

July 24, 2006

**VIA COURIER AND EMAIL**

Ms. Kirsten Walli  
Board Secretary  
Ontario Energy Board  
P.O. Box 2319  
2300 Yonge Street, 27<sup>th</sup> Floor  
Toronto, ON  
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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 written submission 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 submission in both searchable Adobe Acrobat (PDF) and Word has also been sent by e-mail to [boardsec@oeb.gov.on.ca](mailto:boardsec@oeb.gov.on.ca).

Please direct any questions in this matter to the undersigned.

Yours truly,



Andrew Barrett

Encl.

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



## ONTARIO ENERGY BOARD

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

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

### SUBMISSION OF ONTARIO POWER GENERATION INC.

#### 1. INTRODUCTION

Ontario Power Generation Inc. ("OPG") submits 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 and Ontario Regulation 53/05 in a fair, efficient, and transparent manner, and start its regulation of OPG on a firm foundation. Most importantly, a cost of service approach is required to produce payment amounts that are just and reasonable.

The incentive regulation model proposed in Board Staff's Discussion Paper will not produce just and reasonable payment amounts. In addition, it lacks transparency and is inconsistent with accepted regulatory practice and experience. For incentive regulation to work, it must rest on an accurate cost base and apply appropriate adjustment factors. The model offered in the Discussion Paper includes neither of these prerequisites. By 2008, the current interim payment amounts will be outdated and the method proposed for resetting them is incomplete. The Discussion Paper also significantly understates the complexities associated with developing accurate productivity and cost adjustment factors to apply to OPG's prescribed facilities going forward. In addition, the proposed minimum term of one year is insufficient to capture efficiencies. For these reasons, while moving to incentive regulation may be desirable in the long term, it is not practical in the current circumstances.

Accordingly, OPG recommends that the Board set OPG's initial payment amounts after a limited issues COS review.

#### 2. BACKGROUND

In deciding on the appropriate method for regulating OPG's prescribed assets, the Board should select the method that:

- Best reflects the policy considerations that underpin the decision to establish the prescribed assets and have their payments set by the Board;
- Produces just and reasonable rates;
- Is consistent with the Board's own regulatory experience and precedents; and
- Follows standard regulatory approaches.

OPG submits that these considerations should lead the Board to adopt COS regulation. While it may be appropriate to evolve to incentive regulation ("IR") in the future; only COS offers the appropriate regulatory starting point in the current context.

**A. The policy considerations that underpin the decision to set regulated payments for OPG's prescribed assets support cost of service regulation**

The prescribed assets were established to stabilize prices and reduce volatility by removing the output of OPG's large baseload facilities from price determination by the market. In OPG's submission, the Government also intended that this decision would contribute to its overall goal of having prices reflect the true cost of power. As Minister Duncan stated:

We're moving from a situation where for over a decade the price of electricity has been artificially capped to one in which consumers pay the true cost of power....  
...and we've taken politics out of electricity pricing for good by handing pricing issues to our independent regulator....

Consistent with our policy to regulate a portion of the market, we set an average price of 4.5 cents per kilowatt-hour on the output of Ontario Power Generation's regulated assets... it's baseload nuclear and large hydroelectric facilities representing approximately 40 per cent of all generation in our province.

Regulating the price of these assets will reduce price volatility and have a stabilizing effect on electricity prices, which we believe will be of great benefit to electricity consumers in Ontario as we bring balance back to the sector. (Notes for remarks by The Honourable Dwight Duncan, Minister of Energy, Independent Power Producers Society of Alberta 2005 Conference, Banff, Alberta, March 14, 2005)

To reflect the true cost of power, ensure stability and reduce volatility, the payment amounts set by the Board must be sufficient to cover the full cost of owning, operating, maintaining and developing the prescribed assets. As the quote from the Minister indicates, these assets represent a large part of Ontario's generation mix. Operating them efficiently and maintaining them properly is crucial if they are to fulfill their essential role in Ontario's electricity system and provide the greatest benefit to the people of Ontario.

In OPG's submission, COS will allow the Board to properly assess, in an open and transparent manner, the costs of these assets. OPG will produce evidence on its operations, maintenance and administration expenses and capital expenditures. All parties will have an opportunity to evaluate OPG's filing and to make submissions on the evidence presented. After evaluating the evidence and submissions, the Board will set the payments amounts.

