

August 3, 2012

Regulatory Affairs Correspondence
Gas: gas.regulatory.affairs@fortisbc.com
Electric: electricity.regulatory.affairs@fortisbc.com

British Columbia Utilities Commission
Sixth Floor
900 Howe Street
Vancouver, B.C. V6Z 2N3

Attention: Ms. Erica M. Hamilton, Commission Secretary

Dear Ms. Hamilton:

Re: Generic Cost of Capital Proceeding

**FortisBC Utilities (comprised of FortisBC Inc., FortisBC Energy Inc., FortisBC
Energy (Vancouver Island) Inc., and FortisBC Energy (Whistler) Inc.)**

Filing of Evidence

In Order No. G-20-12 (“the Order”), dated February 28, 2012, the British Columbia Utilities Commission (the “Commission” or “BCUC”) established the Generic Cost of Capital (“GCOC”) proceeding under section 82 of the *Utilities Commission Act* (the “UCA” or “Act”). As the Commission stated, the purpose of the proceeding is to establish a method to determine the appropriate cost of capital for a benchmark low-risk utility in British Columbia for 2013 and to establish how the benchmark rate of return will be reviewed and, if required, adjusted on a regular basis. By Order No. G-47-12, the Commission issued the Final Scoping Document for the Proceeding and in subsequent Orders (Order No. G-72-12 and Order No. G-84-12), the Commission determined the Minimum Filing Requirements for Affected Utilities and Regulatory Timetable for the proceeding. In accordance with these orders, the FBCU respectfully submit the attached Written Evidence.

Due to electronic file size, the FBCU’s Written Evidence has been submitted as separate files as follows:

1. FBCU Written Evidence
2. Appendix A – Sections 1 to 2
3. Appendix A – Section 3A – Debt Investment Analyst Reports for FEI
4. Appendix A – Section 3B – Equity Analyst Reports, Beacon to Credit Suisse
5. Appendix A – Section 3B – Equity Analyst Reports, Macquarie to UBS
6. Appendix A – Sections 4 to 11
7. Appendices B to J

Request for Confidentiality for Some Appendices

Pursuant to the Commission's Practice Directive on Confidential Filings, the FBCU request that some documents in Appendices A, B and C be kept confidential. They are filed under separate cover.

The Capital Market reports by Aon Hewitt Limited and Mercer Limited (included in Appendix A – Section 11) need to be treated confidentially as these reports are proprietary information. The Financial Statements for FEVI and FEW (included in Appendix B and C – Section 1) are confidential. Both FEVI and FEW consider their financial statements to be commercially sensitive and are not publicly disclosed; corporate policy is to maintain confidentiality over non-public financial information. For the same reasons, FEVI's offering memorandum (included in Appendix B – Section 4) is also filed confidentially. Furthermore DBRS credit rating reports for FEVI (included in Appendix B – Section 2) should be treated as confidential. The DBRS reports reflect a private rating provided by DBRS and are subject to confidentiality requirements requested by DBRS. In accordance with the Practice Directive, the FBCU request that the reports only be made available to interveners for the exclusive purpose of this proceeding and upon execution of an Undertaking of Confidentiality.

Sincerely,

on behalf of the FORTISBC UTILITIES

Original signed by: Shawn Hill

For: Roger A. Dall'Antonia

cc (e-mail only): Registered Parties

Attachments

TABLE OF CONTENTS

1.	INTRODUCTION AND OVERVIEW	1
1.1	Introduction	1
1.2	Context for the GCOC Proceeding	4
1.3	Overview of FBCU Position on “In Scope” Issues	8
1.4	Outline of the Filing	12
2.	FBCU POSITION AND EVIDENCE ON MATTERS IN ISSUE	14
2.1	Application of the Fair Return Standard to the Benchmark	14
2.2	Rationale for the Selection of FEI as Benchmark	17
2.3	FEI Business Risks Increasing	21
2.4	Proposed ROE for FEI Benchmark	23
2.5	Capital Structure for FEI Should Include 40% Equity	24
2.6	Periodic Review, Not Return to ROE AAM, is Most Appropriate at this Time	27
2.7	Debt Related Matters	29
3.	COMPANY SPECIFIC DOCUMENTS	31
4.	DETERMINING UTILITY-SPECIFIC COST OF CAPITAL	32
4.1	Use of a Generic Methodology or Formula is Not Appropriate	32
4.2	Listing “Generic Concepts”	33
4.3	Joint Hearing for Utility-Specific Cost of Capital	33
5.	CONCLUSION	34

LIST OF APPENDICES

- Appendix A** Company-Specific Information for FEI
- Appendix B** Company-Specific Information for FEVI
- Appendix C** Company-Specific Information for FEW
- Appendix D** Company-Specific Information for FBC
- Appendix E** Evidence of Aaron Engen, Managing Director, BMO Capital Markets
- Appendix F** Opinion of Ms. Kathleen C. McShane, MBA, CFA
- Appendix G** Evidence of Dr. James H. Vander Weide, PhD
- Appendix H** Evidence of the FBCU regarding business risk facing FEI
- Appendix I** Evidence of Concentric Energy Advisors Inc.
- Appendix J** Table of Concordance with MFR

1. INTRODUCTION AND OVERVIEW

1.1 INTRODUCTION

On February 28, 2012, the British Columbia Utilities Commission (the “Commission”) issued Order No. G-20-12, establishing this Generic Cost of Capital Proceeding (the “Proceeding”) under section 82 of the *Utilities Commission Act* (the “UCA”). In subsequent orders, the Commission established the main purposes and scope of the Proceeding in a Final Scoping Document.¹ It issued Minimum Filing Requirements (the “MFR”) for utilities identified by the Commission as Affected Utilities.² The Affected Utilities identified by the Commission included FortisBC Energy Inc. (“FEI”), FortisBC Energy (Vancouver Island) Inc. (“FEVI”), FortisBC Energy (Whistler) Inc. (“FEW”) and FortisBC Inc. (“FBC”) (collectively, the “FortisBC Utilities”, the “Companies”, the “FBCU” or “we” in this Filing). This Filing, including the appended materials and expert reports, is the evidence of the FortisBC Utilities on the matters stipulated in the MFR and provides the necessary evidentiary basis, upon which the Commission can determine a fair return for a benchmark utility in BC.

The Commission identified the main reason for this Proceeding as being the changes in the financial markets since it issued its decision (“2009 Decision”) in the 2009 Return on Equity and Capital Structure Application (the “2009 Application”).³ Expert evidence included with this Filing speaks to the state of the capital markets in 2009 and today. By the time the Commission held the oral hearing for the 2009 Application on September 28 to October 1, 2009, the world had emerged to some extent from the financial crisis that had formed part of the backdrop for the FEU’s⁴ 2009 Application filing. There is continued, and significant, volatility in capital markets. The sovereign debt crisis is a new development in the financial markets since 2009 that poses challenges for capital market participants. The most significant change in the financial markets since the 2009

¹ Order No, G-47-12, April 18, 2012.

² Order No. G-72-12, June 1, 2012.

³ Order No. G-20-12, Appendix B, p.1.

⁴ FEI, FEVI and FEW are referred to collectively as the FortisBC Energy Utilities or FEU in this Filing.

Application is in long-term Government of Canada bond yields, but these low yields are primarily the product of monetary policy and difficult global market conditions that have favoured “safe haven” securities. The FBCU submit that while the Commission’s observation that the financial markets have changed since the 2009 Decision is in part correct, the expert evidence included in this Filing demonstrates that BC utilities on the whole still find themselves challenged with respect to the cost of capital.

