**RP-2004-0188**

**ONTARIO ENERGY BOARD**

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

**AND IN THE MATTER OF** the preparation of handbook for electricity distribution rate applications.

# INITIAL WRITTEN SUBMISSION

**on behalf of the**

**COALITION OF ISSUE THREE DISTRIBUTORS**

February 14, 2005

# TABLE OF CONTENTS

## I. Introduction

1. The following 18 distributors comprise the Coalition of Issue Three Distributors ("CITD"):

Aurora Hydro Connections Limited
Barrie Hydro Distribution Inc.
Cambridge and North Dumfries Hydro Inc.
Chatham-Kent Hydro Inc.
ENWIN Powerlines Ltd.
Guelph Hydro Electric Systems Inc.
Halton Hills Hydro Inc.
Hydro One Networks Inc.
Innisfil Hydro Distribution Systems Limited
Kitchener-Wilmot Hydro Inc.
Newmarket Hydro Ltd.
Orangeville Hydro Limited
Orillia Power Distribution Corporation
Tay Hydro Electric Distribution Company Inc.
Toronto Hydro-Electric System Limited
Waterloo North Hydro Inc.
Westario Power Inc.
Whitby Hydro Electric Corporation

2. CITD sponsored Kathleen C. McShane as an expert witness to provide evidence on the following issue: "3. Disposition of tax savings on disallowed expenses."[1] Issue 3 arises from the alternatives presented in Chapter 7, Taxes/PILs, of the draft *2006 Electricity Distribution Rate Handbook* ("Draft *Handbook*") in respect of "7.1.2 Principles Applicable to Specific Components of the Calculation."[2]

3. CITD filed Ms. McShane's written evidence with the Board on January 12, 2005; it is a report entitled "The Disposition of Tax Savings on Disallowed Expenses."[3] Her report described in detail the three regulatory principles and one governmental objective that, in her opinion, the Board should follow in resolving Issue #3. Her analysis in this regard, and her consequential recommendations to the Board, are markedly different than the

[1] Procedural Order No. 2, Schedule A.
[2] See p. 71 *et seq.* of Draft 2 dated January 10, 2005; this draft is Exhibit A.2. Draft 1 dated December 9, 2004 is Exhibit A.1.
[3] See Exhibit B.9.

analysis and recommendations of Jack M. Mintz whose written evidence was filed on behalf of the School Energy Coalition ("SEC").[4]

4. Ms. McShane testified during the fifth day of the Board's oral hearing on January 24, 2005. She was qualified "as an expert entitled to give opinion evidence on the issue of the disposition of tax savings on disallowed expenses."[5] She subsequently described her area of expertise as "energy regulatory principles" with an emphasis on cost of capital.[6]

5. Ms. McShane used an analogy, in her written evidence and in her direct testimony, to illustrate the distinction between a distributor and its utility operations for rate-making purposes.[7] The distributor is "the box;" it is the legal entity that pays income or proxy taxes. The distributor's utility operations, for which the Board approves a revenue requirement, are lodged in "the circle in the box;" it is the notional entity that has an allowance for income or proxy taxes.

6. Ms. McShane summarized her written evidence, using this analogy, in the following words during her direct testimony:

> My evidence is intended to take the principles and objectives that are typically adopted by regulatory boards to evaluate how the specific income tax or PILs issue in this proceeding should be treated in determining the revenue requirement.
>
> And those principles are as follows: There's the benefits-follows-cost principle, the stand-alone principle, the objective of maintaining a level playing field, and the no-harm principle.
>
> These principles are the same principles that would apply in determining each and every other cost element of the utility revenue requirement.[8]

---

[4] Dr. Mintz's written evidence was filed with the Board on December 14, 2004 and is entitled "Corporate Tax Adjustments and the Determination of Electricity Rates in Ontario;" see Exhibit B.3.
[5] Volume 5, paras. 48-49, of the transcript or "5 Tr. 48-49." The latter is the style used for subsequent transcript citations.
[6] 5 Tr. 160-163
[7] See, for example, Exhibit B.9, paras. 22-24 (pp. 7-8).
[8] 5 Tr. 70-72.

