

Canadian Electricity
Association

2005 Federal Budget

Pre-Budget Submission

**To: The Minister of Finance
By: The Canadian Electricity Association**

November 2004

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Executive Summary

Why are Capital Cost Allowance (CCA) Rate Improvements important?

After extensive analysis by Ernst & Young (E&Y) and in consultation with key stakeholders, CEA requests improvements to the CCA Rates for the electricity industry for the following key reasons:

- ❑ Current CCA rates *do not* reflect the economic lives of electricity assets and were set at a time when the industry was not in a competitive market environment.
- ❑ CCA rate improvements would *enhance reliability* of the overall electricity system by attracting new investment into transmission systems to reduce congestion by adding and modernizing existing capacity, supporting competitive markets, and increasing export capability.
- ❑ Improved CCA Rates are vital if we are to *safeguard our competitive advantage* in electricity in North America through timely investment in modern efficient capital stock. Higher CCA rates for both new and used assets would also allow the industry to *improve environmental performance*, including the reduction of greenhouse gas emissions, by increasing the turnover of older capital stock and upgrading the efficiency of existing electricity assets more rapidly.
- ❑ Given steadily *growing demand* and *long lead times* to plan and bring new replacement and infrastructure on line, a decision on CCA rates is urgently needed to allow utilities to build out generation infrastructure by approximately 35% of existing capacity over the next two decades.
- ❑ Enhanced CCA rates will allow for *improved customer service* such as a wider choice of value added services at lower prices, improved power quality, reduced energy consumption with deployment of advanced meters, and improved environmental performance using distributed generation technology.
- ❑ Expansion of Class 43.1 to allow for the introduction of energy efficiency upgrades, as well as enhanced monetization via the use of Investment Tax Credits, are strong signals to develop more environmentally preferable energy.

What CCA Rate and Class 43.1 adjustments are specifically proposed?

- ❑ **Adequate CCA Rates to Attract New Investment** – CEA is seeking CCA rates of 12% for new generation assets, and 10% for new transmission and distribution assets.
- ❑ **Higher CCA Rates for Used Assets** – The electricity industry is the only sector that does not receive adequate tax treatment for *used* as well as *new* assets. With virtually all of the industry's assets trapped at a 4% CCA rate, companies cannot receive a "fresh start" upon the transfer from a tax-exempt to a taxable entity, which is a key issue for companies restructuring into a more competitive market. Hence, CEA is recommending that used equipment receive a CCA rate of 12% for generation, transmission and distribution assets to adequately reflect the remaining economic life.
- ❑ **Class 43.1** – Enhanced eligibility features including capital used to increase hydraulic, wind power etc. output resulting in incremental output and or energy efficiency improvements of existing sites, should be eligible for Class 43.1 treatment. A two-tiered approach for gas-fired combined cycle plants could be introduced i.e. 30% declining balance (db) for higher efficiency plants, and a 20% db for plants not achieving the higher heat rate/efficiency of 6,000 BTUs. Equipment and pipelines for District Energy and ground source field loops should also be declared eligible for Class 43.1 treatment. Finally, investment Tax Credits for all technologies in Class 43.1 should be used to provide a more neutral investment decision.

What is the cost to the Federal Government?

Ernst & Young's estimates completed in 2001, and shared with the Department of Finance, show these improvements would have a minimal impact on short-term federal tax revenues and over time provides a growing tax base for the Federal Treasury.

Introduction

The Canadian Electricity Association (CEA) is the national voice of the electricity sector in Canada, representing over 90 percent of all generation, transmission, distribution, and retail services provided to customers. CEA was founded in 1891, and has been a leading industry association advocating important consensus policy positions to the federal government on issues such as climate change, fish and water management, market access, energy efficiency and innovative technologies including clean coal and electronic metering applications. Since the mid-1990s the electricity industry has been undergoing massive restructuring, including unbundling, increased competition, and greater regulatory oversight and environmental regulation, all while moving towards a more competitive market reality.

