

British Columbia Utilities Commission

2012 Generic Cost of Capital Proceeding

Final Submissions

Industrial Customers Group

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A. The Fair Return Standard

1. The ICG agrees with FBCU that the Fair Return Standard is the touchstone of this proceeding. (FBCU Final Submission, p. 1) However, FBCU then goes on to state that Dr. Safir did not apply the Fair Return Standard. (FBCU Final Submissions, p. 10) The ICG disagrees, and provides the following quote from Dr. Safir's filed testimony:

The standard for a "fair return" arises from both legal and economic precedents and have been discussed in numerous Provincial decisions as well as those of the National Energy Board ("NEB") ...

Regulation is imposed to acquire the benefits of large scale efficiencies while protecting customers of those services from the potential exercise of monopoly power. It is designed to emulate competitive outcomes that would otherwise be unobtainable. As a result, regulation is imposed over utilities for the benefit of customers, not for the benefit of utilities themselves. Consequently, where a range of competitive returns is available for evaluation, the outcome of a "fair return" should always favour the lower range presented. (Exhibit C4-9, p. 7)

2. In Final Submissions, FBCU requests that the Commission exclude from the record Exhibit B1-42 (FBCU Final Submission, p. 11, para. 20). In the 2009 Decision, the Commission presented a table that highlighted the revenue requirement impacts of a 1% equity increase and of a 0.25% ROE increase. (2009 Decision, p. 6) Just as revenue requirement impacts were considered in the 2009 Decision, revenue requirements found in Exhibit B1-42 should be considered, and the Commission Panel should reject the request of FBCU to exclude Exhibit B1-42 from the record.

3. The significance of the evidence found in Exhibit B1-42 includes consideration of the historic approach by the Commission to vary either capital structures or ROEs, or both. (2009 Decision, p.2) In this proceeding, the ICG's primary interests relate to the characteristics of the benchmark utility that are relevant to FBC, that is, the determination of the fair return on equity (ROE) of FEI. As a result, the focus of Dr. Safir's evidence

has been a fair ROE for FEI. Exhibit B1-42 provides evidence that is relevant to the Commission Panel decision to vary either capital structure or ROEs, or both. In the 2009 Decision, the Commission stated:

The allowable return on a utility's invested capital is a *combination of two factors* when determining a fair return:

1) the percent of its invested capital that is held as equity relative to the percent held as debt, that is, its capital structure; and

2) the rate of return allowed on the equity portion of the capital structure. (2009 Decision, p. 2)(emphasis added)

4. The ICG submits that the Commission should reduce the ROE before reducing the capital structure of FEI, and that Exhibit B1-42 provides evidence that is relevant to that determination. For example, the change in revenue requirements from a reduction in equity thickness to 35% is far less than the change in revenue requirements from a reduction in ROE from 9.5 to 7.5%. The Commission Panel should ensure that the Fair Return Standard is met, but with due consideration to the revenue requirements changes that will follow. In that context, the interests of customers should be paramount to those of the shareholders.

B. Significance of Business Risk of FEI

5. The conclusions of FBCU regarding business risk of FEI are stated as follows:

On a whole, FEI's business risk (including regulatory risk) is being characterized as being similar – no lower, and perhaps somewhat higher- than it was in 2009. (Exhibit B1-9-6, Appendix H, p. 2, and Exhibit B1-33, Opening Statement of Mr. Dall'Antonia, see T2, 110, line 21-23)

6. Contrary to the submissions of FBCU (see also Final Submissions of FBCU, p. 45, para. 72), the ICG submits that the business risks of FEI from 2005 to the present need to be considered in order to apply the Fair Return Standard. The business risks of

FEI from 2005 to the present are relevant to the application of the Fair Return Standard in this proceeding because the cost of capital approved in the 2006 Decision for FEI needs to be given equal or more weight to cost of capital approved in the 2009 Decision. Moreover, the business risks of FEU as compared to the business risks of its peers from 2005 to the present are also relevant to the application of the Fair Return Standard in this proceeding.

7. FBCU submits the most significant business risks of FEI are regulatory risks. (FBCU Final Submission, p. 37, para. 58; T2:271, lines 2-23) However, those risks have either declined or have not changed since 2005 (T2:299, lines 21-23), and therefore do not advance a comparison of the business risks of FEI over time, and perhaps not with its peers either, assuming no change in the regulatory risk of its peers. (T2:272, lines 22-24) At least in the context of short-term business risks, the most significant indicators of business risks relate to system throughput and to use per customer. With respect to those two indicators, the key driver of rate changes is the cost of gas relative to the cost of electricity.

C. Natural Gas Supply and Prices

8. Ms. Des Brisay testified that the shale gas development has been a “game changer.” (T2, 163, lines 11-14, and T2, 263, lines 5-6) Ms. Des Brisay further testified:

The company agrees that the supply potential there we’re seeing that’s coming out of the development of the shale resources is huge. And it has been a major shift in the market. (T2: 147, lines 11-14)

9. In response to questions from Mr. Fulton, Mr. Stout testified, “... people are looking at opportunities to bring methanol plants, ammonia plants, that sort of thing, to North America, that were offshored a number of years ago.” (T3:320, lines 13-18) Ms. Des Brisay further testified, that “we have enormous reserve potential in the province”

(T3:322, lines 10-11), and as quoted by the Vancouver Sun in “Natural Gas Seen as Green Fuel”:

B.C. has truly huge natural gas resources. We’ve got over a hundred years of supply at current production rates and, according to the National Energy Board, British Columbia has a potential to exceed Alberta production, possibly later this decade. (Exhibit A2-34)

10. And in response to questions from Mr. Wallace, Ms. Des Brisay agreed with the following quote:

The exploration and production of natural gas has accelerated rapidly over the last five years and the recoverable gas resource has grown tremendously. Approved domestic reserves are now at highest levels in 40 years and outlook suggests more than 100 years of available natural gas supply at today’s production levels. (T2:166, lines 1-11, American Gas Association Report, “Squeezing Every BTU)

11. Given this “game changer”, the outlook for natural gas prices today are certainly lower than in 2009. (T2: 128, lines 24-26) Moreover, commodity prices were much lower in 2009 than in 2005, and commodity prices in 2012 were much lower than in 2009. (T2:135 and Exhibit B1-9-6, Appendix H, p. 16, Figure 8)

12. But just as significantly, there was a significant year-over-year increase in commodity prices to the time of the 2006 Decision hearing. (T2: 130, lines 18-25 and Exhibit B1-38) And as will be mentioned in a subsequent section of these submissions, system throughput had been decreasing for the three years preceding the 2006 Decision. (T2:261, lines 12-18) Given the circumstances prior to the 2006 Decision, the “game changer” occurred after the 2006 Decision. It follows that the business risks of FEI were higher in 2006 than in 2009. This conclusion is consistent with the Commission conclusion in the 2009 Decision that TGI’s ability to earn a return on or of its capital had not been adversely affected since 2005.

