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November 19, 2013

#### <u>Via Email</u> Original via Mail

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

Attention: Ms. Erica M. Hamilton, Commission Secretary

Dear Ms. Hamilton:

### Re: Generic Cost of Capital Proceeding – Stage 2 FortisBC Inc. (FBC or the Company) Rebuttal Evidence

In accordance with the Regulatory Timetable established in Order G-77-13, FBC respectfully submits the Rebuttal Evidence of the Company and its Expert.

If further information is required, please contact the undersigned.

Sincerely,

FORTISBC INC.

Original signed:

Dennis Swanson

Attachments

cc (email only): Registered Parties

## BRITISH COLUMBIA UTILITIES COMMISSION 2012 GENERIC COST OF CAPITAL PROCEEDING STAGE 2

**Rebuttal Evidence of FortisBC Inc.** 

November 19, 2013

1 2	Q1:	What is the purpose of this Rebuttal Evidence and how is it organized?
3	A1:	The purpose of this Rebuttal Evidence is to provide FortisBC Inc.'s (FBC) response to aspects of
4		the evidence of Dr. Andrew Safir (Exhibit C4-22). FBC has not sought to reply to every matter,
5		particularly where matters have already been addressed in FBC's primary Evidence. Our silence
6		should not be construed as agreement.
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8		Ms. McShane has provided separate rebuttal as it relates to her areas of expertise.
9 10	02:	On page 13, lines 4 to 7, Dr. Safir states:
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12		"However, prior to the Stage 1 decision, the BCUC had determined that a fair rate of return for
13		FBC would entail the same capital structure and a 40 basis point premium in the ROE
14		compared to the benchmark FEI. <sup>13</sup> "
15		-
16		Footnote 13 states: "The risk differential was first determined and confirmed by the
17		Commission in 1999 as a result of a NSP. More recently, the 2009 Terasen/Fortis gas utility
18		rate proceeding re-affirmed the differential."
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20		And, in response to FBC's Information Request No. 2.2 where Dr. Safir is requested to
21		provide the quote from the Commission's Decision on the Terasen Utilities 2009 ROE and
22		Capital Structure proceeding (Exhibit C4-24), Dr. Safir states:
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24		"There is no single quote. However, it is Dr. Safir's understanding that the Commission re-
25		affirmed the differential indirectly by leaving the differential unchanged. If the Commission
26		had considered the differential to be inappropriate, it is Dr. Safir's opinion that the
27		Commission would have so indicated."
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29		What is your response to this evidence?
30 31	A2:	Dr Safir appears to be advocating in his evidence that because FBC's and FEI's respective
32		common equity ratios were equivalent in 2009 (at 40 percent), a reduction in FEI's common
33		equity ratio as a result of the Stage 1 Decision should translate into a reduction in FBC's common
34		equity ratio of the same magnitude. His logic is based on a misconception, evident in the above
35		passages, that the Commission had assessed FBC's business risk in 2009. In fact, as set out
36		below, the last time the Commission considered evidence on FBC's business risk and cost of
37		capital was in 2005.
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39		The Commission determined in FBC's 2005 Revenue Requirements Application that FBC should
40		receive a 40 basis point premium compared to the benchmark ROE, and a capital structure of 40
41		percent equity. At the time of that decision (May 31, 2005), FEI's (then Terasen Gas Inc. (TGI))
42		common equity ratio was 33 percent. In other words, the differential was 7 percent at that time.
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1 Terasen Utilities' (now FortisBC Energy Utilities) 2005 ROE Application Decision on March 2, 2 2006 resulted in FEI's common equity ratio increasing to 35 percent from 33 percent. As FBC's 3 common equity ratio was not assessed that year (it was under a PBR negotiated settlement 4 agreement), the differential in common equity ratios was reduced to 5 percent only by virtue of 5 the increase in FEI's common equity ratio.

In 2009, the Terasen Utilities (now FortisBC Energy Utilities) filed an application for review of the ROE and capital structure of FEI, FortisBC Energy (Vancouver Island) Inc. and FortisBC Energy (Whistler) Inc. FBC was not an applicant in the Terasen Utilities 2009 Application. It did not file any FBC-specific evidence in that proceeding. It did not request any determination be made by the Commission on its own Capital Structure and ROE within that proceeding or separate from the proceeding.

In its Decision on the Terasen Utilities 2009 ROE and Capital Structure Application, the Commission specifically addressed what impact its determination should have on the remaining utilities in BC that may be affected, and determined that the ROE for TGI would continue to serve as the benchmark ROE for affected utilities. The Commission also determined a capital structure of 40 percent equity effective January 1, 2010 for FEI (previously approved as 35.01 percent equity in 2009). Contrary to Dr. Safir's evidence, the Commission made no determination that FBC's capital structure should be the same as the benchmark FEI, either explicitly or implicitly.

