2006 EDR – Taxes/PILs - Section 3.5

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1. Summary of Work to Date

- Development of a more detailed list of sub-issues to be addressed
- Consideration of the Board Staff straw man plus other conceptual frameworks for forecasting and then tracking the Taxes/PILs component of 2006 rates
- Identification of some initial filing requirements, and establishment of a process to develop a better (ie. simpler) Taxes/PILs spreadsheet for calculation and filing purposes
- Reached complete consensus on seven issues, but despite four meetings and a blizzard of emails no consensus emerged on the remaining two issues

2. Questions of Scope

- Will the Board confirm that Local Distribution Companies will be permitted to re-base in 2008?

3. Issues on Which the Group has Reached Proposed Consensus

A. Taxes Payable Method.

Background:

- The group accepted the basic principle that LDCs should not recover from ratepayers for taxes more than they actually have to pay.
- It is recognized that using taxes payable may result in the rate of return as shown on the financial statements may not be consistent with the allowed rate of return for regulatory purposes.

Proposed consensus:
There is a consensus that the tax amount included in rates should be based on taxes payable, rather than taxes calculated for accounting purposes.

Qualifications on consensus:
Taxes payable may result in the rate of return as shown on the financial statements may not be consistent with the allowed rate of return for regulatory purposes. Some group members are investigating whether the timing differences between GAAP and taxes payable can be treated as a regulatory asset or liability for accounting purposes, in order to alleviate that problem. If this cannot be so treated, consensus may not hold.

Crossover

- The consensus on this issue is conditional on satisfactory resolution of a number of other issues. The immediate one identified is the introduction of some form of revenue adjustment mechanism that corrects for any significant revenue erosion arising out of conservation and demand management plans

B. Historical Year vs. Forecast Year.

Background:

- The group determined that, whether the revenue requirement for the test year is projected by taking 2004 and making adjustments, or by a full-fledged forecast of cost of service, the end result is an assumed revenue, expenses and rate base for 2006, and a taxes payable number flows from that by a straightforward calculation.
- The group considered whether to take the actual taxes payable in 2004 and make adjustments to get to a 2006 number. It was determined that the end result would be the same as the forecast method proposed, but the process would be more cumbersome and more complicated.
- The group also considered the “tax wedge” method that has been tried in other jurisdictions, but concluded that it adds nothing material to the simpler approach being proposed here.

Proposed Consensus:
There is a consensus that, however the rate year revenue, expenses, and rate base are determined, those figures should be used to calculate expected taxes payable in the test year.

The group has established a small team, made up of representatives of small, medium and large LDCs, to review the existing tax calculation model, to identify other models used by individual LDCs (there are many), and between those to come up with a simple tax calculation spreadsheet that can be used in the Rate Handbook as the default calculation method. That spreadsheet is expected to be completed in November.

There is a consensus that, because of the tax calculation that is proposed, the question of how to adjust from historical year does not arise.

Qualification on consensus:
The use of forecast year, approached as proposed, is for some group members conditional on satisfactory resolution of the true-up/pass-through issue.

C. Inclusion of Future Changes in Tax Rules or Rates.

Proposed Consensus:
There is a consensus that, if GAAP would require that a proposed but not yet enacted tax change be taken into account for financial statement purposes, it will also be taken into account for regulatory filing purposes. In addition, the Rate Handbook should allow the OEB to direct, in its filing instructions each year, that LDCs assume enactment of specific and quantifiable changes that, while not yet in a budget, have been formally announced and are reasonably certain to

occur.

D. Tax Planning.

Background:

- It is expected that the opportunities to achieve tax planning benefits will be limited.
- The Rate Handbook should include a general statement of the principle of keeping tax costs down, e.g. "All distributors are allowed and expected to take prudent steps to minimize their tax costs with the same diligence as they seek to minimize other expenses."
- The standard filing should not require any formal documentation or certification with respect to tax planning.
- The tax calculation spreadsheet should include, in its footnotes, suggestions flagging common deductions and other tax planning opportunities to assist utilities with limited resources to apply to the tax planning exercise.

Proposed Consensus:
There is a consensus that all LDCs should be allowed and required to make reasonable efforts to keep their tax costs down, in the same way as they are required to keep all other costs down.

E. Information to be Filed.

Proposed Consensus:
There is a consensus that the following minimum information should be filed with respect to Taxes/PILs in the 2006 rate filing:

- The tax calculation spreadsheet with all relevant information contained in it.
- Audited financial statements for the years 2002, 2003, and 2004.
- Taxes actually paid for each of 2002, 2003 and 2004, including a narrative description of any material variances between those years and the rate year forecast.

