

IN THE MATTER OF the *Ontario Energy Board Act, 1998*;
S.O. 1998, Section 78.1.

AND IN THE MATTER OF Staff Discussion Paper on
Regulatory Options for Setting Payments for the Output
from OPG's Prescribed Generation Assets.

Power Workers' Union's Comments

The Power Workers' Union ("PWU") appreciates the opportunity to provide comments on the final version of Board Staff's Discussion Paper on Regulatory Options for Setting Payments for the Output from OPG's Prescribed Generation Assets (discussion paper).

The PWU represents a large portion of the employees working in Ontario's electricity industry and has utmost interest in initiatives that impact the energy industry and the provision of on going service quality and reliability to customers. Attached please find a list of PWU employers.

The PWU provided comments on Board Staff's Draft 1 and Draft 2 of the discussion paper. In both sets of comments the PWU took the position that the preferred regulatory mechanism for the payments to OPG for the output from the prescribed generation assets ("PGA") is a cost of service regime.

As in the case of the Board Staff discussion paper Draft 2, there is nothing in the Board Staff final discussion paper that changes our view. We believe that our prior comments are still valid and we repeat and rely upon them in our submission to the Board for its consideration. Attached please find the PWU's submissions to Board Staff on Draft 1 (Attachment 1) and Draft 2 (Attachment 2) of the discussion paper.

In addition to the comments contained in the attached submissions, the PWU notes the following. Based on the regulatory criteria articulated in the discussion paper and consideration of the Board's statutory objectives, Board Staff identifies the task before the Board as one of determining "payment amounts that can continue to limit exposure to price volatility, provide price stability for consumers and contribute to the mitigation of OPG's market power while maintaining OPG's financial integrity and maximizing opportunities for efficiencies and cost containment in OPG's operations."

The Board's two objectives with respect to electricity under the *Ontario Energy Board Act, 1998* as noted in the discussion paper are:

- to protect the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service; and,

- to promote economic efficiency and cost effectiveness in the generation, transmission, distribution, sale and demand management of electricity and to facilitate the maintenance of a financially viable electricity industry.

Entirely missing from the Board Staff's evaluation of the task before the Board in its determination of the payment amounts is any assessment of the impact of its proposal on the adequacy, reliability and quality of electricity service.

Board Staff notes that the Board's key business objective reflected in its 2006-2009 Business Plan is: "To provide sound economic regulation that balances the interests of consumers with the need for a financially viable energy sector." Board Staff identifies price stability, and reliability and quality of service as common interests of consumers and the regulated company, and that these common interests are reflected in the regulator's balancing of interests.

However, Board Staff recommends that the Board use the existing payments in Ontario Regulation 53/05 as the initial base payments in an IR plan, rather than an initial base payment determined through a Cost of Service review. This recommendation is made notwithstanding Board Staff's recognition that there is a risk that initial base payments based on the existing payments "may not provide sufficient revenue to enable OPG to recover all of its future costs, which could in turn result in short-term cost cutting in order to maintain returns on equity." In the PWU's view, Board Staff's recommendation speaks to the need for the Board to better balance interests with regard to price stability with those of reliability and quality of service in its evaluation of a regulatory option for setting payments for OPG's PGA output. The PWU therefore urges the Board to explicitly consider adequacy, reliability and quality of service in its evaluation of regulatory options for the payments for OPG's PGA output.

These are the PWU's comments on Board Staff's final discussion paper.

List of PWU Employers

Atomic Energy of Canada Limited (Chalk River Laboratories)
Barrie Hydro
BPC District Energy Investments Limited Partnership
Brant County Power Incorporated
Brascan Power Corporation - Lake Superior Power Inc.
Brighton Beach Power Limited
Bruce Power Inc.
Corporation of the City of Dryden - Dryden Municipal Telephone
Corporation of the County of Brant
Electrical Safety Authority
Erie Thames Services Corporation
Goldman Hotels Inc. - Hockley Highlands Inn & Conference Centre
Great Lakes Power Limited
Grimsby Power Incorporated
Halton Hills Hydro Inc.
Hydro One Inc.
Independent Electricity System Operator
Inergi LP
Innisfil Hydro Distribution Systems Limited
Kenora Hydro Electric Corporation Ltd.
Kincardine Cable TV Ltd.
Kinectrics Inc.
Kitchener-Wilmot Hydro Inc.
London Hydro Incorporated
Middlesex Power Distribution Corporation
Milton Hydro Distribution Inc.
Mississagi Power Trust
New Horizon System Solutions
Newmarket Hydro Ltd.
Norfolk Power Distribution Inc.
Ontario Power Generation Inc.
Orangeville Hydro Limited
PUC Services Inc.
Sioux Lookout Hydro Inc.
Sodexo Canada Ltd.
TransAlta Energy Corporation - O.H.S.C. Ottawa
Vertex Customer Management (Canada) Limited
Whitby Hydro Energy Services Corporation