As part of this new competitive market reality, CEA has been engaged over the past seven years in providing innovative technical analysis to the federal government on tax changes that would better reflect the actual useful lives of the industry's assets. CEA with the support of Ernst & Young (E&Y) submitted a comprehensive report to the Department of Finance in October 2001. CEA members, foreign investors and independent power producers (see Appendix #1), all participated in a consultative study process that has led to several Prebudget Submissions including this one focused on attaining CCA rate improvements.

The following recommendations have been presented to the Department of Finance over the past four years and are viewed as essential by the electricity industry if it is to remain competitive over the long term, while improving on, and accelerating its recent environmental performance including the reduction of greenhouse gases.

Recommendations: CCA Rate Proposal

(i) Generation Assets

CCA rates for new generation assets should be set at a new rate of 12% to adequately reflect useful lives. This request is reasonable given that on the grounds of tax neutrality with other industries that manufacture their output similar to the electricity sector, CCA rates of 30% could arguably be extended to the electricity industry as well.

(ii) Transmission and Distribution (T&D) Assets

T&D assets have experienced a rapid erosion of their useful asset lives due to competitive conditions and rapid technological change. CCA rates of 10% are required to attract new investment and optimize existing T&D assets. New T&D infrastructure is also lagging badly when compared to new supply, which is critical to the electricity system reliability, power quality, and for acceptance of new distributed generation technologies. DBRS, the rating agency, has cited the fact that there is insufficient capacity in transmission to meet the growing demand for electricity in Canada, particularly in Alberta and in Ontario.

(iii) Treatment of Used Assets

For existing assets of exempt utilities, a "fresh start" principle should apply to establish appropriate CCA tax rates for existing assets upon privatization upon a transfer of used assets to a taxable purchaser. On this basis CCA rates of 12% should be established to reflect the remaining economic life of these assets.

(iv) Class 43.1

Existing assets—and not just "new" assets, should qualify for the Class 43.1 treatment, so that capital upgrades will improve the overall efficiency of any technology regardless of age. Existing hydro, coal, nuclear and gas plants, older wind farms and established district energy and groundsource or geoexchange projects should all qualify for improved CCA rates on investments made to existing assets. The age of these plants is entirely irrelevant if they can be improved upon to yield greater energy efficiencies.

In addition, accessing Class 43.1 for Co-generation or Combined Cycle Gas Turbine (CCGT) plants is very restrictive in that developers must meet a hurdle heat rate of 6000 BTUs and 6700 BTUs

respectively. There are instances where such heat rates are unattainable due to the lack of a steam host or restrictive operational hours, but the technology still merits development since it is still highly efficient and the power is required by the grid.

District Energy and Geexchange (Groundsource Heat Pumps) are also hindered by the higher capital cost of piping and loopfields/drilling, and these costs should be fully entered into Class 43.1.

Finally, a refundable investment tax credit should be introduced to assist in the monetization of the costs associated with environmentally preferable power, including cogeneration and district energy projects.

1.0. Background and Emerging Trends

1.1. The Need for New Investment

The Canadian electricity industry is facing a growing demand for electricity, along with rising customer service expectations and requirements to improve its environmental performance. The industry is also attempting to cope with aging infrastructure in a rapidly changing regulatory environment and in markets that are reflective of increasing competition. These factors are requiring electric utilities to invest in new, more efficient and cleaner technologies. Newer technologies, however, have shorter useful lives i.e. economic lives. Incremental investment is occurring much too slowly in the Canadian electricity industry, as low rates of return are no longer sufficient to offset the political and regulatory risks facing investors. Investment in new supply and new transmission capacity has declined over the last ten years while growth in domestic demand for electricity continues to increase at about 1.5 % per year. Since the necessary additional and replacement generation and infrastructure capacity investment will largely come from private capital markets, changes to CCA rates would send the appropriate financial signals to investors.

1.2. Growth in Electricity Consumption in Canada

From 1990 to 2000, demand for electricity continued to grow at 1.5% p.a. in Canada. Projected demand for electricity in Canada by federal government sources such as the National Energy Board (NEB) and Natural Resources Canada (NRCan) from 2000 to 2010 would see demand in the 1.2% to 1.5% p.a. level. This conservative estimate effectively translates into a need to build and or replace about 40,000 MW by 2020, equating to 35% of Canada's installed capacity. The new supply will likely take all forms, from hydro, coal, and nuclear to gas-fired plants, depending on where the resource mix is best situated geographically. Increasingly, windpower has provided its contribution to new supply but on a smaller scale than larger plants. Typically, large generation and transmission projects can take between 8-12 years to complete depending on the regulatory review process, consultation with local communities and planning, construction and commissioning phases of the project.

