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Ontario Energy Board

Setting Payments for Output from Ontario Power Generation's Prescribed Generation Assets

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Ontario Power Authority Comments on Board Staff Discussion Paper dated July 6, 2006

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1.0 Background

Pursuant to Section 78.1 of the *Ontario Energy Board Act, 1998*, the Ontario Energy Board (the “OEB” or the “Board”) will determine the payments to be made to Ontario Power Generation Inc. (“OPG”) with respect to the output of its prescribed facilities. Pursuant to O. Reg. 53/05, April 1, 2008 is established as the date on which the OEB’s authority to determine those payments commences. The prescribed generation facilities (the “Prescribed Assets”) are the nuclear generating stations operated by OPG (Pickering NGS, Darlington NGS) and the base load hydroelectric assets in the Regional Municipality of Niagara (Sir Adam Beck I, Sir Adam Beck II, Sir Adam Beck Pumped Generating Station, De Cew Falls I and De Cew Falls II) and on the St. Lawrence River (R.H. Saunders).

On March 21, 2006 the OEB issued a letter to interested parties describing the process it intended to use to establish a methodology for setting payment amounts to OPG, and in a subsequent letter, dated April 27, 2006, the schedule for that process. The OEB posted the first draft of OEB Staff’s Discussion Paper, dated May 8, 2006, setting out various alternative approaches to the methodology to be used to set those payments, and on May 19, 2006 a meeting was held to discuss the draft Discussion Paper and for OPG to make a presentation to interested parties about the operating characteristics of the Prescribed Assets. The OPA was invited to participate in a session on June 5, 2006, hosted by OEB Staff, to provide comments on the draft Discussion Paper. The OPA followed up with written comments submitted June 8, 2006.

On July 6, 2006, the OEB posted on its web site the Board Staff Discussion Paper (the “Discussion Paper”) that proposed various regulatory models. This paper also presented some of the issues that the OEB may consider in its choice of regulatory methodology and the pros and cons of the various models.

The purpose of this document is to provide follow up written comments from the OPA to Board Staff, and to ensure that the OPA’s input is provided to the OEB prior to final decisions being made regarding the payment methodology for OPG’s Prescribed Assets.

2.0 Introduction

The OPA appreciates the opportunity to provide comments to assist the OEB in this important matter, setting payments for the output from OPG’s Prescribed Assets.

The resolution of the payment methodology for the Prescribed Assets that supply nearly half of Ontario’s annual electricity consumption will have a material and lasting effect on the balance of Ontario’s electricity sector, the future evolution of the electricity marketplace and the level and types of risks borne by electricity customers.

Given the legislative framework laying out the hybrid electricity market structure, and acknowledging that electricity policy has changed several times in the recent past, any payment option must provide sufficient flexibility to allow for future market structure reforms as well. Customers and market participants need assurances that commitments entered into today will not be rendered obsolete due to possible market changes in the future. Therefore, the OEB is encouraged to ensure that the framework designed today can adapt smoothly as conditions change, without the need for major structural modifications which create uncertainty and, as a result, unnecessarily expose customers and market participants to additional costly risk.

3.0 Board Staff Recommendation

The OPA urges the Board not to adopt the recommendation of Board Staff of an incentive regulation ("IR") payment method for OPG's Prescribed Assets. The OPA believes that only the regulated contract approach provides the opportunity for efficient short term operating decisions and long term investment decisions.

Board Staff have evaluated each of the three payment-setting options on the basis of four regulatory criteria: transparency, fairness, regulatory efficiency, and consistency. While the OPA accepts that these are relevant criteria, the OEB should also look beyond these criteria to consider the broader context of the implications of these payments on the remainder of Ontario's electricity sector, including the existing wholesale marketplace and the users of electricity.

The focus of these broader considerations should be the impact of the method of regulating OPG's prescribed assets on:

- the efficient operation of the existing wholesale electricity and operating reserve markets; and
- private sector investment in new generation in Ontario.

The OEB should not accept the narrow view that payments for Prescribed Assets impact only OPG's operational and financial position. In fact, these regulated payments, and how the mechanism is established, will impact all other segments of Ontario's electricity sector and have a material impact on the options that customers have both in the near term and the long term for meeting their electricity needs.

