

**ONTARIO ENERGY BOARD**

**IN THE MATTER OF** the *Ontario Energy Board Act, 1998*, S.O. 1998, c.15, Schedule B;

**AND IN THE MATTER OF** a proceeding to determine the methodology by which the Ontario Energy Board will determine payment amounts under section 78.1 of the *Ontario Energy Board Act, 1998* for the prescribed assets of Ontario Power Generation Inc.

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**Setting Payment Amounts  
for Ontario Power Generation**

**Energy Probe Research Foundation – Final Submissions**

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**October 2, 2006**

## **Setting Payment Amounts for Ontario Power Generation**

### **Energy Probe Research Foundation – Final Submissions**

#### **Introduction – How these matters came before the Board**

- 1. On March 20, 2006, the Ontario Energy Board (OEB) issued a letter to interested parties giving notice of the process that it intended to follow to decide the methodology by which it would determine payment amounts for the prescribed assets of Ontario Power Generation Inc. (OPG) under section 78.1 of the Ontario Energy Act, 1998.**
- 2. Board Staff released Draft Number 1 of its Discussion Paper on May 8, 2006 and held a Plenary Consultation Meeting on May 19<sup>th</sup>, followed by a number of Affinity Group Sessions ending on June 5<sup>th</sup>, 2006, with Interested Parties filing comments on Draft Number 1 shortly thereafter.**
- 3. A second Plenary Consultation Meeting was held by Board Staff on June 16<sup>th</sup> followed by release of Draft Number 2 of its Discussion Paper on June 20<sup>th</sup>, and a report prepared on behalf of Board Staff by London Economics International, LLC – “Alternatives for Regulating Prices Associated With Output From Designated Generation Assets”. Comments from Interested Parties were filed by the end of June.**
- 4. The final version of the Staff Discussion Paper was released on July 6<sup>th</sup> with comments from Interested Parties filed by the end of that month. The Board made provision for a Reply Submission, of which four were received.**

5. All of the above was posted on the Board's web site to facilitate a wide ranging debate on which methodology the Board should select to determine payment amounts for the prescribed assets of OPG.

6. On August 10, 2006 a Board letter announced that the Oral Presentation Phase would be held on September 15, detailing procedures for those presentations. A list of presenters was included in the letter and provision was made for the Board Staff to develop and deliver *Questions for Presenters* on August 17th, to guide participants in their preparations for presentation.

7. After the Board granted dispensation to the Ontario Power Authority to deliver a presentation, the interest of parties making presentations on September 15, 2006 was:

- For Incentive Regulation: the Board Staff Hearing Group  
School Energy Coalition  
Assoc. of Major Power Consumers of Ontario
- For Cost of Service: the Cost of Service Participant Group
- For Regulatory Contracts: Electricity Market Investment Group  
TransAlta  
the Independent Electricity System Operator  
the Ontario Power Authority
- Ontario Power Generation in its own right

### **September 15<sup>th</sup> Argument Overview**

8. Throughout the consultation process, both in written material and during discussions, it appeared to Energy Probe that there were deep divisions between the parties supporting the three methodologies being examined by Board Staff.

9. However, the September 15<sup>th</sup> presentations by parties to the consultation process and the ensuing question and answer sessions leads us to believe that in many fundamental respects we are not now so very far apart. There now seems to be general agreement among the parties that some form of cost of service process should be undertaken by the Board.

