Shepherd Rubenstein

BY EMAIL and RESS

Jay Shepherd
jay@shepherdrubenstein.com
Direct: 416-804-2767

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Ontario Energy Board
2300 Yonge Street
27th Floor
Toronto, Ontario
M4P 1E4

Attn: Kirsten Walli, Board Secretary

Dear Ms. Walli:

Re: EB-2018-0269 – Hydro One Transmission – Tax Issue

We are counsel for the School Energy Coalition ("SEC"). Pursuant to Procedural Order #1 in this matter, this letter constitutes SEC's submissions on the questions posed.

Overview

1. The Procedural Order asks the Parties to respond to the following questions:

> *"If the errors identified by the Review Panel are accepted, and with due consideration given to the May 2005 Report and any other matters argued in the original case, would the Original Decision be reasonable regarding the allocation of future tax savings between shareholders and ratepayers? If not, what is the appropriate outcome?"*

It also explicitly makes clear that the Parties should not re-argue the issues that were argued before the Review Panel, and determined by them. SEC notes that it does not agree with all of the conclusions of the Review Panel, but in these submissions has accepted all of the findings of the Review Panel.

2. SEC has interpreted the Board's Procedural Order differently from Hydro One. Hydro One has argued that the Review Decision is "binding" on the current panel[1], and as a result only one outcome is possible. With respect, that is not the law, and it is contrary to logic. SEC agrees with this panel – unlike Hydro One - that the Review Panel has not determined this issue, which is why the case is back in the Original Panel's hands at all. The second phase of the threshold test has not yet been answered. It still remains to be determined what is the appropriate outcome of the Hydro One Transmission case – i.e. the just and reasonable rates – once the Review Panel findings are taken into account.

3. This panel is therefore not simply pushing paper. It is exercising the Board's jurisdiction to set rates. There are multiple principles and rules that have to be balanced or reconciled. The Review Panel did not carry out that balancing/reconciliation process. It sent the case back to this panel to do that.

4. In response to the Board, SEC would answer the two questions posed as follows:

    a. Accepting the findings of the Review Panel, the analysis by the Original Panel is not reasonable, and the second of the two allocation methods (based on the ownership of shares) is not reasonable. The first of the two allocation methods is still reasonable once the errors are corrected, and the outcome of the Original Decision – sharing of the future tax savings based on recapture percentage - is one of the reasonable outcomes the Original Panel could have reached based on the evidence.

    b. The division of the future tax savings between shareholders and ratepayers based on recapture vs. capital gain is one appropriate outcome consistent with the findings of the Review Panel. A more appropriate outcome, SEC submits, is allocation of all of the future tax savings to ratepayers. That would still be consistent with the findings of the Review Panel, but is a more just and reasonable result.

5. Hydro One specifically noted in argument before the Review Panel that "*the Future Tax Savings are not a benefit, but a recovery over time of the cost of the PILs Departure Tax*"[2]. Hydro One takes that a step further in its argument in this proceeding, saying:

    > *"It cannot be said that the Future Tax Savings will cause regulatory taxes to be in excess of the actual taxes payable as Hydro One, in effect, prepaid its taxes through the payment of the PILs Departure Tax."*

    The Review Panel implicitly accepts that[3].

6. The fundamental problem in this case is that the utility is seeking to collect taxes in rates as if they were a real cost, but then will not actually pay those taxes. That is contrary to the

[1] Argument in Chief, p. 6.
[2] Hydro One Submissions on Review, p. 7.
[3] Review Decision, p. 8.

principles of cost of service regulation accepted by this Board and the courts[4], and the Board's longstanding practices and principles.

7. Hydro One justifies recovering taxes that are not actual costs by saying that it had to pay the Departure Tax, i.e. that the future taxes collected in rates are simply collecting the Departure Tax from customers over time. However, all parties appear to agree that the ratepayers are not responsible for the Departure Tax. Thus, any resolution that results in the ratepayers paying amounts to Hydro One in rates so that it can recover the Departure Tax from them is contrary to the rule that the customers should not be paying the tax on the IPO. The Review Panel did not discuss how these this rule should be applied.

8. The Review Panel also did not consider the Board's 2005 Report in rendering its decision. That Report considered a similar Fair Market Value Bump, and allocated 100% of the bump to the customers, not for one reason, but for two separate reasons. First, the shareholders of the utilities did not have to incur a cost to receive the tax savings. Second, tax changes are as a matter of principle and practice trued-up, so that actual taxes and taxes recovered in rates are as nearly identical as possible. This is effectively application of the normal rule that actual taxes are included in revenue requirement The Board specifically noted that any future cost to the utilities due to recapture of depreciation would also be for account of the ratepayers, also consistent with that principle.

