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January 6, 2014
File No.: 240148.00595/14797

BY E-MAIL

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

Attention: Erica Hamilton
Commission Secretary

Dear Sirs/Mesdames:

Re: FortisBC Inc.
Generic Cost of Capital Proceeding - Stage 2

We enclose for filing in the above proceeding the electronic version of the Reply Submission on behalf of FortisBC Inc. dated January 6, 2014.

Fifteen copies of the Reply Submission will follow by courier.

Yours truly,

FASKEN MARTINEAU DuMOULIN LLP

[original signed by Matthew Ghikas]

Matthew Ghikas

MTG/fxm
Enc

BRITISH COLUMBIA UTILITIES COMMISSION

IN THE MATTER OF THE UTILITIES COMMISSION ACT

R.S.B.C. 1996, CHAPTER 473

and

RE: BRITISH COLUMBIA UTILITIES COMMISSION

GENERIC COST OF CAPITAL PROCEEDING - STAGE 2

REPLY SUBMISSION OF FORTISBC INC.

January 6, 2014

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PART ONE: INTRODUCTION

1. BCPSO and ICG were the two interveners that filed submissions relating to FBC.[1] Both advocate an overall return for FBC that is lower than what Ms. McShane has recommended as meeting the Fair Return Standard (although BCPSO accepts Ms. McShane's evidence that maintaining a common equity ratio of 40% "appears to be reasonable").[2] Their positions are not sustainable on the evidence. Neither intervener has disputed the key facts upon which FBC relies, and neither has provided a compelling basis to challenge FBC's and Ms. McShane's analysis of how those facts impact FBC's business risk. The interveners have also left unanswered many of the points raised by FBC's December 3, 2013 Final Submission. FBC respectfully submits that the Commission should maintain FBC's common equity ratio at 40% with a risk premium at the upper end of Ms. McShane's 50 to 75 basis point range, consistent with the Fair Return Standard.[3]

2. FBC's Final Submission anticipated and addressed most of the interveners' arguments. In this Reply Submission, we have focussed our response on those primary points where further response is necessary. FBC's silence on a particular matter should not be construed as agreement with intervener submissions.

PART TWO: FBC FACES HIGHER OVERALL BUSINESS RISK

3. In this Part, FBC first addresses ICG's submission that 2009 should be used as a reference point for assessing FBC's business risk. Otherwise, FBC's reply is organized according to the same business risk factors outlined in its December 3, 2013 Final Submission.

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[1] Abbreviations used in the Final Submission are also used in this Reply Submission.

[2] BCPSO Final Submission, para.32.

[3] Exhibit B1-81, BCUC-FBC (McShane) IR 2.24.2.

A. ICG'S USE OF 2009 AS A REFERENCE POINT IS MISGUIDED

4. ICG has devoted a significant portion of its written argument to justifying why the Commission should use 2009 as a reference point in assessing FBC's business risk relative to the benchmark utility. This is not surprising, given how fundamental that position is for Dr. Safir's evidence. FBC has already addressed in its December 3, 2013 Final Submission the basic flaws with Dr. Safir's approach, but provides responses to ICG's specific arguments below. In short, ICG's arguments are without merit and should be rejected.

(a) FBC's Position is Consistent with Stage 1 and Prior Decisions

5. In paragraph 4 of its submissions, ICG portrays FBC's submissions on Dr. Safir's approach as somehow contradicting the Stage 1 Decision:

> Despite the Commission Panel's conclusion that the 2009 Decision was a reasonable first point of reference in the Stage 1 proceeding, FBC submits that the use of the 2009 Decision by Dr. Safir 'invalidates his opinion.' (FortisBC Final Submission, para. 84) Going even further, FBC also requests that the Commission Panel virtually ignore all earlier decisions regarding business risk.

ICG and Dr. Safir are ignoring *why* the Commission had used the 2009 Terasen Gas ROE Decision as its primary point of reference in Stage 1. The answer is that the Commission was using as its primary point of reference the last occasion when the Commission had comprehensively assessed the benchmark utility's business risk. The 2005 FBC RRA Decision, not the 2009 Terasen Gas ROE Decision, was the last occasion when the Commission had performed a similar assessment of FBC's business risk.

6. Dr. Safir's opinion that FBC's common equity ratio should now be set at 38.5% is invalidated by his reliance on the 2009 Terasen Gas ROE Decision because his opinion is premised entirely on the incorrect assumption that the Commission had determined in the 2009 Terasen Gas ROE Decision that the common equity ratios of FEI and FBC should be the same based on their relative business risk. The Commission made no such determination. Dr.

Safir did not otherwise attempt to justify why a 38.5% common equity ratio was appropriate for FBC based on FBC's business risk relative to the benchmark utility.

7. FBC's position is consistent with the Stage 1 Decision and recognizes past decisions regarding FBC's business risk. Although FBC has expressed the view that a "first principles" assessment is appropriate given the passage of time since 2005, FBC has provided evidence to permit the Commission to use 2005 as a point of reference. Using 2005 as a point of reference, when the differential above the benchmark utility was 5%-7% common equity plus 40 basis points ROE, only reinforces the reasonableness of Ms. McShane's recommendation today.

