KPMG Report

Review of Rate Setting Implications of Tax Losses Carry Forward

Oral Hearing on July 13, 2016

Michel Picard's Resume

Certification and Experience

- Michel is a CPA, CA and a Partner of KPMG in Toronto and is the Power & Utilities leader in KPMG's Accounting Advisory Services practice
- Led IFRS projects for a number of Power & Utilities organizations in Ontario and is also the technical accounting partner on a number of IFRS conversion projects for Power & Utilities and gas organizations across Canada
- Provide regular updates and annual training on accounting and regulatory matters to Canadian utilities, Canadian Electricity Association (CEA), Electricity Distribution Association (EDA) of Ontario, Canada's Energy and Utility Regulators (CAMPUT) and Ontario Energy Board (OEB)

Rate Regulation

- Member of the IASB Consultative Group on Rate Regulation representing the KPMG Global Network of independent member firms
- Commercial Member Steering Committee of EDA
- Member of the CEA
- Developed deep knowledge and experience in accounting for the effect of rate regulation in the power and utilities sector
- Led the OEB's industry-wide IFRS project
  - to initially identify and assess the impact of the transition to IFRS on the regulation of rates levied under the cost of service regulatory model
  - to prepare a report on the impacts of IFRS on regulated utilities in Ontario
    - The report then assessed the implications of the alternatives on ratepayers, utilities, and the rate making process
    - The report identified accounting differences that would arise upon transition to IFRS and the range of alternatives available to utilities and the OEB to address these differences
    - The report was tabled as part of the OEB's formal industry consultation and helped inform OEB policy setting on this issue.
  - to re-write the OEB's Accounting Procedures Handbook following the adoption of IFRS by Ontario's rate regulated entities
- I have recently led the preparation of an expert report addressing the rate-regulatory treatment of Pension and Other Post- Employment Benefit costs for the electricity and gas utilities in Ontario. The report is currently being used by the OEB as part of a formal industry consultation on this issue
  - Possible methods of recovering P&OPEB costs in the rates charged to customers and related Information Requirements
  - Accounting requirements for P&OPEB costs in general purpose financial statements

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Assignment

- To provide my view on the treatment of GPI's non-capital tax losses carry forward for rate setting purposes
  - specifically whether GPI's shareholder or its customers should receive the future benefit of these tax losses for setting the 2016 distribution rates
- This report has been prepared by me to the best of my knowledge, acting independently and objectively
- KPMG LLP are not the auditors of GPI and we do not have any other current engagement with GPI
- KPMG LLP's compensation is not contingent on any action or event resulting from the use of this Report
- GPI retained KPMG LLP on June 15, 2016 to advice on the issue
- I confirm that I was not involved with the preparation of the 2016 rates application

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Issues

GPI currently has an application before the OEB for the setting of distribution rates, including rates for an Embedded Distributor Class to be effective May 1, 2016. In connection with this rate application, there are two specific tax issues under dispute

- Issue No. 1: Should GPI use forecast or actual tax loss carry forwards as at December 31, 2015 in estimating its tax liabilities in the future for rate setting purposes?
- Issue No. 2: Should tax loss balances held by NWTC prior to its amalgamation with GPI be included in the tax loss balances used by GPI for estimating its tax liabilities in the future for rate setting purposes?

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Actual Tax Loss Balances at Dec. 31, 2015

Movements in tax losses carry forward	GPI	NWTC	Merged entity
Balance at January 1, 2015	234,927	684,153	919,080
Add: new tax loss carry forwards	-	53,239	53,239
Deduct: tax losses which have expired	-	(206,925)	(206,925)
Deduct: tax losses used to reduce the taxable profit	(234,927)	-	(234,927)
Balance at September 30, 2015	-	530,467	530,467
Balance at October 1, 2015	-	530,467	530,467
Add: new tax loss carry forwards	-	-	-
Deduct: tax losses which have expired	-	-	-
Deduct: tax losses used to reduce the taxable profit	-	(138,646)	(138,646)
Balance at December 31, 2015	-	391,821	391,821

