Constellation Energy

Submission to the Ontario Energy Board

Setting Payments for Output from OPG's Prescribed Generation Assets

EB-2006-0064

Comments on Staffs Draft Paper

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Ontario Power Generation Inc.
Determining Payment Amounts for
Prescribed Generation Assets (EB-2006-0064)

Proposal of the Constellation Energy Companies

Executive Summary

Of the options that are currently under consideration, Constellation NewEnergy Canada, Inc. ("CNEC"), Constellation Generation Group, LLC ("CGG"), and Constellation Commodities Group, Inc. ("CCG") (collectively "Constellation" or "Constellation Energy"), recommend that the Ontario Energy Board ("Board" or "OEB") adopt the "regulatory contract" to address market power concerns and maximize the efficient stewardship and operations of the generating assets of Ontario Power Generation ("OPG"). Under the "regulatory contract" option, OPG would have the option of continuing to sell its output into the spot market or sell the output on a bilateral basis. Bilateral contract sales would be subject to a price floor and OPG's revenue would be capped but the market price would not be capped. By adopting the regulatory contract option, the OEB will bring benefits to consumers, add liquidity to the marketplace, and promote retail competition. As will be discussed in greater detail below, there are numerous benefits to such an approach. Constellation Energy is committed to the promotion of a competitive, market-based response that results in the financial risk being transferred from electricity consumers to retailers and generation investors. Further, Constellation's proposal satisfies the Board's three (3) statutory objectives that govern this issue.

In order to fully explore the issues in this matter, Constellation urges the Board to hold a full hearing on the issue of which is the appropriate methodology to address market power concerns.

Introduction and Background

CNEC and CCG are wholly-owned subsidiaries of Constellation Energy Group, Inc., a Fortune 200 company that evolved out of Baltimore Gas & Electric, the oldest continuously operated utility in the United States. Constellation Energy has grown into the largest supplier of competitive energy in North America, serving over 24,000 MW of electric load. We are active in all competitive energy markets in North America and are interested in the development of vibrant wholesale and retail competitive markets for Ontario. In Ontario, CNEC participates in the retail market and has a professional staff of over 20 people serving the electricity requirements of commercial and industrial customers since May 2003. Our interest in Ontario extends to the wholesale marketing and generation segments of the electricity market as well. CCG is active in the Ontario wholesale market as a both a buyer and seller. On the generation side, CGG is exploring opportunities for new plant development.

In this proceeding, the OEB has correctly identified its statutory obligations and role to establish the appropriate rates for the prescribed assets of OPG. In reaching a determination, the Board should be fundamentally guided by the goal of replicating efficiencies and incentives the market would produce. Market forces will discipline returns and promote innovation and improved operations.

OPG currently has (as of December 31, 2005) 22,173 MW of in-service capacity consisting of 3 nuclear stations (6,606 MW), 5 fossil fuel stations (8,578 MW), 64 hydroelectric stations (6,982 MW) and 3 wind power stations (7 MW). OPG's total in-service capacity at the end of 2005 represented 72% of Ontario capacity and produced 69% of total Ontario consumption of 157.0 TWh.

Observers of Ontario's restructured electricity market have long considered OPG's dominant market position in the electricity generation market to be the Achilles heel of that market. The McDonald Commission recommended that OPG be divided into four or five separate corporations, but the Ontario government at the time was not prepared to take that step. Instead, it created a Market Design Committee, which, in its final recommendations to the government on the issue of OPG's market power, admitted that its terms of reference did not permit it to recommend divestiture and/or the creation of several generation companies out of OPG. It proposed the Market Power Mitigation Agreement ("MPMA") as a second-best solution.

The MPMA, which was in effect between May 1, 2002 (market opening) and April 1, 2005, was intended to protect consumers from OPG using its dominant position to charge unduly high prices. OPG was required to pay a rebate to the Independent Electricity System Operator ("IESO"), to be passed on to customers, equal to the excess, if any, of the average hourly spot market price over 3.8 cents/kWh for the amount of energy subject to this rebate mechanism (approximately 80 TWh hours per year) for those generation stations that OPG controlled. It also proposed some divestiture targets for OPG with respect to its nuclear generation and total generation in order to help create a more competitive generation market.