8. ICG's suggestion that FBC is virtually "ignor[ing] all earlier decisions regarding business risk" is ironic. First, ICG mischaracterizes the scope and outcome of both the 2009 Terasen Gas ROE Decision and the 2008 FBC RRA Negotiated Settlement Agreement ("NSA", discussed below), neither of which addressed FBC's cost of capital. Second, ICG never once acknowledges the 2005 FBC RRA Decision.[4]

(b) ICG's Submissions on the 2008 FBC NSA

9. In paragraph 5, ICG "bring[s] to the attention of the Commission Panel" an excerpt from FBC's Final Submissions in the 2009 Terasen Gas ROE proceeding ("FBC 2009 Final Submission"). ICG appears to place great significance on the fact that FBC had informed the Commission Panel about the 2008 FBC RRA NSA, contending in paragraph 7 that "…it must be presumed that the Commission Panel that issued the 2009 [Terasen Gas ROE] Decision considered the cost of capital of FBC established by Order G-193-08." The fundamental flaw in this logic is that it was never the role of the Commission to make a finding regarding FBC's business risk or cost of capital in a Terasen Gas application. It is self-evident that the passage

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[4] It would still have been consistent with the Stage 1 Decision to use the 2005 FBC RRA Decision as a point of reference even if ICG's untenable characterization of the 2009 Terasen Gas ROE Decision had been accurate. The Stage 1 Decision made reference to both the 2009 Terasen Gas ROE Decision *and the previous 2006 Terasen Gas ROE Decision*: GCOC Stage 1 Decision, Executive Summary, p. (ii) (the very same passage quoted by ICG in paragraph 3 of its submissions).

from the FBC 2009 Final Submission upon which ICG is relying had only explained how changes in the benchmark ROE would affect FBC under FBC's existing negotiated settlement. For ease of reference, the key portion of the passage quoted by ICG is:

> FortisBC's 'allowed return on equity' is calculated by reference to the TGI benchmark ROE with adjustments and sharing as contemplated in the approved Negotiated Settlement Agreement [approved by Order G-193-08]. The agreement incorporates the application of the benchmark ROE for the purposes of setting FortisBC's ROE.[5]

The 2009 FBC Final Submission had nothing to do with FBC's business risk, common equity ratio, or equity risk premium.[6]

10. In paragraph 8 of its submissions ICG states: "FortisBC submits that the last time that the Commission determined the capital structure of FBC was in 2005. However, the fact that the capital structure was approved by settlement agreement in Order G-193-08 cannot be taken to mean that the Commission did not approve the same equity ratio for FEI and FBC. It would be particularly unfair to customers that participated in the NSP process in good faith for elements of the NSP to have no future evidentiary consequences for the utility." There are two responses.

- First, the correct articulation of FBC's position is that the Commission has *not comprehensively assessed FBC's business risk since 2005*. Obviously, every time utility rates are re-set, they are based on an approved capital structure; but, the Commission's practice has not been to re-assess a utility's business risk, common equity ratio and ROE each time utility rates are approved. The effect of FBC's 2008 RRA NSA was that FBC's allowed ROE would continue to be determined with reference to the benchmark ROE. The 2008 FBC RRA NSA did not even address as part of its terms FBC's common equity ratio or the appropriate equity

[5] 2009 Terasen Gas ROE proceeding, FBC Final Submission, para.13.

[6] FBC notes that this is an example of ICG referencing in final submissions documents that it never introduced into evidence. This is procedurally improper.

risk premium. What follows is the sum total of the discussion on cost of capital in the 2008 FBC RRA NSA:

> The requested rate increase remained unchanged, as a net result of the adjustments, at 5.6 percent, effective January 1, 2009, subject to the determination of the 2009 Return on Equity arising from the Automatic Adjustment Mechanism, the outcome of a Negotiated Settlement Process ("NSP"), and the flow through of any adjustments as the result of a proceeding with the Commission for the additional sale of 25 GWh of energy to the City of Nelson from FortisBC.[7] [Emphasis added.]

- ICG is essentially suggesting that the Commission Panel approving the 2008 FBC RRA NSA, by virtue of its silence on FBC's capital structure and equity risk premium, can be deemed to have determined that FBC's pre-existing capital structure had reflected its business risk relative to the benchmark utility in circumstances where cost of capital had not been at issue before the Commission in the first place. That is a novel concept. A NSA can only be expected to address what is in-scope for that proceeding. ICG's submissions in paragraphs 6 and 8 about the validity and enforceability of an NSA are irrelevant, given that ICG has mischaracterized the scope of the 2008 FBC RRA NSA approved Order G-193-08.

- Second, even if the Commission were to accept ICG's argument about the 2008 FBC RRA NSA having "evidentiary consequences" relating to cost of capital, the "evidentiary consequences" still would not support the two utilities having the same common equity ratio. The two utilities did not have the same equity ratio at the time of Order G-193-08. The benchmark utility's common equity ratio was 35%, not 40%, and there was still a 5% differential. If anything, ICG's argument would seem to suggest that FBC's common equity ratio should now be set above

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[7] *In the Matter of FortisBC Inc. 2008 Annual Review, 2009 Revenue Requirements and Negotiated Settlement Process*, Order No. G-193-08, December 11, 2008, Appendix A, p.2.

40% (FEI's current ratio of 38.5%, plus the same 5% differential that existed in 2008, is 43.5%).

