Jay Shepherd
Professional Corporation
2300 Yonge Street,
Suite 806
Toronto, Ontario M4P 1E4

BY RESS and EMAIL

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Our File No. 20100131

Ontario Energy Board
2300 Yonge Street
27th Floor
Toronto, Ontario
M4P 1E4

Attn: Kirsten Walli, Board Secretary

Dear Ms. Walli:

Re: EB-2010-0131 – Horizon 2011 Rates

We are counsel for the School Energy Coalition. Pursuant to Procedural Order #2, these are SEC's submissions with respect to the preliminary issue of the timing of this cost of service application.

After a thorough review of the Application, and in light of the principles that we believe should apply, SEC recommends that the Board reject the cost of service application, and direct the Applicant to file under the 3rd Generation IRM system.

General Submissions on Early Filing

1. In our submissions with respect to the Hydro Ottawa application in EB-2010-0133, SEC provided a detailed analysis with respect to the balancing act the Board should adopt in considering LDCs who want to rebase early. In those submissions, which we will not repeat here, we raised five concerns that we believe are important when the Board considers these applications:

    a. ***The "Right" to Apply.*** The Board has always maintained a flexible approach to hearing applications from utilities. That does not mean utilities have a right to apply any time, but rather that the Board will consider every application that it sees, to determine whether it is appropriate to hear it, and to ensure that every exceptional circumstance is addressed.

    b. ***Control Over the Process.*** The Board has to regulate a diverse group of companies, and to do so efficiently requires that it maintain a tight control over its process. The process must be driven by the overall public interest, not by the wishes of individual utilities.

    c. ***Fairness to Other LDCs.*** Allowing LDCs to rebase early, just because they want to spend at a higher level, is unfair to those LDCs who abide by the process and constraints that the

Tel: (416) 483-3300 Cell: (416) 804-2767 Fax: (416) 483-3305
jay.shepherd@canadianenergylawyers.com
www.canadianenergylawyers.com

Board has established. In addition to seeking an advantage by not following the process, those LDCs use up scarce Board resources that need to be used for those who are scheduled to be before it.

d. ***Supporting Successful IRM.*** The purpose of IRM is not only to make the regulatory process more efficient, but also to give LDCs an opportunity to introduce productivity improvements over multi-year periods, while at the same time providing ratepayers with some level of rate predictability. If LDCs believe that they can run back to the Board for more money at the first sign of financial pressure, the value of IRM is seriously undermined.

e. ***Changing Corporate Culture.*** Many LDCs were at one time government departments, where budgets are often based on how much you can justify. One of the values of the IRM model is that there is no place to get more money, so the focus becomes making good management decisions, a business rather than government model. This approach, which is consistent with government policy, is a slow process in which some LDCs embrace the new model more quickly than others.

2. Against this backdrop, it is submitted that most LDCs will not – or at least should not - need to rebase out of schedule. The Hydro Ottawa decision in EB-2010-0133 reinforces that with a welcome clarity, and has sent the first part of an important message to all LDCs in the province.

3. At the same time, it would not be consistent with the above principles if there were no circumstances in which an LDC could seek an early rebasing. The easiest example is the utility – and there are several of them in the province – that has a single customer with a substantial percentage of their load. If that utility loses their main customer, is there any doubt that a full cost of service review is in order? Of course not. Indeed, it is in the interests of the utility, its ratepayers, and the Board to get them in for a review as quickly as possible. There may be significant impacts, and the faster there is a public review of how they should handle this major change, the more likely the response will be effective in minimizing the adverse impacts. It should not, for example, be necessary for them to meet the off-ramp test. If it is obvious that they have a big problem, the time to start solving the problem is right away.

4. In our submission what this application does is put to the Board the second part of the early rebasing question. The first part is whether early rebasing is in the discretion of the individual utility. The clear answer from EB-2010-0133 is no. The second part is where the line should be drawn between those whose applications should be heard, and those who should be advised to wait.

