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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 Energy (Vancouver Island) Inc. and FortisBC Energy (Whistler) 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 Energy (Vancouver Island) and FortisBC Energy (Whistler) 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 ENERGY (VANCOUVER ISLAND) INC. and

FORTISBC ENERGY (WHISTLER) INC.

January 6, 2014

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PART ONE: INTRODUCTION

1. BCPSO was the only intervener that filed Stage 2 submissions with respect to FEVI/FEW.[1] It does not dispute that FEVI and FEW face higher overall business risk relative to the benchmark utility, which has also consistently been the view of the Commission.[2] BCPSO has either acknowledged or not disputed most of the factors identified by the Companies as driving the Companies' elevated business risk *vis à vis* the benchmark utility. Ultimately, despite BCPSO's arguments on some issues, there is only a relatively small differential between Ms. McShane's recommendation and BCPSO's position. The Companies respectfully submit that, once the discreet areas of disagreement are reconciled, BCPSO's submissions only reinforce the reasonableness of Ms. McShane's recommendation for both FEVI and FEW.

2. In this Reply Submission, we have addressed only those issues where further response is necessary, without repeating the Companies' December 3, 2013 Final Submission. The Companies' silence on a particular issue should not be construed as agreement with BCPSO's submissions.

PART TWO: THE PROPER APPROACH TO COST OF CAPITAL ASSESSMENT

3. BCPSO states that it is "struck by the irony of a utility seeking to increase its allowed cost of capital in part on the basis of price competitiveness, given that the cost of capital adds a significant element to the utility's overall costs."[3] This is a telling comment, as it evidences a fundamental misapprehension of why utilities are entitled to a fair return.

4. Utilities must borrow money and invest equity to pay for the services that customers receive. Money isn't free, and the equity investor is expected to tie up hundreds of

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

[2] For example, *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 ROE Decision"), p.30; TGW 2009 RRA Decision, pp.51-53; 2009 ROE Decision, pp.74-77.

[3] BCPSO Final Submission, para.27.

millions of dollars in utility assets for long periods of time. The allowed return on equity is intended to compensate investors for their investment. If the return on equity is inadequate, then (a) equity investors choose to invest their money elsewhere where they are more fairly compensated for the risk they are taking on; and (b) debt investors get concerned about whether there is sufficient cash flow to pay interest and repay the principal. The service that customers have come to expect from FEVI cannot be maintained without adequate investment, and adequate investment cannot be maintained without the Commission providing for a fair return.

5. In short, the allowed return is as much of a cost of service as O&M or capital. It is only "ironic" for an equity investor to expect fair compensation for its investment if one views customers as being entitled to subsidized utility service from investors. The courts have made it clear that is not the case, and that is also why the Commission has consistently affirmed the duty to determine a fair return without consideration of rate impacts.[4]

PART THREE: FEVI/FEW FACE HIGHER OVERALL BUSINESS RISK

6. In this Part, the Companies answer BCPSO's specific arguments on business risk. The submissions are organized by risk factor.

A. Smaller Service Area

7. BCPSO's submissions regarding the business risk implications of a smaller service area is one instance where BCPSO's argument is not supported by the evidence.

8. Although BCPSO accepts that FEVI's and FEW's significantly smaller service areas mean that "certain types of local events are likely to have a greater impact…than they would on

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[4] *ATCO Gas & Pipelines Ltd. v. Alberta (Energy & Utilities Board)*, 2006 SCC 4, paras.62-68 (online at: http://canlii.ca/en/ca/scc/doc/2006/2006scc4/2006scc4.html); 2006 ROE Decision, p.8; 2009 ROE Decision, p. 15; GCOC Stage 1 Decision, p.12.

comparable utilities with more widely dispersed assets”,[5] BCPSO also implies that FEVI/FEW’s small size is advantageous because:

> Intuitively, compact utilities have significant advantages. They require less infrastructure to serve the same load, resulting in a lower rate base and cost of service relative to their more widely dispersed counterparts. In addition, the infrastructure they do have is less likely to be affected by either natural or human created disaster, assuming a roughly equivalent chance of disaster affecting any given area.[6]

In fact, FEVI/FEW do not “require less infrastructure to serve the same load”. FEVI/FEW’s delivery rates are higher than FEI’s rates precisely because it costs FEVI/FEW more to deliver each GJ of throughput. Moreover, FEVI and FEW each require significantly more infrastructure to serve each customer on the system - FEVI’s rate base per customer is more than double that of FEI, and FEW’s rate base per customer is almost five times greater.[7] A high rate base per customer means that FEVI and FEW are more reliant on each customer to recover their invested capital.[8] It amplifies competitive risk associated with high delivery rates because the loss of a single customer to a competing energy source has a larger impact on delivery margin.

9. The third sentence in the above-quoted passage from BCPSO’s Submission implies that FEVI/FEW face lower business risk than the benchmark because their smaller geographic scope makes it more likely that a disaster will miss them altogether. There are two problems with this argument.

- First, it is a very simplistic, and ultimately illogical, view. The probability of any utility being affected by a disaster depends on where it is located and the events that might conceivably affect its operations. A simple example will illustrate this point: a very large utility in central Canada is subject to less risk of earthquake

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[5] BCPSO Final Submission, para.7.

[6] BCPSO Final Submission, para.8.

[7] Exhibit B1-71, FEVI/FEW Evidence, Appendix A, p.8; Exhibit B1-77, BCPSO-FEVI/FEW IR 1.23.1.

[8] Exhibit B1-71, FEVI/FEW Evidence, Appendix B, McShane Evidence, p.12.

damage compared to a small utility in BC; geographic location, not size, dictates the relative risk in that case.

- Second, BCPSO's submission also misses the key point when it comes to assessing business risk: negative events can have proportionately greater impact on the earnings and viability of a small utility operating in smaller geographic areas because localized events or disruptions can affect a greater percentage of the utility's customers and rate base.[9]

B. Less Diverse Customer and Economic Base

10. BCPSO concedes that, relative to the benchmark utility, FEVI and FEW have smaller and less diverse customer bases, and customers are more concentrated in particular industry segments.[10] The arguments that BCPSO raises as offsetting considerations are overstated.

11. BCPSO first emphasizes that FEI's customer growth rate is 0.72%, whereas the customer growth rates of FEVI and FEW are 2.21%.[11] BCPSO is correct that this works out to FEVI/FEW's growth rate being three times that of FEI. However, both of these percentages are still very low (i.e., three times a very small number is still a very small number). FEW's growth is also very small in absolute number of customers, and small year over year changes can significantly affect its calculated growth rate. There is, in reality, little to distinguish among the three utilities when it comes to growth rates. The more notable difference among the utilities is FEVI's and FEW's much higher rate base per customer.

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9 Exhibit B1-71, FEVI/FEW Evidence, Appendix A, p.7; Appendix B, McShane Evidence, p.8. Dr. Safir's evidence in respect of FBC also supports this conclusion: Exhibit C4-22, ICG Evidence, Safir Evidence, p.8.

10 BCPSO Final Submission, para.9.

11 BCPSO Final Submission, para.9.

12. BCPSO states that “FEVI and FEW are also experiencing more rapid growth in rate base than FEI.”[12] There are two answers to this argument.

- First, the statistics cited by BCPSO are skewed by the timing of significant “one-off” projects undertaken by FEVI and FEW; the data does not reflect the normal rate base growth of either utility.[13] The large increase in FEVI’s rate base between 2010 and 2012 was due primarily to the inclusion of the capital costs of the Mt. Hayes LNG Facility in rate base upon the facility going into service. The large increase in FEW’s rate base in 2010 was mainly due to the Whistler conversion project.