FBC's 2012 - 2013 Revenue Requirements and Review of 2012 Integrated System Plan Application (2012-13 RRA) was the Company's first revenue requirements application since emerging from PBR. The Commission issued a procedural order (Order G-199-11) on November 30, 2011 determining in response to a request from ICG that there was no need to expand the hearing for FBC's 2012-13 RRA to include a comprehensive review of FBC's capital structure and ROE. The Commission's rationale was the Commission's November 28, 2011 letter that had expressed its intent to conduct a Generic Cost of Capital (GCOC) Hearing. FBC's capital structure and ROE were maintained pending determinations made in the GCOC Hearing.

In short, FBC's capital structure has been approved at 40 percent equity since 1997<sup>1</sup>. Only FEI's common equity ratio has changed in that time. When the Commission considered evidence on FBC's and FEI's business risk and cost of capital within a 9 month span in 2005/2006, it established common equity ratios of 40 percent and 35 percent, respectively. On Dr. Safir's logic, that would support a minimum differential of 5 percent.

### Q3: On page 24, lines 17 to 19 and page 25, lines 1 to 6, Dr. Safir states:

*"Finally, FBC and Ms. McShane are confusing the risks stemming from vertical integration or ownership of assets with the risk of a disaster. Even if FBC did not own generating assets, it would still face supply risks from generation plant failures. Absent vertical integration, if a plant owned by one of its suppliers were knocked out of service, FBC would still need to find* 

<sup>&</sup>lt;sup>1</sup> FBC Response to ICG IR 2.5(b) (Exhibit B1-82)

and purchase alternative sources of electricity to supply its downstream facilities. In such a case, FBC would have to compete with other downstream electricity sellers for supply. As a result, this potential separation of ownership would not necessarily reduce total risk." (Footnote omitted)

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#### What is your response to this evidence?

8 A3: Typically both vertically integrated utilities like FBC and Local Distribution Companies (LDCs) 9 like FEI bear similar types of risks associated with *delivering the commodity* onto its system; 10 however, from a commodity perspective, a vertically integrated utility also has commodity supply 11 risk. Typically - and FEI is no exception - a LDC will contract for its commodity supply and the 12 supplier bears the generating plant failure risk of having the commodity available for delivery; whereas a vertically integrated utility is the supplier for that portion of its commodity that it self-13 14 supplies thus bearing the commodity risk associated with such generation plant failures. In the 15 case of FBC, which is a vertically integrated utility that effectively self-supplies 71 percent of its 16 energy, the Company bears such commodity risks from generation plant failures on that 71 17 percent of its energy supply. The risk of failure is a real one, even for the generation units that have had the electrical and mechanical components refurbished (one of the recent failures was a 18 19 refurbished unit).

This risk allocation issue as between FBC and a third party supplier matters because Generation failures can impact reliability. The BC Mandatory Reliability Standards framework gives rise to a risk of significant penalties in such circumstances, despite FBC's best efforts. At a minimum, there would be unforecasted MRS compliance costs. FBC's customers affected by service interruption might also seek redress, challenging exclusion of liability provisions in the tariff.

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### 27 Q4: Does this conclude your Rebuttal Evidence?

28 29 A.4: Yes.

## **REBUTTAL TESTIMONY**

ON

# CAPITAL STRUCTURE AND EQUITY RISK PREMIUM

FOR

# FORTISBC INC.

Prepared by

**KATHLEEN C. MCSHANE** 



November 2013

- 1 INTRODUCTION
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# Q. What is the purpose of your rebuttal evidence in Stage 2 of the British Columbia Utilities Commission's ("BCUC" or "Commission") Generic Cost of Capital ("GCOC") proceeding?

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A. The purpose of my rebuttal evidence is to respond to certain issues related to the common
equity ratio and equity risk premium for FortisBC Inc. ("FortisBC' or "FBC") raised in
the *Prepared Evidence of Dr. Andrew Safir* on behalf of the Industrial Customers Group
("ICG"). The fact that I do not address specific areas of his evidence should not be
construed to mean that I agree with either the analysis or conclusions. My qualifications
were previously filed as Appendix A to Exhibit B1-72, Appendix B, Expert Opinion of
Kathleen C. McShane (hereafter referred to as "*Opinion*").

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15Q.Do you agree with Dr. Safir's approach, i.e., to assess whether the business risk of16FBC relative to FEI has changed since 2009, and then to recommend a reduction to17FBC's existing equity ratio from 40% to 38.5% and equity risk premium from 4018basis points to 30 basis points based on the outcome of that assessment?

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20 A. No, for two reasons.

