Hydro One Deferred Tax Asset

Briefing Note

ISSUE:

- On September 28, 2017, the Ontario Energy Board (OEB) released its Decision and Order regarding Hydro One Networks Inc's transmission revenue requirement application and related changes to uniform transmission rates
- As part of this decision deals with the regulatory treatment of a deferred tax asset (DTA) resulting from the Initial Public Offering (IPO) of Hydro One shares, this could have implications for the Province's fiscal plan

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. 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 recorded in 2015-16
    - The Province dedicated the $2.4B provincial portion of the Deferred Tax Asset to the Trillium Trust. The Provincial portion was determined based on the Province's ownership share in Hydro One at the time (i.e. 84%)
- The OEB has determined that 29% of the transmission portion of the DTA should be returned to ratepayers (~428M)
    - While the decision was exclusively on Hydro One's transmission segment, the OEB indicated in its decision that a similar approach would result in 16% of the distribution portion of the DTA be returned to ratepayers (~179M)
- While ratepayers will benefit from this decision, the extent of the impact will not be known until the OEB issues revised uniform transmission rates, expected in November
    - This benefit will flow to ratepayers over up to 15 years, but for the 2017 and 2018 years will result in Hydro One's revenue requirements being reduced by ~$30M annually
- Hydro One has filed its draft revenue requirement order and uniform transmission rate order and indicated it is in the process of preparing a Motion to Review and Vary the OEB decision with respect to a few elements of the decision, including the benefit of the deferred tax asset.
    - Hydro One has also indicated it is considering an appeal to the Ontario Divisional Court, which would be a separate process.
- Implications for the Province from a fiscal perspective are uncertain as they depend on Hydro One accounting treatment, potential implications for its distribution business, and any operational adjustments that the company may make in response to the impact of the OEB decision
    - A Preliminary assessment of the fiscal impact of the OEB's decision suggests a

  ~$15-20M annual reduction resulting from ongoing lower revenues from Hydro One
  - If the accounting treatment required Hydro One to write down the deferred tax benefit value on its books, it could result in an ~$300M one-time fiscal impact (based on about 50% Provincial share ownership)

Next Steps:

- Intervenors, OEB staff and other transmitters may submit comments on Hydro One's draft revenue requirement order no later than October 14, 2017. Hydro One will respond to any comments no later than October 18, 2017.
- Hydro One may file a Motion to Review and Vary the OEB decision. Under the OEB's rules, the motion must be made no later than October 18, 2017. The OEB may determine, with or without a hearing, whether the motion should be heard before conducting any review on its merits. There is no timeline for this process.
- Hydro One may make an appeal to the Ontario Divisional Court. The appeal must be commenced no later than October 27, 2017.
- The Province will work with Hydro One to determine the impact on Public Accounts and the Trillium Trust.
- The OEB has indicated that this does not currently impact distribution rates as of now, but a similar principle could be applied once it issues its Hydro One Distribution decision

BACKGROUND

Provincial Implications

<u>Departure Tax</u>

- Hydro One exited the payment in lieu of tax (PILs) regime and entered the corporate tax regime as a result of the IPO in November 2015.
- Due to exiting the PILs regime, Hydro One was deemed to have disposed of its assets for proceeds equal to the assets' fair market value. This resulted in Hydro One paying a departure tax of $2.6 billion under the PILs regime. Hydro One also paid the Province $0.2 billion in additional corporate PILs in connection with leaving the corporate PILs regime.
- On entering the corporate tax regime, Hydro One (re)valued the tax basis of its fixed assets at fair market value (FMV) and recognized eligible capital expenditures.
- As a result of a higher valuation of its assets for tax purposes than had been the tax-depreciated value under the PILs regime, Hydro One recorded $2.810 billion in a one-time, non-cash DTB, which increased its net income by the same amount. This deferred tax benefit included $191 million recognized prior to the IPO and $2.619 billion recognized after the IPO.
- The Province recognized a fiscal benefit of approximately $2.4 billion upon consolidation of its proportionate share of Hydro One's net income on the Province's books (i.e., 100%

pre-IPO and about 84% after the IPO).

