FORTIS BC™

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October 29, 2012

British Columbia Public Interest Advocacy Centre
Suite 209 – 1090 West Pender Street
Vancouver, BC
V6E 2N7

Attention: Ms. Leigha Worth, Executive Director

Dear Ms. Worth:

Re: Generic Cost of Capital Proceeding

FortisBC Utilities[1] ("FBCU")

Response to the British Columbia Public Interest Advocacy Centre on behalf of the British Columbia Pensioners' and Seniors' Organization *et al* ("BCPSO") Information Request ("IR") No. 2

On August 3, 2012, the FBCU filed its Written Evidence in the Generic Cost of Capital proceeding as referenced above. In accordance with the British Columbia Utilities Commission Order No. L-52-12 revising the Amended Preliminary Regulatory Timetable, the FBCU respectfully submit the attached response to BCPSO IR No. 2.

If there are any questions regarding the attached, please contact the undersigned.

Yours very truly,

on behalf of the FORTISBC UTILITIES

Original signed:

Diane Roy

Attachment

cc (e-mail only): Commission Secretary
Registered Parties

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[1] comprised of FortisBC Inc., FortisBC Energy Inc., FortisBC Energy (Vancouver Island) Inc., and FortisBC Energy (Whistler) Inc.

1.0 Reference: Exhibit B1-20, BCUC 1.5.1

1.1 Who does FBCU consider to be FEI's peers amongst investor-owned utilities?

Response:

The FBCU discussed this response with Ms. McShane. The FBCU are not certain as to what the BCPSO intends by the term "peers". In terms of Canadian utilities, the FBCU consider that the large, mature investor-owned gas and electric utilities with which it might be compared should include:

- AltaLink
- ATCO Electric Distribution
- ATCO Gas
- ATCO Electric Transmission
- Enbridge Gas
- FortisAlberta
- Gaz Métro
- Newfoundland Power
- Nova Scotia Power
- Union Gas

1.2 If FBCU does not consider itself to be a "low risk utility", what does FBCU consider to be the characteristics of a "low risk utility" that would distinguish it (i.e., the low risk utility) from FEI?

Response:

FEI is low risk relative to non-regulated businesses, but is not low risk among other utilities.

The six major business risk categories have been set out at pages 39-41 of Ms. McShane's testimony and at page of Appendix H to the Application (Evidence of FBCU Regarding Business

Risk Facing FEI). The FBCU would consider a low risk utility as one which faces low risk in all the major business risk categories. The primary factors that distinguish FEI from a low risk utility are its market, competitive and political (e.g. government policy, regulatory, First Nations etc.) risks.

1.3 If FEI is not a "low risk utility", does FBCU consider any of the utilities in its peer group to be low risk utilities? If so, why?

Response:

FEI is low risk relative to non-regulated businesses, but is not low risk among other utilities.

The FBCU's conclusion that it is not a low risk utility is in the context of business (including regulatory) risk. In the FBCU's view, whether a utility is to be considered low business risk depends on its relative position on the spectrum of utilities, both in terms of its sector and company-specific risks. Ms. McShane's evidence at pages 45-48 ranks the various utility sectors in order of relative business risk. As among the five sectors ranked by Ms. McShane, electric transmission and electric distribution utilities are ranked lower than natural gas distribution in terms of relative business risk, for the reasons which are set out on pages 45-48 of her testimony. Of the companies listed in response to BCPSO IR 2.1.1, the FBCU consider that, as the lowest ranked sector in terms of relative business risk, the electric transmission utilities (AltaLink and ATCO Electric Transmission) could be considered low risk. The factors that establish the electric transmission utilities as the lowest business risk sector are set out at page 45 of Ms. McShane's testimony.

1.4 Does FBCU consider any of the utilities in its peer group to have a lower risk than it (i.e. FBCU) does and, if so, why?