Through this process, the Board will further the important goal of ensuring that the price of electricity reflects its true cost. It will also help ensure stable prices by allowing OPG to recover its demonstrated costs on a consistent basis over a defined period. To do otherwise would create the potential for price instability as under-recovery of costs over time would lead to

deferred expenditures. This would in turn eventually threaten reliability and set the stage for large price increases in the future.

In contrast, embarking on IR using rates based on the existing payment amounts as a starting point will not ensure that prices reflect the true cost of owning and operating OPG's prescribed assets going forward. The current payment amounts were established by the Government to allow recovery of the prescribed assets' costs as estimated in 2004. Since that time, changes have occurred in the assets and their operating costs. More changes will occur in the next few years. Using the current payment amounts as the starting point for IR may create the appearance of stability, but it will be the same type of false stability that has troubled Ontario's electricity sector in the past.

## **B. The method of regulation chosen must produce just and reasonable rates**

The Board's jurisdiction to set the payment amounts for OPG's prescribed assets arises from section 78.1 of the *Ontario Energy Board Act* (the "OEB Act"). Section 78.1 requires the OEB to fix payment amounts that are "just and reasonable". While Section 6 of O.Reg 53/05 provides that "the Board may establish the form, methodology, assumptions and calculations used in making an order that determines payment amounts for the purpose of section 78.1 of the Act," it must do so in a manner that results in payment amounts that are "just and reasonable."

In *Northwestern Utilities Ltd. v. Edmonton (City), Board of Public Utility Commissioners of Alberta*, the Supreme Court of Canada held that "The duty of the Board was to fix fair and reasonable rates; rates which, under the circumstances, would be fair to the consumer on the one hand, and which, on the other hand, would secure to the company a fair return for the capital invested." Much the same point was made in *Garland v. Consumers' Gas Co.*, where the Ontario Superior Court of Justice found that "The Energy Board sets rates as low as possible while still providing shareholders of the utility company with the opportunity to earn a fair return. Rates should be just and reasonable for both customer and shareholder."

To achieve just and reasonable rates, the Board must set payment amounts for the prescribed assets that allow OPG to recover its prudently incurred costs and earn a fair return on equity. In this regard, "fair rate of return" is equivalent to a commercially reasonable return. As the Supreme Court of Canada has stated: "By a fair return is meant that the company will be allowed as large a return on the capital invested in its enterprise (which will be net to the company) as it would receive if it were investing the same amount in other securities possessing an attractiveness, stability and certainty equal to that of the company's enterprise."

(*Northwestern Utilities Ltd. v. Edmonton (City), Board of Public Utility Commissioners of Alberta*) Moreover, as the court clearly articulated in *Transcanada Pipelines Ltd. v. Canada (National Energy Board)*, the determination of a commercially reasonable return must be made on its own merits, independent of the impacts on consumers. (*Transcanada Pipelines Ltd. v. Canada (National Energy Board)*, para. 32-37)

The Board's own decisions support the view that just and reasonable rates must be sufficient to provide a reasonable opportunity to earn a fair rate of return. In RP 2000-0069, where the Board decided to phase in market-based returns for municipal electric distributors in response to a Ministerial directive, the Board stated that:

Reasonable return is generally accepted to mean sufficient earnings for the utility to perform its tasks and to provide a fair return to its owner. Case law supports the principle that just and reasonable rates for an enterprise operating in a commercial setting

generally entitle the owner of a utility to be given an opportunity to earn a fair return. There are also economic and regulatory principles that dictate that a commercial utility's viability cannot be sustained unless there is an opportunity for market returns. (Para. 3.1.11, p.13)

...

In the long run, the utility's viability and consumer protection will depend on the utility's ability to capitalize on opportunities for market returns afforded by the applicable regulatory framework. (Para. 3.1.13, p.14)

In OPG's submission, the way for the Board to establish fair rate of return is to undertake a COS review of the prescribed assets. This process will provide a basis for the Board to fulfill its mandate to establish just and reasonable rates.

### **C. Starting with cost of service would be consistent with the Board's regulatory experience and precedents**

In general, the Board has moved to IR only after establishing a firm understanding of an entity's underlying cost structure through COS regulation. In discussing the establishment of a new IR mechanism for natural gas utilities, the Board concluded: **"Each IR plan must begin with a robust set of cost-based rates, based on a thorough and transparent review."** (Natural Gas Regulation in Ontario: A Renewed Policy Framework, p. 25 (emphasis in the original)) This conclusion applies with even greater force to OPG because, unlike the natural gas utilities with their long history of COS regulation by the Board, OPG's prescribed assets have never been subject to COS regulation.