13. In 2009, FBCU and others started to gain a much fuller understanding of the opportunity and potential of shale gas development as evidenced by commodity forecast prices. In 2009 the 2020 forecast for gas prices was \$9, and today the 2020 forecast for gas prices is \$6. (Ex. B1-36). And so as Ms. Des Brisay had no choice but to acknowledge:

We believe our risk is lower in terms of availability of supply, that the company's risk is lower in terms of the long-term outlook for price. (T2, p. 155, 9-12)

14. Given abundant supply and declining prices since 2005, FBCU chose to focus on gas price volatility in an effort to resist the obvious conclusion that the “game changer” has reduced business risk.

15. In an effort to support the proposition as to how volatile prices could be in the future, Ms. Des Brisay referred to Figure 13 --- AECO/NIT Forward Curve and Implied Volatility. (T2:159, lines 5-10, and Exhibit B1-9-6, p. 22, Figure 13) However, Figure 13 does not calculate implied volatilities; instead Figure 13 calculates a forecast of gas prices based on confidence levels. (T3:360, lines 13-26)

16. The inevitable conclusion is that the “game changer” of shale gas development results in a business risk “game changer” for FEI.

D. Throughput Risk

17. This “game changer” or “shift” in the shale gas development and supply potential needs to be considered in the context of the following synopsis of the testimony of the Terasen witnesses in the 2009 Decision proceeding:

Terasen submits that the carbon tax reduces natural gas' competitiveness relative to alternative energy sources that are not subject to the carbon tax and will help to sensitize customers to the level of GHG emissions they

generate by sending them price signals. The provincial carbon tax increases the business risks of TGI. (Terasen Argument, para 52)

Terasen states that government policy that discourages consumers from using natural gas will have the effect of reducing throughput volumes on the TGI system and reducing the attachment of new customers. The recovery of fixed costs from a smaller customer base, and on lower throughput, leads to rate pressure for the remaining customers. Left unmitigated and unchecked, these effects can lead to loss of existing natural gas customers and a potential “downward spiral” in which the risk of non-recovery of invested capital increases and assets potentially become stranded. (Exhibit B-11, Panel 1.1)” (2009 Decision, p. 22) (emphasis added)

18. In this proceeding, FBCU continued the same theme in opening comments: “Yet we still see the same trend in capture rates, declining use rates, and *declining throughput on the system.*” (T2:p. 109, lines 11-13)(emphasis added) And later, Ms. Des Brisay testified that: “what our customers are actually experiencing today is very similar to what they were experiencing in 2009.” (T2:129, lines 17-19)

19. So in opening comments and several times during the proceeding, FBCU claimed that throughput on the system has been declining. But again, the evidence contradicts the claim. The evidence regarding throughput on the system is graphically illustrated in Exhibit B1-41. There simply has been no declining trend in system throughput since 2009. In fact, system throughput has either been flat since 2009, or as evidenced by the bar graph at Exhibit B1-41 with the benefit of year-to-date actuals for 2012, there has been a year-over-year increase in throughput on the system from 2009 to 2012.

20. FBCU claims increasing industrial throughput since 2009 cannot be relied upon. (Exhibit B1-9-6, Appendix H, p. 9, Figure 4) However, there is a four year upward trend in industrial throughput reflective of the “shift” in natural gas prices since 2009. (Exhibit B1-41, Undertaking No. 6, p. 3) Given this four year trend, the FBCU evidence regarding industrial throughput forecasts for 2013 to 2016 noted on the same graph should not be accepted by the Commission. This would then change the throughput

forecasts found on Undertaking No. 6, p. 1, and the upward trend in system throughput from 2009 to 2012 would continue. Given this upward trend in system throughput since 2009, the ICG submits that the Commission Panel should conclude that business risks are in fact lower now than in 2009, and much lower than in 2006 when system throughput had been declining prior to the decision.

E. Trend in Customer Rates

21. Both Mr. Stout and Ms. Des Brisay emphasized the importance of customer rates. (T2:131, lines 8-14) Commodity prices are a driver of customer rates, so forecasts of commodity prices are relevant to an assessment of business risks, despite the fact that customers only see the final rates.

22. Regarding customer rates Mr. Stout and Ms. Des Brisay relied on evidence that later needed to be corrected. As can be seen in the corrected evidence (Exhibit B1-35), customer rates not only did not follow inflation but declined from July 09 to July 12 by 11 per cent, which is a significant change in rates. In fact the corrected rate difference was approximately four times the amount testified to by Mr. Stout. (T2:136, lines 25-26) In Final Submissions, FBCU refers to the change in customer rates from November 09 to November 12, which indicates a 3% decline in rates during that period, and then goes on to boldly speculate that the remaining gap between the bills depicted above is likely to be eliminated in the near future. (FBCU Final Submissions, p. 65, para. 118 and para. 119)

23. There is no reason to think that the FBCU witness panel in any way intended to mislead the Commission Panel. Nevertheless, the evidence filed by FEU (Exhibit B1-9-6, p. 51, Figure 34) was incorrect regarding a central issue in this proceeding, was relied upon by the FEU witness panel, and then was very reasonably relied upon by the FEU expert witnesses. Nevertheless, the change in customer rates over time should be given little or no weight because the change in customer rates is a very poor indicator of the

business risks of FEI. In the next section, the much more important metric of FEI business risks, that is, gas rates vs. electricity rates, will be considered.

F. Gas Rates vs. Electricity Rates

24. In opening comments, FBCU stated:

FEI's business risk is largely dictated by how successful we are at retaining the core space and water heating load and market share in the residential and commercial sector. In that regard, we continue to face challenges. (Exhibit B1-33, and T2:110, line 4-7)

25. There has been a dramatic improvement in the cost competitive position of natural gas relevant to electricity since 2009 and since 2005. The graphic illustrations of the operating cost differences are provided in response to an information request from AMPC/BCPSO/CEC. (Exhibit B1-11, p. 31, AMPC IR#1, 4.2) The operating cost advantage in terms of annual expenditure space heating was about 45% in 2012, 28% in 2009, 12% in 2005 for a lower mainland residential customer. The operating cost advantage of natural gas over electricity for water heating has also improved. (Exhibit B-11, p. 32, AMPC IR#1, 4.2)

26. The graphic illustrations of the operating cost advantage of natural gas over electricity as compared to other provinces are also provided in response to an information request, this time from the BCUC. (Exhibit B1-20, p. 244, BCUC IR#1, 101.2) The natural gas advantage of electricity over gas in BC is 53%, in Alberta it is 84%, in Ontario it is 76%, and in Quebec it is 9%.

