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Delivered by Courier and E-mail

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
P. O. Box 2319, 27th Floor
2300 Yonge Street
Toronto, Ontario
M4P 1E4

Dear Ms. Walli:

**Re: Welland Hydro-Electric System Corp.
Request for recovery of 2007 PILs expense**

Introduction:

We are counsel to Welland Hydro-Electric System Corp. (“Welland Hydro”) in the above-captioned matter. On April 12, 2007, the OEB issued its Decision and Order in respect of Welland Hydro’s 2007 electricity distribution rate adjustment application (OEB File No. EB-2007-0586). That application was prepared and filed based on the OEB’s mechanistic adjustment process for 2007 rates.

At this time, Welland Hydro wishes to address with the OEB the matter of its 2007 Payments in Lieu of Taxes (“PILs”) expense. This matter arises because for 2006, Welland Hydro’s net PILs obligation was substantially offset by available Loss Carry Forwards, so that Welland Hydro’s 2006 distribution rates provided minimal PILs recovery.

As the OEB is aware, adjustments to reflect changes in local electricity distribution companies’ (“LDCs”) PILs obligations were not addressed by the OEB in its 2007 Incentive Regulation Mechanism (“IRM”) process. However, Welland Hydro’s PILs expense has increased significantly from the level approved by the OEB in its order in respect of Welland Hydro’s 2006 electricity distribution rate (“EDR”) application (RP-2005-0020/EB-2005-0428). The incremental PILs liability for 2007 is estimated to be \$353,832 (approximately 11.9% of Welland Hydro’s distribution expenses before taxes, an amount approximately 60 times the OEB’s materiality threshold).

Welland Hydro respectfully requests that the OEB provide for the recovery of Welland Hydro’s incremental 2007 PILs expense as follows:

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Calgary



- (a) Confirm that all of Welland Hydro’s incremental PILs expenses (including its 2007 PILs), together with carrying charges thereon, will be recoverable through rates by way of an adjustment mechanism commencing in 2008 with no requirement that Welland Hydro rebase in 2008, or upon rebasing in 2009 or 2010 (the rebasing year for Welland Hydro is yet to be determined), subject to verification of the amount of the expense; and
- (b) Permit Welland Hydro to establish a deferral account now that will allow it to track its incremental PILs expenses for 2007 and any additional year(s) prior to rebasing, and the carrying costs associated therewith, for recovery at such later date.

The circumstances giving rise to this request are discussed below.

Welland Hydro’s Current PILs Recovery:

In its 2006 EDR order, the OEB approved \$97,286 in PILs recovery. This amount can be found at Tab 4-2 of the Welland Hydro 2006 EDR Model, an electronic copy of which accompanies this letter. The calculation of that PILs amount was performed in Welland Hydro’s 2006 PILs Model (also enclosed) and is summarized as follows:

PILs Calculation from Welland Hydro 2006 OEB PILS Model:

**Non-Capital Loss Carry Forward
Deduction (Source: Test Year Sch 7-1
Loss Cfd)**

Actual/Estimated December 31, 2004	\$(805,523)
Application of Loss Carry Forward to reduce Taxable Income in 2005	<u>\$71,895</u>
Balance Available in Test Year	\$(733,628)

**Test Year Taxable Income Calculation
(Source: See Test Year Taxable Income
Tab):**

Net Income for Tax Purposes	\$909,194
Non-Capital Loss Carry Forward	<u>\$(733,628)</u>
Taxable Income	\$175,566

**Test Year PILs, Tax Provision (Source:
See Test Year PILs, Tax Provision Tab)**

	Base	Grossed Up
Income Tax	\$32,690	\$40,170
Ontario Capital Tax	\$57,116	<u>\$56,116</u>
Total PILs		\$97,286

As can be seen in the above table, Welland Hydro’s Non-Capital Loss Carry Forward of \$733,628 was projected to be completely used up in the 2006 EDR year. That projection was borne out in Welland Hydro’s actual results for 2006. Loss Carry Forwards were

applied against actual 2006 taxable income of \$1,772,434. As a result and as predicted, there are no Loss Carry Forwards for 2007 and future years.

