Summary Comments of the Ontario Power Authority (OPA)
on
Ontario Energy Board (OEB) Staff Discussion Paper dated May 8, 2006
re
Regulatory Options for Setting Payments for the Output from
Ontario Power Generation Inc.'s (OPG's) Prescribed Generation Assets

June 8, 2006

1.0 Background

Pursuant to Section 78.1 of the *Ontario Energy Board Act, 1998*, the OEB will determine the payments to be made to OPG with respect to the output of its prescribed facilities, and pursuant to O. Reg. 53/05, April 1, 2008 is established as the date on which the OEB's authority to determine those payments commences. The prescribed generation facilities (the "Prescribed Assets") are the nuclear generating stations operated by OPG (Pickering NGS, Darlington NGS) and the base load hydroelectric assets in the Regional Municipality of Niagara (Sir Adam Beck I, Sir Adam Beck II, Sir Adam Beck Pumped Generating Station, De Cew Falls I and De Cew Falls II) and on the St. Lawrence River (R.H. Saunders).

On March 21, 2006 the OEB issued a letter to interested parties identifying the regulatory process to be used in setting payment amounts to OPG, and in a subsequent letter, dated April 27, 2006, the schedule for that process. The OEB posted a staff Discussion Paper, dated May 8, 2006, setting out various alternative approaches to the methodology to be used to set those payments, and on May 19, 2006 a meeting was held to discuss the draft Discussion Paper and for OPG to make a presentation to interested parties about the operating characteristics of the Prescribed Assets. Finally, the OPA was invited to participate in a session on June 5, 2006, hosted by OEB staff, to provide comments on the draft Discussion Paper.

The purpose of this document is to provide follow up written comments from the OPA to OEB staff, and to ensure that the OPA's input helps inform the next draft of the Discussion Paper, due to be posted by June 12, 2006.

2.0 Introduction

The OPA appreciates the opportunity to provide comments on the alternative methodologies under consideration by the OEB with respect to setting payments for the output from OPG's Prescribed Assets, and encourages the OEB to continue the broad exploration of the options.

The resolution of the payment methodology for the Prescribed Assets that supply nearly half of Ontario's annual electricity consumption will have a material and lasting effect on the balance of Ontario's electricity sector and future evolution of the electricity marketplace and the level and types of risks born by electricity customers.

Considering the legislative framework laying out the hybrid electricity market structure, and acknowledging that electricity policy has changed many times in the recent past, any payment option must afford sufficient flexibility in order to account for future changes as well. Customers need the assurance that can only come from policy stability and the OEB is encouraged to ensure that the framework can adapt smoothly as conditions change without the need for the types of major structural or conceptual changes which create uncertainty and as a result unnecessarily expose customers to additional risk.

The OEB is encouraged to consider payment options both within the narrower requirement for establishing regulated payments to OPG with respect to the Prescribed Assets, and in the broader context of the implications of these payments on the remainder of Ontario's electricity sector, including the existing wholesale marketplace and the users of electricity.

These considerations must include:

- Offer strategies for the Prescribed Assets into the real-time wholesale electricity and operating reserve markets, ancillary services, and the determination of marginal cost offers that help set Ontario's wholesale electricity prices;
- Supply of operating reserves, and ancillary services from the Prescribed Assets;
- Settlement processes for regulated payments with respect to any future changes to the electricity market (e.g., day-ahead markets);
- Impacts on market power concerns and market power mitigation so as to better enable the balance of Ontario's electricity to operate efficiently and ensure customers get fair value and the alternatives for purchasing power that they need;
- Implications for new generation investment and its competitive procurement; and
- Attribution of costs with respect to investments by OPG including maintenance, potential incremental expansion, potential refurbishments, and new projects.

OEB, stakeholders and electricity customers must refrain from taking the narrow view that payments for Prescribed Assets impact only OPG's operational and financial position. In fact, these regulated payments, and how the mechanism is established, will impact all other segments of Ontario's electricity sector and have a material impact on the options that customers have for meeting their electricity needs.

3.0 Payment Methodology Alternatives

Power from the Prescribed Assets must be offered in a manner which does not distort real time or forward prices, so as not to inhibit new generation and demand response, and it should not be sold in a manner that disadvantages customers who choose to buy their supply from competitive wholesale suppliers or retailers.

