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December 1, 2016

VIA RESS AND COURIER

Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319
2300 Yonge Street, 27th Floor
Toronto, Ontario M4P 1E4

Dear Ms. Walli:


**RE: EB-2016-0160 Hydro One Networks Inc. ("Hydro One") Transmission Rates
Application – Responses to Undertakings J1.03, J2.09, J2.10, J4.03 and J4.04**

Hydro One's responses to Undertakings J1.03, J2.09, J2.10, J4.03 and J4.04 are enclosed.

Yours truly,

McCarthy Tétrault LLP

Per:


Gordon M. Nettleton
GMN

UNDERTAKING – J1.3

Undertaking

Provide the tax cost before and after revaluation of Hydro One Networks Inc. (“HONI”) and the departure tax calculations.

Response

The tax cost of HONI’s net assets was \$1.1 billion prior to the revaluation of the company. The fair market value of HONI’s net assets was \$12.7 billion and was the basis of the calculation of the departure taxes for HONI.

As described in the prospectus, Hydro One Limited’s (“HOL”) departure tax cost was based on an estimated fair market value of Hydro One Limited’s net assets of approximately \$13,522 million.

The facts entered into the record by Mr. Thompson in Transcript Day 2 beginning at page 164, line 16 and continuing through page 187 line 20 require correction in the following three instances:

- (a) Prior to the IPO, which is not an activity related to the cost of providing regulated service, the Province was the sole shareholder of HOL. The recapitalization of the company by the shareholder following the payment of the departure tax by each of the HOL’s legal entities did not increase the book value or equity value of HOL; it reinstated the value of HOL to what it was immediately prior to the payment of the departure tax (Transcript Day 2, page 162, lines 1 to 22). The shareholder incurred a cost to preserve the market value of the company. The market value of the company related to its regulated operations arises solely from the equity return (deemed equity component times allowed ROE) that is included in rates that compensate the shareholder for the opportunity cost associated with making its assets available to provide rate regulated services (Transcript Day 2, page 171, lines 12 to 14 and Transcript Day 2, page 172, lines 4 to 10).
- (b) The shares purchased by the Province to recapitalize HOL were purchased for \$1.00 per share; as a result 2.6 billion shares were issued by HOL to the Province. A reverse stock split was undertaken at a 4.3699 to 1 ratio. This ratio is not the effective cost of the Province's shares in HOL, it is merely the ratio needed to

Witness: Glendy Cheung

1 implement the necessary reorganization that results in a rational number of issued
2 and outstanding shares, in anticipation of the initial public offering. It is therefore
3 not correct to state that the shareholder “paid” \$4 to \$5 per share (Transcript Day
4 2, page 174 lines 18 to 28).

5
6 (c) It is not a correct statement of fact that the shareholder has recovered the \$2.6
7 billion cost to recapitalize the HOL via the sale of shares. Any gain realized by
8 the Province above the book value per share of the company recovers only a
9 portion of the cumulative book value of HOL, where the book value includes
10 retained earnings, contributed capital and capital arising from the sale of shares.
11 If the government retains a 40% equity interest in the company, as expected, it
12 will continue to have a net residual interest in the \$2.6 billion recapitalization cost
13 equal to \$1.040 billion (Transcript Day 2, page 177, lines 1 to 8).

14
15 As requested in this undertaking, we have provided the tax cost of the asset before and
16 after the revaluation, and the departure tax computation.

HYDRO ONE NETWORKS INC.
2015 TAX COST AND DEPARTURE TAX CALCULATIONS

	FMV	Tax Base *	Recapture	Cap Gain	ECE Income	Total
Fixed Assets	18,919	11,476	4,833	2,074	-	
Construction In Progress	1,457	1,266	-	191	-	
Future Use Assets	148	148	-	-	-	
Regulatory Assets	1,762	1,762	-	-	-	
Accounts Receivable	1,066	1,066	-	-	-	
Materials and Supplies	19	19	-	-	-	
Other current assets	19	19	-	-	-	
Goodwill	4,027	77	-	-	2,281	
Liabilities	(14,718)	(14,718)				
	<u>12,700</u>	<u>1,117</u>	4,833	2,264	2,281	
		Inclusion Rate	100%	50%	100%	
			<u>4,833</u>	<u>1,132</u>	<u>2,281</u>	
		Tax Rate	26.5%	46.17%	26.5%	
		Departure Tax	<u>1,281</u>	<u>523</u>	<u>604</u>	2,408
					Less: dividend refund	<u>(144)</u>
					Departure Tax	<u>2,264</u>
					Rounded	<u><u>2,300</u></u>

* The tax base is the tax cost of the asset prior to the revaluation.

