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January 31, 2022

British Columbia Utilities Commission Suite 410, 900 Howe Street Vancouver, BC V6Z 2N3

Attention: Mr. Patrick Wruck, Commission Secretary

Dear Mr. Wruck:

Re: British Columbia Utilities Commission (BCUC) 2022 Generic Cost of Capital (GCOC) Proceeding – Stage 1

Evidence of FortisBC Energy Inc. (FEI) and FortisBC Inc. (FBC) (collectively FortisBC)

In accordance with BCUC Order G-281-21 dated September 24, 2021 and as amended by Order G-288-21 dated October 6, 2021, FortisBC hereby files its Evidence in the above referenced proceeding.

If further information is required, please contact the undersigned.

Sincerely,

on behalf of FORTISBC

Original signed:

Diane Roy

Attachments

cc (email only): Registered Interveners



## BRITISH COLUMBIA UTILITIES COMMISSION 2022 GENERIC COST OF CAPITAL (GCOC) PROCEEDING – STAGE 1

## FortisBC Energy Inc. and FortisBC Inc. (collectively FortisBC Utilities) Evidence

January 31, 2022



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## 1 1. INTRODUCTION AND EXECUTIVE SUMMARY

2 On March 8, 2021, the British Columbia Utilities Commission (BCUC or the Commission) initiated a Generic Cost of Capital proceeding (GCOC Proceeding). By Order G-156-21 dated May 21, 3 4 2021 and as amended by Order G-205-21 dated July 7, 2021, the BCUC established a scope and 5 set out a two-stage proceeding to determine public utilities' cost of capital.<sup>1</sup> By Order G-281-21 dated September 24, 2021, the BCUC decided that the Benchmark Utility methodology for 6 7 determination of the cost of capital for utilities in BC is appropriate. Additionally, and as amended by Order G-288-21 dated October 6, 2021, the BCUC set out further process in the regulatory 8 9 timetable and directed both FortisBC Energy Inc. (FEI) and FortisBC Inc. (FBC) (together, FortisBC) to submit evidence in support of their respective cost of capital by January 31, 2022.<sup>2</sup> 10

In accordance with the BCUC Orders and pursuant to sections 59 to 61 of the *Utilities Commission Act*, R.S.B.C. 1996, c. 473 (UCA), FortisBC seeks:

- For FEI, approval of a capital structure consisting of 45 percent common equity and 55 percent debt, and a return on common equity of 10.1 percent.<sup>3</sup>
- For FBC, approval of a capital structure consisting of 40 percent common equity and 60 percent debt, and a return on common equity of 10.0 percent.<sup>4</sup>
- 17

FortisBC respectfully submits that the accompanying evidence on FEI's and FBC's business risks and return on common equity and capital structure considerations, including the independent expert evidence of Mr. James Coyne of Concentric Energy Advisors Inc. (CEA or Concentric), demonstrates that FortisBC's proposals meet the Fair Return Standard, and should be approved. A draft form of order sought is provided in Appendix E.

## 23 1.1 FAIR RETURN STANDARD

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

<sup>&</sup>lt;sup>1</sup> In addition, Order G-205-21 established that the issue of deferral account financing cost shall be reviewed after the completion of Stage 1 and Stage 2 of the GCOC Proceeding.

<sup>&</sup>lt;sup>2</sup> The BCUC order for FortisBC to submit evidence in support of the cost for capital for each of FEI and FBC departs from past practice in the sense that FBC's cost of capital is being addressed in Stage 1 and on a stand-alone basis, as opposed to relative to a benchmark utility.

<sup>&</sup>lt;sup>3</sup> As compared to FEI's existing common equity thickness of 38.5 percent and allowed return on common equity of 8.75 percent.

<sup>&</sup>lt;sup>4</sup> As compared to FBC's existing common equity thickness of 40 percent and allowed return on common equity of 9.15 percent.

<sup>&</sup>lt;sup>5</sup> Decision attached to Order G-158-09 (2009 Cost of Capital Decision), at p. 15, citing on p. 8 to 9 of the 2009 Cost of Capital Decision, p. 6 of National Energy Board Decision RH-1-2008 in respect of Trans Quebec & Maritimes Pipeline (TQM). 2013 GCOC Decision, p. 24. As well as 2016 Cost of Capital Decision, Section 2, pages 3-5.



- is comparable to the return available from the application of the invested capital to other • 2 enterprises of like risk (comparable investment requirement);
- 3 • enables the financial integrity of the regulated enterprise to be maintained (financial 4 integrity requirement); and
  - permits incremental capital to be attracted to the enterprise on reasonable terms and • conditions (capital attraction requirement).
- 6 7

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8 The application of the Fair Return Standard to FEI and FBC must account for the ongoing 9 challenges that each utility respectively faces in attracting capital on reasonable terms and 10 conditions. The overall return must reflect the business risks facing FEI and FBC that define the 11 potential risks and uncertainties that each company faces in achieving a Fair Return on and of 12 invested capital in both the short and long-term. In addition, it must account for the risks 13 associated with continued volatility and uncertainty in the financial markets. The combination of 14 all of these factors justifies the respective proposed capital structure and return on common equity 15 for FEI and FBC.

#### 1.2 BUSINESS RISK INFORMS A FAIR RETURN 16

17 Business risk analysis is an important factor in an investor's decision-making process. From the investors' perspective, and as confirmed by the BCUC in multiple cost of capital decisions, any 18 19 factor that may negatively impact a utility's current and future cash flows should be considered a 20 risk.6

21 BCUC Order G-281-21 directs FEI and FBC to submit evidence in support of their respective cost 22 of capital. Accordingly, FortisBC's evidence in this Application includes two separate business 23 risk appendices, one for each of FEI and FBC. Consistent with past practice, a key reference point for assessing FortisBC's business risk is the previous BCUC assessment of FortisBC's 24 25 business risk in the context of determining cost of capital. FEI's business risk was last reviewed 26 in FEI's 2016 Cost of Capital proceeding (2016 Proceeding). FBC's business risk was last 27 assessed in the 2013 Stage 2 GCOC proceeding (2013 Proceeding). These comparisons provide 28 an indication of whether each utility's overall risk is changing over time.

- 29 A second way in which FortisBC's business risk comes into play in the determination of a Fair 30 Return is through a comparison with other utilities. Concentric's evidence (Appendix C) compares
- 31 FEI's and FBC's business and financial risk with their respective Canadian and U.S. proxy groups.

<sup>&</sup>lt;sup>6</sup> 2013 GCOC Decision, p. 24.



# 11.2.1FEI's Business Risk Is Significantly Higher Relative to the 20162Proceeding

3 FEI's business risk has significantly increased since the 2016 Proceeding. This increase supports

4 FEI's request for both an increase in ROE and, in particular, an increase in common equity 5 thickness.

Most notably, the increasing pace of the Energy Transition from fossil fuels to cleaner sources of
 energy through electrification of the e

8 conomy, and increased recognition of the effect of this transition on natural gas utilities by utility

9 analysts and investors, represent what Concentric refers to as a "transformation of long-term risk

10 environment" for natural gas utilities across North America since the time of the 2016 Proceeding<sup>7</sup>.

11 FEI, in particular, is at the forefront of this transition, with all levels of government introducing new 12 policies in rapid succession. This is apparent in the provincial government's recently updated 13 CleanBC Roadmap to 2030 (Roadmap)<sup>8</sup> which won an award at the United Nations COP26 14 climate conference at Glasgow, Scotland<sup>9</sup> and is anticipated to have a significant impact on FEI's competitive and operational landscape with implications for FEI's customer rates and throughput. 15 16 FEI has characterized the policy developments associated with the Energy Transition as political 17 risk, but these developments also impact other risk categories. For instance, increasing carbon 18 tax and adding more costly Renewable Gas<sup>10</sup> to FEI's supply portfolio along with increases in 19 natural gas commodity prices and the impact of sectoral emission reduction targets and 20 Greenhouse Gas Reduction Standard (GHGRS) and related Roadmap policies on FEI's 21 throughput will continue to erode FEI's price competitiveness versus electricity, leading to overall 22 higher energy price risk.

While the single biggest increase in risk relates to political/Energy Transition risk, increases in
 other risk factors since the 2016 Proceeding – such as Indigenous rights and engagement,
 demand/market risk, regulatory risk, operating risk and economic conditions, are also material
 and further support FEI's request for the increase in ROE and equity thickness.

### 27 **1.2.2 FBC's Business Risk is Similar to the 2013 Proceeding**

FBC's overall business risk is best characterized as being similar to that of the 2013 Proceeding. Increases in some of FBC's risk categories – such as operating risk, Indigenous rights and engagement, regulatory risk and economic conditions are offset by FBC being a beneficiary of the above mentioned Energy Transition and the provincial government's policies that are supportive of electrification (although the predominant beneficiary of these policies is BC Hydro, whose service territory overlaps most of FEI's service territory). BC Hydro continues to compete

<sup>&</sup>lt;sup>7</sup> Appendix C, page 95.

<sup>&</sup>lt;sup>8</sup> <u>https://cleanbc.gov.bc.ca/</u>.

<sup>&</sup>lt;sup>9</sup> <u>https://news.gov.bc.ca/releases/2021ENV0068-002116</u>.

<sup>&</sup>lt;sup>10</sup> FEI uses the term Renewable Gas to refer collectively to the low carbon gases or fuels that the utility can acquire under the Greenhouse Gas Reduction (Clean Energy) Regulation (GGRR), which are: Renewable Natural Gas (RNG or biomethane), hydrogen, synthesis gas and lignin.



with FBC for customers in parts of FBC's service territory, with BC Hydro availing itself of
 competitive advantages not available to FBC due to its role as a Crown corporation.

## 3 1.3 EVIDENCE ON RETURN ON COMMON EQUITY

FortisBC retained Mr. James Coyne of Concentric, a cost of capital expert with many years of
experience regarding the North American utility industry<sup>11</sup>, to provide an independent expert
opinion on FEI's and FBC's cost of capital. Mr. Coyne's report is attached as Appendix C. Mr.
Coyne's evidence, among other things:

- 8 Explains the changes in capital market conditions since the 2016 Proceeding. He 9 concludes that extraordinary measures taken by the central banks to stabilize the 10 economy and financial markets have driven investors from very low yielding bonds into 11 equities, creating upward pressure on valuations and downward pressure on yields for 12 dividend paying companies such as utilities. These dynamics indicate that interest rates 13 are being driven primarily by actions of central banks rather than investors in the bond 14 markets, and that a level of informed judgement and reliance on forecast interest rates is 15 necessary to adjust for these biases.
- Discusses that U.S. and Canadian capital markets are highly integrated and that it is appropriate to use the U.S. proxy group data for FEI's and FBC's ROE and capital structure determination.
- Performs a number of screens to determine the appropriate proxy group for each of FEI and FBC separately. In Mr. Coyne's expert opinion, compared with Canadian and North American proxy groups, the U.S proxy groups are more representative of FEI's and FBC's regulated operations.
- Conducts Capital Asset Pricing Model (CAPM) and Discounted Cash Flow (DCF) analyses, with alternative inputs and model specifications, to determine an appropriate ROE for FEI and FBC. The BCUC has employed the CAPM and DCF analyses in past proceedings. Further, Concentric has used the results of the Bond Yield Plus Risk Premium (Risk Premium) approach to test the reasonableness of the CAPM and DCF models.
- Provides a jurisdictional comparison of applied flotation cost and financing flexibility in
   Canada and concludes that the majority of Canadian regulators apply a 50 basis points
   upward adjustment to account for these factors.
- 32

Mr. Coyne's conclusions regarding a Fair Return on common equity, based on his analysis, for
 each of FEI and FBC are as follows:

<sup>&</sup>lt;sup>11</sup> Mr. Coyne filed expert testimonies in both the 2016 Proceeding as well as the 2013 GCOC Proceeding.



- A reasonable estimate of FEI's required cost of equity is 10.1 percent, which is the average of the CAPM and Multi-Stage DCF model results for the U.S. Gas proxy group.
- A reasonable estimate of FBC's required cost of equity is 10.0 percent, which is the average of the CAPM and Multi-Stage DCF model results for the U.S. Electric proxy group.<sup>12</sup>

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Capital structure and the cost of common equity are closely linked in determining the Fair Return
for regulated utilities. As such, Mr. Coyne indicates that for the Fair Return Standard to be met
his proposed ROEs as set out above must be considered together with FEI's and FBC's proposed
capital structures, discussed next.

11 **1.4** EVIDENCE ON CAPITAL STRUCTURE

12 The BCUC has historically given substantial weight to business risk, and more particularly 13 changes in business risk, to justify its capital structure determinations for both FEI and FBC. As 14 such, FEI and FBC demonstrate how the changes in their business risk justify their proposed 15 common equity ratios. This filing also discusses financial risk, and the importance of maintaining 16 FEI's and FBC's credit ratings and provides evidence as to why weak financial metrics can result 17 in negative rating action. In addition, Concentric assesses FEI's and FBC's operating and financial 18 profile, and conducts a risk analysis, including an assessment relative to other utilities, as part of 19 assessing the reasonableness of FortisBC's proposed capital structures.

The materials related to business and financial risk demonstrate the reasonableness of the proposal for a 45 percent common equity ratio for FEI and maintaining the existing 40 percent common equity ratio for FBC. Specifically:

- 23 FEI: The significant increase in FEI's business risk, in particular, warrants an increase in • 24 the common equity component of FEI's capital structure to 45 percent. Mr. Coyne 25 endorses FEI's proposal, concluding that FEI's proposed common equity thickness ratio 26 of 45 percent is reasonable, if not conservative, given the pace of change in its business 27 and financial risks. He points to evidence that the Energy Transition risk has contributed 28 to a significant increase in investors' perceived risk for the natural gas industry in general 29 and FEI in particular since the 2016 Proceeding<sup>13</sup>. The increase in the common equity 30 component of FEI's capital structure will also strengthen FEI's credit metrics and support 31 ongoing access to capital at reasonable rates, particularly given current weak metrics and 32 the need to access capital over the near term.
- **FBC:** Considering the overall stability in FBC's business risk profile, a 40 percent common equity thickness remains appropriate. Given FBC's lower credit rating and weak credit

<sup>&</sup>lt;sup>12</sup> Further, Mr. Coyne states that given FBC's small size relative to the proxy group, a size premium adjustment may be appropriate.

<sup>&</sup>lt;sup>13</sup> Appendix C, p. 4.



1 metrics, a minimum of 40 percent is necessary to provide ongoing access to capital at 2 reasonable rates in various market conditions. FBC's proposal is aligned with Mr. Coyne's 3 expert evidence that while FBC's business risk may improve to some degree due to the 4 electrification of the economy, FBC's core credit ratios provide little cushion for FBC to 5 maintain its current credit ratings. Mr. Covne concludes that FBC's deemed equity ratio 6 should be maintained at 40 percent at a minimum, and that the smaller size of FBC relative 7 to the proxy group companies in both Canada and the U.S. could justify an increase in the 8 Company's deemed equity ratio.<sup>14</sup>

## 9 **1.5** *EFFECTIVE DATE FOR BCUC DETERMINATIONS*

The appropriate effective date for cost of capital decisions depends on the timing and progress of the GCOC Proceeding. Considering the BCUC's established regulatory timetable in this Proceeding (Order G-288-21 dated October 6, 2021), FortisBC expects a decision on FEI's and FBC's cost of capital in this Proceeding in the fourth quarter of 2022 or the first quarter of 2023. Therefore, based on the current expected timing, FortisBC submits that an appropriate effective date for the approved ROE and capital structure established in Stage 1 of this Proceeding is January 1, 2023.

## 17 **1.6** AUTOMATIC ADJUSTMENT MECHANISM IS STILL UNDESIRABLE

18 Mr. Coyne reviews the application of formula approaches in other Canadian jurisdictions and 19 concludes that an evidentiary review of a utility's cost of capital is most likely to provide the most 20 accurate estimate of a utility's cost of equity<sup>15</sup>. FortisBC submits that the BCUC should continue 21 to set FortisBC's allowed ROE and capital structure by way of a traditional cost of capital 22 application process and the BCUC decision in the 2016 Proceeding to terminate the use of 23 Automatic Adjustment Mechanism (AAM) continues to be appropriate.

# 1.7 FEI AND FBC ARE UNAFFECTED BY DETERMINATION OF BENCHMARK 25 UTILITY

Given the BCUC's direction for each of FEI and FBC to file separate evidence in Stage 1 of this proceeding, FortisBC submits that the BCUC can individually determine each of FEI's and FBC's appropriate allowed ROE and capital structure without reference to a Benchmark Utility. In this regard, the choice of the Benchmark Utility is a topic that is better addressed by other utilities to whom the Benchmark Utility approach applies. Therefore, other than the comments already provided in FortisBC's Letter to the BCUC on July 21, 2021 (Exhibit B2-4), FEI and FBC have no additional comments at this time concerning the choice of the Benchmark Utility.

<sup>&</sup>lt;sup>14</sup> Appendix C, p. 151.

<sup>&</sup>lt;sup>15</sup> Appendix C, pp. 152-155.



## 1 **1.8** *TRIGGERS, CRITERIA FOR FUTURE APPLICATIONS*

FortisBC is unaware of any regulator that considers pre-defined triggers or criteria for future applications, and questions whether any trigger mechanism can capture all of the various factors that can impact the investors' opportunity cost. Mr. Coyne concludes that a pre-defined trigger for future cost of capital application is not needed and that periodic cost of capital proceeding that is conducted every three to five years is the best approach.<sup>16</sup> FortisBC thus submits that the established approach, which includes a periodic review of utilities' cost of capital, is the most appropriate.

<sup>&</sup>lt;sup>16</sup> Appendix C, p. 156.