- Second, the implicit - and flawed - assumption underlying BCPSO’s submission is that increases in rate base necessarily reflect utility growth generally. While the Mt. Hayes LNG Facility performs a valuable function, it was never intended to drive customer growth the way that investments in main extensions do. The Commission commented in 2009 that the effect of the Whistler conversion was to double the rate base of the utility without adding any customers[14] - the Commission’s point being that doubling rate base per customer directionally increases risk.

13. BCPSO also contends that FEVI’s business risk has decreased as the pulp and paper industry emerges from unfavourable market conditions.[15] In fact, the long-term risk arising from having customers in a highly cyclical industry is the same irrespective of where these industries currently fall in their economic cycle.[16] As BCPSO recognizes elsewhere in its submissions, “From an investment perspective, the future matters more than the present.”[17] Utility investors making long term investment decisions face the risk that customers in a cyclical

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[12] BCPSO Final Submission, para.10.

[13] Exhibit B1-79, BCUC-FEVI/FEW IR 2.29.1.

[14] TGW 2009 RRA Decision, p.52.

[15] BCPSO Final Submission, para.11.

[16] Exhibit B1-76, BCUC-FEVI/FEW IR 1.8.1, 1.9.1.

[17] BCPSO Final Submission, para.9.

industry will fail when the cycle inevitably hits a low ebb, and thereafter will be unavailable as a source of revenue for the utility.

14. Despite BCPSO's recognition that "From an investment perspective, the future matters more than the present",[18] it evaluates FEVI's business risk associated with the utility's heavy reliance on two customers (the VIGJV and BC Hydro - Island Generation) according to whether each customer is at risk "in the *near term*" (emphasis added).[19] An assessment of longer-term risk yields a different picture than the one portrayed by BCPSO:

- The VIGJV's "near term" demand is very much tied to the current state of the pulp and paper industry; FEVI's long-term risk is more associated with the potential for mill closures and their long-term requirements. There is uncertainty around the VIGJV's requirements beyond 2017.[20] While the VIGJV's contractual status was known in 2009, one of the VIGJV pulp mills has closed permanently since 2009 thereby elevating the importance of the remaining mills to FEVI.[21]

- BCPSO's "near term" view gives insufficient recognition to the fact that the risk of losing significant throughput associated with Island Generation after a contractual notice period has increased with the recent change in how BC Hydro uses the facility.[22]

15. The PEC project, which was referenced by BCPSO,[23] is an exciting prospect for FEVI and its customers because of its potential to add load to FEVI's system if it proceeds; however, it would be inappropriate for the Commission to give this factor any material weight in its business risk assessment because the PEC project remains uncertain. The feasibility and

[18] BCPSO Final Submission, para.9.

[19] BCPSO Final Submission, para.11.

[20] Exhibit B1-71, FEVI/FEW Evidence, Appendix A, pp.9-10; Exhibit B1-76, BCUC-FEVI/FEW IR 1.6.1.

[21] Exhibit B1-76, BCUC-FEVI/FEW IR 1.8.5.2.

[22] Exhibit B1-71, FEVI/FEW Evidence, Appendix A, pp.10-11; Exhibit B1-76, BCUC-FEVI/FEW IR 1.7.1.

[23] BCPSO Final Submission, para.13.

development costs being incurred by the proponent indicate that the proponent is serious about investigating the opportunity, but its willingness to commit hundreds of millions of dollars to construct a facility is entirely dependent on the results of that analysis and any number of other factors known only to PEC. The proponent will not make a determination on whether to proceed for some time. The PEC project, should it proceed, is properly a consideration for the next cost of capital proceeding.

16. BCPSO appears to argue at paragraph 15 of its Final Submission that, wholly apart from the potential PEC project, the shale gas supply and the potential for LNG development reduce the Companies' business risk. This argument is out of step with the objective of the Stage 2 analysis, which is to determine the Companies' business risk *vis à vis* the benchmark utility. As described in the Companies' primary submission, the development of shale gas reserves has had the same impact on FEVI and FEW as it has on FEI.[24] There is no evidence in this proceeding to support a determination that FEVI has greater prospects for LNG development than FEI.