## II. Issue #3

### A. Definition of PILs

7. The Draft *Handbook* states that "[m]ost Ontario distributors will pay income and capital taxes in the form of section 93 proxy tax payments (PILs) to the Province."[9] The Board's 2006 Tax Model, moreover, applies only to distributors that are required to pay section 93 proxy taxes. The Draft *Handbook* recognizes, however, that a few distributors "may pay section 89 proxy taxes, or as taxable corporations be subject to normal provincial and federal taxation."[10] Distributors that are subsidiaries of Hydro One Inc. ("Hydro One") pay section 90 as well as section 89 proxy taxes and, while only two in number, they account for a large amount of the proxy taxes payable by the distribution sector.

8. For the purposes of this submission, then, CITD uses the term "PILs" to mean the following:

- proxy taxes under section 90 as well as section 89; and
- proxy taxes under section 93.[11]

9. There is a distinction between the allowance for PILs in a distributor's utility revenue requirement, for rate-making purposes, and the amount of PILs paid by the distributor: they are not calculated on the same basis. There is also a distinction between PILs paid by distributors and "payments in lieu of taxes" as a source of funds to retire stranded debt. The latter includes payments in lieu of additional municipal and school (or property) taxes, as well as payments in lieu of income and capital taxes (i.e., PILs), by the following "universe" of corporations:

- Hydro One and each of its subsidiaries whether or not regulated by the Board;
- Ontario Power Generation Inc. ("OPG") and each of its subsidiaries whether or not regulated by the Board; and

[9] Exhibit A.2, p. 66.
[10] *Id.*
[11] The section references are references to the *Electricity Act, 1998*.

- each "municipal electricity utility" including, for this purpose, the following:

  - section 142 corporations -- distributors, generators, transmitters, retailers, and holding companies incorporated before May 2, 2003 -- and their respective subsidiaries whether or not regulated by the Board; and

  - holding companies incorporated after May 1, 2003.[12]

10. "Toronto Hydro," for example, is not a single municipal electricity utility. It is, rather, a group of five distinct municipal electricity utilities (as so defined): Toronto Hydro Corporation, Toronto Hydro-Electric System Limited, Toronto Hydro Energy Services Inc., Toronto Hydro Street Lighting Inc., and Toronto Hydro Telecom Inc. From a stranded debt perspective, then, it is important to realize that each of these corporations is required to make PILs payments.

11. It is also important to realize, from the same perspective, that the size of the budgeted amount of PILs is $630 million for Ontario's 2004-05 fiscal year. This is the amount of "Electricity Payments-In-Lieu of Taxes" that the Ontario government expects to receive as a line item of "Taxation Revenue."[13] This is the amount expected from all PILs - paying corporations, in other words, and not just from public sector distributors -- the ones owned by Hydro One and the municipalities -- let alone just the distributors owned by municipalities.

12. It is clear that none of the latter, not even Toronto Hydro-Electric System Limited, would be liable to pay $150 million of PILs in a single year. The $150 million example for "Toronto Hydro" (i.e., in this case, only the distributor) that SEC's counsel, Mr. Shepherd, used in his cross-examination of Ms. McShane was presumably an exaggeration for effect. Toronto Hydro Corporation's "[c]urrent tax expense" for 2003, in

[12] See section 88 of the *Electricity Act, 1998*. The reference to "a corporation established pursuant to section 142" in clause 88(d) includes a holding company incorporated "after November 6, 1998 and before May 2, 2003;" see subsection 142 (1.1).
[13] 2004 Ontario Budget, *The Plan for Change*, Budget Papers, Table A2 (p. 70).

sharp contrast, was $45.5 million on a consolidated basis; that is, five municipal electricity utilities (as so defined).[14]

13. There are two more items of note on the source of funds to retire stranded debt. One is that the Ontario government expects to receive $335 million from Hydro One and OPG, as a line item of "Income from Investment in Government Business Enterprises," for Ontario's 2004-05 fiscal year. The other item is that the Ontario government expects to receive $1,009 million from the "Electricity Debt Retirement Charge," as a line item of "Other Non-Tax Revenue," for Ontario's 2004-05 fiscal year.[15] These two items, when combined, total $1,344 million or more than double the amount expected from all PILs-paying corporations.

