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July 2, 2008

BY EMAIL & COURIER

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge St, Suite 2701
Toronto ON M4P 1E4

Dear Ms. Walli:

Board File No. EB-2007-0697
Horizon Utilities Corporation –2008 Rates Rebasing Application
Final Argument of Energy Probe

Please find two hard copies of the Final Argument of Energy Probe Research Foundation (Energy Probe). An electronic version of this communication will be forwarded in PDF format.

Should you have any questions or require additional information, please do not hesitate to contact me.

Yours truly,

David S. MacIntosh
Case Manager

cc: Cameron McKenzie, Horizon Utilities Corporation (By email)
Mark Rodger, Borden Ladner Gervais LLP (By email)
James Sidlofsky, Borden Ladner Gervais LLP (By email)

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Ontario Energy Board

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

AND IN THE MATTER OF an Application by Horizon Utilities Corporation for an Order or Orders approving or fixing just and reasonable rates and other service charges for the distribution of electricity as of May 1, 2008.

Final Argument On Behalf Of

Energy Probe Research Foundation

July 2, 2008

**Final Argument On Behalf Of
Energy Probe Research Foundation**

How these Matters came before the Board

- 1. As part of its regulation of the electricity distributors, the Ontario Energy Board established a multi-year electricity distribution rate setting plan, which indicated that, commencing with the 2008 rates, each year a limited number of distributors would be identified and if any of them sought a general change in their distribution rates, the application had to be based on Chapter 2 of the Board's Filing Requirements, issued November 14, 2006 (EB-2006-0170). This required the distributor to submit a forward test year, cost of service based application.**
- 2. On May 4, 2007, the Board identified a list of electricity distributors that would be subject to this process, should any of them seek changes to their distribution rates for 2008. The letter requested that each of these distributors file a letter with the Board confirming they will file a forward test year rate application by August 15, 2007 for rates to become effective May 1, 2008.**
- 3. On August 15, 2007, counsel for Horizon Utilities Corporation (the Applicant or Horizon Utilities), Borden Ladner Gervais LLP, filed a letter notifying the Board that it was unable to file its 2008 rates rebasing application on that date as requested. Horizon Utilities indicated that it anticipated filing by mid-September and submitted that it was in the interest of the Board and all intervenors for it to take the time to complete a filing that could be processed with the minimum of effort.**

4. Subsequently, the Board received Horizon Utilities' application on October 22, 2007 but was not rewarded with a filing that could be processed with the minimum of effort.
5. Energy Probe Research Foundation (Energy Probe) filed its Notice of Intervention on November 16, 2007 and received confirmation of its intervention from the Board on November 30, 2007.
6. After interrogatories were filed by intervenors and responded to by the Applicant, the Board in Procedural Order No. 2 agreed to a request by the Schools Energy Coalition, supported by Energy Probe, and ordered a Settlement Conference (ADR) commencing February 25th with provision for three days in total. Ms. Cindy Diamond was provided by the Board as the facilitator.
7. Energy Probe took part in an Intervenor Conference on the first day of the ADR, and with the Applicant on the second day. After an adjournment which allowed the Applicant time to gear up for discussions with intervenors in respect of concerns with the Application, Energy Probe took part in the second phase of the ADR on March 18th, 19th and 20th.
8. On April 16, 2008, in Procedural Order No. 4, the Board ordered an Oral Hearing for June 5, 2008 on three outstanding Issues requiring testing of evidence, and indicated that all other outstanding Issues were to be dealt with in written Argument.

Argument Overview

9. In its Argument, Energy Probe will not seek to explore all outstanding Issues before the Board, but will be examining those Issues of concern to Energy Probe where we believe we can be of most assistance to the Board.

Cost of Capital/Debt

Issue 2.2 Are Horizon's proposed costs and mix for its short and long-term debt for the 2008 test year appropriate? Are the interest rate and other terms of Horizon's affiliate debt appropriate, and should the interest payable on that debt be fully recoverable from ratepayers?