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First, Dr. Safir does not take issue with my quantitative analysis in support of the equity risk premium. He merely says that I do not adequately explain what has changed since 24 2009 to warrant an increase in the differential between FBC and the benchmark utility. 25 The explanation for the increase in the equity risk premium is clear and simple: market 26 return data support a risk premium of 50 to 75 basis points for FBC relative to FEI.

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Second, a first principles approach is appropriate for FBC, more so than for FortisBC
Energy (Vancouver Island) Inc. (FEVI) or FortisBC Energy (Whistler) Inc. (FEW),
because the Commission has not comprehensively evaluated FBC's business risks since

2005, more than eight years ago.<sup>1</sup> FBC was not an applicant in the 2009 cost of capital 31 32 proceeding, which was initiated by FEI, FEVI and FEW (at the time Terasen Gas Inc., 33 Terasen Gas (Vancouver Island) Inc., and Terasen Gas (Whistler) Inc.). Therefore, FBC's business risks relative to those of FEI were not addressed in the 2009 proceeding 34 35 and thus there is no foundation for assuming that 2009 is the valid starting point for assessing the change in FBC's business risk relative to that of FEI. The 40% equity ratio 36 37 and 40 basis point equity risk premium to the benchmark utility ROE approved by the 38 Commission in 2005 were subsequently agreed to by stakeholders in negotiated 39 settlements covering 2006-2011, not as the result of a comprehensive review of FBC's 40 cost of capital. If Dr. Safir believes that the incremental approach is the appropriate one, 41 the logical point of departure should have been FBC's 2005 RR Decision, when FBC's risk was last considered by the Commission. The differential in equity ratios between 42 43 FBC and FEI at that time was seven percentage points (40% versus 33%) and FBC's equity risk premium was 40 basis points. Nevertheless, given that the last in-depth 44 45 relative business risk analysis was performed more than eight years ago, it makes more 46 sense to assess how the relative risks compare currently, rather than attempt to assess 47 how much the relative risks of the two utilities have changed since that last assessment 48 was done.

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# 50Q.At page 30 of his evidence, Dr. Safir disagrees that it is appropriate to compare the51proposed equity ratio for FBC to those of other Canadian electric utilities, claiming52that all that is required is to compare FBC with FEI. Do you agree?

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A. No. FBC is a riskier utility than FEI, it is in a different utility sector than FEI, and, as shown above, its equity ratio has typically not been the same as FEI's. Comparing the proposed equity ratio to utilities in FBC's own utility sector provides a useful and appropriate gauge of its reasonableness relative to the equity ratio of FEI, the less risky benchmark utility. Moreover, comparing FBC's equity ratio and equity risk premium to

<sup>&</sup>lt;sup>1</sup> BCUC, In the Matter of FortisBC Inc., 2005 Revenue Requirements Application 2005-2024, System Development Plan, 2005 Resource Plan, Decision, May 31, 2005, hereafter referred to as "2005 RR Decision"

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the equity ratios and ROEs of its electric utility peers is required to ensure that the comparable return requirement of the fair return standard is achieved.

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Q. At pages 9-10 and 12 of his evidence, Dr. Safir appears to agree that FBC's
competitive risk relative to that of FEI has increased due to lower natural gas
prices, but then essentially dismisses this factor due to the mitigating impacts of
LNG exports. Please respond.

- 67 A. In the GCOC Stage 1 Decision, the Commission reduced the common equity ratio of FEI because it found FEI's business risks were lower than in 2009 due to two factors, one of 68 which was the improved competitive position of natural gas versus electricity.<sup>2</sup> While I 69 70 agree that the potential LNG market will help mitigate the impact of the low level of gas 71 prices, the development of the LNG export market remains in early stages. Further, in my opinion, Dr. Safir has not fully assessed the relative competitiveness of FBC versus 72 73 natural gas. FBC's competitive position is not only a function of natural gas prices. It is 74 also a function of trends in electricity prices, which, in FBC's case, remain subject to upward pressure due to required infrastructure investment.<sup>3</sup> Dr. Safir acknowledged that 75 he did not take into account the likely trajectory in FBC rates.<sup>4</sup> Because he has not taken 76 77 account of the likely trend in electricity rates, Dr. Safir underestimated the reduced 78 competitiveness of FBC versus natural gas and correspondingly underestimated the risk 79 of FBC relative to the benchmark utility.
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In the *GCOC Stage 1 Decision*, the Commission concluded that the improved competitive position of natural gas versus electricity was sufficiently significant to support a reduction in FEI's common equity ratio. If, as the Commission concluded, the improvement in the competitive position of natural gas was sufficient to support a reduction in FEI's common equity ratio, conversely, the corresponding deterioration in

<sup>&</sup>lt;sup>2</sup> BCUC, In the Matter of British Columbia Utilities Commission Generic Cost of Capital Proceeding (Stage 1) Decision, May 10, 2013, page 32; hereafter referred to "GCOC Stage 1 Decision".

