Hydro One Deferred Tax Asset
Briefing Note

ISSUE:

- The Ontario Energy Board (OEB) is currently reviewing whether a tax asset resulting from the Initial Public Offering (IPO) of Hydro One should flow to ratepayers or shareholders
    - Hydro One is currently in oral hearings at the OEB regarding its associated transmission rate application. A decision on rates is expected in late winter or early spring 2017

EXECUTIVE SUMMARY

- In connection with the IPO, as a result of leaving the PILs regime and entering the corporate tax regime, Hydro One was deemed to dispose of its assets for proceeds equal to its fair market value, triggering a PILs liability of $2.6 billion (Departure Tax)
    - In order to mitigate the potentially negative financial consequences arising from the payment of the departure tax, the Province (as shareholder) funded the payment by making an equity injection of $2.6 billion in Hydro One and received $2.6 billion common shares in return
- The revaluation of the tax basis of the assets of Hydro One and its subsidiaries to fair market value resulted in a net deferred tax recovery of $2,619 million recorded in 2015
    - The Deferred Tax Asset (DTA) arises because cash taxes payable by Hydro One, including those payable to the Province, will be reduced for some period into the future
- In August 2016, the Province announced it had dedicated $3.2 billion from the sale of Hydro One shares in 2015 to the Trillium Trust – this included the provincial portion (84% or ~$2.4 billion) of the $2.6 billion Deferred Tax Asset
- As part of the hearing on Hydro One's 2017-2018 rates for transmission, the Ontario Energy Board (OEB) is now considering the treatment of the DTA. Stakeholders in the process are suggesting that some of this benefit should flow to ratepayers
    - Hydro One has taken the position that the DTA should remain as a benefit to the company, given that it incurred a cost associated with the deferred tax asset that was not recovered from ratepayers, as it had to pay a departure tax of $2.6 billion and would be disadvantaged if it is not allocated 100% of the benefit of the deferred tax recovery
        - This argument is complicated by the equity injection from the Province
    - There is no clear precedent, as it is rare for the seller to benefit from tax collections
        - It is the view of the company that it is unlikely the OEB will rule in favour of ratepayers, as Hydro One paid the departure tax, investors purchased shares on the basis that the value of the tax shield would flow to their benefit, and ratepayers are no worse off as a result of the transaction
        - This argument hinges on treating the Province and Hydro One as separate
        - The Board has focused considerable attention on the DTA in the current Transmission rate filing, asking whether there was really a cost that justifies

keeping the benefit.

- In the event some or all of the benefit from the DTA is required to flow to ratepayers, impacts will depend on the proportion of sharing
  - For the company, this would effectively reduce revenues, and that reduction would likely also be mirrored when it returns to the OEB for revised distribution rates
  - Energy staff have assumed that the value to Hydro One is about $135M annually (representing Hydro One's forecast 2017 income tax expense in their transmission and distribution applications). The prospectus suggests that this value flows for at least five years. However, preliminary feedback from banks estimates the tax shield may benefit Hydro One for 8-10 years before the tax asset is extinguished (Hydro One confirmation required)
  - Depending on amounts flowing to ratepayers, Hydro One may also write down a portion of the $2.6B DTA, which could affect the Province's financials and amounts available for investment through the Trillium Trust
    - As an extreme scenario in which the OEB directs the full amount to go toward ratepayers, the Province would require a price of about $28-32 per share on its remaining share sales to reach its objective of $4B for the Trillium Trust
  - However, the share price would likely decline as a result of this adverse decision, due in part to the reduction in expected future earnings, which preliminary feedback from banks suggests could result in a decrease of $1B, or 1.85 per share on an earnings basis. This surprise decision could affect perceived regulatory risk, resulting in a reduction in the premium for Hydro One shares
    - Although this risk was flagged in the Prospectus, investors may take action against the Province and Hydro One
  - Ratepayers could benefit from a small reduction in rates, potentially continuing over several years. Assuming the most extreme case, where revenue requirements are reduced by $81.3M in the transmission application and $53.9M in the distribution application and all benefits flow to ratepayers (please note that this analysis is subject to a number of assumptions and requires validation by Hydro One):
    - Transmission costs for residential customers could be reduced by 0.9% or 8 cents per month from a projected cost of $8.96/month to $8.88/month, all other things being held constant
    - The 2017 distribution portion of the bill for a typical medium density Hydro One customer could be reduced by an additional 78 cents/month or 1.3%, from $59.65 to $58.87/month, all other things being held constant
    - Out year impacts are too uncertain to model accurately

