Fasken Martineau DuMoulin LLP *
Barristers and Solicitors
Patent and Trade-mark Agents

2900 – 550 Burrard Street
Vancouver, British Columbia, Canada V6C 0A3

604 631 3131 Telephone
604 631 3232 Facsimile
1 866 635 3131 Toll free

www.fasken.com

FASKEN MARTINEAU

Matthew Ghikas
Direct 604 631 3191
Facsimile 604 632 3191
mghikas@fasken.com

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Via Electronic Filing

British Columbia Utilities Commission
Sixth Floor, 900 Howe Street
Vancouver, BC V6Z 2N3

Attention: Erica Hamilton, Commission Secretary

Dear Sirs/Mesdames:

Re: Generic Cost of Capital Proceeding

We enclose an outline of counsel's oral submissions on behalf of the FortisBC Utilities for tomorrow's procedural conference. Copies have been provided to intervenors.

Yours truly,

FASKEN MARTINEAU DuMOULIN LLP

Matthew Ghikas

MTG/bs

British Columbia Utilities Commission
2012 Generic Cost of Capital Proceeding

Outline of Procedural Conference Submission

of the FortisBC Utilities ("FBCU")

October 4, 2012

1. This submission provides a high-level outline of the FBCU's position on the three issues identified by the Commission Panel for discussion at the October 4, 2012 Procedural Conference. Counsel for the FBCU will speak to each of the issues in greater detail. Attached to this Outline is a compendium of extracts from the evidence in support of the FBCU's position on the appropriate benchmark utility (Issue 1).

PART ONE: IDENTIFICATION OF THE BENCHMARK

2. The Commission Panel has sought submissions on the merits of the following options for serving as a benchmark utility: (i) FEI of today as described in its company profile; (ii) FEI in 2009 frozen in time; (iii) FEI in 2012 but only as a "pure play" gas distribution utility; and (iv) other hypothetical construct or other utility. The FBCU submit that "FEI of today as described in its company profile" (i.e. the first option) is the appropriate benchmark for the purposes of determining the allowed rate of return for BC utilities until the next Commission review of the benchmark in three to five years. There are six reasons, each of which is discussed below, why the Commission should adopt "FEI of today" as the appropriate benchmark utility:

(a) Using a real utility, rather than a hypothetical construct, permits greater understanding of the characteristics of the benchmark and thus permits more efficient comparisons;

(b) Among the BC utilities, FEI is best suited to being the benchmark because of its large and diverse geographic, customer and asset base, as well as other attributes;

(c) "FEI today as described in the company profile" and "FEI of 2012 but as a 'pure play' gas distribution utility" are one and the same;

(d) There are no advantages, and potential disadvantages, to using "FEI of 2009 frozen in time" as the benchmark;

(e) The potential amalgamation of the FEU and expansion of Alternative Energy Services need not be a factor in determining the appropriate benchmark; and

(f) The FBCU have presented evidence based on "FEI of today" being the benchmark, and for the Commission to adopt a different benchmark mid-way through this process would introduce procedural challenges and inefficiencies.

The approach of benchmarking BC utilities to "FEI as it exists at the time of a cost of capital proceeding" has worked for almost two decades, despite changes in FEI's business during that time. There is every reason for the Commission to continue using that approach, and no compelling reason to change.

A. THE MERITS OF USING A REAL UTILITY AS THE BENCHMARK

3. The FBCU have long recognized that *any* benchmark will be, by definition, a hypothetical construct in as much as the estimated benchmark return is derived from market data that reflects the composite of the risks of the companies selected as proxies, each of which, individually, has different characteristics.[1] Since 1994, however, the resulting benchmark return has always been applied to an actual utility (FEI), designated the benchmark utility. The benchmark utility itself has specific risk characteristics that then provide a single tangible foundation for making inter-utility comparisons.[2] The FEU have interpreted the Commission Panel's inquiries in this GCOC Proceeding about a hypothetical benchmark to go beyond the practice that has been in place since 1994, such that the Commission would take the additional step of first "creating" a utility and seeking to exhaustively define its characteristics. The FBCU submit that this new potential approach is impractical and less efficient, and the Commission's current approach is superior.

4. The FBCU and Ms. McShane have addressed in the Filing and IRs the relative merits of using a real utility versus a hypothetical construct as the benchmark utility. The most important feature of a benchmark utility is that its characteristics and business risks are capable

[1] McShane Evidence, p.14 (footnote 15).

[2] McShane Evidence, p.14 (footnote 15).

of objective determination such that other utilities can be compared to it. Ms. McShane articulated in her evidence why the efficiency and transparency rationales favouring the use of a benchmark to begin with are undermined by using a hypothetical utility. Her key reasons are:

- First, the concept of a hypothetical utility is too ambiguous to serve as a meaningful yardstick for the purpose of comparing business risks of utilities.
- Second, every utility has unique business risk characteristics that are a function of a variety of factors. While it might be possible to arrive at some general conclusions about the riskiness of a hypothetical utility, it is necessary to understand the particular circumstances affecting the benchmark utility in order to specify what the appropriate capital structure and ROE would be for that utility.[3]

5. Designating a benchmark utility is supposed to make the process of determining cost of capital for BC utilities more efficient. Introducing another layer of complexity of having to "create" a utility and exhaustively define its characteristics before being able to perform comparisons would be less efficient. It will make Generic Cost of Capital proceedings, particularly this proceeding, more complicated. It will necessitate another proceeding to assess FEI's cost of capital relative to the hypothetical benchmark utility, even if amalgamation does not proceed. It will create unnecessary debate when determining a specific utility's cost of capital about how the Commission has defined the benchmark. The FBCU submit that the Commission should continue to use its current approach.

