Horizon Utilities Corporation

EB-2014-0002

Board staff Submission

Introduction

On September 22, 2014 Horizon Utilities Corporation filed a Settlement Proposal with respect to its Custom Incentive Rate-setting ("CIR") application for an order approving just and reasonable rates and other charges for electricity distribution to be effective January 1, 2015, and each year thereafter until January 1, 2019.

The parties to the Settlement Proposal are Horizon and all the Board-approved intervenors in the proceeding:

- Association of Major Power Consumers of Ontario ("AMPCO");
- Building Owners and Managers Association ("BOMA");
- City of Hamilton ("Hamilton");
- Consumers Council of Canada (CCC);
- Energy Probe ("EP");
- School Energy Coalition ("SEC");
- Sustainable Infrastructure Alliance of Ontario ("SIA"); and
- Vulnerable Energy Consumers Coalition ("VECC")

(collectively referred to as the "Parties")

This submission reflects observations which arise from Board staff's review of the evidence and the Settlement Proposal, and is intended to assist the Board in deciding upon Horizon's application with respect to the issues laid out in the Settlement Proposal and in setting just and reasonable rates.

The Settlement Proposal represents a settlement of all issues regarding the elements of the revenue requirement and those which pertain to the CIR application. Not settled were issues regarding cost allocation and rate design. Those proposals will be heard by way of oral hearing to commence on September 30, 2014.

Board staff Submission

Board staff has reviewed the Settlement Proposal in the context of the objectives of the Renewed Regulatory Framework for Electricity ("RRFE"), other applicable Board policies, relevant Board decisions, and the Board's statutory obligations. The RRFE is a rate-setting option developed for distributors in *Report of the Board Renewed*

Regulatory Framework for Electricity Distributors: A Performance-Based Approach October 18, 2012 (the "RRFE Report"). The Parties considered the issues and outcomes of the RRFE in the context of Horizon's five year Custom IR term. Board staff is of the view that the Settlement Proposal reflects a reasonable evaluation of the distributor's planned outcomes in this proceeding, and appropriate consideration of relevant issues.

Board staff submits that the Board's approval of the proposal as filed would adequately reflect the public interest and would result in just and reasonable rates for customers.

As a supplement to Board staff's overall position, summarized above, Board staff offers the following discussion on matters pertinent to the application and to Board policy, given that this Settlement Proposal is the first such proposal to be filed for an application for rates set through a CIR application process. Board staff have evaluated the Settlement Proposal by drawing upon the principles and expectations laid out in the RRFE Report, as an aide to the evaluation of the sufficiency of the Settlement Proposal from the perspective of the policy intent of the RRFE and the Custom IR filing option.

The Board expressed its expectation that "the rate-setting process needed to put greater focus on delivering value for money, aligning the interests of customers and distributors, and serving both present and future customers". [1] The Board stated that "each rate method will be supported by: the fundamental principles of good asset management; coordinated, longer – term optimized planning; a common set of performance expectations; and benchmarking."

The option to file for rates to be set on a multi-year basis was extended to distributors on the expectation that certain utilities with large or variable capital investment needs could make efficient use of an approach to rate-setting that would be better suited to their needs relative to other approaches.

While the RRFE Report stated that the Board "expects that the specifics of how the costs approved by the Board will be recovered through rates over the term will be determined in individual rate applications"[2], it nevertheless made certain expectations clear. According to the Board's report[3], a distributor that applies under this method will:

- File robust evidence of its cost and revenue forecasts over a five year horizon;
- File detailed infrastructure investment plans over that same time frame; and

[1] *Report of the Board Renewed Regulatory Framework for Electricity Distributors: A Performance-Based Approach October 18, 2012*, p. 1
[2] Ibid 1, p.18
[3] Ibid 1, p. 19

- Demonstrate its ability to manage within the rates set, given that actual costs and revenues will vary from forecast.

In addition to these general expectations, the Board specified the core elements of the approach to rate-setting, including regarding the use of benchmarking, productivity expectations, benefit-sharing and other considerations. A full list of these elements is available at Table 1: Rate-Setting Overview – Elements of Three Methods on page 13 of the RRFE Report.

