SCHOOL ENERGY COALITION

CROSS-EXAMINATION MATERIALS

EB-2016-0160

DEFERRED TAX ASSET

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

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

As requested in this undertaking, we have provided the tax cost of the asset before and 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)				
	12,700	1,117	4,833	2,264	2,281	
		Inclusion Rate	100%	50%	100%	
			4,833	1,132	2,281	
		Tax Rate	26.5%	46.17%	26.5%	
		Departure Tax	1,281	523	604	2,408
					Less: dividend refund	(144)
					Departure Tax	2,264
					Rounded	**2,300**

* 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)

	2017	2018
Calculation of Regulatory Income Tax - Ontario		
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	35.9	39.2
Calculation of Ontario Corporate Minimum Tax		
Regulatory Net Income (before taxes)	452.5	483.8
Ontario Corporate Minimum Tax Rate	2.7%	2.7%
Ontario Corporate Minimum Taxes	12.2	13.1
Regulatory Ontario Income Tax **	**35.9**	**39.2**

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

** Corporate minimum tax not applicable.

- in 2014, insurance proceeds related to 2013 floods at the Company's Richview and Manby transformer stations were recorded as a reduction in 2014 OM&A costs and did not recur in 2015; partially offset by:
- decreased expenditures related to forestry control and line clearing on the Company's transmission rights-of-way.

Distribution OM&A Costs

The decrease of $109 million or 14.7% in distribution OM&A costs for the year ended December 31, 2015 was primarily due to the following:

- a decrease in bad debt expense and lower expenditures related to remediation of the Company's customer information system;
- decreased vegetation management expenditures relating to the distribution line clearing and forestry control; and
- lower volume of work associated with locating and restoring power outages; partially offset by
- increased costs associated with responding to power outages as a result of multiple wind storms during the fourth quarter of 2015.

Other OM&A Costs

The increase of $20 million or 35.7% in other OM&A costs for the year ended December 31, 2015 was primarily due to costs to integrate acquired local distribution companies and increased compensation costs.

Depreciation and Amortization

The increase of $37 million or 5.1% in depreciation and amortization costs for the year ended December 31, 2015 compared to last year was mainly due to the growth in capital assets as the Company continues to place new assets in-service, consistent with its ongoing capital investment program.

Income tax expense

Income tax expense for the year ended December 31, 2015 increased by $16 million compared to 2014, and the Company realized an effective tax rate of approximately 12.8% in 2015, compared to approximately 10.6% realized in 2014. The differences are primarily due to the following:

- lower capital cost allowance in excess of depreciation and amortization; and
- additional tax expense in connection with the spin-off of Hydro One Brampton; partially offset by
- an income tax recovery recorded on the revaluation to fair market value of the tax basis of the assets of Hydro One Inc. and its subsidiaries in excess of the Departure Tax triggered when Hydro One exited the PILs Regime.

Non-GAAP Measures

FFO and Adjusted FFO

FFO is defined as net cash from operating activities, adjusted for the following: (i) changes in non-cash balances related to operations, (ii) dividends paid on preferred shares, and (iii) distributions to noncontrolling interest. Adjusted FFO is defined as FFO, adjusted for the impact of the deferred income tax asset that resulted as a consequence of leaving the PILs Regime and entering the Federal Tax Regime. Management believes that FFO and adjusted FFO are helpful as supplemental measures of the Company's operating cash flows as they exclude timing-related fluctuations in non-cash operating working capital and cash flows not attributable to common shareholders, and, in the case of adjusted FFO, the impact of the IPO-related deferred income tax asset. As such, these measures provide a consistent measure of the cash generating performance of the Company's assets.

The following table presents the reconciliation of net cash from operating activities to FFO and adjusted FFO:

Year ended December 31 *(millions of Canadian dollars)*	2015	2014
Net cash from (used in) operating activities	(1,253)	1,256
Changes in non-cash balances related to operations	(208)	55
Preferred dividends	(13)	(18)
Distributions to noncontrolling interest	(5)	–
FFO	(1,479)	1,293
Less: Deferred income tax asset[1]	(2,810)	–
Adjusted FFO	1,331	1,293

[1] Impact of deferred income tax asset that resulted as a consequence of leaving the PILs Regime and entering the Federal Tax Regime

Pro forma Adjusted non-GAAP Basic and Diluted EPS

The following pro forma adjusted non-GAAP basic and diluted EPS has been prepared by management on a supplementary basis which assumes that the total number of common shares outstanding was 595,000,000 in each of the years ended December 31, 2015 and 2014. The supplementary pro forma disclosure is used internally by management subsequent to the IPO to assess the Company's performance and is considered useful because it eliminates the impact of the issuance of common shares to the Province prior to the IPO. Prior to the IPO, the Province was the sole shareholder of Hydro One and disclosure of EPS did not provide meaningful information. EPS is considered an important measure and management believes that presenting it for all periods based on the number of outstanding shares on, and subsequent to, the IPO provides users with a basis to evaluate the operations of the Company with comparable companies and with prior periods.

