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October 2, 2015

**Via Email**  
**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: FortisBC Energy Inc. (FEI or the Company)**  
**Application for its Common Equity Component and Return on Equity (ROE) for 2016 (the Application)**

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On May 10, 2015, the British Columbia Utilities Commission (the Commission) issued its Decision and Order G-75-13 in the Generic Cost of Capital (GCOC) Stage 1 proceeding (the GCOC Stage 1 Decision). In the GCOC Stage 1 Decision, the Commission directed FEI to file an application for the review of its common equity component and ROE by no later than November 30, 2015.

Attached is FEI's Application and supporting evidence.

Given that the GCOC Stage 1 Decision is relatively recent, and that the Company evidence is consistent with the previous application, FEI believes that the Company evidence in this Application would be most efficiently and effectively handled through a written process. FEI is cognizant that the Commission Panel may wish to hear from expert witnesses, and therefore proposes a regulatory review process which includes a limited scope oral hearing (likely one or two days) on the expert evidence filed during the proceeding (both Company and intervener, if any). FEI proposes the following regulatory timetable.

Action:	Date (2015):
Intervener Registration	Tuesday, October 20
Commission Information Request (IR) No. 1	Tuesday, October 27
Intervener IR No. 1	Tuesday, November 3
FEI Response to IRs No. 1	Tuesday, November 17
Commission and Intervener (IR) No. 2	Tuesday, December 1
FEI Response to IRs No. 2	Tuesday, December 22
Date (2016):	
Intervener Evidence (if any)	Thursday, January 7
IRs on Intervener Evidence	Thursday, January 21
Intervener Response to IRs on Evidence	Thursday, February 11
Rebuttal Evidence (if any)	Thursday, February 25
Oral Hearing (limited scope Expert Evidence)	Week of March 7
FEI Written Final Submission	Thursday, March 31
Intervener Written Final Submissions	Thursday, April 7
FEI Written Reply Submission	Thursday, April 14

Based on the proposed timetable, a decision will not be reached in this proceeding until mid-2016. Interim rates, effective January 1, 2016 are necessary to facilitate this process. However, there is no need to request interim rates in this Application, since FEI has already sought interim delivery rates effective January 1, 2016 in its Annual Review for 2016 Rates. That request in the Annual Review contemplated the present Application.

If further information is required, please contact the undersigned.

Sincerely,

**FORTISBC ENERGY INC.**

***Original signed:***

Diane Roy

Attachments

cc (email only): Registered Parties to the 2012 GCOC Stage 1 Proceeding



**FORTISBC ENERGY INC.**

**Common Equity Component and Return  
on Equity for 2016**

**Volume 1 – FEI Evidence**

**October 2, 2015**

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## 1. INTRODUCTION AND EXECUTIVE SUMMARY

On May 10, 2013, the British Columbia Utilities Commission (BCUC or the Commission) issued Order G-75-13 for Stage 1 of the Generic Cost of Capital (GCOC) proceeding, establishing FortisBC Energy Inc. (FEI or the Company) as the benchmark utility with a return on equity (ROE) of 8.75 percent and common equity ratio of 38.5 percent. Order G-75-13 directed FEI to file an application for the review of its common equity component and ROE by no later than November 30, 2015.

In accordance with the Commission's Order and pursuant to sections 59 to 61 of the *Utilities Commission Act*, R.S.B.C. 1996, c.473 (*Act*), FEI applies for approval of a capital structure consisting of 40 percent equity and 60 percent debt, and a return on common equity of 9.5 percent. FEI respectfully submits that the accompanying evidence on FEI's business risk and return on equity and capital structure considerations demonstrate that FEI's proposals meet the Fair Return Standard, and should be approved. A draft form of order sought is provided in Appendix D.

### 1.1 FAIR RETURN STANDARD

The Fair Return Standard is a fundamental element of the regulatory compact and is captured in section 59(5) of the *Act*. The Commission has confirmed<sup>1</sup> that the Fair Return Standard requires that a fair or reasonable overall return (including a return on and of capital) is one that meets all three of the following requirements:

- is comparable to the return available from the application of the invested capital to other enterprises of like risk (comparable investment requirement);
- enables the financial integrity of the regulated enterprise to be maintained (financial integrity requirement); and
- permits incremental capital to be attracted to the enterprise on reasonable terms and conditions (capital attraction requirement).

The application of the Fair Return Standard to FEI must account for the ongoing challenges that FEI faces in attracting capital on reasonable terms and conditions. It must reflect the business

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<sup>1</sup> Decision attached to Order G-158-09 (2009 Cost of Capital Decision), at p. 15, citing on p. 8 to 9 of the 2009 Cost of Capital Decision, p. 6 of National Energy Board Decision RH-1-2008 in respect of Trans Quebec & Maritimes Pipeline (TQM).

1 risks facing FEI that define the risk that the Company faces in achieving a fair return on and of  
2 invested capital in both the short and long-term. In addition, it must account for the risks  
3 associated with continued volatility and uncertainty in the financial markets. It is the combination  
4 of all of these factors that justifies a capital structure consisting of 40 percent equity and 60  
5 percent debt, and a return on common equity of 9.5 percent.

## 6 **1.2 BUSINESS RISK SINCE 2012**

7 Business risk analysis is an important factor in an investor's decision-making process. A key  
8 reference point for assessing FEI's business risk is the GCOC Stage 1 proceeding which  
9 determined the cost of capital for the benchmark utility (FEI). FEI filed evidence in that  
10 proceeding in August of 2012. Since the Commission considered FEI's cost of capital relatively  
11 recently, there is a significant amount of continuity in the underlying business conditions  
12 applicable to FEI. However, there have been developments that are important for understanding  
13 why FEI considers that its required return on equity and equity component of capital structure  
14 are higher than what the Commission approved in the GCOC Stage 1 Decision.

### 15 **Amalgamation**

16 One notable change since the GCOC Stage 1 proceeding is the amalgamation of FEI with  
17 FortisBC Energy (Vancouver Island) Inc. (FEVI) and FortisBC Energy (Whistler) Inc. (FEW).  
18 The Commission approved the amalgamation of FEI, FEVI and FEW on February 26, 2014, by  
19 Order G-21-14. On May 23, 2014, the Lieutenant Governor in Council (LGIC) issued Order in  
20 Council No. 300 consenting to the amalgamation, and on December 31, 2014 the three  
21 companies amalgamated. The amalgamated entity is carrying on business as FEI, and in this  
22 proceeding may be referred to as "FEI", "amalgamated FEI" or "FEI Amalco" as the context  
23 requires.

24 At the time of the amalgamation, both FEW and FEVI had a higher ROE and thicker equity than  
25 FEI, commensurate with their relatively higher business risk. On March 25, 2014, the  
26 Commission issued its Decision and Order G-47-14 in the GCOC Stage 2 proceeding (GCOC  
27 Stage 2 Decision). The GCOC Stage 2 Decision set a common equity ratio of 41.5 percent for  
28 both FEVI and FEW and equity premiums over the benchmark utility's ROE of 50 and 75 basis  
29 points for FEVI and FEW, respectively.



1 In the GCOC Stage 2 Decision, the Commission acknowledged that the evidence in the GCOC  
2 proceedings treated FEI, FEVI and FEW as separate entities and that it did not contemplate the  
3 potential impact of an amalgamated entity, and as such there was no firm basis on which to  
4 make a determination with respect to the amalgamated entity.<sup>2</sup> The Commission further stated:

5 *“...once amalgamation has been effected and postage stamp rates implemented, the*  
6 *ROE and capital structure will be the same for the amalgamated entity as for FEI as the*  
7 *Benchmark utility. In the alternative, if FBCU considers the cost of capital for the*  
8 *amalgamated entity is not indicative of current circumstances, it may apply to the*  
9 *Commission on behalf of the amalgamated entity.”<sup>3</sup>*

10  
11 In this filing, FEI has considered the extent to which FEI’s risk profile has changed as a result of  
12 amalgamating with FEVI and FEW. While amalgamation is a factor affecting FEI’s business risk  
13 that should be considered, it is not the primary justification for FEI’s request to increase FEI’s  
14 equity thickness or ROE. FEI Amalco remains a large natural gas distribution utility, regulated  
15 by the BCUC, whose core business is to provide space and water heating to its customers. As  
16 was the case in 2012, FEI’s core market is experiencing declining use per customer and low  
17 customer growth while facing the same competitive challenges as FEI did, pre-amalgamation.  
18 The addition of the Vancouver Island and Whistler service territories to FEI’s service area has  
19 increased the amalgamated FEI’s supply interruption risk as both of the Vancouver Island and  
20 Whistler areas are exposed to greater security of supply risk. As such, FEI Amalco is now  
21 exposed to certain factors as a result of amalgamation that contribute to a slight increase in  
22 overall business risk.

### 23 **Changes in FEI’s Business Risk Apart from Amalgamation**

24 Amalgamated FEI’s business risk, independent of the effect of amalgamation noted above, is  
25 broadly similar to what it was in 2012; however, there are some differences that point to a  
26 somewhat higher business risk than what is reflected in the capital structure and ROE  
27 determined in the GCOC Stage 1 Decision.

28 FEI business risk is closely related to its ability to attract new customers (add new load to the  
29 system) and retain its existing customer base in its various customer segments (maintain or

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<sup>2</sup> GCOC Stage 2 Decision, p.138.

<sup>3</sup> Ibid.

1 increase the throughput levels of its existing customers). Key indicators such as total  
2 throughput, use per customer, or natural gas capture rates in various sectors can be used, in  
3 conjunction with other considerations, to assess the change in a utility's risk status. For  
4 instance, all else equal, if throughput levels decline for whatever reason, FEI's business risk in  
5 effect increases because the invested capital must be recovered over fewer GJs. These  
6 indicators are affected by various exogenous factors, including customer preference, price  
7 competitiveness of natural gas versus other alternatives, the macro-economic environment as  
8 well as provincial and local governments' energy policies and regulations. Closely related to  
9 business risk is the risk faced by utilities, termed regulatory risk, associated with having to  
10 obtain approval from a regulator for rates (and therefore revenues), the cost of capital, as well  
11 as new utility investments.