The touchstone of this GCOC, as with any cost of capital application, is the Fair Return Standard. It is a fundamental element of the regulatory compact and is captured in section 59(5) of the *Utilities Commission Act*. The Commission has confirmed⁵ that the Fair Return Standard requires that a fair or reasonable overall return (including a return on and of capital) is one that meets all three of the following requirements:

- is comparable to the return available from the application of the invested capital to other enterprises of like risk (comparable investment requirement);
- enables the financial integrity of the regulated enterprise to be maintained (financial integrity requirement); and
- permits incremental capital to be attracted to the enterprise on reasonable terms and conditions (capital attraction requirement).

The FBCU are proposing that FEI, as it exists today, remain the benchmark for the purposes of determining the allowed rate of return for all other BC utilities until the next Commission review of the benchmark. The application of the Fair Return Standard to FEI must account for the risks associated with continued volatility and uncertainty in the financial markets. It must account for the ongoing challenges that FEI and other BC utilities face in attracting capital on reasonable terms and conditions. It must reflect the business risks facing FEI and other BC utilities that define the risk that shareholders of BC utilities face in achieving a fair return on and of their invested capital.

⁵ 2009 Decision, at page 15, citing p.8 of RH-1-2008 in respect of TQM.

The elements that define FEI's business risk include the competitiveness of natural gas to alternative energy sources, such as electricity, and the ability to attract customers and retain its customer base. These two elements influence the volume of natural gas (throughput) flowing through the FEI system. Throughput is the vehicle, from variable rates charged to customers, by which almost all of FEI's investments are recovered. All else equal, if throughput levels decline for whatever reason, FEI's business risk in effect increases. Closely related to business risk is the risk faced by utilities, termed regulatory risk, associated with having to obtain approval from a regulator for rates (and therefore revenues), the cost of capital, as well as new utility investments.

Although natural gas commodity prices have declined since 2009, other countervailing circumstances exist. Factors such as government energy and environmental policy, market trends relating to building construction and energy use, and consumer attitudes towards natural gas remain obstacles for attracting customers and maintaining throughput levels. Data obtained since the 2009 Application further supports the trends identified in 2005 and 2009 related to energy consumption and market share, particularly in the residential market. On the whole, FEI's business and regulatory risk is best characterized as being similar - no lower, and perhaps somewhat higher, than what it was in 2009.

The FBCU are proposing for the benchmark FEI, a 10.5% ROE and maintenance of the current 40% equity component in its capital structure.

The expert evidence included in this Filing demonstrates that the current equity component of 40% is the reasonable minimum equity component. Further, the proposed capital structure should be combined with a ROE of 10.5% to meet the Fair Return Standard in the current market conditions and in light of FEI's overall business and financial risk.

The preferred process for ensuring a return for FEI that meets the Fair Return Standard going forward involves periodic reviews of the benchmark ROE, rather than an Automatic Adjustment Mechanism ("AAM"). This position is supported by the expert evidence appended to this Filing.

1.2 CONTEXT FOR THE GCOC PROCEEDING

The Commission identified the main reason for this Proceeding as being: “Since the issuance of the 2009 Decision, changes have occurred in the financial markets.”⁶ In this section, the FBCU discuss how the financial markets have changed since 2009, and the impact that this has on FEI’s cost of capital. Although financial markets have changed since the time of the oral hearing in the 2009 Application, financial markets, in particular equity markets, remain uncertain. Against the backdrop of ongoing market volatility, the risk factors that have influenced the BC utility business in years past remain relevant today.

Context for the 2009 Application

In May 2009, the FortisBC Energy Utilities (at the time referred to as the Terasen Utilities) filed the 2009 Application. The 2009 Application was premised on FEI remaining as the benchmark utility. The 2009 Application made three key requests in respect of the benchmark utility: 1) that the allowed ROE be increased from 8.47% to 11.00%, 2) that the deemed equity component of the capital structure be increased from 35.01% to 40%, and 3) that the ROE AAM be abandoned. The primary basis for the 2009 Application was that the allowed ROE of 8.47% and equity thickness of 35.01% failed to meet the Fair Return Standard, and that the AAM was broken. The economic turmoil accelerated the 2009 Application. There was a reasonable prospect that the AAM, which was tied to Government of Canada long bond yields, would soon yield an ROE below 8%. The financial crisis of 2008 thus influenced the timing of the Application, but it was not the sole basis for the 2009 Application.

Over the course of the 2009 Application proceeding, financial markets underwent material changes. The 2009 Application was filed on May 15, 2009 following significant turmoil in the financial markets. The Government of Canada 30-year bond yield was approximately 3.90% while the indicative credit spread on a 30-year TGI bond issue was approximately 2.50%, and the TSX was trading at approximately 9,800. By the time of

⁶ Order No. G-20-12, Appendix B, p.1.

the oral hearing for the 2009 Application, the corresponding data were approximately 3.85%, 1.75%, and 11,400.

The FEU articulated in the 2009 Application that the trend of increasing business risk that the FEU had identified in the 2005 ROE and Cost of Capital Application (“2005 Application”) was continuing.⁷ The FEU also identified some new business risk factors.

In the 2009 Decision, the Commission agreed with significant aspects of the FEU’s position on the Fair Return Standard and how it is to be determined. It also accepted key aspects of the FEU’s evidence regarding FEI’s business risks. The Commission noted, for example:

“It also agrees with Terasen that the combination of the equity ratio and the allowed return thereon should be adequate to attract capital on reasonable terms and conditions and allow TGI to maintain the A3 rating on its debt and unsecured debt from Moody’s.” (p. 15)

“As for the US data, the Commission Panel agrees with the NEB and AUC that utilities in Canada need to compete for capital in the global market place, and regulatory agencies in Canada have to ensure that utilities subject to their jurisdiction are allowed a return that enables them to do so.

In addition, the Commission Panel continues to be prepared to accept the use of historical and forecast data of US utilities when applied: as a check to Canadian data, as a substitute for Canadian data when Canadian data do not exist in significant quantity or quality, or as a supplement to Canadian data when Canadian data gives unreliable results. Given the paucity of relevant Canadian data, the Commission Panel considers that natural gas distribution companies operating in the US have the potential to act as a useful proxy in determining TGI’s capital structure, ROE, and credit metrics.” (p. 15-16)

⁷ 2009 Application, page 24-25

“The Commission Panel has considered the three approaches to determining ROE for a regulated utility and agrees with Terasen that it should take all three into account when establishing an ROE.” (p. 44)

“The Commission Panel determines that, in its present configuration, the AAM will not provide an ROE for TGI for 2010 that meets the fair return standard.” (p. 72)

“The Commission Panel agrees that a single variable is unlikely to capture the many causes of changes in ROE and that in particular the recent flight to quality has driven down the yield on long-term Canada bonds, while the cost of risk has been priced upwards.” (p. 73)

“In the Commission Panel’s opinion, reliance on CAPM by Canadian regulatory agencies has also contributed to the divergence between Canadian and US allowed ROEs. In light of the limited weight given by the Commission Panel to CAPM in determining the ROE for TGI for 2010, it would seem inconsistent to retain the adjustment mechanism.” (p. 73)

“The Commission Panel considers that TGI’s business risk has increased since 2005. In the Commission Panel’s opinion the additional risk suggest an equity ratio for TGI of 40%.” (p.37)

Although the Commission agreed with key aspects of the FEU’s evidence, it determined that the allowed ROE for FEI should be set at 9.50% based on a capital structure including 40% equity. The outcome was less than what the FEU had sought, and less than what had been identified by the FEU’s experts as the return required to meet the Fair Return Standard. It was, however, higher than the return yielded by the AAM, and thus the 2009 Decision represented an improvement in the overall financial position of the FEU.