<sup>&</sup>lt;sup>3</sup> Exhibit B1-72, Evidence of FortisBC Inc., page 19.

<sup>&</sup>lt;sup>4</sup> In response to BCUC ICG IR 4.4.3, Dr. Safir states that he has no prediction regarding the future level of FBC rates.

the competitive position of electricity should be sufficient, all else equal, to support an
increase in FBC's common equity ratio.

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# Q. At page 11 of his testimony, Dr. Safir concludes that FBC's risks have declined due to the establishment of deferral accounts in the 2012-2013 Revenue Requirements proceeding. Please address Dr. Safir's assertion.

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93 As indicated above, in the context of FBC, a comparison of current circumstances with A. 94 those of 2009 has limited relevance to the determination of reasonable financial 95 parameters, since there was no evaluation of FBC's business risks relative to those of FEI 96 in 2009. Consequently, the better approach is to compare the risks of FEI today with 97 those of FBC today. Notwithstanding that conclusion, the last comprehensive evaluation 98 of FBC's business risks was in 2005. Compared to 2005, as confirmed by FBC in 99 response to BCUC IR 2.46.1 and 2.46.2, FBC's overall risk mitigation of its deferral 100 accounts in 2013 is similar; the percentage of its revenue requirement covered by deferral 101 accounts is lower in 2013 than in 2005.

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# 103Q.At page 17, Dr. Safir analyzes the relative growth of FBC versus FEI between 2009104and 2012 and concludes that FBC has grown in size relative to FEI, so the risk105differential has fallen. Do you agree with Dr. Safir's analysis?

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107 A. No. Dr. Safir's analysis is incorrect in several instances and his conclusions flawed, 108 leading him to overstate FBC's growth relative to FEI's. At page 17, lines 9 to 11, Dr. 109 Safir states that FBC's revenues went from 17% of FEI's in 2009 to 23% in 2012. While 110 literally correct, the comparison fails to recognize that FEI's revenues fell between 2009 111 and 2012 because natural gas prices fell. Since gas commodity prices are a flow-through 112 to customers and can change dramatically from year to year, revenues inclusive of gas 113 costs do not accurately measure growth. The more relevant comparison for purposes of 114 assessing relative growth is between gross margin (revenues minus cost of gas) for FEI 115 and FBC's net regulated revenue (net of purchased power), as shown in Table 1 below.

That comparison shows that FBC's net regulated revenue as a percent of FEI's gross margin changed very little between 2009 and 2012 (32% in 2009 and 34% in 2012).

Table 1

	Net Revenues/Gross Margin		
	2009	2012	CAGR
FEI	526.1	613.0	5.2%
FBC	167.8	206.9	7.2%
FBC as % FEI	32%	34%	

Source: Consolidated Financial Statements of Terasen Gas Inc., December 31, 2009; FortisBC Energy Inc., Consolidated Financial Statements, December 31, 2012; FortisBC Inc., Annual Information Form for the Year Ended December 31, 2009; FortisBC Inc., Preliminary 2011 Revenue Requirements Application; FortisBC Inc., Annual Information Form for the Year Ended December 31, 2012.

130 With respect to customer growth, Dr. Safir's Table 1 indicates that customer growth for FEI was 0.1% between 2009 and 2012, compared to 0.9% for FBC, resulting in the 131 132 number of FBC customers relative to FEI's customers increasing from 13% in 2009 to 133 14% in 2012. Dr. Safir appears to have been unaware of the note in FEI's 2012 Annual 134 Information Form (page 7): "With the implementation of the new Customer Care Enhancement Project ("CCE Project") on January 1, 2012, the Corporation changed its 135 136 definition of a customer. As a result of this change in methodology, the Corporation has 137 reduced its customer count by approximately 15,000 customers effective January 1, 2012. 138 The 2011 customers have been restated for comparative purposes." Dr. Safir's customer 139 growth calculation for FEI was based on the 2009 number of customers using the 2009 140 definition and the number of customers in 2012 using the new definition. Table 2 below 141 shows FEI's customers and customer growth using a common (pre CCE project) 142 definition of customer. The correct comparison indicates that FBC's growth in customers 143 was only slightly higher than FEI's, and the differential far less than Dr. Safir's numbers 144 suggest. With the corrected customer count for FEI, the ratio of FBC's customers to 145 FEI's customers was the same in 2012 as it was in 2009, i.e., 13%.

