UNDERTAKING J12.2

Undertaking

Provide complete calculation of the impact on capital structure or ROE of the elimination of all variance and deferral accounts.

Response

In response to KT1.6, Ms. McShane assessed the impact on OPG's cost of capital of the absence of the following deferral/variance accounts:

1) Water Conditions
2) Ancillary Services
3) Nuclear Fuel Cost
4) Segregated Mode and Water Transactions
5) Pension and OPEB Cost
6) Changes in Taxation Rates or Rules

She assumed in that response that the Board would approve the following accounts required by Regulation 53/05:

7) PARTS Deferral Account
8) Nuclear Liability Deferral Account
9) Capacity Refurbishment Variance Account
10) Nuclear Development Variance Account

In KT1.6, Ms. McShane estimated that the absence of the six deferral and variance accounts that are not required under Regulation 53/05 would increase OPG's cost of equity by approximately 25-50 basis points.

This Undertaking requests that Ms. McShane quantify the impact on OPG's capital structure or ROE if the Board were to deny all the proposed deferral/variance accounts, including the four required under Regulation 53/05.[1]

[1] It bears noting that Board Staff introduced Undertaking J12.2 by stating that Ms. McShane had referred to TransAlta as the most comparable to OPG and that TransAlta is a merchant generator. Ms. McShane's testimony indicates that TransAlta

Any assessment of the impact of the loss of all the accounts, including the four required by Regulation 53/05, needs to make a distinction between the treatment of costs that were incurred prior to April 1, 2008 and the costs that would be subject to future deferral/variance account treatment. Ms. McShane views the denial of recovery of costs incurred prior to April 1, 2008 as a form of retroactive ratemaking. Not only would the denial of recovery of these costs have an enormous one-time impact on OPG's net income, it would likely be viewed by the investment community as constituting a significant increase in regulatory risk and the cost of capital. The impact on the cost of capital, however, is not readily subject to quantification. Even if OPG were publicly traded, the impact could only be estimated after the fact through the impact on the share price.

The absence of the nuclear liability, capacity refurbishment and nuclear development accounts is likely to have a significant impact on the cost of capital given (a) the magnitude of the 2007 balance ($130.5 million) in the nuclear liability variance account at year-end 2007 and (b) the potential magnitude of capacity refurbishment and nuclear development costs. However, until such time as there are sufficient data to analyze potential variances between forecast and actual costs over time, it is not possible to isolate and explicitly quantify the impact of these accounts on the cost of capital.

Corporation and TransAlta Utilities Corporation (two separate entities) are the closest peers in Canada for OPG's regulated operations. While TransAlta Corporation is a merchant generator, TransAlta Utilities Corporation would not be considered a merchant generator. Of the 3919 MW of capacity owned by TransAlta Utilities Corporation, all but 279 MW is governed by the Alberta PPAs, which S&P refers to as "quasi-regulated". The Alberta PPAs are effectively a cost of service framework which provides for recovery of forecast fixed and variable costs, including an allowed return on deemed equity. The Alberta PPAs include change in law provisions, which allow recovery of such unanticipated costs as legislated environmental compliance costs. While it is at risk for unanticipated increases in fuel costs, TransAlta Utilities owns or controls the coal mines that provide fuel for its Alberta thermal plants, thus limiting its exposure to the market price of coal. Further, the PPA regulation provides for full recovery of decommissioning costs of the plants through the Balancing Pool. DBRS notes that the key challenge facing TransAlta Utilities Corporation is unplanned outages. If TransAlta Utilities fails to meet the availability targets specified in the PPAs, it must make payments to the holders of the PPAs based on the market price of electricity. However, if it exceeds the availability targets, it receives incentive payments. DBRS indicates that the ROE of TransAlta Utilities has averaged 25% from 2003-2006.