### 1 2. OUTLINE OF THE APPLICATION

- This filing, including the appended materials, provides the necessary evidentiary basis upon which
   the BCUC can determine a Fair Return for FEI and FBC.
- 4 In the following sections, FortisBC sets out its position and evidence on the following matters:
- Section 3: The Fair Return Standard and its implications for setting the cost of capital for
   a benchmark utility;
- Section 4: The assessment of FEI's and FBC's business risk;
- Section 5: The appropriate allowed ROE for FEI and FBC;
- Section 6: The appropriate capital structure for FEI and FBC;
- Section 7: The effective date for the approved ROE and capital structure;
- Section 8: The Automatic Adjustment Mechanism;
- Section 9: The appropriate benchmark for other utilities; and
- Section 10: Triggers, criteria for future applications.
- 14
- 15 The Appendices are:
- Appendix A Evidence of FEI regarding business risk facing FEI.
- Appendix B Evidence of FBC regarding business risk facing FBC.
- Appendix C Evidence of Mr. James Coyne, Concentric Energy Advisors Inc. regarding
   the appropriate return on common equity and capital structure for FEI and FBC.
- Appendix D Supporting documents.
- Appendix E Draft Order.
- 22 23

FortisBC has filed the following information as supporting documents in Appendix D:

- FEI's and FBC's 2020 Financial Statements, Annual Information Form and Management
   Discussion and Analysis;
- Credit Rating Agency Reports;
- Investment Analyst Reports including both Equity and Debt Analyst Reports;
- Prospectuses of Public Debt Offerings;
- Bond Issue Listing;
- Fortis Inc. Equity Prospectuses;
- Historical Regulatory Financial Information; and
- Accounting Policy Changes.



## 1 3. APPLICATION OF THE FAIR RETURN STANDARD

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

5 evidence.

## 6 **3.1** *The Obligation to Fix a Fair Return for Ratemaking Purposes Is* 7 *Absolute*

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

- 11 Section 59(5) of the UCA provides that a rate is "unjust" or "unreasonable" if it is:
- a) more than a fair and reasonable charge for service of the nature and quality provided bythe utility;
- b) insufficient to yield a fair and reasonable compensation for the service provided by the utility, or a fair and reasonable return on the appraised value of its property; or
- 16 c) unjust and unreasonable for any other reason.
- 17

There is a substantial body of case law that deals with the principles that utility rate regulators must apply in determining a fair and reasonable return for the utility shareholder. The following passage from the Decision attached to Order G-14-06 regarding the cost of capital for TGI<sup>17</sup> and TGVI<sup>18</sup> (2006 Cost of Capital Decision) articulates the BCUC's duty to approve rates that will provide a reasonable opportunity to earn a Fair Return on invested capital:

23 The Commission Panel does not accept that the reference by Martland J. [in British 24 Columbia Electric Railway Co. v. British Columbia Public Utilities Commission<sup>19</sup> to 25 a "balancing of interests" to mean that the exercise of determining a fair return is an exercise of balancing the customers' interests in low rates, assuming no 26 27 detrimental effects on the quality of service, with the shareholders' interest in a fair 28 return. In coming to a conclusion of a fair return, the Commission does not consider 29 the rate impacts of the revenue required to yield the fair return. Once the decision is made as to what is a fair return, the Commission has a duty to approve rates 30 that will provide a reasonable opportunity to earn a fair return on invested capital.<sup>20</sup> 31

<sup>&</sup>lt;sup>17</sup> Terasen Gas Inc., now FortisBC Energy Inc.

<sup>&</sup>lt;sup>18</sup> Terasen Gas Vancouver Island Inc., now part of FortisBC Energy Inc.

<sup>&</sup>lt;sup>19</sup> [1960] S.C.R. 837 at 856.

<sup>&</sup>lt;sup>20</sup> 2016 Cost of Capital Decision, p.8.



Similarly, in FEI's 2016 Cost of Capital Decision (2016 Decision), the BCUC reiterated the principles articulated in the 2006, 2009 and 2013 Cost of Capital Decisions and confirmed that it has a duty to provide a reasonable opportunity to the utility to earn a Fair Return on and of invested capital:

5 Consistent with previous decisions and the "regulatory compact" the Panel confirms that it has a duty to approve rates that meet this standard, and to provide a reasonable 6 7 opportunity for the utility to earn a Fair Return on invested capital. The Panel also concurs with the finding in the 2013 GCOC Decision that in assessing the Fair Return Standard, 8 9 the utility must be assessed on the basis of the standalone principle. That is, it must be 10 assessed as if FEI is a stand-alone entity, raising capital on the merits of its own economic, 11 business and financial characteristics<sup>21</sup>. No party challenged the application of this principle<sup>22</sup>. 12

13 This BCUC's articulation of the Fair Return Standard is consistent with prior court decisions,

including the concurring reasons of Locke J. in *British Columbia Electric Railway*, in which Locke
 J. stated in part:

- 16 The Commission is directed by s.16(1)(a) [of the old legislation] to consider all 17 matters which it deems proper as affecting the rate but that consideration is to be 18 given in the light of the fact that the obligation to approve rates which will give a
- 19 fair and reasonable return is absolute.<sup>23</sup>
- 20 The application of the Fair Return Standard ensures that utilities are in a position to:
- meet their customers' service needs at a reasonable cost;
- attract investment capital at reasonable cost under all market conditions;
- earn a fair and reasonable return on previously invested capital;
- support the energy and environmental policy objectives of the BC government to the
   extent appropriate under the UCA;
- pursue investments in efficiency; and
- be financially sustainable in the face of ongoing and changing business risks.

<sup>&</sup>lt;sup>21</sup> 2013 GCOC Decision, p. 100.

<sup>&</sup>lt;sup>22</sup> 2016 Cost of Capital Decision, p.4.

<sup>&</sup>lt;sup>23</sup> [1960] S.C.R. 837 at 848.



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

The BCUC has endorsed<sup>24</sup> the National Energy Board (NEB) [now the Canada Energy Regulator]
 articulation of the Fair Return Standard in NEB Decision RH-1-2008. The NEB had stated:

- 5 The Fair Return Standard requires that a fair or reasonable overall return on capital 6 should:
- be comparable to the return available from the application of the invested
  capital to other enterprises of like risk (comparable investment
  requirement);
- enable the financial integrity of the regulated enterprise to be maintained
   (financial integrity requirement); and
- permit incremental capital to be attracted to the enterprise on reasonable terms and conditions (capital attraction requirement).

14

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

<sup>&</sup>lt;sup>24</sup> 2009 Cost of Capital Decision, at p.15, citing p.6 of RH-1-2008 in respect of TQM.



## 1 4. BUSINESS RISKS

This section summarizes FEI and FBC's respective business risk. Business risk analysis informs cost of capital determination because business risk can affect the likelihood that the company will be able to earn a Fair Return on and of its invested capital. Generally, any factor that can negatively affect a company's current or future earnings and/or cash flows is considered a risk by investors.

7 4.1 FORTISBC'S APPROACH TO ASSESSING BUSINESS RISK ALIGNS WITH THE 8 BCUC'S DEFINITION OF RISK

In the 2013 GCOC Stage 1 Decision (2013 Decision) and the 2016 Decision, the BCUC defined risk as the probability that the future cash flows will not be realized or will be variable resulting in a failure to meet investors' expectations<sup>25</sup>. The BCUC's 2013 Decision also reaffirmed its previous statement in the 2009 Cost of Capital Decision (2009 Decision) that "*the assessment of the risks has a significant bearing on the application of the fair return standard and the determination of an* appropriate common equity ratio for regulatory purposes."<sup>26</sup>

- Business risk can be analyzed in various fashions. For instance, one can analyze the business
  risk by comparing the direction and pace of change in risk factors for the same company over
  time. In this Application, FEI's and FBC's Business Risk Appendices (Appendix A and Appendix
  B) assess each Company's business risk from this perspective.
- Another important approach, particularly in the context of cost of capital applications, is to analyze a company's risk relative to other firms. The BCUC may then use the changes and/or differentials in business risk to inform its cost of capital determinations. Concentric's expert testimony in this proceeding includes this aspect of business risk analysis.
- 23 Business risk can be categorized in different forms. For the sake of consistency and continuity of 24 risk assessment, in this proceeding FEI and FBC have both adopted similar business risk 25 categories to each other, which are consistent with the 2016 Proceeding. The only new risk 26 category relates to the Indigenous rights and engagement that due to its increased significance 27 and impact has now been promoted to its own risk category. These categories conform to the 28 BCUC's definition of risk, since each one of these risk categories (and each one of the factors 29 within each category) can potentially limit FEI's and FBC's ability to realize its current and future earnings and/or cash flows.27 30
- The following sections provide a snapshot of FEI's and FBC's business risk, summarizing FortisBC's evidence in Appendices A and B and Mr. Coyne's assessment in Appendix C.

<sup>&</sup>lt;sup>25</sup> 2016 Cost of Capital Decision, pp. 8-9.

<sup>&</sup>lt;sup>26</sup> GCOC Stage one 2013 Decision, pp. 24-25.

<sup>&</sup>lt;sup>27</sup> Certain risk categories impact investors' expectations in the short-term while others are more long-term risk factors.



### 1 4.1.1 FEI's Business Risk Has Increased Significantly Since 2016

2 FEI's overall business risk is **significantly higher** in comparison to the 2016 Proceeding.

Mr. Coyne of Concentric's assessment that risk has increased since 2016 focusses primarily on what it calls the **Energy Transition**. Mr. Coyne describes how the transition from fossil fuels to cleaner forms of energy and increasing recognition of the impact of this transition on natural gas utilities by utility analysts and investors represents a transformation of long-term risk for the natural gas utility industry in general and FEI in particular that needs to be reflected in FEI's allowed ROE and capital structure. Mr. Coyne explains the Energy Transition risk as follows<sup>28</sup>:

- Reflecting and even leading the public policy environment, an increasing number of investors are prioritizing environmental, social and governance (ESG) considerations when making investment decisions. S&P and Moody's have incorporated ESG criteria into their credit rating analysis, while other investment firms and pension funds have adopted restrictions that prohibit them from owning equity or debt in companies seen as contributing to climate change.
- Investor ESG concerns are already affecting capital markets, as illustrated by S&P's analysis of the financing costs of North American oil and gas companies relative to their environmental impact.
- Multiple regulators have opened dockets investigating the role that gas LDCs will play during and after the Energy Transition and dozens of North American electric and gas utilities that collectively represent hundreds of billions of dollars in market capitalization have established "net-zero" targets by 2050 or earlier, with many interim emission reduction targets announced as well.
- The long-term viability and acceptability of alternative pathways for natural gas, such as
   investments in renewable natural gas or hydrogen, is uncertain and pursuing those
   pathways carries risk from an investors' perspective.
- 26

27 Second, while the Energy Transition risk is impacting all utilities, it varies considerably according 28 to public policy and jurisdiction. British Columbia is at the forefront of climate change initiatives, 29 and the use of fossil fuels for water heating and space heating is discouraged. More than two 30 dozen municipalities in FEI's service territory have declared climate emergencies, and there have 31 been proposals for making new buildings "net-zero energy ready" by 2032 in BC, both of which 32 could substantially affect FEI's volumetric growth prospects. Further, the 2021 Roadmap and the 33 related carbon reduction targets can have a fundamental impact on FEI's business. While FEI is 34 taking certain steps to position itself in response to this risk, and to provide future growth pathways 35 for FEI, these measures do not eliminate the substantial increase in uncertainty created by the 36 Energy Transition.<sup>29</sup>

<sup>&</sup>lt;sup>28</sup> Appendix C, pp. 80-88.

<sup>&</sup>lt;sup>29</sup> Appendix C, p. 95.



- 1 FEI's own evidence further substantiates these points. At present, while all of the risk categories
- 2 are important aspects of FEI's overall business risk, FEI highlights **political risk** and **regulatory**
- 3 **risk** in particular as the risk categories where changes can have the greatest potential to affect
- 4 FEI's ability to earn its return on, and of, invested capital.
- 5 FEI's own assessment of risk in Appendix A can be summarized as follows:
- Business Profile: FEI's primary market continues to be residential and commercial space and water heating end-uses. Despite some shift in load to the industrial and low carbon transportation sectors, which are both more volatile and more sensitive to economic conditions, FEI assesses its overall business profile risk to be similar to the 2016 Proceeding.
- Economic Conditions: The current Canadian economic environment continues to be dominated by uncertainty. FEI's assessment of major economic indicators indicates that BC is recovering from the pandemic lows. Nevertheless, the record high inflation rate, caused by government fiscal and monetary policy to boost economic growth and improve employment, and BC's challenges for long-term economic growth points to higher risk.
- Political: The increase in political risk is the most notable of all of the risk factors. 16 17 Government policies and regulations at all levels, as well as stakeholder interests, have a 18 significant impact on FEI's operations, competitiveness and ability to achieve its important initiatives. The overall thrust of climate change and energy policies is moving at a more 19 20 rapid pace than at the time of the 2016 Proceeding and the role of natural gas, or even 21 Renewable Gas, within the province's future energy landscape is unclear. While FEI 22 believes that gas infrastructure is an optimal tool to reach decarbonization goals, there is 23 a lack of awareness and acceptance of that role, given it is not directly discussed in net-24 zero climate goals and plans. This is apparent in the provincial government's recently 25 updated Roadmap which is anticipated to have a significant impact on FEI's competitive 26 and operational landscape with implications for customer rates and throughput. The 27 Roadmap introduced a GHGRS that establishes a greenhouse gas (GHG) reduction 28 obligation for natural gas utilities to reduce emissions from energy delivered to the 29 buildings and industrial sectors. Although the full extent of the impacts are not yet known, 30 the short timeframe by which to reduce GHG emissions to meet the GHGRS cap 31 represents substantial risk to FEI. FEI's risk is further compounded by the fast pace of 32 legislation and policies on electrification initiatives and BC Hydro's Electrification Plan<sup>30</sup>, 33 which increases competition from electricity. FEI assesses that its political risk has 34 increased significantly relative to the political risk environment at the time of the 2016 35 Proceeding.
- Indigenous Rights and Engagement: FEI has made Indigenous Rights and Engagement
   risk its own category (instead of being one of the risk factors under Political Risk) to reflect

<sup>&</sup>lt;sup>30</sup> <u>https://www.bchydro.com/content/dam/BCHydro/customer-portal/documents/corporate/electrification/Electrification-Plan.pdf.</u>



the increasing significance of these considerations for FEI's overall business. FEI defines 1 2 Indigenous Rights and Engagement risk as the potential for utility operations to be 3 negatively impacted by policy or legislation concerning Aboriginal rights and title or by 4 Indigenous groups intervening directly in the utility regulatory process or by asserting 5 Aboriginal rights and title. As provincial and federal governments navigate reconciliation 6 and implement the UN Declaration on the Rights of Indigenous Peoples, FEI has assumed 7 a higher level of business risk related to its relationship with Indigenous groups compared 8 to what it anticipated at the time of the 2016 Proceeding. Indigenous groups in BC are 9 diverse and the added uncertainty from outstanding claims to Aboriginal title and rights 10 further complicates the landscape within which FEI operates. Combined with regulatory 11 updates that have increased consultation requirements and included a focus on seeking 12 consensus and consent of Indigenous groups, as well as the risk of litigation in the 13 absence of consent, FEI faces an elevated risk of cost escalation, project delays and/or 14 projects being denied approval.

- 15 *Energy Prices:* The risk relating to energy prices is higher than what it was in the 2016 • Proceeding. Current market prices for natural gas are higher than in 2015 and forecasted 16 17 to increase as demand from power generation and liguefied natural gas (LNG), and a 18 potential decline in crude oil production, puts pressure on prices. Furthermore, market 19 prices are expected to remain volatile as a result of extreme weather events, changes in 20 natural gas demand for power markets in the region, and anticipated growth in demand to 21 supply the LNG export market. The volatility is greater than that presented in the 2016 22 Proceeding. In terms of competitiveness, the current price advantage of natural gas 23 versus electricity is not expected to be maintained, especially with recent rate 24 announcements from BC Hydro which will see electricity rates held fairly flat over the next 25 several years. Current and planned carbon tax rates will continue to negatively affect 26 natural gas price competitiveness relative to electricity. Further, the increasing share of 27 higher cost Renewable Gas in FEI's gas supply portfolio further contributes to FEI's higher 28 price competitiveness risk. The upfront and installation costs of natural gas-fired 29 equipment have increased relative to the cost data available in 2015 for that same 30 equipment. Moreover, new technology which supports the use of electricity, such as 31 electric heat pumps, that have a higher upfront and installation cost than natural gas-fired 32 equipment, are more cost competitive when government-provided incentives and rebates 33 are considered.
- 34 Demand/Market: Overall, since the 2016 Proceeding, FEI's demand/market risk has • 35 increased. Customers' energy choices are increasingly influenced by a desire to minimize negative environmental impacts. While Renewable Gas can be a relatively affordable 36 option to achieve this goal, the electric options such as high-efficiency heat pumps are 37 gaining faster and more widespread traction among customers and policy makers. FEI is 38 already experiencing the effects of this shift in its net customer additions, particularly in 39 40 the residential sector, where due to BC's high turnover rate, a large segment of its existing 41 customers homes may be torn down and rebuilt with electric-only options to meet more 42 stringent code requirements. Further, the gradual decline in the single-family dwelling



segment, where FEI has higher capture rates, in favour of multi-family dwellings and the downward trend in the share of natural gas in space heating and water heating applications continue to impact FEI's risk profile. FEI's new residential customers continue to have lower use per customer (UPC) than average residential customers do. This is somewhat offset by load growth in the more volatile and economically sensitive transportation and industrial sectors.

