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Ontario

BY EMAIL

August 10, 2012

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

Attention: Ms. Kirsten Walli, Board Secretary

Dear Ms. Walli:

Re: Parry Sound Power Corporation
Application for the Disposition of Account 1562 – Deferred Payments in Lieu of Taxes
Board Staff Submission
Board File No. EB-2012-0229

In accordance with the Notice of Application and Hearing, please find attached the Board Staff Submission in the above proceeding.

In addition, Board staff reminds Parry Sound Power Corporation that its Reply Submission is due by August 24, 2012.

Yours truly,

Original Signed By

Daniel Kim
Analyst, Applications & Regulatory Audit

Encl.

ONTARIO ENERGY BOARD

STAFF SUBMISSION

Parry Sound Power Corporation

EB-2012-0229

August 10, 2012

Parry Sound Power Corporation
Board staff Submission
Account 1562 Deferred PILs Disposition

Background

Parry Sound Power Corporation ("PSPC") filed a stand-alone application for the disposition of Account 1562 – Deferred PILs, dated April 30, 2012. The PILs evidence filed by PSPC in this proceeding includes tax returns, financial statements, Excel models from prior applications, calculations of amounts recovered from customers, SIMPIL[1] Excel worksheets and continuity schedules that show the principal and interest amounts in the Account 1562 Deferred PILs balance. The current proceeding does not deal with Reporting and Record Keeping Requirements ("RRR"). Rather, this proceeding is a prudence review of the final evidence filed by the applicant to recalculate the Account 1562 PILs variances to be refunded to its customers.

In its pre-filed evidence, PSPC applied to refund to customers a credit balance of $120,735 consisting of a principal credit balance of $108,976 plus related credit carrying charges of $11,759. In response to interrogatories, PSPC has stated that the refund should now be a principal credit balance of $143,256 and related credit carrying charges of $24,660, a total of $167,916.

Submission

<u>Interest Expense True-up</u>

In reply to interrogatories, PSPC filed information related to interest expense and Independent Electricity System Operator ("IESO") prudential amounts included in OM&A.[2] PSPC's maximum deemed interest approved in its 2002 rate application was $237,860. By including interest on debt and IESO prudential costs, and by excluding interest on regulatory assets and on customer deposits, the actual interest amounts in each year are below the approved maximum deemed interest.

Board staff submits that there are no excess interest variances to be included in the true-up calculations.

[1] Spreadsheet implementation model for payments-in-lieu of taxes
[2] Responses to interrogatories/ Appendix 14.

Income Tax Rates

In 2001, the Board approved a regulatory PILs tax proxy approach for rate applications coupled with a true-up mechanism filed under the RRR to account for changes in tax legislation and rules, and to true-up between certain proxy amounts used to set rates and the actual amounts. The variances resulting from the true-up were tracked in Account 1562 for the period 2001 through April 30, 2006.

In Procedural Order No. 8 of the Combined Proceeding,[3] the Board included language at the top of the approved final issues list. The Board released the following on Issues Day:

> In the Board's Decision in this proceeding, which was issued December 18, 2009, the Board established certain parameters for this proceeding. Among those parameters, the Board stated: "The Board will not enter into an enquiry as to what the methodology should have been but rather, will determine, where necessary, what the methodology was and what the appropriate application of the methodology should have been." Accordingly, the individual issues below are to be interpreted in a manner that exclusively furthers the Board's determination as set out in the Decision.
>
> Further, the issues below only address the issues relevant to the three named applicants; Account 1562 Deferred PILs issues that are relevant to the disposition of the account for other LDCs, but which are **not relevant to the three named applicants, are not within the scope of this proceeding**. *[Emphasis added.]*

In the transcript of Issues Day before the Board, Presiding Member Ken Quesnelle made the following statements:

> What we don't want to do now, in fairness to the applicants that are before the Board, is slow down these proceedings in testing hypothetical scenarios, in tweaking the existing evidence to a point where it might suit someone else who is outside of this proceeding and to test hypotheticals.[4]

[3] EB-2008-0381, Procedural Order No. 8, Final Issues List, February 17, 2010.
[4] Decision on Issues List, Transcript, Issues Day, February 9, 2010, Page 32, lines 21-26

> We have come this far and we want to concentrate on the applicants that are before us and the evidence that is here.[5]
>
> But we will be resisting the stretching of the current applicants' evidence to consider all permutations of scenarios that could occur.[6]

The generic issue of which income tax rates would apply to distributors that were not subject to the maximum income tax rates was not decided in the Combined Proceeding. In conducting the prudence review of the re-calculation of the balance in Account 1562, the Board has to consider many inputs that a distributor used throughout its evidence. The income tax rates are one of many important inputs in the calculations.

