ONTARIOPOWER GENERATION

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VIA COURIER AND EMAIL

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319
2300 Yonge Street, 27th Floor
Toronto, ON
M4P 1E4

Dear Ms. Walli:

EB-2006-0064 - Setting Payments for the Output from OPG's Prescribed Generation Assets

Enclosed please find three copies of Ontario Power Generation Inc.'s reply submission to submissions received on the Staff Discussion Paper – "Regulatory Options for Setting Payments for the Output from OPG's Prescribed Generation Assets" – that was posted on the Board's website on July 6, 2006. An electronic version of the reply submission in both searchable Adobe Acrobat (PDF) and Word has also been sent by e-mail to boardsec@oeb.gov.on.ca.

Please direct any questions in this matter to the undersigned.

Yours truly,

Andrew Barrett

Encl.

c: Michael Penny (Torys) via e-mail
All interested Parties via e-mail

EB-2006-0064

ONTARIO ENERGY BOARD

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, Schedule B

AND IN THE MATTER OF reply submissions concerning the Staff Discussion Paper on Regulatory Options for Setting Payments for the Output from OPG's Prescribed Generation Assets;

REPLY SUBMISSION OF ONTARIO POWER GENERATION INC.

1. INTRODUCTION

Ontario Power Generation Inc. ("OPG") has reviewed the intervenor submissions made in response to the Board Staff Discussion Paper on Regulatory Options for Setting Payments for the Output from OPG's Prescribed Generation Assets, issued July 6, 2006.

Nothing in these submissions has caused OPG to reconsider its view that the Board should adopt a limited issues cost of service ("COS") methodology to establish the payment amounts for the output of the prescribed generation facilities beginning April 1, 2008. Adoption of this regulatory approach will allow the Board to meet the requirements of Section 78.1 of the *Ontario Energy Board Act, 1998* and O.Reg. 53/05 in a fair, efficient and transparent manner. It will start the regulation of OPG on a firm foundation by providing a vehicle for the OEB to assess the costs of OPG's regulated operations in order to meet its statutory responsibility to establish payment amounts that are just and reasonable.

The requirement to review OPG's costs as an initial step in developing just and reasonable rates supports the adoption of a COS methodology as this is the approach typically adopted by regulators in advance of (or in conjunction with) other regulatory approaches such as Incentive Regulation ("IR"). Starting with payment amounts based on COS preserves the future options and provides an appropriate base for the move to other approaches.

OPG notes that the Power Workers' Union (PWU), Vulnerable Energy Consumers Coalition (VECC) and Energy Probe Research Foundation have made submissions that are supportive of a COS approach, and that Hydro One and the Consumers Council of Canada support a full COS review as a precursor to IR.

OPG notes that a number of the other submissions have focused on a secondary issue, the interaction between the prescribed assets and the development of the competitive market, and have either ignored or glossed over the central issue, which is the setting of just and reasonable payment amounts. The regulated assets have been paid a regulated rate since April 1, 2005 without any upset to the operation of the Ontario electricity market and there is no reason to suggest that this will change in the future. As developed in greater detail below, many of these submissions also focus on market power, which because of operating characteristics and existing regulatory constraints is not a meaningful issue in relation to the prescribed assets. In the end, the greatest risk to the Ontario electricity market comes from providing insufficient funds for OPG to maintain and operate the prescribed facilities at a high level of reliability.

OPG submits that only COS offers the appropriate regulatory starting point in the current context.

2. SELECTED ISSUES AND REPLIES TO INTERVENOR SUBMISSIONS

A. A Limited Issues Cost of Service Methodology Can Achieve the Board's Objectives While Promoting Financial Stability and Operational Efficiency for OPG

OPG submits that a properly designed, limited issues COS review can achieve the objectives of just and reasonable rates, transparency, and regulatory efficiency. This approach is supported by intervenors who favour COS on its own or as a precursor to IR.

This model would entail selecting the issues to be addressed in the first hearing based on a review of financial and operational information filed with the Board by OPG. Issues selected by the Board would receive a typical COS level of scrutiny, while the detailed review of the remaining issues would be deferred to later hearings. OPG envisions that the types of issues selected for the first hearing could include:

- cost or revenue streams that are materially changed from the amounts provided to the Province for use in establishing the interim payments,
- issues that entail a significant financial impact on the payment amounts,
- the resulting implications of changes in payment structure, or
- whether OPG has the ability to control the occurrence of an event/issue.

B. The "Regulated CfD" Approach Proposed by the IESO and Variants of the Regulatory Contracts Approach Proposed by Others is Neither Policy-Neutral nor Efficient and Will Create an Unacceptable Level of Risk for OPG

A number of parties, Constellation, Direct Energy, Electricity Market Investment Group (EMIG), TransAlta, IESO, and OPA, propose or support variants of the regulatory contract approach. The Board should firmly reject all these proposals as variations on a bad theme. Whether they are suggested from competitive or institutional self interest, they represent a path which will not meet the Board's obligation to develop just and reasonable payment amounts.

