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Ontario Energy Board
27th Floor,
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ATT: Kirsten Walli, Secretary

May 15, 2008.

Dear Ms. Walli,

3rd Generation Incentive Regulation for Electricity Distributors
Board Staff Proposal for Stakeholder Meeting on May 6, 2008
Board File No.: EB-2007- 0673

In accordance with the OEB's e-mail and web posting of May 2, 2008, ECMI submits its comments on the Board staff proposed PBR 3 Framework and the discussion of May 6, 2008.

Three paper copies are enclosed. Electronic copies in both Adobe Acrobat have been sent this date to boardsec@oeb.gov.on.ca.

Requested contact details are as follows:-
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Respectfully submitted for the Board's consideration,

Original signed by R. White

Roger White
President

ECMI comments on
Board staff proposed PBR 3 Framework and the discussion of May 6, 2008
3rd Generation Incentive Regulation for Ontario's Electricity Distributors
Board File No.: EB-2007- 0673

The use of industry specific inflation factors

The Board isn't regulating the entire Canadian economy but only a narrow component of the energy sector in Ontario. Through this process it is regulating the Ontario electricity distribution industry.

In ECMI's view, industry specific inflation factors for Ontario's electricity distributor should be developed and utilised by the Board in the regulation of the Ontario electricity industry. The use of an Ontario IPI is in fact a form of benchmarking for the Ontario electricity industry in that those above the IPI receive a lower inflation adjustment than those below it.

The application of U.S. TFP data to Ontario

The thrust of the PEG analysis in its February 2008 report and again in its presentation of May 6, 2008 is that U.S. and Ontario distributors and their data are similar enough that U.S. data can be used in place of an Ontario productivity factor.

In ECMI's view the PEG analysis is flawed with respect to its comparison of U.S. and Ontario electricity distribution TFP growth and thereby overestimates the Ontario TFP growth rate. The PEG comparison is shown in Table 12 on page 28 of the PEG presentation "Calibrating Rate Indexing Mechanisms for Third Generation Incentive Regulation in Ontario: Update, Dated May 6 2008."

Table 12 compares U.S. and Ontario electricity distribution TFP growth for the period 1988 to 2006. The comparison attempts to address the issue of the "missing years" of Ontario data for 1997-2002 by assuming four different scenarios for Ontario TFP growth for these years. The closest match between the U.S. and Ontario occurs in Scenario 2 where it is assumed that the TFP growth for Ontario during this five year period is the same as the U.S. data. Under this scenario, there is a lack of fit between the U.S. and Ontario TFP growth, due to differences in TFP growth between Ontario and the U.S. in the periods 1988-2003, 1993-1997 and 2002 -2006. These are the years in the overall 1988-2006 period for which Ontario data is provided and analysed.

Regardless of what data is utilised, is should be updated for the actual year 2007 for which Ontario data is now available. The update for 2007 will indicate some commitment to the use of Ontario data to regulate the Ontario industry.

In an effort to consider the U.S. data provided by PEG, ECMI submits the attached functional spreadsheet which provides a method of integrating the U.S. data analysis provided by PEG with the good Ontario data. The comparison of weighted growth between Ontario and the U.S. is shown in ECMI Tables 1 and 2. The weighted average TFP factor for Ontario for the period 1988-2006 is obtained in ECMI Table 1 by totalling the TFP factors for each group of years shown on the PEG Table 12 under Ontario scenario 2 by the number of years to which that factor applies. The process is repeated in ECMI Table 2 for the U.S. using the TFP factors in column 5 of Table 12. The sum of the Ontario weightings in ECMI Table 1 for 1988-2006 is 14.33, or 0.38 higher than the 13.95 total shown for the same period in ECMI Table 2 for the U.S.

All of the difference comes from the periods for which both Ontario and U.S. data is available. In order for there be a match between Ontario and U.S. TFP growth for the overall period 1988 to 2006, the sum of the weightings must be the same. Therefore the Ontario sum must be reduced by 0.38 to match the U.S. total. Further, all of this 0.38 adjustment must occur in the years 2002-2006 plugged period as this is only period for which Ontario data is not available.

ECMI Table 3 shows the adjusted Ontario sum of weightings for the years 2002 -2006, that is 6.16 instead of 6.54. The adjusted Ontario TFP growth rate for the 10 year period 1997 to 2006 is 0.62% (that is (6.16 + 0.04)/10)).

Table ECMI 4 permits the Ontario TFP data to be updated for actual 2007 Ontario data. The Ontario 2007 TFP would be inserted in the active spreadsheet in cell D51. The adjusted TFP for the 10 year period without weighting for the more recent period would then be produced. Assigning more weight to the more recent data would permit a TFP more consistent with PBR1 approach.