5. In our submission, this line is not a bright line, with a clear delineation between those who qualify and those who don't. As the Board has made clear, it must be decided on a case by case basis. However, while recognizing that fact, it is still true that the level of "need" or "justification" that the Board will generally expect in these applications will be established by the guidance given in this and other decisions. In short, how serious does the situation have to be to justify early rebasing?

<u>The Real Reason for this Application: The Increase in the Cost of Capital</u>

6. When the Board's Cost of Capital Report was released in December of 2009, many stakeholders believed that there would be a rush of cost of service applications this year, with LDCs seeking to get the higher ROE level as soon as possible. The Board's letter on April 20th caused many LDCs to rethink that strategy, and as a result there are fewer cost of service applications this year than many had feared. The Hydro Ottawa decision in EB-2010-0133 has reinforced that reality.

7. The Applicant in this case claims that the availability of the higher ROE in a cost of service application is not the driving force behind this Application, saying [Staff IR responses, p. 19]:

> *"The recognition of the need for a reasonable rate of return was not a driver in making this Application, but instead is one of the normal results that are an integral outcome from a comprehensive cost of service application."*

8. Sadly, that statement is demonstrably untrue. That statement, made by the Applicant on November 8, 2010, flies in the face of the following statement, made in Note 2 to the Applicant's 2009 audited financial statements, on February 5, 2010, the same day that the Applicant advised the Board in writing that it planned to seek early rebasing for 2011 [Ex. 1/3/1, App. 1-10, p. 9]:

> *"In December 2009, the OEB concluded a Cost of Capital proceeding with the issuance of a final report. The report principally dealt with the adequacy and determination of the Maximum Allowable Return on Equity (MARE)…. The short term result is an initial rise in MARE to 9.75%....<u>The method of transition to the new MARE is through a Cost of Service Application similar to the 2008 EDR application.</u> The Corporation anticipates filing such an application with an effective date of May 1, 2011."[emphasis added]*

The same wording is found in the Management Discussion and Analysis for the Applicant's parent company, dated the same date [Ex. 1/3/4, App. 1-13, p. 6].

9. What in fact happened, it is clear, is that the Applicant, like other LDCs (including Hydro Ottawa), understood the interaction of the Cost of Capital Report and the "right" to rebase as meaning that anyone who wanted a higher ROE could simply apply for it via a cost of service application. When the Board's April 20th letter came out, the Applicant concluded that they could no longer admit to a higher ROE as their true reason for early rebasing. They therefore looked for other "reasons" that they felt would satisfy the Board. Their motives didn't change, just their explanation.

10. It would have been better for them to simply admit that, rather than try to hide their primary motivation.

11. This is not the first time the Applicant has taken a position before this Board that was not tenable. In the EB-2007-0697 case, for their 2008 rates, the Applicant took the position that a promissory note that they claimed had been previously approved by the Board, and was not, was overlooked by them since it was "mere housekeeping". The Board rejected their arguments out of hand, saying "This is clearly not the case." [Page 24 of the Decision].

12. It is SEC's view that the Applicant has been less than straightforward with the Board about its rationale for early rebasing. Given the Applicant's history in this regard, we are concerned that a pattern may be emerging. While we are not for a minute suggesting that the Applicant is deliberately trying to mislead the Board, we are concerned that they may believe they have more licence to provide "spin" to their evidence than the regulatory process really allows.

13. Notwithstanding the problem with their statement in the Application, SEC believes that the Board's decision whether to allow this early rebasing should be determined on the basis of the facts. If those facts demonstrate a proper justification, then regardless of whether the Applicant has communicated it appropriately, the Application should be allowed to proceed. If not, they should be directed to file under the 3rd Generation IRM mechanism.

Claimed Reasons for Early Filing

14. The Applicant has dealt with its reasons for early rebasing [Staff IR #4a, pages 13-20] under three headings based on the Hydro Ottawa decision: IRM framework, implementation of Board policy determinants, and LDC specific circumstances, and we will deal with each area in turn.

15. ***IRM Framework.*** The Applicant argues that, while it doesn't technically meet the 300 basis point IRM off-ramp for any year, it will under-earn by that much in 2011, and has lost more than 300 basis points cumulatively over the last three years relative to Board approved ROE [Staff IRs, pp. 13-14].