The Electricity Conservation & Supply Task Force, in its Final Report to the Minister in January 2004, advocated the replacement of the MPMA by some form of "heritage contract". It said:

> "The current Market Power Mitigation Agreement cannot be effectively implemented given the Government's commitment to ongoing public

> ownership. It is necessary to develop a simpler approach to address market power and provide price stability. The Government should initiate a process to develop a suitable substitute arrangement to address concerns over OPG market power. Long-term regulated contracts for "heritage power", reflecting the costs of power generated from most of OPG's waterpower and nuclear assets, may provide a means to reduce price volatility for all consumers and effectively remove that supply from potentially unfair competition with private supply. Complementary measures would be needed as well to ensure OPG does not exercise market power with respect to its assets not covered by such contracts."[1]

Effective April 1, 2005, the Ontario government replaced the MPMA with fixed payments for the output of OPG's prescribed assets, namely, nuclear, and base-load hydro, pursuant to section 78.1 of the Ontario Energy Board Act[2] (the "Act") and Ontario Regulation 53/05. The price caps are $49.50 per MWh for nuclear power and $33.00 per MWh for the first 1900 MWh of hydroelectric output in any hour, with any excess to receive the market price. The arrangement was to last from April 1, 2005 to at least May 1, 2008, at or after which time the Board was expected to assume responsibility for approving the required payments to OPG. The Act provides the Board wide discretion as to the type of order it makes to set the payments to OPG. In addition, the Act requires the Board to review for prudency, and in some cases, approve, without prudency review, any amounts in the several deferral accounts created by the regulation. The payment levels appear to reflect two objectives: (1) to provide OPG with sufficient revenue to allow it to pay all of its capital and operating costs and earn a modest return on investment and; (2) to ensure that it does not abuse its position of market dominance by charging higher prices than necessary to achieve the first objective.

Effective April 2005, the Ministry of Energy also imposed a price cap on 85% of the output of all the OPG's remaining stations, excluding the Lennox Generating Station ("Lennox"), of $47/MWh until April 30, 2006, $46/MWh to April 2007, $47/MWh to

[1] *See* Electricity Conservation & Supply Task Force, *Tough Choices: Addressing Ontario's Power Needs, Final Report to the Minister,* dated Jan. 2004, at pp. 16-17.
[2] S.O 1998, Chapter 15, Schedule B.

April 2008, and $48/MWh to April 2009. In early 2006, the Board approved a "reliability must-run" contract for Lennox, essentially a cost plus margin arrangement.

The Hybrid Market

While the Ministry of Energy often says Ontario has a hybrid market, the true electricity market - defined as that part of the supply that is not under contract - is small in Ontario and has been shrinking rapidly. The June Report of the Market Surveillance Panel of the Board (the "Report") reviewed IESO spot market transactions over the 6-month period from November 2005 to April 2006, and concluded that over this period the amount of domestic generation without fixed pricing, in other words, not under contract, averaged 23% overall, with a low of 13% and a high of 31%. Including imports as part of the spot market does not change the numbers very much, resulting in low, high and average shares of 19%, 38% and 27% respectively.[3]

When the market opened, only the non-utility generation ("NUG") contracts (1,900 MW) had fixed energy prices. In the last few years many other contractual or legislative arrangements have been made to fix the price for generation. The Report stated:

> "This includes OPG's prescribed assets (10,000 MW) and non-prescribed assets (about 11,000 MW), the Bruce Power refurbishment (1,550 MW now and up to 3,000 MW in future),44 Clean Energy Supply (CES) contracts (1,955 MW in total with 117 MW GTAA now in-service), the Lennox Reliability must-run (RMR) contract with the IESO (2,100 MW), early mover contracts for Brighton Beach, TransAlta's Sarnia generation and others (over 1,100 MW), and renewable energy contracts (about 100 MW now in-service.). More generation is expected to be contracted and come into service in the next few years including new plant such as the Portlands project (550 MW in Toronto) and imports from Manitoba (400 MW)."[4]

[3] *See* Market Surveillance Panel, *Monitoring Report on the IESO-Administered Electricity Markets for the period from November 2005-April 2006*, dated June 14, 2006, at pp. 116-117.
[4] *Id.* at p. 115.

Constellation's Proposal

Under Constellation's proposal, effective May 1, 2008, OPG's market power would be constrained by requiring the contracting of capacity from OPG's prescribed assets to other market participants. In other words, OPG would have the option of continuing to sell its output into the spot market or on a bilateral basis. Bilateral contract sales would be subject to a price floor and OPG's revenue would be capped but the market price would not be capped. The purpose of the revenue cap is to avoid over earning of OPG in the bilateral market. The price floor would ensure that OPG recovers it costs

The OPG revenue cap would be set at a fixed percentage above the legislated payments. Constellation recommends that the Board set this cap at 10%. The price floor would be set at a level to cover OPG's cost of debt, other fixed costs, and unit variable costs. The legislated payments on the output from OPG's prescribed assets would remain in place, at current levels, and the global rebate would continue. The difference between the revenue cap and the legislated prices for the contracted volumes would provide an incentive to OPG to sell into the bilateral contract market rather than into the pool at the spot price.

If OPG chooses to sell any of its output into the spot market, it must do so as a price-taker, not a price-setter so that it cannot use its dominant position to affect the clearing price. If the spot clearing price is above the legislative price, the difference will be return for provincial benefit. The Ontario Power Authority ("OPA") would continue its current role of banker/holder of deferral accounts to finance the difference between the price the generators receive and the regulated retail price the small, and designated, consumers pay.