11. ICG appears to be arguing in paragraph 10 of its submissions that FBC had admitted in the 2009 Terasen Gas ROE proceeding either that its overall business risk was equal to that of FEI or that its common equity ratio should be the same. It is self-evident, however, that the quotation from FBC's submission in that proceeding that forms the basis for ICG's argument has been taken out of context.[8] FBC was arguing for the continued use of a benchmark utility for the purpose of establishing the allowed ROE for smaller BC utilities. To that end, FBC was pointing out that other utilities affected by the benchmark are subject to some common risks given that they are all located in BC. FBC never suggested in 2009 (in the passage quoted by ICG or otherwise) either that FBC's and FEI's business risk profiles were identical or that their capital structure should be the same. In fact, FBC had expressly identified in the quoted passage the need to account for variances in business risk. FBC's submissions were focussed on the process for establishing ROE, rather than capital structure, because the benchmark ROE was the only aspect of the 2009 Terasen Gas ROE proceeding with the potential to directly impact FBC's overall return. In short, ICG is taking liberties with the facts and its argument should be rejected.

(c) ICG's Position Regarding 2009 Also at Odds With BCPSO's View

12. Unlike ICG, BCPSO views 2005 as being the appropriate point of reference.[9] BCPSO's position is that "…the risk differential between FEI and FBC is considered to be smaller today than in 2005. In these circumstances, it is generous to allow FBC an equity thickness and return on equity that is proportionately greater than that allowed in 2005." Ms. McShane's recommendation, even at the higher range, is consistent with BCPSO's view; it contemplates a

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[8] ICG never introduced the 2009 FBC submission as evidence in this proceeding, either through IRs or its own evidence. The fact that ICG is now taking a quote from the document out of context, necessitating a response from FBC, is a good example of why parties should not be permitted to introduce new evidence in the guise of argument.

[9] BCPSO Final Submission, paras. 3 and 5, for example.

1.5% differential in equity thickness and a 75 basis point equity risk premium. In 2005, the differential in overall return as between FEI and FBC had been much larger - 5% to 7% of common equity, with a 40 basis point equity risk premium.

B. SMALLER SIZE AND MORE CONCENTRATED ASSETS

13. Neither ICG, nor BCPSO appears to challenge that FBC is a smaller utility and that this increases its risk relative to the benchmark utility. Dr. Safir expressly concedes this point.[10]

14. BCPSO states that "while FBC is a smaller utility than FEI, unlike FEI it is not suffering from declining use per customer. Rather, FBC's load has been relatively flat since at least 2008."[11] Neither of these points relate to the risk that FBC faces by virtue of being of smaller size with greater asset concentration. In any event, FBC and FEI were in a similar situation in 2005 *vis à vis* UPC and load; the facts that BCPSO has highlighted do not represent any change in FBC's business risk relative to the benchmark utility over the time period cited by BCPSO.[12] BCPSO makes no mention of FBC's growing rate base per customer.

C. LESS DIVERSE CUSTOMER BASE

15. ICG says that "The most significant change to customer composition occurred with the purchase of the City of Kelowna", citing the growth in customer base and the conversion of a municipal Wholesale customer into a greater number of Residential and Commercial customers.[13] BCPSO similarly cites the associated decline in Wholesale load since 2005.[14] Despite the directionally favourable impact on customer diversity, FBC's overall

[10] Exhibit C4-22, ICG Evidence, Safir Evidence, p.8, ll.13-16.

[11] BCPSO Final Submission, para.7.

[12] Exhibit B1-73, BCUC-FBC IR 1.12.1.

[13] ICG Final Submission, para.26.

[14] BCPSO Final Submission, para.8.

business risk has not materially changed as a result of the transaction.[15] The evidence of Ms. McShane and FBC on this topic includes:

- The transaction was not a material change from the perspective of utility size and asset concentration. The effect on rate base was no different than incurring a couple of larger capital expenditures, such as substations, in a given year.[16] The vast majority of FBC's recent capital expenditures are related to system sustainment, not the acquisition of the City of Kelowna utility assets.

- The transaction was net neutral in terms of the load served.[17]

- It did not significantly expand the Company's service area.

- Even with the City of Kelowna transaction, FBC's rate base per customer is higher today than it was in 2009 due primarily to significant sustainment capital expenditures. FBC's rate base per customer growth since 2009 has outpaced FEI's growth in rate base per customer by more than a 2:1 margin.[18]

- The transaction also provided rate mitigation for customers, other things being equal. However, as described in the next section, the new direct Residential customers (formerly indirect customers of FBC) are now subject to FBC's Residential Conservation Rate, which increases costs to those former City of Kelowna customers that heat electrically.

- An offsetting risk consideration is that FBC faces additional operational risk as a result of assuming ownership of the assets and the statutory obligation to serve the additional direct customers.[19]

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[15] Exhibit B1-73, BCUC-FBC IR 1.10.1.2.

[16] Exhibit B1-81, BCUC-FBC IR 2.34.1; Exhibit B1-73, BCUC-FBC (McShane) IR 1.10.9.

[17] Exhibit B1-81, BCUC-FBC IR 2.34.1; Exhibit B1-73, BCUC-FBC (McShane) IR 1.10.9.

[18] Exhibit B1-84, FBC Rebuttal Evidence, McShane Rebuttal Evidence, p.6.

[19] Exhibit B1-81, BCUC-FBC IR 2.32.2, 2.32.1; Exhibit B1-73, BCUC-FBC IR 1.10.1.2.

D. LESS DIVERSE ECONOMIC BASE

16. ICG is silent on this issue, but BCPSO cites "some slight improvement in recent years" in the forestry industry as "decreasing the risk that FBC will lose a significant industrial customer to mill closure."[20] BCPSO's argument is a "red herring". Investors making long-term investments - as utilities must do - will look beyond the current circumstances; BCPSO conceded this point in its submissions for FEVI/FEW.[21] The long-term business risk faced by FBC is associated with the "boom and bust" nature of the forestry industry and the potential for customers to fail during the inevitable challenging times in the future. This risk is the same regardless of how the industry is currently performing.