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Evaluation of Issue No. 1

GPI's initial application for rates effective May 1, 2016 was filed on December 23, 2015. This application included forecast values for the 2015 bridge year because actual numbers for 2015 were not yet available

At the request of the intervenors, the application was amended after April 2016 to incorporate actual numbers for 2015 for many items, as a result of interrogatories submitted. The following is a list of what was updated:

- 1-Energy Probe-1 – Update 2015 rate of return
- 1-SEC-4 – Update 2015 Capital Expenditures & OM&A & 2-Energy Probe -10 – Update 2015 Capital Expenditures
- 2-Energy Probe-6 – Update 2015 Fixed Assets Continuity Schedule
- 3-Staff-31 – Update 2015 Actual Load Summary
- 3-Energy Probe-14 – Update 2015 Customer/Connections by Rate Class, Annual Usage,
- 3-Energy Probe-17 – Update 2015 billed annual kW , Ratio kW to kWh
- 3-Energy Probe-19 – Update 2015 Other Distribution Revenue
- 3-VECC-18 – Update 2015 Purchased Energy
- 3-VECC-19 – Update 2015 Average customer/Connections
- 4-Staff-33 & 4 – Energy Probe-21 - Update 2015 OM&A
- 4-Energy Probe-22 – Update 2015 Employee Costs
- 4-Energy Probe-30 – Update 2016 Cost of Service Application Costs
- 4-Energy Probe-33 – Update 2015 PILs information in the regulated model
- 4-Energy Probe-34 – Update 2015 Tax Calculation based on 2015 Corporate Tax Return
- 4-VECC-28c – Update 2015 Intercompany Transactions
- 4-VECC-30 – Update 2015 Actual Bad Debts
- 4-VEC-37 – Update 2015 EDA, Mearie Fee
- 6-Energy Probe-40 – Update 2015 Revenue Deficiency

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Evaluation of Issue No. 1

As a result of the updates noted above, the revenue requirement for the test year was reduced from $6,273,356 in the initial application to $6,272,238, a reduction of $1,118. The revenue requirement was further reduced by the Settlement proposal agreement and the recent interrogatories to $6,102,645

The bridge year of 2015 has been updated to reflect actual (including the above updates) versus forecasted values, which resulted in an increase in the projected income before taxes in that year. As a result, the remaining 2014 tax loss of $234,927 were fully used up in the year. There were thus no longer any tax losses available at the end of 2015 for future use

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Conclusion on the Issue No. 1

In my professional opinion, based on the equity and fairness regulatory principle, it would be unreasonable to update the GPI rate application to reflect actual revenue and expense figures for 2015, but not to similarly update estimates of income before tax, Payments in Lieu of Tax (“PILs”) and of tax loss balances to reflect the impact of the changes made to revenues and expenses at intervenors’ requests. To do so would reflect only a partial consideration of relevant parameters.

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Evaluation of Issue No. 2

History of Rate Applications

2005 Application

- In response to NWTC's first application for rates in 2005, the Board provided NWTC with an interim rate of $1.50/kW, which was equal to the UTR rate charged by other transmitters. The Board Decision noted:
  - "The rate is authorized on an interim basis, pending the Board's final determination of the true cost of service."

2008 Application

- The interim rate initially remained in place for a three-year period until it was renewed at the same figure in a Decision and Order on February 19, 2008. With respect to NWTC's status, the Board noted:
  - "In 2004, NWTC was issued a short term transmitter license due to unresolved issues with respect to rates and the status of the entity. These issues remain unresolved. These issues are expected to be addressed following the Board's proceeding for the 2009 electricity transmission rates…."

