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Our File No. 185126

December 4, 2018

VIA RESS, EMAIL AND COURIER

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

Attention: Kirsten Walli,
Board Secretary

Dear Ms. Walli:

Re: EB-2018-0269: **Hydro One Networks Inc., 2018 Transmission Revenue Requirement and Charge Determinants, Reconsideration of Future Tax Savings Issue**

Pursuant to Procedural Order No. 1, please find enclosed herewith BOMA's Submission.

Yours truly,

FOGLER, RUBINOFF LLP

Thomas Brett

Thomas Brett
TB/dd
Encls.
cc: All Parties *(via email)*

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EB-2018-0269

ONTARIO ENERGY BOARD

Hydro One Networks Inc.

2018 Transmission Revenue Requirement and Charge Determinants,

Reconsideration of Future Tax Savings Issue

SUBMISSION OF

BUILDING OWNERS AND MANAGERS ASSOCIATION, GREATER TORONTO

("BOMA")

December 4, 2018

Tom Brett
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Counsel for BOMA

Introduction

The issue for the Board in this case is what is the allocation of a windfall that is fair to both ratepayers and shareholder. The Board needs to decide which of the two (2) options, the original decision in EB-2016-0160, that the savings should be shared in the manner set out therein, or HONI's proposal that all of the windfall should accrue to it, the shareholder, or another allocation between ratepayers and the shareholder that is fair to both is most reasonable. Only a fair allocation of the windfall will result in 2017, 2018, and future years' rates being just and reasonable. The windfall arises from future tax savings that become available as a result of the FMV Bump.

In referring this issue back to a "new panel", and not the original panel, the Board, in Procedural Order No. 1 of EB-2018-0269, gave that panel broad discretion to reassess the evidence and arguments in the original case (EB-2016-0160), and, accepting the errors identified by the Review Panel, and with due consideration given to the May 2005 Report of the Board, and any other matters argued in the original case, to determine whether the original decision is reasonable, with respect to the proposed allocation of future tax savings between ratepayers and shareholders, and if not, what should that allocation be.

In EB-2016-0160, Hydro One Networks Inc. ("HONI") proposed to include in the 2017 and 2018 rates, income taxes of $81.7 million and $89.6 million, respectively. Those amounts were the initial tranches of a total of $2.56 billion in notional income taxes (in both its transmission and distribution business) that HONI proposes to collect in rates from its customers over the next fifteen (15) to twenty (20) years.

BOMA refers to these amounts as notional amounts because they are not the amounts that HONI will actually pay in those years. The Board's normal practice for many years has been to include in rates derived from a cost of service based revenue requirement determination, only the actual taxes forecast to be paid by the regulated utility in the test year(s) HONI's proposed approach, if accepted, would be an exception to this principle, an exception that needs to be justified. As the Board noted, in RP-2004-0188:

> *"rates must be just and reasonable, and any substantial variation between the tax determined for regulatory purposes, and actual taxes paid by the distributor [transmitter] must be justified"* (our emphasis) (p55).

The Board, in its Decision dated September 28, 2017, and its Decision and Rate Order dated November 9, 2017, allowed HONI to collect from ratepayers only sixty-two percent (62%) of those national income taxes, $51.0 million in 2017 and $55.0 million in 2018, for a total of $106.0 million. The Board decided that the remaining $65.3 million should not be included in rates.

Assuming the same principles would apply in later years, the Board determined that $1.59 billion of the $2.56 billion (sixty-two percent (62%)) could be recovered in rates. In coming to its decision, the Board relied in part on the logic of the Board's decision in RP-2004-0188 to determine a fair allocation of the tax savings resulting from the FMV Bump arising from the change in tax status of HONI from PILs regime to federal/provincial.

In BOMA's view, the fairer decision is that reached by the Board in its original decision. Even if one believes there were errors in either the Board's application, or failure to apply certain regulatory principles, none of these errors were material enough to justify changing the original decision of the Board. The Board's decision is fair to both ratepayers and HONI. HONI's proposal is not.

