Hydro One Networks Inc.
7th Floor, South Tower
483 Bay Street
Toronto, Ontario M5G 2P5
www.HydroOne.com

Tel: (416) 345-5393
Fax: (416) 345-5866
Joanne.Richardson@HydroOne.com

Joanne Richardson
Director – Major Projects and Partnerships
Regulatory Affairs

BY COURIER

April 7, 2017

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

Dear Ms. Walli:

EB-2016-0276 – Hydro One Networks Inc. MAAD S86 to Purchase all of the issued and outstanding shares of Orillia Power Distribution Corporation – Argument in Chief

In accordance with Procedural Order No. 5, please find attached Hydro One Networks Inc.'s Argument in Chief.

An electronic copy of this cover letter and Argument in Chief has been filed through the Ontario Energy Board's Regulatory Electronic Submission System (RESS).

Sincerely,

ORIGINAL SIGNED BY JOANNE RICHARDSON

Joanne Richardson

EB-2016-0276

IN THE MATTER OF an application made by Hydro One Inc. for leave to purchase all of the issued and outstanding shares of Orillia Power Distribution Corporation, made pursuant to section 86(2)(b) of the *Ontario Energy Board Act, 1998*.

AND IN THE MATTER OF an application made by Orillia Power Distribution Corporation seeking to include a rate rider in the 2016 Board-approved rate schedules of Orillia Power Distribution Corporation to give effect to a 1% reduction relative to 2016 base distribution delivery rates (exclusive of rate riders), made pursuant to section 78 of the *Ontario Energy Board Act, 1998*.

AND IN THE MATTER OF an application made by Orillia Power Distribution Corporation for leave to transfer its distribution system to Hydro One Networks Inc., made pursuant to section 86(1)(a) of the *Ontario Energy Board Act, 1998*.

AND IN THE MATTER OF an application made by Orillia Power Distribution Corporation seeking cancellation of its distribution licence, made pursuant to section 77(5) of the *Ontario Energy Board Act, 1998*.

AND IN THE MATTER OF an application made by Hydro One Networks Inc. seeking an order to amend its distribution licence, made pursuant to section 74 of the *Ontario Energy Board Act, 1998*, to serve the customers of the former Orillia Power Distribution Corporation.

HYDRO ONE INC. ARGUMENT-IN-CHIEF

April 7, 2017

Introduction

1. Hydro One Inc. ("HOI") provides its Argument-in-Chief in accordance with the Ontario Energy Board's ("OEB" or "Board") directions set out in Procedural Order No. 5 dated March 27, 2017.

2. This Application arises due to a commercial transaction involving, among others, the Corporation of the City of Orillia (the "City"), Orillia Power Corporation (the "Vendor") and HOI (the "Purchaser"). As described in the Application, HOI has agreed to acquire all of the issued and outstanding shares of Orillia Power Distribution Corporation ("OPDC") and thus requires leave of the Board in accordance with section 86(2)(b) of the *Ontario Energy Board Act, 1998*.

3. The Board is also requested to approve a rate rider in the 2016 Board-approved rate schedules of OPDC, to give effect to a 1% reduction relative to 2016 base distribution delivery rates (exclusive of rate riders).

4. Hydro One is seeking approval to implement an Earning Sharing Mechanism ("ESM") to operate during the extended deferred rebasing period (i.e., years six to ten), which will guarantee a benefit to OPDC customers.

The Transaction Satisfies the No Harm Test

5. The no harm test is used to assess MAAD transactions. The Handbook states that the "no harm" test considers whether the proposed transaction will have an adverse effect on the attainment of the OEB's statutory objectives. The primary focus in applying this test has been on the impacts of the proposed transaction on price, quality of service and the cost-effectiveness, economic efficiency and financial viability of the industry.

6. The impacts of this transaction in relation to the Board's "no harm" test have been addressed throughout this proceeding, with the following justifying why the "no harm" test is satisfied:

Operational Cost Savings

7. This transaction eliminates duplication of effort between Hydro One and OPDC and results in a single electricity service provider for the Orillia area. This will ultimately drive down cost structures across both Hydro One and OPDC service areas. Hydro One has provided evidence that there are significant ongoing savings as a result of this transaction[1]. Hydro One has provided evidence that the ongoing OM&A cost savings expected to result from the transaction are approximately $3.9 million per year - a 60% reduction in OPDC's 2015 OM&A costs. Capital expenditures are also expected to be reduced by roughly $0.6 million per year. These savings are achieved by the elimination of redundant activities and operations through amalgamating the two utilities and leveraging Hydro One's economies of scale (see **Exhibit A, Tab 2, Schedule 1, section 2.2**). OPDC's annual OM&A cost/customer for 2015 is $362. Comparatively, Hydro One's evidence is that Hydro One's annual OM&A cost/customer for 2015, in its most comparable rate class, the Urban Rate class, is $173. For these reasons, Hydro One believes the cost savings forecast in this transaction are attainable.