At their heart, these proposals are all aimed at the goal of enhancing the competitive market. As Board Staff correctly notes, however, the regulatory method chosen should be neutral as to

the future evolution of the electricity sector, not attempt to dictate it. The legislation that created the prescribed facilities did so in order to remove the baseload output of these facilities from price determination by the market. It strains credulity for these parties to suggest that the future of the competitive market should now be the paramount consideration in selecting a regulatory approach for OPG's prescribed facilities. The Board's task in determining the payment amounts is not to presuppose a market structure for Ontario, or to address market power concerns. These issues are addressed through other forums and should not be the drivers in determining the form of regulation for OPG's prescribed assets.

In promoting their vision of regulatory contracts, these parties fail to address the fundamental question before the Board which is: "how should the Board determine just and reasonable payment amounts for the output of OPG's prescribed assets." None of these proposals present any analysis of this question. Instead, they choose to focus on how these assets should be regulated to promote their vision of the Ontario wholesale market.

The Regulatory Contract Proponents Would Have the Board Ignore Its Obligations Under Controlling Statutes and Regulation.

The fundamental regulatory task before the Board is to establish just and reasonable payment amounts for the output of OPG's prescribed facilities. Proponents of regulatory contracts suggest various methods for ignoring this task, rather than accomplishing it.

Constellation would set the payment amounts by having OPG offer its output into the bilateral contract or wholesale spot market with a price floor and caps. Thus, it would have market participants, rather than the OEB, establish the payment amounts. Direct Energy ignores the issue of setting payment amounts altogether, preferring to focus solely on how the regulated assets will interact with the market. EMIG takes this approach as well. TransAlta, while primarily advocating further discussion, indicates its continued support for regulatory contracts as the most appropriate regulatory methodology, but does not provide any rationale for this view or indicate how it believes regulatory contracts would work.

The OPA would have the payment amounts set through negotiations between it and OPG, as informed by unspecified "contract parameters" to be established by the OEB through a mechanism that is also unspecified. Not only is the OPA approach vague on how the Board's task of setting just and reasonable rates should be accomplished, it doubles the amount of effort that will be required to accomplish this task. Under the OPA approach, OPG will be subject to both OEB and OPA processes, with the potential for two appearances before the OEB, one to establish the parameters and another to approve the resulting contract.

The OPA submission agrees with the London Economics paper as to the preferred methodology for setting payment amounts. The London Economics model, however, begins with a COS-type filing and the determination of a revenue requirement as the means of establishing the necessary parameters for regulation by contract. The OPA submission acknowledges, in one line on page 6, the need for the OEB to determine OPG's revenue requirement under the regulation by contract approach but otherwise ignores the issue and certainly fails to explain the means by which this important and necessary step would take place.

The IESO actively rejects the need for a full review of OPG's revenue requirement. Instead, the IESO, adopting a role that is totally inappropriate for an "independent" market operator,

has assumed that the current payment amounts would be the appropriate starting point for a CfD model without providing any basis for this assumption. In doing so, the IESO completely loses sight of the OEB's fundamental obligation to set payment amounts which are just and reasonable.

In short, none of the parties advocating the regulatory contract approach has offered any insight into how the OEB should meet its obligation to establish just and reasonable payment amounts.

Market Power Mitigation is Unnecessary for the Prescribed Facilities and Irrelevant in Selecting the Appropriate Regulatory Approach

A number of parties supporting regulatory contracts have suggested that one reason for selecting this approach is to address concerns about OPG's market power. This concern is both unsupported by the facts and illogical. The exercise of market power is not a substantial concern in relation to the prescribed facilities and has nothing to do with the selection of an appropriate regulatory model for establishing payment amounts.

OPG's prescribed facilities, like all of OPG's generation assets, operate pursuant to a licence issued by the OEB. A unique condition of OPG's Generation Licence requires that OPG offer all available capacity into the energy and operating reserve markets. In the more than four years since the Ontario market opened, there has never been a single finding that OPG has violated this condition by withholding available capacity.

The prescribed facilities are primarily baseload generation plants that are designed to operate continually at full capacity. OPG's nuclear units have a narrow operating range. For its hydroelectric facilities, OPG strives to use the available water as efficiently as possible. In fact, OPG's overall operation of the regulated facilities is designed to make the most efficient use of resources. The interim payment amounts reinforce these incentives because OPG is paid based on the output it produces and has the opportunity for additional earnings if it can move available water into high value periods. OPG supports the continued development and use of methods to encourage maximizing the value of hydroelectric production. For nuclear, such incentives are unnecessary and likely to be counter productive, and would be difficult to mesh with the IESO outage management regime set out in the market rules.