Developments Since the 2009 Decision

The changes in financial markets since 2009 are well documented in the evidence of Ms. Kathy McShane of Foster Associates (see Appendix F) and Mr. Aaron Engen, Managing

Director with BMO Capital Markets (see Appendix E). They describe how capital markets remain in a period of turmoil. In contrast to the 2008 crisis, which was a crisis within the financial sector that led to governments providing financial support, this current turmoil is marked by concern over sovereign nations and the fact that a coordinated bailout of these sovereign credits will be more difficult.

A significant result of the situation described by Ms. McShane and Mr. Engen is the current low yields on Government of Canada long-term bonds. In the 2009 Application, the FortisBC Energy Utilities observed that the decrease to sub 4% yields on Government of Canada long-term bonds was in part a 'flight to quality', as investors moved into government bonds from riskier assets. Today, the long-term Canada bond yields are sub 3%, but, as noted by Ms. McShane, the recent downward trend is primarily a function of an increase in investor risk aversion, monetary policy, weak economic conditions, and a smaller supply of safe haven assets, and not indicative of a reduction in utility risk or the market cost of equity.

Mr. Engen also describes the state of equity markets in Canada. While markets have not hit the lows of early 2009, the level of and volatility in the equity markets currently are similar to those prevailing at the time of the oral proceeding in the 2009 Application, while investor confidence is weaker. Equity markets are directly relevant in the determination of the appropriate ROE. In Mr. Engen's opinion, the current tone of the equity markets support an increase in the allowed ROE for the benchmark, FEI.

As referenced above, the 2006 and 2009 Decisions approved increases to the equity component of FEI's capital structure on the basis of the business risks it faced. The business risks identified in 2009 remain relevant today. The operating cost of natural gas compared to electricity has improved due to the reduction in natural gas commodity prices, but the energy decisions of consumers and developers are also influenced by other factors such as capital cost of equipment, type of housing being constructed, municipal requirements, efficiency standards, and perception of electricity as a cleaner energy source. Data that post-date the 2009 Application re-confirms the concerning trends that FEI had identified in 2005 and 2009 relating to energy consumption and natural gas market share. Recent government policy has encouraged Liquefied Natural

Gas (“LNG”) for export and the use of natural gas for transportation purposes, but the key elements of government energy and environmental policy still favour electricity development over natural gas consumption in FEI’s core heating business. FEI’s overall business risk remains at least as high, if not higher, compared to 2009. FBCU’s evidence on the business risks faced by FEI is included in Appendix H. Ms. McShane discusses FEI’s business risk and articulates how business risks are considered in the context of determining the appropriate ROE and equity thickness. Dr. Vander Weide (Appendix G) also discusses how investors consider business risk.

The Path Forward

The 2009 Decision resolved the issue of the broken AAM and the allowed return was an improvement on the overall return for the benchmark utility; however, the evidence in this Filing demonstrates that the cost of capital for the benchmark FEI is higher than what the Commission allowed in 2009. The totality of the evidence included with this Filing supports FBCU’s position that the Fair Return Standard is met for the benchmark FEI by the requested ROE of 10.5% on an equity component of 40%.

1.3 OVERVIEW OF FBCU POSITION ON “IN SCOPE” ISSUES

Order No. G-47-12 defined the scope of this Proceeding by reference to several issues. The Commission later clarified some of these issues in Order No. G-72-12. Below, we summarize FBCU’s position on the “in-scope” issues identified by the Commission. The FBCU submit that the evidence in this Filing, including the Companies’ business risk evidence and the appended expert reports, support the positions articulated below. The Filing provides a sound evidentiary basis upon which the Commission can determine the cost of capital for FEI as the benchmark utility. FBCU expand on these positions, with reference to specific evidence, in Section 2.2 of this Filing.

FEI as the Benchmark

Order No. G-72-12 specified that Affected Utilities are to identify what they consider to be the appropriate benchmark, and then provide the required information in the Minimum Filing Requirements “Other Filing Requirements” in respect of the selected benchmark

only. The FBCU submit that the appropriate benchmark utility at this time is FEI, with its current characteristics and before any amalgamation takes place. If amalgamation takes place, FEI *in its present state* can remain as the benchmark utility until the next comprehensive cost of capital review.

Ms. McShane confirms that FEI remains the logical choice for the benchmark utility at this time. FEI is the largest investor owned utility in BC. Unlike other investor owned utilities in BC, there is a significant body of evidence that has been developed in recent proceedings that help to define FEI's financial and business risk profile. The FBCU submit that FEI is not a "low risk benchmark"⁸; however, a benchmark need not be "low risk" to be an effective point of comparison for establishing the cost of capital for other BC utilities. The most important characteristic of a benchmark is that its characteristics and business risks are capable of objective determination.

Ms. McShane discusses that the purpose of designating a benchmark utility is to serve as a point of departure to establish the cost of capital for other BC utilities. It is impractical to use a fictitious entity for this purpose. The key benefit of designating a real entity as the benchmark utility is that its characteristics and risks can be identified and defined, and serve as a foundation for assessing the relative risks and costs of capital for other BC utilities. The same is not true of a purely hypothetical utility.

In short, there is no compelling reason to depart from using FEI as the benchmark, while there are compelling reasons to continue using it. Consistent with the Commission's direction in Order No. G-72-12, the FBCU have addressed the remaining "in-scope" issues only in relation to the selected benchmark, FEI.

Cost of Capital for FEI

Commission in Order No. G-47-12 identified the following two related issues:

The appropriate cost of capital for a benchmark low-risk utility effective January 1, 2013. Cost of capital includes capital structure, return on common equity, and interest on debt.

⁸ 2009 Decision, p. 78.

Establishment of a Benchmark ROE based on a benchmark low-risk utility effective January 1, 2013 to December 31, 2013 for the initial transition year.

Ms. McShane and Dr. Vander Weide undertake multiple tests to determine FEI's cost of capital. Each recommends an appropriate ROE, based on an equity component of capital structure, for FEI as follows:

	Capital Structure	Return on Equity
Ms. McShane	40%	10.5%
Dr. Vander Weide	40%	10.5%

Mr. Engen has also offered his opinion, as a capital markets expert, that the requested capital structure and ROE for FEI is consistent with current market conditions, and would be viewed by financial markets as more representative of the cost of capital.

ROE Automatic Adjustment Mechanism

In the 2009 Decision, the Commission abandoned the use of the AAM. The scope of this Proceeding includes consideration of whether ROE AAM should be re-established:

Whether re-establishment of an ROE AAM is warranted. If a return to the use of a formulaic ROE AAM is accepted as a result of the GCOC Proceeding, it would be implemented January 1, 2014. If not, a future regulatory process will be set to review the ROE for a benchmark low-risk utility beyond December 31, 2013 on a regular basis.

The FBCU's position is that a review of the benchmark ROE and capital structure every three to five years, rather than a ROE AAM that makes annual adjustments, is the appropriate means for determining the benchmark ROE and capital structure. The rationale for adopting a ROE AAM is that it can be an administratively efficient means to determine the appropriate allowed ROE on an annual basis. However, an ROE AAM must still be reviewed periodically. Moreover, while administrative efficiency is a desirable objective, the Commission's paramount obligation is to establish a regulated rate of return for each BC utility that meets the Fair Return Standard. It is difficult to capture in one or two variables the varied factors that need to be considered in determining the appropriate ROE for a utility. Ms. McShane and Dr. Vander Weide articulate why holding periodic proceedings to determine the allowed ROE of the benchmark is the preferred approach.