27. The evidence simply does not support the conclusion of FBCU that the present downward trend in natural gas commodity prices is "being muted by the realization, and potential acceleration, of the trends identified in 2009 that challenge FEI's core space and water heating market." (Exhibit B1-9-6, Appendix H, p. 2) In fact, as noted above, the

evidence supports the contrary proposition, the trends in the cost advantage of natural gas over electricity for “core space and water heating” improved in 2009 over 2005, and again in 2012 over 2009.

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

G. Trends in Other Jurisdictions

29. In the previous section, the ICG considered evidence that supports the conclusion that the business risks of FEI declined from 2005 to 2009 and then again business risks declined from 2009 to 2012. In this section, the ICG submits that this decline in business risks should be given significant weight by the Commission Panel.

30. The first issue for the Commission Panel to consider is whether or not the 2009 Decision or the 2006 Decision should be the point of reference for this decision. The FEI submits that the 2009 Decision should be the point of reference for this decision. The ICG submits that the point of reference for cost of capital determinations should be the 2006 Decision. The ICG further submits that the 2009 Decision balanced the interests of customers and shareholders in a manner that gave too much weight to the interests of shareholders. Moreover, the 2009 Decision was a significant departure from historical cost of capital decisions by the Commission. Therefore, the ICG submits that this

Commission Panel should now issue a cost of capital decision that is in line with cost of capital decisions issued prior to the 2009 Decision.

31. The ICG agrees with Ms. McShane's evidence regarding how the weighted equity return component of FEI compared to its Canadian peers in 2005. Moreover, the ICG agrees with Ms. McShane's evidence regarding how the weighted equity return component of FEI now compares to its Canadian peers. On the critical facts, there is no dispute. And the facts are: 1) in 2005 through to 2009 the weighted equity return component of FEI was materially lower (0.47) than its Canadian peers, and 2) in 2010 through to 2012 the weighted equity return component of FEI was materially higher than its Canadian peers (0.57). Given a steady decline in business risks of FEI since 2005, the facts lead inexorably to the conclusion that the 2009 Decision should not be the point of reference for this decision. The point of reference for this proceeding should be the 2006 Decision.

32. First, to the two critical facts listed above. In 2005, Ms. McShane testimony stated:

... the lower allowed ROEs in British Columbia penalize that province's utilities relative to their Canadian peers. As indicated in the following table, the British Columbia utilities' risk compensation (the weighted equity return component of the allowed return on rate base) has been materially lower than their peers. (Exhibit C4-14)(emphasis added)

33. And then in this proceeding, Ms. McShane confirmed the second of the two critical facts listed above:

Ms. McSharne “--- FEI was higher [in 2012] than what the allowed returns were for this group of companies.

Mr. Hobbs: Materially higher.

Ms. McShane: Well, compared --- yes. I mean, I think it would only be fair to say that, based on the conclusions, you know, the difference, when we said that they were lower. (emphasis added)(T4:563, lines 18-24)

34. It is now necessary to examine the evidence regarding the 2005 and 2012 weighted equity component of FEI as compared to its peers. To further refine resolution on this issue, it will also be helpful to examine the trends in return on equity decisions since 2005.

35. The evidence regarding the 2005 weighted equity component of FEI as compared to its peers is provided in Exhibit A2-11 and the relevant portions of Exhibit A2-11 can be found also in Exhibit B1-47. The evidence regarding the current weighted equity component of FEI as compared to its peers is provided in Exhibit B1-20, p.8, BCUC IR 4.1. The weighted return component of FEI as compared to the average was 0.49 lower than the average in 2005, and the comparable number for is 0.57 higher than the average in 2012. The testimony of Ms. McShane quoted above is found in C4-14. (see also T4:602, lines 9-13)

36. As stated on the first page of the 2006 Decision,

“TGI has the lowest return on equity and smallest equity component of capital structure of any gas distribution company in Canada.”

37. In the 2006 Decision, the approved return on equity for TGI was 8.80 percent (3.90 percent over the risk free rate) on an equity component of 35%. As noted above, at the time of the 2006 Decision hearing throughput was declining and commodity prices were dramatically increasing. Following the 2006 Decision, the weighted equity

component of the allowed return on rate base continued to be materially lower than FEI's peers until the 2009 Decision.

38. In the 2009 Decision, the Commission approved an increase to the return on equity for TGI from 8.80 per cent to 9.50 per cent (4.71 per cent over the risk free rate) on an equity component of 40%. Following the 2009 Decision, the weighted equity component of the allowed return on rate base moved from being materially lower than FEI's peers to being materially higher than FEI's peers. The Commission Panel now has an opportunity to return FEI to a weighted equity component that is materially lower than the weighted equity component of its peers, just as it was prior to and following the 2006 Decision. As the Commission stated in the 2006 Decision:

The Commission Panel's view is that it holds generic hearings into a fair return on such an infrequent basis, that there is little danger of circularity should it consider the returns allowed in other jurisdictions to ensure that the return it allows for 2006 is in line with returns allowed to benchmark low risk utilities in other jurisdictions. (2006 Decision, p. 49)

39. The ICG submits that the Commission Panel should give considerable weight, just as Ms. McShane encouraged in filed testimony in the 2006 Decision proceeding, to FEI's position relative to its peers. It is time for this Commission Panel to conclude that there has been a declining trend in returns across Canada and that FEI returns should be reduced. The Commission awards to regulated utilities should not be materially higher than the FEI peers, Commission returns should be materially lower than the FEI peers.

40. The evidence regarding the rates of return on common equity adopted by regulatory boards for Canadian Utilities is provided by Ms. McShane at Exhibit B1-9-6, Schedule 3, page 2 of 2, and at Exhibit B1-54, which corrects Schedule 3 for the Ontario Energy Board decisions. There are eight important observations that can be drawn from Schedule 3 and Exhibit B1-54:

Returns on equity for gas distributors in 2012 are lower than 2006 returns and lower than 2010 returns in all jurisdictions, *except in BC*;

In BC, returns on equity for gas distributors in 2012 are higher than 2006 returns;

In BC, returns on equity for gas distributors in 2012 are the same as 2010 returns;

In BC, returns on equity for FEI are lower than the mean for gas distributors in 2006 and higher than the mean from 2010 to 2012;

Returns on equity for electric utilities in 2012 are lower than 2006 returns, except in BC and Ontario, and lower than 2010 returns in all jurisdictions, except in BC;

In BC and Ontario, returns on equity for electric utilities in 2012 are higher than 2006 returns; and

In BC, returns on equity for electric utilities in 2012 are the same as 2010; and

In Ontario, returns on equity for electric utilities are lower in 2013 than in 2012.