4. Unresolved Issues

A. **True-Up/Pass-Through Approach.** *"To what extent, if any, should differences between forecast taxes/PILs included in 2006 rates and actual taxes/PILs paid in respect of 2006 be trued-up after the fact, with excess refunded to ratepayers and shortfalls charged to ratepayers?"*

The group identified several possible alternatives on this issue, but others may be considered:

1. ***100% Pass-Through/True-Up.*** This is equivalent to the Board Staff straw man. A variance account would be set up for 2006 taxes/PILs. Any variance between actual taxes and forecast taxes would be credited or debited to this account, and cleared to

ratepayers in the following year. The primary rationale for this is that, in the past several years, actual taxes for many utilities have been materially different from the taxes included in rates. This is similar to the rationale behind the "taxes payable method", an issue that has been resolved. A variance account would ensure that the LDCs collect from ratepayers only the taxes they actually pay.

2. ***100% Asymmetrical Pass-Through/True-Up***. This would use the same mechanism as the first position, but would only true up if taxes are less than forecast, so would only allow for a refund to ratepayers. One rationale for this is that, where a utility's income is higher than forecast, taxes are higher, but the ratepayers have already paid those higher taxes in the rates that generated the extra income. The converse is not true where income and therefore taxes are lower than forecast.

3. ***Partial True-Up for Changes in Tax Rates and Rules.*** This position provides for a similar after-the-fact adjustment to taxes/PILs, but only where actuals and forecast differ due to changes in tax rates or rules. The rationale for this is that it limits true-up to matters clearly beyond the control of the utility.

4. ***No True-Up.*** This follows the model used for natural gas distribution utilities. Taxes/PILs is forecast like any other expense, and that forecast amount is included in rates. Any variance between forecast and actual is enjoyed or borne, as the case may be, by the shareholder. The primary rationale for this is that there is no fair way of truing up taxes if the underlying drivers of the tax variance (e.g. expense or revenue variations) are not also trued-up.

Crossovers. A decision on this issue also affects the level of allowed return. If the risk of taxes/PILs variations is shifted to the ratepayers, the overall utility risk may be reduced, and thus the risk premium may have to be reduced as well.

Proposed Path. It is proposed that this issue be dealt with in a full oral hearing process, because a number of parties may wish to call evidence with respect to this issue.

B. **Taxes/PILs on Disallowed Expenses.** *"If an expense of the utility is not allowed for the purposes of calculating revenue requirement, but is still incurred, thus reducing taxes/PILs payable, how much, if any, the tax savings thus generated should accrue to the benefit of the shareholder and how much, if any, should accrue to the benefit of the ratepayers?"*

The group identified several possible positions on this issue, but others may be considered:

1. ***100% of Tax Savings to Shareholder.*** The rationale for this position is that, if the shareholder has to actually bear the expense, any tax saving based on the expense should follow the expense itself. The shareholder should only have to bear the after-tax net cost of the expense.

2. ***100% of Tax Savings to Ratepayers.*** Unless otherwise adjusted, the full pass-through/true-up option in the previous issue would have the effect of giving 100% of any

tax savings to the ratepayers through the variance account. No proposal has been made to adjust for this in the event that a true-up is used.

3. ***Sharing of Tax Savings between Shareholder and Ratepayers.*** The rationale for this position is that most LDC shareholders are non-taxable entities, so if they had to pay disallowed expenses themselves they would generate no tax savings. It is only the taxable revenue generated by the ratepayers that creates the tax savings. This follows the model of a tax shelter, in which a person with taxable income and a person with unusable deductions combine the two to create a tax saving, then share that saving.

Crossovers. The crossover issue is to review of distribution expenses in Section 3.4. This issue only arises if expenses are disallowed that must reasonably still be paid by the utility.

Decision Path. It is proposed that this issue be dealt with in a full oral hearing process, because a number of parties may wish to call evidence with respect to this issue.

C. Tax calculation on a stand alone basis

Is the stand alone basis of projecting test year taxes (ie. taxes calculated on the assumption that the existence of affiliates of the LDC does not impact taxable income, deductions, credits, or rates of tax) appropriate?

Two options were identified: stand alone and allocation among affiliate companies eg.large corporations tax exemption. If allocation is chosen, how is allocation to be determined? What information, including affiliate information, has to be filed?

D. Definition of Materiality

What is the meaning of “material variances” in filing requirements?

E. Filing requirements

Are the minimum requirements as listed sufficient or should more information be filed?