Ontario Energy Board

Commission de l'énergie de l'Ontario

Ontario

EB-2010-0008

IN THE MATTER OF AN APPLICATION BY

ONTARIO POWER GENERATION INC.

PAYMENT AMOUNTS FOR PRESCRIBED FACILITIES FOR 2011 AND 2012

DECISION WITH REASONS

March 10, 2011

Capacity Refurbishment Variance Account; Nuclear Fuel Cost Variance Account; and the Bruce Lease Net Revenues Variance Account.

10.3.1 Tax Loss Variance Account

The Tax Loss Variance Account was established by the Board in the motion proceeding EB-2009-0038. That proceeding was held to review the Board's previous payments decision, and in particular the Board's decision in the area of tax losses for the period that preceded regulation by the Board and rate increase mitigation. The motion decision stated "the clearance of this account will be reviewed in OPG's next payment application hearing when a future panel of the Board reviews the tax analysis ordered in the Payments Decision [EB-2007-0905]." In the current proceeding, OPG seeks recovery of the December 31, 2010 balance in the account over a 46 month period. The audited balance is $492 million: $78 million is allocated to the hydroelectric business and $414 million is allocated to the nuclear business.

The Tax Loss Variance Account and the history of the tax losses is a matter of considerable complexity. It is useful to review the history of this issue through the various proceedings.

In the previous payments proceeding, OPG recognized that the revenue requirement increase it was requesting was significant and would result in a 19% increase in payment amounts. OPG identified that the regulatory taxable income calculation for the years 2005-2007, the period during which the Province established the payment amounts and before the period in which the Board set the amounts, resulted in tax losses for those years. OPG calculated the regulatory tax losses at the end of 2007 to be $990.2 million in total. OPG proposed to accelerate the application of the available tax losses to reduce the test period revenue requirement in order to mitigate the increase in the payment amounts to 14.8%. Specifically, OPG proposed to exclude the 2008-2009 test period tax provision from the revenue requirement and to reduce the revenue requirement by a further $228 million.

In the payments decision, the Board stated that it was not convinced that there were any regulatory tax losses to be carried forward to 2008 and later years. The Board directed OPG to file better information on its forecast of test period income tax provision and a re-analysis of the prior period tax returns in its next application. The Board also required OPG to provide mitigation in an amount that was proportional to the originally proposed mitigation amount (i.e. 22% of the revenue deficiency). The resulting mitigation was $168.7 million.

OPG filed a motion for a review and variance of the original decision related to these matters. The Board granted the motion and made the following decision:

> The Board varies the Payments Decision [EB-2007-0905] in a manner that links the revenue requirement reduction and regulatory tax losses, and orders the establishment of a tax loss variance account to record any variance between the tax loss mitigation amount which underpins the rate order for the test period and the tax loss amount resulting from the re-analysis of the prior period tax returns based on the Board's directions in the Payments Decision as to the re-calculation of those tax losses.[49]

In the current proceeding, OPG's evidence is that the Board's EB-2007-0905 decision reduced OPG's revenue requirement by $342 million, consisting of $168.7 million for the mitigation amount and $172.5 million for the elimination of the tax provision for 2008 and 2009. This amount was also identified during the motion proceeding. OPG described the determination of this amount as follows:

- The amount of mitigation included in the EB-2007-0905 decision (excluding tax) was $168.7 million.
- The benchmark tax expense for the previous test period was $66 million.
- The provision for taxes and gross up is $106.5 million.
- The total is $341.2 million

In accordance with the Board's decision in EB-2007-0905, OPG recalculated its regulatory tax losses for the period April 1, 2005 to March 31, 2008 to be $188.5 million. OPG described the adjustments it made to the original estimate of $990.2 million to arrive at $188.5 million as follows:

- The Board's decision on the Pickering A Return to Service Deferral Account ("PARTS") required OPG to provide tax benefits to coincide with the timing of the recovery of the costs. OPG determined that this would reduce the tax loss by $147 million.
- The previous decision stated that any calculation of tax loss "in respect of the prescribed facilities should exclude revenues and expenses related to the Bruce

[49] Decision and Order, EB-2009-0038, May 11, 2009, p. 15.

lease." OPG determined that the tax loss should be reduced by $390 million as a result.

- The Board noted in the previous decision that the operating loss in 2007 was borne completely by OPG's shareholder, which reduced the tax loss by $234.2 million.
- OPG determined that a further $37 million reduction was required due to an update of information for 2007 and that a $6.5 million addition was required due to allocation of adjustments to the period prior to regulation.

