

Considerations for Extending Existing Contracts

January 24, 2016

Purpose: To provide a full set of considerations around the possibility of extending existing contracts to mitigate costs for ratepayers.

Considerations: Extending contracts was an option considered by the IESO when evaluating rate mitigation measures in late 2016. However, after evaluating the impacts of extending contracts the IESO concluded that the negotiation timelines would be lengthy, the benefits (or cost reductions) would be small, and the risks and future opportunity loss would be too great. These considerations are therefore based on existing IESO experience through contract negotiations, preliminary IESO analysis, current forecasts of system need, and the evaluation of current drivers of electricity system costs, the IESO continues to be of the opinion that that extending contracts leads to an overall loss of value to ratepayers.

1. Timeline to complete negotiations:

Past IESO contract experience shows that renegotiations are lengthy and not consistent with rate mitigation timelines. It suggests that re-negotiation tends to be lengthier than originally anticipated. Given the complex nature of the contracts, the government's desired outcomes, and numbers of parties involved, the IESO would anticipate about 1.5-2 years to complete negotiations.

Considerations:

- Urgency provides leverage to the counterparties leading to lower bargaining power for the province
- Negotiations are expected to will be multi-party as there are numerous equity participants and secured lenders with a security interest in the contracts who will likely require agreement to any amendments.
- Follow-on impacts to credit agreements may also would require renegotiation, which extend timelines and could introduce the involvement of additional parties.
- Different counterparty needs will likely result in a checkerboard variations of different amendments (i.e., one size will not fit all), complicating the legal and financial analysis and overall negotiations terms
- Contract counterparties tend to co-ordinate on these types of matters, including through industry groups, where they tend to share information in order to gain additional leverage on the province
- Additional staff, technical consultants, and legal counsel will likely be required to undertake such an effort.

The Renewable Integration Experience: In 2012(?) the IESO (formerly Ontario Power Authority) was required to re-negotiate wind and solar contracts to align with market rule changes to more effectively integrate these facilities in the operation of the electricity system. This renegotiation required over 2 years (?) from initiation to implementation. At the time, parties with similar contracts banded together to leverage a greater negotiating position.

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2. Potential benefits:

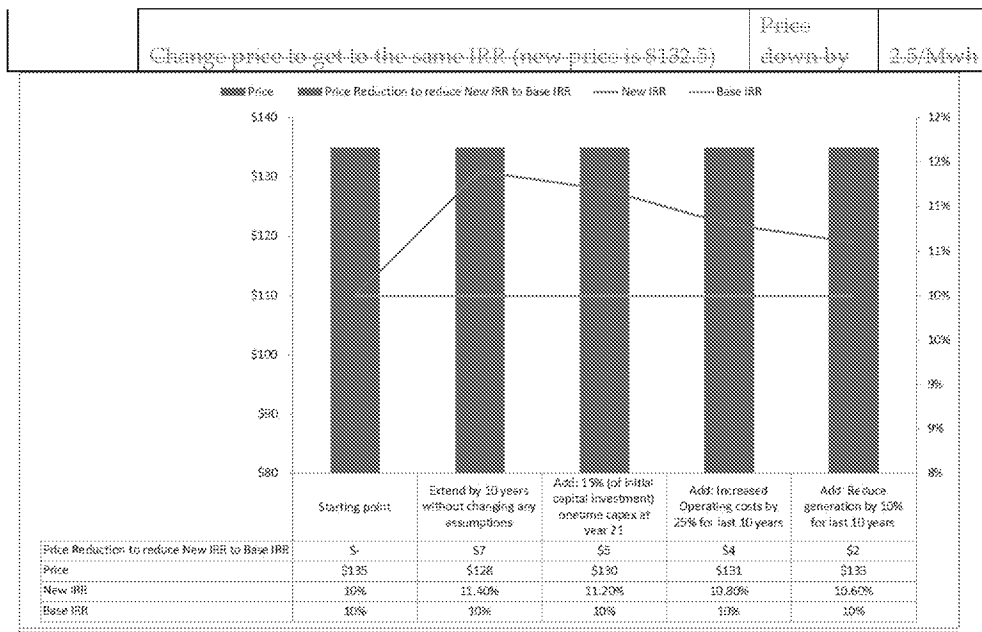
Preliminary IESO analysis indicates that extending the contract term by ten years may not result in much in the way of annual savings:

- Counterparties will demand to be kept whole not entertain any proposal unless there is additional value beyond what is already provided in the current contracts;
- Extending the operational life will likely mean require new increased capital investment prior to the currently planned end of lives expenses;
- Operating expenses would all necessarily increase as facilities age, while reliability and output would reduce;
- Counterparties will need to recoup incremental capital and operating expenses through the new price and earn a return on any new investments.

IESO has modeled several scenarios to show the potential impact on price reduction from extending existing FIT wind agreements

Preliminary IESO Analysis			
Case 1	Add 10 Years and change nothing else	IRR up by	1.40%
	Change price to get to the same IRR (new price is \$12¢)	Price Down by	\$7/MWh
Case 2	Add 10 years and \$5 Million capex to extend life	IRR up by	1.26%
	Change price to get to the same IRR (new price is \$13¢)	Price Down by	\$5/MWh
Case 3	Add 10 years and \$5 M capital investment to extend life and operating cost up by \$1M/year	IRR up by	0.8%
	Change price to get to the same IRR (new price is \$13¢)	Price down by	4/Mwh
Case 4	Add 10 years and \$5 M capex to extend life, opex up by \$1M/year and generation down by 5000MWh	IRR up by	0.6%

Commented [IESO2]: I think we need to include some of our analysis in this note to substantiate our claims. However, this will likely result in an ask that we provide the underlying data. We will need to be comfortable with that.