1.3. Trade in Electricity

Electricity trade typically averages 5% of Canada's annual production, which represents about 1.2% of total U.S. consumption. Electricity sales are principally from BC, Manitoba, Québec, and New Brunswick. Much higher export potential exists from these and other provinces should investment in new supply and transmission ties for export be encouraged via improved tax rates. U.S. demand will continue to increase and given the complementary nature of supply from Canada, owing to different peaking and seasonal needs, will add value by improving reliability and market efficiency of the North American power grid by improving transmission linkages both to the south and east-west.

The National Energy Board (NEB) in its June 2004 paper entitled, A Compendium of Electric Reliability Frameworks across Canada points out that "*interconnections between power systems improve reliability*", however, a disturbance can upset the entire system since the North American grid is only as strong as the weakest link. The NEB noted the trend is towards strengthening the overall interconnected system, through the introduction of mandatory reliability legislation and the creation of a North American Electric Reliability Organization, which will set the guidelines for what is expected from system operators. The NEB also points out that "*Technology has an important role in enhancing reliability. Technological*

innovation may contribute to system adequacy by increasing the capacity in existing rights-of-way.” The tools to attract investment continue to lie in improving the tax regime and overall rates of return.

The August 14th 2003 Blackout cost the Ontario manufacturing sector \$2.3B in shipments alone, impacting both industrial productivity and possibly long-term investment into Ontario. Yet, Ontario which constitutes roughly 40 percent of the Canadian market has seen its consumption increase by 6 percent over 2003, indicating a slow to develop conservation culture will not negate the need for new long term supply and investment in transmission and distribution systems.

1.4. Capital Investment Trends in Canada

The electricity industry’s historical level of investment has been highly cyclical with the last significant peak of \$12.5 billion in 1991 (Electricity sector witnessed a huge drop from 12% in 1991 to 5.5% in 2003 of Canadian capital expenditure according to Statistics Canada). The severe economic downturn in the early 1990s brought a far greater contraction of electricity investment than other sectors such as the oil and gas industry.

Most new cogeneration supply projects have been designed to fit exclusively within Class 43.1 because the enhanced depreciation helps to meet investor expectations. Insufficient additions of new generating plants not qualifying for Class 43.1 (i.e. 30% depreciation) have been built over the past 15 years in part due to the inadequate CCA rate regime. Moving to 8% for new generation investment in 2000 has been deemed to be insufficient, even by the Department of Finance. Current investment trends are not keeping pace with the demand for electricity, and need to be improved to attract private capital in the range of \$12 billion annually to replace the industry’s aging infrastructure, improve environmental performance and to meet new competitive realities including continued load growth, reliability of supply, and to address export opportunities.

1.5. Relationship of CCA Rates on Investment and Competitiveness

Current CCA treatment is inadequate as rates for new investment do not reflect the useful life of electricity assets, and rules on treatment of new and used equipment also serve to impede industry restructuring by penalizing asset transfers and not allowing a “fresh start” that would encourage much needed new investment to remain competitive. The federal government has recognized the need for tax changes by allowing the electricity industry access to the M&P income tax rate and by increasing the CCA rates for generation assets from 4% to 8% in the February 2000 budget. Although this was an improvement from the earlier rates, as shown in the E&Y study these rates remain inadequate to reflect useful life.

Merchant transmission line investors, for example, are seeking much faster paybacks on their investments. As evidence for this position, the U.S. Federal Energy and Regulatory Commission (FERC), has overruled the State of California’s Public Utility Commission in approving a 200 basis point add on to the rate of return, in addition to a 10 year depreciable life on transmission upgrades and a new 500kV transmission line in California, to be built by Pacific Gas & Electric and Trans-Elect.

