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Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
230 Yonge Street
Suite 2700
Toronto, Ontario, M4P 1E4

Dear Ms. Walli:

Re: Tax Changes Applicable to 3rd Generation IRM Model

In the EB-2007-0673 Supplemental Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors dated September 17, 2008, the Board dealt with the issue of tax changes in relation to the Z-factor. At page 35 of the Report the Board stated:

> *"Therefore, for 3rd Generation IR, the Board has determined that a 50/50 sharing of the impact of currently know legislated tax changes, as applied to the tax level reflected in the Board-approved base rates for a distributor, is appropriate. An approach similar to that adopted in the gas IR plans will be used to calculate the savings for purposes of the sharing."*

In reviewing the tax changes shown in the 3rd Generation IRM model filed by London Hydro in EB-2009-0235, it has come to my attention that some of the known tax changes have not been reflected in the model, while other changes have not been reflected at all.

I would appreciate your bringing this issue to the attention of the Board as soon as possible.

The comments that follow are directed at all of the 3rd generation IRM filings and are not specifically directed to London Hydro. The London Hydro filing is used to demonstrate the current deficiencies in the IRM model.

a) Ontario Capital Tax

The Ontario capital tax is scheduled to be eliminated effective July 1, 2010. The calculation shown on page F1.1 Z-Factor Tax Changes for 2010 utilizes the appropriate deduction from taxable capital of $15 million and the appropriate rate of 0.150%.

The calculation of the Ontario capital tax prorates the calendar year to reflect the elimination of the tax as of July 1, 2001. This proration is accomplished by multiplying the product of the net taxable capital and the rate by a factor of 182/365. I believe this factor should be 181/365, reflecting 181 days in the January through June period during which the capital tax exists. While this change is minor in nature – the reduction in the London Hydro case is $864 on a base of $157,312 – the use of the appropriate ratio is also relevant in the calculation of the income tax rate changes discussed in part (b) below.

b) Income Tax Rate Changes

The income tax rates shown on page F1.1 Z-Factor Tax Changes appear to reflect only reductions in the federal tax rate. In particular, the federal income tax rate declines from 19% in 2009, to 18% in 2010, to 16.50% in 2011 and to 15.00% in 2012. Adding the current provincial tax rate of 14% to each of theses federal tax rates yields 33% in 2009, 32% in 2010, 30.50% in 2011 and 29.00% in 2012. These are the figures shown on page F1.1 Z-Factor Tax Changes.

As the Board is aware, there are reductions to the provincial tax rate schedule to take place over the next number of years, including 2010. In particular the 14.00% current rate will be reduced to 12.00% on July 1, 2010, to 11.50% on July 1, 2011 and to 11.00% on July 1, 2012. A further reduction is planned for 2013.

The following table provides the calculation of the weighted average Provincial tax rate in 2010, 2011 and 2012 based on the number of days that each tax rate is in place (note that 2012 includes the impact of the leap year, using weights of 182 and 184 days). The table also shows the addition of the declining federal tax rate, resulting in the rates shown.

	Days	2010	2011	2012
	181	14.000	12.000	11.500
	184	12.000	11.500	11.000
Provincial Rate	365	12.992	11.748	11.249
Federal Rate		18.000	16.500	15.000
Total Tax Rate		30.992	28.248	26.249

I believe that the above corporate tax rates are the appropriate rates to be included in the IRM model. In the case of London Hydro, the use of 30.992% in 2010 in place of the 32.00% currently used in the model reduces taxes by approximately $85,460. The reduction in the corporate tax rate also further reduces the grossed-up tax amount. Again, using the London Hydro example, the reduction is the grossed-up tax amount using the 30.992% tax rate in 2010 is more than $182,000.

