ONTARIO ENERGY BOARD

STAFF SUBMISSION

2011 ELECTRICITY DISTRIBUTION RATES APPLICATION -

Board staff Submission

On the Preliminary Issue of Early Rebasing

Horizon Utilities Corporation

EB-2010-0131

November 23, 2010

The following constitutes Board staff's submission on the preliminary issue of whether Horizon's application for early rebasing is justified.

These submissions address the following:

- Expected Return on Equity; and
- Load Volatility and Horizon's Asset Management Plan.

Expected Return on Equity.

In Exhibit 1/Tab 2/Schedule 1 of its Application, Horizon states:

> The calendar year adjusted return on equity related to regulated investments has been 7.2% in 2008; 6.6% in 2009; and is forecast at 5.9% for 2010. Such return in 2010 is 2.7% below the regulated rate of return underlying Horizon Utilities' 2008 Board approved COS application and 3.9% below the current regulated rate of return for 2010 COS applications. Without the relief requested, Horizon Utilities estimates its adjusted return on regulated investments for 2011 between 2.0% and 5.0%, depending on the extent to which it can continue to defer costs and absorb inflation, without creating undue risk to its distribution system and customer service delivery.

In responses to Board staff interrogatory # 1 and VECC interrogatory # 1, Horizon explained the derivation of the "calendar year adjusted return on equity related to regulated investments". Board staff is generally comfortable with the methodology described, which attempts to derive a regulated number that can be benchmarked against the allowed ROE. In Board staff's view, Horizon's approach is superior to that where other utilities have compared accounting returns against the allowed ROE for regulatory rate-making purposes.

However, Board staff makes the following observations on Horizon's approach.

First, as documented in the response to Board staff IR # 1 d), Horizon has estimated an adjusted ROE on regulated investments of 7.9% for the first three quarters of 2010, and estimated an updated 2010 adjusted ROE of 7.2%, up significantly from the 5.9% documented in E1/T2/S1/page 7.

Second, as documented in the responses to Board staff IR # 1 c) and d), Horizon has included smart meter assets and costs, and the offsetting revenues collected through the smart meter funding adder into the determination of the adjusted regulated investments rate base and revenue requirement. Including both the costs and the funding adder revenues is appropriate. However, Board staff believes that the inclusion of smart meters will reduce the calculated ROE; as Horizon indicates that it has largely completed smart meter deployment[1], but has not yet applied for disposition and recovery of associated costs.

Horizon has a smart meter funding adder of $1.56 per month which, based on the Board's experience with smart meter costs to date, is probably not compensatory with respect to the operating and capital-related costs of deployed smart meters in 2010 and beyond. In other words, $1.56 per month per metered customer would not, in all likelihood, recover ongoing operating and capital-related costs (amortization, PILs, interest expense and return of equity portion); all else being equal, this will reduce the net income and the achieved (or estimated ROE). As such, Horizon's estimates of 5.9%, or 7.2% or 7.9% will be biased downwards (i.e. understated) because of the inclusion of smart meters in the manner calculated by Horizon.

Remedy for Under-Recovery of Revenues

Guideline G-2008-0002: Smart Meter Funding and Cost Recovery ("Guideline G-2008-0002") offers remedies to deal with the recovery of costs related to smart meters. In particular, a distributor can make application seeking disposition of incurred and audited smart meter costs, which involves a prudence review of such costs. While application for disposition of smart meter costs is not to be made as part of an IRM application, Guideline G-2008-0002 contemplates that smart meter costs be reviewed either as part of a cost of service application or through a stand-alone application. While review as part of a cost of service application is preferred, as it allows the smart meter assets and ongoing operating costs to be factored into rate base and revenue requirement, and allocated amongst customer classes appropriately, application on a stand-alone basis is acceptable.

Board staff notes that Horizon, in this early rebasing application, has not sought disposition of its smart meter costs and has, subsequently, filed an application to increase its smart meter funding adder.[2] Seeking disposition of smart meter costs would be one method for Horizon to improve its expected ROE.

[1] E9/T1/S2/Table 9-10 indicates that Horizon had deployed smart meters to 94.1% of applicable residential and small general service customers as of December 31, 2009, and expects to have 97.4% deployment as of December 31, 2010.

[2] This application proposes to increase the smart meter funding adder from $1.56 per month to $2.45 per month per metered customer, effective December 1, 2010. The Board has assigned file number EB-2010-0292 to this application.

The calculated ROE for 2010, as documented in the Board's letter of February 24, 2010[3], is 9.85%. The updated ROE calculated by Horizon of 7.2% is less than 300 basis points below the threshold and, as discussed above, this estimate is biased downwards by the inclusion of smart meters. Further, there are remedies other than a full cost of service application for Horizon to seek regulatory approval to address situations, such as under-recovery of the revenue requirement for installed smart meters.

Load Volatility and Horizon's Asset Management Plan

Another factor that Board staff submits is in issue is Horizon's Asset Management Plan as filed in this application vis-à-vis documented load volatility.

