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Commercial Energy Consumers Association of British Columbia
c/o Owen Bird Law Corporation
P.O. Box 49130
Three Bentall Centre
2900 – 595 Burrard Street
Vancouver, BC
V7X 1J5

Attention: Mr. Christopher P. Weafer

Dear Mr. Weafer:

Re: British Columbia Utilities Commission (BCUC) – 2022 Generic Cost of Capital Proceeding – Project No. 1599176

FortisBC Energy Inc. and FortisBC Inc. (collectively FortisBC) Response to the Commercial Energy Consumers Association of British Columbia (CEC) Information Request (IR) No. 1 on FortisBC Rebuttal Evidence

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On January 18, 2021, BCUC initiated the proceeding referenced above. In accordance with the regulatory timetable established in British Columbia Utilities Commission Order G-217-22A for the review of FortisBC's Evidence, FortisBC respectfully submits the attached response to CEC Rebuttal IR No. 1.

For convenience and efficiency, FortisBC has occasionally provided an internet address for referenced reports instead of attaching lengthy documents to its IR responses. FortisBC intends for the referenced documents to form part of its IR responses and the evidentiary record in this proceeding.

If further information is required, please contact the undersigned.

Sincerely,

on behalf of FORTISBC

Original signed:

Diane Roy

Attachments
cc (email only): Commission Secretary
Registered Parties

84. Reference: Exhibit B1-21 page 5 of FortisBC evidence

> FortisBC notes that there have been certain instances for both FEI and FBC where the debt issuance timing has shifted because of volatile and unpredictable market conditions, most recently during the COVID-19 pandemic. Fortunately, FEI and FBC have not been in a position where that they had to cancel a publicly announced debt issuance due to market disruptions.

84.1 Please elaborate on the example of how FEI and FBC shifted their debt issuance timing due to the COVID-19 pandemic, and identify any other instances that occurred over the last 10 years.

Response:

An example of the shift in timing that occurred is FEI and FBC not extending their credit facilities in 2020 and allowing a year of maturity to lapse. FEI and FBC maintain $700 million and $150 million credit facilities, respectively, and these credit facilities are extended on an annual basis to maintain a 5-year maturity period to avoid a situation where FortisBC would be required to repay $850 million on a short notice. However, on advice from FortisBC's lenders and due to significant market volatility in 2020, FortisBC did not extend these facilities and thus was not able to maintain a 5-year maturity period. FortisBC did not incur any additional cost because of not executing the extensions in 2020; however, it did have a shorter maturity period for the credit facilities until the next extension in 2021, which increased refinancing risk.

Other examples are longer execution timing for debt issuances because FortisBC had to wait for the right windows of opportunity to issue debt due to market volatility; for example, FEI's debt issuance in 2020 or FBC's debt issuance in 2022. The shift in timing was anywhere from several months to up to six months. No direct additional cost was incurred because of the extended execution timing; however, long-term debt issuances are a means of reducing refinancing risk compared to utilizing short-term debt facilities and any delay in issuing long-term debt adds to the risk of not being able to obtain adequate funding.

84.2 In what ways did this/these timing shift(s) impact FEI or FBC, and please provide quantification for any costs that accrued as a result.

Response:

Please refer to the response to CEC Rebuttal IR1 84.1.

85. Reference: Exhibit B1-21, page 7 of FortisBC evidence

Table 1: Moody's rating grid for regulated utilities

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[1] Generation and Fuel Diversity[2]	5 % 5 %
Financial Strength	40 %	CFO Pre-WC[1] + Interest / Interest CFO Pre-WC / Debt CFO Pre-WC – Dividends / Debt Debt / Capitalization	7.5 % 15 % 10 % 7.5 %

Further, with regards to the likelihood of downgrade, Moody's does comment on the financial and non-financial factors that can lead to a downgrade. In the specific case of FBC, Moody's considers two main factors that, if they occurred, could lead to a rating downgrade:

- A forecast of a sustained deterioration in credit metrics including CFO Pre-W/C to debt of less than 8%
- An adverse regulatory decision

85.1 FortisBC states that a 'sustained deterioration in credit metrics including CFO Pre-W/C to debt of less than 8% could result in a downgrade. Over what period of time would a deterioration generally be considered as 'sustained'.

