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July 14, 2022

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

Attention: Ms. Sara Hardgrave, Acting Commission Secretary

Dear Ms. Hardgrave:

**Re: British Columbia Utilities Commission (BCUC) Generic Cost of Capital (GCOC) Proceeding**

**FortisBC (comprised of FortisBC Energy Inc. (FEI) and FortisBC Inc. (FBC)) Submission on Topics of Divergence among the Experts**

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FortisBC writes in response to the BCUC's Letter dated July 8, 2022 (Exhibit A-19) seeking written submissions from participants regarding topics for which Mr. Coyne of Concentric Energy Advisors Inc. and Dr. Lesser of Continental Economics Inc. have diverging opinions. These submissions have been sought to assist the Panel in refining the scope of an oral hearing, should one occur.

FortisBC's submissions below address this request by highlighting both the areas of agreement and disagreement among the experts as set out in the experts' evidence that has been filed in this proceeding.

## Areas of Agreement

On pages 157-158 of his initial report (Exhibit B1-8-1, Appendix C), Mr. Coyne set out the main areas of alignment between his evidence and Dr. Lesser's final report:

> I have reviewed Dr. Lesser's August 2021 report regarding the methodologies used to estimate the cost of equity for regulated utilities and agree with several aspects of that report, including:
>
> - His conclusion that capital markets are international and integrated, and that if the regulatory framework is similar, there is generally no reason to exclude comparable companies in a foreign country. However, Dr. Lesser cautions that regulators should weigh data carefully as there may be risk differences due to accounting treatment, vertical integration, etc. Ultimately, Dr. Lesser concludes that the Commission should allow integration of extra jurisdictional

companies on a case-by-case basis, while I support use of both U.S. and North American proxy groups as an alternative to a purely Canadian proxy group.

- His support of earnings growth rates in the DCF model, and his support for an adjustment to the dividend yield equal to ½ the earnings growth rate.
- His conclusion that betas tend to revert toward the market mean of 1.0 and his conclusion that adjusted betas are most appropriate in the CAPM analysis.
- His recognition that the Hamada equation can be used to adjust for differences in capital structure between the company for which the return is being established and the proxy group. While I have not adjusted my CAPM results for financial leverage, I agree that such an adjustment can be appropriate and would increase the ROEs for FEI and FBC.
- His support for the use of the income-only return in calculating the historical market risk premium, as evidenced by his statement that the historical MRP in the U.S. was 7.15 percent from 1926-2019.
- His recognition of the merits of a forward-looking market risk premium in the CAPM analysis.
- When calculating a historical market risk premium, his support for using the arithmetic average rather than the geometric average return, and his support for using the entire time period to compute the average historical market risk premium.
- His recognition that many Canadian regulators include 50 basis point ROE adder for flotation costs and financial flexibility.
- His statement that the resulting ROE values from an AAM may not accurately reflect a regulated utility's actual cost of capital.
- Dr. Lesser's recognition that not all deferral accounts reduce risk; some such as weather deferral accounts are neutral, while others may increase risk (i.e., accounts with a growing deferral balance).

[Footnotes omitted]

In response to BCOAPO IR2 25.1 (Exhibit A2-24), Dr. Lesser confirmed that Mr. Coyne has accurately highlighted the main areas of alignment between his evidence and that of Dr. Lesser:

> I confirm that Mr. Coyne has appropriate reflected my views. However, I note that, while the point on p. 158, lines 6-7 is correct, I do not agree that is

appropriate to add a 50 basis point adder to ROE values for flotation costs, for the reasons set forth in my August 2021 report.