9. Here, Hydro One proposes that it should be entitled to two exceptions to the Board's past principles and practices:

    a. The customers should be required to pay Hydro One's Departure Tax, over time, contrary to the normal rule that costs caused by non-regulated activities are not recoverable from customers in regulated rates.

    b. The allocation of a similar FMV Bump in 2005 to ratepayers should be treated as inapplicable to this situation, because the current FMV Bump came at a "cost" to Hydro One, i.e. distinguishing the first of the two reasons the Board cited in that report. Hydro one asks this Board panel to completely ignore the second reason on which the Board relied, i.e. the principle that customers should pay in rates the actual taxes the regulated utility is paying each year.

10. Contrary to Hydro One's submissions, the Review Decision does not require this result. If this result was the necessary conclusion from the Review Decision, the Review Panel would have made it.

[4] See, e.g. ***Union Gas Limited v. Ontario Energy Board*, 2015 ONCA 453, para 25** : "Just and reasonable rates permit a utility to recover its prudently incurred costs and earn a fair return on invested capital." This is a well-accepted principle. In the context of taxes, the OEB applies the "taxes payable" principle in determining that component of prudently incurred costs. That means taxes are calculated, related to regulated activities only, on a cash rather than accrual basis. The customers pay in rates what the utility pays to the government.

11. There is a fundamental tension between the result suggested by the benefits follow costs principle, and the result suggested by the just and reasonable principle, all still consistent with the findings in the Review Decision. SEC's basic argument in these submissions is that, since benefits follow costs results in the customers paying the Departure Tax, the better view is that the statutory just and reasonable principle should apply instead. This is consistent with the 2005 Report as well.

Legal Nature of the Review Panel's Decision

12. Hydro One, in its Argument in Chief, makes the following surprising statement[5]:

> *"The findings of the Review Panel are binding on this panel and cannot be varied, reconsidered, or ignored as a matter of law."*

Despite Hydro One's extensive Book of Authorities, no authority is cited for this proposition. That is because it is not, in fact, the law.

13. Hydro One takes a further step, though, which is as follows[6]:

> *"Allocating in accordance with Hydro One's request is the only outcome consistent with the Review Panel's findings."*

14. As we note below, this cannot as a matter of simple logic be true. However, it is not completely crazy that Hydro One reached that conclusion. The Review Panel did say[7]:

> *"In addition, using the benefits follow costs rate-making principle, the OEB finds that since Hydro One Networks paid the PILs departure tax, it should benefit from the future tax savings."*[8]

15. Hydro One has thus concluded that this debate is over, they have won, and this Original Panel must simply process the result already determined. Their conclusion is incorrect on two counts:

    a. It fails to recognize the legal rights and responsibilities of individual Board panels in considering issues within the Board's jurisdiction.

    b. It assumes that benefits follow costs is the only principle the Board has to consider. That is, it treats the above quote as an overall conclusion, rather than an "if…then" statement relative to the application of only one of the applicable principles.

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[5] Argument in Chief, p. 6.

[6] Argument in Chief, p. 11.

[7] Review Decision, p. 8. We note that this is consistent with one of SEC's submissions on this issue in the original proceeding, and for the same reasons as discussed below SEC's submission then presented only one of the possible outcomes that could be considered, and we said as much at the time.

[8] See our discussion below on the proper interpretation of this conclusion.

16. The powers and responsibilities of the Review Panel are controlled by a statutory provision, which reads as follows[9]:

> ***"Power to review***
> *21.2 (1) A tribunal may, if it considers it advisable and if its rules made under section 25.1[10] deal with the matter, review all or part of its own decision or order, and may confirm, vary, suspend or cancel the decision or order. 1997, c. 23, s. 13 (20)."[emphasis added]*

17. What the Review Panel did in this case is the first part of its statutory authority, i.e. it reviewed the Original Panel's decision. What it did not do is the second part, i.e. "confirm, vary, suspend or cancel" the Original Panel's decision. It had the power to do so. It did not.