41. This evidence confirms that the 2009 Decision was not in line with returns on equity adopted by other regulatory bodies for Canadian utilities. The fact that the 2009 Decision was not in line with returns on equity adopted by regulatory bodies for Canadian utilities was also confirmed by the company witness panel (T2:p. 117, lines 7-14). For that reason, if for no other, FBCU have adopted the 2009 Decision as their reference point for almost all their evidence, including the evidence from their experts. The ICG submits that more consideration should be given to the 2006 Decision because it was in line with historic returns for BC utilities relative to their Canadian peers.

42. The observations from Schedule 3 further confirm the need for this Commission Panel to now ensure returns in BC are in line with returns on equity adopted by other Canadian regulators. Given the consistent decline in returns across all other Canadian regulatory jurisdictions since 2010, and the consistent decline in returns in most other jurisdictions since 2006, the ICG submits that the Commission Panel should reduce returns to FEI, at least in part, so that returns in BC are in line with other jurisdictions.

The return decisions in other jurisdictions should be once again afforded considerable weight by the Commission.

H. Allowed vs. Actual Returns

43. FEI over-earned every year in the last ten years, except in 2010. ((Exhibit B1-20, p. 212, BCUC No. 1, 95.1; T2:296, lines 13-19) The ICG submits that the Commission Panel should not accept that consistent over-earnings can be explained by PBR. The purpose of PBR is to establish targets for efficiency gains that should be “stretch” targets. Consistent over-earnings are attributable to how effectively FBCU manages the regulatory risk, which it claims is its largest risk, not how effectively FEI operates the utility.

44. The FBCU evidence that PBR increases regulatory risk should be rejected. (T3: 378, lines 18-22) The conclusion to be drawn from over-earnings during the PBR period is that the so called regulatory risks should be thought of as regulatory benefits that can be enhanced to provide increased earnings that exceed the Fair Return Standard. Although FBCU claims that Dr. Safir and Dr. Booth have not applied the Fair Return Standard, the historic returns suggest that FBCU have come to expect returns that exceed a fair return.

45. The effectiveness of the deferral accounts is also evidenced in the comparison of allowed vs actual returns. As observed from Exhibit B1-20, p. 219, Table 1: FEI Cost Categories and Deferral Accounts: 75.3% of revenue requirements are covered by deferral accounts. There should be no doubt that deferral accounts reduce business risks, although deferral accounts may also serve other purposes. (T4: 620, lines 5-12; T4:625, lines 10-21)

I. The Financial Models and ROE Determinations

46. The Brattle Group states the role of financial models as follows:

It is useful to recognize explicitly at the outset that models are imperfect. All are simplifications of reality, and this is especially true of financial models. Simplification, however, is also what makes them useful.

... Analysts have a dizzying array of potential models at their disposal, and it must be acknowledged that cost of capital estimation continues to be *as much art as it is science*. The generally recommended “best practice” is therefore to look at a totality of information from alternative methodologies. (Exhibit 2-3, p. 3) (emphasis added)

47. Dr. Safir states the role of financial models in his Opening Statement as follows:

Virtually every commission does it in essentially the same manner. They review the output from a capital asset pricing model, a discounted cash flow model, or a comparative earnings approach, mix and match the outcome of all three, or sometimes land squarely on the outcome of only one. In fact, the US Federal Energy Regulatory Commission has even streamlined this process. It has basically limited the ROE model for oil & gas pipelines to only the DCF approach.

... it is about exercising appropriate judgment and analysis in interpreting the data, and doing so in a manner that balances the interests of shareholders and customers alike.

... there is no one certain answer, and a fair return estimate need not be a precise point from some complex algorithm. Rather it can, and in my opinion should be, a common sense number based on direct, first order estimation techniques from readily available data.

... Where possible, I have used simple model specifications and data which were relatively easy to obtain. Where I have modified traditional approaches, as I have done in my analysis of comparable earnings, I have done so in order to emphasize my belief that historical data are the only real sources for forecast information. Because I am cognizant that regulators in Canada have not embraced the comparable earnings approach presented by any witnesses, I have attempted to recast the approach in such a manner that it may provide

some guidance to the Commission. (Exhibit C4-15, Opening Statement of Dr. Safir)

48. It is in this context, but also in the context of regulatory decisions in other jurisdictions, that this argument now turns to the financial models.

J. The Capital Asset Pricing Model (CAPM)

49. Dr. Safir's Canadian CAPM Equity Return Estimate is 6.47% (Exhibit C4-9); Ms. McShane's comparable estimate is 9.5%. (Exhibit B1-9-6, Table 1, and Exhibit B1-9-6, p. 98, line 2483) The key differences between the CAPM estimates of Ms. McShane and Dr. Safir are the market risk premium and the adjusted betas. (T4: p. 540, lines 16-23)

50. Both Ms. McShane and Dr. Safir begin modelling by calculating a risk free rate of 4.0%. Dr. Safir's calculation of the risk free rate is provided in response to an information request (Exhibit C4-11, p. 5, BCUC IR No. 1, 4.1) and Ms. McShane's calculation of the risk free rate is provided in response to an undertaking (Exhibit B1-52). The difference between the calculations is the forecast period used. Dr. Safir uses a five year forecast and Ms. McShane uses a three year forecast of 30-year Government of Canada bond yields. Dr. Safir's use of the five year forecast period is to properly discount the impact of U.S. monetary policy. The choice of the forecast period leads to a significant distinction between Dr. Safir and Ms. McShane market risk premium.

51. In Dr. Safir's opinion there is no or limited evidence to support the conclusion that market risk premiums are correlated with risk free rates. It is also Dr. Safir's opinion that U.S. monetary policy has artificially lowered the current yield on long bonds in both the U.S. and Canada. The ICG submits that an issue that will need to be considered by the Commission Panel is whether or not market risk premiums are in fact correlated with the risk free rate.

52. In Ms. McShane's makes an adjustment to the market risk premium of approximately 100-150 basis points because in her opinion market risk premium are in fact correlated with the risk free rate. Dr. Safir properly characterizes this adjustment to the market risk premium as being arbitrary and not in keeping with the CAPM model. The ICG submits that before the Commission Panel accepts this adjustment to the market risk premium there must be very strong evidence to support the adjustment. In the absence of such strong evidence, then the CAPM specifications should not be changed.

