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Ontario Energy Board

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

Energy Probe Research Foundation

◆ Comments on OEB Staff Discussion Paper ◆

Submitted July 24, 2006

Board Staff Discussion Paper – Final

Comments of Energy Probe Research Foundation Following Publication on July 6, 2006

General Comments

The following comments are provided on behalf of Energy Probe Research Foundation (Energy Probe) in response to the Board Staff Discussion Paper "Regulatory Options for Setting Payments for the Output from OPG's Prescribed Generation Assets" July 6, 2006.

Energy Probe appreciated the opportunity to review and comment on the two draft papers published by Board Staff, and notes that it is now presenting final comments in response to the final version of the Board Staff Discussion Paper.

Energy Probe continues to believe that any method for setting payments adopted by the Board should allow OPG to continue to operate in a business-like manner and to maximize the value of OPG's generation resources to consumers, consistent with the constraints OPG faces.

Read together, Section 78.1 of the Ontario Energy Board Act and Ontario Regulation 53/05 ask the Board to determine appropriate payments to OPG for its output. Energy Probe suggests that the public, the government, and OPG will be looking to the Board to develop a fair and transparent regulatory methodology that validates the process.

Background Comments in Respect of Board Staff's Regulatory Bias

During the course of the Consultation Sessions and within the draft Discussion Papers circulated to interested parties, it appears that Board Staff has become committed to at least two concepts which are not generally held by stakeholders and other interested parties:

- **Obtaining regulatory efficiency is a higher level goal to be achieved in this proceeding; and,**
- **Ontario Power Generation will respond quite favourably to financial incentives which will be crafted by the Board.**

Perhaps it is a lack of acceptance of these two concepts by stakeholders and other interested parties that explains the utter lack of support for the recommendations put forward by Board Staff in their final version of the Discussion Paper.

As background to its comments on Board Staff's Draft No. 2, Energy Probe noted that a full cost of service, validated by Intervenor participation, has never been completed on the prescribed assets that the Ontario Energy Board has been directed to regulate. That includes all the time that these assets formed part of Ontario Hydro. It was always too big a job, too difficult to undertake, the resources to do a full service were never available, the government of the day, no matter which of the three major Ontario political parties it represented, never had the will to do it – it was just too hard. Even as Ontario Hydro blew through billions of dollars of investments (stranded costs), it was always just too hard to do.

Energy Probe suggests that this is the time. Board Staff can run through all those tired excuses, and it has in both drafts and the final Discussion Paper, but the Board itself should consider that it is never too late to do a thorough job for the ratepayers, those customers that the Ontario Energy Board is mandated to protect. And finally, the Board has the mandate to do just that.

Although administrative simplicity is a legitimate goal, regulatory efficiency should never be a goal which trumps regulatory effectiveness.

Comments Attributed by Board Staff to Interested Parties

In Draft No. 2 and again in the final Discussion Paper, Board Staff attributes multiple comments by interested parties in support of each of the three main categories of Regulatory Models put forward for consideration, and multiple comments by interested parties opposed to each. A reader might well perceive that support and opposition is equally spread among the Regulatory Models.

Energy Probe notes that of the 14 interested parties that were interested enough to make a submission in writing on either Draft No. 1 or Draft No. 2, a review of their submissions reveals that none came out in favour of Incentive Regulation as their first choice.

Board Staff is an outlier. Only Board Staff is on the record as picking Incentive Regulation as their first choice of Regulatory Model to begin the regulatory process.

Constellation Energy in its comments on Draft No. 1 submitted that the "Ideal Solution" would be to sell the prescribed OPG assets to independent owners, but accepted Regulatory Contracts as the best solution short of an asset sale to independent owners.

Coral Energy Canada and TransAlta Energy Corporation, in their comments on Draft No. 2, supported Regulatory Contracts, as did the Ontario Power Authority (OPA) – perhaps not a stretch as its choice.

The Independent Electricity Market Operator (IESO) indicated that it pretty well likes things as they currently function.

All other written submissions by interested parties picked Cost of Service, either full or modified, as their first choice of Regulatory Model to begin the regulatory process. It is true that several parties felt that a form of incentive regulation would be an option for obtaining efficiency benefits once a Cost of Service process was undertaken. Nevertheless, Cost of Service was the overwhelming pick on the record of the three Options presented.

One must ask the question: "Why is Board Staff an outlier?" Does Board Staff see what others miss? Or has Board Staff fallen victim to accepting that same old conclusion – it is just too hard!

