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VIA EMAIL AND COURIER

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319
26th Floor
2300 Yonge Street
Toronto, ON
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Dear Ms. Walli:

Re: OEB's Regulatory Process for Setting Payment Amounts for Ontario Power Generation (OPG) Inc's Prescribed Generation Assets (EB-2006-0064)

VECC's Comments on OEB Staff's July 6, 2006 Discussion Paper

As Counsel to VECC, I am writing to provide our comments regarding the OEB Staff's recommendations as to the payment-setting methodology to be applied to OPG's Prescribed Generation Assets. In preparing these comments, VECC has considered the written comments provided by the other participants as well as the oral comments made during the Stakeholder Sessions. The comments and conclusions focus on four aspects of the Staff Paper:

- The criteria and considerations that should be used to determine the appropriate approach for setting the payments for prescribed assets as discussed in Sections 2.4, 3.0, 5.1 and 5.2 of the Staff Discussion Paper.
- The description and characterization of the various regulatory models considered as discussed in Section 4.0.
- The Board Staff's overall evaluation of the various regulatory models as discussed in Section 5.3. This part portion of the comments also considers the generic issues identified in Section 6.0 of the Staff Discussion Paper.
- The Board Staff's recommendation supporting the use of an Incentive Regulation model and the detailed recommendations regarding how Incentive

Regulation should be implemented for OPG's prescribed assets as discussed in Section 7.0 and Appendix A.

In preparing these comments, VECC has also drawn on its June 6th and June 28th comments submitted on earlier drafts of the Staff Discussion Paper. To a great extent the content and conclusions of July 6th Staff Discussion Paper are unchanged from earlier versions. As result, VECC has repeated many of the key points repeated below. However, for a complete picture of VECC's position regarding the proposals, VECC requests that the Board also review these earlier comments.

1.0 Key Considerations in Determining Appropriate Regulatory Model

The Staff Discussion Paper identifies a number of factors that need to be considered in determining the appropriate approach for setting the payments for OPG's prescribed assets. These include:

- Regulation 53/05 as discussed in Section 2.4,
- The Objectives of the *Ontario Energy Board Act, 1998* as discussed in Section 3.0
- The objectives of Government of Ontario in deciding that OPG's prescribed assets should be subject to rate regulation as discussed in Section 5.1, and
- The need for the regulatory process to be transparent, fair, effective, efficient, and consistent, as discussed in Sections 3.0.

It is VECC's submission that the requirements of the first two factors (i.e., the Regulation and the Act) are not only the primary considerations but are also mandatory. In the case of the "Government's objectives", without a specific Government directive to the OEB[1], any assessment of intended Government objectives is somewhat speculative. However, in VECC's view, the key consideration underlying the decision to regulate OPG's prescribed assets was the desire to reduce electricity price volatility as expressed in both the 2003 report of the Government's Electricity Conservation and Supply Task Force and the Minister's February 2005 announcement regarding the initial payment to OPG. To a large extent this consideration is captured by the OEB's statutory objective "to protect the interests of consumers with respect to prices".

While VECC agrees that regulatory process issues are a consideration in the determining the regulatory model to be adopted, VECC submits that they can not used as a rationale for not meeting the Board's statutory obligations. Indeed apart from the concerns regarding regulatory "efficiency", VECC believes there is considerable alignment between the process objectives of transparency,

[1] per *Ontario Energy Board Act, 1998*, Section 27 (1)

fairness, effectiveness and consistency and the Board's statutory objectives. The interests of consumers and the financial viability of the industry are both best protected through a process that is transparent, fair, effective and consistent.

Subsequent sections of the Staff Discussion Paper make a number of references to the efficiency or lack of efficiency associated with various regulatory models, particularly in terms of their resource requirements. However, when doing so, the Paper fails recognize that efficiency can not be measured simply in terms of inputs but rather must be measured in terms of the inputs required to achieve a certain output. A regulatory model that requires less time and resources is not necessarily "efficient" if the end result does not produce (in this case) payments for OPG's prescribed assets that meet the Board's statutory objectives. Similarly, a regulatory model is not necessarily more "efficient" if does not produce results that are equally transparent, fair and effective.

<u>*Conclusions*</u>*: a) The Board's statutory obligations, as set out in the OEB Act and Regulation 53/05, should be the primary factors in determining the regulatory model to be adopted for setting the paymenst for OPG's prescribed generation assets.*

b) Regulatory process objectives should be secondary factors in this determination.

c) Regulatory efficiency must consider more than just the resources required but also the results achieved.