Generic Methodology for Establishing Utility Specific Cost of Capital Based on Benchmark

The Commission's scoping order identified as an issue in this Proceeding: "A generic methodology or process for each utility to determine its unique cost of capital in reference to the benchmark low-risk utility." The objective of achieving additional regulatory efficiency by identifying generic factors that can be referenced in determining an equity risk premium for individual utilities relative to the benchmark is laudable, but the cost of capital of each public utility regulated by the Commission will depend on the specific nature of its business. Ms. McShane underscores that the determination of a public utility's risk profile and resulting capital structure and equity risk premium is not a simple matter of tallying-up, grouping or ranking risk factors; all of the factors must be considered together, holistically.

Utilities Without Third-Party Debt

The scoping order identified issues that related specifically to utilities without third-party debt. One issue was:

In certain circumstances, a methodology to establish a deemed capital structure and deemed cost of capital, particularly for those utilities without third - party debt. This would involve setting a methodology on how to calculate a deemed interest rate.

A second issue was whether an Interest AAM is appropriate for utilities without third-party debt:

In certain circumstances for those utilities that require a deemed interest rate, a methodology to establish a deemed interest rate automatic adjustment mechanism (Interest AAM). If warranted, the Interest AAM would be implemented for January 1, 2014. If not warranted, setting a future regulatory process on how the deemed interest for a benchmark low-risk utility would be adjusted in future years beyond December 31, 2013.

Ms. McShane discusses scenarios where the deeming of both the debt and the cost is appropriate. A deemed debt and deemed cost of debt are appropriate for very small utilities, such as a division or separate class of service within a larger public utility, or a small regulated subsidiary of a larger corporate entity. In these cases, it is inefficient for

the small utility to incur third party debt, and there are efficiencies to be gained that may benefit utility customers by deeming the debt amount and rate. For situations where there is a utility division or class of service that is part of a larger regulated entity, the Commission can approve an allocation of the debt issued by the legal entity to the division or class of service. For small regulated subsidiaries of a larger entity, the Commission can approve a deemed debt amount and deemed interest rate for debt provided by the parent entity. In both instances, the utility customers may benefit from the efficiency of obtaining debt from the larger entity and avoided a more inefficient standalone debt issuance.

There are two reasonable options for deeming an interest rate. One option is to assess a credit rating for the utility operation on a stand-alone basis, and then obtain indicative quotes for the deemed credit rating. This would be consistent with the stand-alone principle. This approach is currently used for FEW. The alternative approach is to use the embedded cost of debt of the issuing utility. This approach is currently used for the Fort Nelson Service Area of FEI.

The FBCU do not support the use of an Interest AAM, as the cost of debt is more readily observable than the cost of equity and there is no real efficiency benefit. The FBCU believe the more appropriate approach is to determine the appropriate rate on a case by case basis.

1.4 OUTLINE OF THE FILING

The remainder of this Filing is organized into four parts as follows:

- Part 2 provides more detailed evidence on the issues from the scoping identified in the Final Scoping Document and in the “Other Filing Requirements” set out in Section B of the MFR.
- Part 3 addresses the “Company-Related Documents” identified in Section A of the MFR.
- Part 4 addresses other matters related to the Proceeding.

- Part 5 is our conclusion.

The Appendices are:

- Appendix A – Company-Specific Information for FEI.
- Appendix B – Company-Specific Information for FEVI.
- Appendix C – Company-Specific Information for FEW.
- Appendix D – Company-Specific Information for FBC.
- Appendix E – Evidence of Aaron Engen, Managing Director, BMO Capital Markets, regarding capital markets matters.
- Appendix F - Opinion of Ms. Kathleen C. McShane, MBA, CFA regarding appropriate cost of capital for FEI.
- Appendix G – Evidence of Dr. James H. Vander Weide, PhD regarding appropriate cost of capital for FEI.
- Appendix H - Evidence of the FBCU regarding business risk facing FEI.
- Appendix I – Evidence of Concentric Energy Advisors Inc., regarding the applicability of an Automatic Adjustment Mechanism for determining the allowed ROE.
- Appendix J - Table of Concordance with MFR.

Consistent with the Commission’s MFR direction, we have not filed evidence apart from the Company-Specific Documents in Appendices B to D relating to FEVI, FEW or FBC. We understand that all matters related to the business and financial risk facing those entities, relative to the benchmark, are not relevant in this initial phase of the Proceeding and will be determined subsequently. We will prepare the necessary evidence for that purpose at a later date.

2. FBCU POSITION AND EVIDENCE ON MATTERS IN ISSUE

In this Part, the FBCU set out our position and evidence on the issues identified in the Final Scoping Document and in the “Other Filing Requirements”. We address the following points:

- The Fair Return Standard and its implications for setting the cost of capital for a benchmark utility;
- FEI is an appropriate benchmark;
- The appropriate approach to assessing business risk for a benchmark;
- The appropriate ROE for FEI;
- The appropriate capital structure for FEI;
- The reasons why the Commission should revisit and adjust the ROE and capital structure every three to five years, rather than adopt a ROE AAM at this time; and
- The circumstances in which deemed interest rates and debt may be appropriate.

2.1 APPLICATION OF THE FAIR RETURN STANDARD TO THE BENCHMARK

In this section, we provide an overview of the Fair Return Standard, which the Commission must apply in determining a public utility’s cost of capital for ratemaking purposes. The benchmark cost of capital established in this Proceeding will be used as the basis for establishing the cost of capital of other regulated utilities in British Columbia. Therefore, it is fundamental that the Commission apply the Fair Return Standard in determining the cost of capital for FEI, or for any other benchmark it might choose to adopt. The Fair Return Standard, and how it is to be applied, is addressed in greater detail by Ms. McShane and Dr. Vander Weide.

The Obligation to Fix a Fair Return for Ratemaking Purposes

The Commission's obligation to determine, in respect of every utility, a cost of capital for ratemaking purposes that meets the Fair Return Standard is expressed in the *UCA*. The obligation is absolute, and is not an exercise in balancing shareholder and ratepayer interests.

Section 59(5) of the *UCA* provides that a rate is "unjust" or "unreasonable" if it is:

- (a) more than a fair and reasonable charge for service of the nature and quality provided by the utility;
- (b) insufficient to yield a fair and reasonable compensation for the service provided by the utility, or a fair and reasonable return on the appraised value of its property; or
- (c) unjust and unreasonable for any other reason.

There is a substantial body of judicial case law that deals with the principles that utility rate regulators must apply in determining a fair and reasonable return for the utility shareholder. The following passage from the Commission's 2006 Decision articulates the Commission's duty to approve rates that will provide a reasonable opportunity to earn a fair return on invested capital:

The Commission Panel does not accept that the reference by Martland J. [in *British Columbia Electric Railway Co. v. British Columbia Public Utilities Commission*⁹] to a "balancing of interests" to mean that the exercise of determining a fair return is an exercise of balancing the customers' interests in low rates, assuming no detrimental effects on the quality of service, with the shareholders' interest in a fair return. In coming to a conclusion of a fair return, the Commission does not consider the rate impacts of the revenue required to yield the fair return. Once the decision is made as to what is a fair return, the Commission has a duty to approve rates that will provide a reasonable opportunity to earn a fair return on invested capital.¹⁰

⁹ [1960] S.C.R. 837

¹⁰ 2006 ROE Decision, p.8.

This articulation is consistent with prior court decisions, including the concurring reasons of Locke J. in *British Columbia Electric Railway*, in which Locke J. stated in part: “The Commission is directed by s.16(1)(a) [of the old legislation] to consider all matters which it deems proper as affecting the rate but that consideration is to be given in the light of the fact that the obligation to approve rates which will give a fair and reasonable return is absolute.”¹¹

The application of the Fair Return Standard ensures that utilities are in a position to: meet their customers’ service needs at a reasonable cost; attract investment capital at reasonable cost under all market conditions; earn a fair and reasonable return on previously invested capital; support the energy and environmental policy objectives of the BC Government; pursue investments in efficiency; and, be sustainable in the face of ongoing and changing business risks.

