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BY E-MAIL

October 28, 2010

Board Secretary
Ontario Energy Board
2300 Yonge Street, Ste. 2700
Toronto ON M4P 1E4

Attention: Ms. Kirsten Walli, Board Secretary

Dear Ms. Walli:

Re: Board Staff Interrogatories
2011 Electricity Distribution Rates – Preliminary Issue
Horizon Utilities Corporation - Board File No. EB-2010-0131

In accordance with Procedural Order No. 1, please find attached Board staff interrogatories in the above proceeding with respect to the Preliminary Issue of early rebasing. Please forward the following to Horizon Utilities Corporation and its legal counsel and to all other registered parties to this proceeding.

Sincerely,

Original Signed By

Keith C. Ritchie
Project Advisor - Applications

Attachments

Horizon Utilities Corporation
2011 Cost of Service Application
Board File No. EB-2010-0131

Board Staff Interrogatories on the Preliminary Issue of Early Rebasing

1. Ref: E1/T2/S1/page 6/ll. 27-28

Horizon Utilities Corporation (“Horizon”) states that its adjusted Return on Equity (“ROE”) on its regulated investments was 7.2% in 2008 and 6.6% in 2009, and is forecast to be 5.9% for 2010.

a) Is the actual or forecasted adjusted ROE documented in this exhibit an accounting return or a regulatory return? Please explain your response.
b) What adjustments have been made in the derivation of the actual ROEs for 2008 and 2009 and the forecasted ROE for the 2010 bridge year shown in this exhibit?
c) Please provide a detailed derivation of the 5.9% ROE forecasted for 2010.
d) Please provide information on Horizon’s achieved return to date for 2010 (e.g. to September 30, 2010). Please provide any update available on what Horizon expects to earn to December 31, 2010.

2. Ref: E1/T2/S1 and Response to Board staff IR # 5 in Horizon’s Z-factor Application

Board staff has attached a copy of the redacted version of the response to Board staff interrogatory # 5 from Horizon’s Z-factor application dealt with under File No. EB-2009-0332. In response to Board staff IR # 5 d) in that proceeding, Horizon forecasted an adjusted ROE of 6.29% for 2009 and 6.19% for 2010. Elsewhere in that interrogatory response, Horizon explained the drivers for expected underearning of its ROE.

On page 6 of E1/T2/S1 in this application, Horizon has documented an actual 2009 ROE of 6.6% and a forecasted 2010 ROE of 5.9%.

a) Please explain what factors lead to actual 2009 earnings being 31 basis points higher than was forecast in the Z-factor case.
b) Please explain what factors are contributing to a further decline in the forecasted ROE for 2010.

3. Ref: E1/T2/S1/page 6/ll. 27-28, E5/T1/S1/page 2 and E5/T1/S2/Appendix 5-1

In Appendix 5-1, Horizon provides a copy of the Promissory Note dated February 28, 2005 due to Hamilton Utilities Corporation ("HUC"). This Promissory Note attracts a rate of 7.0% on a principal of $116 million and matures on July 30, 2012. This Promissory Note was considered in Horizon's 2008 Cost of Service application under File No. EB-2007-0697, and the Board determined that a debt rate of 6.1% would be allowed for this debt based on the timing and Board's policy and practice on cost of capital, based on market conditions and the timing of the 2005 updated note.

In its application, Horizon states: "Horizon Utilities requests a debt rate of 6.1% with respect to the $116MM HUC Note. Such rate was approved for such note in the 2008 EDR COS Application Decision. There have been no changes to the terms of such note since such decision."

a) Please confirm whether Horizon is paying interest to HUC on the rate of 7.0% as documented in the executed Promissory Note.
b) Please confirm that Horizon's distribution rates as approved by the Board in the application considered under File No. EB-2007-0697 and in distribution rates subsequently approved through IRM rate adjustments for 2009 and 2010 would reflect recovery of interest on the $116M Promissory Note at a rate of 6.1%.
c) Please confirm whether or not Horizon earns a lower net income and hence return on equity as a result of Horizon paying interest on the Promissory Note at a rate of 7.0%, higher than the 6.1% approved by the Board for recovery in Horizon's revenue requirement. Please explain your response.
d) If possible, please estimate the impact that paying a 7.0% interest rate on the $116M Promissory Note rather than the 6.1% allowed for rate-setting would have on the actual ROEs of 7.2% in 2008, 6.6% in 2009 and forecasted to be 5.9% in 2010.

