Opening Statement of R.L. (Randy) Jespersen, CEO on Behalf of the Terasen Utilities

Good morning Mr. Chair, Commissioners and members of the audience.

I am Randy Jespersen, President and CEO of the Terasen Utilities making this application to the Commission.

This application is very important to the Terasen Utilities.

There are two broad topics addressed in the application that I will address in my Opening Statement.

The first topic is the requirement for a fair return on equity, the Commission's current automatic adjustment mechanism for setting return on equity, and the inappropriate results of that mechanism with respect to satisfying the fair return requirement.

The second topic is the increased business risk faced by the Terasen Utilities, arising primarily from the dramatic change that has occurred in government policies and public perception regarding greenhouse gases and the consumption of fossil fuels, and how this change increases the long term risks of gas distribution companies operating in this Province.

Return on Equity and Automatic Adjustment Mechanism

As the Commission recognized in its March 2006 Decision, the Commission has a mandate to ensure that the public utilities it regulates are afforded a reasonable opportunity to earn a fair return on invested capital.

The Commission was the first regulator in Canada to adopt an automatic adjustment mechanism for setting allowed returns for utilities, when it did so in 1994. At the time the formula was adopted, the starting ROE was higher than the average North American Utility returns. Over the first years of the formula, it produced on average, a return on equity that was comparable to those awarded other North American utilities. The formula was linked to long Government of Canada yields for administrative efficiency, which reduced the regulatory burden for utilities, the Commission, and intervenors. The Commission has periodically reviewed and amended the mechanism with the last such hearing in November 2005.

Since the automatic adjustment mechanism was first introduced, and in particular since the Commission's March 2006 Decision, we have seen the returns allowed on our utility investments erode while we have continued to invest in utility infrastructure and have provided safe and reliable service.

Over the past six years Terasen Gas Inc. has operated under a Performance Based Rate settlement that has resulted in level nominal delivery rates for our customers and declining real delivery rates. Customers have truly received increased value in the services that the Terasen Utilities provide, and yet under the current automatic adjustment mechanism the utility's shareholder has been rewarded with declining allowed returns on both an absolute basis, and relative to North American peers.

Such declining returns are not limited to the Terasen Utilities, but are prevalent across Canada for utilities that operate under formula based ROE determinations similar to the formula used in British Columbia.

Over the past 15 years the use of formulas based on long Canada bond yields to set allowed returns on equity has resulted in a current divergence between the returns allowed by Canadian and US utilities of 200+ basis points; where there is no reasonable basis for this difference.

Studies, including one commissioned by the Ontario Energy Board, have concluded that there was no material difference in the cost of capital, tax, regulatory or operating environments between the two countries, nor the technologies employed by US and Canadian utilities, that would justify a difference in the ROE awards of US and Canadian regulators for gas distribution utilities.

For a number of years Canadian utilities have been raising concerns about the automatic adjustment mechanisms used in Canada, and the results of those mechanisms. It is now apparent that concern about the use of these mechanisms has spread beyond the utilities.

Market participants, including equity analysts, debt analysts, rating agencies and industry associations have been studying and providing comments on problems with the formula based adjustment mechanisms in Canada for several years, referring to their inherent shortcomings, suggesting that these mechanisms have outlived their usefulness, and offering the view that the formulaic mechanisms used in Canada have resulted in allowed returns that are at best unfair and at worst, confiscatory (as described by a prominent investment analyst).

Since 1995 the National Energy Board has made use of a formula similar to that used by this Commission to set allowed returns for major pipelines it regulates. However, in its March 2009 Decision respecting Trans Quebec & Maritimes Pipelines Inc. the NEB acknowledged that the formula approach no longer produced a fair return for TQM, setting aside the use of the formula to establish the allowed return for TQM, and adopting a methodology that translates into an increase to both TQM's return and equity component of capital structure.

Following that Decision the NEB advised the companies it regulates and other participants in its proceedings that it was considering a review of the RH-2-94 Decision that implemented the formula based approach; and in July the Board advised that it decided to initiate that review. Submissions to the NEB were to be filed by September 18.

The Ontario Energy Board is undertaking a consultative process on the cost of capital for the utilities it regulates, which process started this past Monday (September 21). There was also a recent generic proceeding in Alberta, an ongoing proceeding in Newfoundland, and perhaps others.

As can be seen by the breadth of proceedings across Canada, the Terasen Utilities are not alone in their view that the fair return standard is not being met, and that the formulaic approach is a contributing factor.

The Terasen Utilities believe it is now time to establish an appropriate return on equity that will meet the fair return standard and are therefore requesting an 11% return on equity as the benchmark. Terasen believes that the ROE should be determined considering a number of methodologies, and not solely the equity risk premium methodology, which has driven down the equity returns allowed for utilities as Canada bond yields have decreased over the period since the mid-1990s.

We believe that the focus on the equity risk methodology is part of the reason the resulting utility returns are unfair. Setting returns solely on the basis of betas and a portfolio investment theory that is far removed from the requirement to invest in pipe in the ground has the potential to lead to unfair returns, which clearly has occurred over the period these formulas have been in place. The Terasen Utilities have introduced equity risk premium evidence in this application, but the evidence of the Companies' experts also provides discounted cash flow analyses, which we believe are important and relevant analytical approaches.

We believe the Commission should also consider the returns of non-regulated enterprises of comparable risk as well. This is consistent with the Commission's 2006 Decision in which the Commission Panel said at page 56:

> …the Commission Panel is not convinced that the [Comparable Earnings] methodology has outlived its usefulness, and believes that it may yet play a role in future ROE hearings.