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Customers		
2009	2012	CAGR
836,918	853,956	0.7%
110,853	113,915	0.9%
13%	13%	
	<b>2009</b> 836,918 110,853 13%	Customers           2009         2012           836,918         853,956           110,853         113,915           13%         13%

Source: Company data for FortisBC Energy Inc.; FortisBC Inc., Annual Information Form for the Year Ended December 31, 2009; FortisBC Inc., Annual Information Form for the Year Ended December 31, 2012.

154 With respect to rate base growth, the preponderance of FBC's growth in rate base 155 between 2009 and 2012 was for system reliability and infrastructure replacement 156 (sustainment capital), not system expansion or customer growth. Because FBC's 157 customer growth was not significantly higher than FEI's, FBC experienced much higher 158 rate base per customer growth than FEI from 2009 to 2012 (6.9% versus 3.0%, 159 respectively). Increasing rate base per customer indicates that FBC is increasingly reliant 160 on individual customers for its capital recovery. As a result, contrary to Dr. Safir's assertion, FBC's relatively high rate base growth is a factor that suggests higher risk for 161 162 FBC relative to FEI.

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Q. At pages 18-19 of his evidence, Dr. Safir agrees with you and FBC that FBC has a
less diverse customer base than FEI, but then states, "Contrary to what the utility
and Ms. McShane argue, the Dominion Bond Rating Service ("DBRS") considers
FBC to actually have a diversified and stable customer base..." Please respond.

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169 My testimony never suggests that FBC's service area or customer base is not diversified. A. 170 My testimony and that of FBC state that FBC's service area is less diverse than FEI's, a conclusion with which Dr. Safir agrees. The DBRS report cited by Dr. Safir does not 171 172 contradict that position, as it makes no comparison between FBC and FEI, which is what 173 is required for Stage 2 of this proceeding. In contrast to DBRS, the Moody's Credit 174 Opinions for FBC and FEI allow a comparison of the relative diversity of the service 175 areas and customer base of the two utilities. Moody's debt ratings represent the 176 composite of ratings in a number of categories, including market position. Market

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178 179 position reflects the diversity of a utility's operations among various markets, geographic regions or regulatory regimes. As shown on Table 3 of my *Opinion*, FBC is rated Baa in the market position category. FEI is rated A.<sup>5</sup>

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Q. At pages 22 to 25 of his evidence, Dr. Safir discusses the risks of FBC as a vertically
integrated electric utility. He dismisses the conclusion that FBC, as a vertically
integrated electric utility, is riskier than FEI, a distribution utility, based on studies
that have concluded that vertical integration reduces risk. Please respond.

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186 Dr. Safir is correct that the studies he cites in footnote 19 conclude that vertical A. 187 integration reduces risk. However, Dr. Safir has either misinterpreted or misapplied the conclusions of the studies when he suggests they would point to lower risk for a 188 189 vertically integrated electric utility than a distribution utility. None of the articles cited in 190 Dr. Safir's footnote 19 deals with vertically integrated electric utilities, i.e., ones that own 191 and operate transmission, distribution and generation assets, and their risk relative to 192 distribution utilities. The basic message of the studies referenced in Dr. Safir's footnote 193 19, which are dealing generically with the issue of vertical integration (e.g., one firm 194 which owns and operates oil and gas production, refining facilities and gas stations), is 195 that a firm that owns and operates related businesses is less risky than a portfolio of the 196 individual businesses, owned and operated separately. For example, as stated in one of 197 the articles cited by Dr. Safir in footnote 19:

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We present evidence that suggests that vertical integration, executed by merger, may reduce a firm's systematic or undiversifiable risk. That is, vertical mergers reduce risk by more than the simple portfolio effects that arise from combining business units in which returns are not perfectly correlated, suggesting that internal organization does have distinctive properties which cannot be easily replicated by stockholders taking separate asset positions in specialized companies operating at each stage of an industry.<sup>6</sup>

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<sup>&</sup>lt;sup>5</sup> Exhibit B1-9-6, McShane Evidence, Appendix F, Table 6, page 58.

<sup>&</sup>lt;sup>6</sup> Constance E. Helfat and David J. Teece, "Vertical Integration and Risk Reduction", *Journal of Law, Economics and Organization*, Vol. 3, No. 1, Spring 1987, page 47.

That message in no way leads to the conclusion that a vertically integrated electric utility is less risky than a distribution utility. It simply means that the vertically integrated electric is less risky than the sum of its parts, not that it is less risky than any one of the individual parts.

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# 212Q.Dr. Safir then cites a seven year old article published by the Edison Electric213Institute<sup>7</sup> which says that integrated companies may be less risky than non-214integrated companies because they are less sensitive to variations in purchased215power costs. Please comment on Dr. Safir's statement.