BOMA will address the significance of each of the alleged errors and their relevance to the Board's original decision in the comments that follow.

In BOMA's view, the Board relied, although not exclusively, on the Board's decision in RP-2004-0188. In that proceeding, the Board communicated a number of principles that should assist the Board in arriving at a fair solution. The Review Panel also stated that, in its review, parties should have due regard to RP-2004-0188.

As noted above, the Board reaffirmed its long-held position that actual taxes paid, or forecast to be paid, are included in rates. The onus is, therefore, on HONI to justify its proposed departure from this basic principle.

In RP-2004-0188, the Board dealt with initial Fair Market Value Bump ("FMV Bump") for municipal utilities. The Ministry of Finance required the revaluation of distributor assets to market value effective October 1, 2001, as part of the commercialization of the heretofore not-for-profit entities.

The Board described the impact, as follows:

> *"This Fair Market Value Bump, or FMV Bump, adjusted the value of distributors' Cumulative Eligible Capital or Undepreciated Capital Cost. No adjustments to rate base were made for regulatory purposes. There is a potential impact on the Cumulative Eligible Capital (or Eligible Capital Expenditures) deduction or the Capital Cost Allowance. With respect to the Cumulative Eligible Capital or Undepreciated Capital Cost, the issue is whether the tax savings arising from the FMV Bump should be shared between ratepayers and shareholders, allocated 100% to the ratepayers, or allocated 100% to the shareholder"* (Report, p56).

The Board found that:

> *"any tax savings resulting from the FMV Bump will be allocated to the ratepayers"* (Report, p56)

In RP-2004-0188, the Board did recognize, as did the hearing panel, that in the event the assets, the value of which had been the subject to the FMV Bump were subsequently sold, the part of the sale price that represented recapture of CCA engendered by the FMV Bump and taken prior to the sale, could be considered for recovery from ratepayers, and the utility would be free to apply for such recovery at the time of the transaction. Until such a transaction, the Board ruled that the utilities' 2006 tax calculation would incorporate the impact of enhanced CCA deal (and lower taxes) due to the FMV Bump. In other words, the tax savings accrued to the ratepayers.

The Board decision in RP-2004-0188 was meant in part to reduce the variance between actual taxes and the taxes reflected in rates. The Board was also of the view that the shareholder had no claim to the windfall, since it had done nothing to cause it. The tax savings was caused by the FMV Bump.

That decision influenced the approach taken by the Board in EB-2016-0160 to allocate the tax savings between the ratepayers and the shareholder (HONI).

BOMA notes that the FMV Bump is a longstanding feature of the federal (and provincial) tax regime. It applies not only to utilities, and not only to instances where corporations move from a non-income-tax-paying status to income-tax-paying status. It is a very broad general provision of the Income Tax Act, and has nothing to do with the Ontario "departure tax", which is a feature of Ontario's PILs tax regime for which the charging statute is the Electricity Act, sections 89 and 90, and the PILs Regulation.

For its part, HONI was wrong to suggest in its Motion to Review that the RP-2004-0188 had no application to the case. The fact that the utilities incurred no cost as a result of the revaluation of the assets in 2001, did not diminish the importance of the Board's Report. The Review Panel stated in Procedural Order No. 1 that:

"The two allocation methodologies used in the Decision appeared to be inappropriate".

They did not say they were inappropriate. In fact, in BOMA's view, one of the allocation methods used in the recapture method was appropriate for the reasons outlined below.

The new panel, of course, did not make a full review of the merits of the decision. It held only a one-day hearing while the hearing panel spent many days on the matter. Many pages of that decision were dedicated to the topic, as the Board had specifically asked intervenors to deal with the issue in depth. The Board's analysis was exhaustive, and, in BOMA's view, basically correct.

It is worth noting that it was the shareholder and the Board of Networks et al, not the ratepayers, that decided to sell part of HONI to the public, the event which prompted the requirement to pay the "departure tax", since the company was "escaping" the PILs regime.

