EB-2007-0905

ONTARIO ENERGY BOARD

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O.1998, c.15, (Schedule B);

AND IN THE MATTER OF an application by Ontario Power Generation Inc. pursuant to section 78.1 of the *Ontario Energy Board Act, 1998* for an Order or Orders determining payment amounts for the output of certain of its generating facilities

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Written Argument Of
The Consumers Council of Canada

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WRITTEN ARGUMENT OF THE CONSUMERS COUNCIL OF CANADA

I INTRODUCTION AND OVERVIEW

1. Ontario Power Generation Inc. ("OPG") is applying, pursuant to section 78.1 of the Ontario Energy Board Act, 1998 (the "Act") for approval of payment amounts for the output of certain of its generating facilities.

2. OPG's Application is unique, in several respects. The first is that this is OPG's first Application, under section 78.1 of the Act, and therefore the first opportunity for the Ontario Energy Board (the "Board") to consider OPG's operations, and the amounts which should be charged for the output of its so-called "prescribed" facilities. As discussed in greater detail, at various points in this Written Argument, the fact that this is OPG's first Application places practical limits on the exercise of the Board's discretion. It is also unique because of the regulatory framework within which the application must be considered and, in particular, the limits which have been placed on the exercise of the Board's discretion to determine just and reasonable rates.

3. OPG's Application is also important because of the precedent value of any decision which the Board will render. Among other things, the Board must determine whether,

or to what extent, the constraints which Ontario Regulation 53/05 (the "Regulation") imposes on the exercise of the Board's discretion in this Application will affect the exercise of the Board's discretion in determining payment amounts for the output of OPG's prescribed facilities in the future applications.

4. This is the written argument of the Consumers Council of Canada ("Council").

5. We will begin with a review of the regulatory framework within which this application must be considered. We will then consider the individual issues in the application. The Council will not make submissions on all of the issues on the Issues List. Where the Council does not make submissions, it is because it either believes that the Regulation takes away the Board's discretion to reject what OPG proposes, or because the Council believes that there is no evidence on which the Council can fairly argue that what OPG proposes is unreasonable.

II THE REGULATORY FRAMEWORK

6. As noted above, OPG has applied under section 78.1 of the Act. Absent any constraints, subsection 78.1(5) of the Act grants the Board the discretion to determine whether the payment amounts proposed by OPG were just and reasonable. In exercising that discretion, the Board would be required to have reference to section 1 of the Act, which requires the Board, in carrying out its responsibilities under the Act in relation to electricity, to be guided by the objectives of protecting the interests of consumers with respect to prices, and the adequacy, reliability and quality of electric service, and to promote economic efficiency and cost-effectiveness in the generation, transmission, distribution, sale and demand management of electricity, and to facilitate the maintenance of a financially-viable electricity industry.

7. However, the exercise of the Board's discretion is constrained by the Regulation, in the following ways:

1. It requires the Board to accept OPG's assets and liabilities as established by OPG's 2007 audited financial statements. That effectively precludes the Board from, for example, examining whether OPG's capital expenditures have been reasonable;

2. It requires the recovery of the following amounts:

(i) the differences in production due to differences between forecast and actual water conditions, differences in ancillary services revenues, and costs associated with transmission;

(ii) the funding of nuclear liabilities;

(iii) costs incurred to increase the output of prescribed facilities;

(iv) costs of planning in preparation for new nuclear facilities;

(v) costs incurred with respect to the Bruce Generating Station;

(vi) costs of the Pickering A return to service project.

8. The Regulation requires OPG to create certain deferral and variance accounts, and to record certain costs and revenue. The Regulation also sets out rules which the Board is to apply in disposing of these accounts in this application.

9. One of the distinctive features of the Regulation is that it creates two broad categories of these deferral and variance accounts. There are those which, by the terms, are to record revenues or costs up to the time of the first order, and there are those which, by the terms, are to record revenues or costs beyond the time of the first order. An example of the former is the deferral account created by section 5.3 of the Regulation. Examples of the latter are the variance accounts created by section 5.4 of the Regulation, and perhaps by section 5(4) of the Regulation.

10. It is essential that the Regulation be understood, not just for its effect in constraining the exercise of the Board’s discretion with respect to specific items, but for what it represents. The Council submits that the Regulation reflects an exercise of OPG’s shareholder's extraordinary power to limit the risk which OPG’s business operations would face, and to do so by limiting the discretion of the regulator to determine whether the proposed payments are otherwise just and reasonable. This exercise of the shareholder’s extraordinary power fundamentally alters not just consideration of the payment amounts but of the risk which OPG

faces. The nature and content of the Regulation also clearly signal the willingness of OPG's shareholder to take any additional measures it feels are required to protect OPG from material risks.

11. OPG suggests that the exercise of the Board’s discretion is constrained by the terms of the Memorandum of Agreement (“MOA”) **(Ex. A, T1, S4, App. B)** between the province, in its capacity as OPG’s shareholder, and OPG. OPG describes the MOA as a "policy directive", words which suggest that the Board is in someway bound by its terms **(Argument-in-Chief (“AIC”), p. 7).** In particular, OPG relies on the statement in the MOA, that “OPG will operate as a commercial enterprise…”. OPG relies on that statement in support of its argument that the Board must treat OPG as a stand-alone entity, entitled to the same capital structure and return on equity that any other, similarly-situated commercial enterprise would have.

12. It bears repeating the obvious, namely that the MOA does not, and can not, constrain the exercise of the Board’s discretion under section 78.1 of the Act. To the extent that it might influence the way the Board regards OPG, then other statements within the MOA should be given equal weight. In particular, equal weight should be given to the statements, in the MOA, that, “OPG will operate these assets in a manner that mitigates the Province’s financial and operational risk”, that “OPG’s key nuclear objective will be the reduction of the risk exposure to the province, arising from its investment in nuclear generating stations in general, and in particular the refurbishment of older units” and that, “with respect to investment in new generation capacity, OPG’s priority will be hydroelectric generation capacity”. These three statements from the MOA indicate that its shareholder does not regard OPG as an ordinary commercial enterprise, but as one that must, to the greatest extent possible, minimize the risks its activities entail.

13. A consideration of the regulatory framework must also include OPG’s critical role in providing the essential baseload supply of electricity for the province. OPG’s shareholder has directed the Ontario Power Authority (“OPA”) to develop an integrated power supply plan (“IPSP”). In doing so, the province has directed the OPA to include in the IPSP provision for up to 14,000 megawatts of nuclear supply. It is OPG that will be the primary supplier of nuclear power. The provision of that nuclear supply is essential to the long-term economic health of the

province and its residents. OPG is not a normal “commercial enterprise”. Rather, its activities are designated by its shareholder as being essential to the health of the province’s economy. That is a factor that must be kept in mind in determining, among other things, whether OPG faces the same kinds of risks as other, similarly-situated utilities.

14. In considering the regulatory framework governing this application, it must also be remembered that this is OPG’s first application. There is no precedent for Board treatment of the payment amounts for the prescribed assets. Quite apart from the constraints imposed by the Regulation, the Board has no factual basis against which it can measure the reasonableness of the payment amounts which OPG proposes. In the ordinary course, the Board would consider the rates or charges which a utility proposes against the background of a history of Board consideration of the revenues and costs of that utility. That is not possible here. The practical effect of that is to limit the Board’s ability to critically assess the reasonableness of what OPG proposes. This limitation has implications, discussed below, for what the Board should require OPG to produce in its next application.

15. The Board will not only have to consider the ways in which the Regulation constrains its discretion in deciding this application. As noted above, the Regulation requires preparation of deferral and variance accounts, and recording of amounts in those accounts, for periods beyond the date of the Board's first order. In addition, OPG argues that the provisions of sections 6(2)7(i), 6(2)5, and 6(2)8 of the Regulation prescribe the way the Board must, now and in the future, treat OPG’s nuclear liabilities. The Board will have to decide whether, or to what extent, the Regulation constrains its discretion in deciding payment amounts in future cases. This is particularly important in the case of the treatment of nuclear liabilities.

III SPECIFIC ISSUES

Issue 2.1: **What is the appropriate capital structure for OPG’s regulated business for the 2008 and 2009 test years? Should the same capital structure be used for both OPG’s regulated hydroelectric and nuclear businesses? If not, what capital structure is appropriate for each business?**

16. OPG is seeking a capital structure for its prescribed assets consisting of 55.7% equity and 42.5% debt, and ROE of 10.5%.

17. OPG's argument, in support of its proposed capital structure, is based principally on the notion that it faces considerably higher risks that a typical regulated utility in Canada. (**AIC, p. 7**). There are three main components, or building blocks, to OPG's argument in support of its proposed cost of capital and return on equity. They are:

1. The application of the stand-alone principle;

2. The calculation of the cost of common equity using the standard mechanisms;

3. The assessment of risk and the appropriate common equity ratio.

We will address these three components, or building blocks, individually.

