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Ontario Energy Board

Setting Payment Amounts for Ontario Power Generation Inc.'s Prescribed Generation Assets

Energy Probe Research Foundation

◆ Reply Submissions to Comments on OEB Staff Discussion Paper ◆

Submitted August 9, 2006

Board Staff Discussion Paper – Reply

Reply Submissions of Energy Probe Research Foundation to Comments on OEB Staff Final Discussion Paper

General Comments

The following comments are provided on behalf of Energy Probe Research Foundation (Energy Probe) in response to the Submissions of several parties to the consultation process initiated by the Board.

Ontario Power Authority (OPA) Submission of July 24, 2006

The submission of the OPA describes in some detail a series of steps that the OEB could take to ensure that a regulatory contract option would meet its objectives of transparency, fairness, regulatory efficiency and consistency. However, there are two persuasive arguments in opposition to a regulatory contract option that the counsel for OPA has not addressed in his submission.

First, it appears that Ontario Power Generation (OPG) will be in operation for the foreseeable future; the OEB must develop a long term solution to deal with its market dominance, its financial stability, and the regulatory challenges represented by its generation fleet. As stated by the OPA in the last paragraph of Page 5 of its submission:

> **The OPA embraces the concept that its procurement and contracting function are interim only, and works toward the long term goal of reducing and eventually eliminating the OPA's procurement contracting responsibilities.**

It would be perverse for the OEB to design a special methodology to widen a form of regulatory contracting that is mandated to be eliminated.

Second, as pointed out by the Vulnerable Energy Consumers Coalition in its June 28, 2006 submission at Page 2, second full paragraph, last sentence:

> **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 through the Ontario Power Authority (the "OPA") who is better positioned to implement such an approach.**

The Ontario Power Authority is clearly in a growth mode. But the spectre of OPA taking control of the power output from OPG's prescribed generation assets at the same time that it is building its Integrated Power System Plan, and coincident to ramping up to assume its new responsibility for electricity conservation and demand-side management programs by local distribution companies in Ontario, might be more than even the Ontario government could cope with.

It is interesting to note that OPA's choice of methodology is supported by market participants who are generators and marketers, those parties interested in earning a return in the market, but totally rejected by those parties footing the bill for the market.

Ontario Power Generation (OPG) Submission of July 24, 2006

Energy Probe found much to agree with in the OPG Submission, especially in respect of its comments concerning the Board's obligation to set just and reasonable rates, and the policy objective of the Government to move, however slowly, in the direction of having prices reflect the true cost of power.

OPG has been diligent in providing the Board with an impressive number of quotes from its own Decisions With Reasons supporting Cost of Service as the starting point for the establishment of incentive regulation, and has again brought to public

attention the fact that OPG's proscribed assets have never been subject to Cost of Service regulation.

In Energy Probe's submission, it is most important for the Board to appreciate that the concerns of OPG, with respect to the Board's deliberations on the proper methodology to select for setting the Payments, revolve around avoiding an outcome which fails to provide sufficient revenue to cover "the full cost of owning, operating maintaining and developing the prescribed assets"[1].

In a scenario which includes current interim payment amounts developed in a black box, the distinct possibility of significant capital investments in the prescribed facilities, and maintenance costs which can be lumpy, OPG needs to be concerned in respect of avoiding regulatory risk in this proceeding. The concept of Incentive Regulation of nuclear facilities is enough to raise the hair on the back of one's neck.

The one area that Energy Probe was disappointed to see undeveloped in OPG's July 24th submission is the omission of an analysis as to why, from its perspective, a regulatory contract option would be of limited value in this proceeding. With that exception, its submission is well balanced and well presented.

Constellation Energy Submission of July 24, 2006

Constellation has both generator and marketer interests. Not surprisingly, therefore, Constellation is proposing a regulatory contracts methodology that would promote high prices for generators and high margins for marketers. The surprise is Constellation dressing up its recommendations in a cloak of consumer protection, warning against the dangers of the exercise of market power by OPG.

[1] OPG Submission – Staff Discussion on Regulatory Options, July 24, 2006, para.7, p.2.

To ensure high prices for generated power, Constellation proposes a price floor for bilateral contract power sales to protect against the danger Constellation sees of OPG agreeing to sell below cost.

To create commercial opportunities for marketers, Constellation recommends tilting the playing field in their direction. Constellation would have the Board create rules that would encourage OPG to sell its power forward through the bilateral contract market. To limit bidding in this proposed contract market, Constellation recommends a limit on the amount of power any participant can buy of approximately 12% of the total Ontario demand.

Constellation makes some criticism of incentive regulation as applied to OPG that Energy Probe agrees with. Constellation notes the risk of creating a "dysfunctional regulatory regime" if incentive regulation is not preceded by cost-of-service analysis that allows the regulator to develop some grasp of OPG's costs and operational challenges. Constellation also draws attention to the difficulties inherent in identifying a suitable productivity factor.

