AESO’s 2011 Annual Report (pages 20-21) and include:

- a pay-for-performance salary administration process designed to align with and attain corporate goals based on business priorities, with the AESO Board providing oversight and approval of the annual corporate goals;
- regular updates to the AESO Board on the status of attaining corporate goals, with strategies developed or altered to better achieve goals at risk of not being met, including reprioritization of goals;
- risk prioritization and mitigation through development and implementation of financial and other policies managed by a Security Policy and Risk Committee;
- internal controls approved by the AESO Board and its Committees to provide reasonable assurance of achieving effective and efficient operations, reliable financial reporting, and compliance with laws and regulations; and
- evaluation of the AESO’s governance, risk management, and control processes through audits, reviews, and procedures performed throughout the year by the AESO’s Controls & Audit Services group and by third-party audit firms when required.

Additional details on the AESO’s approach to risk management and control processes are provided in the “Risk Management” section of the AESO’s 2011 Annual Report (pages 37-38) and include:

- an annual assessment of the design and effectiveness of internal controls over financial reporting based on the Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), which most recently concluded that, as of December 31, 2011, the AESO maintains effective internal control over financial reporting;
- review and monitoring by the Audit Committee of the system of internal controls, the systems for managing risk, the external audit process, and the AESO’s process for monitoring compliance with laws and regulations, with a view to adopt best practices as appropriate;
- an internal audit function to provide the organization with an objective and independent assessment of internal controls, risk management activities, and governance mechanisms; and
- risk assessment as a continuous process to proactively identify and address potential risks as well as implement appropriate mitigation action plans.

The business of the AESO is also conducted in accordance with the bylaws established by the AESO under section 10 of the Electric Utilities Act. Under Article 6 of the bylaws (publicly available on the AESO website), the AESO Board (acting as the “ISO members” described in section 8 of the Act) oversee the business and affairs of the AESO and have the ability to delegate powers or duties to a committee, officer, employee, or other persons under appropriate conditions and with appropriate restrictions. Such delegation is common to board governance of corporations, and is not unique to the AESO.

In addition to the controls and processes described above, AESO management actively manages the organization’s financial affairs on a timely basis, including convening on a monthly basis to review the
AESO's monthly financial results, the status of corporate goal achievement, and key human resource
statistics. The monthly financial review includes a comparison of actual costs to budget amounts with
analysis of material variances for general and administrative costs, losses costs, ancillary services costs,
and capital, in addition to a comparison of actual costs to budget amounts by department for general and
administrative costs.

During the year, the AESO prepares updated financial forecasts of costs for the current year. Quarterly
reports are provided to stakeholders along with updates on the status of the AESO’s corporate priorities,
which both provide transparency of the AESO’s on-going operations.

The AESO notes that its general and administrative budget is approved and managed on a corporate
basis. At the end of the year, an administrative process is used to allocate general and administrative
costs to the AESO’s three functions of transmission, energy market, and load settlement, as discussed in
the “Service Area Cost Detail” section of the AESO’s 2011 Annual Report (pages 30-31). One impact of
this cost allocation approach is that cost variances may be greater or smaller on a percentage basis at
the functional level than at the corporate level. For example, in 2011 general and administrative costs
were $3.5 million (or 3.3%) more than the approved budget of $105.2 million. After allocation to the
AESO’s three functions, however, general and administrative costs for transmission were $8.3 million
(or 12.1%) more than the transmission function budget of $68.5 million. The greater variance at the
transmission function level arises from increased focus on transmission priorities during the year, which
resulted in a greater allocation of corporate general and administration costs to transmission.

The AESO considers that the structure and approach described above provides an appropriate and
adequate process to establish and manage the AESO’s budget. The AESO further considers the
effectiveness of this approach is demonstrated by a comparison of its forecast and recorded general and
administrative costs for the AESO’s transmission function over 2004-2011 as included in the Application
and summarized in Table 2-1 below.

Over the eight years included in the Application, the AESO’s transmission general and administrative
costs have been only 1.1% above budget, in aggregate. Variances of recorded costs from forecast reflect
the difficulty of accurately forecasting the AESO’s costs, given the complex nature of the AESO’s
activities and the various adjustments to the AESO’s priorities and changes to its mandate that have
occurred over that period. The AESO notes that general and administrative costs have varied both below
and above forecast in individual years, indicating the absence of systemic bias in the AESO’s process
and perhaps reflecting the acceleration or delay of activities from year to year.