B. FEI IS THE LOGICAL CHOICE AMONG BC UTILITIES

6. The Commission has used FEI as the benchmark since 1994. Ms. McShane has articulated in her Evidence why the Commission's long-standing approach has made sense. She explains that the utility designated as the benchmark should be a large, well established entity, with a relatively diverse geographic, customer and asset base, and no unique risk characteristics. Ideally, the designated benchmark utility will have market data that will provide

[3] McShane Evidence, pp.14-15.

an independent capital market assessment of its risks and return requirements. FEI continues to be the logical choice to serve as the benchmark BC utility based on these criteria. In particular:

- FEI is the largest investor-owned utility in British Columbia, is one of the largest gas distribution utilities in the country, and has a relatively diverse geographic, customer and asset base;
- FEI is more representative of the general business risk characteristics facing BC utilities, making comparisons with other BC utilities easier;
- Although FEI's equity is not publicly traded, its debt is rated by two debt rating agencies, providing some independent capital market assessment of its overall business and financial risks, albeit from a bondholder's perspective; and
- FEI's business risks and the trends in those risks have been extensively and comprehensively assessed by the Commission in multiple proceedings since 1994.[4]

7. FEI addresses later in this Submission the notion that FEI is transitioning to something other than a "pure play" gas distribution utility. Regardless of the merits of that assessment, a benchmark utility does not have to be static or "frozen in time" to be an effective benchmark. FEI has remained the benchmark utility since the concept of a benchmark was adopted in 1994, despite ongoing business changes, including changes in customer profile and load composition, and the adoption of a combined utility structure to serve FEVI, FEW and FEI. At each successive proceeding since 1994, the benchmark employed was was FEI at the time of the proceeding, not FEI "frozen in time" from a prior period.

8. PNG and FBC are the only other sizable investor-owned utilities in the Province. FBC and PNG both lack the broad geographic scope and large customer base of FEI. There would be regulatory inefficiencies associated with moving away from a long-established

[4] McShane Evidence, p.16.

benchmark utility and designating PNG or FBC as the benchmark.[5] FEI remains the logical choice as the benchmark utility.

C. FEI OF TODAY IS A "PURE PLAY" NATURAL GAS DISTRIBUTION UTILITY

9. The Commission Panel has expressed the view in Exhibit A-17 "that the benchmark utility should as closely as is reasonable represent a mature and stable 'pure play' gas distribution utility." The Commission's list of alternatives for serving as a benchmark includes "FEI today as described in the Company profile" and "FEI in 2012 but only as a 'pure play' gas distribution utility". The FBCU make two points in response:

- First, these options are one and the same in the sense that "FEI of today" remains, and will remain for the foreseeable future, a "pure play" gas distribution utility; and
- Second, FEI can be an effective benchmark regardless of whether it is characterized as a "pure play" natural gas distribution utility.

(a) "FEI of Today" is a "Pure Play" Natural Gas Distribution Utility

10. There are no unequivocal criteria for defining the term "pure play". However, several facts demonstrate that "FEI of today" remains, and will remain for the foreseeable future, a "pure play" gas distribution utility on any reasonable definition.

11. First, the Thermal Energy Services ("TES") business is being undertaken by FortisBC Alternative Energy Services Inc. ("FAES"), not FEI. As such, this business cannot affect FEI's current cost of capital. In the event that FEI were to hold TES assets in the future, it would be necessary for the benchmark utility return to reflect the cost of capital of the natural gas class of service only, without reference to TES.[6] In other words, the benchmark utility and return are unaffected either way.

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[5] BCUC-FBCU IR 1.5.3

[6] By virtue of the requirements of section 60(1)(c) of the *Utilities Commission Act*.

12. Second, NGT and Biomethane offerings make use of the existing utility infrastructure. The Biomethane offering is a notional mix of 90% natural gas and 10% biomethane for residential and commercial customers, which are predominantly traditional heating and cooling loads. The natural gas required to serve NGV customers – both CNG and LNG - must be transported across the system just like the natural gas used to serve heating and cooling loads. The FBCU consider these offerings to be integrated with FEI's existing business.

13. Third, there has been no suggestion in the AES Inquiry or in other proceedings that FEI's provision of natural gas across the existing distribution system should be relegated to a separate class of service simply because the end use happens to be a natural gas vehicle. The debate in the AES Inquiry is focussed on how the dispensing facilities themselves are treated for regulatory purposes. Similarly, the debate around Biomethane is related to the regulatory treatment of new upgrading facilities; the Commission is already regulating the provision of the Biomethane rate offering as part of the core business, which only makes sense since the service is a notional product delivered as natural gas on the existing system. Regardless of the outcome of the AES Inquiry, the source of throughput on the existing system should not affect the selection of FEI as a benchmark utility.

14. Fourth, while the FBCU do not consider the New Initiatives to be relevant to the assessment of whether "FEI of today" can be the benchmark utility, on any objective measure, FEI's traditional customer base remains the overwhelmingly dominant component of FEI's business:

- ***Rate base:*** FEI's forecasted rate base for 2012 is $2,717.1 million. FEI has no TES rate base; it is held by FAES. FEI's rate base relating to biomethane is forecasted to be under $3 million, only 0.1% of FEI's rate base for 2012. In the next 5 years, the biomethane rate base will still only represent approximately 1% of total rate base, all else equal. FEI's rate base relating to NGT is forecasted to be under $2 million, only 0.1% of FEI's rate base, for 2012. Even if NGT were to expand over the next 5 years and if we include the forecast NGT incentives of $62 million which result from the *Greenhouse Gas Reductions (Clean Energy) Regulation*,

rate base relating to NGT will only be approximately 3% of total rate base in the next five years, by 2017, all else equal.

