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ONE Nicholas Street, Suite 1204, Ottawa, Ontario, Canada K1N 7B7

Tel: (613) 562-4002. Fax: (613) 562-0007. e-mail: piac@piac.ca. http://www.piac.ca

Michael Janigan
Counsel for VECC
(613) 562-4002 x.26
mjanigan@piac.ca

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VIA EMAIL

Mr. Russell Chute
Policy Advisor
Ontario Energy Board
P.O. Box 2319
26th Floor
2300 Yonge Street
Toronto, ON
M4P 1E4

Dear Mr. Chute:

Re: OEB's Regulatory Process for Setting Payment Amounts for Ontario Power Generation (OPG) Inc's Prescribed Generation Assets (EB-2006-0064)

VECC's Comments on OEB Staff's June 20, 2006 Discussion Paper

As Counsel to VECC, I am writing to provide our comments regarding the OEB Staff's recommendations as to the payment-setting methodology to be applied to OPG's Prescribed Generation Assets. In preparing these comments, VECC has considered the written comments provided by the other participants as well as the oral comments made during the June 16th Stakeholder Session.
The comments focus on three sections of the Discussion Paper:

- Section 5.0 – Board Staff Evaluation of the Regulatory Models,
- Section 6.0 – Generic Issues, and
- Section 7.0 – Recommendations as to Payment-Setting Methodology

<u>Board Staff Evaluation of the Regulatory Models (Section 5.0)</u>

The discussion paper suggests (page 12) a number of policy considerations that underlie the decision to regulate a portion of OPG's generation assets. In VECC's view, the key policy consideration underlying the decision was the desire to reduce electricity price volatility. This objective is reflected both in the 2003 report of Government's Electricity Conservation and Supply Task Force and in its announcement of the initial payment to OPG in February 2005. Ensuring that the regulatory scheme adopted drives OPG to contain costs and improve operating efficiencies are important considerations for the type of regulatory model adopted but, in VECC's view, are not the reasons why OPG's prescribed assets are rate regulated.

The Discussion Paper makes reference to Regulation 53/05 and its requirements as to how the OEB is to determine the payments for prescribed assets and the need to ensure the recovery of certain costs. In VECC's view the methodology recommended by Staff does not clearly set out how the specific requirements of section 6 (2) of Regulation 53/05 will be met. While recovery of balances in the variance and deferral accounts established by the Regulation can be addressed through some form of price/rate rider, it is not clear how the Staff's approach will ensure that OPG recovers:

- The costs incurred for investments to increase the output of, refurbish or add operating capacity to the prescribed generation facilities (sub-section 3),
- The costs incurred in connection with the Ontario Nuclear Funds Agreement (sub-section 6), and
- The costs (net of earnings) associated with the Bruce Nuclear Generating Stations and the associated lease (sub-sections 7 & 8).

VECC agrees with Staff's analysis (page 13) as to why the task of determining future payments to OPG for prescribed generation assets was assigned to the OEB and, in particular, the considerations associated with transparency and fairness. With respect to "regulatory efficiency" it is important to recognize that efficiency is not simply measured in terms of inputs but rather in terms of inputs required to obtain a certain output. A regulatory model that requires less time/resources is not necessarily "efficient" if the end result does not produce (in this case) prices for prescribed generation assets that meet the goals of the regulator and Government. VECC would also note that, if the Government had intended the prices to be set through some form of "regulatory contract" then it would likely have assigned responsibility for pricing directly to the Ontario Power Authority (the "OPA") who is better positioned to implement such an approach.

VECC also generally agrees with the task definition as set out by Staff on bottom of page 13 of its Discussion Paper.

The main drawbacks attributed to Cost of Service regulation (pages 14-15) are that:

- There is an asymmetry of information that makes it difficult to ensure that COS proceedings are fair to all participants.
- The Board and intervenors lack sufficient time and resources to conduct a full COS review of OPG's prescribed assets, particularly given the fact that OPG has not been regulated to date and, as result, there is no history to rely on.
- COS type regulation does not promote economic efficiency and productivity.

VECC acknowledges that there is some legitimacy to all of these concerns. However, the Paper fails to recognize that asymmetry of information will exist with any regulatory model. For example, the setting of an appropriate productivity factor under incentive regulation is confounded by the fact that the opportunities for future productivity improvement are best understood by the regulated entity itself.

The Paper makes reference (page 15) to incentive regulation being used to set natural gas distribution rates. However, this was only after years of cost of service based regulation which provided a firm understanding and vetting of the underlying cost structure. Similarly, the paper suggests that Incentive Regulation is the Board's preferred methodology for setting future electricity distribution rates. However, the Paper does not acknowledge that the move to incentive regulation for electricity distribution utilities is, in part, motivated by the large number of entities involved and includes a plan for setting base rates for each distributor on a cost of service basis before incentive regulation is fully adopted.

The operation of an effective Incentive Regulation model is only as good as the starting point, which has been traditionally determined based on cost of service regulation. Lack of an appropriate starting point will likely only lead to an early triggering of any off-ramps or Z-factors incorporated in an incentive regulation type model and complaints from either the utility or consumers that the plan is inherently unfair.