In RP-1998-0001, Ontario Hydro Service Company (now Hydro One Networks) proposed a performance based ratemaking program to apply to its transmission rates. This case was similar to the upcoming regulation of OPG's prescribed assets in that it considered a government-owned electricity company facing regulation for the first time. The Board chose not to implement IR stating: "The Board finds that implementation of the PBR plan in the year 2000 is premature at this time. The lack of a solid base year revenue requirement makes it difficult to implement a PBR program that provides incentives for efficiency gains with any confidence." (Decision RP-1998-0001, page 44)

In Decision RP-1999-0017, the Board addressed Union Gas's proposal to adopt the first experimental performance based regulation (PBR) regime for an Ontario gas utility. In discussing the introduction of PBR, the Board made the following finding: "The Board is of the view that, at the commencement of a price cap PBR plan for a utility, it is important to have full reliable and tested base data for the utility reflecting current operations and including class cost-of-service data and class revenue-to-cost ratios." (Decision RP-1999-0017, Para. 2.50, p.32) Given that Union's application was based on 1999 revenue requirements and the Board determined that the PBR regime would not begin until 2001, the Board was particularly concerned about the appropriate starting point. After adjusting Union's 1999 revenue requirement information to reflect year 2000 cost changes, the Board emphasized that: "The Board believes that it is important to establish a realistic base set of data at the commencement of price-cap PBR plan and that such data must be representative of the current operations of the utility." (Decision RP-1999-0017, Para 2.165, p.60)

The only example in Ontario where the Board has commenced regulation in a new area using IR occurred in the electric distribution sector. The selection of PBR in that case was driven by

the need to regulate a very large number of diverse utilities and do so quickly, in advance of the then scheduled market opening date. Even in that circumstance however, in its decision adopting the first generation PBR for electric distributors, the Board acknowledged the draft Rate Handbook's proposal to conduct a "re-basing" study to examine distributors' costs prior to establishing rates for any second generation PBR. (Decision RP-1999-0034, Para. 2.0.2, p.10)

As the proceedings cited above demonstrate, the Board has considered the question of the appropriate starting point for IR and, except in one very unique circumstance, concluded that IR should commence with a thorough cost review. OPG submits that the logic of these Board precedents holds here.

#### **D. The Board should follow standard regulatory approaches in beginning to regulate OPG's prescribed assets**

The issue of the appropriate starting point for IR has received significant attention from practitioners and academics alike. In an earlier context, Board Staff recognized that: "One of the most important issues in PBR implementation is the process selected for setting initial rates. Rates should be just and equitable and allow the utility an appropriate return." (PBR Options For Electricity Distribution In Ontario, Ontario Energy Board Staff Report, October 15, 1998, p. 16)

Regulatory analysts commenting on the move to IR have emphasized the importance of the base from which it starts. The Regulatory Assistance Project states: "Indeed, one of the important steps in a PBR is to establish the right starting point. Most begin with a traditional style rate case." (Performance-Based Regulation For Distribution Utilities, Regulatory Assistance Project, Report for the National Association of Regulatory Utility Commissioners, December 2000)<sup>1</sup> A similar sentiment was expressed by Dr. Johannes Bauer in testimony presented during the Union Gas PBR proceeding discussed above: "The most important thing in a forwardly going PBR plan is that the base is correct. Because any mistake made in determining the base is compounded over the duration of the plan." (See quote in Decision RP-1999-0017, Para. 2.13.8, p. 53)

Given the importance of the starting point, most IR mechanisms develop from a thorough COS review. The Discussion Paper acknowledges this, stating: "IR proceedings usually start from a CoS-type basis – a determination of an applicant's revenue requirement based on rigorous examination of a cost and other information filing." (Staff Discussion Paper, p.15)

The Board should adopt the view of its staff and other regulatory analysts and carefully consider the starting point for developing IR. The way to do this is to begin with a COS review.

### **3. THE RECOMMENDATION TO ADOPT AN INCENTIVE REGULATION MODEL AND REJECT COST OF SERVICE REGULATION IS BASED ON A FLAWED EVALUATION**

The Discussion Paper's recommendation to propose IR and reject COS fails to discuss how the selected IR model will produce just and reasonable rates. It rests on an analysis that attributes

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<sup>1</sup> "The Regulatory Assistance Project (RAP) is a non-profit organization, formed in 1992 by experienced utility regulators, that provides research, analysis, and educational assistance to public officials on electric utility regulation." (See <http://www.raponline.org/Home.asp>)

theoretical benefits to IR (that are unlikely to be realized in the proposed model), and detriments to COS, which can be avoided. The level of effort associated with the recommended approach is likely to equal that associated with a limited issues COS approach. Moreover, the claimed efficiency benefits for IR do not match the proposed model, but can be realized through a limited issues COS approach. Finally, the Discussion Paper ignores the fact that COS offers greater transparency and is supported by most stakeholders.