- ***Throughput:*** FEI's forecasted total natural gas throughput for 2012 is 168,496 TJs. Purchased biomethane volumes are currently forecasted at approximately 60,000 GJs, or 0.04% for 2012. NGT volumes are currently forecasted at approximately 178,000 GJs, or 0.11% for 2012. If biomethane expands to its potential over the next 5 years, the expected volumes will represent around 800,000 GJ or approximately 0.47%. Also, even if NGT expands to its potential over the next 5 years, the volumes will still only represent 2,882,387 GJs or 1.71%.

- ***Customer count:*** FEI is forecasted to have 856,815 residential, commercial and industrial natural gas customers at the end of 2012. It is forecasted that only 3,850 of those natural gas customers who also take biomethane in 2012, or 0.44%, with an expected increase in enrolment of approximately 18,000 customers over the next 5 years . There are only 4 NGT customers at present, and even if NGT expands to its potential over the next 5 years, the customer counts will still number less than 75 customers. In percentage terms, that number of customers is very, very small.

15. The significant regulatory focus on the New Initiatives is a function of the fact that these initiatives are new. While the regulatory focus is understandable and necessary, it may have distorted how some stakeholders perceive FEI's overall business. FEI's core business remains and will remain natural gas transportation and distribution.

16. The Commission need not try to predict how the Company may evolve many years into the future. The benchmark can, if the Commission wishes, be revisited at some point in the near future (3-5 years) at the next cost of capital proceeding.

(b) FEI Does Not Need to Be "Pure Play" to Be an Effective Benchmark

17. FEI's natural gas business can be an effective benchmark utility regardless of whether or not the Commission chooses to characterize it as "pure play". First, TES is not relevant to the benchmark cost of capital, for the reasons discussed above. Second, the benchmark is being used as the starting point for determining the Fair Return for vertically integrated electric utilities (FBC), smaller gas distribution utilities (PNG, FEVI and FEW), and thermal energy micro-utilities. These comparisons can be made just as easily using FEI's true characteristics as they could with a benchmark utility that strips out certain real operating characteristics of the natural gas business to achieve the Commission's notion of a "pure play" gas distribution utility.

D. FEI OF 2009 "FROZEN IN TIME"

18. The Commission has always defined the benchmark utility with reference to the characteristics of FEI as of the date of the cost of capital proceeding, not FEI's characteristics "frozen in time". It is more efficient in this proceeding to adopt "FEI of 2012" as the benchmark utility, as there are no discernible benefits associated with adopting "FEI of 2009 frozen in time" as the benchmark utility. The Commission has a full evidentiary record of what FEI's characteristics are at present. The more out of date the benchmark is, the less the benchmark cost of capital reflects current conditions.[7]

E. THE IMPACT OF AMALGAMATION/COMMON RATES CAN BE ISOLATED

19. The Commission Panel also expressed a concern "that the risk profile for FEI may change significantly if amalgamation is approved...". The FBCU submit that the benchmark should be "FEI of today", prior to any amalgamation and the adoption of common rates. Determining the cost of capital of FEI Amalco will, in the near term, be a matter of determining the risk premium relative to the benchmark. "FEI of today" can remain the benchmark utility for the next 3 to 5 years until the next time that the Commission considers the benchmark cost

[7] BCUC-FBCU IR 1.111.3.

of capital. At that time, the Commission would have the option of adopting FEI Amalco as the new benchmark. Ms. McShane endorsed this approach in her evidence.[8]

20. While the magnitude of the difference in risk profile between "FEI of today" and FEI Amalco need not factor into the selection of a benchmark, it should not be assumed that amalgamation and adoption of common rates will result in a "significant" change in the risk profile. The cost of capital evidence filed by FortisBC in the *Amalgamation and Common Rates* proceeding was that FEI Amalco, in essence, has the combined risk profile of the three constituent utilities. The FBCU's evidence suggested a 12 bps risk premium on the same 40% equity thickness, a relatively narrow spread.

F. PROCEDURAL ISSUES ASSOCIATED WITH ADOPTING A DIFFERENT BENCHMARK

21. The Commission's scoping decision directed Affected Utilities to identify the appropriate benchmark, and then present evidence based on the selected benchmark. The FBCU, consistent with the Commission's practice for many years, have presented evidence based on "FEI of today" being the benchmark. PNG has adopted that evidence. Corix's expert has agreed that FEI should be the benchmark.[9] The FBCU have responded to an extensive round of IRs based on its evidence.[10]

22. Adopting a different benchmark mid-way through this process would introduce significant procedural challenges and inefficiencies. Fairness would require giving the Affected Utilities the opportunity to revisit, and potentially supplement, their evidence to address the new selected benchmark. It would potentially render many of the IRs and the related responses moot, as they were prepared on the basis that "FEI of today" is the relevant benchmark utility. New evidence could make additional IRs necessary. The current timetable does not account for such changes.

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[8] McShane Evidence, p.16.

[9] BCUC-Corix IR 1.1.1.

[10] 788 IRs

23. The existing benchmark, "FEI of today", has worked for almost two decades. It will continue to serve all parties well in the present proceeding without causing the procedural challenges identified above. The FBCU respectfully submit that if the Commission wishes to adopt a different benchmark from "FEI of today", it should make that determination at the outset of the next GCOC, before the evidence is filed. Doing so will ensure that all parties are working from a common starting point and can prepare evidence accordingly.