16. Neither of these arguments is credible.

17. On the first point, the Board's policy on the off-ramp is clear. If an LDC actually under- or over-earns by 300 basis points, the off-ramp is triggered. It is not prospective, and there is no automatic cost of service proceeding. The Applicant here is simply seeking to re-write the Board's policy, although it admits that "Horizon…would not meet the off-ramp test in any of those years".

18. On the second point, Horizon is concerned with "cumulative impairment". This point is not different from the "unsustainable deferrals" point, which is one of their LDC specific issues, so we will deal with it in that section, below.

19. ***Implementation of Board Policy Determinants.*** The Applicant claims that getting a higher ROE, aligning the rate and fiscal years, clearing deferral and variance accounts, and GEA approval, are not the drivers of this Application, and they are not relying on these reasons as justification for their early rebasing.

20. As we have noted above, the higher ROE is, of course, the primary reason for this Application. As well, the alignment of fiscal and rate years stands, with a $19.6 million deficiency, to add more than $6 million to their calendar 2011 revenues.

21. Notwithstanding these facts, these are not valid justifications for early rebasing, and the Applicant admits that is the case.

22. ***Utility-Specific Operational Reasons.*** The Applicant has four reasons for filing early that are based on their specific operational and spending needs and situation [Staff IRs, pages 16-20].

23. ***Loss of Revenue/Decreasing Load.*** The Applicant is legitimately suffering from a drop in its distribution revenues, in part due to the economic downturn. That was the subject matter of their unsuccessful Z factor application (EB-2009-0332), in which evidence was led as to the loss of one large customer, and economic impacts on industrial customers generally.

24. It is important, though, to keep this in perspective. The Applicant is a large electricity distributor, and it is well accepted that they are not particularly vulnerable to loss of load. On July 8, 2010, Standard & Poor's, in rating the Applicant A/Stable, said [Ex. 1/3/4, App. 1/14, p. 3]:

> "*Growth in the LDC's mature customer base averaged less than the provincial average of 1% per year for the past four years. Nevertheless, in our opinion, Hamilton's economy continues to benefit from its proximity to the Greater Toronto Area. Other key sectors, such as biotechnology and health care, figure prominently in the city's economic development strategy. Net distribution revenues are not exposed to any single industrial customer sufficient to cause a*

rating concern in our view. The bulk of the 235,000 customer base is residential."

They go on to say, under the heading "Excellent Business Risk Profile" [page 6]:

"*Profitability in 2009 was marginally weaker than previous years due to lower-than-forecast consumption. Gross billings fell 4% in 2009 for several reasons, including weak economic conditions, mild weather, and provincial conservation measures.*"

Their point is that this is not a concern.

25. It is also important to consider the absolute dollar impact of the loss of load. It is difficult to determine, given the sometimes conflicting evidence, what that amount is, but there are two sources that can be used to triangulate at least the order of magnitude:

    a. [Ex. 1/2/4, page 1] The table calculating the deficiency shows that Distribution Revenue at Current Rates increases from the amount included in current rates (2008 Board-approved) of $86.6 million to the 2010 forecast of $90.8 million. While the Applicant then forecasts a drop to 2011 distribution revenue of $83.7 million, that figure, even if it is right, is still only $2.9 million (3.3%) below 2008 Board approved, which is the basis of current rates.

    b. [VECC IR #1, page 2] The table in this response shows 2008 Board-approved distribution revenues of $86.7 million, but 2008 actuals of $83.1 million. The 2010 forecast in this table is $85.9 million, a drop of $724,000 from the amount included in rates. There is no forecast for 2011 (the new rates are assumed), but based on the deficiency of $19.6 million claimed, and the change in the Miscellaneous Revenue, the revenue at current rates would have to be $83.7 million, the same as the previous reference. The drop is therefore still only 3.3% from Board-approved, and an increase from 2008 actuals.

26. Therefore, our conclusion is that for this, the strongest of the justifications provided by the Applicants, the external evidence is that it is not sufficient to support an early rebasing application.

