ONTARIO ENERGY BOARD

Ontario

Staff Discussion Paper

Account 1562 - Deferred Payments in Lieu of Taxes

Methodology and Disposition of Balances for Electricity Distribution Companies affected by section 93 of the *Electricity Act, 1998*

EB-2007-0820

August 20, 2008

1. INTRODUCTION

On March 3, 2008, the Ontario Energy Board (the "Board") issued a letter to all Licenced Electricity Distributors and all intervenors in the 2008 Distribution Rate Proceedings announcing that it intended to initiate a combined proceeding to determine the methodology to be used for the calculation and disposition of balances in account 1562 – Deferred PILs. The Board assigned file number EB-2007-0820 to the PILs Combined Proceeding. The combined proceeding will determine accurate balances in account 1562 for the seven cost of service Applicants that have requested disposition of account 1562 in their 2008 rate applications and provide guidance for the remaining distributors for use in their subsequent applications. The Board intends to initiate the EB-2007-0820 proceeding in the fall of 2008.

The purpose of this paper is to assist the parties in the combined proceeding in resolving outstanding issues in respect to the disposition of balances in account 1562.

The PILs matters before the Board are similar among the seven Applicants. These distributors have used a variety of interpretations and methods that impact the balances in account 1562 in each of the years 2001 to 2006 and may impact the balances of the other PILs related account, 1592 - PILs and Tax Variances for 2006 and Subsequent Years.

1.1 The EB-2007-0820 Process

In each year since 2001, distributors have been filing the Spreadsheet Implementation Model for Payments in Lieu of Taxes ("SIMPIL") as part of their Reporting and Record Keeping Requirements ("RRR").

The balances reported by distributors in their RRR filings for account 1562 under element 2.1.7 (Trial Balance) as at December 31, 2006 are expected to agree with the balance reported in the final PILs filing due August 11, 2006.

The methodology used in the SIMPIL model is underpinned by certain principles. The principles and methodology have not been reviewed by the Board in a proceeding. In order to determine the final balances in account 1562, the Board must approve a final methodology. The approved methodology will form the basis for a final model to be drafted by Board staff, reflecting the Board's findings. This final model would include information for the entire October 1, 2001 to April 30, 2006 period.

Applicants could then use this model or their own to file an application for the Board's review and approval, including the disposition of the final balances in account 1562.

As stated in the March 3, 2008 letter, it is the Board's expectation that the combined proceeding decision (EB-2007-0820) will be used to determine the accuracy of the final balances in account 1562 for the remaining distributors. After the remaining distributors use the final model to file their account 1562 balances, the Board will review and dispose of their account 1562 balances.

The last PILs filings required were for the 2005 tax year. Parties can access the 2005 tax year SIMPIL model that distributors were to have filed in the summer of 2006, from the Board's website. The link to the website can be found at Appendix C, tab 6. The 2005 tax year SIMPIL model contains the principles and methodologies for each year for which a PILs filing was required.

1.2 <u>Organization of this Paper</u>

This discussion paper sets out the key features of:

- Account 1562 – Deferred PILs,
- The process of adding PILs to distribution rates, and
- The SIMPIL model.

This paper is organized into six parts. Following the introduction, sections 2 and 3 provide an overview of the history and workings of account 1562. Section 4 provides an overview of the process of adding PILs to distribution rates in the 2001 to 2005 period. Section 5 provides a brief overview of the current practice which became effective May 1, 2006.

The final section of this paper is comprised of three appendices:

Appendix A discusses how variances are tracked in account 1562 through the workings of the SIMPIL model and provides an overview of the established principles underpinning the current methodology.

Appendix B provides a list of items that this paper has identified as requiring resolution as part of this proceeding. This list is not presented as a definitive list of issues, but represents a draft list of items that Board staff believes require clarification.

Appendix C identifies the relevant Board documents related to account 1562, the SIMPIL model and the documents made available to guide distributors in their annual rate applications since 2001.

2. THE NEED FOR A PROCEEDING PRIOR TO DISPOSITION OF ACCOUNT 1562

The determination of PILs deferred expense amounts entered in account 1562 has followed a specific process over the last several years. There is an initial determination of an expense amount that is to be reflected in distribution rates. The amount collected varies depending on the number of customers and their consumption. The amount of PILs expense paid also varies based on revenues, costs and income. The total difference between the expected amount included in rates and the amount collected has been tracked in a deferral account. If this amount were to be disposed of in rates, it would be considered a flow through expense i.e. the actual amount is reconciled with the forecast amount. For the PILs expense, only a portion of the difference between the amount reflected in rates and that actually paid is tracked in a deferral account. There are specific factors used in the calculation of the actual PILs expense paid that are reconciled with the original forecast, but not all the factors are used in the reconciliation. There is a need to clarify how the differences should be determined and what, if any, disposition is to be made of those accounts.

Over the years, Board staff provided guidance on the recording and tracking of amounts in account 1562, how to determine the PILs expense for incorporating PILs in rates, and on how to complete the SIMPIL model. This guidance has taken the form of the Accounting Procedures Handbook (“APH”), responses to Frequently Asked Questions (“FAQs”) and various letters, spreadsheets, instructions and application filing guidelines issued by Board staff. To date, the Board has not provided any ruling on the disposition of account 1562. Therefore the guidance provided by Board staff has not been subject to a proceeding in which parties who object to, or wish to modify, the current process can have their views heard by the Board.

