RESPONSE TO UNDERTAKING E.5.1
Tax Question from the Chair for Ms. McShane (see 5 Tr. 733-737)

Preamble

The Chair (Mr. Kaiser) and Ms. McShane discussed the effect of a political donation on a distributor's PILs payable, compared to the PILS allowance in its utility revenue requirement, and on a distributor's rate of return on January 24, 2005 (5 Tr. 713-720). A political donation is a non-recoverable expense for rate-making purposes but it is, nevertheless, a deductible expense (or the equivalent) for PILs purposes albeit only to a limited extent.

The Chair has become aware of the complications arising from the use of a political donation, which has limited deductibility, compared to another type of expense that is also non-recoverable in a distributor's utility rates but fully deductible when calculating the distributor's PILS payable (5 Tr. 721-726). Mr. Farrell requested that Ms. McShane "answer the question by way of giving an undertaking now," the Chair agreed, and Mr. Farrell suggested consultation with Board staff to ensure that Undertaking E.5.1 poses "the question that the Chair wants to have answered" (5 Tr. 727-735).

The Chair's two-part question below, including the assumption, was provided by Board Staff on January 31, 2005 and was modified slightly on February 1, 2005. The question reflects Board Staff's understanding that the Chair is seeking clarification, by means of a numerical example, of the underlying principles used by Ms. McShane. The example in the assumption is accordingly approximate, rather than precise, in terms of the effect of a non-recoverable but deductible expense of PILS payable and rate of return.

The Chair's Question

Assume that the utility has a return on equity of $500 million and has a PILs payment of $125 million. The utility reduces the PILs payment to $100 million by making a non-recoverable expenditure of $60 million. In that case, the PILs expense of that utility has been reduced by $25 million but the return on equity has been reduced by $35 million so that is now $465 million instead of $500 million.

- Is it not the case that the cost of the PILs expense reduction is entirely borne by the shareholder?
- Is it not the case that the rate of return has declined?

Ms. McShane's Response

The cost of PILs expense reduction is entirely borne by the distributor, and therefore by the shareholder, and so its rate of return has declined. Ms. McShane's references in this response to "the distributor" are references to the corporate entity (i.e., the "box"); her references to "the utility" are references to the distributor's stand-alone utility operations (i.e., the "circle" in the box).

Exhibit D.5.1 can be used to illustrate the impact on the distributor's equity return/return on equity (ROE) when (a) an expense is included in the calculation of the distributor's utility PILs allowance, even though it is a non-recoverable cost for the distributor's utility operations, because it is a cost to the distributor; and (b) the expense is otherwise excluded from the calculation of the distributor's utility revenue requirement because it is a non-recoverable expense. The corporate entity is identical to the utility in Exhibit D.5.1, in this illustration, except for a non-recoverable expense of $5.00 that is fully deductible.

The "McShane" utility values in Exhibit D.5.1 at page 6 (i.e., the "McShane column) can be compared to the corporate entity's values, for this purpose, by inserting a non-recoverable but deductible expense at line 26.5 in the following table:

Line		Utility	Corporate Entity
24.	Revenue	$ 226.25	$ 226.25
25.	Allowed Expenses	($135.00)	($135.00)
26.	Allowed Interest Expense	($ 42.25)	($ 42.25)
26.5	Non-Recoverable/Deductible Expense	$ 0.00	($ 5.00)
27.	Pre-tax Return on Equity	$ 49.00	$ 44.00
28	Adjustment for Timing Differences	($ 4.00)	($ 4.00)
29.	Pre-Tax Return on Equity	$ 45.00	$ 40.00
30.	PILS Allowance/Payment	($ 15.75)	($ 14.00)
31.	Equity Return (27-30)	$ 33.25	$ 30.00
32.	ROE (on $350 deemed/actual equity)	9.5%	8.6%

The government shares in the cost of the non-recoverable/deductible expense, in effect, and so the corporate entity's PILs payment is $1.75 (i.e., $5.00 x 0.35) less than the utility's PILs allowance at line 30. The net cost of the non-recoverable/deductible expense to the corporate entity is accordingly $3.25 (i.e., $5.00 x 0.65), rather than $5.00, and so the corporate entity's equity return is $3.25 less than the utility's equity return at line 31. The corporate entity's ROE, then, is 0.9% or 90 basis points less than the utility's ROE at line 32. There is a net cost of $3.25 to the distributor (and therefore to the shareholder), but no cost to the ratepayer, even though the amount of the non-recoverable expenses is fully deductible for PILs purposes. The distributor has chosen, in effect, to use a portion of the equity return allowed by the OEB to fund the non-recoverable/deductible expenses on an "after-PILs" basis.