

**IN THE MATTER OF the *Ontario Energy Board
Act, 1998, S.O. 1998, c.O.15, Sch. B;***

**AND IN THE MATTER OF an Application by
Horizon Utilities Corporation for recovery of a Z
factor commencing January 1, 2010.**

**FINAL ARGUMENT
OF THE
SCHOOL ENERGY COALITION**

1. On September 3, 2009 Horizon filed an application to recover \$2,850,486 of lost revenue from a single customer, covering the period from May 2008 through April 2011. This has since been adjusted more than once, and currently the claim, as set forth in Undertaking J1, is \$2,191,246.
2. These are the final submissions of the School Energy Coalition. We have benefited from discussions with other parties prior to preparing these submissions, which has saved some time, and we have also seen some partial draft submissions. In addition, we will only comment on certain of the issues.
3. In these submissions, we will deal with the various timing issues that have arisen, then the two components of the test of materiality. Our conclusion after that analysis is that this particular revenue loss does not meet either of the materiality tests, and the timing issues also militate against any recovery. Finally, we consider the issues of quantum of recovery, and recovery method/allocation, in the event that the Board determines that some level of recovery should be allowed.
4. ***Z Factor Treatment of Revenue Losses.*** We are not in these submissions taking a position on whether a loss of revenue from a specific event should, as a matter of interpretation or Board policy, qualify for Z factor treatment. We believe that is a live issue, and one that in the appropriate circumstances will likely have to be addressed by the Board. However, in the view we take of this situation, the issue of Z factor treatment for lost revenues does not need to be determined, because in this case the claim doesn't qualify on other grounds. Therefore, we have in these submissions assumed that Z factor treatment is applicable for the purpose of reviewing the other issues. This is not indicative of our position on the issue in future proceedings.

Timing Issues

5. There are two categories of timing issues in this proceeding. First, there is the question of which period or periods should be eligible for Z factor treatment. Second, there is the question of how the four month lag in rate year vs. fiscal year should impact on the calculations.
6. *Which Years are Recoverable?* As the application is framed, it is assumed that there are three periods for which recovery is being requested. The first is the period May 2008 to April 2009, all of which has actual data available. The second is the period May 2009 to April 2010, which is partially actual data, and partially forecast. The third is the period May 2010 to April 2011, which is entirely forecast.
7. The problem with the first year is that it is the actual cost of service year on which the rates of the Applicant were originally based. Generally speaking, it would appear to us that the 3rd Generation IRM regime under which the Applicant is operating assumes that Z factors apply to IRM years. In a cost of service year, a utility is expected to forecast as accurately as possible. If the forecast – whether for costs or for revenues – ends up being incorrect, that is one of the risks for which they are compensated in their ROE. In an IRM year, the utility does not forecast costs or revenues, so the Z factor provides a relief valve if the formula produces a revenue requirement that doesn't reflect a new reality, different from that in the cost of service year.
8. But the problem in this case is worse, because unlike most large distributors, Horizon does not have a key account or large customer representative whose job is to maintain a strong relationship with the largest customers [Tr:129]. This would be surprising in any large distributor, but more so for a utility that relies as heavily on its large customers as Horizon does. Whether or not lacking that important resource was imprudent (on balance, we think it was within a reasonable range of management choices at the time), it does make clear that the Applicant may have been in a position in 2007 to do a more accurate load forecast for its 2008 rate year (including forecasting the reduction in the load from the subject customer, which had already started in early 2007), but was unable to do so at least in part because of a management decision not to gather information they know is important from large customers.
9. The problem with the second and third years is that the Applicant is seeking recovery based on a new forecast to replace their old forecast. We can understand the argument that reality ended up being substantially different from a forecast. That is the essence of the Z factor, where it applies. But replacing a forecast with a new forecast seems to be inconsistent with that concept. Why would the Board believe that the new forecast is any better than the old one, particularly when it was adjusted more than once during the proceeding?
10. A simple test of the “new forecast” issue is this. If the new forecast turns out to be incorrect, can the Applicant come back in again for another Z factor adjustment? If not, why not?
11. The question does not need to be answered, of course, but it does highlight the problem with the second and third years. A Z factor was not intended to replace one forecast with another. It was intended to replace a forecast (usually of costs) with reality in specific circumstances.