12 FEI has performed its business risk analysis using the same risk categorization that it had used  
13 in the GCOC Stage 1 proceeding, so as to facilitate the Commission's review of how business  
14 risk has evolved over time. FEI's assessment of risk can be summarized as follows:

- 15 • For the majority of the risk categories identified, the risk status has remained relatively  
16 stable compared to 2012.
- 17 • The primary difference from 2012 is in the political risk category. Most notably, FEI  
18 faces greater risk now due to recent local government policies and initiatives to promote  
19 mandatory connection to neighbourhood energy systems or installing renewable or  
20 higher efficiency energy systems that will hinder FEI's ability to attract new customers  
21 and/or retain existing ones. In addition, the recent legal developments related to  
22 Aboriginal rights and land title issues have led to an increase in risks.
- 23 • The adoption of a Performance Based Ratemaking (PBR) Plan starting in 2014 has  
24 given rise to some additional regulatory uncertainty and risk compared to previous  
25 periods, although the broader regulatory constructs that supported FEI's characterization  
26 of regulatory risk in 2012 remain substantially the same.

27  
28 Therefore the amalgamated FEI's overall business risk is best characterized as being similar to  
29 that of 2012, and is trending higher.

### 30 ***1.3 EVIDENCE ON COST OF CAPITAL, FINANCIAL MARKET CONDITIONS AND*** 31 ***CREDIT METRICS***

32 FEI retained Mr. James Coyne of Concentric Energy Advisors Inc. (CEA or Concentric), a cost  
33 of capital expert with many years of experience regarding the North American utility industry, to

1 provide an expert opinion on FEI's cost of capital. Mr. Coyne's report is attached as Appendix B.  
2 Mr. Coyne's evidence, among other things:

- 3 • Discusses capital market conditions in the U.S. and Canada, concluding that U.S. and  
4 Canadian capital markets are highly integrated and that it is appropriate to use the U.S.  
5 proxy group data for FEI's ROE and capital structure determination.
- 6 • Conducts Capital Asset Pricing Model and Discounted Cash Flow analyses, with  
7 alternative inputs and model specifications, to determine an appropriate ROE for FEI.
- 8 • Assesses FEI's operating and financial profile and conducts a comparative risk analysis  
9 as part of assessing the reasonableness of FEI's proposed capital structure.

10  
11 Mr. Coyne concludes, based on his analysis, that the proposed minimum equity component for  
12 the amalgamated FEI at 40 percent should be combined with an ROE of 9.5 percent to meet the  
13 Fair Return Standard in the current market conditions and in light of FEI's overall business and  
14 financial risk.

15 In addition, FEI has presented information, in section 6, regarding capital structure  
16 considerations. FEI's analysis demonstrates that an increase in the common equity component  
17 of its capital structure to 40 percent is warranted, considering the upward trend in FEI's  
18 business risk, the need to strengthen the Company's credit metrics and to support the ongoing  
19 access to capital investment.

#### 20 ***1.4 AUTOMATIC ADJUSTMENT MECHANISM***

21 FEI continues to believe that the appropriate approach for setting its allowed ROE and capital  
22 structure is by way of a traditional cost of capital application process. However, if the  
23 Commission determines it is appropriate to maintain an Automatic Adjustment Mechanism  
24 (AAM), then the two factor model approved by the Commission in its GCOC Stage 1 Decision  
25 should be continued.

#### 26 ***1.5 BENCHMARK UTILITY***

27 As cited earlier in this section, the GCOC Stage 2 Decision stated that the amalgamated FEI  
28 shall remain the benchmark utility<sup>4</sup>. FEI believes that Amalgamated FEI continues to be the  
29 logical choice to serve as the benchmark utility. FEI Amalco is engaged in the same businesses

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<sup>4</sup> Ibid.

- 1 as pre-amalgamation FEI. The Commission should consider the business and risk profile of the
- 2 amalgamated FEI and continue to treat FEI as the benchmark utility.
  
- 3 It should be noted that a determination in this regard does not impact the determination of FEI's
- 4 cost of capital. The benchmark is used in setting the ROE for other utilities in their own cost of
- 5 capital determinations.
  
- 6

1 **2. OUTLINE OF THE APPLICATION**

2 This filing, including the appended materials, provides the necessary evidentiary basis upon  
3 which the Commission can determine a fair return for the amalgamated FEI.

4 In the following sections, FEI sets out its position and evidence on the following matters:

- 5 • The Fair Return Standard and its implications for setting the cost of capital for a  
6 benchmark utility;
- 7 • The appropriate approach to assessing business risk for FEI;
- 8 • The appropriate ROE for FEI;
- 9 • The appropriate capital structure for FEI;
- 10 • The Automatic Adjustment Mechanism; and
- 11 • FEI as a benchmark for other utilities.

12  
13 The Appendices are:

- 14 • Appendix A - Supporting Documents.
- 15 • Appendix B - Evidence of Concentric Energy Advisors Inc. regarding the appropriate  
16 cost of capital for FEI.
- 17 • Appendix C - Evidence of FEI regarding business risk facing FEI.

18  
19 FEI has filed the following information as supporting documents in Appendix A:

- 20 • FEI's 2014 Financial Statements, Annual Information Form and Management  
21 Discussions and Analysis;
- 22 • Credit Rating Agency Reports;
- 23 • Investment Analyst Reports including both Equity and Debt Analyst Reports;
- 24 • Debt Prospectus;
- 25 • Bond Issue Listing;
- 26 • Fortis Inc. Equity Prospectus;
- 27 • Historical Regulatory Financial Information; and
- 28 • Accounting Policy Changes.

29

1 **3. APPLICATION OF THE FAIR RETURN STANDARD TO THE**  
2 **BENCHMARK**

3 In this section, FEI provides an overview of the Fair Return Standard, which the Commission  
4 has repeatedly confirmed applies in determining a utility's cost of capital for ratemaking  
5 purposes. The practical application of the Fair Return Standard is addressed in detail in Mr.  
6 Coyne's expert evidence.

7 **3.1 THE OBLIGATION TO FIX A FAIR RETURN FOR RATEMAKING PURPOSES IS**  
8 **ABSOLUTE**

9 The *Act* sets out the Commission's obligation to determine, in respect of every utility, a cost of  
10 capital for ratemaking purposes that meets the Fair Return Standard. The obligation is  
11 absolute, and is not an exercise in balancing shareholder and ratepayer interests.

12 Section 59(5) of the *Act* provides that a rate is "unjust" or "unreasonable" if it is:

- 13 a) more than a fair and reasonable charge for service of the nature and quality provided by  
14 the utility;  
15 b) insufficient to yield a fair and reasonable compensation for the service provided by the  
16 utility, or a fair and reasonable return on the appraised value of its property; or  
17 c) unjust and unreasonable for any other reason.

18  
19 There is a substantial body of case law that deals with the principles that utility rate regulators  
20 must apply in determining a fair and reasonable return for the utility shareholder. The following  
21 passage from the Decision attached to Order G-14-06 regarding the cost of capital for TGI and  
22 TGVI (2006 Cost of Capital Decision) articulates the Commission's duty to approve rates that  
23 will provide a reasonable opportunity to earn a fair return on invested capital:

24 *"The Commission Panel does not accept that the reference by Martland J. [in British*  
25 *Columbia Electric Railway Co. v. British Columbia Public Utilities Commission<sup>5</sup>] to a*  
26 *"balancing of interests" to mean that the exercise of determining a fair return is an*  
27 *exercise of balancing the customers' interests in low rates, assuming no detrimental*  
28 *effects on the quality of service, with the shareholders' interest in a fair return. In coming*

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<sup>5</sup> [1960] S.C.R. 837.

1           to a conclusion of a fair return, the Commission does not consider the rate impacts of the  
2           revenue required to yield the fair return. Once the decision is made as to what is a fair  
3           return, the Commission has a duty to approve rates that will provide a reasonable  
4           opportunity to earn a fair return on invested capital.”<sup>6</sup>

5  
6       Similarly, in the GCOC Stage 1 Decision, the Commission reiterated the principles articulated in  
7       the 2006 and 2009 Cost of Capital Decisions and confirmed that it has a duty to provide a  
8       reasonable opportunity to the utility to earn a fair return on and of invested capital.<sup>7</sup>

9       This Commission’s articulation of the Fair Return Standard is consistent with prior court  
10      decisions, including the concurring reasons of Locke J. in *British Columbia Electric Railway*, in  
11      which Locke J. stated in part:

12           “The Commission is directed by s.16(1)(a) [of the old legislation] to consider all matters  
13           which it deems proper as affecting the rate but that consideration is to be given in the  
14           light of the fact that the obligation to approve rates which will give a fair and reasonable  
15           return is absolute.”<sup>8</sup>

16  
17      The application of the Fair Return Standard ensures that utilities are in a position to:

- 18           • meet their customers’ service needs at a reasonable cost;
- 19           • attract investment capital at reasonable cost under all market conditions;
- 20           • earn a fair and reasonable return on previously invested capital;
- 21           • support the energy and environmental policy objectives of the BC government to the  
22           extent appropriate under the *Act*;
- 23           • pursue investments in efficiency; and
- 24           • be financially sustainable in the face of ongoing and changing business risks.

25  
26      In addition to being fair to the utility, adhering to the Fair Return Standard is beneficial for  
27      customers who can continue to obtain utility service from a utility operating on a financially  
28      strong and sustainable basis.

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<sup>6</sup> 2006 Cost of Capital Decision, p.8.

<sup>7</sup> GCOC Stage 1 Decision, p.12.

<sup>8</sup> [1960] S.C.R. 837 at 848.

1 **3.2 ADHERING TO THE FAIR RETURN STANDARD INVOLVES SATISFYING THREE**  
2 **TESTS**

3 The Commission has endorsed<sup>9</sup> the National Energy Board's (NEB) articulation of the Fair  
4 Return Standard in NEB Decision RH-1-2008. The NEB had stated:

5 *"The Fair Return Standard requires that a fair or reasonable overall return on capital*  
6 *should:*

- 7 • *be comparable to the return available from the application of the invested capital to*  
8 *other enterprises of like risk (comparable investment requirement);*  
9 • *enable the financial integrity of the regulated enterprise to be maintained (financial*  
10 *integrity requirement); and*  
11 • *permit incremental capital to be attracted to the enterprise on reasonable terms and*  
12 *conditions (capital attraction requirement)."*

13  
14 Each of the three requirements of the Fair Return Standard is separate and distinct and all three  
15 must be satisfied. None of the three requirements is given priority over the others. In other  
16 words, the Fair Return Standard is only satisfied if the utility can attract capital on reasonable  
17 terms and conditions, its financial integrity can be maintained and the return allowed is  
18 comparable to the returns of enterprises of similar risk.