A review of account 1562 filings indicates that not all distributors have followed the instructions regarding the use of account 1562 and the SIMPIL model resulting in some inconsistency in the manner in which amounts have been recorded.

On July 12, 2005, as part of the 2006 EDR process, Board staff issued Filing Guidelines for applications for final recovery of regulatory assets. Those guidelines stated,

> "[D]ue to utility specific variability in the calculation of PILs and the fact that stakeholders did not have an opportunity to comment on the quantum and appropriate allocation methodology of the PILs amounts in the Phase 2 oral hearing proceeding, the Board will not be considering amounts in the PILs variance accounts for final disposition at this time. In the meantime, the Board has continued to allow for recovery of PILs during the first two interim recovery periods. The Board intends to address this issue at a later time through consultations with industry stakeholders."

In the current 2008 EDR proceedings, seven Applicants asked the Board to dispose of the balance in account 1562. A number of issues require resolution for this to occur. The issues are similar among the Applicants and include:

(1) Clarification of the proper treatment of account 1562 and any related issues with account 1563 – Contra Deferred PILs,
(2) Clarification of certain variances arising due to the manner in which PILs were incorporated into rates during the 2001 to 2006 period,
(3) Clarification as to when amended or reassessed tax returns can be incorporated to modify account entries.

Appendices have been added to this paper to provide background and detail on account 1562 from 2001 to 2006. As noted above, Appendix A discusses how variances are tracked in account 1562 through the workings of the SIMPIL model and provides an overview of the established principles underpinning the current

methodology. Appendix A describes aspects of the current SIMPIL model for which Board staff believes consensus exists, including those items for which some distributors have misinterpreted the Board's guidance.
Appendix B provides a list of items that this paper has identified as requiring resolution as part of this proceeding. This is not a definitive list of issues, but is a draft list of items that Board staff believes require clarification. Appendix B is also divided into two parts. Part I lists items where guidance was provided but where final resolution is still required arising from how the annual PILs expense was incorporated into rates. Part II lists items which are of a global nature, but relate to certain aspects of the SIMPIL model for which no guidance was provided.

3. ACCOUNT 1562 – DEFERRED PILS

Distributors became subject to PILs effective October 1, 2001 with the proclamation of section 93 of the *Electricity Act, 1998*. As of this date, payments were required to be made to the Ontario government.[1]

On August 24, 2001, the Board informed distributors by letter that a new deferral account would be established to implement the Board's approach to the recovery of PILs[2]. Following consultations which included Board staff, the Electricity Distributors Association and some member distributors in late 2001, the Board established this deferral account and later identified it as account 1562, Deferred PILs[3].

3.1 Entries to Account 1562

Entries to Account 1562 are designed to track and record:

- The variances resulting from the difference between the Board approved PILs amount and the amount of actual billings that relate to the recovery of PILs.

[1] Does not include payments in lieu of property taxes covered under other legislation.
[2] Appendix C, tab 2 – *with reference to* Board Letter to distributors dated August 24, 2001 regarding Impact of Proposed Proxy Taxes in Rates
[3] Appendix C, tab 2 – *with reference to* Accounting Procedures Handbook, Effective January 2000, Revised December 2001

- Variances between the PILS tax estimate and the actual tax liability caused by changes to tax legislation.
- The difference between certain items reported by the utility in the SIMPIL model and amounts reported for tax purposes (called "True-up Items").
- An allowance for deemed interest.

Refer to the April 2003 FAQs which can be found at Appendix C, tab 4, for specific details.

3.2 <u>Tax Reassessment</u>

In its 2006 EDR Handbook, the Board stated that it would allow account 1562 to stay open until the last year under which balances may accrue (2006) is no longer subject to tax reassessment. This matter is set out as item 1 of Part II in Appendix B. Reference to the 2006 EDR Handbook and Report of the Board can be found at Appendix C, tab 7.

3.3 <u>Account 1563 – Contra Deferred PILs</u>

In April 2003, in addition to identifying the specific account entries, FAQ#2 directed distributors to use one of three accounting methods for recording these entries in account 1562[4]. Once a method was chosen, a distributor was required to use this method in all subsequent years.

Method No.1 and Method No. 2 are similar, differing only in which income statement account the recovery of PILs approved by the Board would be recorded. Method No.3 requires the establishment of PILs Contra account 1563, to record the off-setting entries of PILs approved by the Board and posted to account 1562 (thereby not affecting the income statement). Under any of the three alternatives, the balance in account 1562 should be identical.

Account 1563 has been the source of some confusion. In certain rate applications filed with the Board, distributors have applied to dispose of the balance in this account. However, the balance in account 1562 establishes the obligation to, or the receivable from, the distributors' ratepayers. The purpose of account 1563 is to record the offsetting entries to those posted in account 1562.

[4] Appendix C, tab 4 - *with reference to* FAQ #2, April 2003

As such, account 1563 is merely a tracking account and applicable only when Method No. 3 is chosen. Amounts in account 1563 cannot be recovered in rates. This matter is identified in Part II in Appendix A.

4. HISTORY OF INCORPORATING PILS IN RATES (2001-2005)

A number of issues have arisen due to the specific circumstances of PILs incorporation into rates over the period 2001 to 2006. These are identified below and summarized in Part I of Appendix B.