Response:

Of the utilities listed in response to BCPSO IR 2.1.1, the FBCU consider that, as electric transmission utilities, AltaLink and ATCO Electric Transmission are of lower business risk than FEI. As electric distribution utilities, ATCO Electric Distribution, FortisAlberta and Newfoundland Power are of lower business risk than FEI. The reasons for the lower business risk ranking of electric distribution utilities than gas distribution utilities are listed in Ms. McShane's testimony at pages 45-46. As regards other gas distribution utilities listed in response to BCPSO IR 2.1.1,

the FBCU consider that, on balance, FEI is of higher business risk than the Alberta and Ontario gas distribution utilities (ATCO Gas, Enbridge Gas and Union Gas) due to FEI's higher market and competitive risks, which are discussed in detail in Appendix H to the Application.

1.5 Within the "universe of Canadian gas and electric distribution utilities" (per BCUC 1.5.2), which utilities (if any) does FBCU consider to be "low risk"?

Response:

The FBCU discussed this response with Ms. McShane. The FBCU consider that electric transmission utilities, which are positioned at the lower end of the business risk spectrum of Canadian utilities, could be considered low risk utilities. They include, as regards investor-owned utilities, AltaLink and ATCO Electric Transmission, as indicated in response to BCPSO IR 2.1.3. The low risk categorization also includes utilities in the same sector which are not investor-owned (ENMAX and EPCOR Transmission and Hydro One Transmission).

1.6 Within the "universe of Canadian gas and electric distribution utilities" (per BCUC 1.5.2), which utilities (if any) does FBCU to have a lower risk than FEA and why?

Response:

Please refer to the response to BCPSO IR 2.1.4.

2.0 Reference: Exhibit B1-20, BCUC 1.31.1 and 1.31.3

Exhibit B1-11, BC Utility Customers 1.7.1 (Evidence of the Companies)

Preamble: The first part of BCUC 1.31.3 question was – "While private equity and Canadian pension funds may 'seek' returns on equity of 10 percent, is there any indication they are currently achieving such returns?"

2.1 Please respond to this part of BCUC 1.31.3.

Response:

Actual returns earned by pension funds on their direct investments in the energy infrastructure sector are not public. Consequently, Mr. Engen cannot respond to the question. But actual returns are not what matter. What matters are investor *expected* returns at the time investments are made.

2.2 Please also indicate the returns such pension funds are currently achieving on their portfolios overall.

Response:

Mr. Engen is not aware of what returns pension funds are currently achieving on their portfolios overall. But currently achieved portfolio returns are not what matters for two reasons. First, portfolio returns are an average of returns on various investments, some higher and some lower. Portfolio returns say nothing about expected investor returns on investments – in this case, pension fund expected returns on direct energy infrastructure investments. And that leads to the second point, namely, that what matters is investor expected returns at the time the investment is made.

2.3 What is the expectation of Canadian pension funds as to their return on (equity) investments in regulated energy infrastructure businesses relative to their average returns on investment?

Response:

Mr. Engen's evidence addresses pension fund expected returns on direct investments in energy infrastructure assets and does not touch on those returns in the context of pension fund average returns on investment. Consequently, responding to this question requires an analysis of pension fund average returns on investment, information which Mr. Engen does not have. Consequently, Mr. Engen declines to respond to this request as the request requires that he undertake research and analysis, and provide new evidence regarding pension fund average returns on investment which are not referred to in his written evidence. The request is not a question or clarification of his evidence and it does not constitute a request for material in his possession.

2.4 Please reconcile the 10% or more return on target equity returns for investment in the energy infrastructure sector per BCUC 1.31.1 with the 7% expected return on Canadian equities overall referenced in response to BC Utility Customers 1.7.1. In doing so please comment on the relative return expectations of pension funds regarding Canadian equities overall vs. energy infrastructure sector equity based on the perceived risks associated with the two types of investment portfolios.

Response:

Assuming a 7% expected return on equities overall, pension fund target equity returns of 10% to 12% mean pension funds are expecting their energy infrastructure direct investments to outperform the lower expected return on equities overall. Mr. Engen cannot comment on pension fund energy infrastructure direct investment returns relative to their overall Canadian equities returns as he has no knowledge of pension fund return expectations for overall Canadian equities.

