FORTIS BC™

Diane Roy
Vice President, Regulatory Affairs

Gas Regulatory Affairs Correspondence
Email: gas.regulatory.affairs@fortisbc.com

Electric Regulatory Affairs Correspondence
Email: electricity.regulatory.affairs@fortisbc.com

FortisBC
16705 Fraser Highway
Surrey, B.C. V4N 0E8
Tel: (604) 576-7349
Cell: (604) 908-2790
Fax: (604) 576-7074
www.fortisbc.com

October 20, 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) 2022 Generic Cost of Capital (GCOC) Proceeding – Stage 1

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

September Update to Concentric's Financial Models

As part of Order G-217-22 dated August 8, 2022, the BCUC panel directed FortisBC to ask its consultant, Concentric Energy Advisors, Inc. (Concentric), to provide an update to financial models used to estimate investors' expected returns with data inclusive of September 2022.

In compliance with the BCUC's direction, Concentric's updated financial models with data inclusive of September 2022 and the related commentary are attached.

If further information is required, please contact the undersigned.

Sincerely,

on behalf of FORTISBC

Original signed:

Diane Roy

Attachments

cc (email only): Registered Interveners

REPORT:

COST OF CAPITAL UPDATE

PREPARED FOR:

FORTISBC ENERGY INC. AND FORTISBC INC.

BEFORE THE:

BRITISH COLUMBIA UTILITIES COMMISSION

OCTOBER 20, 2022

www.ceadvisors.com

Updated Model Results

As directed by the British Columbia Utilities Commission ("BCUC") in its Order dated August 8, 2022, Mr. Coyne has updated his ROE analysis for FEI and FBC using market data as of September 30, 2022. Mr. Coyne has used the same models, proxy group companies, inputs, and data sources in his updated ROE analysis as in his original ROE analysis. The results of the updated analysis are summarized in the figures below, along with the results of the original analysis for ease of comparison. The updated analyses indicate that the two-model average (Multi-Stage DCF and CAPM) has shifted down to 9.3% for the U.S. Gas proxy group (as compared to 10.1% as of December 2021), and to 9.5% for the U.S. Electric proxy group (as compared to 10.0% as of December 2021). The four-model averages are higher, but also down since December.

Figure 1: Summary of Results – Natural Gas[1] - Sept 2022 Update

	Canadian Regulated Utilities	US Gas Utilities	North American Utilities - Gas	Average
CAPM	10.08%	9.87%	10.24%	10.1%
Constant Growth DCF	11.74%	9.69%	10.72%	10.7%
Multi-Stage DCF	10.24%	8.81%	9.57%	9.5%
Risk Premium		10.12%	10.12%	10.1%
Average	10.7%	9.6%	10.2%	10.1%
Avg CAPM and Multi-Stage DCF	10.2%	9.3%	9.9%	9.8%

1 DCF results are based on 90-day average stock prices for proxy group companies. Results include 50 basis points for flotation costs and financial flexibility except for U.S. risk premium results. The risk premium analysis was only conducted for the U.S. Gas proxy group; as such, there are no risk premium results for the Canadian Regulated proxy group. The CAPM results do not include a leverage adjustment using the Hamada formula.

Figure 2: Summary of Results – Natural Gas[2] - As Filed

	Canadian Regulated Utilities	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%

Figure 3: Summary of Results - Electric[3] - Sept 2022 Update

	Canadian Regulated Utilities	US Electric Utilities	North American Utilities-Electric	Average
CAPM	10.08%	10.43%	10.17%	10.2%
Constant Growth DCF	11.74%	9.66%	9.92%	10.4%
Multi-Stage DCF	10.24%	8.64%	8.93%	9.3%
Risk Premium		10.17%	10.17%	10.2%
Average	10.7%	9.7%	9.8%	10.0%
Avg CAPM and Multi-Stage DCF	10.2%	9.5%	9.6%	9.8%

2 Ibid.
3 Ibid.

Figure 4: Summary of Results - Electric[4] - As Filed

	Canadian Regulated Utilities	US Electric Utilities	North American Utilities-Electric	Average
CAPM	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%

Under normal market circumstances, Mr. Coyne would accept these results as determinative, but substantially higher interest rates and sustained higher inflation levels do not indicate a reduction in the cost of equity -- this is not an intuitive result. Markets have been anything but normal in 2022. Illustrating this point (all data as of 10/19/22):

- S&P 500 index has declined 22.6% YTD
- TSX index is down 11.4% YTD (the decline mitigated by the strength of energy companies)
- U.S. 30 Year Government Bond Yield opened the year at 1.9% and is currently 4.096%
- Canada 30 Year Government Bond Yield opened the year at 1.68% and is currently 3.45%

Contributing to this capital market turmoil, inflation in both the US and Canada is running at levels not seen since the early 1980s. In previous periods of market disruption, utilities have served as a safe haven for investors, but as explained in a *Wall Street Journal* article this week, that has not been the case recently.