10. The Applicant's prefiled evidence at Exhibit F, Tab 1, Schedule 3, Page 1 of 3, titled **COST OF DEBT**, sub-titled Long-term Debt, beginning at line 17, states:

Horizon Utilities' only long-term debt is embedded debt in the form of a Promissory Note in favour of Hamilton Utilities Corporation ("HUC"). The original Promissory Note was issued July 1, 2000 in the amount of \$142,000,000. This Promissory Note was restated and replaced, on August 10, 2001, in order to amend the restrictions on HoldCo's ability to demand repayment prior to July 1, 2001 and to amend the interest rate to the permitted rate. On July 18, 2002, Horizon Utilities' predecessor, Hamilton Hydro, made a payment on the Promissory Note in the amount of \$26,000,000. The Promissory Note was restated and replaced in the outstanding amount of \$116,000,000, due and payable July 30, 2012. Horizon Utilities notes that the latest Promissory Note dated February 28, 2005, and included in Appendix A, reflects an amendment to the terms of the Promissory Note with *respect to the frequency of interest payments. No other terms were revised.* (Italics added)

11. Testimony before the Board in the Oral Hearing on June 5 and 6, 2008, disproves the evidence filed by the Applicant and quoted in the preceding paragraph. Not only were other terms revised, but the very form of the obligation was changed.

12. In the Examination-in-Chief of Horizon Utilities Corporation Panel 3 on June 5th, the witness John Basilio, Senior Vice President and Chief Financial Officer for Horizon Utilities, described the Promissory Note:

The most recent version of the Horizon note is from February 2005, and that reflects non-substantive amendments to the 2002 note. In keeping with the 2006 rate handbook, the debt rate used for rate making in 2006 was the 7 percent rate in this most recent version.

Amendments to the original note did not result in dispositions and reissuances at law, for tax or for accounting purposes. As such, the present note is a continuation in all substantive respects of the original note.
(Transcript, Volume 1, p. 201, starting at Line 21)

13. In his testimony during the Examination-in-Chief, the witness John Basilio portrayed the February 28, 2008 note as reflecting the 2002 note with any amendment being a matter of some late housekeeping:

The rate on Hamilton Hydro's debt, and now Horizon's debt, has been 7 percent for the past eight years. It has effectively been a fixed-term, non-callable note since 2002, subject to some housekeeping.

Horizon's most recent rebasing application was its 2006 rate application, and the Ontario Energy Board approved its 7 percent debt rate in the underlying note. The OEB also approved Horizon's 2007 adjustment application and the 7 percent rate remained intact in rates.
(Transcript, Volume 1, p. 205, starting at Line 9)

14. However, during cross examination by Mr. Shepherd, Counsel for the School Energy Coalition, it becomes apparent that the foregoing characterization of the Promissory Note now before the Board is not in fact correct:

MR. SHEPHERD: But the 2002 note doesn't have a fixed 7 percent rate, does it?

MR. BASILIO: No. Well, it has -- for all practical purposes, we were applying this note at 7 percent.
The intention with respect -- again, the intention with respect to these notes has been to deal with them as long-term debt. Certainly we completed our housekeeping in February of 2005.

MR. SHEPHERD: Sorry, I'm having a hard time understanding that. You signed a document that said the note rate was variable.
So how can you now say under oath that it was fixed at 7 percent. That is just not true, is it?

MR. BASILIO: Well, I think you have to look beyond -- I think you have to look beyond the mere words and notes, and whatnot, and try to deal with some of the realities and the intentions underlying the note, because this has a significant impact on Horizon Utilities Corporation and Hamilton Utilities Corporation. I mean --
(Transcript, Volume 1, p. 211, starting at Line 25)

15. A formula interest rate adjustment clause, referred to as the Permitted Rate, based on a rate permitted by the Board had been replaced by a fixed interest rate of 7%. A substantive change had been made to the note at a time that the market rate was approximately 5.25%.