Further, on pages 2 to 3 of his rebuttal evidence filed on June 28, 2022 (Exhibit B1-21), Mr. Coyne listed eight broad areas of agreement between his ROE analysis and Dr. Lesser's responses:

1) Dr. Lesser and I agree regarding the use of North American gas and electric proxy groups to estimate the authorized ROE for FEI and FBC. [See Dr. Lesser's response to BCUC IR2 1.3.] I do not, however, agree with his suggestion that lower allowed returns for Canadian companies might warrant a downward adjustment to the U.S. data. The general reasons for my disagreement were addressed in my initial Report on pages 37-38, and specifically in my risk analysis for FEI on pages 112-117 and for FBC on pages 138-141.
2) We agree that projected EPS growth rates should be used in the DCF model rather than dividends per share or sustainable growth rates. [See Dr. Lesser's response to BCUC IR2 5.1.]
3) We agree that beta coefficients in the CAPM analysis should be adjusted for their tendency to revert to the market average of 1.0 (i.e., the Blume adjustment). Dr. Lesser supports use of Value Line betas, while I have relied on betas from both Value Line and Bloomberg. [See Dr. Lesser's response to BCUC IR2 7.1.]
4) We agree that it is reasonable to use a North American proxy group and that the U.S. and Canadian economies are highly integrated and capital markets are international. [See Dr. Lesser's response to BCUC IR2 1.3.]
5) I agree with certain of his comments on Energy Transition risk. In particular, I agree with Dr. Lesser that Energy Transition risk partly depends on the response of policymakers and regulators. Their responses can mitigate some, but not all exposure for shareholders. [See Dr. Lesser's response to BCOAPO IR2 14.4.] A case in point was Pacific Northern Gas' ("PNG") experience in 2000, when a major company reorganization was undertaken in response to liquidity issues created when PNG's largest customer, the methanol complex in Kitimat, closed for a one-year period. Shareholders were exposed to a sharp reduction in the share price and a cut in the dividend. Looking ahead, there is risk that cannot be completely mitigated by regulators or policymakers related to the future growth prospects for regulated gas utilities such as FEI that Dr. Lesser does not directly address in his responses to data requests.
6) I agree with Dr. Lesser that it is possible to take into account differences in financial leverage between the proxy group companies and FEI and FBC by adjusting the authorized ROE. [See Dr. Lesser's response to

BCUC IR2 8.1.] Dr. Lesser has indicated that the Hamada equation can be used for this purpose; however, I have not used the Hamada formula to adjust my CAPM analysis, so my estimated ROEs for FEI and FBC are lower than they would be if I had used this adjustment.

7) Dr. Lesser does not provide any specific recommendations regarding the appropriate capital structure for FEI or FBC, nor does he provide any responses that oppose my recommendation to increase the deemed equity ratio for FEI from 38.5 percent to 45.0 percent. However, he does state that he is not aware of any evidence that gas utilities have been raising their equity ratios due to the Energy Transition risk, which I will address later in my Rebuttal Testimony.

8) Finally, I agree with Dr. Lesser's view that it is not possible to isolate the effects of the COVID 19 pandemic on the model inputs and that even if one could isolate any impacts that does not mean that these inputs are any less representative than their actual values. [See Dr. Lesser's responses to BCOAPO IR2 21.1, 22.1 and 22.1.2.]

## Areas of Divergence

On pages 158-159 of his report (Exhibit B1-8-1, Appendix C), Mr. Coyne set out the main areas of divergence between his evidence and Dr. Lesser's final report:

> I disagree, however, with Dr. Lesser on several important aspects of his report, including:
>
> - His concern that short-term EPS growth rates from equity analysts are overly-optimistic as compared to GDP growth, and his statement that EPS growth rates should be from a single source rather than from multiple providers of market data. Ultimately, Dr. Lesser appears to prefer the multi-stage DCF model over the constant growth DCF form. Although I do not share Dr. Lesser's concern that EPS growth rates for utilities are overly-optimistic, my ROE recommendation relies on an equal weighting of the Multi-Stage DCF and CAPM results.
> - His assertion that it is not appropriate to use a forecast interest rate in the CAPM, and that only current government bond yields should be used.
> - His claim that the forward-looking MRP should be determined using a multi-stage DCF model rather than a constant growth DCF model.
> - His conclusion that the existence of a size premium is often disputed and is primarily observed for U.S. firms, despite his earlier statement

that smaller firms tend to have higher returns than those predicted by the CAPM.