While Constellation's proposal addresses wholesale market design, one result of the proposal would be to make more power available to both wholesalers and retailers. As the Board should be aware, there exists in Ontario today a substantial number of well

capitalized, credit worthy, and well managed wholesalers and retailers, enough to ensure a vibrant competition for OPG's output.

The Board would only need to establish the level of the OPG's revenue caps and floor prices (on a uniform basis) for bilateral contracts for nuclear and hydro power, an adjustment mechanism for these prices, and approve the terms and conditions of the standard contract between OPG and the buyers. The contracts should be for a range of terms up to and including 5 years. Short and medium term contracts ensure that if the market price increases, the Ontario ratepayers will receive the benefit of the now larger spread between the market price and the legislated payments. It would require OPG to file, as an information item, contract pricing information on a confidential basis, so as to be able to monitor compliance with the cap. Through its licensing power, the Board would direct OPG and the other market participants as to the maximum amount of OPG prescribed capacity any party could acquire and OPG would enforce that requirement by obtaining representations by all buyers that they remain within the prescribed market share limit. Constellation recommends that the Board prescribe a maximum amount of 25%.

Advantages of the Constellation Proposal

The advantages of the contract approach, coupled with the retention of the current Section 78 payments, are compelling. There are at least four (4) major advantages.

First, the approach is relatively simple. The Board need not embark on an extensive and costly program of cost-of-service ratemaking or incentive ratemaking for OPG.[5] Under Constellation's proposal, there is no need to delve into the details of OPG's costs beyond what is necessary to establish cost and revenue contract prices, and

[5] An incentive ratemaking alternative would be no less intrusive than cost-of-service for two reasons: First, to be effective and fair to both OPG and consumers, it could not start immediately. It would need as prelude at least a two or three-year cost-of-service ratemaking to validate the going-in costs and to allow stakeholders to thoroughly understand OPG's cost structure. Otherwise the risks of creating a dysfunctional incentive regulatory regime are too great. Second, the task of establishing a proper productivity factor is very complicated, as demonstrated in the natural gas proceedings which led to the original incentive rate plans of Enbridge and Union.

to deal with proposed recoveries of balances in deferral accounts authorized by Ontario Regulation 53/05, and the future role of deferral and variance accounts.

Second, OPG is not a monopoly provider of transportation services. It is a competitor in the market place for the electricity commodity, albeit a competitor in a dominant position. The task at hand is to prevent the exercise of market power while protecting and encouraging the nascent and fragile electricity marketplace. OPG is a part of that marketplace and it must be both permitted and incented to become a supportive player in it, otherwise the market will not survive. Complex cost-of-service regulation designed for monopoly carriers is inappropriate for OPG, and a step backwards.

Third, traditional forms of utility regulation such as cost-of-service and incentive ratemaking (which is dependent on cost-of-service ratemaking as a base) will be particularly difficult to apply to a corporation the size and complexity of OPG. The complexities include OPG's government ownership, its enormous planned nuclear refurbishments, likely nuclear new-build, myriad deferral accounts, special provisions, and various types of assured cost recoveries that OPG has already been granted in Ontario Regulation 53/05. The end result of such an exercise would be to visit on rate payers increasing responsibility for OPG's costs. This is all the more likely so long as OPG remains owned by the Ontario government. A contract-based approach incents OPG to be more efficient, and internalize the risks that it cannot negotiate onto other commercial parties, and, generally, behave like a company in a competitive business, rather than a regulated utility.

Conversely, OPG does not need, and should not be entitled to, the protection of rates of return that are effectively guaranteed. Most rate experts agree that while regulators prescribe "allowed" rates of return, any well run utility ought to be able to, and normally does, earn at least its allowed rate, or more than its allowed rate. This has certainly been the experience in recent years with the Ontario gas utilities. OPG is not a supplier of last resort, has no franchise, and has no special status in the electricity market place, other than its size. It should not have any special legislated protection unavailable

to other generators. It should have to compete to earn a return, not be guaranteed one. Constellation requests that the Board should ensure that OPG does not abuse its dominant position, which was the rationale behind the original MPMA.

Fourth, Constellation's approach will result in many more forward contracts between OPG and credit worthy counterparties. New of contracts will add liquidity to the wholesale market, incent generators to build and encourage the continued growth of the retail market, which in time would enhance the prospects for Conservation and Demand Management and Demand Response, and price certainty for retail customers, as well as direct connect customers. Purchasers could also include LSEs of various types.

