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August 15, 2007

Delivered by Courier and E-mail

Ontario Energy Board
P.O. Box 2319, 26th Floor
2300 Yonge Street
Toronto, ON M4P 1E4

Attention: Ms. Kirsten Walli, Board Secretary

Dear Ms. Walli:

Re: PUC Distribution Inc.
Request for Recovery of 2007 PILs Expense

I. Introduction:

We are counsel to PUC Distribution Inc. ("PUC Distribution") in the above-stated application (the "Application"). On April 12, 2007, PUC Distribution received its Decision and Order in respect of its 2007 electricity distribution rate application (OEB File No. EB-2005-0412). That application was prepared and filed on the basis of the Ontario Energy Board (the "Board")'s mechanistic adjustment process for 2007 rates.

PUC Distribution brings this Application before the Board in order to address its 2007 Payment in Lieu of Taxes ("PILs") expense. The issue arises as a result of three distinct factors: 1) a cessation of loss carry forwards which has resulted in an increase in PUC Distribution's PILs expense; 2) PUC Distribution's reporting of the recovery of regulatory assets which are currently being received by the utility and forms part of PUC Distribution's taxable income; and finally 3) as a result of the March 22, 2007 Ontario Budget (the "Budget"), a change in tax policy which has resulted in a change to PUC Distribution's deemed debt equity recovery ratio and the resultant amount of deductible interest.

PUC Distribution wishes to address these three factors and their resultant increase in PILs liability by respectfully requesting the following relief from the Board:

1) Confirmation that an immediate adjustment effective September 1, 2007 will be made to PUC Distribution's 2007 distribution rates whereby the required PILs adjustment will be granted resulting in new distribution rates as are detailed in Sheet 7 of the Model which is attached;

2) Confirmation that PUC Distribution's incremental PILs expense (including 2007 PILs) together with carrying charges thereon, will be recoverable through rates by way of an adjustment mechanism commencing in 2008, subject to verification of the amount of the expense; or

3) Confirmation that PUC Distribution will be permitted to establish a deferral account immediately, by which it will track its incremental PILs expenses for 2007.

Below are details related to the circumstances upon which this claim for relief is based.

PUC Distribution's 2006 rates provided for an amount of $164,831 in PILs expense. This amount was later reduced by $9,241 on account of a mandated capital tax reduction, leaving an amount for PILs in rates of an amount of $155,590.

II. <u>Detailed Calculations for 2007 PILs</u>

2007 PILs RATE ADJUSTMENT MODEL

Sheet 6 -Increased PILs Payable
(2007 Provincial Budget Changes, loss carry-forward depleted and regulatory asset recovery)

Accounting Income (2007 budgeted) before interest				$2,312,907
Add Depreciation				$2,870,000
Less CCA				-$2,000,000
Less Loss Carry-forward				-$255,942
Add Recovery of Regulatory Assets to be included in taxable income (previously deducted from taxable income)				$1,450,000
<u>Deductible Interest</u>			days	
Less actual interest to shareholder Jan. 1 to March 22, 2007	$2,807,650		81	-$623,068
Less deemed interest (50/50 at 6.25%) March 23 to December 31, 2007				
(A) Net Fixed Assets	$35,539,125	(2006 audited fs)		
(B) Working Capital Allowance	$7,892,864	(2006 audited fs)		
(C) Deemed Debt to Equity	50%			
(D) Deemed Debt Cost	6.25%			
	(A + B) x C X D	$1,357,250	284	-$1,056,052
	Deemed Taxable Income			$2,697,846

	PILs rate		36.12%	
	Income Tax		$974,462	
plus Capital Tax (included in accounting income above)			$135,000	
	Total Recoverable			$1,109,462
Provision in 2006 rates for PILs			$164,831	
Less LCT reduction in 2007 rates			$9,241	
	PILs recovery in 2007 rates			$155,590
PILs payable not in 2007 rates				$953,872
Rate change effective September 1, 2007 - recovery months =		8		$1,430,808

Grossed up additional 2007 PILs would be $2,239,836.86.

III. Reasons for 2007 PILs Deficiency

The reasons for this discrepancy between the provision for PILs in the 2006 rates as opposed to the actual PILs requirement can be attributed to the following three factors which are contained in Sheet 6 – Increased PILs.

A) Loss Carry Forwards

In 2006, PUC Distribution had loss carry forwards of $978,338. As the Board is aware, PILs obligations were not addressed by the Board in its 2007 Incentive Regulation Mechanism ("IRM") process. Loss carry forwards of $255,942 represent the remaining loss carry forwards available to PUC Distribution. Given that 2007 distribution rates were based on 2006 rates which included a much larger carry forward amount, the lower carry forward amount had a significant impact on 2007 PILs payable. While it no doubt was assumed that the PILs obligation in 2007 distribution rates would in some way be reflective of 2006 distribution rates, given the reduction in loss carry forward amounts of over $700,000, the PILs obligation in 2007 does not bear a resemblance to the 2006 PILs obligation.

B) Regulatory Asset Account Treatment

The Detailed Calculation for 2007 PILs shows the additional income associated with the recovery of regulatory assets which were previously allowed by the Board but for which PUC Distribution has determined that the proper reporting is as 2007 income as that is the year in which PUC Distribution is receiving the income. These amounts were previously deducted from taxable income. As a result of this accounting and the fact that PUC Distribution is receiving the amount in 2007, PILs payable has increased.