4.1 2001 Rate Adjustment

Prior to 2001, distributor's distribution rates were bundled with the cost of power. In an effort to assist distributors in filing their unbundling rate applications, the Board provided distributors with the Rate Unbundling and Design ("RUD") model. Most distributors filed applications, including the RUD model, to unbundle rates in 2000 and 2001 for implementation in 2001. The RUD model also adjusted the newly unbundled distribution rates for the first instalment of the Market Adjusted Revenue Requirement ("MARR"). The rates approved in 2001 did not include a provision for PILs since legislation had not yet been enacted to require distributors to pay PILs.

The Board's communication with respect to PILs in these rate years is set out in Appendix C, tab 2.

4.2 2002 Rate Adjustment

Distributors became subject to PILs effective October 1, 2001 and accordingly, the 2002 rate adjustment included a provision for PILs. As noted above, rate application filing instructions for the 2002 rate adjustment were issued to distributors in December 2001 (amended on January 18, 2002). These instructions described the PILs calculation methodology and the methodology to be used to include the PILs expense in rates. The rates were effective March 1, 2002 for most distributors.

Board staff provided a model (the 2002 SIMPIL model) that calculated the PILs amounts that each distributor was entitled to recover in rates. The methodology underlying the 2002 SIMPIL model was used to develop all future models used to set PILs expenses in subsequent years. This model was superseded by the PILs/SIMPIL model for the March 1, 2002 rate adjustment mechanism.

The 2002 SIMPIL model calculated two amounts for PILs:

- the PILs expense for 2001, prorated for the final three months of the year given that distributors became subject to PILs on October 1st; and,
- the PILs expense for 2002.

Distributors incorporated these two PILs expenses into the main Rate Adjustment Model ("RAM") which generated the final distribution rates.

Board staff issued accounting instructions based on the assumption that the 2002 rates would be implemented for a full year[5]. For distributors that had an effective rate change date later than March 1, 2002 but that followed the instructions, an under-collection may have been created. The issue of whether distributors in this position should have prorated their 2002 PILs amount based on the effective date of the rate adjustment is set out in Item 1 of Part I in Appendix B.

The Board's communication regarding PILs in this rate year is set out in Appendix C, tab 3.

4.3 <u>2003 Rate Adjustment</u>

In November 2002, the *Electricity Pricing, Conservation and Supply Act* ("Bill 210") was passed. The Board's authority to change electricity rates was restricted by section 79 of the Act. Consequently, no rate adjustment was implemented in 2003.

The 3 month 2001 PILs expense, initially designed to remain in rates for one year (2002) only, remained in rates until March 2004.

[5] Appendix C, tab 2 - *with reference to* FAQ #15 - December 2001 and APH, Article 220, Account 1562

This meant that this expense was collected, not only for the 2002 rate year as intended, but also for 2003 and part of 2004, resulting in an over-collection of PILs. The question arises as to whether this should be treated as an "over collection" of PILs to be reflected in the final balance in account 1562. This issue is set out as Item 2 of Part I in Appendix B.

The 2002 PILs expense also remained in rates for 2003. However, since the 2002 expense was a twelve month expense consistent with annual income, no significant over or under collection was likely for this amount.

4.4 2004 Rate Adjustment

Notwithstanding the Bill 210 rate freeze, for the 2004 rate year the Minister of Energy permitted distribution rates to be adjusted for recovery of the first instalment of regulatory assets.

In order to mitigate the rate impact of permitting partial recovery of regulatory assets, the Minister requested that the Board identify opportunities for any reduction to distribution rates and charges which could be implemented coincident with the recovery of regulatory assets. Consequently, the 2001 PILs expense was removed from rates for purposes of calculating the 2004 rate adjustment. This rate adjustment was implemented in March 2004.

A new PILs expense for 2004 was not calculated and therefore the 2002 annual PILs expense remained in rates for the 2004 rate year.

The tax treatment of regulatory assets has varied among distributors. In its May 11, 2005 Report on the 2006 EDR process, the Board established a policy on the tax treatment of regulatory assets. In Chapter 7, on page 61, the Board stated, "A PILs or tax provision is not needed for the recovery of deferred regulatory asset costs, because the distributors have deducted, or will deduct, these costs in calculating taxable income in their tax returns." The Board repeated this position in several recent decisions.

Some distributors have adjusted their SIMPIL model filings over the years to reflect variances relating to regulatory assets even though they were not permitted a regulatory tax provision on regulatory assets. This issue has not been addressed by the Board because account 1562 has not been approved for disposition. This issue is set out in more detail at Item 3 of Part I in Appendix B.

In addition, recovery of regulatory assets and the variances this causes in the PILs expenses are not posted to account 1562 after April 30, 2006 and beyond since filings for tax years after 2005 are not required. (see section 5.0 below)

This raises another issue pertaining to regulatory assets. The time period for recovery is 2004 to 2008 while the time period of the SIMPIL model calculation ends at April 30, 2006. This timing miss-match may result in tax expenses in 2006, 2007, and 2008, which are not trued-up through the SIMPIL model. As noted above, this matter is further explained as Item 3 of Part I in Appendix B.

The reference to the Board's communication regarding PILs in this rate year is set out in Appendix C, tab 5.

4.5 2005 Rate Adjustment

On January 1, 2005 most of the Bill 210 provisions restricting the Board's authority in electricity rate-making were repealed. On December 20, 2004 the Board issued rate application filing instructions to adjust rates, effective April 1, 2005. For most distributors, rates were adjusted for three items:

1. Final instalment of MARR;
2. Second instalment of regulatory asset recovery; and,
3. 2005 PILs expense.

The 2004 PILs expense was replaced with a 2005 PILs expense. Reference to the Board's communication regarding PILs in these rate years is set out in Appendix C, tab 6.

