EB-2017-0336

ONTARIO ENERGY BOARD

IN THE MATTER OF a cost of service application made by Hydro One Networks Inc. on May 31, 2016 under section 78 of the *Ontario Energy Board Act*, 1998, S.O. 1998, c. 15, (Schedule B), seeking approval for changes to its transmission revenue requirement and to the Ontario Uniform Transmission Rates, to be effective January 1, 2017 and January 1, 2018;

AND IN THE MATTER OF the Decision and Order dated September 28, 2017 in this proceeding;

AND IN THE MATTER OF the Decision and Order dated November 9, 2017 in this proceeding; and

AND IN THE MATTER OF Rules 40 and 42 of the Ontario Energy Board's *Rules of Practice and Procedure.*

WRITTEN SUBMISSIONS OF THE SCHOOL ENERGY COALITION

January 29, 2018

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1 OVERVIEW

1.1 *Background*

1.1.1 ***The Initial Issue.*** In EB-2016-0160 the Applicant and Moving Party, Hydro One Networks Inc.("Hydro One"), sought to include in rates grossed-up income taxes in 2017 of $81.7 million, and in 2018 of $89.6 million, in aggregate $171.3 million[1].

1.1.2 These were part of an aggregate $2.565 billion of hypothetical income taxes for both the transmission and distribution businesses that Hydro One will not actually pay, but that it wants to collect from customers over time. In seeking this rate recovery, Hydro One was asking the Board to make an exception to the normal rule that the income taxes included in rates are the actual taxes expected to be paid by the regulated entity.

1.1.3 ***The Decision.*** The Board, in the Decision and its subsequent rate order[2], carried out an extensive analysis of the applicable principles in play, and how they related to the facts before them. In the result, the Board determined that the Applicant should be entitled to collect from customers only 62% of those hypothetical income taxes. This amounted to $51.0 million in 2017, and $55.0 million in 2018, in aggregate $106.0 million[3]. The remaining $65.3 million was determined not to be recoverable from the customers.

1.1.4 The overall impact of this determination was that the sum of $1.590 billion of the $2.565 billion of hypothetical taxes would be recoverable from customers. The remaining $975 million of hypothetical income taxes, said the Board, should not be included in rates. The Board essentially adopted the reasoning in the Board's RP-2004-0188 Report[4], adapted to respond to the particular facts of this case.

1.1.5 ***This Motion.*** The Applicant wants customers to pay that other $975 million of hypothetical income taxes as well, and so brings this motion claiming errors on the part of the Board.

1.1.6 The Applicant is also seeking additional amounts in rates relating to AFUDC and the Ombudsman's Office, both of which were denied by the Board in the Decision.

1.1.7 SEC opposes the Motion. These are SEC's written submissions as required by Procedural Order #1.

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[1] EB-2016-0160, Decision of the Board dated September 28, 2017 (the "Decision"), p. 84.
[2] EB-2016-0160, Decision of the Board dated November 9, 2017 (the "Rate Order Decision")
[3] Rate Order Decision, p. 17.
[4] 2006 Electricity Distribution Rate Handbook, Report of the Board, May 11, 2005 ("RP-2004-0188").

1.2 *Summary of Submissions*

1.2.1 The Tax Allocation Issue. On the issue of the additional $975 million of hypothetical income taxes Hydro One wants to collect:

(a) The FMV Bump under the federal *Income Tax Act*[5] that gives rise to the future tax savings was not caused by the payment of Departure Tax under the PILs provisions of the *Electricity Act*[6] and the PILs Regulation[7]. The deemed disposition under the PILs Regulation, and the deemed acquisition under the ITA, are not legally or factually interdependent. The central argument of Hydro One therefore fails.

(b) The Board was correct in the Decision when it said that "the departure tax that the Province funded was effectively a payment from itself to itself"[8]. As a result, in substance no cost was incurred.

(c) The Board correctly determined, consistent with the reasoning in RP-2004-0188, that the benefits follow costs principle did not apply to give 100% of the benefit of the FMV Bump to the shareholders.

(d) The Board correctly analyzed the relevance of the Stand-Alone Principle to the facts of this case.

(e) The Board's ratemaking jurisdiction was not fettered, as Hydro One has proposed, by the Province's legislated authority to sell shares of Hydro One.

(f) The Recapture Ratio is a technically correct, and reasonable, allocation of certain of the future tax savings associated with the FMV Bump as between shareholders and customers.

(g) The Actual FMV Sales and Payments Ratio, while conceptually justifiable, is not technically sound, but any error in its construction would only reduce the allocation of the future tax savings to the Moving Party.

(h) Subject to the last point, the Board applied the principles in RP-2004-0188, and related regulatory and legal principles, to the facts of this case, and appropriately balanced the interests of shareholders and customers in dealing with the future impacts of the FMV Bump.

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[5] Income Tax Act, Canada, RSC 1985, c.1 (5th Suppl.), as amended.("ITA")
[6] Electricity Act, 1998 (Ontario) (the "Electricity Act").
[7] O.Reg. 207/99, s. 16.1
[8] Decision, p. 99.

1.2.2 ***AFUDC.*** On the AFUDC for the Niagara Reinforcement Project, SEC has no submissions.

1.2.3 ***The Ombudsman Office.*** On the Ombudsman Office, SEC submits that the Board's reasoning was sound, and is not in error.

2 THE FACTS

2.1 *Background*

2.1.1 The Board in its Decision made a determination that, based on ratemaking rules, principles and guidelines that the Board articulated in some detail, part but not all of the future tax savings arising because of the FMV bump in section 149(10) of the federal ITA[9] should be allocated to the shareholders of Hydro One. For the remainder of those savings, the normal rule that utilities recover actual tax costs in rates should be applied.

2.1.2 The effect of the Decision is to make an exception to that normal rule, and to allow Hydro One to collect from customers $1.590 billion of income taxes that it will not actually pay.

2.1.3 Before dealing with the Issues and the Law, SEC believes it is necessary to deal with certain aspects of the facts as set out by Hydro One in their Written Argument.

2.2 *Fundamental Characterization of the Issue*

2.2.1 In their Written Argument, the Moving Party seeks to characterize the issue in this proceeding as whether certain future tax savings "should be applied to reduce Hydro One's revenue requirement for 2017 and 2018"[10].

2.2.2 With respect, this completely misses the point. This was never about whether revenue requirement should be **reduced**, as the Moving Party seeks to say. This has always been about whether revenue requirement should be **artificially increased** to include hypothetical taxes that will not actually be paid, as if they were a real cost that will in fact be paid (and therefore must be recovered from customers in rates under the fair return standard).

2.2.3 As the Decision correctly points out[11], the Board long ago made a determination that the appropriate "cost" to include in regulated rates for income tax is – subject to certain exceptions – the actual income tax forecast to be paid by the regulated utility in the test year.

2.2.4 In this respect, income taxes are one of the exceptions to the normal practice that costs are determined using generally accepted accounting principles (or, today, MIFRS or USGAAP, as the case may be). It is virtually always true that the "cost" of income tax for accounting purposes is different from the amount actually paid. The Board's longstanding policy, also followed by most other jurisdictions, is that the accounting cost

[9] Referred to throughout as the "FMV Bump".
[10] Written Argument of Hydro One, para. 1.
[11] Decision, p. 84.

of income tax is not appropriate for ratemaking purposes. The actual (forecast) tax payable is the appropriate amount to use.

2.2.5 In the Decision, the Board quoted RP-2004-0188 on this very point[12]:

> *"Rates must be just and reasonable, and any substantial variation between taxes determined for regulatory purposes and actual taxes paid…must be justifiable."*

2.2.6 Hydro One, in its Application, sought to have the income tax cost in the 2017 and 2018 revenue requirements increased above the standard level (actual tax payable). It did so on the basis of its assertion that the effects of the FMV Bump that it was experiencing under the federal ITA should be treated as an exception to the normal rule.

2.2.7 In essence, Hydro One's characterization is that they were entitled to something, and the Board unfairly took part of it away.

2.2.8 That is not the factual basis for this Motion. The factual basis is that Hydro One asked for special – exceptional - treatment of its income tax cost in determining its rates. The Board did give them special treatment, but not for the whole amount they requested.

2.2.9 In the end, though, SEC believes it is important for the Board to keep firmly focused on the underlying reality. This is about whether customers should reimburse the utility in rates for a cost the utility will not actually pay out, and whether the Board's balanced approach to that question – giving the utility reimbursement of some but not all of this hypothetical cost – was in error.

2.3 ***What is the Cause of the Future Tax Savings?***

2.3.1 Part of the problem in the Hydro One Written Argument is that they assume as a fact that the Future Tax Savings of $2.595 billion arise because Hydro One paid a Departure Tax on leaving the PILs regime. Their entire Written Argument is based on the premise that the Departure Tax and the FMV Bump are causally connected.