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<td>($5.4)</td>
<td>($3.2)</td>
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<td>(5.3%)</td>
<td>(0.7%)</td>
<td>7.2%</td>
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<td>9-1:L61</td>
<td>10-2:L5</td>
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The AESO submits that the above summary demonstrates that the AESO budget and AESO Board approval processes are thorough and comprehensive. The AESO accordingly submits that CCA’s recommendations for changes to those processes should be rejected.

2.2 2011 Staff and Benefits Costs

With respect to the AESO’s 2011 forecast and recorded costs for staff and benefits, CCA recommends that “the AESO be directed to institute changes to the budget process as may be necessary to ensure upcoming budgets are reasonably accurate with respect to staff and benefit costs.” (CCA Argument, page 4, paragraph 14) CCA discusses several concerns leading up to this recommendation, including the magnitude of the variance, approval of salary increases after approval of budgets, an apparently high salary increase, and lack of justification for increased hiring.

The AESO submits that CCA’s concerns are groundless. In particular, the AESO notes that CCA’s salary increase calculation ignores many factors, such as the higher share of costs allocated to the AESO’s transmission function discussed in section 2.1 of this reply argument. The AESO confirms that the actual general salary increase for 2011 was 3.2% compared to the 3.0% increase approved through the Budget Review Process.

The AESO’s staff and benefits budget is developed, using the best information available, several months before the beginning of the year for which the budget is prepared. Subsequent to this process, annual performance reviews are completed at the end of each year for all staff which determines actual salary increases and incentive payments. The AESO Board’s Human Resources, Compensation and Nominations Committee reviews human resources programs (including salary planning, benefits, and incentive design), and human resources practices each year to ensure staff-related costs are prudent and reasonable and to provide checks and balances on the AESO’s exercising of judgment with respect to staff-related matters.

CCA also recommended that “the AESO should be required to provide support that would demonstrate the staff and benefit costs reflect appropriate market conditions.” (CCA Argument, page 4, paragraph 14)

The AESO completes thorough compensation survey and analysis work each year, including attending compensation planning meetings with broader industry and outside experts to ensure it understands economic trends, the labour market, and compensation trends. The AESO also uses compensation survey information from Mercer (for total and energy sector compensation data), Towers Watson (previously Towers Perrin, for Canadian utility, Alberta utility, and Calgary energy compensation data), and Wynford Group (for information technology compensation data).

The information collected is applied to determine total compensation changes (including base salary, short term incentive program, and benefits) that are recommended for AESO Board approval. In addition, the AESO periodically contracts an external human resources consulting firm to complete a full total compensation review to assess the AESO for competitiveness, with such a review completed by Towers Watson during 2011. The AESO targets total compensation in the 50th percentile of the comparable market benchmarks.

After establishing a competitive benefits program through the total compensation review process, the AESO uses a benefits broker to find the best rates and service provider for the required benefits.

The AESO submits that the process used to ensure its compensation and benefits are competitive is thorough and comprehensive. The above summary supports that the AESO’s staff and benefit costs reflect appropriate market conditions.
2.3 2011 Contract Services and Consultants Costs

With respect to the AESO’s 2011 forecast and recorded costs for participation in regulatory proceedings, CCA recommended that the AESO explain “the nature of the regulatory costs” and “why these costs became ineligible to be claimed through the AUC’s cost claim process” as part of the AESO’s reply argument. (CCA Argument, page 7, paragraph 25)

Information response AUC-AESO-003(a) identified $0.7 million of cost variance for the AESO’s participation in regulatory proceedings during 2011. The variance was comprised of the amounts listed in Table 2-2 below.

The AESO applied for costs it had understood to be eligible for recovery in the first three hearings listed in Table 2-2. In Decision 2011-489 on the costs claim for the AltaLink-EPCOR Heartland Transmission Project, the Commission stated:

_The Commission finds that the AESO’s participation in the proceeding was helpful. The Commission is satisfied that the evidence provided by the AESO contributed to a better understanding of the issues before it, especially in relation to the technical feasibility of the underground option. The Commission is also of the view that the costs claimed on behalf of the AESO for this participation are reasonable and were directly and necessarily related to its participation in the proceeding._

_While the Commission acknowledges that it has the necessary discretion to direct the applicants to pay the AESO’s participation costs under Section 21 of the Alberta Utilities Commission Act, the Commission has decided not to exercise this discretion. In the Commission’s view the AESO’s costs are best recovered through its own tariff application. The AESO’s claim for costs is therefore denied without prejudice to any future re-filing of those costs in its next tariff application._ [Decision 2011-489, section 2.1.4, page 6, paragraphs 29-30]

<table>
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<tr>
<td>AltaLink-EPCOR Heartland Transmission Project Facilities Application</td>
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<td>Application No. 1606667 Proceeding ID No. 690</td>
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<td><strong>Costs Not Claimed</strong></td>
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<td>Application No. 1607153 Proceeding ID No. 1069</td>
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<tr>
<td><strong>Total</strong></td>
<td>—</td>
<td><strong>$729,139</strong></td>
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Language similar to that used in Decision 2011-489 was also used in the denial of AESO cost claims for the Fidler and Edmonton Area proceedings. Based on the denial of AESO cost claims in these three proceedings and the Commission’s view that “the AESO’s costs are best recovered through its own tariff application,” the AESO no longer submits costs claims when participating in proceedings for need and facilities applications. Starting with its 2013 budget preparation, the AESO will now be including such regulatory proceeding costs in its budget.