#### **A. The Discussion Paper's evaluation does not address just and reasonable rates**

Surprisingly, the evaluation criteria that are included in the Discussion Paper do not include the necessary requirement to establish just and reasonable rates. The "fairness" criterion is defined in the Discussion Paper as "interested parties should have a fair opportunity to explore relevant issues with sufficient rigour and depth." (Staff Discussion Paper, p. 13) This definition addresses regulatory process only and ignores the central consideration of whether the process will result in just and reasonable payment amounts as required by section 78.1 of the OEB Act. The need to address this substantive issue should figure prominently in the criteria used to evaluate the alternative regulatory models.

The prescribed assets are critical to the reliability of the Ontario electrical system. As such, it is important that OPG be provided with sufficient revenues to operate these facilities safely and reliably, meet all regulatory requirements, including those of the Canadian Nuclear Safety Commission ("CNSC"), and fulfill its mandate from the Province to operate as a commercial enterprise. Adopting the existing payment amounts as the base payments for an IR model, with no review of the underlying cost of service, presents a significant risk that the payments will not provide sufficient revenues to meet these requirements.

Subjecting a newly regulated entity to an untried IR model would present an inappropriately high level of regulatory risk. This level of risk would make it very difficult for OPG to operate and develop the prescribed facilities successfully. This is particularly true in the present environment where OPG is making, or considering, significant capital investments in the prescribed facilities (e.g. Niagara tunnel project, nuclear refurbishment, etc.). An IR system that would use a simple and untested formula to adjust the payment amounts received by OPG is unlikely to produce just and reasonable rates. Such an approach would be much better suited to a regulated utility with a history of stable and predictable cost and production levels.

OPG does not agree that because there is no prior Board-approved cost information to use for trend analysis, a COS proceeding will not be able to address whether OPG's prescribed assets' costs and earnings are reasonable. Lack of prior Board-approved figures is an issue with any newly regulated entity and with any of the three proposed regulatory models. It is best resolved by taking the time to review the costs of the prescribed assets.

A COS process is the best way to ensure that OPG receives sufficient funds to both operate and maintain the prescribed assets, and renew and expand them pursuant to Government direction. OPG agrees with the statement in the Discussion Paper that "A CoS methodology can result in a consistent and well understood regulatory process that can be supported well into the future." (Staff Discussion Paper, p. 15) As a newly regulated entity, OPG must be afforded the opportunity to move into the future with payments that are just and reasonable.



**B. The evaluation of incentive regulation in the Discussion Paper is theoretical and not applicable to the IR model ultimately recommended**

The Discussion Paper presents a simplified review of the theoretical advantages of an IR model with little consideration of how IR has worked or will work in practice.

OPG agrees that IR has the potential to promote efficient operation and reduce regulatory costs if it starts from an appropriate base and includes a well designed mechanism that fairly balances the allocation of risk and includes appropriate incentives. OPG believes that Board staff's recommendation does not provide such a regime and that many of the advantages cited in the evaluation of IR cannot be applied to the Discussion Paper's recommended model.

OPG submits that the Discussion Paper's evaluation of the benefits of IR is based on a traditional performance-based ratemaking approach which starts with a COS review, establishes cost inflation and productivity factors based on a detailed analysis of an applicant's historical costs and performance and operates over a multi-year term. This evaluation cannot be applied to Board staff's recommended model for OPG because it does not start from a well-established cost basis and does not provide a workable basis for the development of cost inflation and productivity factors and has a minimum term of only one year.

**C. The selection of IR appears to be an attempt to artificially constrain the payment amounts**

The selection of incentive regulation appears to flow from objectives other than those set out in the paper. In presenting the recommended IR approach, the Discussion Paper states that "Board staff has also taken into consideration the objective of reducing price volatility and increasing electricity price stability. A full CoS proceeding may result in payments that are quite different (and presumably higher) than current payments." (Staff Discussion Paper, p. 20)

The presumption that a full CoS proceeding would result in payments that "are quite different (and presumably higher)" is not based on any information provided by OPG and calls into question whether the Discussion Paper is seeking a methodology to counteract any increase in the interim payment amounts, even one necessary to produce just and reasonable rates. If this is the case, OPG submits that this purpose is inappropriate.

