From: Jay Shepherd [jay.shepherd@shibleyrighton.com]
Sent: May 26, 2006 1:54 PM
To: Russell Chute
Cc: Malcolm Rowan; David Poch; Marika Hare; Martine Band
Subject: OPG Prescribed Assets Regulation

Further to the consultation meeting the other day, you commented that it would be useful if some of the ideas we discussed were summarized in writing. This email is not our position, per se, but simply a summary of a possible regulatory framework that we think might work. Note that Malcolm Rowan of CME indicated at the meeting that this made sense to him. I have since talked to David Poch of the Green Energy Coalition. They are not participating in this consultation, because they are stretched too thin with other regulatory activities. However, David and I did discuss the regulatory framework set out below, and he indicated that it looked like a good approach to him. He asked me to pass that information on to you.

The possible structure we think might work is the following:

1. The basic approach to establishing regulated prices for OPG Prescribed Assets would be full cost of service. This reflects the basic principles that a) prices, at least in the short and medium term, should be cost based, and b) those costs should be reviewed for prudence.

2. A full cost of service proceeding for all of the Prescribed Assets, done thoroughly, would take an unacceptably long time. Rates could not be put in place by April 1, 2008. The two options to deal with this are a) do a review of all Prescribed Assets operations, but limit the depth and thoroughness of the inquiry, or b) review, thoroughly, less than the entire set of costs. Since OPG has not been regulated in the past, a review that is too superficial is not appropriate, and would not meet the Board's goals of transparency and credible results. The alternative, reviewing part of OPG's Prescribed Assets operations each year, allows the Board to do a complete review over several years.

3. We have proposed that the Board divide up OPG's Prescribed Assets operations by business unit rather than by O&M category. For example, in 2007 the Board could review Pickering's costs. In 2008, it might be Bruce, or Beck, or Darlington, or the Board might select Head Office costs that year. Over the course of six or seven years, the Board would be able to do a detailed review of the costs of the all aspects of the Prescribed Assets operations. Further, each year the review is likely to be shorter and more focused, because many general issues will have been canvassed in prior years.

4. Since this type of staged cost of service approach would take several years, the Board would need a transitional regime so that rates could be in place for 2008. We have suggested that you consider a type of indexing system akin to incentive regulation. The method that might be most acceptable to all parties (ratepayers, utility, and government) could be the following:

a) Start with existing prices for generation from the Prescribed Assets. Starting there ensures that the potential for rate shock is minimized.

b) Adjust those prices to change the ROE from 5% to a market rate. This could be done by simply applying the current ROE used for gas and electric distribution companies, or, more likely, by a hearing in 2007 on the appropriate ROE for OPG's Prescribed Assets business. Such a hearing could be combined with the issue in (c) below, and would not be unwieldy. The reasons it is appropriate to increase the ROE are 1) it moves OPG further down the path towards the competitive market, and 2) it provides some cushion for OPG so that a substantial productivity factor can be introduced, and 3) it allows the shareholder of OPG to establish internal compensation structures based on achieving ROE goals while still driving year over year prices down in real terms.

c) Index the prices to inflation starting in 2008, less a substantial productivity factor. The indexing structure, the productivity factor, and other aspects of the transitional IR system, could be determined in the same 2007 hearing process that sets the initial ROE.

d) Each year, as part of the cost of service review of an business unit, the Board can determine whether a specific adjustment to the IR price should be made. For example, if the cost of service review of Pickering results in a decision that costs of Pickering operations should be cut by, say, an additional $10 million, the Board in that same decision can determine whether the price cap should also be reduced to reflect that amount. On the other side, if OPG demonstrates that it is prudent to ramp up spending on that facility, the Board can determine whether that should result in an overall adjustment to OPG's prices. In both cases, the answer would generally be yes, but the Board would be in a position to specify exactly how that adjustment would take place, and consider whether there are other factors that would lessen or remove the adjustment.

e) Once the Board had cycled through all of the OPG Prescribed Assets business units, it would have a full cost of service base for those prices. At that point, it could determine that it should 1) continue the same partial annual cost of service review coupled with the same IR system, 2) move to a more conventional IR system once all costs had been rebased, 3) move to more market-driven prices if the generation market in Ontario is at that time sufficiently robust, or 4) implement another option, or some combination of options, for future regulation of those prices.

This is a summary of what we discussed the other day. Note that this is in many ways similar to one of the models staff presented in the discussion paper. The major difference is probably cosmetic rather than substantive, ie. we have characterized this as a slow implementation of cost of service, with IR to set transitional rates. Whatever the characterization, the result is much the same.

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