## B. Scope of Issue #3

14. Chapter 7 of the Draft *Handbook* begins with a description of "rules and principles" such as the following:

- The goals of the 2006 tax filing guidelines are to allow recovery of the distribution-only tax payable expected to be incurred by the distributor, with consideration to be given to regulatory fairness and administrative simplicity.[16]

- The tax amount included in rates is based upon taxes expected to be actually payable as a result of operating the distribution-only business, rather than upon taxes calculated for accounting purposes. Future/deferred taxes will not be recovered through rates as a result of this filing. [17]

15. The Board uses the taxes payable, or "flow through," method of calculating the PILs or income tax allowance in a distributor's utility revenue requirement instead of the tax allocation, or "normalized," method for both electricity and gas distributors. The references to "taxes payable expected to be incurred" and "taxes expected to be actually payable" must mean, in this context, the amount that the Board will calculate for rate-

[14] Initial Annual Information Form for the Year Ended December 31, 2003 (February 27, 2004), Annex A- Consolidated Financial Statements, Note 21-Corporate Income Taxes, pp. A-35 and A-36.
[15] See footnote 13 for both items.
[16] Exhibit A.2, p. 66.
[17] *Id.*, p. 67.

making purposes rather than the amount that the distributor will calculate on its tax return. The two are calculated, as noted earlier, on a different basis. If there is any doubt in this regard, however, the text of the Draft *Handbook* should be revised accordingly.

16. Chapter 7 of the Draft *Handbook* goes on to describe the guidelines that municipally-owned distributors must use in the calculation of the PILs allowance for their utility revenue requirement. A key issue is the treatment, for this purpose, of the tax savings that arise from operating and capital cost elements that are excluded, for rate-making purposes, from a distributor's utility revenue requirement.

17. The Draft *Handbook* identifies six categories of cost items whose tax implications for revenue requirement purposes must be resolved. Ms. McShane lists these categories in her written evidence.[18] They can be summarized, with one exception,[19] with reference to the following costs components that are not recognized in the Board's rate-making process:

- OM&A expenses that are disallowed by the Board or are otherwise non-recoverable but are, nevertheless, deductible by the distributor for PILs purposes;
- interest expense that exceeds the deemed cost of the deemed debt component of a distributor's utility capital structure (and thus its utility rate base) but are, nevertheless, deductible by the distributor for PILs purposes; and
- capital costs (other than excess interest expense) that exceed the net book value of a distributor's utility rate base (i.e., the original cost, less accumulated depreciation, of the assets comprising the utility rate base).

18. The third cost component requires a further explanation. For utility revenue requirement purposes, the return of (depreciation expense) and on (allowed return on rate base) capital are based on the net book value of a distributor's utility rate base. The utility revenue requirement explicitly excludes the recovery of higher depreciation expense or goodwill that the distributor may incur due to the purchase of utility assets at any value, including

[18] Exhibit B.9, para. 16 (p. 4).
[19] The exception is capital gains and losses on the disposition of distribution assets; see para. 20 below.

fair market value, above net book value. The purchase of utility assets by a distributor at a price above net book value, however, would make available to the distributor the following benefits or "savings" for PILs purposes:

- Undepreciated Capital Cost ("UCC") at a higher level, and thus a deduction of Capital Cost Allowance ("CCA") at a higher level, in relation to the distributor's tangible assets;[20] and

- Cumulative Eligible Capital ("CEC"), and thus a deduction of Cumulative Eligible Capital Amount ("CECA"), in relation to the distributor's intangible assets.[21]

19. The Draft *Handbook* describes three alternatives for the treatment of the tax savings arising from a distributor's ability to deduct, for PILs purposes, the amounts that are excluded from the distributor's utility revenue requirement:
    - a sharing of the tax savings between the ratepayer and distributor;
    - 100% of the tax savings to the ratepayer; and
    - 100% of the tax savings to the distributor.

20. The Draft *Handbook* also prescribes, in Chapter 7, that a distributor's capital gains and losses on the sale of utility assets be treated in the same way as the accounting gain or loss is allocated between the distributor and its ratepayers. This treatment is presented elsewhere in the Draft *Handbook.* There are no alternatives but, nevertheless, Dr. Mintz's written evidence offered one. Ms. McShane's written evidence, in response, canvassed the regulatory precedents on this topic.

---

[20] The UCC based on fair market value could be greater than the UCC based on original cost either for two reasons. One is that the distributor paid fair market value for tangible assets in excess of net book value. The other reason is that the distributor's "FMV bump-up" on October 1, 2001 produced a fair market value for tax purposes in excess of net book value.

[21] There is "no "higher level" of CEC because CEC is the tax analogue of goodwill; the latter is excluded from the distributor's utility rate base and, therefore, there is no CECA in the calculation of the PILs allowance in the distributor's utility revenue requirement. Exhibit A.2 also refers to CEC as "eligible capital expenses" or "ECE;" see pp. 72-73. Ms. McShane does likewise in Exhibit B.9; see paras. 16 (p. 4) and 58 (p. 22).