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<sup>9</sup> 2009 Cost of Capital Decision, at p.15, citing p.6 of RH-1-2008 in respect of TQM.



## 1    **4.    FEI BUSINESS RISKS**

2    FEI's business risk informs its cost of capital because it impacts the likelihood that the Company  
3    will be able to earn a fair return on and of its invested capital. The section below provides a  
4    high level summary of factors affecting FEI's risk profile. FEI's complete evidence regarding its  
5    business risks is found in Appendix C. In addition, Mr. Coyne has reviewed FEI's business risk  
6    evidence, augmented that assessment with his own review, and has conducted a comparative  
7    risk analysis of FEI's business and financial risks relative to Canadian and U.S. proxy groups.  
8    Mr. Coyne's analysis is included in his report (Appendix B).

9    In the GCOC Stage 1 Decision, the Commission defined risk "*as the probability that the future*  
10    *cash flows will not be realized or will be variable resulting in a failure to meet investors'*  
11    *expectation*" and asserted that the investment risk is comprised of the sum of business risk,  
12    financial risk and regulatory risk. The Commission also reaffirmed its previous statement in the  
13    2009 Cost of Capital Decision that "*the assessment of the risks has a significant bearing on the*  
14    *application of the fair return standard and the determination of an appropriate common equity*  
15    *ratio for regulatory purposes.*"

16    A business risk assessment is by its very nature a qualitative assessment. In general, however,  
17    there is a positive relationship between business risk and cost of capital, i.e., the higher the  
18    business risk, the higher return required by investors and therefore the higher the cost of capital.

19    Business risk can be categorized in different forms. For the sake of consistency and continuity  
20    of risk assessment, FEI has adopted the same eight business risk categories that it had  
21    employed in the GCOC proceeding. These eight categories conform to the Commission's  
22    definition of risk, since as each one of these risk categories (and each one of the factors within  
23    each category) can potentially limit FEI's ability to realize its future cash flows and/or meet  
24    investors' expectations.<sup>10</sup>

### 25    **4.1    REGULATORY RISK**

26    Regulatory discretion in approving or denying a utility's applications is the main cause of  
27    regulatory uncertainty. It gives rise to the risk that the allowed return does not accord with the  
28    Fair Return Standard, that rates are set at a level that does not provide FEI with an opportunity

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<sup>10</sup> Certain risk categories impact investors' expectations in the short-term while others are more long-term risk factors.

1 to earn its fair return, or that necessary investments are not approved. The broader regulatory  
2 constructs that supported FEI's characterization of regulatory risk in 2012 remain in place,  
3 although the adoption of a PBR Plan in 2014 results in some additional regulatory uncertainty.  
4 FEI has thus assessed its overall regulatory risk as being similar to what it was in 2012, with the  
5 potential to be higher over the term of the PBR Plan.

#### 6 **4.2 MARKET SHIFT RISK**

7 This risk category considers the various market elements that influence FEI's ability to attract  
8 new customers and retain its existing customer base and throughput. Similar to 2012, the trend  
9 in FEI's throughput level, particularly for the residential sector, is characterized by: (a) weak  
10 capture rates in the new construction market in the growing multi-family dwelling sector, and (b)  
11 declining use per customer from existing and new customers which is caused by factors such as  
12 smaller average dwelling size, higher capital costs for natural gas appliances versus electric  
13 appliances, changes in customers' preference and improvements in energy efficiency and  
14 conservation efforts supported by the policies of provincial and local governments.

#### 15 **4.3 POLITICAL RISK**

16 This risk category addresses the impact of provincial and local government policies, as well as  
17 Aboriginal rights and land title issues, on FEI's operations and its ability to grow its business by  
18 attracting new customers and/or retaining existing ones and increasing the throughput on the  
19 system. Government policies in particular have a direct influence on FEI's growth potential. As  
20 in 2012, the provincial government does not promote the use of natural gas in FEI's core space  
21 heating and water heating markets while promoting the role of natural gas in the transportation  
22 sector and LNG export. The intensity of local government green initiatives, and their potential to  
23 significantly impact FEI's operations, has increased since 2012. For instance, FEI's capture  
24 rate is threatened by municipal bylaws proposing mandatory connection of new buildings and  
25 even entire neighborhoods to district energy systems. In addition, FEI may fail to retain some of  
26 its existing customers due to the amendments to certain bylaws that require higher efficiency  
27 appliances that are not easily installed in older homes. On the subject of Aboriginal rights and  
28 title issues, the 2014 Supreme Court of Canada Decision in *Tsilhqot'in Nation v. British*  
29 *Columbia* introduces new uncertainties. As such, political risk is assessed as higher.

1 **4.4 ENERGY PRICE RISK**

2 This risk category consists of natural gas commodity price risk, natural gas commodity price  
3 volatility risk and price competitiveness of natural gas (including the upfront and installation  
4 costs). These risk factors incorporate elements of both long-term and short-term risk. While  
5 actual spot market prices are currently similar to what they were in mid-2012, medium and long  
6 term commodity price forecasts are lower than what was expected in 2012. However, market  
7 prices continue to remain volatile, despite the abundance of gas supply driven by shale gas  
8 production growth. In terms of competitiveness, the current price competitiveness of natural gas  
9 versus electricity has improved on an operating cost basis as electricity rates have increased  
10 relative to FEI's natural gas rates. However, the upfront and installation costs have not changed  
11 significantly for natural gas versus electricity and this, along with other non-price factors,  
12 continues to add to the challenge of maintaining throughput on FEI's system. All things  
13 considered, FEI assesses that the overall risk associated with energy price is similar to that of  
14 2012 levels.

15 **4.5 BUSINESS PROFILE**

16 FEI's business profile is characterized by a large service territory and a relatively large customer  
17 base. The business profile of the FEI as a result of the amalgamation is not materially different  
18 from FEI's pre-amalgamation business profile.

19 **4.6 ECONOMIC CONDITIONS**

20 Economic conditions shape companies' and households' consumption and investment decisions  
21 which in turn could impact FEI's throughput and growth potential. The current Canadian  
22 economic environment continues to be dominated by uncertainty. A combination of factors from  
23 the significant drop in oil prices and a slow-down in economic growth in Europe and China, to a  
24 weaker Canadian dollar and U.S. recovery leads to the assessment that while the overall  
25 Canadian economy technically fell into recession in the first half of 2015, the impact of the  
26 overall economic condition on the BC economy is not materially different from 2012 levels.

1 **4.7 OPERATING RISK**

2 This risk category includes the assessment of FEI's system integrity and the possibility of third  
3 party damages and other unexpected events. All things considered, the overall operating risk is  
4 assessed to be similar to 2012.

5 **4.8 ENERGY SUPPLY RISK**

6 Compared to 2012, the natural gas transportation infrastructure in FEI's service territory has  
7 remained relatively unchanged. The development of several significant gas transmission  
8 infrastructure projects connecting BC natural gas deposits with Alberta and with eastern  
9 markets in the coming years could alter the amount of gas available to FEI and the historical  
10 pricing relationship of BC supply in relation to Alberta production. This could have a negative  
11 impact on the price that consumers pay for natural gas in BC in the coming years. The addition  
12 of FEVI and FEW to FEI's service territory has slightly increased FEI's exposure to security of  
13 supply risk, as these two utilities are downstream of pre-amalgamated FEI on a radial system  
14 that crosses challenging terrain and the Strait of Georgia. As such, the overall energy supply  
15 risk is considered to be slightly higher than 2012 levels.

16 Considered together, amalgamated FEI's overall business risk is best characterized as being  
17 similar to that of the 2012 benchmark utility and trending higher.

18

1 **5. PROPOSED ROE FOR FEI**

2 FEI submits that the appropriate allowed ROE is 9.5 percent, based on a minimum of 40  
3 percent common equity. These proposals are supported by the expert evidence of Mr. Coyne.  
4 Mr. Coyne's methodology for estimating the appropriate ROE is consistent with the key  
5 elements of how the Commission has previously determined FEI's ROE.

6 In prior proceedings, the Commission has supported the application of Discounted Cash Flow  
7 (DCF) and Capital Asset Pricing Model (CAPM) as the main methodologies to calculate a  
8 utility's cost of equity. The Commission has also consistently supported the use of a U.S. proxy  
9 group of comparable companies' data when Canadian data do not exist in significant quantity  
10 or quality, or as a supplement when Canadian data gives unreliable results.

11 For instance, in the 2009 Cost of Capital Decision, the Commission accorded the primary weight  
12 to the DCF approach, stating that the DCF model has "*more appeal in that it is based on a*  
13 *sound theoretical base, it is forward looking and can be utility specific*"<sup>11</sup>. The Commission also  
14 concluded that "*given the paucity of relevant Canadian data, the Commission Panel considers*  
15 *that natural gas distribution companies operating in the US have the potential to act as a useful*  
16 *proxy in determining TGI's capital structure, ROE, and credit metrics*"<sup>12</sup>.

17 In the GCOC Stage 1 Decision, the Commission reiterated its support for the DCF and CAPM  
18 models however gave equal weights to the two methodologies:

19 *"The Panel finds that the two most compelling frameworks for assessing the cost of*  
20 *equity are the DCF model and the CAPM. These models have well understood*  
21 *theoretical bases and explicitly recognize the opportunity cost of capital. Accordingly,*  
22 *these two models are given equal weight in determining the allowed ROE.*"<sup>13</sup>

23 Similar to the Commission's approach in past decisions, Mr. Coyne's view is that more than one  
24 test should be used to determine the fair ROE. He uses both DCF and CAPM methodologies,  
25 with alternative inputs and model specifications, to calculate a range for ROE estimation.

26 The results produced by Mr. Coyne's analysis cover a broad spectrum. Giving equal weight to  
27 DCF and CAPM models and considering the Commission's finding in GCOC Stage 1 Decision

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<sup>11</sup> 2009 Cost of Capital Decision, p.45.