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A. The article that Dr. Safir cites is comparing the risks of electric utilities in a traditional vertically integrated world to a restructured environment (e.g., unbundling of functions, divestiture of generation assets). Its conclusions at the time were that (1) "policymakers should not assume that restructured utilities are less risky than the traditional utilities that preceded them"; (2) "utility risk should be evaluated on a company-specific basis, using analytic frameworks that address the new risks in restructured markets"; and (3) "Policymakers can control the cost of capital by controlling risk."<sup>8</sup>

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225 The example used in the article to suggest that a restructured electric utility may not be 226 less risky than its traditional vertically integrated predecessor, and on which Dr. Safir 227 relies, is one for which purchased power costs make up a significant portion of the 228 restructured utility's total costs and which is not assured of timely recovery of its purchased power costs, e.g., through a fuel adjustment clause.<sup>9</sup> This example is not 229 230 analogous to FEI, to which FBC is being compared. FEI has variance accounts that 231 provide timely recovery of its purchased gas costs and mid-stream costs. Thus the 232 example that Dr. Safir cites is not relevant to the relative risk of FBC and FEI.

<sup>&</sup>lt;sup>7</sup> Edison Electric Institute, *Electric Utilities and Risk// Compensation*, June 2006.

<sup>&</sup>lt;sup>8</sup> *Ibid.*, pages v –vi.

<sup>&</sup>lt;sup>9</sup> *Ibid.*, pages 11-20.

Q. Dr. Safir also claims that the EEI article indicates that, if FBC were to divest its
generating assets, its business risk would increase due to the reduction in the rate
base. Is that correct?

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A. No. First, the article does not mention FBC. Second, the article is saying that the typical unbundled utility (distribution or transmission/distribution only) is a much smaller utility than the corresponding traditional bundled vertically integrated utility, but the unbundled (distribution) utility's expenses are not commensurately less. With a smaller equity base relative to expenses, an unanticipated increase in costs will have a larger impact on the unbundled utility than the vertically integrated utility. Two points are germane to FBC's circumstances.

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246 First, the example that the article uses to indicate that risk may not be lower for an 247 unbundled utility is a comparison of a bundled utility with a rate base of \$4 billion 248 compared to an unbundled utility with a rate base of \$1 billion, one quarter its former 249 size. If FBC had divested its generation assets in 2012, its rate base would have declined 250 from \$1.1 billion to \$0.9 billion, and, while smaller, still over 80% the initial size. 251 Consequently, any size-related increase in risk for FBC from divestiture of its generation assets would be relatively minor, particularly when compared to the example used by the 252 253 article authors and relied on by Dr. Safir.

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255 Second, this claim is effectively a restatement of the prior claim, i.e., that integrated 256 companies may be less risky than non-integrated companies because they are less 257 sensitive to variations in purchased power costs. As indicated previously, as FEI, the 258 "non-integrated" utility to which FBC is being compared, has variance accounts for its 259 purchased gas and mid-stream costs, the potentially higher risk of the non-integrated 260 utility is not relevant to FEI.

262Q.At pages 23 to 24 of his evidence, Dr. Safir appears to conclude that DBRS does not263consider FBC to be more risky, as a vertically integrated utility which owns and264operates generation facilities. Please comment on Dr. Safir's interpretation of265DBRS' comments regarding FBC's generation risk.

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A. DBRS stated in its *Rating Report: FortisBC Inc.*, March 25, 2013, which Dr. Safir
inaccurately quoted:

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"FortisBC generates virtually all of its earnings from its integrated and regulated transmission, distribution and generation operations. Risks associated with **the** regulated electricity generating assets (which tends to be higher risk than transmission and distribution) are manageable, given that the hydro facilities are low cost, emission free and have no exposure to hydrology risk." (emphasis added)

277 The report clearly states that the risks associated with FortisBC's electricity generating 278 assets, while manageable, tend to be higher than transmission and distribution, not, as Dr. 279 Safir contends, that "although, in general, the risk associated with regulated electricity 280 generating assets 'tends to be higher risk than transmission and distribution' the same 281 cannot be said for FortisBC's generating assets." When DBRS says that the generation 282 asset risks are manageable due to FBC's specific circumstances, it means they may be 283 lower than the risks associated with other generation technologies, not that they are lower than the risks related to transmission and distribution assets. 284

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286 Q. At page 24 to 25 of his evidence, Dr. Safir concludes that "FBC and Ms. McShane 287 are confusing the risks stemming from vertical integration or ownership of assets 288 with the risk of a disaster. Even if FBC did not own generating assets, it would still 289 face supply risks from generation plant failures. Absent vertical integration, if a 290 plant owned by one of its suppliers were knocked out of service, FBC would still 291 need to find and purchase alternative sources of electricity to supply its downstream 292 facilities. In such a case, FBC would have to compete with other downstream 293 electricity sellers for supply. As a result, this potential separation of ownership 294 would not necessarily reduce total risk." Please comment.