Response:

Moody's indication of what period of time would constitute a "sustained" deterioration is intentionally not defined. This is because qualitative comments such as these involve a degree of subjectivity and if such a deterioration were to occur, the length of time would be considered amongst a number of other factors in applying analyst judgement in whether a downgrade is warranted.

85.2 Should the statement be interpreted to mean that a sustained reduction in the CFO Pre-W/C to debt metric would be sufficient to cause a downgrade, or would this need to be accompanied by deterioration in other metrics as well? Please explain.

<u>Response:</u>

In Moody's comments on potential downgrade triggers, it is not specified whether one of both of those factors would trigger a downgrade. Any ratings action decisions by Moody's would likely be determined by assessing the overall significance of each of the factors and in consideration of any other credit risk factors at the time of assessment.

85.3 Please provide the converse information to indicate what % would be considered as being an 'improvement' in the metric that might lead to an upgrade. Ie. What would be the expected threshold which would be considered a significant improvement? Over 9%? 10%?

<u>Response:</u>

The following statement was included in FBC's latest credit rating report dated November 25, 2021 included in Appendix D of the Evidence:

> **Factors that could lead to an upgrade**
>
> Given the ongoing forecasted weakness in credit metrics, an upgrade is unlikely over the near term. We could upgrade the company with a material, sustained improvement in financial metrics, including CFO pre-W/C to debt in the low teens.

The above comment implies that FBC's CFO pre-WC to debt should be above 13 percent in addition to improvements in the other three metrics to be considered for an upgrade.

86. Reference: Exhibit B1-21, page 7 of FortisBC evidence

In its primary evidence, FBC discussed that its CFO pre-W/C to debt metric for the two years ending 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. As explained in response to BCUC IR2 72.3, Moody's forecasts that FBC's CFO Pre-WC / Debt metric will remain between 8 to 10 percent range. FBC's proposed ROE and equity thickness provide some assurance that FBC's CFO Pre-WC / Debt would remain in the upper bound of Moody's 8 to 10 percent forecast which along with other factors in Moody's rating methodology will help to maintain its current credit rating.

86.1 Please provide the CFO pre-W/C to debt metric for 2021.

Response:

Please refer to the response to BCUC IR1 25.3 where FBC provided an internally calculated CFO pre-WC to debt metric for 2021. As discussed in the response to that IR, Moody's annual credit rating reviews typically occur in the third or fourth quarter of the year and so FBC has not yet received the 2022 Moody's Credit Rating Report with 2021 fiscal year end financial metrics. As such, the 2021 CFO pre WC to debt metric was calculated internally by FBC to simulate Moody's methodology for calculating its proprietary credit metrics. FBC cannot represent that it has accurately incorporated all elements and this calculation should be used solely for illustrative purposes:

CFO pre-WC to Debt for 2021 = 10%

Information Requests on Concentric Rebuttal Evidence

87. Reference: Exhibit B1-21 page 3 of Concentric evidence

> 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.

87.1 Please elaborate on the types of risks for future growth prospects that cannot be completely mitigated by regulators or policy makers.

Response:

Concentric provides the following response:

Please see pages 88-89 of Concentric's January 2022 report for a discussion of how the energy transition affects the future growth prospects of gas distribution utilities such as FEI. Concentric observes in that section of the report that, depending on the specific pathways ultimately taken by the Canadian federal government and the Province of BC, FEI's growth prospects (i.e., new customer additions, average use per customers) may be severely constrained.

Concentric ultimately concludes that both short-term and long-term risk is important from an investor's perspective, and regulation generally is better at addressing short-term risk, whereas some long-term risks cannot be mitigated as effectively by regulation. If FEI's growth prospects over the long-term are impeded because of changes in environmental policy or investor sentiment toward the natural gas industry, it will be difficult, if not impossible, for regulation to fully mitigate that risk for investors.

