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Undertaking

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Response

Attached is the February 2005 Ministry of Energy Backgrounder.

Ministry of Energy

Ministère de l'Énergie

February 23, 2005

ONTARIO GOVERNMENT ANNOUNCES PRICES ON ELECTRICITY FROM ONTARIO POWER GENERATION

The Ontario government has established prices for electricity produced by Ontario Power Generation (OPG) effective April 1, 2005. These prices are designed to:

- Better reflect the true cost of producing electricity
- Ensure a reliable, sustainable and diverse supply of power in Ontario
- Protect Ontario's medium and large businesses by ensuring rates are stable and competitive
- Provide an incentive for OPG to contain costs and to maximize efficiencies
- Allow OPG to better service its debt while earning a rate of return that balances the needs of customers and ensures a fair return for taxpayers
- Relieve taxpayers of the burden of a financially unsustainable rebate program.

Prices on Output of OPG's Regulated Assets

- Under Bill 100, the Electricity Restructuring Act, the government is obliged to set a price for the output of OPG's regulated assets. These assets include the Adam Beck and Decew hydro stations at Niagara, the R.H. Saunders hydro station near Cornwall, and the Pickering and Darlington nuclear stations. These assets provide much of the province's baseload generation, and operate on a nearly constant basis to provide Ontario's homes and businesses with power.
- Regulating the price of OPG's baseload nuclear and hydroelectric assets will reduce price volatility and have a stabilizing effect on electricity prices, which will be of benefit to all consumers.
- Ontario Power Generation's regulated assets represent approximately 60 per cent of OPG's annual output, and approximately 40 per cent of the total generation in Ontario.
- Under the regulation announced today, OPG's baseload hydroelectric generation will be set at 3.3 cents per kilowatt hour, and the price for OPG's nuclear generation will be set at 4.95 cents per kilowatt hour. An average price of 4.5 cents per kilowatt hour is projected for the weighted forecast output for the hydroelectric and nuclear generation combined.
- The prices on OPG's regulated assets are based on projected costs of operation, plus a five per cent return on equity (ROE). While the standard ROE for North

American utilities is ten per cent, a five per cent 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.

- The new prices will stay in effect until the Ontario Energy Board (OEB) develops mechanisms for setting prices for OPG's regulated assets as stipulated in the Electricity Restructuring Act, 2004, no later than March 31, 2008. Transferring the authority to the OEB to set prices for electricity generated from OPG is consistent with the government's commitment to ensure politics are taken out of electricity pricing in the province.

Prices on Output of OPG's Unregulated Assets

- As a result of a ministerial directive, OPG's revenues on most of the output of its unregulated assets (non-baseload hydroelectric, coal and gas-fired stations), which represents approximately 33 per cent of all generation in Ontario, will be temporarily set at an upper limit of 4.7 cents per kilowatt hour. Ontario Power Generation will pay a rebate on revenues over this amount.
- This revenue limit will temporarily be in place from April 1, 2005 to April 30, 2006. It replaces the Market Power Mitigation Agreement (MPMA) implemented by the previous government when it attempted to open Ontario's electricity market in May 2002.
- The revenue limit on OPG's unregulated assets is designed to ensure continued pressure on OPG to contain costs and enhance performance, while acting as a transitional measure to protect consumers as they adjust to the new prices. It is also designed to ensure that OPG has the incentive to respond to market signals and limit OPG's market power.
- The recent Request for Proposals (RFP) which will result in almost 400 megawatts of new renewable energy supply, together with the current RFP for 2,500 megawatts of new clean energy supply, demand response and energy conservation initiatives, both clearly demonstrate that the McGuinty government is taking decisive steps to close the looming gap between electricity supply and demand in the province.

Effect on Consumers

- The new pricing takes effect on April 1, 2005, and will have an immediate impact on the approximately 55,000 large industrial and commercial electricity customers across Ontario who use more than 250,000 kilowatt hours per year.
- To provide some recent historical comparisons on the likely price impacts, commodity prices that large consumers will pay starting April 1 are expected to be 1.5 per cent higher than the prices which prevailed in 2002/2003, the first year of

market opening. The prices will be about 5 per cent higher than 2003 prices, and between 8 to 12 per cent higher than the unusually soft prices in 2004 (in part, the result of extremely moderate weather in both the summer and winter peak demand periods).

- It is important to look at today's announcement in the broader context of price trends over a number of years, rather than just looking at comparisons to any one specific period where, for example, unusual weather patterns could be a key driver in setting overall price levels.
- It is also important to look at today's announcement in the context of commodity price increases that have also recently taken place or have been announced in key U.S. jurisdictions, as well as in Quebec and Manitoba, two of the lowest cost electricity jurisdictions in North America. By April 1, 2005, for example, it is forecast that Quebec (which relies almost exclusively on hydroelectric power) prices for all classes of customers will have increased by about 7 per cent over the period 2004/2005. In addition, on August 1, 2004, Manitoba (another major hydroelectric jurisdiction) introduced new general rates which represented an average increase of 5 per cent for all customer classes.
- Even with the removal of the MPMA, electricity costs for large industrial and commercial users in Ontario will continue to match neighbours with whom we compete such as Michigan and Illinois, and in fact will be lower than such jurisdictions as New York, Massachusetts and Pennsylvania.
- In order to help large customers cope with the realities of increasing electricity prices, while adding needed new electricity supply to Ontario, the McGuinty government has also announced that it is appointing an industrial co-generation facilitator to actively encourage industrial cogeneration projects in the province (see accompanying backgrounder). Co-generation opportunities can significantly reduce electricity costs for large industrial users, resulting in enhanced operational efficiencies and improved overall competitiveness.
- While residential, small business and designated consumers will not be affected immediately the Ontario Energy Board's new regulated price plan (RPP) will take effect no later than May 1, 2005. The board will blend the various prices paid to generators into a fixed price that consumers will pay under the RPP. That price will be stable but still reflect the true cost of producing electricity.

History of the Market Power Mitigation Agreement

- The MPMA was put in place by the previous government when it tried to open Ontario's electricity market in May 2002, in order to prevent OPG from exploiting its dominant position as the majority supplier of Ontario's electricity. The MPMA structure was intended to be a temporary measure consistent with the previous government's policy of selling OPG's generation assets.

- Since its inception, the MPMA has cost OPG approximately \$100 million per month and approximately \$3.3 billion in total. As a result, OPG has suffered poor financial performance over the last three years, and the government and taxpayers have not been able to realize any financial benefit from OPG.
- Under the MPMA, all customers who use more than 250,000 kilowatt hours per year receive a rebate if the annual average Ontario electricity price exceeds 3.8 cents per kilowatt hour. This rebate applies to half of the electricity they consume.
- Due to the MPMA, electricity prices for consumers have been effectively subsidized by taxpayers, and OPG has not been able to recover the cost of generating the electricity it produces. This has severely compromised the company's ability to improve its overall financial performance.

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