

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

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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 Board 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.

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24 The 2010 and 2011 Hydro One Distribution regulatory tax calculation has been prepared
25 in 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 31% (Federal 18% and Ontario 13%) has been used for 2010 and
4 28.25% for 2011 (Federal 16.5% and Ontario 11.75%). Prior to 2010, the following
5 combined income tax rate was in effect: 33% for 2009, 33.5% for 2008 and 36.12% for
6 2004 through 2007.

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

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11 Reconciliations between the regulatory net income before tax (“NIBT”) and taxable
12 income for the test years 2010 and 2011 are provided in Exhibit C2, Tab 6, Schedule 1,
13 Attachment A. This schedule contains the income tax component of the PILS
14 computation. It also shows how the taxable income is computed by making adjustments
15 to the regulatory NIBT for items such as depreciation, capital cost allowance (“CCA”)
16 etc.

17
18 Reconciliations between the accounting NIBT and taxable income for the historical years
19 2006, 2007 and 2008 are provided in Exhibit C2, Tab 6, Schedule 1, Attachment C.

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

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

- 1 3) Reversal of accounting adjustments not included in the revenue requirement;
- 2 4) Recurring items not in the revenue requirement; and
- 3 5) Items where the impact is immaterial in total, and as such, have not been included
- 4 in our business plan (applicable to test year only).

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6 **4.0 OVERVIEW OF PROCESS TO ARRIVE AT TAXABLE INCOME**

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8 The starting point for the computation of the Hydro One Distribution's taxable income is
9 the NIBT as shown on the utility's income statement for the year. There are typically
10 many adjustments that are made to the NIBT to arrive at taxable income, since the 2010
11 and 2011 NIBT is prepared using Canadian generally accepted accounting principles and
12 taxable income is computed using the relevant tax legislation, interpretations and
13 assessing practices. Essentially, the NIBT is increased by amounts that are not deductible
14 for tax purposes (includes items such as depreciation, contingent liabilities, accounting
15 losses, accounting provisions such as OPEB etc. and revenue that has been received but
16 not recognized for accounting purposes (e.g. LV revenue)) and is reduced by amounts
17 that are deductible for tax purposes but have not been deducted in computing NIBT
18 (includes items such as CCA, the deductible portion of capitalized overhead, expenses
19 incurred for which a deferral account has been set up on the balance sheet rather than
20 being deducted through the income statement, accounting gains, OPEB payments etc).

21

22 Consequently, it is imperative that the NIBT be adjusted for amounts that have been
23 included (or deducted) for accounting purposes that are not income (or deductible) for tax
24 return purposes. This is a key point in comparing the historical years tax return data to
25 that computed for the test year, since the tax return NIBT has been increased (or reduced)
26 by amounts that have not been added (or deducted) in computing the regulatory NIBT
27 (e.g. contingent liabilities, accounting gains, capitalized interest). That is, for test years
28 2010 and 2011, only differences between the tax and accounting rules related to costs

1 included in either the regulatory revenue requirement or rate base (e.g. CCA, capitalized
2 overhead) are adjusted in arriving at taxable income.

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4 **5.0 TREATMENT DEFERRAL ACCOUNTS (REGULATORY ASSETS AND**
5 **LIABILITIES)**

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

11
12 For example, assuming that a \$100 expense is incurred at a 30% tax rate, the utility will
13 be allowed to deduct the \$100 in computing taxable income for the year in which the
14 expense has been incurred. If the Board subsequently approves recovery of these
15 expenses over a two year period through a rate rider, the income will be included in
16 computing taxable income for the year in which it is billed to ratepayers. The net result is
17 that the utility has recovered the \$100 cost although the income/expense has been taxed
18 or deducted in different years.

19
20

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>CUM</u>
21 Income (deduction)	(100)	50	50	nil
22 Tax refund (payable)	<u>30</u>	<u>(15)</u>	<u>(15)</u>	<u>nil</u>
23 Cash inflow (outflow)	(70)	35	35	nil

24

25 Therefore, deferral accounts have not been included in computing tax payable for
26 purposes of the revenue requirement since the tax benefit has or will be obtained through
27 the tax system. It should be noted that this conclusion is consistent with the "2006 EDR
28 Handbook Report of the Board" issued May 11, 2005 (Page 61) that stated as follows: "A

1 PILS or tax provision is not needed for the recovery of deferred regulatory asset costs,
2 because the distributors have deducted, or will deduct, these costs in calculating taxable
3 income in their returns. The Handbook will reflect this treatment."
4

5 **6.0 CONTINGENT LIABILITIES/ACCOUNTING RESERVES**

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

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

19
20 No changes were forecast in those contingent liabilities reflected in 2010 and 2011 and as
21 such, it is not necessary to adjust the 2010 and 2011 NIBT for contingent liabilities in
22 computing taxable income. Therefore, such amounts are not included in the tax
23 computation for purposes of the revenue requirement.

24
25 The contingent liabilities movement resulted in a \$20.4 million deduction in 2006, a \$0.5
26 million deduction in 2007 and a \$4.3 million deduction in 2008 (Exhibit C2, Tab 6,
27 Schedule 1, Attachment C, line 26). This is required to reverse the accounting income
28 inclusion resulting from the net reduction in the various contingent liability balances

1 and/or the deduction of actual payments. As stated above, contingent liabilities are not
2 relevant in computing taxable income.

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4 **7.0 COMPUTERS AND SOFTWARE, DISTRIBUTION ASSETS 100% CCA**
5 **RATE:**

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7 In computing its 2010 and 2011 utility income taxes, Hydro One Distribution has used a
8 100% CCA rate for computers and software, (Class 50 and Class 12), for new assets
9 acquired subsequent to January 27, 2009 and before February 2011. (See Exhibit C2, Tab
10 6, Schedule 1, Attachment B).

11
12 **8.0 ONTARIO CAPITAL TAX**

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14 Networks pays Ontario capital tax on its taxable capital as defined by the Corporations
15 Tax Act (Ontario). However, for regulatory purposes, it recovers capital tax computed by
16 reference to its rate base net of the applicable Ontario exemption, as directed by the
17 Board. Please refer to Exhibit C2, Tab 4, Schedule 1 for the calculation of the Ontario
18 capital tax. The test year 2010, reflects an Ontario capital tax rate of 0.075%. No Ontario
19 capital tax is reflected in the 2011 test year as the 0.15% rate was eliminated on July1,
20 2010. This compares to a capital tax rate of 0.225% applicable to the historical and
21 bridge years.

22
23 For 2010, the Ontario exemption is allocated amongst the related regulated entities, based
24 on rate base.