Electricity Canada Électricité Canada

CANADIAN GAS ASSOCIATION
ASSOCIATION CANADIENNE DU GAZ

September 8, 2023

The Honourable Chrystia Freeland P.C., M.P.
Deputy Prime Minister and Minister of Finance
Department of Finance Canada
90 Elgin Street
Ottawa, Ontario K1A 0G5

Re: August 2023 Draft EIFEL Rules

Electricity Canada and the Canadian Gas Association ("**CGA**") have commented on each of the prior drafts of the excessive interest and financing expenses limitation ("**EIFEL**") rules. (See attached Appendix B for a copy of our most recent submission dated January 5th, 2023). Unfortunately, the August 4th, 2023 revisions to the EIFEL rules have not addressed our concerns. In particular, the proposed EIFEL rules will increase energy prices for many Canadian consumers and will impede our nation's progress toward achieving net-zero emissions by 2050 by increasing the cost of capital necessary for such investments. We believe this is not the desired policy intent of these rules. To prevent increased energy costs, Canada should provide relief from these rules for regulated utilities.

Regulated utilities are required by the relevant regulators to maintain a high proportion of debt. In addition, the regulators set rates for consumers across the country based on the utilities' costs. Denied interest expenses under the EIFEL rules increase the utilities' costs – and therefore are expected to increase energy costs for Canadian consumers. Moreover, denied interest expenses increase the cost of capital to a regulated utility. Increased costs of capital make it more difficult for regulated utilities to make the material investments required for Canada to reach its net-zero target by 2050.

The Canadian Electricity and Gas industries have very high interest expenses. In 2021, a subset of Electricity Canada and CGA members had combined net interest expenses of over $11 billion. The proposed rules will increase our after-tax costs, which will generally be passed on to Canadian customers. Moreover, the aggregate expenses of the industry are even higher and are rising – including as a result of increasing interest rates. For instance, estimates suggest that Ontario alone will require approximately $400 billion in new infrastructure to achieve net-zero emissions by 2050, with annual costs of around $60 billion.

Although the EIFEL rules exempt certain Canadian public-private partnership infrastructure projects, the rules continue to apply to privately-owned public-benefit assets (such as regulated utilities). Contrary to Canada's approach under the EIFEL rules, countries like the United States, the United Kingdom, and Ireland provide more expansive exemptions that apply to regulated utilities and their holding companies. Those countries have recognized the indispensable role of utilities and the imperative of maintaining affordable energy.[1]

[1] For more information: details on Ireland's long-term public infrastructure exemption is available beginning at page 33 of https://www.revenue.ie/en/tax-professionals/tdm/income-tax-capital-gains-tax-corporation-tax/part-35d/35D-01-01.pdf; details on the United Kingdom's public benefit infrastructure exemption is available at https://www.gov.uk/hmrc-internal-manuals/corporate-finance-manual/cfm97100; and details on the United States' regulated utilities and their holding companies exemption is available at https://www.irs.gov/newsroom/basic-questions-and-answers-about-the-limitation-on-the-deduction-for-business-interest-expense.

We acknowledge that the Department of Finance has made some revisions to the EIFEL rules since the November 2022 draft which attempt to address the concerns raised by Electricity Canada and CGA:

1. the group ratio has been given a 10% uplift to address certain book to tax differences; and
2. government assistance, such as the new investment tax credits ("**ITCs**"), are deemed not to impact the earnings amount in calculating EBITDA.

While Electricity Canada and the CGA commend these revisions, they are unfortunately not sufficient to address our main concerns. In particular, the following three principal factors (unique to regulated utilities) demand more significant legislative revisions:

- we have large amounts of long-term debt – which is required by our regulators **(Provincial authorities mandate the debt levels of regulated utilities generally around 55-70%),**

- our costs are generally passed on to customers through the rates set by our regulators, and

- we have unique and very material book to tax differences (far in excess of the proposed 10% uplift) that prevent us from relying on the group ratio.

Our principal recommendation continues to be to revise the proposed exemption from the EIFEL rules for Canadian public-private partnership infrastructure projects to include regulated utilities and their holding companies. (Our updated suggested revisions to the EIFEL rules in Appendix A address these concerns through an election in a manner that is generally analogous to the relief provided in other countries such as the United States, the United Kingdom and Ireland). Such an amendment to the EIFEL rules would better align the tax policy underlying the proposals with the objectives set out in Budget 2023: making life more affordable and growing a green economy. (Further details on such an exemption are set out in the submission we made to Department of Finance officials dated May 4, 2022).