5. THE PERIOD MAY 1, 2006 TO PRESENT

After consultation with stakeholders in 2004 and 2005, the Board established a new framework for adjusting electricity rates in 2006. This process (2006 EDR) called for applications to adjust rates effective May 1, 2006. PILs were calculated and incorporated into rates in a similar manner as in previous years.

The 2005 PILs expense was replaced with an updated 2006 expense using the PILs model.

However, the Board changed its treatment of the tax expense variances as it embraced a more conventional concept, i.e., a forecast amount with very limited true-up. Only differences resulting from legislative or regulatory changes to tax rates or tax rules are allowed as a true-up entry. Account 1592 - PILs and Tax Variances for 2006 and Subsequent Years was established, replacing account 1562 from May 1, 2006 onward. Also, as noted in a December 2005 FAQ, account 1592 also captures any differences arising from changes to a distributor's opening 2006 tax account balances resulting from prior period assessments or reassessments[6].

The three 1562 PILs accounting methods (see section 3.3 above) ceased to be a requirement effective May 1, 2006. Account 1562 is only used for recording interest on the remaining 1562 principal balance and recording the impact of tax authority reassessments for 2001 to 2005 depending on the nature of the tax issues.

The treatment of the PILs variances for the period January 1, 2006 to April 30, 2006 is still unclear. Distributors have tax returns for 2005 but not for the affected period in 2006. This matter is further explained as Item 5 of Part I in Appendix B.

The Board's communication regarding PILs in the 2006 rate year is set out in Appendix C, tab 7.

[6] Appendix C, tab 6 – *with reference to* FAQ #19, December 2005

APPENDIX A

Appendix A provides the background on the current SIMPIL model and identifies the specific principles that underpin that methodology. Board staff believes that these items are not contentious issues, but rather are items for which general consensus exists among distributors and stakeholders.

THE SIMPIL MODEL

In 2001, Board staff developed the SIMPIL model which was to be filed annually by distributors with their rate applications. The SIMPIL model allowed for a reconciliation to be made between certain components of the PILs methodology and the T2 federal tax return and the CT23 Ontario tax return. As noted above in section 4, the SIMPIL model is used in determining Entry 2 in account 1562. For convenience, the SIMPIL model contains a tab labeled, “PILs 1562 calculation” which provides a summary of all activities in previous years associated with not only the PILs variances but all summary level entries in account 1562.

Background

The Board developed the SIMPIL model following consultations with stakeholders in late 2001. On December 21, 2001 Board staff issued the first SIMPIL model as part of the rate application filing guidelines for the March 2002 rate adjustment[7]. On January 18, 2002, a revised version of the SIMPIL model was issued as part of Supplemental Instructions regarding the March 2002 rate adjustment filing guidelines[8].

At that time, the SIMPIL model was used to calculate the PILs expense to be included in rates. It also contained placeholders to allow distributors to file reconciliations (i.e. to calculate differences between certain components of the PILs methodology and the tax returns) when submitting the annual filings[9].

The SIMPIL model was used by distributors for their annual filings from 2002 to 2006. For the 2005 rate adjustment, the part of the SIMPIL model that calculated

[7] Appendix C, tab 3 - *with reference to* December 21, 2001 Filing Guidelines
[8] Appendix C, tab 3 - *with reference to* January 18, 2002 Supplemental Instructions
[9] Appendix C, tab 3 - *with reference to* June 3, 2002 letter to all Electricity Distributors regarding Reporting Requirements

the PILs amount to be incorporated into rates was separated into its own stand-alone model named, the "PILs model". Distributors continued to file the entire SIMPIL model as part of their annual filings for 2005 and 2006.

Consensus on the Mechanics of SIMPIL

Underpinning the SIMPIL model is a set of principles which the Board established, not through a proceeding, but through consultations with industry stakeholders in late 2001. These principles and the mechanics of the SIMPIL model were communicated to distributors by way of filing instructions in each year since 2001. The key principles underpinning the established SIMPIL model are identified below under "Mechanics of SIMPIL".

As noted above, the 2005 SIMPIL model contains the principles and methodologies common to each year for which a PILs expense filing was required.

It is Board staff's view that there is consensus among stakeholders that the established principles underpinning the mechanics of the SIMPIL model are appropriate. A need for clarification may arise with respect to the manner in which the SIMPIL model is applied and how the model calculates the appropriate entry to be recorded in account 1562. (see Appendix B)

Mechanics of SIMPIL

There are a number of specific items in SIMPIL that warrant further description and clarification:

A) <u>True-ups</u>

> Principle: There should be a 100% true-up between the PILs expense in rates and that collected from customers. There should be partial true-up between the amount collected from customers and that paid to government.

The SIMPIL model is a spreadsheet which provides reconciliation between the amount of PILs allowed in rates, collected from customers and the amount of PILs actually paid. However, only certain items are subject to this "true-up". In SIMPIL, a variance is determined through a series of true-up adjustments based on the difference between values of certain line items used for ratemaking purposes and values of certain line items used for amounts reported on the utility's actual filed tax returns. Each of the amounts subject to true-up are summed by the SIMPIL model, multiplied by the appropriate tax rate and then grossed up to determine the 1562 deferral account entry.