The best example of a tax issue from the decision in the Combined Proceeding relates to regulatory assets and liabilities. Historically, the distributor recorded the tax impact of its tax planning measures in Account 1562. An incomplete cycle with respect to the creation and recovery of regulatory assets straddled the theoretical end date of Account 1562 (April 30, 2006). The Board decided that the tax impact of regulatory assets and liabilities should be excluded in the determination of the final balance in Account 1562 to be disposed since the distributor would continue to recover these amounts from 2004 up to 2009. Each distributor has to re-calculate a theoretical principal balance and related interest carrying charges in Account 1562 by following guidance and Board decisions.

PSPC through its own tax planning strategies created tax losses of $134,607 in 2001, and $149,716 in 2002 which it used to avoid paying any income taxes during the period October 1, 2001 to December 31, 2003.[7] In 2004, the remaining income tax losses were utilized to reduce taxable income. While PSPC was subject to small amounts of corporate minimum tax, this minimum tax was recoverable when PSPC began paying income taxes in 2004. Based on the Board's instructions issued in the 2002 application guidelines, corporate minimum tax was not used in the determination of the PILs proxy.[8]

A challenge for the Board in its prudence review of a re-calculated balance of PSPC's Account 1562 deferred PILs is how to interpret the effects of the tax losses on the PILs

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[5] Decision on Issues List, Transcript, Issues Day, February 9, 2010, Page 33, lines 10-12.
[6] Decision on Issues List, Transcript, Issues Day, February 9, 2010, Page 34, lines 10-12.
[7] Application/federal T2 tax returns/ page 3 and Schedule 4 for each of 2001, 2002, 2003 and 2004.

[8] EB-2008-0381, Exhibit: 2002_Application_PILs_proxy_notes_180102, May 14, 2010, page 1.

methodology, and how to select the most reasonable income tax rates to be used in the calculations. Since this proceeding is not generic, and relies on PSPC's specific tax facts and evidence, the Board must select from the evidence the applicant places before it. In the decision in the Combined Proceeding, tables of maximum and minimum income tax rates appear on page 17.

The range of income tax rates is delineated from zero percent implied by utilizing tax losses to create zero taxable income, to the minimum tax rates, to innumerable income tax rates that lie between maximum and minimum which must be calculated based on the specific tax facts of the distributor. The Board has decided that the floor of the range is delimited by the minimum income tax rates and the ceiling by the maximum income tax rates.

PSPC collected $782,284 from its customers during the period covered by the Account 1562 methodology. PSPC was assessed only $84,595 for the same period as shown in the following table. Recoveries from customers exceeded PILs assessments by $697,689. While PSPC paid corporate minimum tax, this is similar to a deposit for future income tax payments as PSPC was able to offset this tax paid against income taxes when it started to pay in 2004. Corporate minimum taxes have been excluded from the Board's PILs 1562 methodology since December 2001.[9]

Parry Sound	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**Total**
Notices of Assessment							
Corporate minimum tax			4,188				4,188
Ontario income tax				5,523	7,280		12,803
Ontario capital tax	1,638	6,553	7,223	8,794	2,865		27,073
Federal income tax				18,089	22,442		40,531
Taxes Assessed (1)	**1,638**	**6,553**	**11,411**	**32,406**	**32,587**		**84,595**
Billed to Customers (2)		**166,613**	**210,587**	**178,723**	**161,478**	**64,883**	**782,284**
Billed recoveries exceed taxes assessed							**697,689**

Sources:
1. Notices of assessment filed in evidence
2. Replies to interrogatories, Appendix 17

9 http://www.rds.ontarioenergyboard.ca/webdrawer/webdrawer.dll/webdrawer/rec/198685/view/

The Board's PILs methodology is not the same as flow through taxes. Board staff understands that a total true up of the amounts collected from ratepayers and the amounts actually paid in taxes to the government was not the intent of the PILs Account 1562 methodology and Board staff would not argue for such an outcome. However, the analysis does demonstrate that PSPC would not be harmed by the Board selecting the minimum tax rates to re-calculate the balance in Account 1562. The refund amount to customers calculated by PSPC using the minimum income tax rates is $203,653[10].

In interrogatory #1 Board staff requested that PSPC file the correspondence it received from its external auditors that show how the income tax rates were calculated. PSPC answered, "Appendix 1 provides the details supporting the determination of effective income tax rates by Parry Sound's external auditors for the period from 2002 to 2005." The evidence filed as Appendix 1 does not indicate that it was prepared by PSPC's auditors.

Board staff asked if PSPC's auditors had calculated the tax rate for the fourth quarter 2001. PSPC replied, "Parry Sound did not request its auditors to calculate an effective rate for Q4 2001. The approval of Q4 2001 PILs was completed at a time when the Board had full knowledge of what the actual tax rate would have been (late 2001 and early 2002)."

Board staff asked PSPC to provide SIMPIL models for 2001 to 2005 that used the minimum income tax rates for the Board's consideration. PSPC filed the requested evidence but replied as follows.