The Commission must keep in mind that what it will be doing in its Decision on this application is setting an allowed return on the book value of the assets in which the utilities have invested (rate base); the Commission is not setting an allowed return in the stock market. The evidence of Ms. McShane includes the results of the comparable earnings approach, which looks at the return on book value of companies of risk similar to Terasen Gas. This evidence should be considered by the Commission in its determinations on this application.

Terasen Gas is also requesting an increase in the equity component of its capital structure. At the current 35.01%, TGI has the lowest equity ratio of the major Canadian gas distribution utilities, and far below its US peers. The change in capital structure is considered in tandem with the requested ROE to meet the financial integrity and comparability requirements of the fair return standard, which will aid in the attraction of capital on a continuing basis.

In this application, the Terasen Utilities are not seeking unreasonable returns. The requested return is not put forward as a bargaining position with the expectation that the regulator will determine something in the middle between the companies' position and that of intervenors. The Benchmark proposal of 11% ROE on 40% deemed equity is a balanced request. It is well below the 2008 average US regulated LDC capital structure of 50.4% equity and 10.4% return on equity.

Competition for capital across North America given aging infrastructure along with investments required to meet climate change initiatives in the coming years is going to be intense. The Terasen Utilities must compete for capital, both debt and equity, with utilities, other infrastructure providers and the market in general across North America. It is important when establishing an allowed ROE and capital structure that the Commission consider not only the returns awarded by Canadian regulators but also those awarded by US regulators, given the degree of integration of North American capital markets.

This application arises out of fundamental issues of fairness, inappropriate decreases in the allowed ROEs, a lack of comparability of allowed returns with our North American peers, and increasing business risks faced by Terasen Utilities. These issues pre-date the events in the capital markets over the past year. It was anticipated that the Commission's 2006 Decision would survive for five years unless circumstances developed that could lead to formula based awards below 8%.

The events of the past year, that include the re-pricing of risk and flight of capital from corporate bonds and equity to government bonds, thereby driving down the long Canada yield, presented the Terasen Utilities with the scenario of a sub-8% ROE award under the current formula. This was a factor that influenced the timing of this application and served as the catalyst for our request, but this application is not based on those market conditions. The Terasen Utilities are not seeking higher returns because of the swings in capital markets of the past year, although those events demonstrated, as it says in the application, that the formula is broken. The underlying problems of the current formula have existed for many years, and must now be addressed.

Business Risk

This application also addresses the increased business risk being faced by the Terasen Utilities.

It is important to emphasize that the companies' investments are long term and captive to this jurisdiction unlike capital invested by stock market participants. Our investments in utility infrastructure are recovered over a long period, and the Terasen Utilities are facing increasing uncertainty over the competitive and business environment in which these utilities will operate over the longer term.

The evidence is clear. Given government policy pronouncements on climate change initiatives, new legislation and the introduction of carbon taxes, our business risks have increased. Tab 1 of the filed application discusses at length the policies and legislation that have the effect of favouring the use of electricity over natural gas, and will discourage the consumption of fossil fuels, including natural gas, because of concerns regarding greenhouse emissions specifically in B.C..

The recent Provincial Speech from the Throne re-emphasized the risk the Terasen Utilities are facing because of policy initiatives. The Throne Speech said that the government will implement an aggressive new strategy on the challenge of climate change, that green energy will be a cornerstone of B.C.'s climate change plan, that electricity self-sufficiency will be integral to efforts to fight global warming, that this Commission will receive specific direction, and that phasing out Burrard Thermal is a critical component of the Province's greenhouse gas reduction strategy. In our view there can be no doubt that the result of such measures will be increased use of electricity and decreased use of natural gas.

The implications of these policy initiatives are profound for Terasen. Currently the Terasen Utilities generate over $27 million of transportation revenue serving BC Hydro for its gas fired generation facilities at Burrard Thermal and the Island Co-gen Plant. Elimination of gas fired generation by BC Hydro will significantly reduce the revenues of TGI and TGVI. In addition, Municipalities, Universities, Schools and Hospitals are being compelled to reduce their carbon footprint and this sector's actions will further impact revenues and as a consequence our cost competitiveness.

The indirect impact of the general public's perceptions regarding the use of natural gas being a problem rather than part of the solution to climate change has significant potential to result in migration away from natural gas appliances in new applications as well as when capital stock turns over. This is significantly different than in other jurisdictions where consumers are encouraged to use gas in place of electricity and different from recent past when BC Hydro also provided incentives to consumers to use gas appliances rather than electricity.

All of this increases the long-term business risks of the Terasen Utilities.

Summary

The Terasen Utilities have lost ground as a result of allowed return being tied only to declining government bond yields in both an absolute and a relative sense.

The current automatic adjustment mechanism is flawed and does not produce a fair result. We recognize the administrative efficiency of a formula, but that efficiency cannot override the need for a fair result. We will continue to explore an alternate formula, and the other reviews of cost of capital that are occurring in Canada may provide guidance. At this time the Commission must establish a benchmark return that allows the Terasen Utilities an opportunity to earn a fair return on their investments in utility assets. The benchmark for that fair return is 11% on the requested capital structure.

The business risks of the Terasen Utilities have increased.

The application requests an increase in the equity component of Terasen Gas Inc. to 40% of its capital structure. This increase in the equity component is required because of the increased business risks being faced by the company, to ensure that financial integrity and flexibility is maintained, and to allow Terasen Gas to attract capital on a comparable basis to its utility peers in Canada and the United States.