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.

REPLY SUBMISSION

on behalf of the

COALITION OF ISSUE THREE DISTRIBUTORS

February 28, 2005

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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 filed its initial submission on February 14, 2004. The initial submission was confined to 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 submitted that the Board should apply the following three dispositive factors, in the manner described in CITD's initial submission, 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;"

[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.

- the Ontario government's stated objective to create a level playing field, through payments in lieu of taxes ("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.

4. CITD also submitted that, by applying these dispositive factors, the Board 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*.

5. Only two parties -- London Property Management Association ("LPMA") and School Energy Coalition ("SEC") -- made substantive arguments in their initial submissions that were contrary to the position taken by CITD.

II. Reply to SEC

A. Overview

6. In its Initial Submission, SEC seeks lower rates for its constituents at the expense of the shareholders of electricity distributors in Ontario. SEC would have the Board give tax savings to ratepayers when they do not incur the corresponding costs. SEC wants your RRSP deduction, in other words, without reimbursing you for your investment. The Board should resist SEC's suggestion because to do otherwise would be unfair to utility shareholders and fly in the face of accepted rate-making methodology and long-standing regulatory principles.

7. In order to make its case, SEC ascribes inappropriate behaviour and ulterior motives to municipalities and their distributors. From CITD's perspective, this is the most troubling

and offensive aspect of SEC's Initial Submission. There is not a scintilla of evidence to suggest, as SEC does, that the Board's usual rate-making methodology and regulatory principles would promote the use of a distributor as its shareholder's "captive tax shelter vehicle".[3]

8. In the absence of any evidence to support its allegations of impropriety and its dismissal of regulatory principles, SEC resorts to conjecture, distortion, and error. The following are but a few examples:

- "We estimate that it [i.e. the amount of PILs related to non-recoverable expenses] could be as high as $100 million per annum."[4] There is no evidence to this effect and, in any event, the estimate seems exaggerated. It would result in non-recoverable expenses representing 25% to 33% of SEC's estimate of PILs.

- "Enbridge Inc. engages in complex inter-company tax planning throughout the corporate group, but the gas distributor, Enbridge Gas Distribution, is excluded from these activities."[5] There is no indication that this is the case in the Board's RP-2003-0203 Decision with Reasons (November 1, 2004).

- "[G]iving the shareholders a benefit from causing the utility to spend on non-recoverable items… promotes the use of the utility as the shareholder's captive tax shelter vehicle."[6] This distortion ignores the law in two respects. One is the restriction on a distributor's business activities imposed by section 71 of the *Ontario Energy Board Act, 1998* ("*OEBA*"). The other is the standard of care that is imposed on a distributor's directors and officers by section 134 of the *Business Corporations Act* ("*BCA*"); namely, to "act honestly and in good faith with a view to the best interests of the corporation."

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[3] SEC at para. 167 (p. 35).
[4] SEC at para. 135 (p. 29).
[5] SEC at para. 178 (p. 38).
[6] SEC at para. 167 (p. 35).

- "If the shareholder doesn't get any financial benefit from washing non-recoverable expenditures through the utility, it will be less likely to do so."[7] SEC uses interest deductions as "a particular example of this problem" without regard, as CITD demonstrated in its Initial Submission, to the restrictions imposed by law on municipalities and their distributors.[8] SEC simply ignored the law even though its counsel, Mr. Shepherd, was invited by the Presiding Member (Mr. Kaiser) to address the law "in argument."[9]

- "Dr. Mintz... described what happens when the utility spends $100,000 for political donations... The effect is that the ratepayers pay 35% of the political donation."[10] This is an error, as CITD demonstrated in its Initial Submission,[11] and it is surprising that any tax expert -- whether accepted by the Board (SEC's witness) or self-proclaimed (SEC's counsel) -- would make such an obvious error.

- "[T]he *Income Tax Act* provides that half of that purchased goodwill can be deducted for tax purposes, spread equally over the next seven years, as 'eligible capital expenditures', or ECE."[12] This is another error by SEC's tax expert(s). Subsection 14(5) of the *Income Tax Act* (Canada) allows a taxable distributor to include 75% of an ECE in its Cumulative Eligible Capital ("CEC"); paragraph 20(1)(b) then allows the taxable distributor to deduct, when computing taxable income, an amount equal to 7% of its year-end CEC balance. The effect of these provisions, then, is that 75% of an ECE is deductible for tax purposes on a 7% declining balance basis.

B. SEC's Critique of CITD

9. Ms. McShane introduced Exhibit D.5.1 during her direct testimony. This exhibit demonstrates two indisputable facts:

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[7] SEC at para. 170.
[8] CITD at para 54 (pp. 17-18).
[9] 5 Tr. 245-246. Mr. Shepherd was even given the references; see 5 Tr. 247-248.
[10] SEC at para. 139 (p. 30).
[11] CITD at para. 51 (p. 16).
[12] SEC at para. 201 (p. 42).