<sup>12</sup> Ibid, p.16.

<sup>13</sup> GCOC Stage 1 Decision, p. 56.

1 regarding the multi-Stage DCF vs. constant growth DCF, Concentric concludes that an  
2 appropriate ROE for FEI is 9.5 percent (including the standard 50 bps flotation costs previously  
3 approved by the Commission). Mr. Coyne's complete evidence can be found in Appendix B.

4 Mr. Coyne has also provided a summary of current capital market conditions and has compared  
5 those conditions to 2012, at the time of the GCOC Stage 1 filing. In summary, the capital  
6 market conditions can be considered broadly similar. While Government of Canada bond yields  
7 are somewhat lower, corporate credit spreads are higher thus supporting the view of ongoing  
8 risk aversion. In addition, while the level of equity markets is higher, there has been an increase  
9 in market volatility. In total, there has not been a substantial shift in capital market conditions  
10 since the last proceeding, and markets continue to be marked by ongoing uncertainty.

11

1 **6. CAPITAL STRUCTURE FOR FEI SHOULD INCLUDE 40 PERCENT**  
2 **EQUITY**

3 Utilities are large consumers of both equity and debt capital. Their fundamentals are watched  
4 carefully and scrutinized thoroughly by the financial analyst community for equity investors and  
5 by the credit rating agencies for debt holders. The latter are especially sensitive to (i) the  
6 proportion of common equity in a utility's capital structure as it provides security for investors  
7 lending money to a utility, and (ii) the cash generated by the allowed returns to ensure that the  
8 interest on the debt of the utility can be serviced. The combination of an upward trend in FEI's  
9 business risk and relatively weak financial metrics that impact access to capital, demonstrate  
10 that FEI's common equity ratio should be increased to 40 percent.

11 FEI's financial flexibility and financial integrity depend on its ability to access the capital markets  
12 on reasonable terms and pricing in all economic conditions. A stand-alone investment grade  
13 debt rating in the A category ensures FEI's ability to access capital markets and gives FEI the  
14 required flexibility to finance its large capital plan on reasonable terms.

15 FEI's continued weak credit metrics impact the assessments of the Company's ratings by credit  
16 rating agencies, which impacts FEI's financing terms and flexibility when accessing debt capital  
17 markets. This is particularly important, considering the Company's potentially high capital  
18 expenditure requirements and the ongoing access to debt capital that will be necessary in the  
19 near term. An increase in the common equity percentage is further supported by a comparison  
20 of FEI's financial metrics to its Canadian utility peers and the continued upward trend in FEI  
21 business risk. Additionally, an increase in the common equity component of the capital  
22 structure will support the Company's ongoing debt issuance capacity under its Trust Indenture.

23 As such, FEI respectfully submits that the equity component of FEI's capital structure should be  
24 increased from the current 38.5 percent to 40 percent. This change will adequately reflect FEI's  
25 business risk. In conjunction with the proposed ROE, 40 percent equity will address the  
26 requirements of the Fair Return Standard from a capital structure perspective, ensuring that  
27 financial integrity and flexibility is maintained as well as to allow FEI to attract capital on a  
28 comparable basis with its North American peers.

29 Mr. Coyne conducted a comparative risk analysis of FEI's risk with the Canadian and U.S. proxy  
30 groups and reviewed FEI's financial metrics. In Mr. Coyne's expert opinion, a 40 percent equity  
31 thickness is appropriate, but at the low end of the range of reasonableness because of FEI's

1 higher risks relative to the majority of proxy companies, especially with regards to long-term  
2 business risk. For more information regarding Mr. Coyne's evidence on this matter please refer  
3 to Appendix B.

#### 4 **6.1 BUSINESS RISK ASSESSMENT SUPPORTS REQUESTED CAPITAL** 5 **STRUCTURE**

6 In the GCOC Stage 1 Decision, the Commission panel recognized that business risk,  
7 particularly long-term business risk, should be reflected in the capital structure of the utility, in  
8 consideration of investors' ability to recover their invested capital. The Commission further  
9 explained the link between business risk and capital structure as follows:

10 *"This is because if the underlying risk decreases, more debt can be issued; if it*  
11 *increases, the common equity ratio would increase resulting in less debt"<sup>14</sup>.*

12  
13 There are a number of factors as explained in FEI's risk analysis evidence (Appendix C) that  
14 indicate FEI's business risk and particularly long-term business risk continues on an upward  
15 trend compared to 2012.

16 FEI is operating in a challenging competitive environment due to BC's low cost of electricity,  
17 which is predominantly hydro-based generation, and is viewed as a more environmentally  
18 friendly energy source. As well, FEI faces more political risk due to the challenges faced by  
19 natural gas as a fuel source for space and hot water heating, as discussed previously. A  
20 detailed explanation of FEI's competitive environment can be found in Appendix C.

21 In addition, Mr. Coyne has assessed FEI's competitive environment and has compared FEI's  
22 business and financial risk with that of the U.S. and Canadian proxy groups. In his assessment,  
23 FEI has higher long-term business risk than the majority of utilities in the U.S. and Canadian  
24 proxy groups.

25 Given FEI's higher long-term business risk and lower equity ratio compared to the majority of  
26 utilities in Mr. Coyne's proxy groups, it is reasonable to increase FEI's equity ratio.

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<sup>14</sup> GCOC Stage 1 Decision, p.24.



## 6.2 MAINTAINING FEI'S CREDIT RATING IN THE A CATEGORY

As discussed below, maintaining a credit rating in the A category carries with it important benefits, notably in terms of the cost of borrowing, access to capital markets, and FEI's credit with its counterparties. One of the primary determinants of FEI's credit rating is its financial metrics, which are currently viewed by the rating agencies as being below the range acceptable for an A rating. The lower financial metrics are due to FEI having a common equity ratio and allowed ROE that are at the lower end of the range of comparable utilities. An increase in FEI's common equity component will improve FEI's financial credit metrics and support the likelihood of FEI maintaining its A-category credit rating.

### The Approach of Rating Agencies and FEI's Current Ratings

Securities issued by FEI are rated by DBRS Limited (DBRS) and Moody's Investors Service (Moody's). DBRS rates debt instruments by rating categories ranging from AAA which represents the highest quality of securities, to D which represents the lowest quality of securities rated. Moody's rates debt instruments by rating categories ranging from Aaa which represents the highest quality of securities to C which represents the lowest quality of rated securities. The Table below presents Moody's and DBRS' rating categories for long-term debt.

**Table 1: Moody's and DBRS' Rating Categories for Long-term Debt Instruments**

Moody's	DBRS
Aaa,	AAA,
Aa1, Aa2, Aa3	AA (high), AA, AA (low)
A1, A2, A3	A (high), A, A (low)
Baa1, Baa2, Baa3	BBB (high), BBB, BBB (low)
Ba1, Ba2, Ba3	BB (high), BB, BB (low)
B1, B2, B3	B (high), B, B (low)
Caa1, Caa2, Caa3	CCC, CC, C
Ca, C	D

Moody's rating methodology for electric and natural gas utilities is primarily based on a rating grid comprised of four key factors. Table 2 below provides a description of Moody's rating factors and sub-factors as defined for regulated utilities.

1

**Table 2: Moody's Rating Grid for Regulated Utilities**

Broad Rating Factor	Factor Weighting	Rating Sub-factor	Sub-factor weighting
<b>Regulatory Framework</b>	25 %	legislative and judicial underpinnings of regulatory framework	12.5 %
		consistency and predictability of regulation	12.5%
<b>Ability to recover costs and earn returns</b>	25 %	timeliness of recovery of operating and capital costs	12.5 %
		sufficiency of rates and returns	12.5 %
<b>Diversification</b>	10 %	Market Position*	5 %
		Generation and Fuel Diversity**	5 %
<b>Financial Strength</b>	40 %	CFO Pre-WC <sup>15</sup> + Interest / Interest	7.5 %
		CFO Pre-WC / Debt	15 %
		CFO Pre-WC – Dividends / Debt	10 %
		Debt / Capitalization	7.5 %

2 \* 10% weight for issuers that lack generation

3 \*\* 0% weight for issuers that lack generation

4 The factors in the rating grid do not constitute an exhaustive treatment of all of the  
5 considerations for ratings of companies in the regulated electric and gas utility sector. Other  
6 considerations that may play an integral part in a rating process include items such as liquidity,  
7 management quality, ownership and governance. Therefore, the grid-indicated ratings do not  
8 always match the actual Moody's rating of each company.

9 The ratings assigned to securities issued by FEI are reviewed by credit rating agencies on an  
10 ongoing basis. Currently FEI's unsecured long-term debt is rated as "A3" by Moody's (the lowest  
11 level of the A category) and "A" by DBRS (the middle level of the A category).

12 As FEI carries an A3 rating from Moody's, which is one notch above a Baa1 rating and lower  
13 than its DBRS rating, a Moody's downgrade would put FEI into the Baa/BBB category. This  
14 would result in a split-rating for FEI (that is, one debt rating in the A category and one rating in  
15 the Baa/BBB category). Investors typically focus on the lowest rating<sup>16</sup> and as such the  
16 predominant weight on the lower Moody's rating would result in FEI being considered principally

<sup>15</sup> CFO Pre-WC stands for Cash Flow from Operations pre Working Capital.