- 7 Energy Supply: Relative to 2015 levels, FEI's energy supply risk remains similar. 8 Availability and accessibility of natural gas supply to FEI's service territory remains 9 unchanged, as natural gas producers forecast production increases to meet growth in 10 demand for gas-fired power generation and LNG. In terms of delivery risk, FEI continues 11 to rely on a single system for a significant portion (currently 80 percent) of its gas 12 requirements, and the material supply risk that this represents was highlighted in 2018 13 when Enbridge's T-South pipeline (or Westcoast T-South system) ruptured. The 14 expansion of FEI's Renewable Gas supply adds new energy supply risk considerations 15 since the 2016 Proceeding, such as the risks of lower than expected supply volume, 16 competition from other purchasers, natural gas system readiness, and acceptance of non-17 local supply.
- 18 Operating: FEI's overall operating risk has increased since the 2016 Proceeding. • 19 Operating risk factors continue to include infrastructure integrity and time dependent 20 threats, and third party damages. Unexpected events also continue to contribute to FEI's 21 operating risks. Since 2015, events such as the COVID-19 pandemic and the Enbridge 22 T-South pipeline rupture, as well as more frequent extreme weather events, have 23 highlighted the ever-changing nature of unexpected events facing FEI. While these types 24 of operating risks have always been present, there is a growing recognition in the industry 25 of utility exposure to significant unforeseen events and the importance of resiliency. 26 Furthermore, unlike in the 2016 Proceeding, FEI now identifies its operating risks as including negative sentiment towards companies within the fossil-fuel industry which 27 28 increases the risk of protests and environmental activism against utility assets, challenges 29 recruiting top talent to a carbon-based industry and poses difficulty and delays in obtaining 30 capital project approvals or operating permits, and increases cybersecurity risk across 31 many aspects of its operations. FEI is also facing municipal challenges to its right to 32 construct and operate that were not previously experienced as frequently or at the level 33 FEI experiences today. All of these factors working together increase FEI's overall 34 operating risk.
- 35 Regulatory: The degree to which FEI, as a regulated public utility, is dependent on • 36 regulators for timely and objective approvals that directly impact its ability to earn a fair 37 return on and of capital is what is referred to in this section as regulatory risk. FEI has 38 assessed its overall regulatory risk as higher than what was assessed in FEI's 2016 39 Proceeding, with certain risk factors increasing and others being similar. The BCUC's 40 jurisdiction is confined to what is conferred by the UCA, but within that framework the 41 BCUC has significant discretion in the exercise of those powers. Regulatory discretion in 42 approving or denying a utility's applications is the main cause of regulatory uncertainty



1 which in itself gives rise to the risk that the allowed return does not accord with the Fair 2 Return Standard, that rates are set at a level that does not provide FEI with an opportunity 3 to earn its fair return, or that necessary investments are not approved. The underlying 4 BCUC regulatory framework remains the same, but there are new developments that merit 5 note. There is uncertainty caused by the level of regulatory support for the implementation 6 of certain initiatives and the BCUC's decision to consider a more generic approach to 7 deferral account financing treatment. The risk associated with regulatory lag and ultimate 8 approval of cost recovery has also increased since the 2016 Proceeding, with new 9 challenges in both BCUC and other regulatory processes. There are increased 10 requirements for stakeholder consultation, environmental reviews, Indigenous rights and 11 title and municipal operating challenges.

12 For a detailed review of FEI's business risk please refer to Appendix A.

#### 4.1.2 FBC's Business Risk is Similar to 2013 13

14 FBC's overall business risk is similar to what was assessed in the 2013 Proceeding. Despite slight increases in some of FBC's risk categories, these increases are not material enough to 15

significantly change FBC's overall risk profile and are otherwise offset by the above mentioned 16

17

Energy Transition and the provincial government's supportive policies to electrify the economy.

18 Concentric describes how FBC can expect to see some increase in load growth and customer 19 growth from the electrification movement, but that this will be relatively small since the majority of the electrification efforts are focused in regions and municipalities that are served by BC Hydro<sup>31</sup>. 20

21 FBC has, for consistency, performed its business risk analysis using a similar risk categorization 22 to the one that FEI is continuing to use (the FEI nomenclature / categorization differs slightly from 23 what FBC had used in the 2013 Proceeding), but overall captures the same risks. At present, 24 while all of the risk categories are important aspects of FBC's overall business risk, FBC 25 highlights regulatory risk and its business profile related risk (small size and its vertically 26 integrated nature), as the risk categories where changes can have the greatest potential to affect 27 FBC's ability to earn its return on, and of, invested capital. FBC's assessment of risk can be 28 summarized as follows:

29 Business Profile: FBC is a fully integrated electric utility that owns and operates 30 hydroelectric generating plants, high voltage transmission lines, and a network of 31 distribution assets in the southern interior of BC. FBC's structure as a fully-integrated 32 electric utility contributes to a higher risk profile than for a distribution-only utility of a similar 33 size, a situation exacerbated by a less diverse and relatively small customer base. 34 concentrated in a small, but geographically diverse service area. 25 percent of revenue 35 and more than 30 percent of load is attributable to two customer classes, Industrial and 36 Wholesale, a significant number of which have the ability to receive service from alternate 37 sources of supply with only limited notice. Despite the slight increase in FBC's customer

<sup>&</sup>lt;sup>31</sup> Appendix C, pp. 130-131.



- profile risk due to a higher share of the Industrial sector in the company's load and revenue
   profile, FBC has assessed the overall business profile risk to be similar to what was
   assessed in the 2013 Proceeding.
- Economic Conditions: The current Canadian economic environment continues to be 4 5 dominated by uncertainty. FBC's assessment of major economic indicators indicates that 6 BC is recovering from the pandemic lows. Nevertheless, the record high inflation rate, 7 caused by government fiscal and monetary policy to boost economic growth and improve 8 employment, and BC's challenges for long-term economic growth points to higher risk. In 9 addition, compared to other larger utilities, FBC's smaller size and dependence on highly 10 cyclical industrial load in one or two sectors contribute to FBC's higher economic related 11 risk.
- 12 Political Risk: The government push for electrification of the BC economy is providing 13 FBC with both opportunities and challenges. Namely, government policies to electrify the 14 building and transportation sectors can increase FBC's market share and load; however, 15 rapid policy-driven customer migration from fossil fuels to electricity presents operational 16 challenges for FBC which has limited resources in a small geographical service territory, 17 and government's ability to subsidize BC Hydro customers is not a path open to FBC. 18 Overall, however, FBC assesses that its political risk is lower than what was assessed in 19 the 2013 Proceeding.
- 20 Indigenous Rights and Engagement: FBC has made Indigenous Rights and Engagement 21 risk its own category (instead of being one of the risk factors under Political Risk) to reflect the increasing significance of these considerations for FBC's overall business. FBC 22 23 defines Indigenous Rights and Engagement risk as the potential for utility operations to be 24 negatively impacted by policy or legislation concerning Aboriginal rights and title or by 25 Indigenous groups intervening directly in the utility regulatory process or by asserting 26 Aboriginal rights and title. As provincial and federal governments navigate reconciliation 27 and implement the UN Declaration on the Rights of Indigenous Peoples, FBC has 28 assumed a higher level of business risk related to its relationship with Indigenous groups 29 compared to what it anticipated at the time of the 2013 Proceeding. Indigenous groups in 30 BC are diverse and the added uncertainty from outstanding claims to Aboriginal title and 31 rights further complicates the landscape within which FBC operates. Combined with 32 regulatory updates that have increased consultation requirements and included a focus on seeking consensus and consent of Indigenous groups, as well as the risk of litigation 33 34 in the absence of consent, FBC faces an elevated risk of cost escalation, project delays 35 and/or projects being denied approval.
- Energy Price: The analysis of energy price risk focuses on power supply factors placing upward pressure on FBC's rates and on the competitiveness of FBC's rates. The factors influencing the risk related to FBC's power supply costs are higher compared to 2013. While the risks related to the BC Hydro Power Purchase Agreement rate increases remain similar, market price volatility and Brilliant Power Purchase Agreement contract rate risk have increased. Power supply costs impact the level of utility rates, which can influence



consumers' energy choices. Specifically, higher electricity rates in FBC's service territory 1 2 relative to other electricity providers can hinder FBC's ability to attract new customers 3 (particularly new Industrial and larger commercial customers). In addition, higher electricity 4 rates can discourage residential customers from using electricity for space heating and 5 water heating which can affect FBC's market share and use per customer. Further, FBC's 6 rate competitiveness risk compared to BC Hydro is similar to the 2013 levels but is trending 7 higher. As compared to 2013, FBC's rate competitiveness relative to natural gas is similar; 8 however, given expected increases to gas and carbon tax rates, FBC expects that the 9 trend that has emerged in recent years where its rate competitiveness relative to natural 10 gas is improving will continue in coming years. FBC assesses that its overall rate 11 competitiveness risk is similar to what was assessed in the 2013 Proceeding.

- 12 Demand/Market: Emerging technologies can provide challenges for FBC. In particular, alternative sources of energy, such as home solar generation, can reduce the demand on 13 14 FBC as an electricity provider, while new load requirements, such as EV charging, can 15 conversely increase the load requirements of FBC. Both situations create potential risks 16 for higher costs and to grid integrity and managing the timing of load on the system to 17 avoid peak demand impacts. Also, FBC continues to face demand risk in its Wholesale 18 and Industrial customer segments. This is because FBC's Wholesale and some Industrial 19 customers are able to take service from competing utilities within the province, build 20 generation to serve some or all of their load or purchase electricity from the open market. 21 BC Hydro, whose Industrial and Wholesale rates are competitive with FBC's, continues to 22 be an alternative for FBC's eligible customers. FBC faces risk associated with being highly 23 dependent on load concentration in only two industries - forestry and cryptocurrency 24 mining. The growing share of Industrial load in FBC's load profile contributes to FBC's 25 higher risk since Industrial load is more volatile. Compared to 2013, FBC's residential and 26 commercial UPC values have been on a downward trajectory while Industrial UPC has 27 increased. FBC expects an increase in its electricity thermal market share relative to 28 natural gas and other fuel sources over the longer term as heat pump penetration 29 increases, thereby reducing this aspect of FBC's market share risk from 2013 and current 30 levels. Overall, FBC's demand risk is similar to what was assessed in the 2013 Proceeding. 31
- 32 Energy Supply: The majority of FBC's supply risk has been mitigated through long-term, firm power purchase agreements; although, as these agreements expire, there is no 33 34 guarantee that FBC will be able to renew them, or that they could be renewed at a similar cost. Furthermore, there is risk associated with FBC accessing supply from the wholesale 35 market. FBC's access to the wholesale market is dependent on FBC's access to Teck's 36 37 Line 71. FBC has no transmission facilities that connect directly with markets outside of BC, and is dependent on this availability of third-party transmission capacity to serve its 38 39 customers' growing demand and the potential for increased likelihood of severe weather 40 events such as the June 2021 heat dome and the new all-time peak demand in December 41 2021. In addition, FBC-owned generating plants are located within the Kootenay region, 42 while most of FBC's customer load requirements are in the Okanagan. Failure of a plant



generating unit would result in FBC needing to acquire replacement power which may not be available due to either lack of available supply or lack of available transmission. In addition, the replacement power, if acquired, could be at a significantly increased cost on the open market. Overall, FBC's risk in terms of energy supply is similar to 2013.

- 5 The primary operating risks associated with FBC's generation and • Operating: 6 infrastructure assets are related to the age and cost to maintain and upgrade these assets. 7 FBC is also exposed to operating risk related to the requirement that the generating units 8 always be available to run for FBC to receive its capacity and energy entitlements as 9 provided for under the Canal Plant Agreement. Failure of one or more of the generating 10 units owned by FBC could potentially result in significant power supply costs to replace 11 the lost entitlements. FBC is exposed to additional risk from its transmission and 12 distribution assets which are primarily above ground, and the potential for increases in unpredictable extreme weather events, such as wildfires and flooding, to compromise the 13 14 integrity of these assets. Other unexpected events, such as the COVID-19 pandemic, 15 disrupt supply chains and cause delays in FBC's capital work which impacts its ability to 16 maintain and operate its system. Additionally, FBC has experienced an increase in 17 incidences of cyber-attacks and expects to see increased resistance to projects, which will 18 lead to higher risks to execute projects on time at the lowest reasonable cost. Therefore, 19 FBC assesses its operating risk as being higher than in 2013.
- 20 Regulatory: The degree to which FBC, as a regulated public utility, is dependent on 21 regulators for timely and objective approvals that directly impact its ability to earn a fair 22 return on and of capital is what is referred to in this section as regulatory risk. FBC has 23 assessed its overall regulatory risk as higher than what was assessed in FBC's 2013 24 Proceeding, with certain risk factors increasing and others being similar. The BCUC's 25 jurisdiction is confined to what is conferred by the UCA, but within that framework the 26 BCUC has significant discretion in the exercise of those powers. Regulatory discretion in 27 approving or denying a utility's applications is the main cause of regulatory uncertainty 28 which in itself gives rise to the risk that the allowed return does not accord with the Fair 29 Return Standard, that rates are set at a level that does not provide FBC with an opportunity 30 to earn its fair return, or that necessary investments are not approved. The underlying 31 regulatory framework remains the same, but there are new developments that merit note. 32 There is uncertainty caused by the BCUC's decision to consider a more generic approach 33 to deferral account financing treatment. The risk associated with regulatory lag and 34 ultimate approval of cost recovery has also increased since the 2013 Proceeding when considering increased requirements for stakeholder consultation, environmental reviews, 35 and Indigenous rights and title. 36
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<sup>38</sup> A detailed review of FBC's business risk is provided in the Appendix B.



## 1 5. PROPOSED ROE

FortisBC retained Mr. Coyne of Concentric to provide an independent expert opinion on FEI's and
FBC's cost of capital. Mr. Coyne's evidence can be found as Appendix C to this Application. Mr.
Coyne's methodology for estimating the appropriate ROE is consistent with the key elements of
how the BCUC has previously reached its ROE determinations, specifically the use of multiple
methodologies and the determination of utility proxy groups on which the analyses are performed.

# 7 5.1 CONCENTRIC ROE METHODOLOGY TRACKS PRIOR BCUC 8 DETERMINATIONS

9 In prior proceedings, the BCUC has supported the application of DCF and CAPM as the main
10 methodologies to calculate a utility's cost of equity. For instance, in the 2013 Decision, the BCUC
11 gave equal weights to the DCF and CAPM methodologies:

12 The Panel finds that the two most compelling frameworks for assessing the cost 13 of equity are the DCF model and the CAPM. These models have well understood 14 theoretical bases and explicitly recognize the opportunity cost of capital. 15 Accordingly, these two models are given equal weight in determining the allowed 16 ROE.<sup>32</sup>

Further, in the 2016 Proceeding, the BCUC reiterated its support for using multiple tests tocorroborate ROE determinations:

19 The Panel notes that while there are some differing perspectives among the 20 experts and parties, their views are generally consistent with the Brattle Group 21 Report's finding that decisions should be informed by use of multiple financial 22 models and other indicators of investor expectations where appropriate. The Panel 23 agrees it should consider the "totality of information resulting from applying multiple 24 tests." The Panel also agrees it should consider all of the information from the 25 application of the models presented, as well as other indicators of the fair ROE 26 and should apply its own judgment to determine the appropriate ROE.<sup>33</sup>

Similar to the BCUC's approach in past decisions, Mr. Coyne's view is that more than one test
should be used to determine the fair ROE. He uses both DCF and CAPM methodologies, with
alternative inputs and model specifications, to calculate a range for ROE estimation. In addition,
he uses results of the Risk Premium approach to test the reasonableness of his DCF and CAPM
model results.

The BCUC has also consistently supported the use of a U.S. proxy group of comparable companies' data when Canadian data do not exist in significant quantity or quality, or as a supplement when Canadian data gives unreliable results. For instance, in the 2016 Decision, the

<sup>&</sup>lt;sup>32</sup> GCOC Stage 1 Decision, p. 56.

<sup>&</sup>lt;sup>33</sup> 2016 Decision, p. 47.



BCUC panel found that the use of a U.S. proxy group is appropriate and that the companies in the U.S. proxy group have some more comparable risk characteristics with FEI than the companies in the Canadian proxy group. The following passages are excerpts from the BCUC's discussion [bold in original]:

- 5 The Panel finds the use of US proxy companies as comparators to assist in the 6 determination of what is the appropriate rate of return for FEI in terms of meeting 7 the Fair Return Standard is relevant.
- 8 ...

9 The Panel finds that the screening criteria used by Mr. Covne to choose his US 10 proxy companies are reasonable for consideration in assessing growth rate in the DCF model and capital structure. The companies chosen are found by the Panel 11 12 to have business characteristics somewhat but not directly comparable to FEI. The 13 Panel also found the detailed information provided by Mr. Coyne on each proxy 14 company to be useful in its determinations. The Panel also finds that the eight US 15 proxy companies chosen by Dr. Booth, although not chosen with the same rigour as employed by Mr. Coyne, includes six of the companies used by Mr. Coyne, and 16 17 is also a reasonable sample.

18

. . .

19 The lack of stand-alone publically traded natural gas distribution companies in 20 Canada results in the reliance on data from holding companies whose interests 21 include significant assets outside of the natural gas distribution business. The 22 difference in corporate make-up of these proxy companies compared to FEI 23 requires applying considerable judgment to any calculations flowing from this data. 24 The Panel finds the differences in the business circumstances of the 25 Canadian proxy companies to FEI are significant. In the Panel's view, this is 26 evident from the proportion of the proxy companies activities in non-regulated 27 activities or in regulated activities not related to natural gas distribution.

28 In addition, it is the Panel's view that the evidence with respect to ROE and the 29 equity component of utilities in other jurisdictions and the calculations derived from 30 proxy companies can help inform our decision, but are insufficient, in and of 31 themselves, to define it. As is reflected in the sections in this decision dealing with 32 FEI's risk and the assessment of the models used to calculate a fair ROE, the 33 Panel has needed to weigh the implications of the deficiencies of the Canadian 34 proxy companies in terms of differences in business functions compared to FEI 35 and the deficiencies of the US proxy companies in terms of their different 36 regulatory environments. 34

<sup>&</sup>lt;sup>34</sup> 2016 Decision, pp. 52-53.



- Consistent with the BCUC's findings above, Mr. Coyne's expert view is that the development of a 1
- 2 proxy group comprised entirely of Canadian regulated gas or electric utilities is challenged by the
- 3 small number of publicly-traded utilities in Canada and the fact that many of those Canadian
- 4 companies derive a significant percentage of revenues and net income from non-regulated operations. He therefore relies on a mix of Canadian, U.S. and North American proxy groups for
- 5
- 6 his models but places greater weight on the results for U.S. proxy groups.<sup>35</sup>

#### 5.2 7 **PROPOSED ROE FOR FEI**

8 The various ROE estimation models and proxy groups used by Mr. Coyne produce a range of 9 results for the gas proxy group companies from 9.53 percent to 11.61 percent with an average of 10 all methods calculated at 10.6 percent. Giving more weight to the U.S. Gas Utilities proxy group

11 and considering the BCUC's findings in prior cost of capital decisions regarding the multi-Stage

12 DCF and CAPM models, Concentric concludes that an appropriate ROE for FEI is 10.1 percent

- 13 (including the standard 50 bps flotation costs previously approved by the BCUC and used by a
- 14 majority of Canadian regulators).