2.3.2 Perhaps the most blatant example of that is where Hydro One says, in its Written Argument[13]:

> *"Under the same deemed disposition and reacquisition by Hydro One of its assets at FMV that gave rise to the liability to pay the PILs Departure Tax, Hydro One obtained a step-up in the tax basis of its assets, increasing the amount of CCA and CEC that it, as a taxable*

[12] Decision, p. 84, fn. 125, quoting RP-2004-0188 at p. 46.
[13] Written Argument of Hydro One, para. 14.

entity, could deduct in computing its income for federal and provincial corporate tax purposes." [emphasis added]

2.3.3 That is not correct, in fact or in law. The deemed disposition and the deemed reacquisition are different, arising in different taxing statutes, and operating independently of each other. The payment of the Departure Tax in no way "caused" the FMV Bump and the future tax savings, and the FMV Bump is not the result of, nor in any way dependent on, the payment of the Departure Tax.

2.3.4 Under the ITA there is a deemed disposition and acquisition of all assets at fair market value (called colloquially the "FMV Bump") at the time a non-taxable entity becomes subject to tax under that Act. The terms of the relevant provision are as follows[14]:

"Becoming or ceasing to be exempt

(10) If at any time (in this subsection referred to as "that time"), a person — that is a corporation or, if that time is after September 12, 2013, a trust — <u>becomes or ceases to be exempt from tax under this Part on its taxable income</u> otherwise than by reason of paragraph (1)(t), the following rules apply:

(a) the taxation year of the person that would, but for this paragraph, have included that time is deemed to end immediately before that time, a new taxation year of the person is deemed to begin at that time and, for the purpose of determining the person's fiscal period after that time, <u>the person is deemed not to have established a fiscal period before that time</u>;

… (b) <u>the person is deemed</u> to have disposed, at the time (in this subsection referred to as the "disposition time") that is immediately before the time that is immediately before that time, of each property held by the person immediately before that time for an amount equal to its fair market value at that time and <u>to have reacquired the property at that time at a cost equal to that fair market value</u>; and

(c) for the purposes of applying sections 37, 65 to 66.4, 66.7, 111 and 126, subsections 127(5) to (36) and section 127.3 to the person, the person is deemed to be a new corporation or trust, as the case may be, the first taxation year of which began at that time." [emphasis added]

[14] ITA, s. 149(10)

2.3.5 Hydro One was exempt from federal income tax under Section 149(1)(d) of the ITA, because it was wholly-owned by the province of Ontario. Section 149(1)(d.1) of the ITA allows non-public-sector ownership of up to 10% before the exemption is lost. Once an entity goes over that threshold, it ceases to be exempt under the federal ITA, and at that time Section 149(10), quoted above, applies.

2.3.6 It should be noted that Section 149(10) deals with both becoming, and ceasing to be, taxable under the ITA. It is for that reason that it has both a deemed disposition and a deemed reacquisition. If a company is ceasing to be taxable under the ITA (for example, it is a private company that is acquired by a province), then the federal government requires that all of the accrued recapture and capital gains, etc., be realized upon exiting the federal tax system. Hence the deemed disposition.

2.3.7 Conversely, if a company is becoming taxable under the ITA, as is the case with Hydro One, the federal government recognizes that it has no right to tax gains in value that arose prior to the company becoming taxable. The deemed acquisition (i.e. the FMV Bump) permanently excludes such gains from taxation under the federal ITA.

2.3.8 Note that none of this has anything to do with the Ontario PILs regime under the *Electricity Act*, and there is no reference to Departure Tax. In fact, whether or not Hydro One paid Departure tax is completely irrelevant to the operation of the FMV Bump. The FMV Bump exists because the ITA recognizes that the initial cost for tax purposes of assets to which the ITA first applies should be the fair market value at the time the company becomes taxable[15]. This arises for any entity that becomes taxable under the federal ITA[16].

2.3.9 The best way to confirm that is to look at the situation in which a company moves from the PILs regime to the federal ITA, and is exempted by the provincial government from paying Departure Tax. A good example would be a municipally-owned distributor that was or is exempt from certain parts of the Departure Tax under O.Reg. 112/16[17]. Notwithstanding this exemption, the full FMV Bump would apply under the ITA.

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[15] Another example of the same concept is in subsection (c), also quoted above. That provides that loss carryforwards (section 111) are not available from a prior period to reduce taxable income for the period the company is taxable. In essence, everything that happened prior to the company becoming taxable is irrelevant to taxation under the federal ITA. The company is starting afresh.

[16] It is important to note that the deemed acquisition under s. 149(10) is not in any way specific to utilities, or even to companies that are moving from one taxing regime to another. It would apply, for example, to a charity that ceases to so qualify, or to a non-profit corporation, or to a trust for a pension plan, etc. Section 149 has many exemptions from federal income tax. Section 149(10) requires a deemed acquisition (and thus, as is often the case, a FMV Bump) for many different entities that cease to be exempt. This is one of a number of such provisions in the federal ITA that implement the same principle (i.e. the fresh start approach for values). For example, under section 128(1), if a corporation that is not resident in Canada becomes resident in Canada, it has a similar FMV Bump. Whether or not it was taxable in its previous jurisdiction is irrelevant.

[17] Cited by the Board in the Decision at p. 98.

2.3.10 Hydro One would like the Board to think of the FMV Bump, and the tax savings that arise from it, as being "caused" by the payment of the Departure Tax. Even if Hydro One had truly paid the Departure Tax[18], that simply has no bearing on the existence or amount of the FMV Bump and resulting tax savings.

2.3.11 In fact, the FMV Bump exists to ensure that future taxes under the ITA are calculated fairly and correctly. It has no relationship to past taxes paid by the company, if any, and it applies in exactly the same way whether there is a deemed disposition under the PILs regulation or not, and whether there is any Departure Tax payable.

2.3.12 There is thus no causal relationship between the payment of the Departure Tax and the FMV Bump. To the extent that Hydro One is relying on that concept[19], they are relying on an assumption that is simply not correct.

2.4 ***Was a Departure Tax Actually Paid?***

2.4.1 Hydro One also posits the notion that because the Departure Tax and the FMV Bump both have the same cause – the Province's decision to proceed with the IPO – the exclusion of the Departure Tax from rates should result in the exclusion of the FMV Bump from rates. SEC does not agree that common causation is an appropriate expansion of the "benefits follow costs" concept in this situation. However, for Hydro One even to make this argument, the Departure Tax must actually have been paid, Hydro One thus relies heavily on its argument that they in fact paid the Departure Tax[20].

2.4.2 This question also is important for Hydro One's argument because, absent actual payment of the Departure Tax, Hydro One would have a difficult time distinguishing this case from the situation in RP-2004-0188, a long accepted decision of the Board[21]. While SEC disagrees that actual payment of the Departure Tax would make that case inapplicable, it is certainly true that, in order for Hydro One to put that argument forward, the Departure Tax really had to be paid.

2.4.3 The Applicant undoubtedly did make a wire transfer to the province to pay the Departure Tax. As a matter of technical compliance, i.e. form over substance, there is no dispute that the amount was paid.

2.4.4 The appropriate question, however, is whether the Applicant paid the Departure Tax in substance.

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[18] See our analysis in Section 2.4 of these Written Submissions.
[19] See, for example, paras. 21and 35 of the Written Argument of Hydro One. They took the same approach in their EB-2016-0160 Argument in Chief, p.77.
[20] Written Argument of Hydro One, para. 64, 65, 71, 72, and others. The EB-2016-0160 Argument in Chief makes all of the same points, in some detail.
[21] We note that the Board did not agree that whether the Departure Tax was paid was determinative, and said so in so many words: Decision, p. 99.

2.4.5 The Departure Tax payment was funded by the Province subscribing for and paying for shares of Hydro One that had no value[22]. The Province was 100% owner of Hydro One before the issuance of those shares, and it was the 100% owner after the issuance of those shares.

2.4.6 Nothing changed except two things. First, the Province gave $2.6 billion to Hydro One, and second, Hydro One gave $2.6 billion to the Province (through its wholly owned agency, OEFC). As the Board correctly pointed out in the Decision[23]:

> *"From the perspective of the Province, as the then owner of all of the shares of the Hydro One group of companies, the departure tax payment that the Province funded was effectively a payment from itself to itself, as the ultimate owner of Networks' utility assets to preserve the Exempt Utility FMV of those assets." [emphasis added]*

2.4.7 The reference to Exempt Utility FMV is important. The Board went through a thorough analysis of the real economic impacts of the Departure Tax payment, and the Province's share purchase. Distilled to its essence, the Board's quite correct analysis[24] was as follows:

(a) Upon Hydro One incurring the liability to pay Departure Tax, its FMV declined by $2.6 billion, and the value of Hydro One shares thus declined by that amount.

(b) If the Province then proceeded with the IPO, the amount it would be paid for its shares, plus the value of its remaining shares, would be reduced by $2.6 billion. If it sold 60% of Hydro One, for example, it would lose $1.56 billion immediately in lower proceeds of sale, and it would lose the other $1.04 billion in the future, due to the lower value of its remaining shares.

(c) Upon the Province paying for $2.6 billion of additional shares, the FMV of Hydro One increased by $2.6 billion, and the value of the Hydro One shares thus increased by $2.6 billion.[25]

(d) The result of this transaction is to allow the Province to proceed with the IPO as if the Departure Tax had not been paid at all, i.e. at the share value that would have been the case had Hydro One been exempt from the tax.