Independent Electricity System Operator (IESO) Submission

The IESO has introduced a new proposal for a regulatory contract-for-differences (CfD) mechanism which has not previously entered into this review process. The proposed mechanism's major feature is that payments to OPG would be based on prescribed quantities and prices.

The IESO provided little quantitative analysis to support its outline.

Energy Probe believes, that subject to addressing the three concerns outlined below, the IESO's proposed regulatory CfD mechanism may be the best method so far advanced for regulating OPG's prescribed hydro-electric operations. The IESO's

proposal appears particularly attractive as a method to include the Beck Pumped Storage in regulation without impairing its efficiency.

The IESO expresses the opinion that $33/MWh plus an inflation factor is the proper value to ascribe to the hydro-electric output. Energy Probe suggests that the base amount and appropriate inflation factor should be independently confirmed by the Board in a public process.

The determination of the quantities of output for a successful regulatory CfD mechanism would require significant effort. If prorated annual average production is used to assign the regulated weekly production quantities, the seasonality of production from OPG prescribed hydro-electric assets may introduce significant seasonal earning swings for OPG. If Energy Probe's concern is accurate, this variability might raise finance problems for OPG, which is subject to the securities rules applicable to public debt issuers. A possible remedy for the IESO's regulatory CfD mechanism might be to base the regulated quantities on seasonally adjusted averages.

A related concern is that the IESO's proposal would make a significant portion of OPG's revenues vulnerable to the vagaries of unusual weather. The IESO's proposed requirement that OPG replace missing generation during shortfalls and have full rights to any excess generation would amplify the impact of weather on OPG relative to the status quo. Although OPG's overall hydro-electric output is generally fairly stable – plus or minus approximately 2 TWh on about 37 TWh of production – this happy circumstance is significantly influenced by the wide geographic diversity of OPG's hydro-electric fleet. The prescribed fleet is more geographically concentrated than the entire fleet and therefore subject to larger percentage variability than the full fleet in wet and dry years. As a result, during wet years, like the current one, OPG might substantially over-earn under the IESO's proposal. During dry years, like 2005, OPG might substantially under-earn on its regulated hydro-electric operations.

Energy Probe believes that these issues need to be more fully examined before any decisions are made by the Board. We suggest that a technical conference or other public forum be held to explore these issues. We also recommend that OPG be allowed to participate fully in any examination of these issues and that OPG's input be actively solicited by the Board before any decisions are made.

While Energy Probe believes that the IESO's regulatory CfD model is worthy of consideration for making payments to OPG for prescribed hydro-electric generation, Energy Probe does not believe that the regulatory CfD model can be successfully applied to OPG's nuclear operations. The uncertainties that prevail with nuclear operations make the CfD mechanism unduly risky for OPG.

It appears that sometime in the early years of the next decade, some of OPG's prescribed nuclear units will be out of service or undergoing refurbishment. On August 3, 2006, the Canadian Nuclear Safety Commission announced that it will conduct a screening commencing on July 28, 2006 of the refurbishment and continued operation of the Pickering B Nuclear Generating Station.[2] The Canadian Nuclear Safety Commission has received notice of intent and a project description from Ontario Power Generation for the refurbishment and continued operation of the Pickering B Nuclear Generating Station Units 5, 6, 7 and 8. Feeder pipe integrity issues associated with Darlington may also impact operations of those units significantly in the early years of the next decade.

In the immediate lead-up to closure or refurbishment, it appears likely that Pickering B units may be subject to more outages for inspection and possibly repair than they have been in recent years. Darlington may face similar issues. Historical productivity and cost results for Pickering B and Darlington may therefore not be a good guide to the future output and costs.

[2] Canadian Environmental Assessment Review reference number **06-01-21226.**

Given the profound uncertainties around the expected output and costs for Pickering B and Darlington, Energy Probe sees no realistic alternative to a Cost of Service review for these operations.

In Conclusion

Despite the assertion of Board Staff that assigning responsibility for payment determination of the prescribed assets to the Board by the Government is somehow consistent with its commitment to take politics out of electricity pricing in the province[3], the Board should remain cognizant of the Government's proclivity to change regulatory direction. And right now, by moving the oversight of electricity CDM from the Board to the OPA, the Government has freed up time for the Board to do a full Cost of Service review.

And more to the point, OPG and its predecessor have been under the direct control of government for almost one hundred years. If the Board only gets one chance every hundred years to do a full regulatory review, it should make the most of it for ratepayers by undertaking a Cost of Service review now.

Respectfully submitted at Toronto, Ontario this 9th day of August, 2006.

Tom Adams
Executive Director

[3] Staff Discussion Paper, Regulatory Options for Setting Payments for the Output from OPG's Prescribed Generation Assets, July 6, 2006, para.5, p.12.