This U.S. example would be equivalent to a 17% CCA rate for new transmission investment, compared today to an outdated 4% CCA rate here in Canada.

1.6. Accelerating Environmental Performance Improvement

Existing CCA rates serve only to continue the slow rate of progress that can be achieved with respect to improving environmental performance such as the lowering of greenhouse gases, restoring fish habitat or reducing air quality emissions. Alternatively, higher CCA rates would significantly increase innovation, promote deployment of new technology and encourage capital stock turnover. These changes are particularly important if the Canadian electricity industry is expected to invest in and accelerate environmental performance improvements to meet Canada’s Kyoto commitments.

Supporting further improvements to Class 43.1 would greatly enhance environmental performance in the electricity sector. This change in policy would recognize the value of upgrading existing hydro assets to optimize efficiency and help realize incremental generation including by diverting spilled water through a new turbine, therein, increasing plant efficiencies to 90% or more. In addition to supporting this hydropower concept, providing a secondary tier for CCGT plants with slightly lower heat rates, would

encourage more high efficiency gas fired plants to be built. As well, allowing for the equipment and piping used in district energy and groundsource heat pump loopfields to be included in Class 43.1, would spur the deployment of such systems and further reduce greenhouse gases. Finally, a refundable investment tax credit would be a more neutral approach for investors that could improve monetization for all renewable energy projects in Class 43.1.

2.0. Flaws in the CCA System

2.1. Inadequacy of Current Rates

Canada's CCA rate system is based on the asset's "useful life" to determine the depreciation life of assets. In the case of the electricity sector, the useful life has been assessed in the past based entirely on engineering considerations without any consideration of the asset's "economic life", or its competitive value in the North American market. The impact of betterments on the useful life is analogous to the outer shell of a building that can last a longer period than the inner core of moving parts such as boilers and lighting equipment, which needs to be replaced and upgraded from time to time. The inner components of electricity assets also are replaced frequently due to plant shutdowns for preventative maintenance and equipment failure, changing regulatory and environmental requirements, and new technological advancements.

The CCA rate of 4% now 8% for new generation equipment, and 4% for Transmission and Distribution assets, was not predicated on an in depth review of the useful lives of these assets. Now that the industry has moved into a highly competitive environment, and are striving to meet the demands of global capital markets providers, as well as more demanding shareholder and ratepayer expectations, higher CCA rates that reflect the true useful lives has become more critical.

2.2. Neutrality with Other Domestic Sectors

Historically, electricity has been denied tax preferences because the output was considered non-tradable and the fact that regulated suppliers passed on taxes to customers. Emerging trends in the new paradigm of electricity warrant a more neutral treatment relative to other sectors. Electricity is becoming highly competitive, tradable as a commodity, exposed to price volatility and taxability, and subject to capital mobility. Today, electricity is a manufactured good that transforms raw input fuels, and clearly is no different from any other manufactured commodity, and therefore should receive the same incentives as manufacturing, including the higher 30% CCA rate. Now that neutrality has been achieved in income tax rates, the government should acknowledge the need for neutrality in CCA rates. However, the electricity industry is *not seeking* incentive CCA rates but only higher CCA rates to achieve *appropriate treatment* for the assets useful life. CEA believes that its proposal on CCA rates accurately reflects the useful lives of its varied asset fleets as demonstrated in the E&Y tax study.

2.3. Competitiveness and International Tax Comparisons

Tax reform has been integral to market reform in other jurisdictions. A brief summary of these tax changes in the U.S., U.K. Australia and New Zealand are found below:

CCA rates are more generous in the U.S. than in Canada. Most equipment (generation, transmission and distribution) is depreciated over 20 years (8% for new and existing assets), with exceptions for nuclear production plants and the distributed generation class for combustion turbines that are at 15 years (equivalent to a 12% CCA rate). Nuclear fuel assemblies are at 5 years (equivalent to a 30% CCA rate), as compared to Class 1 at 8% for new investment and 4% for existing assets for Canada. U.S. industry in the wake of the post August blackout of 2003 is also advocating for depreciation enhancements to transmission infrastructure to be set at an equivalent CCA rate of 12% (already mandated by the FERC to alleviate a key transmission constraint in California) to ensure both system reliability and for national energy security.

