

June 27, 2006

PWU Comments on Board Staff Discussion Paper Draft 2
Regulatory Options for Setting Payments for the Output from
OPG's Prescribed Generation Assets

The Power Workers' Union ("PWU") represents a large portion of the employees working in Ontario's electricity industry and has utmost interest in regulatory proceedings that impact the energy industry and the provision of on going service quality and reliability to customers.

The following are the comments of the Power Workers' Union (PWU) on Board Staff's Discussion Paper Draft 2 on Regulatory Options for Setting Payments for the Output from OPG's Prescribed Generation Assets ("PGA").

The PWU notes that it is regretful that there was no opportunity for stakeholder discussions on Board Staff's Discussion Paper Draft 2 ("Draft 2"), as originally intended for the second plenary session. Such an opportunity would have allowed for a better understanding of Board Staff's recommendations set out in Draft 2 and more fulsome discussions on Board Staff's basis for coming up with the recommendations.

As the PWU understands it, Board Staff is recommending that payments to OPG be determined by an incentive regulation scheme, where the base payment is the payment prescribed by Regulation 35/05. This base payment would be adjusted over time by the application of an inflation factor, and a productivity factor. There will be no review of the allowed return on equity ("ROE") in the Board's first proceeding on the PGA.

In addition, OPG would face extensive periodic cost data filing requirements. This data would be used, over time, for a variety of purposes, including the "tweaking" of the inflation and productivity factors, as well as reviewing the base price.

1. The PWU's Position

Prior to the release of Draft 2, the PWU took the position that the preferred regulatory mechanism for payments to OPG for output from the prescribed assets is a cost of service regime.

There is nothing in the Board Staff discussion paper Draft 2 that changes this view.

2. Total Failure of Transparency

Board Staff indicates that they recognize that “transparency” is an important consideration in the selection of a regulatory scheme for these assets. It suggests that the preferred option fulfills this objective. The PWU disagrees.

The major failing of transparency is Board Staff’s suggestion that the current payments form the “base payment” of the future incentive regulation scheme. The current payments were determined in a completely non-transparent fashion. They were set in a “black box” with absolutely no public scrutiny as to their appropriateness on any regulatory standard. This is no criticism of the Government in setting the initial payments. It is clear from Regulation 53/05 that the level of these payments was considered to be temporary, and transitional. In the PWU’s opinion, the Government understood and intended that, over time, responsibility for setting the payments would devolve to the OEB, who would have the responsibility to determine that the payments were “just and reasonable”.

As a result, even if the OEB imposed adjustment factors (i.e. inflation and productivity), which were accurate and appropriate, neither the Board, nor stakeholders, nor the consumers could have any assurance that the product of the adjustments would be “just and reasonable”. The product of the adjustments would only be just and reasonable to the extent that the base payments are found to be so. Absent a cost of service review, this will not be established.

3. Incentive Regulation Not “Cost-Based”

By definition, incentive-based (“IR”) regulation is not “cost-based” at least for the duration of the IR plan term. By definition, the regulator is not interested in the actual operations and costs of the regulated entity during the IR plan. To the contrary, with the requisite incentives in place, the regulated entity is left to manage its business as it sees fit. Having established the reasonableness of the costs that underpin the starting charges for the IR plan, adjustments to the charges during the IR period are untethered to the regulated entity’s actual costs or revenues.

This decoupling of the charges from costs over the IR plan term is problematic when, as in this case, there is absolutely no assurance that the starting charges have any form of cost basis.

The absence of a cost basis for the proposed payments is significant because there is a very strong indication in Regulation 53/05 that the payments are to be cost-based.

(a) OEB must give effect to Legislature's distinctive treatment of prescribed assets.

The intent of the Legislature is absolutely clear insofar as the legislation and regulation reveals that the prescribed assets are to be treated differently than other generation assets. They are not to receive market-based pricing.

(b) Cost-Based Pricing Most Consistent With Long-Term Stewardship Of Prescribed Assets

It is clear that the Legislature understood and intended that the prescribed assets were "heritage assets" which should serve the long-term benefit of the electricity users of the Province of Ontario. Regulation 53/05 specifically contemplates that OPG will make ongoing investments to maintain, refurbish, and expand the output from these assets. Given the nature of these assets, and the generation options otherwise available to Ontario, this approach is understandable, and laudable. It is an approach that will ensure the ongoing safety and reliability of the PGA. The PWU submits that failure to abide by this approach puts at risk the safety and reliability of the PGA.

Given the primacy of the objective of long-term stewardship of these assets, short-term objectives such as profit maximization and price minimization must be viewed as having subordinate significance. Cost-based payments are most consistent with long-term stewardship of these assets, even if they might not be the best means to achieve short-term pricing objectives.

(c) Incentive Regulation Inconsistent With Requirements Of Regulation 53/05

While it is true that the provisions of Regulation 53/05 does not prescribe that the payments to OPG for the prescribed assets must be determined on the basis of a cost of service review, there are very strong signs in the Regulation that this is the appropriate approach. In particular, Regulation 53/05 requires that in setting payments to OPG, the OEB must ensure that OPG recovers certain specific costs. Those requirements are set out in section 6(2) of Regulation 53/05.

Those costs include:

1. The balance of the variance account under subsection 5(1) over three years, "to the extent the Board is satisfied that the costs recorded in the account were prudently incurred and accurately recorded in the account";
2. The balance in the deferral account established under subsection 5(2) on a straight line basis over a period not to exceed fifteen years;

3. The costs and firm financial commitments incurred for investments to “increase the output of, refurbish or add operating capacity to” a prescribed asset if,
 - a. the costs and financial commitments were approved prior to the OEB making its first order under s.78.1, or
 - b. the Board is satisfied that the costs and financial commitments were prudently incurred.
4. The costs in connection with the Ontario Nuclear Funds agreement;
5. The costs incurred in respect of the Bruce Nuclear Generating Stations (less earnings from lease on Bruce Nuclear Generating Stations).