2.4.8 The Board correctly described the result of the analysis in the Decision[26]:

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[22] As demonstrated by the exchange between Hydro One's witnesses Ms. Cheung and Mr. Vels, and SEC counsel, at Tr.11:44, cited by the Board in the Decision, p. 99.
[23] Decision, p. 99.
[24] Decision, p.97-8.
[25] See also Decision, p. 100.
[26] Decision, p. 98.

> *"Accordingly, as a pragmatic matter, to facilitate the privatization of its wholly owned utilities, the Province had to either reduce or eliminate this departure tax burden on the Exempt Utility FMV of the assets. This is the reality that faced the Province and Hydro One in connection with the IPO. In response to that reality, the Province and Hydro One arranged to eliminate the departure tax obligation before completing a sale of shares to the public." [emphasis added]*

2.4.9 We note that the Province agreed with the Board's characterization of the transaction in the Decision, as shown in this excerpt from the 2015 Estimate Committee hearings, quoted by BOMA in its Final Argument in EB-2016-0160[27]:

> *"Mr. Peter Tabuns [MP]: OK, Mr. Imbrogno, you previously said that the $2.6 billion transaction from the Ontario Financing Authority to Hydro One and then on to the OEFC would be both cash neutral and fiscally neutral. Was this not correct?*
> *Mr. Serge Imbrogno [Deputy Minister of Energy]: Yes.*
> *Mr. Peter Tabuns: I want to just get into that a bit further. This is a $2.6 billion contribution to Hydro One.*
> *Mr. Serge Imbrogno: That is correct.*
> *Mr. Peter Tabuns: So it's coming out of our treasury.*
> *Mr. Serge Imbrogno: Well it's fiscally neutral, because when Hydro One exited the PILs regime under the Income Tax Act, it makes a departure tax payment like any other corporation would. That's a $2.6 billion tax payment to the Province. To keep Hydro One whole, there is a $2.6 billion payment back to Hydro One, to maintain its capital, so it can optimize its valuation going forward.*
> *Mr. Peter Tabuns: So we're recycling the cash. It goes from our working capital to Hydro One. Hydro One pays it to the OEFC. I am assuming the OEFC isn't paying off debts, because if I understand you correctly, the cash comes back to the Ontario Financing Authority. Is that correct?*
> *Mr. Serge Imbrogno: That's correct."*[28] *[emphasis added by SEC]*

2.4.10 Thus, what actually transpired – a circulation of funds between the Province and Hydro One – has the same substantial result as the Province exempting Hydro One from Departure Tax in the first place. Did the Applicant pay the Departure Tax if the result is the same as if they had not paid the Departure Tax? In substance, the answer as the Decision correctly points out, is they did not.

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[27] EB-2016-0160, BOMA Final Argument, p. 4.
[28] Ontario, Legislative Assembly, Standing Committee on Estimates, *Official Report of Debates (Hansard)*, E-20, (29 September 2015), at p. E-419-420.

2.4.11 Put another way, did Hydro One incur a cost associated with the Departure Tax, if the amount of that cost is identical to the cost they would have incurred had they not paid the Departure Tax, i.e. zero?

2.4.12 It has long been the Board's practice to ensure that it implements and recognizes the substance of utility activities, not just the form of those activities. The Board in the Decision did exactly that.

2.4.13 In response to this reality, Hydro One has raised two objections.

2.4.14 First, Hydro One argues that the tax payment went to Ontario Electricity Financial Corporation, not to the government per se. Therefore, so their argument goes, the payment and the share purchase were not really circular at all.

2.4.15 This is a variation on the form over substance argument.

2.4.16 With respect, monies paid to OEFC are used by OEFC to pay down obligations that are ultimately obligations of the Province. OEFC is wholly owned by the Province, and when OEFC receives funds, those funds accrue indirectly to the benefit of the Province.

2.4.17 In any case, however, that doesn't matter. As the testimony before the Legislative Committee revealed[29], the money completed the circle, and came right back to where it started. It wasn't just in substance a payment by the Province to itself. It was also in form a payment to itself.

2.4.18 Second, Hydro One relies[30] on the evidence that there were other ways the Departure Tax could have been funded. What they fail to realize – but which the Board realized in the Decision – is that all of the ways of funding the Departure Tax ultimately produce the same economic result for the Province as exemption from the tax.

2.4.19 There were basically four ways that Hydro One and its shareholder, the Province, could deal with the $2.6 billion Departure Tax:

(a) Hydro One incurs additional debt of $2.6 billion.

(b) Hydro One issues shares to third parties for $2.6 billion.

(c) The Province exempts Hydro One from paying the tax.

(d) The Province buys shares in Hydro One with no ownership value, in effect just giving the tax money back to Hydro One (i.e. what they actually did)

[29] See para. 2.4.9 of these Written Submissions.
[30] Written Argument of Hydro One, para. 74-77.

2.4.20 The four methods can be grouped together into two similar pairs, as follows:

(a) In options (a) and (b), the Province retains the amount of the Departure Tax, but the value of its shares in Hydro One goes down by a similar amount.

(b) In options (c) and (d), the Province doesn't end up with the Departure Tax money, but the value of its shares remains at the value prior to the deemed disposition (i.e. what the Board refers to in the Decision as the "Exempt Utility FMV").

The fact that these four choices are logically grouped this way is not accidental. The underlying similarities show that the Board's analysis was correct.

2.4.21 If Hydro One incurred $2.6 billion in debt, they would indeed be able to pay the Departure Tax to the Province. However, with $2.6 billion of additional debt on the balance sheet, the value of the Province's shares would drop by the same amount. The Province receives the tax dollars, but loses the same amount in value, so is net zero. The FMV Bump would be available in the future in the same way, of course.

2.4.22 The other disadvantages with the debt approach are a) there is a non-trivial cost to borrowing that much money, and b) a Hydro One with too much debt might actually lose more than $2.6 billion in value, since its credit rating might decline[31].

2.4.23 If Hydro One issued $2.6 billion of shares to third parties, that would also allow them to pay the Departure Tax. On the other hand, the Province would then be able to sell less shares into the IPO, and still keep under their 60% threshold.

2.4.24 For example, if Hydro One issued 10% of the shares of the company for $2.6 billion, the Province would then only hold 90% of the shares of Hydro One. If it was willing to go down to 40% ownership, as was the plan, it could only sell 50%, not 60%. If that 10% difference is worth $2.6 billion (as in this hypothetical), then the Province will receive $2.6 billion less in proceeds from the IPO. (As with all of the options, the FMV Bump would still arise in the same way.)

2.4.25 The effect of issuing shares to third parties is that the Province loses all of its $2.6 billion in value immediately, in cash, through lower IPO proceeds. That contrasts to the debt approach. In that case, the Province loses only up to 60% of its value in cash right now. The other 40%.is in the lower value of the shares held by the Province.

2.4.26 The third and fourth options are quite different.

[31] There was no evidence on these points, and they were not referred to in the Decision.

2.4.27 The exemption approach is the simplest and cleanest. No tax is paid, so the Province doesn't have $2.6 billion of extra tax dollars. However, the value of the shares does not decrease, so the Province is better off to the tune of that $2.6 billion. The FMV Bump still arises in any case.

2.4.28 The main problem with this option is that then, any other LDC that wants to do an IPO (Toronto Hydro, for example) is going to ask for the same exemption. This would, in the long term, be tantamount to simply repealing the Departure Tax for everyone. Whether or not that might be a good idea, it is a big policy step, and one can understand why the Province did not choose that direction.

2.4.29 The Province chose the fourth method, essentially giving back the $2.6 billion Departure Tax in return for nothing. As discussed earlier, the result is the same as if the tax was not paid.

2.4.30 Hydro One makes a big point that the Board didn't recognize the other options available to Hydro One to fund the Departure Tax. That is not correct. The Board did recognize those other options, and did take them into account[32]. The Board just understood the true impact of those options.

2.4.31 No matter what they did, the Province was not going to get the benefit of an extra $2.6 billion out of this company, because it was both the taxing authority and the shareholder. Every dollar it got in taxes it would lose in share value, and vice versa[33]. The only choice the Province had available to it was whether it wanted to receive that value through taxes, or through shares. It chose to receive that value through shares.

[32] Decision, p. 82, 99, among other places.
[33] Decision, p. 82, 98.

3 ISSUES AND LAW

3.1 *Overview*

3.1.1 SEC submits that, once the facts are viewed in a manner consistent with the law and the evidence before the Board, pretty well all of Hydro One's objection to the Board's Decision falls away.

3.1.2 However, Hydro One has sought to make a number of specific points in their Written Argument. This section of SEC's Written Submissions goes through the arguments provided by Hydro One in their Written Argument on this Motion, testing to see whether any of them are compelling.

3.2 *The Test for A Motion to Review and Vary*

3.2.1 Hydro One sets out, at para. 27, its view of the test the Board applies on a motion to review and vary a decision. SEC has no reason to quarrel with the characterization by Hydro One, especially since Hydro One's presentation is largely in the wording of prior statements by the Board.

3.2.2 SEC is concerned with the suggestion, in para. 27(c), that the "reviewing panel" should "change the outcome of the Decision".

3.2.3 While Board panels hearing motions for review sometimes substitute their conclusion for that of the hearing panel, particularly if the error is very specific and/or technical in nature, reviewing panels are usually also very cognizant of the fact that they have not heard the evidence in the proceeding.