(a) The Stand-Alone Principle

18. OPG's argument is that it should be considered on the "strength of its own business and financial parameters" (**AIC, p. 15**). The essence of this argument is that the Board, in considering the capital structure, should ignore the reality of the province's ownership of OPG.

19. The Council disagrees with this argument. It is inconsistent with the reality of OPG's relationship with its shareholder, as evidenced in various actions of the shareholder, including the provisions of the Regulation. It is also important to remember that, although OPG is an OBCA corporation, its only shareholder is the province. Further, although it is not required to make income tax payments, it does make "payments in lieu of taxes" all of which go to the province to help service the interest on the debt that was stranded when Ontario Hydro was reorganized. Consequently, it is highly unlikely that its current status will change in the foreseeable future.

20. The Council begins with the proposition that the real shareholders are the residents of the province of Ontario, and that the government is acting as their agent or proxy. In that latter capacity, the government has responsibilities to the residents with respect to ensuring that there is an adequate supply of electricity, at reasonable prices.

21. In carrying out those responsibilities, the government has done a number of things, as follows:

1. It has directed the OPA to develop the IPSP. As noted above, it has required the OPA to include in the IPSP up to 14,000 megawatts of nuclear supply and up to 10,000 megawatts of renewable energy from hydroelectric sources. Since OPG will be the principal supplier of any additional nuclear power, the government has directed OPG to develop additional nuclear generation capacity and to refurbish its existing nuclear generation capacity. That direction is embodied in a letter, dated June 16, 2006, to James Hankinson of OPG, from the then-Minister of Energy, Mr. Duncan. In that letter, the Minister says the following:

> The Ontario Government announcement directed the OPA to ensure adequate baseload electricity supply while maintaining the nuclear generation component of that baseload at today's level of 14,000 megawatts of installed capacity.

The letter then says that

> Recognizing that maintaining the current level of nuclear baseload through 2025 requires a combination of refurbishment of existing units and construction of replacement units, and given the long lead time required for licence approval of these activities, I am directing OPG to: a) begin feasibility studies on refurbishing its existing nuclear units. As part of this initiative, OPG is directed to also begin an environmental assessment on the refurbishment of the four existing units at Pickering B, and b) begin a federal approvals process, including an environmental assessment, for new nuclear units at an existing site. **(Ex.L3.47)**

The nature of what the government is doing, as reflected in this letter, and as reflected in its directive to the OPA, is important. The government is acting in the interests of ratepayers in directing OPG to maintain and develop nuclear generation. The government is saying, in effect, that nuclear supply is essential to the wellbeing of the province.

2. As noted in the letter from Minister Duncan to Mr. Hankinson, the government has directed OPG to ensure a sufficient supply of nuclear generation, and to do so, in part, through refurbishing its existing nuclear generation capacity. In the Regulation, the government has created a deferral account, to recover the costs of both refurbishing activities and exploring new generation capacity and has directed the Board to allow the recovery of the costs incurred in relation to both. What this amounts to, the Council submits, is that the government has directed OPG to take risks, but has simultaneously required the Board to ensure that OPG is protected from any adverse impact from taking those risks.

22. The government has exercised a power no private sector shareholder has, namely to direct the regulator to ensure risks which are taken in the public interest are protected. We will return to this point, below, when discussing the issue of risks. The point is that the shareholder, because it has obligations to Ontario's residents, and because of its extraordinary powers, has a unique relationship to OPG.

23. Accordingly, the Council submits that trying to consider OPG as somehow separate from its shareholder is contrary to common sense and contrary to all of the evidence which is before the Board. In addition, the bond-rating agencies have consistently recognized that OPG's relationship to the government, and the government's extraordinary power, are important factors in assessing OPG's relative risk. The Council submits that the stand-alone principle, as articulated by Ms McShane, and as relied on by OPG, does not apply here. The Council submits that the facts require the Board to consider the capital structure and return on equity, not on the basis of what amounts to an artificial concept of a stand-alone entity, but on the basis of the reality that the government, because of its obligations to the residents of the province, has a stake in limiting the risks which OPG faces, and ensuring that OPG does not fail.

24. OPG argues that Dr. Booth, the expert witness called by the Council and the Vulnerable Energy Consumers Coalition, agrees that the stand-alone principle should apply **(AIC, p. 16)**, on the basis of evidence filed by Dr. Booth in a proceeding some 20 years ago.

25. Dr. Booth addressed OPG's position, on that point, in his testimony-in-chief. He pointed out that the evidence given in the case OPG relies on was given before Ontario Hydro's debt had accumulated to the point where it had to be transferred directly to ratepayers, and before the government took the extraordinary step of limiting the risks OPG faces by constraining the discretion of the Board, through the mechanism of the Regulation.

26. Dr. Booth summarized his response to OPG's argument on this point, in the following terms:

> So that testimony that we filed in 1987 was appropriate for the questions that we were asked to address at that time.
>
> At this point in time, I was asked to estimate the fair rate of return under the current regulatory regime and the current policies under which OPG's prescribed assets are regulated.
>
> My perception, on that basis, is the risks that we looked at in 1987 actually did come true, but, currently, even if those risks were to come true again, they would be effectively transferred to the ratepayers and are not borne by the province.
> (**Tr., Vol. 13, pp 146-147)**

27. The Council submits, therefore, that the first building block of OPG's argument, namely the stand-alone principle, must be rejected.

(b) The estimation of the cost of common equity

28. In arriving at her recommended cost of equity, OPG's expert, Ms McShane, relies on three approaches, namely the calculation of the equity risk premium, the discounted cash flow, and a comparable earnings test. Her overall estimates are:

Risk premium	9.75-10.75% mid-point 10.25%
Discounted Cash Flow:	9.75-10.0% mid-point 9.875%
Comparable Earnings:	12.50%

Her overall recommended ROE for a benchmark utility is 10.50%. Ms McShane then makes her risk adjustments with her 57.5% recommended common equity ratio **(Ex. C2, T1, S1, P6)**.

29. Dr. Booth follows the same general procedure as Ms McShane in first estimating a benchmark return and then making risk adjustments through the common equity ratio. In his case he uses two risk premium models to estimate a fair return of 7.25%, to which he adds a 50 basis point "cushion" to arrive at a fair ROE of 7.75%. He estimates that OPG has sufficient financial flexibility to access capital markets on reasonable terms with a 7.75% ROE on his recommended 40% common equity ratio **(Ex. M, T3, P3)**.

30. Before even considering other factors it should be borne in mind that, as shown in Schedule 1 of Dr. Booth's Appendix E, the average return on the Canadian equity market has only been 10.42% over the whole period from 1924 until 2007, while current allowed ROEs are generally under 9% for most utilities in Canada on a formula ROE mechanism **(Ex. M, App. E, S1)**. So allowing an ROE of 10.50% on a 57.5% common equity implies that OPG's prescribed assets exceed, by a considerable margin, the riskiness of any other regulated assets in Canada. The Council will show that there is no factual basis for such a huge discrepancy in how Ms McShane views the prescribed assets and how regulators have viewed other utilities in Canada.

31. With respect to the risk premium estimates, there is little disagreement as to the forecast long Canada rate as the basis for the risk premium estimates, but there is considerable disagreement on the risk premium. Here there are two elements: the market risk premium and the relative risk adjustment or beta coefficient.

32. Dr. Booth uses a market risk premium estimate of 5.0% derived from Canadian data, whereas Ms McShane uses 6.5% derived predominantly from US data. We will deal with Ms McShane's use of US data in greater detail, below, but the critical element is what does the market use and here Dr. Booth in his evidence asked the basic question as to what has been the experience of the professionals working in the capital market. His Schedule 5 in his Appendix E makes it very clear that you have to include data going all the way back to the early 1950s to get an estimate of a market risk premium above 5.0%, which is why so many place greater weight on the market experience of the last fifty years of a much lower risk premiums (**Ex. M, App. E, S5**).

Further, there is simply no factual evidence of a Canadian market risk premium close to the 6.5% level used by Ms McShane.

33. In terms of the risk adjustment or beta coefficient, the evidence here is similar. Both Dr. Booth and Ms McShane adjust their betas; the difference is *how* they adjust them. Ms McShane adjusts them by averaging them with 1.0, but since utility betas are almost always less than 1.0 this invariably *increases* them. In contrast, Dr. Booth looks at all the evidence and adjusts them based on his judgment and where we are in the business cycle. At the moment he too adjusts his beta estimates upwards, but only based on recent market conditions. The result again is clear: there is simply no evidence that betas for benchmark Canadian utilities are of the order of 0.65-0.70 as used by Ms McShane. They simply haven't been at this level since the 1970s.