C. Less Competitive

17. BCPSO does not dispute that FEVI and FEW delivery rates are higher than those of FEI, thereby rendering natural gas less price competitive relative to electricity than is the case in FEI's service area.[25] BCPSO does contend, however, that "gas in the FEVI and FEW service areas is significantly cheaper than tier 2 electricity for customers with existing natural gas appliances and is priced very closely to the tier 2 electricity for customers installing new natural gas appliances."[26] The relevant evidence for the Commission's Stage 2 assessment of

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[24] FEVI/FEW Final Submission, para.28.

[25] BCPSO Final Submission, para.16.

[26] BCPSO Final Submission, para.16. FEVI/FEW note that BCPSO, in making its arguments, has referred to data that is not in the evidentiary record in this proceeding, and has done so elsewhere in its submissions as well, e.g., paras. 14 and 18 (ICG has done this too in the FBC context in a number of instances.). While it is of no consequence in the context of this particular point argued by BCPSO (since the data was a "red herring"), the practice is wrong in principle and in law, gives rise to procedural fairness concerns by denying the applicants an opportunity to respond to it, and consequently opens Commission decisions to legal challenge. Interveners have the ability to file evidence or ask appropriate IRs to get relevant information into the record. The Commission should actively discourage in its decision the practice of introducing new evidence in the guise of final argument.

competitive risk is that FEVI/FEW's service is less competitive *vis à vis* electricity than the benchmark utility, a fact which BCPSO concedes. The figure included on page 12 of FEVI/FEW's Stage 2 Final Submission illustrates visually the greater competitive challenge faced by the Companies relative to the benchmark utility.

18. BCPSO does ultimately acknowledge that BC Hydro rate increases affect all three utilities. However, at the same time, BCPSO maintains that the impact of BC Hydro rate increases will have a larger favourable effect on FEVI/FEW's competitive position relative to electricity than would be the case for FEI "because the smaller utilities struggle more than FEI does with cost competitiveness".[27] This argument is not supported by any evidence. Plus, it is illogical: if anything, BC Hydro rate increases have to be much greater before FEVI/FEW's natural gas service becomes cost competitive with electricity.

19. BCPSO downplays the loss of royalty revenues as an additional risk faced by FEVI, stating that "it cannot legitimately be seen as an issue urgently affecting shareholders or the ability of FEVI to raise capital when the RSDA balance will not be depleted for a decade."[28] There are two answers to this argument.

- First, the Commission recognized in the 2009 ROE Decision that the loss of the royalty revenues is a risk faced by FEVI that is not faced by the benchmark utility.[29]

- Second, investors making long-term investments must consider long-term business risks, and the RSDA will be depleted well within that time horizon. BCPSO's insistence on "urgent" risk before giving weight to the loss of royalty

[27] BCPSO Final Submission, para.19.

[28] BCPSO Final Submission, para.19. BCPSO also makes passing reference in paragraph 18 to the fact that the forecasted rate impacts once the RSDA balance is depleted has changed. The change is due to an update of gas cost and revenue forecasts. The updated forecast of rate increases is based on updated gas cost forecasts. The timing of actual rate increases will inevitably vary from this forecast: Exhibit B1-79, BCUC-FEVI/FEW IR 2.34.3.

[29] 2009 ROE Decision, pp.74-77.

revenues is again at odds with its earlier concession that "From an investment perspective, the future matters more than the present."[30]

20. BCPSO's submission regarding FEW focusses on the "very favourable price impact on customers as a result of the switch from propane to natural gas in late 2009", asserting that this is not a "benefit gained by FEI" since 2009. FEW's current allowed return already accounts for the benefits associated with FEW's conversion to natural gas. In 2009, the Commission found that while FEW's "supply risk may be reduced following conversion, its business risk will have increased by virtue of the fact that its rate base will have doubled as a result of the conversion while its customer base remained largely unchanged."[31] The Commission should not double count the effects of conversion.