3.2.4 In this case, the law and regulatory principles interact with a complex and difficult set of facts. Further, if the reviewing panel finds that any of the alleged errors in this case did arise, those errors will almost certainly affect the analysis of the other aspects of the tax issue.

3.2.5 SEC therefore submits that, if the reviewing panel is inclined to allow any of the Motion, the appropriate action is to remit the case back to the hearing panel to make a new decision based on the issues raised on the Motion.

3.3 *Did the Applicant Get a Fair Hearing?*

3.3.1 The Written Argument of Hydro is replete with references to Hydro One's lack of opportunity to make submissions before the EB-2016-0160 panel on various issues relating to the future tax savings.

3.3.2 The facts are that the Argument in Chief had 15 of its 78 pages devoted to this issue.

Then, intervenors made submissions totaling 32 pages[34] on the question. Inexplicably, perhaps, Hydro One chose in reply to limit itself to five pages, and basically deal with only one sub-issue; whether the Departure Tax was actually paid. Tellingly, in that Reply Hydro One did not address the express statements by the Deputy Minister of Energy to the Legislature – quoted in the BOMA Final Argument - that the Province intentionally paid the Departure Tax to itself through the circular share transaction[35].

3.3.3 Thus, it is hard to characterize Hydro One's complaint that it didn't get a fair hearing as anything more than: "We lost. Had we known we were going to lose, we would have tried harder."

3.3.4 That having been said, it is useful to go through the arguments now being presented by Hydro One on this Motion, and see whether the Board panel in EB-2016-0160 heard those arguments as well. SEC has therefore identified the main arguments in the Written Argument of Hydro One, and comments below on how those arose in the original proceeding, if at all.

3.3.5 ***Stand-Alone Principle.*** Hydro One argues[36] that, under the Stand-Alone Principle, only costs and benefits related to the provision of regulated services can be recognized in rates, and failure to do so constitutes a breach of the Fair Return Standard.

3.3.6 This was the central theme of the Argument in Chief, dealt with in some detail by Hydro One[37].

3.3.7 It was also dealt with in the submissions of OEB Staff, PWU, LPMA, SEC, and BOMA, among others.

3.3.8 ***Benefits Follow Costs.*** Hydro One argues that the Departure Tax and the FMV Bump are causally connected, and as a result payment of the Departure Tax means entitlement to the FMV Bump[38].

3.3.9 This was dealt with in the Argument in Chief[39], and also by the PWU. Other parties did not feel the need to refer to this causal connection specifically, but all of the Final Arguments dealt with the benefits follow costs principle and its relationship in this context.

3.3.10 Of course, as noted earlier in these Written Submissions, this question is actually a matter of law, not opinion. The FMV Bump did not in fact arise because of the payment of the

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[34] In support of Hydro One: OEB Staff (2 pages), PWU (3), SEP (1), LPMA (1). Opposed to the Hydro One position, or neutral: SEC (16), BOMA (5), CME (3), VECC (1),
[35] See para. 2.4.9.
[36] Written Argument of Hydro One, para. 18, 21, 30-37, 40-47.
[37] EB-2016-0160 Argument-in-Chief, p. 65-67, 71-76.
[38] Written Argument of Hydro One, para. 14-16, 21, 34.
[39] EB-2016-0160 Argument-in-Chief, p. 64, 76.

Departure Tax. Even if the cost was paid – which it was not – the benefit does not flow from that cost.

3.3.11 ***Hydro One Actually Paid the Departure Tax.*** Hydro One reiterates once more its insistence that it in fact paid the Departure Tax. This is a key theme of its Written Argument on this Motion. In addition to the repeated assertions that the Departure Tax was really paid, Hydro One also attacks the contrary conclusion of the Board in the Decision, i.e. that the Departure Tax was "variable at the discretion of the Province" as being made without a factual record[40].

3.3.12 The question of whether the Departure Tax was actually paid was also referred to in the Argument-in-Chief[41], and it was the central point Hydro One was seeking to make in its Reply Argument.

3.3.13 The same question was also an important element in the submissions of PWU, SEC, BOMA and CME.

3.3.14 ***Should RP-2004-0188 be Applied to this Case?*** Hydro One seeks to distinguish the Board's Report in RP-2004-0188, the only other time it had to deal with a deemed acquisition of assets[42].

3.3.15 This was dealt with in some detail in the Argument-in-Chief[43], and it was also an important element in the Final Arguments of SEC, BOMA, CME, PWU and OEB Staff.

3.3.16 ***Hydro One Had Other Financing Options Available to It***. Hydro One asserts that the Board should have considered this evidence[44]. This is the identical argument that Hydro One made to the EB-2016-0160 hearing panel[45].

3.3.17 ***Recapture Ratio.*** Hydro One argues that one of the allocation methodologies, the Recapture Ratio, was not supported by the facts and the principles at play, and no-one had any ability to made submissions on this methodology[46].

3.3.18 The Argument-in-Chief dealt expressly with the recapture component of the Departure Tax[47], and SEC spent considerable time in its Final Argument on an analysis of the pros and cons of just such a methodology. When it appeared in the Decision, it was not news.

3.3.19 ***Actual FMV Sales and Payments Ratio.*** Hydro One objects in its Written Argument

[40] Written Argument of Hydro One, para. 64-65.
[41] EB-2016-0160 Argument-in-Chief, p. 71, 74.
[42] Written Argument of Hydro One, para. 77.
[43] EB-2016-0160 Argument-in-Chief, p. 73-74, 77.
[44] Written Argument of Hydro One, para. 74-76.
[45] EB-2016-0160 Argument-in-Chief, p. 75.
[46] Written Argument of Hydro One, para. 21-22.
[47] EB-2016-0160 Argument-in-Chief, p. 71, 74

that this component of the Decision[48], which it has for some reason renamed the Share Ownership Methodology[49]. Among other things, Hydro One objects that it did not have any opportunity to make submissions on this potential outcome.

3.3.20 SEC agrees that this arose for the first time in the Decision, and no party had an opportunity to make submissions on it. In fact, SEC did not include this approach in the menu of options it provided to the Board in SEC's Final Argument, and had it been proposed by someone else SEC would likely have argued against it.

3.3.21 It is not necessarily fatal to a Board decision that a construct developed by the Board has not previously been debated by the parties. Board decisions often synthesize the facts before them, and the submissions of the parties, into something new or unique, often as a form of compromise or alternative solution. In retrospect, however, if the Board planned to propose this unique solution, it probably would have benefited from further submissions from the parties before its implementation.

3.3.22 That having been said, it is important to note that the Actual FMV Sales and Payments Ratio benefits Hydro One, because in the result it increases the percentage of hypothetical income taxes that the Board was willing to include in rates.

3.3.23 ***Interfering with the Discretion of the Province.*** Hydro One argues that the Board's decision to treat the Departure Tax as "variable" interfered with the Province's policy-making discretion with respect to the IPO[50].

3.3.24 SEC agrees that this argument is entirely new, not one that was presented to the Board in EB-2016-0160. Of course, Hydro One had the opportunity to make this argument at that time, and other parties could have responded to it. The facts and the law have not changed from that time until now. Why Hydro One elected not to make that argument at that time is not clear from the record, and it is not obvious how Hydro One is prejudiced by the fact that, with the same counsel then as now, it did not make an argument that it could have made at that time.

3.3.25 ***Result of the Analysis.*** SEC believes that this Motion is just a re-arguing of the same points from the EB-2016-0160 case. The analysis above demonstrates that to be true.

3.4 ***Did the Board Appropriately Apply the Benefits Follow Costs Principle?***

3.4.1 The Moving Party's primary substantive argument is that, under the "benefits follow costs" principle, Hydro One was entitled to all of the future tax savings arising out of the FMV Bump.

[48] Written Argument of Hydro One, para. 42, and elsewhere.
[49] That term does not appear to arise from the Decision.
[50] Written Argument of Hydro One, para. 51-63.

3.4.2 The Board highlighted the importance of the "benefits follow costs" principle up front in the Decision, describing it as follows[51]:

> *"If a cost, not included in the utility's revenue requirement, causes or produces a benefit, then, for ratemaking purposes, that benefit is allocated to utility shareholders and not to its ratepayers."*

3.4.3 SEC agrees with the Board's formulation of the principle, and believes that this is in fact common ground among the parties..

3.4.4 Hydro One's argument on this issue has three steps:

(a) ***Premise #1:*** Hydro One incurred a cost – the Departure Tax – that is not being recovered in rates. It is a cost borne solely by the shareholders of Hydro One.

(b) ***Premise #2:*** From that cost flow certain benefits – the FMV Bump and the tax savings that arise as a result.

(c) ***Conclusion:*** Those benefits must go to those who incurred the costs that caused them, i.e. the shareholders.

3.4.5 The argument fails for two independent reasons:

(a) Premise #1 is not true. Hydro One did not in substance incur a cost[52].

(b) Even if Premise #1 were true, Premise #2 is not true. Incurring the cost did not cause the benefits[53]. The benefits are entirely independent of the cost, and would have arisen even had Hydro One been exempt from paying the cost.

3.4.6 If <u>either</u> Premise #1 or Premise #2 is untrue, then Hydro One does not in fact have the purported entitlement to the benefits arising out of the FMV Bump.

