



**Account 1562 Deferred PILs  
EB-2008-0381**

**BOARD STAFF SUBMISSION  
on  
the Unsettled Issues**

**DECEMBER 24, 2010**

**IN THE MATTER OF** the *Ontario Energy Board Act, 1998*,  
S.O. 1998, c. 15, (Schedule B);

**AND IN THE MATTER OF** a proceeding commenced by the  
Ontario Energy Board on its own motion to determine the  
accuracy of the final account balances with respect to  
account 1562 Deferred PILs (for the period October 1, 2001  
to April 30, 2006) for certain 2008 and 2009 distribution rate  
applications before the Board.

### **Board Staff's Submissions on the Unsettled Issues**

Board staff is providing these submissions in the above noted proceeding on the issues for which no complete negotiated settlement was reached by the parties. Board staff is not a party to the settlement agreement, nor does it have any interest in the proceeding other than assisting the Board to reach a decision in this proceeding.

Please note that Board staff's submissions are made on the basis of the record to date and may be varied after submissions are filed by the parties. This submission is being provided as a courtesy to the parties that have requested some indication of staff's views in advance of making their submissions.

#### **Issue 3: Has the distributor correctly applied the true-up variance concepts established by the Board's guidance?**

This issue encompasses all of the guidance and documents released by the Board since the PBR I Handbook in January 2000 as they relate to PILs. The unsettled issues in the draft Settlement Agreement reflect disagreement about whether:

- 1) The issue includes both a determination of what true-up variance concepts were established by the Board's methodology, and then a review of the applicants' implementation of the Board's methodology, or
- 2) The issue exclusively requires a determination of whether the applicants properly implemented the Board's methodology.

While the scope of Issue 3 is extremely broad, and covers a large body of evidence in the public domain, staff will make comments on one aspect of the guidance that concerns the parties.

There is still disagreement in this proceeding as to what constitutes an “error”. In the 2003 SIMPIL model, there was a cell reference “error” that selected the “wrong” income tax rate. This “error” therefore flowed through the true-up calculations.

Accounting for changes in tax legislation and rules has been a feature of the PILs and SIMPIL methodologies since inception. Board staff is of the view that the PILs liability and related true-up entries to the 1562 deferral account should be calculated based on the correct tax rates for the relevant years. The error in the model that caused the wrong tax rate to be selected for 2003 is not part of the Board’s methodology, but an inadvertent miscalculation. Staff does not agree that this miscalculation became “frozen” into the model due to Bill 210.

Distributors had the responsibility to ensure that the inputs into the SIMPIL models were taken directly from the tax returns, the Board decisions for the relevant applications, and the supporting PILs filing models. The PILs proxy for 2002 was based on a tax rate of 38.62%. In 2003, the maximum blended tax rate declined to 36.62% and the reduction in that tax rate and of the PILs liability should be included in the true-up amounts in the 1562 deferral account.

In reply to staff interrogatories in 2009, the three applicants confirmed that they agree that the blended tax rate for 2002 was 38.62% and 36.62% for 2003. Each of the applicants has amended its evidence in this proceeding to correct other errors and to reflect their changed views on how different elements should be calculated. If Bill 210 froze the methodology, then none of the changes to evidence would have been made voluntarily by the applicants.

Until the Board renders its decision on all of the issues in this proceeding, staff does not believe that a conclusion can be reached that all of the guidance provided by the Board has been correctly applied by the applicants, as set out in the following documents:

- 2001\_PILs letter\_Announce Consultation 2001\_240801.pdf
- 2002\_Applications\_RAM Instructions\_Jan18,2002.pdf Ref: page 1, II PILs Provision, paragraph 2; b) vi) Capital Taxes.
- 2003\_APH\_FAQs\_April2003.pdf Ref: page 5, entry 2
- 2004\_SIMPIL-Model Guide\_210704\_December 31, 2003 Tax Year.pdf Ref: Page 3, Security of the SIMPIL spreadsheets
- 2005\_SIMPIL\_AppendicesAB\_RRR\_2.1.8\_Dec.31,2004\_Tax Year.pdf Ref: Item 20
- 2006\_SIMPIL\_2005 tax year\_instructions\_040706.pdf Ref: pages 6, Tax Rates Spreadsheet, pages 8-9.
- 2006\_SIMPIL\_2005 tax year\_appendix A, B\_040706.pdf Ref: Appendix A, page 13.
- Barrie, 05/27/2009, IRRs # 1,4,10,12,13, 14, 15, 18,19,21,22, 24, 27, 28, 33, 49, 50
- Barrie, 03/12/2010, IRRs # 4, 6, 13, 14

