

A NEW PROPOSAL TO ADDRESS ONTARIO'S ELECTRICITY NEEDS

By The Distributors' Electricity Efficiency Policy Group ("DEEP")

A. Proposal Outline

I. Background

The Distributors' Electricity Efficiency Policy Group ("DEEP") consists of a diverse group of distribution utilities, including Erie Thames Powerlines, Enersource Hydro Mississauga, Veridian Connections, Oshawa PUC Networks, Vaughan Hydro, London Hydro and Oakville Hydro, committed to leading change in the industry. We represent 600,000 customers and at least 2,000 MW of default supply in Ontario.

DEEP was formed in the summer of 2003, in response to unsustainable features of Ontario's electricity market. These features include a subsidized electricity price, no new investment in generation, a stagnant electricity market and a provincial deficit.

Currently, investors lack the confidence to invest in new generation in Ontario. With the subsidization of electricity prices, there are insufficient customers available to enter into long-term contracts for electricity, which are a pre-requisite for new investment.

Over the past few months, DEEP has developed a proposal to succeed the electricity price protection program that achieves following goals:

- Investments in new generation, including renewable energy.
- Stable and predictable electricity prices with little spot market volatility
- Portfolio electricity prices that combines OPG heritage assets, new generation and conservation.
- Electricity conservation as a fundamental part of the supply portfolio.
- Diversification of risk through multiple buyers, thereby transferring at least a portion of government financial liability.
- A robust, liquid electricity market with multiple credit-worthy buyers and sellers.

II. LSE Model

DEEP is proposing that the government create the regulatory environment by the spring of 2004 that would permit LDCs to become Load Serving Entities ("LSEs"). The OEB would issue a new class of license, "LSE License", on an interim basis to all LDCs to perform LSE functions. Consolidation of some of Ontario's 95 LDCs is required in order to achieve economies of scale through the

centralization of engineering, billing and administration. Studies have shown that the most efficient size for electricity distributors in order to achieve economies of scale is between 500,000 and 1,500,000 customers. At present, 50% of Ontario's LDCs serve an average of less than 5,000 customers each.

LSEs would have the responsibility to acquire the entire load consumed by low-volume and large-volume default supply (standard service supply) customers in their distribution service area. LSEs would have the freedom to procure default-supply power through a variety of competitively procured power purchase agreements with generators and wholesalers. Each LSE would have an obligation, imposed by the OEB and monitored by the IMO, to contract for an adequate amount of supply.

The OEB would be responsible for mandating the portfolio mix (length and source) of contracts to meet the government's objectives of price stability, new generation, renewable energy and conservation. It is recommended that at least 30% to 50% of the source of the contracts be new generation, including 4% to 8% renewable energy. By requiring at least 6,000 MW to be contracted with new capacity across Ontario, investors would have the assurance required to start building new generation.

In order to ensure that LSEs remain credit-worthy and able to enter into long-term contracts, LSEs must have the ability to recover the full cost of the contracts from their customers, as well as a fixed return or margin on their default supply load. This will drive the LSE to increase its net income by growing its customer base or increasing efficiency, which benefits customers because it leads to greater purchasing power and lower prices.

Should an LDC elect not to exercise its LSE license either on its own or through a co-operative of LDCs, it could either sell or lease it to another LSE or third party, subject to OEB consent, or it could surrender it to the OEB who would then be responsible for reassigning it.

The identity of LSEs would be determined by the fall of 2004, which would allow LSEs to sign power purchase agreements by the spring of 2005, with the agreements coming into effect by January 1, 2008. This would give investors three years to finance and construct 6,000 MW of new capacity to fulfill the agreements, with coal being shut down as new capacity comes on line, and fully eliminated by 2008.

III. Why a Single Government Purchaser Must be Transitional

A single provincial entity, such as the OEFC, acting as the aggregate procurer of default supply across the province, is too risky for a number of reasons:

- Such a system could lead Ontario down the road to a situation where the entire provincial default supply load could be priced too high as a result of a single contract or market event.
- Just as a single generator with market dominance is an obstacle to true competition, so is a single consumer who could be buying up to 30% of total Ontario demand. This scenario is not conducive to the promotion of a true competitive market. Encouraging multiple buyers and sellers is the most effective way to promote true competition, lower prices and new supply.
- A central aggregator would be distanced from the knowledge of local customer behaviour and load forecasting.
- Centralized power planning has not been a success in recent Ontario history. Just as centralized generation has failed to produce optimal results, so would centralized purchasing.
- Such a system would permanently place contingent liabilities on the government's balance sheet.

IV. Benefits

The LSE model would help the government of Ontario achieve the following goals:

- **Immediate investments in generation.** DEEP alone would have the ability to contract for 2,000 MW of new capacity immediately, 1000 MW of which could be through long-term contracts. This represents 40% of the 2,500 MW sought under the recent government RFP.
- **Elimination of coal generation by 2008.** On a province-wide basis LSEs could contract for over 6000 MW of new capacity through long-term contracts. This is almost enough to eliminate coal entirely.
- **Price stability.** Default supply customers would receive a stable price based on passed through costs of portfolio electricity prices, which in turn are based on a mix of market prices, heritage prices and conservation.
- **Conservation and renewable generation.** The OEB would be responsible for mandating the percentage of the LSE portfolio that must be renewable power, as well as mandating that a portion of the portfolio be based on conservation.
- **Distributed generation.** LSEs would have the ability and incentive to satisfy some of its requirements through local options, thereby encouraging the expansion of distributed generation and reducing the reliability risks (due to either system failure or terrorist attack) associated with heavy reliance on the long-distance transmission system.