2.0 Characterization of Various Regulatory Models

2.1 Cost of Service

VECC concurs with the statement in the Staff Discussion Paper[2] that "COS ratemaking is the "standard" regulatory model used for decades by regulators in numerous jurisdictions". However, VECC disagrees with the suggestion[3] later in the Paper that "IR regimes have become a preferred regulatory methodology in response to the perceived deficiencies of COS". Practice in both Canada and the US would suggest that Cost of Service continues to the approach most used by regulators. One way regulators have sought to address the perceived deficiencies with COS has been through the use of Negotiated Settlement (i.e., ADR) processes.

The two main drawbacks the Staff Discussion Paper attributes to COS regulation are a) the resource/time requirements and b) the fact that a COS-type process provides little incentive for the rate regulated entity to improve efficiency and

[2] Section 4.1, first paragraph
[3] Section 5.3.2, fifth paragraph

reduce costs. With respect to the first concern, the paper suggests[4] that one way of addressing this would be through a modified COS process. VECC notes that various stakeholders also raised the possibility of a modified or "phased" COS process to address resourcing issues.

The paper suggests[5] that the modified COS approach could be implemented by accepting the existing payments prescribed in Regulation 53/05 as the "base payment" and then, through the phased COS process, establish the changes that should be made to these payments. VECC notes that another way the modified COS approach could be implemented would be to request that OPG provide historical costs (based on audited statements) and a forecast for the base year (i.e., April 1, 2008 – March 31, 2009) and use this as the starting point instead of the existing payments. The first proceeding would then set the base payments based on a cost examination that focused on the items of greatest importance. In VECC's view, this approach fits well with Regulation 53/05 which requires[6] that the OEB in making its first order under section 78.1 of the Act accept the values for a number of items as are set out in OPG's most recently audited financial statements. This approach is also similar to the partial COS approach discussed under Incentive Regulation for setting the base year payments.

With respect to encouraging efficiency improvements, VECC believes Staff Paper's suggestion[7] that COS-type processes provides "little incentive" to improve efficiency is overstated. Even under COS regulation there continues to be an incentive (in terms of shareholder returns) to pursue efficiency improvements if increased returns can be achieved between COS reviews. Furthermore, VECC submits that entities under COS-regulation do pursue efficiency improvements for other objectives. Capital investments made to achieve efficiency improvements increase overall earned returns and cost reductions arising from efficiency improvements (based on either capital or OMA spending) will lower overall revenue requirements – leading to improved customer satisfaction and reduced regulatory burden[8].

VECC acknowledges that there are alternative regulatory approaches that can offer increased incentives for efficiency improvements; however they must be properly designed. A poorly designed incentive regulation model may be less effective than COS-type regulation in encouraging efficiency improvements. Indeed, if the scheme does not provide sufficient funds, the regulated entity may sacrifice longer term gains (in returns and/or reliability) to meet short-term financial objectives. Similarly, if the scheme is too rich it could well encourage overspending, particularly towards the end of the incentive regulation period.

[4] Section 4.1, sixth paragraph
[5] Section 4.1, sixth paragraph
[6] Regulation 53/05, Section 6 (2), paragraph 4
[7] Section 4.1, eighth paragraph
[8] As a matter of course, regulated entities requesting material rate increases are generally subjected to greater regulatory scrutiny and burden.

Finally, a poorly designed scheme simply increases the likelihood that any off-ramps provided for in the plan will need to be exercised which will also reduce the efficiency incentives.

2.2 Incentive Regulation

The Staff Discussion Paper states[9] that the "Board is currently developing IR regimes for the gas and electricity distribution sectors". However, the Paper does not capture the comments made by a number of stakeholders that in the case of the gas sector this initiative follows years of COS-type regulation and for electricity will be accompanied by an implementation plan than ensures each distributor under goes a COS-type review. VECC believes that this is an important context for the subsequent discussion regarding the options for setting the base year rates under incentive regulation.