It should be noted that when the electricity industry was first unbundled, the OEB was faced with a similar situation with respect to Hydro One Networks (i.e., formal regulation for the first time, limited availability of historical data, etc.) and undertook a cost of service type review of both the transmission and distribution businesses (RP-1998-0001). Furthermore, in response to an application by Hydro One Networks (then OHSC) that incentive regulation be adopted for the transmission business the Board specifically stated (Decision RP-1998-0001, page 44) the following:

> "The Board finds that implementation of the PBR plan in the year 2000 is premature at this time. The lack of a solid base year revenue requirement makes it difficult to implement a PBR program that provides incentives for efficiency gains with any confidence. A solid foundation of historical capital and OM&A spending is required before a PBR program can be established for transmission."

VECC sees considerable similarities between the situation that existed in 1998/99 with respect to Hydro One Networks and where the OEB finds itself today with respect to OPG.

Generic Issues and Recommendations (Section 6.0)

Rates of Return

Staff proposes that the Board not address the issue of rates of return in the first proceeding. The rationale offered is that "examination of appropriate rates of return (ROE) will be better informed after the Board and intervenors have access to the financial and other data that Board staff is recommending that the Board require OPG to file quarterly". The expected timing of the availability of such information is not discussed in the Paper. However, during the June 16th Stakeholder meeting there seemed to be a suggestion that this type of financial information would be available for the first proceeding. In any event, VECC notes that Regulation 53/05 (section 6 (2)-4) requires the Board to accept the values for OPG's assets and liabilities as set out in OPG's most recently audited statements for purposes of its first Order. As a result, it may be practical to consider OPG's ROE in the first proceeding. Indeed, matters could be simplified even further if the Board were to adopt (as a short-term measure) the same capital structure used for Regulation 53/05 and an ROE equivalent to what will be approved for Hydro One Transmission in its upcoming rate case.

It is VECC's view that addressing ROE is important if the OEB is to proceed with an incentive regulation model, particularly if it is to have a term extending much beyond one year. Setting an allowed ROE would allow for cleaner definition of Z-factors and events that could trigger off-ramps. It could also provide the basis for an earnings sharing mechanism if one was deemed appropriate by the Board. Without a "defined" ROE, earnings sharing mechanisms can not be developed.

VECC would strongly encourage OEB Staff to include in any subsequent draft proposals more clarity as to how the quarterly financial reporting format will be established and when the related information would likely start to become available.

Payment Structures

The Discussion Paper suggests that structured payments may be an appropriate means of encouraging the efficient operation of OPG's prescribed assets and/or a way to match payment methods with cost characteristics. It goes on to recommend (page 18) that the Board examine the appropriateness of applying differential payment structures. In VECC's view different payment structures payments could result depending upon whether the objective is to:

a) Match OPG's cost characteristics (e.g., fixed payments for fixed costs),
b) Encourage OPG to operate its assets more efficiently from a technical perspective, or
c) Encourage OPG to operate its assets when most needed by the Ontario Market.

While all three objectives are desirable, Staff should clarify in its next draft which one(s) are the primary objectives. In VECC's view, the last of the three objectives is the most important.

"Z" Factors and "Off Ramps"

The Staff recommends (page 18) that "within the provisions of Regulation 53/05 the Board examine the need for mechanisms to account for unanticipated events and conditions that could have a material impact on OPG's payments and/or costs recovery in the first proceeding for possible application as an adjustment to the base payments in the first order or for application to the results of future proceedings". However, as the Staff proposal is to use the existing payment scheme as the starting point, it could be argued that OPG is already experiencing unanticipated events (e.g., the decision not to return the Pickering units to service). In VECC's view, there is need for greater clarity regarding how/when Staff sees Z factors and Off Ramps applying under its proposed approach when:

a) The planning assumptions used to develop the existing payment levels are no longer valid,
b) There is no approved cost base which could be used to define materiality (Note: In the first generation electricity distribution PBR scheme a material impact was defined as an expense that represented 0.25% of a utility's net assets), and
c) There will be no "approved" ROE to use as a benchmark for overall financial performance.

Service Quality Indices

VECC agrees that appropriate service quality indicators must be established for OPG's prescribed assets and that this should be one of the matters dealt with in the first proceeding.

<u>Recommendations as to Payment-Setting Methodology</u>

Overview

Staff believes that Incentive Regulation is best suited to the fulfillment of the Board's task. In VECC's view, it is important for Board Staff to more clearly articulate the rationale for this recommendation. There are two possible motives – each of which suggests a different course of action and work plan going forward:

- First, the recommendation could be predicated on the view that incentive regulation is the preferred approach and sufficient information exists to implement a satisfactory scheme. This paradigm would suggest the development of a multi-year scheme with primary emphasis placed on the determination of the appropriate productivity factor, inflation factor, off-ramps and payment structure. Given the potential longevity of the scheme, debate regarding the methodology would also likely have to include consideration of earnings sharing mechanisms and appropriate payment mechanisms to ensure the operation of OPG's prescribed assets is aligned with the needs of the Ontario market , or

- Second, the recommendation could be predicated on the view that sufficient information does not exist to establish an appropriate base year value off of which to build an incentive regulation methodology <u>and</u> that time is required to develop and vet the necessary cost data. Under this paradigm, the term of the incentive regulation scheme would be much shorter (at most 2 years). Less effort would likely be put into defining either the productivity or inflation factors, off ramps or payment structures. Efforts would be more focused on establishing the necessary financial/operations reporting framework and having OPG start it reporting as soon as possible and perhaps even exploring the possibility of having past years such as 2005 and 2004 restated in a similar format. Efforts could also focus payment structures and on the appropriate payment schemes to ensure OPG's operation of the prescribed assets is aligned with the needs of the Ontario market, but with the recognition that both could be fine-tuned in the future as part of the cost of service review.