15

	Canadian Regulated Utilities <sup>36</sup>	US Gas Utilities	North American Utilities - Gas	Average
CAPM	10.68%	10.67%	11.05%	10.8%
Constant Growth DCF	11.61%	10.39%	10.99%	11.0%
Multi-Stage DCF	10.28%	9.53%	10.05%	10.0%
Risk Premium		9.97%	9.97%	10.0%
Average	10.9%	10.3%	10.7%	10.6%
Avg CAPM and Multi-Stage DCF	10.5%	10.1%	10.6%	10.4%

Table 5-1: Summary of Results of Concentric's evidence for FEI

16

#### 5.3 **PROPOSED ROE FOR FBC** 17

The various ROE estimation models and proxy groups used by Mr. Covne produce a range of 18 19 results for the proxy group companies from 8.82 percent to 11.61 percent with average of all 20 methods calculated at 10.3 percent. Giving more weight to the U.S. electric Utilities proxy group 21 and considering the BCUC's findings in prior cost of capital decisions regarding the multi-Stage 22 DCF and CAPM models, Concentric concludes that an appropriate ROE for FBC is 10.0 percent

<sup>&</sup>lt;sup>35</sup> Appendix C, pp. 37-38.

<sup>&</sup>lt;sup>36</sup> Risk Premium analysis is only based on authorized returns for U.S. gas distributors and U.S. electric utilities because there are not a sufficient number of Canadian ROE decisions to develop a statistically-meaningful regression analysis.



- 1 (including the standard 50 bps flotation costs previously approved by the BCUC and used by
- 2 majority of Canadian regulators).
- 3

Table 5-2: Summary of Results of Concentric's Evidence for FBC

	Canadian Regulated Utilities <sup>37</sup>	US Electric Utilities	North American Utilities- Electric	Average
САРМ	10.68%	11.12%	10.80%	10.9%
Constant Growth DCF	11.61%	9.57%	9.87%	10.4%
Multi-Stage DCF	10.28%	8.82%	9.07%	9.4%
Risk Premium		10.01%	10.01%	10.0%
Average	10.9%	10.0%	10.0%	10.3%
Avg CAPM and Multi-Stage DCF	10.5%	10.0%	9.9%	10.2%

<sup>4</sup> 

<sup>&</sup>lt;sup>37</sup> Ibid.



### 1 6. CAPITAL STRUCTURE

2 Utilities are large consumers of both equity and debt capital. Their fundamentals are watched 3 carefully and scrutinized thoroughly by the financial analyst community for equity investors and 4 by credit rating agencies and debt analysts for debt holders. As explained in Mr. Coyne's 5 evidence, capital structure and the cost of common equity are closely linked in determining the 6 Fair Return for regulated utilities<sup>38</sup>. Other factors being equal, firms with lower common equity 7 ratios require higher rates of return to compensate for the additional financial risk in the form of 8 financial leverage which their shareholders are exposed to. As such, both equity and debt 9 investors are sensitive to the proportion of common equity in a utility's capital structure and the 10 cash generated by the allowed return as they provide assurance to creditors and shareholders 11 alike that utility will be able to meet its obligations regardless of business cycle and capital market 12 environment.

As discussed earlier, the Energy Transition risk is a significant long-term risk to natural gas utilities that is increasingly being recognized by utility analysts and investors. FEI in particular is at the forefront of this Energy Transition. FEI's own analysis also indicates that its long-term business risk, particularly political risk, has increased significantly and at a faster pace than what was anticipated in prior cost of capital proceedings. As such, FEI submits that its common equity ratio needs to increase to reflect this change in long-term risk.

The analysis of FBC's long-term risk, on the other hand, indicates that FBC's capital structure should remain unchanged. This is because, while there have been increases in some of FBC's risk categories, these increases are not material enough to justify a material increase in FBC's common equity thickness and are otherwise offset by the above mentioned Energy Transition.

23 In addition to the business risk, financial risk and credit ratings determine the FortisBC utilities' 24 ability to attract capital and maintain its financial strength. One of the primary determinants of 25 FEI's and FBC's credit ratings is financial metrics, which are currently viewed by the rating 26 agencies as being weak for the respective ratings, with one of the key financial metrics critically 27 close to a rating downgrade threshold for each of the utilities. The main factor contributing to FEI's 28 and FBC's weak financial metrics are the low allowed equity component of their capital structure 29 and low return on equity.<sup>39</sup> As further discussed below, most of FEI's financial metrics place FEI 30 in the BBB credit rating category while most of FBC's financial metrics are consistent with non-31 investment grade credit rating. Maintaining the current credit ratings for both FEI and FBC is of 32 utmost importance, as these ratings impact FEI's and FBC's ability to issue debt on reasonable 33 terms and pricing in all market conditions. This is particularly important for FEI currently, due to 34 its large capital expenditure requirements, although FBC is also a regular debt issuer. An increase in pricing driven by credit rating downgrades would have a significant financial impact on FortisBC 35 36 and their customers.

<sup>&</sup>lt;sup>38</sup> Appendix C, p. 147.

<sup>&</sup>lt;sup>39</sup> Moody's Credit Rating Reports for FEI and FBC dated November 25, 2021.



- 1 Additionally, ESG-related risks are having a significant impact on FEI not only from a business
- 2 risk perspective but also from a financial risk and credit perspective, and are putting additional
- strain on the credit rating. Another factor that is contributing to financial risk for the FortisBC
   utilities is proposed restrictions on interest deductibility, a risk that did not exist at the time of the
- 5 2013 and 2016 Proceedings.
- To reflect FEI's and FBC's long-term risks and to support maintaining current credit ratings,
  FortisBC respectfully requests that:
- the equity component of FEI's capital structure should be increased from the current 38.5
   percent to 45 percent; and
- the equity component of FBC's capital structure should be maintained at a minimum 40 percent.
- 12

This request is supported by Mr. Coyne who conducted a comparative risk analysis of FEI's and
FBC's risk with the Canadian and U.S. proxy groups and reviewed FEI's and FBC's financial
metrics.

16 In Mr. Coyne's expert opinion, FEI's proposed common equity ratio of 45 percent is reasonable. 17 if not conservative, given the business and financial risks of the company. The proposed equity 18 ratio of 45 percent recognizes its increased risks, in particular those associated with the Energy 19 Transition. The recommended increase in equity ratio also recognizes the greater business risk 20 of FEI relative to its Canadian investor-owned gas utility peer companies.<sup>40</sup> With respect to the 21 U.S. gas proxy group, FEI has substantially greater financial risk and comparable to higher 22 business risk. Yet, FEI's proposed equity ratio would fall significantly below the U.S. gas proxy 23 company average debt/capital ratio of 50 to 52 percent<sup>41</sup>. A common equity ratio of 45 percent 24 would better align with the company's increasing risk profile and strengthen FEI's debt metrics, 25 while also narrowing the gap between FEI and its U.S. comparators with whom Canadian utilities 26 like FEI compete for capital.

27 In terms of FBC, Mr. Coyne concludes that FBC's deemed equity ratio should be maintained at 28 40 percent at a minimum, and that the smaller size of FBC relative to the proxy group companies 29 in both Canada and the U.S. could justify an increase in the company's deemed equity ratio. This 30 aligns with Mr. Coyne's conclusion that FBC's business risk is comparable to its Canadian peers 31 and comparable to slightly lower compared to the U.S. electric utility proxy group at the operating 32 utility level. Further, in Mr. Covne's expert opinion the financial risk of FBC with 40 percent 33 common equity is slightly greater than the Canadian proxy group and markedly greater than the 34 U.S. electric utility proxy group, based on an analysis of deemed equity ratios and key cash flow

<sup>&</sup>lt;sup>40</sup> Mr. Coyne concludes that FEI has higher overall business risk than Enbridge Gas and ATCO Gas, but somewhat lower business risk than Energir although FEI's business risk is converging with Energir due to the greater impact of the Energy Transition on FEI.

<sup>&</sup>lt;sup>41</sup> Appendix C, p. 149.



and interest coverage metrics<sup>42</sup>. For more information regarding Mr. Coyne's evidence on this
 matter please refer to Appendix C.

- In conclusion, in conjunction with the proposed ROE for both utilities, these changes will address
   the requirements of the Fair Return Standard from a capital structure perspective, ensuring that
   financial integrity and flexibility is maintained as well as allowing FEI and FBC to attract capital on
   a comparable basis with their North American peers. They will also adequately reflect FortisBC's
- 7 increased business risk and alleviate pressure on FEI's and FBC's financial metrics.

# 8 6.1 BUSINESS RISK ASSESSMENT SUPPORTS REQUESTED CAPITAL 9 STRUCTURES

Business risk, along with financial risk, should be reflected in the capital structure of the utility in consideration of investors' ability to recover their invested capital. Business risk is inherent in a company's operations regardless of how it is financed while financial risk is a function of the extent to which a company incurs fixed obligations in the financing of its operations.<sup>43</sup> The BCUC has consistently referred to the changes in a company's business risk to justify its authorized capital structure. Regulators in jurisdictions such as Alberta, Ontario and Quebec similarly consider the

- 16 business risk in their capital structure decision-making process<sup>44</sup>.
- In general, there is a positive correlation between business risk and cost of capital, i.e., the higher
  the business risk, the higher return and/or common equity thickness required by investors and,
  therefore, the higher the cost of capital. In particular and as confirmed in the BCUC's 2013
- 20 Decision, changes in long-term risk should be primarily reflected in capital structure:

21 Ms. McShane comments that both the capital structure and the ROE incorporate elements 22 of long-term and short-term risks (Exhibit B1-9-6, McShane Evidence, Appendix F, p. 39). 23 The Commission Panel does not disagree with Ms. McShane but notes that long-term risk, 24 which Ms. McShane outlines as being of primary importance to the utility investor, is 25 primarily reflected in the equity structure determined for FEI considering the investors' 26 ability to recover their invested capital. This is because if the underlying risk decreases, 27 more debt can be issued; if it increases, the common equity ratio would increase resulting 28 in less debt.45

FortisBC agrees with the BCUC's above mentioned statement and applies the same principle to its capital structure proposals for FEI and FBC.

<sup>&</sup>lt;sup>42</sup> Appendix C, pp. 145-146.

<sup>&</sup>lt;sup>43</sup> 2016 Decision, p. 9.

<sup>&</sup>lt;sup>44</sup> Exhibit A2-3, Dr. Lesser's Final Report, pp. 102-103, 111, 114.

<sup>&</sup>lt;sup>45</sup> 2013 Decision, p. 24.



## 1 6.1.1 BCUC's Previous Reasoning Now Supports Thicker Equity for FEI

The BCUC's consideration of FEI's evolving business risk is notable because the political and energy price risk factors on which the BCUC placed significant reliance in the 2013 Decision when reducing FEI's common equity thickness to the current 38.5 percent have now reversed. In fact, FEI's overall business risk today is much higher than at the time of the 2009 Decision when FEI's common equity thickness was set at 40.0 percent.

In FEI's 2009 cost of capital proceeding (2009 Proceeding), the BCUC increased FEI's authorized
 common equity thickness from 35 percent to 40 percent. The main reason for this change was
 explained as follows:

10 The Commission Panel agrees with Terasen that the introduction of climate 11 change legislation by the provincial government has created a level of uncertainty 12 that did not exist in 2005 and that the change in government policy will guite 13 probably cause potential customers not to opt for natural gas and persuade 14 potential retrofitters to opt for electricity. In addition, the Commission Panel 15 considers that the Nyboer Report presents a scenario that did not exist in 2005 16 under which the three Terasen utilities might not earn a return of their capital. The 17 scenario that now exists is described in a publication of a reputable consulting group which appears to have the attention of policymakers ... The Commission 18 19 Panel considers that TGI's business risk has increased since 2005. In the 20 Commission Panel's opinion the additional risk suggests an equity ratio for TGI of 21 40 percent.46

Then, in the 2013 Decision, the BCUC panel decreased FEI's allowed equity thickness to 38.5
 percent stating that the political and energy price risks described in the 2009 Proceeding did not
 materialize to the extent expected:

The Commission Panel does not consider the current environment to be as threatening to FEI as it was perceived to be in the period leading to the 2009 Decision. As BCPSO points out, there are no plans to raise the carbon tax beyond the current \$1.50 per GJ level and as AMPC/CEC reports, the Western Climate Initiative has collapsed and emission trading has become a dormant issue. These all reflect a less threatening current environment and with it, a lessening of risk associated with provincial government climate and energy policies.<sup>47</sup>

The Panel has found that reductions are warranted in long-term risk associated with provincial government climate and energy policies as well as the competitive position of natural gas relative to electricity. Both of these risk areas were rated by the FBCU as category 2 risks. To offset these there is not a single area where the Panel has been persuaded the level of long-term risk has been demonstrated to have increased materially since 2009. The Commission Panel notes that the 2009

<sup>&</sup>lt;sup>46</sup> 2009 Decision, p. 37.

<sup>&</sup>lt;sup>47</sup> 2013 Decision, p. 27.



Decision put considerable emphasis on the uncertainty created by climate change legislation that did not exist during the previous cost of capital proceeding. In addition, the 2009 Decision acknowledged the change in the competitive position of natural gas versus electricity but concluded that there were too many variables at play for this to be considered permanent. The Panel's finding that there is lower long-term risk related to both of these factors since 2009 is indicative of a reduction in overall risk to FEI which needs to be reflected in the common equity ratio.<sup>48</sup>

8 The BCUC decision in the 2016 Proceeding to keep FEI's capital structure unchanged reflected 9 the BCUC's view that FEI's risk was not materially different from what it had considered in the 10 2013 Proceeding<sup>49</sup>. It stated:

11 The parties generally agree there is little change with respect to the level of risk in a number of identified risk areas as compared to the 2013 GCOC Decision. The 12 13 parties also appear to be in general agreement that there is little change in 14 operating risk, market shift risk and the risk associated with economic conditions 15 since the last decision. In addition, none of the parties take issue with the position taken by FEI that the amalgamation of FEW and FEVI with FEI has not resulted in 16 any material risk change for the amalgamated Company and the combined entity's 17 18 business profile remains much the same.

19 However, there were a number of important areas where the parties were in 20 disagreement which were more closely examined by the Panel. Probably most 21 contentious among these was with political risk where the Panel determined there 22 was a slight increase in risk primarily due to developments at municipal and 23 provincial government levels. Under the same political risk category, the Panel was 24 not persuaded the evidence on recent jurisprudence concerning First Nations 25 would have a material effect on FEI's ability to earn a return of on and of its capital. 26 Offsetting the increase in political risk to some degree was the Panel's 27 determination that energy price risk has decreased somewhat. As noted in Section 28 4.2, the Panel finds there was little change in regulatory risk and only a slight 29 increase in energy supply risk. Taking these factors together and weighing them 30 accordingly, the Panel considers there to be insufficient justification for awarding 31 either a higher or lower equity ratio at this time.

There are a number of factors as explained in FEI's risk analysis evidence (Appendix A) that indicate that compared to the 2016 Proceeding, FEI's business risk – including the political risk and risk associated with Indigenous rights and engagement noted in the passage quoted above – has increased significantly. Moreover, FEI's overall risk is much higher than had been apparent in 2009 when the BCUC had increased FEI's common equity ratio to 40 percent.

<sup>&</sup>lt;sup>48</sup> 2013 Decision, pp. 53-54.

<sup>&</sup>lt;sup>49</sup> 2016 Decision, p. 44.



# 6.1.2 FBC's Similar Business Risk Relative to 2013 Supports Maintaining Equity Thickness

3 In the case of FBC, the 2014 Stage 2 GCOC decision also linked changes in business and 4 financial risks (relative to the benchmark) and the authorized capital structure:

- 5 The Commission Panel agrees with Ms. McShane's overall assessment that FBC
- 6 faces a higher level of business risk than the Benchmark. This higher level of risk
- 7 is the basis for our support of the recommendation of maintaining the equity ratio
- 8 at its present level of 40 percent.<sup>50</sup>
- 9 Given that in this proceeding, the BCUC directed FortisBC to file evidence for each of FEI and
- 10 FBC, the main focus of FBC's business risk assessment in this filing is to compare FBC's risk with
- 11 its own risk in 2013 rather than relative to FEI. FBC assesses that despite increased risk in some
- 12 risk categories, FBC's overall business risk today is similar to what it was in the 2013 Proceeding
- 13 (the last time FBC's business risk was reviewed as part of a cost of capital proceeding).

## 14 6.2 CREDIT RATINGS AND PROPOSED CAPITAL STRUCTURES

As discussed below, maintaining the current credit ratings of the FortisBC utilities carries with it
 important benefits, notably in terms of the cost of borrowing and access to capital markets.
 Previous BCUC decisions have recognized the importance of credit ratings in the determination
 of capital structure.

19 One of the primary determinants of FEI's and FBC's credit ratings is financial metrics, which are 20 currently viewed by the rating agencies as being below the range acceptable for their respective 21 ratings. The lower financial metrics are due to FEI and FBC's common equity ratio and allowed 22 ROE, which are at the lower end of the range of comparable utilities. An increase in FEI's common 23 equity component will improve FEI's financial metrics, demonstrate regulatory support in the face 24 of the increasing ESG risks discussed in section 6.3, and support FEI maintaining its A-category 25 credit rating. Similarly, maintaining FBC's current equity thickness would alleviate the risk of the 26 utility being downgraded.

## 27 6.2.1 The Approach of Rating Agencies

Securities issued by FEI and FBC are rated by DBRS Morningstar (DBRS) and Moody's Investors Service (Moody's). DBRS rates debt instruments by rating categories ranging from AAA which represents the highest quality of securities, to D which represents the lowest quality of securities rated. Moody's rates debt instruments by rating categories ranging from Aaa which represents the highest quality of securities to C which represents the lowest quality of rated securities. Table 6-1 below presents Moody's and DBRS' rating categories for long-term debt.

<sup>&</sup>lt;sup>50</sup> 2013 GCOC Stage 2 Decision, p. 87.



#### 1

#### Table 6-1: Moody's and DBRS' Rating Categories for Long-term Debt Instruments

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

### 2

3 The FortisBC utilities are rated by both Moody's and DBRS but have traditionally received lower

4 credit ratings from Moody's. In cases where credit ratings diverge (a "split rating") between

5 different rating agencies, the investor focus is typically on the lower rating<sup>51</sup>. A rating downgrade

6 by Moody's would therefore have a more significant impact on FortisBC's utility credit risk from a

7 lender perspective and, as such, FortisBC focuses on Moody's rating methodology and current

8 credit ratings in this Proceeding.