3.1 Policy Neutrality

One of the reasons that Board Staff cite in their Discussion Paper for not supporting the regulatory contract approach is that it is not "policy neutral". The Discussion Paper states at p.16 that:

> "…Board staff advocate that the choice of methodology should be 'policy neutral' in the sense of allowing the Board sufficient flexibility to adjust the methodology to respond to specific market policy direction in the future. Regulatory contracts depend on fairly specific policy goals and institutional sector stability to negotiate contract terms and conditions."

The OPA does not believe that Cost of Service ("CoS") or IR methodologies are any more policy neutral than the regulatory contract approach. For example, assuming the IR payment methodology is approved and the IR formula is applied to additional capacity for the Prescribed Assets, and provides OPG a comparative advantage over private generation developers, the level of new investment from the private sector may decrease and therefore participation in the wholesale market would likely decrease over time as contracts expire. As a result, these decisions regarding the payment methodology for OPG's Prescribed Assets can negatively bias the competitive market and are therefore not policy neutral.

The OPA does not agree with Board Staff's contention that:

> "Regulatory contracts depend on fairly specific policy goals and institutional and sector stability to negotiate contract terms and conditions. If the basic business environment changes as a result of policy changes or one of the contracting parties no longer exists, then the status of an existing regulatory contract would become uncertain."

The opposite is true. Given the history of policy changes for Ontario's electricity sector[1], the OPA has ensured that all procurement contracts it has negotiated and executed afford sufficient flexibility to adapt to future directions of Ontario's electricity sector. While these contracts have been executed within the existing hybrid electricity structure, they have the ability to be liquidated within a competitive market or can exist under a fully regulated electricity sector. Thus, policy neutrality has been achieved. The regulatory contracts for OPG's Prescribed Assets should contain similar provisions.

4.0 Drawbacks of CoS and IR

4.1 Price Distortions

Power from the Prescribed Assets must be offered in a manner which does not distort real time or forward electricity prices, so as not to inhibit new generation investment and demand response initiatives. The OPA believes that both CoS and IR would distort real time and forward electricity prices, if OPG is not sufficiently incented to economically participate in the wholesale market. While it is unclear whether CoS or IR can achieve this, the existing OPA contracts do not distort market pricing.

Government policy as enunciated in O. Reg. 426/04, s. 4, is that the OPA is to ensure in its contracting that "to the greatest extent possible" the terms and conditions of its contracts not adversely impact investment by others. The OPA believes that the OEB should be guided by the same principle in developing a pricing methodology for OPG's Prescribed Assets.

Further, power from the Prescribed Assets should not be sold in a manner that disadvantages customers who choose to buy their supply from competitive wholesale suppliers or retailers.

The current market pricing context should be given stronger consideration. Offer strategies for the Prescribed Assets (i.e., 10,000 MW of baseload generation) will impact the rest of the market, particularly if it is being offered in a manner that is not revenue-maximizing. Inefficient bidding behaviour will be created from OPG's market power.

The spectre of inefficient OPG bidding results in independent power producers refusing to enter the market unless under guaranteed payment contracts with the OPA, as opposed to participating via the competitive side of the hybrid electricity market. If one

[1] For example, Bill 35 (1998), Bill 4 (2002) and Bill 100 (2004)

segment of the market is structured to operate inefficiently, then it will influence the balance of the market to also operate in such a manner.

The OPA encourages the OEB to heed the concerns of their Market Surveillance Panel (the "MSP") concerning the most appropriate payment option for OPG's Prescribed Assets. It is noted in the most recent MSP report, dated June 14, 2006, under the sub-section 'Future Supply Arrangements' on p. 120 that "… the financial arrangements for OPG's Prescribed and Non-Prescribed Assets … may under certain circumstances provide incentives for inefficient bidding [in the wholesale market]. … We will continue to monitor the implementation of these arrangements …"

Any payment methodology should capture appropriate value from the Prescribed Assets that will be returned to rate payers without distorting market prices or eliminating investor confidence which is critical for new investment in generation and in demand response.

4.2 OPG Investments in Refurbishments, Expansion and New Projects

O. Reg. 53/05 provides for OPG cost recovery for investments to increase output of, refurbish or add capacity to the Prescribed Assets (if the OEB is satisfied that such costs were prudently incurred). However, the Discussion Paper does not sufficiently answer how these additional costs will be factored into the payment-setting methodology.