- Halton Hills, 06/02/2009, IRRs # 13, 16, 17, 21, 24, 26, 28, 29, 30, 51, 52
- Halton Hills, 03/15/2010, IRRs # 5, 6, 7, 8, 34
- EnWin, 04/30/2009, IRRs # 4, 5, 6, 7, 8, 18, 21, 24, 27, 30, 32, 33, 53, 54
- EnWin, 03/19/2010, IRRs # 6, 7,

### **Issue 8: How should the materiality threshold be applied to determine which amounts should be trued up?**

The Parties do not agree on what materiality threshold, if any, should be used within the SIMPIL models.

In completing the form "TAXREC" in the SIMPIL worksheets, the distributor could choose a materiality level. In some cases, the use of a non-zero materiality threshold causes a mis-match between additions and deductions of related items. For example, the accounting bad debts expense must be added back, and the tax amount deducted in determining net income for tax purposes. It is possible for the addition to be above the materiality threshold and the deduction to be below the threshold (or the reverse). Only part of the related transaction is correctly handled by the worksheet.

The Settlement Agreement on page 12 states that *"The Parties agree that where the use of a materiality threshold within a model creates a mis-match between additions and deductions, this should be corrected by deeming both sides of the equation to surpass the materiality threshold if any one side surpasses the materiality threshold."* This is a valid suggestion for this combined proceeding, but is still dependent on the applicant making the correct choices and entering the correct net amount in the SIMPIL worksheets. It is probable that the applicants will have to re-run the existing or revised worksheets to reflect the Board's decisions in this proceeding.

The results of this combined proceeding will inform the Board's process for the remaining distributors. Board staff's preferred approach is to set the materiality threshold at zero in the worksheets. Distributors would then enter the information directly from their tax returns into the SIMPIL worksheets. This should not change the end result very much if the items are, by definition, not material.

The original intent of including a materiality threshold was to relieve the distributor of producing evidence to support small individual line item amounts when it sought disposition of the balance. Materiality was not intended in this case to result in a mathematically exact outcome. The tax returns and related assessments, etc. are considered the evidence in this proceeding. There is no requirement to provide documentary support for the various non-material items.

Board staff recognizes that this would be a change from the methodology previously issued in the SIMPIL worksheets. The Board should consider whether the administrative simplicity of this option warrants the change.

Barrie and EnWin submitted SIMPIL worksheet models with a number inserted in the materiality threshold cell. In March 2010, Halton Hills submitted SIMPIL models where it selected zero as the materiality threshold.

Halton Hills' revised models submitted in March 2010 eliminated the mis-match that existed in its original evidence. Rather than net the two related amounts for bad debts and inserting the net number in the SIMPIL worksheets, the model by virtue of having the materiality threshold set to zero correctly trued up both amounts. This eliminated the added complexity of having to identify related offsetting items in the tax return, then calculating the net amount, and inserting the correct net amount into the correct cell in the SIMPIL worksheets. EnWin and Barrie did not have this mis-match problem in the SIMPIL worksheet evidence they each submitted.

Staff relied on the following documents in the formation of the thoughts and ideas expressed above.