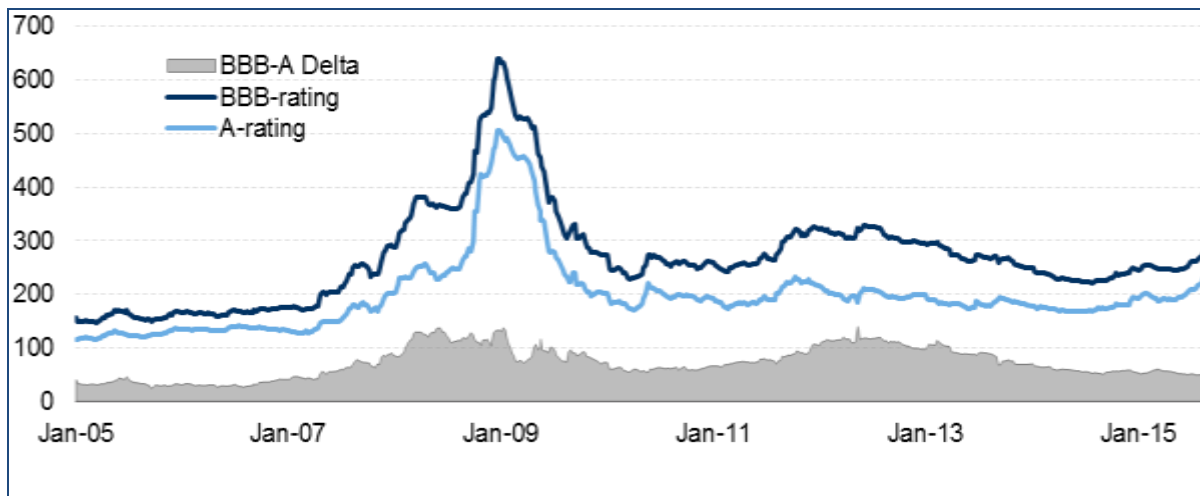
<sup>16</sup> The impact of split-rating on risk premia has been studied in a 1997 study by R. Cantor et al. titled "Split-rating and the Pricing of Credit Risk" concluded that credit risk pricing "in the investment-grade sector is more conservative - placing more weight on the lower rating than the higher rating" and that "the market prices split rated bonds between the yield implied by the lower rating and that implied by the average rating".

1 a BBB rated entity. This outcome would have an adverse impact on FEI's cost of debt (both  
 2 short-term and long-term), access to capital markets and credit with its counterparties.

3 **Credit Rating and Cost of Debt**

4 With respect to the cost of debt, the credit spread associated with a BBB credit rating category  
 5 is higher than that associated with an A credit rating category. In addition, A-rated debt yields  
 6 are less volatile than BBB-rated debt. Figure 1 below shows the new issue credit spreads of  
 7 BBB and A-rated corporate issuers, and the difference between them, from January 2005 to  
 8 August 2015. During this period, the average credit spread differential was approximately 70  
 9 basis points, with the pricing difference more pronounced during periods of market disruption  
 10 (see 2008 and 2009).

11 **Figure 1: Indicative 30 year credit spreads of BBB-rated and A-rated new issuances (from January**  
 12 **2005 to August 31<sup>st</sup> 2015)**



13  
 14 Source: RBC Capital Markets

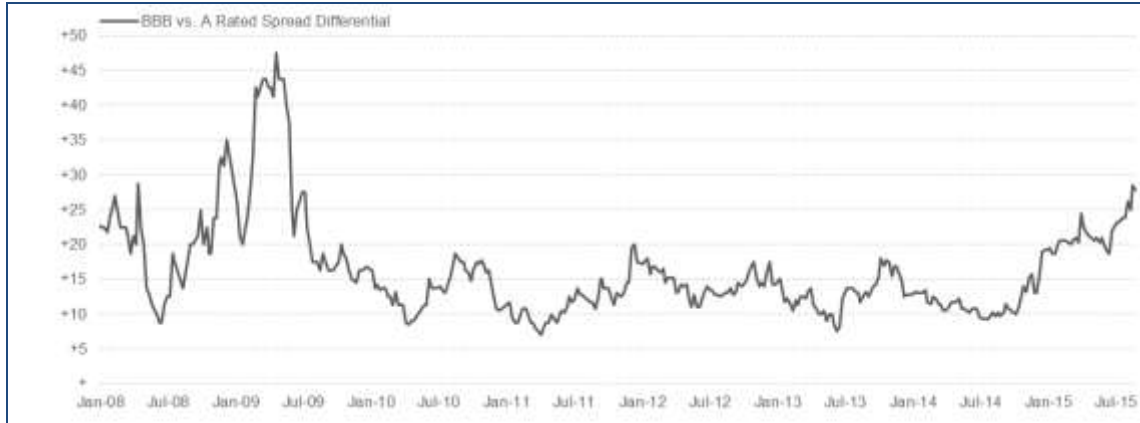
15  
 16 A similar trend can be seen in the Canadian utility sector. Figure 2 below shows the incremental  
 17 credit spread between the average indicative new issue spreads, on a weekly basis between  
 18 January 2008 and July 2015, of four Canadian utilities<sup>17</sup> with, at a minimum a split rating, or a  
 19 majority of their ratings in the BBB category and four Canadian utilities<sup>18</sup> with all or a majority of  
 20 their ratings in the A category. The figure demonstrates that there is a significant range in credit

<sup>17</sup> FortisBC Inc. , Union Gas Limited, West Coast Energy Inc. and Nova Scotia Power Inc.

<sup>18</sup> Enbridge Gas Distribution Inc., FortisAlberta Inc., Gaz Metro Inc. and FortisBC Energy Inc.

1 spreads between rating categories, particularly during periods of market disruption, as seen in  
 2 2008/09.

3 **Figure 2: Indicative 30 year credit spread between selected BBB/split rating and A-rated utilities**

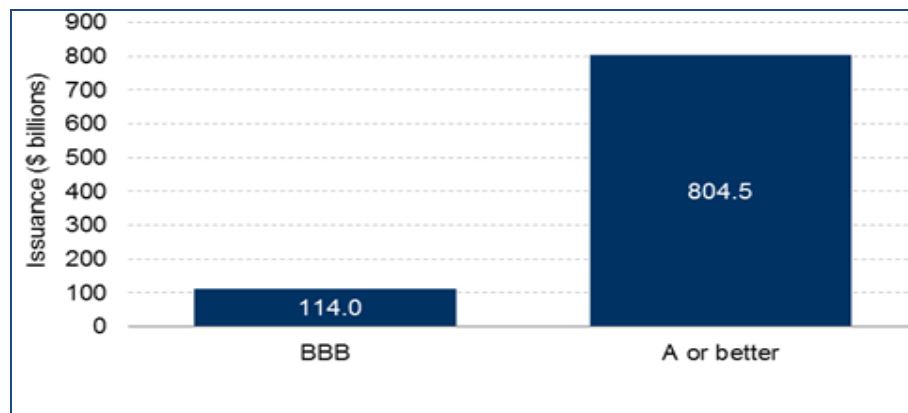


4  
 5 Source: Scotiabank Debt Capital Markets

6 **Credit Rating and Access to Capital Markets**

7 In the context of debt capital markets, as illustrated in Figure 3 below, there is a much larger  
 8 market for A-rated debt compared to BBB-rated debt, with a large majority of debt issued in the  
 9 A-rating category. Many institutional investors face limits on the proportion of Baa/BBB rated  
 10 debt they are allowed to hold in their portfolios and in case of a downgrade they may have to  
 11 rebalance their portfolios by selling their lower rated bonds to meet their investment guidelines.  
 12 As indicated in Figure 3, approximately 88 percent of all long-term domestic corporate debt  
 13 issued from 2005 to August 31, 2015 are A-rated or higher.

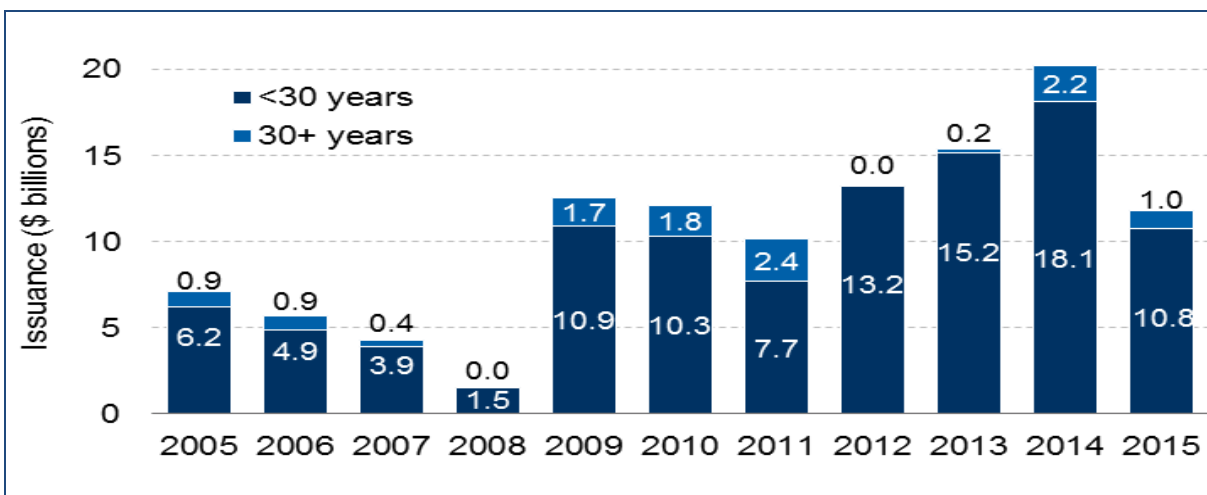
14 **Figure 3: Corporate Bond Issuance Volumes by Rating from 2005 to August 2015**



15  
 16 (Source: RBC Capital Markets)

1 In order to match the long term nature of its regulated assets, FEI typically finances the majority  
2 of the debt portion of its capital structure with debt at terms of 30 years and longer. Issuers with  
3 Baa/BBB category ratings can be shut out of the Canadian debt capital markets at times,  
4 particularly during periods of market distress and for longer tenure issuances, such as 30 years.  
5 As a regulated utility, maintaining the flexibility to access debt capital under various market  
6 conditions, and in particular for longer duration bonds, is critical. Figure 4 below illustrates the  
7 limited access to 30 year and longer term bonds in the Baa/BBB category, and how access to  
8 debt capital for this category can be even more challenged in distressed markets like the one  
9 that existed in 2008.

10 **Figure 4: BBB-rated Corporate Bonds Issuances by Year and Term from 2005 to August 2015**



11  
12 (Source: RBC Capital Markets)

### 13 **Credit Rating and FEI's Credit with its Counterparties**

14 FEI's credit ratings also have significance for FEI's operations. Currently, counterparties to FEI  
15 do not require collateral in the form of letters of credit, nor has FEI experienced any restrictions  
16 on the amount of unsecured credit the counterparties have extended to FEI. This is due in part  
17 to FEI's A credit rating designation. A credit rating downgrade below the A rating category could  
18 lead to FEI being required to post letters of credit with its counterparties, which would add direct  
19 costs in the form of letter of credit fees and lead to a higher utilization of debt facilities, reducing  
20 the availability of its credit facilities to fund ongoing operations, including capital requirements.