No matter which of the three regulatory models is ultimately implemented, it is the relationship between OPG's costs and the authorized payment amounts, and not the regulatory model that has the potential to impact price volatility and stability. If the regulatory model chosen fails to provide OPG with sufficient revenues to properly operate and maintain the regulated facilities, then the potential exists for large future cost increases, reduced reliability and, possibly, the need to obtain more expensive replacement power. The objective of price stability cannot be interpreted to mean that the payment amounts for OPG's prescribed assets should not change even when the Board determines that changes are required to make them just and reasonable.

**D. The level of effort under the proposed IR model will be at least as onerous as a properly scoped and managed cost of service proceeding**

Under Board staff's proposed model, considerable time would be devoted to determination of the cost inflation and productivity factors. No support is provided for the suggestion that

productivity factors based on benchmarking and cost inflation factors based on widely collected statistical indices would be appropriate or feasible for OPG's prescribed facilities.

In addition, should the Board adopt an IR model, OPG submits that the proceeding would need to address adjustments to the base amounts to incorporate items such as:

- A risk-appropriate rate of return;
- The disposition of variance and deferral account balances, and other regulatory assets;
- The decision not to restart Pickering units 2 and 3 and to place them in safe storage;
- A mechanism for recovering costs for items such as nuclear refurbishment, new nuclear facilities, and the Niagara Tunnel;
- "Z" factors and off-ramps; and
- A continuing market-based incentive for hydroelectric.

The Board's experience with new IR regimes has demonstrated that implementation of IR can require considerable time and resources. Union Gas applied for the introduction of PBR in March, 1999 and a decision in the case was not reached until July 21, 2001. The hearing to establish the PBR regime lasted 19 hearing days and there were major contested hearings in two of the three subsequent years of the PBR regime.

Contrary to the Discussion Paper's conclusion that neither full nor partial COS is the most efficient model, OPG submits that a properly managed limited issues COS review would provide no greater regulatory burden than the recommended IR model. OPG proposes a two year term under a limited issues COS approach.<sup>2</sup> A two year term would reduce the regulatory burden as compared to an annual hearing. OPG would also provide stakeholder consultation as part of the preparation for such a proceeding.

OPG also does not agree with the statement that there are significant challenges in relation to the allocation of OPG's total costs as between the prescribed assets and OPG's other assets. OPG undertook a cost allocation exercise to support the development of the interim payments. It also provides audited, segmented financial reporting for its regulated and unregulated operations. Further, as indicated in OPG's Financial Overview presentation provided at the May 19, 2006 plenary discussion, in the allocation of assets, liabilities and costs between regulated and unregulated operations, 97% of fixed assets (by value), and 87% of OM&A costs are either located at the regulated facilities or can be easily shown to directly support specific production facilities (e.g. nuclear waste or nuclear specific IT systems). OPG submits that it would be a relatively straight-forward matter to address the issue of cost allocation in the first hearing.

#### **E. Efficiency incentives are not necessarily a feature of the proposed model nor are they necessarily absent from cost of service regulation**

The concern that there is no incentive to reduce costs under a COS model arises over time and will not be an issue in establishing the Board's first order for payment amounts. It is only after establishing payments based on costs that have been reviewed and found to be reasonable that IR can be used to encourage further efficiencies. This view is supported by the statement in the Discussion Paper that: "CoS proceedings can, in the absence of resource limitations, allow for a very rigorous examination of specific cost accounts and the identification of efficiency opportunities." (Staff Discussion Paper, p. 6)

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<sup>2</sup>OPG proposes that the first proceeding cover a 21-month period (from April 1, 2008 through December 31, 2009) to allow OPG to base future filings on calendar years.

The Discussion Paper states that “One of the regulatory efficiency advantages of IR is the ability to set a payment level and then have it automatically adjust over a period of years.” and “once the base payment and adjustment factors have been determined, an IR regime does not require annual proceedings to reset payments like a CoS approach.” (Staff Discussion Paper, p. 15)

Obtaining efficiency improvements through an IR regime relies on an appropriately established base payment, appropriate inflation and productivity factors and a multi-year IR regime. The model proposed in the Discussion Paper has none of these features. The Discussion Paper does not propose a multi-year term. Rather it recommends a minimum term of one year, which provides little expectation of efficiency gains when compared to COS. In fact, the Discussion Paper highlights the uncertainty surrounding any expectation of stability in its recommendation on the term of the first order: “The actual duration of the first order will be set after a review of OPG’s financial and cost information and a determination of the suitability of continuing to use the existing base payments in the incentive regulation regime.” (Staff Discussion Paper, p. 22)

Under a COS model with payments established for a two-year period, OPG would have an incentive to reduce costs and improve efficiency over the term of the payments to increase its earnings.

