FORTIS BC™
Alternative Energy Services

3700 2nd Avenue
Burnaby, BC V5C 6S4

September 17, 2013

Via Email
Original via Mail

British Columbia Utilities Commission
6th Floor, 900 Howe Street
Vancouver, BC
V6Z 2N3

Attention: Ms. Erica M. Hamilton, Commission Secretary

Dear Ms. Hamilton:

Re: British Columbia Utilities Commission (BCUC or the Commission) Generic Cost of Capital (GCOC) Proceeding – Stage 2

FortisBC Alternative Energy Services Inc. (FAES) Response to the BCUC Information Request (IR) No. 2

In accordance with the Regulatory Timetable set out for Stage 2 of the GCOC proceeding by Commission Order G-77-13, FAES respectfully submits the attached response to BCUC IR No. 2.

If you require further information or have any questions regarding this submission, please contact Grant Bierlmeier at (250) 380-5794.

Sincerely,

FORTISBC ALTERNATIVE ENERGY SERVICES INC.

Original signed:

Grant Bierlmeier
Business Development Manager

Attachments

cc (email only): Registered Parties

31.0 Reference: Exhibit B6-3-1, BCUC IR 1.1.1, IR 1.4.6

Project Classification in Accordance to the Draft TES Regulatory Framework

FAES is requesting that the Commission provide direction on: (a) how Stage 2 of the GCOC proceeding will impact projects classified in the various streams under the draft TES Regulatory Framework: and (b) in a broader sense, what role will the Commission be playing in overseeing and re-determining the utility's return for projects in each stream going forward.

FAES' interpretation of the draft TES Regulatory Framework includes the following:

(a) if the Lieutenant Governor in General agrees to a <u>blanket exemption</u> of "on-site energy systems with a single customer, unless that single customer is a strata corporation," then future projects like the Delta School District would fall under the exempted category;

(b) On-site TES, including those with more than one customer and third-party owned TES selling to a Strata Corporation will receive a "light-handed regulation" approach. These are <u>Stream A utilities</u> that, going forward, will be exempted from the CPCN, rate setting, and long-term resource planning requirements of the *Utilities Commission Act*. Examples are PCI Marine Gateway, TELUS Garden, Tsawwassen Springs, and Helen Gorman;

(c) District energy system type projects, i.e., a system designed for intended future expansion to connect to future unknown customers and sites where the demand is uncertain and/or are larger than $15 million in costs to construct are <u>Stream B utilities</u> and these utilities must follow the regulatory requirements in the TES Regulatory Framework. An example is the Kelowna District Energy System.

31.1 Under the proposed Stream A TES regulation, alternative rate setting mechanisms are promoted and encouraged. Is it FAES' understanding that under this approach, the Commission will no longer be required to determine the deemed return on equities (ROEs), deemed capital structures, or deemed costs of debt which allow the utility to earn a reasonable return on investments?

<u>Response:</u>

As discussed in the responses to BCUC FAES IRs 1.4.4 and 1.4.6, it is FAES' understanding that Stream A TES utilities would still be regulated utilities, and rates would still be subject to the just and reasonable standard, but that the Commission will no longer be required to determine the deemed return on equity, capital structures and cost of debt for each Stream A utility from the outset.

31.2 Is it also FAES' understanding of the TES Regulatory Framework that the rates Stream A utilities entered into in the contracts with their customers could be higher or lower than the rates that reflect fair and reasonable return on investments the Commission could have allowed if Stream A utilities were fully and actively regulated?

Response:

FAES would not phrase it in terms of being higher or lower than "the rates that reflect fair and reasonable return on investments…". It is FAES' understanding based on what is currently described within the draft Regulatory Framework that Stream A utilities will continue to be regulated, but on a light handed basis. As the utility is still subject to the Act, rates must meet the just and reasonable standard which includes both the fair return standard and the requirement that the rate reflect a fair and reasonable charge for the service provided. The fact that the rate is negotiated in a competitive context would be a relevant factor for the Commission to consider in applying that standard, were the matter to later be brought before the Commission by the customer or utility.