16. On the second day of the Oral Hearing, in response to questions from the Panel Chair, the substantive changes became more apparent – a demand note had become a term note:

MR. KAISER: There were three notes before we got to February 28th of 2005, and all of them could be called on demand at any time and you had 18 months to pay. That's how I read them.

MR. BASILIO: Eighteen months.

MR. KAISER: And then when we come to February 28th of 2005, the term goes from 2005 to 2012. That's a seven-year note. That's not an unsubstantial change.

MR. BASILIO: Again, subject to some housekeeping here, that had been accepted in 2002.

MR. KAISER: How would we know that looking at these documents? All we can do is look at the notes. The note says it is a demand note. They can call it at any time, and I've got 18 months to pay. Am I reading the notes wrong? There is three of them. They all have the additional language, July 1st, 2000; August 10th, 2001; July 18th, 2002. They're identical as to the interest rate term and as to the ability to call the note at any time.

MR. BASILIO: Respectfully, the legal form of the note is as they are presented, but the -- again, the intentions underneath the notes, they have --

MR. KAISER: What could this Panel look to that would give us comfort that the legal rights under this promissory note are not as set out in the note, but by some other intention?

MR. BASILIO: Well, beyond my testimony or perhaps --

MR. KAISER: Well, you were there, I presume. You signed all of these notes, I guess, we know that, along with Mr. Leitch at the time.

MR. BASILIO: At the time, yes, sir.

(Transcript, Volume 2, p. 41, starting at Line 15)

17. Returning to the Applicant's prefiled evidence, Exhibit F, Tab 1, Schedule 3, Page 2 of 3, titled COST OF DEBT, sub-titled Long-term Debt, beginning at line 17, states:

The interest rate on the Promissory Note is 7%, and it matures on July 30, 2012. Horizon Utilities' deemed long term debt rate, as approved in prior OEB decisions, is 7%. Horizon Utilities has no new debt, no variable-rate debt and no affiliate debt that is callable on demand. Accordingly, the long-term debt rate to be used for the purposes of establishing Horizon Utilities' 2008 distribution rates is 7%.

18. Once again testimony before the Board in the Oral Hearing on June 5 and 6, 2008, disproves the evidence quoted from the Application. The Panel Chair and Board Counsel in questioning Horizon Utilities Corporation Panel 3 established that the actual promissory notes being presented to support the prefiled evidence of the Applicant had never been approved by the Board in a prior decision:

MR. KAISER: Mr. McKenzie?
Were any actual notes ever filed with the Board?

MR. McKENZIE: No. To my recollection, this was the first application that included an actual copy of the notes.

MR. KAISER: Well, did it include an actual copy of the note? Or just a reference to the note?

MR. McKENZIE: Oh, I'm sorry.

MR. KAISER: Oh, you mean this application?

MR. McKENZIE: This application that we have now.

MR. KAISER: So prior to now, the Board has never seen any of these notes? Is that your position?

MR. McKENZIE: That's correct.

MR. KAISER: All right. Thank you. I'm sorry I interrupted you again.

MS. COCHRANE: Again, my information is that -- concurs with that of Mr. McKenzie, that no note was filed and no interrogatories were asked in the 2006 EDR to -- that got into the specifics of the note or asked for production of a copy of the note.

So as far as everybody is aware, it would appear that the Board was not aware of the 2005 note when it was considering your 2006 EDR application?

MR. BASILIO: That appears correct.

MS. COCHRANE: Thanks.

Again, if after this oral hearing, you find information to contradict anything that you are agreeing with today -- because I don't want to be putting words in your mouth -- we will accept an undertaking to correct anything that was given in evidence at this point, with respect to this particular issue.

So the Board also would not have been aware that the note -- because it was, you know, just told in the application about a 2002 note -- it wasn't aware of the changes that were made in the 2005 note, and that it had been converted from a demand to a term note.

Do you agree with that assessment?

MR. BASILIO: It hadn't seen the notes, so it had no basis for being aware of it.