4. Ref: E1/T2/S1 and the Board's Decision on Hydro Ottawa Limited's 2011 Cost of Service Application (Board File No. EB-2010-0133)

On October 27, 2010, the Board issued its Decision on the Preliminary Issue of early rebasing with respect to Hydro Ottawa Limited's 2011 Cost of Service application, considered under File No. EB-2010-0133. In that Decision, the Board discussed the evidence and its findings on specific issues and criteria that would justify a distributor filing for early rebasing in reference to the Board's letter of April 20, 2010.

In E1/T2/S1 of Horizon's current cost of service application, and specifically on pages 6 and 7, Horizon lists in some detail four criteria in support of its proposed early rebasing.

a) With reference to the Board's Findings documented on pages 9-11 of the Hydro Ottawa Decision, please identify how the criteria documented in

E1/T2/S1 (and in any other areas of Horizon's application) justify an early rebasing.

b) Please identify any aspects of the Board's Decision with respect to Horizon's Z-factor application dealt with under File No. EB-2009-0332, and of subsequent load reductions or growth, that would support an early rebasing application.

5. Ref: Application Summary, p. 6

It is stated that with respect to the loss of distribution revenue related to the large customer that:

> *This has made it necessary for the Applicant to review its expenditures in order to determine which projects may be deferred without incurring any risk to system reliability or customer safety. Furthermore, the deferral of any project from 2009 to 2010 is only a short term deferral – any project being deferred is still necessary and must be completed in 2010, a year in which the Applicant anticipates a further loss of distribution revenue of $1,056,232. In addition, the impact of the distribution revenue deficiency now requires the Applicant to consider a plan to accelerate the filing of its next cost of service application to August 2010 for implementation May 1, 2011. The Applicant submits that, despite such deferral, it will not achieve its maximum allowable return on equity, and that such deferrals are necessary as prudent measures in relation to available regulated cash flows. “*

a) Please identify which projects have been deferred to 2010 or beyond and please provide an explanation as to why they were chosen for deferral. Please include the dollar amount of each project.

b) Please state how Horizon determined that it was necessary to defer these capital projects in order to maintain prudent levels of regulated cash flows.

c) Please provide the following:

i) an explanation as to what Horizon would view as a prudent level of regulated cash flow for each of 2009 and 2010 and why.

ii) the level of cash flow for each of these years had the projects not been postponed and with their postponement.

iii) In this context, please state how their postponement would bring the cash flows to acceptable levels.

iv) the assumed financing mix that was used in assessing the impacts of deferring these projects (approved or actual capital structure, 100% debt, 100% equity, or some other mix).

d) Please state in which years Horizon anticipates not achieving its maximum allowable return on equity and provide the currently forecast levels for the relevant years. Please state whether the loss of the large customer revenue is the only factor that is leading to

REDACTED version based on OEB Decision on confidentiality dated January 18, 2010

this underachievement, or, if there are other factors, please state what they are.

Response:

5a) The following projects were deferred from fiscal 2009 to fiscal 2010 or beyond:

Description	$ Amount	OM&A or Capital
ERP Implementation – Planning and Scheduling and Field Devices -Productivity Improvement	$295,000	OM&A – Business Process Mapping, Definition, Training and development
Human Resources – New Hires and Filling of Vacant Positions - Skilled Trades/ Apprentices - Finance/HR	$515,000	OM&A
Asset Management Planning	$50,000	OM&A
GIS Technology Strategy	$60,000	OM&A
Repairs and Maintenance - Facilities	$230,000	OM&A
Communications	$100,000	OM&A
Supply Chain Productivity Initiatives	$100,000	OM&A
Various operating expense reductions	$80,000	OM&A
	$1,430,000	**TOTAL OM&A**
Depreciation expense	$60,000	Impact of Capital Reductions
	$1,490,000	**TOTAL OPERATING**
Computer hardware/software upgrades	$173,000	Capital
Facilities upgrades	$185,000	Capital
Other miscellaneous capital	$318,000	Capital
	$676,000	**TOTAL CAPITAL**
Smart Meter – Commercial Customers – Deferred pending approval of Smart Meter Adder	$2,900,000	Other Capital

Please note that the capital expenditure deferrals of $0.7MM are expected to be offset by $2MM in higher distribution system capital expenditures for 2009.

With respect to the Commercial Smart Meter capital expenditures, these expenditures are a component of the Smart Meter variance accounts and are outside the scope of the revenue sufficiency/deficiency.