34. In terms of the discounted cash flow ("DCF") test, Dr. Booth's position has been very clear that this is one of the two main methods for estimating fair returns. However, he only uses it as a check due to the lack of pure play utilities and the endemic data problems (**Tr., Vol. 13, pp. 140-141)**. Instead he uses it as a check by estimating a DCF return for the market as a whole where there are fewer problems. The Council would also like to emphasize that Ms McShane's use of analyst growth forecasts in the DCF model data has been questioned and rejected in other jurisdictions, since these forecasts are known to have an *optimism* bias. Dr Booth references the very latest (December 2007) research that puts this bias at an average of 2.84% (**Ex. M, pp. 85-86**). While, as Ms McShane suggests, the bias may be lower for lower growth rate companies like utilities, this is conjecture and not evidence (**Tr., Vol. 13, p. 142**). The fact is there is no evidence of how to adjust for the bias. To accept Ms McShane's DCF analysis would require the Board to accept estimates known to be biased high.

35. Finally we come to comparable earnings evidence. Here Dr. Booth has a full Appendix B showing the actual ROEs of Canadian companies before using screens to narrow down the sample. His position is that such ROEs are useful for gauging the state of the economy, and where we are in the business cycle, but are of no value as a basis for establishing fair ROEs **(Tr., Vol. 13, p.143)**. Further, he reminded the Board, in his examination-in-chief, of how such estimates had been used by the Board in the past:

> "But at that time, Board witnesses provided comparable earnings testimony, but they did so with a market-to-book adjustment. Because when you look at a sample of firms, there is no reason to believe that there is not an element of monopoly power, market power. When you look at high rates of return earned by these firms, you can't just take them over and apply them to a regulated utility, designed to be regulated to remove the effects of market power. So as far as I am aware, the only times this Board accepted comparable earnings testimony was with market-to-book adjustments. And Ms McShane hasn't made any market-to-book adjustments, and I would put no weight on that testimony."
> **(Tr., Vol. 13, p.143)**

36. In looking at the differences between the estimates of Dr. Booth and Ms McShane the Council would like to emphasize two points. In her use of the DCF and the comparable earnings test, Ms McShane relies, to a significant extent, on US data. What is striking about her reliance on this data, and about her use of the DCF and the comparable earnings tests, is that their use has been rejected, explicitly, and by necessary implication, by the Board on several occasions.

37. In the "Decision and Order of the Board" in RP-2002-0158, dated January 16, 2004, which arose from the Board's review of the guidelines for establishing return on equity for the two largest gas utilities in the province, the Board made the following observation on reliance on US data.

> Discussions of ROE decisions from other jurisdictions invariably come into the evidence and arguments of parties. We continue to view such evidence as informative. However, we do not believe that decisions in other jurisdictions are determinative of what ought to be a prospective fair ROE for Ontario utilities. There are many reasons why ROE may differ from one jurisdiction to another in North America. These may include differences in legislation, timing, tax laws, accounting practices, risk considerations arising from different capital structures and from regulatory practices which may or may not shield the utility from business or weather risks, and other regulatory considerations unique to each jurisdiction, including varying reliance on the common tests for determining a fair ROE. There was no evidence that would allow the Board to make a meaningful comparison of these factors, including the relative riskiness of Canadian and American utilities, in order to understand the difference in ROE between American and Canadian utilities. The bare fact that American utilities might earn a higher ROE than Canadian utilities, as suggested by Ms McShane and

> argued by the Applicants, is an inadequate basis upon which to determine whether the ROE for the Applicants should be increased to a level similar to the ROE for American utilities. Similarly, the fact that some Canadian regulators may have awarded higher or lower returns than the Ontario Energy Board, while informative, is not determinative for largely the same reasons. (**Ex. K-11.1, p. 104**)

38. The significance of the Board's observation, set out in the preceding paragraph, is not simply in the Board's explicit rejection on the reliance on US data in setting ROE levels for Canadian utilities. It lies also in the reasons why the Board rejected it. As noted above, the Board observed that there are many reasons why the ROE may differ from one jurisdiction to another in North America, including "risk considerations arising … from regulatory practices which may or may not shield the utility from business or weather risks…". In this proceeding, neither Ms McShane nor OPG provided any evidence that the US data would be the same given the unique regulatory framework, described above, governing OPG. To put the matter another way, neither Ms McShane nor OPG have provided evidence as to why the Board should, in this case, take a different position on the use of data from the US than the Board took in its 2004 decision.

39. In its "Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors", dated December 20, 2006, the Board again rejected reliance on US data, a point with which Ms McShane agreed. (**Ex K-11.2, and Tr., Vol. 11, pp 31-32**)

40. In addition to rejecting reliance on US data, the Board has expressed strong reservations about the use of the DCF and comparable earnings tests. In the "Decision and Order of the Board" in RP-2002-0158, dated January 16, 2004, the Board made the following observations:

> On the basis of the evidence adduced in this proceeding, we find that the reservations the Board expressed in the compendium to the current ROE Guidelines about the CE "that is Comparable Earnings" and DCF approaches and the Board's decision not to employ these tests remain valid. With respect to the CE test, we continue to be concerned with the problems associated with the assembling of an acceptable list of comparable companies against which to assess the regulated utility, as well as the selection of a

> suitable time period from which to draw historical evidence. We note that the subjectivity involved in the selection of an appropriate sample of comparators and the selection of the time period were the primary factors in arriving at an ROE difference of 300 basis points between Ms McShane and Dr. Cannon. We also reiterate our concern with this test's heavy reliance on past performance as an indicator of future performance.
>
> With respect to the DCF test, we note the sensitivity of the results to assumptions, including growth estimates. We note that as a result of different assumptions, Ms McShane's ROE result from the DCF test is over 200 basis points higher than the results obtained by Dr. Booth and Dr. Cannon. Further, in the context of the specific applications before us, we remain uncomfortable with the results of the DCF test given that the shares of the Applicants are no longer traded on the open market.
>
> As a result of the above, we reiterate the Board's conclusions reached when it developed the existing ROE Guidelines that the results from the CE and DCF tests should be given little or no weight for purposes of these applications. (**Ex. K-11.1, pp 131-133**)

41. Again in the "Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors", dated December 20, 2006, the Board "determined that the current approach to setting the ROE will be maintained" and, by necessary implication, rejected the use of the DCF and comparable earnings test. (**Ex. K-11.2, pp 20-21**)

42. The Board's observations, in the 2004 and 2006 Decisions, set out in the preceding paragraphs, were put to Ms McShane in cross-examination, and she was asked whether she agreed that the Board had rejected the use of the comparable earnings and DCF methods. Ms McShane agreed that they did (**Tr., Vol. 11, p. 35**).

43. It bears repeating that neither Ms McShane nor OPG, although aware of the Board's past rejection of the use of US data, and the DCF and comparable earnings test, did not lead evidence, in this case, as to why the Board should change its positions on these matters. This is particularly striking in circumstances where there is such a unique regulatory framework for OPG, a circumstance which would seem, based on the Board's reasoning, to cry out for persuasive evidence as to why the US data, and the two tests which rely so heavily on US data, should be relied on in this case.

44. With respect to Dr. Booth's evidence, OPG, in its AIC, takes comfort in the proposition that "no regulatory tribunal in Canada has adopted his recommendations". (**AIC, p. 30**) While no regulatory tribunal may have agreed with the specific numbers which Dr. Booth has recommended, it is also the case that no regulatory tribunal has rejected the methodology that Dr. Booth used to arrive at those numbers. By contrast, Ms McShane's recommendations have been accepted by only one of the many Canadian regulatory tribunals before which she has given testimony. More importantly, the Board itself has not only rejected Ms McShane's recommendations but, as noted in the preceding paragraphs, has rejected the methodology she has used to arrive at those recommendations.

45. The Council submits that the Board should prefer the testimony of Dr. Booth to that of Ms McShane because Dr. Booth's analysis is based on Canadian data and on the use of a methodology which the Board has repeatedly accepted, while Ms McShane's analysis is based, in large part, on US data, and the use of a methodology which the Board has repeatedly rejected. Finally if any validation is needed Dr. Booth's recommended ROE for a benchmark utility of 7.75% is about 100 basis points lower than the formula ROEs currently being awarded, whereas Ms McShane's recommended ROE is about 175 basis points higher. The Council would stress that Dr. Booth's recommended ROE is within a zone of reasonableness whereas that of Ms McShane is not.