Year ended December 31	2015	2014
Net income attributable to common shareholders *(millions of Canadian dollars)*	690	731
Pro forma weighted average number of common shares		
Basic	595,000,000	595,000,000
Effect of dilutive share grant plans	94,691	–
Diluted	595,094,691	595,000,000
Pro forma adjusted non-GAAP EPS		
Basic	$1.16	$1.23
Diluted	$1.16	$1.23

Adjusted Net Cash from Operating Activities

Adjusted net cash from operating activities is defined as net cash from operating activities, adjusted for the impact of the deferred income tax asset that resulted as a consequence of leaving the PILs Regime and entering the Federal Tax Regime. Management believes that this measure is helpful as a supplemental measure of the Company's net cash from operating activities as it excludes the impact of the IPO-related deferred income tax asset. As such, adjusted net cash from operating activities provides a consistent measure of the Company's cash from operating activities compared to prior periods.

The following table presents the reconciliation of net cash from operating activities to adjusted net cash from operating activities:

Year ended December 31 *(millions of Canadian dollars)*	2015	2014
Net cash from (used in) operating activities	(1,253)	1,256
Less: Deferred income tax asset[1]	(2,810)	–
Adjusted net cash from operating activities	1,557	1,256

[1] Impact of deferred income tax asset that resulted as a consequence of leaving the PILs Regime and entering the Federal Tax Regime

To the extent that adjusted net income is used in future continuous disclosure documents of Hydro One, it will be defined as net income, adjusted for certain items, including non-recurring items and other one-time items that management does not consider to be reflective of the operating performance of the Company. No such adjustments to net income are presented in this MD&A. Management believes that this measure will be helpful in assessing the Company's financial and operating performance in the future.

FFO, adjusted FFO, pro forma adjusted non-GAAP basic and diluted EPS, adjusted net cash from operating activities, and adjusted net income are not recognized measures under US GAAP and do not have a standardized meaning prescribed by US GAAP. They are therefore unlikely to be directly comparable to similar measures presented by other companies. They should not be considered in isolation nor as a substitute for analysis of the Company's financial information reported under US GAAP.

Summary of Sources and Uses of Cash

Hydro One's primary sources of cash flows are funds generated from operations, capital market debt borrowings and bank financing that are used to satisfy Hydro One's capital resource requirements, including the Company's capital expenditures, servicing and repayment of debt, and dividends.

The following table presents the Company's sources and uses of cash during the years ended December 31, 2015 and 2014:

Year ended December 31 *(millions of Canadian dollars)*	2015	2014
Operating activities		
Net income	713	747
Deferred income taxes	(2,844)	10
Changes in non-cash balances related to operations	208	(55)
Other	670	554
	(1,253)	1,256
Financing activities		
Long-term debt issued	350	628
Long-term debt retired	(585)	(776)
Short-term notes issued	1,491	–
Common shares issued	2,600	–
Dividends paid	(888)	(287)
Amount contributed by (distributed to) noncontrolling interest	(5)	72
Other	(9)	(32)
	2,954	(395)
Investing activities		
Capital expenditures	(1,632)	(1,504)
Capital contributions	62	–
Acquisitions of local distribution companies	(90)	(66)
Investment in Hydro One Brampton	(53)	–
Proceeds from investment	–	250
Other	6	(6)
	(1,707)	(1,326)
Net change in cash and cash equivalents	(6)	(465)

In January 2016, the OEB issued a Decision and Rate Order for the area formerly served by Norfolk Power approving Hydro One's implementation plan to transition residential customers to fixed rates over a four year period. Although Norfolk Power customers' rates are frozen for five years, the OEB Order approved Tariffs of Rates and Charges for 2016 only.

In 2015, Hydro One Networks filed applications with the OEB with respect to the new rate design for residential customers in the service areas formerly served by Haldimand Hydro and Woodstock Hydro that include fixed rates for five years and implementation plans to transition to fixed distribution rates. Approvals for these applications are pending.

Performance Measurement for Electricity Distributors

On September 18, 2015, Hydro One Networks submitted its 2014 Performance Scorecard to the OEB. In addition to ongoing operations, a major focus in 2014 was investing in improvements to the Company's customer call centre and billing operations. Hydro One plans to continue developing targeted products and services that respond to its customers' unique needs, including realizing value from the new customer information system, simplifying and shortening timeframes for the delivery of services, and enhancing accessibility to allow effective self-service for simple transactions. The Company is also committed to delivering programs to help its customers manage their energy consumption. Hydro One Networks' 2014 Scorecard was posted on the Hydro One and the OEB websites.

Renewed Regulatory Framework for Transmitters

In 2015, the OEB initiated a discussion to develop a framework for the application of Renewed Regulatory Framework principles to transmitters, and in January 2016, issued a new set of draft filing requirements for transmitters for discussion.

Transmitter Consolidations

On January 19, 2016, the OEB issued the *Handbook for Electricity Distributor and Transmitter Consolidations* (the "handbook") to provide guidance on applications for approval of electricity utility consolidations by way of mergers, acquisitions, amalgamations and divestitures and subsequent rate applications. The handbook is intended to provide guidance on the process for review of consolidation applications by the OEB and affirms the OEB's policy of using the "no harm" test in reviewing consolidation applications. This test requires applicants to demonstrate that the costs to serve acquired customers post-consolidation will be no higher than they otherwise would be without consolidation. In addition the OEB will consider whether any price premium paid on the acquisition is financially burdensome to the applicant, as any premium paid over historic asset value is not recoverable in rates. The handbook will allow applicants to defer rebasing of the acquired utility for up to a 10 year period with the view of permitting the applicant to fully realize the anticipated efficiency gains and offset the overall costs of the transaction.