HONI has argued that it incurred a real cost when it paid the "departure tax" of $2.6 billion. The hearing panel rejected the argument on the grounds that just before or just after HONI wrote a cheque to the OEFC (the Province) for that amount, and while HONI was still 100% owned by the Province, HONI received a cash transfer from its sole shareholder, the Province of Ontario, of exactly the same amount, so HONI incurred no economic loss from writing the cheque. HONI's balance sheet remained the same; it did not incur any diminution in its cash assets, or its liquidity, its equity, or its value, which would otherwise have declined by $2.6 billion. Any diminution of its value would have meant the share price for the IPO would have had to been lowered; the value of Ontario's one hundred percent (100%) interest in HONI would have declined by $2.5 billion, perhaps more, due to second order impacts, like a potential lower debt rating. HONI was able to preserve its value. The economic impact of writing the cheque was zero.

The fact was verified by the evidence filed with respect to the testimony of the Deputy Minister of Energy at the Ontario Estimate Committee, which was cited in BOMA's Argument in EB-2016-0160, and accepted and relied upon by the panel in its decision. The evidence is reproduced on p8 of this Submission.

The financial and economic details of HONI's receipt of funds from the Province are important. The corporation did not pay for the funds; they received them free because, while they issued additional shares to the Province, the shares were of no value. The Province already owned one hundred percent of the corporation. They could not own more than that. Second, as noted above, the receipt of the free funds allowed the company to maintain its cash position, the structure of its balance sheet, and preserve its value, prior to going public. It retains that same amount of cash that it had before it made the payment and the same structure and level of debt. HONI did not have any other option to obtain the funds that would not do it harm. Additional debt would weaken the capital structure, and, might have led to ratings warnings or downgrades, either of which would have adversely impacted the planned IPO. Equity from a third party commercial investor would require HONI to dilute its sole shareholder, the Province, even before it sold some of its shares to the public. HONI was wrong to state that it could have raised the funds in other ways without cost and other disadvantages. Only by accepting free funds from its sole shareholder, Ontario, was it able to "write a cheque" to Ontario for the departure tax, with incurring an economic loss.

The company has also admitted that it was completely reimbursed for its economic loss. In short, there was no economic cost for the company. The company was held harmless by its sole shareholder. To argue that HONI incurred a "real" cost when it wrote a cheque to the Province and received on the same day or a prior day is the same amount of money from the Province is to elevate form over substance to an outrageous extent. It does not make sense.

The transcript of the discussion between the Ontario Deputy Minister of Energy, Serge Imbrogno, and the NAP Energy Critic, MLA Peter Tabuns, at 2015 Estimates Committee of the Ontario Legislature hearing on the Energy Department's Estimate, which is reproduced in the Decision, and p4 of BOMA's Final Argument in EB-2016-0160 (reproduced from pE419), confirms the above analysis. Unfortunately, BOMA did not reproduce the same page in Appendix A to its Submission, for which it apologizes to parties.

> *"Mr. Peter Tabuns: 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 <u>cash neutral and fiscally neutral</u> (our emphasis). Was this not correct?*
>
> *Mr. Serge Imbrogno: 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 [Ontario government]. Is that correct?

Mr. Serge Imbrogno: That's correct." [Page E419, Estimate Committee Proceeding of September 29, 2015]. The relevant pages from the Estimates proceeding are in Appendix A to this Submission"."

At least three (3) key points emerge from the above evidence:

1. HONI received a $2.6 billion contribution from Ontario to allow it to make the payment required by the Electricity Act, upon leaving the PILs regime.

2. The company incurred no economic cost and loss from the transactions. It was held harmless by its sole shareholder, the Province, in a manner that preserved HONI's value.

3. While HONI made out its cheque to OEFC, OEFC is not using it to pay off debts, but will return the cash to the Ontario Financing Authority (the Ontario government). The distinction that HONI labours to make between OEFC and the Ontario government is false. There is no significance to the fact that HONI makes its cheque out to the OEFC rather than directly to the government (see below for more detail).