PART TWO: PROCESS FOR DETERMINING COST OF CAPITAL FOR OTHER BC UTILITIES

24. The process for determining the cost of capital of other BC utilities should recognize that the cost of capital of a BC utility relative to the benchmark is a function of unique business and financial risks. It is most efficient to address the cost of capital of BC utilities as follows:

- The FBCU should collectively apply to determine their cost of capital relative to the benchmark;
- PNG should proceed with a separate process to identify its own unique business risks; and
- There should be a process to address the cost of capital of micro-utilities, which would include FAES, Corix and any other relevant micro-utilities.

25. The timing of these focussed processes, or alternatively the Phase II process, should reflect two important considerations. First, the parties need a reasonable opportunity to assess the implications of the Commission's GCOC decision before filing evidence, since the utility-specific evidence must identify risks relative to the benchmark utility. Second, the timetable should reflect the constraints imposed by the involvement of parties in other proceedings. For instance, it may not be efficient for the FBCU to proceed with a filing until the Commission has determined the *Amalgamation and Common Rates Application* and the LGIC has rendered its decision on the matter. The outcome of the *Amalgamation and Common Rates Application* will determine whether the FBCU must file evidence for the individual

FortisBC Energy Utilities or FEI Amalco. For some utilities, depending on timing, it may be most efficient to address the appropriate equity risk premium as part of the utility's revenue requirements application.

26. The FBCU submit that the Commission should convene a procedural conference to address these issues approximately one month after the GCOC decision.

PART THREE: TYPE OF PROCESS FOR THIS PROCEEDING (ORAL VS. WRITTEN)

27. The FBCU submit that this proceeding can be addressed fairly and efficiently with a written process. Alternatively, the oral proceeding should be limited to specific issues addressed in testimony submitted by the expert witnesses.

28. The Commission should approach this issue with the recognition that there is nothing inherently superior about an oral process; a written process is equally valid. The Commission should undertake a cost-benefit analysis to ensure that significant costs are not incurred after the point of diminishing returns. There are two key reasons why a written process is reasonable in the circumstances:

- The written evidentiary record will be robust. The Minimum Filing Requirements have ensured that the initial filings by the Affected Utilities, particularly the FortisBC Utilities, are comprehensive – even more so than in past cost of capital proceedings. The Affected Utilities have responded to numerous IRs in round one (788 by FBCU; 21 by PNG; and, 134 by Corix). With another round of Affected Utility IRs still to occur, as well as intervener evidence and IRs, and rebuttal evidence, the evidentiary record will be much more substantial than the proceeding in 2009.

- At the same time, the cost of an oral process will be significantly greater than the cost of a written process. This GCOC proceeding has raised many more issues than were at play in 2009 and involves more parties. As a result, an oral hearing in this GCOC proceeding can be expected to be more involved than in 2009.

29. In the alternative, if the Commission determines that it needs to hear oral evidence, it can avoid a sprawling and unfocussed hearing by limiting the oral hearing to expert testimony on the cost of capital of the benchmark (i.e. only the ROE and capital structure that meet the Fair Return Standard). The other issues addressed by experts lend themselves to a written process. Deemed debt issues have been thoroughly canvassed in IRs already, as have the merits of an AAM. The written record is also adequate with respect to FEI's business risks, specifically:

- FEI's business risks were assessed in detail within the last three years and the business fundamentals have not changed significantly in that time;
- FEI is not seeking an increase in equity thickness; and
- The IRs have canvassed in detail how various factors are affecting throughput.

Circumscribing the scope of the oral hearing in this manner can help to reduce the risk of diminishing returns.

ALL OF WHICH IS RESPECTFULLY SUBMITTED.

Dated: October 4, 2012

[original signed by Matthew Ghikas]
Matthew Ghikas
Counsel for the FortisBC Utilities

Gas ("LNG") for export and the use of natural gas for transportation purposes, but the key elements of government energy and environmental policy still favour electricity development over natural gas consumption in FEI's core heating business. FEI's overall business risk remains at least as high, if not higher, compared to 2009. FBCU's evidence on the business risks faced by FEI is included in Appendix H. Ms. McShane discusses FEI's business risk and articulates how business risks are considered in the context of determining the appropriate ROE and equity thickness. Dr. Vander Weide (Appendix G) also discusses how investors consider business risk.

The Path Forward

The 2009 Decision resolved the issue of the broken AAM and the allowed return was an improvement on the overall return for the benchmark utility; however, the evidence in this Filing demonstrates that the cost of capital for the benchmark FEI is higher than what the Commission allowed in 2009. The totality of the evidence included with this Filing supports FBCU's position that the Fair Return Standard is met for the benchmark FEI by the requested ROE of 10.5% on an equity component of 40%.

1.3 OVERVIEW OF FBCU POSITION ON "IN SCOPE" ISSUES

Order No. G-47-12 defined the scope of this Proceeding by reference to several issues. The Commission later clarified some of these issues in Order No. G-72-12. Below, we summarize FBCU's position on the "in-scope" issues identified by the Commission. The FBCU submit that the evidence in this Filing, including the Companies' business risk evidence and the appended expert reports, support the positions articulated below. The Filing provides a sound evidentiary basis upon which the Commission can determine the cost of capital for FEI as the benchmark utility. FBCU expand on these positions, with reference to specific evidence, in Section 2.2 of this Filing.

FEI as the Benchmark

Order No. G-72-12 specified that Affected Utilities are to identify what they consider to be the appropriate benchmark, and then provide the required information in the Minimum Filing Requirements "Other Filing Requirements" in respect of the selected benchmark

only. The FBCU submit that the appropriate benchmark utility at this time is FEI, with its current characteristics and before any amalgamation takes place. If amalgamation takes place, FEI *in its present state* can remain as the benchmark utility until the next comprehensive cost of capital review.

