

September 29, 2006

VIA COURIER AND EMAIL

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

Dear Ms. Walli:

**EB-2006-0064 - OPG's Final Submission -
Setting Payments for Output from OPG's Prescribed Generation
Assets**

Enclosed please find three copies of Ontario Power Generation Inc.'s final submission following the oral presentations on September 15, 2006. An electronic version in searchable Adobe Acrobat (PDF) format has also been submitted by e-mail to 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
Barbara Reuber



ONTARIO ENERGY BOARD

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

AND IN THE MATTER OF a process to determine the methodology by which the Ontario Energy Board will determine payment amounts under Section 78.1 of the *Ontario Energy Board Act, 1998* for the prescribed assets of Ontario Power Generation Inc.;

FINAL SUBMISSION OF ONTARIO POWER GENERATION INC.

RE: OEB SESSION – SEPTEMBER 15, 2006

1. Introduction

In this submission, Ontario Power Generation Inc. (OPG) addresses matters that arose during the Ontario Energy Board's (OEB or Board) session concerning the form of regulation for OPG's prescribed generation assets on September 15, 2006 (the Presentation). OPG has previously submitted written materials supporting its position that the OEB should adopt a limited issues cost of service (CoS) approach to establish the payment amounts for the prescribed facilities.

2. Summary Of OPG Position

Before providing its comments regarding the Presentation, OPG felt it would be helpful to summarize its position. In this regard, it is OPG's submission that a CoS methodology will best allow the Board to meet its statutory obligation to set just and reasonable payment amounts. A CoS review is necessary at this time to establish the appropriate base from which

the Board may, at some future time, move to other regulatory methodologies. While other methodologies remain ill-defined, the CoS methodology is well-defined and familiar to the Board. It will provide the appropriate starting point which is critical as the Board assumes the responsibility for regulating OPG's prescribed facilities.

3. Core Consensus Regarding Cost Of Service

During the Presentation, there appeared to be consensus among all parties that some type of CoS review by the Board is required to establish the level of the payment amounts. While this had always been acknowledged by the CoS group and OPG, other parties also indicated the need for the Board to take this step. For example, Board Staff, AMPCO and Schools all agreed that a modified CoS approach is necessary, but stated that this should occur once "more information" is available. (See September 15, 2006 transcript, AMPCO pg 13 lines 11-13 and pg 23 lines 2-9; Board Staff pg 31 lines 15-22, and pg 45 lines 15-22; Schools pg 42 lines 3-9.) OPG submits that all relevant information will be available through the limited issues CoS proceeding it has proposed. EMIG, OPA and IESO, while focusing their remarks on regulatory contracts (RC) as the desired form of regulation, also agreed that CoS could be used to set the payment amounts under RC. (EMIG pg 103 lines 24-25; OPA pg 112 line 20 and pg 113 line 27 to pg 114 line 1; IESO pg 123 lines 16-20 and Slide 8 last bullet.)

The existence of a consensus on the need for some type of CoS review raises two questions: is there a need for any other regulatory approach beyond CoS and, if an additional approach is needed, what is the correct sequence for implementing CoS and any additional approach? OPG submits that there is no need for another regulatory approach in addition to CoS at this time and, therefore, the sequencing issue is moot. A limited issues CoS proceeding covering a 21 month test period from April 1, 2008 to December 31, 2009 will allow the Board to set just and reasonable payment amounts and provide OPG with incentives to control costs. Necessary and appropriate operational incentives can be addressed by structuring the payment amounts to include a suitable variable component based on output (i.e., \$/MWh) and incorporating a market-based incentive for peaking hydroelectric.

Once the Board has established a base for the payment amounts through a CoS review and OPG's prescribed facilities are on a clear path forward following the completion of the Niagara tunnel project and with major decisions having been taken regarding nuclear refurbishment, consideration of other regulatory approaches may be appropriate.

4. Concerns Regarding Incentive Regulation

The proponents of incentive regulation (IR) have claimed that the IR model will provide efficiency incentives and be easier to implement. In making these claims, they have glossed over the substantial difficulties involved in developing appropriate escalation and productivity factors for OPG's prescribed assets. In addition, because of its short duration, the IR proposal currently advocated by Board Staff will be ineffective in encouraging efficiency.