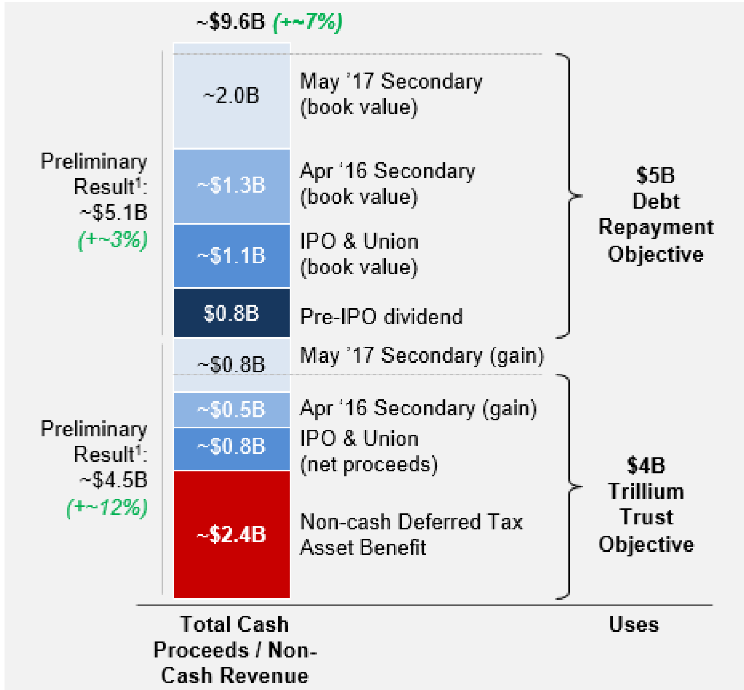
- This approximate $2.4 billion fiscal benefit was credited to the Trillium Trust in August 2016.
- Hydro One did include in the IPO prospectus a risk that, in future rate applications, the OEB could reduce Hydro One's revenue requirement by all or a portion of net cash savings associated with the DTB. The IPO prospectus also noted that if the OEB were to reduce the Company's revenue requirement in this manner, it could have a material adverse effect on the Company.

<u>Fiscal Impact (Preliminary Analysis – Further Discussion with OPCD, Hydro One and the OFA required)</u>

- As a result of the allocation of about 30% of the value of the deferred tax asset related to the transmission business being removed from Hydro One's revenue requirement, Hydro One has assessed this to be about $25M per year
- There is a risk that the OEB follows the same approach for Hydro One's distribution rate application. This could amount to an additional $10M being removed from Hydro One's revenue requirement
- Based on the Province's ownership share, this would represent ~$15-20M annual reduction in net income
- If Hydro One were to write-down or take an upfront provision for the full amount (transmission and distribution), the impact to Hydro One could be ~$607M, or about $304M at consolidation, based on approximately 50% Provincial share ownership

<u>Trillium Trust</u>

- 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 Benefit recognized by Hydro One in 2015.
    - The Province benefited by its proportional ownership (84% at the time) of Hydro One's DTB through consolidation, reflected in Income from GBEs ($2.392 billion)
- As there is currently no legal mechanism to reduce Trillium Trust credits if the Province decided that amounts already credited to the Trillium Trust should be adjusted to reflect lower net contributions from broadening Hydro One's ownership, a legislative amendment to facilitate the change may be required.
    - This may impact the Province's ability to dedicate $4B to the Trillium Trust from the broadening of ownership of Hydro One



Market Implications:

- Analysts continue to review the submission, but preliminary feedback suggests the overall OEB decision will result in a reduction in earnings per share up to $0.07 per share, and potentially result in up to a dollar reduction in the current target price[1]

OEB Decision

- The OEB has determined that part of the ~$2.6B Deferred Tax Asset (DTA) that Hydro One argued should be kept by Hydro One shareholders, should be returned to ratepayers. The OEB's Order and Decision was specific to the transmission portion of Hydro One's business. The Decision and Order also determined a specific allocation for Hydro One's distribution business segment.
- In its decision, Hydro One has directed that the proportion of 71/29 be used to allocate future tax savings between shareholders and ratepayers for its transmission business segment, and 84/16 for its distribution business segment.
- For Hydro One's 2017-18 transmission revenue requirement, this has resulted in the OEB directing Hydro One to reduce grossed up taxes proposed by Hydro One in 2017 and 2018 from $81.9M and $89.6M, respectively, to about $58.1M and $63.6M, respectively.
- According to the approach in the decision, the proportion of regulatory taxes calculated under an assumed 100% allocation of tax savings to shareholders would be limited to 71% per year until the cumulative amount allocated to transmission ratepayers totals 29% of $1,475 or about $428 million.