c) Ontario Small Business Deduction & Surtax

The current Ontario corporate income tax rate on the first $500,000 of taxable income is 5.50%. The benefit of the small business deduction is gradually phased out (clawed back) on taxable income between $500,000 and $1.5 million. This claw back is achieved through a 4.25% surtax that is applied to taxable income between $500,000 and $1.5 million. This means that if taxable income is in excess of $1.5 million there is no benefit associated with the small business deduction as the surtax claws back the reduction on the first $500,000. This is illustrated as follows. Based on current provincial tax rates, the 5.50% rate applicable to the first $500,000 in taxable income reduces taxes by $42,500 [(14.00% - 5.50%) x 500,000]. The claw back takes place on taxable income in excess of $500,000 up to $1.5 million and is equal to $42,500 [(1,500,000 – 500,000) x 4.25%]. Corporations with taxable income of less than $1.5 million have reduced provincial taxes as a result of the small business deduction.

Effective July 1, 2010, the small business rate applicable to the first $500,000 of taxable income decreases to 4.50%. In addition, also effective July, 2010, the surtax (or claw back) of 4.25% is eliminated. This means that for 2010 the effective small business rate is 5.00% and the surtax is 2.125% (using a simplifying assumption of 6 months rather than 181 days).

The impact on the provincial tax payable is shown by the following example, again assuming that the taxable income is in excess of $1.5 million. In the following example, a weighted provincial tax rate of 13.00% is used for simplicity.

The tax on the first $500,000 is reduced by $40,000 [(13% - 5%) x 500,000]. The surtax, or claw back, is $21,250 [(2.125% x (1,500,000 – 500,000)]. As a result there is a net reduction in the provincial income tax of $18,750 [40,000 – 21,250] for a company with taxable income of more than $1.5 million. For London Hydro, the incremental tax savings is this figure of $18,750.

The savings are larger for a company with taxable income of less than $1.5 million. For example, a company with taxable income of $1.0 million would have a tax reduction of $29,375.

I believe this tax impact should be calculated and included on page F1.1 Z-Factor Tax Changes.

d) Harmonization of the GST and PST

The Provincial Sales Tax (PST) and the Goods and Services Tax (GST) will be harmonized effective July 1, 2010. Unlike the GST, the PST is included as an OM&A expense and as a capital expenditure.

When the GST and PST are harmonized, corporations will see a reduction in OM&A expenses and capital expenditures because the PST is essentially be eliminated and replaced with a GST with a higher rate. As noted above the GST is not included as part of OM&A expenses or capital expenditures since any GST paid is credit to GST collected and the net balance is remitted to the government.

As noted in the Board's Supplemental Report of September 17, 2008, the Board has adopted a similar approach to that adopted in the gas IR plans when it comes to tax related Z-factor changes.

In EB-2009-0275, Union Gas indicated that it would address any tax change impacts in its 2011 rate application related to the planned harmonization in 2010. Union could not provide an estimate of the impact of the elimination of the PST in 2010 as it currently does not track PST for good and services purchased in Ontario (Exhibit B3.3). Union also indicated that the tax harmonization would have an impact on the costs associated with O&M expenses, capital expenditures and the working cash allowance. Union also indicated that some billing changes may be necessary to accommodate the changes.

Hydro One Distribution had a similar response to an interrogatory in its current 2010 rates proceeding (Exhibit H, Tab 3, Schedules 12 & 21, of EB-2009-0096). In particular, Hydro One indicated that a process would be developed to estimate the savings in costs after July 1, 2010 that result from the PST/GST harmonization and that such savings would be reflected in Deferral Account 1592. Hydro One also indicated that it currently does not track PST related to expenditures.

Given that distributors currently do not track PST related costs, I believe the Hydro One and Union Gas approaches are appropriate and should be applied by the Board to other distributors. No adjustments would be made to the current IRM model for this tax reduction, but it should be made clear to all distributors that a mechanism needs to be put in place to estimate the savings to be placed in Deferral Account 1592.

If the Board requires any further information or clarification, please do not hesitate to call me.

Sincerely,

Randy Aiken

Randy Aiken
Aiken & Associates

cc David Williamson, London Hydro (e-mail)