ONTARIO POWER GENERATION

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VIA RESS AND COURIER

Ms Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319
2300 Yonge Street, Suite 2700
Toronto, Ontario
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Dear Ms. Walli:

Re: OPG's Written Submission- Consultation regarding Incentive Rate Making Options for Ontario Power Generation's Prescribed Generation Assets
Board File No. EB-2012-0340

The OEB issued a letter dated August 30, 2012 to all parties participating in EB-2010-0008 and other interested parties soliciting written submissions by October 1, 2012 commenting on the issues and options presented in, and content of, the Power Advisory LLC ("PA") Report ("PA Report") and the presentations and discussions at the stakeholder meeting held August 28, 2012.

The presentations prepared by OPG and its independent consultant, London Economics International LLC ("LEI"), reflect OPG's views on the PA Report and, while details still need to be developed further, in OPG's view there appeared to be a substantial level of agreement between PA, LEI and OPG as to the possible forms of incentive regulation applicable to OPG. OPG's submission summarizes the areas where there appears to be a substantial level of agreement between PA, LEI and OPG, clarifies OPG's response to a question related to the hydroelectric Incentive Regulation Mechanism ("IRM") term, and provides a suggested path forward.

1. AREAS OF SUBSTANTIAL AGREEMENT

1.1 General

- **OPG's current form of regulation already contains significant incentives:** The PA Report, the LEI presentation and OPG's presentation highlighted that OPG's current form of regulation already contains significant incentives. As a result, OPG noted during the consultation that an incentive-based regulation methodology for OPG could be an extension of the current framework (i.e., evolutionary rather than revolutionary).
- **An IRM can be established on a technology specific basis:** PA and LEI highlighted a number of differences between hydroelectric and nuclear operations, concluding independently that a technology-specific set of incentives should apply. OPG agreed, noting in the consultation that the majority of the capital and OM&A costs are incurred at the

technology-specific level, and the allocation of corporate and centrally held costs had been reviewed in both EB-2007-0905 and EB-2010-0008 and accepted without outstanding concerns cited.

- **IRM should be introduced in a staged fashion:** Stakeholders and others expressed concern with the paucity of examples of IRM applied to generation-only utilities. LE and OPG saw value in applying IRM to hydroelectric operations first, and then applying lessons learned to the design of a nuclear IRM.
- **A Price Cap approach is recommended:** As part of its menu of options, PA recommended a price cap option for both nuclear and hydroelectric businesses. LEI also recommended a price cap for both technologies.
- **A Cost-of-Service approach should be used to establish the base year price:** The PA Report (page 7) states that IRM benefits from the establishment of a price based on Cost-of-Service principles as the initial value of "cast-off" point. LEI agreed with this statement, although cautioned against applying immediate stretch factors to that initial "cast-off" point in deriving the base year price. OPG also agreed, noting that this approach has been used by the OEB to set incentive rates for all other utilities it regulates.
- **The Business Plan is an appropriate starting point for a building blocks form of price cap (PA's "N2" and LEI's proposal for an "H7"):** The PA Report (pages 45-46) stated that OPG's top-down business planning approach for nuclear operations incorporates performance target improvements, and PA agreed in their presentation that such a business plan is a reasonable starting point. LEI agreed, stating that it was not only reasonable, but also the proper starting point. OPG concurs.
- **An Earnings Sharing Mechanism ("ESM") can be appropriate:** PA, LEI and OPG agreed that an earnings sharing mechanism can be appropriate, especially given the lack of IRM experience in a generation context. The ESM, in LEI's view, would be an advantageous feature of an IRM mechanism from both the regulator's and company's perspective. All parties provided comments as to how such a mechanism should be applied; with PA indicating an ESM should apply to both technologies at the same time, and LEI advocating why any ESM must be considered on a holistic basis with other aspects of the proposed IRM. LEI and OPG further noted that any ESM must be symmetric.
- **Total Factor Productivity ("TFP") studies are significantly more difficult to perform for generation:** PA and LEI both cited technical issues which are exacerbated in the context of a generation TFP study. OPG agreed, highlighting issues of data availability (given the unregulated nature and private ownership of comparable generation assets) and questioned the relevance of such a study/data gathering exercise in a situation where the future operating environment will be substantially different from the past operating environment. All parties recommended other options, as discussed in section 1.2 and 1.3 below.
- **An Incremental Capital Module ("ICM") is recommended:** In comparison to distribution and transmission utilities, generation capital investments are even more "lumpy" and output can be more variable around capital plans. An ICM of some form is suitable to address this issue generally, although LEI noted that the current ICM plan used by the Board with distribution utilities may need to be adapted. OPG's Darlington refurbishment is a more substantial capital project and the approach to address it is discussed in section 1.3 below.
- **"Y" and "Z" - factors should be permitted:** Both PA and LEI agreed on this issue; however there was little discussion as to what should constitute a "Y" or "Z" factor. PA made