(Transcript, Volume 2, p. 58, starting at Line 8)

19. As pointed out by Mr. Shepherd and Panel Member Chaplin, there was another substantial change. The notes prior to the February, 2005 note contained a Prepayment Option, 30 days notice and without penalty, which was missing from the current note before the Board:

MS. CHAPLIN: Or were you referring to the prepayment option that appears further down?

MR. SHEPHERD: Yes, exactly.

MS. CHAPLIN: It actually says "30 days' notice".

MR. SHEPHERD: Yes.

MR. KAISER: That's in the prepayment, though.

MR. BASILIO: Had an option at the time, yes.

MR. SHEPHERD: So you say you had this permission to prepay, but of course, you had the right to prepay. So it wasn't exactly huge consideration you were getting. True?

MR. BASILIO: Again, at this time -- oh, prior to this time? Yes, but again, these are accommodations that were made because of uncertainty -- this doesn't change the intention of the note.

I mean this is the legal form of the note. I don't dispute it.

(Transcript, Volume 2, p. 74, starting at Line 3)

20. Finally, the witness John Basilio was acting for both Hamilton Hydro Inc. and Hamilton Utilities Corporation as Chief Financial Officer on July 18, 2002, signing a promissory note on behalf of Hamilton Hydro Inc. borrowing money at 7% from Hamilton Utilities Corporation, and issuing a debenture on behalf of Hamilton Utilities Corporation at an interest rate of 6.25%. At the time, Hamilton Hydro Inc. was a wholly-owned affiliate of Hamilton Utilities Corporation. (Transcript, Volume 2, p. 78, starting at Line 11)

21. Testimony before the Board in this proceeding has revealed that the evidence filed by the Applicant in respect of its cost of long-term debt was not true. The Board must render a decision on the interest rate to approve for the Applicant's 2008 revenue requirement and distribution rates, the interest payable on the long-term debt that may be recovered from Horizon Utilities' ratepayers.

22. As a matter of public interest, Energy Probe was particularly concerned when a similar issue arose in EB-2005-0421, the cost of service application of Toronto Hydro-Electric System Limited (“THESL”) for its 2006 distribution rates. In that proceeding, the Board Panel examined the circumstances in respect of THESL paying an interest rate, well above the market rate, to an affiliate.

23. In its Decision, the Board Panel made several points that Energy Probe submits are noteworthy when considering the principles which should be applied in this proceeding:

5.3.15 Ratepayers are entitled to just and reasonable rates. That is the over-riding principle, not that the City of Toronto as sole shareholder should be able to extract from ratepayers above-market returns. There is little logic to that, and the logic cannot be defeated by the bald assertion that the Handbook is being followed. This is particularly the case where the utility is filing on a forward test year basis.

5.3.16 Aside from the relevance of the Handbook to a utility that files on a forward test year basis, there is a more important consideration. That is that this is debt to an affiliate. It is not only debt to an affiliate, but it is debt clearly above the market rate. 1

24. In its very next paragraph, 5.3.17, the Board Panel points out that “... the jurisprudence indicates that the burden shifts to the utility to defend its position to ensure that fair market values are being used.”

25. Energy Probe submits that the Applicant changed substantial terms when replacing the note dated 2002 with the February 2005 note, and changed it from a promissory note to a term note. It became a new debt instrument.

26. Energy Probe submits that the Applicant failed to protect its ratepayers by exercising the Prepayment Option, its right under the note dated 2002 to prepay without penalty, and to finance its debt at the market rate.

27. It is the submission of Energy Probe that as of the effective date of its Decision in this proceeding, the Board disallow as a regulatory expense any interest charges above the market level which it finds to be appropriate for the date that the current note came into effect. Energy Probe suggests the testimony in the Oral hearing indicates that a rate of

1 EB-2005-0421, Decision With Reasons, April 12, 2006, p. 36.

5.25%, plus an allowance 0.25% for issuance costs, for a total of 5.5% would be appropriate.