It is particularly inappropriate for the IESO to suggest that additional measures are required to discourage OPG from withholding supply from the prescribed facilities. The IESO knows full well that there is not now and never has been any issue of withholding supply from the prescribed facilities. If the IESO believes that it has evidence of OPG exercising market power in its operation of the prescribed facilities, it is well aware of the available venues for raising such concerns. A proceeding to establish payment amounts under O.Reg. 53/05 clearly is not one of them. The Board's task of setting just and reasonable payments is sufficiently complex without adding extraneous concerns.

The IESO's Contract for Differences Proposal is an Ill Conceived Rehash of the MPMA that Creates Excessive Financial and Accounting Risk for OPG

At its core, the IESO's proposal reprises the Market Power Mitigation Agreement (MPMA), but without any of the thought and analyses that originally went into creating that agreement. The MPMA had two salient features: the quantity that OPG was deemed to produce in each hour

and the price that OPG would receive for its output. The MPMA hourly quantities and price were developed through extensive modelling, analysis and negotiation.

In contrast the IESO suggests that the Board can set the hourly quantities based on policy goals. This suggestion ignores the excessive financial risk that would be associated with hourly quantities that approached the expected production of the prescribed facilities.[1] OPG management should be focused on operating and sustaining the prescribed facilities and not be diverted by concerns about impacts of market prices beyond management's control.

OPG's prescribed facilities include 10 nuclear units that range in size from 515 to 880 MW. When they are removed from service, either for planned or forced outages, they can be off-line for several months. The combination of the size of the nuclear units and their potential outage duration would, under the IESO proposal, expose OPG to the risk of being required to purchase massive amounts of energy at market prices. This translates to the potential for hundreds of millions of dollars in financial exposure.

The extreme financial risk associated with the IESO proposal would require both risk mitigation provisions and extremely high payment amounts. This again illustrates that the IESO proposal to base a CfD on current payment amounts is unworkable. The IESO approach would not only expose OPG to the risk of having to purchase from the market whenever one of its units failed to produce, it would also deprive OPG of the funds needed to operate and maintain its prescribed facilities so that they are less likely to fail.

The IESO's proposal could also result in a significant negative impact to OPG's financial statements. A contract which requires settlement of OPG's output at HOEP and a subsequent adjustment to OPG's income to reflect the regulated/strike price would likely create a derivative obligation for accounting purposes. This would require OPG to record a significant loss at the inception of the contract because the value of the contract is derived from changes in price (HOEP less the regulated payment amounts). Such loss recognition is not required under the current methodology, which establishes regulated payments in advance, and results from regulation rather than a contractual arrangement.

Further, OPG's Memorandum of Agreement, dated August 17, 2005, with the Province of Ontario expressly states, among other things, that, "As an OBCA corporation with a commercial mandate, OPG will operate on a financially sustainable basis and maintain the value of its assets for its shareholder, the Province of Ontario." Introducing a regulated contract for differences, such as proposed by the IESO, could violate current OPG risk management programs and policies. This risk would be difficult and costly for OPG to mitigate, and, if unmitigated, would be contrary to the terms of the company's Agreement with the Province.

In addition, the IESO proposal could have significant negative implications for OPG's credit rating. Introduction of the proposed regulated CfD would represent a material change to the business of OPG. As a reporting issuer, disclosure of any material change is required, along with disclosure of the magnitude of the effects on OPG. Any resulting downgrade would make

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[1] The examples provided by the IESO use 95% of the rated capacity of the nuclear fleet to set the hourly quantities. This percentage greatly exceeds the planned availability of OPG's nuclear fleet. Thus even if the nuclear units perform exactly as planned, OPG would be exposed to extreme financial risk. Contrary to the IESO's suggestion that its examples show upside potential, its approach provides only downside risk.

it more difficult and costly to borrow money or enter into sizeable contracts. The result of any increased borrowing costs will needlessly add to the costs of expanding and developing the prescribed facilities. Similarly, there could also be ramifications for existing contracts whereby certain counterparties may require OPG to post collateral because the company has dropped below an investment grade credit rating.

Theoretical Concerns about Potential Interaction Between the Prescribed Facilities and the Market Have No Basis in Fact

The IESO and OPA rely on a theoretical concern expressed in the recent MSP report that under certain conditions "OPG has a financial incentive to run the plant even if the market price is less than incremental cost. This could lead to a loss of efficiency if a lower cost supplier is displaced and the market price is less than the incremental cost of generation." (MSP Report June 2006, pp. 119-120.) The MSP does not cite any examples of these conditions occurring in the more than fifteen months since the prescribed facilities began receiving regulated prices. This is not surprising given the operating characteristics and position in the dispatch stack of the prescribed facilities.