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Considerations around analysis:

- A simple extension of a 20 year FIT wind contract by 10 years leads to a 5% reduction in price if all assumptions are kept the same while only varying the price to get a supplier to the same internal rate of return (IRR).
- However, past IESO experience suggests that this is an unlikely scenario and suppliers would be estimating increased maintenance and capital costs in the additional 10 years, reduced equipment reliability, and increased IRR expectation to cover additional risks.
- IESO estimates show that the likely decrease in price would be less than 1 to 2%.
- For perspective, all of the wind generation in 2016 amounted to ~9TWh and cost approximately \$1billion. The savings even at 5% would be \$50 million per year.
- This analysis does not include costs to renegotiate the agreements and therefore the should the potential cost reduction be in the 1-2% range (\$10 million to \$20 million annually), other costs may erode that even further

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Additional negotiation cost risks:

- IESO will likely begin negotiations in very weak bargaining position, which could be further eroded if public commitments are made to presuppose the outcome.

- The incremental cost to consumers may be greater than just shifting or levelizing supplier revenues from the near term to the longer term since asset owners will naturally attempt to extract additional benefits or value.
- Initial analysis does not include the costs for suppliers to renegotiate their agreements, including secured lender agreements

3. Future need and operability of the electricity system:

Ontario currently benefits from adequate supply, but future needs are uncertain. Locking in resources for the long term and ahead of when they are needed can appear to initially provide reliability benefits and planning certainty, but may actually come at a cost to the consumer. In the end, it is the consumer who bears the full risk should electricity conditions or needs change, which they do frequently.

Recent examples include:

- Technology developments in renewable generation have lowered the cost of production dramatically in the space of a short time.
- Shale gas has lowered the cost of producing electricity during on peak hours more than what was previously anticipated.
- Peak demand and overall consumption have been lower than original planning projections. This has contributed to oversupply of energy and capacity and lower market prices.

Although there are no energy or capacity needs in the short-term, there is an understanding that the IESO has emerging operability needs. The IESO is addressing these needs, procuring additional regulation service and reactive control devices, and exploring sources of additional flexibility through the *Enabling System Flexibility* stakeholder engagement. If contracts were extended for renewable resources, these new agreements may continue to limit the flexibility necessary to manage the operability needs of the future (and sometimes current) system.

The Non-Utility Generators (NUGs) experience: NUGs provide a recent example of what can happen when resources become inefficient and/or provide limited system value time, but remain committed through long term contracts. Contracts with Non-Utility Generators (NUGs) were signed in the 1990s primarily to provide baseload power and the incentive structure of the original contract was designed accordingly. Ontario's electricity supply mix and policy needs evolved and their value to the electricity system became negligible. In recognition of these changes, the IESO entered into negotiations with NUGs to extract *some* value for ratepayers in the final months and years of these contracts. This has led to these facilities essentially being shut down, while continuing to receive payments at a lower rate than their original contract.

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4. Opportunity Cost:

One of the most significant drawbacks of this proposal is the lost opportunity of future value to ratepayers. There are additional options available to ratepayers and the sector that will help address the fundamental issues that drive consumer costs, in particular, IESO's the *Market Renewal Project*, and taking advantage of future technological will realize the value of innovation and cost decreases by utilizing competitive market tensions that have shown positive results in other jurisdictions. Extending existing contracts creates an opportunity cost which could be offset through contract extensions with no flexibility to avoid in the future.

Emerging clean tech technologies such as energy storage, demand response and energy efficiency would be shut out of the clean energy market should contracts be renewed, even if these technologies are cheaper and provide greater value to the system.

The objective of the *Market Renewal Project* is to achieve material efficiencies in the near and longer term and introduce competitive mechanisms to meet system needs to achieve cost savings for the ratepayer. Preliminary estimates suggest that the Market Renewal project could find efficiencies greater than \$3.5 billion, with a significant portion of those savings coming from re-committing existing or acquiring new assets at lower costs through a competitive transparent auction process. The IESO recently implemented a similar mechanism for demand response that has helped to reduce the cost of DR by about 20-30 percent compared to the original contracts – and new technologies and participants have entered into the sector as a result. IESO expects a comparable level of cost savings and innovative solutions from a broader capacity auction. By extending contracts, these benefits and reforms would be lost for Ontario ratepayers.

Background:

As at September 30, 2016, the IESO was managing over 28,000 contracts which have a combined capacity of over 27,000 MW. This capacity is spread across nuclear (6300 mw), wind (6065 MW), solar (2632 MW), hydro (2426 MW) and bioenergy (494 MW) fuel types and ranging in size from 10 kw to the Bruce Nuclear contract for 6300 MW.

Beginning in 2005, contracting mechanisms used have ranged from sole source negotiations; standard offer pricing, contracts and rules; to highly competitive Requests for Proposals (RFP's). Suppliers (or counterparties) of these contracts range from sophisticated international companies to the homeowner.

The IESO (and formerly the OPA) have significant negotiating experience (gas plant relocations, Bruce Nuclear Amended and Restated Implementation Agreement, and renewables integration, etc.) as well a significant day to day contract management experience (assignments, change of control, site amendments, etc).