#### **F. COS is the best model to deliver increased transparency**

OPG agrees with the statement in the Discussion Paper that “Both variations of CoS have the potential to be the most transparent (in the sense of access to and examination of information) of the options considered, and a well-managed CoS proceeding can provide valuable information to the Board and intervenors.” (Staff Discussion Paper, p. 14)

Absent an initial COS review, the incentive regulatory model proposed by Board staff will not achieve the objective of transparency. Although OPG will provide financial reporting during the proposed IR period, there will be no opportunity for interested parties to build an understanding of the considerations underlying the reported costs. Furthermore, OPG submits that the potential for information asymmetry exists equally in all three regulatory models.

#### **G. COS is the model supported by the majority of stakeholders**

OPG submits, that based on the posted submissions and comments at the plenary sessions, a clear majority of stakeholders prefer a COS model for establishment of the initial payment amounts. Several stakeholders support IR as a longer term objective, but believe a COS review is an essential starting point.

### **4. IN THE ALTERNATIVE, IF THE BOARD ADOPTS INCENTIVE REGULATION, IT MUST AMEND THE MODEL RECOMMENDED IN THE DISCUSSION PAPER TO ARRIVE AT A WORKABLE APPROACH**

OPG supports the use of a limited issues COS model. In the alternative, should the Board instead determine to proceed with an IR model, the following matters are among the most significant items that must be addressed to make the approach workable:

- Inclusion of a risk-appropriate rate of return;
- A review of the implications of the decision to place Pickering units 2 and 3 in safe storage and work to develop the prescribed facilities (e.g. the Niagara tunnel, nuclear refurbishment, etc.) on the payment amounts;

- A full review of productivity and inflation factors;
- Inclusion of “Z” factors and off-ramps;
- Continuation of a market-based incentive mechanism for hydroelectric production;
- An initial term of 21 months;
- Recovery of costs as provided for in O.Reg 53/05;
- Payment amounts with both fixed and variable components; and
- Pricing for the Beck Pump Generating Station (“PGS”) that is integrated with pricing of the other Beck facilities.

#### **A. The base payments must be adjusted to provide a risk-appropriate rate of return**

As stated above, OPG submits that as part of its obligation to ensure that the payments are just and reasonable, the Board must provide OPG with a reasonable opportunity to earn a commercially reasonable return on the capital associated with these facilities.

In OPG’s submission, the Government’s statement regarding the ROE included in the interim payment amounts can only be applied to the interim payment amounts as established by the Government and cannot be presumed to apply to the period after the Board assumes responsibility for establishing the payments.

The Board has addressed the issue of ROE in establishing transmission and distribution rates for Hydro One, another Government-owned successor company of Ontario Hydro. There is no basis for the Board to presume that the Government’s expectations for the regulation of OPG are any different than they are for Hydro One.

The Government’s intent with respect to OPG is clearly and publicly stated in the Memorandum of Agreement between OPG and the Province of Ontario, its Shareholder, which states:

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.

As a transition to a sustainable financial model, any significant new generation project approved by the OPG Board of Directors and agreed to by the Shareholder may receive financial support from the Province of Ontario, if and as appropriate. (Memorandum of Agreement between Her Majesty the Crown In Right of Ontario (the “Shareholder”) AND Ontario Power Generation (“OPG”), p. 3)

This statement of a commercial mandate for OPG is consistent with an expectation that OPG’s regulated facilities would receive a commercially reasonable rate of return.

OPG is prepared to provide the necessary evidence to allow the Board to determine an appropriate rate of return for the prescribed facilities. The Discussion Paper states that “Examination of appropriate rates of return will be better informed after the Board and intervenors have access to the financial and other data that Board staff is recommending the Board require OPG to file quarterly.” (Staff Discussion Paper, p. 17) This puts the cart before the horse. The setting of the initial payment amounts is the time to examine all costs, including the cost of capital. OPG is prepared to file the financial and other data in the context of the Board’s first hearing so that the Board and intervenors will be sufficiently informed to consider the issue at that time.

