C6-22

Dr. Booth's Opening Statement

The BCUC has two important decisions to make that my testimony addresses. The first is, has the business risk of FEI changed, in which case should the common equity ratio be changed? The second is whether the cost of equity capital has changed, where according to the Supreme Court of Canada, as well as basic economics, this is the rate investors can earn on other securities of equivalent risk to that of the regulated utility.

In terms of business risk and capital structure, in 2006 the BCUC decided that the appropriate common equity ratio for FEI was in a range of 35-38% and decided on 35% due to the more extensive set of deferral accounts available to FEI. This was changed in 2009 to 40%, but it is important to understand why. In 2008 the competitive advantage of natural gas over electricity almost disappeared, while the Province was enacting legislation that would increase FEI's costs through a carbon tax. This was to increase FEI's costs by $0.50 a gj in 2009 up to $1.50 a gj by 2012 and there was discussion of it moving to $15 a gj. In fact, natural gas was being described as a transitional fuel to such an extent that the President of TGI had to say that natural gas is a *foundational* fuel not a t*ransitional* fuel (decision page 23).

The point is that the threat to FEI was that provincial fuel policy would increase the carbon tax, threaten the competitive position of natural gas and jeopardize FEI's ability to recover its rate base investment. I did not accept this at the time, but regardless this has now changed. FEI has absorbed the $1.50 gj carbon tax and its competitive advantage over electricity has increased substantially, so that it is now greater than it has been for the last ten years; even after the carbon tax the competitive position of FEI is only slightly behind that of Union Gas and EGDI in their markets. I regard it as a reasonably straight forward conclusion that FEI's business risk is equivalent to what it was in 2006 and recommend the same 35% common equity ratio.

In terms of the opportunity cost, it has to be remembered that the FEI testimony was mainly drafted during the worst of the financial crisis of 2008/9. Ms McShane's

testimony, for example, was dated March 2009 and Dr. Vander Weide's May 2009, but his last DCF estimates were for February 2009. The company and its witnesses stress that the hearing was in late 2009, but the bulk of the evidentiary record was put together at a period of real financial crisis and the memory of this was very much upper most in people's minds. I note, for example, that my testimony was dated August 2009 and while my own recommended ROE was 7.75%, I also recommended that the BCUC maintain its own ROE formula that would have resulted in a higher ROE.

Times have now changed. According to the Governor of the Bank of Canada our financial system is now "firing on all cylinders" and the limited output gap that remains is expected to disappear in 2013. The only negative is actually a positive, which is that as a AAA rated country foreign investors are buying Canadian government debt, pushing up prices and driving down yields thereby increasing the credit spread with corporate bonds. Some would say that this is a "re-pricing of risk" and indicates "increased investor risk aversion." However, to say the least this is a stretch. The fact is that Canadian utilities can borrow at incredibly low interest rates for 40 or 50 year terms, which on sober reflection does not indicate any significant increase in risk aversion.

The low Canadian government bond yields do pose problems however, in that they are largely being set by foreign investors and reflect the actions of what RBC calls the global policy maker. As a result I have added 0.80% to my long Canada bond yield forecast to reflect the impact of Operation Twist and the Euro crisis and like many others do not regard current Government of Canada bond yields as anywhere close to equilibrium levels. As a result, my recommended ROE increases to 7.50%.

There is no question that a lower allowed ROE and a return to a 35% common equity ratio, combined with FEI's high embedded interest cost, also means a return to interest coverage ratios around 2.0. However, if the BCUC feels that FEI needs more financial flexibility then the answer is for FEI to issue 5.0% in preferred shares. What I don't recommend is that a debt market access problem be solved in the equity market by giving the shareholders either more common equity or a higher ROE than is warranted.