12. For these reasons, we are concerned that none of the three years in question qualify for Z factor treatment, even if the other tests are satisfied. The first year is a cost of service year, and the other two are wholly or partly forecasts rather than actuals.
13. **Rate Year.** The second timing issue arises because the Applicant is claiming lost revenues on a rate year basis, when rates are actually set on a calendar year basis.
14. This means, for example, that the Applicant is seeking to have a Z factor adjustment for a calendar 2008 load forecast based on the actuals for the subject customer from May 2008 to April 2009. This is a mismatch, and any comparison of the two figures would give an erroneous result.
15. At the other end of the three year period, the opposite problem arises. The Applicant is seeking recovery for "lost revenues" for the period January 2011 to April 2011. However, the Applicant also plans to file a cost of service application for the 2011 year, which will include, of course, a load forecast that includes that same four months. It is difficult conceptually to understand how the Applicant could get Z factor treatment for a period in which they have not yet filed their load forecast, and plan to do so this year. When they get new rates established for 2011, the loss of revenue will already be included, which means that they will adjust twice for that same revenue loss.
16. On the other hand, it is a fact that rates are recovered over a May to April period, although being set on a calendar basis. Thus, if lost revenue does qualify for Z factor treatment, one can understand the argument that revenue is in fact lost on a May to April period, no matter how it is calculated in the first place. The problem is that adjusting on this basis would not only rectify the revenue loss, but also offset the rate recovery delay period that applies as a matter of course to all distributors.
17. We do not have a proposed general resolution to this problem to suggest to the Board. It appears to us clear that recovery for any period in 2011 is not possible if that is a cost of service year. Beyond that, we do not propose a solution to the calculation of the losses in 2008, 2009 and 2010.

Materiality

18. We have two issues with the materiality test. First, in our view when properly calculated the revenue loss from the subject customer does not meet the formal materiality threshold in 2009 or 2010. Second, it appears clear that the loss does not meet the second part of the materiality test, i.e. "significant influence on the operations of the distributor", for the 2008 year and likely the others as well.
19. **Threshold.** We discuss the issue of quantum of recovery in a section later in these submissions, but quantum of loss is a different issue. The formal materiality threshold for 2008 is \$468,160, and for 2009 it is \$471,758 [Tr:31-32]. A similar figure for 2010 appears evident, perhaps \$475,000.

20. The problem with this is that the materiality threshold must be tested by the net value of the Z factor loss, and that must include both losses and offsetting gains from the same cause. While it may be argued that mitigating savings should not be offset (see our commentary below on Quantum of Recovery), any saving directly caused by the Z factor event must clearly be part of the calculation.
21. In this case, the impact in question was a reduction in working capital allowance, and thus a reduction in the revenue requirement needed in each year. In SEC IR#14, the Applicant provided the revenue requirement impacts of the reduced working capital requirements. They were [REDACTED] for 2008, [REDACTED] for 2009, and [REDACTED] for 2010.
22. By our calculations, this means that the net loss, before any mitigation, was in fact [REDACTED] in 2008 (which exceeds the threshold), [REDACTED] in 2009, and [REDACTED] in 2010. The latter two are far below the threshold for each year.
23. Therefore, it is our submission that the actual "loss" of the Applicant in each of 2009 and 2010, being the net loss accounting for both positive and negative impacts directly resulting from the Z factor event, is less than the formal materiality threshold. For each of those years, even if all other criteria are met, and all other issues resolved, in our view there is no qualifying Z factor amount.
24. **Significant Influence.** In the highest impact year, 2008, the total impact is [REDACTED]. Is it possible for that to have a 'significant influence on the operations of the distributor'?
25. While of course it is possible to compare that to the overall size of the distributor (\$95 million in annual revenue), that is really just a non-quantitative replication of the formal materiality threshold.
26. There are two other aspects of the evidence directly showing that this impact did not have the required "significant influence".
27. First, Horizon has admitted that it increased capital expenditures in 2009 by \$2 million [Tr:57-8] and operating expenditures in 2008 by \$1 million [Staff IR #4(a)], in the latter case despite \$700,000 of expenses deferred to 2009. All of these numbers are well in excess of the under \$600,000 largest annual net impact of this load loss.
28. A similar level of magnitude can be seen in the other revenue losses. The loss for the subject customer is less than a third of the total revenue loss reported to management for 2009 [Undertaking J3], and about 22% of the largest net impact, \$600,000.
29. In our submission, a utility that can add \$1.7 million to its OM&A, and then move \$0.7 of it to a subsequent (and already impacted) year, and can continue with business as usual with a known revenue erosion more than four times the largest net impact from this particular cause, cannot experience a "significant influence in distributor operations" from that \$600,000 impact.