E. PRICE COMPETITION POSES HIGHER RISK FOR FBC

(a) Response to BCPSO

17. BCPSO addresses price competition in the Residential sector by referring to FBC's UPC, and 57% capture rate for new homes.[22] One answer to this argument is that the two utilities were in a similar situation in 2005 with respect to UPC and load growth, so even on BCPSO's analysis these facts should not affect the differential between FEI's and FBC's overall allowed return since 2005.[23] More importantly, BCPSO is taking a retrospective approach, when even BCPSO acknowledges that business risk can only be assessed prospectively.[24] The key fact for assessing competitive risk in the Residential sector, which BCPSO does not address, is that FBC's rates are facing considerable upward pressure at a time when natural gas rates at the burner tip are relatively low.

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[20] BCPSO Final Submission, para.10.
[21] BCPSO Final Submission for FEVI/FEW, para.9.
[22] BCPSO Final Submission, para.13.
[23] Exhibit B1-73, BCUC-FBC IR 1.12.1.
[24] BCPSO Final Submission, para.2.

18. BCPSO's response to FBC's evidence regarding the risk of Industrial customers leaving FBC's system is to characterize the risk as "not one that is imminent".[25] FBC submits that the Commission should not limit its assessment only to "imminent risks". The Commission has always given greatest weight to longer term business risks, as is appropriate when utility investments are long-term in nature. As indicated above, BCPSO has also conceded the importance of a long-term view when assessing business risk.[26] FBC's evidence does identify a realistic longer-term risk of losing Industrial load.

19. Although BCPSO acknowledges that rising BC Hydro's rates put upward pressure on FBC's rates, it suggests that "FBC appears to be minimizing the effect that increases in BC Hydro's future prices will have on improving its relative competitiveness with BC Hydro and focussing solely on the impact such increases will have on its own costs." [Emphasis added.][27] While there are some areas where FBC directly competes with BC Hydro for Residential and Commercial customers, the number of potential customers in these contested areas represents only a fraction of FBC's Residential and Commercial customer base. Given that FBC's primary competition in the Residential and Commercial markets is from competing energy forms such as natural gas and alternative energy as opposed to direct competition with BC Hydro (one-third of FBC's Residential sales[28] are for space and water heating), BC Hydro rate increases are more likely to increase FBC's business risk than to decrease it.[29]

(b) Response to ICG

20. ICG says that it represents Industrial customers, and cites Celgar's efforts to gain access to utility service in response to FBC's evidence on the risk associated with industrial customers leaving the system.[30] Despite ICG's argument, Industrial customers are businesses

[25] BCPSO Final Submission, para.15.
[26] BCPSO Final Submission for FEVI/FEW, para.9.
[27] BCPSO Final Submission, para.17.
[28] Exhibit B1-72, FBC Evidence, Appendix A, p.17.
[29] Exhibit B1-80, BCPSO-FBC IR 2.5.1; Exhibit B1-73, BCUC-FBC IR 1.14.4, 1.14.5, 1.16.1.
[30] ICG Final Submission, para.28.

and must do their best to operate competitively in order to remain in business. Given that energy costs are a significant operating cost for Industrial customers, one can reasonably expect Industrial customers to consider all options available to them to reduce costs. As alternatives to FBC's service become more economically viable, the potential for a customer to leave FBC's system increases for FBC.

21. ICG is at pains in its Stage 2 submission to downplay the significance of lower natural gas prices. ICG asserts, for instance, that the Commission also considered other factors in its Stage 1 Decision, specifically "provincial government climate and energy policies".[31] Contrast this tone with ICG's focus in its Stage 1 submissions on the natural gas "game changer":

> 28. As noted above, shale gas has been a "game changer" for gas prices. This seismic shift in gas prices, together with significant general rate increases for electricity, has resulted in a seismic shift in the competitive position of natural gas rates as compared to electricity rates. Moreover, given the upward pressures on electricity rates in recent years, the Commission Panel should conclude that the current trends of the improving competitive position of natural gas rates as compared to electricity rates will continue. It also necessarily follows that FEI has lower business risks now than in 2009 and much lower than in 2005.[32]

ICG's change of tone is no doubt attributable to a recognition that lower gas prices that improve FEI's competitive position *vis à vis* electricity can logically only have the opposite effect on FBC.

22. The fact that lower gas prices represent a challenge for FBC is a very significant point when one considers how Dr. Safir arrived at his recommended common equity ratio for FBC. Dr. Safir has recommended reducing the equity thickness to 38.5% because FEI and FBC had the same common equity ratio in 2009 and the Commission has now reduced FEI's common equity ratio to 38.5%. He hasn't undertaken further empirical assessment. Since the

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[31] ICG Final Submission, para.24.

[32] GCOC Stage 1 ICG Final Submission, para.28.

lower natural gas prices were an important factor in the Commission's reduction of FEI's common equity ratio, and since lower natural gas prices have had the opposite impact on FBC, Dr. Safir's recommendation for FBC is illogical even if (as ICG incorrectly asserts) the Commission had determined in 2009 that FBC's and FEI's common equity ratios should be the same based on an assessment of their relative business risk.