53. As Dr. Safir testified:

Well, there is, except that one of the ways to limit that subjectivity is to do some averaging across models, because they do come out with different numbers and a better central tendency can be generated without using subjective judgement so much by simply taking an average of what the outputs are. (T7: 1167, lines 11-19)

54. And Dr. Safir further testified:

It also depends on how you – to what degree you adhere to how the model operates. If you will, it depends on your belief in the model. If you believe in the model and you use the model, then you get outputs from the model. If you don't believe in the model, or don't believe in it wholeheartedly, you get outputs and then you change them. I chose not to do that. I, you know – trying to get some simple models that work in my opinion, and see where they average out, but I think that give me a better, more reliable cost of capital for your utility. (T2:1171, lines 1-12)

55. The evidence regarding the correlation (inverse relationship) between the market risk premium and the risk free rate is in fact just that, it is a subjective judgement, with at best, very limited evidence in support of Ms. McShane's proposed departure from the CAPM model. Again, in the absence of very strong evidence to change the model outputs, the model should not be changed.

56. As Ms. McShane acknowledged the specific data that she relies on for making the adjustment to the market risk premium is “essentially captured in this table [Table 12].” (T4:543, line 26) Table 12 provides the evidence for Canada and Table 15 provides the evidence for the U.S. that Ms. McShane relies on for her subjective adjustment to the CAPM outputs. The specific adjustment proposed to the CAPM outputs is approximately 125 to 150 basis points. (Appendix B1-9-6, p. 82, lines 2097 to 2100)

57. As Ms. McShane confirmed Table 12 and Table 15 provide the analysis on a cumulative basis. (T4:544, lines 6-9) The same data is also provided on a non-cumulative basis by Ms. McShane in an undertaking. (Exhibit B1-53, Undertaking No.14) As can be observed on page 2 of Undertaking No. 14, in the U.S. risk premiums do not follow income returns in the manner suggested by Ms. McShane. For example, for the observations with income returns between 4% to 6% the risk premium is 1.2%, and yet for income returns between 6% to 8% the risk premium is 2.1% and for income returns between 8% to 10% the risk premium is 11.9%. In these three groupings, the data support the opposite conclusion to that observed by Ms. McShane. (see also Dr. Vander Weide’s regression analysis at Exhibit B1-9-6, Appendix 3) As noted above, in the absence of compelling evidence, the ICG submits that the adjustment to the CAPM outputs proposed by Ms. McShane should not be accepted by the Commission Panel.

58. The second significant difference in the CAPM model results of Dr. Safir and Ms. McShane relate to the calculation of the adjusted betas. Dr. Safir calculates an adjusted beta for the Canadian CAPM equity return estimates of 0.36 (Exhibit C4-9, p. 12-13, Table 1), and Ms. McShane calculates a comparable adjusted beta of 0.65. (Exhibit B1-9-6, Appendix F, Table 21)

59. Both calculations rely on two components: a “raw” beta, and a second component that is used to adjust the raw beta. (Dr. Vander Weide does not accept that adjustments can be made to raw betas based on a reasoned approach. (T6, 1039, lines 12-18)) Dr. Safir refers to the second beta as the long run market tendency beta that is 0.58. Ms.

McShane calculates a relative risk adjustment beta of 0.78. (Exhibit B1-9-6, p. 96, line 2427)

60. In Final Submission, FBCU challenges Dr. Safir's CAPM equity return estimate beta of 0.36 on the basis that it does not match investor expectations. During cross-examination in response to the same inquiry from Commission counsel regarding investor expectations and a beta of 0.36, Dr. Safir stated:

A beta is one element of how you calculate out a market risk premium for a utility and ultimately arrive at a return --- at an estimated return which would be appropriate. So it's one element that predicts the return that investors expect or require. (T7:1228, lines 1-6)

I think that it [0.36 beta] accurately reflects ... the non-diversifiable risk of a portfolio of like-risked Canadian utilities, and as a result it does bear on their returns. (T7:1232, lines 2-5)

61. The fundamental difference between the approaches employed by Dr. Safir and Ms. McShane relate to the justification for an adjustment to the raw betas. Ms. McShane view is that "raw" betas should be adjusted toward the equity market beta of 1.0, and that adjusted betas are better predictors of returns than are "raw" betas. (Exhibit B1-9-6, p. 96 - 97, lines 2441-2451) But that is not the issue; Dr. Safir agreed that adjusted betas are better predictors of returns than are "raw" betas. Therefore, the key differences in the approach to calculating betas relate to whether or not "raw" betas should be adjusted on the assumption that utility betas trend towards the equity market beta of 1.0.

62. Dr. Safir's calculation of the long run market tendency beta of 0.58 is provided in response to an information request, and is the average value of 11 surveys. (Exhibit C4-11, p. 9, Table 1, BCUC IR No. 1, 6.1; see also T7:1229, lines 16-26) In contrast, Ms. McShane's sources for the adjustment to the raw betas all assume that "raw" betas trend towards the equity market beta of 1.0, and then their methodologies give 2/3 weight to

the calculated “raw” beta and 1/3 to the equity market beta of 1.0. (Exhibit B1-9-6, Appendix F, p. 96, lines 2445 to 2448) It is simply not reasonable to assume that betas for utility stocks will trend towards 1.0 in the long-term. For this reason, the ICG submits that the Commission Panel should accept Dr. Safir’s calculation of the long run market tendency beta of 0.58. After determining the long run market tendency beta of 0.58, Dr. Safir gives the same weight to the “raw” beta and the long run market tendency beta as does Ms. McShane’s sources.

63. As an alternative to the CAPM model, Dr. Vander Weide uses his “Ex Post Risk Premium Results”. (T6:1037, lines 24-26) However, Dr. Vander Weide’s approach does not differentiate between diversifiable and non-diversifiable risks. As Dr. Vander Weide testified he had not considered whether or not his use of “S&P/TSX Utilities” in the ex post risk premium results included diversifiable and non-diversifiable risks. (T6:1034-1035, lines 24-2, and T6: 1036, lines 16-21) For that reason if for no other, Dr. Vander Weide’s ex post risk premium results should be given little or not weight.

64. In conclusions regarding the CAPM model, the ICG believes the Commission Panel should accept Dr. Safir’s use of the CAPM model for the two reasons noted above. First, there is insufficient evidence to support the conclusion that market risk premiums need to be adjusted with changes to bond income returns. Second, it is not reasonable to assume that utility betas will trend towards the equity market beta of 1.0.

