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

November 3, 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

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

Opening Statements

By Order G-66-21 dated March 8, 2021, the BCUC established the 2022 GCOC proceeding and by Order G-217-22A, the BCUC established both the scope [1] and the dates for a two-part Oral Hearing taking place from Monday, November 7, 2022 to Thursday, November 10, 2022.

Attached please find the Opening Statements of Mr. James M. Coyne from Concentric Energy Advisors, Inc. FortisBC's expert in this proceeding and Mr. Doug Slater, FortisBC's Vice President of External and Indigenous Relations.

If further information is required, please contact the undersigned.

Sincerely,

on behalf of FORTISBC

Original signed:

Diane Roy

Attachments

cc (email only): Registered Interveners

---

[1] Order G-217-22A, Appendix C.

OPENING STATEMENT OF FORTISBC UTILITIES

DOUG SLATER, VICE PRESIDENT, EXTERNAL AND INDIGENOUS RELATIONS

Good morning Mr. Chairman, Commissioners and fellow participants.

FortisBC Energy Inc. (FEI) and FortisBC Inc. (FBC) are pleased to appear to speak to our evidence in support of the companies' respective proposed capital structures and returns on equity (ROE).

Cost of capital proceedings are of fundamental importance to utilities like us. We are a very capital intensive business. We need to make significant long-term investments in infrastructure to maintain safe and reliable service for customers, and we need to finance those investments with equity as well as debt. Investors consider both their prospects of earning their expected return, and recovering all of their invested capital. That makes risk – including both financial risk associated with how leveraged our business is, and the underlying risk facing the business – a key consideration for investors and for us. In the current context, we believe that the proposed ROEs and capital structure for FEI and FBC appropriately reflect risk considerations.

FEI's Business Risk Has Increased Significantly Since 2016

Since the 2016 proceeding, FEI's business risk has increased significantly. Above all else, the Energy Transition from fossil fuels to cleaner sources of energy looms large. Its influence on our business is now pervasive. The Energy Transition has become an existential issue for FEI as a gas utility.

As part of preparing for this hearing my colleagues and I were looking back at the documents and decisions from FEI's previous Cost of Capital proceedings. What struck us is that nobody in that 2016 proceeding was using terms like "Energy Transition" or Environmental, Social and Governance (ESG) based investing. Indeed, in the 2013 Stage 1 Generic Cost of Capital (GCOC) decision, the BCUC reduced FEI's common equity ratio from 40 percent to 38.5 percent citing "a lessening of risk associated with provincial government climate and energy policies" since the proceeding in 2009, and maintained this reduced equity thickness levels in the 2016 cost of capital

proceeding.[1] Of course, since 2016 the pace and scope of the Energy Transition, and its potential impact on FEI, has far surpassed what had been contemplated in any of the 2009, 2013 or 2016 proceedings. The Energy Transition is more sweeping, more stringent and is happening much faster. And BC is at the forefront of it, as demonstrated by the provincial 2018 CleanBC plan and 2021 CleanBC Roadmap.

In recent years, all levels of government have introduced new policies in rapid succession to promote GHG reductions and/or electrification. More than two dozen municipalities in FEI's service territory have declared climate emergencies. Some of the largest municipalities in FEI's service territory are already effectively banning the use of gas which will have material impacts on FEI's growth and customer base. For example, gas attachments in the communities that have placed restrictions on new gas connections represented approximately 37 percent of FEI's net customer additions over the past five years.[2] The challenge is expected to increase significantly as the Province finalizes the Carbon Pollution Standard which will allow municipalities to set Greenhouse Gas Intensity targets for buildings in their communities. At the same time, competition is increasing, with BC Hydro aggressively promoting fuel switching, with legislative support, in a way it has never done before. These types of policies, and the cost implications of them, challenge our ability to attract and maintain load.

We have strategies that, if successful, would see FEI preserving a role for itself in the Energy Transition. We hope our efforts succeed, and we think they can succeed if we have the right policy and regulatory support. But the risk that we won't succeed is real, and the need to take dramatic steps just to remain relevant in BC's energy landscape is certainly not something we ever contemplated having to face back in 2016.

Adding to our challenges is the decrease in natural gas price competitiveness relative to electricity since the previous cost of capital proceeding. This is mainly caused by a significant increase in natural gas commodity prices, current and planned carbon tax increases and the increasing share of higher cost Renewable Gas in FEI's gas supply portfolio, which will challenge FEI's ability to preserve a role for itself in this Energy Transition.