23. The fact that the Commission also determined in Stage 1 that policy conditions are now more favourable for FEI than in 2009 is not an answer to FBC's point that lower natural gas prices increase FBC's competitive risk. There can be no denying that the Commission found in the Stage 1 Decision "that there has been some reduction in the level of risk associated with the competitive position of natural gas as compared to electricity."[33] Moreover, if policy considerations are, in the Commission's view, now less disadvantageous for natural gas, then presumably the policy considerations are less advantageous to electric utilities that compete with natural gas.

F. ENERGY SUPPLY RISK

24. FBC's Final Submission already addressed the points raised by BCPSO relating to energy supply risk, so we focus on responding to ICG.

(a) ICG's Submissions on the WAX CAPA

25. ICG's submissions on the Waneta Expansion Capacity Purchase Agreement ("WAX CAPA") in paragraphs 31-35 address matters well beyond the scope of this proceeding. The Stage 2 proceeding is concerned with setting a fair return for FBC, a task which requires the Commission to assess FBC's business risk. Given the stand-alone principle, the Commission should not be exploring (as ICG advocates) "the relationship between FBC and its parent company, in terms of the WAX agreement".

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[33] GCOC Stage 1 Decision, p.32.

26. ICG argues that "the Commission Panel should now give considerable weight to the views of customers by providing some relief for customers from the costs of the WAX CAPA with a fairer balancing of interests amongst the stakeholders by reducing the cost of capital for FBC in this proceeding."[34] While ICG may not like the WAX CAPA, the Commission has already determined that the WAX CAPA is in the public interest (which includes the interests of FBC's customers as a whole).[35] In reaching this conclusion, the Commission has accounted for the fact that the WAX CAPA results in greater rate impacts on customers in its early years and has already directed FBC to develop a rate smoothing mechanism to address them.[36] This GCOC proceeding is not a WAX CAPA reconsideration application. In any event, ICG's argument that customers should be somehow compensated for past Commission decisions by denying an overall return for FBC that appropriately reflects FBC's business risk is also inconsistent with the Fair Return Standard.

27. ICG's interest in the out-of-scope topic of the "relationship between FBC and its parent company, in terms of the WAX agreement" underlies its multiple demands to view the WAX CAPA since it was first approved. The Commission has already determined on two occasions in response to similar arguments by ICG that the WAX CAPA is a confidential document.[37] It is entirely appropriate and fair for the Commission to continue to treat the agreement as confidential in this proceeding.

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[34] ICG Final Submission, para.35.

[35] *In the Matter of A Filing by FortisBC Inc. for Acceptance of a Capacity Purchase Agreement*, Order No. E-15-12, May 25, 2012 ("WAX Order"), Recital H: "The Commission has completed its review of the WAX CAPA and determined it is in the public interest and a hearing is not required before accepting the WAX CAPA for filing pursuant to section 71 of the Act".

[36] WAX Order, Recital I: "The Commission notes that although the WAX CAPA is a long-term capacity purchase agreement and is in the public interest, there is the potential for disproportionate rate impacts in the early years of the agreement". The WAX Order stated: "FortisBC is directed to develop a rate smoothing proposal for the Commission's approval either through a separate submission or with the next Revenue Requirements Application."

[37] *In the Matter of A Filing by FortisBC Inc. for Acceptance of a Capacity Purchase Agreement*, Order No. E-29-10, September 23, 2010 and WAX Order. For instance, in the latter order the Commission ordered: "The Commission will hold confidential the Capacity Purchase Agreement and the Justification Report."

(b) Response to ICG on Supply Interruption Risk

28. ICG's relevant submissions on supply risk and FBC's power purchases from BC Hydro under RS 3808 (paragraphs 37 to 40) miss FBC's fundamental point. FBC takes no issue with the fact that the renewal of the BC Hydro PPA (assuming that it is approved, since the process is still ongoing) and the WAX CAPA have reduced FBC's risk in terms of availability of supply. However, this element of supply risk was already fairly low.[38] FBC's energy supply risk is primarily associated with supply interruption and the resulting reliability and/or price consequences. ICG has not addressed the evidence referenced by FBC starting at paragraph 40 FBC's Final Submission, which includes:

- FBC is an electric utility, and this in and of itself affects interruption risk *vis à vis* the benchmark (natural gas distribution) utility.
- The price risk remains because of uncertainty with respect to future rate increases related to FBC's PPA with BC Hydro and prices on the open market, and increases in supply costs put upward pressure on FBC's rates.[39]
- FBC has higher supply interruption risk relative to FEI resulting from having owned and contracted generation located within its service area, and this risk applies equally to WAX CAPA.[40]

29. ICG suggests that "FBC's analysis has ignored the reality that because FEI receives most of its supply via the Spectra and TransCanada pipelines, there are risks of pipeline failures that influence FEI's supply risk profile."[41] Both FBC and FEI have risk associated with getting the commodity from where it is produced to where it is needed. The difference is that FBC's transmission is above ground and more exposed, and that any failure of on-system

[38] Exhibit B1-72, FBC Evidence, Appendix B, McShane Evidence, p.13.
[39] Exhibit B1-72, FBC Evidence, Appendix A, p.4.
[40] Exhibit B1-81, BCUC-FBC IR 2.38.1.
[41] ICG Final Submission, para.48.

generation has an instantaneous effect on the utility's ability to serve load (i.e., FBC doesn't have access to line pack or storage near load).