a general comment that it is not unusual for Canadian utilities to have lots of variance accounts and stated that the number of accounts that OPG has is unusually high. OPG notes that the two largest utilities currently on IRM, Enbridge Gas Distribution and Union Gas Limited, both have more deferral and variance accounts than OPG based on OPG's review of recent rate orders. OPG is of the view that, as most of the deferral and variance accounts approved by the OEB are required by O. Reg. 53/05 or are necessary to facilitate findings in OEB decisions (e.g., the Tax Loss Variance Account, the Pension and OPEB Cost Variance Account, the Hydroelectric Incentive Mechanism Variance Account, etc.), OEB-approved deferral and variance accounts are a reasonable starting point for establishing "Y" or "Z" factors.

- **Off-ramps should be considered:** PA noted that this provides a level of protection in conjunction with an ESM if the initial regulatory mechanism or significant changes in OPG's circumstances occurred during the IRM term. LEI stated that they generally agreed; but additional consideration is required to refine specific details and parameter values.
- **Incentives should be aligned with the incentives of those making decisions:** PA highlighted this foundational requirement in the PA Report and again in their presentations. OPG agreed, noting that if the OEB's approved IRM reflected the performance metrics in OPG's corporate scorecard, then the performance incentives would be aligned with those of decision makers at OPG as OPG's pay-for-performance plans are designed to support OPG's corporate scorecard performance metrics and targets.

1.2 Hydroelectric: Operations

- **Maintain the current Hydroelectric Incentive Mechanism ("HIM"):** Alternatives to the current HIM were considered, however a better alternative was not identified by either PA or LEI. Both PA and LEI support the continuation of the current HIM. PA stated that the incentive itself should be proportionate to the benefits enjoyed by ratepayers, and must be large enough to induce OPG to act in best interests of consumers, but made no specific proposals to change the current HIM. LEI expressed concern about the after-the-fact review of the SBG assessment, suggesting that a more stream-lined and predictable approach be considered. OPG was directed to perform an analysis of SBG in the OEB's EB-2010-0008 Decision, which OPG intends to file in its upcoming hydroelectric main payment amounts application. The next hydroelectric payment amounts application is expected to establish the cast off rates for incentive regulation; therefore changes to the HIM as a result of the analysis directed by the Board in EB-2010-0008 will be reflected in OPG's 1st Generation incentive regulation methodology.
- **Do not conduct a TFP analysis:** The PA Report concluded that a TFP analysis will be difficult, cumbersome and possibly ineffective or inconclusive for purposes of rate setting as OPG's regulated hydroelectric portfolio consists of plants in the latter part of their life cycle. PA indicated that the cost of conducting the study may not be worth the benefit given the high percentage of hydro revenue requirement that is based on fixed capital costs. In lieu of a TFP analysis, the PA Report recommended setting a "modest" X factor, while LEI recommended applying the building blocks approach the PA Report had recommended for nuclear operations. OPG suggested either using the building blocks approach or a percentage of the escalation approach (e.g., GDP-IPI-FDD) as used by the OEB for Enbridge Gas Distribution Inc.

