

George Vegh
Direct Line: 416 601-7709
Direct Fax: 416 868-0673
E-Mail: gvegh@mccarthy.ca

December 1, 2008

Ontario Energy Board
2300 Yonge Street
P.O. Box 2319
Suite 2700
Toronto ON M4P 1E4

Attention: Ms Kirsten Walli
Board Secretary

Dear Ms. Walli:

Re: Transmission Connection Cost Responsibility Review
Board File No.: EB-2008-0003

Introduction and Summary

These comments are provided on behalf of Great Lakes Power Transmission (“GLPT”) with respect to the Board’s request for comments on the proposed amendments to the Transmission System Code (the “Proposed Code”). GLPT appreciates the Board’s proactive approach to addressing infrastructure needs to enable new supply and recognizes that the Board’s treatment of this issue puts it in the top tier of North American energy regulators when it comes to removing barriers to renewable power.

GLPT supports the basic direction and rationale of the Board’s proposed hybrid model for funding enabling transmission facilities, including the need to reflect connection costs in the price of electricity supply, and not the price of transmission. However, the proposed method of transferring connection costs from transmission costs to supply costs (a lump sum pro-rata capital contribution from a connecting generator toward the cost of an enabler facility – the “Capital Contribution Model”) raises unintended consequences in terms of inappropriate incentives for transmitters as well as increases in generators’ cost of capital. Specifically, the Capital Contribution Model method (i) rewards transmitters for having facilities that are unsubscribed and punishes transmitters for having subscribed facilities; and (ii) unnecessarily increases generators’ costs of capital.

GLPT's proposed remedy to this issue is that the generators' capital contribution be structured as lease payments to transmitters, and not a one time capital contribution. In this way, transmitters continue to receive payments for invested assets, and generators do not have to finance a large, capital contribution at the time a facility comes into service.

GLPT's proposed approach to this issue is set out in greater detail below.

The second point that will be addressed in these comments relates to the process for designating transmitters to carry out development work. GLPT supports the proposed approach in this regard, and will offer a little more detail on how it may be implemented.

Because the changes to the Proposed Code suggested in these comments are implementation details, and not material changes to the Proposed Code, the changes may be implemented without a further round of submissions (see: *Ontario Energy Board Act, 1998*, s. 70.2). Having said this, it may be valuable for the Board to organize a brief consultation among stakeholders to address how to implement some of the key components of these proposals. This could be carried out pending the completion of the application to amend transmission licences that is referred to in the TSC Proposal so as to not delay the implementation of the Proposed Code.

GLPT would be pleased to participate and provide leadership in such a consultation.

Generator Cost Contribution under the Hybrid Model

GLPT's understanding is that the Board sees two advantages of the hybrid model over the pooling model: first, it maintains the allocation of costs of connection facilities to electricity supply as opposed to transmission; and second, it puts generation that connect in renewable clusters on the same footing as other generation (which is responsible for connection costs).

Both of these rationales are reasonable, and GLPT supports an approach that maintains appropriate cost allocation between supply costs and transmission costs as well as non-discriminatory treatment of generators. The issue is what is the best way to do this. The Capital Contribution Model does this through a one time lump sum capital contribution reflecting a generator's proportionate share of the costs of an enabler facility. The value of transmission assets in the transmitter's rate base is then reduced by the contribution so that only the unsubscribed capacity remains in rate base.

There are two concerns with this approach.