8. These savings depict the ongoing benefits of consolidation that were originally contemplated by the Ontario Distribution Sector Review Panel Report: "Renewing Ontario's Electricity Distribution Sector: Putting the Customer First", as well as the Commission on the Reform of Ontario's Public Services: "A Path to Sustainability and Excellence". These reports together formed the basis of the OEB's current consolidation policy – "Rate-Making Associated with Distributor Consolidation"[2] ("the Amended Report").

Reliability

9. Hydro One has provided evidence that it currently serves customers in Orillia and that the reliability results for those existing Hydro One customers in the vicinity of

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[1] Exhibit A, Tab 2, Schedule 1, Table 1
[2] EB-2014-0138

the OPDC service area are similar to that experienced by current OPDC customers. Hydro One's evidence is that it anticipates reliability may in fact improve by eliminating the artificial electrical border and by optimizing resources of both utilities in the broader Orillia area[3]. Notwithstanding the anticipated savings in both OM&A and capital, the adequacy, reliability and quality of service of OPDC's distribution system will not be impacted as a result of this transaction.

ESM

10. Hydro One has selected a 10-year deferred rebasing period and, in concert with that, Hydro One has a proposed an ESM consistent with the Amended Report. The ESM will operate in years six to ten of the extended deferred rebasing period. Hydro One has proposed an ESM based on forecast cost savings that will provide OPDC customers with a cumulative $3.4 million sharing of forecast earnings, corresponding to approximately 45% of OPDC's current Board approved revenue requirement. To track future actual overearnings, would require separate financial statements for the OPDC business segment. As Hydro One has indicated, in order to maximize the benefit of the consolidation, Hydro One will not keep separate financial statements for the OPDC business segment. To do so would decrease forecast synergies by adding both one-time and ongoing costs. Therefore, the proposed ESM on forecast savings is a practical and cost-effective method for maintaining the intent of the Board policy. Hydro One's ESM not only protects ratepayers but guarantees OPDC's ratepayers a sharing of the benefits of consolidation by transferring all the risks of achieving the forecast savings to Hydro One. This means that, no matter what, ratepayers will receive $3.4 million, a substantial amount of money.

11. Key aspects of Hydro One's proposed ESM are:
    - *Term and Eligibility* – Hydro One is proposing to implement an ESM in years six through ten of the deferred rebasing period. In that period, excess earnings

[3] Exhibit A, Tab 2, Schedule 1, Page 7

above 300 basis points on the allowed ROE will be shared 50/50 with the customers of the former OPDC.

- *Mechanics of the ESM* – The ESM has been calculated on forecast OM&A and capital costs based upon Table 1 of the evidence provided in **Exhibit A, Tab 2, Schedule 1**.
- *Ratepayer refund* – The projected overearning amounts shared with customers will be recorded in a regulatory account, interest-improved, and used to offset future rate mitigation that might be required after the deferral period.

12. Hydro One has applied a 20% risk factor to OM&A costs in the calculation of earnings. The risk factor negates a portion of all risks, both within and outside Hydro One's control [(e.g., weather impacts (storm damage, load), interest rates, inflation, customer growth, etc.] that are absorbed by Hydro One over the 10-year planning period. Notwithstanding the 20% risk factor adjustment, the OM&A savings forecast by the transaction would still be comparable or better than other mergers and acquisitions in the industry to date (see **Exhibit I, Tab 1, Schedule 18**).

13. In calculating the ESM values to be shared with ratepayers, as shown in Table 6 of **Exhibit A, Tab 3, Schedule 1**, Hydro One has used OPDC's approved debt rate. Hydro One is proposing to maintain the same debt rate throughout the 10-year deferral period. The inability to modify debt rates is a risk that Hydro One is undertaking in proposing the guaranteed ESM sharing amount. This means that if debt rates were to rise in the ten-year period, Hydro One's forecast earnings would diminish and OPDC ratepayers would still receive the same ESM over-earnings refund.