21 In previous proceedings, the Commission has recognized the importance of an A category  
22 credit rating. For instance, in the 2009 Cost of Capital Decision, the Commission Panel agreed

1 with FEI that “the combination of the equity ratio and the allowed return thereon should be  
2 adequate to attract capital on reasonable terms and conditions and allow TGI to maintain the A3  
3 rating on its debt and unsecured debt from Moody’s.”<sup>19</sup> Similarly, in the GCOC Stage 1  
4 Decision, the Commission restated its support for an A category rating to the extent that is  
5 required by the Fair Return Standard:

6 *“The Commission Panel is supportive of maintaining an “A” category credit rating but*  
7 *only to the extent that it can be maintained without going beyond what is required by the*  
8 *Fair Return Standard.”*<sup>20</sup>

9  
10 FEI believes that maintaining an A category credit rating is essential to meet the Fair Return  
11 Standard criteria as it will support FEI’s financial integrity and will enable FEI to satisfy its  
12 significant capital needs on reasonable terms and conditions, even under challenging economic  
13 conditions.

14 FEI’s allowed capital structure and ROE are key determinants of the credit metrics that support  
15 the Company’s rating in the A category.

16 Table 3 below shows Moody’s four key financial metrics and the relative position of these  
17 metrics compared to Moody’s guidelines for an A3-rated entity<sup>21</sup>. In the event of a decrease to  
18 FEI’s equity and allowed ROE, financial ratios that are weak at equity levels of 38.5 percent and  
19 allowed ROE of 8.75 percent would be further weakened and may risk a downgrade, while an  
20 increase in deemed equity and allowed ROE would alleviate some of the pressure on weak  
21 financial metrics relative to current ratings. It is worth noting that when the current rates were set  
22 as a result of the GCOC Stage 1 Decision, FEI was initially placed on negative watch by  
23 Moody’s due to expected deterioration of credit metrics. The subsequent removal of the  
24 negative watch appears to be based on Moody’s expectation of a stable regulatory environment  
25 and stable, albeit weak financial metrics<sup>22</sup>. Reductions in either allowed ROE or equity thickness  
26 will not only weaken financial metrics, it may also lead credit rating agencies to reconsider the  
27 qualitative evaluation of regulatory support and stability of financial metrics, putting pressure on  
28 FEI’s ratings. The reaction of Moody’s to the GCOC Stage 1 Decision highlights the risk of FEI’s

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<sup>19</sup> 2009 Cost of Capital Decision, p.15.

<sup>20</sup> GCOC Stage 2 Decision, Executive Summary, p.(iii).

<sup>21</sup> The reason for focus on Moody’s metrics was articulated earlier in this section.

<sup>22</sup> Moody’s Credit Rating Report for FEI, dated July 15<sup>th</sup> 2014.

1 current rating, which is influenced by the Company's relatively weak credit metrics. FEI's  
 2 proposal to increase its allowed equity thickness will lessen the risk of a negative credit rating  
 3 action.

4 **Table 3: FEI's Key Financial Indicator Scores Compared to minimum A3 rating per Moody's Utility**  
 5 **Rating Methodology<sup>23</sup>**

	FEI's Score	A3 - Rating Threshold <sup>24</sup>	2011	2012	2013	2014
<b>CFO pre-WC + Interest / Interest</b>	Ba	4.5x	2.3x	2.5x	2.7x	2.8x
<b>CFO pre-WC / Debt</b>	Baa	19.0%	11.2%	14.5%	15.1%	14.4%
<b>CFO pre-WC - Dividends / Debt</b>	Baa	15.0%	6.6%	9.6%	8.0%	10.3%
<b>Debt / Capitalization<sup>25</sup></b>	A	50.0%	47.4%	44.0%	43.6%	45.2%

6  
 7 As shown in the above Table, with the exception of Debt to Capitalization ratio, all financial  
 8 metrics are below the Moody's designated threshold for an A3 rating<sup>26</sup>.

9 Moody's most recent credit rating on FEI stated:

10 *"FEI's credit quality is driven by its credit supportive regulatory environment and its*  
 11 *monopoly position. The company has a long term track record of earning its allowed*  
 12 *return on equity and its cash flow continues to be highly predictable. This is offset by the*  
 13 *company's weak financial metrics, with limited headroom at the current rating level, that*  
 14 *are primarily a product of the allowed return on equity and the equity component of its*  
 15 *capital structure<sup>27</sup>.*

16  
 17 Table 4 below compares the approved capital structure and other credit metrics of a sample of  
 18 Canadian utilities with those of FEI.

<sup>23</sup> Financial Metrics per Moody's Credit Opinion on July 20, 2015.

<sup>24</sup> Threshold between Baa-rating and A-rating per Moodys Rating Methodology for low Business Risk Entities. Source: Moody's Investors Service Rating Methodology for Regulated Electric and Gas Utilities December 23, 2013.

<sup>25</sup> For Debt/Capitalization %, lower scores denote higher creditworthiness.

<sup>26</sup> Debt/Capitalization has been positively impacted by the adoption of US GAAP which resulted in an increase in Shareholder's Equity on the Balance Sheet of FEI as Goodwill was increased on the Asset side of the Balance Sheet with a proportionate increase in Shareholder's Equity.

<sup>27</sup> Moody's Credit Opinion on July 20, 2015, Appendix A.

**Table 4: Comparative Analysis of Utilities' Credit Metrics, Allowed ROE and Equity Thickness  
 (Source: DBRS Research)**

Fiscal Year	DBRS Rating	EBIT Interest Coverage			Debt to Total Capital			Allowed ROE			Equity Thickness		
		12	13	14	12	13	14	12	13	14	12	13	14
		X	X	X	%	%	%	%	%	%	%	%	%
Enbridge Gas Distribution Inc.	A	2.05	2.58	2.37	55.5	55.5	60.9	8.4	8.9	9.4	36.0	36.0	36.0
Gaz Métro inc. <sup>2</sup>	A	2.11	1.83	1.85	63.7	65.3	67.9	8.9	8.9	8.9	38.5	38.5	38.5
Union Gas Limited <sup>6</sup>	A	2.35	2.48	2.59	64.2	65.1	63.7	8.5	8.9	8.9	36.0	36.0	36.0
TransCanada Pipelines Limited <sup>5</sup>	A	2.36	2.63	2.74	51.7	53.9	54.0	11.5	11.5	11.5	40.0	40.0	40.0
<b>Average Natural Gas Distribution and Transportation</b>		<b>2.22</b>	<b>2.38</b>	<b>2.39</b>	<b>58.8</b>	<b>60.0</b>	<b>61.6</b>	<b>9.3</b>	<b>9.6</b>	<b>9.7</b>	<b>37.6</b>	<b>37.6</b>	<b>37.6</b>
<b>FortisBC Energy Inc.</b>		<b>2.03</b>	<b>1.99</b>	<b>2.05</b>	<b>58.9</b>	<b>60.3</b>	<b>61.4</b>	<b>9.5</b>	<b>8.8</b>	<b>8.8</b>	<b>40.0</b>	<b>38.5</b>	<b>38.5</b>
FortisAlberta Inc. <sup>1</sup>	A(low)	2.34	2.19	2.19	57.9	57.6	56.7	8.8	8.3	8.3	41.0	40.0	40.0
FortisBC Inc.	A(low)	2.43	2.54	2.44	58.5	59.0	58.4	9.9	9.2	9.2	40.0	40.0	40.0
Hydro One Inc. <sup>3</sup>	A(high)	2.91	2.95	2.92	55.5	55.1	52.9	9.4	8.9	9.4	40.0	40.0	40.0
Newfoundland Power <sup>4</sup>	A	2.74	2.95	3.10	55.2	54.6	55.1	8.1	8.8	8.8	45.0	45.0	45.0
Toronto Hydro Corporation	A	2.44	2.50	2.64	57.2	57.6	61.2	9.6	9.6	9.6	40.0	40.0	40.0
AltaLink L.P. <sup>7</sup>	A	2.54	2.84	2.89	57.4	60.3	60.5	8.8	8.3	8.3	37.0	36.0	36.0
<b>Average Electric Distribution and Transmission</b>		<b>2.57</b>	<b>2.66</b>	<b>2.70</b>	<b>57.0</b>	<b>57.4</b>	<b>57.5</b>	<b>9.1</b>	<b>8.8</b>	<b>8.9</b>	<b>40.5</b>	<b>40.2</b>	<b>40.2</b>
<b>FortisBC Energy Inc.</b>		<b>2.03</b>	<b>1.99</b>	<b>2.05</b>	<b>58.9</b>	<b>60.3</b>	<b>61.4</b>	<b>9.5</b>	<b>8.8</b>	<b>8.8</b>	<b>40.0</b>	<b>38.5</b>	<b>38.5</b>

<sup>1</sup> For assets not being funded by capital tracker revenue, Allowed ROE and Equity Thickness were set at 8.75% and 41%, respectively, for 2013 and 2014.

<sup>2</sup> Financials based on Gaz Métro Limited Partnership. Regulatory ratios based on Gaz Métro-QDA.

<sup>3</sup> Allowed ROE is for the transmission segment.

<sup>4</sup> 2014 data is for the 12 months ended June 30, 2014.

<sup>5</sup> Allowed ROE and Equity Thickness based on Canadian Mainline. 2014 data is for the 12 months ended March 31, 2014.

<sup>6</sup> 2014 data is for the 12 mos. ended September 30, 2014.

<sup>7</sup> 2014 data is for the 12 mos. ended March 31, 2014.

As can be seen in the table above, FEIs credit metrics are generally weaker than its Canadian peer group. For instance, FEI's 2014 Earnings Before Interest and Tax (EBIT) interest coverage at 2.05 is lower than the average of both the natural gas and electric distribution and transportation peer group of companies. In addition, Mr. Coyne's evidence indicates that FEI



1 and Canadian utilities in general, have more financial risk and weaker financial metrics than the  
2 U.S. proxy group companies.