Even if the Board expects to move to an IR approach eventually, the correct sequencing is for the Board to follow its usual practice of conducting a CoS review before moving to IR. Otherwise, the Board cannot be satisfied that the base used for IR will produce payment amounts that are just and reasonable. The Board cannot simply presume that the interim payment amounts are adequate. The interim payment amounts were determined by the Government for use during the interim period before the Board assumes its regulatory mandate.¹ The regulatory task for the Board is to determine just and reasonable payment amounts to come into effect once the interim period ends. Without a proper starting point, the Board will have no assurance that any IR mechanism it imposes will actually generate the incentives or behaviours that are desired.

5. Concerns Regarding Regulatory Contracts

The presentations and statements of those supporting regulatory contracts (RC) during the Presentation made it clear that the purpose of the RC approach is not to set payment amounts at all, but rather to deal with market issues. For example, in its presentation, EMIG made reference to what it termed the Board's "obligation" to the market. (See September 15, 2006 transcript, EMIG pg 96 lines 15-18, and pg 99 lines 11-20.) OPG submits that using the Board's authority to set payment amounts for the output of the prescribed assets in the manner proposed by the proponents of an RC approach would be contrary to the legislative purpose for which these assets were placed under OEB regulation.

¹ While OPG and others provided information to the Government, it was the Government that ultimately decided what numbers to include in O. Reg. 53/05. Characterizing this process as a "negotiation" or the resulting ROE or payment amounts as being based on "a third party recommendation" is simply inaccurate. (See September 15, 2006 transcript, Board Staff pg 12 lines 5-10, AMPCO pg 24 lines 14-23 and pg 38 lines 9-21.)

Through the market power mitigation agreement (MPMA) and subsequent rebate mechanisms, Ontario has substantial experience allowing OPG generation to receive market prices and then providing rebates based on a predetermined cap. In deciding to regulate the prescribed assets, the Government adopted a different approach under which prices would be established on a cost rather than a market basis. The Government further determined that this would be done through independent regulation by the Board, rather than through contract negotiation with the OPA.

Moreover, there is no need to graft a contract process on to the regulatory process. With respect to market integration, the prescribed facilities continue to be subject to the market rules and are generally operated in the market in same way they were before they were regulated. The baseload characteristics of these facilities largely determine how they operate. With the exception of some peaking capacity at the hydroelectric facilities, the prescribed hydroelectric and nuclear facilities are offered into the market so as to run at their maximum available capacity.

The limited amount of peaking water that is available at the hydroelectric facilities is used in a manner that maximizes its value to the Ontario electric system. The current hydroelectric incentive mechanism encourages this use by providing OPG with market-based pricing for output above 1900 MW. Under a CoS approach the Board will be able to structure the payment amounts to continue to provide OPG with those operational incentives it determines are necessary and appropriate.

The claim that a contract process is needed to place OPG's prescribed facilities on a level playing field with other generators in the market is not well founded. Other generators are not regulated. Market generators receive market revenues and profits. Contracted generators entered into voluntary contracts to further their business interests. They were able to make their own assessments about whether the revenue stream proposed was sufficient to compensate them for their investment and risk. They have not been subject to a public, transparent negotiation process with cost parameters set by the OEB and a subsequent OEB review of the negotiated contracts as is being suggested for OPG.

Contrary to the perception of some proponents of the RC methodology, there are no market power issues with respect to these facilities. The prescribed facilities rarely set price; they are price takers. Like all OPG units they operate under a licence condition that requires them to

offer all available capacity into the market. OPG's actions are scrutinized by the Market Surveillance Panel and since market opening there has never been even an allegation, much less a finding, of supply withholding or dumping. Therefore, there is no basis to support adopting the RC approach in order to address market power.

6. There Will Be Sufficient Information For Cost Of Service Regulation

Whenever the Board begins to regulate in a new area, it embarks into previously uncharted waters. As the representatives of the CoS group made clear, however, the Board successfully initiated CoS regulation for Hydro One, the IESO and the OPA. The fact that OPG is a regulated generator does not preclude CoS regulation. There are many utilities in North America with nuclear and hydroelectric generating stations that are regulated under CoS. The task of applying CoS to OPG is challenging, but it is neither unprecedented nor inordinately complex. In fact, compared to the approaches suggested by others, it is relatively straight forward.