18. What it said, instead, is the following[11]:

> *"In summary, the Decision erred in failing to take these factors into account in coming to a conclusion regarding the Future Tax Savings Determination. The OEB finds that this part of the Decision should be returned to the original panel to reconsider in light of these findings and all the evidence and argument it heard."*

19. If Hydro One is correct, then there was no other decision for the Review Panel to make. Since it had the authority to vary the Board's decision, and there was no other option (so says Hydro One), then the Review Panel would have varied the Original Decision, as it had the power to do. Hydro One would get all the phantom taxes. Discussion over.

20. Why did that not happen? In our submission, the Review Panel recognized that the underlying decision on rates, including the amount of taxes to be included in rates, was more complex than the issues argued before the Review Panel. While the Review Panel got great swaths of verbiage about rules and principles, that was insufficient to have a full perspective on the amount of taxes to be included in rates.

21. The Review Panel was considering whether the Original Panel made mistakes. It was not considering what the just and reasonable rates should be, and didn't in any way purport to do so. The balancing and reconciliation of the relevant principles remained to be determined[12].

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[9] Statutory Powers Procedures Act, RSO 1990, C. S-22.

[10] Section 25.1 deals with the general power for a tribunal like the Board to have its own rules of procedure, so this provision simply circumscribes what those rules can say about reviews of the Board's own decisions.

[11] Review Decision, p. 9.

[12] The other possible explanation is that Review Panel misunderstood their jurisdiction, and thought that they had to let the Original Panel decide. This is not only not credible, but in the absence of evidence that the Review Panel was confused about the Board's rules, and their statutory authority, it would be perverse to the point of being disrespectful.

22. That means that the Review Panel did NOT make determinations that result in only one outcome in this proceeding. If they had, they would have ordered that outcome. The only reasonable conclusion is that this panel has to make the final determination among multiple possible outcomes. On this point, Hydro One is wrong[13].

Errors Identified by the Review Panel

23. The Board should, in our submission, look at each error determined by the Review Panel and reach a conclusion as to how that error affected the analysis and outcome of the Original Decision. Put another way, the Board should consider how the Original Decision would change, if at all, both in terms of reasoning and result, if that error had not been made.

24. The Review Panel said that the errors were as follows:

    a. *"The Decision does not follow the stand-alone utility principle and is inconsistent with prior OEB applications of the stand-alone utility principle…The Decision treated Hydro One Networks differently because its shareholder is the Province."*[14]

    b. *"The Decision found that the PILs departure tax was "variable"…The Decision erred in speculating or assuming that the Province could have or should have made changes to the PILs legislation."*[15]

    c. *"The Decision did not accept that Hydro One Networks paid the departure tax in substance and that it was a real cost to the utility…The Decision finding that the departure tax was a "payment from itself to itself" by the Province is inconsistent with the evidence on the record…Again, the Decision considered the payment of the departure tax from the perspective of the Province, not the utility's stand-alone perspective."*[16]

    d. *"The two allocation methodologies used in the Decision are inappropriate. In particular: … Recapture Ratio methodology – did not recognize the real cost of the departure tax liability paid by Hydro One Networks…. Actual FMV Sales and Payment methodology – treats shares of Hydro One Networks that continue to be owned by the Province differently than those owned by other shareholders."*[17]

25. What is striking about these four errors is that they are all based on the same fundamental issue: the Original Panel considered the fact that the Province was the sole shareholder

[13] That does not mean the current panel simply ignores what the Review Panel said. What it means is that, as a matter of law, the conclusions of the Review Panel should be given due (and in this context that means heavy) consideration, but the current panel should recognize that the jurisdiction to make the final decision under the OEB Act remains with it.
[14] Review Decision, p. 7
[15] Review Decision, p. 8.
[16] Review Decision, p. 8.
[17] Review Decision, p. 9.

(and also the taxing authority) as a salient fact. The Original Decision proceeded from the logical perspective that the Departure Tax was paid to the province, and then paid back into Hydro One for shares as a simple way to refund the tax. This, said the Review Panel, was to commingle the province's roles as shareholder and as taxing authority. This was inconsistent with the standalone principle, and thus the underlying reasoning of the Original Decision was wrong.

26. SEC completely understands that the Original Decision was in fact making a pragmatic decision, interpreting the "reasonable" in "just and reasonable" as requiring the application of common sense to the facts before the Board. The fact that the tax money went around in a circle was relevant to the Original Panel precisely because an ordinary person – the person paying the rates being determined - would consider it to be relevant. Nothing in the discussion that follows is intended to criticize that approach, or question whether it is consistent with the Board's mandate.