As a regulated entity, OPG applies rate regulated accounting to its regulated facilities in its external financial reporting. Rate regulated accounting enables regulated entities to record costs in the period when they benefit ratepayers. In order to adopt rate regulated accounting, generally accepted accounting principles (GAAP) require that a regulated entity demonstrate that regulated rates are designed to recover the cost of providing services or products. An appropriate rate of return is an important factor in that demonstration and consequently in allowing OPG to apply rate regulated accounting.

**B. The base payments must be adjusted to reflect the decision to place Pickering units 2 and 3 in safe storage**

At the time that the interim rates were established, the decision had not yet been taken to place Pickering units 2 and 3 in safe storage. The base payments must be adjusted to reflect both the cost and revenue impacts of that decision, including cost impacts for units 1 and 4.

**C. A mechanism for recovering costs associated with work on nuclear refurbishment, new nuclear, and the Niagara Tunnel must be included in the IR model**

OPG has been instructed by the Government to initiate new work including a feasibility study on refurbishing its existing nuclear facilities, an environmental assessment on the refurbishment of the four existing units at Pickering B and the federal approvals process for new nuclear units at an existing site, including an environmental assessment. The amounts currently budgeted for these projects were not included in the current interim rates. A mechanism to recover these costs must be included in any IR model adopted by the Board.

OPG agrees with the Discussion Paper's conclusion that the Board should consider the impact of the Niagara tunnel on OPG's costs and revenue requirement. It is unclear how the recommended model would accommodate this conclusion since it does not propose to establish a revenue requirement or to review the costs for the regulated hydroelectric facilities. Whatever mechanism is developed to review the Niagara tunnel should be expanded to include the nuclear projects referenced above and all other required capital projects.

**D. A full review of productivity and cost inflation factors is required as a simplified approach could lead to unforeseen and undesirable outcomes**

OPG believes that a full review of the input cost inflation factor is required to determine the appropriate factor to apply to the regulated assets. Without evaluating the specific cost inputs for the regulated facilities, the Board would have no assurance that an established statistical index was appropriate.

The Discussion Paper states that a proceeding to examine OPG's historical costs and outputs will not necessarily provide a better basis for determining an appropriate inflation index and productivity factor than would existing statistical indices or benchmarking studies. OPG disagrees. Establishing these factors without any expertise or experience in applying IR to a generator and without examining the specifics of the regulated facilities will almost certainly create inappropriate incentives and unforeseen and undesirable outcomes for consumers or OPG.

Establishing the productivity factor for the nuclear units on the basis of benchmarking would be extremely risky because the ages, condition, size and technology of OPG's nuclear units make it very difficult to find an appropriate basis for comparison. An inappropriate productivity factor presents the risks of providing inadequate revenues for maintenance and life-cycle management of the reactors.

**E. "Z" factors and off-ramps should be included in the IR model**

OPG agrees with Board staff's recommendation that if the Board chooses to adopt IR, the Board should examine the need for mechanisms to account for unanticipated events and conditions that could have a material impact on OPG's payments and/or cost recovery in the first proceeding. These should include both "Z" factors and off-ramps.

In OPG's submission, at least some of the issues that would need to be addressed through Z factors include:

- Force majeure events affecting the prescribed assets or their access to the electricity grid;
- Changes to pension and OPEB costs associated with changes in factors beyond OPG's control;
- Significant changes in nuclear production levels and costs due to "lumpiness" in outage cycles and specific unusual outage requirements (e.g., OPG is required to periodically perform vacuum building outages which result in planned outages of a significant duration for all units in a multi-unit nuclear station) or due to technological discoveries;
- Changes in Bruce Lease revenues and costs, consistent with the requirements of O.Reg. 53/05;
- Changes to accounting standards (e.g. the new accounting standard for financial instruments);
- Changes in costs or production associated with new legal or regulatory requirements, changes to tax assessments/reassessments or settlement of past Aboriginal grievances.

**F. The model should retain a market-based incentive for regulated hydroelectric facilities**

OPG agrees that the Board should retain a payment structure whereby some of the output of the regulated hydroelectric facilities receives the market price in order to provide an incentive to maximize production when it is most valuable.

**G. The term of the IR regime should be defined as two years**

The term of the first IR period should be defined as two years with Z factors and off ramps to address circumstances where adjustments may be required. Given that there is no history of regulating OPG, an open-ended term presents an unacceptable level of risk to both OPG and customers. A period of longer than two years also would not work given the significant initiatives underway at OPG's prescribed facilities.