296 A. Dr. Safir's proposition is entirely hypothetical. Whatever change in risk FBC might 297 experience would depend on the market structure that was in place. Rather than compare 298 FBC as it exists with a purely hypothetical, it can be compared to actual pure distribution 299 utilities in Canada, e.g., in Alberta and Ontario. In neither of those jurisdictions do the 300 utilities have the obligation to acquire power for their customers, either by constructing, 301 owning and operating generation facilities or by contracting for power. In Alberta, the 302 electric distribution utilities have exited the retail function; they do not face power supply 303 cost risks. Although Ontario distributors still sell power to their customers, under the 304 existing market structure, power is acquired at market prices and those prices flowed through to customers.<sup>10</sup> Unlike the Alberta and Ontario distributors, FBC retains those 305 306 obligations and the corresponding risks, including the risks of operating owned 307 generation facilities.

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#### 309 Are you aware of any capital market participants who currently consider vertically 0. 310 integrated electric utilities to be less risky than distribution utilities?

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#### No. As demonstrated in footnote 17 of my *Opinion*,<sup>11</sup> all three of the major debt rating 312 A. 313 agencies consider vertically integrated utilities to be more risky than transmission and 314 distribution utilities.

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316 Q. At page 26, Dr. Safir takes the position that, because the debt rating agencies did not 317 definitively state that there would be debt rating downgrades due to a lower ROE 318 and/or equity ratio, this constitutes a flaw in FBC's and your evidence on credit 319 ratings. Do you agree?

- 320
- 321 No. Since the Commission had not made a decision in Stage 1 when DBRS commented A. 322 on the potential impact of the GCOC on FBC (March 2013) and had not made a decision 323 in Stage 2 when Moody's issued its Credit Opinion for FBC (June 2013), it is not

<sup>&</sup>lt;sup>10</sup> Exhibit B1-9-6, McShane Evidence, Appendix F, page 43 and. Exhibit B1-72, Appendix B, Expert Opinion of Kathleen C. McShane, page 22.

Exhibit B1-72, Appendix B, Expert Opinion of Kathleen C. McShane, page 15.

324 surprising that they made no outright pronouncement that there would be downgrades, as
325 it would be premature on their part to judge what the Commission would do.
326 Nevertheless, particularly in the case of Moody's, their concerns are valid and should be
327 taken into account by the Commission.

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329Q.At page 26, Dr. Safir suggests that Moody's would not downgrade FBC because, "In330fact, Moody's, the harshest critic, indicated that a downgrade would likely result331were the determination made 'that the BCUC has become a less supportive and332predictable regulatory framework ...' However, Moody's did not view the Stage 1333benchmark decision as fulfilling this conditions, ..." Is Dr. Safir's interpretation of334Moody's Credit Opinion fair and complete?

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A. No. Dr. Safir left out a key sentence in the Credit Opinion. He failed to mention that
Moody's also said that "Ratings could also fall if sustained CFO pre-WC to debt metrics
remain around 10%." As FBC's recent, i.e., pre-GCOC, CFO pre-WC to debt metrics
were already in the 9-11% range, a downgrade remains well within the realm of
possibility without Moody's determining that the BCUC has become a less supportive
and predictable regulatory framework.

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343Q.Dr. Safir appears to believe that downgrades for FBC into the BBB category by344DBRS and to a Baa2 rating or lower by Moody's are not problematic, as observed345spreads between FEI and FBC debt yields, even when the debt rating difference was346two notches, were relatively small. Is Dr. Safir correct to be so sanguine?

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A.

No. The Alberta Utilities Commission (AUC) explained the issues succinctly:

798. Moreover, the Commission considers that the downgrade cannot be characterized simply as a matter of cost. The Commission has considered the UCA's evidence that BBB rated companies are able to issue debt. However, the Commission finds that although that may be true, as a BBB category issuer, a utility may face more significant challenges in accessing debt markets, particularly at a time of adverse market conditions. A list of individual debt transactions provided by AltaLink shows that during the period June 11, 2008 to January 29, 2009, companies with credit rating outside of an A category were not 358able to issue long-term debt on any terms in the public Canadian debt market.359(footnote omitted)

361 799. Finally, the Commission has also considered the risk associated with
attempting to reverse a credit metric downgrade, and, based on the evidence
provided by AltaLink, and in particular, noting the recent experience of Nova
Scotia Power, the Commission considers that it would be difficult to reverse a
downgrade even if the Commission took steps to assist AltaLink in restoring its
credit metrics after the downgrade.