> One of Wall Street's go-to safety plays isn't shielding investors from market turmoil anymore.

4 Ibid.

> Earlier this year, utility stocks were among the best-performing segments of the market as investors turned to defensive sectors to weather the financial storm. Utility stocks are typically thought of as more stable than overall equity markets as providers collect steady checks from customers even when the economy slows. At its 2022 high in mid-September, the S&P 500 utilities sector was up more than 8% year to date.
>
> That trade has unraveled. Over the past month, utility stocks have been the worst-performing sector of the S&P 500, down 14% versus the broad benchmark's 5% decline. All but one of the 28 stocks in the group have pulled back, including Consolidated Edison Inc., Duke Energy Corp. and Dominion Energy Inc. Last week, the utilities sector dropped to its lowest level of the year.
>
> A big draw of utility stocks has become less attractive as interest rates have climbed. Utility stocks are known for their sizable dividends, offering investors a regular stream of income. Companies in the S&P 500 utilities sector offer a dividend yield of 3.3%, among the highest payout percentages in the index, according to FactSet.
>
> But the outsize dividends of utility stocks are no match for climbing bond yields. The yield on the benchmark 10-year Treasury note finished above 4% on Monday for a second consecutive session. Friday marked the 10-year yield's first close above the 4% level since 2008 and 11 straight weeks of gains. Treasurys are viewed as essentially risk-free if held to maturity.[5]

These market circumstances require an examination of the models and inputs used for estimating the cost of capital and the application of informed judgment. Mr. Coyne has two specific concerns:

1. The forecast interest rates used in the September 2022 analysis are well below current levels. This may be due to the Consensus Economics' forecast lagging the fast-moving market, or to an expectation that central bank actions will stall the economy and bring down interest rates in the future. This has a direct impact on the CAPM and Risk Premium models.
2. Utility stock prices, as indicated in the above article, have responded slowly to the down market in 2022, so the 90-day historic stock price averages used in the DCF model are not reflective of current market conditions.

[5] Utility Stocks Tumble as Treasury Yields Climb, Hannah Miao, *Wall Street Journal*, October 18, 2022.

To place these circumstances in perspective, Mr. Coyne has examined the impacts of these two specific factors on the outputs of the models. To do so, he has incorporated the current government bond yields in the CAPM and Risk Premium models, and current stock prices in the DCF (both constant growth and multi-stage versions).[6] When doing so, the model results shift back to those estimated in December.

Figure 3: Summary of Results – Natural Gas[7] - Spot Update

	Canadian Regulated Utilities	US Gas Utilities	North American Utilities - Gas	Average
CAPM	10.10%	10.33%	10.51%	10.3%
Constant Growth DCF	12.38%	10.04%	11.14%	11.2%
Multi-Stage DCF	11.06%	9.21%	10.07%	10.1%
Risk Premium		10.22%	10.22%	10.2%
Average	11.2%	10.0%	10.6%	10.5%
Avg CAPM and Multi-Stage DCF	10.6%	9.8%	10.3%	10.2%

Figure 4: Summary of Results - Electric[8] - Spot Update

	Canadian Regulated Utilities	US Electric Utilities	North American Utilities-Electric	Average
CAPM	10.10%	10.88%	10.50%	10.5%
Constant Growth DCF	12.38%	10.17%	10.49%	11.0%
Multi-Stage DCF	11.06%	9.23%	9.61%	10.0%
Risk Premium		10.28%	10.28%	10.3%
Average	11.2%	10.1%	10.2%	10.5%
Avg CAPM and Multi-Stage DCF	10.6%	10.1%	10.1%	10.3%

6 Current bond yields and stock prices as of October 18, 2022.

7 DCF results are based on 90-day average stock prices for proxy group companies. Results include 50 basis points for flotation costs and financial flexibility except for U.S. risk premium results. The risk premium analysis was only conducted for the U.S. Gas proxy group; as such, there are no risk premium results for the Canadian Regulated proxy group. The CAPM results do not include a leverage adjustment using the Hamada formula.

8 Ibid.

It is Mr. Coyne's opinion that the December market data represented more normal market circumstances. The War in Ukraine, aggressive federal action on interest rates, sustained elevated levels of inflation, and pullback on the fiscal stimulus required to support the pandemic-ailing economies in Canada and the U.S. have had significant impacts on capital markets in 2022. While Mr. Coyne would not rely on spot market data to estimate the models, he considers the results more indicative of the actual cost of equity than data ending in September skewed by these market disruptions. In considering these assumedly transitory market circumstances, he would be reluctant to change his ROE recommendations based solely on the September market data.