- 2002\_Application\_PILs\_proxy\_notes\_180102.pdf Ref: Notes to Proxy Model, General Comments, #9; Footnotes 7 and 13.
- 2004\_SIMPIL-Model Guide\_210704\_December 31, 2003 Tax Year.pdf Ref: Page 15, paragraph 3.
- 2006\_SIMPIL\_2005 tax year\_appendix A, B\_040706.pdf Ref: Appendix A, Item 6, page 6; item 12, page 7.
- Barrie, 03/12/2010, IRRs # 11, 13, 14
- Halton Hills, 03/15/2010, IRRs # 13
- EnWin, 03/19/2010, IRRs # 13

#### **Issue 9: What are the correct tax rates to use in the true-up variance calculations?**

The three applicant distributors are effectively subject to the maximum blended income tax rate for federal and Ontario taxes due to size. They were not eligible to claim the small business deduction. However, they may receive investment tax credits (ITCs) which reduce the taxes payable in the current year. The Board did not specify with precision how to select the income tax rate for calculating true-up amounts or whether it should be the maximum rate or the rate after the ITCs are deducted. Deducting the ITCs was part of the filing instructions in January 2002.

A second question is whether the federal corporate surtax should be included in the rate for calculating PILs true-up entries. The surtax could be offset against the Large Corporation Tax (LCT), and as such, was deducted from the income tax rates included in the SIMPIL worksheet for true-up item calculations.

The federal and Ontario tax returns, and income tax legislation are very complex and require a series of calculations to compute dollar amounts. The positive and negative dollar amounts for a multitude of items are added to arrive at the income tax payable.

Board staff is seeking a reasonably simple method that can apply to most distributors. For example, distributors could derive the income tax rate for the true-up calculations by dividing the income tax actually payable from the final tax returns by the taxable income for each tax year. For some distributors, this will be slightly below the maximum statutory tax rates. Staff recognizes that the applicants in this proceeding may have unique situations that require individual consideration, such as tax loss carry-forwards which could reduce taxable income for the year to zero.

From page #17 of the SIMPIL Model Guide for 2002 RRR and beyond issued in 2003 (2004) the following question was posed and the answer was provided.

*Q: "Which year's income tax rates should be used in the gross-up calculation for the true-up amount?"*

*A: "It should be the same year the true-up variance is collected from customers. For example, a utility would normally use the income tax rates of the calendar year 2004 to calculate the gross-up of the true-up variance related to the fiscal 2002 year as the true-up variance would normally be collected from customers in the 2004 rate year. Given the rate setting limitations of Bill 210, LDCs may need to adjust the gross-up amounts in future periods to reflect the rates in effect at that time. In the interim, 2004 tax rates should be used."*

From the April 2003 FAQ, on page 4, footnote #1: *"Please note the gross-up calculation is based on the tax rates legislated for the year during which the corresponding PILs is recovered from customers."*

True-up variances have not yet been collected from or refunded to customers. The references cited above suggest that the tax rates for 2011 could be used for calculating all true-up entries for all years 2001-2005 should the Board not permit collection until the next rate change scheduled for May 1, 2011.

There are more than 30 distributors that are subject to tax rates that lie between the minimum and maximum rates and several arithmetical computations are required to determine the tax dollars payable. The tax rate can only be derived in these cases by dividing the net income tax payable by the taxable income.

For clarification, this tax rate, once approved by the Board, will be the rate to be applied to the items that are subject to a true-up variance. Deferral account entries for changes in tax legislation are dealt with separately.

Staff relied on the following documents in the formation of the thoughts and ideas expressed above.

- 2002\_Application\_PILs\_proxy\_notes\_180102.pdf Ref: Notes to Proxy Model, General Comments, #7; Footnotes 14 and 15C.
- 2003\_APH\_FAQs\_April2003.pdf Ref: page 4, footnote 1.

- 2004\_SIMPIL-Model Guide\_210704\_December 31, 2003 Tax Year.pdf Ref: Page 15, Miscellaneous Tax Credits; page 17, tax rates, first 5 paragraphs.
- 2006\_SIMPIL\_2005 tax year\_instructions\_040706.pdf Ref: page 6
- 2009\_T2 Corporation Income Tax Return.pdf
- Barrie, 05/27/2009, IRRs # 2, 3, 4, 10, 12, 14, 15, 16, 22, 25,
- Barrie, 03/12/2010, IRRs # 4, 12, 13, 14
- Halton Hills, 06/02/2009, IRRs # 3, 5, 6, 7, 8, 9, 10, 14, 15,
- Halton Hills, 03/15/2010, IRRs # 14
- EnWin, 04/30/2009, IRRs # 3, 19, 20,
- EnWin, 03/19/2010, IRRs # 14

**Issue 10: How should the continued collection of the 2001 PILs amount in rates be considered in the operation of the PILs deferral account?**

After the rate unbundling applications in 2000-2001, the first PBR1 adjustment was made in early 2002. The IPI-PF formula was applied to base distribution rates that excluded 2001 deferred PILs, 2002 PILs proxy, Z-factors and interim transition cost riders.

