OPG's Comments on the June 21, 2006 – OEB Staff Draft Discussion Paper: "Regulatory Options for Setting Payments for the Output from OPG's Prescribed Generation Assets" EB-2006-0064

Ontario Power Generation Inc. (OPG) submits the following comments on the second draft of the Board Staff Discussion Paper "Regulatory Options for Setting Payments for the Output from OPG's Prescribed Generation Assets" issued on June 21, 2006. Also provided is an appendix that provides some additional detailed comments on the Discussion Paper.

Cost of Service Model is the Most Appropriate model for OPG

- OPG submits that Cost of Service regulation is the most appropriate model for setting the new payment amounts for OPG's prescribed assets. In OPG's submission, a Cost of Service model is the best way to promote transparency, to ensure just and reasonable rates, and to allow OPG to manage its prescribed assets with an acceptable level of regulatory risk.
- One of the policy goals underpinning the establishment for the prescribed assets was increased transparency. A Cost of Service model is the best way to support this goal since it involves a public review of OPG's costs, production forecasts and financial and operational risks. The Incentive Regulatory system proposed by Board staff will not achieve this objective to the same degree.
- Under section 78.1 of the *Ontario Energy Board Act, 1998,* the Board has an obligation to ensure that the payments are just and reasonable. OPG does not see how this statutory obligation can be achieved without a cost of service review.
- The prescribed assets are critical to the reliability of the Ontario electrical system. As such, it is important that OPG be provided with sufficient revenues to: operate these facilities safely and reliably, meet all regulatory requirements, including those of the CNSC; and fulfill its mandate from the Province to operate as a commercial enterprise. Only a Cost of Service process can ensure that OPG is provided with sufficient funds to meet these requirements.
- To subject a newly regulated entity to an untried Incentive Regulatory model would present an unacceptable level of regulatory risk to OPG. This level of risk would make it very difficult for OPG to plan and operate its business successfully. This is particularly true in the present environment. OPG is making, or considering significant capital investments in the prescribed facilities (e.g. Niagara tunnel project, nuclear refurbishment, etc.). An Incentive Regulatory system that would use a relatively simple formula to adjust the payment amounts received by OPG would not work in this context. Such an approach works best for regulated utilities with stable and predictable cost and production levels.
- Part of the rationale advanced in support of the Incentive Regulatory model is that it will reduce the regulatory burden associated with the first hearing to set the new payment amounts. OPG does not find this rationale compelling. OPG submits that the hearing to establish the details of this new system, including the underpinning production forecasts, cost escalation adjustments and productivity factors, would likely be just as lengthy as a properly managed Cost of Service review.
- In this regard, OPG submits that a properly managed Cost of Service review could be scoped to look at a limited set of key issues. This would reduce the amount of evidence required and the length of any hearing. The approach would also include procedural orders to ensure timely filings by parties and appropriate disclosure by OPG. Appropriate

disclosure requirements would also alleviate any perception by other parties to the hearing of "information asymmetry" favoring OPG.

- OPG agrees with Board staff's view that a Cost of Service methodology can (and, in fact, has) result in a consistent and well-understood regulatory process that can be supported well into the future.

- Finally, OPG is not aware of any stakeholder that favours the model proposed by Board Staff. OPG submits, that based on the posted submissions and comments at the plenary sessions, a clear majority of stakeholders prefer a Cost of Service model for OPG.

An Incentive Regulation Model would require certain minimum features to be workable

- In the alternative, if an Incentive Regulation ("IR") model is pursued, then it must include, at least, the following features in order to be workable in OPG's submission.
  - The base payments must be adjusted to provide a risk-appropriate rate of return on the capital associated with these facilities, when viewed against returns authorized for other regulated entities.
  - It must provide for the recovery of the variance/deferral account balances.
  - Have a term no longer than two years.
  - Provide for an adjustment to recognize the Pickering 2 and 3 decision.
  - Provide "off ramps" to deal with significant changes in circumstances.
  - Allow OPG to meet all regulatory requirements, including those of the CNSC, and
  - Provide Z factors to deal with material items beyond the control of OPG's management (as discussed further below).

- At least some of the issues that would need to be addressed through Z factors include:

  - Changes in hydroelectric generation levels due to water availability
  - Force majeure events affecting the prescribed assets or their access to the electricity grid
  - New work as directed by the government (for example - studies and assessments of the potential for refurbishment of existing nuclear facilities)
  - Changes to pension and OPEB costs associated with changes in economic factors
  - Significant changes in nuclear production levels, and costs due to "lumpiness" in outage cycles and specific unusual outage requirements (e.g., regulation requires periodic vacuum building outages which result in planned outages of a significant duration for all units in a multi-unit nuclear station)
  - Changes in Bruce Lease revenues, consistent with the requirements of O. Reg. 53/05
  - Changes in the regulation specifying the Gross Revenue Charge for regulated hydroelectric facilities
  - Recovery of significant one-time costs associated with new legal or regulatory requirements or settlement of past First Nation grievances.

