**EB-2006-0064**

# Ontario Energy Board

## Setting Payments for Output from Ontario Power Generation's Prescribed Generation Assets

## Comments on Board Staff Discussion Paper dated July 6, 2006

**Submitted: July 26, 2006**

## Overview

The Electricity Market Investment Group ("EMIG") appreciates the early consultation process which the Board has initiated regarding payment amounts for OPG prescribed generating assets. This objective is important, and the issues are complex. EMIG submits that further specific payment mechanism analysis is required as the next step in the process. Amongst other issues, key questions regarding the desired behaviour of OPG to be incented, and the consequences of that behaviour on Ontario's electricity hybrid policy model, needs to be carefully considered. EMIG submits that the Board has the jurisdiction and the obligation to consider the implications of any mechanism on the hybrid model policy objectives, and in particular on the competitive generation and market objectives.

EMIG concurs with the conclusions of the London Economics International LLC paper of May 19, 2006, that regulated contracts are the most effective mechanism for determining prescribed generation asset payments. The Board Staff paper would benefit from a more in-depth analysis of this model, and the examples of regulated contracts which exist elsewhere.

EMIG requests that a further Board Staff paper be developed, to acknowledge and address the concerns raised by EMIG and other parties. Further, given the importance of these issues, EMIG strongly urges the Board to hold a technical conference with Board members present, to determine the mechanism before proceeding to consider the mechanics.

## EMIG's Objectives

EMIG is a coalition of companies that represent a significant portion of the private-sector investment in Ontario's electricity marketplace. Members include:

- Constellation NewEnergy Canada Inc.
- Constellation Energy Commodity Group Inc.
- Coral Energy Canada Inc.
- Direct Energy Marketing Limited
- EPCOR Utilities Inc.
- Invenergy Canada
- Ontario Energy Savings L.P.
- Sithe Global Power LLC
- Universal Energy Corporation

EMIG works cooperatively with the Province, agencies and stakeholders to:

- support the continuing evolution of the Province's electricity hybrid policy model, with particular emphasis on supporting competitive market fundamentals and related generation investment as major objectives of the policy model of Ontario;

- develop solutions to ensure that an Ontario electricity marketplace is sustainable and effective, and will grow to meet Ontario's needs; and

- support positive changes to meet a range of customer needs for electricity pricing options and price stability.

EMIG supports the view of many regulators that competition is good public policy:

> "Competition in wholesale electricity markets is the best way to protect the public interest and ensure that electricity consumers pay the lowest price possible for reliable service".[1]

EMIG agrees that competition is the preferred method of achieving the lowest price for Ontario's electricity consumers. EMIG also acknowledges, however, that the Ontario market is in transition, and includes both regulated and competitive generation components. While the transition is in its early stages, the objective is to depart over time from a reliance on regulated generation to a greater role for privately financed and competitive generation, which meet a range of electricity customer needs.

In recognition of the early stage of the hybrid model, EMIG supported the creation of the Ontario Power Authority ("OPA") as a necessary vehicle to act as a creditworthy counterparty, to procure and contract with generation developers and private investors. Absent such a counterparty, Ontario's new generation needs could not be met, given early market conditions. However, EMIG believes that the transition of the Ontario market place must now evolve to include:

- moving from the historic monopoly generation development model (which includes non-utility generation contracts with the monopoly), whereby customers or taxpayers assume all of the risk, to a greater role for the private sector in meeting customer energy needs while assuming associated risk. This transition emphasizes the importance of the private sector assuming generation development, operation, financing and trading risks, which risks are carried collectively between many generation projects and project owners, and other wholesale and retail market participants, for the benefit of all customers;

- the development of generation competition, as multiple generation facilities produce and compete against each other on price and products;

- a market place which is open to all customers in Ontario, whereby multiple suppliers and electricity offerings are available to meet a wide range of customer needs, whether short, intermediate or long term; and

- as the market fundamentals for private investment and meeting customer needs mature, the reduction of the OPA to a procurement agency of truly last resort, and a concurrent reduction in generation risk assumption by customers and taxpayers.

Attached is the EMIG presentation to the OPG Review Committee of February 24, 2004. While this requires some updating, it provides an overview of the means by which the prescribed assets of OPG can evolve as a key component of the hybrid policy model, to meet the objectives

[1] US Federal Energy Regulatory Commission, Rule on Regional Transmission Organizations, Order No. 2000

articulated above. The role of OPG's generating assets, both the prescribed and non-prescribed assets, is critical to the overall success of the Province's hybrid market.

**Ontario's Energy Policy**

While an electricity industry end state has not been articulated, the model for Ontario has been. This has been stated by the Province on many occasions, including in its document *"Electricity Transmission and Distribution in Ontario – A Look Ahead"* (December 21, 2004):

> "[*The Electricity Restructuring Act (2004)]* institutes government policy of a hybrid electricity market. This legislation takes a balanced approach to energy policy ***by combining features of a regulated industry with those of a competitive electricity sector***" (p.2). (emphasis added)

The government has also been clear that a forward contracting market is an important component of the hybrid model and is important for Ontario consumers:

> "***Another aspect of the market that is currently underdeveloped is forward contracting.*** In many jurisdictions, large consumers and retailers are able to buy one, three or five year contracts for electricity deliveries from generators. In Ontario, when the previous government imposed a price cap on electricity shortly after market opening, they effectively killed the forward contracting marketing. Industrial consumers were basically left to the volatility of the spot market, with very little ability to hedge their risks at reasonable prices. ***Making the markets work for all consumers requires the availability of a variety of flexible products and services.***" – Ontario Energy Minister Dwight Duncan, Canada-Europe Roundtable for Business, The Ontario Club, May 31, 2005. (emphasis added)

The Province has since supported the development of forward auctions to address the market need identified by Minister Duncan. These initial auctions included the auction of OPG future power.