The first concern is with respect to the incentives that this approach provides transmitters. The paper accompanying the TSC Proposal addresses the issues of incentives for transmitters between the pooled option and the hybrid option as follows:

“The Board acknowledges the comments of stakeholders regarding the incentives for transmitters that arise from gaining a rate-based asset under the pooling option, and of the weaker incentives under the other options that lead to little or

no additional rate base for transmitters. The Board agrees that the incentives may be strongest under the pooling option, but notes that the hybrid option does allow the costs to be included in rate base temporarily, and the un-depreciated capacity associated with any unsubscribed portion of the facility may remain indefinitely. The hybrid option therefore allows potentially significant additions to rate base while maintaining, in a proportionate sense, full generator cost responsibility." (Emphasis added)

As a result, the paper recognizes that transmitters are incented to add assets to rate base and that the hybrid option provides this incentive "indefinitely" for unsubscribed assets. It is only the unsubscribed portion of assets that attracts the rate base incentive. As a result, the incentive for transmitters is to build assets that remain unsubscribed. In other words, under this model, the best case scenario for a transmitter is that transmission assets remain unsubscribed; the worst case is that the assets are fully subscribed.

The other concern with this approach is that it creates uncertainty (and hence increased costs) with respect to a generator's cost of capital. The Capital Contribution Model requires generators to make a large one time contribution to the transmitter upon connection. The cost of that contribution may be significant: the estimated cost of enabler facilities for the three clusters specified in the IPSP are approximately \$117,000/MW (Goderich), \$175,000/MW (Manitoulin Island), and \$242,000/MW (Bruce Peninsula)¹. Also, and equally important, the precise cost will not be clear at the time a generator is seeking financing. This lack of certainty will increase the risk (and hence the cost) of the project. Given that the contribution may be significant, a developer with limited access to capital, including community groups and First Nations and Métis Peoples', may find it difficult or expensive to finance that contribution.

GLPT proposes an alternative approach which satisfies the rationale for the hybrid option but also creates an incentive for a transmitter to build capacity that is likely to be subscribed and, at the same time, lowers financing costs for project developers. Under this approach, the transmitter may maintain the enabler facility in rate base but, instead of receiving revenues from transmission load customers, receives revenues from generators who subscribe to the enabler line. These revenues can take the form of a lease with the generator for the period in which the generator is in commercial operation. Under this model – the "Lease Model" - the cost of the lease payment may be passed through in a supply arrangement with the OPA (either in a PPA, SOP or other payment mechanism).

The lease can be structured as a simple monthly flat payment. Neutrality between the Lease Model and the hybrid approach may be maintained by basing the lease on a generic generator's cost of capital. Although this is likely higher than a transmitter's OEB approved rate of return, the premium reflects both the risk that a generator may go out of business (and hence the lease payments are not owing) as well as the higher societal value in subscribed capacity than unsubscribed capacity. In this way, the key difference between the TSC Proposal and the Lease

¹ See IPSP Application, Exhibits E-3-8, E-3-10 and E-3-9 (respectively).

Model is that the former requires that generation contributions be a one time payment while the latter has a monthly payment requirement.

A demonstration of the difference between generators' costs under the Capital Contribution Model and the Lease Model is attached as Schedule A.

The advantages of the Lease Model are that it:

- (i) allows generators to include the costs of their capital contribution for generator connection in their project costs and pass it through to the OPA as a procurement cost, thereby reducing financing uncertainty and hence costs to ratepayers;
- (ii) provides a positive incentive to transmitters to have subscribed capacity instead of unsubscribed capacity (on the assumption that generators have a higher cost of capital than transmitters);
- (iii) more precisely reflects underlying generation costs which would provide the allocation sought in the proposed policy than does the pooling option; and
- (iv) reflects the more conventional approach taken in California where transmitters receive the generators' contribution as a monthly credit against the transmitters' revenue requirement.

GLPT therefore proposes that the hybrid model be refined to redesign the method of structuring a generator's contribution from the Capital Contribution Model to the Lease Model.

Transmitter Designation Process

The Proposed Code Paper states that, following an amendment to transmitter licences that authorizes the Board to implement enabler transmission facilities, the Board may, either on its own motion or by way of application by transmitter, conduct a hearing to designate a transmitter who will develop and ultimately construct an enabler facility. The details with respect to this designation process are not addressed in the Proposed Code.

GLPT agrees that this basic approach and acknowledges that there is no need at this time to delineate every issue that should be addressed in the process. The Board should leave room for innovation and learning by doing in this area.