(c) Risk

46. The third of OPG's, and Ms McShane's, argument in favour of its proposed capital structure and ROE is risk. This is the basis for the common equity recommendation and why it should differ from the 36% currently allowed Enbridge and Union Gas as "benchmark utilities. As noted above, it is OPG's position that it "faces considerably higher risks that the typical regulated utility in Canada" (**AIC, p. 7**).

47. The Council submits that any analysis of OPG's risks must begin with certain common sense observations. OPG's prescribed assets produce 40% of the electricity used in Ontario, and some 70% of its baseload power. It follows from that, the CCC submits, that the production of OPG's prescribed assets is essential to the economic health, now and in the future, of Ontario's economy. Further as prescribed assets they are regulated primarily because their

dispatch risk is very, very low since both the nuclear and hydro facilities are designed for continuous operation with very low marginal costs. This differentiates them from peaking plants fired by coal or natural gas where there *is* dispatch risk.

48. That the production of OPG's prescribed assets is essential to the health of Ontario's economy, now and in the future, is reflected in the fact that the OPA has been directed to include, in its IPSP, provision for nuclear generation which is to meet more than half of the forecast needs of the province by the year 2025.

49. The Council submits that it makes no sense that the government, which bears obligations to the residents of the province, would ever allow OPG to fail, or for that matter, to face significant risks. The Council submits that the regulatory framework in this application, and in particular the Regulation, reflects that reality. Any analysis of the risk faced by OPG must start from that point.

50. OPG argues that the Regulation simply reflects "the well-recognized prohibition against retroactive ratemaking" (**AIC, p. 23**). The Council submits that the Regulation reflects much more than that. It reflects the unique capacity of OPG's shareholder to both direct OPG to take certain risks, in order to protect the residents of the province, and to control how those risks are managed, through a direction to OPG's regulator.

51. OPG asserts that the regulatory risks it faces are "relatively high" **(AIC p. 25)**. OPG argues that "the novelty and uniqueness of OPG's circumstances creates uncertainty about the regulatory end-state and increases the risk of unintended consequences from regulatory decisions. (**AIC, p. 25**) The Council finds OPG's argument on this point unpersuasive, for several reasons. The first is that the "novelty and uniqueness" of OPG's circumstances lie in the nature and extent of the protection from risk afforded it by its shareholder. The Council is unaware of any comparable circumstance in which the shareholder of a utility has dictated, in considerable detail, the way in which the utility's rates must be set, and its risks controlled. Beyond that, OPG did not lead any evidence to show that the Board, in its dealing with any of the newly-regulated electricity entities, had treated those entities in a way which has increased their risks. Implicit in OPG's argument is the wholly unfounded notion that this Board, even

without the Regulation, would treat OPG in an arbitrary or unfair manner. There is simply no evidence to support that proposition.

52. The argument that the Board would treat OPG, or indeed any other newly-regulated electricity entity, in a way which increases their risk is belied by the decisions of the Board. For example, Hydro One Networks Transmission sought, on the basis of Ms McShane's evidence, a higher ROE to reflect, among other things, the risks it ostensibly faced because of the significant investment required for new transmission infrastructure. The Board rejected HON's request for a higher ROE, and in the process rejected Ms McShane's arguments. OPG has lead no evidence that the Board's treatment of Hydro One Networks Transmission has had any adverse effect on that entity.

53. OPG argues that the use of deferral accounts is common and therefore does not reflect a means of mitigating risk which is unique to OPG. What is curious about that argument is that the deferral accounts it refers to have been mandated by the Board, whose decisions OPG says represent a risk to it. What is different in this circumstance, however, is that the deferral accounts are mandated by OPG's shareholder. That, in itself, suggests that, were OPG to face any unforeseen risks, its shareholder would take appropriate action to ensure that the risks were controlled and mitigated.

54. In terms of the prescribed assets, approximately 50% of the rate base is nuclear and 50% hydro. To justify a 57.5% common equity ratio, which is much higher than for any other utility regulated by the Board, either nuclear and hydro are *both* very risky or the nuclear assets are simply incredibly risky.

55. In terms of the hydro assets, there is simply no evidence that they are risky. They have been around for over 100 years and have known stable technology. The only significant risk is that of hydrology, that is, the actual water flow, and this is fully captured in a deferral account and passed on to ratepayers so it is a risk not borne by OPG. The Council submits that the judgment of Dr. Booth that, on their own these assets could be financed with 35% common equity ratio, is reasonable and was not contested in cross-examination.

56. In terms of the nuclear assets there is little question that these assets are riskier, but there is also no question that the risk of these assets has been largely passed on to ratepayers through a comprehensive set of deferral accounts and OPG's admission that it reserves the right to seek further deferral accounts should events change.

57. The Council submits that the only meaningful risks which OPG faces are the production and operating risks of its nuclear facilities. In addressing that risk, the important point to remember is that this is not an ordinary utility. It is a utility whose operations the government has specifically identified as critical to the economic health of the province. It is inconceivable that the government would allow OPG to be materially adversely affected by production or operating risks.

58. The Council also submits that the risks posed by production outages can be mitigated by increasing the fixed portion of the payments for the nuclear facilities from 25% as proposed by OPG, to 50%. OPG has conceded that doing so would mitigate the risks it has identified.

59. The central issue, in the analysis of OPG's risk, was posed by Member Chaplin in two questions to Ms McShane, as follows:

> MS CHAPLIN: Ms McShane, isn't it, at the end of the day, the shareholder is going to control how much risk this entity bears? It has, as Mr. Kaiser explained, they have all of the tools and they have used those tools. So why is it appropriate to compensate a shareholder for the risk that they control?
>
> **(Tr., Vol. 10, p. 71)**
>
> MS CHAPLIN: -- to compensate them for the fact that they can't control them. In this instance, the shareholder quite clearly has control over those risks. Ergo, so then I am trying to understand why you believe it is still appropriate to compensate that shareholder, for that risk that they control.
>
> **(Tr., Vol. 10, p. 71)**

60. In all of the evidence which OPG presented, and in its AIC, it has not been able to adequately respond to those questions. The reality, as Ms Chaplin pointed out, is that OPG's

shareholder can not only control the risks OPG faces, but has taken actions, through the Regulation, to control those risks already.

61. The Council submits, in conclusion, that OPG's risks are no higher than any other utility. Accordingly, the third building block of OPG's, and Ms McShane's argument in support of the proposed capital structure, fails.

62. The Council submits that Dr. Booth's recommendation for a common equity ratio of 40% for the overall prescribed assets is the correct one and should be adopted by the Board. At an approximate 50:50 split, this would mean 45% for the nuclear assets which would correctly place them as among the riskiest utilities in Canada (See the Alberta EUB's 2004 allowed common equity ratios across a variety of regulated sectors in Dr. Booth's evidence page 39). It would also place the hydro assets as low risk equivalent to the risk of the benchmark utilities reflecting the province's expectations in the MOA.

Issue 3.5: **Is the additional capital spending (beyond the levels being recovered under section 6(2)4) appropriate?**

63. OPG Hydro and Nuclear Divisions over-forecast capital expenditures each year in the period 2005 to 2007 as indicated below:

Capital Expenditures	Hydro (actual v. budget)	Nuclear (actual v. budget)
2005	($3.2 million)	($66.6 million)
2006	($24.1 million)	($117.5 million)
2007	($145.1 million)	($54.7 million)

(Ex. D1-T1-S1 and D2-T1-S1)

64. The sizeable differences between spending and forecasting during this period were due primarily to scheduling delays. This proceeding is OPG's first rates case and there is a lack of historical evidence against which to measure the reasonableness of the forecasts, and so to justify any reduction. Accordingly, the Council has little choice but to accept OPG's forecast capital budgets and in-service additions for the 2008 and 2009 test years. However, the Council is concerned that corporate controls in place during project execution will not effectively maintain schedules and manage capital requirements.

65. The Council submits that OPG's project approval and control processes seem overly complex and inconsistent with effective central control. For example, the funding approval structure, as set out in the Organization Authority Register **(Ex. L, T14, S94),** is Byzantine in its complexity. It would appear that much of the significant business planning, even for the largest projects, takes place within the business units, without significant central control **(Tr., Vo1. 1, p. 46)**. For example, it would appear that, for the Niagara Tunnel Project, a billion dollar expenditure, the decision to proceed was made outside of the normal business planning process, by OPG's shareholder **(Tr., Vol. 1, p. 49)**.

66. OPG's witnesses were asked to address the example for a project that was approved as a capital expenditure of approximately $12,000,000, but which was converted to an OM&A funded project in the same amount **(Ex. L, T14, S48)** and **(Tr., Vol. 1, p. 55)**. OPG's witnesses agreed that such a change would have implications for the rates which OPG charges **(Tr., Vol. 1, pp. 56 – 57)** and yet there was no central control or required approval for such a change **(Tr., Vol. 1, p. 56)**. The change would be approved by the business unit or wherever the authority resides on the Organizational Authority Register **(Tr., Vol. 1, p. 56)**.