UNDERTAKING – J2.9

Undertaking

Provide the component of the deferred tax recovery of \$2,619 million that is related to distribution business.

Response

Of the \$2,619 million deferred tax asset for Hydro One Limited and its legal entities, \$1,120 million relates to the Hydro One Networks Inc.'s distribution business. The total deferred tax recovery for Hydro One Networks Inc.'s transmission and distribution businesses is \$2,595 million, which resulted in a deferred tax asset of \$2,595 million in Hydro One Networks Inc.

The initial public offering process gave rise to the requirement to pay the departure tax and recognize the deferred tax asset. The requirement did not arise from activities that were related to the cost of providing regulated service to ratepayers. Should the OEB determine that the regulatory principles of "benefits follow costs" and the "standalone principle" do not apply, and allocate the deferred tax asset to ratepayers, shareholders would be disadvantaged. The deferred tax asset is presently reflected both in the value of the company's shares held by non-government shareholders and in the valuation of the shares owned by the Province, as per its public financial statement disclosures.

The \$2.595 billion deferred tax asset attributable to Hydro One Networks Inc.'s distribution and transmission businesses represents up to \$4.36 per share (\$2.595 billion divided by 595 million shares) of the market value of the company. Non-government shareholders who have purchased the shares of Hydro One from the government of Ontario have purchased an interest in an entity that has paid the departure tax. These shareholders would not recover the departure tax cost without accessing the benefits from the deferred tax asset. If the deferred tax asset is allocated to ratepayers, the shares of Hydro One Limited could decline and impair the value recognized by the Province in its consolidated financial statements and also harm non-government shareholders.

UNDERTAKING – J2.10

Undertaking

To provide the calculation of corporate minimum tax for Transmission for 2017 and 2018 test years.

Response

Ontario imposes Ontario corporate minimum tax (“CMT”) on companies with total assets and revenue amounts exceeding certain threshold amounts. Hydro One Networks Inc. would be subject to CMT and will have a CMT payable to the extent that CMT exceeds income tax payable for a tax year under the Ontario tax legislation.

Based on the revised Transmission rates revenue requirement as updated in Exhibit A-3-1, the CMT for Hydro One Networks Inc. Transmission is calculated to be \$12.2 and \$13.1 million for 2017 and 2018, respectively. However, CMT as calculated does not exceed the Ontario income tax on the regulatory taxable income for both test years. Accordingly, CMT would not be applicable.

As a legal entity, Hydro One Networks Inc. would be subject to CMT due to the non-regulated tax deductions, such as the CCA deduction arising from the Fair Market Value Bump as discussed in Exhibit I, Tab I, Schedule 134.

The activities that gave rise to the increased CCA deduction were activities that are not related to the cost of providing the regulated service. If this calculation was to be used to determine how much of the Fair Market Value Bump contributes to cash tax savings for the purpose of adjusting revenue requirement, the calculation of the CMT would be incomplete without the inclusion of:

1. Assumptions to recover the \$1.475 billion departure tax associated with Hydro One Networks Inc.’s transmission business in rates; and
2. Adjustments to the accounts and records, including rate base, used for transmission rate making purposes to fair market value.

Both of these adjustments would be required in order to be consistent with the “benefits follow costs” principle, should the OEB determine that the deferred tax asset be allocated to ratepayers, contrary to the “standalone principle”.