The Staff Discussion Paper sets out two ways for setting the starting (or base year) payments for OPG under incentive regulation - one based on cost of service and the other on the existing payments. The Paper notes that under the first approach the base year payments could be established based on either a "full" or a "partial" cost of service analysis. VECC notes that under the full cost of service analysis the proceeding would need to address all the same issues as the standard COS model as well as the details of the incentive mechanism that would be applied in subsequent years. As noted in the Paper[10], a partial cost of service analysis would reduce the work load for the initial proceeding by only examining certain aspects of OPG's cost structure. However, VECC notes that this approach would likely involve more time and resources than a simple "partial COS" model as it would require the Board to address the elements of the incentive mechanism in the first proceeding as well.

The Paper acknowledges[11] that under the second approach, (i.e., use the existing payments to set the initial base year payment) it is necessary to assume that the payments result in revenue sufficient to meet OPG's costs and provide a return on equity. In VECC's view this is a critical assumption, as the Board's objectives require that it "facilitate the maintenance of a financially viable electricity industry". Furthermore, the *Act* requires[12] that the amount fixed by the OEB be just and reasonable and Regulation 53/05 requires[13] that Board ensure that OPG recover certain costs.

The Paper also acknowledges[14] that under this model studies would have to be undertaken to develop the appropriate productivity index for use in the incentive

[9] Section 4.2, first paragraph
[10] Section 4.2, third paragraph
[11] Section 4.2, fourth paragraph
[12] Ontario Energy Board Act, 1998, Section 78.1 (7)
[13] Regulation 53/05, section 6 (2), paragraphs 6, 7 & 8
[14] Section 4.2, seventh paragraph

mechanism formula. The Paper properly identifies that this would require historical OPG cost data and that questions would arise about the adequacy and accuracy of the data. In VECC's view, the Paper correctly notes[15] that the cost data required to support a productivity analysis could impose similar data requirements on OPG as a COS model.

However, VECC does not agree that issues regarding the use of historical OPG data can be readily resolved by relying on practices and examples from other jurisdictions. The Paper has already indicated that research has found no examples of rate or payment regulation for stand-alone generation. As a result, VECC does not see how it will be possible for the Board to rely on "examples and practices from other jurisdictions". Indeed, as generation increasingly becomes a competitive activity it is unlikely that cost data from other jurisdictions will be readily available.

The Paper suggests[16] that the complications associated with establishing the base year payments and incentive mechanism are offset by the advantages of the longer term approach of incentive regulation as subsequent payment adjustments are done by formula and do not require extensive proceedings. VECC notes that there is an important caveat to this claim which is that the formulaic approach to setting subsequent years' payment must also yield a result that is just and reasonable and meets the Board's statutory obligations.

In VECC's view establishing an appropriate base year payment and an incentive formula are critical to achieving this. If the base year payment is inappropriate then the subsequent annual payments will also be inappropriate. Similarly, if the incentive formula is not well designed then the subsequent years' payments will be inappropriate. VECC submits that in either of these cases the "advantage" of the incentive mechanism is an illusion as there is no reasonable assurance that the results of the incentive mechanism model will produce just and reasonable rates and, in dong so, protect the interests of consumer and maintain the financial viability of the regulated entity. Furthermore, the gains from such incentive regulation can be short-lived if an ill-defined base year payment or escalation mechanism leads to the early triggering of an "off-ramp" or the request for a Z-factor adjustment that must be adjudicated.

The Paper rightly flags[17] the need to ensure that regulated entities do not increase returns under incentive regulation by cutting costs inappropriately. The Paper suggests a couple of way of addressing the issue but does not mention the need for properly designed service quality indicators to help address the issue. In VECC's view there are also serious limitations with the suggestions put forward in the Paper. First, frequently, cost cuts do not immediately impact on performance and so linking payments to output is only a partial solution. Second,

[15] Section 4.2, eighth paragraph
[16] Section 4.2, eighth paragraph
[17] Section 4.2, ninth paragraph

adoption of a revenue sharing factor presupposes there is an approved rate of return on equity for the entity, which will not be the case for OPG under Staff's recommended approach.

The Staff Discussion Paper suggests[18] that another issue the Board could address with incentive regulation is ensuring that OPG's prescribed generation output is available to the Ontario Market when it is most valuable to consumers. VECC agrees and, indeed, made similar comments to Board Staff in both its June 6th and June 28th comments. However, VECC does not see this issue as being limited only to the Incentive Regulation model. Even a COS-type regulatory model can include incentives and incentive payments to encourage such behaviour. In VECC's view this issue must be addressed regardless of which regulatory model is adopted.

