



Jay Shepherd

Professional Corporation
2300 Yonge Street,
Suite 806
Toronto, Ontario M4P 1E4

BY EMAIL and RESS

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Ontario Energy Board
2300 Yonge Street
27th Floor
Toronto, Ontario
M4P 1E4

Attn: Kirsten Walli, Board Secretary

Dear Ms. Walli:

Re: EB-2012-0340 – Ontario Power Generation – IRM Options

We are counsel for the School Energy Coalition. These are SEC's reply submissions on the issues in this consultation.

General

As a preliminary matter, SEC believes it is important to emphasize that the prescribed assets are legacy assets. All growth in the OPG business is (with few exceptions) in the unregulated assets.

The primary result of this is that the capital side of costs will have a general trend downward. Life extension projects – whether Darlington or Saunders – will be exceptions to that, but with those unusual exceptions these are a limited group of assets that will decline in value over time.

In this respect, the OPG Prescribed Assets are quite different from, for example, the PP&E of an electricity distributor or transmitter. In those companies, while existing assets decline in value, there are always new assets being built, plus growth in the market for their services. Indeed, that may be true of OPG as well, but the artificial division of their assets into Prescribed Assets and unregulated means that the decline is in one bucket, and the growth is mostly in another.



This overall truth means that most IRM models – which assume a business in a constant state of renewal – are inapplicable here. What LPMA in their submissions referred to as a lack of “diversity” in the assets is essentially this division. The Prescribed Assets are static and, except for life extensions, deteriorating over time.

Consensus Issues

Our review of the first round of submissions leads us to conclude that all, or almost all, of the parties to this consultation have agreed on the following:

1. **Separate Plans.** There should be separate rate-setting plans for the hydroelectric and nuclear Prescribed Assets.
2. **Nuclear IRM.** The nuclear Prescribed Assets should stay on COS until the Darlington Refurbishment Project is in-service and the Pickering units are taken out of service. It may be that the RCC does not agree with this, although some kinds of multi-year COS for nuclear may satisfy their other conditions. Otherwise, it appears that all parties, including SEC, agree on this. Whether COS should be on a multi-year basis, and if so for how many years, does not present a similar consensus.
3. **Safety.** Safety requirements and performance must be a key element in the rate-setting regime for at least OPG’s nuclear Prescribed Assets. This appears to have 100% support. PWU has also proposed the same condition for the hydro Prescribed Assets, but there no consensus is apparent. That having been said, even if there are safety requirements prescribed for hydro, it is not likely that the rate impacts would be material, or that the performance standard needs any incentive mechanism. It would likely simply be a threshold that must be met.
4. **Nuclear TFP Study.** It is not practical to develop a study of total factor productivity for nuclear that would be reasonably applicable to OPG’s nuclear Prescribed Assets. Some parties reached the same conclusion for hydro, but there is no clear consensus on this.
5. **SBG/HIM.** OPG will file a study of the HIM, and by implication the SBG problem, with its 2014 hydro COS application. At that point, the Board and all parties will have a better view of the situation, and be in a better position to assess how these things should be handled going forward. SEC was initially of the view that the HIM should be ended, and there should not be any Y factor or variance account for SBG in the future. In light of the submissions of others, SEC agrees that it will be better on this point to wait and see the results of the study before reaching a conclusion.
6. **Scorecard.** There should be performance incentives for OPG during any multi-year rate-setting period that are based on some form of balanced scorecard. The devil is, of course, in the details, but the concept appears to be agreed. There is no consensus, however, on whether the scorecard should be asymmetrical (incentives only), or symmetrical (incentives and penalties).



7. **Earnings Sharing.** Except for SEC, all parties agree that some form of earnings sharing should be implemented for OPG. SEC remains opposed to earnings sharing, but does believe that the Board should not determine this in advance. When the first multi-year application is filed, OPG or any other party can propose a specific earnings sharing mechanism suited to the situation, and the matter can be decided in the context of that proceeding.

The SEC Proposal - Modified

In its October 1st submissions, SEC provided an IRM analysis, and a proposal for OPG's Prescribed Assets that sought to achieve some of the goals of IRM, while recognizing the unusual characteristics of OPG.

The crux of our submission is that a forward test year cost of service proceeding already achieves some of the goals of IRM, in that once the baseline revenue requirement is set, costs will diverge from rates over time. This happens in a single year cost of service, but is much more pronounced where rates are set for multiple years. Not only are longer term forecasts more uncertain and less granular, but the reality will over time become more and more different from what was expected. Thus, SEC proposed a multi-year cost of service approach, in order to get some of the benefits of IRM while still reflecting the fact that at OPG, historical data is not likely to be predictive of future costs or events.

