

1           **PAYMENTS IN LIEU OF CORPORATE INCOME TAXES**

2  
3           **1.0 INTRODUCTION**

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5           Under the *Electricity Act, 1998*, Hydro One Networks Inc. is required to make payments  
6           in lieu of corporate income taxes (PILS) relating to taxable income earned by its  
7           distribution business. The Ontario Energy Board (OEB) has directed that the taxes  
8           payable method should also be used for regulatory purposes (2006 EDR Handbook  
9           section 7.1 “OEB 2006 regulatory expense methodology”).

10  
11           Under the taxes payable method, no provision is made for future income taxes that result  
12           from timing differences between the tax basis of assets and liabilities and their carrying  
13           amounts for accounting purposes. Accordingly, the taxes payable method will result in  
14           the PILS income tax payable being different than the amount that would have been  
15           recorded, had the combined Canadian Federal and Ontario statutory income tax rate been  
16           applied to the regulatory net income before tax. When unrecorded future income taxes  
17           become payable, it is expected that they will be included in the rates approved by the  
18           OEB and recovered from the customers at that time.

19  
20           PILS installments are remitted by Networks to OEFC at the end of each month. Any  
21           balance owing at the end of the year is required to be paid by February 28th of the  
22           following year.

23  
24           The 2008 Hydro One Distribution regulatory tax calculation has been prepared in  
25           accordance with the 2006 EDR Handbook and the 2006 EDR Tax Model.

1 **2.0 INCOME TAX RATE (FEDERAL AND ONTARIO):**

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3 A combined rate of 34.50% has been used for 2008 (Federal 20.50% and Ontario 14%)  
4 Prior to 2008, a 36.12% combined Federal and Ontario income tax rate had been in effect  
5 from 2004.

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7 **3.0 RECONCILIATION BETWEEN REGULATORY NET INCOME BEFORE**  
8 **TAX AND TAXABLE INCOME**

9  
10 A reconciliation between the regulatory net income before tax (NIBT) and taxable  
11 income for the test year 2008 is provided in Exhibit C2, Tab 6, Schedule 1, Attachment  
12 A. This schedule contains the income tax component of the PILS computation. It also  
13 shows how the taxable income is computed by making adjustments to the regulatory  
14 NIBT for items such as depreciation, capital cost allowance (CCA) etc.

15  
16 A reconciliation between the accounting NIBT and taxable income for the historical years  
17 is provided in Exhibit C2, Tab 6, Schedule 1, Attachment C.

18  
19 In order to make it easier for parties to follow the historic reconciliations, we have  
20 grouped adjustments made to regulatory NIBT to arrive at taxable income into the  
21 following five categories:

- 22  
23 1) Recurring items that must be added (deducted) because they have been included in  
24 the OM&A expenses in arriving at the revenue requirement or for which appropriate  
25 tax adjustments are made (e.g. depreciation vs. CCA);  
26 2) Deferral accounts not included in the revenue requirement;  
27 3) Reversal of accounting adjustments not included in the revenue requirement;  
28 4) Recurring items not in the revenue requirement; and

1 5) Items where the impact is immaterial in total, and as such, have not been included in  
2 our business plan (applicable to test year only).

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4 **4.0 OVERVIEW OF PROCESS TO ARRIVE AT TAXABLE INCOME**

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6 The starting point for the computation of the Networks Distribution taxable income is the  
7 NIBT as shown on the utility's income statement for the year. There are typically many  
8 adjustments that are made to the NIBT to arrive at taxable income, since the NIBT is  
9 prepared using Canadian generally accepted accounting principles and taxable income is  
10 computed using the relevant tax legislation, interpretations and assessing practices.  
11 Essentially, the NIBT is increased by amounts that are not deductible for tax purposes  
12 (includes items such as depreciation, contingent liabilities, accounting losses, accounting  
13 provisions such as OPEB etc. and revenue that has been received but not recognized for  
14 accounting purposes (e.g. LV revenue)) and is reduced by amounts that are deductible for  
15 tax purposes but have not been deducted in computing NIBT (includes items such as  
16 CCA, the deductible portion of capitalized overhead, expenses incurred for which a  
17 deferral account has been set up on the balance sheet rather than being deducted through  
18 the income statement, accounting gains, OPEB payments etc).

19  
20 Consequently, it is imperative that the NIBT be adjusted for amounts that have been  
21 included (or deducted) for accounting purposes that are not income (or deductible) for tax  
22 return purposes. This is a key point in comparing the historical years tax return data to  
23 that computed for the test year, since the tax return NIBT has been increased (or reduced)  
24 by amounts that have not been added (or deducted) in computing the regulatory NIBT  
25 (e.g. contingent liabilities, accounting gains, capitalized interest). That is, for test year  
26 2008, only differences between the tax and accounting rules related to costs included in  
27 either the regulatory revenue requirement or rate base (e.g. CCA, capitalized overhead)  
28 are adjusted in arriving at taxable income.

1 **5.0 TREATMENT DEFERRAL ACCOUNTS (REGULATORY ASSETS AND**  
2 **LIABILITIES)**

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4 Deferral accounts are typically recognized by utilities (i.e. on their balance sheet) for  
5 foregone revenue or for expenses that have been incurred for which recovery will be  
6 sought from ratepayers through future rates. Disposition of the deferral accounts is  
7 determined by the OEB often through a rate rider process.