- Expenses that are incurred by a distributor (the "box") for its utility operations (the "circle"), but that are nevertheless not recovered its utility rates, are paid out of the distributor's utility return on equity. In the result, the distributor earns less than the fair return that has been approved by the Board, and that the distributor is entitled by law to earn, for its utility operations.

- The consequence of giving, to the ratepayers, any of the tax savings associated with costs that are not recovered in rates is that the distributor's utility return is further eroded.

10. SEC attempts to refute Exhibit D.5.1 by modifying it to add two columns that are designed to "show the results of the tax amount on line 30 is not a pretend amount, but the actual amount of tax paid by the distributor."[13] SEC states that "if ratepayers only pay the actual tax cost... Ms. McShane's approach would result in the utilities earning substantially above their allowed ROE, while Dr. Mintz's approach would leave them bang on the approved ROE."[14]

11. During cross-examination, counsel for SEC attempted to have Ms. McShane accept this "amendment" of Exhibit D.5.1. Ms. McShane refused to do for the reasons set out at 5 Tr. 510-550. Her reasons are summarized at 5 Tr. 538-539:

MR. SHEPHERD: Okay. So let's figure out what that return is, because you've got $49 left, but you're only paying $5.28 in PILs, so doesn't that mean that you have $43.72 left after you've paid your taxes?

MS. McSHANE: No, I'm sorry, I disagree with the basic premise of your example that, as long as we're dealing with utility expenses, utility depreciation expense, the utility-allowed interest expense, then you have to deal with the utility stand-alone income tax. If you're going to start mixing the corporate income tax, then your whole stand-alone principle is effectively blown and you have to go and look at the corporate interest expense and all of the corporate expenses. You can't have it both ways.

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[13] SEC at para. 184 (p. 39).
[14] *Id.*

12. Appendix A on its own, moreover, is seriously flawed. The Mintz 2 column erroneously calculates the utility ROE using the income tax that would result from claiming, for the "circle," the tax deductions available to the "box" without deducting the corresponding non-recoverable expenses from the utility revenues. If this column were corrected to include the non-recoverable expenses, which correspond to the $5.28 actual tax payable by the "box," the result would be as follows:

MINTZ 2 (corrected)

24	Revenues	$215.78
25	Allowed Expenses	($135.00)
26	Allowed Interest Expense	($ 42.25)
27	Pre-Tax Utility Return before Non-Recoverable Expense	$ 38.53
27.5	Non-Recoverable Expenses	
	Disallowed OM&A	($ 4.00)
	Additional Depreciation	($ 10.00)
	Additional Interest Expense	($ 8.45)
	Total Non-Recoverable Expense	($ 22.45)
	Pre-Tax Utility Return on Equity	$ 16.08
28	Adjustment for Timing Differences	($ 1.00)
29	Pre-Tax Utility Return on Equity (i.e., taxable income)	$ 15.08
30	Income Tax (29@35%)	$ 5.28
31	Equity Return (27.5 - 30)	$ 10.80
32	ROE (on $350 deemed equity)	3.1%

In fact, since the Mintz 2 income tax allowance is based on the corporate expenses of the "box," the ROE should also be calculated on the equity of the "box;" that is, from Exhibit D.5.1, $420 million instead of the $350 million for the "circle." The corresponding ROE is 2.6% ($10.80 ÷ $420).

13. CITD's Initial Submission otherwise stands as a complete reply to the balance of SEC's critique of CITD. Nothing further is required in this regard.

C. SEC's "Five Reasons"

14. In its Initial Submission, SEC sets out five reasons why 100% of the tax savings on "disallowed expenses should be allocated to ratepayers (i.e., Alternative 2).[15] Each of these reasons ignores the conclusions inherent in Exhibit D.5.1.

15. SEC's first reason is that ratepayers would be subsidizing a distributor's "unregulated activities" if tax deductions were not given to ratepayers.[16] SEC is wrong on two counts. Firstly, just because costs are not allowed for rate-making purposes does not mean that such costs were incurred in respect of "unregulated activities." To the contrary, a distributor is prohibited from carrying on "any business activity other than... distributing electricity" with limited exceptions.[17] Put another way, all of the distributor's activities are "regulated activities" unless otherwise permitted by law. Not all of the costs associated with such activities, however, are allowed in rates. Secondly, expenses that are not permitted to be recovered in utility rates, but that are nevertheless incurred to provide utility service, must come out of the distributor's return on equity and thus the shareholder's pocket. In these circumstances, a distributor and its shareholder(s) will end up subsidizing its ratepayers. To then require the distributor to turn over its tax deductions to its ratepayers is to add insult to injury.

