Coal Displacement Directive Interpretive Guideline

On June 15, 2005, the Minister of Energy directed the Ontario Power Authority (the "OPA") to enter into contracts with certain generators pursuant to ss. 25.32(4) and (7) of the *Electricity Act, 1998* (the "Directive"). A copy of the Directive is attached.

These contracts are subject to approval of the Board. According to the Directive, the Board's approval is to be "based on a review of the reasonableness of the contracts in accordance with this Directive." If these contracts are approved, the legal effect is that costs incurred by the OPA under the contracts will be passed through to electricity customers.

The Board expects that the OPA will apply for one or more contract approvals. The issues raised under the Directive are unique. In order to provide some guidance on this matter, the Board believes it is appropriate to set out its approach to applying the Directive.

As will be further elaborated below, the Board is of the view that there are three necessary threshold components that the OPA must demonstrate in order for the contracts be considered reasonable in light of the Directive: First, the OPA must demonstrate that the contracts result in the procurement of electricity supply or capacity; second, that the supply or capacity acquired under the contract must displace coal-fired generation; and third, the OPA must demonstrate that the economic value of the contracts is reasonable when compared to the economic value associated with the Clean Energy Supply Contracts entered into by the OPA in accordance with the direction issued to the OPA on March 24, 2005 (the "CES Contracts").

Each of these components is described in greater detail below.

1. Procurement Contracts

The Directive is made pursuant to ss. 25.32 (4) and (7) of the *Electricity Act, 1998*. These sections are transitional and cease to have effect following the Board's review and approval of the OPA's initial procurement process. It is therefore helpful to outline the relevance of the Board approved procurement process and the role of the transitional provisions authorizing the Directive.

Under the *Electricity Act, 1998*, the OPA is required to file with the Board for approval an Integrated Power System Plan ("IPSP"). The IPSP is the plan by which the Government's goals respecting electricity supply and demand management are to be met. In addition, the OPA is to file with the Board for approval "appropriate procurement processes for managing electricity supply, capacity and demand in accordance with its approved integrated power system plans." After the procurement process is reviewed and approved by the Board,

the OPA may enter into "Procurement Contracts" in accordance with the procurement process.

Procurement Contracts are defined in ss. 2(1) and 25.32 (1) *Electricity Act, 1998* as contracts for "(a) electricity supply or capacity, including supply or capacity to be generated using alternative energy sources, renewable energy sources or both; or (b) measures that will manage electricity demand or result in the improved management of electricity demand on an on-going or emergency basis."

Under ss. 25.20(4) of the *Electricity Act, 1998*, Procurement Contracts "shall be deemed to be approved by the Board" and their costs are automatically passed through to consumers. In other words, unlike other goods and services that are acquired by the OPA or other utilities, goods and services acquired under OPA "Procurement Contracts" are not subject to prudence reviews or other types of regulatory review to ensure that they provide value to rate-payers.

As a result, following the Board's review and approval of an IPSP, and the OPA's procurement process, the OPA may enter into Procurement Contracts. Costs incurred under Procurement Contracts are automatically passed through to electricity customers without further regulatory review.

The Directive is provided pursuant to transitional provisions in the *Electricity Act, 1998* pending the development and approval of the IPSP and procurement process. Specifically, ss. 25.32 (4) and (7) provide:

> s. 25.32 (4) … the Minister may direct the OPA to assume, as of such date as the Minister considers appropriate, responsibility for exercising all powers and performing all duties of the Crown, including powers and duties to be exercised and performed through an agency of the Crown,
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> (a) under any request for proposals, draft request for proposals, another form of procurement solicitation issued by the Crown or through an agency of the Crown or any other initiative pursued by the Crown or through an agency of the Crown,
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> (i) that was issued or pursued after January 1, 2004 and before the Board's first approval of the OPA's procurement process under subsection 25.31 (4), and
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> (ii) that relates to the procurement of electricity supply or capacity or reductions in electricity demand or to measures for the management of electricity demand; and
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> (b) under any contract entered into by the Crown or an agency of the Crown pursuant to a procurement solicitation or other initiative referred to in clause (a). 2004, c. 23, Sched. A, s. 36.