27. That having been said, the task in this proceeding today, consistent with Procedural Order #1, is to determine a reasonable result while accepting the Review Panel's analysis of this principle.

28. The discussion that follows therefore considers how this set of interrelated errors affects:

    a. The application of the "benefits follow costs" principle.

    b. The application of the "standalone" principle.

    c. The application of the "taxes payable" principle, the just and reasonable principle, and, related to that, the Fair Return Standard.

    d. The conclusion in the Original Decision that the recapture vs. capital gain approach to allocation should be applied.

    e. The conclusion in the Original Decision that the share ownership approach to allocation should be applied.

    f. The Board's interpretation of the 2005 Report of the Board relating to the only previous FMV Bump.

Benefits Follow Costs

29. The argument of Hydro One, and its interpretation of the Review Decision, can be re-stated as follows:

> ***"You should allow us to recover the Departure Tax in rates over time, because we paid that tax, and it was a real cost to us."***

30. Under the federal tax system, there is a benefit to companies that first enter the system. They get a bump in value – a FMV Bump – at that time, and it means that the capital cost

allowance and similar deductions are overstated for a period of time, relative to actual cost values. This is the benefit (in "benefits follow costs") that Hydro One is referring to. It arises because Hydro One became subject to federal tax.

31. The cost Hydro One is referring to (in "benefits follow costs") is the Departure Tax, a tax paid not to the feds, but to the province under the PILs regime. While the cost and the benefits do not have a causal relationship, they are both the result of the same external cause, i.e. the IPO[18].

32. The problem is that this analysis of the issue creates a conflict between at least two different principles.

33. On the one hand, the Departure Tax is clearly not recoverable from customers. Any order that directly or indirectly results in the customers paying the Departure Tax would – as all appear to agree – be contrary to settled principle. The Departure Tax is not a cost of the regulated activity, so it is not recoverable from customers in rates.

34. On the other hand, the lower taxes under the federal system clearly arise as a result of the same event that generated the Departure Tax.

35. The question for this panel, therefore, is how to deal with that conflict. Does the Board order that customers pay more than $2 billion of taxes that it knows are not real costs to the utility, simply because the utility paid a different tax of $2 billion plus in the past? Does the Board order the customers to, in effect, reimburse Hydro One over time for the Departure Tax?

36. Or, does the Board give the customers what might be perceived to be a $2 billion plus windfall, for perhaps twenty years into the future, because Hydro One benefitted from a bump in value on entering the federal tax system?

37. There are at least two longstanding principles at play here. It would be an error to assume that "benefits follow costs" governs the situation, and nothing else needs to be considered.

38. SEC submits that the simplistic approach urged by Hydro One – let us collect these taxes we won't have to pay because we paid the Departure Tax – misses the point. The Board's rate rule is "just and reasonable". In our submission, when regulatory principles collide, the Board must go back to that statutory rule. That means balancing the interests of customers and shareholders.

39. SEC therefore submits that, in the context of the Review Decision, "benefits follow costs" does not deliver the outcome Hydro One seeks. It is relevant, but not the whole story. The Board is still left in the position of having to balance competing interests, and seeking a fair and equitable resolution. Very much, we note, as it does in most cases before it.

[18] As accepted in the Review Decision, p. 9.

Standalone Principle

40. The error identified by the Review Panel was that the Original Decision treats the province qua shareholder and the province qua taxing authority as one and the same. As a result, when money went to the province as taxing authority, and then the province as shareholder gave that money back to Hydro One, the Original Decision (and government officials in legislative committee) treated that as money going around in a circle. The conclusion reached was that the tax was never "really" paid.

41. The first and third errors are entirely driven by the standalone principle, basically two parts of the same problem. The second error is similar, in that it postulates the province as taxing authority taking actions to reduce the Departure Tax. Province as taxing authority is irrelevant – due to the standalone principle - to the issues the Original Panel was considering.

42. The fourth error, related to the two allocation methods, similarly is based on the standalone principle. The challenge to the Recapture allocation was based on whether the tax was actually paid, the same as error #3. The challenge to the Share Ownership allocation was based on treating Hydro One differently because the province was the owner, the same as error #1.

43. Accepting that the Original Panel misapplied the standalone principle, treating the Departure Tax as not paid and treating the province as the same in both shareholder and taxing authority roles, how does that affect the outcome of the Original Decision?