BACKGROUND

Bookrunner View of Risk:

- RBC and Scotiabank as part of pre-IPO due diligence reached out to regulatory experts to assess the likelihood that the OEB would determine the DTA should flow to ratepayers
  - Based on those conversations, and past precedents the banks were confident that this would be a significant change in the Board's regulatory policy, and Hydro One and shareholders would keep the benefit
- While the risk was low, it was flagged in the prospectus for potential investors
  - "a risk that in future rate applications, the Ontario Energy Board will reduce the Company's revenue requirement by all or a portion of those net cash savings. If the Ontario Energy Board were to reduce the Company's revenue requirement in this manner, it could have a material adverse effect on the Company."
  - This was also discussed at roadshow meetings, though it was not a focus

Trillium Trust

- In August 2016, the Province announced it had dedicated $3.2 billion from the sale of Hydro One shares in 2015 to the Trillium Trust – this included the provincial portion of the Deferred Tax Asset
  - The Province benefited by its proportional ownership (84% at the time) of Hydro One's DTA through consolidation, reflected in Income from GBEs ($2.392 billion[1])
    - In the April TB/MBC submission, this amount was estimated around $770M, and the assumption was that it would be recognized as part of Investment in GBEs and contribute to reducing net debt unless the Province amended the Trillium Trust Act in order to credit that amount to the Trillium Trust
    - In the Fall of 2015, the estimated amount of the DTA was revised to approximately 2 billion and the Province decided to move forward with amendments to the Trillium Trust Act to ensure that this non-cash gain was also directed to the Trillium Trust
- In the event the Ontario Energy Board determines that ratepayers should benefit from the DTA (full amount or some portion), Hydro One would write down its asset by the directed amount and the Province's funds for the Trillium Trust would be reduced by the corresponding amount
  - This may impact the Province's ability to meet its stated objective of raising $4B for Trillium Trust through the broadening of ownership of Hydro One
  - As an extreme scenario in which the OEB directs the full amount to go toward ratepayers, the Province would require a price of about $28-32 on its remaining share sales to meet its stated objectives

Share Price Impact

- In the event the OEB determines ratepayers should benefit from the DTA (full or a portion), the share price may decline
  - This would reduce expected future earnings for Hydro One as the earnings would decline.

[1] Represents 84% of the full deferred tax benefit which includes $2.6B DTA and elimination of a deferred tax liability

Preliminary feedback from banks suggests that in the event ratepayers are dedicated the full benefit the present value impact of the reduction in earnings would be about $1B or $1.85 per share.

- Though not quantifiable, the surprise decision would also affect perceived regulatory risk, resulting in a reduction in the premium for Hydro One shares as the OEB is a stable principles-based regulator.

<u>Ratepayer Impact</u>

- Indicative rate impacts are estimated by assuming Hydro One, in the event the OEB determined the deferred tax asset should be returned to ratepayers, would be unable to claim an $81.3M income tax expense for transmission in 2017 and a $52.9M income tax expense for distribution in 2017 (total of $134.2M). The indicative analysis assumes all other costs proposed by Hydro One for rate recovery stay the same. All components of revenue requirement require OEB approval and are subject to change.
  - This analysis assumes that the OEB would flow the return of the DTA to consumers through the disallowance of income tax expenses from the revenue requirement. However the OEB has discretion in this area and may not take this approach. The Ministry cannot presuppose the manner/method or timeframe in which the OEB would instruct Hydro One to return the DTA to consumers. The OEB also has discretion to order a benefit-sharing arrangement, requiring Hydro One to only flow a portion of the DTA to consumers.
  - This analysis presents impacts for a single year. As the value of the DTA greatly exceeds Hydro One's projected annual income tax requirement, this process would continue for a period of time that the OEB considered sufficient to flow the benefit back to consumers.