14. Hydro One has used OPDC's approved ROE in calculating the ESM. SEC questioned whether Hydro One's current approved equity should be utilized to calculate the ESM over-earnings refund. The Consolidation Handbook indicates that rate resetting during the deferred rebasing period is based upon the principles

under the OEB's RRFE. Each of the rate-setting mechanisms available provides that an annual adjustment mechanism be applied to current approved rates. Future annual adjustments are limited to inflation and productivity factors; changes to the utility's approved ROE or its debt rates are not contemplated under the OEB's RRFE annual adjustment mechanisms. For these reasons, using OPDC's approved ROE is the approach that is most consistent with current Board policy.

15. If the proposed ROE and debt rates used to calculate the ESM are not accepted, then the ESM as proposed would be subject to annual true-up for both ROE and debt rates. The calculation would be based upon the same rate base, OM&A and depreciation outlined in Table 6 of **Exhibit A, Tab 3, Schedule 1**, but the calculation of interest expense, net profit and overearnings would be adjusted to take into account the change in both debt and equity rates. Hydro One contends that the debt and equity rates used are the appropriate rates to calculate the ESM. To do otherwise would transfer economic risk associated with the variables aforementioned back to the ratepayers of OPDC.

16. CCC asked Hydro One if it would support modifications to the ESM, e.g., the commencement of the ESM to effectively start immediately and to share 100% of the achieved savings with ratepayers.

17. The OEB policy makes it clear that there should be an appropriate balance of benefits and risks shared between ratepayers and the shareholders of the consolidated entity in order to incent consolidations and efficiencies in the industry. As outlined in **Exhibit I, Tab 4, Schedule 15**, Hydro One's ESM is consistent with the Board's policies, e.g., the ESM is in effect in years six through ten, and savings over 300 basis points should be shared on a 50/50 basis with ratepayers. This encourages LDCs to maximize savings during the deferred rebasing period to the ultimate benefit of customers.

Premium Impact

18. HOI is provided the opportunity to recover transaction costs and premiums, and ratepayers share in cost savings and efficiencies commencing in year 6 through to year 10. In the longer term, achieved savings reflected in lower cost structures are ultimately passed onto all ratepayers through the rebasing process. Any premiums associated with this transaction will not be recovered from ratepayers of either utility, and the transaction will not have a material impact on the financial viability of HOI.

Other Items

19. Tax: SEC expressed concerns with the tax and PILS impacts of the transaction in light of Hydro One's change in status from exempt under the *Income Tax Act, Canada* to taxable in 2015. This issue was also explored in Hydro One's recent transmission rate filing application – EB-2016-0160. Hydro One, as part of this transaction, purchased the deferred tax asset. This is included in the premium paid. Based on the regulatory principle that benefits follow costs and given that the premium paid is not a cost recoverable in rates, the benefit arising from the deferred tax asset should accrue solely to shareholders. The premium paid on the transaction and the departure tax liability resulting from OPDC departure from the PILs regime will not impact the books and records upon which rates are set: there is no impact on the ratepayer. The premium is financed by the shareholder and is outside the rate-regulated construct and will not be recovered from ratepayers. As such, the benefit arising from the deferred tax benefit should also accrue to the shareholder. Further information can be found in **Exhibit I, Tab 5, Schedules 3 and 18**.

Specific Service Charges

20. Board Staff questioned Hydro One on transitioning OPDC customers to Hydro One's current Specific Service Charges ("SSC"). These SSCs apply to a small subset of customers. To transition the customers to Hydro One's SSC is the most cost-effective solution as it would not require billing system modifications and/or

manual workarounds. The rates that OPDC is currently charging are based on the *2006 OEB Distribution Rate Handbook* and can no longer be considered cost-based rates. Hydro One has requested changes to its SSCs to reflect more accurate costs to provide the specific services as requested by the Board. Hydro One submits that these would be the appropriate rates to also charge OPDC customers. If and when the OEB does approve new SSCs for Hydro One, Hydro One would submit a new draft rate order to reflect these new SSCs for the current OPDC service territory. Prior to the approval of new Hydro One SSC rates, OPDC customers would be transitioned to Hydro One's existing SSC rates.

<u>Conclusions</u>

21. Hydro One submits that the evidentiary record in this proceeding satisfies the no harm test for the following reasons:
    - The transaction does not cause harm to the Board's fulfillment of its statutory obligations. Leave to purchase all outstanding voting securities of OPDC should therefore be granted.
    - The proposed guaranteed ESM is consistent with the principles of protecting ratepayers and balancing the benefits of consolidation as set out in the Handbook.
    - The transaction will have no adverse impact on the reliability, quality and adequacy of service experienced by customers.
    - The premium will not be recovered from ratepayers and will have no material impact on the financial viability of Hydro One.

All of which is respectfully submitted this 7th day of April 2017.