44. SEC submits that much of the analysis would be different, of course. However, the outcome would not. This is because, aside from the standalone principle, the problems remain that a) Hydro One seeks to recover from customers a cost that it will not pay, and b) the effect of allowing them to do so would be to require the customers to pay the Departure Tax, which they should not have to pay. These two problems continue to exist, even if the errors relating to the standalone principle are corrected.

Taxes Payable Method, Just and Reasonable Principle, and Fair Return Standard

45. ***Basic Principle.*** The Board's basic rule with respect to taxes is that a utility recovers in rates the actual taxes it expects to pay. This is an exception to the normal rule that accrual accounting is used to determine costs.

46. The fundamental reason for this is to ensure that the benefit of accelerated depreciation, and other advantages and incentives provided in the tax system, flows through to the customers in their rates.

47. ***The Standalone Exception.*** There is a key exception to the basic principle. Like all costs, taxes must be allocated between regulated and unregulated activities. Utilities often carry out unregulated activities in the same company as the regulated activities, and those unregulated activities (renewable energy investments, pref share swaps, etc.) can result in extra tax deductions.

48. The standalone principle requires the Board in those cases to calculate the tax on the regulated activities as if the unregulated activities were not occurring. The effect is sometimes that the regulated activities have a tax cost that will not actually be paid, because the unregulated activities are generating an offsetting tax credit.

49. The standalone principle is not applicable in that manner to the current case. Hydro One does not carry on any relevant or material unregulated activities in the same company as the regulated transmission and distribution businesses. In essence, the company is entirely composed of regulated activities. It is those regulated activities that will actually not be paying tax.

50. We note that the discussion in the Review Decision about the standalone principle does not deal with it from this perspective, precisely because it is not relevant on the facts of this case. The Review Panel considered the standalone principle, but from the point of view of the identity of the province as shareholder. That is a different and unrelated application of the standalone principle.

51. ***Fair Return Standard.*** That leaves us with a much simpler situation. A company that is essentially 100% regulated wants to recover $150 million per year from customers to pay taxes, and then will not pay them.

52. The basic principle of just and reasonable rates, cited earlier, is that the utility can collect the prudently incurred costs to deliver the regulated service, plus a fair return on invested capital.

53. Hydro One seeks to recover more than its prudently incurred costs each year for the next 15-20 years. Because the amount recovered in rates exceeds the amount Hydro One will pay out in costs, its annual return on equity will be higher than the levels the Board has determined meet the Fair Return Standard. It will have excess profits, built into rates at the outset.

54. The principle at play is often cited as follows[19]:

> *"The duty of the Board was to fix fair and reasonable rates; rates which, under the circumstances, would be fair to the consumer on the one hand, and which, on the other hand, would secure to the company a fair return for the capital invested."*

55. It has long been understood that it is the responsibility of the Board to ensure that the rates it approves should be expected, in normal circumstances, to produce a return at this level. It would be an error for the Board to establish rates that could reasonably be expected to produce a lower return, and the utility would rightly complain. It would similarly be an error

[19] *Northwestern Utilities v. City of Edmonton* [1929] S.C.R. 186 at 193; [1929] 2 D.L.R. 4 (*NUL 1929*), per Lamont J. at p. 8.

for the Board to establish rates that could reasonably be expected to produce a higher return, and the customers would rightly complain.

56. The Board has a process for determining a fair return, and in the case of Hydro One Transmission the Board has determined that it is 8.78% on 40% equity for each of 2017 and 2018[20]. There has been no appeal from or review of this finding.

57. If the future tax savings are allocated to Hydro One, as they request, then the predicted ROE for each of those years will be in excess of 12%, far greater than the Fair Return Standard stipulates. Further, that would continue well into the future, until the future tax savings are completely depleted.

58. Hydro One is not in a position to redirect this issue by saying that the additional return is for something else, and isn't really return on the regulated equity. They only have regulated equity, so all return is on regulated equity. Unless this is something else other than return, the return on equity will be too high relative to the Fair Return Standard.

59. The only other thing they could call this is recovery of the Departure Tax. It is common ground that the Board cannot and should not order the customers to pay the Departure Tax, whether today or over time.

60. We note that the Review Panel did not consider the impact on Hydro One's ROE, or the application of the Fair Return Standard, in their decision. It is left to this panel to determine whether, in the circumstances of this case, the exception to the Fair Return Standard that Hydro One seeks should be allowed.