Transmission

- Transmission comprises slightly less than 7% of average residential customer total bill. A typical Hydro One R1 (medium density) residential customer using 750 kWh per month would pay $8.96/month at current rates.
- Hydro One is currently before the OEB with an application for 2017-2018 transmission revenue requirement of $1.518B. Hydro One has indicated the requested transmission revenue requirement would result in a typical R1 residential customer seeing a 0.3% increase in 2017, or 2.6 cents to $8.99 per month.
- Based on this application, all else being equal, removal of $81.3M in income tax expense from the transmission revenue requirement would reduce the requirement to 1.437B. If the revenue requirement reduction due to removal of tax is applied equally to all components of transmission, the projected cost of $8.96/month could fall by 0.9%, or by 8 cents to $8.88/month.
- The above example is indicative only, all other things being held constant. Transmission rates are paid by all customers in the province, directly or indirectly.

Distribution

- There are a multitude of distribution rates charged by Hydro One, depending upon customer type and density. Hydro One uses a residential R1 customer (medium density) as a typical residential customer. Distribution comprises approximately 34% of the total bill of a Hydro One R1 customer. Currently, an average R1 residential customer using 750 kWh per month pay $60.38 per month for distribution.

- Hydro One is currently before the OEB with an application to set 2017 distribution rates based on the revenue requirement that was approved in 2015 of $1.444B. Hydro One, as a result of re-assessing the division of costs between its rate classes, is proposing to reduce distribution rates for 2017 such that an average R1 customer would pay $59.65/month (-$0.73/month compared to 2016).
- Based on this application, all else being equal, removal of $52.9M in income tax expense from the 2017 distribution revenue requirement would reduce the requirement to $1.391B. Assuming the removal of tax expense is applied equally across all classes, the 2017 distribution bill would be reduced by an additional 78 cents/month, to $58.87/month, all other things being held constant.
    - Costs are allocated to each customer class based on cost causality. Not all rates increase or decrease the same as the overall revenue requirement, and thus rate classes may not experience the removal of income tax expenses in a uniform manner. Tax would likely be allocated to class based on the allocated income associated with it.
- This change would apply only to Hydro One distribution customers (roughly 25% of customers in Ontario).
- Note that Hydro One's 2017 distribution revenue requirement is already approved, including income tax expenses. The first opportunity to examine these costs in detail would be when Hydro One submits an application to set its distribution revenue requirement for 2018 and beyond, expected to be submitted in mid-2017. The precedent set in the transmission application could influence the treatment of these costs at that time.

<u>Market Implications for Utility Sector:</u>

- While unable to quantify what the impact on the share price of Hydro One would be at this point, based on discussions with the investment community, a decision from the OEB directing the benefit to flow to ratepayers would have broader implications for the utility sector in general, not just for Hydro One
- Preliminary feedback from banks suggests that in the event that the OEB determines the DTA benefit would flow to ratepayers, consolidation in the sector would likely be significantly slowed

NEXT STEPS

- Energy staff plan to:
    - work with Hydro One to determine implications for Hydro One of an OEB decision which dedicates the DTA to the benefit of ratepayers

