From: Mark Lowry [mailto:mnlowry@pacificeconomicsgroup.com]
Sent: Friday, 23 April 2010 6:26 AM
To: Eamonn Corrigan
Subject: TFP Review FINAL DRAFT

Mr. Corrigan,

You and I have not met but I am the President of Pacific Economics Group ("PEG")Research LLC, a company in the Pacific Economics Group consortium that has for many years been the leading practitioner of index based regulation. As you probably know, we have been involved for many years in ANZ regulation, working for the Essential Services Commission, the Queensland Competition Authority, and a number of utilities. I mostly work the western hemisphere, and one of my clients is the Ontario Energy Board ("OEB").

I am writing to you at this time because I had occasion recently to read an account of the Ontario gas proceeding in a paper that was prepared for the AEMC. This paper creates a distorted view of what happened in that proceeding and I wanted to set the record straight. The key challenge in that proceeding was that there were only two companies in Ontario, and the data in Canada that are needed to prepare a TFP study are deficient. There is need then to use the abundant, high quality data that is available in the States. The key question was: how should they be used. Research by Toronto-based academic economists, published in a classic paper by Denny, Fuss, and Waverman, had usefully decomposed the drivers of TFP growth. This theory, in combination with econometric cost research, could be used to identify suitable productivity peers, and it was also possible to develop productivity growth targets econometrically that were expressly tailored to the business conditions of the two Ontario utilities. Our econometric cost research showed that the key driver of gas utility TFP was the opportunity to earn economies of scale. Since customer growth was brisk in Ontario, and especially in the large metro areas served by Enbridge Gas Distribution, the best peers were utilities that also experienced rapid customer growth. As it happens, the US utilities in the northeast US, which are closest to Ontario, have the *slowest* customer growth in the U.S. Our research for the Board was recently published in a refereed journal, the *Review of Network Economics.*[1]

Each utility hired outside advisors, Union Gas choosing the distinguished Mel Fuss of the University of Toronto. In the proceeding, Dr. Fuss had few substantive objections to our methodology (which was based on his work) and Union ultimately settled on terms very similar to those that were indicated by our research. Even though the X factor was much higher than that ultimately chosen for Enbridge, Union's earnings under the plan have been quite high.

Enbridge elected to challenge our research vigorously using a "kitchen sink" approach that included ideas that in our view ranged from good to not so good. We incorporated several of their ideas into our research during the proceeding. The settlement adopted terms that were roughly halfway between those proposed by us and the Enbridge consultant. Settlements are widely used in North American regulation. While there are many advantages to the process, one disadvantage is that the regulator does not have the opportunity to rule on the methodological issues that arise.

The following statement in your TFP report

> It is noteworthy that the Board was not able to accept the findings of its advisors—criticism of the advisors' report from the companies resulted in a settlement agreement that was significantly different from the recommendation of the Board's advisors

is thus misleading in two key respects. 1) The plans for both companies were the result of settlements and this was the only sense in which the Board was "not able" to accept our findings. 2) One of the settlements was very much in line with our research and this was the company who was advised by Dr. Fuss.

In summary, I do not believe that the Ontario experience should give you pause concerning the adoption of index-based regulation. By and large it has worked well in Ontario, where the Board has hired competent specialists who are willing to listen to the ideas of other parties. The OEB recently adopted a price cap plan for power distributors with less controversy. One downside of index-based regulation that *is* revealed by Ontario experience is that you will have to deal occasionally with witnesses with disparate views on methodological issues. It is quite possible to work through the methodological issues and arrive at a sensible outcome. Having a PhD production economist on staff is certainly helpful, and a good investment in any event. If you rule on a methodological issue, you will not subsequently have to deal with the associated "hot air". Along the way, you can economize considerably on regulatory cost and avoid the audacious exaggerations of future spending needs that have unfortunately been part and parcel of building block regulation in Britain and Australia. Given the large number of utilities that you regulate, this is an important consideration. Index based regulation is widely used today by regulators with responsibility over 20 or more utilities, and for good reason.

I would also like to comment that there are many other approaches to utility regulation, beside building blocks and indexing, that merit your consideration. These include X factor nomination schemes and the "hybrid" approach to the design of rate and revenue caps (which uses indexing for O&M expenses and forecasts for capital costs) which originated in California and has been used in several other states and provinces since the early 1980s. A recent paper that I prepared that discusses the hybrid option for *revenue* cap design can be found at **http://www.oeb.gov.on.ca/OEB/Industry/Regulatory+Proceedings/Policy+Initiatives+and+Consultations/Distribution+Revenue+Decoupling**.

Thanks for giving me this opportunity to comment on your initiative. You have my permission to enter only these comments into the record for the proceeding.

[1]Mark Newton Lowry and Lulitt Getachew, " Econometric TFP Targets, Incentive Regulation and the Ontario Gas Distribution Industry", *Review of Newtork Economics*, Vol.8, Issue 4 – December 2009.

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