30. ICG has correctly identified in paragraph 50 that our Final Submission had, in quoting Dr. Safir's evidence regarding DBRS' report, placed a close quotation mark in the wrong location. As a result we had incorrectly attributed to Dr. Safir the words "the same cannot be said for FortisBC's generating assets". We apologize for this error. However, the point that FBC was making stands. Dr. Safir is using DBRS' statement that the risks from FBC's generating assets are "manageable" to conclude: "Thus, the mere fact that FBC owns generating assets does not make it more risky than FEI". Although Dr. Safir presents his inference as the logical corollary of DBRS' view that FBC's generation risk is "manageable", that is not the case. FBC's generation risk is "manageable" due to the nature of hydro facilities (versus nuclear or gas/coal-fired) and also because hydrology risk is mitigated by the Canal Plant Agreement by reserving capacity and energy for FBC based on average hydro conditions. DBRS was not comparing generation to a natural gas LDC like the benchmark utility. FBC is exposed to supply interruption risk, to which FEI is not exposed, by virtue of being an electric utility with on system generation. Also, as discussed below, FBC's generation facilities give rise to greater operational risk than is faced by FEI. ICG is conspicuously silent with respect to operating risks associated with FBC's generation.

31. At paragraph 47, ICG states "FBC and Ms. McShane misunderstand the economic effect of vertical integration. The process of vertical integration is akin to compiling a portfolio. Owning a diversified portfolio is less risky than simply owning a single entity of which the portfolio is composed." Ms. McShane's Rebuttal Testimony makes it clear that she understands that the process of vertical integration is akin to compiling a portfolio. At page 7 of her Rebuttal Testimony, Ms. McShane provided the following reference from the literature on vertical integration:

> 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.[42]

The reference starts with the basic proposition that vertical integration is akin to compiling a portfolio. It addresses the further question of whether the process of vertical integration accomplishes more in terms of systematic risk reduction than simply holding the component entities in a portfolio. The fact that diversification reduces risk is at the very heart of portfolio theory and the Capital Asset Pricing Model ("CAPM").[43] According to the CAPM, since risk can be reduced by diversification, investors should not expect to be compensated for unsystematic risks or company-specific risks that they can diversify away by investing in a portfolio of assets.[44] Thus, the return that an investor should expect on any particular asset in the portfolio reflects the investor's ability to diversify and represents that asset's marginal contribution to the systematic risk of the portfolio. Adding an entity or operation with higher systematic risk (i.e., higher beta) to a portfolio increases the risk of the portfolio. In the context of utilities, when higher risk generation assets are added to a portfolio made up only of lower risk electric transmission and distribution assets, the resulting portfolio is riskier.

32. In a similar vein, ICG says in paragraph 53 "the DBRS reports (sic) lists vertical integration as a ratings strength (DBRS, p.2)…". The quote is accurate, but ICG is misapplying DBRS' statement in using it to imply that FBC's ownership of generation is a factor that directionally suggests FBC is lower risk than the benchmark utility. DBRS does not operate within the regulatory construct of using FEI as a benchmark when rating FBC; rather, it is assessing business risk from the perspective of the broader universe of utilities. Vertical integration is a ratings strength if your point of comparison is other generation-only utilities. DBRS has stated elsewhere that the highest business risk is associated with generation: "Generally, DBRS views transmission as the area with the least business risk, followed very

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[42] Exhibit B1-84, FBC Rebuttal Evidence, McShane Rebuttal Evidence, p.7.

[43] GCOC Stage 1, Exhibit A2-3, p.7.

[44] GCOC Stage 1 Exhibit B1-9-6, Appendix F, McShane Evidence, Appendix A, p.A-2.

closely by distribution, followed by generation."[45] As stated above, in the context of utilities, when higher risk generation assets are added to a portfolio made up only of lower risk electric transmission and distribution assets, the resulting portfolio is riskier. FBC is higher risk than FEI, in part, because of the supply interruption risk and operational risk associated with its on-system owned and contracted generation.

G. FBC'S HIGHER OPERATING RISK

33. ICG has not challenged any of FBC's evidence on operating risk. BCPSO similarly appears not to dispute FBC's elevated operating risk associated with PCBs, greater exposure of above-ground facilities, or the radial configuration of FBC's system. BCPSO's limited submissions on operating risk miss the mark for the reasons set out below:

- First, BCPSO addresses the relative age of FBC's assets and end of life issues by stating "it is clear from the evidence that the risks in this area are being appropriately managed."[46] FBC agrees that it is managing these risks appropriately, just as FEI is appropriately managing its own operating risks; however, the relevant question is whether or not the operating risk faced by FBC is greater than FEI's operating risk (having regard to the appropriate asset management undertaken by both utilities to manage risk).

- Second, BCPSO makes a similar error when it downplays FBC's operating risk by stating that "only 17% of FBC's rate base is in generation", and that hydroelectricity is lower risk than fossil fuel generation.[47] BCPSO is factually accurate on both accounts. However, the relevant risk comparison is with FEI, a natural gas distribution utility with 0% of its rate base attributable to natural gas production.

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[45] Exhibit B1-72, FBC Evidence, Appendix B, McShane Evidence, p.15, fn 17.
[46] BCPSO Final Submission, para.24.
[47] BCPSO Final Submission, para.25.

34. When the appropriate comparison with the benchmark utility is undertaken, accounting for all of the evidence (age and end of life issues, PCBs, greater exposure of above-ground facilities, or the radial configuration of FBC's system), the only reasonable conclusion is that FBC's operating risk remains higher.