The Board's decision understood all of the foregoing and drew the correct conclusion, namely that there was no real cost. HONI tried to link the departure tax proceeds to a statement by the Minister at the Estimates proceeding. That is a political statement. The facts are otherwise. Some of it may, but only before it goes first to the Ontario Treasury.

Given that HONI did not incur an economic loss when it paid the departure tax, it cannot invoke the benefits following cost principle that it has. The cause and effect falls away. The Board's original decision fits squarely with this interpretation – to look at the underlying economics of the transactions.

The increased available tax savings due to the Bump-up ordered by the Ontario government for its own purposes both in 2001 and FMV Bump required by the Income Tax Act in 2015, for the federal/provincial governments' own purposes, the latter being the intent of tax policy and law to have a fresh start when an event occurs that changes the tax status of a taxpayer or non-tax-paying entity is correctly viewed as a windfall to both HONI's shareholder and its ratepayers, and should be apportioned between them.

<u>Comments on HONI Submission of November 20, 2018 ("Submission") That Have Implications for This Case</u>

At paragraph 21 of its Submission, HONI stated:

> *"The variability of the PILs Departure Tax was one of the findings in the Board's decision, on which the allocation methodologies were based".*

That statement is incorrect. The Board's decision would have remained the same had the Board decided that the size of the Departure Tax was a matter determined by the Electricity Act and the PILs regulation, the charging statute for the "departure tax". The finding as to "variability" was not critical to the Board's decision. The amount of the tax was determined by a reference to certain provisions of the Income Tax Act, but the rationale for "departure tax" was a different provincial policy(ies). The legal basis for them was the PILs Act and Regulation.

In HONI's Notice of Motion filed on October 13, 2017, it stated that HONI paid the "departure tax" to the Ontario Energy Finance Corporation ("OEFC"). The statement is only partially correct. While noted earlier in this Submission, HONI's cheques went originally to the OEFC, the amounts in economic terms were paid to the Ontario Finance Authority, in effect, the

Province of Ontario, and were not earmarked for any particular purpose. This was made clear in the quotation cited by BOMA in its Submission on the EB-2016-0160, and cited again by Schools in its Submission on the Review Motion. The exchange between Mr. Imbrogno and Deputy Minister Tabuns made the pathway for funds clear. As noted earlier in this Submission, the Board will recall the exchange, in question:

> *"Mr. Peter Tabuns: 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 <u>cash neutral and fiscally neutral</u> (our emphasis). Was this not correct?*
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>
> *Mr. Serge Imbrogno: That's correct." [Page E419, Estimate Committee Proceeding of September 29, 2015]. The relevant pages from the Estimates proceeding are in Appendix A to this Submission".*

The OEFC is a non-share corporation created by statute. It consists of its directors, all or most of whom are public servants. It is an agent of the Crown, and its assets and liabilities are consolidated with the Province's financial statements. Its liabilities are guaranteed by the Province. For a more detailed account, see Part V of the Electricity Act. It was established to assist the government to administer various financial transactions related to energy on behalf of the Crown, including the organization and management of the process for the gradual "repayment" of the global adjustment.

The Province may inject funds into it. The OEFC may raise funds by issuing long or short term notes in the market with the approval of the Minister of Finance. Its operations are integrated with the more general financial operations of Ontario, including through the Ontario Finance Authority. Finally, the Act makes clear that in the event the OEFC were wound up at some future date, any payments made to it would, from that time forward, be made directly to the Provincial Treasury.

Moreover, even if there were some significance to the fact that the "departure tax" was paid to the OEFC, and BOMA believes there is none, in making this argument, HONI is doing exactly what it accused (wrongly) the Board for doing, in its original decision, which is to focus on the payment issue from the provincial perspective, rather than examine the economic impact of the transactions. In this Submission, BOMA has focused on the issue from HONI's perspective to determine whether it has incurred an economic cost from paying the "departure tax". HONI incurred no economic loss. HONI tried to make much of the nuances of how the funds were used, unsuccessfully. It is irrelevant to the fair allocation of the savings.