K. Discounted Cash Flow (DCF)

65. Dr. Safir begins his DCF analysis by identifying the theoretical premise of this model, and then defines the model mathematically. (Exhibit C4-9, pp. 22-23) Dr. Vander Weide challenged the model used by Dr. Safir. (T6:1081 to 1084) In response to an undertaking, Dr. Safir provided the equation used by FERC. (Exhibit C4-16, Undertaking #3) Undertaking #3 confirms that the model, as expressed mathematically,

that is used by Dr. Safir is the same model used by FERC. (T7:1233, line 16-p.1234, line 6) Dr. Safir then testified as follows:

I think what he [Dr. Vander Weide] wanted me to do was to abandon the FERC approach, use one that was more to his liking, and the analyst estimates in the manner in which he chose to use them, and again only for the U.S. system, because for some reason he had --- he's create a box for himself in Canada which didn't have anybody in it. (T7:1234, lines 7-13)

66. Dr. Vander Weide explanation of why he does not use Canadian utilities in his DCF studies is that there are very few, if any, analysts' growth forecasts available for the Canadian utilities. (Exhibit B1-9-6, Appendix G, lines 27-29) In this regard, Dr. Vander Weide did create "a box for himself in Canada which didn't have anybody in it". As Dr. Safir demonstrated, Canadian companies can be included in the sample of companies used in the DCF modelling. In fact, Ms. McShane also demonstrated that Canadian utilities can be used in DCF analysis. (Exhibit B1-9-6, Appendix F, p. 110, lines 2789 – 2792) The ICG respectfully submits that the Commission Panel should reject Dr. Vander Weide's DCF analysis because it does not include Canadian companies.

67. Dr. Safir and Ms. McShane take two diverging approaches to estimate future growth, although both witnesses relied on analysts growth expectations and GDP growth expectations. Dr. Safir looked to analyst growth expectations for short-term growth and then GDP growth expectations for long-term growth. Once he obtained two separate estimates of growth, Dr. Safir calculated a weighted average of the two to establish a weighted average growth rate. (Exhibit C4-9, p. 25; T7:1238, lines 15-18)

68. Ms. McShane presented two different DCF approaches. The first approach was similar to that of Dr. Safir. The second approach assumed a five year period for the short-term growth rate and beyond the five years, Ms. McShane applied the long-term growth rate. By using a two-stage model, Ms. McShane makes an unnecessary assumption as to when to shift from analysts' growth expectations to GDP growth

expectations. (T7:1239, line 17- T7:1240, line 6) Moreover, in Ms. McShane's Canadian calculations, analysts' growth forecasts are much higher than long-term GDP growth estimates which partially explains the estimate differences between Dr. Safir and Ms. McShane.

69. Dr. Safir presented his DCF estimates in tabular format at Exhibit C4-9, p. 26, Table 3. Dr. Safir DCF estimates an overall average of 8.92%, not including flotation costs. For the Canadian sample of companies the estimate is 9.46%, including flotation costs of 0.47%. For the U.S. sample of companies the estimate is 9.33%, including flotation costs of 0.47%. Dr. Safir then accounted for the U.S. results by weighting the U.S. results at 33%.

70. Ms. McShane presented her DCF results in tabular format at Exhibit B1-9-6, p. 113, Table 30. DCF results are an overall average of 9.4%, not including flotation costs. Ms. McShane gave equal weight to her U.S. results and her Canadian results. (T4: p.551, lines 3-13) Although the difference in weightings of the U.S. results and the Canadian results by Dr. Safir and Ms. McShane will not materially change the results, weighting U.S. results at 33% should be the preferred approach.

L. Comparable Earnings

71. Dr. Safir calculated comparable earnings using net income and market-value of equity. Ms. McShane calculated comparable earnings using book-values. As Dr. Safir states:

In order to evaluate what an investor would be willing to invest in today, one should look at what can be earned on investments today. The return on investment should take into account current and expected conditions in the competitive capital markets. This is best represented by the economic rate of return as opposed to an accounting rate of return. (Exhibit C4-9, p. 31, lines 13-17)

The rate of return should account for current conditions in the capital market since that is the place where any alternative investment would be made and

the basis by which the investment in the utility should be compared. (Exhibit C4-9, p.32, lines 1-3)

72. As noted by Dr. Safir, the Commission has rejected Ms. McShane's comparable earnings results in the 2006 Decision and in the 2009 Decision. (Exhibit C4-9, p. 30, lines 21-22) The ICG respectfully submits that the Commission has previously rejected or given a "very small amount of weight" to Ms. McShane's comparable earnings test on two occasions (2009 Decision, p. 45; see also Mr. Wallace cross re other jurisdictions at T3:397, lines 3-12), and this Commission Panel should not now accept Ms. McShane's comparable earnings test. In an effort to address the concerns of the Commission regarding Ms. McShane's approach to comparable earnings, Dr. Safir used net earnings and the market-value of equity. The ICG respectfully submits that Dr. Safir's comparable earnings test should be preferred to that of Ms. McShane's comparable earnings test. The ICG further submits that as long as equal weight is given to the three tests, then Dr. Safir's comparable earnings test should be accepted by the Commission Panel.

M. Fair ROE and Model Estimates

73. Dr. Safir presented his model estimates in table format (Exhibit C4-9, p. 36, Table 5), with an average of the model estimates of 7.64%. As a result, Dr. Safir's recommendation for a fair ROE for FEI would be 7.6%. It is noteworthy that Dr. Booth's recommendation for a fair ROE for FEI is a very close 7.5%. In information requests, FBCU inquired as to whether or not Dr. Safir and Dr. Booth discussed their evidence prior to its filing date; the response confirms that Dr. Safir and Dr. Booth did not discuss their evidence prior to it being filed. (Exhibit C4-11, p. 2, FBCU IR No. 1 2.4 and 2.5) Therefore, the Commission Panel has before it not only the model results, but independent determinations of a fair return on equity for FEI that are remarkably close.

N. Automatic Adjustment Mechanism (AAM)

74. The first and perhaps the most significant issue related to an AAM is whether or not it or any other alternative is to be effective only for a defined period. The 2009 Decision eliminated the AAM (2009 Decision, p. 73), but did not establish an effective period for the cost of capital determinations in the decision. As a result, while the spread between cost of capital decisions in other Canadian jurisdictions and BC was ever widening in favour of shareholders, no change was made to the cost of capital determinations in the 2009 Decision. In the fall of 2011, the ICG submitted that this was unfair to customers, and continues to believe that this was unfair to customers. Of course, in the future, trends in cost of capital decisions across Canada may result in a gap that favours customers. Nevertheless, the ICG believes that it is necessary for the Commission Panel to establish an effective period for the cost of capital determinations in the decision.

75. In Final Submissions, FBCU states:

The Commission should set the ROE with the expectation that it will remain in place for at least three years but no more than five years. (FBCU Final Submissions, p. 161, para. 339)

76. This is contrary to the following testimony of Mr. Coyne:

MR. HOBBS: Q: That's what I thought. And I'm confused then by your continual reference to three to five years.

MR. COYNE: A: Right.

MR. HOBBS: Q: Are you suggesting, then, that the Commission should determine a specified period and that specified period may be three to five years? But in this decision, the Commission should be definitive about how long the rates are going to be fixed.