10. Energy Probe believes the following comments made during Presentation Day support this conclusion:

What I'm first going to do, though, is clarify our position. It's not entirely accurate to suggest that we support incentive regulation. We do support the Board Staff proposal for a modified cost-of-service approach, starting from where we are now. We do, however, have some reservations about moving too quickly to a formulaic approach to performance incentives, and I'll get into that a little bit.  
(Adam White, AMPCO, Trans. Sept. 15, 2006, p. 13)

And we've filed material and we're generally in support of the Board Staff proposals. Whether you call them modified cost of service or whether you call them some form of incentive regulation really doesn't matter. To our mind, the essence of the Board Staff proposals is that they are traditional and -- they're -- sorry, transitional and they're incremental, and that the key to them is to expand the amount of information that is available and expand the level of transparency so we can start to get a better look at an entity that has not been regulated in the past.  
(Jay Shepherd, SEC, Trans. Sept. 15, 2006, pp. 20/21)

Addressing first transparency. As I stated a moment ago, the OPA supports the approach put forward in the London Economics paper of having a transparent quasi-judicial process to determine the appropriate cost inputs to any regulatory contract. We believe cost-of-service proceeding is the fundamental building block for the regulatory contract model.

And as we've heard this morning, there appears to be a great deal of consensus between ourselves and the cost-of-service group in that regard.

**The OPA has limited experience in cost-of-service rate-making and looks to other parties with more experience for their insights into the issues that need to be considered in a cost-of-service hearing.  
(Michael Lyle, OPA, Trans. Sept. 15, 2006, pp. 113/114)**

**In reflecting upon the issues that have been the subject of this consultation, what model made sense, we thought about a range of options. But in the end, we could think of no other way to make sure that the payment amounts are just and reasonable other than by going through a review of costs. Our proposal for a limited issues cost-of-service proposes a pragmatic process for doing that.**

**Also, we understand that people have an interest in understanding the OPG's business. Going through this type of review will help people understand the OPG's business.  
(Andrew Barrett, OPG, Trans. Sept. 15, 2006, p. 159)**

## **September 21, 2006 Technical Conference –**

### **Development of 2<sup>nd</sup> Generation Incentive Regulation**

**11. It may assist the Board sponsors in this process to consider information being presented in a concurrent process, with different Board sponsors, which has been assigned Board File No. EB-2006-0089, entitled Development of 2<sup>nd</sup> Generation Incentive Regulation, being one part of the Board's initiative for a Multi-Year Electricity Distribution Rate Setting Plan.**

**12. One of the expert presenters in that process is Dr. Adonis Yatchew of the University of Toronto, well known to the Ontario Energy Board, who has provided expert testimony in a number of Hearings, and who spoke at the Technical Conference on incentive regulation. Dr. Yatchew was commenting on the Board staff's proposals for incentive regulation for Ontario's electricity local distribution companies (LDCs), a number of his points relate to our deliberations on a payment methodology for OPG.**

**13. And very much to the point of the Cost of Service Participant Group's presentation on September 15<sup>th</sup>, allow us to draw your attention to Dr. Yatchew's comments as follows:**

**The extent to which the conventional price-cap approach has been effective in public-sector companies is rather less clear. The instinct might be to take a regulatory approach that works in the private sector and to simply directly apply it to companies in the public sector under the assumption that it should produce the same kinds of efficiency improvements.**

**I would argue that there are fundamental reasons why it might not, and it might need to be modified.**

**Private companies are, in my view, more amenable to conventional incentive regulation. Shareholders can sell their shares, signalling disaffection, leading to a decline in share price.**

**If the company under-performs, management and even the board can be replaced. If the company exceeds expectations, there is greater scope for rewarding management and executives. And, finally, private-sector companies are generally allowed to earn and retain returns or additional returns under incentive regulatory schemes for a certain period of time.**

**For public firms, the potential for spontaneous incentive creation is more limited. Government and the taxpayers are, in effect, collective owners, and individual shares cannot be sold. We cannot sell our notional shares, let's say, in Hydro One, if we don't like its performance.**

**Owner interests are diffuse and indirect. In public-sector firms, it's generally more difficult to reward employees for exceptional performance and also in effecting changes to management if the company performs poorly.**

**And, finally, public-sector firms are frequently used as instruments of public policy, and a good example is the kinds of rate freezes and rate moratoria and directions from provincial government on how returns are to be allocated, where they should be spent.  
(Dr. Adonis Yatchew, Trans. Sept. 21, 2006, pp. 116/117)**