The Fair Return Standard

The Commission has endorsed¹² the National Energy Board’s (“NEB”) articulation of the Fair Return Standard in NEB Decision RH-1-2008. The NEB had stated:

“The Fair Return Standard requires that a fair or reasonable overall return on capital should:

- be comparable to the return available from the application of the invested capital to other enterprises of like risk (comparable investment requirement);
- enable the financial integrity of the regulated enterprise to be maintained (financial integrity requirement); and
- permit incremental capital to be attracted to the enterprise on reasonable terms and conditions (capital attraction requirement).”

Each of the three requirements of the fair return standard is separate and distinct and all three must be satisfied. None of the three requirements is given priority over the others. In other words, the Fair Return Standard is only satisfied if the utility can attract capital

¹¹ [1960] S.C.R. 837 at 848

¹² 2009 Decision, at page 15, citing p.8 of RH-1-2008 in respect of TQM.

on reasonable terms and conditions, its financial integrity can be maintained and the return allowed is comparable to the returns of enterprises of similar risk.

Ms. McShane and Dr. Vander Weide expand on the means by which experts determine whether the utility cost of capital meets these three requirements. They have each recommended a capital structure and range of ROE for the FEI that meets the Fair Return Standard.

2.2 RATIONALE FOR THE SELECTION OF FEI AS BENCHMARK

The Commission has requested that Affected Utilities provide evidence on “Whether it is more appropriate that FortisBC Energy Inc. or some other utility be the benchmark utility for purpose of setting a benchmark low-risk utility return on equity and capital structure or whether a hypothetical benchmark low-risk utility be construed instead?”¹³ the FBCU submit the following:

- The benchmark utility should be an actual, known utility as opposed to a hypothetical construct;
- The benchmark utility should be FEI; and
- FEI, while an appropriate benchmark utility, is not a “low-risk” utility.

Ms. McShane has provided her expert opinion on these matters. Her conclusions support the FBCU position.

Utilization and Characteristics of a Benchmark Utility

The Commission should continue to designate a benchmark utility, and the benchmark utility should be a real utility rather than a purely hypothetical construct.

The Commission determined in 1994 (and re-affirmed in the 2009 Decision) that the use of a benchmark utility was in the public interest. Since that time, a benchmark utility has been designated for the purposes of determining the allowed ROE of utilities in BC. The

¹³ Order No.G-72-12, Appendix B, page 3.

use of a benchmark allows for one hearing to determine the key economic, financial market and jurisdictional issues that affect all utilities from a ROE perspective. There are a number of advantages that flow from a benchmark including:

- cost savings to the Commission and to Intervenors in avoiding additional, unnecessary hearings; the evidence related to economic outlook and capital market conditions need not be presented nor heard more than once;
- a consistent approach to economic outlook and capital market conditions, considered with reference to expert evidence gathered at a single point in time; and
- greater consistency with respect to ROE determinations for individual utilities from a common base.¹⁴

An important additional consideration is that the use of a benchmark captures these regulatory efficiencies without compromising the Commission's obligation to meet the Fair Return Standard.

Ms. McShane and Dr. Vander Weide articulate a number of reasons why an actual utility should be designated as the benchmark utility, rather than relying on a purely hypothetical construct. At a high level, these reasons are:

- First, designating an actual utility as the benchmark eliminates ambiguity and reduces subjectivity in determining the characteristics of the benchmark, such as its size, scale, geographic scope, competitive position and business risks. While it may be possible to arrive at a common understanding among affected parties regarding certain features or characteristics, it is not practical to define a purely hypothetical utility, since every utility has its own unique features. The use of such a construct has the potential to counteract the efficiencies associated with using a benchmark, as it may introduce points of contention that do not otherwise need to exist.

¹⁴ FBC submission in 2009 ROE proceeding, as referenced in 2009 Decision, p. 79

- Second, to the extent that determination of an allowed ROE considers trends over time to the business profile and business risks affecting the benchmark, it is more efficient and practical to observe and compare such changes relative to an actual utility than to a purely hypothetical one.
- Third, the business risks can consist of local factors that impact the operations of the utility. It is easier to ascertain the impact of, for instance, government policy or local competition on a real utility.
- Finally, the purpose of designating a benchmark utility is to act as a reference point to compare the relative risks of utilities whose returns will be set relative to the benchmark. Every utility in BC has unique features, and, in order to undertake a detailed comparison, it must be possible to define the risk characteristics of the benchmark in as detailed a manner as the utility to which the benchmark is being compared. Otherwise, there will be a gap in information. Relying on a real benchmark utility also assists in the assessment of changes in relative risk over time.

Neither the FBCU, nor Ms. McShane, has identified any added benefits associated with using a hypothetical construct as the benchmark in place of a real utility.

In principle, any utility can serve as the benchmark, as the role is simply one of a reference point. However, the FBCU believe that the benchmark utility should be a relatively large utility with diversity in customer base, asset composition and geographic scope. The benchmark is intended to be representative of the scope and a degree of risk that utilities generally face to set a baseline ROE, with which to compare and adjust for the degree of or existence of certain risks to a specific utility. A relatively large utility with diversity in customer base, asset composition and geographic scope is less likely to be susceptible to unique or specific risks that have a disproportionate impact on risk profile that may make comparisons more difficult. A larger, diverse utility should therefore encompass all the general risks that a smaller utility would encounter, but be less exposed to a material, unique business risk.

FEI Should Continue as the Benchmark Utility

In BC, FEI remains the obvious candidate to serve as a benchmark. It has the desired characteristics in terms of size and diversity. The Commission, intervenors and other utilities are familiar with FEI as the benchmark. Past proceedings have examined the business profile and business, regulatory and financial risks of FEI. There is a well-developed evidentiary record in place from those proceedings. It is more efficient to utilize the record from those proceedings as necessary, and add to it, rather than to start over with a new benchmark. The continued use of FEI as the benchmark also allows for analysis of the changes to business risk over time, for both FEI as the benchmark as well as for each utility that benchmarks to FEI.

The FortisBC Energy Utilities are currently before the Commission with an application that, if approved, will result in an amalgamation of FEI, FEVI and FEW into one legal entity, FEI Amalco. The potential for amalgamation of the FortisBC Energy Utilities to proceed need not disqualify FEI from serving as a benchmark, and the use of FEI as a benchmark does not predetermine the ROE and capital structure of FEI Amalco. The evidence put forward in this Filing relates to FEI as it exists today. The Commission's order in this Proceeding can specify that the benchmark will remain unaffected by amalgamation and postage stamping. FEI Amalco will join the group of other BC utilities for which an appropriate ROE and capital structure must be determined with reference to the benchmark, FEI. The Commission can consider in the course of its next review of the benchmark whether the benchmark should be changed to reflect FEI Amalco.

FEI is a Benchmark Utility but not the 'Benchmark Low-risk Utility'

The concept of FEI as the 'benchmark low-risk utility' was raised in the 2009 Application. In response to an information request, FEI was asked if it still considered itself a 'benchmark low-risk utility' for purposes of setting allowed ROEs. In its response, FEI noted that it had been designated 'a benchmark low-risk utility' by the Commission, but that it did not consider itself as such at the time, if ever. The 2009 Decision refers to Ms. McShane's evidence that the benchmark need not be the lowest risk utility and that it does not necessarily follow that benchmark's business risks won't change over time

relative to its peers.¹⁵ FEI is still not a “low risk utility”. It is however, the logical benchmark in BC.

