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Frank D'Andrea
Vice President, Regulatory Affairs & Chief Risk Officer

BY COURIER

December 6, 2018

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
Suite 2700, 2300 Yonge Street
P.O. Box 2319
Toronto, ON M4P 1E4

Dear Ms. Walli,

EB-2017-0049 - Hydro One Networks Inc. 2018-2022 Distribution Custom IR Application - Section 78(5.0.2) of the *Ontario Energy Board Act* – Reply Submissions

Pursuant to the Ontario Energy Board's (OEB) Procedural Order No. 10 in EB-2017-0049 issued October 12, 2018 pertaining to section 78(5.0.2) of the *Ontario Energy Board Act*, please find enclosed Hydro One's reply submissions in respect of this matter.

This filing has been submitted electronically using the OEB's Regulatory Electronic Submission System and two (2) hard copies will be sent via courier.

Sincerely,

ORIGINAL SIGNED BY FRANK D'ANDREA

Frank D'Andrea

Cc: EB-2017-0049 Intervenors

ONTARIO ENERGY BOARD

OEB PROCEEDING EB-2017-0049

APPLICATION FOR ELECTRICITY DISTRIBUTION RATES BEGINNING JANUARY 1, 2018 UNTIL DECEMBER 31, 2022

REPLY ARGUMENT OF HYDRO ONE NETWORKS INC.

RE: SUBSECTION 78(5.0.2) OF THE *ONTARIO ENERGY BOARD ACT, 1998*

December 6, 2018

Introduction

These are the reply arguments of Hydro One Networks Inc. (“Hydro One” or “HONI”) in respect of the impact of the *Hydro One Accountability Act, 2018* (“*HOAA*”) and section 78(5.0.2) of the *Ontario Energy Board Act, 1998* (“*OEB Act*”) on Hydro One’s revenue requirement.

Hydro One correctly applied the legislation to remove the compensation costs of executive positions of Hydro One Limited (“HOL”) including the President and Chief Executive Officer, the Chief Financial Officer and the EVP and Chief Corporate Development Officer. Hydro One also voluntarily removed compensation costs of all other members of its executive leadership team (“ELT”) who are employed by Hydro One Inc. (“HOI”) or Hydro One Networks Inc. (“HONI”) and thus fall outside the scope of the *HOAA* and section 78(5.0.2) to the *OEB Act*.

Ontario Energy Board (“OEB”) Staff agree with Hydro One’s interpretation and application of the legislation but have asked for clarification of the allocation of costs between OM&A and capital expenditures.

School Energy Coalition (“SEC”) and Canadian Manufacturers and Exporters (“CME”) disagree with Hydro One’s application of the legislation but note that it has no impact on their proposed reductions to Hydro One’s capital and OM&A. In advancing this position, SEC and CME fail to address the clear language of the legislation and ignore substantial reductions made by Hydro One to its recoverable compensation since the Mercer study.

Hydro One’s detailed response to OEB Staff and intervenor submissions is set out below.

OEB Staff's Position & Hydro One's Response

OEB Staff accept Hydro One's interpretation of section 78(5.0.2) of the *OEB Act* as applying to executives in HOL and agree that Hydro One's decision to voluntarily remove all ELT compensation costs from its revenue requirement is reasonable.[1]

OEB Staff ask for clarification of the allocation of compensation costs between capital and OM&A and suggest the allocation should be 12% capital and 88% OM&A based on references in Hydro One's evidence to Exhibit D1, Tab 3, Schedule 1. Hydro One's clarification is set out below.[2]

The 12% OEB Staff refer to is actually the overhead capitalization rate. The overhead capitalization rate is function of total overhead dollars to be capitalized in the year divided by the forecast capital spending for the year. The 12% rate is not used in determining the amount of Common Corporate Costs to be capitalized.

The methodology to determine the amount of Common Corporate Costs which should be allocated to capital is also outlined in Exhibit D1, Tab 3, Schedule 1 and also utilizes the Black & Veatch model. As provided in Attachment 1 of the exhibit the amount of Corporate Functions and Services expenses to be capitalized is 55.7%.[3] This is the overall rate for this group of costs. The specific amount of capitalization related to ELT compensation is the approximately 55% as indicated in Table 1 of Hydro One's October 26, 2018 submission.[4]

The capital allocation percentage should be applied to total ELT compensation of $6.6 million, not the $4.1 million remaining after Exhibit Q reductions. This is because Exhibit Q reductions were only applied to OM&A and not capital, an approach revised

[1] OEB Staff Submissions dated November 30, 2018, p. 5 [Staff Submissions]
[2] Staff Submissions, p. 6
[3] See Exhibit D1, Tab 3, Schedule 1, Attachment 1, p. 10 , line 49
[4] Capital Compensation/Total ELT Compensation = 3.6/6.6

by Hydro One in applying the impact of the *HOAA* and section 78(5.0.2) of the *OEB Act*, as explained in its response to OEB Staff interrogatory S5(b). The appropriate breakdown of the remaining $4.1 million of executive compensation to be removed from rates is $0.5M million OM&A and $3.6 million capital.