KPMG's comment

- We note that in both 2005 and 2008, the rate approved was not based on NWTC's actual or forecast cost of service position. Rather, rates were set based on rates in place for other transmitters, such rates being placeholders pending filing and acceptance by the Board of actual or forecast NWTC cost data

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Evaluation of Issue No. 2

History of Rate Applications

2011 Application

- NWTC finally filed an application with details of its forecast cost of service on November 2010 to determine its 2011 revenue requirement and load forecast to set a just and reasonable rate. Given its forecast load and expenses, the rate of $1.77 ultimately provided for in this proceeding did not provide for a full return on equity. The Board noted:
  - "The application of the requested tariff ($1.77 per kW) to the forecasted load of 432,175 kW produces revenue of $648,262 per year, and therefore results in a revenue deficiency of $118,830, which is intended to be furnished by the shareholder through the diminishment of its return on equity."

Actual 2011 results (see table on next slide)

- The loss from operations, before the unrealized loss on the change in the fair value of the interest swap agreement, was $12,706. The operating loss reflected a confluence of negative factors:
  - A reduction in load from 435,343 kW (Board forecast) to 418,635 kW
  - Increases in OM&A expenses from $210,900 to $262,288
  - Increases in interest expense by $110,019 (from $202,107- deemed interest to $312,126 - actual interest)

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2011 NWTC Application

	Actual	2011 NWTC Application				
		Decision Deemed Interest	Updated Application Deemed Interest	Original Application Deemed Interest	Existing Rates Actual Deemed Interest	Revenue at Existing Rates Forecasted Interest
Revenue requirement						
Transformation connection rate	1.77	1.77	1.77	1.94	1.50	1.50
Forecasted load in KW	418,635	435,343	432,175	432,175	432,175	432,175
	740,984	770,557	764,949	838,672	648,262	648,262
Revenue						
Transformer connection charges	740,984	770,557	764,949	838,672	648,262	648,262
Other revenue	1,615	2,520	2,520	2,520	2,520	2,520
	742,599	773,077	767,469	841,192	650,782	650,782
Expenses						
OM&A	262,288	210,900	210,900	210,900	210,900	210,900
Depreciation	180,891	180,794	180,794	180,794	180,794	180,794
Interest	312,126	202,107	202,107	202,107	202,107	121,000
Total expenses	755,305	593,801	593,801	593,801	593,801	512,694
Loss from operations	(12,706)	179,276	173,668	247,391	56,981	138,088
Loss on change in FV of interest swap agreement	(348,672)	0	0	0	0	0
Net loss before PILs	(361,378)	179,276	173,668	247,391	56,981	138,088
PILs - current	0	0	0	0	0	0
PILs - future	0	0	0	0	0	(55,000)
Net profit (loss)	**(361,378)**	**179,276**	**173,668**	**247,391**	**56,981**	**83,088**

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Evaluation of Issue No. 2

History of Rate Applications

KPMG's comments

- In 2011, NWTC applied for a rate that would result in a lower than full rate of return on equity. Hence, the shareholder forecast that it would subsidize customers by accepting a lower rate than those to which it was otherwise entitled
- The 2011 rate application did not include an allowance for PILs, reflecting the expectation that income before taxes could be offset by available amounts in the non-capital tax loss carry forward pool
- As it turns out, NWTC did not achieve the lower rate of return that it requested. In fact, it showed an operating loss based on outcomes that were less favourable than forecast. The operating loss resulted in an increase in amounts outstanding in the tax loss pool, rather than a decrease in such amounts

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Evaluation of Issue No. 2

Evidence on the cause of NWTC's tax losses

- Based on the 2011 deemed interest amounting to $202,107 which is applicable until the next rebasing, we can make the following observations:
  - The actual interest expenses were higher than the 2011 deemed interest of $202,107 in 2011, 2012, 2013, 2014 and 2015 by $110,019, $96,291, $59,997, $63,997 and $34,152 respectively
    - Thus, the tax loss incurred in 2011 ($46,358), 2012 ($344), 2014 ($26,690) and 2015 ($53,239) can be almost entirely attributed to the differences between actual and 2011 deemed interest (see the table on next slide)
- Of the total balance of tax losses outstanding as at September 2015, $265,190 (the sum of $18,675, $128,090 and $118,425 for 2006, 2008, and 2010 respectively) were attributable to years prior to 2011. For the period before 2011, the rates in effect were not based on NWTC's forecast cost of service and therefore did not include any allowances for PILs specific to NWTC's circumstances