Board Staff, with Schools support, has proposed that OPG file quarterly information and that the Board use this information to assess the need for changes to the payment amounts. In OPG's submission, quarterly information is too limited and too volatile a basis on which to develop regulatory principles or oversight. Further, Board Staff, AMPCO and Schools all propose that the Board can determine whether to change the payment amounts based on these suggested quarterly filings. (See September 15, 2006 transcript, Schools pg 21; Board Staff pg 28 line 15 to pg 29 line 3; AMPCO pg 25 lines 3-6 and pg 27 lines 16-9.) Schools specifically states that "if it looks like – as the information is being filed over the next couple of years... OPG is not getting sufficient amounts of money to do the job well, then the Board can respond with a process at that time." (Schools pg 21 lines 14-17.) Adopting this approach would introduce an unacceptable level of regulatory uncertainty. It would be impossible for OPG to operate and make forward-looking investment decisions in such a "regulate-as-you-go" environment.

7. OPG Has Proposed A Reasonable Process For Implementing A Limited Issues Cost Of Service Approach

OPG has suggested a workable approach for a limited issues CoS proceeding. OPG's proposal clearly sets out the best-defined process that will lead to the establishment of just

and reasonable payment amounts in a timely manner. In contrast, both the IR and RC approaches remain undefined.

For example, EMIG, a proponent of RC, proposes that the OPA and IESO establish a workshop process to work out the details of the regulatory contract methodology. Not only does this suggestion limit the role of the Board, OPG (the party most affected by the outcome) and other stakeholders, it emphasizes the fact that if the Board were to select the RC methodology, it would be doing so before the methodology had been fully defined. The proponents of IR and RC still have not explained how their proposals can be practically applied to produce just and reasonable payment amounts.

For IR, some of the necessary elements that remain unexplained include:

- how cost changes since the setting of the interim payment amounts will be recognized;
- how, in the absence of establishing an up-to-date base including a target ROE, the Board would make a determination on the suitability of continuing with the interim payment amounts;
- how the provisions of O. Reg. 53/05 which require cost adjustments, such as the variance and deferral accounts, will be addressed;
- how a one-year period will encourage efficiency; and
- what events will trigger “Z” factors and “off-ramps.”

For RC, the unanswered questions include:

- why a contract is necessary given that these are prescribed facilities subject to regulation;
- how the initial payment amounts will be established and what metrics the Board will use to determine that they are just and reasonable;
- how the Board can develop a negotiation process that is both efficient and allows all parties to participate;
- who the counter party for the contract is; and
- the scope of the Board’s review of the negotiated contract.

In OPG’s submission, it would be inappropriate for the Board to select IR or RC in the face of these and other unanswered questions.

8. The Payment Amounts Should Be Structured To Drive Efficiency

Many of the proponents of regulatory approaches other than CoS have attempted to justify their proposals on the basis that they will encourage efficient operation at OPG. The mechanism to accomplish this goal under a CoS methodology is through the structure of the payment amounts. The payment amounts should provide meaningful economic incentives that match OPG's costs and encourage efficient action in areas where OPG can respond. Thus, OPG submits that the Board should adopt a payment structure that includes both fixed and variable payments to recognize the many fixed costs associated with the prescribed facilities. The Board also should include market-based incentives that continue to encourage OPG to make the most economic use of the peaking capacity available at OPG's prescribed hydroelectric facilities. There is no need for additional incentives for nuclear facilities because an incentive to operate these facilities at their maximum available capacity is inherent in their design, i.e., they are designed to operate continually at full capacity, and is reinforced by having a suitable variable component in the structure of their payment amounts.

9. Conclusion

As this process concludes, OPG submits that, at this time, CoS is the only practical approach to addressing the task before the Board. Without establishing a firm and appropriate basis for regulation through a review of OPG's anticipated costs and revenues, the Board cannot fulfill the regulatory responsibilities assigned to it by the legislation. OPG has proposed a method of limiting issues for the initial CoS proceeding that is practical, efficient and transparent.

All of which is respectfully submitted,

for Andrew Barrett



Vice President, Regulatory Affairs and
Corporate Strategy
September 29, 2006