VT INCEPIT FIDELIS SIC PERMANET
Ontario

ONTARIO ENERGY BOARD

STAFF SUBMISSION

2007 ELECTRICITY DISTRIBUTION RATES AMENDMENT (RECOVERY OF 2007 PILs EXPENSE)

PUC DISTRIBUTION INC.

EB-2007-0723

November 29, 2007

INTRODUCTION

The purpose of this document is to provide the Ontario Energy Board (the "Board") with the submissions of Board staff after its review of the evidence filed in the 2007 electricity distribution rates application by PUC Distribution Inc. ("PUC Distribution") to amend its approved distribution rates, effective September 1, 2007, for the purpose of recovering its reasonable taxes/PILs expenses ("PILs expense") for 2007 on a going-forward basis.

PUC DISTRIBUTION's RATE AMENDMENT PROPOSAL

PUC Distribution applied for and was approved distribution rates effective May 1, 2007 in accordance with the guidance provided in the Report on Cost of Capital and 2nd Generation Incentive Regulation Mechanism for Ontario's Electricity Distributors (the "Board Report"), issued December 20, 2006. Its 2007 distribution rates were considered in the IRM proceeding under Board file No. EB-2007-0568.

The IRM approach is a formulaic adjustment to the prior year's rates which allows for inflationary adjustments to the costs of inputs (labour, material and capital) less expected annual improvements in productivity through technological advances, management expertise, and cost management. The IRM formulaic approach does not reflect material changes in individual cost components.

PUC Distribution filed its current submission on the basis that the use of its 2006 approved rates were inadequate and inappropriate to allow for the full recovery of its expected 2007 PILs expenses. They contend that:

1. the 2006 rates incorporated a reduced PILs expense due to the use of a loss carry-forward that resulted in a reduction to its tax/PILs expense in 2006l;
2. the need to incorporate the recovery of regulatory assets as part of the regulatory PILs calculation, which are currently embedded in rates being received by the utility and form part of PUC Distribution's taxable income as reported in its tax return;
3. the March 22, 2007 Ontario Budget (the "Budget") which resulted in a change from the actual debt equity ratio (90/10) to the deemed debt equity ratio (50/50) to the calculation of tax payable thus reducing their allowable deductible interest and increasing their PILs liability. The Budget restricts the amount of interest that can be deducted in the calculation of PILs income tax payable.

As a result, PUC Distribution expects to pay a higher level of PILs in 2007 than that reflected in its approved 2007 rates which were based on unmodified 2006 PILs allowance.

In developing the proposed change in the 2007 revenue requirement, PUC Distribution developed a 2007 PILs expense calculation which incorporates each of the factors listed above and the results were compared with the level of PILs expenses included in the currently approved 2007 rates. PUC Distribution proposes that it is the difference indicated by this comparison that would have to be incorporated into any proposed revenue requirement.

PUC Distribution's PIL expense Calculation is shown below:

Accounting Income (2007 Budgeted) before interest	$2,312,907
Add Depreciation	$2,870,000
Less Capital Cost Allowance ("CCA")	$(2,000,000)
Less Loss Carry-forward	$(255,942)
Add Recovery of Regulatory Assets	$1,450,000
Less Interest:	
Actual with 90/10 D/E ratio (Jan. 1 to March 22/07)	$ (623,068)
Deemed with 50/50 D/E ratio (Mar. 23 to Dec. 31/07)	$(1,056,052)
Deemed Taxable Income	$2,697,845
Resulting Income Tax/PILs @ 36.12%	$ 974,462
Add Capital Tax (included in Accounting Income)	$ 135,000
Total PILs Expense for 2007	**$1,109,462**
Forecast PILs Recovery in current 2007 Rates	$ 155,590
PILs under recovery in current 2007 Rates	**$ 953,872**

PUC Distribution proposed that the currently-approved 2007 rates be adjusted to collect the above noted under-recovery and be made effective September 1, 2007. PUC

Distribution's rates from May 1 to August 31, 2007 will be left unchanged. PUC Distribution have indicated in their supporting details that, based on this approach, the estimated impact on a typical residential customer consuming 1,000 kWh per month would be a bill increase of 3.6%, while a typical General Service < 50 kW customer consuming 2,000 kWh per month would experience a bill increase of 4.35%.

