RE: Summary Comments of the Independent Electricity System Operator (IESO) on Ontario Energy Staff Draft Discussion Paper (May 8, 2006): Regulatory Options for Setting Payments for Ontario Power Generation Inc.'s (OPG) Prescribed Generation Assets

Consultation Session: June 5, 2006

Introduction

- The IESO appreciates the opportunity to participate and to propose issues for consideration by the Board in this consultation process.
- The IESO is established under the *Electricity Act, 1998* to operate the IESO-administered markets and to direct the operations and maintain the reliability of the IESO-controlled grid. In maintaining the reliability of the power system, the IESO procures ancillary services either through cost-based contracts or market-based mechanisms. The IESO is also responsible for the financial settlement of charges for services provided in the wholesale electricity markets, including market settlement requirements for the global adjustment and regulated rates on OPG's prescribed generation assets.

Pricing Methodology

- The IESO supports a pricing methodology that would:
    - Ensure the secure and reliable supply of electricity from OPG's prescribed assets, i.e., should not cause a degradation in system reliability;
    - Promote economically efficient generation by OPG's prescribed assets;
    - Support the recovery of costs related to the improvement, maintenance and operation of all these facilities;
    - Encourage measures to increase the capacity, availability and efficiency of the existing facilities and improve the operation of these facilities; and
    - Allow for the development of economic efficiency and sustainability in the generation and supply of electricity for the Province.

- In jurisdictions that have yet to establish competitive markets, regulators seek to impose the discipline of competitive conditions by replacing cost-based regulation for performance-based regulation as a means of imposing or substituting for competitive pressures. However, there is no need to simulate competitive conditions in Ontario through such regulatory structures. Since May 2002, the IESO has in place real-time energy and operating reserve markets that have been used to derive economic efficiency of OPG's prescribed assets.

- The Board should consider a pricing methodology that would build upon market mechanisms and market based pricing for setting payments on aspects of OPG's prescribed assets. This would impose the discipline and provide for market-like incentives that performance-based regulation attempts to simulate. Participation in the IESO-administered markets would impose those necessary competitive conditions that lead to:

- Maximizing the value of the generating capabilities of these resources (i.e., store water for use at high demand peak periods);[1]
- Allowing the output of these resources to respond to changes on the system which contributes to overall system optimization and ensures the efficient allocation of resources; and
- Minimizing the costs of maintaining and operating these facilities given that competitive pricing induces the output to be offered at marginal cost (i.e., price discipline).

- In order to encourage OPG to maximize the output from the prescribed hydroelectric facilities, the Board should consider, at minimum, the continued use of the existing pricing structure for those assets where OPG receives the market price for any output greater than the 1900 megawatt hours in any hour. The Board should also consider further developing the economic benefits derived from such a market based mechanism by incorporating the use of financial incentives and disincentives such as those found in a contract for differences approach.

- A pricing methodology that would incorporate the use of market mechanisms and market-based pricing also leads to more effective and efficient regulatory oversight by avoiding the pitfalls associated with cost-of-service and performance-based regulation such as:
  - Accruing over-earnings
  - Costly and onerous regulatory proceedings
  - Determining what is an appropriate level for productivity factor and other performance indices
  - Difficulty in obtaining complete and comprehensive data on the cost structure of the prescribed assets

- The Board should also consider retaining the current compensation methodologies for operating reserves for OPG's prescribed assets. The IESO operates an operating reserve market which led to efficient pricing for such services by allowing OPG to offer.[2]

- The nature and use of variance accounts to recover costs from a pricing methodology that incorporates a hybrid model of regulatory and market based mechanisms for different aspects of OPG's prescribed assets should be clearly established by the Board.

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[1] For example, if the OEB were to apply a fixed price to energy from OPG's hydroelectric heritage resources OPG would have no incentive to use its pump generators at the Beck plant to pump overnight in order to release this stored energy during the high-priced peak period of the following day. This time-shifting of generation reduces the total net amount of MWh produced from the Beck facility, (which is discouraged by fixed prices). But the increase in value of the water by shifting production from off-peak to on-peak times is significant and it is important to preserve this market efficiency by incenting more electrical production when demand and prices are high. This is best done by positively linking production revenue to market prices.

[2] Under the current bid cap agreement between the IESO and OPG, if an accepted offer from an OPG facility that sets the market price exceeds both a negotiated threshold and OPG's cost of providing operating reserve from that facility, OPG generally pays a rebate for each dispatch interval equal to the difference in price between the market price and a re-calculated operating reserve price with an acceptable OPG offer, multiplied by OPG's quantity of the relevant operating reserve category provided. This mitigates OPG's market power in the operating reserve markets by incenting OPG to offer its incremental costs to provide from its facilities.