3.0 Reference: Exhibit B1-20, BCUC 1.76.1

3.1 Given that the two methods used yielded significantly different results (i.e. 75 vs. 200 basis points), please comment on the relative merits of each method and the appropriateness of using the average of the two results.

Response:

As Ms. McShane recognized at page E-5 of her testimony, there is no universally accepted methodology for making a downward adjustment to the unregulated low risk company returns on common equity for the lower risk of utilities. However, given the clear evidence that the selected unregulated companies are of higher risk than the utilities, a risk adjustment is required. Ms. McShane's objective was to estimate a reasonable relative risk adjustment based on measures that were observable and lend themselves to the estimation of return requirement differentials. Both measures that were used (debt spreads and relative betas) satisfy those criteria. Neither is a perfect measure of relative equity risk, however, nor is either clearly a superior measure. For example, debt spreads relate to debt risk rather than equity risk. They incorporate not only credit risk, but liquidity, the effects of which are difficult to disentangle. In addition, not all of the companies in the unregulated sample have debt ratings and some have very little debt outstanding. With respect to betas, the issues with respect to beta as the sole measure of equity risk and with respect to the CAPM's underestimation of returns for companies with low betas are discussed at pages 67-69 of Ms. McShane's testimony. Sole reliance on betas would, in Ms. McShane's estimation, overstate the relative risk of the unregulated firms relative to utilities. As such, the two measures constitute a reasonable range for the relative risk adjustment and their mid-point an appropriate balance of the pros and cons of the two measures.

4.0 Reference: Exhibit B1-20, BCUC 1.125.1.2

FBCU Evidence, page 2

Preamble: The first reference states that "the return performance of a Utility is meant to equal the return demanded by its investors in any market". The second reference state that the Fair Return Standard requires an overall return "comparable to the return available from the application of the invested capital to other enterprises of like risk (comparable investment requirement)".

4.1 While over the long run what is "demanded by investors" may be comparable to "what is available", the response to BUB 1.125.1.2 suggests that there will be periods of time when the two are not equivalent. In such circumstances, is it the definition of the Fair Return Standard as set out in FBCU's initial evidence that should be used by regulators in setting the "allowed ROE"?

Response:

Yes, the Fair Return Standard should continue to be used by regulators in setting the "allowed ROE".

5.0 Reference: Exhibit B1-13, BC Utility Customer 1.7.1 (Evidence of Concentric)

5.1 Please explain in what way corporate bond yields show a "stronger relationship" to utility authorized returns than to government bond yields. In doing so, please indicate which of the two yields better explains the variations seen in utility authorized returns. Also, are the coefficients estimated by the two equations statistically different?

Response:

Please refer to pp. 13-14 of Concentric's December 2010 Report, where the relationships between government and corporate bond yields and utility authorized equity returns were measured using linear regression analysis. Table 1 on page 13 reflects that the sensitivity of authorized equity returns to corporate bond yields (as given by the beta coefficient) was greater than the sensitivity to government bond yields, and the R^2 is nominally greater. On p. 14 of the December 2010 Concentric Report, we note a possible explanation is the differing impacts of fiscal and monetary policy on government bond yields vs. alternative factors influencing corporate risk. In Figure 3, on p. 14 of the same Report, Concentric shows that government bond yields and corporate bond yields may actually move opposite one another. For these reasons, Concentric considers corporate bond yields to be a more reliable indicator of corporate risk and thereby would better explain variations in utility authorized returns than government bond yields. The analysis shows that for U.S. equity returns, corporate bond yields have a nominally higher statistical significance and R^2 value in explaining variability in equity returns than does government bond yields. The results are less consistent when applying Canadian bond yields to U.S. data, though still statistically significant.

We also note that regressing the difference between the two bond yields against authorized returns, yielded a result that was statistically significant at 89% confidence (marginally significant); and that both bond yields when included in the same regression equation against authorized returns were each statistically significant in explaining authorized returns, with t-statistics ranging from 2.65 to 3.52, respectively for government and corporate bond yields. With these tests we conclude that even though the independent variables are highly correlated, the difference between the government and corporate bond yield makes a marginally significant contribution to explaining the variation in utility authorized equity returns.