The Paper notes[19] that there is a need for the Board to examine the potential for gaming under an incentive regulations scheme. In VECC's view this issue is primarily a function of the payment structure (as opposed to the regulatory model used to determine the payment levels) and must be considered regardless of the regulatory model adopted. VECC also notes that any examination by the Board should be limited to the impact the payment scheme has on OPG's actions as there already exists a Market Surveillance Panel that is concerned with broader gaming issues and generator behaviour in the Ontario market.

2.3 Regulatory Contracts

The Paper notes[20] that output from new generation facilities that are being built in the province is subject to long term contracts between the OPA and prospective generators and suggests that OPG's prescribed assets could be compensate through a similar set of contractual arrangements. What the Paper fails acknowledge is that for the OPA these contracts are generally developed after the prospective generator has been the successful "bidder" in an RFP process[21]. It is through this process that the OPA has assured itself (and other stakeholders) that the prices being paid are "just and reasonable". Similarly, the prospective generator is assured a "just and reasonable" payment since the contract will reflect the generator's bid. In contrast, the purpose of the OEB regulating the payment level for prescribed assets is to establish what a just and reasonable level is for the payments in the first place.

In VECC's view the regulatory contract model is, at best, a mechanism that could be adopted for defining and implementing the payment scheme for OPG after the appropriate payment level has been established. It is the payment scheme that needs to address issues such as ensuring OPG's compensation aligns with the

[18] Section 4.2, 10th paragraph
[19] Section 4.2, 12th paragraph
[20] Section 4.3, first and second paragraphs
[21] Unless sole sourced by Government directive

Ontario's needs and the market so as to ensure optimal availability and efficient operation of OPG's generation.

Conclusions: *a) There are two critical decisions to be made with respect to the "regulatory model" to be used for OPG. The first is whether, from an overall perspective, the Board wishes at this point to adopt a COS-type model or an Incentive Regulation model for determining the level of payments for prescribed assets. The second decision is what approach to use in setting the initial year's payments which could be based on i) the existing payments, ii) a full COS-type review or iii) a partial COS-type review. It is also important to note that a full or partial COS-type first year review could be used under either the COS or Incentive Regulation model.*

b) Regulatory Contracts do not offer an effective "regulatory model" for establishing overall payment levels.

c) Incentive regulation offers increased opportunities (relative to cost of service regulation) for improvements in both economic efficiency and regulatory efficiency. However, these gains will be made at the expense of other critical regulatory objectives unless both the base year payment and incentive formula are properly established. Furthermore, an ill-defined incentive plan may not improve economic (or even regulatory) efficiency.

3.0 Board Staff Evaluation of the Regulatory Models and Generic Issues

3.1 Board Staff Evaluation of Regulatory Models

3.1.1 General Observations

Board Staff expresses[22] the view that "the legal framework associated with its mandate in relation to prescribed assets does not dictate the selection of a particular methodology". VECC agrees but also notes that the legal framework and, in particular, Regulation 53/05, sets out specific requirements that the OEB's regulatory approach must satisfy. These requirements have been discussed above and noted to Board Staff in previous written comments by both VECC and other stakeholders[23]. However, despite specific requests, the Staff Paper does not demonstrate that the Board Staff's recommended approach can satisfy the requirements of Regulation 53/05.

A number of other issues were also raised by parties regarding the recommendations put forward in Board Staff's June 20th Discussion Paper that continue to be unanswered. For example, VECC requested clarification as to:

- How will Z factors and off-ramps be defined in the absence of an approved ROE, planning assumptions or cost base?

[22] Section 5.3, second paragraph
[23] For example, OPG and the PWU.

- o The term of the first order and the plans with respect to when a cost of service review would occur.

However, neither Board Staff's evaluation nor it's discussion of the recommended approach addresses these matters.

Finally, the Board Staff's evaluation focuses primarily on the issues of regulatory efficiency and economic efficiency and fails to adequately address whether each of the potential regulatory models meets the Board's statutory objectives with respect to protecting the interests of consumers and maintaining a financially viable industry. Overall, it is VECC's view the final draft has failed to fully address the various factors that need to be considered in selecting the appropriate regulatory model for OPG prescribed assets and, as a result, the evaluation is inadequate and the resulting recommendations flawed.