## III. CITD's Position

21. The Board should have regard to the following three factors when resolving Issue #3 *vis-à-vis* "disallowed expenses":

- the three regulatory principles that have historically underpinned the determination of utility revenue requirements; namely, "benefits follow costs," "stand-alone utility," and "no harm to ratepayers;"
- the Ontario government's stated objective to create a level playing field, through PILs, for both private and public sector distributors in both the electricity and gas sectors; and
- the distributor's ability to earn the rate of return on equity ("ROE") in its utility operations that the Board has approved for rate-making purposes.

## IV. Dispositive Factors

### A. Principles and Objective

22. Ms. McShane's evidence sets out the three regulatory principles and the governmental objective that the Board should apply when resolving Issue #3. These three principles and this objective are summarized in the following paragraphs with reference to Issue #3.

- **"benefits follow costs"**

23. The stakeholder who has borne the costs should receive the tax saving. If the ratepayer is not required to bear the expense and yet receives the benefit of the tax saving, the distributor bears the entire pre-tax cost of the expense (i.e., the actual out-of-pocket cost) and, as a result, so too the distributor's shareholder(s). Moreover, the distributor's ROE in its utility operations is reduced below the level approved by the Board.

- **"stand-alone utility"**

24. Only those costs and risks related to a distributor's stand-alone utility operations are reflected in the distributor's utility revenue requirement. The stand-alone principle requires that the income tax or PILs allowance in the utility revenue requirement be

similarly calculated; that is, with reference only to the operating and capital costs actually allowed in the distributor's revenue requirement for its utility operations.

25. The Board and other Canadian regulators have applied the stand-alone principle for the purpose of calculating all elements of a utility revenue requirement, including the allowance for income taxes, for over a quarter of a century: "[a] long standing regulatory principle espoused by the Ontario Energy Board, and by other regulators in North America, is the stand-alone principle."[22] More specifically, the Board has relied on the stand-alone principle to calculate a gas distributor's income tax allowance for its utility revenue requirement as recently as 1998.[23]

26. The stand-alone principle must be consistently applied across all utility cost categories and not in an *ad hoc* manner. Tax savings arising from costs that are not incurred by the distributor for its stand-alone utility operations must, similarly, not be allocated to utility ratepayers.

- **"level playing field"**

27. The objective of PILS is to create a level playing field which, in turn, requires that the PILs allowance for a non-taxable distributor be determined in a manner equivalent to the income tax allowance of a taxable distributor.[24] To do otherwise would give a systemic pricing advantage to a non-taxable distributor, relative to a taxable distributor, and this outcome would defeat the very objective that PILs was designed to achieve.

- **"no harm to ratepayers"**

28. A minimum condition for deciding who should receive the tax savings is that the decision must not make the ratepayer any worse off. When neither the distributor nor the ratepayer incurs any costs, but the distributor gains a benefit for its shareholder(s), there is "no harm" to the ratepayer.[25]

---

[22] RP-2002-0158 Decision with Reasons (January 16, 2004), para. 124.
[23] EBRO 496 Decision with Reasons (August 20, 1998), paras. 3.2.59, 3.2.60, 3.2.67, and 3.2.68
[24] A distributor is non-taxable for PILs purposes when it is a tax-exempt entity under subsection 149(1) of the *Income Tax Act* (Canada).
[25] EBRO 367-I & II Reasons for Decision (January 30, 1981), p. 70.

## B. Equity Return and Income Tax (PILs) Allowance

29. One component of a distributor's utility revenue requirement is the allowed return on rate base; that is, the amount derived by multiplying the utility rate base by the utility rate of return. The latter is a percentage that is derived from the debt/equity ratio of the utility capital structure and the cost rate of, respectively, the utility debt and equity capital. The cost rate of equity, or the ROE, is determined by the Board using its equity risk premium methodology.