H. SHORT-TERM RISKS AND DEFERRAL ACCOUNTS

35. Only ICG addresses short-term risk, and ICG appears to place considerable importance on it.[48] However, ICG is overplaying the significance of the new deferral accounts and FBC's track record of achieving its allowed ROE:

- First, FBC's ability to achieve its allowed ROE is not a factor that distinguishes FBC from the benchmark utility because FEI has a similar track record.
- Second, deferral accounts do not address underlying business risk.[49]
- Third, FBC's track record of consistently achieving its allowed ROE predates the introduction of these accounts.
- Fourth, the Commission did not give the lack of change in FEI's short-term risk any significant weight in the Stage 1 Decision.[50] It would be inconsistent for the Commission to now give any significant weight to an increase in FBC's deferral account coverage since 2009.
- Fifth, the percentage of FBC's revenue requirement covered by deferral accounts is lower in 2013 than in 2005 when FBC's common equity ratio was 40% and the

48 ICG Final Submission, para.41.

49 Exhibit B1-81, BCUC-FBC IR 2.46.1, 2.46.2.

50 GCOC Stage 1 Decision, p.(iii): "While acknowledging that there has been little change in short-term risk since the 2009 Decision, the Panel had determined that only minimal weight can be given to short-term risk as an impediment to earning a fair return."

differential in equity thickness compared to FEI was 5% to 7% (i.e., significantly greater than the differential that Dr. Safir is now recommending).[51]

PART THREE: EVIDENCE REGARDING RATING DOWNGRADE AND TRUST INDENTURE

36. BCPSO makes cursory submissions regarding credit ratings and trust indenture. ICG provides more extensive submissions on these issues. FBC's answers to their submissions are set out in this Part.

A. RESPONSE TO SUBMISSIONS ON CREDIT RATING DOWNGRADE

(a) Answer to ICG's Submissions on Credit Rating Downgrade

37. ICG's position is that "the Commission cannot conclude from the evidence that an equity ratio of 38.5% and an ROE of 9.05% will result in a lower credit rating for FBC."[52] FBC explained in its Final Submission that it would be impossible to prove definitively that any particular Commission decision "will result" in (or will avoid) a downgrade, since rating agencies are independent and apply their own judgment. However, there is a significant body of evidence demonstrating that FBC's credit rating is at risk even at the existing allowed common equity ratio and ROE - evidence that ICG is choosing to ignore. Case in point: ICG's written argument makes no reference whatsoever to the following evidence summarized in FBC's Final Submission:

- Moody's decision to put all of the rated FortisBC Utilities on negative watch for a possible downgrade, citing the "severely weak" financial metrics and the recent GCOC Stage 1 Decision that further weakened the credit metrics of the utilities;
- Moody's noted concern of further weakening of the credit metrics for the smaller utilities, which includes FBC, due to Stage 2 of the GCOC;

[51] Exhibit B1-81, BCUC-FBC IR 2.46.1, 2.46.2.

[52] ICG Final Submission, para.59.

- Moody's recent credit opinion on FBC at Baa1 (negative outlook);

- The fact that, based on Moody's methodology, on a weighted average basis including liquidity, FBC is borderline investment/non-investment grade on Financial Strength; and

- The fact that FBC's "indicated rating from the methodology grid" is one notch lower (Baa2) than its actual rating (Baa1), suggesting that FBC is at risk of a downgrade even based on its current metrics.

ICG's position in Stage 2 will result in the type of further weakening of FBC's credit metrics, about which Moody's is expressing concern when it comes to the outcome of Stage 2 Decision.

38. In terms of the implications of a downgrade, ICG maintains that "the costs of a lower credit rating can reasonably be expected to be in the order of 10 basis points".[53] Dr. Safir's evidence focuses on average bond spreads over time. It is not meaningful to examine bond yield spread differentials over more normal market conditions and extrapolate from that data, as Dr. Safir does, that the customer rate impact of a downgrade will be small. In troubled economic periods when there is a flight to quality, spreads of lower rated credits relative to higher rated credits widen.[54] For example, the difference in the indicative spread between FEI and FBC bonds during depth of the crisis on January 31, 2009 was 90 basis points.[55]

39. While ICG acknowledges that FBC faced a number of challenges issuing debt on its desired terms prior to its 2010 credit rating upgrade,[56] ICG dismisses these instances on the basis that FBC has declined to characterize the terms of its issuances as "unfavourable". ICG is overlooking the fact that FBC was encountering these restrictions on issuances well before the market crash (in 2004, 2007), and after the worst of the financial crisis had abated and the

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[53] ICG Final Submission, para.57.
[54] Exhibit B1-81, BCUC-FBC IR 2.27.1, 2.27.2; Exhibit B1-73, BCUC-FBC IR 1.3.6.
[55] Exhibit B1-81, BCUC-FBC IR 2.27.2.
[56] These are recounted in Exhibit B1-73, BCUC-FBC IR 1.3.4.

Commission had increased the benchmark ROE in 2009.[57] FBC did not even attempt to raise debt during the worst of the financial crisis.[58] Maintaining access to capital is equally important in adverse market conditions, and the fact that FBC was constrained generally prior to the upgrade is compelling evidence that a downgrade could affect access to capital in adverse market conditions.

40. ICG also has not addressed the following points raised by FBC in its Final Submission regarding *access to capital*:

- The AUC's position on the importance of access to capital, rather than just focussing on cost;

- The evidence that, 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; and

- Ms. McShane's evidence that "during the period June 2008 to January 2009, there was not a single issuer without at least one "A" credit rating who was able to issue long term debt on any terms in the Canadian market."