1. Going In Rates
2. Form, Term & Coverage
3. Annual Adjustment Mechanism, including Role of Benchmarking
4. Sharing of Benefits
5. Treatment of Unforeseen Events
6. Deferral and Variance Accounts
7. Performance Reporting and Monitoring

Board staff proposes to examine each of these items in order, as well as two others:

- Distribution System Plan
- Other Policy Matters

1. "Going in" Rates

RRFE Expectation: Multi-year application review. Term: Minimum 5 years

Horizon's filed a multi-year (five year) proposal for setting rates and the Settlement Proposal has agreed to a revenue requirement for each of these five years, subject to certain annual updates. Board staff submits that this multi-year mechanism is consistent with the RRFE Report.

2. Form, Term and Coverage

RRFE Expectation: Custom Index rate form covering both OM&A and capital

Horizon's application includes a forecast of five years of controllable costs, OM&A and capital expenditures for the period 2015 – 2019 and therefore is consistent with the coverage expected for Custom IR. In accordance with the proposal, OM&A is indexed to an agreed-upon rate. This is discussed further below. The Board's policy for the Custom IR states that "the specifics of how the costs approved by the Board will be recovered through rates over the term will be determined in individual rate applications."[4]

[4] Ibid 1, p.18

3. Annual Adjustment Mechanism, including Role of Benchmarking

RRFE Expectation: Distributor-specific rate trend for the plan term to be determined by the Board, informed by the distributor's forecasts, the Board's inflation and productivity analyses and benchmarking to assess the reasonableness of the distributor's forecasts.

The Parties have agreed upon a revenue requirement that is forecast to increase 15.7% in the first year of the plan relative to its last Board-approved revenue requirement (2011) and an average of 2.3% thereafter. Board staff submit that from an overall perspective, this average rate increase reflects a reasonable outcome given the capital renewal program intended by Horizon and the cost containment measures to which Horizon has committed. The main drivers of the increase in the revenue requirement are the increased depreciation, return and taxes from the capital additions and increases in OM&A. Capital expenditures increase $11.3 million or about 6.7% annually % over the five year term.

Board staff submits that the Parties have based many of the elements within the proposed annual revenue requirements upon a reasonable balance between Horizon's requirements, its forecasts, the use of indexation and acceptable recourse to annual adjustments where the risks and benefits of doing so are reasonable.

Regarding OM&A costs, which comprise an average of 51% of the revenue requirement each year, the Parties agreed upon a base period OM&A for the purposes of developing a cost trend. For each year of the plan, starting in 2015, parties have agreed that OM&A will rise 1.47% annually, a figure based on a set of inflation rates assumed for third party services, supplies, and salaries, wages and benefits that are incorporated in the forecast. Board staff submit that this level of cost increase is below industry inflation levels; Board staff also accepts, as the parties maintain, that since this cost trend falls below inflation, it implicitly contains a stretch factor for the utility and reflects its commitment to develop and deliver productivity improvements, or else face declining returns.

According to the Settlement Proposal, Horizon will not adjust any of its controllable costs throughout the term. Horizon's envelope of controllable costs has been agreed-to by the Parties and is built into the forecast set in rates for each of the remaining four years of the period covered by this application. Board staff submit that this commitment by Horizon demonstrates its willingness and ability to manage within the rates set, given that actual costs and revenues will vary from those forecast.[5]

[5] Ibid 1, p 19

At the same time, a number of other cost elements have been proposed to be subject to annual updates. Parties have agreed that Horizon can apply to update its cost of capital on an annual basis, as well as passing through the cost of power that is an input to the working capital allowance ("WCA").

Board staff would generally prefer to minimize the elements of a Custom IR that will be updated annually, and it is not clear that any benefits of updating WCA annually outweigh the additional administration. However, in the context of a Settlement Proposal an annual update to the WCA is an acceptable outcome. The Board has previously approved annual updates to cost of capital in other multi-year rate decisions.[6]

As for other elements of the revenue requirement, annual adjustments will exclude updates to depreciation and net book value. Those forecast values through to 2019 have been agreed upon in the Settlement Proposal. However, the Settlement Proposal allows for updates to PILs for changes in net income and tax rates.

Role of Benchmarking

While the Parties' proposal does not include explicit discussion of the manner in which benchmarking has been used to evaluate Horizon's initial or planned costs, Board staff submit that its proposed efficiency incentive, which will be based upon results in the Board's annual benchmarking report, will provide an adequate incentive for Horizon to continue to maintain its efficiency levels throughout the plan term. The Parties and Board staff have noted its efficiency is relatively high when compare to other Ontario distributors. Both its total recent historical and current cost levels are below those expected based on the econometric model in "Empirical Research in Support of Incentive Rate-Setting: 2013 Benchmarking Update", July 2014, Table 3.