Ms. McShane confirms that FEI remains the logical choice for the benchmark utility at this time. FEI is the largest investor owned utility in BC. Unlike other investor owned utilities in BC, there is a significant body of evidence that has been developed in recent proceedings that help to define FEI's financial and business risk profile. The FBCU submit that FEI is not a "*low risk* benchmark"[8]; however, a benchmark need not be "low risk" to be an effective point of comparison for establishing the cost of capital for other BC utilities. The most important characteristic of a benchmark is that its characteristics and business risks are capable of objective determination.

Ms. McShane discusses that the purpose of designating a benchmark utility is to serve as a point of departure to establish the cost of capital for other BC utilities. It is impractical to use a fictitious entity for this purpose. The key benefit of designating a real entity as the benchmark utility is that its characteristics and risks can be identified and defined, and serve as a foundation for assessing the relative risks and costs of capital for other BC utilities. The same is not true of a purely hypothetical utility.

In short, there is no compelling reason to depart from using FEI as the benchmark, while there are compelling reasons to continue using it. Consistent with the Commission's direction in Order No. G-72-12, the FBCU have addressed the remaining "in-scope" issues only in relation to the selected benchmark, FEI.

Cost of Capital for FEI

Commission in Order No. G-47-12 identified the following two related issues:

> The appropriate cost of capital for a benchmark low-risk utility effective January 1, 2013. Cost of capital includes capital structure, return on common equity, and interest on debt.

[8] 2009 Decision, p. 78.

357 # V. THE BENCHMARK UTILITY

358

359 ## A. PURPOSE OF BENCHMARK UTILITY

360

361 The objective of specifying a benchmark utility is to have a point of reference against which the
362 regulator can compare other utilities under its jurisdiction for the purpose of setting their allowed
363 returns (capital structure and ROE) without conducting a "from first principles" cost of capital
364 proceeding for each one.[15] A "from first principles" proceeding entails a comprehensive review
365 of capital market and economic conditions and the application of the various traditional tests for
366 estimating the fair return on equity. By designating one utility as the benchmark, the
367 Commission can conduct a single "from first principles" cost of capital proceeding, from which
368 it can establish an appropriate common equity ratio and ROE for that benchmark utility. Those
369 two parameters, common equity ratio and ROE, then become the benchmarks for the remaining
370 utilities' allowed common equity ratios and ROEs.

371

372 The designation of one utility as the benchmark utility is partly a matter of efficiency, i.e., it
373 avoids frequent reassessment of factors that are common to all utilities.[16] In addition, it provides
374 a means of ensuring that all the utilities subject to the jurisdiction of the Commission are
375 awarded overall returns that appropriately reflect their business risk relative to the benchmark
376 utility, and, in turn, relative to each other.

377

378 Given both objectives, it makes most sense to designate a specific utility as the benchmark
379 utility, rather than to rely on a hypothetical construct or hypothetical utility as the benchmark.
380 By designating a specific real utility as the benchmark, that utility's business risks can used as a

[15] When comparable companies are initially selected for the purpose of the estimating a "benchmark" ROE, the concept of "benchmark utility" is *per force* a hypothetical construct, inasmuch as the estimated benchmark return reflects the composite of the risks of the selected companies, each of which, individually, has different characteristics. The resulting benchmark return is applicable to an actual utility, designated as the benchmark utility, which has specific risk characteristics that provide a single tangible foundation for making inter-utility comparisons.

[16] In the 2009 Application, FortisBC Inc. summarized the advantages of a benchmark (cited by the Commission in the *2009 ROE Decision*) as (1) cost savings to the Commission and to Intervenors in avoiding additional, unnecessary hearings; the evidence related to economic outlook and capital market conditions need not be presented nor heard more than once; (2) a consistent approach to economic outlook and capital market conditions, considered with reference to expert evidence gathered at a single point in time; and (3) and greater consistency with respect to ROE determinations for individual utilities from a common base.

381 baseline for assessing the relative risks of the other utilities in the jurisdiction. The concept of a
382 hypothetical utility is too ambiguous to serve as a meaningful yardstick for the purpose of
383 comparing business risks of utilities. It is not feasible to delineate the "generic" business risk
384 characteristics of a hypothetical utility, be it a "low", "average" or "high" business risk utility, to
385 an extent that would permit specifying what capital structure and ROE should apply to the
386 hypothetical utility.
387
388 Every utility has unique business risk characteristics that are a function of: (1) the utility sector in
389 which it operates; (2) the nature and age of its assets; (3) the geographic characteristics of its
390 service area; (4) the economic characteristics of its service area; (5) its customer profile; (6) the
391 political landscape; and (7) the regulatory framework under which it operates. The specifics of
392 these broad factors interact to define an individual utility's aggregate market/demand,
393 competitive, operating, supply and regulatory risks. While it might be fair to conclude that, as a
394 general proposition, an electric transmission utility is a "low business risk" utility compared to
395 other utilities operating in other sectors, it would still be necessary to identify and understand a
396 particular electric transmission utility's specific circumstances in order to specify what the
397 appropriate capital structure and ROE would be for that utility. In sum, it is not practical to
398 determine an appropriate capital structure and fair ROE for a fictitious utility.
399

400 **B. CHOICE OF BENCHMARK UTILITY**

401
402 The benchmark utility is simply the entity that serves as the standard or point of reference against
403 which other utilities can be compared. The utility designated the benchmark utility need not be
404 the lowest business risk utility in the province. It is no more difficult to subtract percentage
405 points of equity or basis points of incremental equity risk premium from the ROE or the equity
406 ratio of the benchmark utility than it is to add them.
407
408 The utility designated as the benchmark against which other utilities will be compared should
409 preferably be a large, well established entity, with a relatively diverse geographic, customer and
410 asset base, and no exceptional risk characteristics. Ideally, the designated benchmark utility will