3.4.7 As discussed at length in Section 2.3 and 2.4 of these Written submissions, both of these Premises are false, and the Board clearly recognized that in the Decision.

3.4.8 However, while the Board did not agree with the approach proposed by Hydro One, the Board did not reject the benefits follow costs principle. It applied the principle in a manner specific to the facts of the case.

3.4.9 First, it established the Recapture Ratio, which recognizes that Hydro One incurred capital costs in the past for its assets, but has not yet received the benefit of all of the tax

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[51] Decision, p. 11.
[52] See Section 2.4 of this Written Argument.
[53] See Section 2.3 of this Written Argument.

deductions associated with those costs.

3.4.10 Because of accelerated CCA, the customers have received the benefit of more tax deductions than the costs that have been allocated to them in rates. In the normal course, this would eventually even itself out, and after the "crossover" point, the customers would receive the benefit of less tax deductions than the costs that have been allocated to them in rates. Over the lifecycle of each asset, the customers get the same tax deductions as they incur in costs. It is a wash.

3.4.11 Where there is a break in the tax calculation over time, as here with the deemed disposition and acquisition, the imbalance between deductions allocated and costs allocated is frozen in time. Given the nature of accelerated depreciation, this will normally be to the net benefit of customers[54].

3.4.12 The amount of recapture for tax purposes is a calculation of that extra benefit the customers have received. The shareholders have to receive an amount equal to that benefit in order to match the costs borne by the customers with the tax benefits borne by the customers over time. SEC agrees that this approach is fair[55].

3.4.13 The Board also established the Actual FMV Sales and Payments Ratio, intended to recognize that some of the shares were purchased by arms-length third parties at FMV[56]. SEC does not agree that this approach, as implemented by the Board, is fair[57], but this "error" – if it is one - is not the subject of the relief sought on this Motion, so it is a red herring.

3.5 ***Did the Board Properly Recognize the Stand-Alone Principle?***

3.5.1 The argument based on the Stand-Alone Principle starts from the basic concept that rates should only include costs and benefits that arise from the regulated business. Costs and benefits that arise because of unregulated activities are not part of the ratemaking process. The standalone principle is a longstanding regulatory guideline fairly consistently applied, for decades, by the Board.

3.5.2 The Board also highlighted this principle upfront in the Decision, describing it as follows[58]:

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[54] Except where the break is before and after becoming regulated, as with Ontario Power Generation. See EB-2010-0008, Decision with Reasons, p. 131-137. SEC and others argued in that case exactly the same principle as the Board has implemented in this case to develop the Recapture Ratio. If the reasoning of the Board in that prior case were to be applied here, the result would be that the shareholders would not get the benefit of the Recapture Ratio component of the tax savings either. Despite the temptation to argue for the application of EB-2010-0008, SEC did not agree with that decision then, and it doesn't agree now. The Board got it wrong in that case (benefiting the utility), and got it right in this case (also benefiting the utility).
[55] See further discussion in Section 3.8 of this Written Argument.
[56] Decision, p. 88.
[57] See Section 3.9 of these Written Submissions.
[58] Decision, p. 10.

> *"**STAND ALONE OR PURE UTILITY PRINCIPLE***
> *This principle limits the amounts recoverable in utility rates to costs related to the provision of regulated utility services. For ratemaking purposes, costs related to unregulated or non-utility business activities are excluded from the ambit of the "stand-alone" or "pure" utility activities."*

3.5.3 As before, SEC agrees with the Board's formulation of the principle, and believes that this is in fact common ground among the parties.

3.5.4 Hydro One's argument on the Stand-Alone Principle is based on the assertion that the Departure Tax and the FMV Bump both arise because of the decision of the Province to proceed with the IPO. Since that decision was a corporate decision, independent of the rate regulated activities, the costs and benefits that flow from it cannot be included in rates. This is, in fact, Hydro One's central thesis on this Motion.

3.5.5 This creates a logical box for Hydro One. To make this argument, they need to be able to show both that the Departure Tax was actually paid, and that it is causally connected with the FMV Bump.

3.5.6 SEC discusses earlier in these Written Submissions, neither of the preconditions can be shown to be true. The Departure Tax was not actually paid in substance[59], and in any case the FMV Bump does not depend on the deemed disposition or payment of Departure Tax under the PILs regime[60].

3.5.7 The problem for Hydro One arises because if they can't rely on payment of the Departure Tax as the basis for the future tax savings, then even at its best their argument cannot distinguish the case of RP-2004-0188. This situation would be on all fours with that Report of the Board, and as a result Hydro One would likely be entitled to none of the benefit of the FMV Bump.

3.5.8 Thus, if Hydro One's characterization of the Stand-Alone Principle is accepted at its face value, this Motion is all or nothing for the utility. Either the shareholder is entitled to an additional $975 million, or customers are entitiled to an *additional* $1.560 billion. Their argument has no middle ground. If the causation and payment are proved, under their thesis they get 100%. Conversely, if either is not proved, the customers get 100%.

3.5.9 As SEC has argued elsewhere in these submissions, even on their thesis the evidence does not support they result they seek.

3.5.10 In any case, SEC does not agree with Hydro One's thesis, and neither did the Board in

[59] See discussion in Section 2.4.
[60] See discussion in Section 2.3.

the Decision.

3.5.11 The Board took a more nuanced approach[61], saying that the issue is one of a fair and reasonable allocation of the future tax savings as between shareholders and customers. The reason for this is that the future tax savings arise entirely because of the continuing operation of the regulated business by the utility[62].

3.5.12 SEC would put this another way. The actual, primary, and proximate cause of the FMV Bump is that Hydro One has become subject to federal income tax, and under the federal ITA Hydro One effectively gets lower taxes than under the previous PILs regime.

3.5.13 There is a secondary cause, which is that the Province decided to carry out an IPO[63]. There is a tertiary cause as well, which is that the Province wanted to raise some money for public transit and similar goals. There are other causes: Hydro One has a regulated flow of revenues that makes it more valuable than its book value; the actual value of individual assets has not decreased, but has increased, over time; the public have confidence in the OEB as a regulator to ensure that Hydro One continues to be viable and have an investment grade credit rating; and so on, presumably indefinitely.

3.5.14 What the Board correctly distinguished[64] is the situation of an entity like Hydro One, which at the time of the Decision was for all intents and purposes almost entirely regulated, and a situation like that of Enbridge, or Union Gas, which have substantial unregulated activities that are interconnected with the regulated activities[65].

3.5.15 In this case, the Board is not faced with distinguishing between regulated and unregulated businesses. Hydro One has been about as close to a pure utility as it gets.

3.5.16 Thus, the application of the Stand-Alone Principle to an entity that is only an utility is quite different.

3.5.17 What the Board also recognized, in applying the RP-2004-0188 case, is that the better way to look at this is as the application of a new set of tax rules to the entity, much like a change in tax rules[66].

3.5.18 In this respect, consider what would happen if the federal government repealed Sections 149(1)(d) and (d.1) of the ITA, so that entities owned by the Province became fully taxable, but with the same FMV Bump that now applies. None of the tax benefits associated with that change in tax regime would be allocated to the shareholders.

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[61] Decision, p. 85-6.
[62] Decision, p. 86.
[63] The Board recognizes this in the Decision, p. 82, 85, and elsewhere.
[64] Decision, p. 86.
[65] Or the situation of Great Lakes Power at the time the case cited by Hydro One in Written Argument, and in Argument-in-Chief, took place.
[66] See. RP-2004-0188, p. 56.

3.5.19 Similarly, consider how the Board would respond in rates if the Province (or the Federal Government under the ITA) reduced the PILs or tax rates to 10%. The Board would almost certainly immediately pass those savings through to the customers in rates when they are being set. This would be consistent with the basic principle that the customers pay, in rates, the actual taxes payable to the fiscal authorities. No more and no less.

3.5.20 SEC submits that the Board got it right on the Stand-Alone Principle[67]. Hydro One is essentially all a stand-alone utility, so the issue before the Board was not whether the future tax savings applied to regulated vs. unregulated activities. All taxes, and tax savings, and assets, apply virtually entirely to regulated activities.

3.6 *Did the Board Overlook its Statutory Framework?*

3.6.1 Hydro One, at para. 51-63 of its Written Argument, makes the rather curious argument that the Board's rate-setting discretion for Hydro One is somehow circumscribed by the right of the Province "to dispose of its interest in Hydro One". Under this argument, the failure of the Board to allow Hydro One to collect hypothetical taxes from its customers is illegal interference with the Province's discretion to sell its Hydro One shares.

3.6.2 While it is true that the presumption of coherence requires that two related statutes be read together so as to avoid a conflict where possible[68], that principle simply has no application to the present case. The provisions regarding the Province's ability sell its shares in Hydro One under section 49-50.2 of the *Electricity Act* have no affect on, nor are they relevant to, the question of how the Board's rate-making authority is exercised under section 78(3) the *Ontario Energy Board Act* ("*OEB Act*"). They are not in conflict, as they do not address the same issues.

3.6.3 The Board's rate-setting authority is broad[69] and has nothing to do with the Province's discretion to dispose of securities of Hydro One. That transaction has already occurred, and the Board's rate-setting does not impact the Lieutenant Governor or Minister's authority to dispose of further securities.

