Undertaking J1.3

Undertaking

To provide an analysis of what is described on Page 19 of the CIBC report as Option 2 in connection with the test period; show the difference and provide an explanation between the proposed method and the method recommended by CIBC and Option 2 method in L-2-58

Response

With respect to the two options in the CIBC report (L-2-10, Attachment 1), Option 1 is the rate base treatment that OPG has used in its application.

Option 2 differs from Option 1 in that the unfunded nuclear liability is removed from rate base for purposes of calculating return on rate base, and this reduction in return is replaced by accretion less nuclear fund earnings. Thus Option 2 is similar to the "flow through" approach discussed in L-2-58 in that it features accretion less nuclear fund earnings. It differs however in that the unfunded nuclear liability is removed from rate base in Option 2 whereas under the "flow through" approach the ARC is removed from rate base.

Depreciation on the Nuclear Fixed Assets, which include the Asset Retirement Cost (ARC), is the same for Option 1, Option 2 and the "flow through" approach in L-2-58.

Using the same format as in L-2-58, the difference in the revenue requirement for the test period between Option 2 and Option 1 is shown below.

$ Millions	2008 (9 months)	2009	Test Period
Average unfunded nuclear liability*	1231	878	
Exclude unfunded nuclear liability from rate base return **	(78.3)	(75.1)	(153.4)
Include accretion cost	450.7	624.0	1074.7
Less: segregated fund earnings	(362.2)	(525.9)	(888.1)
Increase in Revenue Requirement	10.1	23.0	33.2

*based on liability and fund values per 2007 financial statements projected forward to the test period. The liability projection is provided in L-1-83 and fund value projection is consistent with the fund earnings forecast in L-2-58

**includes similar treatment for Bruce assets

For the period 2005 to 2007, Option 1 provided for a higher revenue requirement than Option 2 (see L-2-10, attachment 1, page 19). For the test period, Option 2 results in a higher revenue requirement than Option1. The shift is due to the significant decline in the unfunded liability since 2005.

It is OPG's view that Option 2 and the "flow through" approach in Ex. L-2-58 would be unfair since both options credit ratepayers with the earnings from the segregated funds even though most of the money in those funds is investor supplied capital. In addition, any approach that involves nuclear fund earnings (i.e., Option 2 and the so called "flow through" approach) would require a forecasting of fund performance for purposes of establishing the revenue requirement. As such performance is difficult to predict with accuracy, OPG would be subject to increased forecast risk and volatile regulatory earnings, together with an increased regulatory burden associated with the scrutiny of past and future fund performance. In addition, approaches that depend on the nuclear funds levels and associated earnings are dependent on the prescription for funding included in the Ontario Nuclear Funds Agreement (ONFA). This would not necessarily provide an appropriate basis for allocating nuclear liability costs to the appropriate time periods. The fund contributions required under ONFA tend to result in front-end loading of the funding requirement due to limitations on the ability to reduce contributions from current levels should changes in the nuclear liability warrant such a change. This would arise, for example, in circumstances where the expected service lives of nuclear generating facilities are extended (as was the case for Bruce NGS).

OPG believes that its proposed approach (Option1) represents an appropriate allocation of the nuclear liability costs to the test period. The rate base approach is the approach adopted by the Province when it established interim rates. It was also supported by CIBC World Markets who observed that this approach is simple and transparent and will result in a less volatile revenue requirement impact over the life of the liability.

One way to understand the appropriateness of the "rate base" approach is to consider a simple analogy. In this analogy, an investor is considering two possible investments in regulated assets. The first investment option involves a non-nuclear generation plant with a capital cost of $100. If the investor makes this investment the total amount of his/her investment will go into its regulated rate base and the investor will earn a return on as well as a return of the capital committed to that investment. The second investment option is a nuclear plant with a $100 capital cost and the assumption of a $100 long term liability for the disposal of spent fuel and decommissioning. If there is no consideration of the liability in setting the rate base (or alternatively the return on the rate base) then the investor will never select the second investment option since he/she is not being compensated for taking on the financial risk associated with satisfying the long term liability or committing capital for that purpose.

It is OPG's view that sections 6(2)5 and 6(2)7 of Regulation 53/05 require the Asset Retirement Cost (ARC) associated with the nuclear liability be included in rate base. With

respect to section 6(2)5, rate base includes the fixed asset values from OPG's audited financial statements. These asset values include an Asset Retirement Cost (ARC) component which represents the present value of the long-term nuclear liability obligation. As such, it should form the basis for the nuclear liability costs included in the revenue requirement. The rate base treatment, including earning a return on the ARC component, is also clearly contemplated by section 6(2)7 of the Regulation which deals with nuclear liability deferral accounts both for the interim rate period and for future periods.

It should also be noted that in making her recommendation regarding the composite cost of capital for OPG's regulated facilities Ms McShane took into account OPG's rate base treatment of the nuclear liability costs.