9 Moody's rating methodology for electric and natural gas utilities is primarily based on a rating grid

10 comprised of four key factors. Table 6-2 below provides a description of Moody's rating factors

11 and sub-factors as defined for regulated utilities.

<sup>&</sup>lt;sup>51</sup> The impact of split rating on risk premium has been studied in a 1997 study by R. Cantor et al. titled "Split-rating and the Pricing of Credit Risk" concluded that credit risk pricing "*in the investment-grade sector is more conservative placing more weight on the lower rating than the higher rating*" and that "*the market prices split rated bonds between the yield implied by the lower rating and that implied by the average rating*".



Broad Rating Factor	Factor Weighting	Rating Sub-factor	Sub-factor weighting
Regulatory Framework	25 %	Legislative and judicial underpinnings of regulatory framework Consistency and predictability of regulation	12.5 % 12.5%
Ability to recover costs and earn returns	25 %	Timeliness of recovery of operating and capital costs Sufficiency of rates and returns	12.5 % 12.5 %
Diversification	10 %	Market Position <sup>1</sup> Generation and Fuel Diversity <sup>2</sup>	5 % 5 %
Financial Strength	40 %	CFO Pre-WC <sup>52</sup> + Interest / Interest CFO Pre-WC / Debt CFO Pre-WC – Dividends / Debt Debt / Capitalization	7.5 % 15 % 10 % 7.5 %

#### Table 6-2: Moody's Rating Grid for Regulated Utilities

2 Source: Moody's Rating Methodology for Regulated Electric and Gas Utilities, June 2017.

### 3 <u>Notes to Table:</u>

1

- 4 <sup>1</sup> 10% weight for issuers that lack generation.
- 5 <sup>2</sup> 0% weight for issuers that lack generation.
- 6 The factors in the rating grid do not constitute an exhaustive treatment of all of the considerations
- 7 for ratings of companies in the regulated electric and gas utility sector. Other considerations that
- 8 may play a part in a rating process include items such as ownership, management, corporate
- 9 legal structure or governance. Moody's considers these and other qualitative considerations that
- 10 do not lend themselves to a transparent presentation in a scorecard format. Therefore, the grid-
- 11 indicated ratings do not always match the actual Moody's rating of each company.

# 6.2.2 FEI's Current Moody's Credit Rating Is Only One Notch Above Baa/BBB Category and Metrics Are Marginal

14 The ratings assigned to securities issued by FEI are reviewed by credit rating agencies on an

15 ongoing basis. FEI has been assigned the following credit ratings by Moody's and DBRS:

16

### Table 6-3: FEI Credit Ratings

FEI Credit Ratings	Moody's	DBRS
Unsecured long-term debt	A3	А

17

18 FEI carries an A3 rating from Moody's, which is the lowest level of the A category and just one

- 19 notch above a Baa1 rating. A Moody's downgrade would put FEI into the Baa/BBB category. This
- 20 would result in one debt rating in the A category (DBRS) and one rating in the Baa/BBB category
- 21 (Moody's). Investors typically focus on the lower rating and as such, the predominant weight on

<sup>&</sup>lt;sup>52</sup> CFO Pre-WC stands for Cash Flow from Operations pre Working Capital.



- the lower Moody's rating would result in FEI being considered principally a BBB rated entity. As discussed later in greater detail, this outcome would have adverse impact on FEI's cost of debt
- 3 (both short- and long-term) and access to capital markets.

# *6.2.2.1* FEI's Weak Financial Metrics Would Benefit from Thicker Common Equity

According to Moody's published guide on utility credit rating methodology, financial metrics contribute 40 percent to the overall credit rating. Table 6-4 below shows Moody's four key financial metrics and the relative position of these metrics compared to Moody's guidelines for an A-rated entity. As shown in the table, with the exception of Debt to Capitalization ratio, all financial metrics are consistent with Baa/BBB rating<sup>53</sup>. This shows that FEI's ability to maintain an A rating is marginal.

## 12

13

## Table 6-4: FEI's Key Financial Indicator Scores Compared to Minimum A3 Rating per Moody'sUtility Rating Methodology

	FEI's Score	A - Rating Threshold <sup>54</sup>	2018	2019	2020	LTM Sept 2021
CFO pre-WC + Interest / Interest	Baa	4.5x-6.0x	2.5x	3.0x	2.9x	3.6x
CFO pre-WC / Debt	Baa	19.0% - 27.0%	13.6%	13.6%	11.3%	12.7%
CFO pre-WC - Dividends / Debt	Baa	15.0% - 23.0%	8.8%	8.7%	6.6%	7.9%
Debt / Capitalization55,56	А	40.0% - 50.0%	47.8%	47.5%	48.8%	47.9%

14 Source: Moody's Credit Rating Report for FEI, dated November 25, 2021.

15 Key determinants of FEI's weak financial metrics are the low allowed equity component of its 16 capital structure and relatively low return on equity. Moody's most recent credit rating on FEI 17 stated:

FEI's credit profile is driven by its low business risk gas transmission and distribution assets that operate in the credit supportive regulatory environment of British Columbia and its monopoly position in its service territory. The company has a long term track record of earning its allowed return on equity and its cash flow continues to be highly predictable. These strengths are offset by the company's weak financial metrics that we forecast will be in the range of 11-13% CFO pre-W/C to debt. These financial metrics are primarily a product of a low

<sup>&</sup>lt;sup>53</sup> Debt/Capitalization was positively impacted by the adoption of US GAAP which resulted in the recognition of Goodwill on the Balance Sheet of FEI with a corresponding increase in Shareholder's Equity.

<sup>&</sup>lt;sup>54</sup> Threshold for A-rated entities with low business risk per Moody's Rating Methodology for Regulated Electric and Gas Utilities June 2017.

<sup>&</sup>lt;sup>55</sup> Debt/Capitalization was positively impacted by the adoption of US GAAP which resulted in the recognition of Goodwill on the Balance Sheet of FEI with a corresponding increase in Shareholder's Equity.

<sup>&</sup>lt;sup>56</sup> For Debt/Capitalization %, lower scores denote higher creditworthiness.



- allowed equity component of its capital structure, a relatively low return on equity,
   and depreciation rates.<sup>57</sup>
- In addition, in its latest Credit Rating Report published in November 2021, Moody's stated that
   there are two factors that could lead to a credit rating downgrade:
- 5 an adverse regulatory decision or
- a forecast of a sustained deterioration in credit metrics including CFO pre-W/C to debt of
   less than 11 percent. <sup>58</sup>

8 In the same report, FEI's CFO pre-W/C to debt metric for the year ended December 31, 2020 was 9 11.3 percent which means that this financial metric is critically close to a rating downgrade 10 threshold. FEI's weak financial metrics are a further indication that its deemed equity ratio and 11 ROE are at the low end of comparable investor-owned gas utilities in North America as 12 demonstrated by Mr. Coyne in Appendix C. Considering the capital intensive nature of FEI's 13 business where the utility needs regular access to capital, it is prudent to maintain a greater layer 14 of financial metric protection than FEI currently has. Being so close to a rating downgrade 15 threshold due to weak financial metrics does not provide FEI room to absorb unusual or 16 unexpected negative events without dropping below downgrade thresholds for key financial 17 metrics. Increasing the deemed equity ratio would be appropriate as a protective measure to 18 alleviate pressure on weak financial metrics.

19 The second factor mentioned by Moody's that could lead to a downgrade is an adverse regulatory 20 decision. BCUC decisions regarding FEI's capital structure and ROE, especially if they are 21 unfavourable to FEI, will directly impact credit rating agency actions. For example, in 2013, when 22 the BCUC reduced FEI's equity component of capital structure and ROE, Moody's changed FEI's 23 credit outlook to negative stating "the BCUC's recent generic cost of capital decision (GCOC) ... 24 is likely to weaken the company's financial metrics further and is the impetus for the company's 25 negative ratings outlook." While FEI's credit rating outlook returned to stable in June 2014, this 26 signals that FEI's credit ratings are not secure. FEI's proposal to increase its allowed equity 27 thickness would lessen the risk of a negative credit rating action. It is also important to note that 28 if FEI is downgraded, any subsequent increase in the equity component of the capital structure 29 or ROE would not necessarily lead to a credit rating upgrade.

Another important factor that is putting pressure on FEI's credit rating is the Energy Transition Risk. Since 2019, Moody's credit rating reports include a discussion on ESG related risks. For example, according to the latest Moody's Credit Rating Report for FEI published in November 2021, Moody's views FEI as having a "very negative carbon transition risk" because of risks associated with carbon emissions targets and the fact that the Province of BC's legislated targets of 40 percent GHG reduction by 2020 and 80 percent GHG reduction by 2050 exceed FEI's own

<sup>&</sup>lt;sup>57</sup> Moody's Credit Report for FEI dated November 25, 2021.

<sup>&</sup>lt;sup>58</sup> Moody's Credit Report for FEI dated November 25, 2021.



30 percent GHG reduction target by 2030.<sup>59</sup> Further discussion on ESG considerations and FEI's
 credit risk can be found in Section 6.3.

## 3 6.2.2.2 A-category Credit Rating Lowers FEI's Cost of Debt and Enhances 4 Pricing Stability

5 With respect to the cost of debt, the credit spread associated with a BBB credit rating category is 6 higher than that associated with an A credit rating category. In addition, A-rated debt yields are 7 less volatile than BBB-rated debt. Figure 6-1 below shows the new issue credit spreads of BBB 8 and A-rated corporate issuers, and the difference between them, from January 2011 to October 9 15, 2021. During this period, the average credit spread differential was approximately 70 basis points, with the pricing difference more pronounced during periods of market disruption (see 2016 10 and 2020). This means that based on a \$200 million bond issued for 30-years, a BBB rated utility 11 12 would have paid \$1.4 million in additional interest expense annually that would have to be 13 recovered from ratepayers. Over a lifetime of a 30-year bond, this translates into \$42 million in 14 additional interest expense.

#### 15

#### Figure 6-1: Indicative 30 Year Credit Spreads of BBB-rated and A-rated New Issuances



16 17

Source: RBC Capital Markets

A similar trend can be seen in the Canadian utility sector. Figure 6-2 below shows the incremental credit spread between the average indicative new issue spreads, on a weekly basis, between January 2014 and October 2021, for a select four Canadian utilities<sup>60</sup> with, at a minimum a split rating, or a majority of their ratings in the BBB category and four Canadian utilities<sup>61</sup> with all or a majority of their ratings in the A category. The figure demonstrates that there is a significant range

<sup>&</sup>lt;sup>59</sup> Moody's Credit Report for FEI dated November 25, 2021.

<sup>&</sup>lt;sup>60</sup> FortisBC Inc., Nova Scotia Power Inc., Emera Inc. and TriSummit Utilities Inc. (formerly AltaGas).

<sup>&</sup>lt;sup>61</sup> FortisAlberta Inc., Energir Inc., FortisBC Energy Inc. and Enbridge Gas.



1 in credit spreads between rating categories, particularly during periods of market disruption, as

2 seen in 2016 and 2020.

5 6

## Figure 6-2: Indicative 30 Year Credit Spread between Selected BBB/Split Rating and A-rated Utilities



## 7 6.2.2.3 FEI's A-Rated Status Provides for Better Access to Capital Markets

8 Utilities are among the largest debt issuers of any industry and typically require consistent access 9 to the capital markets to continue to fund operations, including capital expenditure requirements. 10 There is a much larger market for A-rated debt compared to BBB-rated debt, with a large majority 11 of debt issued in the A-rating category (see Figure 6-3). Many institutional investors face limits on 12 the proportion of BBB rated debt they are allowed to hold in their portfolios and in case of a 13 downgrade they may have to rebalance their portfolios by selling their lower rated bonds to meet their investment guidelines. As indicated in Figure 6-3, approximately 72 percent of long-term 14 15 domestic corporate debt issuances in the A/BBB category from January 2011 to October 2021 16 were A-rated or higher.



### 1 Figure 6-3: Corporate Bond Issuance Volumes by Rating from January 2011 to October 2021





Source: RBC Capital Markets

4 In order to match the long-term nature of its regulated assets, FEI typically finances the majority 5 of the debt portion of its capital structure with debt at terms of 10 to 30 years. Issuers with BBB 6 category ratings can be shut out of the Canadian debt capital markets at times, particularly during 7 periods of market distress and for longer tenure issuances, such as 30 years. As a regulated 8 utility, maintaining the flexibility to access debt capital under various market conditions, and in 9 particular for longer duration bonds, is critical. Figure 6-4 below illustrates the limited access to 30 year and longer term bonds in the BBB category. Access to debt capital for this category can 10 11 be even more challenged in distressed markets, like the one that existed in 2008.

#### 12 Figure 6-4: BBB-rated Corporate Bonds Issuances by Year and Term from 2011 to October 2021



15 Maintaining an A level credit rating ensures FEI is able to access capital markets on reasonable

16 terms and pricing in most market conditions. A potential for a market disruption exists despite the

17 current low interest rate environment.

<sup>13</sup> 

<sup>14</sup> Source: RBC Capital Markets



## 1 6.2.2.4 FEI's High Capital Expenditures and Need for Higher Equity Ratio

- 2 Over the past three years, FEI's rate base assets have grown by approximately 36 percent.<sup>62</sup> This
- growth reflects the company's capital expenditures, a significant portion of which can be attributed
   to major capital projects such as Tilbury Liquefied Natural Gas Expansion Project, the Coastal
- to major capital projects such as Tilbury Liquefied Natural Gas Expansion Project, the Coastal
   Transmission System Project, and the Lower Mainland Intermediate Pressure System Upgrade
- 6 Project. With a number of major capital projects currently underway or under review by the BCUC,
- 7 FEI's capital expenditures are expected to increase substantially over the next several years as
- 8 shown in Table 6-5 below.

9

#### Table 6-5: Capital Cost for FEI's Major Capital Projects for 2019-2026

FEI's Major Capital Projects <sup>1</sup>	Actu	uals <sup>2</sup>			Pro-Fo	orma <sup>3</sup>			Total Project	
(C\$ millions)	2019	2020	2021	2022	2023	2024	2025	2026	Costs <sup>4</sup>	Approval
Tilbury 1B	7.8	12.1	-	32.1	40.6	52.2	80.9	-	400.0	OIC
Inland Gas Upgrades Project	8.2	50.1	99.3	93.5	67.4	31.2	-	-	360.2	BCUC
Okanagan Capacity Upgrade	-	7.9	11.3	113.5	139.2	-	-	-	271.3	Under Review
Pattullo Bridge Crossing Replacement	-	6.4	51.9	118.7	11.3	2.9	-	-	191.7	BCUC
TIMC CTS <sup>5</sup>	-	9.4	21.3	7.4	4.5	92.5	2.9	-	137.8	Under Review
Advanced Metering Infrastructure	-	-	28.0	17.1	116.1	193.3	182.9	97.5	638.4	Under Review
Tilbury LNG Storage Expansion	-	8.6	4.6	18.0	165.8	251.7	210.2	110.9	769.0	Under Review
Sustainment and other capital <sup>6</sup>	151.5	163.2	166.1	159.7	162.2	165.8	169.2	172.5	995.5	_
Total	167.5	257.7	382.5	560.0	707.1	789.6	646.1	380.9	3,763.9	-

<sup>1</sup> Woodfibre LNG has been excluded from FEI's Major Capital projects shown in this table.

<sup>2</sup> Actuals are from 2019-2020 Annual Reports filed with BCUC.

<sup>3</sup> 2021-2026 figures are from CPCNs and OICs filed with an exception of Sustainment and other capital (see note below).

<sup>4</sup> Total Project Costs include capital expenditures prior to 2019 and subsequent to 2026 and were compiled based on CPCNs and OICs filed with an exception of Sustainment and other capital (see note below).

<sup>5</sup> TIMC CTS stands for Transmission Integrity Management Capabilities Project, Coastal Transmission System.

<sup>6</sup> Sustainment and other capital figures are per 2019-2021 Annual Reports filed with BCUC and 2020-2024 MRP Application. For 2025 and 2026, FortisBC assumed 2% escalation over prior year. Total Sustainment and other capital is for 2021-2026.

11 As can be seen in the table above, FEI's financing requirements for its large capital projects are

12 expected to increase substantially in the upcoming years.

13 A downgrade to below an A-category credit rating would result in a higher cost of debt, which

14 would result in FEI incurring significant additional cost to finance its large capital program. An

15 increase in FEI's equity component would support the company's current credit ratings and

16 provide confidence that FEI will have access to low cost debt to finance its capital projects, even

17 under challenging economic and capital market conditions.

# 6.2.3 FBC Is Already Baa1 Rated and Has Weak (Non-Investment Grade) Credit Metrics

- 20 Similar to FEI, FBC's credit ratings are reviewed by Moody's and DBRS on an ongoing basis.
- 21 FBC has been assigned the following credit ratings:

<sup>&</sup>lt;sup>62</sup> FEI's Annual Information Form for the year ended December 31, 2020 dated March 12, 2021.



1

### Table 6-6: FBC Credit Ratings

FBC Credit Ratings	Moody's	DBRS
Unsecured long-term debt	Baa1	A (low)
Secured debentures	-	A (low)

2

3 FBC is rated at the Baa1 level by Moody's and the A (low) level by DBRS meaning that FBC has

4 a split rating, i.e., one in the Baa/BBB category and one in the A category. As investors typically

5 focus on the lower rating,<sup>63</sup> FBC is considered principally a BBB rated entity.

6 Maintaining FBC's credit rating is critical since FBC already has more limited access to debt

7 capital markets compared to FEI due to its smaller size and restrictive Trust Indentures that are

8 highly sensitive to changes in the cost of borrowing. If downgraded, FBC would further diminish

9 its access to capital markets and would potentially not be able to finance the debt component of

10 its capital expenditures and operations on reasonable terms.