CCA also recommended that an “explanation of the nature of the other costs variance should be provided as part of the AESO’s Reply.” (CCA Argument, page 7, paragraph 26) CCA’s recommendation appears to result from a concern that “[t]he AESO has not explained what types of expenditures the other category includes nor has it explained why this item was not budgeted for in the first place.” (CCA Argument, page 6, paragraph 22)

The AESO provided the contract services and consultants cost variance breakdown in information response AUC-AESO-003(a). In the Application, the AESO had highlighted the development of the competitive process and participation in regulatory proceedings as the primary causes of the variance (section 3.1.4, page 37, paragraph 194). The “other” variance category was not referred to by the AESO in its Application, and originated in the Commission’s information request. There were no significant components for the contract services and consultants cost variance beyond the two that the AESO had already identified. The “other” variance category includes contract services and consultants variances from all other AESO departments (for the portion that was allocated to the AESO’s transmission function), with the largest amounts resulting from transmission consulting in support of the Milner Power complaint against the ISO loss factor rule and studies required for Alberta reliability standards.

The AESO summarized its budget process in section 2.1 of this reply argument. As explained in the Application (section 3.1.4, page 37, paragraph 194), the AESO uses contract services and consultants “to assist in the completion of those tasks that require specialized skills that are neither resident in the AESO nor required by the AESO on an ongoing basis, and to address workload peaks. Contract services and consultants include technical and project consultants as well as contracted legal and audit services.”

The AESO submits that its budget process is thorough and comprehensive, and provides reasonably accurate budget amounts for contract services and consultants. The AESO does not consider that changes to its budget process will increase the accuracy of those budget amounts.

2.4 2011 Capital Projects

With respect to the AESO’s 2011 forecast and recorded capital costs presented in the Application (section 3.1.5, pages 38-39, paragraphs 199-203 and Table 3-2), CCA questioned the Network Upgrade project change order approval by AESO management and recommended that “significant scope changes be subject to Board of Directors approval in the future.” (CCA Argument, page 9, paragraph 35)

The AESO confirms that, subsequent to the AESO management approval discussed in information response CCA-AESO-002(b), the Network Upgrade project change was approved by the AESO Board in May 2011. This approval was consistent with and required by AESO policies and practices that address AESO Board approval of capital projects. In accordance with those policies and practices, significant scope changes that have material financial impacts are generally brought to the AESO Board for approval on a case-by-case basis, following approval by AESO management.
CCA also recommended “that an explanation of why the AESO could not have anticipated and avoided the $0.3 million Phase II cost overrun [due to vendor delivery issues] for the EMS project should be provided as part of the AESO’s Reply.” (CCA Argument, page 10, paragraph 36)

The AESO uses appropriate contractual safeguards with vendors to avoid cost increases associated with vendor delivery and related issues. However, the AESO has found that if significant contractual safeguards transfer an unreasonable level of risk to the vendor, vendor proposals (and, subsequently, costs) can be driven to be as much as 50% higher than proposals with more limited risk transfer. For the EMS Phase II project, the AESO considered the risk associated with the project could be managed appropriately with limited safeguards. This approach proved successful, with the project incurring a capital cost variance of 7% ($0.2 million variance on a Phase II capital budget of $2.8 million).

On a case-by-case basis, the AESO has incorporated and continues to incorporate safeguards (such as development of an expectation model that must be met by the vendor) into its ongoing vendor management capability and vendor agreements, as considered necessary and appropriate to manage risks associated with vendor supply.
3 Conclusion

The AESO submits that CCA, through its information requests and argument, has not provided satisfactory evidence that the AESO’s costs included in the Application are unreasonable. Therefore, in accordance with section 46(1) of the Transmission Regulation, those costs must be considered prudent by the Commission.

The AESO submits that neither CCA nor any other party has raised, through information requests or in argument, a sufficient or reasonable basis that would warrant correction or revision to the proposals included in the AESO’s Application.

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 11-12) of the Application should be granted in full.