- OPG notes that Ontario Regulation 53/05 provides for recovery of certain costs, including:
  - The recovery of the deferral and variance accounts established in section 5 of O. Reg 53/05; and
  - The recovery of costs and firm financial commitments incurred for investments to increase the output of, refurbish or add operating capacity to a regulated facility (Section 6. (2) 3).

  The recovery of these costs must be incremental to the "base amounts" of $33/MWh for regulated hydroelectric and $49.50/MWh for nuclear output to be consistent with the intent of the regulation. Accordingly, it is OPG's submission that even in the case of an IR hearing, evidence with respect to all of the above-noted costs would have to be adduced. This would add to the length and complexity of such a hearing, making it analogous, in any event, to a Cost of Service-type review.

Issues that should be addressed regardless of the model adopted

- Changes in the form of the payment amounts to include both a fixed ($/month) and variable ($/MWh) component should be made to recognize the large proportion of fixed costs associated with the prescribed facilities that continue regardless of output levels. The precise nature of the new form for the payment amounts should be determined in the hearing scheduled for 2007.

- The concept of Service Quality Indicators (SQIs) must be adapted for OPG since it does not interface with any end-use customers. OPG suggests that the initial period be used to collect data on various performance metrics that could ultimately be considered as Service Quality Indicators. The need to maintain asset integrity should be primary in any SQIs that are evaluated.

- It is critical to the reliable operation of the IESO-administered market that the peaking production from the regulated hydroelectric facilities responds to changing demand conditions as reflected in the Ontario market price. OPG submits that the proposal to isolate the Beck PGS from the other Niagara facilities in establishing the payments will not work. The operations of all facilities at the Beck complex are integrated and decisions on the use of the PGS involve the prices for generation from all of the Beck facilities as well as the requirement to provide ancillary services (particularly automatic generation control) and to consider water transfers and diversion limitations.

- Since OPG is the only generator prescribed by regulation, the Board should be pragmatic when establishing filing guidelines and make use of OPG's existing account structure to the extent possible as this will minimize the costs associated with regulating OPG. A clear purpose should be identified for any information that is required and for any changes in account structure from the status quo. This will help to keep the cost of regulation to a manageable level.

APPENDIX – Additional Comments on Draft 2 of the Discussion Paper

- Section 2.1 - The conclusions of the Electricity Conservation and Supply Task Force (ECSTF) report were only one of the inputs to the policy framework for Ontario's electricity sector established in the *Electricity Restructuring Act, 2004* (Bill 100). These conclusions should not be presented as the complete policy background.

- Section 2.3 – OPG agrees with the statement in this section "This financial incentive encourages OPG to maximize output from the prescribed hydroelectric facilities." But would add that the incentive also encourages OPG to produce output from these facilities in those hours when the power is most needed – as indicated by a high market price. The continuation of a significant variable component in the payment amount would also incent OPG to maximize output from all of the regulated facilities.

- Section 3.0 –This section should also reference the requirements of section 78.1 of the *Ontario Energy Board Act, 1998*, specifically the requirement that the Board fix payment amounts that are just and reasonable.

- Section 4.1 – OPG disagrees with the statement: "If a full CoS model were to be used, OPG's financial and cost accounts would have to be segmented by production facility." The Board could review costs at the technology level in support of payments by technology, consistent with the current payment amounts. Segmenting costs by production facility requires allocation of common nuclear costs and common costs within the Niagara Plant Group, which is not necessary to establish payments at the technology level.

- Section 4.2 – The opening paragraph indicates that the Board has used IR to set rates for natural gas distribution services and is developing an IR regime for electricity distribution. For completeness, this paragraph should also acknowledge that gas distribution utilities and electricity distribution utilities were subject to cost of service review as a first step in establishing IR and that for one gas distribution utility (Enbridge) the application of IR was initially applied on a transitional basis and at the end of the three year term it returned to cost of service.