67. OPG asserts that "significant improvements" have been made to project management processes to reduce variances due to project delays noted during the historic period **(Ex. D2, T1, S1)**. Unfortunately, the effects of those "significant improvements" are not apparent in the evidence OPG has filed.

68. The Council is concerned that OPG's decision-making processes, which involve enormous sums of money, and which result in significant rate impacts, are too diffused and lack the required degree of central control and accountability. That accountability is particularly important if there is to be effective regulatory oversight.

69. From a ratemaking perspective, schedule delays that extend a project timeline increase the carrying cost of construction work-in-progress and capitalized costs that are recovered though rates. The Niagara Tunnel Project is the largest capital project undertaken by the hydroelectric division of OPG to date **(Tr., Vol. 1, p. 48)** and schedule delays have extended the project timeline and may increase the overall cost of the project. "There is a potential that the schedule delay could significantly impact the project costs." **(Ex. D1, T1, S1, p. 3)**

70. As OPG is a corporation seeking funding in external capital markets, the Council is concerned with the direct and indirect opportunity costs of capital expenditures forecast if such forecasting is habitually overstated. When the Niagara Tunnel Project was under budget by $144.6 million in 2007, OPG's Treasurer decided not to draw upon the Corporation's credit facility with the Ontario Electricity Financial Corporation **(Tr., Vol. 1, p. 53)**. Given OPG's current borrowing arrangements, the cost and opportunity cost implications appear to have been zero. This latitude is a characteristic of public sector funding that won't be available to OPG in external markets.

71. The Board should direct OPG to demonstrate that sufficient controls are now in place to ensure scheduling delays will be eliminated. Furthermore, a review of the effectiveness of OPG's capital budgeting process controls and the implications on capital and carrying costs are necessary. The Board should require OPG to prepare and file, as part of its next application, an external review of its capital budgeting process and the implications of that process for capital and carrying cost. The focus of that external review should be on whether improvements need to be made to ensure that there is a sufficient level of central control and accountability in the business planning and budgetary processes.

72. One of the reasons that such a review is necessary is the provision in the MOA, which provides that "OPG will seek continuous improvement in its nuclear generation business and internal services" and that "OPG's top operational priority will be to improve the operation of its existing nuclear fleet" **(Ex. A, T1, S4, App. B)**. It is apparent from the evidence filed in this proceeding that OPG has not met those requirements.

Issue 3.6: **Will OPG's accounting policies result in capitalization of an appropriate amount of costs incurred in 2008 and 2009 with respect to the construction or acquisition of capital assets?**

73. The Council submits that OPG's accounting policies for the capitalization of project expenditures are appropriate. The Council also notes that, when compared with other Board regulated utilities, OPG's accounting policies are relatively stringent; all indirect costs are expensed as incurred.

74. The Council is, however, concerned with OPG's stated intention to capitalize all costs associated with the Isolation Project when the project is completed in 2010. The Isolation Project is a capital expenditure project for isolating Pickering A Units 2 and 3 from Units 1 and 4. The fixed asset values associated with Units 2 and 3 were written off in 2005 when the Board of Directors decided to refurbish Units 1 and 4 and place Units 2 and 3 in safe storage **(Ex. F3, T2, S1, Appendix B, p. 7)**. The useful lives of Units 1 and 4 have been extended to 2021.

75. The Council asks the Board to direct OPG to provide evidence in its next rates case that will justify the capitalization and depreciation expense associated with the Isolation Project. In particular, OPG should be required to establish why all costs should be attributable to refurbishing Units 1 and 4 rather than placing Units 2 and 3 in safe storage. In addition, OPG should provide evidence to prove that it cannot draw on the nuclear segregated funds to cover the costs of safe storage for Units 2 and 3.

Issue 5.4: **Are the corporate costs allocated to the regulated hydroelectric and nuclear business appropriate?**

76. The "Report to Ontario Power Generation Inc. Regarding Corporate Allocation Methodology Review" by R.J. Rudden Associates (the "Rudden Study") reviewed the methodology employed by OPG to distribute centralized support and administrative costs among the regulated nuclear, regulated hydroelectric, and the unregulated operations. The Rudden Study also reviewed OPG's methodology for computing assets service fees used by both the regulated and unregulated generation operations **(Ex. F4, T1, S1, p.1).**

77. The Council acknowledges the Rudden Study as an important first step in OPG's review of Corporate Costs. However, the effectiveness of the allocation study is dependent upon the prudence and efficient incurrence of expenditures. OPG's Corporate Costs for the test period are significant as indicated below:

Corporate Costs	**2008**	**2009**
Hydroelectric	$47.5 million	$46.8 million
Nuclear	$475.0 million	$430.2 million

(Ex. F3, T1, S1)

78. The Council acknowledges that the centralization of support groups has helped to decrease costs through common processes, improve reporting and leverage specialized resources **(AIC, p. 69)**. While OPG conducts internal reviews of its corporate costs through its operating business units and senior management, **(AIC, p. 69)** the Council urges the Board to direct OPG to undertake an independent end-to-end review of its internal corporate processes to ensure that:

- Services are not duplicated with the OPG's operating divisions; and
- Processes for review, reporting and approval are effective.

79. The MOA provides that "OPG will seek continuous improvement in its nuclear generation business and internal services" and that "OPG will benchmark its performance in these areas." **(Ex. A1, T4, S1, Appendix B, p. 1)** OPG has participated in a number of benchmarking studies including some for corporate functions **(Ex. A1, T4, S2, pp. 14-21; Ex. A1, T4, S3, pp. 15-26; Ex. J8.3)**.

80. The Board should direct OPG to continue benchmarking all corporate support and administrative departments. Meaningful benchmarking exercises are not only an important management tool for OPG, but afford the Board a means to assess the prudence of OPG's expenditures and the reasonableness of OPG's forecasts. Meaningful benchmarking exercises can be, in other words, an important regulatory tool, particularly in circumstances, where, as here, there is no history of Board reviews of OPG's business. To be meaningful, however, the benchmarking exercises should be broadly acceptable to the Intervenors. If the benchmarking exercises are not acceptable to the Intervenors, then effective regulatory oversight becomes more difficult. There can be legitimate differences, between OPG and the Intervenors, over the significance of the results of benchmarking exercises, and on the application of those results to OPG's operations. There should, however, be no differences over the design and implementation of the benchmarking exercises. To be acceptable to the Intervenors, the benchmarking exercises should be conducted independently and on terms that the Intervenors have at least had an opportunity to comment on. That requires that, at a minimum, the exercises be conducted independently and on terms acceptable to the Intervenors.

81. While on the surface the idea of having Intervenors comment on the terms of a proposed benchmarking exercise may seem both awkward and contrary to reasonable business practice, there is an important regulatory precedent for an effective collaborative process between a utility and Intervenors. Enbridge Gas Distribution Inc. ("EGD") and a group of interveners, participated, with the Board's knowledge and approval, in a consultative process for the acquisition, by EGD, of a new customer information system. That consultative process resulted in EGD's acquisition of a new customer information system on terms acceptable to Intervenors and the Board. In the process, a very substantial amount of regulatory time and expense was avoided. That consultative process suggests that there is a model for effective, co-operative regulatory oversight. That Council suggests that a model along those lines would work effectively for OPG's benchmarking exercises.

82. OPG’s proposed Corporate Affairs budgets increase from $16 million to $31 million in the test years **(Ex. F3, T1, S1, Table 1)**. The Corporate Affairs budget is largely comprised of Regulatory Affairs & Corporate Strategy and Public Affairs.

83. The Council does not take issue with the 2008 Corporate Affairs budget but does consider the 2009 Regulatory Affairs budget of $12.4 million to be overstated. OPG is holding its first rates proceeding in 2008 for a test period of two years. A rates proceeding is not scheduled for 2009 but the forecast budget is the same as it is for 2008 **(Ex. L3, S79)**.

84. OPG justifies the 2009 regulatory budget as necessary for expenses to prepare a 2010 rates case. The Council would expect OPG’s regulatory department and rates case participants to have effectively established a template for the filing requirements. In addition, expenses incurred during 2008 including external consultants, benchmarking studies, cost of capital witness, legal fees and Board expenses should not be repeated in 2009.

85. OPG’s use of its 2008 budget as a baseline for the 2009 budget is not justified. The Council submits that the Board should reduce OPG’s Regulatory Affairs budget by 50% in 2009. As OPG is new to the regulatory process, a variance account could be established to capture deviations from budget as OPG gains experience with regulatory forecasting.

