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BY EMAIL and RESS

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2300 Yonge Street
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October 16, 2017
Our File: EB20170160

Attn: Kirsten Walli, Board Secretary

Dear Ms. Walli:

Re: EB-2016-0160– Hydro One Transmission 2017-2018 – SEC DRO Comments

1. We are counsel to the School Energy Coalition ("SEC"). Pursuant to the Decision and Order (the "Decision") these are SEC's comments on the draft UTR rate order ("DRO") filed by Hydro One Network Inc. ("Hydro One"). SEC has major concerns with the DRO's implementation of the Board's Decision regarding the reduction in capital expenditures, and the tax adjustment.

A. Capital Expenditures Reduction

2. In its Decision, the Board reduced Hydro One's capital expenditures by $126.1M in 2017 and $122.2M in 2018.[1] Since the revenue requirement component of capital spending is based on in-service additions, Hydro One was required to translate the capital expenditure reductions into in-service additions reductions. SEC has two related concerns regarding the implementation of the capital expenditure reductions in the DRO, a) Hydro One's allocation of the reductions to the spending categories, and b) how the Board ordered capital expenditure reductions were translated into in-service additions reductions.

3. ***Reduction Allocation***. Hydro One has provided very limited information regarding how it will implement the capital expenditure reductions and the explanatory information it has provided does not appear to match with what it actually has done. For example, although Hydro One states in the DRO that it is modifying its investments "including core power system investments, reducing tower coating, and deferring investments in line and station projects"[2], its actual reductions are taking place not within the sustaining category, as one would expect based on that description, but within the development category.

[1] Decision and Order (EB-2016-0160 - Hydro One Networks Inc.), September 28 2017, ["Decision"], p.1
[2] Hydro One Draft UTR Rate Order ["DRO"], p.2

Capital Expenditure ($M)									
	Evidence			**Decision**			***Variance***		
	2017	**2018**	**Total**	**2017**	**2018**	**Total**	**2017**	**2018**	**Total**
Sustaining	776.8	842.1	1618.9	758.9	780.4	1539.3	*-17.9*	*-61.7*	*-79.6*
Development	196.3	170.2	366.5	117.2	109.9	227.1	*-79.1*	*-60.3*	*-139.4*
Operations	25.4	30.8	56.2	13	42.9	55.9	*-12.4*	*12.1*	*-0.3*
Common	77.6	79.1	156.7	60.9	66.8	127.7	*-16.7*	*-12.3*	*-29*
Total	**1076.1**	**1122.2**	**2198.3**	**950**	**1000**	**1950**	***-126.1***	***-122.2***	***-248.3***
In-Service Additions ($M)									
	Evidence			**DRO Proposal**			***Variance***		
	2017	**2018**	**Total**	**2017**	**2018**	**Total**	**2017**	**2018**	**Total**
Sustaining	771.1	747.7	1518.8	728.3	773.5	*1501.8*	*-42.8*	*25.8*	*-17*
Development	64.6	374.9	439.5	72.2	308.7	*380.9*	*7.6*	*-66.2*	*-58.6*
Operations	8	10.3	18.3	4.4	9.7	*14.1*	*-3.6*	*-0.6*	*-4.2*
Common	87.8	76.8	164.6	62.9	86.5	*149.4*	*-24.9*	*9.7*	*-15.2*
Total	**931.5**	**1209.7**	**2141.2**	**867.8**	**1178.4**	***2046.2***	***-63.7***	***-31.3***	***-95***
Source: DRO, p.2-3									

4. The allocation of the reductions between spending categories is also contrary to the spirit, if not the wording, of the Decision. Although the Board did approve "a capital envelope, as opposed to a specific set of projects"[3], all of its criticisms of its capital plan were directed at Hydro One's sustaining spending, not other categories.[4] It is the sustaining spending that concerned the Board and most intervenors, and are outlined in the detailed findings of the Board in the Decision. Yet, only 32% of the Board ordered reduction was allocated to the sustaining category, while 56% is from the development category.

5. The allocation creates a situation where projects and programs the Board and parties did not have issues with will see large cutbacks, whereas projects and programs where there were significant issues will see relatively small reductions. In the future, those development projects will still be required, yet the sustaining capital budget which the Board heavily criticized, will have already been spent. What further worries SEC is that the reduction in the development category may simply be artificial reductions due to Hydro One's history of delays in large capital projects that would have occurred regardless of the reductions.[5]

6. The Board should require Hydro One to fully explain the rationale for its reduction between categories and how it is consistent with addressing the findings the Board raised in its Decision.