2.3 FEI BUSINESS RISKS INCREASING

In this Proceeding, the Commission has requested that the Affected Utilities discuss business risks faced by the benchmark they have selected, in our case FEI. The Commission’s MFR included:

- 1) Present business risks:
 - (i) Itemized listing of each risk with full explanation,
 - (ii) Significance and impact of each risk to a utility,
 - (iii) Ranking of the business risk,
 - (iv) Business risks faced by all utilities in Canada, and
 - (v) Business risks unique to British Columbia.
- 2) Changes in business risks in the last 5 years and explanation.

The FBCU’s evidence regarding business risks facing FEI is found in Appendix H. Ms. McShane considers FEI’s business risk, and Dr. Vander Weide also addresses business risk matters at a higher level.

As noted in the 2009 Application, business risk is comprised of many elements. For a gas distribution utility like FEI, significant components of business risk include: the competitiveness of natural gas as compared to alternate energy forms, primarily electricity; and, the utility’s related ability to attract and retain customers, which affect throughput levels. Competitiveness, and the utility’s ability to attract and retain customers is affected by many factors, including operating costs of the energy source and equipment, upfront capital costs related to the energy equipment, carbon tax, new housing stock development and their affordability, new technology and energy forms, consumer perception and sentiment towards energy form, environmental considerations

¹⁵ 2009 Decision, p. 78.

and government policy. Other risks are natural gas supply environment, regulation, operating risks of natural gas versus other energy sources, and First Nations issues.

As the FortisBC Energy Utilities had noted in response to IR CEC 13.1 in the 2009 Application proceeding, a business risk assessment is by its very nature a qualitative assessment, not a quantitative one. Ms. McShane highlights in her evidence that the various elements of business risk are inter-related and inter-dependent and, for ROE purposes, it is impossible to isolate and quantify individual business risk factors. There is no accepted methodology for quantifying increments of ROE for individual business risk factors. In general, however, there is a positive relationship between business risk and cost of capital, i.e., the higher the business risk, the higher return required by investors and therefore higher cost of capital.

The business risks faced by FEI have been well documented. Since the 2005 Proceeding, business risks have been increasing. The change in risk from 2005 to 2009 was part of the justification of the increase in the common equity ratio granted in the 2009 Decision. While no new types of business risks have been identified, the key risks are still prevalent and have not declined. In certain instances, the trends suggest business risk is increasing over time. Notably:

- Provincial climate change and energy policies continue to impact the risk inherent in FEI's core natural gas business. For instance, FEI is now seeing local governments mandating certain non-natural gas energy solutions as a condition of obtaining municipal approvals for building permits.
- Natural gas' long term competitive position relative to electricity remains challenged despite current lower natural gas commodity costs. Developers and customer decisions to install natural gas appliances are also influenced by capital cost of appliances, and the perception of electricity as being cleaner.
- FEI is capturing a smaller percentage of new construction; high density/multi-unit housing is the predominant type of new

construction, and electricity is increasingly the choice of high-density housing.

- Alternative energy sources continue to pose competitive challenge to FEI. Gas is being used in combination with new energy forms and equipment, meaning that FEI obtains only some of the load that it would otherwise obtain had the customer taken gas service.

The trend in the overall business risk supports i) the proposed increase in ROE compared to that awarded in 2009, and ii) maintenance of the current 40% equity component of capital structure for FEI.

2.4 PROPOSED ROE FOR FEI BENCHMARK

The FBCU submit that the appropriate allowed ROE for FEI is 10.5%, based on a minimum of 40% equity thickness. The requested ROE and equity thickness are driven by the need to ensure the Fair Return Standard is met and allow FEI to compete effectively for capital with both Canadian and US utilities. The use of US utilities as a comparator group for the determination of ROE and equity thickness is appropriate in this Proceeding, just as it has been appropriate in other proceedings and other jurisdictions. Ms. McShane and Dr. Vander Weide support this proposal based on their detailed assessment of the current cost of capital.

The FBCU's proposed ROE for FEI is based on a number of tests, including the discounted cash flow test, the comparable earnings test, and the equity risk premium test. In the 2009 Decision, the Commission determined that all three tests are valid:

Accordingly the Commission Panel determines that in determining a suitable ROE for TGI, it will give most weight to the DCF approach, some lesser weight to the ERP and CAPM approaches and a very small amount of weight to the CE approach.¹⁶

¹⁶ 2009 Decision, p.45.

As noted in her evidence, Ms. McShane believes that a single test is inadequate and inappropriate to determine the fair ROE, and utilizes the discounted cash flow and comparable earnings tests, and three variants of the equity risk premium test. In Ms. McShane's opinion, significant weight should be attributed to the comparable earnings tests. In summary, Ms. McShane recommends an ROE of 10.5%.

Dr. Vander Weide also supports the use of multiple tests and bases his recommended ROE of 10.5% on the application of multiple methods to groups of comparable risk utilities.

2.5 CAPITAL STRUCTURE FOR FEI SHOULD INCLUDE 40% EQUITY

The capital structure, in conjunction with the appropriate ROE, is set to address both business and financial risk faced by the utility and to ensure the financial integrity aspect of the Fair Return Standard is met. The FBCU believe and regulators including the Commission have recognized, that financial integrity is addressed in part by allowing a utility to maintain a minimum credit rating in the A category. This credit rating is central to maintaining financial flexibility to meet ongoing capital requirements, be it for growth, maintenance, technological change or emergent situations. Utilities must make large, long-term capital commitments without the luxury of market timing, and as such it should have sufficient flexibility to raise capital when required. In addition, comparability of the benchmark utility with its peers regarding its capital structure will allow FEI to attract capital on a comparable basis with its peers.

The FBCU are proposing a 40% equity ratio, which based on the expert evidence is the minimum equity component that is appropriate. The proposed capital structure for FEI, together with an ROE of 10.5% will meet the Fair Return Standard, ensuring financial integrity, comparability and the ability to compete for capital, and the necessary flexibility to raise capital when required on reasonable terms.

Ms. McShane has addressed the appropriateness of the requested minimum equity ratio with respect to the Fair Return Standard, the trend in business risk, the importance of access to capital, credit metrics and the comparability of capital structure with peers. Dr.

Vander Weide has put forth evidence on comparable Canadian and US utilities, and discusses the appropriate capital structure for FEI. In addition, Mr. Engen addresses the increasing competition for capital, and he and Ms. McShane discuss the importance of maintaining a minimum A category credit rating.

Equity Ratio and ROE Support Credit Ratings and Maintain Financial Flexibility

The financial integrity component of the Fair Return Standard is met with the capital structure and ROE that, in tandem, allow the benchmark utility to maintain a minimum credit rating in the A category. The Commission, in the 2009 Decision, also endorsed the maintenance of a minimum A rating¹⁷. FEI has ongoing capital requirements to ensure system deliverability, reliability and safety, and support customer growth. FEI needs to access capital markets on a regular basis, in both strong and weak economic conditions and when financial markets are both stable and volatile.

As part of the 2009 Application, FEI raised concerns regarding the risk of potential downgrade by Moody's based on what Moody's had noted was weak credit metrics.¹⁸ The increase to 40% equity and 9.50% equity partially addressed that concern. However, Moody's current rating remains at A3 and Moody's still expresses concerns at the weaker metrics of FEI relative to its peer group. As outlined in the "Rating Factors" sub section found on page 3 of the Moody's 2011 report, 4 out of the 5 key financial metrics of FEI are below an "A" rated score. Further, Moody's states:

"FEI's financial metrics are materially weaker than those of its A3 rated global gas utility peers such as Piedmont Natural Gas Company, Inc. Northwest Natural Gas Company, UGI Utilities and its sister company FEVI. We recognize that FEI's weaker financial metrics are largely a function of deemed equity and allowed ROE approved by the BCUC. In general, Canadian deemed equity ratios and allowed ROE's are low relative to those of other jurisdictions."