Issue 6.1: **Are the proposals for the treatment of revenues from Segregated Mode of Operations, Water Transactions and Congestion Management Settlement Credits appropriate?**

86. OPG, on its own initiative, established deferral accounts to afford ratepayers the opportunity of sharing net revenue earned from Quebec Hydro and the New York Power Authority ("NYPA") during the interim period of 2005-2007. The deferral account balances are based on the 50/50 sharing mechanism between shareholders and ratepayers **(Ex. J1, T1, S1, p. 5)**.

87. The Council accepts OPG's offer to share SMO and Water Transaction revenues earned during this period. The Council also accepts the balances of the deferral accounts as they were part of OPG's 2007 audited financial statements.

88. In the event the Board allows SMO and Water Transactions deferral accounts to be maintained in 2008 and 2009, the question is whether the existing sharing mechanism is appropriate, or should be changed.

89. The underlying physical assets that create the opportunity to generate SMO and Water Transaction revenue are included in OPG's regulated rate base. The associated depreciation expense and the return on rate base are recovered through OPG's rates **(Tr., Vol. 15, p. 41)**. However, the actual transactions are facilitated by Trading Desk Operators who are non-regulated employees. As a result, both the regulated and unregulated divisions of OPG are required to execute the transactions.

90. The Council submits that OPG's ratepayers should earn a return from use of the assets they have paid for. The Council acknowledges that some portion of the return should be paid to OPG for the use of the employees of its unregulated division. However, the existing 50/50 sharing arrangement provides OPG with a disproportionate share of the return. A reduced share for OPG would appropriately reflect the scale of the involvement of the unregulated division and provide an incentive to maximize the return. OPG has an obligation to maximize that return for its ultimate shareholders, the residents of the province.

91. The Council submits that the sharing mechanism should be changed so that OPG's ratepayers receive 75% of the net revenue. This would reflect the realty that it is use of the regulated assets that earns the return. It would also be consistent with the regulatory precedents, in the natural gas sector, for similar sharing arrangements. The Council's submissions are predicated on the assumption that the deferral account balances are positive. To the extent that OPG enters into uneconomic transactions at a net cost to the company (**Tr., Vol. 15, p. 179**), OPG's ratepayers should not be expected to bear any cost.

Issue 6.1: **Are OPG's forecast of costs related to the Bruce Nuclear Generating Station, and costs and revenues related to the Bruce lease, accurate?**

92. The Council's submissions with respect to the Bruce Nuclear Generating Station ("Bruce NGS") should be read in conjunction with its submissions on issue 7.1, Nuclear Waste Management and Decommissioning.

93. Section 6(2)9 of the Regulation requires the Board to ensure OPG recovers "all the costs it incurs" with respect to the Bruce NGS. OPG explained that 95% of the Bruce NGS assets were asset retirement costs ("ARC") **(Ex. J1.5, Tr., Vol.7 p. 109).**

94. Ms McShane, OPG's cost of capital witness, supported OPG's proposal. In her view, the equity supporting the Bruce assets has a cost associated with it and this cost should be equal to the weighted average cost of capital **(Tr., Vol. 10, p. 10)**.

95. Rate base is a regulatory construct for which there is no accounting "cost" embedded in OPG's financial statements. OPG will not incur a cost as if the Bruce assets were included in rate base. Further, the Regulation does not guarantee OPG a return on the Bruce assets. The Council submits that the Board should exclude a return on the Bruce assets "as if" they were included in rate base for the purpose of section 6(2)9 of the Regulation.

Issue 7.1: **The proposed rate base includes the estimated net book value of OPG's nuclear fixed assets, which in turn includes amounts related to OPG's obligations to decommission the nuclear plants and manage nuclear waste. The amounts fall within the parameters of O. Reg 53/05? The proposed revenue requirement includes depreciation of those nuclear**

fixed asset costs and a return on rate base. Is this method of recovering nuclear fixed asset removal and nuclear waste management appropriate? Or should alternative recovery mechanisms be considered?

96. OPG's proposed revenue requirement treatment for its nuclear liabilities in the 2008 and 2009 test years assumes the following:

- Inclusion of the ARC in rate base;
- Recovery of the depreciation expense on the ARC in rate base;
- Recovery of the weighed average cost of capital ("WACC") on the ARC in rate base;
- Recovery of the used fuel expense; and
- Recovery of the low and intermediate level waste provision.

(OPG's "Rate Base Proposal")

97. OPG indicates that its proposal is consistent with:

- The revenue requirement treatment used by the province when determining interim rates;
- Section 6 (2)7 of the Regulation regarding the Nuclear Decommissioning Deferral Account; and
- Section 6(2)5 of the Regulation regarding the amounts in OPG's 2007 audited financial statements.

(Ex. A1, T4, S1, Appendix B)

98. OPG's witnesses stated that the organization has no other choice given the directives of the Regulation (**Tr., Vol. 7, p. 100).**

99. OPG's witnesses also indicated that the words "return on rate base" contained in section 6(2)7(i) applicable to the Nuclear Liabilities Deferral Account implied a return equal to

WACC. In addition, the words "return on rate base" were implied in section 6(2)8 regarding Nuclear Liabilities. The witnesses acknowledged that the meaning of the words "return on rate base" in the context of the Regulation were subject to legal interpretation (**Tr., Vol. 7, p. 157)**.

100. OPG argues that it would be "entirely capricious and arbitrary to employ one method for recovering balances in a deferral account resulting from changes to ONFA obligations and an entirely different method to recover the cost of existing obligations from the current ONFA reference plan itself" **(AIC, p. 84)**.

101. OPG filed evidence regarding the regulatory precedents for recovery of nuclear waste management and decommissioning costs as reviewed through cross examination. OPG asked Foster Associates Inc. ("Fosters Associates") to review precedents related to the recovery of nuclear liability costs. Fosters Associates concluded there were no regulatory precedents in Canada **(Ex. J1.3, Attachment 1)**.

102. Foster Associates also provided a review of regulatory practice in the US but concluded that the US examples were not applicable to OPG. OPG's inclusion of ARC in the original cost of the assets and in rate base was a "point of departure from US treatment" **(Ex. J1.3, p. 8)**.

103. Intervenors filed excerpts of prior OEB and NEB decisions pertaining to Canadian ratemaking treatment of other types of unfunded assets such as deferred taxes **(Ex. K11.6, Tab 7, Decision with Reasons, E.B.R.O. 486, Appendix G)**. These exhibits were not actively reviewed through cross examination. In addition, OPG in its AIC did not make any reference to these documents or comment on their relevance to its nuclear liabilities proposal or the potential regulatory precedent.

104. The Council submits that the Board should include ARC in rate base for the prescribed assets and should allow recovery of the associated depreciation expense in the revenue requirement.

105. By including ARC in rate base, the Board need not opine on section 6(2)7 and the legal implications for section 6(2)8. Rather, the Board could justify the recovery of the

depreciation expense in regulated rates in order to establish consistency with CICA accounting policies **(AIC, p. 84)**.

106. The Council submits that once rate base is established, the Board should distinguish between the funded and unfunded components of ARC in awarding a return on rate base. The funded portion of ARC should earn WACC and the unfunded portion of ARC should earn zero return. The funded portion of ARC should earn WACC as there is a cost and an opportunity cost to the funds invested, regardless of the source within the deemed capital structure. The average unfunded liability in 2008 and 2009 should be effectively removed from the capital structure as per Method 3B leading to a $77.9 million and $77.1 million reduction in the revenue requirement **(Ex. J12.1 Attachment 1, p. 2)**.

107. The Council agrees with OPG that "an investor...will require recovery of the cost of capital associated with both the generating asset and the asset retirement obligation. If no consideration is given to the capital required to finance the asset retirement obligation as well as the asset itself, no investor would invest in nuclear generation" **(AIC, pp. 84-85)**. However, the Council submits that, while a return on capital is justified, a return on future capital to be raised is not justified.

108. The Council submits that ratepayers would be dismayed to learn that part of their 2008 and 2009 rates increase compensated the Ontario Government for capital not spent. Taken one step further, given that Government raises capital through taxes to the extent that taxpayers consume electricity, the ratepayers would be paying a return on future tax dollars.

109. In proposing to isolate the unfunded assets within rate base, the Council supports a streaming of assets within rate base. The practical effect of the Council's proposal is a streaming of accounting assets, not physical assets within rate base. The Council submits that the Board has the ability to stream assets as appropriate and determine the cost of capital that should be applied. The Board Staff position is to the same effect **(Board Staff Submission, p. 14)**.

