

Technical Conference Questions

Board Staff Follow-up Question on OPG Responses to Interrogatories

Number: 6

The response in L-T1-S13 (Board staff IR #13) states, "Ms. McShane did take into account the risk mitigating impacts on the cost of capital of the applied-for deferral accounts." It appears Ms. McShane meant she took into account applied-for variance accounts (as well as deferral accounts) since she noted in that response "the [water conditions] variance account is a key risk mitigator for OPG" to clarify she had taken them into account. Please confirm. Also, given Ms. McShane did make adjustments for the requested variance and deferral accounts as explained in L-T1-S13, please identify what Ms. McShane's recommended ROE and capital structure would be under a scenario whereby none of the applied-for variance and deferral accounts were approved by the Board.

Response

With respect to the first part of the question, it is confirmed that Ms. McShane considered the potential risk mitigating impacts of all deferral and variance accounts applied for by OPG.

With respect to the second part of the question, the deferral and variance accounts are discussed under two major categories.

- (1) accounts required by Regulation 53/05; these include the PARTS deferral account, the Nuclear Liability Deferral Account, the Capacity Refurbishment Variance Account, and the Nuclear Development Variance Account.
- (2) accounts which were provided for in the Regulation and which OPG is proposing to continue (the Water Conditions Variance Account, and the Ancillary Services Variance Account) and newly proposed accounts (which include Nuclear Fuel Cost Variance, Segregated Mode and Water Transactions Variance, Pension and OPEB Cost Variance and Changes in Taxation Rates or Rules Variance Accounts).

Ms. McShane's response presumes that the OEB will approve accounts required by Regulation 53/05.

With respect to the second category of accounts, Ms. McShane views the Segregated Mode and Water Transactions Variance Account as largely a means to ensure that ratepayers share the benefits of revenues from these sources, not a risk mitigator to OPG. With respect to Changes in Taxation Rates or Rules variance account, this account would capture variations that are in the nature of one time changes. While changes in taxation rates or rules can have a material effect on earnings between rate proceedings, the approval of the account is an efficient means of addressing such changes. A similar account has been adopted for the Ontario LDCs, and effectively

1 takes the place of an accounting order to allow the recovery or refund of material one
2 time changes. As Ms. Ms. McShane has no reason to conclude that the Board would not
3 allow OPG to recover/refund costs related to changes in taxes either through the
4 creation of a deferral account or an accounting order, the approval or denial of the
5 deferral account would not have a material effect on the cost of capital. The remaining
6 four, the Ancillary Services Variance Account, the Pension and OPEB variance account,
7 the Nuclear Fuel Cost Variance Account and the Water Conditions Variance Account, all
8 relate to elements of the revenue requirement that are likely to exhibit year-to-year
9 volatility principally due to, respectively, higher or lower than forecast revenues from
10 ancillary services, changes in discount rate, cost of fuel, and water conditions.

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12 With respect to Ancillary Services, Ms. McShane understands that these revenues are
13 inherently difficult to forecast. Based on recent experience (2005-2007), the variation
14 between forecast and actual could be equal to approximately \$4 million on an after-tax
15 basis (approximately 0.1% variation in ROE). With respect to Pension and OPEB, OPG
16 has estimated that a 0.25% change in the discount rate would impact company-wide
17 pension/OPEB expense by approximately \$50 million. With 80% of that attributable to
18 regulated operations, the after-tax impact would be approximately \$25 million (or slightly
19 over 0.50% in the regulated operations' ROE). With respect to the Water Conditions
20 Variance Account, in response to L-2-015, Ms. McShane indicated that, in assessing
21 OPG's risk as it relates to the impact of the variance account, she considered the
22 potential for hydroelectric production to differ from long-term averages by close to 10%.
23 A reduction in hydroelectric production of 10% from forecast in isolation is equivalent to
24 a reduction in earnings of approximately \$30 million after-tax, equivalent to a reduction in
25 the regulated operations' ROE of approximately 0.7%. As regards nuclear fuel, OPG has
26 estimated that its actual cost of fuel during 2009 could be as much as \$24 million higher
27 than forecast, equal to approximately \$16 million after-tax, or equivalent to
28 approximately 0.4% short-fall in ROE. This variance reflects consumption of fuel in
29 inventory and could be higher in the future as the lower cost inventory is used up.

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31 Taken all together, the absence of the four accounts could result in a short-fall from the
32 proposed ROE of approximately 1.7 percentage points (i.e., 0.1% Ancillary Services +
33 0.5% Pension/OPEB + 0.7% Water Conditions + 0.4% Nuclear Fuel) based on the
34 proposed forecast 2009 equity. (It follows logically that, if the adopted equity component
35 were lower, the impact on ROE would greater). In assessing the impact of the absence
36 of these accounts, however, it must be recognized that there is no evidence to indicate
37 that year-to-year variations in ancillary revenues, pension/OPEB discount rates, cost of
38 fuel and water conditions are highly correlated. Thus, a negative variance from forecast
39 in one area may be offset by a positive variance in another. Given the potential variance
40 from forecast in conjunction with the possibility of both positive and negative variances,
41 In Ms. McShane's judgment, in the absence of these four accounts, the increase in the
42 required ROE would be in the range of approximately 25-50 basis points. When
43 translated into a required change in common equity ratio (keeping the proposed ROE
44 constant at 10.5%), the proposed common equity ratio would increase from the filed-for
45 57.5% to a range of approximately 60-63%.