AMPCO
Association of Major Power Consumers in Ontario

September 29, 2006

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

Dear Ms Walli:

Re: EB-2006-0064 – Proposed Regulatory Process for Setting Payment Amounts for Prescribed OPG Assets

The OEB staff's discussion paper on regulatory options and the subsequent oral presentations provided opportunities for interested parties to respond to the principal concerns raised by OEB staff with regard to the regulatory options under consideration. The purpose of this note is to summarize AMPCO's interpretation of parties' responses to the concerns raised by OEB staff.

Cost-of-Service

OEB staff point out that this approach provides transparency but brings with it some significant other problems:

- Cost – this approach is resource and time-intensive for the OEB, the regulated entity and intervenors.
- Misdirected Incentives – by its nature Cost-of-Service encourages a regulated entity to exaggerate its costs.
- Information Asymmetry – the regulated entity has an information advantage over all other parties.

OPG dismisses concerns about cost: "Regulatory efficiency is a secondary consideration to effectiveness". Those promoting a Cost-of-Service approach suggest a possible solution to the problem of cost would be to spread the Cost-of-Service review out over a number of years (response to Question 6). This would allow the OEB to deal with a major element each year. This, of course, would require that some agreed-upon prices be in place until this review is completed. To this end supporters of a Cost-of-Service approach recommend that the current payment arrangements (from Regulation 53/05) be used. This recommendation results therefore in an approach that is almost identical to that proposed by OEB staff (presentation p.2), AMPCO (presentation p. 3) and the School Energy Coalition.

None of the supporters of Cost-of-Service deal with the Misdirected Incentives issue, which Board staff identifies as a major shortfall of Cost-of-Service regulation. Cost-of-Service supporters dismiss the Information Asymmetry problem: "The OEB has demonstrated the ability to address and work through information shortfalls", notwithstanding Board staff acknowledgement of limitations on the OEB's ability to gather information: "Asymmetries can be addressed in part, but not completely, by instruments such as procedural orders and filing guidelines that ensure information disclosure" (discussion paper p.15).

In summary, none of the proponents of a Cost-of-Service approach address problems with the approach identified by Board staff in its evaluation of the alternatives.

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Regulatory Contracts

OEB staff has identified major problems with this approach:

- End-state Market – the approach assumes a particular end-state market model.
- Transparency – by the nature of bilateral contracts this approach lacks transparency.
- OEB mandate – it places the OEB between contracting entities, raising the question of the effectiveness of the Board in carrying out its regulatory mandate.
- Complexity – by its nature the process is complex

The OPA presentation recommends Regulatory Contracts based largely on its apparent desire to promote "market evolution", despite the OPA's acknowledgement that: "this [proceeding] is not the forum to decide on future evolution of electricity sector in Ontario", and despite the critical need for a clear understanding of a future market structure to any justification of such an approach.

On transparency, the OPA "recommends as much transparency as possible in a negotiation process". This is hardly an acceptable basis for protecting the interests of consumers. The OPA presentation does not address the serious problem of how the OEB is to fulfill its mandate as regulator when contract terms are negotiated bilaterally. While the OPA "acknowledges that regulatory contracts option involves complexity", it proposes no solution. Like the OPA, the presentations of TransAlta and the Electricity Market Investment Group are primarily concerned with market evolution and do not deal directly with problems raised by OEB staff.

The IESO proposal appears not to be a distinct contractual approach in the sense of the OPA proposal but rather a simple way of distributing rebates arising from regulated rates in the current market structure. It would still require the OEB to set payment amounts but adds an obligation for the Board to regulate volumes as well. The proposal seems to suggest that setting payment amounts could start by using the prices that are currently in place with adjustments for changes in costs over time (presentation p.5). While this proposal is not inconsistent with Board staff proposals, it has the added feature that the benefits of fixed payment amounts could be distributed via contracts-for-differences. It is not clear what would be gained by such an approach.

Incentive Regulation

The major problems associated with incentive regulation are:

- OPG government-owned – may not respond to incentives in the same way as a private company whose shareholders might benefit from cost reductions.
- Productivity Determination – assumed productivity improvements must be based on a realistic assessment of the potential of each type of production process.
- Revenue-maximizing versus cost-minimizing incentives – may be a greater need for cost-minimizing incentives.

Various presentations raise the question of whether or not OPG's ownership might affect its responsiveness to incentives. There is an apparent strong interest on the part of the shareholder that OPG's net earnings should cover its interest obligations to the OEFC and that any net earnings surplus to this requirement should be dedicated to pay down electricity debt held by the Ontario Electricity Finance Corporation. This is important to consumers but may not be adequate to encourage a strong response by OPG or its shareholder to incentives that increase OPG's net income. The OEB staff presentation does not effectively deal with this issue.

The Board staff paper recognizes that the determination of appropriate productivity factors will be complex: available data may be "insufficient to support a productivity analysis", requiring "other methods such as 'benchmarking' … to set a productivity factor". The Board staff proposal nevertheless proposes a formulaic approach to incentive regulation. While the latter approach may be appropriate in the case of electricity or gas distribution companies (recognizing that Ontario has in fact little practical experience with this form of regulation even in these industries that are relatively well-understood), it may not fit well with a generation company with significantly different production processes. The form Incentive Regulation might take therefore will not be evident until further work is undertaken on the subject of benchmarking. This OPG is required to do in any case under its Memorandum of Agreement with its shareholder and could provide a useful starting point for the resolution of the productivity problem.

On the nature of incentives to be considered, the OEB staff paper notes that, while OPG already has incentives built in under Regulation 53/05 to increase production, there are questions as to the effectiveness of these incentives either to maximize revenues, to minimize costs or otherwise promote greater efficiency. The relative effectiveness of revenue-increasing versus cost-reducing incentives was not dealt with in the Board staff's presentation.

Conclusions

The Board staff second discussion paper raises a number of concerns with each approach under consideration. Those promoting Cost-of-Service have not effectively addressed these problems. Similarly, those promoting Regulatory Contracts approach have not indicated how problems with that approach might be resolved. The Board staff recommendation of a modified Cost-of-Service combined with some form of incentive regulation remains the approach that is most practical in the near term. However, in our view, Board staff seem to suggest moving too hastily to a formulaic approach to incentive regulation without a detailed examination of the effectiveness and implications of existing incentives under Regulation 53/05. The implementation of incentive regulation, such as is described in the Board staff paper, is likely to be more complicated than has been assumed.

Yours truly,

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President

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