16. SEC's second reason for advocating Alternative 2 is that if "all deductions" are not taken in calculating the tax allowance for rate-making purposes, a distributor's utility tax expense will be overstated and the distributor will over-recover the cost of its utility operations.[18] Indeed, this appears to be at the very heart of SEC's entire position on Issue #3: that, somehow, distributors would get more money in their rates for utility service than they would spend on their utility operations. This is simply untrue. A distributor's revenue requirement for its utility operations, including its allowance for taxes, is based

[15] SEC at para. 138 (pp. 29-30).
[16] SEC at paras. 139-145 (pp. 30-32).
[17] *OEBA*, subsection 71(1). The limited exceptions are set out in subsections 70(9) and 71(2). Section 73 is a further restriction on affiliates of municipally-owned distributors.
[18] SEC at paras. 146-152 (pp. 32-33).

on costs that are allowed for rate-making purposes. Other costs may nevertheless be incurred in providing utility service but, by definition, these costs are not included in the revenue requirement. In the result, the "circle's" tax allowance -- the amount in the revenue requirement -- is an accurate reflection of the "circle's" tax liability.

17. SEC claims that CITD would use the stand-alone principle as a means of having a distributor's regulated activity -- its utility operations -- cross-subsidize its unregulated activity. SEC uses the example of a profitable regulated activity and an unprofitable unregulated activity.[19] SEC again fails to understand the purpose of the stand-alone principle in the rate-making process:

> Taxes are a cost of providing the distribution service. This is the reason why they are recoverable from ratepayers. With all other costs, the amount recovered from ratepayers is the actual amount expected to be paid. The question is fairly raised: Why should taxes be any different?[20]

18. The initial two sentences are correct, as far as they go, because the tax allowance in a distributor's utility revenue requirement is a cost of providing utility service.[21] The third sentence would also be correct if, and only if, SEC were to confine "actual amount" to the "cost of providing service;" that is, the cost that is recovered in rates. SEC does not, of course, because SEC misses the whole point. The "actual amount expected to be paid" is not necessarily the amount that a distributor would recover in its rates for providing utility service. A distributor may incur additional costs that the Board disallows for lack of evidentiary support, for example, and so these too are "amounts expected to be paid" by the distributor to provide utility service. The source of the funds, in this case, is the distributor's return on equity. The consequential tax savings accordingly belong to the distributor and its shareholder(s).

19. There is no cross-subsidization, moreover, when the stand-alone tax allowance for a distributor's utility operations (the "circle") exceeds the distributor's taxes payable (the "box"). This proposition is best illustrated by a decision of the National Energy Board ("NEB") involving TransCanada PipeLines Limited ("TransCanada") in 1981.

[19] SEC at paras. 141-146 (pp. 31-32).
[20] SEC at para. 146 (p. 32).
[21] It is the cost, in effect, of providing the distributor with an opportunity to earn the after-tax return on equity that the Board has allowed on its utility operations.

TransCanada's tax deductible expenses from its non-utility activities were used to offset revenue from its utility operations in computing its income taxes payable as a corporation. The application of such expenses to utility revenues reduced the taxes actually paid by TransCanada as a corporation below that level collected from ratepayers on a stand-alone basis. The NEB nevertheless allowed TransCanada to recover, in rates, the stand-alone level of income taxes because it was "the equitable resolution of this issue."[22]

20. SEC's third reason is that tax savings would be passed on to customers in the form of lower prices, in an unregulated competitive market, rather than to shareholders or employees.[23] The Board should follow the competitive market, where "tax costs cannot be paid to or deducted from the return to the shareholders,"[24] and so tax costs would be for the account of the customers. SEC misses the point, again, for two reasons. One is that the shareholder "takes the hit" when the distributor incurs costs to provide utility service but, nevertheless, cannot recover those costs in its rates for utility service. This situation would be exacerbated if the distributor's shareholder(s) cannot keep the consequential tax savings.

21. The other reason is that SEC is naïve in saying "[r]egulation of monopoly prices is intended to be a proxy for competition."[25] Consider the following in this regard:

- Regulation has an inherent limitation. No regulator can acquire or utilize effectively, for example, the range of data that may influence a competitive market.[26] SEC fails to recognize this obvious fact.
- Regulatory policies are shaped by various economic, social, and political pressures such that, on occasion, regulation may seek other than competitive objectives. "But even when economic objectives are sought, it is not easy to specify with any precision that competitive standard which regulation should

[22] RH-4-81 Reasons for Decision (August 1981) at p. 5-12.
[23] SEC at paras. 153-162 (pp. 33-34).
[24] SEC at para. 155 (p. 33).
[25] SEC at para. 152 (p. 33).
[26] C.F. Phillips III, *The Regulation of Public Utilities*, Third Edition (Arlington, VA: Public Utilities Reports, 1993) at p. 174.

seek, for competition through-out the economy is imperfect (i.e., it is not the perfect form of competition envisioned by Adam Smith)."[27] Dr. Mintz, on the other hand, seems to have the same vision today as Adam Smith had in 1776 when he published *Wealth of Nations*.