APPENDIX

Hydro One Transmission Rate Hearing

- As part of the hearing on Hydro One's 2017-2018 rates for transmission, the OEB staff have noted that Hydro One realized a deferred tax recovery of $2,619 million that was triggered by the deemed disposition of its assets upon exiting the PILs regime in 2015, and that the impact of this deferred tax recovery has been excluded from the application. That is, the effect of the tax deferral is not included in the requested revenue requirement for transmission.
- OEB staff also noted that the 2006 OEB Distribution Rate Handbook and the associated Board Report reviewed a similar matter related to a deferred tax recovery that utilities realized upon first entering the PILs regime in 2001.
    - This matter refers to a re-valuation of distributor assets to market value required by the Ministry of Finance, effective October 1, 2001 (referred to as Fair Market Value Bump - FMVB).
    - The FMV Bump resulted in a tax savings resulting from undepreciated capital cost. The OEB considered whether the tax savings arising from the FMVB should be shared between ratepayers and shareholders, allocated 100% to the ratepayers, or allocated 100% to the shareholder.
    - The OEB concluded that any tax savings resulting from the FMVB will be allocated to the ratepayers. The reasoning was that:
        - The shareholder has not incurred any cost related to the change in value for tax purposes
        - Without incurring costs, the shareholder cannot legitimately claim a tax benefit flowing from those costs (known as the "benefits follows costs" principle), so the benefits follow costs principle does not apply.
- In the current Hydro One transmission rate hearing, OEB Staff asked Hydro One since the circumstances are similar, if this is being considered in determining the regulatory treatment of the $2,619 million deferred tax recovery in the current transmission application.
- Hydro One's response is that its current circumstances are significantly different than the FMVB issue discussed in the Board's Report on the 2006 Distribution Rate Handbook. Hydro One has stated that in its opinion that:
    - The IPO and resulting change in tax status cannot be reasonably described as a change in tax rules that would fall into the category of a taxation change subject to true-up in rates.
    - Hydro One did incur a cost associated with the deferred tax asset, as it had to pay a departure tax of $2.6 billion and would be disadvantaged if it is not allocated 100% of the benefit of the deferred tax recovery.
- The transmission application is currently being adjudicated by the OEB. The hearing is scheduled to resume on November 24, 2016.

Pre-IPO – Departure Tax and Cash Contribution

- *Province makes $2.6 billion cash contribution to buy shares:*

- In order to mitigate the potentially negative financial consequences arising from the payment of the departure tax, the Province (as shareholder) funded the payment by making an equity injection of $2.6 billion in Hydro One and received 2.6 billion common shares in return
- The transaction is fiscally neutral for the Province due to offsetting impacts from the increase in Hydro One's investment value on the Province's financials

- *Hydro One pays $2.6 billion departure tax:*
  - Hydro One's tax-exempt status ended as a result of the IPO, and it exited the corporate PILs regime to become subject to federal and provincial taxes. Immediately before that occurred, the entity was deemed to have disposed of its assets for proceeds equal to the assets' fair market value.
  - As a result of this deemed disposition, before exiting the corporate PILs regime Hydro One had to make a payment to the Province through the Ontario Electricity Financial Corporation under the Electricity Act, 1998, related to the income and capital gains arising from the difference between the assets' fair value and tax value. This one-time payment to the Province, referred to as the departure tax, was $2.6 billion.
  - The revaluation of the tax basis of the assets of Hydro One Inc. and its subsidiaries to fair market value resulted in a net deferred tax recovery of $2,619 million recorded in 2015
  - The deferred tax asset reflects the fact that cash taxes payable by Hydro One, including those payable to the Province, will be reduced for some period into the future
  - The transaction is fiscally neutral for the Province due to offsetting impacts from lower equivalent Hydro One net income on the Province's financials.

<u>Post IPO - Deferred Tax Asset Benefit</u>

- Hydro One is now subject to corporate income taxes.
- The transition into the corporate income tax regime also resulted in Hydro One eliminating a deferred tax liability and recognizing a deferred tax asset
- The deferred tax asset reflects the fact that cash taxes payable by Hydro One, including those payable to the Province, will be reduced for some period into the future.
- The Province's proportionate share of the deferred tax benefit increased the Province's revenues by $2.4B, and is reflected in Income from GBEs
  - The deferred tax benefit is only one part of Hydro One's consolidated net income (shown as $236M in public accounts), other items such as the departure tax also impact Hydro One's consolidated net income.