411 have market data that will provide an independent capital market assessment of its risks and
412 return requirements.
413
414 FEI is the logical choice to serve as the benchmark BC utility. FEI is the largest investor-owned
415 utility in British Columbia, is one of the largest gas distribution utilities in the country, and has a
416 relatively diverse geographic, customer and asset base. It has no exceptional business risk
417 characteristics that are likely to make comparisons with other BC utilities problematic. Although
418 FEI's equity is not publicly traded, its debt is rated by two debt rating agencies, providing some
419 independent capital market assessment of its overall business and financial risks, albeit from a
420 bondholder's perspective.[17] Further, its business risks and the trends in those risks have been
421 extensively and comprehensively assessed by the Commission in multiple proceedings.
422
423 FEI is currently part of the FortisBC Energy Utilities' Common Rates, Amalgamation and Rates
424 Design Application, which, if it is approved and it proceeds, will result in an amalgamation of,
425 and postage stamp rates for, FEI, FEVI and FEW. The proposed amalgamation does not
426 invalidate designating FEI as the benchmark BC utility, as comparisons with other BC utilities
427 can be made based on the characteristics of FEI pre-amalgamation for purposes of establishing
428 their cost of capital by reference to the benchmark utility. In addition, FEI pre-amalgamation
429 can be used as the benchmark utility for establishing the cost of capital for FEI Amalco, should
430 amalgamation proceed. Whether FEI Amalco should be designated the benchmark utility (if
431 amalgamation proceeds) can be resolved in a future proceeding.
432
433 The analysis that follows determines an appropriate capital structure and fair return on equity for
434 FEI pre-amalgamation as the benchmark BC utility.
435
436

[17] Although bondholders and equity shareholders would consider the same business risks (and financial risks), the bondholders not only have a prior claim on the assets and earnings of the company, but also may benefit from protective covenants in the bond indentures. As a result, it would be incorrect to assume that the equity risks of two regulated companies with A rated debt are the same.

437 438 439

VI. TRENDS IN ECONOMIC AND CAPITAL MARKET CONDITIONS SINCE 2009

440 This section addresses broad trends in cost of capital since the oral portion of the 2009
441 Application that ended October 1, 2009. In simple terms, the purpose of this section is to
442 compare the current state of, and risks in, the markets where the costs of the various forms of
443 capital are determined compared to the end of the oral portion of the 2009 Application. It is also
444 intended to provide an appreciation of the protracted nature of the recovery from the global
445 financial crisis and economic recession and of the recurrent bouts of capital market turbulence in
446 the intervening 2¾ years.
447
448 In brief, as of the end of June 2012:
449
450 1. The systemic risks to the global financial system, as assessed by the Bank of
451 Canada, are no lower than they were at the end of 2009.
452
453 2. Long-term Government of Canada bond yields are much lower than they were at
454 the end of the oral portion of the 2009 Application. The reduction reflects a
455 confluence of factors, including weak global economic conditions, central bank
456 decisions to keep short-term interest rates low, investor risk aversion/flight to
457 safety and a shrinking pool of risk-free assets. The trend in long-term
458 Government of Canada bond yields is not indicative of the trend in the market
459 cost of equity.
460
461 3. Yields on high grade Canadian corporate bonds have also fallen, largely tracking
462 the decline in long-term Government of Canada bond yields. Spreads on high
463 grade corporate bonds, including utility bonds, are slightly higher than they were
464 at the end of the oral portion of the proceeding, indicating that the credit risk is
465 not perceived to have declined.
466

5.1.2 If a sample of "low risk" instead of "relatively low risk" unregulated Canadian firms had been used instead, would the return on equity in Table 1 under Comparable Earnings Test of 11.5 percent be lower?

Response:

No. It is the underlying characteristics of the firms, rather than the presence or absence of the label "low-risk" or "relatively low-risk", that informs Ms. McShane's analysis. Please note that, in performing the comparable earnings test, it was explicitly recognized that the sample of companies was of somewhat higher risk than a benchmark BC utility. The resulting comparable earnings ROE incorporates a downward adjustment to recognize the unregulated companies' higher risk.

5.2 DBRS describes FEI's business as low-risk business. Moody's describes FEI as a "low-risk, cost-of-service regulated gas transmission and distribution utility" (Exhibit B1-9-1, Appendix A-2, DBRS February 29, 2012 Rating Report, Moody's Global Credit Research 21 July, 2011). Do the FBCU agree? If not, why not?

Response:

Yes, in the context of the entire universe of rated companies. However, the FBCU do not regard FEI as low risk in the context of the universe of Canadian gas and electric distribution utilities.

5.3 In the view of the FBCU, are there any other utilities in B.C. besides FEI that could also be selected as a benchmark utility and capture the regulatory efficiencies without compromising the Commission's obligation to meet the Fair Return Standard? For example, PNG or FortisBC electric?

Response:

FortisBC Inc. is the only potential alternative, although it is a much smaller utility than FEI. However, as discussed at lines 414-421 of Ms. McShane's evidence, FEI possesses the characteristics that should define the benchmark utility, including the fact that its business risks and the trends in those risks have been extensively and comprehensively assessed by the Commission in multiple proceedings. As a result, the FBCU see no advantages to be gained by designating a different utility as the benchmark.