The basic IR formula recommended in the Discussion Paper represents a standardized formula that is more easily applied to an existing asset with known costs and risks. Given the variables comprising the formula, it is not clear how, in particular, costs and risks associated with investments to increase output of, refurbish or add capacity to the Prescribed Assets will be sufficiently addressed.

In fact, with respect to its recommended basic IR formula, the Discussion Paper states, "The more difficult question is the basis on which the elements of the formula … should be determined. Board staff has struggled, and expects that the Board will struggle, with this question in light of the unique issues and challenges associated with setting payments for OPG's Prescribed Assets."

5.0 Benefits of Regulatory Contracting Payment Methodology

The OPA agrees with the conclusions of London Economics International LLC in its May 19, 2006 report to the OEB with respect to their preferred payment methodology.

When compared to the CoS and IR options, the regulatory contracting methodology has the least negative impact on the remaining portions of the electricity system, and has been demonstrated to allow for regulatory efficiency.

In Alberta where such an approach was used (i.e., Power Purchase Agreements) the negotiation was undertaken by a legislatively empowered special entity with the final form of contract subject to appeal to the regulator. The form of contract was determined through an open process that allowed stakeholder input. While Alberta's approach had some issues, those issues did not relate to difficulties in putting in place contracts that were acceptable to both generation owners and electricity users.

5.1 Level Playing Field

How new investment costs are addressed is a very important issue for Ontario's electricity sector. It is well documented[2] that Ontario needs to embark on a massive re-development of its electricity system. It is economically prudent and cost effective to provide a level playing field for all generation and demand response investment options to help meet the reliability requirements of Ontario's power system. Not doing so will inevitably result in future reliability issues, with economically inefficient solutions. Therefore, any payment methodology for OPG's Prescribed Assets must support a level playing field to best ensure economically prudent and cost effective new investment to meet the reliability needs of Ontario's power system.

Aside from the Board Staff recommended basic IR formula not sufficiently addressing potential OPG capacity expansion of its Prescribed Assets (as addressed above in 4.2), it is not clear whether this formula would yield similar economic and cost results for the contracts executed by the OPA with existing and new independent power producers. Therefore, the playing field may not be level if the IR methodology is put into force for OPG's Prescribed Assets. As a potential result, if the IR formula results in OPG enjoying a comparative investment advantage, private generation developers may choose not to invest in Ontario or at the very least assign additional risk premiums (at least equal to the OPG investment advantage) to their proposals to build new generation. Hence, the OPA, and ultimately the rate payers, will have to pay more for private sector generation in order to offset OPG's comparative advantage. This is an inefficient resource allocation.

There are two main advantages for the regulatory contracting payment mechanism. First, it more easily addresses the broad scope of *all* cost elements, including costs and risks associated with investments to increase output of, refurbish or add capacity to the Prescribed Assets, (as described in O. Reg. 53/05) through appropriate contract provisions. Second, the OPA's procurement and contracting functions to facilitate new investment can better ensure a level playing field for *all* generation investors, including OPG.

5.2 Reducing Reliance on OPA Contracts

The OPA is guided by its mandate found in O. Reg. 424/04 to reduce reliance on OPA procurement over time. The OPA embraces the concept that its procurement and contracting functions are interim only, and works toward the long term goal of reducing and eventually eliminating the OPA's procurement contracting responsibilities. Assignment provisions written into the recommended regulatory contracts will facilitate those long term goals.

[2] See the Market Surveillance Panel Report, May-August 2002; Electricity Conservation and Supply Task Force, *Tough Choices: Addressing Ontario's Power Needs. Final Report to the Minister.* January, 2004; and, Ontario Power Authority, *Ontario's Integrated Power System Plan. Scope and Overview.* June 29, 2006.