800. Consequently, the Commission finds that it is in the public interest to avoid a downgrade from AltaLink's current A- credit rating. The Commission is persuaded that the potential adverse consequences and risk of a downgrade require the Commission to address the potential for a downgrade in this decision.<sup>12</sup>

The AUC's reference to Nova Scotia Power (NSPI) relates to that utility's loss of its Arating from Standard & Poor's (S&P) in 2001 when the Province of Nova Scotia announced that it was introducing competition, a debt rating it has yet to regain. As a BBB+ rated utility by S&P, during the financial crisis (December 2008), NSPI was only able to issue five-year debt and only at a wide spread (400 basis points) to the benchmark Government of Canada bond.

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381 With FBC's current ratings at A(low) by DBRS and Baa1 by Moody's, potential 382 reductions in the credit ratings are a legitimate concern. Downgrades by DBRS and 383 Moody's to BBB(high) and Baa2 respectively, i.e., both ratings in the BBB category, run 384 the risk of impairing FBC's access to capital on reasonable terms and conditions. Unlike 385 the U.S., where the BBB debt market for utilities is deep, it remains relatively small in 386 Canada. For FBC, one of whose ratings is already in the Baa category, a one notch 387 downgrade is more critical than for FEI, both of whose ratings are in the A category. A 388 one notch downgrade by Moody's to Baa2 would bring FBC to within two notches of 389 non-investment grade status. The closer a utility's debt is to non-investment grade status, 390 the more nervous bondholders would be. Many institutions have credit quality 391 constraints on their portfolios and would be required to sell FBC bonds if they fell to non-

<sup>&</sup>lt;sup>12</sup> Alberta Utilities Commission, *AltaLink Management Ltd.*, 2011-2013 General Tariff Application, Decision 2011-473, November 18, 2011. The reference to addressing the potential for a downgrade refers to additional credit metric support that might be warranted, e.g., ability to collect future income taxes, construction work in progress in rate base.

investment grade status and potentially before. It is important to recognize that a
downgrade does not affect only the cost of new issues. A downgrade will increase the
yield on existing issues. A higher yield on existing issues means a lower price to the
sellers of the bonds. If lower bond prices are the result of a downgrade, particularly one
that was avoidable through reasonable regulatory support, existing and potential bond
holders will be less likely to purchase future debt issues without material price (spread)
concessions.

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Q. Dr. Safir states at page 29 of his evidence, "It should also be recognized that, while
an ROE and capital structure along the lines recommended by FBC and Ms.
McShane would undoubtedly aid in securing a higher credit rating, it would come at
the expense of an increase in rates to FBC customers." Please respond.

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First, there is nothing in either my evidence or the FBC evidence that suggests approval 405 A. 406 of the requested equity ratio and equity risk premium can be expected to improve the credit ratings.<sup>13</sup> Rather, the approval of the requested common equity ratio and equity 407 408 risk premium is expected to assist in the avoidance of debt rating downgrades. As 409 discussed in my evidence, FBC's credit metrics are already considered by Moody's as weak for the rating.<sup>14</sup> Even if the Commission approved the top end of the proposed 410 411 equity risk premium range (75 basis points), the combined equity ratio and ROE for FBC 412 in 2013 will be lower than in 2012, i.e., no improvement in credit metrics and thus highly 413 unlikely to aid in securing a higher credit rating.

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Second, if the Commission approves the recommended equity ratio and equity risk
premium, rates will not go up, contrary to Dr. Safir's contention. The equity ratio will be
unchanged and the allowed ROE for 2013 will be lower than the allowed ROE for 2012.
FBC's allowed ROE for 2012 was 9.90%. In the *GCOC Stage 1 Decision*, the

<sup>&</sup>lt;sup>13</sup> Indeed, as FBC stated in response to BCUC FBC IR 5.1, "While FortisBC has performed the above requested calculations to obtain the thresholds for a potential ratings upgrade, it is important to note that the Company has never suggested that its allowed ROE should be such that it achieves specific thresholds that may permit a ratings upgrade. FortisBC is more concerned with maintaining its current ratings and avoiding a downgrade as alluded to in Moody's June 21, 2013 negative outlook ratings action and Moody's June 26, 2013 Credit Opinion. However, a risk premium of 50 to 75 basis points over the allowed benchmark ROE for FortisBC would assist in mitigating this risk. <sup>14</sup> Exhibit B1-72, Appendix B, Expert Opinion of Kathleen C. McShane, page 19.

419		benchmark utility ROE for 2013 was set at 8.75%. If the Commission adopts a 75 basis
420		point equity risk premium relative to the benchmark for FBC, its 2013 allowed ROE will
421		be 9.5%.
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423	Q.	Does this conclude your rebuttal testimony?
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425	A.	Yes.