3.6.4 The interactions between the specific provisions governing the securities of Hydro One and that of the *Ontario Energy Board Act* are specific. As Hydro One's own Written Argument points out, section 86(5.1) of the OEB Act explicitly excludes from the Board's authority the ability to review (under its usual authority) any transactions identified in section 50.1 and 50.1 of the *Electricity Act.*[70]

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[67] Decision, p. 86.
[68] *Reference re Broadcasting Regulatory Policy CRTC 2010-167 and Broadcasting order CRTC* 2010-168, 2012 SCC 68, para 38
[69] *Toronto Hydro-Electric System Limited v. Ontario Energy Board*, 2010 ONCA 284, para 25*; Ontario (Energy Board) v. Ontario Power Generation Inc*., 2015 SCC 44, para. 80
[70] *Ontario Energy Board Act*, 1998, s.86(5.1)

3.6.5 More specifically to the issue raised by Hydro One, the *OEB Act* envisions a specific limitation on the Board's rate-setting authority as it relates to transactions under section 50.1 and 50.2 of the *Electricity Act.*

3.6.6 Section 78(5.1) requires that the Board apply a prescribed method or technique prescribed by regulation in setting rates for Hydro One Inc. or its subsidiaries, for the treatment of transfers under section 50.1 of the *Electricity Act*.[71] No regulation under this section has been ever been passed and so there is no limitation in place. Coincidentally, Hydro One did not mention this section of the *OEB Act* in its Written Argument, even though it speaks directly to the point they were seeking to make.

3.6.7 The *OEB Act* is quite clear on how to deal with conflicts between two pieces of legislation.[72] In fact, in areas where there can be conflicts between other pieces of legislation and the *OEB Act*, it specifies how to deal with them.[73] For example, Section 70(8) sets out how to deal with conflicts between a specific type of license condition and anything in section 31 of the *Electricity Act.* More generally, section 128(1) of the *OEB Act* provides that in the "event of a conflict between this Act or any other general or special Act, this Act prevails."[74]

3.6.8 In Hydro One's application, the Board was required to determinate the appropriate amount of taxes to include as a cost for the purpose of fulfilling its requirement to set just and reasonable rates. In doing so it had to consider the IPO, since it was Hydro One that was seeking to include costs for hypothetical taxes that it is not actually forecast to pay. Hydro One's IPO prospectus outlined the risk that the Board could reduce its "revenue requirement by all or a portion of those net cash savings" caused by the Deferred Tax Asset.[75] Hydro One was right in giving the warning, and the Board was fully within its jurisdiction to do exactly what it did.

3.7 ***Did the Board Decide Without the Necessary Factual Record?***

3.7.1 Hydro One argues at some length that the Board reached conclusions in the Decision without a factual record to back them up:

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[71] *Ontario Energy Board Act,* section 78(5.1):
"In approving or fixing just and reasonable rates for Hydro One Inc. or a subsidiary of Hydro One Inc., the Board shall apply a method or technique prescribed by regulation for the calculation and treatment of transfers made by Hydro One Inc. or its subsidiary, as the case may be, that are authorized by section 50.1 of the *Electricity Act, 1998*."

[72] See for example under the *Ontario Energy Board Act,* sections 19(5), 28(1), 28.3(2), 28.3(3), 59(1.1)(b), 70(1), 70(2.2), 70(8), 70(9), 70(10), 70(12), 71(2*)* 74(1)b, 74(2), 78(2), 78(2.1), 78(3), 78(3.0.1), 78(3.3), 78(4), 78(5.0.1), 78(5.2), 78(8), 82(2)(b), 82(3)(a), 86, 86(5.1), 88(1)(g.5), 125.2(b)

[73] See for example: section 70(8) regarding conflicts between the *OEB Act* and Electricity Act,; section78.6 regarding conflicts between the *OEB Ac*t and the Market Rules which are created pursuant to the *Electricity Act*, Section 44(4.1) regarding a conflict between a rule made under *OEB Act* the Board and the *Public Utilities Act*

[74] *Ontario Energy Act*, section 128(1)

[75] EB-2016-0160, Exhibit I Tab 9 Schedule 2 (CME #2), Attachment 1, p.162

(a) In para. 64-73, the conclusion that the Departure Tax was "variable at the discretion of the Province", and

(b) In para. 74-77, "disregarding" the evidence on the alternative ways that Hydro One could have funded the payment of the tax.

3.7.2 In the case of the "variable" argument, the essence of Hydro One's argument appears to be that since the Board disagreed with them, the Board must not have been listening.

3.7.3 The Board did not say that Hydro One didn't pay the tax, from a technical point of view. What the Board said, as SEC has discussed at length in Section 2.4 of these Written Submissions, is that the Province entered into a series of transactions that had the substantive effect of refunding the tax back to Hydro One. The Province made a payment to itself. That was not an error. It was factually correct.

3.7.4 What is interesting is that the Deputy Minister of Energy said exactly the same thing to the Legislative Committee asking about the transaction[76]. Hydro One conveniently ignores that the Board's conclusion is consistent with the government's own stated characterization of the reality.

3.7.5 Hydro One made arguments asserting its payment of the tax, both in Argument-in-Chief and in Reply, and the Board rejected those arguments. The Board was right. The Province had the discretion to reduce the effective amount of the tax, even to zero. That is exactly what it did.

3.7.6 In the case of the issue of the alternative ways to fund the tax, the Board did not in the Decision carry out a fulsome analysis of those alternatives[77]. As SEC points out earlier in these Written Submissions[78], those alternatives simply were irrelevant to the analysis.

3.7.7 It is perhaps ironic that what the Board did was focus on what actually happened, particularly in light of Hydro One's complaints in their Written Argument at para. 68 (and elsewhere) that the Board is not allowed to speculate on hypothetical actions of the Province.

3.7.8 SEC submits that the arguments that the Board failed to take account of the factual record are nothing more than statements that the Board disagreed with Hydro One. Those are not grounds to vary a decision of the Board.

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[76] Quoted in para. 2.4.9 of these Written Submissions.
[77] It recognized that the other options existed, see e.g. p. 82, and other places. It did not have a need to analyze them, because it analyzed the substance of what happened in full.
[78] At para. 2.4.19, et. seq.

3.8 *Is the Recapture Ratio Appropriate?*

3.8.1 The Written Argument of Hydro One is difficult to understand on this point.

3.8.2 On the one hand, Hydro One appears to argue[79] that it didn't have an opportunity to make submissions on the appropriateness of the Recapture Ratio. This suggests that it is challenging whether the Recapture Ratio is in error.

3.8.3 On the other hand, Hydro One argued in its Argument-in-Chief[80], that it should be allocated the tax savings associated with recapture of past accelerated CCA.

3.8.4 The issue of whether the future tax savings associated with the past recapture should be allocated to the shareholders is a little complicated.

3.8.5 The Board in the Decision discussed the nature of accelerated CCA[81], and the fact that tax deductions tend to exceed actual depreciation for a period of time, until a crossover point. After that point, the actual depreciation exceeds the tax deductions. For the earlier period, there is a net tax saving, which under the Board's normal rules is recognized in rates as a benefit to customers. For the later period, there is a net tax cost, which again under the Board's normal rules is recognized as a net cost borne by customers.

3.8.6 Because of the mathematical nature of accelerated CCA, it is generally true that the net position at any point in time for a going concern is that the average is before the crossover. That is, on average the tax deductions have exceeded the depreciation, which is why most utilities have a net deferred tax liability on their balance sheets[82].

3.8.7 In RP-2004-0188, the Board recognized the potential impact of this timing difference on the fairness between shareholders and customers[83]. However, in that case no-one had received the benefit of any past deductions, as the utilities were tax free prior to the transfer of assets that led to the FMV Bump. There the Board had to contend with the fact that there could be future recapture of accelerated depreciation that the Board had ordered should benefit the customers. The Board determined that if that happened, the utilities could obtain relief from that tax cost under the benefits follow costs principle. Since the tax benefits were going to the customers, the resulting tax cost on recapture should also, in principle, be borne by the customers.

3.8.8 This is a somewhat different situation. In this case, customers have already received the benefit of more tax deductions on the assets of Hydro One than the proportion of cost they have borne through depreciation. There is a net benefit, measured quite accurately

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[79] E.g. para. 20-24.
[80] EB-2016-0160, Argument-in-Chief, p. 71, 74.
[81] Decision, p. 83, esp. fn. 122.
[82] OPG, in EB-2010-0008, was one example where this was not the case, but that is relatively unusual, and arose only because OPG had older and very long-lived assets.
[83] RP-2004-0188, p. 57.

by the calculation of recapture.

3.8.9 The Board recognized that part of the FMV Bump is a resetting of the cost for tax purposes at an amount higher than the net amount remaining after the deductions taken by customers to date. If an asset had an original cost of $100, and the customers have been allocated tax deductions of $60 in the past (leaving $40 remaining to be deducted for tax purposes), then if the FMV of the asset is $70, the new tax deductions will start from that point, rather than the $40 level previously available to the customers. The customer would effectively end up getting $30 of deductions twice: once prior to the transactions, and once in the future.