Cost of Service

Issue 3.5 Are the 2008 Human Resources related costs (wages, salaries, benefits, incentive payments, labour productivity and pension costs) including employee levels, appropriate?

28. Energy Probe is concerned that Human Resources related costs are not being allocated to the Guelph merger business activities. In cross examination undertaken by Mr. Warren, Counsel for The Consumers Council of Canada, it was determined that none of the Applicant's staff time and expense was being allocated to the merger transaction.

MR. WARREN: Now, Mr. Basilio, just using you as the proxy for everybody else on the team, could you tell me how much, if any, of your salary is being allocated to the Guelph transaction? Any of it?

MR. BASILIO: No. Neither my salary or any internal time of staff are being allocated to the transaction and being pulled out of, I assume here, the logical extension of that is and have been pulled out of 2008 rate base.

I mean I think I should go on to explain the rationale for that.

Again, I am not a discrete position in the organization. Whether or not a merger happens, a CFO is required, a controller is required, a CEO is required. There are really a handful of people that work on these transactions, that actually bring them to fruition, and they're not discrete bodies.

The other thing I can tell you is that these transactions don't happen in the course of a nine-to-five work day. These are nights, weekends, staff working tirelessly. So the bottom line is, irrespective of the merger transaction, these costs are incurred by the LDC to support the LDC.

(Transcript, Volume 1, p. 38, starting at Line 2)

29. And again, Mr. Warren continued probing the extent of that expense:

MR. WARREN: Okay. Now, I have your position on the record, Mr. Basilio, that you don't think any of the time spent on the Guelph transaction should be allocated to the shareholder. But I wonder if I could ask this question.

Knowing that you and I disagree on that position or are likely to, can you provide us, sir, with an estimate of the time and quantify that time spent by at least the senior executive team of Horizon on the Guelph transaction? Is that doable, sir?

MR. BASILIO: Well, it's very difficult to do. You know if -- you know, when you're trying to find the baseline to compare that to, let's start with a baseline of 6 zero to 70 hours a week of work. So, you know, if you're trying to take a percentage of that time as it relates to a single transaction in fits and spurts, it could be very difficult to do. Not an insignificant amount of time. But you know, again, not 50 percent of our time. Maybe, you know, it could be somewhere between 10 and 20, I suppose.

MR. WARREN: Okay.

MR. BASILIO: Something like that.

MR. WARREN: Sir, could I then turn to the second area --

MR. BASILIO: Oh, I apologize. There are three of us, really, working on that transaction. Again, we're still in -- this is development mode. There are three of us that form a management steering committee. That's the chief executive officer, myself and the vice president of corporate services, and really at this point, those are the only three executives involved in the transaction.

MR. WARREN: I have to assume, Mr. Basilio, that those three members of that team are supported by, in a pyramidal structure, they're supported by people who would provide you with data from time to time.

MR. BASILIO: Of course, yes.
(Transcript, Volume 1, p. 39, starting at Line 2)

30. In his cross examination of Horizon Utilities Panels 1 and 2, Mr. Shepherd pursued the same topic:

MR. SHEPHERD: Mr. Chairman, can I make a suggestion for a simpler way of dealing with this? I realize that the business case has caused a problem.
Can I ask two simple questions? Does the business case have any benefits in 2008 from the Guelph transaction?

MR. BASILIO: No net benefits. The costs of implementing this transaction will exceed any benefits realized in the first year, probably 18 months.

MR. SHEPHERD: Okay. Second question is, is it correct to say that the total benefits over the next five years, the period when the shareholder would get the benefits, are some multiple, five or ten times all of the internal costs that you are incurring this year, fully allocated internal costs associate the with M and A activity? Is that fair?

I understand you disagree with whether they should be connected. But if you figured out that number, let's say it is a million dollars or a million-and-a-half dollars, whatever, the benefits will be some multiple of that? Is that true?

MR. BASILIO: The benefits will be some multiple, five to ten times aggressive.