88. Reference: Exhibit B1-21 page 11 of Concentric Evidence

> Estimates from alternative sources can also vary. Dr. Lesser is concerned that the growth rates from different sources may have been developed at different times, and he argues that it is not appropriate to average those growth rates for this reason. However, I see no reason to limit the EPS growth rates to a single source, such as Yahoo! Finance, when projected earnings growth rates are provided by a wide variety of sources. Although the Federal Energy Regulatory Commission ("FERC") previously expressed a preference for growth rates from I/B/E/S, more recent decisions (for example, Opinion No. 569) have indicated that EPS growth rates from alternative comparable sources of consensus EPS growth rates may also be considered.
>
> Another consideration is that, in my experience, the EPS growth rates reported on Yahoo! Finance, which is the source Dr. Lesser prefers, are not always updated on a regular basis and may become stale at times. In addition, there is less analyst coverage for Canadian utility companies, and Yahoo! Finance does not provide EPS growth rates for every Canadian utility company, so it is necessary to also consider other sources such as Zacks Investment Research, Value Line, and SNL Financial to develop a more robust DCF analysis for a Canadian proxy group. For these reasons, I continue

88.1 Mr. Coyne states that he is not concerned that information can be developed at different times, but then argues that Yahoo!Finance information can become stale. In what ways, if any, does Mr. Coyne account for the possibility that the growth rates from the different sources made at differing times could include 'stale' information?

<u>Response:</u>

Concentric provides the following response:

Concentric accounts for the possibility of stale growth rate data from one particular source by using forecast growth rates from multiple sources, including Yahoo! Finance, Zacks Investment Research, Value Line, and SNL Financial. This does not completely eliminate the possibility, but substantially reduces it compared to reliance on a single source.

88.2 Does Mr. Coyne apply a maximum period over which he will use information or apply some sort of decay variable to account for the potential for the information being out of date? Please explain.

Response:

Concentric provides the following response:

No, Concentric does not apply a maximum period over which we use information or another method to account for the possibility of stale data. Yahoo! Finance is the only source of growth rates that Mr. Coyne is aware of where growth rates may not have been updated on a regular basis for every company. Value Line publishes updated reports for each company in its coverage universe every three months. Zacks and SNL Financial both update the consensus growth rates for regulated utility holding companies reported on their websites on a regular basis. Yahoo! Finance also updates growth rates on a regular basis for most companies, but in Mr. Coyne's experience there have been occasions when Yahoo! Finance stopped updating growth rate forecasts for a particular company and did not remove the stale forecast from its website.

89. Reference: Exhibit B1-21 page 13 of Concentric Evidence

Figure 3: Projected vs Actual EPS Growth Rates

	Projected EPS Growth - 2016	Actual Compound EPS growth – 2017-2021
U.S. Electric	5.11%	5.13%
U.S. Gas	5.60%	6.86%

89.1 Please provide the same data for the periods 2001-2006, 2006-2011, 2011-2016

Response:

Concentric provides the following response:

Figure 3 (as shown above) compares the projected EPS growth rates in 2016 for the companies in our U.S. Gas and U.S. Electric proxy groups to the actual compound EPS growth rates for these companies from 2017-2021. The time period for this comparison was selected because it covers the most recent five-year period available. Concentric cannot provide the same data for the requested periods because we do not have access to projected EPS growth rates for the U.S. proxy group companies prior to October 2012. The figure below summarizes the data using projected EPS growth rates in October 2012 to the actual compound EPS growth rates from 2013-2018.