### 3 **6.3 FEI'S DEBT ISSUANCE CAPACITY COULD BE CONSTRAINED**

4 As a regulated distribution utility that is required to continually invest in its gas distribution  
5 system to serve its customers, ongoing access to capital is imperative. This is particularly true  
6 for FEI in the near term, considering the capital projects underway or planned. In addition to the  
7 ongoing base capital, FEI has a number of potential large projects such as the Tilbury  
8 expansion project Phase 1B, the Lower Mainland Intermediate Pressure System Upgrade  
9 (LMIPSU), the Coastal Transmission System and the Eagle Mountain Gas Pipeline Project. In  
10 total, the debt financing required to satisfy FEI's capital needs for the 2016 to 2018 period could  
11 approach \$1 billion.

12 FEI's Trust Indenture<sup>28</sup> governs FEI's debentures including the ability to issue new debt. The  
13 debt issuance coverage test in the Trust Indenture provides that FEI will not issue debentures  
14 (other than First Mortgage Bonds or Purchase Money Mortgages (PMMs) (both represent  
15 secured debt) maturing 18 months or more after the date of issue) unless Consolidated  
16 Available Net Earnings (CANE)<sup>29</sup> is at least 2.0 times the annual interest expense on  
17 debentures, excluding interest related to PMMs and including the annual interest requirements  
18 on the additional debentures being issued (defined as Interest on Funded Obligations under the  
19 Trust Indenture). Formulaically,  $CANE/Interest\ on\ Funded\ Obligations \geq 2.0$ . Failure to meet  
20 this test would limit FEI's ability to issue long-term debt.

21 FEI's debt issuance capacity is impacted by its approved ROE and capital structure as well as  
22 the market-driven cost of debt. FEI has provided an illustrative example that demonstrates that  
23 while FEI currently has adequate debt-issuance capacity, it may become more constrained  
24 based on changes in ROE and capital structure as well as debt issuance rates. To support the  
25 Company's ongoing ability to issue debt in this period of high capital growth, FEI's requested  
26 increase in common equity can be viewed as reasonable.

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<sup>28</sup> The Trust Indenture is the legal agreement that specifies the terms and conditions under which debentures are issued and specifies the rights and obligations of both the debt holders and issuer during the term of the debentures.

<sup>29</sup> CANE is calculated by starting with net income, and adding back income taxes, as well as interest on Funded Obligation (which is effectively interest on debt in excess of 18 months, excluding interest on First Mortgage Bonds, PMMs and short term debt).

1 FEI current capacity to issue debt reflects the current equity component of 38.5 percent, ROE of  
2 8.75 percent, and the fact that FEI has \$275 million of debt classified as PMMs (out of total  
3 long-term debt of \$2.045 billion) which is excluded from the debt issuance coverage test. FEI  
4 will begin to lose the benefit of the PMM interest exclusion as \$275 million in PMMs will mature  
5 in 2015 (\$75 million) and 2016 (\$200 million). These maturing PMMs will be refinanced with  
6 senior unsecured debentures under the FEI Trust Indenture, whose interest, unlike the PMMs,  
7 will be included in the issuance test<sup>30</sup>.

8 In order to demonstrate the debt issuance capacity, Table 5 below calculates a base year  
9 issuance capacity using 2014 earnings, but adjusted for the earnings impact that will result from  
10 the reduced ROE and equity percentage applied to the approximately \$845 million rate base of  
11 FEVI and FEW, commencing January 1, 2015. That base issuance capacity, of approximately  
12 \$733 million, is then adjusted for the maturity and subsequent refinancing of PMMs, which will  
13 reduce FEI's issuance capacity by an estimated \$137.5 million.

14

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<sup>30</sup> The Company's Trust Indenture limits FEI's ability to issue secured debt. In addition, FEI believes that it is not prudent to extend the use of secured debt. Secured debt is restrictive and inefficient as it places a direct claim over assets on behalf of debt holders. It is more appropriate for an A3 rated utility to have proper capitalization to ensure debt issuance as opposed to having to resort to less efficient financing instruments.

1 **Table 5: Base Adjusted Issuance Capacity at Current Allowed ROE and Capital Structure**

<b>(CAD\$ 000s)</b>	
<b>Buildup of Adjusted 2014 Earnings</b>	
FEI 2014 Unadjusted Earnings (Per Dec 31, 2014 FS)	141,000
<i>Earnings Impacts of ROE/Equity Changes at Amalgamation:</i>	
Change in FEVI ROE & Equity at Amalgamation <sup>1</sup>	(3,788)
Change in FEW ROE & Equity at Amalgamation <sup>2</sup>	(224)
Interest Savings on Adjusted Equity at Amalgamation <sup>3</sup>	1,521
Pre-Tax Gross-Up of FEVI & FEW Earnings Adjustment <sup>4</sup>	(844)
<b>FEI Total Adjusted 2014 Earnings</b>	<b>137,665</b>
<b>Issuance Capacity Base on Permissive Issuance Test</b>	
<i>Consolidated Adjusted Net Earnings (CANE)</i>	
FEI Total Adjusted 2014 Earnings	137,665
Add: Income Taxes (Per Dec 31, 2014 FS)	35,000
Add: Interest on Funded Obligations <sup>5</sup>	96,310
<b>CANE (A)</b>	<b>268,975</b>
<i>Interest Requirement for Funded Obligations</i>	
Interest on Funded Obligations <sup>5</sup>	96,310
Interest Savings on Adjusted Equity at Amalgamation <sup>3</sup>	1,521
<b>Interest Requirement for Funded Obligations (B)</b>	<b>97,831</b>
<b>Available Status Quo Issuance Capacity<sup>6</sup> = (A/2 - B)/5%</b>	<b>733,100</b>
<b>Impact of Refinancing PMM's on Issuance Capacity At Current ROE &amp; Capital Structure.</b>	
Available Status Quo Issuance Capacity <sup>6</sup>	733,100
Refinancing of \$275 million of PMMs <sup>7</sup>	(137,500)
<b>Net Status Quo Issuance Capacity After PMM Refinancing</b>	<b>595,600</b>
<p>1 - (FEVI Mid-year rate base (\$806,000) X change in ROE (9.25% to 8.75%) X FEI Equity (38.5%)) + (FEVI Mid-year rate base (\$806,000) X change in Equity % (41.5% to 38.5%) X FEVI ROE (9.25%))</p> <p>2 - (FEW Mid-year rate base (\$39,000) X change in ROE (9.50% to 8.75%) X FEI Equity (38.5%)) + (FEW Mid-year rate base (\$39,000) X change in Equity % (41.5% to 38.5%) X FEW ROE (9.50%))</p> <p>3 - FEVI &amp; FEW Mid-year rate base (\$845,000) X change in equity % (41.5%-38.5%) X FEVI/FEW equivalent long term debt rate (6%)</p> <p>4 - Adjustment to gross FEVI and FEW amalgamation earnings adjustments to pre-tax amount using the effective tax rate per December 31, 2014 FS (17.4%) . = (FEVI/FEW Earnings Adjustment for Change in ROE &amp; Equity/(1-2014 Effective Tax Rate)) - FEVI/FEW Earnings Adjustment for Change in ROE &amp; Equity</p> <p>5 = Outstanding Medium Term Notes X Annual Interest Rate. Refer to Note 10 - December 31, 2014 Financial Statements for outstanding notes and interest rates.</p> <p>6 - Permissive Issuance Test requires CANE to be greater than 2X Interest requirement for Funded Obligations. The formula above determines the available capacity for issuance, assuming 5% new issuance yield.</p> <p>7 - Refinancing of \$75 million maturity in 2015 and \$200 million maturity in 2016. Assuming new issuance yield of 5%.</p>	

2

3 The adjusted base issuance capacity for FEI is approximately \$595 million. As mentioned, this

4 analysis is done to illustrate a base level of issuance capacity, adjusting for known changes

5 impacting the issuance test and it is not intended to be a specific forecast of issuance capacity

6 in a given year. This provides a starting point from which to demonstrate the potential further

7 impacts to issuance capacity from changes to the level of allowed ROE and capital structure

8 and the cost of debt for new issuances. The impact of changes in allowed ROE and deemed

1 equity on issuance capacity is presented in Table 6 while the issuance rate sensitivity analysis  
 2 is shown in Table 7.

3 **Table 6: Impact of Changes to ROE and Common Equity Levels on Issuance Capacity**

	(CAD\$ 000s)
Increased Scenario - 9.25% ROE and 40% Equity <sup>1,2,3</sup>	767,800
Status Quo - 8.75% ROE and 38.5% Equity	595,600
Decreased Scenario - 8.25% ROE and 37% Equity <sup>1,2,3</sup>	430,000

4 <sup>1-</sup> Impact On Earnings due to change in ROE = (2014 Mid-Year Rate Base X Status Quo  
 5 Equity % X Incremental Change in ROE from Status Quo)/(1-2014 Effective Tax Rate)

6 <sup>2-</sup> Impact On Earnings due to Change in Equity = (2014 Mid-Year Rate Base X  
 7 Incremental Change in Equity from Status Quo % X New ROE%)/(1-2014 Effective Tax  
 8 Rate) + Incremental Interest Due to Change in Debt = 2014 Mid-Year Rate Base X  
 9 Incremental Change in Debt% from Status Quo X New Issuance Yield (5%).

10 <sup>3-</sup> Impact of Changes in ROE & Equity to Status Quo Issuance Capacity = ((Impact of  
 11 Earnings due to Change in ROE + Impact of Earnings due Change in Equity)/2) -  
 12 Incremental Interest Due to Change in Debt)/New Issuance Yield (5%)  
 13

14 As illustrated in Table 6 above, at a 5.0 percent issuance rate, an ROE reduction of 50 bps and  
 15 an equity ratio reduction of 1.5 percentage points would reduce FEI's issuance capacity by  
 16 approximately \$166 million.