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NWTC financial Information

NWTC financial information										
				NWTC tax losses						
Financial year	Net profit (loss)	Unrecognized gain (loss) on the interest SWAP	Net profit (loss) excluding the interest SWAP	incurred	Used	Expired	Remaining Sep-15	Actual interest expense ***	Deemed interest expense approved	Interest incurred by shareholder
	*	*	*	**	**	**	**	*		
2003	(62,641)	-	(62,641)	-	-	-	-	-		
2004	(131,960)	-	(131,960)	-	-	-	-	354,821		
2005	(763,710)	-	(763,710)	(219,890)	12,965	206,925	-	430,753		
2006	(102,322)	-	(102,322)	(157,321)	138,646	-	(18,675)	390,329		
2007	184,881	87,862	97,019	-	-	-	-	360,117		
2008	97,397	(6,999)	104,396	(128,090)	-	-	(128,090)	332,813		
2009	153,773	216,929	(63,156)	-	-	-	-	334,045		
2010	(191,921)	(24,321)	(167,600)	(118,425)	-	-	(118,425)	305,354		
2011	(361,378)	(348,672)	(12,706)	(46,358)	-	-	(46,358)	312,126	202,107	110,019
2012	160,619	146,359	14,260	(344)	-	-	(344)	298,398	202,107	96,291
2013	365,210	326,986	38,224	-	-	-	-	262,104	202,107	59,997
2014	(107,915)	(79,503)	(28,412)	(26,690)	-	-	(26,690)	266,104	202,107	63,997
Sep-15	(91,755)	(38,140)	(53,615)	(53,239)	-	-	(53,239)	185,732	151,580	34,152
	(851,722)	280,501	(1,132,223)	(750,357)	151,611	206,925	(391,821)	3,832,696	960,008	364,456

Source of the information

* Audited financial statements of NWTC

** Tax returns filed

*** Excludes unrealized gain (loss) on change in fair value of the interest swap agreement

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Great Lakes Power Limited

- The Board decided that tax loss balances should <u>not</u> be taken into account, given the fact that recovery from customers of the operating losses that led to these tax loss balances was not allowed
- In making its determination, the Board considered but rejected the argument that specific wording in the 2006 Distribution Rate Handbook ("2006 DRH") should guide its decision in this particular case relating to GLPL. The Board noted that, based on the decision accompanying the 2006 DRH, the rate treatment proposed in the 2006 DRH reflected certain specific circumstances
- Specifically, the 2006 DRH proposed a particular treatment (that losses benefit customers) because the origin of losses giving rise to tax loss balances was generally not then known for the utilities in question. Because the origin of losses in the case of GLPL was, in contrast, known and because these losses arose as a result of expenses ultimately borne by GLPL's shareholder, the Board in proceeding EB-2007-0744 determined that tax loss balances should benefit this shareholder
- The circumstances associated with the current proceeding in respect of GPI are similar. Tax loss balances now within GPI arose because of losses borne by NWTC's shareholder. Accordingly, the benefits of such tax loss balances should accrue to the shareholder

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Conclusion on the Issue No. 2

As the shareholder covered the losses incurred since incorporation of NWTC, including the additional interest in excess of the deemed interest, and as no PILs were included in the transmission rates, based on the "benefits follow costs" regulatory principle, I believe that the benefits of the NWTC tax loss carry-forward balances as at December 31, 2015 should be for the benefits of the shareholders and not for the customers, as the costs that gave rise to the tax losses were borne by NWTC

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