OPG engaged Ernst & Young to apply specified procedures guided by section 9100 of the CICA Handbook to reconcile information in OPG's corporate tax returns to the determination of prior period tax losses for the prescribed facilities for 2005, 2006 and 2007. Ernst & Young was able to tie the numbers on the schedules back to the source documents with no exceptions.

From this amount of $188.5 million OPG deducted the $77.6 million in taxable income for the period January 1, 2008 through March 31, 2008. This left $110.9 million in remaining net cumulative losses, or a revenue requirement amount of $50.3 million.

The difference between the revenue requirement reduction ($342 million) and the remaining tax loss ($50.3 million), being $290.9 million, was booked to the account for the period April 1, 2008 through December 31, 2009. OPG forecast the amount for 2010 to be $195 million, being an annualized grossed-up amount of the $342 million revenue requirement reduction during the original 21 month test period. To these amounts OPG also applied interest at the Board prescribed levels.

SEC provided in its argument a detailed alternative estimate of the appropriate amounts to be considered in respect of this issue. SEC submitted that there should be no regulatory tax liability for the period 2008 to 2012 because of timing differences which SEC has determined are in the order of $1,660.4 million. In SEC's view, these amounts, which are tax deductions taken by OPG prior to April 1, 2008, should be available to ratepayers. SEC estimated that an amount between $450 million and $500 million would remain available for deduction in 2013 and beyond.

The principle that SEC relied on in its submission is "benefits follow costs" which SEC describes as meaning "if the ratepayers bear a cost in their rates, then any tax impacts that flow from that cost accrue to the ratepayers as well."[50] In particular, SEC is concerned with the application of this principle with respect to tax related timing differences. "Timing difference" refers to government tax policy which in SEC's words "allows taxpayers to front load their tax deductions, and thus save tax dollars, as a way of providing economic stimulus and incenting long term spending."[51] SEC asserted that the general pattern is one of tax savings in the early years and tax costs in later years and in general the regulatory system matches this by using a taxes payable approach to setting rates.

In OPG's case, however, SEC argued that the balance is disrupted because OPG became regulated part way through the tax benefit period, meaning that the shareholder will have gained from the tax benefits in the pre-regulation period and ratepayers will bear the balancing tax costs in the regulation period. In SEC's view, the appropriate approach is to re-examine the relevant periods to ensure ratepayers receive the benefits of these timing differences.

SEC reviewed the evidence and determined that OPG had $1,660.4 million of timing differences (including amounts related to Bruce) in the three years prior to April 1, 2008 which should be available to ratepayers. The largest component (over $1.2 billion) is related to nuclear waste and decommissioning costs. These amounts include impacts related to Bruce, because in SEC's view, when the Board decided that GAAP should be used to calculate the net Bruce lease revenue, the Board was "not intending to say that Bruce should be an exception to the "benefits follow costs" principle related to tax calculations."[52]

SEC further argued that the tax losses prior to April 1, 2005 should also be considered for potential availability to ratepayers and recommended that the Board direct OPG to prepare a detailed review of the losses at the next proceeding.

OPG opposed SEC's analysis on three principal grounds. First, OPG argued that SEC's analysis consists of untested evidence. In OPG's view, SEC's approach is a form of opinion/expert evidence and no authority has been provided for the positions taken in relation to the accounting and regulatory principles related to tax/accounting timing differences.

[50] SEC Argument, para. 10.2.9.
[51] SEC Argument, para. 10.2.16.
[52] SEC Argument, para. 10.2.63.

Second, OPG argued that SEC's analysis violates Board approved regulatory principles and does not comply with accepted tax and accounting practices. In OPG's view, tax loss carry forward is a concept which is recognized in the *Income Tax Act* and OEB regulated tax calculations but timing differences carried forward have no basis in accounting. OPG further argued that SEC's generalization regarding the pattern associated with timing differences is incorrect and pointed, for example, to testimony that deductions for nuclear liabilities are only available when actual cash expenditures are made. OPG also submitted that whereas it applies the deductions against earnings before tax and carries forward any resulting loss, SEC ignores earnings before tax and does not apply the deduction in the period for which it applies.