Consequently, HONI's Footnote 12 on p5 of its Notice of Motion of October 18, 2017, which states:

> *"In fact, Exhibit K2.4 contains testimony by the Deputy Minister of Energy before the Standing Committee on Energy indicating that the PILs Departure Tax of "$2.6 billion goes towards paying down the stranded debt, so that transaction is targeted towards stranded debt"."*

is also incorrect. Taken as a whole, the testimony of the Deputy Minister, reproduced above, is the opposite. The money that is paid into the OEFC is effectively paid into the Ontario government since OEFC is consolidated into the financial statements of the Province. The funds are comingled with other funds, are spent for a variety of purposes, one of which may be a reduction of OEFC's current financial liability to the Province, and payment for other government programs. But essentially, the precise use of the funds does not matter.

Moreover, the statements made by HONI throughout their Submissions, the large increase in HONI's tax shield was caused by a departure tax is not accurate. It is better viewed as a windfall gain for HONI. The windfall gain arises from the provisions of the Income Tax Act, which requires the FMV Bump, when the tax status of the company changes. It is similar to a decrease in tax levels or change in tax structure which applies to corporations including utility corporations. Occasionally, changes in general corporate taxation levels will impact a utility during the term of a multiyear incentive ratemaking plan. In such circumstances, the Board has held that the unexpected benefit should be shared by the ratepayers and the shareholder on an equal basis. It is, in large part, the windfall nature of the benefit accruing to HONI by virtue of its change in tax regime that should lead the Board panel to decide that the benefits should be shared in a fair manner between HONI and its ratepayers. The Board decision does that by dividing up the savings based on the amounts that represent the recaptured capital cost allowance previously taken to shareholder, and future capital cost allowance reductions, which, per RP-2004-0188 and general fairness principles should accrue to the ratepayers, respectively.

HONI makes a further error at p11 of its Submission when it equates a significant financial impact to a "material error". This statement cannot be true. An error is material if it violates legal or evidentiary principles to such an extent that it could reasonably lead the decision-maker to make a different decision, had the error not been made. The financial consequences to either party, the ratepayers or the shareholder are after all, unknown until the final decision of the Board in this case. More importantly, they do not determine whether or not there is an error, and in any event, is not a valid criteria for judging whether a Board finding or conclusion is in error.

On the same page of HONI's Submission, in paragraph 26, the statement that the payment of the Departure Tax on the benefits:

> *"...do not result from any change in the provision of rate regulated service, and therefore are not applicable to Hydro One's rates revenue requirement".*

This statement, which seems to challenge the Board's jurisdiction, is not correct. It reflects a misunderstanding of the cost of service ratemaking principles as they apply to the utility's test year forecast taxes. Tax levels are simply the result of the utility's profitability and sales, which are derived from multiple factors. Forecast tax payments, whether under the Income Tax Act (Canada), or the Ontario PILs regime, or otherwise, have always been a component of the utilities' revenue requirement under cost of service ratemaking. They are seldom, if ever, the result of any "change in the provisions of rate regulated service", as stated by HONI. They may, in a particular rates application, be coincident with some initiative, but are in no way driven by it.

This error is repeated in the Conclusion part of HONI's Submission, at p14. Taxes have always been part of the utility's revenue requirement, and that means that any change in the tax regime or tax rate which affect the amount of taxes the utility pays must be reflected in the Board's scrutiny of the utilities' proposed revenue requirement, and as stated in RP-2004-0188, any proposed revenue requirement which seeks to recover from ratepayers an amount for taxes other than the forecast taxes for the test year, needs special justification.