Other Developments

Change in Hydro One Ownership Structure

During the fourth quarter of 2015, Hydro One and Hydro One Inc. completed a series of Pre-Closing Transactions that resulted in, among other things, the acquisition by Hydro One of all of the issued and outstanding shares of Hydro One Inc. and the issuance of new common shares and preferred shares of Hydro One to the Province. On November 5, 2015, Hydro One and the Province concluded the IPO of Hydro One on the Toronto Stock Exchange, whereby 81.1 million of the 595 million outstanding common shares of Hydro One were sold to the public. On November 12, 2015, the underwriters of the IPO exercised their option to purchase an additional 8.15 million common shares of Hydro One from the Province. All proceeds from the IPO were received by the Province. All of the regulated business and outstanding notes and debentures of Hydro One at the time of the IPO remain at Hydro One Inc. The final prospectus associated with the IPO, which contains details of the IPO, recapitalization and corporate structure, is posted on www.sedar.com.

PILs Deemed Disposition Rules

In connection with the IPO, upon ceasing to be exempt from tax under the Federal Tax Regime in October 2015, Hydro One and its subsidiaries were deemed to dispose of their assets for proceeds equal to their fair market value, triggering a PILs liability of $2.6 billion (Departure Tax). The Departure Tax amount was confirmed in writing by the Minister of Finance and was paid to the OEFC in 2015. To enable Hydro One and its subsidiaries to pay the Departure Tax, the Province made an equity injection of $2.6 billion in Hydro One and received 2.6 billion common shares of Hydro One. The revaluation of the tax basis of the assets of Hydro One Inc. and its subsidiaries to fair market value resulted in a net deferred tax recovery of $2,619 million recorded in 2015.

Consolidated Statements of Operations and Comprehensive Income

For the years ended December 31, 2015 and 2014

Year ended December 31 (millions of Canadian dollars, except per share amounts)	2015	2014
Revenues		
Distribution (includes $159 related party revenues; 2014 – $159) *(Note 23)*	4,949	4,903
Transmission (includes $1,554 related party revenues; 2014 – $1,567) *(Note 23)*	1,536	1,588
Other	53	57
	6,538	6,548
Costs		
Purchased power (includes $2,335 related party costs; 2014 – $2,633) *(Note 23)*	3,450	3,419
Operation, maintenance and administration *(Note 23)*	1,135	1,192
Depreciation and amortization *(Note 5)*	759	722
	5,344	5,333
Income before financing charges and income taxes	1,194	1,215
Financing charges *(Note 6)*	376	379
Income before income taxes	818	836
Income taxes *(Notes 7, 23)*	105	89
Net income	713	747
Other comprehensive income	1	–
Comprehensive income	714	747
Net income attributable to:		
Noncontrolling interest *(Note 22)*	10	(2)
Preferred shareholders	13	18
Common shareholders	690	731
	713	747
Comprehensive income attributable to:		
Noncontrolling interest *(Note 22)*	10	(2)
Preferred shareholders	13	18
Common shareholders	691	731
	714	747
Earnings per common share *(Note 20)*		
Basic	$ 1.39	$ 1.53
Diluted	$ 1.39	$ 1.53
Dividends per common share declared *(Note 19)*	$ 1.83	$ 0.56

See accompanying notes to Consolidated Financial Statements.

Consolidated Balance Sheets

At December 31, 2015 and 2014

December 31 (millions of Canadian dollars)	2015	2014
Assets		
Current assets:		
Cash and cash equivalents *(Note 13)*	94	100
Accounts receivable (net of allowance for doubtful accounts – $61; 2014 – $66) *(Note 8)*	776	1,016
Due from related parties *(Note 23)*	191	224
Regulatory assets *(Note 11)*	36	31
Materials and supplies	21	23
Deferred income tax assets *(Note 7)*	19	19
Derivative instruments *(Note 13)*	–	2
Prepaid expenses and other assets	29	35
	1,166	1,450
Property, plant and equipment *(Note 9)*:		
Property, plant and equipment in service	26,070	25,356
Less: accumulated depreciation	9,414	9,134
	16,656	16,222
Construction in progress	1,155	1,025
Future use land, components and spares	157	154
	17,968	17,401
Other long-term assets:		
Regulatory assets *(Note 11)*	3,015	3,200
Deferred income tax assets *(Note 7)*	1,636	7
Intangible assets (net of accumulated amortization – $274; 2014 – $305) *(Note 10)*	336	276
Goodwill *(Note 4)*	163	173
Deferred debt issuance costs	34	36
Derivative instruments *(Note 13)*	1	–
Other	9	7
	5,194	3,699
Total assets	24,328	22,550

See accompanying notes to Consolidated Financial Statements.

Consolidated Balance Sheets (continued)