MR. COYNE: A: I anticipated that in writing the report. There is also another way to go.

MR. HOBBS: Q: Just before -- I want to make [sure] the record is clear on this. You anticipated what, sir?

MR. COYNE: A: That the Commission would set a fixed period for re-hearing.

MR. HOBBS: Q: Thank you. (T5:812, lines 9-24)

77. It should be now clear that the position of the FBCU regarding the effective period of the cost of capital determinations in this decision is contrary to the opinion of its own expert witness. The reasons for establishing an effective period of this decision, and the unfairness that can occur in the absence of an effective period in the 2009 Decision, were previously addressed in this proceeding by the ICG in its letter dated March 21, 2012. (Exhibit 4-2) For convenience, certain excerpts of that letter are provided below:

The ROE AAM had been applied to determine rates on the basis of an explicit or implicit determination that the results it produces were reasonable. In the 2009 ROE Decision, in the circumstances of the financial markets in 2008 and 2009 the Commission concluded that the ROE AAM did not meet the fair return standard. Specifically, the concern was that the cost of capital resulting from the ROE AAM no longer met the fair return standard. (ROE Decision, p. 72) The objective market evidence is that the market crisis of 2008 and 2009 has now abated. It is now necessary for the Commission to vary in a timely manner the cost of capital approved in the 2009 ROE Decision.

The cost of capital is a significant component of a regulated utility's revenue requirement and there should be no doubt that the cost of capital requires periodic adjustment so as to produce fair and reasonable rates. Given that the ROE AAM adjusted the cost of capital annually, the ICG submits that in the absence of the ROE AAM it is reasonable to conclude that the Commission Panel that issued the ROE Decision anticipated that the cost of capital would continue to be adjusted annually.

In June 2011, FortisBC Inc. filed the 2012-2013 Revenue Requirements Application and 2012 Integrated System Plan (2012-2013 RRA and 2012 ISP) for approval of rates for a two year test period, 2012 and 2013 (Test Period). During the procedural conference held on November 22, 2011 for the 2012 -2013 RRA and 2012 ISP, the ICG submitted that the Commission has never accepted any evidence other than expert evidence regarding cost of capital. The ICG further submitted that in the absence of expert evidence regarding cost of capital for the Test Period the application was deficient, and the Commission should not approve the rates being applied for.

On November 28, 2011, the Commission issued a Preliminary Notification of Initiation of the GCOC proceeding. On November 30, 2011, the Commission established the process for the proceeding and stated the following in the reasons attached to Order G-199-11, at p. 3 of 6:

Accordingly, the Commission Panel has determined that there is no need to expand this hearing to include a comprehensive review of FortisBC's capital structure and ROE. Therefore, the Commission Panel has determined that given the Commission announcement regarding a generic hearing process, it would be appropriate to maintain the current ROE and capital structure pending determinations made in the Generic Cost of Capital Hearing.

FortisBC Inc. should not receive returns that do not meet the fair return standard merely because of the timing of regulatory processes. Rates need to be set effective January 1, 2012 for FortisBC Inc., long before a decision in this separate future proceeding can reasonably be anticipated. Therefore, the ICG submits that the Preliminary Scoping Document should be revised so that utility specific capital structure and risk premiums are considered to be within the scope of the GCOC proceeding.

As noted in the Preliminary Notification of Initiation of Generic Cost of Capital Proceeding and recital D of Order G-20-12 changes have occurred in the financial markets since the issuance of the 2009 ROE Decision. The ICG submits that the Commission Panel hearing the 2012-2013 RRA and 2012 ISP cannot now determine that the cost of capital as determined by the 2009 ROE Decision with no adjustment to return on equity will produce fair and reasonable rates for the Test Period. In order to conclude that there should be no change in the cost of capital of FortisBC Inc. since July 1, 2009, it will be necessary for the Commission to conclude that there has been no change in the financial markets since 2009.

...The effect of the elimination of the ROE AAM cannot be, as would result from Order G-199-11 and the Preliminary Scoping Document with an effective date of January 1, 2013, that rates for the first year of the Test Period would be approved by the Commission for FortisBC Inc. without the Commission first ensuring that the fair return standard was met. Prior to the elimination of the ROE AAM, Commission Panels hearing rate applications could rely on it to ensure that the fair return standard was met. Therefore, the Commission did not need to apply the fair return standard each time it approved rates. However, with the elimination of the ROE AAM, the ICG respectfully submits that it is necessary for the Commission to apply the fair return standard each time it approves rates.

To be specific, for the period between the elimination of the ROE AAM and the outcome of the GCOC proceeding, the Commission must apply the fair return standard to determine fair and reasonable rates by a means other than

by the application of an automatic adjustment mechanism. For the period between the 2009 ROE Decision and the Test Period, the Commission relied on negotiated settlements to ensure that the fair return standard was met. However, unless all elements of the cost of capital of FortisBC Inc. are within the scope of the GCOC proceeding with an effective date of January 1, 2012, the Commission Panel hearing the 2012-2013 RRA and 2012 ISP will need to apply the fair return standard by a means other than an automatic adjustment mechanism before it can determine fair and reasonable rates.

As noted in the Preliminary Scoping Document, the cost of capital includes capital structure, return on common equity, and interest on debt. In a rates proceeding, the onus is on the utility to justify all elements of the revenue requirements before setting rates. There is no onus on ratepayers to seek a change to elements, including the cost of capital, of the revenue requirements. Further, the Utilities Commission Act (Section 58(1)) requires a hearing before rates are set.

Considerations of fairness require that no decision having an effect on rates be made without there being an opportunity for parties opposite in interest to challenge, in a hearing, assertions of fact and opinion that are in dispute. There has been no adjudicative process to determine the cost of capital for FortisBC Inc. for the Test Period. The Commission Panel hearing the 2012-2013 RRA and 2012 ISP cannot now approve rates for the Test Period, unless there is an adjudicative process to determine the cost of capital for the Test Period. The ICG respectfully submits that the adjudicative process should be the GCOC proceeding, and the effective date should be revised from January 1, 2013 to January 1, 2012.

78. Although the Commission did not accept the specific requests underlying these submissions, the ICG submits that the Commission Panel does need to consider in this decision four issues raised in this letter from March 21, 2012. (Exhibit C4-2) First, in the absence of an AAM or an effective period of a cost of capital decision, should the Commission consider the fair return standard every time the Commission adjudicates rates? Second, in the absence of an AAM, what is a reasonable forecast period for cost of capital determinations, and what evidence relevant to cost of capital determinations need to be considered before establishing the effective period of the cost of capital determinations? Third, does a utility applying for rates to be effective during a test period bear the burden of proof regarding the cost of capital component of the revenue requirement? Fourth, what are the evidentiary requirements to meet the burden of proof? The ICG has commented on these four issues in the excerpts above, and believes that these issues should be considered in this decision.