7. ***Capital Expenditures to In-Service Additions***. SEC is concerned with how Hydro One has translated the capital expenditure reductions into in-service additions reductions. Hydro One has calculated the impacts that flow from the Board's capital expenditure reduction of $126.1M in 2017 and $122.2M in 2018 as a reduction of in-service additions of just $63.7M in 2017 and $31.3M in 2018.[6] This has the effect that the Board-ordered reduction of $248.3M in capital expenditures over the two year test period, will result in only a $95M reduction in in-service additions over the same period.

[3] Decision, p.31
[4] Decision, p.30
[5] *Ibid*
[6] DRO Exhibit 1.2, .1

8. While SEC recognizes that the ratio between capital expenditures and in-service additions is not going to be 1:1 (i.e. $1 of capital expenditures in a given year will not equal $1 of in-service in the same year), a ratio of 1:0.51 and 1:0.26[7] as Hydro One has proposed for its reductions is both implausible and contrary to the evidence in this proceeding.

Hydro One DRO						
	Decision CAPEX Reduction ($M)		Proposed ISA Reduction ($M)		CAPEX:ISA Ratio	
	2017	**2018**	**2017**	**2018**	**2017**	**2018**
Sustaining	-17.9	-61.7	-42.8	25.8	2.39	-0.42
Developme	-79.1	-60.3	7.6	-66.2	-0.10	1.10
Operations	-12.4	12.1	-3.6	-0.6	0.29	-0.05
Common	-16.7	-12.3	-24.9	9.7	1.49	-0.79
Total	**-126.1**	**-122.2**	**-63.7**	**-31.3**	**0.51**	**0.26**
Source: DRO, p.2-3						

9. The evidence showed that based on the proposed capital expenditures, the ratio between capital expenditures and in-service additions was 1:0.87 and 1:1.08 in 2017 and 2018.[8] Even using the revised capital expenditure allocation that Hydro One has proposed as a result of the Decision, and applying the same category specific capital expenditure to in-service additions ratio from the evidence, results in an in-service addition reduction of $109.2M and $131.7M in 2017 and 2018.[9]

SEC Corrected Approch												
	Evidence						Decision					
	Proposed CAPEX ($M)		Proposed ISA ($M)		CAPEX:ISA Ratio		Decision CAPEX ($M)		ISA Using Evidence CAPEX: ISA Ratios ($M)		ISA Reduction From Applied ($M)	
	2017	**2018**	**2017**	**2018**	**2017**	**2018**	**2017**	**2018**	**2017**	**2018**	**2017**	**2018**
Sustaining	776.8	842.1	771.1	747.7	0.99	0.89	758.9	780.4	753.3	692.9	-17.8	-54.8
Development	196.3	170.2	64.6	374.9	0.33	2.20	117.2	109.9	38.6	242.1	-26.0	-132.8
Operations	25.4	30.8	8	10.3	0.31	0.33	13	42.9	4.1	14.3	-3.9	4.0
Common	77.6	79.1	87.8	76.8	1.13	0.97	60.9	66.8	68.9	64.9	-18.9	-11.9
Total	**1076.1**	**1122.2**	**931.5**	**1209.7**	**0.87**	**1.08**	**950**	**1000**	**822.3**	**1078.0**	**-109.2**	**-131.7**
Source: DRO, p.2-3												

10. Since Hydro One has not filed any information in its DRO on what specific projects it has cancelled, deferred, or simply chosen not to add to rate base (if any) as a result of the Decision, the Board should use the same capital expenditure to in-service addition ratios from the evidence. Those ratios had the opportunity to be tested during the hearing[10], while new ones have not. Further, the information that has been provided is wholly inadequate to justify them.

11. Based on the evidence, the Board should require Hydro One to reduce its in-service additions by $109.2M in 2017, and $131.7M in 2018.

B. <u>Tax Adjustment</u>

12. SEC submits that the DRO has calculated the reduction in regulatory income taxes ordered by the Board incorrectly. The reduction for 2017 should be $30.0M, and the reduction for 2018 should be $32.4M. As a result, and after applying gross-up to the differential, revenue requirement over the two years has been overstated by $17.4M in the DRO.

[7] See table below. Calculations from DRO p.2-3.
[8] B1-3-1-Attachment 1, p.3; I-6-26 (SEC IR #26), p.3; DRO, p.2-3
[9] See table below.
[10] For example, SEC cross-examined Hydro One on how it calculates in-service additions at Tr.10, p.34-35;

13. ***The Decision.*** The Board determined in the Decision that the percentage of the taxes calculated each year (referred to as "notional or hypothetical income taxes"[11]) that should be recoverable by the shareholders is the greater of[12]:

a. The Recapture Ratio, defined as the percentage of the deferred tax asset created on the FMV Bump that arose because of recapture of past deductions for CCA; and
b. The FMV Sales and Payments Ratio, defined as the percentage of the deferred tax asset that is equal to the proportion of the FMV bump "that is attributable to actual FMV sales and purchases at FMV"[13].