As stated in its June 6th comments, VECC prefers a cost of service type approach for the first proceeding, either in full or in phases as suggested by the Discussion Paper and some of the other stakeholders. Indeed, given that Regulation 53/05 directs the OEB to accept OPG's asset values as set out in its audited financial statements, its would be reasonable for the first proceeding to focus on OM&A costs, in particular those for nuclear (given their materiality), and the clearly defining the scope of the regulated business. In VECC's view such a proceeding could be manageable. In terms of ROE, the Board could adopt a short term solution such as that discussed above.

However, if the Board considers this workload too onerous or has concerns about the availability of historical OM&A information, VECC considers it important that the first order have a limited timeframe, i.e. just sufficient to accumulate the necessary financial information.

Specific Recommendations

The following comments are meant to specifically address issues associated with Staff's incentive regulation proposals.

VECC agrees that there is need to establish an appropriate accounting and reporting framework for the prescribed assets. The Board should work to establish such a framework as soon as possible and OPG should start reporting its results in the defined format as soon as practical. OPG should also be encouraged to restate historical information in a similar format if possible. On a related matter, VECC raised in its June 6th comments the issue of corporate cost allocation and wishes to reiterate that is considers this to be an important issue that must be dealt with in the first proceeding if the Board is to clearly establish the scope of the "costs" that are to be recovered through the regulated prices.

VECC supports Staff's proposal for the development of incentive mechanisms that would encourage OPG to dispatch its prescribed hydraulic resources in a manner that best meets the needs of the Ontario market. However, as noted in VECC's June 6th comments, there is also a need for such incentive mechanisms (and indeed the payment scheme for hydraulic overall) to recognize that water flows will vary from year to year and OPG should be not be penalized or rewarded simply as a result of such variations.

As discussed earlier, Staff should articulate how it envisions off-ramps and Z-factors working and, in particular how "unanticipated events" or "material impact" would be defined without the benefit of any approved costing or planning assumptions.

Provided mechanisms are developed to ensure OPG contributes to market efficiency, VECC would not assign a high priority to the development of separate mechanisms aimed at improving OPG's operating efficiencies for the first Order. Indeed, payment structures based on output (i.e., MWhs) will naturally drive such efficiencies.

As stated earlier, it is VECC's preference that the first order last only 1-2 years with a view to providing sufficient time to develop the necessary cost data to undertake a full and proper cost of service review.

The Staff proposal states (page 23) that "the Board's first Order will need to ensure recovery of … the other costs that are referred to in the Regulation". It is not clear to VECC that this can be accomplished without a full consideration of OPG's costs and would ask that Staff articulate in its next draft how it would generally see this as being accomplished.

Conclusions

OEB Staff have indicated that "the special nature of the task calls for a long-term vision and short-term practical approach to realize that vision". VECC agrees. The proposal as outlined by Board Staff is not VECC's preferred approach. However, recognizing some of the practical limitations the Board and parties may face, VECC could accept need for the proposed approach subject to greater clarity being provided regarding the long-term vision and the nature of the first rate order. A number of the issues still outstanding and requiring clarification have been discussed above and include:

- How will the Incentive Regulation methodology ensure that OPG recovers the costs identified in sections 6 (2), sub-sections 3, 6, 7 and 8? It is not immediately clear to VECC that the Staff proposal can meet the requirements.

- When will the accounting and reporting framework be established and when will financial data for OPG be available? In VECC's view this is a priority item and early definition of the requirements and provision of the data is essential.
- How will Z factors and off-ramps be defined in the absence of an approved ROE, planning assumptions or cost base? In VECC's view the need for Z factors and off-ramps can be obviated by establishing a very short term (i.e., 1-2 years) for the first order. In addition, it should be possible to establish an interim rate base and ROE with minimal effort.
- The term of the first order and the plans with respect to when a cost of service review would occur. Again, in VECC's view, the term of the first order should be no more than 2 years and accompanied by firm direction to OPG that the next filing will be cost of serviced based and need to be supported by both historical and forecast financial and operating data.
- Does the long term vision for incentive regulation include recognition that a full cost of service review is ultimately necessary and a commitment to undertake such a review? Clearly, in VECC's view, the answer to this is yes and sooner as opposed to later.

VECC looks forward to receipt of the Staff's next draft and appreciates the opportunity to participate in the process.

Yours truly,

Michael Buonaguro
Counsel for VECC