79. The ICG submits that the Commission should establish an AAM as proposed by Dr. Safir, with a three year effective period. In the absence of an effective period, the ICG submits that the Commission should consider the fair return standard every time the Commission adjudicates rates. (as per Exhibit C4-2) Although the ICG prefers an AAM with an effective period, the alternative of cost of capital determinations with each revenue requirements decision was the norm prior to the establishment of an AAM in 1994.

80. There are significant advantages to cost of capital components of revenue requirements being considered every time rates are adjudicated, including only utility specific considerations are then relevant, and there is no need to establish a benchmark utility. For these reasons, assuming the Commission Panel agrees with the FBCU and does not establish an AAM, then the ICG submits that Commission Panel should determine an effective period for this decision that matches the currently approved test period of each regulated utility under its jurisdiction.

81. The ICG does not strongly favour an AAM with a three year effective period over the alternative of cost of capital determinations in each revenue requirements decision. However, the ICG does strongly object to the FBCU proposal of no AAM with no “fixed period for re-hearing”. (as noted above, see T5:812, lines 20-24)

82. The ICG also notes that Mr. Coyne stated:

Mr. Hobbs: ...What is the role of a benchmark when there is no automatic adjustment mechanism?

Mr. Coyne: I'm not sure it really serves much of a role. (T5:813, lines 5-9)

83. And then Mr. Coyne stated:

Mr. Hobbs: If we didn't have an automatic adjustment mechanism, would you suggest then that we apply the three approaches to determining the return

on equity for Fortis B.C. Inc. ... which would obviate the need for a benchmark, or eliminate the need for a benchmark?

Mr. Coyne: I believe the latter. That if it were set independently for Fortis from first principles, then the benchmark would not be needed. (T5:814, lines 1-10)

84. Just like the evidence from Mr. Coyne regarding the effective period of this decision, this evidence is very significant to this decision ---there should be no benchmark if there is no AAM. The Commission Panel should not establish a benchmark utility, unless the Commission also establishes an AAM. In the absence of an AAM, there is no role for a benchmark utility other than to unnecessarily complicate the consideration of the cost of capital for other utilities in BC.

85. The ICG respectfully submits that the 2009 Decision was unfair to customers and created considerable uncertainty, in part, because at the same time it eliminated the AAM, it approved a benchmark, and had no stated effective period. This is at time when rates of return in other Canadian jurisdictions had been declining and continued to decline after the 2009 Decision. The effect of the lack of an effective period in the 2009 Decision was that cost of capital determinations in the 2009 Decision that were out of step with other regulatory decisions issued both before and after the decision were "locked in".

86. In Rebuttal Evidence, Mr. Coyne responds to the AAM proposed by Dr. Safir as follows:

Dr. Safir recommends a full cost of capital hearing every three years, which may assist in keeping the formula on track, though we view this as lacking any advantage (administrative, or otherwise) over periodic rate hearings. In practice, we have observed inertia around the formula, in which one party or another will argue that the formula continues to produce a reasonable return. (Exhibit B1-32, p. 1)

87. The ICG agrees that a full cost of capital hearing every three years has limited administrative advantages over consideration of cost of capital in periodic rate hearings. During cross-examination, the “inertia around the formula” is the subject of further comment by Mr. Coyne, and then Mr. Coyne states:

If it were a new and improved formula that was constructed so that it addresses some of the concerns that have been documented regarding that formula, it should directionally track movements in interim years more so than a fixed rate would be short of just stagnant credit markets. (T5:805, lines 3-9)

88. The ICG also agrees that during the interim years it is reasonable to expect that a formula is going to be, in most circumstances, more likely to result in a return on equity that meets the Fair Return Standard than is no formula. For that reason, the ICG recommends an AAM with a three year effective period.

89. In Final Submissions, FBCU states:

Dr. Safir’s modification to use the five year average forecast is intended to compensate for the present unusually low interest rates. However, the more appropriate response to the present low interest rates is to postpone any consideration of a formula, not implement a “quick fix” that artificially suppresses the ROE. (FBCU Final Submissions, p. 160, para. 334)

90. It is not possible to reconcile the above submissions of a “quick fix” with that of Mr. Coyne’s testimony (quoted above) that a formula is more likely to track a Fair Return Standard than no formula. The ICG submits that a formula with periodic reviews is not a “quick fix”, and it is the surest way to ensure that the Fair Return Standard is met between periodic reviews.

91. In Final Submissions, FBCU then states:

Any new formula would need to introduce new factors that would address changes in utility equity risk premium, not solely changes in Government of Canada bond yields, and any adjustment factor would need to reflect the sensitivity to change in bond yields to ROE. (FBCU Final Submissions, pp. 161-162, p. 339)

92. Just as a formula is more likely to meet the Fair Return Standard between periodic reviews than is no formula, a multiple factor model may be more likely to meet the Fair

Return Standard than a single factor model. However, the achieved benefits of a multiple factor model over a single factor model can be expected reasonably to be far less than the achieved benefits of a formula over no formula. Given that the AAM model proposed by Dr. Safir has been tested over a long period, the ICG recommends a single factor AAM to the Commission Panel.

o. Stage 2 and Interim Rates

93. In the reasons for decision attached to Order G-148-12 dated October 11, 2012 (Exhibit A-21), the Commission Panel said:

The Commission Panel agrees with ICG with respect to the moving ahead a quickly as possible and has determined that adding a Stage 2 to the process is the most efficient way to achieve this. The Panel acknowledges the submissions of the parties with respect to process, consistency among the panel members and timing. The Commission will begin the process of planning for Stage 2 in the near future. This will potentially involve scheduling a procedural conference to address process and logistics prior to the end of Stage 1. (Order G-148-12, Appendix A, p.4; see also T3: 379, lines 18-23)

94. The ICG submits the Commission Panel should establish immediately a procedural conference to address “process and logistics” for Stage 2, or in the alternative, establish a filing date for utility specific evidence to be followed by a procedural conference. Stage 2 will benefit from an early decision regarding certain issues related to an AAM that are now before the Commission Panel in this Stage 1 process. For reasons related to procedural fairness, the ICG is of the view that issues that are now before the Commission Panel in this Stage 1 ought not to be on the agenda at the procedural conference. However, the ICG recommends to the Commission Panel that issues relevant to Stage 2 be the subject of a decision as early as possible to be followed later by a decision on all other matters. And that first decision could be issued during the Stage 2 process, and perhaps before utility evidence is filed.

95. The ICG is also of the view that interim rates established by Order G-187-12 dated December 10, 2012 (Exhibit A-30) for FBC should not become final rates until after decisions following Stage 2 are issued.