On January 18, 2002 the Board issued instructions on the SIMPIL model, "Notes to Proxy Model ("SIMPIL")", which identified the items not subject to true-up[10]. These items were:

- Net income;
- Depreciation;
- Capital Cost Allowance ("CCA");
- Cumulative Eligible Capital deduction ("CEC");
- Interest up to the Board's approved debt rate.

Most distributors adhered to this guidance.

Some of the remaining items in the SIMPIL model calculations would be subject to a true-up if they pass a materiality test and are potentially significant in measuring the difference between the actual PILs payable and the regulatory PILs approved in rates. The materiality threshold applied in the calculation of true-ups for the applicable items can be found in the 2005 SIMPIL model at the "TAXREC" tab, rows 13, 14 and 15. Distributors have the choice of materiality thresholds: 0.25% of net assets or 0.25% of deemed equity.

The list below shows some examples, but not a complete list, of the items subject to the materiality threshold under the current true-up methodology:

- Interest and penalties on unpaid or under-paid taxes;
- Non-deductible expenses such as meals, club dues, car expenses;
- Donations paid to registered charities or municipal owners;
- Profits/Losses arising in relation to joint ventures, subsidiary companies, equity income;
- Costs disallowed by the Board in any proceeding;
- Profit or losses on disposals of fixed assets;
- Capital gains or losses on disposals of capital assets;
- Income tax impact of Ontario Capital Tax expenses included in net income.

[10] Appendix C, tab 3 - *with reference to* January 18, 2002 Notes to Proxy Model ("SIMPIL")

Other remaining items are trued-up irrespective of materiality and are listed below:

- Employee benefit plans – accrued and paid amounts;
- Items capitalized for regulatory purposes;
- Certain regulatory adjustments on which true-up may apply (such as change in late payment policy)– additions and deductions;
- Interest adjustment for tax purposes – claw-back for excess interest;
- Tax reserves claimed in current year and prior year;
- Reserves from financial statements - beginning and end of year;
- Contributions to deferred income plans;
- Contributions to pension plans.

B) Tax Rates for the True-up Calculations

Principle: Tax rates for the same year as the PILs expense is paid will be used for true up calculations

The SIMPIL models for tax years 2001, 2002, 2003, 2004 and 2005 used the filing period's effective tax rates as shown on the distributors' tax returns to true-up the PILs variances. The timing of any potential disposition of these amounts does not affect the appropriate tax rate to use.

C) The Stand-Alone Principle

Principle: PILs expenses should be based on the revenues, costs and expenses associated only with the distribution activities.

The first PILs instructions issued by the Board on December 21, 2001 affirmed the stand-alone principle. Under this principle, ratepayers should bear only the costs, risks and benefits arising from the provision of regulated services. Impacts arising from non-wires activities should not be included in the PILs proxy calculations or in the reconciliations in the SIMPIL model.

One example is the impact on taxable capital. For the deductions, or exemptions, from taxable capital in the calculation of Large Corporation Tax ("LCT") and Ontario Capital Tax ("OCT"), the distributor was to take the maximum deduction. If the distributor had non-wires activities greater than 10% of the total of the distributor-corporation, an allocation of the exemptions could be made. Likewise, if there was more than one wires operation under the same ownership, an allocation could be made.

However, distributors applied to the Board to modify this treatment. In the actual tax returns, the capital deductions must be allocated or prorated based on guidance from tax authorities. The Board allowed the regulated distributors to share the deductions with other members of their corporate group. Reference Wellington Electric Distribution Company, RP-2002-0010/EB-2002-0019.

The stand-alone principle was further investigated in 2006 EDR. In gas regulation, the Board has allowed corporate net income to be used in earnings sharing calculations, rather than utility-only earnings. The stand alone principle has been decided by the Board on a case-by-case basis.

D) <u>Rate Base as the Starting Point for Capital Taxes and CCA</u>

> Principle: The 1999 Rate Base is the starting point for capital cost used in the PILs calculations.

On becoming subject to PILs, distributors were required to value their assets and assign the assets to appropriate undepreciated capital cost (“UCC”) classes as prescribed in federal tax legislation. Different tax depreciation rates, or CCA rates, exist for different UCC classes. Since distributors' distribution rates were based primarily on 1999 financial statements, the regulatory tax values of fixed assets were deemed to be the net book values from those same financial statements. These net book values were assigned to the various capital cost classes and formed the opening UCC for regulatory tax calculation purposes. The CCA derived from these values was used as a deduction in the PILs calculations.

E) <u>Interest Claw-Back</u>

> Principle: Interest deductibility is determined based on a true-up between the Board deemed interest rate and the interest determined by the Ministry of Finance.

The maximum interest deductibility is determined by the Board approved capital structure, as determined in the “Interest True-up” calculation in the SIMPIL model. In other words, the maximum amount of interest allowed in the PILs calculations was the Board's deemed interest based on the approved rate base, debt/equity split, and the deemed rate. The purpose of the claw-back was to reduce the tax benefit of any excess interest in the determination of PILs[11] for actual payments to the Ministry of Finance, by recording a credit in account 1562.

F) PILs Billed versus Collected

Principle: The PILs amount collected from customers is deemed to be the billed amount payable without delay.