6.0 Reference: FEI as the Benchmark Utility

Exhibit B1-9, pp. 17, 18; Exhibit A2-12 FEU 2012-2013 RR and Rates Decision pp. 11, 12, April 12, 2012

Utilization and Characteristics of a Benchmark Utility

The FBCU summarize the reasons articulated by Ms. McShane and Dr. Vander Weide as to why an actual utility should be designated as the benchmark utility, rather than relying on a purely hypothetical construct. One of the reasons summarized at a high level is that "designating an actual utility as the benchmark eliminates ambiguity and reduces subjectivity in determining the characteristics of the benchmark, such as its size, scale, geographic scope, competitive position and business risks."

In the April 2012 Decision, the Commission describes FEU as a group of companies in transition; that they have made significant progress in moving away from their traditional roots; that in recent years, the Companies have explored and developed what they believe to be an expanded range of service offerings to satisfy growing needs of the customer base, etc.

6.1 Do the FBCU agree with the description of FEU in the April 2012 RR and Rates Decision? If not, why not?

Response:

No, the FEU do not agree with the description noted above. It is correct that, in recent years, in response to the changing energy environment in BC and the declining throughput levels impacting the FEU's core business, the FEU (mainly FEI) have pursued new initiatives, expanding its range of service offerings. However, at their foundation these offerings make use of natural gas or its established infrastructure. The FEU remain and will remain natural gas distribution utilities whose core business is the transmission and distribution of natural gas to residential, commercial and industrial customers. The NGT and biomethane initiatives are in very early stages of market development, but are service offerings that are part of the core distribution business, with the focus on utilizing FEU's natural gas distribution and transmission system, which provides benefits to existing customers. Thermal Energy Service ("TES") as well are in the early stages of market development and the investment in TES is immaterial relative to the size of the FEU distribution and transmission assets. Furthermore, TES will either be offered as a separate class of service within FEI or by a separate affiliate, and will not be reflected in the profile of the benchmark.

The attributes that make FEI a more appropriate benchmark than a hypothetical entity remain valid even with the potential for business changes over time. The benchmark cost of capital is determined at a point in time, and it is to be revisited over time. Although the profile of the benchmark may change from review to review, the key point is that (unlike a hypothetical utility)

its characteristics and risk profile is capable of being ascertained with certainty when it is reviewed.

Page 12 of the April 2012 Decision in Exhibit A2-12 says: The Commission Panel in the 2009 ROE Decision agreed with the Terasen Companies with respect to climate change and energy policies noting "that the introduction of climate change legislation by the Provincial Government has created a level of uncertainty that did not exist in 2005 and that the change in government policy will quite probably cause potential customers not to opt for natural gas and persuade potential retrofitters to opt for electricity."

6.2 Please confirm that the following has taken place in B.C. since the 2009 ROE Decision:

a) the provincial government has issued a new natural gas policy with respect to encouraging LNG for export and the use of natural gas for transportation purposes;

Response:

Confirmed. Please refer to the response to BCUC IR 1.100.2.

b) the gas commodity prices have decreased further and natural gas is competitive with the two-tier residential electricity rate which is forecast to increase significantly?

Response:

The FEU can confirm that natural gas commodity prices have decreased, making it more price competitive with electricity under step 2 on an operating cost basis. Natural gas also competes with step 1 rates (for example it applies to water heating), which is not expected to increase as much as step 2 rates. Capital costs are also a factor in price competitiveness. Please also refer to the response to BCUC IR 1.97.1.

c) FEU have embarked on new business initiatives such as natural gas for transportation, biomethane services, and alternative energy solutions.

If the FBCU are unable to confirm, please describe in the FBCU's own words the above events.

Response:

Confirmed. In recent years, in response to the changing energy environment in BC and the declining throughput levels impacting FEI's core business, FEI has pursued new initiatives such as biomethane services and natural gas for transportation ("NGT"). Thermal Energy Service ("TES") will either be offered as a separate class of service or by a separate affiliate, and will not be reflected in the profile of the benchmark. FEI's core market remains space and water heating, and will remain so for the foreseeable future even in the case where there is significant uptake in biomethane and NGT initiatives. The throughput associated with these initiatives will still be dwarfed in absolute terms by the core market. FEI's overall risk profile is driven by its success in attracting and retaining customers in the traditional space and water heating markets, which remains as a key challenge for FEI. Please also refer to the response to BCUC IR 1.6.1.

services, will have an increasingly significant impact on the natural gas requirements over time. Thus, from the perspective of natural gas customers it is important to understand the growth of these energy alternatives over time and how they may impact the natural gas throughput and utilization." (Exhibit B-1, p.16, FEI 2012-2013 RRA)

8.2 Please discuss how FEI's expanded service offerings into Biomethane, CNG and LNG Fueling Stations, and Alternative Energy Services are affecting its current and future business risk? Please provide any evidence which supports your findings.

Response:

FEI has begun the expanded service offerings in the areas of NGT and biomethane to assist in mitigating its increasing long term business risk due to declining throughput in its core natural gas markets. As stated in the response to BCUC IR 1.6.1, FEI continues to be a natural gas distribution utility whose core business is in the space and water heating markets. The NGT and biomethane initiatives are in very early stages of market development, but are service offerings that are part of, or supplement the core distribution business, with the focus on utilizing FEI's natural gas distribution and transmission system, which provides benefits to existing customers. However, as also discussed in the response to BCUC IR 1.100.2, these initiatives are at the very early stages of development, and currently have no impact on the business risk of the core market, which has increased mainly due to declining annual use rates from existing customers and the declining rate of capture of the new construction market, particularly in the multi-family sector. Since FEI's core business will continue to be in natural gas distribution for space and water heating for the foreseeable future, and it is within this market that FEI faces continuing challenges, attracting and retaining customers in the traditional space and water heating market is important for offsetting the declining throughput from the existing customer base. The degree of success in mitigating throughput declines or the effects of the initiatives on business risk will not be known until the initiatives have reached a more mature stage of development.