30. **Results.** And, in fact, the results bear this out. Despite the loss of this customer, and the \$600,000 impact in 2008, and even despite overspending \$1 million on OM&A in the same year, the Applicant still managed a return on equity in 2008 of 8.59% [Staff IR#10], which is higher than their Board-approved level. It is hard to envision a revenue impact that had a “significant influence” of the sort required by the Board’s policy, but still allowed the utility to earn more than their allowed ROE.

Quantum of Recovery

31. If the Board determines that there should be recovery for the loss in one or more of the years in question, there remains the question of the appropriate quantum of recovery.
32. This is not the same, it is submitted, as the quantum of loss discussed earlier. The quantum of the loss is the starting point, calculating the net of the impacts that were directly caused by the Z factor event.
33. But there are secondary impacts as well, in particular those resulting from mitigation. The Board heard a lot of evidence in this hearing about the adjustments to spending that the Applicant undertook to mitigate its revenue situation, including operating and capital expenditure reductions, some permanent and some temporary.
34. We have already discussed the deferral of \$700,000 of operating costs from 2008 to 2009. The evidence also discusses a reduction in 2009 costs, hiring deferrals totaling \$320,000 [Undertaking J2]. There were also capital expenditure reductions of \$2 million in 2009. We do not yet have any indication of expenditure reductions in 2010, of course, but presumably there will be some, since the revenue loss continues.
35. The Applicant argues that these are only deferrals, and sooner or later the money has to be spent. Even assuming that is true, they still represent mitigation in the years 2008 and 2009, and likely 2010 as well, at least equal to the net impact of the Z factor event. And if they have to be spent sooner or later? The Applicant plans to file for cost of service for the 2011 year. Assuming that is the year these amounts will be spent (or start), then if they are reasonable and prudent they will be included in 2011 rates. That just leaves the savings in 2008 through 2010 unaccounted for, since the Applicant will get rate recovery for these costs in 2011.
36. In our submission, whether savings are permanent or temporary is irrelevant if they are going to be included – again – in a future budget before this Board. That means reductions in the prior years, when they were presumably also included in the Board-approved revenue requirement, are net savings.
37. The Applicant should not be able to claim the revenue loss, but keep the mitigation savings. The purpose of mitigation is to reduce the impact of the loss. If the loss is fully recovered without netting out the mitigation, that is just a windfall to the utility.

Recovery Method and Allocation

38. In the event that the Board determines that some amount should be recoverable on a Z factor basis, in our submission the Applicant's proposal in this respect is appropriate.
39. The Applicant has proposed two recovery methods, one using a fixed charge in each class, and the other using a variable charge. The Applicant has said they prefer the fixed charge recovery method.
40. In our view, 100% of the lost revenues that form the basis of this claim were based on variable charges. Therefore, 100% of the recovery should also be based on variable charges. The purpose of a Z factor is to make the utility whole. There is no intent to provide an additional benefit, as an increase in the percentage of fixed revenues would do.
41. The Applicant argues that many of its distribution costs are fixed. If that is true, and as a result rates are not designed appropriately, the solution to that problem lies in a general re-design of rates to increase their fixed proportion. That general issue is not appropriately resolved in a Z factor application by an individual utility.

Costs

42. School Energy Coalition submits that it participated responsibly and efficiently in this proceeding, with a view to adding value to the Board's process, while avoiding duplication and keeping costs down. We therefore request that the Board order payment by the Applicant of our reasonably incurred costs.

Respectfully submitted on behalf of the School Energy Coalition this 14th day of February, 2010



Jay Shepherd
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