8  
9 For example, assuming that a \$100 expense is incurred at a 35% tax rate, the utility will  
10 be allowed to deduct the \$100 in computing taxable income for the year in which the  
11 expense has been incurred. If the OEB subsequently approves recovery of these expenses  
12 over a four year period through a rate rider, the income will be included in computing  
13 taxable income for the year in which it is billed to ratepayers. The net result is that the  
14 utility has recovered the \$100 cost although the income/expense has been taxed or  
15 deducted in different years.

16  
17

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>	<u>CUM</u>
18 Income (deduction)	(100)	25	25	25	25	nil
19 Tax refund (payable)	<u>35</u>	<u>(8.75)</u>	<u>(8.75)</u>	<u>(8.75)</u>	<u>(8.75)</u>	<u>nil</u>
20 Cash inflow (outflow)	(65)	16.25	16.25	16.25	16.25	nil

21

22 Therefore, deferral accounts have not been included in computing tax payable for  
23 purposes of the revenue requirement since the tax benefit has or will be obtained through  
24 the tax system. It should be noted that this conclusion is consistent with the "2006 EDR  
25 Handbook Report of the Board" issued May 11, 2005 (Page 61) that stated as follows:"A  
26 PILS or tax provision is not needed for the recovery of deferred regulatory asset costs,  
27 because the distributors have deducted, or will deduct, these costs in calculating taxable  
28 income in their returns. The Handbook will reflect this treatment."

1 **6.0 CONTINGENT LIABILITIES/ACCOUNTING RESERVES**

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3 Where an accounting provision is recognized for certain contingent costs that the utility  
4 may have to incur in the future (e.g. obsolescence provisions, lawsuits, staff reductions,  
5 etc.), the provision will reduce the NIBT of the utility. In each subsequent year, the  
6 balance for the contingent liability/accounting reserve is reviewed by the utility for  
7 reasonableness based upon the information available at that time. The balance may be  
8 adjusted upward or downward with NIBT either decreasing or increasing respectively.

9 However, for tax purposes, a contingent liability or accounting reserve is not deductible.  
10 Rather, the amount will only be deductible (or capitalized) in computing taxable income  
11 for the taxation year in which the obligation has actually been settled. Therefore, to the  
12 extent that the current year NIBT has been increased (or decreased) by the contingent  
13 liability or accounting reserve provision, the NIBT must be adjusted to reverse the  
14 increase (or decrease) in computing taxable income.

15  
16 No changes were forecast in those contingent liabilities reflected in 2008 and as such, it is  
17 not necessary to adjust the 2008 NIBT for contingent liabilities in computing taxable  
18 income. Therefore, such amounts are not included in the tax computation for purposes of  
19 the revenue requirement.

20  
21 The contingent liabilities movement resulting in a \$20.6 million deduction in 2004 and a  
22 \$2.3 million add back in 2005 (Exhibit C2, Tab 6, Schedule 1, Attachment C, line 26), is  
23 required to reverse the accounting income inclusion resulting from the net reduction in  
24 the various contingent liability balances and/or the deduction of actual payments. As  
25 stated above, contingent liabilities are not relevant in computing taxable income.

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1 **7.0 REVERSAL OF 2004 ACCOUNTING GAIN RE: REGULATORY ASSETS**

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3 As a result of the uncertainty created by the Electricity Pricing, Conservation and Supply  
4 Act, 2002, Hydro One did not recognize certain regulatory assets such as those for  
5 suspended low voltage service costs (see Exhibit C2, Tab 6, Schedule 1, Attachment C,  
6 line 28). Such amounts were subsequently approved by the OEB in December, 2004  
7 allowing Hydro One under the accounting rules to recognize the establishment of the  
8 underlying regulatory assets resulting in the \$102 million accounting gain. Assuming  
9 that the current stable environment will continue, Hydro One anticipates full recovery for  
10 prudently incurred costs and therefore does not anticipate the recording of any significant  
11 gains that would be attributable to the recognition of unrecorded regulatory amounts in  
12 2008.

13  
14 It should be noted that for tax purposes, the accounting gain included in the accounting  
15 NIBT, is required to be reversed since tax is paid on the revenue for the year in which it  
16 is billed to ratepayers and not when recognized under the accounting rules.

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18 **8.0 CLASS 45, DISTRIBUTION ASSETS 55% CCA RATE:**

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20 In deriving the 2008 utility income taxes, Hydro One Distribution has reflected the  
21 proposed 10% increase in CCA rate for Class 45 to 55% (from 45%), for new assets  
22 acquired subsequent to March 19, 2007 (see Exhibit C2, Tab 6, Schedule 1, Attachment  
23 B).

1 **9.0 FEDERAL LARGE CORPORATION TAX ("LCT"):**

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3 The LCT has been eliminated effective January 1, 2006, accordingly for 2008, no LCT  
4 component has been included in the PILS computation on Exhibit C2, Tab 6, Schedule 1,  
5 Attachment A.

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7 **10.0 ONTARIO CAPITAL TAX**

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9 Networks pays Ontario capital tax on its taxable capital as defined by the Corporations  
10 Tax Act (Ontario). However, for regulatory purposes, it recovers capital tax computed by  
11 reference to its rate base net of the applicable Ontario exemption, as directed by the OEB.  
12 Please refer to Exhibit C2, Tab 4, Schedule 1 for the calculation of the Ontario capital  
13 tax. For the test year, the Ontario capital tax rate used is the rate proposed in the March  
14 23, 2006 Ontario budget of 0.285%. This compares to a capital tax rate of 0.3%  
15 applicable to the historical and bridge years.

16  
17 The Ontario exemption is allocated amongst the related regulated entities, based on rate  
18 base.

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