**14. Perhaps Board Member Cynthia Chaplin, sponsor of Development of 2<sup>nd</sup> Generation Incentive Regulation, put Dr. Yatchew's concern more succinctly during her questions to him:**

**Okay. I gather one of your key points is we don't know whether or not incentive structures work for publicly-owned utilities.  
(Cynthia Chaplin, Trans. Sept. 21, 2006, p. 141)**

### **Summary of the Current Position of the Consultation Process**

**15. Throughout the consultation process, it has appeared clear that there has been, and perhaps still is, a significant gap between the positions of Board Staff on the one hand, and all other interested parties on the other hand, as to the optimum end result of this process and the way to reach that result. As well, Board Staff became committed to at least two concepts which are not generally held by stakeholders and other interested parties:**

- Obtaining regulatory efficiency is a higher level goal to be achieved in this proceeding; and,**
- Ontario Power Generation will respond quite favourably to financial incentives which will be crafted by the Board.**

**16. While recognizing the value of regulatory efficiency, stakeholders and other interested parties seek regulatory effectiveness and regulatory certainty as higher level goals.**

**17. The current payment amounts to OPG were crafted in a black box. It is not as if the current government that mandated those payment amounts has exhibited the expertise that all previous Ontario governments lacked. There appears to be no particular reason that one should have confidence in those payment amounts as being "just and reasonable", or even "just reasonable". By 2008, they will have been in place for three years.**

17. And yet in this process, Board Staff has come forward to say: “Close enough!” They say that we can take those mandated payment amounts and treat them as if they had been subjected to close, transparent scrutiny, with prefiled evidence tested by cross examination before a regulatory board.

18. Further, they tell us that by utilizing the proper incentives we can squeeze savings out of the mandated payment amounts, incent a publicly owned utility to drive costs down by allowing them to retain some of these savings. Does that make any sense? OPG’s net income is already assigned to the Ontario Electricity Finance Corporation as a portion of the program paying for Ontario Hydro’s sins of the past.

19. But currently we are unable to determine if the current interim payment amounts are too high, too low, or just and reasonable. Incentive Regulation needs a Cost of Service process to allow the bar to be correctly set.

20. On the other hand, those favouring Regulatory Contracts tell us that they are concerned that OPG will use its “market power” to set prices too high for consumers unless constrained by regulatory contracts. The Cost of Service Participant Group tried to come up with a scenario where market participants, for instance generators, were injured by a competitor who sets prices too high and were unsuccessful.

21. It is obvious that these market participants are concerned that OPG will set prices that are too low for their liking, setting prices below the full cost of generating power through prescribed heritage generation units unless constrained by regulatory contracts.

## **Recommendations of Energy Probe**

**22. A broad consensus has developed among of those taking part in the consultation process whereby the starting place for setting just and reasonable payment amounts for OPG is a Cost of Service proceeding, modified to some degree to take into consideration the early stage of OPG in the regulatory process.**

**23. As part of a cost of service initiative, the Board will be able to explore whether incentive regulation is a viable option for OPG. Energy Probe has not seen any evidence of OPG acting in a manner, either in its generation of power or of its bidding of power into the marketplace which requires incentive regulation or regulatory contracts to correct.**

**24. Although counter intuitive, Board Staff should have an opportunity to present evidence of favourable outcomes of the incentive regulation of government-owned utilities that are not legally able to retain their earnings, although such evidence has not been brought forward in this process. Examples of the incentive regulation of government-owned utilities that are allowed to retain their earnings, but only part of their assets are under regulation, could be useful if Board Staff believes such a case can be made.**

**25. It is the submission of Energy Probe that the successful operation of OPG is integral to the well being of the power system in Ontario, and the Board should be very reluctant to accept the regulatory risk of embarking on an untried method of setting payment amounts for the OPG prescribed assets without taking the precaution of investigating the current and future costs for those assets.**

**Respectfully submitted at Toronto, Ontario this 2<sup>nd</sup> day of October, 2006.**

**Tom Adams  
Executive Director**