1.3 Nuclear Operations

- **An IRM only works if the operating environment is sufficiently stable:** The PA Report (page 37) stated that all IRM approaches implicitly assume that the future will not be radically different from the past, at least in a structural sense. Both LEI and OPG highlighted the fact that OPG's future for both Pickering (managed end-of-life going forward) and Darlington (substantial refurbishment to extend useful life***) will not be operating*** in an environment that is in any way similar to the past. LEI stated that, while PA's proposed option N2 is feasible, it may not be ***<u>feasible today without</u>*** a lot of bells and whistles to address fixed costs during periods of outage and lost production. New nuclear should be considered outside the realm of existing nuclear fleet.
- **The building blocks approach (N2) should be adopted:** The PA Report recommended the building blocks approach (N2) using a top-down planning approach to reflect achievement of reasonably aggressive performance targets in revenue requirement. Both LEI and OPG agreed that this appeared to be the most reasonable approach once Darlington refurbishment was completed.
- **Specific targeted incentives (N4) should be considered:** Additional work will be required in this area as the nature of the incremental targeted incentives was not resolved. OPG has recommended that any incremental incentives should reflect the performance metrics and targets contained in its corporate scorecard (e.g., safety, project management, etc.), while the PA seemed to indicate that these would be incremental rewards (i.e., one-sided) for achieving an even higher level of performance than the targets reflected in the N2 approach (e.g., a reward for achieving an even lower forced loss rate than reflected in N2 standards at a specific site such as Pickering). LEI cautioned that such incentives need to be carefully considered on a holistic basis with other aspects of the IRM so unintended consequences do not arise (i.e., need to avoid duplication in compensation or punitive action in terms of penalties because that could undermine other objectives).
- **Darlington refurbishment presents unique challenges best addressed outside the IRM:** In addition to an ICM, the likelihood of significant customer rate impacts due to both the cost of the project and the loss of production during Darlington refurbishment needs to be managed. Innovative approaches may be required to smooth the impact on both utility and customer beyond what occurs in a typical ICM. <u>These unique challenges exist regardless of whether regulation continues in its current form or changes to an IRM mechanism in the future</u>. OPG is of the view that the discussion of the options to address Darlington refurbishment is best considered in the context of a full Cost-of-Service application, as OPG-specific numbers are required to make intelligent trade-offs in terms of collection horizon and customer impacts.

2. IRM TERM

OPG currently prepares detailed 3-year business plans. These plans can be used in a bridge year to set base rates for a 2-year test period, and can be used in the last year of a two-year test period to set an IRM for two additional years. That is the basis of OPG's intended IRM for its hydroelectric operations.

To be clear, OPG is proposing to file a hydroelectric Cost-of-Service application in 2013 to set base payment amounts for 2014 and 2015. Assuming the building blocks approach is used, OPG would then file in 2015 to set the price escalator for 2016 and 2017. OPG stated during the consultation that it has prepared 5-year business plans in the past and, subject to check, could revert to that planning horizon, although a shorter time horizon for OPG's first generation of IRM is preferable as it will permit all parties to learn and consider the merits of potential modifications, including a longer timeline, in the second generation of IRM. OPG's business plan that would be filed in 2013 is already well in progress and only encompasses the 2013 to 2015 period.

3. NEXT STEPS

At the conclusion of the consultation, OEB staff stated that it intended to develop an OEB staff paper in late fall of 2012 that will be provided to senior management for consideration of next steps. OEB staff outlined that senior management could determine to send it to the Board. OEB staff noted that the Board had several options as to how to proceed, including issuing a policy statement or filing guidelines. OEB staff indicated that, as any resulting pronouncement would have long-term implications and may be precedent setting, the Board would proceed cautiously.

OPG submits that, should senior management opt to send this to the Board, and the Board determines that a policy paper or filing guidelines are warranted, that OPG and stakeholders be provided with a chance to make submissions before such policy statements or filing guidelines are finalized.

Yours sincerely,

[Original Signed By]

Pankaj Sardana
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Ontario Power Generation