3.1.2 Cost of Service

The main drawbacks attributed[24] to Cost of Service regulation are that:

- o COS type regulation does not promote economic efficiency and productivity improvement,
- o There is an asymmetry of information that makes it difficult to ensure that COS proceedings are fair to all participants, and
- o COS-type regulation (either full or partial) requires considerable time and resources.

With respect to the first point, the Staff Paper acknowledges[25] and VECC's comments have already noted that this may be an "overstatement". In terms of the second point, the Paper fails to recognize that asymmetry of information will exist with any regulatory model. For example, the setting of an appropriate productivity factor under incentive regulation is confounded by the fact that the opportunities for future productivity improvement are best understood by the regulated entity itself. Finally, the resources required for COS regulation are to a large extent a function of the process established by the Board. Parties supporting a COS-type of regulation generally acknowledge that it can not all be done in one sitting and will require a phased approach. Resources required for the first proceeding could be managed by adopting certain matters as given, identifying others which would be addressed through a written process and restricting the oral portion of the proceeding to a limited number of critical issues.

While not discussed, VECC's view is that under a Cost of Service regulation model the Board would be able to meet its other critical objectives of:

- o Ensuring it meets it obligations under Regulation 53/05,
- o Protecting consumers, and

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[24] Section 5.3.1, paragraphs 2 to 4.
[25] Section 5.3.1, paragraph 2

- o Ensuring industry financial viability

3.1.3 Incentive Regulation

The Paper makes reference[26] to incentive regulation being the Board's preferred methodology for setting future gas and electricity distribution rates. However, as VECC has noted above, in the case of gas distributors, this is only after years of cost of service based regulation which has provided a firm understanding and vetting of the underlying cost structure. In the case of electricity distribution rates, the Paper does not acknowledge that the move to incentive regulation for electricity distribution utilities is, in part, motivated by the large number of entities involved and includes a plan for setting base rates for each distributor on a cost of service basis before incentive regulation is fully adopted.

As VECC has noted earlier, the operation of an effective Incentive Regulation model is only as good as the starting point. Lack of an appropriate starting point will likely lead to an early triggering of any off-ramps or Z-factors incorporated in an incentive regulation type model and reduce the perceived regulatory efficiency gains. Lack of an appropriate starting point can also compromise the Board's fundamental objectives as set out in the OEB Act and Regulation 53/05.

With respect to the setting of the base year, earlier sections of the Staff Paper identified a number of different options that could be used under the current circumstances. While the Paper discusses[27] the relative merits of using cost of service to set the initial payments; there is no discussion with respect to the merits of using the existing payments levels as the starting point. VECC finds this shortcoming to be particularly problematic in that this is Staff's recommended approach[28]. VECC suggests that an evaluation of using the existing payment levels to set the starting point for incentive regulation would conclude that:

- o Use of the existing payments does not result in just and reasonable rates or ensure the necessary payments to OPG as required under Regulation 53/05. The main reason for this is that the existing payments are based on an out of date OPG business plan that no longer reflects reality.
- o For the same reasons, the use of the existing payments will not ensure the financial viability of the regulated entity as required under the OEB Act,
- o While, as the Paper suggests[29], it may protect consumers from rate increases in the short-term, VECC submits that use of the existing payments does not reduce price volatility and may simply lead to higher increases (and greater rate shock) in the future when payment levels are adjusted to reflect the actual cost of service. As a result, it is questionable as to whether such an approach is truly protecting consumer interests with respect to prices.

[26] Section 5.3.2, first paragraph
[27] Section 5.3.2, fourth paragraph
[28] Section 7.1, eighth paragraph
[29] Section 7.1, sixth paragraph

> Furthermore, if excessively low revenues to OPG trigger reductions in needed capital spending or maintenance then the Board will not be meeting its obligation to protect consumer interests with respect to the reliability and quality of electric service.

The Paper states[30] that "compared to COS, IR's data requirements are no more onerous". However, the balance of the same paragraph goes on to demonstrate that when there is no cost data for the base year, the data requirements for an incentive regulation model may prove to be <u>no less onerous</u>.

3.1.4 Regulatory Contracts

The Staff Paper acknowledges some of the inconsistencies, in terms of principles and approach, between a regulatory contract model which assumes there are two equal parties reaching an agreement on a "contract" versus the Board's obligations which are to "approve" a payment level. As VECC has discussed earlier, Regulatory Contracts, as established by the OPA are the result of a totally different process and can not be used to determine what an appropriate overall payment level would be for OPG's prescribed assets (or any other regulated asset).