Having said this, there are some key parameters of the transmission designation process that should be made clear. GLPT offers the following for the Board's consideration.

We believe that any transmitter designation process should be guided by the following five fundamentals:

- early identification of the proponent for each transmission project;
- a streamlined process;

- recognition that it is socially optimal to invest in developing options that may not ultimately proceed;
- the decision process should be transparent; and
- the process and the results of the process should deliver value for money to ratepayers.

After consideration of a number of alternatives, we believe the process described below incorporates these fundamentals while meeting the general objectives of the Act.

First, it is helpful to be precise on the nature of the relief that is granted in the transmitter designation process and how it relates to a subsequent leave to construct application. As GLPT sees it, the designation process is, effectively, a “leave to develop” where a transmitter applies to recover the prudently incurred costs of developing transmission options to connect a renewable energy cluster to the IESO-controlled grid. These development costs consist of:

- Stakeholder, community and First Nations’ consultation;
- Technical system studies;
- Engineering studies including line design;
- Route and site identification and assessment;
- Preparation and seeking approval of EA Terms of References;
- Acquisition of land rights;
- EA studies; and
- Seeking EA approval.

This development work will identify transmission options to connect renewable clusters in light of both transmission and generation opportunities. The result of this development work will provide value to Ontario electricity customers because it will provide information that will either (i) be used to support a subsequent application for leave to construct transmission facilities; or (ii) demonstrate that it may not be feasible to develop transmission to a renewable cluster because of social licence or technical issues.

As indicated, an inherent part of the process is that prudently incurred development costs should be recovered from transmission customers. To be clear, the determination of prudence should focus on whether the development costs were prudently incurred at the time they were spent, and should not turn on whether a leave to construct is filed. Whether or not a leave to construct application is filed, the public interest in developing renewable sources of supply will be advanced by the information gathered through the investment of development costs. It is therefore just and reasonable that prudently incurred development costs be recovered from transmission customers.

Second, the Board should clarify that the preferred method of commencing a leave to develop is by transmitter application and that a Board initiated process should only be used where a transmitter is unlikely to commence an application. If the incentives are aligned correctly, then it may not be necessary for the Board to order transmitters to develop facilities. Indeed, a Board initiated process will only be required where the model fails to achieve the Board's goal of providing incentives to construct enabler facilities – in this case, the model will have failed and the Board must exercise an extraordinary power of ordering a transmitter to develop a facility.

Third, a transmitter should demonstrate that it has a reasonable plan to carry out development work. This involves demonstrating its commitment and qualifications to carrying out development work. GLPT suggests that a transmitter who is seeking approval for “leave to develop” should be required to demonstrate that it has a credible plan to develop the facility; examples of this could include a requirement to demonstrate that:

- Its proposal is consistent with the achievement of renewable energy goals identified by the Government and/or the OPA;
- There is evidence of the level of community support for the project;
- There are viable commercial generation opportunities in the renewable cluster;
- Its proposal contains a series of realistic development time lines and financial commitment by the transmitter;
- The transmitter has the demonstrated financial wherewithal to support the financial commitment required through development to construction;
- The transmitter has the financial strength to support the equity requirement of the project;
- The transmitter is prepared to deposit a security fee at a value of, for example, 0.1% of the project cost to a maximum of \$1 million; and
- The project will be designed, constructed and operated in compliance with all relevant acts, regulations and codes.

Fourth, the standard notice requirements should apply to an application so that, if there are alternatives preferred by other proponents, then those alternatives can be considered as evidence in the application. It is important that any proposed alternatives be real, and not just hypothetical. This is necessary to ensure that the process actually leads to development work being carried out and not an endless debate over hypothetical alternatives or alleged entitlements.