In the U.K. which underwent successful privatization and restructuring in the early 1990s, there are only three categories of treatment; 1) Buildings and Structures at 4% straight line; 2) Long Life Assets which are at 6% declining balance and 3) Plant and Machinery which receive a 25% declining balance

treatment. Ernst & Young's review reveals that as much as 80%-90% of all assets in the electricity sector in the U.K. receive the higher 25% CCA rate.

In Australia, the Electricity Supply Association asked for and received on January 1, 2002 a key decision on the depreciation of new electricity sector assets to reduce investor risk from the Australian Taxation Authority (ATO). The decision by the ATO permits Australian power companies the right to "self assess" the effective lives of their assets. Australian industry cited the need for over US\$20 billion in needed investment, with technological, regulatory and environmental risks as reasons why the ATO had to alter the tax treatment of electricity assets.

New Zealand's tax depreciation rules underwent a major change in 1993. New economic depreciation rates were introduced for the power generation and electrical reticulation assets. The basic economic depreciation rate (default class) was set at 15% DV (diminishing value method) or 10% SL (straight line method). For new assets, a 20% loading applies to the basic economic rate (i.e., additional 20% depreciation rate). In 1994/95 the assets of ECNZ were split and transferred to other State-Owned enterprises / private companies at their fair market value. The price paid by the respective entities for the assets became the cost base of the assets for tax depreciation purposes. For "old" assets (i.e., pre-1 April 1993) the companies had a choice of using the new economic depreciation rate or the old historic rate. The 20% loading did not apply to "old" assets.

2.4. Treatment of Used Assets

Economic lives for used assets are inherently shorter than for new assets. The same CCA rate for both new and used equipment would be neutral for transfers between taxable parties. However, the current income tax rules allow a CCA rate of 8% for new assets and only 4% for transfers of used assets from exempt to taxable utilities. E&Y's analysis shows that the current 4% CCA rate is grossly inadequate for used assets. Used assets require a higher rate to account for a far shorter remaining life of the asset.

3.0 Class 43.1 Issues

Canada's incentives for emerging technologies found in Class 43.1, is inadequate relative to other industrialized jurisdictions. Historically, only "new" equipment investment has been eligible for Class 43.1 so as to encourage new supply. However, all equipment in the class could be included if a minimum energy efficiency criterion was established, and this would enable existing or older equipment to also attain the Class 43.1 rates provided they were proven to be efficient. This would allow utilities and developers to target older turbines and generators where a 3-5% efficiency gain is possible with the installation of new runners for instance. Such capital upgrades should qualify for Class 43.1 treatment, as should the addition of incremental generation from spillways for example.

Cogeneration projects face many hurdles for utilities and other developers in Canada. A stepped approach for gas fired cogeneration and or combined cycle gas plants, should be seriously considered to allow for the introduction of these efficient technologies, in cases where attaining the heat rate of 6000 BTUs and 7500 BTUs respectively is impossible since a large steam host is required over the duration of the plant. Canada has only 6% of national electricity production from co-generation, while the technical potential (economic) is estimated as high as 30% according to a 2002 study completed for NRCan on "Cogeneration Potential in Canada". Also, at present not all the equipment components of a cogeneration system qualify for Class 43.1. Finally, firms must demonstrate that they still qualify (i.e. meet the heat rate) in any given year, or they could forfeit the depreciation allowance for that year for the entire cogeneration operation.

Installing District Energy Plants and Geexchange (Groundsource Heat Pumps) is highly capital intensive. Adding the piping and loopfields to the Class 43.1 treatment, would enhance the attractiveness of deploying these climate friendly technologies. A refundable investment tax credit (ITC) would allow investors freedom to choose any eligible technology, as opposed to the selection of one fuel being predicated on any one program e.g. wind via a production tax credit. Whereas the federal government

has enhanced CRCE treatment for wind energy, it has not provided other renewable technologies with similar eligibility treatment. If an ITC was to be provided to all technologies in the class, a more level playing field would be created.