The PILs reconciliation for calculating the balance of account 1562 uses PILs amounts billed to customers, not amounts collected from customers (i.e. billed less uncollectible)[12]. There may be a difference between PILs amounts billed to customers versus amounts actually collected from customers. This approach is based on the principle that the distributor manages customer collections and assumes the risk of uncollectible amounts. There is also a delay related to the timing of collections; for example, 50% in 30 days, 20% in 60 days, 20% in 90 days, 5% in 120 days, and 5% > 120 days.

G) Account 1562 represents the “Obligation to” or the “Receivable from” Ratepayers

Principle: Contra accounts are for tracking purposes only and are not eligible for disposition.

The balance in account 1562 establishes the obligation to, or the receivable from, the distributor’s ratepayers. In other words, if a distributor reports the same amount in account 1562 and 1563, but with opposite signs, the obligation or receivable is based on the balance in the 1562 deferral account. The purpose of account 1563 is to record the offsetting entries to those posted in account 1562. Account 1563 does not represent an obligation to the ratepayers, merely an offset to account 1562 for tracking purposes.
Nevertheless, as an indication of the confusion regarding the purpose of the 1563 account, some distributors have incorrectly requested disposition of account 1563 in rate applications.

[11] May 11, 2005 Report of the Board on the 2006 EDR Handbook, pages 58-59 and 2006 EDR Handbook, Schedule 7-3
[12] Line 8 on “PILs 1562 calculation” tab in the SIMPIL spreadsheet

APPENDIX B

Appendix B contains two parts. Both parts contain lists of items that Board staff believe require resolution. Board staff believe that the items listed in Parts I and II should be included as part of the Issues List for this proceeding.

PART I - Items where the Board provided guidance on PILs implementation but still require final resolution due to the manner in which PILs expenses were incorporated in rates for the period October 1, 2001- April 30, 2006

1. Date for the Initial Entries into the PILs 1562 Account

For most distributors, the 2002 Board rate decisions were effective March 1, 2002. Several distributors requested a later effective date as part of rate mitigation strategies and many distributors implemented rates on, or after, Market Opening. The APH and related FAQs permitted the following entries to account 1562:

- The fourth quarter 2001 PILs amount should have been divided by 3 and posted to the 1562 account at the end of the month starting with October 2001. Interest was calculated on the opening monthly balance.

- The 2002 PILs amount should have been divided by 12 and the entry should have been posted at the end of the month starting with January 2002. Interest was calculated on the opening monthly balance.

For a distributor whose Board order was effective, for example, on November 1, 2002, the higher income did not start until billings were rendered after November 1, 2002. PILs paid by customers through their rates in 2002 were much lower because of the later effective date. The distributor had PILs obligations starting October 1, 2001 but could not start to recover PILs in rates until November 1, 2002.

By recording the entries in 1562, as outlined above, a receivable from ratepayers may have been created that is higher than the actual PILs included in rates as of November 1.

Question:
Should the distributor prorate the PILs amount approved by the Board based on the effective date of the rate adjustment, rather than follow the instructions outlined above which assumed a full year implementation?

2. PILs Amount for the Fourth Quarter 2001

The fourth quarter 2001 PILs amount included in 2002 rates was meant to have remained in rates only until the 2003 rate adjustment. Due to Bill 210, the 2001 amount remained in rates until March 2004.

Questions:

a) Should the 2001 PILs amount included in rates (which was trued-up in 2002) be also trued-up in 2003 and 2004, or up to the date the Board removed this amount from rates?
b) If yes, how should the true-up be calculated for each period?

3. Regulatory Assets and Liabilities

Background

The Board has a defined policy which it has repeated in a number of decisions regarding the treatment of regulatory asset liabilities for PILs purposes. Some distributors may not have followed this policy when submitting their PILs filings. The dollar impact of regulatory assets on account 1562 is the most material of any item identified in this paper.

The regulatory asset balances arose over a period of several years. Collections or repayments started in 2004 and will continue until 2008. A final reconciliation will be required as of April 30, 2008 to serve as the basis for potential clearing of any residual amounts. In some instances, the Board received requests to approve extensions of rate riders beyond the April 30, 2008 end date. Simple interest or carrying charges are calculated on the opening monthly balances.

Regulatory assets have been the source of confusion for many distributors, mainly due to the treatment of the tax provision on regulatory assets and the "incomplete cycle" effect. Both are discussed below.

The Tax Provision

There may be higher taxable income in a year when distributors recover regulatory assets. However, because some of these same distributors also took tax deductions when allowed by tax law in prior periods, this deduction provided the funds to pay the taxes in the year of recovery. Nevertheless, some distributors have made adjustments in their PILs filings with respect to a tax provision on regulatory assets.

In the Board's report on 2006 EDR, Chapter 7, on page 61, the Board articulated a position on this issue. The Board stated,

> "A PILs or tax provision is not needed for the recovery of deferred regulatory asset costs, because the distributors have deducted, or will deduct, these costs in calculating taxable income in their tax returns."

In the Board's decision on PUC Distribution Inc.'s 2006 EDR application (RP-2005-0020/EB-2005-0412), the addition of regulatory asset recoveries in the PILs calculation was denied. The Board made the same finding in PUC Distribution Inc's (RP-2007-0522) and EnWin Utilities' (RP-2007-0723) applications for an adjustment to their 2007 PILs proxies.

Enbridge Gas Distribution Inc. provided evidence utilizing this treatment in its 2005 rates case (EB-2005-0001). In addition, Hydro One used this treatment in its 2006 EDR proceeding (RP-2005-0020/EB-2005-0378) and again in EB-2007-0681 for 2008 rates.

