HYDRO ONE'S TRANSMISSION RATE APPLICATION AND DEFERRED TAX BENEFIT (DTB)

ISSUE

As part of Hydro One's rate application process, the Ontario Energy Board (OEB) is reviewing whether the deferred tax benefit (DTB) recorded by Hydro One as a result of the 2015 initial public offering (IPO) should be somehow allocated to the benefit of ratepayers rather than shareholders.

CONTEXT

- 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.
- In the on-going hearing on Hydro One's 2017-2018 rates for transmission (Tx), OEB staff have flagged the deferred tax recovery portion of $2.619 billion, and as it relates to the transmission business (so far the discussion has not yet included the portion related to the additional PILs nor on distribution rates as they are not part of the on-going rate application). The analysis that follows is based on the full $2.810 billion benefit.
- The deferred tax asset currently on Hydro One's financial statements reflects the expectation that cash taxes payable by Hydro One will be reduced for some period into the future. This provides Hydro One with cash savings.
- While Hydro One's cash taxes payable will be reduced, it would still recognize a non-cash tax expense, based on statutory tax rates and amortisation of the deferred tax asset for financial reporting purposes. In other word, Hydro One's net income is not expected to change everything else constant.
- Hydro One is seeking recovery of this statutory rate tax expense when requesting transmission and distribution rate approvals from the OEB, similarly as it had in previous rate periods under the PILs

regime.

- A decision on whether Hydro One can recover this amount from ratepayers through rates could have significant impacts for the Province and Hydro One.

- Under the PILs regime, Hydro One had been recovering in its regulated rates an amount based on the statutory tax rate. For PILs purposes, the tax depreciation expense reduced its taxable income under the PILs regime, reducing its cash PILs below the statutory tax rate amount recovered in rates.
  - As it would be expected that, once the assets had been fully depreciated for tax purposes, the tax depreciation expense in the future would be less, Hydro One would then have been expected to pay higher cash PILs in the future – resulting in a higher effective tax rate paid than the statutory rate. Hydro One recorded a deferred tax liability under the PILs regime to reflect this.
  - As Hydro One exited the PILs regime, there was true-up of the above as the associated departure tax was paid in cash by Hydro One.
    - This resulted in the deferred tax liability being reduced to zero.
    - For greater clarity, the departure tax payment is not included in Hydro One's rate application for recovery from ratepayers.
  - The departure tax amount paid was greater than the deferred tax liability on Hydro One's books prior to the IPO, as the fair market value of the assets was greater than the original book value.
    - Hydro One recorded a deferred tax asset on entering the corporate tax system, reflecting the expected impact on its future cash tax payments arising from future tax depreciation expenses (capital cost allowances from the newly set fair market value of assets) to reduce taxable income while Hydro One was expecting to be able to recover in revenues an amount for taxes at the statutory rate.
    - The deferred tax benefit (DTB) impact on Hydro One's net income was equal to the combined amount of the elimination of the deferred tax liability and the amount of the deferred tax asset recorded.
    - While the deferred tax liability elimination portion of the departure tax could be seen as reflecting what Hydro One had already recovered from ratepayers in past rates (reflecting recovering of taxes in rates at the statutory tax rate), the deferred tax asset amount effectively reflects future recovery based on statutory vs effective tax rates.

STAFF DISCUSSION

<u>Fiscal Impacts to the Province / Hydro One</u>

- Should the OEB allocate the DTB as a benefit to ratepayers, the Province would face significant negative fiscal impacts, including the following:
  - Up to approximately $2.4 billion, upfront or over time. (OEB treatment for Hydro One's transmission business is also likely to affect the expected treatment for its distribution

business, therefore affecting the DTB amount for both).

   - Lower share prices, reflecting material decreases in future revenues/cash flows. This would affect future gains on sales (potentially offset by an upfront reduction in the book value of the shares from the above impact.