32.0 Reference: Exhibit B6-3-1, BCUC IR 1.4.6, IR 1.4.7, IR 1.2.1

Rate Setting for Stream B Utilities

"FAES sees the minimum equity risk premium (75 basis points) and common equity ratio (45 percent) to be the starting point only for projects filed under Stream B of the TES Regulatory Framework that is currently being established. Approval of any premium or common equity ratio in excess of the default would likely be sought in the CPCN or initial rate approval process for Stream B projects. FAES, a stakeholder or the Commission could initiate a process at some future date in the event a change occurred that justified a change in the allowed premium or common equity ratio, as is typically done for other utilities whose ROE and capital structure are set relative to the benchmark." (BCUC IR 1.4.6)

"Ms. McShane indicates, and FAES concurs, that the recommended approach is intended to recognize that regulated TES projects as a group are more similar than different ……" (BCUC IR 1.2.1)

32.1 When FAES refers to "initiating a process at some future date" to change the allowed premium or common equity ratio for Stream B utilities "as is typically done for other utilities whose ROE and capital structure are set relative to the benchmark," can FAES acknowledge that a typical utility regulated by the Commission does not have a default, minimum rate?

<u>Response:</u>

FAES confirms that typically each utility has an individual capital structure and rates of return on debt and equity that are set according to their own circumstances, whether they are similar or different to the benchmark. Even when utilities have their capital structure and rates of return set individually, one would logically expect that utilities of similar risk would have a similar capital structures and ROE. The minimum default is really just a recognition of the fact that the TES projects are typically going to be more similar than different, and thus could be logically be expected to generally have a similar capital structure and ROE (i.e. the minimum). If that turns out not to be the case in a given circumstance and the risk is higher, then the proposal allows for an adjustment to reflect that.

32.1.1 What criteria or on what basis does FAES have in mind, if any, for the Commission to consider whether or not to allow the utility to deviate from the default equity risk premium and common equity ratio so that the regulatory efficiency of adopting a “minimum default” approach for TES utilities is not undermined as a result of frequent utility/project applications for additional premium to their cost of capital?

Response:

For Stream B utilities the starting point should be the minimum default capital structure and equity risk premium. FAES is of the view that establishing any premiums or common equity ratios for Stream B utilities that differ from the default should be established primarily at the outset of the project by the BCUC and reflect the specific circumstances of the project in question. In this regard, FAES is not proposing any specific criteria. Subsequent to determining the initial cost of capital, any changes would need to reflect fundamental changes in business risk of the specific project in question. However, FAES supports the position of the Commission in the AES Inquiry Report that the cost of a regulatory process should not outweigh the benefits of the regulation. Given the relatively small scale of these utilities FAES expects that other than large changes in the business risks such as loss of an anchor customer or supply, a review requested by the utility would be infrequent.

33.0 Reference: Exhibit B6-3-1, BCUC IR 1.2.3.1; Exhibit B6-2 Appendix A

Rate Setting for Stream B Utilities

FAES states "The advantages of FAES' proposed approach are that the proposed approach recognizes that the main drivers of the risk of TES utilities are small size and lack of diversity, which supports the concept of a single default capital structure and risk premium in the absence of substantive evidence of a higher cost of capital than the default." (BCUC IR 1.2.3.1) [Underline added]

"Small size and lack of diversity are key reasons why the business risk of TES utilities would remain higher even with mandatory connection." (BCUC IR 1.23.1) [Underline added]

33.1 FAES' proposed approach appears to only place weight on two risk factors: small size and lack of diversity, whereas in the recent past, the Commission has evaluated the risk premiums on TES utilities based on 20 different risk factors when applying the Commission risk matrix. Please explain why the proposed method is fair and reasonable approach to evaluating risk for small utilities and/or as it applies to TES.

Response:

It is not correct to state that FAES' proposed approach "only" places weight on two risk factors. FAES' proposed approach recognizes that, despite differences among projects, from an investor's perspective, small size and lack of diversity dominate other project specific risk factors. As a result, each TES project requires a higher common equity ratio and risk premium than the benchmark utility. In FAES' view, given the dominance of these two factors, the degree of precision in individual TES projects' cost of capital that is implied by the Commission's 20 factor risk matrix is not warranted, supporting the concept of a default capital structure and risk premium.

