Direct Energy

July 24, 2006

DIRECT ENERGY COMMENTS

OEB Staff Discussion Paper, July 6, 2006
OPTIONS FOR SETTING PAYMENTS FOR OPG PRESCRIBED ASSET OUTPUT

Direct Energy is concerned that the "regulatory contracts" discussion in the Staff paper does not reflect a depth of understanding and consideration required to properly evaluate this option. Nor does the paper sufficiently consider the regulatory and policy context in which the Board has been directed to determine the appropriate payments for the prescribed asset output.

The "Regulatory Contract" model.

The essential issue to consider under the rubric of a "regulatory contract" model is whether, and if so how, the output from Ontario's base load generation assets is put into the wholesale real time and forward markets, and what impact such consideration has on the mechanism for setting allowed earnings or payments on that output. Direct Energy notes that the OPA and the IESO, the two agencies charged with the public interest in effective management of the market part of the "hybrid" structure, have strongly indicated that the "regulatory contract" model bears further discussion and consideration.

In Staff's discussion, there is a lack of clarity regarding the essential elements of the "regulatory contract" option, versus the other options. For example:

- There is a concern expressed regarding the appropriateness of relying on "negotiations" between parties to determine the parameters for the "regulatory contract". It is <u>not</u> necessary that the terms of the arrangement would be negotiated between commercial parties. Under the model currently in place, which is essentially a "regulatory contract" model, the government established all of the salient terms and conditions for management of the output from OPG's designated assets, including OPG's earnings in connection with that output. The Board could do so going forward (as acknowledged in the paper, page 16, 3rd paragraph).

- The generic references in the draft paper to the "significant complexities" associated with the "regulatory contract" option (pages 10 and 11) are curious. The generation facilities in question are currently operating under such a structure, as noted in the analysis from London Economics commissioned by Board Staff to inform this discussion. The London Economics paper states [page 41- 3rd paragraph]:

> *Those who view Scenario 3 as complex (regulatory contracts) should examine the current procedures; current practice with regards to the designated assets cannot be viewed as being either simple or transparent. In fact, Scenario 3 is simpler than the former Market Power Mitigation Agreement. Furthermore, any complexity occurs during the initial set-up period. Once the structure is established, the calculations are relatively mechanistic*

- We also note the discussion in the Staff paper (page 9, 2nd full paragraph) of mechanisms to "sculpt" payments to OPG to incent certain bidding behaviour. This is precisely the sort of mechanism one would expect in a "regulatory contract" structure.

The regulatory and policy context.

There is also a lack of discussion in the Staff paper regarding the regulatory and policy context in which the Board has been directed to determine the appropriate payments for the prescribed asset output. In particular:

- The characterization of the Board's statutory objectives is too narrow. The Board's mandate includes imperatives to;

  a. protect the interests of consumers with respect to prices and quality of electric service; and

  b. promote economic efficiency, cost effectiveness and financial viability in Ontario's electricity industry.

  These imperatives require the Board to take a broad view in this matter. Regulation is a (second best) substitute for competition, and any solution now adopted should harness available market mechanisms, and take a view to the preferable longer term solution, within the broader context of Ontario electricity sector restructuring.

- The promotion of economic efficiency and cost effectiveness, and the maintenance of financial viability in Ontario's electricity industry, <u>necessarily</u> involve consideration of the impact of Board decisions on the wholesale and retail electricity market. A functioning forward wholesale power market is essential to:

  - Provide generation investors with the tools to manage, and thus assume, investment risks. The greatest single exigency facing Ontario's power market today is the need to secure cost effective, and economically efficient, investment in new generation. Failure to attract private risk capital will result in taxpayers and ratepayers bearing tens of billions of dollars of investment risk and in unnecessary diversion of scarce public funds.

  - Provide liquidity to support alternative supply and pricing options for customers. Without forward supply retail supply options will be removed from the market.

- The proposition (page 16) that there is lack of specific policy direction in regard to whether a market is part of Ontario's electricity future is simply incorrect. The legislation clearly contemplates, and the Minister of Energy has expressly and repeatedly emphasized, the "hybrid" nature of Ontario's restructured electricity sector – part regulated and part competitive. To ignore this policy context is not "policy neutral", but rather is <u>contrary</u> to clearly stated government policy.

- The Staff paper fails to address the necessary nexus between the generation assets in question and the market. OPG owns and operates most of Ontario's base load generation capacity. Any regulatory mechanism adopted must provide incentive for OPG to bid on a commercial basis into the real time market, and to sell forward when and as commercially appropriate in the contract market. In particular:

  - There is no discussion in respect of the incentive regulation model of how the output from OPG's plants would be put into the real time wholesale electricity market, how market prices paid for that output would be settled, and how this would differ under a "regulatory contract" model.

  - The proposition is made (page 9, last paragraph) that incentive regulation should consider regulatory incentives to substitute for market signals to influence operating decisions. Of course, we have an actual wholesale market, and actual market signals. Market signals are better suited than regulatory approximations to incent efficient and customer responsive behaviours.

  - The proposition is made (page 12, 3rd full paragraph) that:

    > *The fact that the prescribed assets are under rate regulation in and of itself is indicative of a move away from market pricing as the primary basis for the remuneration of their output. If market based pricing was the intended outcome, there would be little need for (or value in) regulatory review of the payments amounts.*

    The proposition excerpted ignores the distinction between the price at which the output is sold into the market, and the payments to be made to OPG on account of that output. That is, the proposition fails to recognize that the prescribed assets have a necessary connection to the market.

Conclusion.

Direct Energy is concerned with the time frames proposed for this critical decision. While we appreciate the open and consultative approach that Board Staff have taken in this matter to date, the time frames for comment have been too tight. This is a matter of fundamental importance to electricity consumers and to the future of our electricity sector.

Direct Energy urges the Board to allow for more careful and thorough consideration and discussion of the options for setting payments for OPG prescribed asset output, and in particular the impact on such payment setting of OPG's interface with the competitive wholesale electricity market. More thoughtful comment and review is required on such a fundamental matter than has been afforded in the discussion paper and the associated time constrained consultations to date.

Even if the Board determines not to deal with such matters in its payments methodology, it must consider how such matters will be addressed. The risk otherwise is implementation of a payments model that frustrates implementation of government policy to develop the competitive part of the hybrid model and that constrains the continuation of retail choice. Direct Energy notes that the OPA's market evolution plan, which is expected to be articulated in the Integrated Power System Plan (IPSP) to be released later in the summer, will provide important context for consideration of the questions raised in this consultation. The Board should, at a minimum, consider the relevant substance of the anticipated IPSP prior to making a determination on any recommendations provided by Board staff.