ONTARIO ENERGY BOARD | COMMISSION DE L'ÉNERGIE DE L'ONTARIO

Decision and Order - Hydro One Networks
Transmission Cost of Service Application

Situation

Hydro One Networks Inc. has applied to the Ontario Energy Board to increase the revenues it proposes to collect for the operation of the transmission system. The Ontario Energy Board's decision on this application will have an effect on all electricity consumers in Ontario. The cost of transmission is reflected in the delivery charges included on bills.

What they asked for

The transmission rates revenue requirement amounts that Hydro One asks the OEB to approve are $1,487.4 million for 2017 and $1,558.4 million for 2018. These proposed revenue requirements reflect a year over year increase of 0.5% for 2017 over 2016 approved levels and 4.8% for 2018 over 2017.

What they got

The precise bill impacts as a result of this decision will be determined when the Draft Rate Order is filed on October 10, 2017. As the OEB has made a number of decisions to reduce costs attributable to ratepayers, the forecast initial impacts will likely be reduced.

Communications Strategy

A relatively low-profile and reactive communications approach appears to be warranted, for the following reasons:

1. The issues related to the revenue requirement application – both specific to the OEB ruling and the larger issues about the company as covered in the media – are primarily Hydro One issues. Media questions are likely to be directed to them. There is little potential criticism of the OEB likely for two reasons:

    a. There has been relatively little media interest in the public hearing; and
    b. While its reduction of Hydro One Networks transmission applied-for revenue requirement is relatively small (an estimated reduction of 3.5% in 2017 and 3.4% in 2018 on a Hydro One Networks revenue requirement in the range of $1.5 billion), it shows that the OEB has conducted a thorough review and that it is operating in the consumers' interests.

2. The monthly electricity bill impact of the revenue requirement for electricity customers is quite small and will be implemented at a time when residential and small business customers are seeing significant monthly bill reductions under the *Fair Hydro Act*.

3. The OEB should nevertheless be prepared with background information to explain its decision in case of media or public inquiries.

Communications Plan

In keeping with its usual approach, the OEB will post all Decision and Order documents (and any other relevant documents it usually posts for applications) on its website, alerting Hydro One and hearing participants. A What's New alert will be issued to the OEB website.

A Backgrounder to the Decision and Order has been prepared (and will be updated as necessary for each stage of rates finalization).

Key Messages

The total impact to customers' monthly electricity bill is expected to be $0.23 per month in 2017 and $0.43 per month in 2018.

- The electricity bill for an average residential electricity customer is expected to increase by slightly less than 0.1% ($0.23) in 2017 and 0.2% ($0.43) in 2018, when transmission rates are finalized.
- **The precise bill impacts as a result of this decision will be determined with the Draft Rate Order is filed by Hydro One**.
- The OEB's rate review process helps control costs while maintaining the needed investments in Ontario's electricity grid.

The OEB sets rates and prices in a manner that balances the interests of consumers with those of utilities. (Re: capital budget)

- The OEB found that Hydro One's proposed capital budget for 2017 and 2018 has not been fully justified (reasons are outlined in section 4.3 under Findings).
- The OEB believes that there is room for further optimization and prioritization in Hydro One's overall capital investment program.
- The OEB has therefore approved a capital envelope of $950 million for 2017 and $1,000 million in 2018.
- **This is a reduction of $126.1 million in 2017 and $122.2 million in 2018.**

If pressed on why the OEB approved a capital envelope instead of a specific set of projects:

- The OEB believes that, through appropriate risk management and prioritization, Hydro One should be able to achieve its objectives of responsible asset management within the approved capital envelope.