The prescribed facilities are baseload plants with very low marginal costs. For a nuclear unit, the true short-term marginal cost is actually negative, because of the costs associated with unit shutdown and lost production during the several days required to return a unit to service once it has been shut down. The prescribed facilities are designed to run near their designed capacity whenever they are available and they generally offer into the market to accomplish this goal.[2] As a result, they rarely set the market price; they are price takers.

In any event, the setting of just and reasonable rates for the prescribed facilities should not be driven by conjecture about the potential interaction between the prescribed facilities and the market. OPG is confident in its ability to continue offering these units appropriately and is equally confident that the MSP will continue overseeing the operation of the market and recommending solutions in the unlikely case that any of these hypothetical concerns ever becomes an actual problem.

C. Arguments Supporting Incentive Regulation are Inconsistent with the Requirement to Set Just and Reasonable Rates

Arguments put forth by the proponents of the Board Staff proposal to proceed with IR based on the interim payment amounts cite the need to address pricing issues in choosing the regulatory model. AMPCO states "our primary concern relates to our interests in keeping electricity prices as low as possible" and the School Energy Coalition states "What the Board has to do, in our opinion, is maintain a close review of the impact (if any – there will not always be one) of OPG's payments on the prices of electricity in Ontario at the margin, and on the price signals being given for future merchant and load displacement generation, and for conservation."

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[2] The exception to this general statement is the relatively small amount of peaking capability associated with some of OPG's prescribed hydroelectric facilities. As noted above, OPG agrees that under any regulatory approach it is important to provide the proper incentives to operate these facilities efficiently in a manner that maximizes the value of their production.

In OPG's submission, the policy intent behind Section 78.1 and O.Reg. 53/05 was to have electricity prices reflect the true cost of power, in addition to stabilizing prices and reducing volatility. To achieve these objectives, the payment amounts must be just and reasonable, meaning that they must be sufficient to cover the full cost of owning, operating, maintaining and developing the prescribed assets while balancing the needs of customers. Accordingly, obtaining the lowest possible prices, or setting the payment amounts based on impacts on price signals in the Ontario electricity market should not be the criteria used to choose the model for setting the payment amounts for OPG's prescribed assets.

D. Using the Interim Rates Established in April 2005 as a Base for OPG's Payments Will Not Recognize Significant Factors Which Will Impact OPG's Costs During the Rate Setting Period

OPG submits that it is inappropriate for the Board to use the interim payments in setting the initial base payment amounts. The Board staff's proposal is made on the basis that the interim payment amounts are sufficient to meet OPG's costs and provide a sufficient return on equity. In OPG's submission, it is impossible to arrive at this conclusion without first doing a review to determine OPG's actual costs. Without such a review, the Board cannot conclude that these payments are just and reasonable, and that they provide sufficient revenue to allow the continued safe and reliable operation of the prescribed assets.

To ensure that the Board arrives at just and reasonable payment amounts, the Board needs to consider in a limited issues COS review the cost and revenue impacts that have or are expected to occur in relation to the prescribed facilities since the initial determination of payment amounts in 2004. This includes the increase in the level of capital budgets resulting from the major new generation projects, the disposition of variance and deferral account balances, adjustments to reflect the decision not to return Pickering units 2 and 3 to service, and adoption of a risk appropriate rate of return. Other changes relating to both the nuclear and regulated hydroelectric facilities would also need to be considered. These include cost pressures on labour and materials, changes in production capacity and the duration and timing of planned outages, and changes in pension plan costs. In addition, as OPG has recommended in its first submission the payment amounts should be restructured to include fixed ($/month) and variable ($/MWh) components to recognize the large proportion of fixed costs associated with the prescribed facilities.

3. CONCLUSION

For the reasons provided earlier in our submission, the Board should reject the submissions of those advocating for regulatory CfDs and other types of regulatory contracts. These approaches create unacceptable levels of financial risks for OPG and are focused on addressing secondary issues that are better dealt with in other forums.

At the inception of regulation for the prescribed assets, COS is the appropriate regulatory approach. COS regulation best reflects the policy considerations that underpin the decision to regulate the payments for output of the prescribed facilities. Beginning with COS would be consistent with regulatory experience and past practice, and would promote transparency and fairness. It would set an appropriate base for future regulation, whatever its form.

OPG believes that a properly scoped limited issues COS review can be designed to achieve the objectives of just and reasonable rates, transparency, and regulatory efficiency in a manner that promotes financial stability and operational efficiency for OPG. In contrast, using the existing payment amounts as a starting point would ignore the numerous changes that have or are expected to occur in relation to the prescribed facilities.

Accordingly, OPG submits that the Board should adopt a limited issues COS model that would use the first hearing to establish payment amounts to be in effect for a 21-month period starting April 1, 2008.

All of which is respectfully submitted,

Andrew Barrett

Vice President, Regulatory Affairs and Corporate Strategy

Date: Aug 4/2006