<u>Conclusions</u>: a) The Staff's evaluation of regulatory models is not comprehensive as it does not address all of the Board's statutory obligations.

b) A key consideration under the Incentive Regulation Model is the approach that will be adopted for setting the base year payment. Again, the Staff Paper has not fully examined the issue.

c) Regardless of whether the overall approach adopted is Cost of Service or Incentive Regulation, the Board's goals can only be met if the setting of the first year's payment involves some form of cost of service review – even if it is only partial.

3.2 Generic Issues

In Section 6.0, the Staff Paper identifies a number of generic issues which may need to be addressed regardless of which regulatory approach is adopted.

3.2.1 Rate of Return

Staff proposes that the Board not address the issue of rate of return in the first proceeding. The rationale offered[31] is that "examination of appropriate rates of return (ROE) will be better informed after the Board and intervenors have access to the financial and other data that Board staff is recommending that the Board require OPG to file quarterly". The expected timing of the availability of such information is not discussed in the Paper.

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[30] Section 5.3.2, fourth paragraph
[31] Section 6.1, third paragraph

It is VECC's view that addressing ROE is important if the OEB is to proceed with either a COS or an Incentive Regulation model. Clearly, under a COS-type approach ROE is key input to determining the overall revenue requirement. Similarly, ROE would be a critical input to an Incentive Regulation model if the base year payment was to be set using COS.

However, in VECC's view, establishing an appropriate ROE is also important under an Incentive Regulation approach even if the starting point is the existing payment level. Setting an allowed ROE will support the definition of Z-factors and events that could trigger off-ramps. It would also provide the basis for an earnings sharing mechanism if one was deemed appropriate by the Board. Without a "defined" ROE, earnings sharing mechanisms can not be developed. If resources are constrained, then VECC suggests the Board could adopt (as a short term measure) the same capital structure for OPG as used for Regulation 53/05 and an ROE equivalent to what will be approved for Hydro One Networks in its upcoming Transmission rate case.

3.2.2. Payment Structures

The Staff Paper suggests[32] that structured payments may be an appropriate means of encouraging the efficient operation of OPG's prescribed assets and/or a way to match payment methods with cost characteristics. It goes on to recommend that the Board examine the appropriateness of applying differential payment structures. In VECC's view different payment structures could result depending upon whether the objective is to:

a) Match OPG's cost characteristics (e.g., fixed payments for fixed costs),
b) Encourage OPG to operate its assets more efficiently from a technical perspective, or
c) Encourage OPG to operate its assets when most needed by the Ontario Market.

While all three objectives are desirable, VECC's submits that the last of the three objectives is the most important.

3.2.3 "Z" Factors and "Off Ramps"

The Staff recommends[33] that "within the provisions of Regulation 53/05 the Board examine the need for mechanisms to account for unanticipated events and conditions that could have a material impact on OPG's payments and/or costs recovery in the first proceeding for possible application as an adjustment to the base payments in the first order or for application to the results of future proceedings". In VECC's view, Staff's recommended approach would lead to a

[32] Section 6.2, first paragraph
[33] Section 6.3, second paragraph

review of the applicability of the planning assumptions underlying the existing payment scheme and the conclusion that OPG is already experiencing unanticipated events (e.g., the decision not to return the Pickering units to service). This, in turn, would lead to a COS-type review of a number of key issues if the base year payments are to be adjusted for "known" Z-factors.

Also, it is not at all clear how Z-factors and Off-Ramps could be applied going forward unless:

a) There is an "approved" cost base which could be used to define materiality (Note: In the first generation electricity distribution PBR scheme a material impact was defined as an expense that represented 0.25% of a utility's net assets), and
b) There is an "approved" ROE to use as a benchmark for overall financial performance.

Finally, VECC notes that Z-Factors and Off Ramps are not truly a "generic issue" but rather one that only needs to be addressed under an Incentive Regulation model.

3.2.4 Service Quality Indices

VECC agrees that appropriate service quality indicators (SQIs) must be established for OPG's prescribed assets. This should be one of the matters dealt with in the first proceeding.