The OEB holds utilities to account for the cost effectiveness and efficiency of its operations before approving a rate increase. (Re: OM&A)

- The OEB finds that Hydro One's amounts for OM&A costs – specifically as they relate to compensation, which Hydro One seeks to recover from transmission services ratepayers, is unreasonably high.
- **The OEB is reducing Hydro One's OM&A envelopes by $15.0 million in both 2017 and 2018.**

- The OEB approves $397.7 million
  OM&A envelope for 2017 and $394.3 million for 2018 to reflect the unreasonable levels of compensation sought to be recovered from ratepayers.
- **This reduction reflects the OEB's findings that Hydro One's increased levels of compensation for senior executives, directors and other managerial personnel should NOT be recovered from ratepayers.** (Found under OM&A Envelope Reduction Related to Compensation – Findings)

Tax Issue Summary

The Province's sale of its Hydro One Limited shares means that the company became subject to federal income tax legislation and subject to a provincial departure tax as they were no longer part of the provincial Payment in Lieu of Taxes (PILs) regime. By losing their PILs status, Hydro One Ltd. became subject to a one-time departure tax which they decided not to recover from ratepayers. As Hydro One absorbed this cost, it believes that they should be allowed to recapture funds granted from the sale of 15% of the shares of Hydro One Ltd. at the time of the IPO. It is estimated that the future tax benefits will total approximately $2.6 billion. In their Transmission rate application, Hydro One proposes to allocate 100% of their future tax savings to its shareholders.

The OEB has denied this request.

The OEB has ordered that the tax benefits be allocated between the shareholder and ratepayers based on a ratio of 71% and 29%, respectively. The OEB panel has estimated that this revised allocation would reduce grossed up taxes proposed by Hydro One of $81.9 million in 2017 and $89.6 million in 2018 to about $58.1 million and about $63.6 million in each of those years, respectively.

Tax Issue – Key Messages (Reactive only)

The OEB balances the interests of consumers with those of utilities.

- **The OEB rejected their request for 100% of their future tax savings to go to their shareholders, and instead deemed that a portion of future recoverable tax savings should go back to ratepayers.**
- The allocation of any tax savings to shareholders should be limited to 71%. The remaining 29% annual allocation of tax savings should go to ratepayers.

Background:

- In November 2015 Hydro One completed an Initial Public Offering (IPO) totaling approximately 15% of Hydro One's common shares.
- Up to the date of the IPO, Hydro One was a tax exempt corporation under both the Federal and Ontario Tax Acts. They were instead required to make Payments in Lieu of Taxes (PILs) to the Province as dictated by the Electricity Act.
- Because of the IPO, Hydro One lost its tax exempt status because more than 10% of the company is now owned by private investors.
- The Electricity Act then dictates that a departure tax must paid by utilities once they are no longer tax exempt (as Hydro One was). Hydro One had to pay a departure tax of $2.6 billion, which was funded by the Province of Ontario.

- In this Transmission cost of service
  application, Hydro One acknowledged their change in tax status (I.e. departure from the PILs regime) and the resulting departure tax that was paid.
- Hydro One does not seek recovery from ratepayers of the departure tax. However, they do make reference to the future tax asset and request in their recent Transmission cost of service application that 100% or recoverable tax benefits be allocated to their shareholders.
- The OEB wrote an interrogatory requesting explanation as to why none of the tax benefits are being allocated in favour of the ratepayers.
  - Hydro One believes cited the fact that as they incurred a departure tax cost for which they have not sought recovery of from ratepayers, the allocation of 100% of the tax benefits to the shareholder is justified.

How did the OEB decide how much of the recoverable tax benefits should go to Hydro One's ratepayers versus their shareholders?

- In determining the appropriate allocation of these tax benefits between the shareholder and ratepayer, the OEB relied on the principles from a previous case to inform their decision.
  - For background info: Case was RP-2004-0188, released May 2005. This proceeding was initiated by the OEB to determine and decide on the key issues for the publication of the 2006 original Rate Handbook which provided a guide as to how distribution rates would be determined in the relatively new regulatory environment, including tax principles. Hydro One was a involved in the consultation process.
- This case addressed a similar matter, mainly the allocation between the shareholder and ratepayer of tax benefits that arose from a deemed sale of utility assets at fair market value that occurred as a result of an October 1, 2001 directive from the Minister of Finance.
- The OEB applied these principles to this current case to determine the future tax savings allocation in a manner that maintains consistency with the principles expressed in the May 2005 Report.
- The OEB's believes that the implementation of these principles (the sharing of future tax savings), succeed in balancing the interests of ratepayers and those of Hydro One.