Further weakening in FEI's credit metrics or a change in Moody's views of the regulatory environment and business risk may lead to a downgrade:

¹⁷ 2009 Decision, page 15

¹⁸ 2009 Application, page 35

“Notwithstanding FEI’s low business risk profile, its financial profile is considered weak at the A3, senior unsecured level. Accordingly, a sustained weakening of FEI’s Cash Flow Interest Coverage below 2.3x and CFO pre WC/debt below 8% combined with a less supportive and predictable regulatory framework would likely result in a downgrade of FEI’s rating. This could occur if gas were to lose its competitive advantage over electricity in British Columbia due to Provincial policies favouring non-carbon emitting energy sources or other factors.”

A reduction in the equity ratio and ROE could negatively impact credit ratios that are currently viewed at the low end of the acceptable range for an A rating, and potentially lead to rating agencies reconsidering the current ratings.

A ratings downgrade to BBB category would have adverse effects on FEI’s cost of debt and potentially impact its access to debt financing over the long-term. Mr. Engen and Ms. McShane both address the reasons to maintain a minimum “A” rating, which will ensure FEI has to access capital on reasonable terms and prices in all capital market environments.

FEI ROE and Capital Structure Should Be In Line With Peers

North American capital markets continue to become more integrated, as noted by Mr. Engen. There is increasing competition for capital from utilities across North America. North America is burdened with a major infrastructure gap. As discussed in the 2009 Application, it was estimated that \$2.2 trillion dollars will be spent in the United States alone between 2009 and 2014 on energy infrastructure¹⁹. In February 2012, the Conference Board of Canada projected that investment in Canadian electricity infrastructure alone will top \$13 billion annually from 2011 to 2030. Ms. McShane’s evidence also notes the significant trend in infrastructure investment. All of the North American utilities undertaking such investments are competing for the same pool of capital. The utilities able to provide investors with the most favourable risk adjusted returns will be the most successful in attracting capital.

The integrated nature of the North American economies and capital markets make the relevant peer group Canadian and US utilities. In this comparison, as noted by evidence

¹⁹ 2009 Application, page 37.

of Dr. Vander Weide, FEI's current ROE and capital structure is lagging. Maintaining a 40% equity ratio and an ROE consistent with that proposed by our experts would address this concern.

An Appropriate ROE and Capital Structure

The FBCU respectfully submit that based on the evidence presented, an allowed ROE of 10.5% and an equity thickness of 40% is appropriate.

2.6 PERIODIC REVIEW, NOT RETURN TO ROE AAM, IS MOST APPROPRIATE AT THIS TIME

Part of the scope of this proceeding, as noted in Appendix B to Order No. G-47-12, is to determine whether the re-establishment of an ROE AAM is warranted. Specifically, in the Minimum Filing Requirements, the Commission has requested evidence on the following question: "Should the Commission return to a formulaic approach to setting a benchmark ROE, and if so, what should the formula be and for what period of time?" The FBCU submit that the Commission should rely on periodic reviews, rather than returning to a formulaic approach to setting the benchmark ROE. Both Dr. Vander Weide and Ms. McShane take this view.

In the 2009 Application, the FEU requested, and Commission determined that the AAM then in use be eliminated as it would not result in an ROE that met the Fair Return Standard. The Commission is to ensure the Fair Return Standard is being met with respect to the allowed ROE, and that this requirement is best met by periodic proceedings to determine the allowed ROE and capital structure. There are two main concerns with adopting a new formula.

First and foremost, shortcomings in the formula can yield a return that does not meet the Fair Return Standard. The attractiveness of a formula is that, in theory, it provides regulatory efficiency in that once established it will determine a fair ROE. To be effective, the formula should be relatively simple and easy to understand, with observable and transparent inputs in order for those involved parties to easily determine the ROE. However, the determination of ROE is complex and does not lend itself to such easy determination. The risk is that by relying on relatively few, easily understood

and observable factors, the formula may return an unfair ROE. While regulatory efficiency is an appropriate consideration, achieving a return that meets the Fair Return Standard is always the paramount obligation.

Second, the efficiency benefits may be illusory. The AAM in use previously was adopted in 1994, and over the 15 year period, there were regular reviews and adjustments with the AAM in part due to concerns that the ROEs produced were not meeting the Fair Return Standard. So while efficiency was intended, it is not clear that the ultimate goal was achieved. In the North American context, there are over 60 regulatory authorities governing utilities, and the FBCU understand that only a handful of those jurisdictions currently employ a formula. The standard practice is for allowed ROE to be determined by proceedings in front of the applicable regulator.

In 2010, the FEU filed a report prepared by Concentric Advisors regarding the use of formulae in the North American context (the “2010 Concentric Report”). The 2010 Concentric Report highlighted certain formulae currently in use. Of note is that the formulae tend to be dependent on a few factors, and those factors are in part influenced by government debt yields. While these formulae are an improvement on the previous single factor AAM, the factors selected may be impacted by events that do not necessarily translate into similar changes to a utility ROE. Periodic review by the Commission of the allowed ROE and capital structure remains the best approach for ensuring the Fair Return Standard is met.

For these reasons, the ROE should be determined in periodic Commission processes. The appropriate period between reviews should be three to five years. However, the resulting ROE and capital structure for all affected utilities must always meet the Fair Return Standard. Any affected utility, or interested party, should remain at liberty to seek an adjustment if the cost of capital no longer meets the Fair Return Standard as a result of emerging circumstances during the period between anticipated proceedings.

Alternatively, if the Commission requires a ROE AAM as an outcome of this Proceeding, the Commission should at a minimum seek to rectify some of the most problematic elements of the old formula. Any new formula would need to introduce new factors that would address changes in utility equity risk premium, not solely changes in Government

of Canada bond yields, and any adjustment factor would need to reflect the sensitivity to change in bond yields to ROE.

2.7 DEBT RELATED MATTERS

In this section, the FBCU address the debt-related matters identified in the Commission's Other Filing Requirements. In addition, Ms. McShane in her evidence discusses the questions raised by the Commission, and the position articulated below is consistent with her evidence.

Appropriate Circumstances for Deemed Debt

The Commission posed the question: What are the appropriate applicable circumstances for a utility to utilize a deemed capital structure with a deemed debt?

Deemed debt makes the most sense for small utilities, such as a separate division or class of service within a larger regulated utility, or for a regulated utility subsidiary within a larger corporate organization, where it would not be as efficient or economic to raise its own debt on a third-party basis. The small size of the utility, be it a division or stand-alone entity, could make debt issuance inefficient due to the high costs of issue relative to the size of the issue that may make the effective debt cost higher than it would otherwise be, or where the size of the utility precludes it from accessing appropriate debt terms. In these instances, a deemed debt would be more efficient.

Basis for Calculating Deemed Interest Rate

The Commission has posed the question: "What is an appropriate basis to calculate a deemed interest rate (long and short-term) for a utility without third-party debt or non-arms-length debt?"

The FBCU have identified two reasonable options for determining the deemed interest rate applicable in the scenarios noted above. The first option is to assign a credit rating on a stand-alone basis, and then obtain indicative quotes from investment dealers or banks based on the credit rating of a comparable proxy issuer. This approach is

consistent with the stand-alone principle, and is how FEW has financed its debt component of capital structure. An alternative option would be to use the embedded cost of debt of the issuing entity as the deemed interest rate and allocate the deemed debt and deemed interest rate based on an approved capital structure. Currently, Fort Nelson debt is deemed and the rate is the embedded cost of debt of FEI.