3.2.5 Other Issues

In its earlier comments[34], VECC identified the annual variation in hydraulic output (due water flow variability) as an issue that needed to be addressed. The Staff Paper has not addressed or even acknowledged this issue. VECC continues to believe that this is an important issue and that the payment scheme established for OPG should ensure that OPG is neither rewarded nor penalized for production variations that are due to Mother Nature as opposed to OPG management. VECC submits that this issue needs to be addressed in the first proceeding, regardless of the regulatory model adopted.

<u>Conclusions</u>: *a) The first proceeding must deal with the issue of ROE, although it may not have to entail a comprehensive review of the issue.*

b) Payment structure design should focus on ensuring OPG is incented to maximize generation and make it available to the Ontario market when most needed.

c) Z-factors and Off-Ramps deal with departures from accepted plans/results. The planning assumptions underlying the existing payment scheme (per Regulation 53/05) are not an appropriate base on which to set Z-

[34] VECC's June 6, 2006 Comments

factors and Off-Ramps. Development of appropriate Z-factors and Off-Ramps will require some form of COS review.

d) The first proceeding should include a consideration of appropriate SQIs for OPG.

e) The first proceeding should include a consideration of mechanisms to ensure that both consumers and OPG are held harmless from the impact of water flow variability.

4.0 OEB Staff Recommendations

4.1 General Approach

Board Staff has recommended[35] that an incentive regulation formula be applied to the existing base payments while at the same time laying the foundation to permit a full cost-of-service review in the future. Board Staff's selection of Incentive Regulation or COS is not based on concerns regarding the resources and timing concerns associated with COS nor with the information asymmetries attributed to COS – all of which they acknowledge[36] could be adequately addressed. Rather the preference for Incentive Regulation is based on the belief[37] that a COS proceeding will not (at this time) be able to address the question of whether OPG's prescribed asset costs and earnings are reasonable. For similar reasons, Board Staff has also concluded that a COS-type approach should not be used for purposes of setting the base payments of an Incentive Regulation formula and that the existing payments should be used instead.

This recommendation is the same as that presented in the Board Staff's June 20th, 2006 Discussion Paper. At that time, VECC indicated that this was not its preferred approach. However, VECC acknowledged the practical limitations that facing the Board and other parties (e.g., timing, resources and data availability) and indicated that the Staff's approach could be acceptable if a number of key issues could be addressed. The July 6th Staff Paper has failed to address (or even acknowledge) a number of these issues as noted in Section 3.1.1 above. The inability of Board Staff to adequately address VECC's concerns, combined with the subsequent comments of other parties[38] and further consideration by VECC, has lead to VECC to conclude that it can not support the Staff Proposal. The specific reasons have been identified in the preceding comments and are summarized below:

a) For an Incentive Regulation model to meet the Board's statutory obligations and regulatory goals, the starting year revenue requirement (i.e., the payments) must be just and reasonable. In the case of OPG, there is strong

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[35] Section 7.1, last paragraph
[36] Section 7.1, fourth paragraph
[37] Section 7.1, fifth paragraph
[38] Notably OPG, PWU, Energy Probe and Hydro One Networks

evidence to suggest that the existing payments do not reflect current conditions and, therefore, are not appropriate. Indeed, VECC does not believe that, under the Staff proposal[39] the Board will be able to ensure in its first order the recovery by OPG of the various costs referred to in Regulation 53/05. Any attempts to "correct" the existing payment levels will (effectively) lead to a COS type review of the associated issues.

b) The application of Incentive Regulation is typically preceded by a period of COS regulation. It should be noted that when the electricity industry was first unbundled, the OEB was faced with a similar situation with respect to Hydro One Networks (i.e., formal regulation for the first time, limited availability of historical data, etc.) and undertook a cost of service type review of both the transmission and distribution businesses (RP-1998-0001). Furthermore, in response to an application by Hydro One Networks (then OHSC) that incentive regulation be adopted for the transmission business the Board specifically stated (Decision RP-1998-0001, page 44) the following:

   > "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. A solid foundation of historical capital and OM&A spending is required before a PBR program can be established for transmission."