Questions and Answers

1. What is the impact of the *Fair Hydro Act* on this application?

For most consumers, the bulk of the impact of the *Fair Hydro Act, 2017* will be on the **Electricity** line of their bills. That is because the *Fair Hydro Act, 2017* is mainly about spreading the cost of investments in Ontario's electricity supply over a longer period of time. It is not about freezing distribution or transmission rates.

The **Delivery** line of the monthly electricity bill covers the cost of delivering electricity from generating stations across the province to your home or business through high voltage (transmission) and low voltage (distribution) lines.

Hydro One needs to continue to maintain its existing transmission wires, equipment and buildings and invest in new ones when needed so that it can keep providing Ontario electricity customers with a reliable supply of electricity and quality of service. Sometimes, that means that that transmission rates may need to go up to cover the cost of providing that service. The same applies to electricity distribution rates from local electric utilities.

As a result, consumers in the province will see their delivery rates fluctuate from time to time over the coming years. But they will also see the Fair Hydro Plan adjustments that will take place through their electricity prices.

2. Why does the OEB even need to run this process and hear this application?

The OEB's role in reviewing rate applications is just as important under the *Fair Hydro Act, 2017* as it has always been. Utilities must still apply to the OEB if they want to change their rates. And it is up to the utility to prove to the OEB that any increases in their costs are justified and why. Before being allowed to raise rates, utilities must show that they are doing everything possible to be more efficient and keep improving.

The OEB will continue to help control costs through its open, robust and inclusive process for reviewing and testing proposed rate increases. And we have a very strong track record of doing just that:

- Since 2009, the OEB has reviewed more than 130 major rate applications and reduced requested rate increases by an average of about 40 per cent.
- Overall, the OEB has kept the annual growth in average distribution rates close to the rate of inflation during the same period.

3. What was the proposed Hydro One Networks' 2017 and 2018 revenue requirement, and what would this September 28th, 2017 OEB Decision and Order allow them?

The revenue requirement amounts that Hydro One asked the OEB to approve are $1,487.4 million for 2017, and $1,558.4 million for 2018, reflecting a year-over-year increase of 0.5% for 2017 over 2016 approved levels, and 4.8% for 2018 over 2017.

While the final revenue requirement amount depends on Hydro One's finalization of its capital spending plans, OEB staff has estimated that the revenue requirement would be reduced by about $39 million in 2017 and $41 million in 2018 (from applied-for amounts). This would represent an estimated reduction of 3.5% in its 2017 revenue requirement and 3.4% in 2018 compared to what Hydro One requested in its application.

4. How much would the requested transmission revenue increase have increased the monthly electricity bill of an average Ontario customer (dollars and percentage), and what would be the bill impacts from this September 28th OEB Decision and Order?

The total bill impact of the Hydro One proposed amounts on medium density residential customers (750 kWh/month) is estimated to be 0.1%, which is approximately $0.23 per month in 2017 and 0.2%, which is approximately $0.43 per month in 2018. For general service energy customers (2,000 kWh/month) the bill impact for transmission- connected customers is estimated to be 0.1%, which is approximately $0.49

per month for 2017 and 0.2%, which is
approximately $0.94 per month for 2018 (assuming that transmission represents about 8.3% of the average transmission-connected customer's total bill).

As a result of the OEB Decision and Order, the actual total bill impact on medium density residential customers (750 kWh/month) is estimated to be 0.1% in 2017 and 0.2% in 2018. For general service energy customers (2,000 kWh/month) the estimated bill impact for transmission- connected customers is estimated to be 0.2% for 2017 and 0.4% for 2018.

The precise bill impacts as a result of this decision will be determined when Hydro One submits their Draft Rate Order on October 10, 2017.

5. What is the difference between the Hydro One Networks' transmission revenue increase application and its distribution rate increase application?