- Section 4.2 – Paragraph 3 on Pg 8 states that "the Board could in setting the initial base payment accept the payments in Regulation 53/05 as providing a level of revenue sufficient to meet OPG's costs and provide a return on equity." It is unclear to OPG the basis upon which the Board would make this determination. For the Board to make such a finding, by necessity, evidence with respect to such costs and return on equity would have to be adduced. This, in turn, necessitates some level of cost-of-service-type enquiry. In particular, the Board would have to satisfy itself that these payments were just and reasonable, and that they provided sufficient revenue to allow the continued safe and reliable operation of the regulated facilities.

- Section 4.2 – OPG does not agree with the statement in paragraph 1 on Pg 9 that there may be a need to rely on allocation assumptions or rules of thumb in the allocation of costs to the prescribed assets. As indicated in OPG's Financial Overview presentation provided at the May 19 plenary discussion, in the allocation of assets, liabilities and costs between regulated and unregulated operations, 97% of fixed assets (by value), 87% of OM&A costs directly support specific production facilities.

- Section 4.2 – Paragraph 2 on Pg 9 states that factors resulting in regulatory costs and complexity could "be avoided or minimized if the Board were able to rely instead on examples and practices from other jurisdictions. While perhaps not fully reflective of OPG's particular circumstances, i.e., generation only, these examples and practices could be sufficiently similar to support a productivity analysis." OPG submits that in order to establish an effective IR regime, the productivity analysis would have to be specific to the circumstances of OPG's prescribed facilities, and that using "sufficiently similar" examples presents a high risk to both consumers and OPG.

- Section 4.2 – Paragraph 3 on Pg 9 discusses incentives for OPG to increase production from its regulated facilities. It is unclear how a reference production level would be established without a review of OPG's production forecast for the proposed period of the IR regime. Further, it is OPG's view that if a large component of the payment is based on energy output, the structure of the payment itself provides the incentive to maximize output.

- Section 4.2 - Paragraph 4 on Pg 9 discusses peak demand periods. Any consideration of incentives for OPG to shift its output to peak periods must consider the operational characteristics of the specific facilities. "Run of the river" hydroelectric output is only available when the water is available and there is no ability to seasonally shift this output and very limited ability to shift it during a given day. These facilities are not suitable candidates for seasonal production incentives.

- Section 4.3 – Paragraph 1 on Pg 11 states "the Board could choose to accept the payments set out in Regulation 53/05, and the associated costs that were used to determine those payments, as a starting point for setting revenue requirements for the contracts." OPG is unclear how the Board establishment of a revenue requirement is consistent with a contracting regime which presupposes negotiation of mutually agreed-upon terms between two independent parties.

- Section 4.3 – OPG does not believe that it is appropriate to establish a return on equity based on historical average performance of OPG in the Ontario electricity market for a historical period, well before the current policy regime was established and the prescribed facilities identified. The rationale for the suggestion in paragraph 2 on Pg 11 should be provided.

- Section 4.3 – The discussion of Regulatory Contracts suggests several variants that would present increased risk to OPG, specifically:

    - A rebate of any excess resulting from the difference between HOEP and the sum of the fixed and variable payment amounts;

    - Establishment of a productivity factor to drive cost efficiencies; and

    - An excess earnings sharing mechanism.

  OPG believes this does not present a fair and balanced treatment of risks associated with the Regulatory Contract approach.

- Section 5.2 – The "fairness" criterion should be expanded to include the requirement to establish payments that are just and reasonable.

- Section 5.3.2 – OPG believes it is essential to review sufficient data to support a productivity analysis in establishing cost inflation and productivity factors. Using a simplified approach may not lead to reasonable results, particularly in the case of an entity such as OPG that has not previously been regulated and that has never undergone a cost review.

- Section 7.0.1 – OPG interprets the formula in Section 7.0.1 to indicate that the inflation and productivity factors would only impact rates in the 2nd and subsequent years of the IR regime. However, Page 20 (bottom) states the Board will "apply cost input inflation and productivity factors to these payment levels to establish a first set of new payment amounts" and paragraph c. in Section 7.0.2 implies that the existing payment levels will be adjusted from the effective date of the Board's first order. OPG would like clarification, under the Board Staff model, of the point at which the inflation and productivity factors would be applied to existing payments.

- Section 7.0.1 – OPG does not understand the rationale provided by the Board staff as to why a CoS proceeding will not answer the question of whether OPG's prescribed asset costs and earnings are reasonable (Pg 20 paragraph 2). OPG draws a parallel with the process used to establish the original transmission rates for Hydro One. In this case a traditional Cost of Service approach was used.

- Section 7.0.1 and Section 7.0.2 - OPG is unclear of the sequence of events regarding reporting of costs and other financial information. A clear timeline and specification of the reporting considered on Pg 20 paragraph 3 and Section 7.0.2 paragraphs a.) and b.) should be provided.