> s. 25.32(7) The OPA shall enter into any contract following a procurement solicitation or other initiative referred to in clause (4) (a) if directed to do so by the Minister of Energy, and that contract shall be deemed to be a procurement contract that was entered into in accordance with any integrated power system plan and procurement process approved by the Board.

According to these provisions, the Minister may direct the OPA to enter into in contracts that relate to "the procurement of electricity supply or capacity or reductions in electricity demand or to measures for the management of electricity demand." These contracts are deemed to be "Procurement Contracts." In other words, pending the completion of the IPSP and the procurement process, the OPA may enter into Procurement Contracts if directed to do so by the Minister. Again, because the contracts are Procurement Contracts, costs incurred thereunder by the OPA are automatically passed through to consumers without additional regulatory review.

Costs incurred under Procurement Contracts are therefore a unique species of utility costs that are passed through to consumers without substantive regulatory review. The only approval processes contemplated in the *Electricity Act, 1998* are (i) the Board's review and approval of the process by which Procurement Contracts are carried out; and, (ii) in the period prior to the procurement process approval, the Procurement Contract must comply with any applicable Ministerial directive.

As a result, in order to meet the terms of the Directive, the OPA will have to demonstrate that the contracts entered into with generators relate to the procurement of electricity supply or capacity.

As is clear from the definition of Procurement Contracts in the *Electricity Act, 1998*, there are three types of contracts that may conceivably fit within the definition of Procurement Contracts: contracts for capacity, contracts for supply and contracts for demand management. In this case, the generators do not provide demand management. As a result, to fall within the terms of the Directive, the contracts presented to the Board must be contracts which relate to the procurement of electricity supply or capacity.

2. Displacing Coal-Fired Generation

The Directive provides that the objective of the contract is to displace *coal-fired* generation. According to the Directive, "with the objective of displacing coal-fired generation, I hereby authorize and direct the OPA to negotiate and, subject to achieving the objective of displacing coal-fired generation and subject to approval by the Ontario Energy Board, execute and deliver definitive contracts for the projects listed below [i.e., the generation projects]."

As a result, according to the Directive, the displacement of *coal-fired* generation is both the objective and the necessary condition to the contracts. This means that, under the contracts, the generators will be paid to provide power to the OPA as a way to *displace coal-fired* generation. Thus, in order to meet the directive, it must be demonstrated that the contracts will lead to the displacement of coal-fired generation.

3. Reasonable Cost by Reference to Economic Value Associated with CES Contracts

The Directive states that the OPA shall enter into contacts "with the objective of displacing coal-fired generation, possibly in combination with other initiatives to be undertaken by the parties, at a reasonable cost to Ontario customers." There are two components of this part of the Directive. The first is the reference to "other initiatives undertaken by the parties"; the second is the reference to "reasonable cost to Ontario customers."

With respect to other initiatives, the Directive also states that "In pursuing these contract negotiations, the OPA may seek to negotiate other matters with the parties that would provide benefits to Ontario electricity customers or to the electricity system." It should be noted however, that goods and services that do not relate to the procurement of electricity supply or capacity are not obtained under Procurement Contracts. Although the Directive authorizes the OPA to enter into negotiations for goods and services outside of Procurement Contracts, it does not purport to suggest that these other goods and services are subject to the same regulatory treatment as are goods and services acquired pursuant to Procurement Contracts. As a practical matter, this means that the automatic pass through of costs incurred under Procurement Contracts does not apply to costs incurred under initiatives that do not relate to the procurement of electricity supply or capacity.

With respect to the reasonableness of costs, the Directive states: "As a measure of reasonableness, reference should be had to the economic value associated with the Clean Energy Supply contracts, entered into by the OPA in accordance with the direction issued to the OPA on March 24, 2005 [i.e., the CES Contracts]". The Board understands that the CES contracts have been structured to incent contract holders to dispatch their gas-fired generation plants when it is economic to do so by reference to the price of gas; the CES contracts do not require or incent the contract holders to dispatch their plants to displace generation from coal-fired generators. The Board will expect the OPA to address these differences when it provides evidence about the reasonableness of the new contracts and how the economic value of these contracts compares to the value of the CES contracts.