17 Similarly, Table 7 demonstrates that an increase in new debt issuance rates impacts issuance  
 18 capacity.

19 **Table 7: Sensitivity of Issuance Capacity to Cost of Debt (issuance rate)**

(CAD\$ 000s)	Decreased ROE & Equity	Status Quo ROE & Equity	Increased ROE & Equity
Issuance Capacity at 5.0%	430,000	595,600	767,800
Issuance Capacity at 6.0%	330,800	473,400	621,400
Issuance Capacity at 7.0%	260,100	386,200	517,000

20  
 21 Based on the potential financing required from 2016 to 2018 of \$1 billion, the average annual  
 22 debt issuance forecast is \$333 million. However in any given year, annual issuances may  
 23 exceed this amount depending on the timing of specific capital projects. An annual debt  
 24 issuance requirement of \$400 million or more in one of the three upcoming years would not be  
 25 unreasonable given the size of the overall potential financings. As the sensitivities in Table 7  
 26 demonstrate, the Company's ability to issue debt may be constrained under certain  
 27 circumstances.

1 From the analysis above, FEI is demonstrating the impact on issuance capacity from a) the  
2 refinancing of maturing PMMs with debentures, b) changes in the allowed ROE and equity  
3 percentage of capital structure, and c) increasing interest rates for new debt issuance. Under  
4 certain circumstances, and in a period of higher debt capital requirements, debt issuance may  
5 be constrained. An increase in equity and/or allowed ROE would be reasonable to support  
6 issuance capacity going forward.

#### 7 ***6.4 CONCLUSION ON CAPITAL STRUCTURE DISCUSSION***

8 Canadian utilities need to compete for capital in the global market place and it is important that  
9 utilities are allowed a return and capital structure that enable them to do so. FEI respectfully  
10 submits that a 40 percent equity thickness is warranted considering the upward trend in FEI's  
11 business risk, the need to strengthen the Company's weak credit metrics and to support the  
12 ongoing access to capital. A 40 percent equity thickness will support FEI's rating as an A rated  
13 utility, providing for access to capital markets under reasonable terms and conditions in all  
14 economic environments, and improve FEI's ability to compete for capital with its peer  
15 companies.

16

## 1 7. AUTOMATIC ADJUSTMENT MECHANISM

2 As stated in FEI's 2009 Cost of Capital Application and again in the GCOC Stage 1 Proceeding,  
3 FEI continues to believe that a regulatory proceeding is preferable to the use of an Automatic  
4 Adjustment Mechanism for setting the allowed ROE for a utility.

5 In the GCOC Stage 1 Decision, the Commission reinstated the AAM that had been eliminated  
6 in 2009 by Order G-158-09. In developing the parameters of the AAM, the Commission agreed  
7 with FEI's argument that an AAM with limited inputs cannot capture all of the complex factors  
8 affecting ROE and acknowledged that a single variable formula similar to the one used prior to  
9 2009 does not satisfy the Fair Return Standard in a low interest rate environment. In the GCOC  
10 Stage 1 Decision, the Commission Panel adopted a two variable formula similar to those  
11 adopted at the time by Ontario and Quebec that consider the changes in both Long Term  
12 Canadian Bond Forecast (LCBF) and the changes to the utility bond spread as follows:

$$13 \quad \text{ROE} = \text{BaseROE} + 0.5 * (\text{LCBF}_t - \text{BaseLCBF}) + 0.5 * (\text{UtilBondSpread}_t - \text{BaseUtilBondSpread})$$

14 To avoid the downward bias inherent in the formula, the Commission also decided to make the  
15 application of the formula conditional upon the actual long term Canadian bond yield meeting or  
16 exceeding a threshold of 3.8 percent. Since 2013, the Canadian long term bond yield has  
17 remained below the 3.8 percent threshold and therefore the AAM has not been applied to FEI's  
18 ROE.

19 The Commission sought comfort in the applicability of AAMs in Quebec and Ontario and stated  
20 that "*application of similar models within both Ontario and Quebec supports its usefulness and*  
21 *acceptance*".<sup>31</sup>

22 Since the GCOC Stage 1 and Stage 2 Proceedings, Quebec has suspended application of its  
23 own formula<sup>32</sup>.

24 Consistent with previous proceedings, FEI believes that a formula cannot capture all the  
25 changes facing a utility's cost of capital and can yield a return that does not meet the Fair  
26 Return Standard. Therefore, FEI respectfully submits that the Commission should suspend the  
27 application of the AAM in BC, instead reviewing the cost of capital for the benchmark utility in a  
28 three to five year time frame. Nevertheless, if the Commission continues to believe that an AAM

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<sup>31</sup> GCOC Stage 1 Decision, p.90.

<sup>32</sup> Regie, Orders D-2013-036, D-2013-085, D-2014-078 and D-2015-076.

1 is appropriate then it should continue with the two factor model approved in the GCOC  
2 proceeding.

3

## 1    **8.    RATIONALE FOR THE SELECTION OF FEI AS BENCHMARK**

2    FEI has been the benchmark utility for the purposes of determining the allowed rate of return for  
3    BC utilities since 1994. In each cost of capital application since 1994, the Commission has re-  
4    examined FEI's business profile and business risk as it existed at the time, thus updating the  
5    profile of the benchmark utility. The use of a benchmark utility, and FEI's suitability for serving  
6    as the benchmark utility, were most recently re-affirmed in the GCOC Stage 1 proceeding. FEI  
7    believes that the same approach that has been used for two decades remains appropriate  
8    today. The Commission should consider the business profile and business risk of FEI as it  
9    exists today, post amalgamation, and continue to treat FEI as the benchmark utility.

10    Designating a benchmark utility for the purpose of establishing the cost of capital for BC utilities  
11    is efficient and encourages consistency in decisions, while still permitting the application of the  
12    Fair Return Standard. Using a real utility, rather than a hypothetical construct, permits greater  
13    understanding of the characteristics of the benchmark utility and thus permits more efficient and  
14    transparent comparisons. FEI has always been considered to be the best suited among all of  
15    the BC utilities to serve as the benchmark utility.

16    The Commission most recently affirmed FEI as the benchmark utility in the GCOC Stage 1  
17    proceeding, citing similar reasons. Procedural Order G-148-12 from the GCOC Stage 1  
18    proceeding stated:<sup>33</sup>

19            *"The Commission Panel notes that there was general agreement among the parties with*  
20            *respect to FEI in 2012 being made the benchmark for the GCOC proceeding. FEI is well*  
21            *established, of sufficient size and has a diverse customer and asset base. In addition,*  
22            *FEI is well understood as a utility by all the participants as it has traditionally been used*  
23            *as the benchmark utility in British Columbia. This and the fact that there is a substantial*  
24            *body of FEI related evidence already on the record in this proceeding makes FEI a*  
25            *reasonable candidate for the benchmark utility. Therefore, notwithstanding the various*  
26            *positions of the participants as to whether FEI can be described as a pure play gas*  
27            *distribution utility, the Commission Panel agrees with the participants and accepts FEI, in*  
28            *the present time frame, as the most appropriate choice for the benchmark utility."*

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<sup>33</sup> Order G-148-12, Reasons for Decision, p.4. The Commission affirmed this in the Stage 1 GCOC Decision (p.114), stating: "The common equity component and the approved ROE in this Decision will serve as the benchmark cost of capital for any other utility in British Columbia that uses the benchmark utility to set rates."



1 FEI continues to be the logical choice to serve as the benchmark utility based on the above  
2 criteria. In particular, as was the case in 2012:

- 3 • FEI is the largest investor-owned utility in British Columbia, remains one of the larger  
4 gas distribution utilities in the country, and continues to have a relatively diverse  
5 geographic, customer and asset base.
- 6 • FEI remains representative of the general business risk characteristics facing BC  
7 utilities, facilitating comparisons with other BC utilities.
- 8 • Although FEI's equity is not publicly traded, its debt is rated by two debt rating agencies,  
9 providing some independent capital market assessment of its overall business and  
10 financial risks, albeit from a debt holder's perspective.
- 11 • The Commission, interveners and other utilities are familiar with FEI as the benchmark.  
12 Past proceedings have examined the business profile and business, regulatory and  
13 financial risks of FEI. It is more efficient to utilize the record from those proceedings as  
14 necessary, and supplement it, rather than to start over with a new benchmark. The  
15 continued use of FEI as the benchmark also allows for analysis of the changes to  
16 business risk over time, for both FEI as the benchmark as well as for each utility that  
17 benchmarks to FEI. The corporate amalgamation of FEI, FEVI and FEW, effective  
18 December 31, 2014, resulted in changes to certain financial and operating metrics of  
19 FEI, but did not fundamentally alter FEI's business profile. FEI Amalco is fundamentally  
20 engaged in the same business as FEI had been involved in before the amalgamation.  
21 The same categories of risk or risk factors that had been applicable to FEI pre-  
22 amalgamation remain relevant for FEI Amalco. Changes in the risk assessment can all  
23 be accounted for in the business risk analysis, and do not affect the suitability of FEI to  
24 serve as a benchmark utility.
- 25 • FEI remains, and will remain for the foreseeable future, primarily a "pure play" gas  
26 distribution utility as it had been in 2012. On any objective measure, FEI's traditional  
27 customer base remains the overwhelmingly dominant component of FEI's business.  
28 Moreover, all services provided by FEI, including Natural Gas for Transportation and  
29 Renewable Natural Gas, represent the distribution of natural gas to residential,  
30 commercial and industrial end users.
- 31 • Pacific Northern Gas Inc. (PNG) and FortisBC Inc. (FBC) are the only other sizable  
32 investor-owned utilities in the Province. PNG and FBC both lack the broad geographic  
33 scope and large customer base of FEI. There would be regulatory inefficiencies  
34 associated with moving away from a long-established benchmark utility and designating  
35 PNG or FBC as the benchmark utility.

36  
37 The approach of benchmarking BC utilities to "FEI as it exists at the time of a cost of capital  
38 proceeding" has worked for almost two decades. There is every reason for the Commission to  
39 continue using that approach, and no compelling reason to change.

1 **9. CONCLUSION**

2 The materials filed in this Application provide the necessary evidence on which to determine the  
3 key matters at issue in the proceeding. In determining an ROE and capital structure for  
4 amalgamated FEI that meets the Fair Return Standard, the Commission should give recognition  
5 to the current assessment of FEI's business risks, which in the view of FEI are trending higher,  
6 consideration of the need for higher equity thickness to support credit ratings and the ongoing  
7 challenges posed by uncertainty in financial markets.

8 Based on the evidence before the Commission, FEI submits that the Fair Return Standard is  
9 met in this proceeding by having a capital structure that includes a 40 percent equity ratio, and  
10 an ROE of 9.5 percent.

11