The "Incomplete Cycle"

The expensing and recovering of regulatory assets for tax purposes covers the period from 1999 through 2008 (and likely into 2009). An "incomplete cycle" exists because account 1562 and the related accounting effectively stop on April 30, 2006. Recoveries of regulatory assets (and any catch-up adjustments) for the latter part of 2006, 2007 and 2008 are not incorporated in the account 1562 true-up reconciliations. Nevertheless, distributors have applied in recent applications for tax provisions on regulatory assets because of the higher income associated with recoveries after April 30, 2006.

If account 1562 continued to operate as under the April 2003 FAQ until, for example, 2009, most distributors would be able to record variances associated with regulatory asset recoveries that would offset prior years' expenses. Since account 1562 stopped operating as of April 30, 2006, the cycle has been interrupted and consequently there may be many distributors with balances in 1562 that are higher or lower than they should be.

Question:
Should the tax impact of regulatory assets in prior years' tax returns be removed from the SIMPIL model reconciliation?

Definition of Over or Under Collection

Over or under collection is defined as the difference between the amount of PILs expense in rates and that collected from customers. According to the variance account methodology for account 1562, if the distributor collected from, (or billed to), ratepayers more than the approved PILs amount allowed in rates, the distributor would record this over-collection. A similar case is made with under collection.

Some distributors and intervenors have interpreted the definition of over or under collection to be the difference between the PILs amount approved in rates, and the amounts actually paid to the Ministry of Finance. A common understanding of over and under collection is desired for consistency in calculating the 1562 deferral account balance.

Question: How should the over or under collection issue be resolved?

5. Calculation of Variances for January 1, 2006 to April 30, 2006

The 2006 EDR PILs expense was implemented in rates on May 1, 2006 for most distributors. The PILs filings for 2005 were submitted in August 2006. Tax returns are filed on a calendar year basis. The questions relate to the determination of the PILs expense for the period January 1 to April 30, 2006.

Questions:

a) Should monthly variances for this period be imputed?
b) If so should it be from the 2005 or 2006 tax returns?
c) An unbilled revenue accrual for the period ending April 30, 2006 would be required to determine these variances. Is this information available?

PART II - Global items arising from the application of the SIMPIL model for which the Board has not provided guidance

1. Impact of Ministry of Finance Audits

Some distributors are currently being audited for the opening October 1, 2001 tax period. Currently there ar e no provisions in the PI Ls guidelines for addressing any changes in taxes payable as a result of the Ministry Audits.

Question:
Should the Ministry of Finance tax audits and possible reassessments, underway or planned, have any effect on the decisions of this proceeding?

2. Interest True-up if Recalculation is required

As a result of this proceeding, balances for individual years could be re-calculated.

Questions:

a) If the PILs principal variances were re-calculated, how should the interest carrying charges be re-calculated?

b) If the interest carrying charges were re-calculated, should any special treatment be given to any over or under accrual of interest carrying charges?

3. Impact of MAADs on the PILs True-up Variances

Certain distributors have amalgamated or acquired other distributors since 2001. Each distributor before the amalgamation had separate PILs provisions and separate 1562 accounts.

Question:
Should the consolidated entity or the acquiring distributor continue to segregate the 1562 accounts in order to calculate the correct final balances for the affected ratepayer group? Or should the accounts be merged and treated in a consolidated manner? How should the balances before consolidation be examined in the proceeding?

APPENDIX C

Relevant Board Documents Related to Account 1562 - Deferred PILs, the SIMPIL Model and Rate Applications

Tab 1 – Documents relating to the year 2000

Rate Application Filing Instructions

Various Documents concerning the 2000 Electricity Distribution Rate Handbook, 2000 Rate Unbundling and Design Model and Model Documentation
http://www.oeb.gov.on.ca/OEB/Industry/Rules+Codes+Guidelines+and+Forms/First+Generation+PBR+Distribution+Rate+Handbook

Letter dated November 3, 2000
Re: RP-2000-0069 Proceeding on Minister's Directive, Dated June 7, 2000
Revisions to 2000 Electricity Distribution Rate Handbook
http://www.oeb.gov.on.ca/documents/cases/RP-1999-0034/revised_letter.pdf

Tab 2 – Documents relating to the year 2001

Rate Application Filing Instructions

Letter dated August 24, 2001
Re: Impact of Proposed proxy Taxes on Rates
http://www.oeb.gov.on.ca/documents/pilsletter240801.pdf

Letter dated September 17, 2001
Re: Immediate Pass-through of 2001 s.93 PILs for Utilities Claiming Financial Distress
http://www.oeb.gov.on.ca/documents/pils.pdf

PILs gross-up spreadsheet
http://www.oeb.gov.on.ca/documents/taxspreadsheet.xls

Revisions to the Accounting Procedures Handbook

December 20, 2001 - Revised Accounting Procedures Handbook
See Article 440, starting at page 81
http://www.oeb.gov.on.ca/documents/cases/usoa/aph_201201.pdf

December 20, 2001 – Revised Uniform System of Accounts
See Article 220, starting at page 34
http://www.oeb.gov.on.ca/documents/cases/usoa/usoa_201201.pdf

December 20, 2001 – Revised Article 480
http://www.oeb.gov.on.ca/documents/cases/usoa/article480_201201.pdf

December 20, 2001 - Responses to December 2001 FAQs on the APH
http://www.oeb.gov.on.ca/documents/cases/usoa/aph_faqs_201201.pdf