33.2 Does FAES agree that each of the projects listed in Table 4 in Appendix A have proposed different rate setting mechanisms which may or may not include various uses of deferral accounts with different purposes, applied different technology with different fuel sources, different technical configurations, different rate designs, etc? If so, how can the minimum default that is weighted to only two risk factors, namely small size and lack of diversity, be a fair approach to evaluate overall business risk?

Response:

FAES agrees that different projects have different characteristics. With regard to the importance of size and lack of diversity as the basis for the minimum “default” equity ratio and risk premium, please refer to the response to BCUC FAES IR 2.33.1.

34.0 Reference: Exhibit B6-3-1, BCUC IR 1.3.4; IR 1.3.5

Competitive Risks

FAES states that even among energy consumers that want a TES solution, there is still competition among providers of TES. Energy consumers also have the option of purchasing their own thermal energy equipment.

FAES also states that pricing to gain market share or limit competition is dealt with by the Competition Bureau of Canada.

34.1 If FAES believes that competition, or its price competitiveness, in the TES market is dealt with by the Competition Bureau of Canada, what role does FAES believe the Commission should have in shielding FAES from competitive risks?

Response:

The Competition Bureau of Canada does not protect or shield FAES from all competitive risks, or price competitive risks. Rather, the Competition Bureau of Canada shields all consumers, FAES and all competitors of FAES from *anti-competitive* acts of predatory[1] or exclusionary conduct.[2]

FAES does not believe that the Commission has any role in shielding FAES from competitive risks, but rather, believes that the Commission should acknowledge TES providers are subject

---

[1] http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03497.html

" Predatory conduct involves a firm deliberately setting the price of a product(s) below an appropriate measure of cost to incur losses on the sale of product(s) in the relevant market(s) for a period of time sufficient to eliminate, discipline, or deter entry or expansion of a competitor, in the expectation that the firm will thereafter recoup its losses by charging higher prices than would have prevailed in the absence of the impugned conduct. Predatory pricing may be implicit (through discounts or rebates, for example), or explicit.

The Bureau's view is that average avoidable cost is the most appropriate cost standard to use when determining if a dominant firm's prices are below cost. Avoidable costs refer to all costs that could have been avoided by a firm had it chosen not to sell the product(s) in question during the period of time the policy has been in place.26 The Bureau will examine whether an alleged predatory price is able to cover the dominant firm's average avoidable cost of supplying the product(s) in question during the time period over which the alleged predation has occurred."

[2] http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03497.html

In general, the Bureau is not concerned with conduct that forces competitors to be more effective, but rather with conduct that makes it more difficult for competitors to be effective. Exclusionary conduct is designed to make current and/or potential rivals less effective at disciplining the exercise of a firm's market power, to prevent them from entering the market, or to eliminate them from the market entirely. Such conduct often does so by raising rivals' costs.

to broader competitive risks than the Benchmark and this should be reflected in its risk premium.

35.0 Reference: Exhibit B6-3-1, BCUC IR 1.8.3.1

Long Term Risks

"FAES projects as regulated services may apply for the use of deferral accounts for uncontrollable items and intergenerational issues, for instance. In many cases, deferral accounts are appropriate risk mitigation tools that are in the interests of both ratepayers and the utility. For the most part, deferral accounts mitigate short term risks through smoothing rate impacts or ensuring appropriate recovery of costs, but do not address long term risks."

35.1 What are some examples of long term risks referenced in the excerpt above which are not, or cannot be, addressed by deferral accounts?

Response:

The deferral accounts lower risk in the short-term in that they can eliminate forecast risk (actual costs or revenues are recovered from or returned to customers), and they can be used to reduce rate impacts from large expenditures when costs are deferred for future recovery over a longer period of time. However, the existence of deferral accounts does not guarantee that the costs will be recovered in rates, and also does not address the fact that cost levels overall may be too high for the utility to be competitive against alternate forms of energy. Deferral accounts are more about managing the timing of cost recovery rather than the underlying costs themselves. It is the overall cost level that determines the long term risk.

For instance, a financier would lend to a business if it expected the business will eventually recover its costs, and those costs were approved to be deferred by its regulator, such as the Commission. Should it be shown that those costs will not be recovered due to poor long-term economics, then a financier would probably not lend to the business. Therefore, the long-term risk is the ultimate recovery of deferred costs in rates.