61. SEC submits that no exception to the Fair Return Standard should be allowed in this case.

Recapture vs. Capital Gains Allocation Method

62. The Review Panel determined that the Original Decision was in error in developing the Recapture vs. Capital Gains Allocation Method because it ignored the real cost to Hydro One of the Departure Tax. The question, therefore, is whether, if you accept that Hydro One paid the Departure Tax in fact, the recapture approach to allocation still makes sense.

63. SEC submits that it still does make sense.

64. As we note elsewhere in these submissions, there is a fundamental tension between the result suggested by the benefits follow costs principle, and the result suggested by the just and reasonable principle. One could argue that they get to different results, and there is no middle ground. In fact, SEC's basic argument in these submissions is that, since benefits follow costs results in the customers paying the Departure Tax, the better view is that the statutory just and reasonable principle should apply instead. This is consistent with the 2005 Report as well.

[20] EB-2016-0160, Decision with Reasons, p. 42.

65. In the Original Decision, the recapture approach was basically seeking a fair way to allocate a windfall between shareholders and customers. The analysis proceeded from the perspective that there was no tax actually paid, so this was essentially like a lottery win.

66. Once it is accepted that the Departure Tax was paid, that logic can no longer hold. However, there remains a further problem: two basic regulatory principles are in conflict, and could arguably be seen as producing diametrically opposed results.

67. SEC has sought to reconcile those principles by showing that benefits follow costs produces an unacceptable result – payment of the Departure Tax by the customers.

68. If the Board does not accept that analysis, though, it is still faced with the challenge of handling two opposing results. One possible solution is to divide the benefits up between shareholders and customers. That effectively refuses to follow either of the two principles completely, since following one implies rejecting the other. As the Board often does, the Board would be balancing interests rather than reconciling principles.

69. SEC believes that the better view is still to allocate 100% of the future tax savings to the customers, based on the just and reasonable standard. We note, however, that the Review Decision does not preclude allocating between shareholders and customers using the recapture approach.

Share Ownership Method

70. SEC did not propose the concept of an allocation based on share ownership, either in its initial submissions in EB-2016-0160, or on review. While we understand the rough logic behind the analysis ("what does it really cost the province as shareholder if the tax savings are split between customers and shareholders?"), we believed that option may be excluded by the standalone principle[21].

71. The decision of the Review Panel appears to reject this allocation method on the basis that it relies on the equivalence between the province as shareholder and the province as taxing authority. It seeks to analyse the economic position of shareholders other than the province, separately from the economic position of the province.

72. SEC has considerable problem with the technical analysis underlying this allocation method, as we discussed in detail in our submissions in the Review Proceeding. While we understand that the Original Panel was trying to implement "benefits follow costs" in a nuanced manner, we are concerned that the result was not just and reasonable given the other principles in play.

73. SEC therefore concludes that, based on the Review Decision and the analysis in SEC's previous submissions, the share ownership approach to allocation fails and should not be implemented by the Board.

[21] Actually, the honest truth is that we just didn't think of it. But, if we had, we likely would have rejected it as requiring a fundamental rethinking of the standalone principle.

The 2005 Report of the Board

74. The Board notes, in PO #1, that the Review Panel referred to, but did not rely on or consider, the Board's conclusions in respect to the only previous FMV Bump that the Board has considered. Hydro One focuses on one aspect of that report, but SEC believes it is important to consider the entire analysis the Board made in that case.

75. The Board in that Report said, with respect to the Fair Market Value Bump it was considering[22]:

> *"The Board finds that any tax savings resulting from the FMV Bump will be allocated to the ratepayers. It is true that the rates themselves are based on book value not market value, which suggests that under the stand-alone principle the FMV Bump should be disregarded. However, the shareholder has not incurred any cost related to the change in value for tax purposes (as CITD acknowledged), so the "benefits follow costs" principle is not applicable. In addition, the FMV Bump could be characterized as a change in the tax rules, and therefore would fall into the category of changes subject to true-up. Ms. McShane testified that the savings would be subject to recapture and Hydro One submitted that if the ratepayer benefits from the FMV Bump, it should also be liable for the recapture. The Board agrees that if the ratepayers benefit from this tax saving, then any subsequent recapture should be considered for recovery from ratepayers as well. However, the Board has no evidence as to how frequently or to what extent this recapture will take place.*
>
> *While the Board cannot address the recapture at this point, it can address the current tax savings. The Board has determined that the 2006 tax calculation will incorporate the impact of the FMV Bump. If at some point a related tax liability arises from a sale of assets or change in tax status, then the distributor will be able to apply to the Board for relief, at which point the issue will be determined. The Board notes that this approach will reduce the variance between actual taxes and the tax provision in rates, that it will not disadvantage the shareholder because the shareholder incurred no cost, and, if there is subsequent recapture, the distributor may apply to the Board for relief." [emphasis added]*

76. There are two important issues that are raised by the Board's conclusions with respect to the benefits of a FMV Bump. Either one, by itself, results in the return of some or all of the future tax savings to the customers, not the shareholders.