Tab 3 – Documents relating to the year 2002

Rate Application Filing Instructions

Letter dated December 21, 2001
Re: Filing Guidelines for March 1, 2002 Distribution Rate Adjustments
http://www.oeb.gov.on.ca/documents/distribution_letter_211201.pdf

Appendix A – Rate Adjustment Model Documentation
http://www.oeb.gov.on.ca/documents/rate_adjustment_model_documentation_211201.pdf

Appendix B – Filing Guidelines for PILs Proxy
http://www.oeb.gov.on.ca/documents/filing_guidelines_211201.pdf

2002 Rate Adjustment Model
http://www.oeb.gov.on.ca/documents/rate_adjustment_model_211201.xls

Letter dated January 18, 2002
Re: Supplemental Instructions for 2002 Rate Adjustment
http://www.oeb.gov.on.ca/documents/cases/pils/instructions.pdf

Spreadsheet Implementation Model for PILs (“SIMPIL”)
http://www.oeb.gov.on.ca/documents/cases/pils/proxy_model_180102.xls

Notes to Proxy Model (“SIMPIL”)
http://www.oeb.gov.on.ca/documents/cases/pils/proxy_notes_180102.pdf

RRR Filing Instructions

Letter dated June 3, 2002
Re: Reporting Requirements – PILs, Trial Balance, Financial Statements
http://www.oeb.gov.on.ca/documents/trial_balance_ltr_030602.pdf

Tab 4 – Documents relating to the year 2003

Letter dated August 19, 2002
Re: Extens ion of First Generation PBR
http://www.oeb.gov.on.ca/documents/letter_pbrextension_190802.pdf

April 17, 2003 – Responses to April 2003 FAQs on the APH
http://www.oeb.gov.on.ca/documents/cases/usoa/APH_FAQs_April2003.pdf

Tab 5 – Documents relating to the year 2004

Rate Application Filing Instructions

Letter dated January 15, 2004
Re: Filing Guidelines for April 1, 2004 Distribution Rate Adjustments and 2004 Rate Adjustment Model Documentation
http://www.oeb.gov.on.ca/documents/electricity_regulatoryassetfilingguidelines_150104.pdf

2004 Rate Adjustment Model
http://www.oeb.gov.on.ca/documents/electricity_2004rateadjustmentmodel_150104.xls

Tab 6 – Documents relating to the year 2005

Rate Application Filing Instructions

Letter dated December 20, 2004
Re: Filing Guidelines for March 1, 2005 Distribution Rate Adjustment
http://www.oeb.gov.on.ca/documents/electricity_2005ratesguidelines_201204.pdf

2005 Rate Adjustment Model
http://www.oeb.gov.on.ca/documents/electricity_2005ramv11_311204.xls

2005 Rate Adjustment Model Documentation
http://www.oeb.gov.on.ca/documents/electricity_2005ramodel_221204.pdf

2005 PILs Model
http://www.oeb.gov.on.ca/documents/electricity_2005pilsfinal_050105.xls

2005 PILs Model Documentation
http://www.oeb.gov.on.ca/documents/electricity_simpilguidefinal_050105.pdf

RRR Filing Instructions

December 21, 2005 – Responses to December 2005 FAQs on the APH
See Q. 19
http://www.oeb.gov.on.ca/documents/cases/usoa/APH_FAQs_December2005.pdf

2006 SIMPIL model for the 2005 tax year
http://www.oeb.gov.on.ca/documents/rrr_2005simpil_040706.xls

2006 SIMPIL model instructions for the 2005 tax year
http://www.oeb.gov.on.ca/documents/rrr_2005simpil_instructions_040706.pdf

2006 SIMPIL appendices for the 2005 tax year
http://www.oeb.gov.on.ca/documents/rrr_2005simpil_appendicesAB_040706.pdf

Tab 7 – Documents relating to the year 2006

Rate Adjustment Filing Instructions

Report of the Board - May 11, 2005
Re: 2006 Electricity Distribution Rate Handbook
http://www.oeb.gov.on.ca/documents/edr_final_boardreport_110505.pdf

2006 Electricity Distribution Rate Handbook
http://www.oeb.gov.on.ca/documents/edr_final_ratehandbook_110505.pdf

Appendices to the Handbook
http://www.oeb.gov.on.ca/documents/edr_final_handbookappendices_110505.pdf

Letter dated July 12, 2005
Re: Filing Guidelines for Final Recovery of Regulatory Assets for May 1, 2006 Distribution Rate Adjustments
http://www.oeb.gov.on.ca/documents/electricity_regulatoryasset_filingguidelines_phase2_120705.pdf

2006 PILs Model: The 2006 EDR PILs model was confidential/ proprietary and Board Staff emailed the model to each distributor. The model was not posted to the public website.

Tab 8 – Documents relating to the year 2007

Revisions to the Accounting Procedures Handbook

July 23, 2007 – Responses to July 2007 FAQs on the APH
http://www.oeb.gov.on.ca/documents/cases/usoa/APH_FAQs_July2007.pdf

Letter dated July 31, 2007
Re: Revised Accounting Procedures Handbook
http://www.oeb.gov.on.ca/documents/cases/usoa/aph_letter_20070731.pdf

July 31, 2007 – Revised Accounting Procedures Handbook
http://www.oeb.gov.on.ca/documents/cases/usoa/aph_20070731.pdf