36.0 Reference: Exhibit B6-3-1, BCUC IR 1.16.1

ATWACC for FEI as per Order G-75-13

In the 9th bullet in the response to BCUC IR 1.16.1, it reads:

3.80% Equity + 2.94% Long-term Debt + 0.08% Short-term Debt = 6.43%

36.1 Please confirm that 3.80% should read 3.37%. If confirmed, please amend the answer if necessary.

Response:

Confirmed. The short-term debt should also be 0.12%. Therefore:

3.37% Equity + 2.94% Long-term Debt + 0.12% Short-term Debt = 6.43%

37.0 Reference: Exhibit B6-3-1, BCUC IR 1.16.2.2

ATWACC for FAES Based on the Minimum Default Cost of Capital Requested

Footnote 5 shows the calculation of ATWACC of 6.2% based on the following formula:

(9.50% ROE x 45.0% Equity Thickness) + ((4.28% LT Debt rate x 60.0% Debt Thickness)*(1-25% Tax Rate))

37.1 Please confirm that the debt thickness should be 55% instead of 60%.

Response:

Confirmed.

37.2 It appears that the long term debt rate used in IR 1.16.2 is 6.87 percent. Please provide the source of the long term debt rate of 4.28 percent used in the formula.

Response:

The long term debt rate used in response to BCUC IR FAES 1.16.1 (not BCUC FAES IR 1.16.2) was 6.87%; FAES had intended to reference BCUC FAES 1.16.2.1; however, the reference to 4.28 percent was incorrect. The correct long term debt rate is 4.73 percent as this was the most recent long term debt forecast obtained by FAES and, as shown in the response to BCUC FAES IR 1.16.2.1, was used in the calculation the ATWACC of the Delta School District for the 2013-2014 Revenue Requirement Application for that project. The revised calculation of the ATWACC in the response to BCUC FAES IR 1.16.2.2, using the 4.73 percent long term debt rate, should be 6.23 percent[3].

37.3 Please provide an amended response to Question 1.16.2.2 based on corrected data.

3 (9.50% ROE x 45.0% Equity Thickness) + ((4.73% LT Debt rate x 55.0% Debt Thickness) x (1 – 25% Tax Rate)) = 6.23%

<u>Response:</u>

Please refer to the response to BCUC FAES IR 2.37.2.

38.0 Reference: Exhibit B6-3-1, BCUC IR 1.6.1 Attachment

Corporate Chart for FortisBC Holdings Inc. (FHI)

38.1 FortisBC Inc. (FBC) is missing from the corporate chart. Please comment how it is related to FHI.

Response:

The corporate chart filed was for FortisBC Holdings Inc. and its subsidiaries. FBC is neither a subsidiary nor is it partially owned by FHI. FHI is neither a subsidiary of FBC nor is it partially owned by FBC. Rather FBC and FHI are affiliated companies in that they are both under common ownership of the ultimate parent company, Fortis Inc.

38.2 Please explain why some boxes in the corporate chart are grey and some are white.

Response:

The shading/colouring of the boxes is a way to differentiate the main operating entities and those where the operations are limited or the companies are inactive.

39.0 Reference: Exhibit B6-3-1, BCUC IR 1.24.1, IR 1.27.3.1

FAES Business Risk Compared to the Benchmark

> "FAES' primary concern in using the Commission's matrix in assessing the business risk is that, while it is easy to understand, it has the outward appearance of reducing a complex business risk assessment to an analysis that is more akin to a checklist. Business risk should be assessed on a more holistic basis." (BCUC IR 1.24.1)

39.1 Please discuss and provide specific example of what "holistic" approaches would be appropriate for the Commission. Does FAES consider its proposed approach, which only recognizes the main drivers of risk to be small size and lack of diversity, a more holistic approach? Why or why not?

Response:

As discussed in Appendix A, the various elements of risk are inter-related and business risk should be evaluated from an overall risk assessment.

FAES disagrees with the suggestion in the question that its approach only recognizes small size and lack of diversity. FAES' evidence, and that of its expert, is that those two factors are defining characteristics for a small utility and have by far the greatest influence on a business risk assessment. The other factors are legitimate considerations, but as individual factors they do not dictate the overall risk assessment.