14. The Board went on to estimate that the Recapture Ratio was 71%[14], and the FMV Sales and Payments Ratio was 45% as of February 2017[15]. The Board also estimated that the recapture amount would always be greater for any sale of shares up to the maximum 60% allowed by legislation. Thus, the Board determined that the Recapture Ratio should be used to determine the percentage of the notional taxes that should be allocated to the shareholders, saying:

> The OEB favours the adoption of a stable and transparent approach and directs Hydro One to reduce the taxes calculated under an assumed 100% allocation of tax savings benefits to shareholders to the level of the recapture ratio for transmission that the OEB calculates at 71%. This would reduce grossed up taxes proposed by Hydro One of $81.9 million in 2017 and $89.6 million in 2018 to about $58.1 million and about $63.6 million in each of those years, respectively.[16]

15. The Board also determined that Hydro One was required to file further evidence to identify the actual amount of recapture, and to make the tax adjustment consistent with the actual recapture amount:

> During the draft revenue requirement/charge determinant approval process, in order to determine whether its calculations of Recapture Ratios require any reduction, the OEB will consider the information to be provided by Hydro One regarding the separation of the FMV Bump in Exhibit J11.3 between its recapture and gain components and the reconciliation of that information to the deferred tax liability and deferred tax asset amounts for Networks recorded in the financial statements on record in this proceeding covering the periods immediately prior to and following the IPO.[17]

16. The Board goes on in a footnote to give an example of the reduction that would arise in that situation.

17. The Board did not contemplate that the Recapture Ratio would be lower than the FMV Sales and Payments Ratio.

18. ***Hydro One Has Not Followed the Board's Decision in the DRO.*** The evidence filed by Hydro One supporting the DRO, and the publicly available information on sales of shares of Hydro One by the province[18], shows that:

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[11] Decision, p.85
[12] Decision, p.88
[13] *Ibid*
[14] Decision, p.91
[15] Decision, p.101
[16] Decision, p.107
[17] *Ibid*
[18] As of May 2017 the Province had completed its sales, and had 49.9% of Hydro One (http://hydroone.mediaroom.com/2017-05-17-Hydro-One-Limited-Announces-Closing-of-Secondary-Offering-of-Common-Shares-by-the-Province-of-Ontario). However, it had also promised to transfer up to 2.5% of the shares to First Nations, which would leave it with 47.4% (https://news.ontario.ca/mei/en/2016/07/ontario-and-first-nations-

i. The Recapture Ratio for transmission is 52.5%.
ii. The FMV Sales and Payments Ratio, at 52.6% of Hydro One's shares sold, is 63.5%.

19. As a result, the notional taxes recoverable in each of 2017 and 2018 should be 63.5% of the amounts otherwise determined. The amounts otherwise determined are $82.2M in 2017 and $88.8M in 2018[19]. The amounts to be included in revenue requirement are thus $52.2M and $56.4M, for a total of $108.6M. The amounts of $58.4Mand $63.0M respectively, totaling $121.4M, reported by Hydro One, are incorrect. They seek to recover income tax that is $12.8M higher than the Board ordered, which when grossed-up results in $17.4M lower revenue requirement over the two years.

20. The details of the calculations of the Recapture Ratio and the FMV Sales and Payments Ratio are below.

21. ***FMV Sales and Payments Ratio.*** The Board has stipulated the method that is to be used to calculate the FMV Sales and Payments Ratio, describing it in detail and finding it to be "appropriate"[20]. Essentially, the method takes the total amount of the FMV bump and multiplies it by the percentage of shares sold at FMV. The concept is that acquirers of those shares have paid FMV for that portion of the bump, so it is not a deemed transaction, but a real one. Then, with respect to the remainder of the shares, still held by the province, that percentage is applied to the actual amount of the departure tax to get the FMV component allocable to the province's shares. Table 15-3 in the Decision provides detailed calculations using this methodology.

22. Assuming that the sale of shares by the province in May 2017 is to be included, and also assuming that the Board determines the sale of 2.5% of the province's shares to First Nations is to be considered a FMV sale (see footnote 18), the total shares held by new shareholders would be 52.6%, and the total shares held by the province as of today, after the end of its sales, would be 47.4%. The transmission component of the FMV bump is $5,567M, so that component of the calculation is $2,928M ($5,567M times 52.6%). The transmission component of the departure tax is $1,280M, so that component of the calculation is $607M ($1,280M times 47.4%). The total "Actual FMV Sales and Payments" is $3,535M, and the ratio is therefore 63.5% (3,535/5,567).