The proposed Hydro One Networks **transmission revenue increase** is to ensure that the company has the revenues to operate, maintain, and renew its electricity transmission assets. These facilities move the electricity produced by electricity generating companies across the province to Ontario's local electricity distribution companies (to whom residential and business electricity customers pay their monthly bills), as well as to large industries. The Hydro One transmission system accounts for about 95% of Ontario's electricity transmission capacity.

Hydro One Networks also owns the province's largest electricity distributor, serving about 1.3 million electricity customers, in both urban and rural areas across the province. It distributes the electricity it receives from the transmission system along its distribution lines to local residential, business and farm customers.

Hydro One Networks has also applied to the OEB to **increase its distribution rates** for its customers. The proposed monthly increase for a typical residential customer using 750 kWh per month would be as follows: for 2018 - $2.79 increase; for 2019 - $2.47 increase; for 2020 - $2.31 increase; for 2021 - $1.95 increase; and for 2022 - $2.23 increase. A hearing for this rate application will take place at the beginning of 2018.

6. What elements of the transmission revenue increase application did the OEB reduce?

The OEB reduced the transmission revenue increase from that requested by Hydro One Networks by denying a portion of the recovery of 2017 and 2018 costs associated with planned capital expenditures, executive compensation, and recovery of taxes from transmission customers.

7. Why did the OEB reduce Hydro One Networks' revenue requirement in these areas?

The OEB decided that some of the costs in these areas do not relate specifically to its transmission business, and relate more specifically to costs incurred by the parent company (Hydro One Limited) that should be borne by its shareholders. Capital expenditure reductions were ordered as the OEB did not feed that some of the proposed spending was fully justified.

8. Did the partial privatization of Hydro One Limited affect its application for a transmission revenue increase?

The partial privatization and transformation of Hydro One Limited did affect the transmission revenue decision in two ways.

First, Hydro One included a portion of the increase in executive compensation in the application. In its decision, the OEB found that certain compensation amounts – related to the transformation of the company from an unregulated holding company to a publicly-traded entity in which the Province now holds a minority interest – were not to be recovered from transmission customers.

Second, certain tax related amounts that may have been recovered from transmission costs were denied by the OEB in its decision.

9. Did the OEB approve the privatization of Hydro One?

No. There is nothing in the *Ontario Energy Board Act, 1998* or the *Electricity Act, 1998* that gives the OEB the power to review or approve the Hydro One share transactions as structured.

It is important to remember that the OEB's approach to regulation is indifferent to ownership. All utilities are held to account in the same way, regardless of who owns them. We will continue to set rates for Hydro One using the same rigorous processes that we always have.

10. Did the Hydro One announced proposed purchase of Avista Corporation affect the transmission revenue increase application?

No. The purchase has not yet occurred; therefore it could not affect the application. Also, the purchase of Avista was done by Hydro One Limited, which is not rate regulated by the OEB, only their transmission and distribution businesses are regulated in this way.

11. What does the OEB do to encourage Hydro One Networks' transmission business to operate as efficiently and cost-effectively as possible to benefit electricity consumers?

Under the OEB's Renewed Regulatory Framework**,** the OEB expects utilities to demonstrate continuous improvements in productivity and cost performance while delivering on system reliability and service quality objectives. The OEB expects utilities to set performance targets with the objective of continuous improvement through the use of benchmarking, including unit cost benchmarks. These benchmarks are relied on to compare a utility's year-over-year performance to that of its reasonably-comparable peers, as well as to its own year-over-year performance in the historic and bridge years and its expected performance in each of the years in the prospective test period.

The OEB requires that utilities publish an annual scorecard to show progress on operational effectiveness and in a rate hearing, the utility must outline its business objectives to drive cost reductions and productivity improvements.

Tax Savings Question:

12. The OEB granted Hydro One the ability to give its shareholders the majority of its recoverable tax assets instead of giving it back to their ratepayers. How is this an example of the OEB standing up for consumers? Shouldn't the OEB have forced Hydro One to give it all back to the ratepayers?

Hydro One's application sought to recoup 100% of its anticipated future tax savings back to its shareholders. The OEB found that this was unreasonable. Instead, future tax savings will be shared between ratepayers and shareholders.