The proposal, discussed in detail at page 31 of the Settlement Proposal, would decrease Horizon's revenue requirement by a formulaic adjustment in the event its efficiency deteriorated sufficiently to be assigned into a less efficient cohort. There is no increase in payment should the utility rise into a more efficient cohort. Board staff finds that while the dollar value of the consequence alone may be insufficient to motivate a distributor, there is significant merit in continuing to tie an evaluation of Horizon's performance to those in the rest of Ontario for the duration of the plan. While not explicitly contemplated in the Custom IR framework, Board staff anticipates that the Board's policy regarding the Custom IR option would include the expectation that there continue to be consequences – both reputational and financial – for Horizon should its

[6] Enbridge Gas Distribution EB-2012-0459; Hydro One Networks Inc. EB-2009-0096; Toronto Hydro Electric System EB-2007-0680

performance deteriorate relative to its peers during the custom rate-setting period in order to provide another means of ensuring a focus on outcomes.

Overall, Board staff submits that the proposed revenue requirements, subject to the modifications set out in the Settlement Proposal, would provide Horizon with the appropriate resources for appropriately managing its system and non-system assets and providing reasonable outcomes for its customers.

4. Sharing of Benefits

RRFE Expectation: Benefits of efficiency improvements would be shared with customers through productivity gains; means and methods to do so would be evaluated on a case-by-case basis.

As discussed in Section 3 above, Annual Adjustment Mechanism, Horizon's cost forecasts do not include an explicit stretch factor or productivity commitment. Instead, Parties maintain that it is implicit in the level of OM&A set over the five year period via a cost inflator. The Parties detail the decrease in agreed-upon OM&A relative to the levels applied for in Horizon's application at page 45.

Board staff submit that, to the extent that Horizon's initially proposed OM&A levels reflect its forecast of its needs over the plan period, the reduction of OM&A levels from those proposed provides an incentive no less strong than an externally imposed stretch factor applied to rates; importantly, customers are also held whole through the plan period if the applicant fails to deliver.

Board staff note, however, that the conventional use of stretch factors, insofar as they apply to rates, provide a stretch incentive regarding containment of all of a distributor's costs, rather than to OM&A alone, as in this instance. Board staff submits that other features of the proposal, discussed below, satisfactorily mitigate this limitation.

One such element is the proposed benefit-sharing of any over earnings, while ensuring that any under-earnings are borne by the utility alone. Modeled on the Board's finding in Enbridge Gas Distribution ("EGD") EB-2012-0459, the proposal states that any earnings below Board-approved regulatory return on equity in a given year will be borne solely by Horizon. Any over earnings would be shared 50/50 between the shareholder and rate payer. There is no dead band -- this asymmetrical treatment would apply from the first dollar of earnings above or below target ROE. Board staff point out that the equal sharing of benefits was found to be a suitable level to incent improved performance in the EGD case. Accordingly, Board staff submit that the earnings sharing mechanism reasonably aligns the interests of customers and the utility in delivering productivity gains beyond those embedded in the plan.

Regarding capital expenditures, to ensure that the planned expenses over the five years are made, and to allow for adjustments in timing of the expenditures over the five year period, a Capital Expenditure Variance Account is proposed. This account will be credited with any under-spending, and the credit reduced by any catch-up in that spending. Over-spending is at Horizon's risk.

Board staff submit that this mechanism provides a reasonable incentive for Horizon to commit to its planned capital spending and reasonable protection for its customers from any over spending; the prudence of which the Board can review at Horizon's next rebasing. Any balance remaining in the account from under-spending will be returned to customers. Board staff submits that this arrangement provides a reasonable means for ensuring value to Horizon's customers.

5. Unforeseen Events

RRFE Expectation: The Board's policies, as set out in the Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors, will continue under all three menu options.

The Board's chief mechanism for managing the consequences of material unforeseen events is the Z-factor, initially described in the *Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors July 14, 2008* ("3GIRM Report").

Consistent with the RRFE for Custom IR, the Parties agreed that Horizon could apply for any Z-factor relief for unforeseen events based on the Board's rules at the time Horizon applies. The parties agreed to lower the materiality for Z-factor events to $0.5Mm which, in Board staff's view, is reasonable, especially given the provision for storm damage ($0.8M) that Horizon has built into its revenue requirement. Of note, a utility the size of Horizon, the materiality for Z-factor relief would be 0.5% of the distribution revenue according to the 3GIRM Report. For Horizon, based on its Service Revenue Requirement, materiality in the normal course would be $570,000 in 2015 growing to $625,000 in 2019. Board staff submit this difference is acceptable given the settlement achieved.