Third, OPG maintained that SEC's analysis is based on misinterpreted facts and faulty assumptions. OPG provided an analysis of why, in its view, SEC's analysis is flawed. For example, OPG explained that its treatment of the PARTS amounts, unlike SEC's proposal, is based on the Board's direction in the first payments decision which required that the timing of PARTS recovery match the timing of providing the associated tax cost or benefit to ratepayers. OPG also pointed to the incomplete nature of SEC's analysis and the lack of identification of adjustments to earnings that were additions. OPG further argued that SEC had incorrectly applied the "benefits follow cost" principle, and OPG has appropriately excluded Bruce lease revenues and costs from its tax loss determination. OPG also argued that SEC has ignored the provisions of O. Reg. 53/05 sections 6(2)5 and 6(2)6 which require the Board to accept the revenue requirement impact of accounting and tax policy prior to the effective date of the Board's first order.

OPG further argued that there is no basis to review the period before April 1, 2005 and therefore SEC's proposal that related evidence be provided at the next proceeding should be rejected.

CME supported SEC's submissions but also presented another approach related to the mitigation amount in relation to the original proceeding. CME pointed out that OPG's evidence in the original proceeding was that a 19% increase was excessive and needed to be reduced in order to bring the increase to about 14.8% to be reasonable. CME estimated this amount to be $360 million. OPG responded that the motion decision varied the original decision in a way that links the mitigation with the regulatory tax losses. OPG argued that CME has mischaracterized the nature of OPG's original proposal as being focused on mitigation.

VECC and CME argued that no amount associated with 2010 should be recoverable. In VECC's view, "The decision establishing the test period Tax Loss Variance Account never contemplates, either explicitly or implicitly, the operation of a similar account beyond 2009."[53] VECC asserted that it is clear in the decision that the variance to be tracked was limited to the test period. VECC went on to submit that if the Board rejects this argument, then at a minimum the $195 million for 2010 should be reduced by $26.2 million to reflect the reduced tax amounts related to nuclear liabilities in 2010. VECC also submitted that had OPG proposed the tracking of $195 million in the accounting order proceeding, EB-2009-0174, intervenors may have made submissions and the Board may have considered different relief. This position was supported by CME and SEC.

OPG replied that the accounting order proceeding was about the mechanics of booking entries in accounts in 2010 and that there was no need to make a request for this matter for the tax loss variance account. Further, OPG stated that it was not necessary to seek extended terms for any of the deferral and variance accounts:

> ...payment amounts are established based on a test period, but they remain in place until changed by the OEB. Similarly, unless the OEB explicitly states otherwise, variance and deferral accounts established in relation to those payment amounts also continue until changed by the OEB.[54]

OPG also rejected VECC's proposal that the 2010 balance be reduced by $26.2 million related to the tax impacts of changes in nuclear liabilities. OPG maintained that the account does not cover changes in 2010 actual amounts resulting from the Darlington Refurbishment project:

> The revenue requirement impact pertaining to income taxes should be treated the same as the revenue requirement impact associated with non-tax factors. They are simply not relevant to the determination of the test period revenue requirement.[55]

CCC supported SEC's submission, but argued that the Board should defer consideration of the tax loss variance account to a separate proceeding, and that an independent expert should report on the issue. OPG objected to this suggestion

[53] VECC Argument, para. 119.
[54] Reply Argument, p. 196.
[55] Reply Argument, p. 156.

referring to direction in the EB-2007-0905 and EB-2009-0038 decisions which stated that the matter would be addressed in this payment amounts application.

Board Findings

The Board approves recovery of the balance in the Tax Loss Variance Account in accordance with OPG's proposal to recover the balances over a 46 month period. However, the riders that will be given effect by this Decision and subsequent payment order will be effective until December 31, 2012.

CCC argued that the matter should be deferred to another proceeding. The Board does not agree. It was made clear in the motion proceeding and the prior payments decision that the issues were to be resolved in this proceeding. It would only be appropriate to defer consideration of the issue if there were insufficient evidence on the record. That is not the case here.

SEC argued that the appropriate application of the "benefits follow costs" principle, which was articulated by the Board in the original payments decision, would see the inclusion of the impact of timing differences in the calculation of the tax amounts. The result of SEC's approach would be a proposed credit for ratepayers resulting from net timing differences of $1,660.4 million. Of this $1,660.4 million, SEC identified $1,052.4 million for the prescribed facilities and $608.0 million for Bruce.