At December 31, 2015 and 2014

December 31 (millions of Canadian dollars, except number of shares)	2015	2014
Liabilities		
Current liabilities:		
Bank indebtedness *(Note 13)*	–	2
Short-term notes payable *(Notes 12, 13)*	1,491	–
Accounts payable	155	173
Accrued liabilities *(Notes 15, 16)*	598	611
Due to related parties *(Note 23)*	138	227
Accrued interest	96	100
Regulatory liabilities *(Note 11)*	19	47
Derivative instruments *(Note 13)*	–	3
Long-term debt payable within one year (includes $nil measured at fair value; 2014 – $252) *(Notes 12, 13)*	500	552
	2,997	1,715
Long-term debt (includes $51 measured at fair value; 2014 – $nil) *(Notes 12, 13)*	8,224	8,373
Other long-term liabilities:		
Post-retirement and post-employment benefit liability *(Note 15)*	1,560	1,533
Pension benefit liability *(Note 15)*	952	1,236
Regulatory liabilities *(Note 11)*	236	168
Deferred income tax liabilities *(Note 7)*	207	1,313
Environmental liabilities *(Note 16)*	185	221
Net unamortized debt premiums	17	18
Asset retirement obligations *(Note 17)*	9	9
Long-term accounts payable and other liabilities	17	17
	3,183	4,515
Total liabilities	14,404	14,603
Contingencies and Commitments (Notes 25, 26)		
Subsequent Events (Note 28)		
Preferred shares *(Notes 18, 19)*	–	323
Noncontrolling interest subject to redemption *(Note 22)*	23	21
Equity		
Common shares *(Notes 18, 19)*	5,623	3,314
Preferred shares *(Notes 18, 19)*	418	–
Additional paid-in capital *(Note 21)*	10	–
Retained earnings	3,806	4,249
Accumulated other comprehensive loss	(8)	(9)
Total Hydro One shareholders' equity	9,849	7,554
Noncontrolling interest *(Note 22)*	52	49
Total equity	9,901	7,603
	24,328	22,550

See accompanying notes to Consolidated Financial Statements.

On behalf of the Board of Directors:

David Denison
Chair

Philip Orsino
Chair, Audit Committee

7. Income Taxes

Income taxes / provision for PILs differs from the amount that would have been recorded using the combined Canadian federal and Ontario statutory income tax rate. The reconciliation between the statutory and the effective tax rates is provided as follows:

Year ended December 31 *(millions of Canadian dollars)*	2015	2014
Income taxes / provision for PILs at statutory rate	217	222
Increase (decrease) resulting from:		
Net temporary differences included in amounts charged to customers:		
Capital cost allowance in excess of depreciation and amortization	(37)	(72)
Pension contributions in excess of pension expense	(25)	(24)
Overheads capitalized for accounting but deducted for tax purposes	(15)	(15)
Interest capitalized for accounting but deducted for tax purposes	(13)	(13)
Environmental expenditures	(5)	(5)
Non-refundable investment tax credits	(2)	(3)
Post-retirement and post-employment benefit expense in excess of cash payments	(1)	3
Prior year's adjustments	(1)	(4)
Other	(2)	(1)
Net temporary differences	(101)	(134)
Net tax benefit resulting from transition from PILs Regime to Federal Tax Regime	(19)	–
Hydro One Brampton spin-off	7	–
Net permanent differences	1	1
Total income taxes / provision for PILs	105	89

The major components of income tax expense are as follows:

Year ended December 31 *(millions of Canadian dollars)*	2015	2014
Current income taxes / provision for PILs	2,949	79
Deferred income taxes / provision for (recovery of) PILs	(2,844)	10
Total income taxes / provision for PILs	105	89
Effective income tax rate	12.84%	10.63%

The provision for PILs / current income taxes is remitted to, or received from, the OEFC (PILs Regime) and the CRA (Federal Tax Regime). At December 31, 2015, $12 million (2014 – $39 million) due from the OEFC was included in due from related parties and $1 million (2014 – $nil) due from the CRA was included in prepaid expenses and other assets on the Consolidated Balance Sheet.

In connection with the IPO, Hydro One's exemption from tax under the Federal Tax Regime ceased to apply. Under the PILs Regime, Hydro One was deemed to have disposed of its assets immediately before it lost its tax exempt status under the Federal Tax Regime, resulting in Hydro One making payments in lieu of tax (Departure Tax) totalling $2.6 billion. To enable Hydro One to make the Departure Tax payment, the Province subscribed for common shares of Hydro One for $2.6 billion (See Note 18 – Share Capital). Hydro One used the proceeds of this share subscription to pay the Departure Tax.

At December 31, 2015, the total income taxes / provision for PILs includes deferred income taxes / recovery of PILs of $2,844 million (2014 – deferred provision of $10 million), including $2,810 million (2014 – $nil) resulting from transition from the PILs Regime to the Federal Tax Regime, that is not included in the rate-setting process, using the liability method of accounting. Deferred income taxes / PILs balances expected to be included in the rate-setting process are offset by regulatory assets and liabilities to reflect the anticipated recovery or disposition of these balances within future electricity rates.

Deferred Income Tax Assets and Liabilities

Deferred income tax assets and liabilities arise from differences between the carrying amounts and tax basis of the Company's assets and liabilities. At December 31, 2015 and 2014, deferred income tax assets and liabilities consisted of the following:

December 31 *(millions of Canadian dollars)*	2015	2014
Deferred income tax assets		
Depreciation and amortization in excess of capital cost allowance	937	(4)
Post-retirement and post-employment benefits expense in excess of cash payments	578	8
Environmental expenditures	75	4
Non-capital losses	62	–
Other	3	(1)
Total deferred income tax assets	1,655	7
Less: current portion	19	–
	1,636	7

December 31 *(millions of Canadian dollars)*	2015	2014
Deferred income tax liabilities		
Regulatory amounts that are not recognized for tax purposes	(153)	(140)
Partnership interest	(41)	(38)
Goodwill	(10)	(21)
Capital cost allowance in excess of depreciation and amortization	(1)	(1,713)
Post-retirement and post-employment benefits expense in excess of cash payments	–	559
Environmental expenditures	–	59
Other	(2)	–
Total deferred income tax liabilities	(207)	(1,294)
Less: current portion	–	19
	(207)	(1,313)

During 2015 and 2014, there were no changes in the rate applicable to future taxes. The Company has recorded a valuation allowance in the amount of $278 million (2014 – $nil) in respect of non-depreciable capital property.