For example, in paragraph (b) of the Conclusion section of its Submission, HONI asked the Board to find that:

> *"the payment of the PILs departure tax was a real cost paid by Hydro One that was not recovered in rates".*

BOMA believes that sentence points to HONI coming before the Board in borrowed clothes. If the departure tax payment was an economic cost to HONI, one which adversely affected its value, shareholder's equity, its balance sheet, its capital structure, or its liquidity position, why did HONI not propose to collect it in rates over an appropriate period of time? Why did HONI use the more complex, less transparent, method of seeking to use the increase in its tax shield to seek to recover taxes that it had not paid in rates? BOMA suggests that the reason HONI chose the route it did is that had it proposed to put, for example, ten percent (10%) of its $2.5 billion in rates in the 2017 and 2018 test years, or collect the full amount by a twenty (20) year rate rider, actually more since the amount would need to be grossed-up for income taxes, the ratepayer and broader community outcry would have been immediate and negative. HONI would be accused of seeking to have ratepayers pay very large sums in rates for an expense for which it was reimbursed in its entirety by its shareholder. As noted above, HONI suffered no economic loss, or economic cost, no loss in liquidity, no deterioration of its capital structure, or no dilution of its sole existing shareholder. HONI's approach was so brazen and controversial that it felt that, in order to comply with securities requirement for "full and true disclosure" it must, and did, include in its prospectus, a paragraph warning that it may not be able to obtain OEB approval for its approval. HONI has over the years recovered in rates other tax costs, including the annual PILs payments, why make a difference with respect to the "departure tax"?

Finally, HONI's statement at paragraph 30 that disparity between taxes to be paid in the last year and taxes HONI proposed to collect in the test year, a discrepancy which the Board disapproved in RP-2004-0188, did not exist because HONI prepaid its taxes through the payment of the PILs departure tax, is fanciful in the extreme. As noted earlier, HONI forecast taxes for a test year are driven by a number of factors, which can vary from year to year, including revenue, and OM&A costs, depreciation, sales levels, and use demand, rate design changes, changes in interest rates, and a host of other factors.

The cheque HONI wrote to the OEFC cannot be reasonably characterized as a prepayment of taxes.

HONI also erred in its motion to review where it stated that the Board's approach denied HONI the opportunity to earn a fair rate of return, and violated the "fair return standard". Their argument has no merit.

First, the forecast for the test year are included in the test year revenue requirement on a dollar for dollar basis, much like operating and maintenance, or depreciation. They are part of the cost of service, but not part of the rate base, on which return is earned. Second, and more important, the fair return standard is the allowed return on equity and on capital that the Board sets each November for the utilities' business in the following year. There is no allowed return, or fair return standard, separate from that Board determined allowed return. The idea of a fair return standard as a separate absolute amount, that the utility is entitled apart from its allowed return, is not supported by Canadian law or regulatory practice.

The standalone principle has been applied by the Board in a number of different contexts. BOMA agrees with the Board's statement in EB-2016-0160 that the principle has been mainly applied to ensure that only costs that are necessary to support the operation of the regulated utility are recoverable by the utility in rates. The principle has been applied to remove utility expenditures from rates if they were not approved by the Board, to benefit a non-regulated division or affiliate of the utility, resulted in the regulated utility subsidizing a non-regulated division by "charging" the division rather than fully allocated costs.

In BOMA's view, the standalone principle has no obvious application to the facts in this case, as HONI is a virtually one hundred percent (100%) regulated entity.

In its decision, the Board offered a second basis for the allocation of tax savings between the shareholder and the ratepayers. The actual FMV Sales and Purchases Ratio. While BOMA appreciates that they asked the Board to deploy that alternative rationale, it finds the details somewhat difficult to understand and suggests it is not required to justify a fair allocation of taxes savings. The "recapture approach" is sufficient for that purpose, and supports that approach. The recapture results in a higher allocation to the shareholder and lowers allocation to ratepayers than would result from the application of the alternative approach. So HONI fares better under the approach the Board utilized.

All of which is respectfully submitted, December 4, 2018.

Tom Brett
Counsel for BOMA