27. Despite this, we are conscious of the fact that the Board, in the EB-2009-0332 decision on the Z-factor application, appeared to rely, as one of its reasons for denying the application, on its view that the matter would be better dealt with in a cost of service application. The Applicant will argue that the Board rejected their Z factor application because it wasn't a cost of service application, and can't now reject their cost of service application for the same thing.

28. While that argument has some merit, on balance we believe that the Z factor vs. cost of service distinction was not central to the Board's reasoning in that decision. The key point decided by the Board that determined the EB-2009-0332 case was expressed on page 10 of that decision, as follows:

    "The Board finds that Horizon has not demonstrated that the harm caused by the Subject Customer's reduced load is genuinely incremental to Horizon's experience or reasonable expectations."

29. Ii is hard not to have some sympathy for the Applicant. First, they believed that the Cost of Capital Report directs them to file a cost of service application to get the higher ROE. That turns out to be wrong. Second, they believed that the Board in the EB-2009-0332 decision directed them to file a cost of service application to deal with their loss of load. That is also likely wrong. In both cases, in

our submission, they have misread the Board's intentions. However, they are understandable mistakes.

30. Despite this, SEC submits that the small reduction of revenues being experienced by the Applicant is part of the normal business risks of an electricity distributor, and contemplated by the IRM process. Utilities are expected to manage their business risks, and a small reduction in revenues such as this one should be well within the capability of a distributor like this one to manage. In this context we note that the utility's revenues in 2008, their cost of service year, were even lower than the forecast for 2011, the result of a forecast error in the year they last rebased. Notwithstanding this, in the EB-2009-0332 proceeding the Applicant reported an ROE for 2008, calculated on a regulatory basis, of 8.59%, i.e. in excess of their Board-approved ROE [EB-2009-0332, Staff IR #10].

31. Therefore, it is submitted that the loss of load in this case is insufficient justification for an early rebasing application. As we note below, the need for $19.6 million more money, it appears, is not about this relatively small - $2.9 million at most - reduction in revenues. It appears instead to be about the desire to increase spending, which is a completely different matter.

32. ***Deferred Spending.*** The Applicant claims that, in both OM&A and capital, necessary spending was deferred in 2008 through 2010 because they didn't have enough money. They need to start spending that money, they say, or their reliability and safety levels, which have not suffered so far, will start to suffer. With respect, these arguments are untenable in both the operating and capital areas.

33. With respect to OM&A, it appears that the main driver is the desire to increase the number of employees in a dramatic fashion. The Applicant had 368 FTEEs in its last rebasing year, 2008, and currently in November 2010 has 378 FTEEs [Energy Probe IRs #1d and 1e, page 4]. Note that the latter figure is much lower than the figure of 401 in Appendix 2-K. The Applicant has now disclosed that there are 23 vacancies that they have not yet been able to fill, so the Board and parties should not rely on Appendix 2-K as being accurate.

34. Despite the relatively even level of employees for the last three years, the Applicant believes it has an immediate, pressing need to increase that by a further 13.2% to 428 FTEEs for the calendar year commencing in less than two months.

35. This is simply not credible, for two reasons. First, as noted earlier the Applicant has a stable and mature customer base, so dramatic increases in total number of employees should generally not be required. Second, even if an FTEE increase is required, no evidence has been led that it must be done in 2011 as opposed to 2012, when the Applicant is already scheduled to apply on a cost of service basis.

36. We note in passing that apparently the big push at Horizon right now is its unregulated solar business, which attracted comments (with respect to increased risk) in the Standard & Poor's Rating report in July 2010. It is more than a little unusual that a utility that claims to be under such financial pressure is expending significant resources and management focus on a new and risky unregulated business like this. In our view, more focus on improving the productivity of the regulated business could have a beneficial effect, and alleviate the "need" for 50 more people.

37. With respect to capital spending, the Applicant raises the same "aging infrastructure" argument that Hydro Ottawa raised. As we noted in our submissions on that case, this is not a new issue. The Applicant has known about this for years, including at the time of and prior to the last rebasing. Rather than sink money into their distribution plant at that time, the Applicant decided to spend money on expensive Enterprise Resource Planning software. We agreed with that prioritization then, and we still do, but the result is that spending on lines and stations takes place later. There is not an

unlimited budget. It is submitted that, in fact, the Applicant's real complaint is that they believe 3rd Generation IRM does not give them big enough rate increases to fund higher levels of capital investment. That is not a good justification to seek early rebasing.