8. Accounts Receivable

December 31 *(millions of Canadian dollars)*	2015	2014
Accounts receivable – billed	379	496
Accounts receivable – unbilled	458	586
Accounts receivable, gross	837	1,082
Allowance for doubtful accounts	(61)	(66)
Accounts receivable, net	776	1,016

In 2015, the Company revised the method to estimate the unbilled accounts receivable by using new technology that improved the estimation process. This change has been accounted for on a prospective basis in the consolidated financial statements at December 31, 2015. At December 31, 2015, the change in estimation technology resulted in a reduction in unbilled accounts receivable of approximately $121 million, with a corresponding offset to various components of the retail settlement variance accounts (RSVA). The change in estimate had no significant impact on 2015 net income.

11. Regulatory Assets And Liabilities

Regulatory assets and liabilities arise as a result of the rate-setting process. Hydro One has recorded the following regulatory assets and liabilities:

December 31 *(millions of Canadian dollars)*	2015	2014
Regulatory assets:		
Deferred income tax regulatory asset	1,445	1,327
Pension benefit regulatory asset	952	1,236
Post-retirement and post-employment benefits	240	273
Environmental	207	239
RSVA	110	11
Pension cost variance	37	90
2015-2017 rate rider	20	–
DSC exemption	10	16
Share-based compensation	10	–
B2M LP start-up costs	8	–
OEB cost assessment differential	–	12
Other	12	27
Total regulatory assets	3,051	3,231
Less: current portion	36	31
	3,015	3,200
Regulatory liabilities:		
External revenue variance	87	54
Green Energy expenditure variance	76	83
CDM deferral variance	53	25
Deferred income tax regulatory liability	23	21
PST savings deferral	4	19
Other	12	13
Total regulatory liabilities	255	215
Less: current portion	19	47
	236	168

Deferred Income Tax Regulatory Asset and Liability

Deferred income taxes are recognized on temporary differences between the carrying amount of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable income. The Company has recognized regulatory assets and liabilities that correspond to deferred income taxes that flow through the rate-setting process. In the absence of rate-regulated accounting, the Company's income tax expense would have been recognized using the liability method and there would be no regulatory accounts established for taxes to be recovered through future rates. As a result, the 2015 income tax expense would have been higher by approximately $101 million (2014 – $132 million).

Pension Benefit Regulatory Asset

In accordance with OEB rate orders, pension costs are recorded on a cash basis as employer contributions are paid to the pension fund in accordance with the *Pension Benefits Act* (Ontario). The Company recognizes the net unfunded status of pension obligations on the Consolidated Balance Sheets with an offset to the associated regulatory asset. A regulatory asset is recognized because management considers it to be probable that pension benefit costs will be recovered in the future through the rate-setting process. The pension benefit obligation is remeasured to its fair value at each year end based on an annual actuarial report, with an offset to the associated regulatory asset, to the extent of the remeasurement adjustment. In the absence of rate-regulated accounting, 2015 OCI would have been higher by $284 million (2014 – lower by $391 million).

main factors that have given rise to the changes in income tax resulting from privatization.

MS. CHEUNG: Yes, I can summarize those changes.

There are three main factors. First, the Province previously owned 100 per cent of the outstanding shares of Hydro One. When the Province decided to sell more than 10 per cent of its interest in Hydro One, it changed the Hydro One's federal non-taxable status and the application of provincial PILs regime. Hydro One will now be subject to tax under the federal tax regime.

Second, the change from the non-taxable to taxable status was not a change in tax law; it was application of those laws. Under the regulation to the Electricity Act, Hydro One became liable to pay a departure tax. That amount of this cost was 2.6 billion.

The tax obligation was a direct result of the Province's decision to sell its interest in Hydro One. It did not relate in any way of -- related to the regulated services which Hydro One provides to its customers. For this reason, no portion of the departure tax is being recovered or included in Hydro One's revenue requirement.

Third, when a corporation ceases to be exempt from tax, a deemed disposition is triggered under the provisions of the Federal Income Tax Act. Hydro One is deemed to dispose and reacquire its asset at fair market value. This deemed disposition triggered a tax obligation on a difference between the fair market value and the tax costs of the assets.

From a tax perspective, this also means that Hydro One's assets was revalued at fair market value. It will now become the new tax costs of its asset for which capital cost allowance is calculated and deducted.

MR. NETTLETON: Now, Ms. Cheung, did the disposition of the Province's shares result in Hydro One actually making a payment for the departure tax obligation?

MS. CHEUNG: Yes, it did. Payment of this amount was made to the Ontario Electricity Financial Corporation, the OEFC. Importantly, when payments are made to the OEFC they are directed to a specific purpose, namely, the retirement of provincial long-term debt.

Prior to the transaction, when Hydro One was under the PILs regime, PILs payments were made to the OEFC. Subsequent to the IPO, Hydro One is no longer subject to PILs of corporate income tax, so the departure tax may be viewed as a lump sum of the future PILs that the OEFC would have received if the IPO did not occur.

MR. NETTLETON: Now, Mr. Vels, with regards to financing the departure tax obligation, can you discuss what options Hydro One had to finance that $2.6 billion obligation?