As previously noted, despite these mitigation efforts, Horizon Utilities will not achieve its regulated rate of return on regulated rate base.

Projects were selected for deferral based on whether or not such would result in any significant business or operational risk to Horizon (e.g. reliability of the distribution system, impact on customers) in the very short-term.

5b) Please refer to Horizon Utilities' response to VECC Question #9.

5 c) i) The "prudent" level of regulated cash flow is that which supports prudently incurred electricity distribution expenditures, within the context of Board rate making policies, while also recovering the full approved regulated cost of capital. Such level of cash flow provides for the financing and operation of the regulated electricity distribution business on a sustainable basis.

Specifically, for 2009 and 2010, Horizon Utilities would view the prudent level of regulated cash flow to be that arising from its Board-approved 2008 cost of service electricity distribution rate application ("2008 EDR") as adjusted through the third generation incentive rate mechanism ("3GIRM"). Such cash flow is effectively the amount of total Revenue Requirement expected from such rate making policy based on assumptions underlying the determination of customer rates and other regulated charges, including consumption forecasts.

The Revenue Requirement arising from the Board - approved 2008 EDR application was $93.4MM on a rate year basis.

On this basis, after considering actual and estimated 3GIRM adjustments and assuming a modest level of customer growth at 0.5%, the prudent level of regulated cash flow/ Revenue Requirement is approximately $94.1MM and $94.9MM for the 2009 and 2010, respectively.

5 c) ii) Given that cash flows are affected by a variety of factors, including working capital timing differences, a more direct approach to evaluating cash flow levels, with or without postponement of projects, is to consider the difference between the prudent level of regulated cash flow/ Revenue Requirement, based on that submitted in response to question 5 c) i), above, and that which is forecast for the 2009 and 2010 fiscal years. Such difference represents a cash flow impairment relative to the amount afforded by Board rate-making policy.

Such analysis requires converting rate year cash flow into fiscal year cash flow. On a fiscal year basis, Horizon Utilities submits that the prudent level of cash flow corresponding to the amount submitted in response to question 5 c) i) is $93.9MM and $94.6MM.

No Postponement

The cash flow impairment, relative to the prudent level submitted above, is represented by the total amount of forecast forgone Revenue Requirement which, in aggregate, is $5.2MM and $3.6MM for 2009 and 2010, respectively. Such aggregate balance comprises:

- forecast forgone Distribution Revenue Requirement of $3.8MM and $1.8MM for 2009 and 2010, respectively; and
- forgone other regulated charges of $1.4MM and $1.8MM for 2009 and 2010, respectively.

With Postponement

Horizon Utilities forecasts 2009 net operating and capital expenditure postponements of $1.5MM and $1.6MM, respectively. Assuming a financing mix based on the approved capital structure, these 2009 postponements mitigate the 2009 forecast cash flow impairment by $2.1MM.

5 c) iii) Such postponement does not bring cash flows to “acceptable” levels; it merely

mitigates cash flow impairments to the extent practicable, with due regard for managing operational risks related to the regulated electricity distribution operations.

Horizon Utilities submits that “acceptable” levels of cash flow mirror its definition of “prudent” level of regulated cash flow in response to 5 c) i). Horizon Utilities submits that an “acceptable level” of cash flow provides for prudent capital and operating programs and its full approved cost of capital which, in turn, supports the creditworthiness and operation of its regulated operations on a sustainable basis.

5 c) iv) Horizon Utilities has assumed the Board-approved capital structure as a basis for its financing mix in assessing the impacts of postponements noted in 5 c) iii).

5 d) Horizon Utilities does not anticipate achieving its maximum allowable return on equity (“MARE”) in either of 2009 or 2010. Horizon Utilities will file a cost of service application in 2010, and anticipates that the Board’s 2011 Rate Order will allow for the achievement of the MARE from the effective date of that rate order.

The levels of return on equity for the regulated electricity distribution operations, adjusted to reflect the approved capital structure, are forecast to be 6.29% and 6.11% for 2009 and 2010, respectively. Such levels are forecast to be 6.86% and 6.59% on an unadjusted basis for 2009 and 2010, respectively.

The loss of the large customer revenue is not the only factor leading to this underachievement. Other contributors to this underachievement include:

- the broader decline in commercial customer load and resulting impact on distribution revenue; and
- the shortfall in other regulated charges, relative to the level approved in Horizon Utilities’ 2008 EDR application, as set out in Horizon Utilities’ response to Board Staff Interrogatory #5(c)(ii), above

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