In addition, they propose that consideration be given to allowing the modification of the items to be permitted as a Z-factor adjustment to capture such changes in future rate calculations. They take the position that the Board, in limiting modifications to the Z-factor to situations involving tax rules and natural disasters, they have failed to appreciate the possible rate impact of changes in regulator asset recovery and reductions in loss carry-forwards.

STAFF SUBMISSION ON PUC DISTRIBUTION'S EVIDENCE

Board staff submits that the test to be met is: Has PUC Distribution demonstrated that the rates currently in place will not provide sufficient funds to cover the forecast PILs expense as a result of the depletion of the loss carry-forward, the inclusion of the recovery of regulatory assets, and the provincial tax policy which changed the debt/equity ratio from the actual level to the deemed level thereby reducing deductible interest expenses and increasing the tax liability.

Board staff has reviewed the current rate application, analysed the rate model submitted by PUC Distribution for 2007 and the responses to interrogatories that PUC Distribution has filed in support of the proposed rates.

The observations made in this analysis are as follows:

a. The model used by PUC Distribution is a modification of the model issued by the Board for 2007 rate setting purposes. The modification to the model in the Z-factor adjustment appears to have been done to provide a "work-around" to accommodate the requested changes.

b. The elimination of the loss carry-forward in the 2006 rate year would have resulted in an increased tax expense of $601,639.

c. The Regulatory Asset figure used by PUC Distribution of $1,450,000 is not consistent with the Regulatory Asset figure of $1,217,901 available for recovery at the end of 2006, as per the audited financial statements provided by PUC Distribution.

d. The CCA used in PUC Distribution's PILs calculation uses only class 1 assets 4% rate and does not take full advantage of the deduction available for tax purposes. There are several additional CCA classes that have higher CCA rates which would reduce this PILs burden on ratepayers

The following Board staff submissions address each of the components of PUC Distribution's application.

a. Loss Carry-forward: Board Staff submits that PUC Distribution's request for the adjustment to 2007 rates to reflect the elimination of historical loss carry-forward has been supported by PUC Distribution's evidence and is reasonable.

b. Regulatory Asset Account: Board Staff submit that the Board Report of May 11, 2005 establishing the 2006 Electricity Distribution Rate Handbook, stated, at page 61 under Regulatory assets and liabilities, that:

"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."

Also, the 2006 Electricity Distribution Rate Decision (RP-2005-0020/EB-2005-0412) for PUC Distribution Inc. did not accept the inclusion of regulatory asset amounts in the PILs calculation, stating that:

"The applicant included in the Revenue Requirement an amount of $1,055,925 for its PILs costs in 2006. In making this calculation, PUC included as an addition to its net income the amount of $1,486,250, which is the amount of Regulatory Asset Recovery in 2006. The Board does not accept that this is a component of net income in 2006. Rather, it is a delayed recovery of costs in previous years that would have already been expensed for tax purposes. The Board has calculated an allowance for PILs cost at $164,831."

As a result the inclusion of a Regulatory Asset recovery amount in these calculations is not supported by Board policy.

c. 2007 Provincial Budget change: Because of a change in the basis for the assessment of the amount of PILs payable as a result of the March 22 Budget, determination of the level of net income for tax purposes that was used in the 2006 EDR rate process appears to be understated as a basis for determining an amount for 2007. The understated amount is approximately $500.000.

d. Criterion for modification to Z-factor adjustment: Board Staff submits that the Z-factor criteria was a matter considered by the Board in a policy review, the Board clearly identified that only two adjustments could be included in the incentive regulation process.

In addition, Board Staff would note that the Board has wide latitude in the determining of the length of time a rate rider could be used to recover costs (from a one time charge to a charge spread out over 1 or more years). The Board should be guided by the impacts associated with rates and intergenerational equity.

All of which is respectfully submitted