	Projected EPS Growth – Oct 2012	Actual Compound EPS growth – 2013 - 2018
U.S. Electric	4.35%	5.58%
U.S. Gas	4.20%	10.46%

90. Reference: Exhibit B1-21, page 21 of Concentric Evidence and FortisBC evidence page 2

Dr. Roger Morin has also observed that utilities need the ability to attract capital even during "market breaks" because they have an ongoing obligation to serve. For that reason, he recommends providing the utility an additional allowance for financial flexibility during difficult market conditions, as follows:

> The flotation cost allowance of 5% allows for both the direct flotation costs and market pressure component but does not contain an explicit allowance for market break.
>
> ***
>
> Such an allowance is desirable, however. If negative events should occur during the time period from announcement of a public issue to actual pricing, the price could fall below book value unless a sufficient margin is maintained. Compared to non-regulated companies, utilities do not possess the same latitude and discretion in accessing capital markets in view of their obligation to serve. They must access capital markets regardless of capital market conditions. Therefore, they have limited ability to time security issuances in order to avoid an adverse market break.[19]

FEI and FBC rely on their parent company, Fortis Inc., for all of their equity issuance needs and have no direct experience with equity markets and their functioning during major market disruptions such as 2008-2009 financial crisis[1]. As such, most of FortisBC's evidence on constrained capital markets conditions is focused on ability to access debt capital markets. Nevertheless, debt and equity capital markets are linked and generally disruptions in either one can impact the other.

90.1 Please comment on the importance of FEI and FBC having financial flexibility during 'market breaks' from flotation cost allowance based on their history, and please explain whether or not this need is impacted by FEI and FBC relying on Fortis Inc for all of their equity issuance needs.

Response:

FEI and FBC are not publicly listed companies and therefore are not able to access equity capital markets nor do they have a history of issuing equity or incurring flotation costs. As described above, FEI and FBC rely on Fortis Inc. for all equity injections. However, if FEI and FBC were publicly listed companies that issued equity, financial flexibility would be important to access equity markets in most market conditions.

Concentric provides the following response:

Regulated utilities are capital intensive, and access to both debt and equity capital is needed regardless of market conditions. As we saw during the financial crisis of 2008/2009, over the course of the pandemic, and the inflation runup in 2022, adverse market conditions can constrain access to capital on reasonable terms. A strong balance sheet is especially important during such periods, and an allowance for financial flexibility provides companies such as FEI and FBC with the ability raise the necessary capital to finance their businesses and to manage the Energy Transition. The fact that FEI and FBC rely on Fortis Inc. for equity does not change that need for financial flexibility, because authorized returns should be established on a stand-alone basis and must satisfy the fair return standard, including offering a comparable return, enabling the company to maintain its financial integrity, and allowing the company to attract capital.

91. Exhibit B1-21 page 25 of Concentric Evidence

> **Q. Dr. Lesser states that he is not aware of any trend of higher equity ratios for gas utilities due to the Energy Transition in his response to BCUC IR2 2.5. Please comment.**
>
> A. Energy Transition is a relatively new risk for gas distributors, as explained in my Report, and policies to reduce carbon emissions are driving fundamental changes in the natural gas industry. As this risk evolves and as regulatory policy matures on this issue, Energy Transition will be accounted for in the business risk profiles of gas utilities such as FEI. , Higher equity ratios are one tool available to regulators and utilities to accommodate Energy Transition risk.

91.1 Please confirm that there are several new technologies and options being developed such as the use of RNG and hydrogen which can be expected to evolve and mitigate the energy transition risk for gas distributors.

<u>Response:</u>

Concentric provides the following response:

Confirmed. However, as discussed on pages 85-87 of Concentric's January 2022 report, there are risks in pursuing those pathways from an investor's perspective. There are concerns about the viability of hydrogen on a broader scale at this time, and this creates uncertainty and risk for investors. Investment advisors and credit rating agencies have expressed concerns with the high cost of hydrogen production and the lack of coordinated policy. Academic studies have questioned whether modifying gas pipelines to carry hydrogen will be an acceptable solution or will be seen as prolonging fossil fuel use. Academic research has also identified a variety of technical, financial and other barriers to the widespread adoption of RNG. Concentric concludes that while hydrogen and RNG may offer a potential pathway for FEI through the Energy Transition, investors perceive significant risk to that pathway due to operational, technical, and financial challenges, especially in the near to intermediate term.