Welland Hydro’s 2007 PILs Expense:

In order to estimate the incremental effect on 2007 PILs expense of the lack of Loss Carry Forwards, Welland Hydro reran the 2006 PILs Model with no Loss Carry Forwards. The calculation of Welland Hydro’s total and incremental 2007 PILs expense is as follows:

Total and Incremental 2007 PILs Assuming a Taxable Income of \$909,194

**Test Year Taxable Income Calculation
(Source: See Test Year Taxable Income Tab):**

Net Income for Tax Purposes	\$909,194
Non-Capital Loss Carry Forward	<u>\$0</u>
Taxable Income	\$909,194

Test Year PILs, Tax Provision (Source: See Test Year PILs, Tax Provision Tab)

	Base	Grossed Up
Income Tax	\$274,881	\$394,002
Ontario Capital Tax	\$57,116	<u>\$56,116</u>
Total PILs		\$451,118
Less PILs recovered through 2006 rates		<u>-\$97,286</u>
Incremental 2007 PILs		\$353,832

The incremental expense will be ongoing, now that Welland Hydro has no further Loss Carry Forwards. A deferral account is therefore requested to capture the lost revenue effective May 1, 2007.

The OEB’s Treatment of PILs Expenses for 2007:

Since the development of the initial (2000) First Generation PBR Electricity Distribution Rate Handbook, referred to here as the “2000 Handbook”, distribution rates have been designed so as to allow distributors to recover their PILs liabilities. In section 3.3.1 of its Decision on the draft 2000 Handbook (RP-1999-0034), the OEB observed that “In establishing initial rates, the draft Rate Handbook stipulates that certain adjustments to current rates may be warranted, such as an allowance for market-based returns, which includes payment in lieu of income taxes, or proxy taxes, and for prudently incurred costs associated with the transition to the new market structure.”

Among the OEB’s guiding principles in determining the allowance for taxes in 2006 rates were that “The tax rates and tax rules used in the tax model should reflect to the extent possible the actual rates and rules that will be applicable in 2006”, and that “Rates must



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be just and reasonable, and any substantial variation between taxes determined for regulatory purposes and actual taxes paid by the distributor must be justifiable”. Welland Hydro expects that the latter principle would apply not only to the adjustment of PILs recovery where the actual PILs exposure is significantly lower than the calculation for regulatory purposes, but also to the adjustment of the recovery where the actual liability is significantly higher than the regulatory calculation.

After the completion of the 2006 EDR process, and in a manner consistent with past practice, the June 19, 2006 Draft Staff Report on Cost of Capital and 2nd Generation Incentive Regulation (Section 3.2, at p.14) contemplated that PILs would not be adjusted as part of the rate adjustment formula during the 2007-2009 (depending on the year in which an individual distributor rebased) – instead, “Payments in lieu of taxes (PILs) would be a separate calculation after the income is derived from the adjustment.”

The July 25, 2006 OEB staff discussion paper on Cost of Capital and 2nd Generation IRM changed this approach, and contemplated the adjustment of a distributor’s allowance for PILs by the price cap adjustment index (see section 4.3.3 – Treatment of Taxes – at page 36 of the staff discussion paper). Appendix “C” to the staff discussion paper set out the proposed methodology for calculating the “K-factor” – at Step 2, staff proposed that “For each distributor, using the 2006 EDR and tax spreadsheets corresponding to the final Board-approved rates, the change in the Base Revenue Requirement (upon which distribution rates excluding rate riders are determined) would be calculated from the Board-approved amount. This calculation would involve altering the allowed ROE from the 9.0% allowed in 2006 to the updated ROE for 2007. The change in Base Revenue Requirement would also include the change in taxes/PILs due to the change in net income.”

Similarly, the OEB, at section 4.2.3 of the December 20, 2006 Report on Cost of Capital and 2nd Generation Incentive Regulation for Ontario’s Electricity Distributors (the “Report”), (page 46), determined that with the exception of the large corporation tax, which was repealed effective January 1, 2006 and would be removed from base rates in 2007, “all other taxes will be adjusted for the price cap index”. However, no provision was made for adjustments to the PILs proxy to reflect changes in individual distributors’ PILs obligations. In effect, the Report and the Model assumed that a distributor’s 2006 PILs obligation would continue largely unchanged for 2007 – this is clearly not the case for Welland Hydro.