MR. VELS: Sure. At the outset, it's important that we understand that the departure tax was only one of the costs that Hydro One incurred at the time of the IPO. For example, we also incurred costs associated with the payment of a special dividend, and these costs were financed by incurrence of additional debt.

With respect to the departure tax, there were only three potential options: firstly, a recovery in rates; secondly, raise debt to finance the payment; or, third, arrange for a shareholder contribution.

Option one was rejected because of cost causation principles. Again, the cost was caused by the IPO. It's really unrelated to regulatory services provided by the company and, as such, would have been inappropriate to request recovery of this amount in customer revenues.

Option 2 was also rejected because, by doing so, it would have significantly affected the valuation of the company. As you recall, this was being done at a time when the market was valuing the shares to be sold in the market. Incurrence of a significant amount of debt required to finance the departure tax payment would have caused a significantly lower recovery for the shareholder when those shares were sold in the market because of the higher leverage levels.

Option 3 was selected because the shareholder could take steps to protect the valuation of Hydro One shares and thus avoid the adverse valuation result. However, this still meant that the shareholder incurred a cost, because it had to raise the necessary funds and make a contribution equal to the departure tax payment, and, in return, it received additional shares in the company.

MR. NETTLETON: Now, panel, were the proceeds of the departure tax used to fund the shareholder's investment? Ms. Cheung?

MS. CHEUNG: No. The payment of the departure tax was used to pay down debt by the OEFC.

MR. NETTLETON: Mr. Vels, the evidence is that Hydro One incurred a $2 billion cost. Is it also the case that the shareholder has incurred a cost?

MR. VELS: Yes. The shareholder incurred a cost because it was required to maintain its valuation in the shares by contributing an amount into the company equivalent to cover the expense of the departure tax.

As a result, it no longer had access the that cash, and it was unable to use it for different purposes. They will be able to, and we expect they will, recover part of that cost in the future as they sell the shares at a higher valuation than would otherwise have been the case if they had not recapitalized the company.

MR. NETTLETON: Now let's turn to capital cost allowance, Ms. Cheung. Will the change in CCA reduce Hydro One's future tax obligations?

MS. CHEUNG: Yes. The CCA is an allowable tax deduction that reduces taxable income, which results in lower income tax obligations. The increase in this deduction arises because Hydro One was no longer a tax-exempt entity under the Federal Income Tax Act, and, as such, its assets were deemed to be acquired at fair market value.

The increased deduction is a benefit to Hydro One. However, this benefit follows from the costs incurred, which resulted from the shareholder's decision to sell a portion of its ownership to the public market. It is this decision that caused Hydro One to no longer have a non-taxable status under the Federal Income Tax Act, so these concepts, the IPO, the cost to finance, and payment of the departure tax were all linked costs and relate to the benefits of the increase in CCA deduction.

MR. NETTLETON: Okay. Ms. Cheung, why is the increase in CCA not reflected in the revenue requirement that's been applied for in this application?

MS. CHEUNG: The principle that Hydro One has applied is that all costs and all benefits arising from the IPO are to the company's account. Hydro One is not seeking the recovery from the ratepayer of any costs associated with the IPO, so the departure tax is not being recovered in rates. Similarly, the fair market value bump does not affect the accounts and balances upon which rates are set. Rates remain calculated using historical net book value. Since ratepayers are not incurring costs of the IPO, the benefits of those transactions, like the deferred tax asset, are also not being included in the Hydro One's rates.

The principles that we are following here are Hydro One's transmission remains regulated on a standalone basis and that benefit should follow costs.

MR. NETTLETON: Now, in the Board Staff's Interrogatory 134, Hydro One was referred to the RP-2004-0188 decision, which is entitled:

“The Report of the Board on the 2006 Electricity

Distribution Rate Handbook”

And, Mr. Vels, do you believe the circumstances in that case are similar to the ones now before the Board?

MR. VELS: No. We believe there are significant factual differences. In the case of Hydro One, the shareholder has incurred a real cost, as we discussed earlier. In the RP 2004-0188 decision, the Board disregarded the regulatory principle that benefits follow costs.

In 2001, the Ministry of Finance required the revaluation of assets to fair market value. The tax bump in that circumstance is due to the introduction of the PILs regime. The shareholder had not incurred a cost, and, thus, the benefits did not accrue to the shareholder. The Board decided in that case to allocate those windfall benefits to the ratepayers.

The obligation to pay the amount is due to the application of existing tax laws and tax regimes. The deemed disposition laws applied when there was a change in the taxpayer's taxable status.

So Hydro One has incurred a real cost and paid $2.6 billion to the OEFC. In contrast, in RP 2004-0188, there was no similar cost payment.

MR. NETTLETON: Thank you, panel.

Mr. Chairman, those are my questions for direct evidence. This panel is available for cross-examination now.

MR. QUESNELLE: Thank you, Mr. Nettleton. I have one it I want to just go back and -- the 2.3 billion that was paid, I mean, speaking very generally, is that the sum total of what you would have paid under the PILs regime to the Ontario government? Is that equivalent to that?

MS. CHEUNG: Can you rephrase --

MR. BRETT: No, no, it's -- no, I am sorry, let me rephrase that. That's not a good question.

Look at 2-A, page 2-A of our compendium.

MS. CHEUNG: Um-hmm.

MR. BRETT: And you can see under the heading "other developments" it talks about the change of ownership structure. And then the last paragraph on the right-hand side, the right-hand column talks about PILs deemed disposition rules. And I have a couple of questions on that.