While an exemption for regulated utilities and their holding companies is the best approach to achieve the desired policy objectives, ***at a minimum the EIFEL rules should contain more targeted adjustments for regulated utilities to neutralize the issue of material book to tax differences and temper the impact the EIFEL rules are expected to have on regulated utilities and their customers***.

Regulated utilities operate within a framework of regulated principles, which encourage a cautious approach to capitalizing various amounts for accounting purposes. The objective is to recover costs gradually from customers over time. Consequently, regulated utility companies hold substantial capitalizations within their Property, Plant, and Equipment (PP&E) and other regulatory assets on their books, even though these amounts are currently deductible for income tax purposes. These disparities pose significant challenges for Canadian utilities under the EIFEL rules, as they restrict the adjusted taxable income of Canadian Utilities, thereby increasing the disallowed interest expenses.

Furthermore, regulated utilities employ distinctive accounting policies that lead to income recognition for accounting purposes, which may not be currently subject to taxation (and sometimes, not at all taxable), and conversely, expenses recognized for accounting that are not currently deductible. These variations typically result in higher earnings for accounting purposes compared to adjusted taxable income, reducing the feasibility of relying on the group ratio alternative.

Below is a summary of some of the most notable differences between book and tax accounting practices found in regulated utilities, collectively referred to as "Regulated Utility Accounting Differences":

- Capitalized amounts in PP&E for accounting, currently deductible for tax purposes.
- Fuel under/over recovery mechanisms and clauses.
- Storm protection plan clauses.
- Storm reserves.
- Capitalized abandonment charges, currently deductible for tax purposes.
- Allowance for funds used during construction (AFUDC).
- Deferred demand-side management program costs.
- Other regulatory cost and revenue deferral mechanisms and clauses.

This issue could be addressed through two possible targeted adjustments for regulated utilities.

(i) Add the amounts capitalized to PP&E, abandonment charges and other regulatory assets under regulatory accounting policy, but deducted currently for income tax purposes, to the calculation of "adjusted taxable income", or
(ii) Deduct the Regulated Utility Accounting Differences when computing EBITDA for purposes of the Group Ratio.

(i) ***Adjusted Taxable Income Add-Back***: By restricting the addback to Capital Cost Allowance (CCA), the calculation of "adjusted taxable income" deviates from the computation of EBITDA for accounting purposes. Consequently, "adjusted taxable income" fails to accurately reflect the ability of Canadian Utilities to meet interest obligations, as it omits expenditures financed through debt and equity issuances, rather than operational cash flows. Failure to reconcile these expenditures effectively results in permanent disparities between "adjusted taxable income" and EBITDA for accounting purposes, which is inappropriate. Furthermore, not adding back these expenditures could lead to denied interest expenses for Canadian Utilities and potentially unnecessary utility rate increases for Canadian customers.

(ii) ***Modification to the Group Ratio***: The Regulated Utility Accounting Differences could be deducted when calculating earnings for the purpose of determining the Group Ratio. Without this adjustment, Canadian Utilities may often be unable to rely on the Group Ratio, even with the proposed 10% uplift in the latest draft of the EIFEL rules.

The group ratio is based on "group adjusted net book income," which computes the group's EBITDA based on figures reported in the consolidated financial statements of the group. In contrast, the fixed ratio relies on "adjusted taxable income," which, as previously mentioned, aims to represent EBITDA for tax purposes. The Regulated Utility Accounting Differences typically result in the group ratio being lower than the fixed ratio because EBITDA for accounting purposes is generally higher than EBITDA for tax purposes. For instance, the accounting and tax treatment of capitalized overhead, abandonment charges and interest expenses differ significantly. In accounting, these expenses are capitalized to PP&E and other regulatory asset accounts, whereas for tax purposes, they are deducted immediately. Several other examples exist where expenditures are deferred to the balance sheet for accounting purposes but deducted immediately for tax purposes.

While the Regulated Utility Accounting Differences outlined above would address the principal book to tax differences for Regulated Utilities, other differences would remain. As a result, from a policy perspective it would be appropriate to maintain the 10% uplift in calculating the Group Ratio.

Electricity Canada and CGA strongly believe an exemption for Canadian Utilities and their holding companies is needed to prevent unnecessary utility rate hikes for customers. In the absence of an exemption, we recommend adjustments to either the group ratio calculation or the "adjusted taxable income" calculation to mitigate the issues arising from the Regulated Utility Accounting Differences. This approach aligns with OECD recommendations and aims to mitigate the expected impact of the EIFEL rules on Canadian Utilities and their customers.