Fifth, and finally, the Board should be neutral as to which transmitter is designated to carry out development work. This goes beyond ensuring a fair hearing on the evidence in a leave to develop application. It also includes ensuring that, in related applications, such as rates cases, the Board does not inadvertently signal an assumption or a preference for a specific transmitter respecting the expansion of transmission facilities. For example, it may be appropriate for the Board to establish deferral accounts in which any licensed transmitter may record development costs for recovery from the transmission pool. However, it would not be appropriate to open a deferral account for the exclusive use of one transmitter.

Conclusion

In conclusion, and to summarize, GLPT supports the basic direction and rationale of the Board's proposed hybrid model for funding enabling transmission facilities, including the need to reflect connection costs in the cost of supply, and not the cost of transmission. However, the proposed method of transferring facility costs to generators through a lump sum capital contribution toward the cost of an enabler facility raises unintended consequences in terms of inappropriate incentives for transmitters and increases in generators' cost of capital. Specifically, the Capital Contribution Model method (i) rewards transmitters for having facilities that are unsubscribed and punishes transmitters for having subscribed facilities; and (ii) unnecessarily increases generators' costs of capital.

GLPT's proposed remedy to this issue is that the generators' capital contribution be structured as a lease, and not a one time capital contribution. In this way, transmitters continue to receive payments for invested assets, and generators do not have to make large, one time investments.

GLPT believes that these implementation details can be addressed without a further round of comments on the Code and would be pleased to assist the Board in providing any additional work on this issue.

Thank you for the opportunity to participate in this process. GLPT looks forward to continuing to work with the Board and staff on this matter and hopes that it has provided a helpful contribution.

Sincerely,



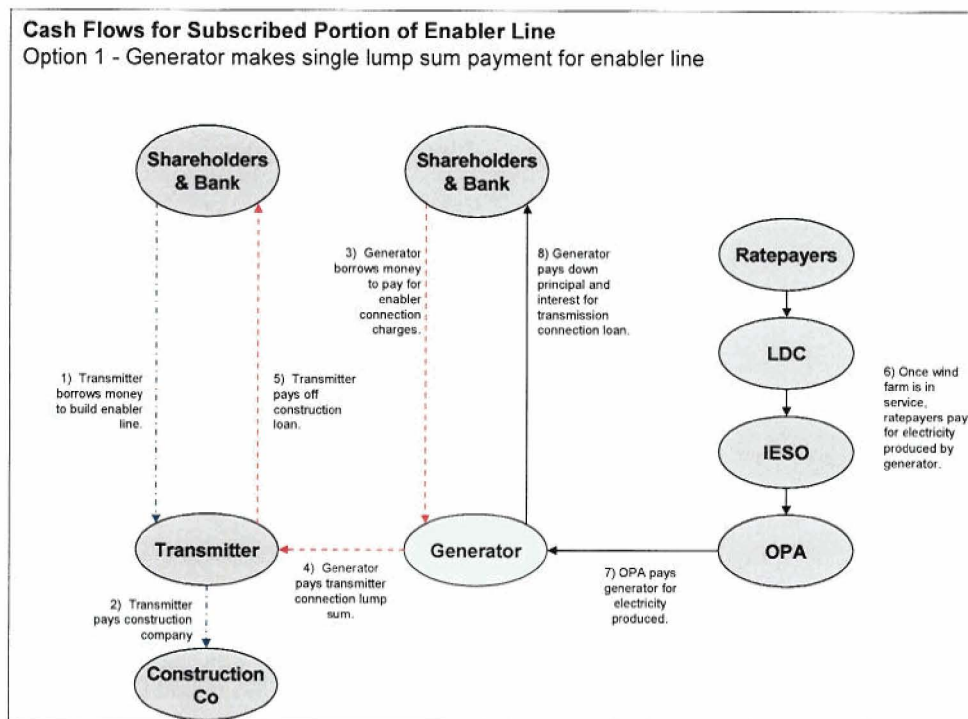
George Weigh
7297646

Schedule A

For generators, the Lease Model has two main benefits over the Capital Contribution model:

- The timing of the payments; and
- The spread between a generator’s actual cost of capital and the generic cost of capital.