The parties have also listed the events that would result in it being able to re-open the application.[7] The Settlement Proposal recognizes that the regulatory regime may

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[7] Exhibit 1 Tab 12 Schedule 2

change and that what is agreed to in the Settlement Proposal is not intended to preclude the application of those measures identified by Horizon. Board staff submits that such adjustments outside the normal course of business are not specifically addressed in the RRFE Report but are acceptable for the purposes of settlement.

6. Deferral and Variance Accounts

RRFE Expectation: Status quo, plus as needed to track against plan.

The agreement with respect to deferral and variance accounts set out in the Settlement Proposal makes no change to the current Board process as defined in *Report of the Board on Electricity Distributors' Deferral and Variance Account Review Initiative (EDDVAR) July 31, 2009*. Included in the Settlement Proposal are three new variance sub-accounts to Account 1508 Other Regulatory Assets to record costs associated with the proposed Capital Expenditure Variance Account, the ESM, and the costs for a study on assessing whether the levels for the Specific Service Charges are appropriate. Board staff has reviewed the terms of these accounts and is in agreement that they provide the necessary means for implementing the benefit-sharing proposals that the Parties have agreed to.

7. Performance Reporting and Monitoring

RRFE Expectation: A regulatory review may be initiated if a distributor's annual reports show performance outside of the +/- 300 basis points earnings dead band or if performance erodes to unacceptable levels.

The Settlement Proposal states that Horizon intends to comply with all applicable requirements of the Board with respect to the monitoring and reporting of its performance, including the reporting of results to be used in the preparation of the Board's scorecard for Horizon Utilities. While the general principles of the Custom IR suggest that the Board could impose additional reporting requirements given the length of the term and the extent of capital investment typically expected to be undertaken by Custom IR applicants, Board staff submit that the agreed-upon reporting is sufficient, when taken in conjunction with the Board's ability to initiate a review should financial or operational performance erode unacceptably.

Distribution System Plan

RRFE Expectation: The Board noted in the RRFE Report that for distributors filing under the Custom IR method, it does not intend to publish filing requirements other than the ones contained in Chapter 5 of the Filing Requirements ("Chapter 5").

Horizon provided a stand-alone, consolidated Distribution System Plan[8] (DSP), in which the company outlined the asset management process, addressed renewable energy connections, regional planning, and proposed associated capital expenditures.

Board staff notes that the DSP was supported by several third party assessments. The level of distribution system expenditures was substantiated by an independent third party review ("Kinectrics' Study") of the conditions of the system assets. [9] The analysis and methodology contained in the Kinectrics Study were further validated by an independent assurance review. [10] Proposed expenditures associated with non-system assets were also supported by several third party studies. [11] OM&A expenditures were not included in the analysis in conjunction with projected capital needs. Board staff submits that while a life-cycle approach was not reflected in the DSP, Horizon provided a comprehensive overview of its planning activities in all the areas outlined in Chapter 5.

Board staff further submits that the DSP provides sufficient evidence that the planning undertaken by Horizon supports the appropriate management of the applicant's assets. Board staff accepts the parties' view that Horizon has used its judgement to direct the capital plan toward delivering solutions to its customers' two primary concerns – price and reliability.

Other Policy Matters

> *RRFE Expectation:* Board policy regarding other matters and public policy objectives will continue to apply under the Custom IR framework.

Stranded Meters

As another aspect of the proposal, the Parties agreed to the removal of stranded meters from rate base and disposing of their net book value through a rate rider. While stranded assets are not an RRFE matter, the proposal deviates from past practices of the Board, and so Board staff is commenting on the issue.

The interest rate which will apply to the stranded meters is the short term cost of debt, 2.11%. This is an exception to the Board convention of applying the Board's posted interest rate to DVAs . The applicable rate for the third quarter of 2014 is 1.47%. The proposed carrying cost of 2.11% collects an addition $289,000 above the NBV for stranded meters of $7,975,000. On average this interest amounts to $96,300 per year over the three year term of the rider.

[8] Exhibit 2 Tab 6 Appendix 2-4 Distribution Plan
[9] KPMG
[10] Kinectrics
[11] Kinectrics

While not aligning with the Board's policy, Board staff, taking the Settlement Proposal as a whole, accepts the treatment of stranded meters as reasonable.

- All which is respectfully submitted -