> "Board Staff have not provided a rationale as to why they feel that the use of minimum tax rates would be appropriate.
>
> PSPC believes that a regulatory approach to the determination of true-up income tax rates is the appropriate approach. The regulatory approach should reflect a taxable income level equal to the regulatory taxable income that was originally used to determine the amount of PILS that were approved to be included in rates. The determination of tax rates should also reflect the entitlement to reduce taxes through the benefit of the small business deduction.

[10] Responses to interrogatories/ Appendix 2/ Continuity Schedule.

PSPC believes these are the proper rates to utilize, as they reflect the intent of the SIMPILS process to capture changes in legislated tax rates. The PILS included in rates were determined well in advance of the actual tax years using proxies for what the actual tax rates would be. Utilizing the actual tax rates that would be applicable to the same level of regulatory net income as used to set PILS in rates properly captures the changes in legislation. This captures the difference between the rates used to determine PILS included in rates and what the PILS would have been if they were set in the actual tax year with knowledge of any changes in tax rates."

Board staff has provided the table below which was prepared by staff from the evidence filed by PSPC in its SIMPIL models and tax returns. PSPC's Board-approved rate base in the 2002 application was $6,561,667. The actual effective tax rates were calculated by dividing the total income tax shown in the table on page 5 (and adding back the corporate minimum tax that was deducted) by the taxable income shown in the table below.

	2001	**2002**	**2003**	**2004**	**2005**
Minimum income tax rates	19.12%	19.12%	18.62%	18.62%	18.62%
Preferred by PSPC	34.12%	24.55%	21.90%	20.76%	21.62%
Taxable income from applications	$70,508	$327,891	$327,891	$327,891	$415,670
Actual taxable income – T2	NIL	NIL	NIL	$137,879	$171,056
Actual effective tax rates	NIL	NIL	NIL	18.62%	18.62%

Midland Power Utility Corporation ("Midland") had no taxable income for the five years 2001 through 2005. The Board decided that Midland should use the minimum income tax rates to calculate the SIMPIL PILs 1562 variances.[11] Midland filed a motion to review and vary the Board's decision.[12] In its Decision on the motion, the Board made the following statements.

"Midland asserted that the findings in the Combined PILs Decision are based on three key factors:

- The level of taxable income was set equal to regulatory taxable income used in the PILs determination models which were used to calculate the amount of PILs that were included in rates;

[11] EB-2011-0182, Decision and Order, page 15.
[12] EB-2012-0219, Decision with Reasons and Order, July 12, 2012.

- The level of taxable capital as per the actual Federal T2 tax returns was used to determine if small business reductions to tax rates were appropriate; and
- The actual level of legislated annual federal and provincial income tax rates was used for the specific years.

The Board notes that these key factors are not identified as such by the Board in the Combined PILs Decision, but more importantly, the issue of which income tax rates should apply to distributors that were not subject to the maximum income tax rates was not decided in the Combined Proceeding. As the Board stated in Procedural Order No.8 of the Combined Proceeding:

> Further, the issues below only address the issues relevant to the three named applicants; Account 1562 Deferred PILs issues that are relevant to the disposition of the account for other LDCs, but which are not relevant to the three named applicants, are not within the scope of this proceeding."[13]

"The Board notes that from a ratemaking perspective, the Board is concerned with regulated balances, not balances that are constructed for taxation purposes. Tax accounting and regulatory accounting have different purposes and from a ratemaking perspective, the Board is concerned with the latter, not the former."[14]

PSPC filed applications for 2009, 2010, 2011 and 2012 rate adjustments. In these applications PSPC applied using the minimum income tax rates.[15]

Board staff submits that PSPC's own applications, and the evidence filed in this proceeding, demonstrate that the minimum income tax rates are appropriate tax rates to use in calculating Account 1562 deferred PILs amounts to be refunded to customers.

Board staff has calculated a refund amount using the SIMPIL models and continuity schedules filed by PSPC as interrogatory response Appendices 8-12 and 17. These models allow the regulatory asset amount in the proxy to true up[16] and have the revised billed

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[13] EB-2012-0219, page 12.
[14] Ibid, page 10, #2, paragraph 2.
[15] EB-2008-0378; EB-2009-0207; EB-2010-0140; EB-2011-0193.
[16] PSPC's response to interrogatories 3 a, b & c.

amounts[17]. Board staff inserted the minimum income tax rates in the SIMPIL models. Board staff calculated that the refund amount with interest to August 31, 2012 is $250,041. Board staff requests that PSPC confirm that this is the correct calculation for the amount to be refunded should the Board approve the use of the minimum income tax rates and the other changes accepted by PSPC in response to interrogatories.

All of which is respectfully submitted

[17] PSPC's response to interrogatory 4 a.