(b) Answer to BCPSO Submissions on Credit Rating Downgrade

41. BCPSO's position is that maintaining a common equity ratio of 40%, with an equity risk premium of 40 basis points "is sufficient to allow FBC to maintain its current credit ratings".[59] There are two answers to this point:

- First, it is evident that BCPSO is approaching this issue from the perspective of achieving the lowest possible return with no margin of error, which is an approach that the Commission has previously rejected.[60]

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[57] Exhibit B1-73, BCUC-FBC IR 1.3.4.

[58] Exhibit B1-73, BCUC-FBC IR 1.3.5.

[59] BCPSO Final Submission, paras.36, 45.

- Second, BCPSO's submission gives insufficient recognition to the facts that FBC's current Moody's credit rating is at risk at the current equity risk premium and common equity ratio, as the negative outlook indicates. Moody's has characterized FBC's financial metrics as "severely weak", FBC's cash flow to debt metrics support only speculative grade credit metrics, and FBC's projected cash flow declines will only exacerbate FBC's meager financial standing versus its similarly rated U.S. peers.

42. The ratings risk alone supports the Commission approving an overall return that reflects the higher end of Ms. McShane's recommended range.

B. FBC'S TRUST INDENTURE AND RESTRICTIONS ON ISSUING LONG-TERM DEBT

(a) Answer to BCPSO's Submissions on Trust Indenture

43. BCPSO's view is that maintaining a common equity ratio of 40%, with an equity risk premium of 40 basis points is sufficient to meet the requirements of FBC's Trust Indenture.[61]

(a) First, it is again evident that BCPSO is approaching this issue from the perspective of achieving the lowest possible return, which is an approach that the Commission has previously rejected.[62]

(b) Second, BCPSO's position is premised on FBC borrowing only $100 million in 2014, which is not an accurate forecast of FBC's 2014 borrowing. BCPSO obtained the $100 million figure from the 2014-2019 PBR Application (it wasn't ever a part of the evidentiary record in this proceeding). That information had

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[60] *In the Matter of Terasen Gas Inc. and Terasen Gas (Vancouver Island) Inc. Application to Determine the Appropriate Return on Equity and Capital Structure and to Review and Revise the Automatic Adjustment Mechanism* Decision, Order No. G-14-06, March 2, 2006 ("2006 Terasen ROE Decision"), p.8. Addressed in FBCU's GCOC Stage 1 Final Submission, para.17.

[61] BCPSO Final Submission, paras.36, 45.

[62] 2006 Terasen ROE Decision, p.8. Addressed in FBCU's GCOC Stage 1 Final Submission, para.17.

been updated in FBC's 2014-2018 PBR Application Evidentiary Update filed on October 18, 2013. The Company is now forecasting *two* $100 million debt issuances in 2014. Moreover, BCPSO's references to borrowing room of $157M to $189M are based solely on new debt issuance rates of 5% and 6% and does not consider that in an environment of rising interest rates, the deterioration of issuance capacity would increase.

(b) Answer to ICG's Submissions on Trust Indenture

44. In paragraphs 60 and 61 of its submission, ICG argues that FBC's interest coverage ratios have been sufficiently higher than required by its Trust Indenture such that the Commission could reduce FBC's common equity ratio to the benchmark utility's 38.5% and reduce the risk premium to 30 basis points. ICG attempts to support this assertion by comparing minimum coverage ratios required under trust indentures to actual coverage ratios, including the comparison that Dr. Booth had made between FEI's trust indenture minimum and actual coverage ratios. In so doing, ICG is perpetuating the error that Dr. Booth had made when he assumed that the two coverage ratios are comparable.[63] They are not. The coverage ratio specified in the Trust Indenture uses historic earnings and future interest expense, including the interest on the additional new debt to be issued. The Trust Indenture coverage ratio is used to assess how much and when new long-term debt can be issued by the utility. ICG's simplistic comparison of FBC's actual historic coverage ratios to a Trust Indenture minimum does not take account of FBC's debt financing requirements and thus provides little insight into how FBC's ability to issue long-term debt will be constrained if ICG's recommendations were to be adopted by the Commission.

45. In paragraph 62 of its submission, ICG essentially asserts that the Commission ignored FEI's Trust Indenture requirements in the Stage 1 Decision when it set the allowed equity ratio and ROE for the benchmark utility, and should do the same for FBC in Stage 2. In FBC's respectful submission, the Commission should consider FBC's proposed equity ratio and

[63] Dr. Booth's error was addressed in FBCU's GCOC Stage 1 Final Submission, para.140.

risk premium on their own merits, including FBC's need to maintain sufficient flexibility to raise new long term debt as required subject to the terms of its Trust Indenture.

PART FOUR: CONCLUSION

46. BCPSO and ICG have left unanswered many of the points raised by FBC's Final Submission. FBC has provided compelling answers, rooted in the evidence, to the arguments they have made. FBC respectfully submits that the Commission should maintain FBC's common equity ratio at 40% with a risk premium at the upper end of Ms. McShane's 50 to 75 basis point range, consistent with the Fair Return Standard.[64]

ALL OF WHICH IS RESPECTFULLY SUBMITTED.

Dated:	January 6, 2014	***[original signed by Matthew Ghikas]***
		Matthew Ghikas Counsel for the FortisBC Utilities

Dated:	January 6, 2014	***[original signed by Tariq Ahmed]***
		Tariq Ahmed Counsel for the FortisBC Utilities

[64] Exhibit B1-81, BCUC-FBC IR (McShane) 2.24.2.