D. Greater Supply Interruption Risk

21. BCPSO acknowledges that FEVI and FEW face higher supply risk than FEI, but suggests that the supply risk has declined for both FEVI and FEW since 2009.[32] BCPSO cites FEI's acquisition of one LNG tanker and the Mt. Hayes LNG Facility coming on-line.[33] The answer to this argument is two-fold. First, the evidence is that FEI's LNG tankers are insufficient to replace a pipeline and meet FEW's demand, even on a short-term basis. It is unreasonable to expect (particularly in the absence of evidence) that a single tanker would make the difference.[34] Second, the role that Mt. Hayes would play in helping to manage supply interruptions was already known in 2009 when the Commission last determined FEVI's and FEW's cost of capital.[35] The commissioning of the facility should not be considered a new development for the purposes of this proceeding.

[30] BCPSO Final Submission, para.9.
[31] Exhibit B1-77, BCPSO-FEVI/FEW IR 1.23.1; TGW 2009 RRA Decision, p.52.
[32] BCPSO Final Submission, para.22.
[33] BCPSO Final Submission, paras.23-24.
[34] Exhibit B1-76, BCUC-FEVI/FEW IR 1.15.4.2, 1.15.5.
[35] Exhibit B1-76, BCUC-FEVI/FEW IR 1.15.5.

E. Other

22. As with a number of other factors cited by BCPSO as new developments since 2009, the Commission had considered in the 2009 ROE proceeding the factors BCPSO is citing as having improved FEVI's "fiscal health" since 2009. In 2009, FEVI was expected to recover the Revenue Deficiency Deferral Account (RDDA) balance by the end of that year. The recovery of the RDDA was cited by the Commission in the 2009 ROE Decision as a risk factor that had improved since 2005.[36] The RDDA was paid off as anticipated.[37] FEVI has been repaying the interest free loans on a consistent schedule since before the 2009 ROE Decision.[38] The RSDA does not affect FEVI's business fundamentals; it delays the rate increases associated with the loss of royalty revenues, but does not eliminate them.

PART FOUR: CREDIT RATINGS

23. In paragraphs 37 to 40, BCPSO argues that scenarios provided by FEVI at different common equity ratios and risk premium indicate that a common equity ratio in the 40% to 42% range with a 50 basis point equity risk premium would produce the credit metrics necessary for FEVI to avoid a ratings downgrade. BCPSO's conclusion is based on an erroneous assumption.

24. BCPSO appears to have assumed that, because FEVI's 40% and 42% equity ratio scenarios produced Moody's credit metrics similar to those achieved in 2012, no downgrade would be forthcoming if FEVI's credit metrics continued at that level. That assumption ignores the fact that FEVI's indicated rating based on the 2012 metrics, as shown in the June 2013 Moody's credit opinion,[39] was Baa1, lower than the actual rating at the time of A3. Consequently, even if all the Commission were to do is establish an equity ratio and ROE which

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[36] 2009 ROE Decision, p.76 (referenced in Exhibit B1-71, FEVI/FEW Evidence, p.7).

[37] Exhibit B1-71, FEVI/FEW Evidence, p.7.

[38] 2009 ROE Decision, p.75.

[39] Exhibit B1-71, FEVI/FEW Evidence, Appendix D. See also, Exhibit B1-71, FEVI/FEW Evidence, Appendix B, McShane Evidence, p.15.

maintained the 2012 metrics, there is a significant risk that FEVI would be downgraded to the indicated rating of Baa1.

PART FIVE: CONCLUSION

25. There is agreement as between the Companies and BCPSO that the overall allowed return (common equity ratio and ROE) is too low and should be increased. In terms of the amount of the increase, Ms. McShane's analysis is well-reasoned and persuasive. The Commission should accept her recommendations and grant the order sought.

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