- His assertion that there is not always an inverse relationship between the equity risk premium and interest rates. My risk premium analysis demonstrates that such an inverse relationship has existed for regulated gas and electric utilities since 1992.
- His concern that the risk premium model assumes that the ROE is determined solely by bond yields. While I present the results of a risk premium model, I do not include those results in my ROE recommendations for FEI or FBC.
- His view that an adjustment of 50 bps for flotation costs almost always over-compensates the utility and his failure to recognize that Canadian regulators have also determined that it is reasonable to include financial flexibility in this adjustment.

[Footnotes omitted]

In response to BCOAPO IR2 25.2 (Exhibit A2-24), Dr. Lesser confirmed that Mr. Coyne has accurately highlighted the main areas of disagreement:

> I believe Mr. Coyne has accurately stated those areas for which he disagrees with statements in my August 2021 report, although several of the reasons he gives for his disagreements do not accurately reflect my views.

Further, on pages 4 and 5 of his rebuttal evidence (Exhibit B1-21), Mr. Coyne further highlighted eight areas of disagreement between his ROE analysis and Dr. Lesser's preferred approach:

> Dr. Lesser and I disagree in the following areas: 1) the composition of the proxy groups for FEI and FBC, although this is not a primary driver of the results, as I will demonstrate; 2) his preference for a single source of EPS growth rates in the DCF model, as well as his comments related to optimism bias in analyst growth rates; 3) his use of current average government bond yields instead of projected bond yields in the CAPM analysis; 4) his preference for using the multi-stage DCF model rather than the constant growth DCF model to calculate the forward-looking market risk premium in the CAPM analysis; 5) his comments regarding an adjustment to the authorized ROE for flotation costs and financial flexibility; 6) certain statements Dr. Lesser has made regarding Energy Transition risk for gas utilities and whether that risk should be reflected in the authorized return for FEI; 7) his position concerning the credit ratings and credit risk of FortisBC, FEI and FBC; and 8) other miscellaneous issues such as how small size affects the return requirements of investors, and whether there is an inverse relationship between interest rates and the equity risk premium.

## Summary and Conclusion

In summary, the main areas of divergence among the two experts are highlighted in Mr. Coyne's evidence and are as follows:

- Proxy group screening criteria and the companies within the proxy groups;
- Risk-free rate assumptions in the CAPM model (use of forecast long-term government bond yields versus currents rates);
- EPS growth rates and analyst bias for use in DCF analysis, as well as the use of multiple sources of EPS growth estimates versus a single source of EPS growth forecast;
- Approach for calculating the forward-looking MRP in the CAPM analysis;
- Flotation cost and financial flexibility;
- Various comments regarding the credit ratings and credit risk;
- The degree of regulators' and policymakers' ability to mitigate the Energy Transition risk and the preferred approach to reflect this risk in the utility's cost of capital (through ROE, capital structure or both); and
- Miscellaneous issues such as small size premium and inverse relationship between interest rates and equity risk premium.

As FortisBC submitted at the procedural conference on July 8, 2022, it believes that that the evidentiary record is sufficiently robust, and the issues sufficiently crystalized, to proceed based on a fully written record. However, FortisBC is not opposed to an oral hearing if the Panel believes that it would be worthwhile.

As also submitted at the procedural conference, if the Panel desires a carefully scoped hearing, it is within its power, and reasonable and fair, to proceed on the basis of a scoped oral hearing that focuses simply on the issues that the participants and experts have identified as areas of disagreement.

If further information is required, please contact the undersigned.

Sincerely,

**on behalf of FORTISBC**

***Original signed:***

Diane Roy

cc (email only): Registered Parties