**H. The model must allow for recovery of costs pursuant to Regulation 53/05**

OPG notes that Ontario Regulation 53/05 provides for recovery of certain costs, including:

- The recovery of the deferral and variance accounts established in section 5 of O.Reg 53/05; and

- The recovery of costs and firm financial commitments incurred for investments to increase the output of, refurbish or add operating capacity to a regulated facility (Section 6. (2) 3).

The recovery of these costs must be incremental to the “base amounts” of \$33/MWh for regulated hydroelectric and \$49.50/MWh for nuclear output to be consistent with the intent of the regulation. Accordingly, it is OPG’s submission that even in the case of an IR hearing, evidence with respect to all of the above-noted costs would have to be reviewed. This would increase the length and complexity of any IR hearing.

**I. The form of the payment should include both a fixed and variable component**

Changes in the form of the payment amounts to include both a fixed (\$/month) and variable (\$/MWh) component should be made to recognize the large proportion of fixed costs associated with the prescribed facilities that continue regardless of output levels. The current payment form creates substantial earnings risk and complicates business planning and budgeting. The precise nature of the new form for the payment amounts should be determined as part of a limited issues COS proceeding.

**J. The pricing of the output from the Beck Pump Generating Station cannot be considered separately from pricing of the other Beck facilities**

Board staff’s proposal to isolate the Beck PGS from the other Niagara facilities in establishing the payments will not work. PGS was designed and built for integrated operation with the other two Beck plants. Integrated operation of PGS with the other Beck plants makes economic sense, optimizes peaking capability, allows OPG to efficiently provide Automatic Generation Control and Operating Reserve at Beck, assists in diversion control at the Beck complex, and provides other safety and system related benefits. To sever the PGS operation from the rest of the Beck facility by developing its payment amounts separately from Beck 1 and Beck 2 would pervert the incentives that currently exist and negatively impact the efficiency with which it performs the valuable roles required by the power system.

**K. An additional incentive mechanism is not required for efficient use of the nuclear assets**

An additional incentive is not required to maximize the efficient use of the prescribed nuclear assets. Adoption of such an incentive would only create additional regulatory risk for OPG without any countervailing benefits for the electricity system. As long as a substantial portion of OPG’s revenues continues to come from variable payments, OPG will have all the necessary incentive to maximize production from these units.

The only times the units are not producing at their maximum capability is during outages and derates. Forced outages and derates are by their nature unavoidable and the fact that OPG does not receive its energy-based payments when the units are not operating is a strong incentive to minimize the duration of any forced outages. Planned outages are scheduled well in advance and have a large component of work driven by regulatory requirements. OPG plans its outages consistent with good utility practice. These outages must be approved by the IESO after consideration of reliability and other system impacts. Thus an incentive is unnecessary and, in any event, is likely to be ineffective because OPG’s ability to alter the availability of its nuclear units in the peak periods in response to an incentive is extremely limited.

**L. Service Quality Indicators are not required because the performance standards for the facilities are established through the IESO Market Rules**

Service Quality Indicators (SQIs) for OPG are unnecessary. OPG does not directly interface with any end-use customers. All the production from OPG's prescribed facilities is offered into the IESO wholesale market. The structure of the payment amounts encourages OPG to make maximum output available. Moreover, OPG's Generation Licence requires it to offer all available production into the wholesale market. Finally, the IESO Market Rules have extensive standards for generator performance and the responsibility for monitoring and enforcing compliance with those rules.

**5. CONCLUSION**

The Board must set payment amounts that are just and reasonable – amounts that reflect the true cost of owning, operating, maintaining and developing the prescribed assets. 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 promote transparency and fairness.

In the interests of regulatory expediency, the recommendation in the Discussion Paper ignores the Board's central mandate – to set payment amounts which are just and reasonable. The Discussion Paper understates the problems with IR and overstates its benefits. Establishing an appropriate starting point for IR and developing appropriate productivity and cost adjustment factors for a previously unregulated entity like OPG will not be an easy task. Moreover, the short duration of the proposed IR mechanism will deprive it of any benefits. If the Board nevertheless chooses to select an IR approach, the changes to the proposed model detailed in the section above must be incorporated to remedy the deficiencies in the proposed IR.

Accordingly, OPG submits that the Board should adopt a COS model which focuses on a limited set of issues in the first hearing and establishes payments to be in effect for a 21-month period starting April 1, 2008.

All of which is respectfully submitted,



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