Ontario Energy Board
P.O. Box 2319
2300 Yonge Street
26th. Floor
Toronto ON M4P 1E4
Telephone: 416- 481-1967
Facsimile: 416- 440-7656
Toll free: 1-888-632-6273

Commission de l'Énergie de l'Ontario
C.P. 2319
2300, rue Yonge
26e étage
Toronto ON M4P 1E4
Téléphone; 416- 481-1967
Télécopieur: 416- 440-7656
Numéro sans frais: 1-888-632-6273

August 24, 2001

To: All Electricity Distribution Companies

Re: Impact of Proposed Proxy Taxes on Rates

Section 93 of the *Electricity Act, 1998* ("the Act"), which has yet to be proclaimed, provides that previously tax-exempt local electricity distributors ("LDCs") will become subject to payments in lieu of taxes ("PILs") commencing October 1, 2001. When proclaimed, the first PILs installments will be due October 31, 2001, which necessitates that LDCs ascertain the financial and rate making implications of this rapidly approaching requirement. It would therefore be expedient to establish a method for dealing with PILs for rate-making purposes in advance of the proclamation of section 93, to enable LDCs time to consider their particular circumstances, and to take account of various options available to them.

A number of divergent views relating to techniques for determining the appropriate tax gross-up and incorporating this into distribution rates have been received by the Board. The Board also has had several requests for consultations regarding this issue. Undoubtedly, in the Board's view, consultations on these matters are desirable, but given the anticipated October commencement of PILs prescribed by section 93, it is clear that it is prudent at this time to make some provision for the recovery of PILs, pending the Board's consultation process.

In general terms, the Board considers PILs on the wires-only portion of the LDC revenue as an additional expense that should be recovered through an increase in distribution rates. Moreover, in the Electricity Distribution Rates Handbook, the Board has already indicated that "the incorporation of PILs will be treated as a pass through".

After considering all the circumstances, the Board proposes that the recovery of PILs for the LDCs' current regulatory year be implemented by means of suitable adjustments to the LDCs upcoming March 1, 2002 rate applications. Therefore, recovery of the section 93 tax expense for the period from October 2001 to February 2002 would be deferred and collected through rates in the 2002-3 regulatory year, along with the utilities' annualized tax expense for 2002.

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There are several advantages of this approach, including: reduction in the number of rate changes; reduction in administration and extra processes, especially in light of the short time period for any initial tax adjustment (until March 1, 2002); the opportunity for the Board to conduct consultations on the details relating to implementation of PILs; the utilities would not be impeded in their efforts for market readiness; and the special installment provisions contained in Regulation 162/01 significantly reducing utilities' 2001 PILs-related cash flow requirements.

To implement the above approach, the Board proposes to establish a deferral account with interest thereon, determined at the utilities' long-term debt rate as indicated in the Rate Handbook. The mechanics of this deferral account will be discussed during the Board's consultation process.

The Board is mindful that LDCs will face an increased cash flow burden for a few months under this deferral approach, and that some utilities may experience financial duress as a result. The Board will therefore provide an opportunity for utilities which can demonstrate financial distress to apply for an adjustment to their current rates, to include provisions for PILs based on its annualized 2001 PILs estimates. Further details, including suggested methodologies for estimating PILs, will be provided as soon as possible.

The Board will also announce particulars of the consultation process, in the near term, to be undertaken with stakeholders regarding the mechanics of the main tax adjustment to take effect on March 1, 2002. Among the issues to be considered are use of a true-up mechanism, non-utility adjustments, and use of deemed interest expense versus actual interest expense.

Utilities requiring further information or guidance on these matters should contact John Vrantsidis at 416-440-7637 (toll free, 1-800-632-2727) or E-mail at vrantsjo@oeb.gov.on.ca

Yours truly,

Paul Pudge

Board Secretary