



3rd Generation Incentive Regulation for Ontario's Electricity Distributors

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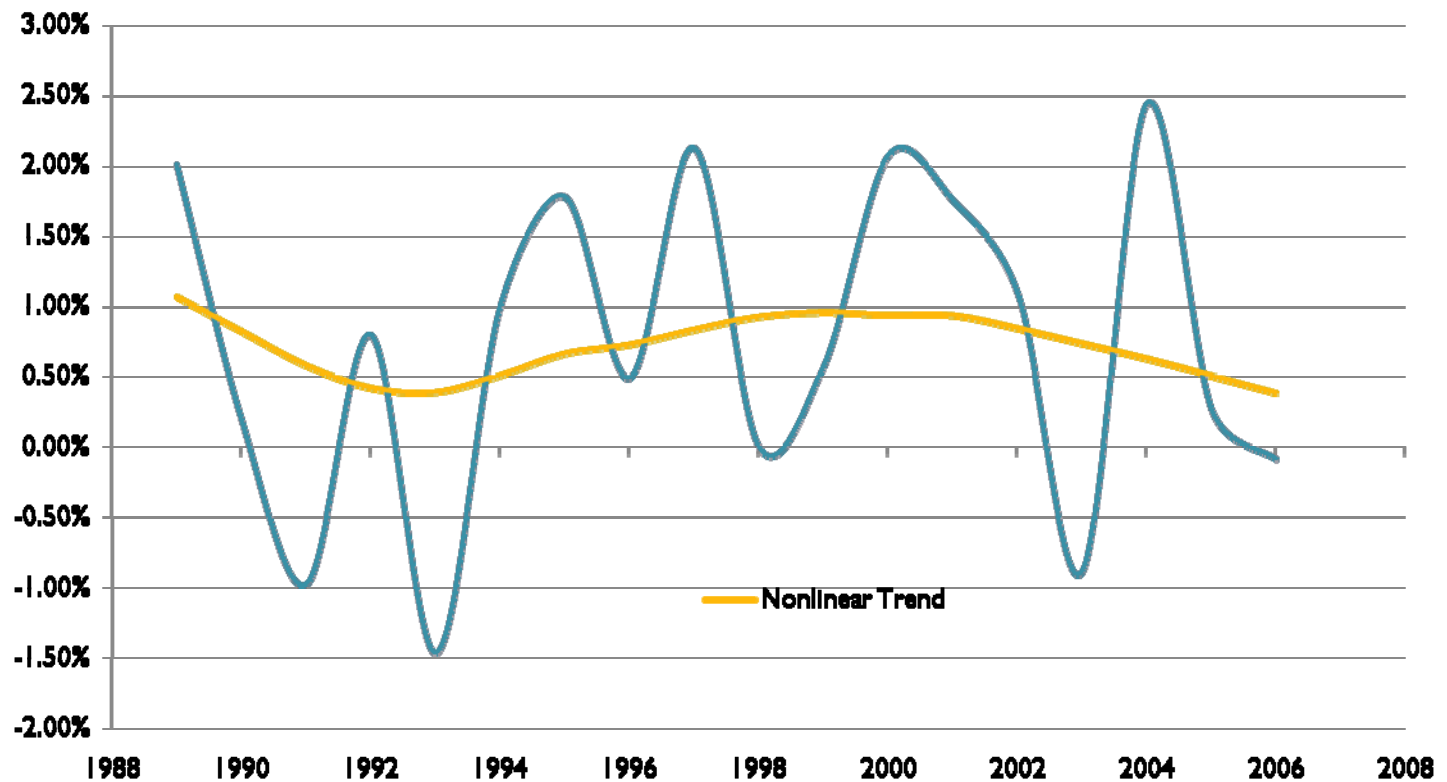
Final Submissions on behalf of the
Electricity Distributors Association

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I. Productivity Factor

Annual Growth in TFP -- U.S. Distributor Data



Source of data: Pacific Economics Group

August 2008



I. Productivity Factor

Important Features of the Data

1. Average annual productivity growth in the U.S. electricity distributor data is 0.72%.
2. There is no statistical evidence of systematic acceleration in productivity growth over the sample period.
3. Estimation of a nonlinear trend suggests variation in average productivity growth between 0.4% and just over 1% over the sample period.



I. Productivity Factor

4. The most recent years of data suggest a period of deceleration with growth of 0.4% in the 2002-2006 period. Recessionary effects in the U.S. are likely to have an adverse impact on productivity trends.
5. The early 1990's were a period of relatively higher unemployment which arguably should not be excluded precisely because the subsequent years enjoyed higher employment levels and are therefore not likely to be representative of the longer term.
6. Neither the raw U.S. data, depicted by the volatile line, nor the estimated trend model would suggest that the data prior to 1995 should be excluded.



I. Productivity Factor

Recommendations

1. The recent slower productivity growth should not be ignored and should be incorporated in the target X-factor.
2. We recommend a productivity factor of 0.55% which combines the 1988-2006 estimated productivity factor of 0.72% and the recent (2002-2006) slower productivity growth observed in both Ontario and U.S. data.
2. The PEG productivity factor of 0.88% inappropriately restricts data to the 1995-2006 period and does not assign any additional weight to the more recent data.



2. Stretch Factors

Rationale for “stretch factors” is weak.

- Stretch factors are rationalized on the basis that a utility should experience “accelerated productivity growth” as one transitions from cost-of-service regulation.
- Ontario distributors have been under a form of price-cap regulation for a period of time.
- In addition, Ontario distributors have been engaged in a form of yardstick competition for many years.
- These two factors weaken the case for stretch factors.



2. Stretch Factors

Misclassification Risks

There is serious misclassification potential arising out of at least four areas:

1. The use of OM&A rather than Total Cost data.
2. Mismeasurement or omission of important variables such as labour costs and age of capital stock.
3. Statistical Type I error is at 20%.
4. The use of U.S. data rather than Ontario data.



2. Stretch Factors

Incentive Distortion

- Regulatory focus on OM&A costs rather than total costs distorts incentives and can lead to:
 - over-capitalization by utilities seeking to reduce OM&A expenditures;
 - under-spending on OM&A;
 - sub-optimal decisions with respect to own vs. lease alternatives.



2. Stretch Factors

Recommendations

- For these reasons the stretch factors should be materially lower than those recommended by the Pacific Economics Group.
- We recommend stretch factors of 0.0%, 0.1% and 0.2% for the three groups with resulting X-factors of 0.55%, 0.65% and 0.75%.
- The average industry X-factor will be approximately 0.65%. This figure is substantially higher than recently observed productivity growth rates in the U.S. and in Ontario.