Attachment 1

**PWU's Comments on Draft 1 of
Staff's Discussion Paper on Regulatory Options
For Setting Payments for the
Output from OPG's Prescribed Generation Assets**

June 5 2006 OEB Consultation Session

Board Staff Discussion Paper Draft 1

Regulatory Options for Setting Payments for the Output from OPG's Prescribed Generation Assets (EB-2006-0064)

Preliminary PWU Comment Summary

The following are the PWU's summary comments on a regulatory framework for OPG's Prescribed Generation Assets ("PGA").

- The PWU's policy position is for full utilization and ongoing investment (e.g. in maintenance, rehabilitation, upgrading) in OPG's PGA and new build on OPG prescribed generation sites to provide on-going stable, predictable, reliable electricity under a cost of service ("CoS") regime.
- Develop a fair and transparent regulatory framework for OPG's PGA, and apply consistently. Review the on going applicability and effectiveness of the regulatory framework on a regular basis.
- Allow OPG's PGA the opportunity to earn a fair rate of return to ensure their on-going financial viability.
- Ensure that OPG recovers all prudent/reasonable cost of service that ensures the on going protection of "the interests of customers with respect to price and the adequacy, reliability and quality of electric service".
- OPG must have the responsibility to maintain and refurbish its PGA to ensure their ongoing value. The efficient operation of these assets through prudent management and investment will be a critical and cost effective alternative to investment in new facilities, and will be a key contribution to ongoing guarantee of reliable, and secure electricity supply and predictable prices.
- CoS regulation will provide the opportunity for the scrutiny of specific and detailed evidence required to support a decision through a transparent adjudicative process that allows for stakeholder participation. Through this process the Board and stakeholders will be provided with an understanding of OPG's operation of the PGA and the associated costs. Given the newness of the Board's regulation of the PGA, this learning process gives the Board and stakeholders the opportunity of building the expertise required in reviewing an application.
- While there are costs associated with CoS proceedings, this form of regulation ensures that all relevant issues are considered. Moreover, as indicated in Board Staff's Discussion Paper (the "Discussion Paper") CoS regulation ensures financial certainty and delineation of how risks are to be allocated. A cost of service review will form a robust and essential basis for the payments, which are to be made effective with the Board's first order under section 78.1 expected in

March 2008. It also provides a sound basis for any Incentive Regulation plan or Regulatory Contract that may follow subsequently.

- A full CoS is preferable to a modified CoS process that accepts existing payments prescribed in Regulation 53/05 as a “base payment” and focuses on establishing the changes that should be made to the base payment. The modified CoS approach, as suggested in the Discussion Paper would see the examination of major issues by addressing single topics annually. If a full examination of the PGA’s cost of service is too onerous to accomplish in the first year of the Board’s review of the PGA’s costs, full cost of service review could be phased-in over several years by examining a different group of costs annually over two or even three years if necessary. However, some major issues related to OPG’s PGA will likely be interrelated, and with a phased review process it may be difficult to provide a comprehensive review of all issues. The grouping of costs that are to be reviewed simultaneously will therefore be the challenge.
- The theory that CoS regulation fails to provide an incentive for efficiency is not sufficient reason to avoid a review of OPG’s PGA costs. An understanding of the cost drivers is needed before contemplating efficiency incentives to avoid putting in place perverse incentives that jeopardize long term supply reliability.
- The Discussion Paper gives the impression that Board Staff is adverse to full CoS regulation because it perceives it to be unduly complex. The Board should accept that regulation of the PGA can be expected to be complex given that it is a part of the generation sector which otherwise is a competitive sector. Further, the operation of the PGA, and in particular the operation of the nuclear stations is complex. While unnecessary complexity should be avoided in the regulatory framework for the PGA, it is necessary to accept the complexity of the nature of the PGA and to manage that complexity. Any contemplation of Incentive Regulation requires consideration of performance indicators and standards to ensure that the incentive for higher earnings does not result in the sacrifice of short and long-term operational performance. Time will be required for the development of reasonable performance indicators and standards.
- The concept of a regulatory contract appears to be inconsistent with the Board’s general approach to carrying out its function through public hearings and consultations that ensure the Board makes informed decisions. It also has the potential of resulting in overly complex regulatory administration in its implementation that is unrelated to the Board’s primary objective of ensuring reasonableness of costs.

Attachment 2

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

June 28, 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.