MS. CHEUNG: Sure.

MR. BRETT: But, first, as I understand it, and Mr. Vels spoke to this briefly this morning, you actually paid a cash -- Hydro One Networks paid a cash amount to the government of 2.3 billion, but effectively the government funded that payment by injecting cash back into Hydro One Networks and taking back shares; is that right?

MR. VELS: Yes, what I stated was we paid a departure tax cost.

MR. BRETT: Right.

MR. VELS: And then in order to avoid a weakening of our balance sheet we issued shares for equity, an equity share, that's effectively to the province, and received

So the deferred tax liability was reversed and resulted in a 1.245 billion deferred tax asset. So if you look at the change, the revaluation was exactly the same amount as the departure tax of 2.6 billion.

MR. BRETT: So it's the sum of those two items that make up the 2.6 billion?

MS. CHEUNG: That's correct.

MR. BRETT: Okay, I am going to ask you about that second item later, because we come to that a little bit later.

But what I wanted to focus on for a moment was the method by which this revaluation was done. And you say in that same paragraph that I was reading, you go on to say:

> "This estimated fair market value of Hydro One's net assets was determined by Hydro One principally using a discounted cash flow approach for certain assets,”

and you go on to describe that,

> "and was used in calculating the amount of the departure tax payable that was agreed between Hydro One and the province in early September 2015.”

So in layman's language, what that tells me is that effectively, it was a negotiated deal between Hydro One and the province. It was a deemed -- in other words, it was a deemed increase write-up of asset values.

And just to that point, the next sentence, as you know, says:

tax recovery of $2.6 billion that was triggered by the deemed disposition of its assets upon leaving the PILs regime in 2015?

MS. CHEUNG: Yes.

MR. MILLAR: And, in a Staff IR, you estimated that about $1.5 billion of that would have been allocated to transmission?

MS. CHEUNG: That's correct.

MR. MILLAR: And, as I understand it, the shareholder paid that amount by injecting $2.6 billion into Hydro One, for which they got 2.6 billion shares?

MS. CHEUNG: I think you need to treat that as two separate transactions. When they exited the -- when they ceased to be exempt, tax-exempt, from the Federal Income Tax Act, that triggers departure tax. So the company incurred a tax liability of $2.6 billion that needed to be paid to the OEFC. In order to get -- so that was an expense that the company incurred.

MR. MILLAR: Yes.

MS. CHEUNG: And then Ontario decided, which we had discussed earlier in direct evidence, that they need to inject $2.6 billion into the company to restore its equity before IPO.

MR. MILLAR: Okay. I understand. And, potentially, there could have been other ways to pay that tax liability; is that correct? You could, for example, have sought to have ratepayers pay that amount?

MS. CHEUNG: In this situation, we have not asked the ratepayers to pay for that 2.6 billion.

MR. MILLAR: No, I know you haven't. But that was another option that could have been open to you today?

MR. VELS: No. Well, we did, in our direct, outline that as an alternative, but we didn't consider it to be an option because -- and I think the wording is important -- because it's not a cost that relates to the cost of providing service. It's the result of an action by the company's shareholder and, as such, we considered it inappropriate to recover that cost from our customers.

MR. MILLAR: No. I understand you think it was inappropriate. Just in the world of possibilities, another way you could have approached this was to have sought permission from the Board to allow that expense to be borne by ratepayers. That was something you could have done, but you didn't.

MR. VELS: Yes. We could have done that, but I didn't.

MR. MILLAR: I think, Mr. Vels, it was you -- I don't have the transcript reference, but I heard you say a third option would have been to take debt that would have covered that expense.

MR. VELS: Yes.

MR. MILLAR: Had you done that, I guess, ultimately that debt -- if it wasn't going to be covered by the ratepayers, that ultimately would be a shareholder liability, whether it's the old shareholders or the new shareholders? Somebody would be holding that debt, and I take it, it wouldn't be the ratepayers?

MR. VELS: Well, it's an interesting question because, had we done it, the balance sheet of the company would have been significantly weakened. We probably would have lost our “A” credit rating, and that would have impacted the regulated utility. At that point, we would have probably had a difficult decision to make and some hard conversations about who should bear that cost.

MR. MILLAR: No doubt that's one of the reasons you didn't go down that path.

MR. VELS: Right.

MR. MILLAR: But that, in theory, was one of the things you could have done.

MR. VELS: Yes.

MR. MILLAR: Okay. So what happened was that the money to pay the departure tax was provided by Hydro One to the shareholder and then, I understand, it's paid to the OEFC? That's who gets the 2.6 billion.

MR. VELS: The amount we paid, the departure tax expense, that was paid by us was paid to the OEFC. That's right.

MR. MILLAR: Right. And what does the OEFC do with that money? Is it used to reduce the stranded debt?

MS. CHEUNG: It's used to reduce the provincial long-term debt.

MR. MILLAR: What is the relationship between your shareholder and OEFC?

MR. VELS: I am not sure I am qualified to answer that

MR. VELS: Okay.

MS. CHEUNG: So, in the prospectus the number, we see right now is 1.245 billion deferred tax asset. We need to look at the reversal of the deferred tax liability and add this component to it. You will get a deferred tax recovery of about 2.6 billion, which is equivalent to the departure tax. This is in the prospectus.