- "[T]he regulatory process is inherently slower than the competitive process and, equally important, creates vested interests itself."[28] The Board's practice and procedure, which reflect its duty of procedural fairness, cannot match the pace of competition. SEC would presumably be loath to trade fairness for pace.

- "It is difficult to adapt regulatory laws and concepts to meet changing economic conditions."[29] This is not only a criticism, but also a fact, of economic regulation. SEC apparently overlooks it.

22. SEC's fourth reason for advocating Alternative 2 is the "special nature of PILs;" if a portion of a distributor's tax allowance for its utility operations is not paid as PILs, but is instead used to "subsidize unregulated activities," then its ratepayers will have to pay the difference again in Debt Retirement Charges.[30] There are a number of fallacies in this reasoning. One is SEC's underlying premise that the difference between a distributor's utility tax allowance and its PILs payment will "subsidize unregulated activities." As noted earlier, the distributor can incur expenses that are not recovered in rates but that are, nevertheless, incurred to provide utility service. These expenses are accordingly in the "box," rather than in the "circle," but not because they pertain to "unregulated activities." A distributor cannot, by definition, engage in unregulated activities except as permitted by law.

23. The second fallacy is that there is a disconnect between the amount that ratepayers will have paid toward the stranded debt and the debt reduction that is realized. SEC argues, by analogy, that allocating tax savings to shareholders is akin to asking ratepayers to

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[27] *Id.* at p. 174.
[28] *Id.* at p. 175.
[29] *Id.* at p. 175.
[30] SEC at paras. 163-164 (p. 35).

repay a loan, with interest, that they had never actually received.[31] This is a faulty analogy because its underlying premise is incorrect. The regulatory purpose of the tax allowance is not to pay down the stranded debt; rather, the regulatory purpose is to compensate the distributor for the tax cost of its utility operations (i.e., the "circle"). This tax allowance is not synonymous with the Debt Retirement Charge. How the Province of Ontario decides to "spend" its tax revenue is not a relevant criterion for the Board when exercising its rate-making jurisdiction. What is relevant is the proper application of rate-making methodologies and regulatory principles.

24. SEC's fifth and final reason for advocating Alternative 2 is that the Board should not allow shareholders to use regulated utilities as a tax shelter; to do so, it argues, is to encourage negative behaviour such as "spending utility funds on shareholder priorities in order to save tax and selecting financially risky capital structures in order to save tax".[32] The notion that municipalities would compel their distributors to spend money that they could not recover, or that they would invest in "risky capital structures" simply to save tax, is both absurd and untenable.

25. The notion is absurd because it assumes that municipalities are irresponsible and irrational investors. It also assumes that the directors and officers of the distributor would ignore the standards of care that govern their conduct.[33] There is absolutely no evidence to support these assumptions.

26. The notion is untenable because, as CITD explained in its Initial Submission,[34] the law that governs investments by municipalities prohibits municipalities from being "encouraged to impose capital structures and terms on their local distributors that are not in the public interest."[35] It is accordingly not credible to claim, as SEC does, that Alternative 2 is needed "to take away the financial incentive causing that behaviour."[36] The law itself serves this purpose.

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[31] SEC at para. 165-166 (p. 35).
[32] SEC at paras. 138(e), 167-171 (pp. 30, 35-36).
[33] See section 134 of the *BCA*.
[34] CITD at para 54 (pp. 17-18).
[35] SEC at para. 171 (p. 36).
[36] *Id.*

III. Reply to LPMA

27. LPMA supports the same regulatory principles and government objective that CITD advocates.[37] LPMA nevertheless abandons them, while at the same time purporting to apply them, simply because "the PILs regime in Ontario is unique."[38]

28. CITD's reply to SEC's fourth reason is, therefore, its reply to LPMA on this point. LPMA's reasoning is no different, in essence, than SEC's reasoning in this regard.

IV. Conclusion

29. CITD's position on Issue #3 is the one the Board should adopt. CITD's position is based on three principles and one objective that complement the Board's rate-making jurisdiction. Neither SEC nor LPMA can credibly make this claim.

30. The Board should accordingly 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 28th day of February 2005.

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

(signed) H T. Newland
Helen T. Newland

[37] LPMA at p. 22.
[38] LPMA at p. 23.