In the rates approved by the Board in 2002, a fourth quarter 2001 deferred PILs recovery component was included. The rate components associated with the collection of the 2001 deferred PILs amount were intended to be removed from rates at the next rate-setting process in 2003 but continued longer than anticipated into 2004, due to the rate freeze imposed by the government in 2002.

The applicants in this proceeding have shown the 2001 deferred PILs amount in the PILs summary reconciliation of the balance in the 1562 deferral account for each period until it was removed from distribution rates in 2004. In addition, the amounts billed to customers for 2001 deferred PILs have been shown in the 1562 summary reconciliation through 2004.

An alternative view involves recording the Board-approved 2001 deferred PILs amount only once for 2002 in the PILs 1562 reconciliation. This treatment reflects an assumption that the Board only intended the 2001 deferred PILs to be collected once from ratepayers. The amounts billed to ratepayers through 2004 would be deducted in the reconciliations and this method would result in a liability for 2003 and 2004 up to the effective date of the rate change for each distributor.

The 2001 deferred PILs was a rate component being collected through 2002 distribution rates, not by a separate rate rider with a sunset date for removal from rates. As such, Board staff is of the view, on a preliminary basis, that the Board-approved rates continued to be in force until the Board changed those rates in 2004. Therefore, in addition to the various true-up items (Issue 11), the pertinent reconciling amounts are

the net differences between the deferred PILs amounts approved in rates and the amounts billed to customers for the period 2002-2004.

Both sides of the argument have merit.

Staff relied on the following documents in the formation of the thoughts and ideas expressed above.

- 2001\_PILs letter\_Announce Consultation 2001\_240801.pdf
- Barrie, 05/27/2009, IRRs # 26, 29, 30.
- Barrie, 03/12/2010, IRRs # 15
- Halton Hills, 06/02/2009, IRRs # 31, 32,
- Halton Hills, 03/15/2010, IRRs # 15
- EnWin, 04/30/2009, IRRs # 35, 36,
- EnWin, 03/19/2010, IRRs # 15
- CLD\_Exhibits\_20100209

**Issue 11: Should the SIMPIL true-up to specified items from tax filings be recorded in the period after the 2002 rate year until the 2001 deferral account allowance was removed from rates?**

The 2001 SIMPIL true-up variances were recorded only once in the 1562 summary reconciliation in 2002. There were no instructions issued that the distributors should continue to calculate additional true-up variances for 2001 deferred PILs as the tax rates declined in 2003 and 2004. Since the Board's intention was to remove 2001 deferred PILs from rates in the 2003 rate-setting process, there was no need at the time to issue any instructions. Revised PILs / SIMPIL guidance was issued in 2003, but no instructions were issued for the continued tracking of true-up variances related to 2001 deferred PILs.

As stated under Issue 3, the Board's methodology requires the changes in tax legislation to be accounted for and included in the true-up entries to the 1562 deferral account. It is staff's recommendation that changes in tax legislation should be dealt with consistently in the 1562 reconciliation process. However, Board staff recognizes that any variance amounts related to 2001 deferred PILs may not be significant because they only pertain to a three-month period.

Staff relied on the following documents in the formation of the thoughts and ideas expressed above.

- 2001\_PILs letter\_Announce Consultation 2001\_240801.pdf
- Barrie, 05/27/2009, IRRs # 26, 29, 30, 31.
- Barrie, 03/12/2010, IRRs # 15
- Halton Hills, 03/15/2010, IRRs # 15
- EnWin, 04/30/2009, IRRs # 35, 36



- EnWin, 03/19/2010, IRRs # 15
- CLD\_Exhibits\_20100209

**ALL OF WHICH IS RESPECTFULLY SUBMITTED**