CALCULATION OF ONTARIO UTILITY INCOME TAXES *

**HYDRO ONE NETWORKS INC.
 TRANSMISSIONS**

Calculation of Ontario Utility Income Taxes
 Test Years (2017 and 2018)
 Year Ending Decmeber 31
 (\$Millions)

	<u>2017</u>	<u>2018</u>
<u>Calculation of Regulatory Income Tax - Ontario</u>		
Regulatory Net Income (before taxes)	452.5	483.8
Regulatory Taxable Income	312.1	341.1
Ontario Corporate Tax Rate	11.5%	11.5%
Ontario Income Tax	<u>35.9</u>	<u>39.2</u>
<u>Calculation of Ontario Corporate Minimum Tax</u>		
Regulatory Net Income (before taxes)	452.5	483.8
Ontario Corporate Minimum Tax Rate	2.7%	2.7%
Ontario Corporate Minimum Taxes	<u>12.2</u>	<u>13.1</u>
Regulatory Ontario Income Tax **	<u>35.9</u>	<u>39.2</u>

* Calculation does not consider refundable credits such as Ontario co-op education credits and Ontario apprenticeship credits.

** Corporate minimum tax not applicable.

1 **UNDERTAKING – J4.3**

2
3 **Undertaking**

4
5 To provide the causes of voltage sags, which then lead to interruptions.

6
7 **Response**

8
9 Faults on the transmission system can result in voltage sags. A voltage sag is a reduction
10 in voltage of 20% to 50% (depending on the duration and type of fault) seen at the
11 customer connection point. There are a range of factors that can lead to a fault including
12 lightning strikes and other weather phenomena, foreign contacts (animal, tree, debris etc),
13 equipment failures, human performance and other external factors such as forest
14 fires. When there are voltages sags of sufficient magnitude and duration that exceed the
15 customer's resilience to the voltage sag, then a customer's process can be interrupted or
16 equipment malfunction can occur.

17
18 The causes for voltage sags are not strictly recorded. However, the causes of faults on
19 the system are recorded wherever possible and are a reasonable proxy for the causes of
20 voltages sags. For the 2011 to 2015 period, of the faults due to weather, lightning
21 represented 71.4% of the instances.

1 **UNDERTAKING – J4.4**

2
3 **Undertaking**

4
5 To provide the list of actions from the customer power quality working group that have
6 been completed

7
8 **Response**

9
10 The following list summarizes the action items and their status from the Power Quality
11 Working Group as recorded in the minutes of the November 11, 2015 meeting.

12
13 **1. Review and agree upon power quality definitions.**

14 On October 22, 2014 (Meeting #4), members deemed this action item to be complete.

15
16 **2. Review and improve customer notification and interface processes.**

17 On October 22, 2014 (Meeting #4), members deemed that this action item to be
18 complete.

19
20 **3. Hydro One leverage PQ data from customer-owned revenue meters.**

21 A pilot installation was placed in service at a customer's site since April 2015. The
22 pilot was considered to be successful. On November 11, 2015 (Meeting #5),
23 members deemed this action item to be complete.

24
25 A program to leverage the revenue meter conversion to all transmissoin-connected
26 end users was started in the fourth quarter of 2016.

27
28 **4. Strengthen Hydro One's own standards for equipment quality.**

29 On November 11, 2015 (Meeting #5), members reached a mutual agreement to
30 permanently close this action item with no further action required. Hydro One
31 standards were deemed adequate.

32
33 **5. Provide customer-specific PQ planning information as a standard offering.**

34 Generic voltage sag studies were prioritized and completed for all the PQ working
35 group members. Meetings with individual customers to present their voltage sag
36 studies were completed. To date, no detailed specific studies have been requested.

37 On November 11, 2015 (Meeting #5), members deemed this action item to be
38 complete.

39
Witness: Graham Henderson

- 1 **6. Increased advocacy for improved ride-through with manufacturers.**
2 On November 11, 2015 (Meeting #5), members agreed to close this item with no
3 further action required. Members saw no practical way for Hydro One to advocate
4 with manufacturers of industrial equipment.
5
- 6 **7. Obtain and leverage customers' information on impacts and costs of PQ events.**
7 Members acknowledged that the information received from customers through the
8 survey thus far is incomplete.
9
- 10 Hydro One is no longer seeking from customers a generic report on impact due to PQ
11 events. The information is acquired on a case-by-case basis as need in a PQ
12 investigation.