30. The Board's methodology sets the allowed the equity return as an after-tax amount. It is necessary, therefore, to add an allowance for income taxes (or PILs) to the distributor's utility revenue requirement in order to provide the distributor with an opportunity to earn its allowed utility equity return on an after-tax basis.[26]

31. The allowance for income taxes (or PILs) in a distributor's utility revenue requirement is a gross-up, in effect, of the allowed equity return so that the distributor has the opportunity to achieve, in its stand-alone utility operations, the after-tax equity return allowed by the Board. Both the after-tax equity return and the corresponding income tax (or PILs) allowance should be calculated on the same basis; that is, on a stand-alone basis using utility values for both operating and capital costs. Only capital costs that are included in rate base, for example, should be used to calculate both the equity return and the income tax (or PILs) allowance. Similarly, only operating costs that are recoverable in rates should be deductible to determine the income tax (or PILs) allowance.

32. On the other hand, if a distributor's utility allowance for income taxes (or PILs) includes the tax savings from costs that are excluded from its utility revenue requirement, the distributor's utility equity return would necessarily take the "hit" because -- other things being equal -- it is the distributor's source of funds to pay those excluded costs. The distributor would accordingly be denied the opportunity to earn the equity return in its utility operations that the Board intended it to have.

---

[26] The same is not true of the debt return; the corresponding interest expense is deductible for income tax (or PILs) purposes.

## V. Application of Dispositive Factors

### A. Principles and Objective

33. The regulatory principles and the governmental objective recommended by Ms. McShane will, when applied to Issue #3, lead the Board to a resolution of the issue that results in both economic efficiency and fairness:

> In my view, when a regulator is looking at setting rates, the regulator is basically concerned with two objectives, what I'll call "economic efficiency" and "fairness." So the principles and objectives that the regulator chooses are intended to be applied so as to reach a solution or a resolution that creates or results in both economic efficiency and fairness.
>
> Now, the term "fairness" is one that is a bit illusive. It's very hard to define what fairness is, because different stakeholders have different views about what's fair. What seems to be fair to the shareholder may not seem to be fair to the ratepayer, so fairness, from the regulator's perspective, is achieved when the interests of both ratepayers and shareholders are balanced and when the principles that they apply are applied symmetrically. So that, in the cases where there's a down side, the principles are applied in no different manner than when there is an up side.
>
> So, in my view, essentially, when you apply these four principles as regulators have, you achieve fairness.[27]

34. Ms. McShane applied these regulatory principles and this governmental objective to the following three categories of a distributor's "disallowed expenses:" disallowed and non-recoverable expenses; excess interest expense; and other capital costs in excess of the net book value of utility rate base. She concluded in each case that the consequential tax savings should flow to the distributor, and thus to its shareholder(s), rather than to the ratepayer. The following paragraphs discuss the basis for her conclusions.

35. The first category is expenses that are disallowed or other otherwise non-recoverable for utility revenue requirement purposes. Disallowed operating expenses are, by their very nature, not part of a distributor's utility revenue requirement and not borne by its ratepayers. The "benefits follow costs" and "stand-alone utility" principles dictate that any tax savings generated by these expenses should flow to the distributor. The "level

[27] 5 Tr. 74-76.

playing field" objective also dictates that these tax savings should flow to the distributor, thus ensuring that no systemic rate advantage is held by PILs-paying distributors relative to taxable distributors in either the electricity or the gas sector.

36. The second category is excess interest expense. The use of a deemed capital structure (and thus deemed interest expense) for calculating the utility revenue requirement requires using the same deemed interest expense for purposes of calculating the PILs allowance. Using a deemed interest expense for revenue requirement purposes -- which the Draft *Handbook* does -- but including additional interest in the calculation of the PILs allowance defeats the very purpose of using a deemed capital structure.[28] No Canadian regulator has applied the stand-alone principle to the cost of capital components of the utility revenue requirement and, having done so, has then abandoned that principle when calculating the utility income tax allowance.

37. The third category is capital costs (other than excess interest expense) in excess of the net book value of utility rate base. A purchase of utility assets above book value may give a distributor higher CCA or CECA (i.e., purchased goodwill), or both, that can be used to reduce the distributor's PILs payable. The ratepayer has not, however, paid any of the costs associated with the purchase; the distributor incurred all of these costs. The depreciation expense and return on rate base that are included in the distributor's utility revenue requirement have not changed; they are still based on the original cost of the utility assets. Consequently, there is no reason the ratepayer should receive the tax savings since they were derived from costs the ratepayer was not required to bear. The distributor's utility income tax allowance must, therefore, exclude the tax savings generated from the purchase of utility assets at prices above net book value.