4.0. Revenue Impacts

The following tables provide estimates of federal revenue impact of the changes proposed by the CEA. They are based on a detailed analysis provided by Ernst & Young. The tables also show the impact on federal revenues of a portion of electricity assets (in both generation and transmission and distribution) being transferred from tax-exempt provincial utilities to taxable entities. As can be seen, the revenue impact (based on 2001 estimates) of the CCA changes is modest, reflecting the fact that the vast bulk of electricity assets are held by the tax-exempt provincial utilities that are not affected by the tax changes. If the improved CCA rates do encourage a partial transfer of assets from the tax-exempt to taxable entities, then there could be a significant gain in federal revenues, far exceeding the cost of CCA rate changes.

- **Revenue Impact of Increased CCA Rates for Currently Taxable Companies**
(From the Ernst & Young CCA Rates for the Electric Power Industry)

Estimated Federal Revenue Cost of Increased CCA Rates for Electric Power Generation and Transmission and Distribution Assets of Taxable Companies (\$ Millions)	2005	2006	2007
20% CCA Rate for Generation	1.2	3.0	3.9
12% CCA Rate for Transmission and Distribution	1.3	3.7	5.6
Total for both changes	2.5	6.7	9.5

- **Revenue Impact of Additional Taxable Companies and Higher CCA Rates**

Estimated Federal Revenue Impact of Higher CCA Rates, Assuming Additional Taxable Companies and Additional Taxable Generation Equaling 10%, and Additional Taxable T&D Equaling 5% of the Electric Power Industry (\$ Millions)	2005	2006	2007
Generation			
Revenue Cost: 20% CCA	(1.6)	(4.0)	(5.2)
Federal Corporate Income Tax from Additional Taxable Companies	120	120	120
T&D			
Revenue Cost: 12% CCA	(0.9)	(2.5)	(3.7)
Federal Corporate Income Tax from Additional Taxable Companies	60	60	60
Total			
CCA Changes	(2.3)	(6.5)	(8.9)
Federal Corporation Income Tax from Additional Taxable Companies	180	180	180

5.0. Conclusions

As the above arguments show, our recommended improvements to the CCA rates and increasing the CCA rate for used equipment are fundamental to the ability of the industry to attract capital and to improve its environmental performance including reducing greenhouse gas emissions and related air quality impacts. Encouraging new investment in supply and transmission / distribution infrastructure is critical to avoiding potential shortfalls in supply, future peaking shortages, and price spikes due to system constraints. The changes recommended will align the CCA rates with the useful lives of electricity assets, while encouraging much needed investment in the electricity sector. While the industry also faces additional challenges, tax changes remain the key signal to encourage investors to buy, build and upgrade electricity assets. Reducing Canada's greenhouse gases can be achieved by implementing further improvements to Class 43.1. Allowing for upgrades to existing equipment e.g. hydro plants, to qualify, establishing energy efficiency goals, introducing two-tier combined cycle gas plant depreciation rates, and adding capital intensive equipment such as piping and loopfields in the eligible criteria, will serve to encourage new development of low or zero carbon technologies to help meet Canada's targets.

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Appendix #1

Participants in the Ernst & Young Study completed September 28, 2001 entitled “*CCA Rates for the Electric Power Industry: The Role and Importance of Capital Cost Allowance Rates and Incentives*”

CEA Members

BC Hydro
Emera Inc.
ENMAX Corporation
EPCOR
Great Lakes Power Limited
Hydro One Networks Inc.
Hydro Ottawa
Hydro-Québec
Manitoba Hydro
New Brunswick Power
Newfoundland & Labrador Hydro
Newfoundland Power
Ontario Power Generation
SaskPower
S&C Electric Canada Ltd. (representing Manufacturers and Suppliers)
Toronto Hydro
TransAlta Corporation

Foreign Investors that participated:

British Energy
DTE/Probyn Energy Solutions
SITHE

Independent Power Industry participants:

Independent Power Producers Society of Alberta
Association of Power Producers' of Ontario (formerly Independent Power Producers' Society of Ontario)
Northland Power Inc.

Other Participants included:

Environment Canada
National Electricity Roundtable represented by Capstone Turbine Corporation
Natural Resources Canada