#### 11 6.2.3.1 FBC's Weak Financial Metrics Presents a Risk of Downgrade to Non-Investment Grade 12

13 Table 6-7 below shows Moody's four key financial metrics and the relative position of these 14 metrics compared to Moody's guidelines for a Baa1-rated entity. These metrics are very weak for 15 the current rating, most of which are consistent with a non-investment grade credit. FBC is at risk of a downgrade if metrics deteriorate further, which would have significant ramifications for FBC's 16 17 ability to issue debt on reasonable terms and pricing.

#### 18 Table 6-7: FBC's Key Financial Indicator Scores Compared to Minimum Baa Rating per Moody's 19 Utility Rating Methodology

	FBC's Score	Baa - Rating Threshold <sup>64</sup>	2018	2019	2020	LTM Sept 2021
CFO pre-WC + Interest / Interest	Ва	3.0x-4.5x	3.6x	2.5x	2.5x	2.7x
CFO pre-WC / Debt	Ba	11.0% - 19.0%	9.8%	8.8%	8.6%	9.6%
CFO pre-WC - Dividends / Debt	Ba	7.0% - 15.0%	6.1%	5.1%	5.0%	5.9%
Debt / Capitalization65,66	Baa	50.0% - 59.0%	55.1%	56.0%	54.3%	54.3%

20

Source: Moody's Credit Rating Report for FBC, dated November 25th 2021.

<sup>&</sup>lt;sup>63</sup> The impact of split-rating on risk premium has been studied in a 1997 study by R. Cantor et al. titled "Split-rating and the Pricing of Credit Risk" concluded that credit risk pricing "in the investment-grade sector is more conservative placing more weight on the lower rating than the higher rating" and that "the market prices split rated bonds between the yield implied by the lower rating and that implied by the average rating".

<sup>&</sup>lt;sup>64</sup> Threshold Baa-rated entities with low business risk per Moody's Rating Methodology for Regulated Electric and Gas Utilities June 2017.

<sup>&</sup>lt;sup>65</sup> Debt/Capitalization was positively impacted by the adoption of US GAAP which resulted in the recognition of Goodwill on the Balance Sheet of FBC with a corresponding increase in Shareholder's Equity.

<sup>&</sup>lt;sup>66</sup> For Debt/Capitalization %, lower scores denote higher creditworthiness.



- 1 The majority of FBC's financial metrics put the utility in the Ba rating category which is considered
- 2 non-investment grade. Similar to FEI, key determinants of FBC's weak financial metrics are the
- 3 low allowed equity component of its capital structure and low return on equity.
- 4 Moody's most recent credit rating on FBC stated:

5 FBC's credit profile is driven by its credit supportive regulatory environment and 6 the monopoly position of its stable vertically integrated utility assets. Like affiliate 7 utility FEI, the company has a track record of earning its allowed return on equity 8 and its cash flow continues to be highly predictable. This is offset by the company's 9 weak financial metrics that we forecast will be in the range of 8-10 percent CFO pre-WC to debt. These financial metrics are primarily the product of a low allowed 10 equity ratio, a low return on equity, depreciation rates and are also affected by a 11 12 significant capitalized lease adjustment.67

- In addition, in its latest Credit Rating Report published in November 2021, Moody's stated thatfactors that could lead to a credit rating downgrade are:
- an adverse regulatory decision, or
- a forecast of a sustained deterioration in credit metrics including CFO pre-W/C to debt of
   less than 8 percent.
- 18

FBC's CFO pre-W/C to debt metric for the last two years ended 2020 and 2019 were 8.6 and 8.8 percent, respectively, which means that this financial metric is critically close to a rating downgrade threshold of 8 percent. To put this in perspective, 2019 was the first time in the last 10 years that this metric has been below 9 percent.

Additionally, FBC's allowed common equity ratio has been stable at 40 percent since 1996 and any reduction in the common equity ratio may be viewed by the credit rating agencies as undermining the support of the regulatory framework. Traditionally, credit rating agencies have been sensitive to decreases in capital structure or ROE, so a decrease may have an adverse impact on FBC's credit ratings and as a result, its ability to continue to obtain debt financing on similar terms as it does now. FBC's proposal to maintain its allowed equity should be viewed as a floor to avoid negative credit rating agency actions.

### 30 6.2.3.2 FBC's Lower Credit Rating Restricts its Access to Liquidity

Being principally a BBB rated company, FBC does not enjoy the same benefits that A rated companies do in terms of access to capital markets and low cost of borrowing (see Figures 6-1 to 6-4 earlier in this filing). FBC's access to capital is further restricted by the Company's smaller

<sup>&</sup>lt;sup>67</sup> Moody's Credit Report for FBC dated November 25, 2021.



- 1 and less frequent debt issuances. Figure 6-5 below shows FBC's debt issuances from 2014 to
- 2 2021 compared to FEI's.



3 Figure 6-5: Frequency and Size of Long-term Debt Issuances for FBC vs. FEI from 2014 to 2021

4

5 Source: Compiled by FortisBC based on 2014-2021 Financial Statements and Debt Issuance documents.

6 As can be seen above, FBC issues debt less often and its issuance size is generally below \$100

7 million. The smaller issuance size does not allow FBC debentures to be part of the bond index in

8 Canada that requires the issue size to be a minimum of \$100 million. Not being part of the bond

9 index, combined with less frequent debt issuances and a lower credit rating, contribute to weaker

10 demand and lower liquidity of FBC bonds.

## 11 6.2.3.3 FBC's Equity Thickness and Restrictive Financing Covenants

FBC's ability to issue long-term debt is further restricted by Earnings Coverage Test financial covenants pursuant to the 1983 and 1996 Trust Indentures for certain of its outstanding debentures. The Earnings Coverage Tests must be passed before any new long-term debt financing is permitted.

The Earning Coverage Tests calculate the ratio of net earnings preceding the date of a new debt
issuance to aggregate annual interest requirements of all outstanding debt after the issuance.
The ratio is required to be above a certain threshold. Since the Earnings Coverage Tests include

19 the aggregate annual interest requirements of all outstanding debt after the issuance, the new

20 debt issuance amount and interest rate impacts the Earnings Coverage Test.

21 In order to demonstrate the debt issue capacity restrictions pursuant to the Earnings Coverage

- 22 Tests, Table 6-8 and Table 6-9 below show the amount of new debt that can be issued at certain
- 23 interest rate levels.

#### 1 Table 6-8: Sensitivity Analysis for FBC's Earnings Coverage Test pursuant to 1983 Trust Indenture

		Sens	itivity Ana	lysis for 1	983 Trust	Indenture	;
				Interest	rate:		
		3.0%	4.0%	5.0%	6.0%	7.0%	8.0%
	\$ 100	2.27	2.22	2.17	2.12	2.08	2.04
New	\$ 150	2.19	2.12	2.06	1.99	1.93	1.88
Debt:	\$ 200	2.12	2.04	1.95	1.88	1.81	1.75
(C\$ millions)	\$ 250	2.06	1.95	1.86	1.78	1.70	1.63
	\$ 300	1.99	1.88	1.78	1.69	1.60	1.53
	\$ 350	1.93	1.81	1.70	1.60	1.52	1.44

2 3

3 <u>Note to table:</u>

4 Red cells denote new debt/interest rate levels where the Earnings Coverage financial covenant
5 test pursuant to 1983 Trust Indenture would not be met (<1.75).</li>

#### 6 Table 6-9: Sensitivity Analysis for FBC's Earnings Coverage Test pursuant to 1996 Trust Indenture

		Sensi	tivity Ana	alysis for	1996 Tru	st Indent	ure
				Interest	rate:		
		3.0%	4.0%	5.0%	6.0%	7.0%	8.0%
	\$ 100	2.27	2.22	2.17	2.12	2.08	2.04
New	\$ 150	2.19	2.12	2.06	1.99	1.93	1.88
Debt:	\$ 200	2.12	2.04	1.95	1.88	1.81	1.75
(C\$ millions)	\$ 250	2.06	1.95	1.86	1.78	1.70	1.63
	\$ 300	1.99	1.88	1.78	1.69	1.60	1.53
	\$ 350	1.93	1.81	1.70	1.60	1.52	1.44

## 7 <u>Note to table:</u>

9 Red cells denote new debt/interest rate levels where the Earnings Coverage financial covenant

10 test pursuant to 1996 Trust Indenture would not be met (<1.90).

The tables above demonstrate that if new debt interest rates rise as a result of economic conditions or a downgrade in FBC's credit ratings, the aggregate level of new debt that FBC would be able to issue would be constrained by the Earnings Coverage Test financial covenants. For example, if the coupon rate for FBC's new bonds rises to 5 percent per annum, FBC would only be able to add an aggregate amount of \$200 million in new debt in order to pass the Earnings Coverage financial covenants.<sup>68</sup> This further highlights the importance of maintaining FBC's credit ratings to allow the Company to access debt capital markets to fund its operations.

## 18 6.3 ESG AND OTHER FACTORS IMPACTING PROPOSED CAPITAL STRUCTURES

19 This section discusses ESG related considerations that are having a significant impact on FEI not 20 only from a business risk perspective, as discussed earlier in this Application, but also from a

21 financial risk and credit perspective. Another factor discussed in this section is a proposed income

<sup>&</sup>lt;sup>68</sup> For the sensitivity analysis purposes, it is assumed that new debt would be issued in a lump sum.



tax change restricting interest deductibility. The risks are generally new to FortisBC and did not
 exist at the time of the 2013 and 2016 Proceedings.

## 6.3.1 ESG Considerations Significantly Impacting the Companies' Long-Term Financial Risk

In recent years, ESG considerations and companies' ESG rankings have attracted a significant
amount of interest among institutional investors and credit rating agencies. The World Economic
Forum Global Risks Report 2020 lists climate change as the biggest long-term risk for the world
and, for the first time since 2006, all of the top five risks listed in the World Economic Forum report
are environmental in nature (such as extreme weather and climate action failure).<sup>69</sup> Climaterelated risks have significant financial implications for many industries and companies, including
FEI.

Further, equity and debt investors as well as utility analysts and credit rating agencies are increasingly aware of the ESG risk and are increasingly considering the ESG issues associated with project execution and corporate activities.

### 15 6.3.1.1 Divestment of the Fossil Fuel Industry

Institutional investors are increasingly focusing on ESG factors when they decide whether toinvest in companies and projects.

18 Blackrock, the world's largest asset manager, stated in a recent letter:

[Climate risk] ... is driving a profound reassessment of risk and asset values. And 19 20 because capital markers pull future risk forward, we will see changes in capital 21 allocation more quickly than we see changes to the climate itself. In the near future 22 - and sooner than most anticipate - there will be a significant reallocation of 23 capital. Over time, companies and countries that do not respond to stakeholders 24 and address sustainability risks will encounter growing skepticism from the 25 markets, and in turn, a higher cost of capital. Companies and countries that 26 champion transparency and demonstrate their responsiveness to stakeholders, by 27 contrast, will attract investment more effectively, including higher-guality, more 28 patient capital.70

- The reallocation of capital that Blackrock describes above has already begun. While the world's
  60 largest banks have collectively financed \$3.8 trillion in fossil fuel investments between 2016
- and 2020, 27 of them, which includes five of the biggest Canadian banks, have decreased their
   financing in the fossil fuel sector.<sup>71</sup> Investment in fossil fuels is trending more towards renewables
- 33 which, due to more stringent regulations on fossil fuel development and increasing technological

<sup>&</sup>lt;sup>69</sup> World Economic Forum's The Global Risks Report 2020.

<sup>&</sup>lt;sup>70</sup> Blackrock's 2020 Letter to CEOs <u>https://www.blackrock.com/corporate/investor-relations/2020-larry-fink-ceo-letter</u>.

<sup>&</sup>lt;sup>71</sup> https://www.cnbc.com/2021/04/22/which-banks-are-increasing-decreasing-fossil-fuel-financing-.html.



- 1 advancements, has started to become more cost competitive with fossil fuels. Figure 6-6 below
- 2 indicates the global investment in the power sector by energy source:
- 3 Figure 6-6: Global Investment in the Fossil Fuel Industry vs. Renewable Energy from 2010 to 2020

Global investment in the power sector by technology, 2010-2020 (billion USD, 2019)



### 4

5

Source: Global Investment Figures by IEA, and Eurasia Group

In recent years, most of Canada's leading banks established Sustainable Finance groups within
 their organizations and announced ESG-related mandates. Some notable examples in the
 Canadian banking sector include:

- 9 RBC, which recently revised its sustainable financing target from \$100 billion to \$500 billion by 2025;<sup>72</sup>
- BMO has committed to mobilize \$400 billion in sustainable finance by 2025 including
   lending, underwriting and investing;<sup>73</sup>
- CIBC has pledged \$150 billion by 2030 to environmental and sustainable finance activities;<sup>74</sup>
- Scotiabank has a target to mobilize \$100 billion by 2025 to reduce the impacts of climate change;<sup>75</sup> and
- TD has targeted a total of \$100 billion in low-carbon lending, financing, asset management
   and internal corporate programs by 2030.<sup>76</sup>
- 19

20 More recently, in October 2021, Canada's Big Six banks<sup>77</sup> announced that they are joining the

21 United Nation's Net Zero Banking Alliance (NZBA). In their announcement, the banks said that

the commitment demonstrates their intention to "play a significant role in financing the climate

<sup>&</sup>lt;sup>72</sup> RBC's ESG Performance Report 2020, p. 48.

<sup>&</sup>lt;sup>73</sup> 2020 Sustainability Report and Public Accountability Statement, p. 2.

<sup>&</sup>lt;sup>74</sup> CIBC 2020 Sustainability Report, p. 30.

<sup>75 2020</sup> Scotiabank ESG Report, p. 16.

<sup>&</sup>lt;sup>76</sup> TD Bank Group 2020 ESG Report, p. 20.

<sup>&</sup>lt;sup>77</sup> CIBC, BMO, National bank, RBC, Scotiabank and TD.



- 1 transition and support collaborative approaches between the public and private sectors to reach
- 2 the goal of net-zero by 2050."78

3 Some notable Canadian investors that have traditionally supported the utility sector are following 4 suit. For example, British Columbia Investment Management Corporation (BCI), one of the largest 5 Canadian investors with almost \$200 billion in total net assets under management, recently announced that it will target a cumulative \$5 billion investment in sustainability bonds by 2025 6 7 and reduce carbon exposure in its public equity portfolio by 30 percent by 2025. BCI believes that 8 gradually lowering exposure to carbon-intensive companies and engaging with companies and 9 regulators to adopt to the low-carbon economy will lead to better financial outcomes for its 10 clients.79

Additionally, a growing number of Canadian universities have started divesting of fossil fuel investments within their endowment funds. In December 2021, the University of Toronto, which has an endowment fund with approximately \$4 billion in assets, announced it would end its investments in the fossil fuel industry. The move followed similar announcements by other postsecondary institutions, notably Harvard University in September 2021, the University of Waterloo in June 2021, and the University of British Columbia in 2019. Ten Canadian universities

17 have now committed to full or partial divestment.<sup>80</sup>

All of this is a testament to the urgency and significant mobilization of capital in the financial sector and the investor community away from traditional fossil fuel based investments. It also suggests that FEI, as a contributor to BC's GHG emissions, may face increasing difficulties in attracting capital from institutional investors. Finally, it underscores how, in recent years, climate-related risk has become a significant financial risk for FEI.

## 6.3.1.2 Long-Term Credit Risk for Investments in Natural Gas Related Assets and the Need for Thicker Common Equity

As mentioned earlier in this Application, ESG matters, particularly the environmental 25 26 consideration part of ESG, are increasingly becoming an important factor for utility analysts and 27 investors as well as credit rating agencies. As credit rating agencies further incorporate climate related risks in their rating methodologies, FEI's financial metrics will have to become stronger to 28 29 mitigate the downward pressure that Energy Transition risk will put on credit ratings. A change to 30 FEI's capital structure, as proposed, would provide a strong signal to the investment community 31 that the BCUC recognizes this risk and is ready to provide the necessary support to maintain 32 FEI's credit worthiness.

<sup>&</sup>lt;sup>78</sup> <u>https://newsroom.bmo.com/2021-10-15-Six-of-Canadas-Largest-Banks-Join-United-Nations-convened-Net-Zero-Banking-Alliance.</u>

<sup>&</sup>lt;sup>79</sup> BCI sets climate-related targets for public markets, press release dated February 19, 2021 <u>https://www.bci.ca/british-</u> columbia-investment-management-corporation-sets-climate-related-targets-for-public-markets/.

<sup>&</sup>lt;sup>80</sup> https://www.universityaffairs.ca/news/news-article/small-but-growing-number-of-canadian-universities-divestingfrom-fossil-fuels/.



Since 2019, Moody's credit rating reports include a discussion on ESG related risks. For example,
 according to the latest Moody's Credit Rating Report for FEI published in November 2021,

3 Moody's views FEI as having a "very negative carbon transition risk" because of risks associated 4 with carbon emissions targets and the fact that the Province of BC's legislated targets of 40 5 percent GHG reduction by 2030 and 80 percent GHG reduction by 2050 exceed FEI's own 30 6 percent GHG reduction target by 2030.81 Another significant area of concern for natural gas 7 companies relates to new investments in gas infrastructure and how credit rating agencies 8 evaluate these investments. In a recent publication from September 2020, Moody's noted that as 9 development of oil and gas transmission infrastructure, in particular, continues to face legal 10 challenges from environmental groups, which are succeeding in delaying pipeline development, 11 and because of growing uncertainties about whether new projects will be completed, Moody's 12 generally does not incorporate any revenue from such pipelines in its base case financial 13 projections for a company. Instead, cash contributions will occur when construction has been 14 completed and the pipeline is in operation. The debt used to finance a given project is, however, 15 on-credit and will depress financial metrics during the construction period, all else being equal.<sup>82</sup>

In fact, corporate sustainability strategies continue to evolve as well with many traditionally fossil fuel focused companies expanding their environmental goals to include net-zero carbon emissions and pivoting away from developing natural gas infrastructure toward clean alternatives. This transition is being spurred in part by mounting pressure from advocacy groups, Indigenous communities and governments, as well as the companies' own green initiatives. Table 6-10 below shows tactical strategies taken by large, diverse utility companies in the United States over the course of several months in the summer of 2020 regarding their natural gas assets.