   VECC sees considerable similarities between the situation that existed in 1998/99 with respect to Hydro One Networks and where the OEB finds itself today with respect to OPG.

c) There is insufficient information to establish a reasonable productivity factor for OPG. The same concerns about lack of historical cost data for OPG to support a COS-type approach also apply to the necessary cost data to support productivity analyses. In addition, VECC seriously doubts whether the Board will be able to undertake the necessary studies to establish an appropriate productivity factor through benchmarking.

d) The potential "economic efficiency" gains of adopting Incentive Regulation are lost if the model does not use appropriate base year values and escalation factors. Both of these are lacking under the Staff's recommendation.

e) Similarly the design of Off-Ramps and Z-Factors (key components of an Incentive Regulation model) also require that the base year values and escalation factors be appropriate.

f) While the Staff recommendation acknowledges the need for a full cost of service review in the future there is no proposal as to when this would occur nor a plan of when and how the Board would reach the point where such an exercise could occur. VECC is concerned that, without such a plan, OPG and its stakeholders will find themselves locked into what was originally supposed to be a temporary scheme for a number of years.

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[39] Section 7.1, last paragraph

4.2 Specific Recommendations

The following comments are meant to address the specific Staff recommendations in Section 7.2 of the Paper.

4.2.1 Financial Reporting Framework

VECC agrees that there is need to establish an appropriate accounting and reporting framework for the prescribed assets. The Board should work to establish such a framework as soon as possible and OPG should start reporting its results in the defined format as soon as practical. OPG should also be encouraged to restate historical information in a similar format if possible. Having said this, VECC believes that it should be possible to undertake a constructive and reasonably effective review of OPG's costs based on the management accounting systems currently employed by OPG.

On a related matter, VECC raised in its June 6th comments the issue of corporate cost allocation and wishes to reiterate that is considers this to be an important issue that must be dealt with in the first proceeding if the Board is to clearly establish the scope of the "costs" that are to be recovered through the regulated prices.

4.2.2 Hydraulic Dispatch and Overall Payment Structure

VECC supports Staff's proposal for the development of incentive mechanisms that would encourage OPG to dispatch its prescribed hydraulic resources in a manner that best meets the needs of the Ontario market. However, as noted in VECC's June 6th comments, there is also a need for such incentive mechanisms (and indeed the payment scheme for hydraulic overall) to recognize that water flows will vary from year to year and OPG should be not be penalized or rewarded simply as a result of such variations.

Provided mechanisms are developed to ensure OPG contributes to market efficiency, VECC would not assign a high priority to the development of separate mechanisms aimed at improving OPG's operating efficiencies for the first Order. Payment structures based on output (i.e., MWhs) will, to some extent, naturally drive such efficiencies.

4.2.3 Productivity Factors

VECC does not believe that an appropriate productivity factor can be established for OPG through benchmarking studies. As noted above, there are no other stand alone generators that are regulated and VECC doubts whether the prerequisite data required for such studies can be obtained from regulated utilities with generation as part of their integrate operations or individual generators operating in competitive markets.

4.2.4 4.2.4 Service Quality Indicators

The Staff Paper appears to suggest[40] that consideration of SQIs can be left until subsequent proceedings. VECC disagrees and submits that this issue should be one to the matters considered in the first proceeding.

4.2.5 Duration of First Order

If the Board decides to adopt an Incentive Regulation model, as recommended by Staff, then VECC's preference is that the first order last no more than 2 years. This should provide sufficient time to develop the necessary cost data to undertake a full and proper cost of service review. Also, there should be a definite "game plan" developed to ensure this objective is met. In this regard, VECC agrees with Board Staff that long-term vision is required.

Overall Conclusions

a) The Board should reject the Staff Proposal to adopt an Incentive Regulation model for OPG using the existing payments as the starting point.
b) The Board should also reject the use of an Incentive Regulation Model based using COS to establish the base year payments.
c) The Board should adopt a phased COS-type approach as the initial regulatory model for OPG.
d) The full consideration of traditional COS issues should occur over 2-3 years.
e) The scope of the first proceeding should be managed by dealing with certain issues through written as opposed to oral processes and the Board pre-specifying a number of issues that would be held over to future years. For these later issues pre-determined values could be used in the first rate order. For example, OPG's audited results could be initially used to establish the opening rate base; the capital structure per Regulation 53/05 could be adopted as an interim measure; the same ROE could be adopted for OPG as approved for HON-transmission; and OPG's actual debt costs (as audited) could be used.

VECC appreciates the opportunity to comment. If there are any questions or if clarification is required regarding the Comments please contact either Bill Harper (416-348-0193) or myself (416-767-1666).

Yours truly,

Michael Buonaguro
Counsel for VECC

[40] Section 7.2, Item (j)