Constellation's Proposal Satisfies The Board's Jurisdiction and Pertinent Objectives

The Act provides that the government, and later the Board, shall make an order setting the payments that the IESO shall make to a generator prescribed by the regulations for the output from a prescribed unit.[6] The Board is to make an order, in accordance with Ontario Regulation 53/05, to take effect no earlier than April 1, 2008. The order setting the payments may include "conditions, classification or practices.".[7] This section is different in several respects from that part of the Act that authorizes the Board to set rates for electricity distribution and transmission companies.

The Board has three statutory objectives that should govern its approach to the task at hand.

1. To protect the interest of consumers with respect to prices and the adequacy, reliability and quality of electric service.

2. To promote economic efficiency and cost effectiveness in, inter alia, the generation of electricity.

3. To facilitate the maintenance of a financially viable electricity industry.

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[6] Act § 78.1(1)
[7] *Id.* at § 78.1(4)

The Constellation proposal meets each of these three objectives. The legislated payments and rebates remain in place to protect the consumers, and to protect the financial position of the company. More important, perhaps, is that OPG has the incentive to be more efficient and cost effective because its ability to pass on additional costs to buyers will be limited by contract. Buyers will normally not accept them and OPG will not be able to recover them through the hourly Ontario energy price "(HOEP)" market. Constellation's proposal will assist in transferring the risks associated with infrastructure needs away from ratepayers. Instead, those risks are transferred to owners and investors of generation facilities such that it will allow those entities to make the necessary investments and financial commitments to build the infrastructure that is needed to meet the energy needs of Ontario's electric consumers.

Moreover, as the Board staff noted in its paper of July 6, 2006, OPG is not a natural monopoly, and the Board staff were not able to find a single precedent for a regulator setting rates for a generation company alone.[8]

Board Staff Paper

In all three versions of its paper, the Board staff described the "regulatory contract option" as not "policy neutral", in that it presupposes, according to them, a "return to a more market-based orientation" in the Ontario electricity system.[9] The Board staff is incorrect on this point. It is the proposals for cost-of-service-based regulation or incentive-based regulation that are not policy neutral, in that they would mark a shift away from the hybrid model to which the government is committed, and would stifle the evolution of the market. Compare the staff's approach with the government's policy reflected in Ontario Regulation 424/04, which directs the Ontario Power Authority ("OPA"), when developing an Integrated Power System Plan for the province, to:

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[8] *See* Staff Discussion Paper, *Regulatory Options for Setting Payments for the Output from OPG's Prescribed Generation Assets,* dated July 6, 2006, at p. 5.
[9] *Id.* at p. 16.

> "Identify and develop innovative strategies to encourage and facilitate competitive market-based responses (our emphasis) and options for meeting overall system needs" (section 2.4)
>
> "Identify measures that will reduce reliance on procurement under section 25.32 of the Act" (section 2.5).

These provisions make clear that the current patchwork quilt of OPA procurement contracts and legislated price caps/floors for OPG's production are temporary expedients, not a long term solution.

Finally, the Board staff suggests that a scheme of regulation-by-contracts would mean the Board's abandonment of its jurisdiction to set the Section 78 payments.[10] This is simply not true. The Board will continue to set the payments for the various categories of power, set terms and conditions of standard form contracts, monitor prices in the aggregate and prescribe a maximum level of market share of any purchaser of "heritage asset" contracts.

Constellation's preference for a contracts-based approach is supported by several other stakeholders, including the OPA, IESO, not to mention London Economics International, the Board staff's chosen consultant for the project.[11]

The Regulatory Process

Given the widely divergent views expressed by OPG, Board staff and other major stakeholders, Constellation urges the Board to hold a full hearing on the issue of which methodology to use. In many respects, the Board's decision about whether to use a contracts-based approach or a cost-of-service/incentive regulatory regime borrowed from traditional monopoly regulation is more important to the future of the hybrid market structure in Ontario than the detailed implementation of whichever option the Board selects. Furthermore, there would appear to be no compelling reason for the Board to rush to judgment through a written process. The statutory payments for the output from prescribed assets remain in place and the Act does not require the Board to begin setting

[10] *Id*. at p. 16.
[11] *See* July 2006 Comments filed by OPA; IESO; and London Economics International.

the payments by a date certain. Ontario Regulation 53/05 states that until the Board decides otherwise, the payments will remain at the existing levels.

Conclusion

Constellation urges the Board, OPG and stakeholders should take the time and make the effort to choose the best approach to integrate the output of the prescribed assets into the hybrid market and in reaching a determination in this proceeding the Board should be fundamentally guided by the goal of replicating efficiencies and incentives the market would produce.

Mistakes avoided now will make everyone's job much easier in the future. Constellation appreciates the opportunity to provide the Board with these comments. Constellation looks forward to the opportunity to continue to work with the Board as it determines the methodology adopted for determining payments amounts for OPG Prescribed Generation Assets. Please fell free to contact the undersigned's with any comments questions or comments.

Respectfully Submitted,

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