110. OPG indicates a need to avoid streaming on the basis that it requires a lower level of analysis and could lead to the potential volatility in the annual evaluation of costs due to changes in market conditions on fund earnings and contributions.

111. The Council submits that the ratemaking difficulties claimed by OPG are overstated. The annual average ARC minus the average annual fund contributions equals the annual average unfunded portion of ARC. As for the volatility associated with market conditions, the Council submits that ratepayers would be willing to accept the market risk in order to defer the cost of funding to future test years when such funds have been raised.

112. The only justification provided by OPG for a return on unfunded capital was in response to questions from the Board. OPG claimed that its shareholders should be compensated for the risk associated with the unfunded liability "obligation" inherent in ARC **(Tr., Vol. 7, p. 162**). The Council submits that the existence of this "risk" is overstated. In any event, the risk of the obligation and the associated compensation should be considered in the determination of OPG's deemed capital structure and return on equity, not in the determination of rate base. The Council submits that any risk can be accommodated by the capital structure and return on equity recommended by Dr. Booth.

113. OPG's states that "Accepting the asset retirement cost into rate base, but attaching a different cost of capital to this element of rate base would…contravene the clear intent of these [O.Reg. 53/05] sections." **(AIC, p. 85)**

114. The Regulation does not directly or necessary implications, require the Board to add unfunded assets to OPG's rate base and award a return equal to WACC. The Ontario Government has demonstrated its ability and willingness to establish directives and would do so again if it disagreed with the Board's rationale in establishing the ratemaking treatment of OPG's nuclear liabilities.

115. OPG argues that its Rate Base Proposal is consistent with interim rates established by the Government of Ontario and the calculations embedded within nuclear liabilities deferral account balances. The Council submits that ratemaking treatments prior to April 1, 2008 are irrelevant. To imply that the ratemaking treatments in 2008 and 2009 must be consistent with

the 2005-2007 interim rates is tantamount to stating that the interim rates established a binding regulatory precedent.

116. Further, the Council submits that although the Board is required to accept the amounts in the 2007 financial statements in accordance with section 6(2)5 of the Regulation such as deferral account balances and nuclear fixed assets, the Board is not required to adopt all the accounting and ratemaking assumptions embedded therein.

117. The Council submits that the government's intent was to provide the Board a set of guidelines, and some explicit directions, for making decisions including rate base determination and the cost of capital. Beyond the explicit directions, however, the Board, and not the Government or its advisors such as CIBC, has jurisdiction for ratemaking decisions – decisions made pursuant to a public hearing with a thorough review of regulatory precedent and accounting policy in order to establish just and reasonable rates.

118. The Council submits that the Board's ratemaking treatment of deferred taxes is applicable to unfunded nuclear liabilities and both are accounting assets not requiring capital outlay.

119. The Board's decision in this case will be significant in terms of the regulatory precedent established. The significance will be evident in future test years if the prescribed asset base is expanded to include new nuclear build. With new nuclear build and an incremental fixed asset base, the entire asset retirement obligation ("ARO") would be unfunded and ARO would equal ARC in rate base.

120. In summary, the Council submits that a zero rate of return for the unfunded liability is justified for the following reasons:

1. Inclusion of ARC in rate base and the associated depreciation expense are consistent with CICA rules and OPG's 2007 financial statements;

2. The Board has the authority to stream assets within rate base;

3. The Board has the authority to set the "return on rate base";

4. A zero return on the unfunded asset in rate base is consistent with the Board's regulatory precedent regarding unfunded assets;

5. Shareholders should only earn a return on capital raised to date;

6. Ratepayers should not pay for a return on capital that has not been raised;

7. The Board should not award a return on unfunded government capital;

8. The math to calculate the deduction from rate base and does not represent an administrative burden; and

9. The Board is not bound by the ratemaking treatments prior to April 1, 2008 and is not bound by the assumptions that underlie the 2007 financial statements.

Issue 8.2: **Is the fixed payment of 25% of revenue requirement an appropriate design for the nuclear facilities?**

121. OPG is proposing a payment structure for the nuclear assets comprised of 25% fixed component and a 75% variable component. OPG states that "the primary rational for this proposal is that the premise that the design of payment amount should reflect, at least to some extent, the underlying cost structure, and the majority of OPG's nuclear-related costs are fixed in nature." **(Ex. L, T1, S92)**

122. OPG also asserts that "a payment design that provides for 75% of the revenue requirement to be recovered through an energy rate is an enormous incentive to avoid unscheduled outages." **(Ex. L, T1, S97)**

123. OPG agrees that unscheduled outages represent a material risk for it and that those unscheduled outages are more significant in the nuclear sector, as it takes longer to address them, and because addressing them may require the approval of nuclear safety authorities **(Tr., Vol. 15, p. 91).** In those circumstances, OPG agreed that it is important to mitigate the risk posed by the potential outages **(Tr., Vol. 15, p. 91)**.

124. The Council acknowledges that it is important to provide a meaningful incentive to OPG to avoid unscheduled outages. However, the Council believes that the more important consideration is to mitigate risk. Given that, the Council submits that the portion of the fixed payment of the revenue requirement for the nuclear facility should be increased to 50%. OPG acknowledged that it would have no objection to increasing the fixed component to that level **(Tr., Vol. 15, p. 92)**.

Issue 9.5: **Are the revenue requirement impacts of any change in OPG's nuclear decommissioning liability, arising from an approved reference plan approved after April 1, 2005, accurately recorded in the nuclear liability deferral account established under subsection 5.1(1), as required by section 6(2)7?**

125. In accordance with section 5.1(1) of the Regulation, OPG established a deferral account to record the impact of a change in its nuclear liabilities resulting from the 2006 Reference Plan (the "Nuclear Liabilities Deferral Account"). OPG included the impact associated with all of its nuclear facilities including the Bruce NGS.

126. The Nuclear Liabilities Deferral Account balance of $130.5 million as at December 31, 2007, recorded as a regulatory asset in OPG's 2007 audited financial statements **(Ex. J1, T1, S1, Table 4)**. Section 6(2)(5) of the Regulation directs the Board to accept the amounts in OPG's 2007 financial statements "other than the variance account referred to in subsection 5(1)". OPG does not propose to recover amounts recorded after December 31, 2007 as part of its application as such balances will be brought forward for disposition in OPG's next rates case **(Ex. J1, T1, S1, pp. 1-2)**.

127. The Council submits that the Board is not required to accept the $130.5 million balance in the Nuclear Liabilities Deferral Account as recorded in OPG's 2007 financial statements given the caveat of section 6(2)(5)i. Further, the Board should not accept the balance relating to the Bruce NGS as those "costs" were incurred during the interim period for a non-prescribed asset. Board Staff, in its Submission, makes the following argument: “section 6(2)(8) and section 5.1 of Regulation 53/05 should be interpreted as applying to the prescribed assets

only, and should therefore not include the decommissioning costs related to the Bruce Facilities" **(Board Staff Submission, p. 23)**. The Council agrees with Board Staff's position.

128. The Council submits that the Board should exclude the Bruce-related costs deferred during the interim period as recorded in the Nuclear Liabilities Deferral Account by OPG.

Issue 9.6: **Are OPG's proposed recovery methods including periods of recovery for the deferral and variance account balances consistent with the requirements of O. Reg 53/05 sections 6(2)1, 6(2)3 and 6(2)7 and otherwise appropriate?**

129. OPG proposes to use its forecast long-term debt rates of 5.65% for 2008 and 6.47% for 2009 to determine the carrying costs for its variance and deferral accounts **(Ex. J1, T3, S1, p.2)**. However, for the Pickering A return to service ("PARTS") deferral account, OPG proposes to use its weighted average cost of capital ("WACC"). OPG's proposed WACC rates are 8.48% and 8.56% in 2008 and 2009 respectively **(Ex. J1, T3, S1, p. 2)**.

130. The Board has approved a methodology to prescribe interest rates applied to variance and deferral accounts of natural gas and electricity rate-regulated companies. In its EB-2006-0117 Decision with Reasons, the Board approved a prescribed, quarterly interest rate for variance and deferral accounts, equal to the 3-month bankers' acceptance rate.

131. OPG states that its forecast of long-term debt rates is more reflective of OPG's costs, eliminates forecast bias, is consistent with multiple test years and is the easiest for OPG to administer. "There is no regulatory efficiency gained by substituting generic proxy date for utility specific cost forecasts" **(Ex. L1, S112, p. 2)**.

132. In terms of its PARTS deferral account, OPG states that the account balance may be recovered over a period of 15 years, a term similar to other long-term assets in OPG's rate base earning WACC **(Ex. J1, T3, S1, p.2; Ex. L1, S111)**.

