

Q. In Section 6.1: Industrial Rate Design, page 42, lines 5-6, the consultants contend that one of the perspectives of the 2008 report, that "Holyrood generation would be the incremental cost for the system/or a substantial future period of time," is no longer valid. Do you agree that when energy rates are below marginal cost, there are adverse price signals that are incentives to consume additional amounts of energy that provide benefits below the resource costs of producing the additional energy? Please explain your response.

A.

The quoted premise that "when energy rates are below marginal cost, there are adverse price signals that are incentives to consume additional amounts of energy that provide benefits below the resource costs of producing the additional energy" is true by definition, but is a gross oversimplification of the energy management decisions of customer firms. The reference ignores many critical factors that are integral to energy usage decisions, such as:

- a) Long-run versus short-run prices, and expectations of prices
- b) Inflexibility in shifts in energy usage over short and even long horizons
- c) The integrated nature of companies who produce comparable or overlapping products in different markets with different energy pricing regimes. For example, a company may have a need for energy at an efficient price below that which is charged by the utility, but still elect not to take the power as a better alternative exists to produce the same produce in a different location in Canada or the world.
- d) The difference in importance of energy prices to the overall variable cost structure of a firm. Some industrial operations have energy make up a very large proportion of their variable costs, while others the proportion is much smaller.
- e) The inflexibility associated with contracted supply commitments for an industrial customer's output, or contracted input quantities such as labour agreements, or the complicated and extensive commitments known to exist for Vale in respect of the processing plant being developed on the Island Interconnected System.

1 It is also important to recognize that industrial customers are often faced with energy  
2 management decisions which often require a large amount of investment by the industrial  
3 company (e.g., new energy efficiency initiatives) or a large commitment to revise operation (e.g.,  
4 closing a shift, or a production line). These initiatives are based on changes that could affect  
5 operations for many years or decades. Imposing a marginal cost signal based on Holyrood in  
6 the short term (approximately 2 years) which is misaligned with much lower marginal costs that  
7 are expected to occur following a Labrador infeed could incent investment in capital or process  
8 changes today that would be significantly inefficient within a reasonably short period of time.

9 For rate design, long-term cost trends should be recognized as well as simply the short-term to  
10 ensure fair and stable rates are set that send correct price signals for decisions with a long  
11 horizon.