MR. THOMPSON: Okay. Well, when we talk about the deferred tax asset, is this -- excuse me. When we talk about this CCA benefit that is in -- you were discussing it with Mr. Millar, and in his exhibit at page -- I guess it's 45 and 46 -- it's here described that the 2.619 million deferred tax recovery -- is that the benefit, the CCA benefit, that is produced because these -- the fair market value was as high as it was?

MS. CHEUNG: It is. That represents the benefit.

MR. THOMPSON: Okay, that's the benefit. And is the number that I was talking about earlier from Mr. Brett's examination, is that the same thing, or is it another thing?

MS. CHEUNG: It's the same idea and concept. The prospectus was based on an estimate whereas the annual report is more based on the actuals.

MR. THOMPSON: Okay. And so -- but am I right that it grew from the prospectus to the timing in the annual report, because you had two sales, not one? Is that what brings it up to the 2.619, or what am I missing?

MS. CHEUNG: No. The prospectus is based on June

MS. CHEUNG: No, they weren't.

MR. THOMPSON: Will they be if you get this benefit in 2017?

MS. CHEUNG: You are talking about the 1.475 as calculated? If they got the benefit, would this applied to --

MR. VELS: The answer is no. These taxes are arising from the historical -- or the tax deductions that apply to the company's regulated asset values. The benefit that you are referring to, or the tax bump, relates to the revaluation for tax purposes that was required as a result of joining the -- I guess, moving into the CRA regime.

So ratepayers will continue to bear the costs of deduction of the taxes relative to the service that's being provided, and the deductions from taxes will relate to the regulated asset values and the book values that are in place and have been in place and which ratepayers have paid for historically.

MR. THOMPSON: Well, what are you going to do with these benefits, the 2.6 million? You are going to have to use them to reduce taxes.

MS. CHEUNG: We will be using them to reduce the taxes as a legal entity basis. We track them as a non-regulated segment as part of our calculations.

MR. THOMPSON: Okay. So I think what you are telling me is you are going to use them to reduce taxes of other companies in the Hydro One Limited family, but you are not going to touch these taxes; is that right?

MS. CHEUNG: No. We will be reducing Hydro One Network Inc.’s taxes as a legal entity, but not in these transmission segment.

MR. THOMPSON: Okay. So when the money flows up, it's not -- all of this 81.3 is not going to go to the government? Hydro One Inc. and Hydro One Limited are going to get the benefit of the CCA deduction above the operating companies?

MR. VELS: That's right.

MR. THOMPSON: Okay. And so let's -- and how much of the 81.3 will not work its way through to the tax authority? Any of it? Or is there this Minimum Tax Rule that applies to these companies?

MS. CHEUNG: There is an Ontario Minimum Tax Rule that would apply, which is based on net income before taxes.

MR. THOMPSON: And what is it -- I forget the number, but 81 would go down to a number, but not below that number.

MS. CHEUNG: That's right.

MR. THOMPSON: And what would be the numbers for the 81 and the 90?

MS. CHEUNG: The minimum tax?

MR. THOMPSON: Yes, the minimum tax, the floor below which the tax cannot go below.

MS. CHEUNG: The tax rate is 2.7 per cent of the net income before income tax.

MR. THOMPSON: Is that easily calculable, or can you do that by undertaking?

MS. CHEUNG: The Minimum Tax is calculated as a legal entity, so there would be different segments. I am just trying to think --

MR. THOMPSON: What I am asking is, as this money moves up, is there a minimum amount of the 81.3 that has to go to the taxing authority, or can it be wiped out by the benefits that you say are yours?

MR. VELS: Yes, there is a minimum tax amount that will be payable. We can't calculate that easily now.

MR. THOMPSON: Can you do it by undertaking?

MR. VELS: Yes, we can.

MR. THOMPSON: Okay. Can I have a number for that, please? I am sorry. I may have interrupted you, Mr. Vels.

MR. MILLAR: J2.10.

UNDERTAKING NO. J2.10: TO CALCULATE THE MINIMU TAX THAT WILL BE PAYABLE

MR. THOMPSON: Did I interrupt you?

MR. VELS: Oh, no, no.

MR. THOMPSON: Okay. I am sorry. And in the material summary -- I think it's the annual report -- you talk about this benefit being available for five years. Is that right?

MS. CHEUNG: That's what is disclosed in the prospectus.

MR. THOMPSON: And is that based on a calculation, or is it -- do they dry up after five years? I guess that’s what I am asking, even if they are unused?

MR. VELS: The position we took is there is a fairly significant amount of uncertainty as to the timing of the recovery of those tax amounts because it's dependent, to a large extent, on the profitability of the company. The deductions do survive for actually many years, but the bulk of the deductions would be utilized to the extent possible up to the value of taxable income that's earned by the company.

So to provide an estimate of how long the material benefits would last, we selected a period of five years to provide shareholders with some level of indication as to the relative materiality of the benefit.

MR. THOMPSON: So it's not tied to any --

MR. VELS: No, no. And those deductions would continue over some time, just because of the nature of the assets.

MR. THOMPSON: Okay. So my last question is this: If the Board were to find that the principles that you rely upon do not apply and that this benefit should be allocated to Transmission, how should it be implemented? Should it be by way of a reduction in the income taxes in cost of service or in some other manner? You want to take that just as a takeaway and get back to me on that, or can you answer it now?

MR. VELS: I am not sure that I can answer it either now or later. I just -- that would be something we would have to think about carefully. I mean, our position would be that we would need to recover the departure tax through rates as well or, alternatively, revalue or change the