23. If the FMV Sales and Payments Ratio applies, under the Decision, Hydro One is allowed, in its transmission applications, to continue to collect 63.5% of its notional or hypothetical income taxes until the cumulative total equals $937.3M (63.5% of $1,476M, the total deferred tax asset created on the FMV bump that is allocated to transmission[21]).

24. ***Recapture Ratio.*** The Board determined that the portion of the deferred tax asset that is for account of the shareholder (subject to the FMV calculation) is limited to the portion for which the customers have already received the benefit of tax deductions, i.e. the recapture. At the time of the Decision, the Board estimated that the recapture allocable to transmission was $3,961M[22], but

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announce-agreement-in-principle-for-sale-of-hydro-one-shares.html). In determining the FMV Sales and Payments Ratio, the Board would have to determine whether the sale to the First Nations is treated as a FMV sale or not. The evidence available to SEC does not allow us to determine whether it was. We have therefore taken the conservative approach of assuming that the First Nations sale is to be treated as a FMV sale, subject to the Board's determination of that question.

[19] DRO Exhibit 1.5, line labelled "Regulatory Income Tax", and Exhibit 2.2
[20] Decision, p.102
[21] Decision, p 93
[22] Decision, p.94

ordered Hydro One to provide more detailed information in the form of an update to Exhibit J11.3, so that the actual Recapture Ratio could be determined.

25. Hydro One has filed a new Exhibit J11.3[23], which shows that recapture is 52.5% of the transmission FMV bump, 47.4% of the distribution FMV bump, and 50.0% of the overall FMV bump.

26. Notwithstanding the Board's clear direction, Hydro One in the DRO has assumed that the Recapture Ratio is the ratio estimated by the Board in the Decision, 71%, and has applied that percentage to do the tax calculation[24]. This is obviously non-compliant with the Decision.

27. The large difference is the result of Hydro One allocating 33.9% of the deemed gain in transmission to goodwill rather than to fixed assets. This does not change the underlying calculation, however. The shelter that arises from that allocation is still based on a notional increase in tax basis. The customers have received no benefit for that in the past, unlike recapture. Therefore, there is no fairness argument that the shareholders should get the benefit of that shelter for that reason. The fact that new shareholders who acquired shares from the province have paid FMV for those shares is already captured in the FMV Sales and Payments Ratio. The Recapture Ratio is intended to capture the benefit the customers have received from past deductions. Only 52.5% of the transmission deferred tax asset reflects benefits customers have previously received.

28. SEC therefore submits that, consistent with the Decision, the Recapture Ratio for transmission is 52.5%.

29. ***Conclusion.*** Under the principles enunciated by the Board, the shareholders are entitled to recover from customers in rates, the notional or hypothetical income taxes otherwise determined, times the greater of the Recapture Ratio and the FMV Sales and Payments Ratio, and must give the benefit of the reciprocal of that ratio to the customers in rates.

30. The result is that the FMV Sales and Payments Ratio applies, 63.5%, which means that the income tax provision as set forth in DRO Exhibit 2.2 has to be reduced by 36.5%, not the 29% used in the Hydro One calculation. The reduction of $23.8M for 2017 should be $30.0M. The reduction of $25.7M for 2018 should be 32.4M.

31. Under the estimates in the Decision, transmission customers would have received 29% of the deferred tax asset over time, using the Recapture Ratio, a total of $428M . Now that the Board has the correct data, transmission customers should be receiving 36.5% of the deferred tax asset over time, using the FMV Sales and Payments Ratio, a total of $539M.

32. We note that the difference is even more striking with respect to distribution customers. The Board estimated that the Recapture Ratio would apply, meaning that distribution customers would have received only 16% of the $1,105M deferred tax asset over time, a total of $177M. With the correct data, distribution customers should be receiving 36.5% of the deferred tax asset over time, using the FMV Sales and Payments Ratio, a total of $403M[25].

33. Given Hydro One's approach to the DRO in this case, SEC recommends that the Board order Hydro One to establish deferral or tracking accounts in transmission and distribution for the final calculated amounts of deferred tax assets that will eventually go to the customers in rates, grossed-up to reflect pre-tax amounts, and to draw down from that account annually, and pay to

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[23] DRO, Exhibit 2.1, Attachment 1
[24] DRO, Exhibit 2.2
[25] Norfolk customers would receive 36.5% of $15M, as well, or $5.5M over time.

customers, 36.5% of its forecast income taxes, plus gross-up, included in rates for each future year until the account is depleted.

Yours very truly,
Shepherd Rubenstein P.C.

Original signed by

Mark Rubenstein

cc: Wayne McNally, SEC (by email)
Applicant and interested parties (by email)