MR. SHEPHERD: You hope. But you don't know.

MR. BASILIO: Well, I would, you know, I would hope, but it is aggressive.

31. Energy Probe submits that the argument put forward by the witness John Basilio concerning non-allocation of the Guelph merger expenses related to internal staff cost to the account of the shareholder because these costs are not incremental, lacks all reasonableness. It is also unreasonable to argue that because much of the time spent on the merger by the management steering committee was done at night and on weekends, it should be paid for by ratepayers. It is a principle of regulatory oversight that costs should be allocated based on causation.

32. Mr. Basilio did not provide the quantum for the merger costs of the management steering committee but opined that he may have spent 10% to 20% of his time on these activities; it is certainly probable that the other members of the committee took as great a position in the merger activities as did he. Each of those executives is supported by internal staff in all their activities.

33. So, the Board is left with the agreement by Mr. Basilio that the return to the shareholder will be some 5 to 10 times all the internal mergers and acquisitions costs incurred this year, but spread over the next 5 years.

34. Energy Probe submits that in its Decision, the Board direct the Applicant to compute those internal mergers and acquisitions costs for 2008, perhaps in the area of \$1 million, and allot them to the shareholder.

Rate Base

Issue 4.7 Are the methodology and assumptions used to determine the Working Capital component of the Rate Base appropriate, and is the resulting Working Capital component of Rate Base appropriate?

35. In the Applicant's Argument-in-Chief, at Paragraph 79, it takes the position that since it has not undertaken a Horizon Utilities-specific lead/lag study, it is entitled to a 15% ratio. Energy Probe is concerned that by accepting the proposed working capital allowance, the Board would permit the Applicant to recover more working capital from ratepayers than is required.

36. As noted in the Submission by Board staff, the Applicant has not used the most current cost of power which was provided in the Board's Regulated Price Plan report of April 2008. Nor has the Applicant used current transmission and wholesale market charges to determine the working capital base.

37. Energy Probe, and the other active intervenors in this matter, have taken part in cost of service proceedings in respect of electricity distributors which are reasonable urban comparators of the Applicant. In the case of Toronto Hydro-Electric Systems Limited, a lead/lag study was provided to the Board. Hydro One Networks Inc. provided a lead/lag study to the Board. Enersource Hydro Mississauga Inc. and Hydro Ottawa Inc. did not provide lead/lag studies to the Board but agreed to undertake them as part of their Settlement Agreement.

38. Energy Probe notes that none of the above urban utilities received a 15% working capital allowance. The range received by the above mentioned utilities was from 13.3% to 11.6%.

39. Energy Probe submits that the Board in its Decision should direct the Applicant to undertake a lead/lag study, should direct the Applicant to revise the base upon which the working capital is determined using the current cost of power and current transmission and wholesale market charges, and should allow the Applicant a working capital allowance within the 13.3% to 11.6% range deemed appropriate for other similar utilities.

In Closing

40. In the run-up to the Oral Hearing, the Applicant submitted letters to the Board complaining that after filing 3,000 pages of evidence and interrogatory responses it was subjected to an ADR and “that there is still no justification for an oral hearing in this Application ...”² Counsel for the Applicant submitted “the point is that Horizon Utilities has filed a complete, comprehensive and transparent application for its 2008 electricity distribution rates.”³

41. Energy Probe submits that the Board has been proven correct in its decision to schedule both the ADR process and an Oral Hearing in this matter. Clearly, the evidence of the Applicant required testing and significant portions of it were found wanting.

Costs

42. Energy Probe submits that it participated responsibly in this proceeding. Energy Probe requests the Board award 100% of its reasonably incurred costs.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

July 2, 2008

Energy Probe Research Foundation

² Borden Ladner Gervais letter to OEB dated March 28, 2008, p. 2 of 10, para. 2.

³ Borden Ladner Gervais letter to OEB dated April 3, 2008, p. 1 of 2, para. 3.