Scale

There are no small LDCs in the U.S. sample, at least in the same ratio as Ontario. Further there are no utilities in the U.S. data that are as small as the smallest utilities in Ontario:-

> *"DR. KAUFMANN: Remember, we're talking about trends and not levels. And the answer is they're not all million-plus utilities. There's a range. But there aren't many - in fact, there are none - that are as small as the smallest utilities in Ontario.*
>
> *So it is extremely diverse, but it doesn't get down to kind of, you know, the tail end of the smallest utilities.*
>
> *We talked about expanding the sample to include co-ops and unions and things like that. We didn't have time to do that in the scope of this project, but we've got some data that could be useful for that.*
>
> *I don't think it would make much difference on a rate of change basis, on a trend basis."*
>
> *Ref transcript Stakeholder Meeting May 6 2008*

There is no indication in the preceding description that results have been weighted in favour of smaller distributors in the US to reflect a marketplace more similar to the Ontario marketplace. This type of correction would not correct fro the fundamental flaws noted herein.

In the meeting of May 6th 2008, Dr Kaufmann when asked about combining U.S and Ontario data indicated that there is a fundamental difficulty in combining some of Ontario data with some of U.S data :-

> *"DR. KAUFMANN: Yes, I think there is. I mean, I think the thing to do is to look at -- I think side-by-side comparisons between the U.S. and Ontario make sense.*

But, you know, for example, if you only had four years of the operations of Toyota in North America -- and you wouldn't say, 'Well, let's combine it with six years of GM's operations.' I mean, you know, that's -- it's just not a sensible way to kind of go at it."

If one thinks about the Toyota data as being Ontario and the GM data as being U.S., one Dr Kaufmann is suggesting is that in order to treat Toyota (Ontario) fairly in terms of regulation we should ignore how Toyota (Ontario) operates and use only GM (U.S.) information to regulate Toyota (Ontario). It is ECMI's view that ignoring Ontario data in favour of U.S. data is a fatal flaw.

ECMI concurs in part with Dr Yatchew's observations in his Concluding Comments on pages 25 and 26 of his May 6 2008 presentation:-

"The determination of a productivity factor should not prejudiced those that have been imposed elsewhere, but rather informed by productivity factors that have been actually observed."

and

"Present circumstances do not justify the superimposition of stretch factors onto the base productivity factor:

- *The sustainability objective: The resulting X-factors (averaging 1.16 for the industry) do not meet the criterion of sustainability, a criterion which has been widely agreed upon.*
- *Arguments based on "precedents":*
  - *The existence of precedents in other jurisdictions does not constitute a justification.*
  - *Nor does the existence of precedents in Ontario. For example, there are important differences between the Ontario electricity distribution and natural gas distribution.*
  - *Equitable treatment of both sectors neither requires nor implies identical treatment."*

Lack of Capital Data

In the absence of capital data, TFP's and stretch factors may both be biased against "good performing distributors". ECMI remains concerned with the lack of capital data in the benchmarking process. The process relies exclusively on comparison OM&A costs, which by PEG's own admission are not the prime driver of LDCs costs:-

"At the same time, available OEB data have important limitations. The most serious problem for TFP research is the available information on capital cost.
Ref page 33 of PEG report February 2008"

As stated in the May 6th 2008 meeting, ECMI remains of the view that it is both premature and ill-conceived to give benchmarking any weight in establishing the approved revenue requirement as part of a PBR process without due consideration of capital.

If, either by accident or intent, small distributors are inappropriately punished due to the lack of full costs (including capital) analysis underpinning any benchmarking process, forcing these distributors into potentially dire financial situations would not protect or serve the customers well. If a system is older, it is reasonable to expect that the O&M would be higher and the cost of capital lower. It is a balance which the regulator in fairness and in reasonableness must bring to the regulation process. In considering the customer and rate stability protection one should consider the alternatives of an existing licence situation.

Start Date analysis

At the May 6, 2008 meeting, ECMI requested further details on PEG's "start date" analysis. PEG's response to ECMI dated May 9 2008 refers to Table 13 of PEG's February 2008 and largely repeats word from that report. It appears from Table 13 that the year 2000 has the best fit with 2006 as 2000 has the smallest difference from 2006. Table 13 also seems to demonstrate that the best fit occurs within the 10 year window. This may indicate that the similarity between the U.S. and Ontario markets may be less robust than implied by the statements made by PEG.

The weather correction done by PEG appears to be a universal weather correction. As the Board well understands from its cost allocation process, a proper and rigorous weather correction must be done on a class by class basis to be valid. This is the standard that the OEB held distributors to as part of the cost allocation process. Establishing the proper revenue requirement is even more important than the allocation of that revenue requirement between classes. The weather correction analysis done by PEG, while a necessary part of any start date analysis, lacks rigour and ECMI would suggest invalidates the PEG start date analysis.

Further, the fit analysis done by Dr Yatchew presents a more compelling argument on slide 3 of his May 6th 2008 presentation that 1990 is a better fit as a start date. Further, Dr Yatchew's analysis does not appear to rely on short term weather analysis for eliminating weather effects. Also, the more years that are included in the analysis the criticality of the start date determination becomes less important.