[1] TD analyst report

- Subject to the determinations by future OEB panels, the duration of the 29% annual allocation of tax savings to ratepayers will depend on the level of income earned from the transmission business; but could be for as many as 15 or more years. The approach to recovering the tax savings attributable to recapture will then cease and the recovery of any further hypothetical taxes from ratepayers will be reviewed.
- Hydro One took 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, 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.
- As part of the hearing on Hydro One's 2017-2018 revenue requirement for transmission, the Ontario Energy Board (OEB) considered what would be the appropriate amount of tax expense to be recovered from customers in Hydro One's transmission revenue requirement. The OEB noted that:
    - For years, Networks' transmission rates have been based on the recovery from ratepayers of estimates of the actual income taxes that Hydro One expected to pay in the rate-setting test periods. The OEB also noted precedent decisions reflecting its preference for adhering to the inclusion of actual tax estimates in rates for both electricity and gas decisions.
    - In Hydro One's 2017-18 transmission application, Hydro One sought to recover "notional" income tax amounts of $81.9M in 2017 and $89.6M in 2018. These notional amounts reflect Hydro One's proposal to allocate to shareholders 100% of the DTA. The actual amount of tax Hydro One Networks expects to pay in 2017 and 2017 are $12.2M and $13.1M, respectively (Ontario minimum tax; federal income taxes will be zero).
    - The OEB indicated in its decision that Hydro One is effectively asking the OEB to approve its plan to recover from the transmission and distribution ratepayers of Networks, in future years, notional or hypothetical income taxes in a total amount of about $2.6B more than the amount of taxes actually payable in those years. About $1.5B of this notional total amount relates to transmission service. The remaining $1.1B relates to distribution service.
    - The OEB noted that the significant difference between taxes collected in rates and the actual amounts payable to the tax authorities after the IPO is reflected in the 2016 numbers for Networks. The utility collected $120.9 million in 2016 transmission and distribution rates. It actually paid $19.7 million to the tax authorities. The difference of $101.2 million is available to Hydro One Limited to support its delivery of value to shareholders in excess of the OEB's allowed ROE.
    - The OEB indicated that at issue is the appropriateness of the proposal to allocate to shareholders 100% of the future tax savings. Further, the OEB concluded that the issue in this case is the "allocation" of the future tax benefit between shareholders and ratepayers. The OEB determined it has jurisdiction to decide this issue as it is the assets of the regulated utility that produces the cash flows and gives rise to the asset value increases. Any future tax savings are subject to OEB allocation as between shareholders and ratepayers.
    - A significant issue for the OEB in determining the allocation between ratepayers and shareholders is "recapture". Actual or deemed sale values falling between the

pre-sale tax cost and original cost constitute “recaptured” CCA eligible capital costs. The OEB agrees that future tax savings attributable to recapture should be allocated to shareholders. The OEB also determined that tax savings attributable to increases in tax value that are “costless” to the utility owner are to be allocated to ratepayers.

  - In its decision, based on information provided during the hearing in evidence and by Hydro One witnesses, the OEB determined “recapture ratios for transmission of 71%; for distribution of 84%; and 77% for Networks as a whole”.[2]
  - Hydro One has directed that the proportion of 71/29 be used to allocate future tax savings between shareholders and ratepayers for its transmission business segment, and 84/16 for its distribution business segment.

Regulatory Treatment and Approach by the OEB on the DTA

- There are two ways to think about dividing a deferred tax asset. The first is between benefits that a shareholder would lose if it ever sold the company (known as benefits eligible for "recapture") and those that it receives immediately and would not lose (your "gain" benefits).
- The second way to think about it is between those benefits the shareholder received because of "actual" sales at Fair Market Value (such as investors buying IPO shares) and those received from "deemed" sales at Fair Market Value (such as when you leave the PILS regime, you are deemed to have sold your assets and repurchased them at FMV).
- The OEB has an approach to determining the way to split a DTA between shareholders and ratepayers under each scenario, and goes with whichever provides more of the benefit to the shareholder.

Last Updated: October 16, 2017

[2] Decision and Order, EB-2016-0160, p.93.