This is important to understand, as it directly relates to why the matrix approach is not ideal. The matrix is perhaps a good way to ensure that all factors have been considered. But if the matrix is interpreted as a checklist, then it will implicitly give equal weight to all of the factors on the list. Even leaving aside this issue of weighting, the matrix also tends to suggest distinctions among TES utilities that, when considering the importance of small size and lack of diversity, may not be material from a cost of capital perspective. Put another way, the degree of precision in individual TES projects' cost of capital that is implied by the Commission's 20 factor risk matrix is not warranted.

> "the ability for a customer to fuel switch creates other performance problems such as reduced efficiency….If a customer group decides to fuel switch and decrease the load of the TES, the TES will then be oversized and will not perform as efficiently as it was intended to."

39.2 Assuming that fuel switching risk is considered to be highly probable in a particular TES project, would this be an example where FAES would apply to the Commission for an equity risk premium that is over and above the proposed minimum default, assuming the default was approved?

Response:

Yes, that is a potential scenario in which FAES might apply for a higher premium. Fuel switching risk is a risk that all utilities face, including incumbent utilities. However, factors such as the scale of the system and the relative impact and probability of the fuel switching along with any regulatory treatments such as rate design will affect the assessment of the business risk associated with fuel switching. Other items such as government policies and technology are further examples of items that may affect fuel switching risk.

40.0 Reference: General

Returns for Comparable Utilities / Projects

Below is a summary table prepared by Commission staff showing some of the Commission approved capital structures and risk premiums for regulated TES:

CPCN Application Business Case	**Dockside Green Energy**	**Corix UniverCity**	**River District Energy**	**FAES Delta School District**	**FAES Tsawwassen Springs**	**FAES PCI Marine Gateway**	**FAES Telus Garden**	**FAES Kelowna DES**
Regulatory Stream According to Draft TES Framework	**B**	**B**	**B**	**Exempt**	**A**	**A**	**A**	**B**
Reference Order	C-1-08	C-7-11 G-133-11	C-14-11 G-2-12	G-31-12 G-71-12 G-88-12	G-100-12 G-131-12	C-10-12 G-74-12	C-1-13	C-8-13
Capital structure (debt/ equity ratio)	Deemed 60/40	Deemed 60/40	Deemed 60/40	Deemed 60/40	Deemed 60/40	Deemed 60/40	Deemed 60/40	Deemed 60/40
Equity Risk Premium	Proposed: 100 bps Approved: 100 bps	Proposed: 200 bps Approved: 50 bps	Proposed: 50 bps Approved: 50bps	Proposed: 50bps Approved: 50 bps (not related to risk, project premium)	Proposed: 50 bps Approved: 50 bps, if FEI is responsible for economic risk	Proposed: 50 bps *Rates Denied*	Proposed: 50 bps *Rates Denied*	Proposed: 50 bps *Rates Denied*

40.1 Does FAES agree with the summary above? If not, please update and provide the reference.

Response:

Agreed.

40.2 Does FAES agree that the 100 basis points approved for Dockside Green was not based on a detailed analysis of risk factors (such as using the Commission's risk matrix) at the time?

Response:

FAES agrees that the Commission did not use the detailed risk matrix in assessing and approving the ROE premium for Dockside Green. Rather, the Commission highlighted a number of factors as identified by DGE and ultimately approved the risk premium on the basis of "the unique nature of this project, its small size, and the fact that it is an entirely greenfield project" (page 9 of C-1-08).

40.3 Given that the approved risk premiums are all equal to 50 basis points (with the exception of Dockside Green), it appears that FAES' proposed minimum default capital structure (45 percent equity and the equity risk premium over the benchmark at 75 basis points) is higher than what was approved in the past. If the proposed default were approved, how likely would FAES bring forth the required evidence to support a higher premium than the default if doing so would require much effort and increases regulatory costs?

Response:

If the minimum default is approved, FAES does not expect that Dockside Green Energy would be revisited. FAES would consider the minimum to be applicable to Kelowna DES. FAES does not currently expect to request premiums above the minimum default for any of its other presently contemplated projects. It would expect that such requests would not be the norm because the minimum default already recognizes the main drivers of the risk of TES utilities, being small size and lack of diversity.