38. The "FMV bump-up" is a unique circumstance, as Ms. McShane acknowledged, in that tax savings (with no explicit corresponding out-of-pocket costs) were created by a "fresh start" regulation made under the *Electricity Act, 1998*.[29] This regulation provides, in subsection 7(1), that a "municipal electricity utility" -- and not just a distributor as

[28] 5 Tr. 704.
[29] O. Reg. 162/01 (amended to O. Reg. 172/01).

discussed earlier -- is deemed to have acquired the following property on October 1, 2001 at a cost equal to "the fair market value of the property on that date:

1. Property that is transferred to the utility under a transfer by-law.
2. Property that is acquired by the utility before October 1, 2001 but after any property is transferred to the utility under a transfer by-law."[30]

39. A deemed acquisition at fair market value applies even when, for example, a distributor acquired its utility assets at their net book value.[31] Ms. McShane demonstrated, in this case, that the no harm principle, the stand-alone principle, and the level-playing field objective all support flowing the tax benefits of the "FMV bump-up" to the distributor.[32]

40. Mc McShane also testified that there is an implicit opportunity cost, even when the utility assets are recorded in the distributor's utility accounts at net book value, because the distributor can always sell these assets at fair market value.[33] The benefits would follow costs, in this case, and the application of this principle requires that the recipient of the tax savings necessarily bear the corresponding costs upon sale of the assets. If the assets are sold at fair market value, in other words, the distributor's prior CCA and CECA deductions based on UCC and CEC at fair market value will be subject to recapture and will be taxed accordingly. This circumstance supports giving the tax savings of what is essentially a temporary benefit to the stakeholder most able to bear the subsequent tax expense.[34] That stakeholder is the distributor since the sale of utility assets leaves it with a tax liability but no ratepayers to bear the tax liability.[35]

41. Ms. McShane also concluded that the tax savings or costs, as the case may be, from the sale of utility assets should follow the losses or gains in the same manner as the losses or gains themselves. To do otherwise makes no logical sense. If a distributor is allocated a

[30] The reference to a "transfer by-law" is a reference to a municipal by-law whereby a municipality transferred the property to a distributor or another type of municipal electricity utility.
[31] 5 Tr. 89-90.
[32] Exhibit B.9, paras. 66-68 (pp. 24-25), and 5 Tr. 93-100.
[33] 5 Tr. 665.
[34] 5 Tr. 98-100.
[35] 5 Tr. 671-673.

capital gain, it would be contrary to the intention of the Board to allocate the consequential tax expense to the ratepayer and *vice versa.*[36]

## B. Equity Return and Income Tax (PILs) Allowance

42. The Board is required by law to allow a distributor to recover its cost of capital and, in particular, its cost of equity capital by means of a "fair return."[37] The cost of equity capital, in this context, is represented by the ROE approved by the Board for rate-making purposes. This requirement will also lead the Board to the same conclusion that Ms. McShane has reached. Exhibits D.5.1 and E.5.1 each demonstrate that, otherwise, a distributor's ROE for its utility operations would be less than the Board intended when setting the ROE.

43. Ms. McShane described, in detail, Exhibit D.5.1 in her direct testimony.[38] This exhibit clearly shows that her recommended treatment of the tax savings in all three categories of "disallowed expenses" is the only way that a distributor could achieve an after-tax equity return at the level -- the ROE -- that the Board sets for the distributor's utility operations. Dr. Mintz's recommended treatment, in sharp contrast, could reduce the ROE by a significant amount. In Exhibit D.5.1, for example, the ROE is reduced by 20% from 9.5% -- the Board-approved level -- to 7.6%. A reduction of this size is very significant.

44. Exhibit E.5.1 illustrates the same point. When the cost of a "PILs expense reduction" is a non-recoverable expense, for rate-making purposes, the cost is borne entirely by the distributor, and therefore by its shareholder(s), and so the non-recoverable expense should be excluded from the calculation of the distributor's PILs allowance in its utility revenue requirement. Otherwise, the distributor would earn an ROE on its utility operations that is less than the Board-approved level.

45. Exhibit E.5.1 also illustrates the point that it is the government, and not the ratepayer, that shares in the cost of the non-recoverable/deductible expense. Ms. McShane also made a

---

[36] Exhibit B.9, para. 74 (pp. 28-29).
[37] *Transcanada Pipelines Ltd. v. Canada (National Energy Board)*, [2004] F.C.J. 654 (C.A.), paras. 32-33, 35-36.
[38] 5 Tr. 38-146.

similar point when Mr. Shepherd used the phrase "ratepayers' money" during their discussion of Exhibit D.5.1:

> I have trouble with the concept of "it's the ratepayers' money." The Board has set the revenue requirement. So you're going to collect revenues from the ratepayers, but once they leave the ratepayers' hands, it's not the ratepayers' money.[39]

46. Ms. McShane's point is worthy of emphasis. A distributor's revenue from its utility operations -- its equity return in particular -- is the distributor's money. A distributor has the right spend its money as its management or its shareholder(s), or both, may determine consistent with the distributor's obligation to provide safe and reliable utility service.