SEC and CME's Position & Hydro One's Response

SEC and CME misinterpret section 78(5.0.2) of the *OEB Act* and take the position that all executive compensation, irrespective of whether the employee is employed by HOL, HOI or HONI, should be excluded from the revenue requirement. In taking this position, SEC and CME ignore the clear language of the legislation, which limits the compensation of executives in HOL only:

> (5.0.2) In approving or fixing just and reasonable rates for Hydro One Limited or any of its subsidiaries, the Board shall not include any amount in respect of <u>compensation paid to the Chief Executive Officer and executives</u>, within the meaning of the Hydro One Accountability Act, 2018, <u>of Hydro One Limited</u>. [emphasis added]

SEC suggests the OEB should disregard the plain wording of section 78(5.0.2) and instead interpret statements made in the Legislative Assembly. Statements made in the Legislature may only be used if the legislation is ambiguous: "[T]he one sure limit on the use of such materials is that they may not be relied on to contradict a legislative text whose meaning is clear."[5] The legislation in this case is not ambiguous. It clearly states that rates shall not include compensation paid to the Chief Executive Officer and executives of <u>Hydro One Limited</u>.[6]

[5] Ruth Sullivan's *Statutory Interpretation* (2d) (Irwin, 2007), p. 289.

[6] The restricted scope of ss. 78(5.0.2) may be compared to s. 4 of the *Hydro One Accountability Act* ("*HOAA*"), which provides that other sections in the *HOAA* apply to "each of Hydro One Limited's subsidiaries."

The suggestion that the OEB should set rates on the basis of statements in the Legislative Assembly, as opposed to the clear, unambiguous words of the *OEB Act* as ultimately passed by the Legislature itself has no proper foundation and is an error.

SEC proposes that the removal of all executive compensation has little impact on reductions it proposed to capital and OM&A in its August 10, 2018 argument, which are based on the difference between the median benchmark in the Mercer compensation study[7] and Hydro One's actual compensation costs.

SEC's position is flawed. The median is not impacted because non-represented positions in the Mercer compensation study are on average within 1% of the market median. Removing compensation costs that are at or near market median will have little impact on the median amount and therefore, will not have an impact on the difference between the median benchmark and actual compensation costs. However, removal of the executive compensation expense <u>does</u> have a real impact on the total compensation to be recovered in rates. Hydro One's October 26, 2018 submission results in a reduction of $4.1 million of compensation recovered in rates, directly benefiting ratepayers. In fact, Hydro One has reduced the amount of compensation for recovery in rates since the application was filed in several areas including:

- In June 2017, Hydro One reduced its 2018 pension OM&A costs by $7.1 million due to the actuarial revaluation of pension expenses completed by Willis Towers Watson (see page 31 of Exhibit C1, Tab 1, Schedule 7);
- In December 2017, Hydro One reduced its 2018 OPEB OM&A costs by $1.9 million (see pages 5-6 of Exhibit Q, Tab 1, Schedule 1);
- In December 2017, Hydro One reduced its 2018 executive compensation OM&A costs by $3.2 million (see pages 5-6 of Exhibit Q, Tab 1, Schedule 1); and

[7] 2017 Mercer Compensation Cost Benchmarking study filed on April 20th, 2018

- Factoring in the December 2017 executive compensation adjustment, Hydro One further reduced ELT compensation to reflect the *HOAA* and section 78(5.0.2) of the *OEB Act* by $0.5 million OM&A (and $3.6 million capital) (see pages 5-6 of Hydro One's October 26, 2018 submissions)

To suggest that these reductions should not be considered would result in an over reduction to the compensation envelope.

Conclusion

Hydro One respectfully submits that its approach is both fair and reasonable. The company has proposed a reduction of executive compensation that goes beyond the requirements of the *HOAA* and section 78(5.0.2) of the *OEB Act* to include all members of the ELT, instead of restricting it to only the executives of HOL as provided for in the legislation. Accordingly, Hydro One submits the further reduction to compensation necessary to comply with the *HOAA* and section 78(5.0.2) of the *OEB Act* is $4.1 million (a reduction of $0.5 million to OM&A and $3.6 million to capital). The revenue requirement impact is described in Table 3 of Hydro One's submissions dated October 26, 2018.

Further, if the Mercer study market median is used as a guide for an envelope reduction to the level of compensation to be recovered in rates, then the reductions to compensation provided since the study was completed should offset this amount. The variance between the Mercer study market median and Hydro One compensation is $17.5M.[8] The appropriate offsetting reductions related to *HOAA* as well as the reductions included throughout the application process are set out in the table below.

[8] I-42-SEC-83 and I-42-SEC-106

Table 1: Net Mercer Median reduction (2018 Test Year)

	$M
Mercer Median – Hydro One variance (SEC-106)	**17.5**
2018 Pension OMA	(7.1)
2018 OPEB OMA	(1.9)
2018 Exec Comp (Exh Q) – Dec 2017	(3.2)
2018 Exec Comp (*HOAA*) – Oct 2018	(0.5)
Total reduction to OMA envelope	**4.8**

Hydro One submits that if the OEB is contemplating a further reduction to the amount of compensation recovered in rates based on the Mercer benchmark median, the appropriate amount is $4.8 million. This amount reflects the reductions already applied in Hydro One's application as well as the amount required to comply with the *HOAA*.