In addition, TES is currently being offered by an affiliate, and will either continue to be offered by an affiliate or will be offered by a separate class of service within FEI depending on the outcome of the AES Inquiry. As such, TES has no material impact on risk faced by FEI's core natural gas business (i.e. the proposed benchmark).

Response:

FEI's risks are outlined in the Business Risk Appendix submitted as part of its filing. Ms. McShane and Dr. Vander Weide address the relative risks of utilities in other provinces and the United States. Credit rating agency reports do not provide a company to company comparison of business risks to FEI. As noted in analyst reports, regulated utilities are lower risk than non-regulated companies.

111.2 Do FBCU consider that FEI is a utility undergoing transformation? E.g., transformation relative to its affiliated companies such as FEVI, FEW? Relative to other regulated utilities in B.C. such as PNG, BC Hydro?

Response:

As noted in the responses to BCUC IRs 1.111.1 and 1.6.1, FEI's core business is, and will remain for the foreseeable future, natural gas distribution.

PNG and BC Hydro are not appropriate candidates to serve as a benchmark. This assessment is not so much related to whether or not they are in transition, but due to their underlying characteristics. For instance, PNG is a relatively small utility while BC Hydro is a Crown corporation. Please refer to Ms. McShane's evidence for further discussion of this matter.

111.3 In the view of FBCU, could the FEI of 2009 – to be treated as frozen in time --- be used as the hypothetical benchmark ROE for 2012 and beyond? Why or why not?

Response:

It is more efficient to adopt the proposed approach of using the "FEI of 2012", and there are no discernible benefits associated with adopting the "FEI of 2009" instead of the "FEI of 2012". The Commission has a full evidentiary record of what FEI's characteristics are at present. The more out of date the benchmark is, the less the benchmark cost of capital reflects current capital market conditions. As such, the evidence put forward by individual utilities in establishing an equity risk premium will have to include more of that type of evidence as well as their evidence on underlying business risk. Please also refer to the response to BCUC IR 1.113.4.

111.4 In the view of FBCU, can the FEI, as it exists today and regardless of changes in the next few years, be used as the benchmark ROE for the next 3 to 5 years and have the future FEI and other utilities' risks and allowed returns on cost of capital evaluated against this entity? Why or why not?

Response:

FBCU are of the view that FEI as it currently exists can serve as the benchmark for the next 3 to 5 years, until the next determination as to what entity will form the appropriate benchmark. Should amalgamation proceed, FEI Amalco may be determined to be the appropriate benchmark in the future. Alternatively, utilities may use FEI as it is currently comprised as a reference benchmark. Please refer to the response to BCUC IR 1.111.3.

111.5 Specifications of a hypothetical benchmark

FEI – BENCHMAKR UTILITY	HYPOTHETICAL BENCHMARK UTILITY
Customer Mix of FEI (% share): • Industrial • Commercial • Residential	
Customer Class Margins	
Competitiveness of Natural Gas (commodity, delivery, carbon tax, etc.) to Other Fuels (e.g., electricity)	
Size of FEI Capital expenditure ($) Sales ($) Number of employees Rate Base	
Size of debt ($, % of capital structure) and Cost of Debt	
State of plants and equipment	
List of risk mitigation deferral accounts	

FEI – BENCHMAKR UTILITY	HYPOTHETICAL BENCHMARK UTILITY
Financial Metrics 5-year indicative spreads (bps) 10-year indicative spreads (bps) 30-year indicative spreads (bps) Credit ratings Credit ratios (EBITDA/interest, FFO/total debt Debt issuance and long term debt maturity schedules	

111.5.1 The table above lists a number of features and characteristics (non-exhaustive) of FEI that as a benchmark, other actual utilities and B.C. are compared to in order to establish ROE and capital structure differentials. Please fill out the left hand column in the above table and add other features that FBCU consider to be defining features.

Response:

FBCU agree that the features listed in the left hand column can inform the benchmark utility's cost of capital. FBCU would add that all of FEI's business risks (i.e. not just the competitiveness as itemized in the third row) should also be considered as characteristics of the benchmark. FEI's business risks are discussed in FEI's Business Risk Appendix.

111.5.2 If the Commission chose a hypothetical benchmark utility, could FBCU explain how the Commission should compare actual utilities in B. C. to the hypothetical benchmark in the right hand column in order to establish actual risk factors and estimate ROE and capital structure differentials. In what aspects should the hypothetical utility be defined as identical to FEI and in what aspects could it be different so that the hypothetical utility could be described as a low-risk utility?

Response:

Irrespective of what benchmark is selected, the comparison would involve a comprehensive assessment of the characteristics of another utility to the characteristics of the benchmark. The

types of features that will inform that inquiry include those features listed in the table in the preamble. However, as noted in the response to BCUC IR 1.111.5.1 a key element of the assessment will be an assessment of the underlying business risks of both the benchmark and the other utility. The business risks are not adequately captured in the table above, which refers only to competition among energy sources. It is in the area of identifying and comparing relative business risks that the FBCU find particularly problematic when it comes to adopting a hypothetical benchmark.

Since the assessment of cost of capital involves a holistic assessment of risks and characteristics of a utility (whether benchmark or otherwise), it is not practical to go through the list of features included in the above table and identify specific factors that, if varied, could reduce the overall risk of the benchmark to the point where it could be characterized as "low risk".

The FBCU believe that it is not necessary to have any particular label – "low risk" or otherwise - attached to a benchmark for it to be an effective benchmark. As a practical matter, given the subjectivity of such labels, avoiding them can avoid unnecessary debate among stakeholders.