3.8.10 Put another way, the total original cost of the asset was borne by Hydro One. That original cost is the amount of depreciation that will be allocated to customers over time. However, unless there is a correction, the total amount of tax deductions allocated to the customers could be $130: the $60 of deductions under the old regime, and another $70 of deductions under the new regime.

3.8.11 The Board determined that this is double counting[84], and adjusted for this by saying that the percentage of the future tax savings that would amount to double counting under this analysis should be allocated to the shareholders each year. That is the Recapture Ratio.

3.8.12 Contrast that with the remainder of the FMV Bump. There is no double counting. The customers have not received any tax deductions with respect to that additional value, but Hydro One has not paid anything for that additional value either. Hydro One has still only paid the original cost of the assets.

3.8.13 In that situation, said the Board, the normal rule should apply, i.e. customers should pay in rates the taxes the utility actually will pay. If in the future there is a recapture as a result of a timing difference on those incremental amounts, that is a separate issue, so as was the case in RP-2004-0188, it is appropriatelyl be dealt with when the recapture arises.

3.8.14 It is at least arguable that the double counting that arises is itself an artifact of the new tax regime, rather than tied to the original cost of the assets. That is, one could argue that there is a double counting benefit allowed by the federal ITA, and it amounts to a windfall to someone. Even there, goes the argument, the normal rule should apply that the taxes recoverable in rates should be the actual amounts payable. There is no principled reason why Hydro One should get the benefit of the double counting, rather than Hydro One's customers[85].

3.8.15 The Board did not go in that direction. Instead, it ensured that the customers would not get the benefit of deducting the same CCA amount twice on the original cost of the asset.

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[84] The term it used was "double dipping": Decision, p. 104.
[85] This would also be consistent with RP-2004-0188.

This was part of the Board's balance in the result. The customers don't get the double counting benefit. The shareholders don't get the windfall gain benefit.

3.8.16 SEC submits that the Recapture Ratio appropriately balances the interests of the shareholders and the customers in the way it allocates the future tax benefits between them. It neither favours the customers, nor favours the shareholders, but recognizes that both can benefit from the FMV Bump in a principled division of benefits.

3.9 *Is the Actual FMV Sales and Payments Ratio Appropriate?*

3.9.1 Much of the Written Argument of Hydro One on this Motion focuses on the Actual FMV Sales and Payment Ratios, which Hydro One argues is inappropriate for many reasons.

3.9.2 This component of the Decision was an attempt by the Board to implement the benefits follow costs principle[86].

3.9.3 The basic concept the Board was trying to address with this approach was that arms-length third parties were incurring a real cost in purchasing shares at a share value approximately equivalent to an enterprise value of book value plus FMV Bump[87]. That premium over book is a real cost to the new shareholders. In considering the benefits follow costs principle, the Board was seeking to make sure this real cost was not lost in the process.

3.9.4 Underlying this concept is the Board's concern that the RP-2004-0188 Report of the Board was dealing with a FMV Bump that was not only "deemed", but was a transaction in which no-one actually paid anything to anyone. Municipal owners of LDCs simply rolled the assets into business corporations, and got the benefit of the FMV Bump.

3.9.5 As we note in our discussion of the RP-2004-0188 Report below, on the face of it this Report is fully applicable to the current case. It is the only other time that the Board has dealt with a FMV Bump, and it applied the basic principle that customers pay in rates the actual taxes the utilities pay to the government.

3.9.6 But what the Board determined in the Decision is that while the RP-2004-0188 case should be applied here[88], it should be adjusted to take account the fact that some shareholders are actually paying real money for their shares[89].

3.9.7 Hydro One has a long list of complaints with this aspect of the Decision, which SEC will not address in detail. While we agree with some of them, we do not believe that they are

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[86] Decision, p. 94.
[87] This is not exactly correct, of course, because the market has a lot to say about share price. However, it is true that a major driver of the difference between the book value of a Hydro One share and the sale price of that share in the IPO would be the increase in FMV of Hydro One at the time of the IPO.
[88] Decision, p. 86, 88, 108.
[89] See Decision, p. 12, 86, 88.

the central issues the Board should consider on this point.

3.9.8 SEC's analysis of the Actual FMV Sales and Payments Ratio looks at it at two levels. First, there is the simple and conceptually appealing approach that the portion of the FMV Bump that relates to FMV share sales (which could be up to 60% under the Province's IPO plan) is effectively paid for by actual payments, and so should go to the shareholders. Second, there is the more complex question of whether that percentage should be increased by an allocation of some amount of Departure Tax notionally paid relative to the shares retained by the Province.

3.9.9 On the simple approach, SEC starts by asking the question: What if the owner of a utility made an arms-length sale of its shares, and as a result got a FMV Bump? This is not a unfounded hypothetical. Under section 88 of the ITA (applicable under the PILs regime as well), if a corporation purchases the shares of another corporation at a price exceeding book value of the underlying assets, it can cause the new subsidiary to be wound up into the new parent, and bump the value of the underlying assets by the amount of the premium paid on the shares[90]. This is, in fact, a common practice in the private sector[91].

3.9.10 In those circumstances, what would the Board do in setting rates? There are two questions. First, would the Board treat the costs of the underlying assets as being the new, higher costs for cost recovery purposes? The answer is likely no. Second, would the Board allocate the higher CCA and similar deductions to the customers in setting rates, or would the Board continue to use the old values. In that case, again the answer is likely that the old values would continue.

3.9.11 Thus, conceptually the starting point is that the net tax benefits arising out of a sale of shares at FMV should generally be allocated to the shareholders who paid the premium associated that gave rise to those benefits[92]. At this point, the Board's approach in deciding on the Actual FMV and Payments Ratio is grounded in logic.

3.9.12 SEC believes that this case is different from the paradigm cited by the Board in the Decision, in two important ways.

3.9.13 First, the FMV Bump does not arise because the new shareholders paid a premium[93]. That is completely irrelevant to both the existence, and the amount, of the FMV Bump. The FMV Bump arises because Hydro One is changing from one taxation regime to another. What the new shareholders pay for their shares on the IPO has no bearing on the FMV Bump. If they pay book value, the FMV Bump still arises. If they pay twice book value, the FMV Bump is not recalculated. It is what it is, and it arises only because the feds are not entitled to tax gains that accrued prior to Hydro One become taxable under

[90] This is an oversimplification of what is often thought of as the single most complicated provision in the ITA. (This is why tax lawyers make the big bucks.)
[91] For example, Enbridge could do this with Union Gas, although we have no knowledge whether this is intended.
[92] Decision, p. 96.
[93] Decision, p. 96.

the federal ITA. Nothing more or less than that.

3.9.14 Second, on the evidence before the Board the new shareholders did not pay more because they would be entitled to a future tax break. None of the evidence in this proceeding would allow the Board to conclude that the future tax savings affected the price the Province could get for the shares.

3.9.15 Contrast that with the section 88 paradigm. A purchaser of the shares of a utility could be confident that it could use section 88 to bump the asset value, and thus get tax-free revenues for some years. That will factor into price.

3.9.16 Where is the evidence of that being the case here? There is none. In fact, the only evidence is that the prospectus on the IPO warned the purchasers that the future tax savings might go in whole or in part to the customers, not the shareholders[94].

3.9.17 Either of these facts would mean that the Actual FMV Sales and Payments Ratio should not be applied. There is no relationship between the premium and the FMV Bump. The FMV Bump arises for a different reason. There is no evidence in this proceeding that the price was affected by the potential future tax savings, so that should also not be the basis for the Board's implementation of the Actual FMV Sales and Payments Ratio.

3.9.18 SEC therefore concludes that this portion of the Decision is conceptually sound, but is in error because of the specific facts of this case.

3.9.19 What the Board implemented, though, is a more complex version of the ratio. Instead of just allocating between the actual sales at FMV, and the deemed sale (to which RP-2004-0188 would obviously apply), the Board added an additional percentage to the shareholder allocation by multiplying the Departure Tax by the percentage of share retained by the Province.

3.9.20 The theory appears to be that the Departure Tax allocable to the shares sold on the IPO is captured in the price. The Departure Tax allocable to the retained shares is not, and is treated as a cost to the Province of its shares.

3.9.21 SEC does not believe this reasoning is sound. If any portion of the FMV Bump arises because of actual transactions (as opposed to deemed transactions)[95], it is only the shares issued to third parties. All of the FMV Bump associated with the shares retained by the Province as entirely driven by the deeming provision, and nothing else.

3.9.22 SEC therefore believes that the addition of this extra percentage by the Board in the Actual FMV Sales and Payments Ratio is a separate error.

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[94] Page 160 of the Prospectus on the IPO.
[95] Which SEC asserts is not the case: See section 2.3 of these Written Submissions.

3.9.23 In the event that the reviewing panel determines that any portion of the Decision on the tax issue is in error, SEC submits that in remitting the case back to the hearing panel the reviewing panel should require that the Actual FMV Sales and Payments Ratio be re-thought consistent with these Written Submissions.

3.10 *Did the Board Have Reason to Depart from the Principles in RP-2004-0188?*

3.10.1 The Board has only once considered the question of how to allocate the tax savings associated with a FMV Bump. In the 2006 Electricity Distribution Rate Handbook: Report of the Board, dated May 11, 2005, the Board had to grapple with the fact that, on October 1, 2001, all of the LDCs had by law a deemed increase to FMV in the book value of their assets for tax purposes.