C) 2007 Provincial Budget Change

On March 22, 2007, the Ontario Budget (the "Budget") was released containing a provision that stated new rules would be made regarding the deductibility of interest payable by municipal electric utilities which would be consistent with proposed cost of capital rules. The new rules would limit the interest rate on debt to municipalities and impose the debt to equity ratio prescribed by the Board. Therefore municipal electric utilities would no longer be able to deduct interest expense on the basis of what their actual debt/equity ratio was. Rather, the Budget required that interest be deducted on the basis of the Board's deemed debt/equity ratio for LDCs (dependant on size of rate base).

As a result of this change in Government policy, PUC Distribution has had to change the deduction of interest from a debt/equity basis of 90/10% to a debt/equity ratio of 50/50%. The 90/10 debt/equity structure was adopted by PUC Distribution to minimize taxes and therefore associated revenue requirements. The beneficiary of this capital structure was solely the ratepayer as the total tax savings were captured in the rates. In the Electricity Rate Handbook, the Board has stated that the Board expects distributors to take prudent steps to manage their tax costs with reasonable diligence as they would with other distribution expenses. PUC Distribution has taken such steps.

The resultant change represents a significant reduction in the amount of interest which PUC Distribution is permitted to deduct from income and has a corresponding effect which increases PILs expense.

IV. <u>Treatment of PILs Incremental Expense</u>

The Board has historically designed distribution rates to allow distributors to recover their PILs liabilties.

After the 2006 EDR process, the Board's June 19, 2006 Draft Staff Report on Cost of Capital and Second Generation Incentive Regulation contemplated that PILs would not be adjusted as part of the rate adjustment formula, but PILs would form a separate calculation after income was derived from the adjustment.

The Board said that in the 2006 EDR process there would not be an adjustment for PILs except in limited circumstances. This continued into the 2007 IRM process. It was assumed in the Board's December 20, 2006 Report (the "Report") on Cost of Capital and 2nd Generation Incentive Regulation that distributors' PILs obligations would largely stay the same for 2007. This has not been the case with PUC Distribution.

The Board has recognized that contingencies need to be built into the regulatory regime in order to provide the flexibility to recognize extraordinary events outside the control of a distributor's management.

The Report states that for second generation IRM (p. 34 of the Report) the Board will limit reliance on Z-factors those being changes in tax rules and natural disasters. However, PUC Distribution takes the view that the Board determined its definition of the Z-factor assuming that 2006 PILs liability would be similar to 2007 PILs liability, not specifically contemplating the specific treatment by PUC Distribution of regulatory assets income, nor the significant impact of reduced loss carry-forwards. PUC Distribution meets the test under these criteria for entitlement as is further described below with respect to the change in tax policy created by the Budget and would be applicable to the two additional factors should the Board expand its definition of Z-factor to address the collection of regulatory assets as 2007 income and the discrepancy with respect to loss carry forwards.

In order to qualify for the factor, the following criteria must be met:

a. Causation: The amount must be related to the Z-factor event and not be part of the basis upon which rates were derived. The incremental PILs amount is clearly outside the basis upon which 2007 rates were calculated.

b. Materiality: The Board sets the materiality threshold for expenses at 0.2% of total distribution expenses before tax and for capital cost recovery at 0.2% of net fixed assets. The incremental PILs shortfall represents 11.98% before gross-up and 18.76% after gross-up of distribution revenue and therefore qualifies as material.

c. Prudence: The amount should be prudently incurred. PUC Distribution submits that a significant factor that has lead to the PILs shortfall is a change in government tax policy. PUC Distribution has made use of all the applicable deductions in order to attempt to reduce the PILs shortfall amount. As previously described, the use of loss carry forwards and accounting treatment of regulatory asset amounts as 2007 income should respectfully be considered by the Board as prudent management. PUC Distribution has no choice as to whether it wishes to pay the PILs shortfall amount. It is required to pay its PILs expense as a condition of its licence.

PUC Distribution takes the view that the Board's current definition of the Z-factor should be expanded to incorporate circumstances where PILs liability bears no resemblance to the amount allocated for PILs in distribution rates. The Board has held as a basic principle that there should not be a substantial difference between taxes determined for regulatory purposes and taxes paid. PUC Distribution asks the Board to consider this principle in considering the three factors PUC Distribution has outlined above.

V. Affect on Customers

Sheets 7, 11 and 14 of the Application spreadsheets contains the Bill Impact of the Incremental PILs adjustment contemplating that an increase is approved and commences effective September 1, 2007. The PILs shortfall is a significant portion of the 2007 Base Revenue Requirement and therefore has a significant effect on PUC Distribution.

The Bill impact of the collection of increased PILs expense through rates is detailed at Sheets 7, 11, and 14 of the Application. PUC Distribution has relatively low distribution rates in comparison to other Ontario LDCs and the applicant asks that this fact be considered in making an assessment of how an additional increase would affect the Bill impact in terms of how it compares to other LDC distribution rates.

VI. Conclusion

For the above reasons PUC Distribution seeks the above-stated relief and requests that the Board allow it to realize its incremental PILs deficiency through its distribution rates.

Attached please find 5 copies of the Application and supplementary materials.

The applicant would look forward to an opportunity to discuss this request further with Board Staff. In addition, should the Board have any further questions or require further information or a more formal application, please do not hesitate to contact the writer or Terry Greco, CFO, PUC Distribution Inc. at (705) 759-6566.

Yours very truly,

Borden Ladner Gervais LLP

Christine E. Long

Christine E. Long

CEL/ac
Enclosures
cc: Terry Greco, PUC Distribution Inc.