- The size of the fiscal impact would depend on how the OEB provides the benefit to ratepayers, in other words, how much revenue is disallowed and over what period.
- The OEB could determine that Hydro One's revenue requirement will be reduced over time by the cash tax savings from the DTB, potentially leading to annual declines in net income.
   - Would need to assess if this would result in an upfront impact from an elimination of the deferred tax asset. Note that Hydro One is not able to avoid all tax cash payments as it still has to pay the Provincial minimum corporate tax in cash (about $25M per year).A detailed assessment of Hydro One's tax income position is provided to the OEB by the company on EB-2016-0160, Exhibit C1, Tab 8, Schedule 1.
- An OEB decision to allocate the DTB as a benefit to ratepayers could have indirect fiscal and related impacts going forward and when considering future share sales:
   - **Book Value of Hydro One Shares:** Any negative impact to Hydro One's net income would reduce the book value of Hydro One's shares.
      - A lower book value would increase the gains from future share sales, all else equal.
      - For Hydro One, a lower book value would cause its debt to capital ratio to rise, which could impact Hydro One's bond rating.
   - **Hydro One Share Prices:** Any negative impact to Hydro One's net income and/or its cash flows would likely have a negative impact on Hydro One share prices.
      - With 595 million common shares outstanding, the deferred tax benefit represented an approximate value of $4.72 per share to common shareholders, or 23% of the value of the common shares at the time of the IPO.
      - At Dec. 31 2015 Hydro One was carrying a deferred tax asset of $1,629 million.
      - Under a scenario where the DTB is allocated to ratepayers, there would likely be a material decline in the share price as company value would be negatively affected, given reduced net income and cash flows to finance capital expenditures and pay dividends.
   - **Communication Issues:** Given the Province's progress and commitment in selling down its ownership stake in Hydro One, there could be communication issues if the Province is perceived as extricating itself from its position ahead of a potentially material negative decision made by the OEB.
      - Hydro One did flag 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. It 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.

Impacts to the Trillium Trust

- As part of the net revenue gains associated with the IPO of Hydro One, the Province passed a regulation recognizing $2.4 billion in non-cash fiscal benefits of the DTB to be credited to the Trillium Trust.
    - Should the OEB allocate some or all of the DTB to the benefit of ratepayers, the Province could be criticised for crediting the Trust with this amount and may face pressure to introduce a regulation to reverse this credit from the Trust.
    - Note that the $2.4 billion fiscal benefit from the DTB is a key component of the Province's commitment to dedicate $4 billion in net revenue gains to the Trillium Trust from broadening Hydro One ownership, and the Province's overall $5.7 billion asset optimization target.
    - Should the Province's portion of DTB be written down as of January 1, 2017 a share price of $27.75 in 17-18 and 18-19 would be required in order to achieve a target of $4 billion in net revenue gains from the Trillium Trust.
        - Note that under this scenario, the Province would only recognize a proportional writedown on its share of 70% (its share of net income at the time) of the $2,619 value of the DTB under consideration by the OEB .

Backgrounder on DTB

- A "departure tax" may be triggered as a result of a sale, cumulatively, of more than 10 per cent of an municipal electricity utility to the private sector, in which case the utility leaves the PILs regime and enters into the regular corporate tax regime.
- A deferred tax benefit may also be triggered upon exit of the PILs regime and entry into the corporate tax regime resulting from the revaluation of the company's assets at fair market value. This can offer a higher shield from future taxes in the form of higher tax depreciation expense going forward, assuming that the assets are revalued at a higher level.
- The amount of the deferred tax benefit represents an upfront recognition of the reduction in future cash taxes payable by the company. While this provides an up-front, non-cash gain to the company, this does not represent additional incremental revenues to the company over time or result in any incremental change to electricity rates.
    - Stakeholders, however, may take a position that an OEB structure that allows a regulated company to recover in rates a tax amount based on statutory rates on regulatory table income should be changed.
    - Any change that negatively affected Hydro One's revenue from approved regulated rates would have a negative impact on the company, and a positive impact on ratepayers (at least in the short-term, other things held constant).

Strategic Investment and Finance Branch
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