Using multi-year cost of service is similar in concept to the Custom IR option that the Board has made available for electricity distributors. The Board has indicated that, for distributors with unusual capital requirements, or other situation in which the future will be very different from the past, a type of five year (or more) cost of service application can be filed. OPG is in a similar situation, and so a similar approach may be warranted.

SEC generally still believes that this approach is appropriate for OPG, but in light of the submissions of others, and other supervening events, wishes to amend some aspects of that proposal, as follows:

Hydroelectric. The hydro Prescribed Assets should have payment amounts set on a cost of service basis for the five year period 2014 through 2018, as originally proposed. Since the costs to generate from hydroelectric assets are likely to continue to go down in the near term, those rate declines can be built into the proposed rates.

OPG has indicated that, while they currently do three year business plans, they can revert to their former five year standard.

The following are some (amended) details of that proposal:

- **Five Year Term.** OPG has indicated that it plans to file COS for hydro in 2013 for 2014/5. As that application may be well advanced, it may be appropriate to allow OPG to proceed on that basis, but make it phase one of the proceeding. Upon the completion of phase one, and having the benefit of the Board's decision in that



regard, OPG can file its COS forecasts and rate proposals for the remaining three years of the plan, 2016/8. Note that the purpose of the five year term is not primarily regulatory efficiency. Rather, it is to build in efficiency initiatives over a reasonable time frame, which OPG then is charged with implementing. As with any IRM, their success over that five years in implementing their plan will drive their actual ROE.

- **Forecasts.** OPG would likely use as its starting point for the Application its own internal business plan. This may include sufficient productivity improvements that it is acceptable to the Board. If not, further improvements should be built in. In the case of the individual line items, the Application is likely to end up looking something like the “building blocks” approach that some parties are proposing, but overall it will be OPG’s best estimate of their reasonable costs for the five year period.
- **HIM/SBG.** OPG will be filing a study that deals with these issues. Based on those results, OPG should propose changes to deal with this, in the context of the planned five year rate term. The Board can then determine the allocation of risk in this case by reference to the relevant facts and analysis.
- **Scorecard.** OPG should propose a scorecard, which may be based on its business plan or internal incentive metrics, and a method of both incenting success and penalizing poor performance on the relevant metrics.
- **Earnings Sharing.** OPG should propose earnings sharing tailored to their specific situation over this five year period. While SEC is generally opposed in principle to earnings sharing mechanisms, a carefully targeted mechanism may be able to manage some of the uncertainty of rates set over a longer period. This would be decided by the Board in the context of the facts in this case.
- **Deferral and Variance Accounts.** We have previously indicated that we believe a multi-year cost of service regime requires fewer deferral and variance accounts than a more conventional IRM regime. That having been said, two additional variance accounts seem to us to be necessary:
 - First, the GRC is a government-imposed levy that comprises more than a third of the hydro revenue requirement. The rate of that levy (but not the volume on which is it calculated) is wholly outside the control of OPG, and so OPG and the ratepayers should be protected with a symmetrical variance account.
 - Second, we have seen from other utilities that pension and OPEB costs have become very volatile due to market conditions, and are likely to continue to be volatile in the next few years. A similar, symmetrical variance account should protect OPG and the ratepayers from these variations.
- **Future Rate-Making.** We do not see it as necessary for the Board to determine now how the hydro payment amounts will be set for the period 2019 and beyond. If, as the PWU suggests, Saunders will need a major life extension in the next decade,



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it may be that a conventional IRM is at that point still not suitable for the hydro assets. Further, the Board will have experience with this “Custom IR” approach, both for OPG and for one or more LDCs. The Board will therefore be able to assess just how much of the IRM benefits are achieved when the baseline is a COS forecast rather than a macroeconomic formula.

Nuclear. We agree with the consensus that, until the DRP is complete, and the Pickering units are taken out of service, some form of COS is essential for the nuclear Prescribed Assets.

We still believe that multi-year cost of service is preferred, because it still provides OPG and the Board with the opportunity to build productivity into a rate-setting plan. There is a fundamental difference between (a) having a budget for a longer period, and having to live within it, versus (b) having the ability to come in asking for more money every year or two in a short-term COS environment. While OPG has not in fact shown any real eagerness to “come back for more” as often as possible (witness their deferrals of COS this year and in the past), it is still better for them, and for their ratepayers, if they are left to work within a known envelope for as long a period as possible.

Our preference would be a single COS application for the next ten years, in order to capture the various significant ups and downs in costs and revenues that we already know are going to arise. However, we realize that is not practical. Instead, a sequence of three year COS (2015/7, probably) and five or six year COS (2018/22 or 23) is probably best. Once the major work has been completed, a rebasing of some sort will in any case be required at that point, and options for future IRM can be explored.