B. Additional Implementation Details

I. LSE License

The LSE license would include conditions established by the OEB, and would serve to address issues of new investment in generation and consumer price protection (predictable, stable and portfolio prices).

Initially, the OEB would issue an LSE license to all LDCs for a term established by the OEB. The term would have to be long enough to allow LSEs to enter into long-term PPAs with some degree of comfort. It is unlikely that a wholesaler or generator would enter into a contract with an LSE that is only licensed for one year, for example, to provide additional security to wholesalers and generators, existing contracts should be automatically assigned to the successor of an LSE that loses or gives up its license.

Should an LSE decide not to exercise its license, it has two options. The first option is to sell or lease the license to another LSE, be it an LDC or a third party, subject to OEB consent. LDC purchasers would be exempt from transfer tax, but subject to payments-in-lieu-of-taxes (PILs). If the license is sold or leased to a third party, the third party would be subject to transfer tax, but tax leakage would follow as a result of federal income taxes.

The second option is to surrender the LSE license to the OEB, who would then be responsible for reassigning it. The OEB should consider the following when determining the reassignment criteria: the LSE's own administrative costs, increased LSE purchasing power, and the OEB's regulatory administration costs. The OEB should also consider whether from an efficiencies perspective a neighbouring LSE should have the right of first refusal. The reassignment criteria should be set within a context that encourages an electricity market with multiple buyers and sellers.

If the LDC does not exercise, or sell or lease its within 180 days, the LSE license would be deemed surrendered by default.

II. Obligation to Serve

LSEs would have an obligation to serve all low-volume default customers in their service territories. Should a customer leave default supply (i.e. to enter into a retail contract or purchase on the spot market) and then return, the LSE should have the ability to impose certain OEB-approved conditions, such as notice requirements. Accurate consumption predictability is important for ensuring that LSEs contract for adequate supplies of electricity.

LSEs must also serve all large-volume default customers. Large-volume customers would be subject to conditions determined by the OEB, such as notice of termination, credit support, and levels of consumption. This is also important for ensuring that an LSE doesn't contract for too much or too little power.

III. Portfolio Mix

In order to satisfy government objectives – new generation (including renewables), conservation, and price stability – the LSE portfolio should be comprised of a mix of contracts for various terms and power types and from various suppliers. In addition, in order to include some price signals from the daily market, and to provide LSEs with some flexibility to account for customers who switch in or out of default supply, a certain amount of the portfolio must continue to be purchased in the spot market. The precise mix with respect to each of these factors would be determined by the OEB.

The mix of contract lengths would also be determined by the OEB. It is important to have a range of contracts (short, medium and long term) because this provides a smoothing mechanism for electricity prices. If price risk is diversified across multiple periods this ensures that a portion of the portfolio is up for renewal at various times.

Each LSE will have an obligation, imposed by OEB and monitored by the IMO, to contract for an adequate amount of supply to ensure that Ontario never gets into a situation where there is insufficient generation to meet demand. Energy conservation must be a key component of how the LSE will achieve its adequacy obligation.

LSEs must abide by the OEB conditions for prudent purchasing strategies, such as requiring a minimum number of bids, approved contractual terms and conditions, approved counter-parties, approved portfolio management and processes, and approved risk management processes. The OEB could approve a standard form of power purchase contract to be used by LSEs and generators and wholesalers for the purchase of default supply.

IV. Default Supply Price

The default supply price charged by an LSE would be based in a cost-plus pass through system, set for a given period of time (i.e. quarterly) at the weighted average contracted price for such period, plus a fixed amount per kWh determined by the OEB to cover default supply administration and a reasonable return. Any LSE that succeeded in reducing its administrative costs would realize a greater return. Any savings in the commodity price would be passed through directly to the customer.

C. Required Government Action

The DEEP Group recommends that the following actions be taken by the Government of Ontario and the appropriate regulatory agencies:

- Create a regulatory climate for LDCs to become LSEs and allow them to enter into power purchase agreements to procure default supply for low-volume customers
- Permit LSEs to transact in the wholesale spot market to sell power when it is long, and purchase power when it is short. Further, allow LSEs to maintain variance accounts for such short-term transactions and bring the variance account to zero balance on a quarterly basis.
- Subject large-volume customers who choose default supply to certain conditions imposed by the OEB.
- Subject low-volume customers who leave and return to default supply to certain conditions approved by the OEB.
- Allow LSEs to receive an appropriate rate of return for carrying out their functions.
- Set out transition plan to allow LDCs to become LSEs without undue impact on their financial situation and credit ratings.

Proposed LSE Model