23	Table 6-10	ESG Stratonios	Takon hy Largo	Divorso I Itility	/ Comnanies in	the United States in 2020
20		LOO Strategies	raken by Large,	Diverse ounity	y companies in	

Company	Date	Event	Impact
Dominion Energy	July 2020	\$10 billion sale of gas transportation and storage business and focus on regulated clean energy	Lowers Dominion's business risk
Duke Energy	July 2020	Cancellation of Atlantic Coast Pipeline	\$2.0 billion write-off
Dominion Energy	July 2020	Cancellation of Atlantic Coast Pipeline	\$2.8 billion write-off
Public Service Enterprise Group	July 2020	Intent to sell about 6.8 GW of merchant fossil generation assets and focus on regulated clean energy	Lowers PSEG's business risk

Source: Moody's Sector In-Depth publication "Shifting environmental agendas raise long-term credit risk
 for natural gas investments" dated September 30<sup>th</sup>, 2020.

26 The above trends demonstrate how environmental concerns are significantly increasing the

27 financial risk for fossil fuel based companies such as FEI from the perspective of credit rating

agencies. While ESG matters form a relatively small part of credit rating assessment at the

<sup>&</sup>lt;sup>81</sup> Moody's Credit Report for FEI dated November 25, 2021.

<sup>&</sup>lt;sup>82</sup> Moody's Sector In-Depth publication "Shifting environmental agendas raise long-term credit risk for natural gas investments" dated September 30, 2020.



present time, FEI expects that credit rating agencies will increasingly focus on ESG considerations and eventually incorporate ESG into their rating methodologies. The downward pressure that ESG related risks will place on FEI's credit rating will have to be offset by stronger financial metrics in order to maintain FEI's current credit rating. Increasing FEI's equity thickness and ROE will strengthen FEI's financial metrics and help alleviate some of the challenges related to ESG from credit rating agencies perspectives.

Concentric's evidence further confirms that S&P and Moody's have incorporated ESG criteria into their credit rating analysis, while other investment firms and pension funds have adopted restrictions that prohibit them from owning equity or debt in companies seen as contributing to climate change. Mr. Coyne's analysis indicates that investors' ESG concerns are already affecting capital markets and refers to an S&P analysis that demonstrates issuers in the highest carbon intensity quartile tend to have more expensive debt than issuers in the lowest carbon intensity quartile<sup>83</sup>.

## 14 6.3.1.3 Climate Related Financial Disclosures

15 In order to make informed investment and voting decisions, investors, particularly institutional 16 investors, are seeking improved disclosure on material risks, opportunities, financial impacts and 17 governance processes related to climate change. The Financial Stability Board, under former Chair and Bank of England Governor Mark Carney, established a Taskforce on Climate-Related 18 19 Financial Disclosures (TCFD) to improve and increase reporting of climate-related financial 20 information. The ultimate goal of TCFD is to develop recommendations for more effective climate-21 related financial disclosures that could promote more informed investment, credit, and insurance 22 underwriting decisions and, in turn, enable stakeholders to better understand the concentrations 23 of carbon-related assets and the financial system's exposures to climate-related risks. Hundreds 24 of global leaders, including major banks, have signed on to these recommendations and have 25 started a multi-year journey to implement them.

26 In its most recent Status Report, TFSD stated that:

Climate change is a financial risk. Climate-related risk is non-diversifiable and will
 have a financial impact on many companies. Climate-related financial risks could
 affect the economy through elevated credit spreads, greater precautionary saving,
 and rapid pricing readjustments.<sup>84</sup>

In November 2021, IFRS Foundation Trustees announced the formation of a new International Sustainability Standards Board to develop a comprehensive global baseline of high-quality sustainability disclosure standards to meet investors' information needs and to be adopted by all companies reporting in accordance with IFRS.<sup>85</sup> The first publication on a proposed general disclosure requirements standard and a climate disclosure standard is expected to be published

<sup>&</sup>lt;sup>83</sup> Appendix C, pp 80-81.

<sup>&</sup>lt;sup>84</sup> TSFD's 2020 Status Report published in March 2021, p.4.

<sup>&</sup>lt;sup>85</sup> <u>https://www.ifrs.org/news-and-events/news/2021/11/ifrs-foundation-announces-issb-consolidation-with-cdsb-vrf-publication-of-prototypes/</u>.



during the first quarter of 2022.<sup>86</sup> The establishment of climate-related financial disclosures
 signals a new era in corporate reporting. Companies will need to apply the same rigour for

- 3 sustainability reporting as for financial information, with the purpose of generating new sources of
- 4 information for investors and policy makers and influencing the allocation of capital to facilitate
- 5 the transition to a more sustainable. low-carbon economy. This could lead to institutional investors
- 6 reallocating capital away from companies seen as contributing to climate change.

### 7 6.3.1.4 Social License and Credit Ratings

8 The topic of social license falls within the social aspect of ESG, but there can often be an overlap 9 with environmental and governance considerations. The BCUC had found in the 2016 Decision: 10 "Under the same political risk category, the Panel was not persuaded the evidence on recent 11 jurisprudence concerning First Nations would have a material effect on FEI's ability to earn a 12 return of on and of its capital."<sup>87</sup> However, there have been clear indications that a company's 13 relationship with Indigenous communities has become an important consideration for investors.

For instance, in June 2020 Moody's published an in-depth research report<sup>88</sup>, in which it highlights the effect that conflict over Indigenous rights can have on credit quality. The report provides the following highlights:

- The absence of social license from the relevant Indigenous communities can be credit negative for corporations. Possible repercussions include a delay in a project construction or even its cancellation; a loss of permit, right of way or operating license; blockades; litigation and boycotts. All these events could lead to lost revenue, increased costs or a balance sheet write-off, all credit negatives for the applicable corporation.
- Indigenous Communities objecting to a specific project or activity is an event risk that
   cannot be determined in advance with certainty, a credit negative for corporations planning
   to develop projects or activities.
- Market developments are driving investments in lands that contain commercially desirable
   and untapped natural resources and where Aboriginal and treaty rights exist.
- 27

Moody's recognized that corporations can apply actions and programs to mitigate some of these
 concerns, however, their best efforts may still be insufficient without the support of Indigenous
 groups.

<sup>&</sup>lt;sup>86</sup> https://www.ifrs.org/news-and-events/news/2021/12/emmanuel-faber-appointed-to-lead-the-issb/.

<sup>&</sup>lt;sup>87</sup> 2016 GCOC Decision, p. 44.

<sup>&</sup>lt;sup>88</sup> Moody's: Indigenous Rights Are Growing Increasingly Important for Canadian Project Execution and Corporate Activities. Moody's Investor Service, June 22, 2020, <u>www.moodys.com/research/Moodys-Indigenous-rights-are-growing-increasingly-important-for-Canadian-project--PBC\_1233788</u>.



### **1 6.3.2 Proposed Restrictions on Interest Deductibility**

The FortisBC utilities obtain external funding for their operations through either debt or equity. In Canada, as in most jurisdictions, interest expenses in respect of such debt are generally fully deductible against the income of the borrower, which reduces taxable income and taxes paid to the Canada Revenue Agency. There are currently no rules that subjectively assess whether or not FortisBC utilities are deducting "too much" interest expense.

7 The 2021 Federal Budget introduced an earnings-stripping rule consistent with the Organization 8 for Economic Co-operation and Development (OECD) recommendations to limit the amount of 9 net interest expense that a corporation may deduct in computing its taxable income to no more 10 than a fixed ratio of "tax EBITDA"<sup>89</sup>. Tax EBITDA is defined as a corporation's taxable income 11 before taking into account interest expense, interest income and income tax, and deductions for 12 depreciation and amortization, where each of these items is determined for tax purposes. In order 13 to facilitate the transition to the new rule, the government proposes a phased approach whereby 14 interest deductibility would be limited to a fixed ratio of 40 percent for taxation years beginning on 15 or after January 1, 2023 and 30 percent for taxation years beginning on or after January 1, 2024. 16 Any interest that would otherwise be deductible that is denied by the proposed rules can be carried 17 back 3 years or carried forward up to 20 years if those taxation years have sufficient interest 18 deduction capacity. A higher ratio may also be allowed, where the overall group has a higher rate 19 of external leverage (Group Ratio Rule) in keeping with the overall policy of preventing the 20 disproportionate allocation of the debt of a multinational group to Canada. However, the 21 opportunity to use the Group Ratio Rule depends on the relative debt level of the corporation to 22 the debt levels of the overall consolidated group.

As FortisBC is part of a multinational group that has the majority of its regulated assets in the United States, the Group Ratio Rule will not likely provide relief because the United States utilities are typically financed with a higher common equity ratio and higher ROE.

If the proposed rules are passed, the FortisBC utilities may be significantly impacted due to their capital intensive nature and the amount of debt financing in their capital structures. Under the rules as proposed, in any given year, utilities with a relatively high regulated debt component may be limited in the amount of interest expense that they can deduct for tax purposes, which would result in an increase in income tax expense and therefore higher costs for ratepayers. In that case, a portion of interest expense incurred would not be allowed the benefit of deductibility for tax purposes, making the regulated capital structure less efficient.

It is unknown at this time the exact form these rules will take when drafted and passed and to what extent the FortisBC utilities may be impacted. Although, as mentioned above, the level of debt in capital structures of FEI and FBC make this risk higher than for companies with higher equity thicknesses. If these tax changes do end up being passed, the proposed increases in allowed ROE for FEI and FBC and the proposed increase in the allowed equity in FEI's capital structure would each reduce the exposure to this issue for customers.

<sup>&</sup>lt;sup>89</sup> <u>https://www.budget.gc.ca/2021/report-rapport/anx6-en.html#interest-deductibility-limits.</u>



## 1 6.4 CONCLUSION ON CAPITAL STRUCTURE DISCUSSION

2 significant increase in FEI's long-term business risk, particularly the Energy The 3 Transition/political risk, growing risks associated with ESG investing and its impact on FEI's credit 4 rating coupled with the Company's weak financial metrics, warrant a material increase in FEI's 5 common equity thickness. The increasing pace of the Energy Transition from fossil fuels to 6 cleaner sources of energy through electrification of the economy and increased recognition of the 7 effect of this transition on natural gas utilities by utility analysts and investors represent a 8 significant change in investors' perceived risk of natural gas utilities across North America that 9 did not exist at the time of the 2016 Proceeding. BC is at the forefront of this transition. In addition, 10 ESG considerations are expected to start impacting the Company's ability to attract capital and 11 putting an additional strain on FEI's credit rating that is already negatively impacted by the 12 Company's weak financial metrics that are at the low end of the range for comparable investor-13 owned gas utilities in North America. Considering the capital intensive nature of FEI's business, 14 an increase in FEI's common equity ratio is necessary to support its A-level credit rating and 15 ensure continued access to capital at reasonable terms and pricing in all market conditions. FEI 16 thus respectfully requests that the equity component of its capital structure be increased from the 17 current 38.5 percent to 45 percent. 18 FBC's overall business risk is best characterized as being similar to that of the 2013 Proceeding, 19 reflecting increased risk in several risk categories offset by the favourable impact of the Energy 20 Transition. Maintaining FBC's credit rating is critical since FBC already has more limited access

- to debt capital markets compared to FEI due to its smaller size and restrictive Trust Indentures that are sensitive to changes in the cost of borrowing. FBC's credit metrics are very weak for the current rating, most of which are consistent with a non-investment grade credit. FBC's financial risk at the current common equity ratio is already slightly greater than the Canadian proxy group and markedly greater than the U.S. electric utility proxy group. When considered together, these factors indicate that, at a minimum, FBC's current 40 percent equity component of its capital
- 27 structure is required to maintain FBC's already constrained access to capital at reasonable terms
- 28 and pricing in all market conditions.

## FORTIS BC

# 17.THE EFFECTIVE DATES FOR FEI'S AND FBC'S APPROVED ROE2AND CAPITAL STRUCTURE

This section explains why January 1, 2023 is the appropriate effective date for FEI's and FBC's
approved ROE and capital structure, based on the current regulatory timetable.

5 FortisBC submitted in its letter to the BCUC dated March 29, 2021 (Exhibit B1-2) that the 6 appropriate effective date of the GCOC decision depends on the regulatory process and 7 regulatory timetable that is adopted for the Proceeding. FortisBC further commented that, 8 although sometimes necessary, a prolonged period of interim rates is an undesirable outcome 9 that causes regulatory and administrative inefficiencies due to adjustments to customers' bills 10 which may become material as additional time passes. In its Order G-156-21, dated May 21, 11 2021, the BCUC agreed with FortisBC's submissions and determined that the effective date 12 should be part of the scope of the Stage 1 GCOC Proceeding:

13 Regarding timing, the Panel finds that the effective date to implement a new cost 14 of capital will depend on the timing and progress of this GCOC proceeding. Therefore, it would be premature at this time to decide on the cost of capital 15 16 effective date and whether interim rates are necessary or not. The same would 17 also apply to any other effective dates that were noted in the Preliminary Scoping 18 Document such as for the ROE AAM and debt interest rate which are discussed 19 further below. If a transition period is required, this will be determined at a later 20 point in the GCOC proceeding. The Panel acknowledges the utilities' submissions 21 on inefficiencies that can occur with a prolonged period of interim rates and encourages thoughtful and timely participation from all parties to ensure an 22 23 efficient and effective GCOC proceeding.90

24 In line with the BCUC statements above and as further explained in FortisBC's March 29, 2021 25 letter (Exhibit B1-2), the effective date should depend on the timing and progress of the GCOC 26 proceeding. If the regulatory timetable set by the BCUC will result in a decision in the first guarter 27 of the year, then having an effective date of January 1 of that year could be appropriate. This 28 would avoid having interim rates in place for an extended period of time, improve administrative 29 and regulatory efficiency, and may reduce customer bill impacts. Further, avoiding an extended 30 period of interim rates can mitigate some of the regulatory risk that investors face by virtue of not 31 knowing the return on the invested capital until the decision is issued.

Considering the BCUC established regulatory timetable in this Proceeding (Order G-288-21, dated October 6, 2021), FortisBC expects a decision on FEI's and FBC's cost of capital in this proceeding in the fourth quarter of 2022 or the first quarter of 2023. Therefore, FortisBC submits that given the above-mentioned conditions, an appropriate effective date for approved ROE and capital structure established in this Proceeding, is January 1, 2023.

<sup>&</sup>lt;sup>90</sup> Order G-156-21, Appendix A, 6.



- As for Stage 2, FortisBC recommends that the same principle regarding the effective date should
- 2 apply to any subsequent stages, such that the Benchmark Utility may have an effective date
- 3 earlier than the other utilities that are reviewed as part of Stage 2.



## 1 8. THE CHOICE OF THE BENCHMARK UTILITY FOR STAGE 2

By Order G-281-21 dated September 24, 2021, the BCUC decided that the Benchmark Utility
methodology for determination of the cost of capital for utilities in BC is appropriate. Additionally,
the BCUC stated that a review of FEI's and FBC's cost of capital evidence is necessary before
determining whether FEI or FBC, or both, shall serve as a Benchmark Utility.

6 Considering the BCUC's direction for each of FEI and FBC to file separate evidence, FortisBC 7 submits that the BCUC can individually determine each of FEI's and FBC's appropriate allowed 8 ROE and capital structure without reference to a Benchmark Utility. In this regard, the choice of 9 the Benchmark Utility is a topic that is better addressed by other utilities to whom the Benchmark 10 Utility approach applies.

- 11 As explained in FortisBC's Letter to BCUC dated July 21, 2021 (Exhibit B2-4), some of the 12 relevant factors to consider in determining a Benchmark Utility are as follows:
- Availability of comparable proxy group: The comparable investment principle is one of the three elements of the Fair Return Standard. Under this principle a fair and reasonable return should be comparable to the return available from the application of the invested capital to other enterprises of like risk. To achieve this legal requirement, cost of capital experts usually establish a proxy group of publicly traded comparable risk companies and use the proxy group's data as inputs in their financial models. Therefore, the availability of a listed comparable risk proxy group is a critical consideration for establishing the Benchmark Utility.
- Credit ratings: The Benchmark Utility should preferably issue its own debt and have its debt
   rated by major credit rating agencies. This would provide the BCUC and other parties with an
   independent analysis of a utility's risk profile, albeit from the bondholder's perspective.
- Size of operation: This factor is closely tied to the availability of a comparable proxy group
   discussed above. The majority of the publicly listed utilities are very large. It is therefore
   preferable that the Benchmark Utility shares characteristics with the proxy group and has a
   large operation. Further, a relatively large utility with diversity in customer base, asset
   composition and geographic scope is less likely to be susceptible to unique or specific risks
   that have a disproportionate impact on risk profile that may make comparisons more difficult.
- 4. Stability of operation: The Benchmark Utility needs to have stable operations and not be
   subject to takeovers or mergers that can drastically change its risk profile.
- 5. Resources and expertise: As explained above, preparation of cost of capital applications
   requires both specialized expertise, usually acquired through retaining external consultants,
   and significant internal resources. The capability of the Benchmark Utility to provide these
   resources without material rate impact to its ratepayers is another relevant consideration.
- Familiarity with and acceptance of the Benchmark Utility by other affected utilities:
   Other affected utilities must be fairly familiar with the Benchmark Utility operation to be able
   to compare their risk with that of the benchmark. A general consensus among affected utilities



- around the appropriate Benchmark Utility will help to facilitate the process and increase the
   administrative efficiencies and avoid unnecessary controversies.
- 3 7. Ownership: The opportunity cost for a Crown corporation like BC Hydro is fundamentally
   4 different from that of investor-owned utilities. Considering that the majority of the utilities are
   5 investor-owned, the Benchmark Utility should be an investor-owned utility.
- 6

As the BCUC summarized in its reasons for Order G-281-21 the majority of the participants in this
 proceeding support FEI remaining the Benchmark Utility in BC:

- All participants, except for MoveUP, BCOAPO, Nelson Hydro and ICG, are in clear
  support of continuing to use FEI as the Benchmark Utility. While MoveUP and
  BCOAPO support FEI as the Benchmark Utility, they comment on the need for
  modifications in relation to a Benchmark Utility for electric utilities. Nelson Hydro
  does not explicitly oppose or support FEI as the Benchmark Utility. ICG opposes
  the continued use of FEI as the Benchmark Utility.
- In general, participants support the continued usage of FEI as the Benchmark
   Utility based on their views that FEI is the optimal market proxy, is the largest
   investor-owned utility in BC, has resources and the capacity to conduct the GCOC
   process and is familiar to other regulated utilities. Participants make the following
   submissions in support for FEI as the single Benchmark Utility:
- While FEI's equity is not publicly traded, its debt is rated by two debt rating agencies, providing an independent capital market assessment of its overall business and financial risks, albeit from a bondholder's perspective.
- As the largest investor-owned utility in BC with a publicly traded parent company, FEI is a Benchmark Utility which is comparatively free of political interference that could alter the utility's risk profile. Participants also note that FEI is a large utility with one of the largest gas distribution utilities in the country, having a diverse geographic, customer and asset base.
- FEI has a history of serving as the Benchmark Utility, and a significant body of evidence has been developed in recent proceedings that helps to define FEI's financial and business risk profile, public interest suitability and acceptability. Several interveners submit that the Benchmark Utility should have the capacity to support and respond to an extensive, thorough and detailed regulatory review, with the level of expertise required to support at the process, which logically points to a large utility.<sup>91</sup>
- Some participants have commented that FBC can serve as the Benchmark Utility for other smaller
   electric utilities.<sup>92</sup> FortisBC generally agrees that FBC can satisfy many of the above criteria

<sup>&</sup>lt;sup>91</sup> Order G-281-21, Appendix A, p. 5.