Reference Point for Long and Short-Term Interest Rates

The Commission has asked: “Should the deemed long-term interest rate be based on a 10-year, 30-year, or other term-to-maturity Government of Canada bond and/or other term-to-maturity Canadian corporate bond?” In general, the deemed long-term interest rate should reflect certain factors, including the long-term nature of utility assets, contractual terms and available debt terms. It should be based on:

- an underlying Government of Canada bond yield reflecting the proposed term of debt, and that could be either the 10-year or 30-year bond as the benchmark, or an interpolation of the two benchmarks, and
- the credit spread of a comparable corporate issuer at the same term to maturity as that selected as the benchmark Government of Canada bond.

The Commission has asked: “What is the appropriate credit spread on the Government of Canada bond and/or the Canadian corporate bond for a benchmark low-risk utility?” The appropriate credit spread will vary based on term, credit rating, and market conditions at the time of issue. FEI, as the benchmark, has its actual credit spread determined by the market at time of each new issuance. Therefore, the benchmark spread will be that of FEI’s but dependent on timing of issue and term of issue.

The FBCU submit that the concept of a benchmark credit spread is not required. The more appropriate approach is to have debt approved by the Commission on a case specific basis. With respect to the interest rate, that rate should be the specific utility’s interest rate from a specific debt issue, or if a deemed interest rate, as determined as above. To utilize a benchmark spread would then require an added process of

determining a premium over that benchmark spread. There does not appear to be much efficiency from this approach.

The basis for determining the deemed interest rate for short-term debt would be similar to that of long-term interest rate noted above. It would be based on an indicative credit spread quotes from investment dealers or banks using comparable proxy issuers plus a short-term benchmark yield. A common benchmark yield in Canada is the Canadian Dealer Offered Rate (“CDOR”). CDOR is the quoted benchmark that is used when a company issues short-term Bankers’ Acceptances, which reflects the short-term benchmark rate plus the company’s applicable credit spread.

Portions of Short-Term and Long-Term Debt

The Commission has asked: “What is an appropriate portion of short-term debt and long-term debt on the debt portion of the deemed capital structure?” The appropriate portion of short-term and long-term debt will depend on the underlying nature of the assets and timing. The FBCU will generally use short-term debt when assets are in development and refinance that debt following project completion when the balance is large enough to support a long-term bond issue. Typically, a utility’s fixed assets in service will make-up the majority of its overall asset base and thus its debt should be mostly long-term in nature to avoid exposure to refinancing risk. Short-term debt is also important, however, as it funds working capital, which can fluctuate significantly due to seasonal variations. The FBCU submit that there is no ‘appropriate portion’ of short-term debt, and that on average, short-term debt will make up a very small component of a utility’s overall capital structure.

3. COMPANY SPECIFIC DOCUMENTS

The Commission, as part of the Minimum Filing Requirements, has directed the Affected Utilities to provide specific information related to each utility. This material is outlined under Section A – Company-Related Documents of the MFR. This material for each utility, including a brief description of the company, is provided separately in Appendices A through D of this Filing.

4. DETERMINING UTILITY-SPECIFIC COST OF CAPITAL

The Commission's Orders to date, including the Final Scoping Document and MFR, make it clear that the utility-specific cost of capital is to be determined only after the benchmark cost of capital has been determined. The Final Scoping Document does identify as an issue to be addressed at this time whether it is appropriate to adopt "A generic methodology or process for each utility to determine its unique cost of capital in reference to the benchmark low-risk utility." The MFR included the following related requirements:

11. Proposed generic methodology or process for each utility to determine its return on equity in reference to the benchmark low-risk utility.
7. Proposed generic methodology or process for each utility to determine its equity ratio.

Ms. McShane addresses both requirements requested by the Commission. The FBCU are generally supportive of regulatory efficiency. However, the FBCU believe a generic methodology or formula for determining an equity risk premium for individual utilities is likely impractical and individual consideration of each utility is important.

4.1 USE OF A GENERIC METHODOLOGY OR FORMULA IS NOT APPROPRIATE

The business risk and financial risk profile of each public utility regulated by the Commission is unique, and will be affected by different factors depending on the nature of its business. Ms. McShane has noted in her evidence that the determination of a public utility's risk profile is not a simple matter of tallying-up, grouping or ranking risk factors; all of the factors must be considered holistically. There is no formulaic way to assign a value or weighting to specific risk factors or utility/utility sector characteristics that would apply across multiple utilities and generate the appropriate cost of capital for each one. Applying a generic mechanism to unique utilities that face unique business and financial risks increases the potential that the resulting cost of capital for a utility may differ materially from the appropriate return.

4.2 LISTING “GENERIC CONCEPTS”

With regard to item 6 under Capital Structure Matters of the MFR, the Commission has requested evidence on “generic company-specific” adjustments. Ms. McShane addresses the three items noted in the MFR, which are tax rates, utility size, and contributed assets. In clarifying its reference in the Preliminary MFR, the Commission cited the example of “a generic concept such as income tax that typically applies to all companies but is also specific to an individual company’s situation which will have its own specific effective income tax rate.”²⁰ It is probably feasible to come up with a list of “generic concepts” that would be relevant to all utilities. However, given that the “generic concept” must be applied to each utility, the efficiency that comes from identifying a “shopping list” of “generic concepts” may be limited. The efficiency comes in the form of guidance to each utility regarding what information the Commission expects to be included in a filing, in much the same way as the MFR in this Proceeding. The use of “generic concepts” must still accommodate the utilities presenting the evidence that they feel is necessary to support their position.

4.3 JOINT HEARING FOR UTILITY-SPECIFIC COST OF CAPITAL

In the past, the utility-specific cost of capital has been determined in the context of proceedings specific to the utility, often in revenue requirements proceedings. This long-standing approach has the benefit of permitting the utility, utility customers and the Commission to deal with all significant rate-related matters for the utility all at once.

It is possible to hold a single hearing for multiple Affected Utilities to determine their utility specific cost of capital based on evidence filed by each Affected Utility. This was done in 1994 in BC for a limited number of utilities. It has been done more recently in Alberta, for example. There are pros and cons of this approach. As indicated previously, there are going to be “generic concepts” that will apply to more than one utility. One might expect there to be some potential efficiencies associated with dealing with the generic concepts together in one proceeding. However, a “generic concept” may, and frequently will, affect each utility or utility sector differently. In those

²⁰ Order No. G-72-12, p.7.

circumstances, there will be potential inefficiencies associated with dealing with the differences in one proceeding. It will necessitate each utility spending greater resources and time to review and process evidence that pertains to other utilities because the evidence forms part of the evidentiary record applicable to all utilities. The level of debate between a utility and interveners about the appropriate cost of capital may differ among the utilities.

The FBCU submit that it may be efficient, given the small size of thermal energy systems, to have a single process to address cost of capital issues for thermal energy systems, irrespective of the provider. This would include FEI and FAES' Thermal Energy Services, and similar systems to be operated by developers or providers like Corix Multi Utility Services.

5. CONCLUSION

The materials filed according to the MFR will establish a significant evidentiary record to determine the key matters at issue in the Proceeding. The primary focus is the determination of the appropriate ROE and capital structure of the benchmark utility, which the FBCU submit should remain FEI. In this determination, the application of the Fair Return Standard is paramount. The Commission should give recognition to the ongoing challenges posed by the volatility and uncertainty in financial markets, in particular equity markets. Consideration should also be given to the ongoing business risk trends faced by the benchmark utility in BC.

Based on the evidence before the Commission, the FBCU submit that the Fair Return Standard is met in this Proceeding by the benchmark utility, FEI, having a capital structure that includes a 40% equity ratio, and a ROE of 10.5%. The preferred process for ensuring a fair return for FEI going forward involves periodic reviews of the benchmark ROE, rather than an AAM.