## VI. Response to Dr. Mintz

47. Issue #3 is a regulatory issue, in essence, but Dr. Mintz acknowledged he was not "a regulatory expert."[40] He was qualified as "an expert in the field of taxation, with a specific expertise in the area of the incidence of tax."[41]

48. Dr. Mintz's opinion is that consumers -- here, the ratepayers -- bear the economic incidence of a distributors income taxes or PILs. Ms. McShane did not challenge Dr. Mintz's opinion in this regard: "[t]he economic incidences [*sic*] of taxes falling on consumers is not new."[42] She then placed economic incidence in its proper context *vis-à-vis* Issue #3:

> So we've always known that the incidence of taxes generally falls on consumers, and in the light of that, we have developed -- the regulators have developed ways of determining how much income tax allowance should be recovered from consumers as an operating cost. And that's where the stand-alone principle applied to income tax came from ...in making that assessment.[43]

49. Dr. Mintz's recommendation is that the ratepayer receive all of the tax savings that are generated by the distributor regardless of whether the ratepayer had incurred the related cost. His recommendation displays a basic lack of understanding of the regulatory

---

[39] Tr. 535.
[40] 1 Tr. 457, 658.
[41] 1 Tr. 458-60.
[42] 5 Tr. 602.
[43] 5 Tr. 604-606.

principles and constructs (e.g., utility revenue requirement) that govern the setting of a distributor's rates for utility service.[44] It violates the basic regulatory principles that underpin the determination of a distributor's utility revenue requirement.[45] His recommendation would also result in a distributor earning an ROE on its utility operations that is lower, and potentially significantly lower, than the ROE allowed by the Board for this purpose.[46]

50. Dr. Mintz was concerned about "a subsidy provided by ratepayers to the shareholder," in his words, and he used a political donation of $100,000 as an example. He testified that, by deducting this amount for tax purposes, a distributor would realize "a savings of about $36,000 in tax.[47] He went on to make the following point:

> Now, by allowing the savings to go to the shareholder, the effect would be to reduce the net cost of the donations from $100,000 to $65,000. The other $35,000 would be paid by the ratepayers.[48]

51. Dr. Mintz is mistaken in this regard. The amount of a political donation is not fully deductible for tax purposes. There is a maximum deduction that is allowed at each of the federal and the provincial level and, as a result, each deduction would be *de minimus* relative to a donation of this size (i.e., $100,000). As a practical matter, then, a political donation would have little or no effect on the amount of PILs that is otherwise payable by the distributor.

52. Dr. Mintz was also concerned about interest expense, which he called "an issue of importance,"[49] and he explained his concern in the following words:

> [I]f the [B]oard allows the shareholder to keep the tax savings from overleveraging, it would, in effect, be encouraging the LDCs to use higher and perhaps inappropriate debt/equity ratios. Particularly in the case where the debt and equity finance are both provided by the municipal shareholder, why would an LDC finance less than 100 percent debt? Well, maybe they won't do 100 percent, they might do 90 percent, but that doesn't matter. The main point is there will

[44] His lack of understanding was evident during Mr. Farrell's cross-examination; see, for example, 1 Tr. 657-658, 821-828.
[45] Exhibit B.9, paras. 76-80 (pp. 29-30).
[46] 5 Tr. 504.
[47] 1 Tr. 482, 486-487.
[48] 1 Tr. 488.
[49] 1 Tr. 523.

> be an incentive to put as much debt into the utilities in order to get the tax savings, where otherwise the municipal owner themselves, if they held the debt, would not be able to get an interest deduction associated with that.[50]

53. Dr. Mintz's "incentive" is a red herring, with respect, because it is theoretical rather than practical for two reasons. One is that the Board could, and presumably would, alter a distributor's debt ratio for rate-making purposes if the distributor were able to conduct its utility operations successfully at a higher debt ratio.[51] The other reason is that the law precludes a municipality from making ever-increasing investments in debt securities issued by its holding company or its distributor, or both, and so a borrower must access debt markets for its own account.[52] The borrower would then be subject to the discipline of the market; for example, a debt ratio consistent with the business risk of its own (or a subsidiary's) utility operations.