77. First, the Board doesn't talk about cost to the "utility". It expressly refers to cost to the "shareholder". "Benefits follow costs" arises, the Board says, if the shareholder incurs a cost that generates benefits. In that case, some of the shareholders were municipalities, but the largest shareholder was the province. No costs were incurred, because no cheques were

[22] RP-2004-0188, Report of the Board, p. 56-7.

written, and the value of the shares held by the shareholders did not fall because of any cost.

78. This case is slightly different, but in substance the same. The shareholder – as opposed to Hydro One – did not incur a cost in order to get the future tax savings. The province actually benefitted because of the tax payment, but consistent with the standalone principle that should be ignored; it benefitted in its capacity as taxing authority, not shareholder. In its capacity as shareholder, the province paid money to Hydro One, and got back shares having identical value. No cost was incurred, and the province as shareholder was in the same economic position before the transaction as after the transaction. It had less cash, but more assets.

79. Hydro One will say in Reply that this is re-arguing the review case, but it is not. The practical reality is that the province – in its capacity as shareholder only – was not out of pocket either in cash or in value as a result of the Departure Tax. Consistent with the 2005 Report, if the shareholder is not out of pocket, then the future tax benefits are not recoverable by the shareholders from the customers.

80. Second, and completely separate from the "benefits follow costs" issue, the 2005 Report dealt with the principle that the amounts recovered in rates should be actual taxes the utilities expect to pay. The Board likened that to a "change in tax rules", and noted that when that happens, the customers get the benefit of the change. For example, if the tax act allows additional deductions for certain capital assets – as it does from time to time – those additional deductions are reflected the taxes included in rates.

81. What is interesting is that, in taking this approach, the Board in the 2005 Report explicitly made an exception to another practice it otherwise followed: taxes recovered in rates are calculated using only deductions of the amounts that are also recoverable in rates. That is why, for example, donations are excluded from the tax calculation. Since the donations themselves are not recoverable in rates, the deduction for those donations should not be reflected in the tax calculation.

82. In the case of the FMV Bump being considered by the 2005 Report, the customers were not going to pay in rates the depreciation and cost of capital on the bumped up value. Therefore, it was at least arguable that the additional CCA deductions associated with the FMV Bump should not be included in the tax calculation. If the customers are bearing the costs, they don't get the tax deduction either, some would say.

83. The Board didn't do that in the 2005 Report. Instead, the Board determined that the fair result was to allocate those future tax savings to the customers, consistent with the more general principle that the utility should recover in costs the taxes it reasonably expected to pay because of the regulated activity[23].

84. In our submission, the Board should reach the same conclusion here.

[23] The Board did identify the possibility that there would be additional recapture at some point in the future, and specifically noted that the customers should, in fairness, pay that additional cost when and if it occurred.

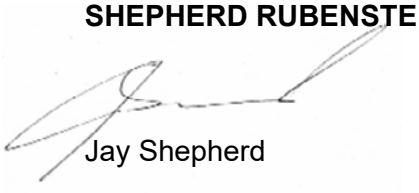
Conclusion

85. SEC therefore submits that the Board should set transmission rates for Hydro One based on the actual taxes expected to be paid by Hydro One each year, and not by reference to notional taxes payable if the FMV Bump had not occurred. The Board's order should, consistent with the 2005 Report, expressly reserve for future determination the responsibility of the customers (in rates) for any future recapture arising out of the fact that the FMV increased tax values for Hydro One.

SEC submits that it has participated responsibly in this proceeding, and requests that the Board order reimbursement of its reasonably incurred costs for so doing.

All of which is respectfully submitted.

Yours very truly,
SHEPHERD RUBENSTEIN PROFESSIONAL CORPORATION



Jay Shepherd

cc: Wayne McNally, SEC (email)
Interested Parties