Comments Directed Toward the London Economics International Report

The London Economics International (LEI) Report in its third paragraph on Page 4, states: "This research is intended primarily as an exploration of concepts that will be used to spark discussion." Energy Probe wishes to commend the LEI for its research and commentary, believing that it has succeeded in its primary objective.

Each discipline operates within its own bias, and where Energy Probe takes issue with the economists of LEI is in their belief that economic incentives will have an impact with OPG similar to that which one might expect to witness from a widely held commercial entity. For that to be true, the incentives crafted by the regulator must motivate either the owner or the employees.

What incentive would be effective in motivating the sole owner of OPG? The sole owner is the Ontario government which reacts through the Energy Ministry. If the OEB was in a position to guarantee an election victory in 2007, perhaps it would have found an excellent incentive. It would certainly not be the first time that election pressures rearranged the operation of the electricity market in Ontario.

For OPG itself, it is very difficult to see any economic reward as having particular effectiveness in incenting its operations. Its profits are already promised elsewhere. It must contribute them to pay for the stranded assets generated while it formed part of Ontario Hydro. Perhaps if the Board were given oversight of all of OPG's assets and operations, it could formulate the compensation of management to include incentives that would support the conclusions of LEI. That is unlikely to occur within the current mandate of the Liberal government, but it is certainly a possibility after the next election, no matter which party triumphs.

Comments Directed Toward Section 5.3 – Board Staff's Evaluation

In the first paragraph, Board Staff describes its opinion of the components of the regulatory task before the Board in determining the payment amounts for OPG that will:

- **Continue to limit exposure to price volatility;**
- **Provide price stability for consumers;**
- **Contribute to the mitigation of OPG's market power;**
- **Maintain OPG's financial integrity; and,**
- **Maximize opportunities for efficiencies and cost containment in OPG's operations.**

The first two components appear to be one and the same. In fact, achieving the first three components will usually result in increased rates for consumers. There is always a cost extracted in one way or another for limiting the price movements of commodities. Price stability smooths price upward. As for mitigating OPG's market power, since OPG can not increase its regulated earnings, the only exercise of market power would be to reduce prices for consumers in order to weaken the financial integrity of other "market participants."

In the second paragraph of this Section, Board Staff lists four determinants for selecting a Regulatory Model: greatest degree of transparency, fairness, regulatory efficiency and consistency. Energy Probe submits that "regulatory efficiency and consistency" should be replaced by "regulatory effectiveness and consistency".

And finally, a comment on the statement in the last paragraph in Section 5.3 that "Those that favoured incentive regulation noted the importance of achieving efficiency gains in OPG's operations." Since only Board Staff appeared on record as picking Incentive Regulation as the favoured model, this statement might well be attributed to Staff itself.

Comments Directed Toward the Regulatory Models Explored by Staff

a) Cost of Service

An overwhelming majority of the written submissions by interested parties picked Cost of Service, either full or modified, as their first choice of Regulatory Model to begin the regulatory process. If "market participants" (competing electricity generators) and government agencies are subtracted from the mix of written submissions, all remaining stakeholders and interested parties advocate Cost of Service, either full or modified, as their first choice of Regulatory Model.

The Discussion Paper sets up a Cost of Service Straw Man – an annual proceeding, either full or modified, one which would consume considerable time and resources, one that suffers from information asymmetries, one which is not likely to result in economically efficient responses from the regulated party – and then, with difficulty, dismissed it as not the most efficient model.

Energy Probe for one, would hope that the Board would spend considerable time and resources in the early years on regulating OPG. It is after all, by far the main generator of electrical power in the province, and it is essential that the Board

makes a credible beginning in its regulation. That said, there is no requirement in a Cost of Service model for an annual review. All parties would be better served with a Cost of Service for OPG every two years, whether it is a modified or full review.

And the other excuses put forward by Board Staff for not being able to do a Cost of Service, are really only excuses. A transparent review is most necessary for the first step.

b) Incentive Regulation

Board Staff begin their evaluation of the Incentive Regulation model by stating "Incentive Regulation is the Board's preferred methodology for setting future gas and electricity distribution rates."

In response, Energy Probe wishes to point out to Board Staff that in setting gas distribution rates, the Board has a history of decades of Cost of Service regulation upon which to rely when designing an incentive regulation plan which will include rebasing. In setting electricity distribution rates, where such a history does not exist, the Board has outlined a process which will include cost of service for utilities on a staggered basis due to their numbers.