We are conscious of the suggestions by CCC and GEC that nuclear should be back in for COS sooner rather than later. On the other hand, we agree with OPG that it is more practical to proceed with hydro for 2014, and nuclear for 2015. In our view, OPG should not be allowed by the Board to delay nuclear COS beyond 2015.

Replies to Other Submissions

A number of other parties have provided submissions on specific issues, and SEC would like to provide responses as follows:

1. ***Off-Ramps.*** Many parties have proposed off-ramps. In our view, in a multi-year COS environment off-ramps are less critical, particularly since the Board will be monitoring OPG’s performance closely throughout. The Board retains the ability to require OPG to file an Application any time that its performance is not within acceptable bounds. In our view, imposing a formula or other test is an unnecessary complication.
2. ***Project Management Incentive.*** OPG has proposed that the scorecard include an incentive based on effective project management. SEC would generally prefer that the Board simply provide fixed price capital project approvals in order to control cost overruns. That is, only certain capital costs are approved. Overruns are prima facie not recoverable. We do understand, though, the difficulties in that more stringent approach, so some



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combination of cost limits and a project management metric in the scorecard, may be an effective compromise.

3. **Scorecard.** OPG and others have proposed that any scorecard provide for incentives only, and no penalties. This is really about how the targets are set. If the targets are set so that only truly outstanding performance is incented, then penalties for failing to meet the targets are not necessary. On the other hand, if the targets are achievable with only good performance, then failure to meet the targets should also have consequences.
4. **ESM.** Some parties, notably PWU, have proposed that any earnings sharing mechanism be symmetrical. SEC strongly disagrees. An ESM is intended to share the benefits of success prior to the end of the IRM period. It is not intended to be a safety net for an underachieving utility.
5. **Benchmarking.** PWU, SEP and others have been clear in their opposition to benchmarking, particularly for the nuclear assets. The Board will be aware that, on the substance of benchmarking, we disagree with those positions, and we won't reiterate our arguments on the values of benchmarking in these submissions. There is a further reason why the SEP and PWU submissions on this point should be rejected by the Board. In our submission, their opposition is in the wrong forum. The government, as OPG's shareholder, has already legally required OPG to use benchmarking, and has stipulated how it will be done. It would, in our submission, be inappropriate for the Board to ignore this requirement. OPG will benchmark until its shareholder relieves it of the obligation to do so. The Board should be cognizant of this operational imperative under which OPG management is working, and should build it into any rate-setting structure.
6. **Workforce Renewal.** PWU argues that OPG faces a significant workforce renewal and succession planning issue, much like the rest of the energy sector. In our submission, OPG is in quite a different position from most other utilities. For the Prescribed Assets, OPG will over the long term need less people, because units such as those at Pickering will be taken out of service, and not replaced. The big personnel requirements, which are in nuclear, will not be in operating the Prescribed Assets, but in nuclear fuel disposal and decommissioning, which are not directly the subject of this consultation. While there may be some "aging workforce" concerns there, they are not likely to have any significant impact on the current operation of the Prescribed Assets.
7. **Demand Destruction.** The PWU is, quite correctly, worried that the demand for the baseload generation from the Prescribed Assets, particularly nuclear, may decline over time as the energy mix changes. It sees this as a challenge OPG faces, and we agree. However, we believe that the multi-year COS approach we have proposed is the most direct and effective way of addressing that challenge.
8. **Targets from the Business Plan.** A number of parties have suggested that the OPG business plan contains sufficient productivity initiatives, and more are not required. The BP may well have enough productivity built right in, and in that case the Board can accept it. On the other hand, it can only do so once it sees the business plan, and that plan is tested



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in an open proceeding. It would be wrong and, in our view, legally incorrect to make any a priori decision that the business plan's productivity initiatives will be sufficient.

9. **DRP Capital Costs.** The PWU made the astonishing statement that the costs of the Darlington Refurbishment Project are not within OPG's control. Those costs, many of which are costs for OPG personnel, or for third party contractors, are very much within OPG's control. Like any business, they are to some extent at the mercy of the market in which their supplies operate. And, like any business, they have tools at their disposal to respond to that market and manage their costs.
10. **Saunders Life Extension.** It has been suggested that Saunders will have to undergo a major life extension project in the next decade. If that is indeed the case, in our submission the Board should get from OPG its long-term plan that deals with this, and sooner rather than later. Depending on the timing, this could have significant impacts on a number of the components of the Board's rate-setting plans for OPG.

Conclusion

SEC appreciates the opportunity to provide input on these important issues, and is interested in continuing to be involved in this consultation to the extent that further stakeholder involvement would be useful to the Board.

All of which is respectfully submitted.

Yours very truly,
JAY SHEPHERD P. C.

Jay Shepherd

cc: Wayne McNally, SEC (email)
Interested Parties