3.10.2 In that case, the underlying situation was essentially the same as here, i.e. the LDCs were about to come under a new taxation regime. The LDCs had been non-taxable entities prior to the transfer. Under the new rules that would be in place, they would be subject to PILs, which was basically the same as the federal ITA rules, but with all of the tax paid to the Province.

3.10.3 However, like the federal ITA in section 149(10)[96], the PILs regime recognized that it was not entitled to tax the value of assets that accrued prior to the LDCs becoming taxable under the PILs regime[97]. Therefore, the PILs rules mimicked those in the ITA in providing for a deemed acquisition of assets at FMV, with the resulting FMV Bump.

3.10.4 The Board in RP-2004-0188 quickly determined that, for rate purposes, the net PP&E of assets would be the old values, and would not be increased to fair market value. The utilities, though, said that if they were not able to recover the new value of the assets from the customers via depreciation, then the customers should not get the credit for the higher tax deductions that were available under the PILs regime.

3.10.5 In short, the benefit of the FMV Bump should be allocated to the shareholders, not the customers. It was fundamentally a "benefits follow costs" argument[98].

3.10.6 The Board did not agree.

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[96] And the Board recognized this in the Decision, p. 82.
[97] This general concept is a principle of tax law that is broadly applicable in most taxing jurisdictions around the world. A taxing regime starts taxing at the time it becomes applicable, and at the values in existence at that time. If the taxing regime ceases to be applicable, the opposite is also true. This is true when people or corporations move from one jurisdiction to another (there are generally deemed dispositions and acquisitions), when they change status from taxable to non-taxable or vice versa (the same), and most of the many other situations in which entities or individuals become or cease to become taxable under a particular taxation regime. It does not just relate to capital asset values. Things such as inventory valuation, loss carryforwards, recognition of receivables, and many other issues are dealt with under this general rubric.
[98] As the Board recognized in RP-20014-0188, p. 51.

3.10.7 The Board started from the principle that rates are generally established using actual (forecast) taxes, not accounting taxes or notional taxes. This was already at that time a longstanding principle used by the Board, as the Board later noted in the Decision[99].

3.10.8 Then, the Board looked at whether there should be an exception to that general rule[100].

3.10.9 What the Board concluded in RP-2004-0188 is that[101]:

(a) The FMV Bump was deemed by the applicable taxing statute. It was therefore, by definition, a benefit that was not the result of the utilities incurring a cost. The benefits follow costs rule therefore would not apply[102][103]. The utilities bore the original cost of the assets, not the bumped up cost.

(b) The situation was more akin to a "change in the tax rules", which the Board had already determined would flow through to the customers, whether positive or negative.

In that situation, the Board concluded that there was no reason to depart from the general rule that actual taxes are included in rates.

3.10.10 The Board did recognize in that Report that there could be a situation in which the greater tax deductions produce concomitantly greater future recapture and resulting tax. The Board made clear that, in keeping with the required balance between shareholders and customers, utilities faced with such a situation could come to the Board at that time for redress[104].

3.10.11 The hearing panel in this case explicitly said that the reasoning in RP-2004-0188 should be applied in EB-2016-0160[105]. However, the Board then proceeded to apply that reasoning with regard to the actual facts of this case, saying:

> *"In the sections that follow, the OEB applies these principles to the facts of this case to determine the future tax savings allocation issue in a manner that maintains consistency with the principles expressed in the May 2005 Report and the OEB's findings in this case based thereon, to achieve a reasonable balance between the interests of*

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[99] Decision, p. 84. One of the members of the Board hearing panel in this case, Peter Thompson, was a participant in many of those Board decisions on the use of actual taxes, so had a more comprehensive understanding of the issues at play in those cases than any of the rest of us.
[100] RP-2004-0188, p. 55-57.
[101] RP-20014-0188, p. 56.
[102] In this respect, the Board noted that it was not like the tax deductions for charitable donations and things like that, where the utility incurs a cost and the tax deduction flows with the cost incurrence.
[103] The Board in the Decision followed that reasoning: p. 87, 88.
[104] RP-2004-0188, p. 57. The Board noted this in the Decision, p. 12.
[105] Decision, p. 86, 88, 108.

utility ratepayers and shareholders."

3.10.12 Hence, the Board introduced the Recapture Ratio and the Actual FMV Sales and Payments Ratio, discussed earlier in these Written Submissions.

3.10.13 Hydro One and other parties sought, in their submissions before the hearing panel, to distinguish or apply, as the case may be, the RP-2004-0188 Report and reasoning. The Board did not accept their arguments.

3.10.14 In their Written Argument on this Motion, Hydro One does not deal with the applicability of RP-2004-0188, presumably because it is not favourable to their position. This is particularly striking given that the Board explicitly said that the RP-2004-0188 reasoning should be applied in this case. Why is that not central to their Written Argument on the Motion?

3.10.15 The best Hydro One could do on this Motion is argue[106] that if the Departure Tax was not incurred as they have proposed, then RP-2004-0188 should result in recovery from customers of all of the Departure Tax.

3.10.16 SEC is unable to understand how that proposition follows from the RP-2004-0188 Report, and so is unable to respond to it.

3.10.17 SEC therefore concludes that Hydro One has not sought to distinguish RP-2004-0188 on this Motion, or to challenge its application to this case. SEC instead says that the Board correctly noted that the reasoning in that Report should, with appropriate changes, apply in this case, and it sought to do so.

[106] Written Argument of Hydro One, para. 77.

4 REMAINING ISSUES

4.1 *AFUDC*

4.1.1 No submissions.

4.2 *The Ombudsman Office*

4.2.1 Hydro One requests the Board vary its decision to disallow costs related to the Ombudsman's Office. This amount ($742,000) per year is significantly below its materiality threshold ($3M).[107]

4.2.2 Hydro One appears to argue that, since the Ombudsman's Office is established by statute and provides a benefit to ratepayers, the Board should not have disallowed it. While SEC agrees that the Ombudsman's Office is legislatively required, and does provide a benefit, that does not mean the cost of the office is necessarily recoverable in rates.

4.2.3 In the Decision, the Board said that it did not believe it was appropriate to pass on the costs related to the transformation of Hydro One, including increases in compensation costs.[108] The Board found that "under the outcomes approach to rate regulation, compensation and other costs incurred in connection with the transformation of a holding company parent are recoverable from ratepayers of an OEB regulated utility subsidiary only to the extent they produce outcomes of demonstrable value to utility customers".[109]

4.2.4 While the Ombudsman's Office does provide benefits to utility customers, it is not an incremental benefit to customers, but an incremental cost. Without the transformation, customers would still have benefited from "an independent office of last resort to resolve customer complaints, investigate systematic issues" regarding Hydro One.[110] It would just have been a different Ombudsman, a more independent one, whose costs ratepayers would not have had to pay.

4.2.5 The 2015 amendments to the *Electricity Act* enacting section 48.3 creating the requirement for Hydro One to have an Ombudsman, were part of Bill 91 *Building Ontario Up Act (Budget Measures*), 2015.[111] The legislation made a number of accompanying amendments to the *Electricity Act* which allowed for the Province to sell its ownership stake, as well to the *Ombudsman Act* to explicitly remove the Ontario Ombudsman's jurisdiction over Hydro One.[112] Until the passage of the amendments to

[107] Hydro One's materiality threshold is $3M (Hydro One confirms this at EB-2016-0160 Technical Conference Transcript Day 1, p.60
[108] Decision, p.56
[109] Decision, p.56
[110] Written Argument of Hydro One, para. 80
[111] *Building Ontario Up Act (Budget Measures), 2015*, see Schedule 9
[112] *Building Ontario Up Act (Budget Measures), 2015*, see Schedule 30, section 1:
Section 13 of the *Ombudsman Act* is amended by adding the following subsections:

allow for the transformation of Hydro One, the Ontario Ombudsman, an independent officer of the Ontario Legislature who is funded entirely by taxpayers, had the same responsibility as the new internal Ombudsman.[113]

4.2.6 The Board was correct that ratepayers should not have to pay for costs that are incurred solely because of the transformation of Hydro One. The Ombudsman role for Hydro One, if not for the privatization, would have remained with the Ontario Ombudsman at no cost to ratepayers. Ratepayers are not getting any incremental benefits from the existence of a Hydro One internal Ombudsman and transmission customers should not pay the incremental $742,000.[114]

Exclusion re: Hydro One Inc.
(5) Hydro One Inc. and its subsidiaries are deemed not to be governmental organizations for the purposes of this Act on and after the date on which the *Building Ontario Up Act (Budget Measures), 2015* received Royal Assent.

[113] https://ombudsman.on.ca/resources/news/press-releases/2015/information-for-new-hydro-one-complainants
[114] Written Argument of Hydro One, para. 81

5 OTHER MATTERS

5.1 *Costs*

5.1.1 The School Energy Coalition hereby requests that the Board order payment of our reasonably incurred costs in connection with our participation in this proceeding. It is submitted that the School Energy Coalition has participated responsibly in all aspects of the process, in a manner designed to assist the Board as efficiently as possible.

All of which is respectfully submitted.

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