5.3 Transparency, Fairness, Regulatory Efficiency and Consistency

The Discussion Paper in part defines regulatory efficiency as, "…time and resource costs associated with a particular option not exceed[ing] the benefits that can be expected to be achieved through that option." Considering the noted difficulty that is expressed in the Discussion Paper regarding derivation of the IR formula, coupled with the fact that setting payments for OPG's Prescribed Assets is a new responsibility for the OEB, it is highly likely that either the CoS or IR payment option for OPG's Prescribed Assets would result in a lengthy proceeding. Such longer proceeding, with corresponding increases to resource costs, would call into question the regulatory efficiency of either the CoS or IR payment option. Under these two payment options, it may be difficult and probably impossible for the OEB to pre-define parameters for timelines and resource costs.

Under the regulatory contracting payment option, the OEB is afforded more flexibility to pre-define conditions in order to better ensure regulatory efficiency. Prior to contract negotiations, the OEB may set parameters addressing base costs, production targets and principles to best achieve productivity incentives, reporting milestones and timelines for completing negotiations, etc. For example, a good approach may be for the OEB to stay with setting "revenue requirements" and then obligate some degree of correlation with OPG's non-prescribed assets to ensure appropriate behaviour, assuming the non-prescribed assets are responding to real-time requirements of the system as reflected in the market price. It could be required that over each 12 month period, the on-peak availability of Prescribed Assets shall be no less than the on-peak availability of OPG's non-prescribed assets. Availability could be measured as having been offered into the market.

Further, the OEB could pre-define how information will be made transparent and how the contract will be reviewed.

Listed below is a high-level overview of the steps to be taken in order to conclude the contract and achieve OEB approval. These steps are taken to ensure the benefits of consistency and regulatory efficiency are balanced against transparency and fairness.

- OEB sets draft guidelines for negotiation and contract parameters, and for guidelines on its own regulatory proceedings;
- Stakeholders comment on draft negotiation guidelines, contract parameters, and procedural guidelines;
- OEB issues final negotiation guidelines and contract parameters (including updates with reporting milestones), and procedural guidelines;
- OPA and OPG begin contract negotiations;
- OPA and OPG provide milestone reports for OEB and stakeholders;
- OEB and stakeholders comment on milestone reports;
- OPA and OPG conclude contract negotiations;
- OPG files with OEB;
- OEB proceedings transpire; and
- OEB issues decision(s).

By pre-defining the negotiation guidelines, contract parameters, review guidelines, and parameters for OEB proceedings, the OEB approval of the negotiated contract should proceed relatively smoothly.

The main advantage of this approach is the flexibility afforded to meet all elements of cost recovery for OPG's Prescribed Assets within an efficient and timely regulatory process. By permitting the OPA to negotiate with OPG to conclude a contract (or contracts), both parties are free to meet as frequently as required in order to meet pre-defined OEB timelines. This negotiation intensity and flexibility would not otherwise occur under the CoS or IR payment options concerning regulatory efficiency.

In addition, regulatory contract terms can be set for many years but if there is a desire for greater transparency or more frequent review, the OEB may set appropriate rules to accommodate such scrutiny. There is no reason why the process outlined above cannot permit sufficient transparency. Stakeholder input concerning the negotiation guidelines, contract parameters, review guidelines, and parameters for OEB proceedings provide multiple avenues to receive information and provide comments. Furthermore, the proceeding can provide the same level of transparency as a typical CoS or IR proceeding.

6.0 Conclusions

The OPA clearly prefers the regulatory contracting payment option for OPG's Prescribed Assets as it preserves the greatest number of future options for Ontario's electricity sector. Considering that the wholesale market is a fundamental element of Ontario's electricity sector, and mechanisms to dispatch the system under such a market have been developed, any regulated payment option needs to ensure economic incentives align with this structure to best serve economic efficiency, with the goal of maintaining reliability and quality of service, to minimize risks to customers and maximize their choices, and provide a level playing field for much needed new generation investment.

The CoS and IR payment options could frustrate the movement toward increased competition, greater customer choice, reduced customer risk and reduced reliance on support contracts for investment in new generation facilities. Any payment option must allow sufficient flexibility in order to account for future changes. The contracting payment option affords such flexibility.

Stakeholders can be satisfied by the fact that all decisions with respect to this option will still need to be approved by the OEB after a full hearing process in order to address the terms of any OPG rate orders and/or performance obligations. The OPA would advocate that there be the same level of information disclosure as would be required in a CoS proceeding.

The OPA thanks the OEB for its consideration of these comments and is available to provide further explanation.