Board Staff suggests at Page 15, Paragraph 4, that since it feels that OPG's historical costs and performance data are insufficient to support a productivity analysis, benchmarking can be used to set a productivity factor. Energy Probe wishes to remind Board Staff that the Board has previously ruled, as in RP-2004-0117/0118 et al, Recovery of Regulatory Assets, that benchmarking is best used for screening, and identifying utilities that require more regulatory attention, not less.

Further, Board Staff would have us believe that it would be acceptable to construct an "applicant specific cost inflation factor" using widely collected statistical data instead of using "the actual cost data from the applicant." Energy Probe believes that it is incumbent upon the Board to determine the actual cost data from OPG,

and believes that, with the assistance of ratepayer intervenors, the Board is capable of doing.

Earlier, under Section 4.2, Incentive Regulation, in the first complete paragraph of Page 9 of the Discussion Paper, Board Staff suggests the Board could establish a "revenue sharing factor for output above the projected level to ensure that consumers, as well as OPG, benefit from productivity increases beyond expectations that are reflected in the formula."

The net revenues of OPG are already committed to pay for old, mainly nuclear, debts known as stranded costs. These stranded debts bear witness to the resistance of an earlier iteration of OPG to incentives, both positive and negative.

c) Regulatory Contracts

The Regulatory Contracts model was favoured by market participants, who are generators like OPG, and the Ontario Power Authority.

Energy Probe wishes to provide credit to a particularly insightful observation made in the June 28, 2006 submission on behalf of VECC, an exceptionally well crafted submission. At Page 2, second full paragraph, last sentence, VECC opines as follows:

> **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.**

This appears to be a valid observation. Although Board Staff quotes in the first paragraph of Section 5.2 of its Discussion Paper the Government's "commitment to ensure politics are taken out of electricity pricing in the province", the government continues to make changes to the electricity situation in Ontario, as it recently did

when it moved management of conservation and demand management activities for local electricity distribution companies from the OEB to the OPA.

Comments Directed Toward Section 7 – Recommendations

In the Overview Board Staff, alone of all stakeholders and interested parties that have made submissions on Draft No. 1 and Draft No. 2, gives its recommendation that Incentive Regulation is the methodology that is best suited to the fulfilment of the Board's task as the Board Staff has described it.

While Board Staff accepts that were Cost of Service their recommended model for determining the payments for OPG, resource and timing concerns could be overcome. But in the end, Board Staff believes it is just too hard.

In the first full paragraph on page 20, puts forward a concern in respect of Cost of Service which is generic. Taking into consideration the objectives it has of "reducing price volatility and increasing electricity price stability" – two ways of expressing the same objective – a Cost of Service proceeding may result in payments that are quite different (and presumably higher) than current payments.

But of course, "reducing price volatility and increasing electricity price stability" will invariably result in upward smoothing of prices whatever the methodology.

Turning to the third complete paragraph of Page 20, in response to the first sentence concerning the recommendation that the existing payment levels be used as the base payment under the Board's initial regulation, Energy Probe wishes to turn to the submission of the Power Workers' Union following Draft No. 2, dated June 27, 2006. This is another well crafted submission, which deserves to be quoted in several places concerning the choice of Incentive Regulation. One such quote speaks to the above recommendation and is found at Page 2, second paragraph of their submission:

The major failing of transparency is Board Staff's suggestion that the current payments form the "base payment" of the future incentive regulation scheme. The current payments were determined in a completely non-transparent fashion. They were set in a "black box" with absolutely no public scrutiny as to their appropriateness on any regulatory standard.

In last paragraph of page 20 of the Discussion Paper, Board Staff provides the exact opposite recommendation of the submissions of all ratepayer groups. That is, an initial incentive regulation formula be applied to the existing base payments, laying the foundation to permit a full cost-of-service review in the future. Energy Probe notes that in the chart on Page 24, there is no mention of a Cost of Service initiative, and suggests that while Board Staff was consulting with stakeholders and interested parties, it certainly was not listening intently.

Recommendations of Energy Probe Research Foundation

Energy Probe submits that the OEB needs to commence a Cost of Service Review as its base line for setting payments for OPG. Once the initial full or modified Cost of Service is completed, once the Board has confidence in the actual cost data obtained from OPG, Energy Probe suggests that OPG should bring its Cost of Service rate application forward every two years for its prescribed generation assets.

This regulatory model go far in assisting the Ontario Energy Board's to satisfy its obligation to establish payments that are just and reasonable, and to protect ratepayers now and in the future.

Respectfully submitted at Toronto, Ontario this 24th day of July, 2006.

Tom Adams
Executive Director