54. The following is a summary of the law governing investments by municipalities:

- A municipality cannot invest in securities other than those that are prescribed by regulation.[53] Section 2 of O. Reg. 438/97 (as amended to O. Reg. 399/02) prescribes among others, the following securities: "9. Bonds, debentures, promissory notes and other evidences of indebtedness of a corporation incorporated under section 142 of the *Electricity Act, 1998*."[54]

- Subsection 3 (8) of O. Reg. 438/97 precludes a municipality from investing in such debt securities unless, at the time the investment is made, the total amount of the municipality's investment in debt in any section 142 corporation -- holding company, distributor, or otherwise -- after the municipality's proposed investment is made does not exceed the total amount of investment in debt, including accrued

---

[50] 1 Tr. 524.
[51] 5 Tr. 152, 373-376, 554-564.
[52] 5 Tr. 153, 236-248, 372.
[53] See section 418 of the *Municipal Act, 2001*; this statute came into force on January 1, 2003. Section 418 replaces, in effect, a comparable provision (section 167) in the previous statute.
[54] Paragraph 9 of section 2 came into force in September 2002: O. Reg. 265/02, subsection 1(2). A section 142 corporation includes a holding company (if incorporated before May 2, 2003) as well as a distributor. (O. Reg. 438/97 was amended effective January 1, 2003 to substitute references to section 418 of the *Municipal Act, 2001* for references to section 167 of the previous statute: 0. Reg. 399/02. The regulation remains in force even though it was initially made under the previous statute: clause 15(a) of the *Interpretation Act*.)

interest, in such a corporation on the day before the proposed investment is made.[55]

- A municipality's ability to invest in debt securities of any section 142 corporation was frozen, in effect, at the aggregate level that existed in September 2002. A municipality cannot hold its investments in such debt securities, moreover, for longer than 10 years from the date of any such investment.[56]

55. Ms. McShane testified that "a lot of the larger utilities are raising debt in the open market."[57] It is public information that the following borrowers have done so in the amounts indicated:[58]

- Electricity Distributors Finance Corporation: $175 million for Barrie Hydro Distribution Inc. ($25 million), ENWIN Powerlines Ltd. ($50 million), and PowerStream Inc. ($100 million);[59]
- Enersource Corporation: $290 million through Borealis Infrastructure Trust;
- Hamilton Utilities Corporation: $105 million;
- Hydro Ottawa Holding Inc.: $200 million; and
- Toronto Hydro Corporation: $225 million.

## VII. Conclusion

56. The Draft *Handbook* prescribes a rate-making process for electricity distributors. It is important, therefore, to keep the objective of rate regulation in mind:

> The objective is to determine what the total costs that will be incurred to provide the service, and therefore, upon which rates should be derived, that will give the utility an opportunity to

[55] Subsection 3(8) also came into force in September 2002: O. Reg. 265/02, subsection 2(2).
[56] See subsection 3(9) of O. Reg. 439/97. This provision also applies to a refinancing, renewal, or replacement of such an investment. It came into force in September 2002: O. Reg. 265/02, subsection 2(2).
[57] 5 Tr. 372.
[58] See Barry Critchley's column, *Off the Record,* in the February 2, 2005 edition of the *Financial Post.*
[59] PowerStream Inc. is the successor of the following three original participants: Hydro Vaughan Distribution Inc., Markham Hydro Distribution Inc., and Richmond Hill Hydro Inc.

recover those costs and to earn a fair rate of return on the utility equity.[60]

57. The Board should apply CITD's dispositive factors, in the manner described earlier, and by doing so should reach the following conclusions:

- 100% of the tax savings on each "disallowed expense," including the "FMV bump-up," should flow to the distributor and, therefore, to its shareholder(s); and
- a distributor's gains and losses on the sale of utility assets should flow to the distributor and the ratepayer, as the case may be, as now prescribed by the Draft *Handbook.*

ALL OF WHICH IS RESPECTFULLY SUBMITTED on behalf of the Coalition of Issue Three Distributors, by its counsel, this 14th day of February 2005.

(signed) J. H. Farrell
Jerry H. Farrell

(signed) H T. Newland
Helen T. Newland

[60] 5 Tr. 537.