OPG has pointed to significant deficiencies in SEC's analysis, and the Board finds that OPG's criticisms have merit. For example, the Board agrees that OPG's treatment of the amounts related to the PARTS account is consistent with the Board's prior decision which required that the timing of the tax effect be aligned with the recovery of the cost. The Board also accepts OPG's evidence that the effect of timing differences is not always as SEC has posited, and in particular not in the case of asset retirement costs. The Board also concurs with OPG's position that it is clear the Board intended for Bruce revenues and costs to be excluded from the analysis. For these reasons, the Board finds SEC's calculations and estimations to be unpersuasive.

With respect to amounts in the account for 2010, the Board finds that there is no basis in the motion decision for the proposition that this account was only effective during the prior test period. The section of the decision that has been quoted by the parties is as follows:

> The Board varies the Payments Decision [EB-2007-0905] in a manner that links the revenue requirement reduction and regulatory tax losses, and orders the establishment of a tax loss variance account to record any variance between the tax loss mitigation amount which underpins the rate order for the test period and the tax loss amount resulting from the re-analysis of the prior period tax returns based on the Board's directions in the Payments Decision as to the re-calculation of those tax losses.[56]

The parties opposed to any recovery for 2010 point to the phrase "the tax loss mitigation amount which underpins the rate order for the test period" as the basis for their position that the account was only established for the duration of the test period. The Board does not agree that the decision is appropriately interpreted in that way for two reasons. First, the plain reading of the phrase indicates that the words "for the test period" are meant to describe the relevant rate order. Second, the Board indicated that the account was to be cleared, and the relevant issues addressed, in the next proceeding. While parties might have expected that the next proceeding would follow directly from the prior test period, having found that the original decision was in error and that the payment amounts included amounts which would need to be adjusted at a future time, it does not follow that the Board would have intended for the account to have a fixed duration for only the test period. In essence, the account was put in place to correct an error in the original decision and as long as those original payments were in place the error continued to exist.

The Board also rejects CME's argument that the account should be adjusted to reflect a quantification of the appropriate level of mitigation. The scope of the account was clearly set out in the motion decision and there is no suggestion that any amounts in addition to the description of the appropriate variance are to be contemplated for purposes of mitigation.

VECC argued that at a minimum the Board should reduce the 2010 balance by $26.2 million to reflect the reduced tax amounts related to nuclear liabilities in 2010 (as compared to the original test period). The Board does not agree. VECC is proposing an adjustment to the original mitigation amount ($341.2 million) to reflect one component of actual results, but the motion decision defined and fixed the original mitigation amount as "the tax loss mitigation amount which underpins the rate order for the test period." This wording effectively fixes the amount at the level which underpinned the original payment order and contemplates no adjustment for actual

[56] Decision and Order, EB-2009-0038, p. 15.

results in relation to regulatory taxes paid during the period. No adjustments have been made to reflect actual regulatory taxes for the original 2008 and 2009 test period; it would likewise be inappropriate to adjust the 2010 amount.

10.3.2 Nuclear Liability Deferral Account

OPG incurs costs associated with decommissioning its nuclear facilities and managing used fuel and low and intermediate level waste. These costs are recognized as expenses over the life of the nuclear stations and are included in payment amounts because they are part of the cost of operating the nuclear stations.

The Nuclear Liability Deferral Account (Transition) was established in 2007 in accordance with section 5.1(1) of O. Reg. 53/05 to capture the revenue requirement impact of any change in OPG's nuclear decommissioning liability arising from an approved reference plan under the Ontario Nuclear Funds Agreement ("ONFA"). Section 5.1(2) of the O. Reg. 53/05 provides that simple interest be applied on the monthly opening balance at an annual rate of 6%. That account was in effect until the Board's first order.

The previous proceeding established the current Nuclear Liability Deferral Account effective April 1, 2008 pursuant to section 5.2(1) of O. Reg. 53/05. The Board directed OPG to record the return on rate base using the average accretion rate on OPG's nuclear liabilities of 5.6% for the test period.

SEC observed that the balance in the account, as noted in the previous decision, was $130.5 million and that no changes to the reference plan under ONFA have taken place. SEC stated that the opening balance of the account on April 1, 2008, as noted in the current application, was $163.9 million with an amount of $31.3 million recorded in the first quarter of 2008.

OPG replied that the difference between nuclear liability costs embedded in payment amounts approved by the province for the period up to March 31, 2008 and those costs arising from the reference plan under ONFA are captured by the Nuclear Liability Deferral Account. OPG referred to the 2008 OPG Audited Financial Statement and the first quarter 2008 Financial Statements. Both noted an increase to the nuclear liability deferral account of $37 million of which $6 million is interest.