133. The difference between using OPG's proposed interest rates and using the generic electricity LDC rates over OPG's proposed recovery period is $60.2 million based on the generic rates posted on the Board's website on June 25, 2008, including Q1 2008 **(Ex. J14.3)**.

134. The Council submits OPG has failed to justify that its deferral and variance accounts are sufficiently unique to justify a different treatment from the one used for other Board regulated entities. The objective of establishing a standard methodology should not be compromised, especially at a cost premium to ratepayers. Approval of OPG's proposal would set a regulatory precedent, and would lead to inequitable regulatory treatment among the entities regulated by the Board.

135. OPG deviates from its own carrying cost proposal in proposing WACC for its PARTS deferral account yet has failed to define thresholds or criteria for this exception. The Council submits that it would be necessary for the Board to define thresholds by which deferral accounts would be deemed "big enough" with recovery terms "long enough" to justify a unique ratemaking treatment from the Board approved methodology. Despite the lack of defined thresholds, the PARTS deferral account containing only non-capital costs should not be afforded a rate base treatment in which WACC is applied to capital costs **(Tr., Vol. 15, p. 78)**.

Issue 9.7: **What deferral variance accounts, other than those mandated by Reg. 53/05, should be established for 2008 and 2009?**

136. The Council supports OPG's proposal regarding the maintenance of existing deferral and variance accounts in the 2008 and 2009 test years. The Council disagrees with OPG's revenue sharing mechanism for SMO and Water Transactions deferral accounts and considers a 75/25 revenue sharing mechanism to be more appropriate. The Council's rationale for supporting a 75/25 revenue share is set out in its submissions on Issue 6.1, above.

137. OPG proposes to establish the following three new accounts for the 2008 and 2009 test years:

- Nuclear Fuel Cost Variance Account (the "Fuel Variance Account")
- Pension/OPEB Cost Variance Account (the "Pension Variance Account")
- Changes in Tax Rates, Rules and Assessments Variance Account (the "Tax Variance Account").

138. The Council encourages the Board to apply a standard set of criteria to evaluate proposals for new deferral and variance accounts. Ms McShane indicated that the Board has demonstrated an inclination to establish deferral accounts and recover costs accrued therein, subject to criteria of:

- Prudence;
- Materiality;
- Causation; and
- Uncontrollability.

(Ex. C2, T1, S1, p. 62)

139. The Council will refer to the above set of criteria in reviewing OPG's proposed new accounts for 2008 and 2009.

140. The Council supports OPG's proposal to create the Nuclear Fuel Cost Variance account. The Council acknowledges OPG hedges against fuel price risk but faces hedging constraints in the market. Any residual risk and costs incurred over or under forecast are beyond management's control. The Council refers to the downward trajectory of fuel costs since OPG's initial forecast in the pre-filed evidence to prove that fuel cost variability for 2008 is material **(Tr. Vol. 4, p. 140)**.

141. The Council does not support OPG's proposed Pension Variance Account. The Pension Variance Account would record deviations from pension costs embedded in rates due to from discount rate changes. The Pension Variance account would apply to OPG's regulated operations only and would be cleared only if the balance exceeded a threshold of +/- $75 million, excluding interest. OPG claims that the proposed variance account reduces forecast risk for OPG associated with material variances and reduces assessment risk for electricity consumers **(Ex. J1, T3, S1, pp. 12-14)**.

142. OPG claims to be unique from other Board regulated entities. "The main difference from my perspective is that, as Ms Ladak has mentioned, a fairly small difference in

the discount rate can have a very significant difference in the amount of pension expense. I think, in part, that is a function of the size of our pension obligation" **(Tr., Vol. 14, p. 118)**.

143. In terms of regulatory precedent, OPG was unable to "find many examples, but we did find two examples…dealing with Northland Utilities in the Northwest Territories, and Yellowknife, and also Terasen Gas" **(Tr., Vol. 14, p. 117).** The Council submits that the Board can draw its own conclusions regarding the relevance of other OEB examples provided by OPG **(Ex. J 14.6, Union's RP 2003-0063 *Decision with Reasons*, p. 91)**.

144. The Council urges the Board to reject OPG's proposed Pension Variance Account. Forecast risk and interest rate risk are fundamental business risks for a regulated entity forecasting short-term and long-term debt rates. The Council submits that shareholders are compensated for these risks through the deemed capital structure and return on equity award recommended by Dr. Booth.

145. Approval of OPG's proposed Pension Variance Account would set regulatory precedent, establishing the basis for all OEB regulated entities to seek a similar account. The Council submits that consistency and equity of ratemaking treatment among OEB-regulated utilities are particularly important in the context of Market-Based Returns and mechanisms for setting ROE.

146. The Council supports OPG's proposal to establish a Tax Variance Account. The Tax Variance Account is proposed by OPG to capture any changes in the *Income Tax Act*, *Corporations Tax Act*, municipal taxes, new administrative policy, or expenses resulting from tax assessments or re-assessments **(Ex. J1, T3, S1, pp. 14-16)**.

147. Changes in tax rules and administrative policy are beyond management's control and the cost implications could be significant. In addition, tax assessment and re-assessment lag fiscal tax years to create a unique risk for regulated utilities with forward test years. For OPG, an assessment or re-assessment of a tax year prior to April 1, 2008 could have implications on the tax expense forecast for the test years. While the Council acknowledges the prior tax year trigger, it only supports the deferral of tax costs related to the period after April 1, 2008 when

OPG was first subject to rate regulation by the Board. The Council submits that the Board has established regulatory precedent in approving tax variance accounts.

148. Issue 10.2: **Is the proposed treatment of OPG's loss carry forwards for the regulated business appropriate?**

149. With the contribution made to the Nuclear Liabilities segregated funds during the interim period, the associated expense and tax deduction created tax losses for the Corporation.

150. As the tax losses occurred during the interim period when rates were set for OPG's prescribed assets, the tax loss accordingly flowed through to the Corporation. As the tax losses were generated mainly due to the regulated assets, OPG proposes to apply the tax losses to 2008 and 2009 thereby eliminating the projected regulated taxable income and mitigate the bill impact of the proposed payment amounts in the test years **(AIC, p. 109)**.

151. The Council accepts OPG's proposal and commends its management for making the proposal to reduce regulated rates in the test years. The Council notes that the tax loss carry forward masks the rate impact OPG's 2008 and 2009 revenue requirement, delaying the full impact to future test years.

IV CONCLUSION

152. As noted at various points in this Written Argument, the Board is constrained in two ways in dealing with OPG's application. The first are the constraints imposed by the Regulation. The second are the practical constraints imposed by the fact that this is the first application for OPG and there are no Board decisions establishing regulatory benchmarks against which the Board can measure the prudence of OPG's expenditures or the reasonableness of its forecasts.

153. How the Board deals with these constraints has important implications for OPG's next application. The Council submits that it was not the intention of the government to limit the discretion of the Board to set just and reasonable rates beyond OPG's first application. To do otherwise would amount to amending section 78.1 of the Act, something which only the legislature can do. The Council submits that the Board should allow the constraints imposed by

the Regulation to affect the decision in this case only to the minimum extent required to give effect to that limited intention. The Board should not allow the constraints imposed by the Regulation to limit or constrain the Board's consideration of OPG's next application.

154. The MOA requires that OPG undertake benchmarking. The evidence filed in this case indicates that OPG has undertaking benchmarking in some areas of its activities. However, benchmarking will not be a meaningful exercise if the Intervenors or the Board do not accept the terms or the scope of the benchmarking, or how it is carried out.

155. The Council submits that, to the extent possible, all benchmarking should be undertaken by external experts, and be based on terms of reference which are acceptable to the Intervenors. Doing so would reduce the risk of material disagreements over the application of the results of the benchmarking in OPG's next application.

V COSTS

156. The Council asks that it be awarded 100 per cent of its reasonably-incurred costs for its participation in this application.

157. The Council submits that it has behaved responsibly in its participation in the proceeding. Recognizing the constraints on what the Board could decide, the Council has limited its participation in the hearing to those issues on which the Board has an unconstrained discretion. In addition, the Council cooperated with the Vulnerable Energy Consumers Coalition to jointly sponsor the expert evidence of Dr. Laurence Booth.

158. Finally, so as to avoid undue hardship because of extended delays in the payment of cost awards, the Council asks that the Board issue its decision on cost claims now and not wait for the issuance of its decision on the merits of OPG's application.

159. The Council submits that the Board's decision-making process is enhanced, particularly in an important case, like this, of first instance, by the participation of the Intervenors and their experts. That participation is made more difficult if there are extended delays in the payment of cost awards. OPG and its experts do not operate under that constraint, and neither should the Intervenors.

All of which is respectfully submitted.

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