38. The other part of the capital spending question is that the evidence discloses no need to spend the additional money in 2011, as opposed to 2012 when cost of service was already planned. On the preliminary issue, the question whether they need to increase capital spending does not yet arise. The question at this stage is whether they need to increase capital spending <u>now</u>.

39. ***Workforce Renewal.*** The third LDC specific justification is "workforce renewal", the aging workforce issue plus more [Staff IR #4, page 19].

40. This is really the same as the last point, the deferral argument. As with the claim that expenses have been deferred, the Applicant argues that it needs more people because of pending retirements. This not only belies the planned increase of 50 FTEEs (retirees should no longer be FTEEs), but in any case is based on the clearly incorrect assumption by the Applicant that everyone who is eligible to retire in 2011 will do so, including all those who were eligible in prior years and did not [Energy Probe IR #1f, page 5].

41. The second part of the aging workforce issue is that thirteen of the twenty-six new people in trades are "needed" because of the expanded capital program. Again, we have already dealt with this under the second point. The urgency of the expanded capital program has not been demonstrated.

42. The end result is that the "workforce renewal" justification really boils down to "we can't live within the budget the IRM mechanism provides us, and we want to spend more money". Not only is this not a good justification, but additionally it doesn't explain why cost of service is required one year early. If this is just a general pressure to spend more, then there would seem to be no reason why it must be addressed in 2011 rather than 2012.

43. ***Reasonable Rate of Return.*** While the Applicant claims that getting the new higher ROE is not a driver of this Application, it's fourth justification for early rebasing is "a requirement for a reasonable rate of return on regulated investments". We are unable to assess what this means (other than "higher ROE"), because it is not explained further [Staff IR #4, page 19].

<u>Analysis and Recommended Outcome</u>

44. It is appropriate to step back and review this request from a broader perspective. Of the various justifications proposed by the Applicant, they essentially boil down to one: loss of revenues due to the economic downturn. That is what drives the all four of the separate justifications listed by the Applicant.

45. The maximum amount of revenue loss is $2.9 million. What the Applicant proposes to do is hang a $19.6 million, 23.4% rate increase on a $2.9 million, 3.3% loss of load. The Applicant proposes that, because of this $2.9 million loss of load, which is not enough to concern the ratings agencies, and not enough to prevent the Applicant from embarking on a risky new solar venture, the Board should allow it to increase OM&A by $7 million ($17.1%), including adding 50 new people, and to allow a major capital expansion, as well as a $6 million acceleration of revenues due to alignment of fiscal year, and a $3.8 million increase in ROE [Energy Probe IR #5e, page 20].

46. SEC has had some difficulty with this Application. There is a loss of load, and the Applicant did believe that the Z factor decision directed them to the cost of service route. But on balance, we believe that the Applicant is not filing a cost of service application responding to a loss of load. That

would be an application showing restraint, seeking to re-align priorities in light of lower revenues, and minimize the impact of the load adjustment. This Application is the opposite. It is an Application that seeks to expand spending, and increase profits, and jump up rates as quickly as possible.

47. This takes us right back to the example of the LDC that loses a dominant customer. In that situation, we would support the utility rebasing, so that the application could look through the menu of solutions to that problem, and select a package of responses that allows the LDC to move forward with the lowest adverse impacts. It is the responsible thing to do, and benefits utility and ratepayers alike.

48. This is not that situation. In this situation, it appears that the loss of load is simply the excuse to increase rates, expand headcount, and embark on an ambitious and expensive capital program, all with higher costs.

Conclusion

49. It is therefore submitted that the Application should be refused, and the Applicant directed to apply under the 3rd Generation IRM for 2011 rates.

All of which is respectfully submitted.

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Yours very truly,
JAY SHEPHERD P. C.

Jay Shepherd

cc: Wayne McNally, SEC (email)
Interested parties (email)