In 2009, Horizon filed an application for Z-factor treatment of a loss of load. The application was considered under File No. EB-2009-0332. While the Board denied Horizon's proposed treatment for the loss of load, the Board did note that a cost of service application was the appropriate forum for consideration of load losses, or at least load volatility, that Horizon was experiencing, particularly related to one subject customer.

Further, since the current application's filing on August 26, 2010, the issue of a drop in load due of the subject customer has once again become an issue as gleaned through publicly available documents. Appendix B to the response to Board staff IR # 4 b) provides a Globe and Mail newspaper article on the shutdown at the U.S. Steel facility published on October 1, 2010.

While the shutdown at the Hamilton facility is well-known now, this was certainly an event that could not reasonably have been foreseen by Horizon at the time of its application. It is also not clear what will be the duration of this load loss. If the loss becomes extended, then it will have repercussions throughout the community, as this is a major industry in the area. If the shutdown becomes permanent, the impacts could be more far-reaching – employees may curtail residential consumption while seeking re-employment or may have to re-locate elsewhere, and businesses serving the community may reduce load if their revenues reduce as a result of the economic prosperity of Hamilton.

The loss, or at least volatility, of Horizon's load must also be considered in light of evidence in Horizon's application. Board staff submits that Horizon's load forecast could be subject to an update. Second, a major driver as documented by Horizon in its application is its Asset Management Plan, documented in Exhibit 2/Tab 3/Schedule 2/Appendix 2-1. Horizon has forecasted capital

[3] http://www.oeb.gov.on.ca/OEB/_Documents/EB-2009-0084/Brdltr_2010CostofCapitalParameters_20100224.pdf

expenditures of over $30 million for 2011, and further states that it forecasts a level of $45 million per year by 2015.[4] The Asset Management Plan also contributes, along with succession planning and other drivers, to increased OM&A. Horizon documents that the increased capex and opex are necessary to maintain, refurbish and replace aging infrastructure and to meet new technological demands.

As documented in Exhibit 6/Tab 1/Schedule 1/Table 6-1, Horizon calculates a 2011 revenue requirement of $103 million, including recovery of a revenue deficiency of $19,560 million. The revenue deficiency represents nearly 20% of Horizon's proposed revenue requirement. As shown in Exhibit 6/Tab 1/Schedule 1/Table 6-2, $3.6 million (or 18.5%) of the revenue deficiency is due to the load forecast, while opex and capital additions each account for about $8 million of the revenue deficiency.

However, as proposed in the application, the 2011 load forecast does not reflect the latest US Steel shutdown. And, as noted above, any longer term shutdown may have wider socioeconomic impacts and further reduce Horizon's customer load and consumption. Conversely, lower load may reduce wear and tear on some components, or defer or eliminate the need for some system expansion. It is also expected that a firm, facing reduced demand and revenues, will also undertake efforts to reduce costs so as to remain financially healthy. It may therefore be necessary to re-examine the Asset Management Plan and its 2011 capital and operating budgets in light of load volatility, if it is anything but a temporary event, to see what can be re-prioritized or even cancelled.

Options

1. Dismiss the Application

Board staff submits that Horizon does not satisfy the 300 basis point threshold to apply for early rebasing as stipulated in the Board's letter of April 20, 2010.

Should the Board dismiss the application, Horizon would re-apply in its usual turn for a cost of service review for 2012 electricity distribution rates. Staff notes that Horizon has requested a January 1, 2011 effective date. In this scenario, when applying for 2012 rates, Horizon would have to file by the end of April 2011 for rates to be effective January 1, 2012, only five months from the date of this submission.

[4] Exhibit 2/Tab 1/Schedule 3/page 6 and Figure 2-3

2. Hear the Application

Despite the fact that Horizon has not met the Board staff's off ramp, due to the uncertainty flowing from the load volatility noted above, it is likely that there may be serious implications for the financial well-being of the utility, which would justify re-examination of Horizon's cost of service at this time. The Board contemplated that early rebasing could be entertained even when the 300 basis point threshold was not met, stating in the April 20, 2010 letter that:

> A distributor, including the four distributors referred to above, that seeks to have its rates rebased in advance of its next regularly scheduled cost of service proceeding must justify, in its cost of service application, why an early rebasing is required notwithstanding that the "off ramp" conditions have not been met. Specifically, the distributor must clearly demonstrate why and how it cannot adequately manage its resources and financial needs during the remainder of its IRM plan period.[5]

A review of the updated load, and the necessity and prudence of Horizon's capital and operating plans, in light of updated and possibly volatile load, may allow the Board to provide guidance to the utility's management commensurate with the Board's objectives of maintaining the financial viability of the firms it regulates while protecting customers with respect to the prices, quality and reliability of electricity services.

– All of which is respectfully submitted –

[5] April 20, 2010 letter from the Board re: Early Rebasing Applications, page 2, http://10.130.130.67/OEB/_Documents/Documents/Ltr_Early_Rebasing_Applications_20100420.pdf