Welland Hydro acknowledges that the OEB determined (in the 2006 EDR process) that there would not be an adjustment mechanism for PILs, with the exception of adjustments for very limited circumstances such as changes in tax policy, an exception that has continued into the 2007 IRM process. However, Welland Hydro submits that this assumes that the existing PILs recovery bears some reasonable relationship to the PILs liability. There is no such relationship in Welland Hydro’s current circumstances, and it is therefore necessary to seek the requested relief from the OEB. If no adjustment is made to Welland Hydro’s rates to account for this incremental PILs expense, then this significant (and material) PILs liability will compound each year, potentially until Welland Hydro’s rates are rebased.

We note that in its Report, the OEB advised (at p.34) that “**For 2nd Generation IRM, the Board will limit reliance on Z-factors to well-defined and well-justified cases only – specifically, Z-factors will be limited to changes in tax rules and to natural disasters.** The Board believes that for 2nd Generation IRM, Z-factors should be limited to events genuinely external to the regulatory regime and beyond the control of management and the Board – changes in Board policy should not be included. The Board can always assess the implications of such changes and make provision for them. Regardless, in order for amounts to be considered for recovery in a **Z-factor**, the **amounts must satisfy the eligibility criteria set out in Table 3**, below. The Board notes that changes in tax rules may result in positive or negative amounts.” Table 3 set out the following criteria for eligibility:

- Causation:** Amounts should be directly related to the Z-factor event. The amount must be clearly outside of the base upon which rates were derived. It should be clear from the foregoing that Welland Hydro’s incremental PILs expense is outside the base upon which its 2007 rates were derived.
- Materiality:** The amounts must have a significant influence on the operation of the distributor; otherwise they should be expensed in the normal course and addressed through organizational productivity improvements. The OEB stated in the Report that it intends to maintain the materiality threshold for expenses of 0.2% of total distribution expenses before taxes; and for capital cost recovery, the materiality threshold would be 0.2% of net fixed assets. As indicated above, Welland Hydro’s incremental 2007 PILs expense far exceeds the OEB’s materiality threshold for expenses.
- Prudence:** The amount must have been prudently incurred. This means that the distributor’s decision to incur the amount must represent the most cost-effective option (not necessarily least initial cost) for ratepayers. In the case of incremental PILs, unlike some other expenditures, the payment of PILs is not a discretionary item for Welland Hydro. It is an obligation that Welland Hydro must meet, failing which it would be in breach of its OEB Distributor Licence conditions. In calculating its incremental PILs expense, Welland Hydro has applied all available credits and offsets in order to ensure that the PILs expense being passed on to its customers is minimized to the extent possible.

Welland Hydro submits that were it not for the OEB’s restrictive approach to Z factors, this incremental PILs expense would have qualified for an adjustment in Welland Hydro’s 2007 distribution rates. If the OEB is still not prepared to return to its practice of PILs adjustments for 2008, Welland Hydro suggests that the OEB revisit its restrictions on Z-factors in order to allow distributors that are affected by material PILs increases to have those increases addressed by the OEB as Z-factors until rebasing.

Recovery of carrying costs on proposed PILs deferral account:

The 2007 change in Welland Hydro’s PILs expenses has arisen through no fault of Welland Hydro’s, and the payment of PILs is not a discretionary item for Welland Hydro.

It is an obligation that Welland Hydro must meet, failing which it would be in breach of its OEB Distributor Licence conditions.

In its December 9, 2004 Decision on applications by certain large distributors for the combined Phase 2 recovery of Regulatory Asset balances, the OEB considered the applicability of carrying charges to all “Regulatory Asset” accounts. At the time, the OEB’s Accounting Procedures Handbook, the 2000 Handbook and the Filing Guidelines for regulatory asset recovery explicitly provided for the accrual of carrying charges on certain accounts, among them various Retail Settlement Variance Accounts (“RSVAs”) which track the differences between amounts paid by distributors for items such as power, transmission and wholesale market services against amounts received from customers and allocated to those costs. The OEB documents did not explicitly provide for carrying charges on other Regulatory Asset accounts. However, the OEB determined that those accounts would also be subject to carrying charges. At paragraph 3.0.17 (page 25) of the December 9, 2004 Decision, the OEB wrote:

“3.0.17 The Board’s general practice however, is to authorize the recording of interest if the deferral accounts are considered to be long term in nature, generally more than one year. In our view, there is no reason to depart from this general approach. In the instant case, certain Applicants included carrying costs without explicit Board authorization in a number of accounts, specifically Accounts 1571, 1508, 1518, 1548, 1525. The Board notes that all of these accounts turned out to be longer term than was originally anticipated. We therefore consider it reasonable for the Applicants to apply interest to the balances, positive or negative, in these accounts. The Board directs the Applicants to do so in their revised filings if they have not already done so. This finding is applicable to all of the relevant regulatory asset accounts.”

As a result, all Regulatory Asset accounts were explicitly made subject to carrying charges. Welland Hydro notes that several of those accounts, including the RSVAs, are still tracked by distributors and the OEB, as those accounts relate to ongoing transactions conducted by the distributors through the Independent Electricity System Operator (the “IESO”).

With respect to the eligibility of a PILs-related deferral account for carrying charges, Welland Hydro submits that the tracking of incremental PILs paid (\$451,118 est.) against PILs collected in rates (\$97,286) is similar to the function performed by the RSVA accounts, which were, and continue to be subject to carrying charges. Even if the OEB were to consider the proposed PILs deferral account to be more similar to the non-RSVA Regulatory Asset accounts, the 2007 PILs would not be fully recovered until, at the earliest, the end of the 2008 rate year (that is, April of 2009), so that this account should also qualify for carrying charges as one that is being carried for a longer term. Accordingly, Welland Hydro submits that its proposed PILs-related deferral account should be afforded the same treatment as these other accounts.

Clearing of the proposed deferral account:

Welland Hydro suggests that the most appropriate means of dealing with this issue is to provide a mechanism for recovery of 2007 incremental PILs expenses as part of the 2008 rate adjustment process. This would limit the deferral account to the 2007 portion of the incremental PILs expense which Welland Hydro suggests could be included as part of the clearing of any balances remaining in Welland Hydro’s Regulatory Asset accounts as of



April 30, 2008. Failure to adjust rates in 2008 for incremental PILs recovery going forward until rebasing will only compound the impact to future rates.

Summary:

In light of the foregoing, Welland Hydro requests that the OEB take the following action in respect of its incremental 2007 PILs expense, and its incremental PILs expenses prior to rebasing:

- (a) Confirm that all of Welland Hydro's incremental PILs expenses (including its 2007 PILs), together with carrying charges thereon, will be recoverable through rates by way of an adjustment mechanism commencing in 2008 with no requirement that Welland Hydro rebase in 2008, or upon rebasing in 2009 or 2010 (the rebasing year for Welland Hydro is yet to be determined), subject to verification of the amount of the expense; and
- (b) Permit Welland Hydro to establish a deferral account now that will allow it to track its incremental PILs expenses for 2007 and any additional year(s) prior to rebasing, and the carrying costs associated therewith, for recovery at such later date.

In the event that the OEB is not prepared to address the recoverability of the incremental PILs expenses at this time and/or would prefer to deal with that issue on a more generic basis, we ask that, at a minimum, the OEB grant the relief requested in item (b) above. The establishment of the deferral account will have no impact on customer bills at this time.

Further, if an application is necessary in order for the OEB to consider and address these requests, we ask that the OEB consider this letter as constituting Welland Hydro's application. Should you require additional and/or more formal material, please contact me and we will arrange for the filing of the additional material. As no person, other than Welland Hydro, will be affected in a material way by the outcome of this request, and particularly by the outcome of the request for the establishment of a deferral account, Welland Hydro requests that the OEB address these requests without a hearing.

We thank you for your assistance in this matter. Should you have any questions or require further information, please do not hesitate to contact me.

Yours very truly,

BORDEN LADNER GERVAIS LLP

Original Signed by James C. Sidlofsky

James C. Sidlofsky
JCS/dp
Encl.



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Copies to: Wayne Armstrong, Welland Hydro
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