All of the costs outlined above are applicable, not only to the OEB’s first order made pursuant to s.78.1, but also to all subsequent orders.

Moreover, the regulation contemplates that some of these costs may be incurred even after the Board’s first order made pursuant to s.78.1. Specifically, the Board is to continue to ensure that OPG recovers “prudently incurred” costs and financial commitments made by OPG to “increase the output of, refurbish or add operating capacity” to the prescribed assets.

It is obvious that the aggregate of these costs could form a very substantial part of OPG’s overall costs in relation to the prescribed assets.

The PWU submits that the Board has no mechanism available to it to determine (a) what these costs are; or (b) whether these costs were prudently incurred, other than by performing a cost of service analysis.

Specifically, during the course of an IR plan implemented in the absence of establishing a cost of service review, the Board could have no assurance whatsoever that it has fulfilled its obligations pursuant to s.6(2) of Regulation 53/05.

3. Incentive Regulation Not “Cost-Based” Over Term of Plan

Board Staff rejects a cost of service review on two bases:

- (a) the time and cost incurred in a cost of service review; and,
- (b) the failure of cost of service regulation to provide adequate incentives to OPG to improve the productivity of the prescribed assets.

Upon examination, neither of these two issues justifies the rejection of cost of service regulation.

Pursuant to s. 78.1 (7) of the *Ontario Energy Board Act* 1998, any order by the Board respecting payments in respect of the prescribed assets is to be premised on a conclusion by the Board that the payment is “just and reasonable”. It is not possible for the OEB to satisfy this statutory obligation, simply by using the interim payments prescribed by Regulation 53/05 as the base for future payments. The mere fact that Cabinet prescribed a particular level of payment on a temporary and transitional basis is no evidence that they are “just and reasonable” for any ongoing or future application.

Only by performing a cost of service review, can the Board reach this statutorily required conclusion.

As noted above, the OEB is required by Regulation 53/05 to undertake a cost of service review in order to fulfill its obligations pursuant to s.6(2) of the Regulation. Although this cost of service review may be reviewing only a subset of total cost of the prescribed assets, it is a cost of service review nonetheless. Any, if not all of the complicating, time-consuming, and expensive attributes of a cost of service review will inevitably be triggered by the review required under s.(6)(2) of the Regulation.

It is not self-evident that it will be less expensive or more expeditious for the OEB and the interveners to undertake some form of “hybrid” proceeding (i.e. part cost of service – part incentive regulation) than it would be simply to perform a full cost of service review.

It is not apparent that an incentive regulation scheme is likely to generate greater productivity improvements than a cost of service regime. It should also be noted that there is no awareness of OPG’s historic or current productivity levels.

In the absence of a private shareholder, it is not apparent that financial incentives will have a meaningful impact on corporate behaviour.

Moreover, it would appear that only small aspects of the overall costs of the prescribed assets are controllable by management in any meaningful way. In particular, a substantial majority of the total costs of the hydraulic assets are capital costs. There is no evidence that it is possible to achieve meaningful “productivity improvements” with respect to the cost of capital. With respect to the nuclear assets, the operation of these facilities is tightly prescribed by the nuclear regulator, the CNSC. It is not apparent that the employer has any meaningful ability to change operational procedures in response to economic incentives without compromising safety, reliability and regulatory compliance.

Board Staff suggests that an incentive regulation formula could include provisions for payment structures with the objective of improving OPG’s operating efficiencies. Board Staff contemplates that the regulated payment mechanism could be used to achieve efficient dispatch of the prescribed assets. In fact, the question of efficient dispatch should not be a factor in designing payments to the prescribed generators. At the present time, the prescribed generators receive a flat payment mandated by Regulation 53/05. There is absolutely no evidence that the assets are not being dispatched efficiently. The PWU does not view the “efficient dispatch issue” as falling within the scope of this proceeding.

Finally, the OEB has no experience in formulating appropriate inflation or productivity adjustment factors for inclusion in an incentive regulation scheme for generation. Great care must be taken to ensure the appropriateness and accuracy of these adjustment factors. If errors are made, the wrong economic signal will be sent, leading to perverse incentives. This could undermine, rather than enhance desired behaviours, resulting in undesirable outcomes.

4. Return on Equity

Board Staff proposes that the Board not address the issue of rates of return in its first proceeding. Board Staff's reasoning is that the examination "of appropriate rates of return will be better informed after the Board and intervenors have access to the financial and other data that Board staff is recommending the Board require OPG to file quarterly".

The Government's statement with regard to the allowed ROE implicit in the current PGA charges as presented on Page 17 of Draft 2, is that while "the standard ROE for North American utilities is ten per cent, a five percent ROE will generate revenue to service the OPG debt held by the Ontario Electricity Financial Corporation, while putting significant discipline on OPG to contain costs and improve overall operating efficiencies". Given the assertion that the standard ROE for utilities in North America is 10% it would appear that an ROE at 5% builds in a productivity factor of 5%. A productivity factor imposed through a PBR plan that has the current charges as the starting charges would then constitute additional productivity demands. However, as submitted earlier in our submission, it is clear from Regulation 53/05 that the levels of the current payments were considered to be temporary and transitional, including the level of ROE implicit in these payments.

These are the PW's comments on Draft 2 of Board Staff's Discussion Paper on Regulatory Options for Setting Payments for the Output from OPG's Prescribed Generation Assets. We hope you will consider them in shaping the final Board Staff proposal to the Board on the methodology to be used to determine payments for the output from OPG's PGA.