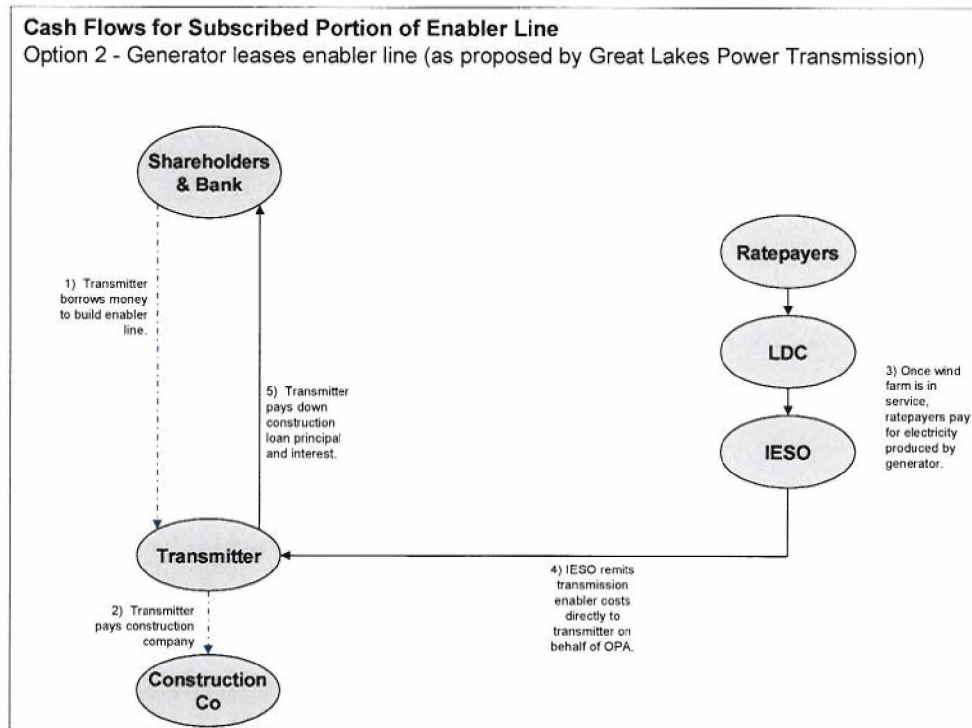
Under the Capital Contribution Model, each generator is required to make a single cash payment up front for their share of the new enabler line. Under the Lease Model, the transmitter receives a monthly payment which, for administrative simplicity, could be collected and paid directly by the Independent Electricity System Operator on behalf of the generator and Ontario Power Authority. This is shown in the diagrams below.



Let us take an example:

- A new enabler line is to be built at a cost of \$80m with a design capacity of 400 MW to serve a 400 MW cluster of wind generation. Generator “W” is proposing to build and connect a 150 MW wind farm to the enabler line.
- Generator “W”’s weighted cost of capital is 17%. The OEB approved generic generator cost of capital used by the transmitter to calculate the monthly lease payment is 15.1%
- The cost of the enabler line is amortized over a 20 year period.

- For simplicity, the calculations ignore taxation and, furthermore, assume that the cost can be modeled as a simple mortgage with compound interest and monthly payments.



Under the Capital Contribution Model, before he can connect his wind farm generator “W” has to raise enough additional cash through equity contributions and loans to make the transmitter an up-front payment of $150\text{MW} / 400\text{MW} \times \$80\text{m} = \$30\text{m}$. This is equivalent to a monthly payment of \$413,000.

Under the Lease Model, the OPA pays the transmitter a monthly lease payment of \$376,000.

Under this example, the Lease Model reduces the amount of debt and equity generator “W” has to raise by \$30m and provides a saving to his project with a net present value of \$2.7m. Provided the OPA uses a competitive procurement process, competition theory suggests that most of this benefit will in turn be passed onto ratepayers, generator “W” gaining by having a project which is more competitive than it would have been had he funded the enabler line through an up-front lump payment.