<sup>&</sup>lt;sup>92</sup> Exhibit C7-3, BCOAPO Submission on Use of a Benchmark Utility, p. 5.



- 1 although FBC's relatively smaller size makes it a less desirable Benchmark (compared with FEI).
- 2 FortisBC also notes that choosing FBC as the Benchmark Utility for smaller electric utilities does
- not necessarily remove the need for judgement-based adjustments as there are still differences
   in risk profiles between FBC and other smaller electric utilities.
- 5 In conclusion, FEI's and FBC's allowed ROE and capital structure can and should be determined
- 6 in the Stage 1 GCOC Proceeding on a stand-alone basis and without reference to the Benchmark
- 7 Utility. The issue of whether FEI and/or FBC shall act as the Benchmark Utility in Stage 2 GCOC
- 8 Proceeding needs to be addressed by other utilities to whom the Benchmark Utility approach
- 9 applies. Nevertheless, FortisBC observes that there is a strong support for FEI to continue its role
- 10 as the Benchmark Utility, although other options such as having two Benchmark Utilities are also
- 11 possible.



## 1 9. AUTOMATIC ADJUSTMENT MECHANISM

- Part of the scope of this proceeding, as noted in Appendix B to Order G-281-21, is to determine whether the re-establishment of a formulaic ROE AAM is warranted. If a return to the use of a formulaic ROE AAM is warranted, then BCUC further seeks evidence on: (a) the specifications of the ROE AAM formula (b) the frequency that the ROE AAM will apply (i.e., annually or some other frequency) and (c) to whom the ROE AAM will apply.
- 7 FortisBC continues to believe that a regulatory proceeding is preferable to the use of a mechanical 8 formula for setting the allowed ROE for a utility, and is the predominant approach in North 9 America. FortisBC submits that attempts to mechanize the cost of capital may lead to ROE values 10 that do not meet the Fair Return Standard, particularly in uncertain market conditions. In addition, 11 AAMs do not create any significant regulatory efficiency, as there is still the need to periodically 12 review the base ROE, formula parameters and their weightings. In Mr. Coyne's expert opinion the simple adjustment mechanisms cannot account for other changes that affect a regulated utility's 13 14 opportunity cost and that historical relationships between equity returns and observable factors such as bond yields may not reflect the changes in the capital markets and investors' expected 15 16 returns.

## 17 9.1 THE HISTORY OF AAM FORMULAS

As described below, AAMs are no longer prevalent. With the exception of the OEB, regulators inCanada have either suspended or eliminated the AAM.

- In the 1980s and 1990s, US regulators made two attempts at instituting generic, formula-based approaches to setting the cost of capital (one at the federal level and one in the state of New York). In the end, however, the federal and state jurisdictions retained their longstanding, case-
- by-case approach over legal concerns that a company-specific record must support the finding of
- 24 a Fair Return.<sup>93</sup>
- Beginning in 1994, Canadian regulators began to adopt AAMs for setting the cost of capital in
  utility rates based on a spread with observed movements in yields on Canadian long-term bonds.
  The formula was first introduced in British Columbia in 1994 before being adopted by the NEB<sup>94</sup>
  in 1995. This was followed by Ontario in 1997 and Quebec in 1999 who adopted formulas
  substantially similar in design and resulting ROEs to the BCUC and NEB formulas. Finally, Alberta
  adopted formula adjustments in 2004.
- Since 1994, the AAM formula in BC had been subject to multiple variations. A synopsis of these
   developments is provided in the table below.

<sup>&</sup>lt;sup>93</sup> Makholm (November 2015); "A Half-Century of Computing the Cost of Capital for Utilities at NERA"; pp. 14-15.

<sup>&</sup>lt;sup>94</sup> Now the Canada Energy Regulator (CER).

1	

Table 9-1: A	Svnopsis	of BCUC Ap	proved Changes	s to AAM	<b>Formula Since</b>	1994
			protoa enango			

Year	Order	Changes made to AAM formula
1994	N/A	The formula adjusted the allowed ROE on a one for one basis with movements in the forecast long-term Canada Bond (LCB) yield provided the yield had moved more than 50 basis points year over year.
1997	G-49-97	BCUC introduced a sliding scale adjustment of 80 percent of the movement of the forecast yield of the 30 year LCB from a starting point of 9.25 percent and directed that the range of LCB yields over which the adjustment formula will apply was 6 percent to 12 percent.
1999	G-80-99	BCUC set the benchmark ROE at 9.50 percent when the LCB yield was forecast to be 6.00 percent and adjusted for 80 percent of the movement of the LCB yield above 6.00 percent.
2005	G-14-06	The BCUC adjusted the starting point for the formula based ROE to 9.145 percent when the LCB yield is forecast to be 5.25 percent, modified the sliding scale adjustment factor to 75 percent of the movement in the LCB forecast from 80 percent and eliminated the asymmetry in the sliding scale adjustment mechanism above and below 6 percent.
2009	G-158-09	AAM was eliminated as it failed to provide an ROE that meets Fair Return Standard.
2013	G-75-13	The AAM formula was re-established in the form of a two-variable model that considers changes to utility bond spreads and the LCB yield. To avoid the downward bias, the formula was only triggered if the actual LCB yield of 3.8 percent is met or exceeded. This threshold was never realized and therefore the formula was never triggered.
2016	G-129-16	The two-variable formula was suspended indefinitely due to its potential undesirable consequences and lack of evidence. The panel stated that this decision may be reversed if the interest rates and economic certainty return to normal.

2

The implementation of the formulaic approach in Canada created a persistent divergence between allowed utility returns in Canada and the US<sup>95</sup>. By 2008-2009, the formula approach created such low ROE values that regulators could not ignore the problems with the formula approach any further.

7 The NEB was the first to move away from the formula approach. In 2008, the NEB heard the 8 application of Trans Quebec & Maritimes Pipeline (TQM) to establish an allowed return on equity 9 and capital structure for 2007 and 2008. The decision in that proceeding was a major departure 10 from the formulaic means by which the NEB had determined allowed ROEs since 1995 for the 11 major pipelines it regulated. In the RH-1-08 Reasons for decision released in March 2009 (TQM 12 Decision), the NEB decided that the ROE for TQM should not be set by the RH-2-94 formula.

<sup>&</sup>lt;sup>95</sup> Kenneth Gordon and Jeff Makholm (2008); "Allowed Return on Equity in Canada and the United States - An Economic, Financial and Institutional Analysis".



Pursuant to the TQM Decision, in 2009 and by Order 2009-216 AUC also moved away from its
 automatic adjustment formula stating that the formula produced results that were not correlated

- 3 with the market movement. As mentioned above, by Order G-158-09, the BCUC also followed
- 4 and eliminated its formula stating that the formula produced values that failed to meet the Fair
- 5 Return Standard. By decision D-2009-156, the Regie in Quebec also suspended the AAM and
- 6 fixed the ROE for Gaz Metro.

7 The OEB is the only regulator that has consistently continued to use the AAM approach since 1997. Nevertheless, the OEB has acknowledged that establishing the initial parameters of the 8 9 generic formula will have a profound influence on the potential success or failure of the process. 10 Over time, these parameters and adjustment factors will have a cumulative or compounding effect 11 such that the application of it may not continue to meet the Fair Return Standard. As such, the OEB has determined that the base and the formula parameters shall be reviewed every five years 12 13 to ensure the produced ROE values are reasonable. In 2009, the OEB reviewed the then existing 14 formula and concluded that it is unreasonable to conclude that the formula correctly specifies the 15 relationship between interest rates and equity returns, based on the passage of time, changes in 16 financial and economic circumstances, and the empirical analyses provided by participants. As 17 such, the OEB re-set the base ROE and changed the formula model to a two-variable formula 18 that considers both changes in LCB and utility bond spread. The OEB decision to refine and reset 19 its formula-based ERP approach rather than abandon it was influenced by the large of number of 20 utilities under the OEB's regulation.

In 2013, the BCUC re-established the AAM approach adopting the OEB's two-variable model. However, to avoid the downward bias inherent in the formula, the BCUC also decided to make the application of the formula conditional upon the actual LCB yield meeting or exceeding a threshold of 3.8 percent. Since 2013, the Canadian long-term bond yield remained below the 3.8 percent threshold and therefore this formula was not applied. Finally, in 2016, BCUC Order G-129-16 suspended the AAM formula indefinitely.

## 27 9.2 MAJOR DRAWBACKS OF THE AAM APPROACH

Despite its initial appeal, a closer look at the AAM approach reveals several major drawbacks that can result in an AAM approach failing to achieve its expected benefits, or worse, formula generated ROE values not meeting the Fair Return Standard. These drawbacks are discussed in the sections below.

### 32 9.2.1 AAM Approach May Not Achieve Regulatory Efficiency

The AAM was first introduced to streamline the regulatory process for determination of cost of capital and to improve regulatory efficiency. However, the application of an AAM would not necessarily bring any efficiency to the regulatory process in BC.

As indicated in Table 9-1 above, the BC experience with the AAM was that both base ROE used in the AAM formula and the parameters of the formula as well as the coefficient factors applied to



each variable needed to be reviewed on a regular basis to ensure that the formula generated
results remained reasonable. The AAM formula in BC was subject to a number of changes in
1997, 1999, 2005 and 2013, with each change coming as a part of a larger proceeding that

4 compared the outputs to other evidence and expert analysis.

5 Ontario is the only Canadian jurisdiction with an AAM in effect. In jurisdictions such as Ontario 6 with a large number of regulated utilities, the AAM can be used to avoid a case-by-case review of 7 individual utilities' cost of capital. However, the experience in Ontario has also been that the 8 parameters of the formula have had to be updated through regulatory processes due to the AMM 9 outputs departing from Fair Returns. While most of the utilities in Ontario are small municipal 10 utilities, applying an AAM output to utilities of more diverse risk profiles also has the potential 11 disadvantage of failing to consider the risk differentials among utilities.

## 9.2.2 AAM Approach Fails to Consider Major Factors that Affect the Change in Cost of Capital

AAM formulas adjust a previously determined allowed ROE based on changes in prevailing
government bond yields and/or utility bond spreads. However, and as explained in Concentric's
evidence, the cost of capital can be impacted by many other equally important factors that cannot
be accounted for in a simple formula:

18 An evidentiary review of a utility's cost of capital is most likely to produce the most 19 accurate estimate of a utility's cost of equity, and an AAM formula with limited 20 inputs cannot capture all of the factors that might impact the ROE estimation.<sup>96</sup>

In addition to changes in an individual company's financial and business risk, the formula approach fails to consider other important factors that can affect the cost of capital models. These may include changes in proxy companies' earnings growth and beta values. For instance, the market volatility created by the COVID-19 pandemic in 2020 led to significant increase in utility betas which would not have been reflected in a formula.

Considering that the Fair Return Standard must be met each time the formula generated ROE values are used, and not on average, the failure of the AAM approach to consider these important factors in every year the formula is used can result in Fair Return Standard not being met in any given year.

# 30 9.2.3 AAM Formula is Designed Based on Historical Relationships that May 31 Not Hold in Individual Future Years

The essential elements of a formulaic approach and their weightings in the formula must be empirically derived. For instance, the parameters in the two-variable formula and their weighting must be supported by the regression of historical equity returns and interest rates. In an era of stable interest rates and equity markets, these relationships may hold for many years; however,

<sup>&</sup>lt;sup>96</sup> Appendix C, p. 155.



as described in Concentric's evidence in the 2012 Stage 1 Proceeding and evidenced by the
 history of AAM application in Canada, historical relationships may not be a good indicator of the

3 future:

There are several fundamental challenges associated with the design and implementation of an ROE formula. Foremost among these is the dynamic nature of financial markets. Formula parameters are typically static and based on historic relationships. Those fundamental relationships may shift, leaving the formula out of touch with current market conditions. Nowhere has this been more evident than with the evolution of steadily lower government bond yields over the past decade,

10 in a shifting relationship with equity markets.<sup>97</sup>

If the historical relationships do not present the current and/or future relationships, then the formula generated ROE values cannot meet the Fair Return Standard. Indeed, many Canadian regulators have cited this issue to justify their decisions to suspend or change their AAM formulas. For instance in its 2009 Decision, the BCUC determined that due to monetary policies of the central banks and the so-called flight to quality, the historical relationships between interest rates and the equity returns cannot be relied on to estimate the allowed ROE that meets the Fair Return Standard:

18The Commission Panel agrees that a single variable is unlikely to capture the many19causes of changes in ROE and that in particular the recent flight to quality has20driven down the yield on long-term Canada bonds, while the cost of risk has been21priced upwards.98

Similarly, in its 2016 Decision, the BCUC decided to suspend the AAM approach until the significant influence of central banks on bond yields, which had changed the historical relationship between the equity returns and interest rates used in the AAM formula, was lessened:

25 The Panel continues to hold the view that an effective AAM can be a useful tool in 26 providing an updating mechanism for ROE thereby eliminating some of the need 27 for lengthy and expensive formal reviews. However, the Panel acknowledges that economic conditions are uncertain and accept Dr. Booth's explanation of long 28 29 Canada bond yields being less affected by investors and more by central banks. 30 Therefore, the Panel does not believe that continuing with an AAM at this time will 31 necessarily result in changes reflecting a fair ROE or meeting the Fair Return 32 Standard.99

In conclusion and consistent with previous proceedings, FortisBC believes that a formula cannot capture all of the changes facing a utility's cost of capital and can yield a return that does not meet the Fair Return Standard. This is particularly true today as the monetary and fiscal policies in response to the COVID-19 pandemic have resulted in significant uncertainty in capital markets

<sup>&</sup>lt;sup>97</sup> Concentric evidence in the 2012 Stage 1 Proceeding, p. 10.

<sup>&</sup>lt;sup>98</sup> 2009 Decision, p. 73.

<sup>&</sup>lt;sup>99</sup> 2016 Decision, p. 89.



- 1 that do not reflect the historical relationship between interest rates and equity returns. Therefore,
- 2 FortisBC respectfully submits that the application of the AAM in BC is not warranted. Instead, the
- 3 BCUC should review the cost of capital for the Benchmark Utility periodically, as it has done in
- the past. Earlier review may be necessary if there are significant changes to the Benchmark
  Utility's risk profile or if they are material changes in the capital market conditions. Nevertheless,
- 6 if the BCUC determines that an AAM is appropriate then it should consider the criteria specified
- 7 in Concentric's evidence.<sup>100</sup>

<sup>&</sup>lt;sup>100</sup> Appendix C, p. 154.



## 1 10. TRIGGERS FOR FUTURE APPLICATIONS

The BCUC's amended scope for Stage 1 of this GCOC proceeding identifies "the criteria, offramps or other triggers to warrant a future cost of capital proceeding"<sup>101</sup> as one of the matters in scope that needs to be considered in this proceeding. FortisBC believes, for the reasons set out below, that the BCUC should not establish a trigger in advance. The established approach, which

6 includes periodic review of utilities' cost of capital, is most appropriate.

FortisBC is not aware of any regulator in Canada that uses an automatic trigger mechanism to
initiate cost of capital review nor is able to formulate a trigger mechanism that can capture all of
the various factors that can impact the investors' opportunity cost.

10 As explained in Mr. Coyne's evidence, off-ramps are often used in incentive rate-setting plans to trigger a review of the plan in the event that the company's actual earned ROE is below or above 11 12 a specified level and indeed similar off-ramp mechanisms already exist in FEI's and FBC's Multi-13 year Rate Plans. Cost of capital proceedings, however, are focused on estimating the "opportunity 14 cost" and there is no basis to rely on the variance between realized and allowed ROEs to initiate 15 a cost of capital proceeding since this variance does not necessarily reflect the changes in 16 investors' opportunity cost nor the changes in market conditions. Numerous business and capital 17 market factors affect the cost of capital for utilities and these factors are inherently dynamic. In 18 Mr. Coyne's expert opinion, there is no need to change the current approach of conducting 19 periodic cost of capital reviews and that periodic cost of capital proceeding that is conducted every 20 three to five years is the best approach to ensure that the authorized return remains appropriate 21 for regulated utilities, including those in BC.<sup>102</sup>

<sup>&</sup>lt;sup>101</sup> Order G-281-21, Appendix B, p. 1.

<sup>&</sup>lt;sup>102</sup> Appendix C, p. 156.



## 1 11. CONCLUSION

- 2 The materials filed in this proceeding provide the necessary evidence on which to determine the
- 3 key matters at issue in Stage 1. In determining an ROE and capital structure that meets the Fair
- 4 Return Standard, the BCUC should give recognition to the current assessment of FEI's and FBC's
- 5 business risks, consideration of the need for thicker common equity to support credit ratings and
- 6 the ongoing challenges posed by uncertainty in financial markets.
- 7 Based on the evidence before the BCUC, FortisBC submits that for FEI the Fair Return Standard
- 8 is met in this proceeding by having a capital structure that includes a 45 percent equity ratio, and
- 9 an ROE of 10.1 percent. Similarly, for FBC, the Fair Return Standard is met by having a capital
- 10 structure consisting of 40 percent common equity and 60 percent debt, and a return on common
- 11 equity of 10.0 percent.