The Province has also codified in O.Reg.424/04, its objective that the OPA reduce its generation procurement role over time. This will only occur if the conditions for significant market-based investment are created.

EMIG submits that Board Staff and the Board must be cognizant of the stated policy objectives of the government, and the legislative framework which intends that both regulated generation (e.g. OPG prescribed assets) and competitive generation (including wholesalers and retailers) shall operate together in Ontario.

**Submission Regarding the OEB Discussion Paper**

EMIG appreciates the opportunity to make submissions regarding this important issue. The decision regarding how OPG will be incented to operate, serve customers, and participate in the regulated aspect of the hybrid market is one of the most important questions in the Ontario electricity market. Since the MacDonald Commission and the Market Design Committee, several forums have recognized the critical importance of the relationship between incentives and OPG's behaviour, the sensitivity of OPG being the dominant supplier, and related issues such as the need to have OPG contract its power in a forward marketplace, rather than selling on the spot market.

The extent of the deliberations since 1996 on this issue is a strong signal that any decision which affects or directs OPG's behaviour or output must be considered carefully, within the larger context – and complications – of the hybrid model.

EMIG strongly supports the view that the role of the Board, in determining the prescribed asset payment amount, includes full consideration of the implications which any mechanism may have on the hybrid model as a whole, to ensure that the proposed mechanism does not have any undesired or unforeseen consequences. To regulate OPG's assets within a hybrid model, with potential blinders on regarding Ontario's broader electricity reality, creates too much uncertainty and risk.

Given the importance of this issue, EMIG submits that the OEB Staff Discussion Paper be viewed as a preliminary consideration of possible methodologies, with more analysis being required of the methodologies and possible implications for the hybrid market. The paper itself, while valuable as a "Straw Man" document, raises many more questions than are answered at this stage of consultation. A closer analysis of each of the proposed methodologies, and particularly of the regulated contracts model, is required.

In identifying a preferred model, EMIG agrees with the conclusions of the London Economics report to the Board Staff. EMIG supports the regulated contract approach as the best option for OPG prescribed asset payments and for facilitating a hybrid market. This model received the least consideration in the Discussion Paper, yet it is successfully employed elsewhere (including in many important respects in Ontario right now). In contrast, the mechanism proposed by Board Staff has apparently not been utilized elsewhere on a larger generating company, for understandable reasons. Stakeholders therefore have a natural anxiety regarding what Board Staff is proposing, whether it will work, and what are the unforeseen consequences.

We note that the Electricity Conservation and Supply Task Force report of January 2004, referred to in the Discussion Paper, specifically referenced (at p.16) "regulated contracts" for heritage power. The ECSTF also recognized that OPG heritage power (now the power from the OPG prescribed assets) would continue to have significant implications for generation competition and private supply, which must be addressed.

EMIG believes that the mechanism for incenting OPG through prescribed asset payments can additionally support the Province's objectives for competitive market-based generation. The success of the competitive supply side of the market depends on a healthy forward energy contracting market, including transparent prices with significant liquidity which will signal incremental, competitive investment in energy and provide investors with tools to manager their risks. Without a market of buyers and sellers of power, investors will not have the confidence to assume risk for new incremental investments in generation, much less major new generation that isn't financed through OPA (customer-guaranteed) contracts. The availability of a robust transparent forward power price curve, which supports forward tracking and enables the discovery of market opportunities, is realistically only possible if the output from OPG's prescribed assets is available for forward contracting. Continued unavailability to the forward market of OPG prescribed asset power, which power is over 40% of the overall Ontario supply, will dramatically dilute (as it does now) the market, and raise many questions regarding its negative effect on other generating assets (as it does now).

Regulated contracts also provide a comparable payment mechanism and potential level playing field with other generation investors in Ontario, thereby bringing transparency to the market overall and increasing investor confidence. The questions raised in the Board Staff paper have not yet addressed these and related issues.

Interestingly, the Board already has some experience in reviewing regulated contracts and asset payment principles. The Board's decision with respect to Lennox Generating Station must-run contract considered a number of the contract elements which would likely be considered in a regulated contract for OPG prescribed assets. Similar regulatory contracts or government approved mechanisms exist in Alberta and elsewhere.

If the OPA is to truly become a procurer of last resort, the model for setting payments chosen by the OEB must be sensitive to the need for market-based investment to grow over time. If not, this policy objective will not be met. We note that this objective is enshrined in Regulation 424/04. For the OPA to diminish its role and achieve the Province's objectives, market conditions must evolve over the next few years. Forward power sales and meaningful price signals are the first steps towards this objective. At over 40% of Ontario's supply, the OPG prescribed assets are key to this evolution to market-based signals and related investment. Only significant market-based investment will enable the OPA to reduce its role as desired by the Province, the OPA, and many stakeholders.

EMIG also submits that there is merit in setting payments for OPG's prescribed assets within the context of the IPSP, which will significantly inform stakeholders regarding the future of many of the elements of the hybrid model, and OPG's role within the next evolution of the hybrid model.

## Conclusion

Given the above perspective, it is premature to conclude from the Board Staff Discussion Paper that an incentive regulation mechanism is the correct choice, or that it is policy neutral. Unless the ultimate mechanism which is adopted by the Board takes into account the impact of a chosen mechanism on the behaviour of OPG and the broader electricity market and hybrid model, the Board runs the serious risk of thwarting, and perhaps further suppressing, a competitive market which the Province has legislated as an important component of Ontario's electricity sector. Further analysis is required, and will benefit the Board, OPG, and all stakeholders. EMIG will contribute to that analysis, and looks forward to the opportunity to participate further.