Finally, given the ongoing developments surrounding the legislation and the practical challenges around seeking clarification in August since the release of the newest draft, we strongly recommend that Finance reconsider the proposed October 1, 2023 effective date. In light of the intricate nature of the EIFEL rules and the impending September 8, 2023 submission deadline for the draft proposal, we firmly believe that an extension is warranted. We recommend that the legislation take effect for taxation years beginning on or after January 1, 2025 allowing for a more comprehensive evaluation of the rules and time to make adjustments necessary for the forthcoming changes.

We thank you for your consideration of our submission and would be pleased to discuss any aspect of the above at your convenience. Should you have any questions or require additional information about our comments, please contact Michael Powell, Electricity Canada's Vice President of Government Relations (Powell@electricity.ca), and Paul Cheliak, CGA's Vice President of Public and Regulatory Affairs (PCheliak@cga.ca).

Sincerely,

Francis Bradley
President and CEO
Electricity Canada

Paul Cheliak
Vice President
Canadian Gas Association

Copy: The Honourable Dominic LeBlanc, Minister of Public Safety, Intergovernmental Affairs, Infrastructure and Communities
The Honourable François-Philippe Champagne, Minister of Innovation, Science and Industry
The Honourable Jonathan Wilkinson, Minister of Energy and Natural Resources
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Simon Kennedy, Deputy Minister, Innovation, Science and Economic Development Canada
Chris Forbes, Deputy Minister of Finance
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Peter Repetto, Department of Finance
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Appendix A – Proposed Amendments

3 (1) The Act is amended by adding the following after section 18.1:

Definitions

18.2 (1) The following definitions apply in this section and section 18.21.

…

exempt interest and financing expenses of a taxpayer for a taxation year means the total of all amounts, each of which would, if the description of A in the definition interest and financing expenses were read without reference to "exempt interest and financing expenses", be included in interest and financing expenses of the taxpayer for that year, and that is incurred in respect of a borrowing or other financing (referred to in this definition as the "borrowing") of the taxpayer or a partnership of which the taxpayer is a member (referred to in this definition as the "borrower"), ~~if~~

(a) if

(i) the borrower entered into an agreement with a public sector authority to design, build and finance, or to design, build, finance, maintain and operate, real or immovable property owned by a public sector authority;

(ii) the borrowing was entered into by the borrower in respect of the agreement;

(iii) it can reasonably be considered that all or substantially all of the amount is directly or indirectly borne by the public sector authority; and

(iv) the amount was paid or payable to persons that deal at arm's length with the borrower (other than any person or partnership that is, or does not deal at arm's length with, a person or partnership that has a direct or indirect equity interest (within the meaning of subsection 18.21(1)) in the borrower);

(b) to the extent that

(i) the borrowing was directly or indirectly used for the purpose of earning income from a business carried on by the borrower or a person or partnership that does not deal at arm's length with the borrower –(referred to in this definition as the "regulated utility");

(ii) all or substantially all of the property of the regulated utility is used or held for the purpose of gaining or producing income from a business that is the provision of property or services of or in support of, the production, generation, storage, transmission, distribution, sale, delivery or provision of electricity, natural gas or steam or any other agent for the production of light, heat, cold or power[2];

(iii) the rates for the provision of the property or services have been established or approved by a government entity (within the meaning assigned by subsection 241(10)) or a similar body of any country, province, state, municipality or other political subdivision or by the governing or ratemaking body of an electric cooperative;[3] and

(iv) the borrower files with the Minister an election in writing in prescribed manner under this paragraph in respect of the borrowing **[NTD: the prescribed election could (i) set out the relevant portion of a borrowing traced/linked to a regulated utility, and (ii) could require election to be filed by the tax return due date of the borrower for its taxation year that includes the borrowing.]**

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[2] See *Utilities Commission Act*, RSBC 1996, c. 473, s. 1 "**public utility**".

[3] US Code Section 163(j)(7) and Regulation §1.163(j)-1(b)(15)(i)(2) use the following language: "State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative." See also Regulation § 1.163(j)-10(c)(5)(ii)(C)(2) (2) that uses the following language for the special rule for CFC utilities: "a foreign government, a public service or public utility commission or other similar body of any foreign government, or the governing or ratemaking body of a foreign electric cooperative."