The current market pricing context should be considered when investigating the three payment options outlined in the OEB Discussion Paper. Offer strategies for 10,000 MW of baseload generation will impact the rest of the market, particularly if it is being offered in a manner that is not revenue-maximizing. Any payment methodology should capture appropriate value from the Prescribed Assets that will be returned to rate payers without distorting market prices or eliminating investor confidence which is critical for new generation investment.

3.1 Option 1 – Regulated Cost of Service (CoS)

The OPA's concern with this option stems from a potential change in incentives with respect to OPG's offer strategy for the Prescribed Assets. If the incentives created by this option are not consistent with the existing market incentives faced by all other market participants (generation and demand-response) in the wholesale market, operational and economic inefficiencies may result, thus potentially causing greater costs to rate payers.

Another concern lies with the fact that this option locks in a settlement mechanism against the existing wholesale market price (i.e., HOEP), which makes it very difficult and complex to adjust the settlement mechanism should there be changes to the market pricing methodology in the future. Any risks resulting from such future settlement relationship will (again) be borne by rate payers.

3.2 Option 2 – Incentive Rates

Like Option 1 above, OPA is concerned with locking in a settlement mechanism against the HOEP, adding risks to rate payers for any future changes to the market.

OPA also believes that it is difficult to derive an incentive or performance-based metric, without a baseline against which to measure. In the past, OPG has been reluctant to provide information to engage in benchmarking exercises, and so it is not clear what information may be available for creating such baseline.

Also, given OPG's governance structure, it may be difficult to ensure incentives are acted upon and complied with, as OPG is not a privately-owned company that relies on its standing in the financial markets to finance capital requirements.

This option is another form of traditional public utility regulation and the incentives may not be related to behaviour in the marketplace.

3.3 Option 3 – Regulatory Contracts

Considering that any payment option will have impacts on the balance of Ontario's electricity sector, and the evolution of the marketplace has yet to be fully defined, the preferred payment option needs to be sufficiently flexible to best accommodate future changes and not effectively close off options to address these changes.

For example, the scope of OPG's Prescribed Assets may change if expansion and refurbishment are required, and the flexibility of this Option 3 could address these issues. As well, this option allows for incorporation into the regulatory contract, if so desired, of incentives tied to performance.

Under this scenario, the payments to OPG could rely on contractual terms based on cost of service formulas and contracted output, and are not locked into settlements against HOEP. These types of contracts already exist in the Ontario electricity market (e.g., contracts resulting from the RFP processes) and serve as general templates from which to craft regulatory contracts for OPG Prescribed Assets.

If the market evolves to using forward contracts, regulatory contracts can allow the energy from the Prescribed Assets to support or be transferred within the forward market to potential third parties for consumption or resale. This contractual provision can help provide alternatives for customer choice and still maintain a consistent payment stream to OPG's Prescribed Assets.

The differentials between forward contract sales and the contracted cost of service obligations can preferably be redistributed to customers but could also be used to provide incentives to new investment. The essential requirement is that the differential for the forward contracts and the payments to OPG are not tied to HOEP, thus allowing HOEP to provide a true price signal reflecting short term supply/demand fundamentals.

4.0 Conclusions

The OPA clearly prefers Option 3 – Regulatory Contracts as it preserves the greatest number of future options for the industry. Considering that the wholesale market is a fundamental element of our electricity industry, and mechanisms to dispatch the system under such a market have been developed, any regulated payment option needs to ensure economic incentives align with this structure to best serve economic efficiency, with the goal of maintaining reliability and quality of service and to minimize risks to customers and maximize their choices.

Options 1 and 2 could frustrate the movement toward competition, greater customer choice, reduced customer risk and reduced reliance on support contracts for investment in new generation facilities. Any payment option must afford sufficient flexibility in order to account for future changes. Option 3 affords such flexibility.

Stakeholders can be satisfied by the fact that all decisions with respect to this option will still need to be approved by the OEB after a full hearing process in order to address the terms of any OPG rate orders and/or performance obligations.

Finally, Option 3 – Regulatory Contracts could exist with a fully regulated electricity sector or a competitive market. It does not prejudice the outcome of sector evolution as do Options 1 and 2.

The OPA thanks the OEB for its consideration of these comments and is available to provide further explanation. We look forward to reviewing and commenting on the OEB's next draft of its Discussion Paper