---

1 See Exhibit B-8, p. 28 for further discussion.

2 BCUC IR 12.2 figure of 5,198 divided by 14,181 from table A7-1 for 20-17 to 2021 net additions.

As our credit rating reports show, and as Mr. Coyne addresses, the Energy Transition and the associated risks that gas utilities face in adapting haven't gone unnoticed in the capital markets. Institutional investors are actively reallocating capital away from fossil fuel industries, and our credit ratings reports now consistently discuss this exposure. Moody's, for instance, has gone from characterizing FEI as having "a low carbon transition risk" in 2019,[3] to now characterizing FEI as having "a very negative carbon transition risk".[4]

While the single biggest increase in risk since 2016 unquestionably relates to the Energy Transition and the associated price competitiveness challenges, there have also been new considerations and challenges in the areas of: Indigenous rights and engagement, with evolving legal principles and the implementation of the United Nations Declaration on the Rights of Indigenous Peoples (UNDRIP); demand/market risk; risks associated with changes to various regulatory frameworks that govern our business; operating risk; and, challenging economic conditions.

FBC's Business Risk Remains Similar, With Offsetting Favourable and Unfavourable Factors

FBC's overall business risk is best characterized as being similar to that of the 2013 Proceeding, which was when the BCUC last considered FBC's cost of capital. FBC is experiencing increased risk in various areas – such as operating risk, Indigenous rights and engagement, regulatory risk and challenging economic conditions. However, these increases are not material enough to justify an increase in FBC's common equity thickness and are otherwise offset by FBC's potential to benefit from the Energy Transition. On the latter point, it should be recognized that BC Hydro is the primary beneficiary from FEI's challenges in the Energy Transition, given that the challenges to FEI's business caused by anti-gas policies and climate emergency declarations are primarily occurring in Lower Mainland and Vancouver Island where the service territories of FEI and BC Hydro overlap, the majority of FEI's customers reside and importantly, the temperate climate means heat pumps are very competitive.

---

[3] Moody's Credit Rating Report for FEI dated August 29, 2019; Exhibit B1-9, FEI-FBC-BCUC IR1 35.2.2.

[4] Exhibit B1-8, p. 46; Exhibit B1-9, FEI-FBC-BCUC IR1 35.2.2.

Conclusion

In closing, we look forward to engaging with everyone regarding our evidence, which we believe supports our proposed capital structures and ROEs for the companies. Thank you.

OPENING STATEMENT OF JAMES M. COYNE, CONCENTRIC ENERGY ADVISORS, INC.

RESULTS AND RECOMMENDATIONS

Good morning Mr. Chair and Commissioners. My analyses support an authorized return on equity of 10.1% for FortisBC Energy, Inc. ("FEI") and 10.0% for FortisBC, Inc. ("FBC").

My recommendations consider the results of four models used in regulatory proceedings for these purposes: the Constant Growth Discounted Cash Flow ("DCF") model, the Multi-Stage DCF model, the Capital Asset Pricing Model ("CAPM"), and the Bond Yield Plus Risk Premium ("Risk Premium") model. My ROE recommendations for FEI and FBC are ultimately based on the average results of two models: the Multi-Stage DCF and the CAPM. I have estimated these models using a combination of Canadian, U.S. and North American proxy groups, placing principal reliance on the U.S. Gas and U.S. Electric groups.

The overall results are summarized in Figures 1 and 2 in my report, and I have included them in the written version of my opening statement for ease of reference. As seen in the figures, the average two model results for the U.S. Gas and Electric proxy groups are 10.1% and 10.0% respectively, and these form the base of my recommendations. I have tested these results with a broader four-model approach, which is the same for the Electric proxy group and 20 basis points higher for the Gas group.

Figure 1: Summary of Results – Natural Gas[1]

	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%

[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. As discussed later in the report, I also considered the results of a CAPM analysis using only a forward-looking market risk premium. Those CAPM results are approximately 180-190 basis points higher than the CAPM results using an average of the historical and forward-looking market risk premium. In addition, the CAPM results do not include a leverage adjustment using the Hamada formula. This adjustment is discussed in Section 11.B of my report.

Figure 2: Summary of Results - Electric[2]

	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%

My initial report was filed on January 31, 2022, based on market data as of December 31, 2021. In accordance with a suggestion I made and the BCUC's subsequent August 2022 Order, I also provided an updated ROE analysis based on market data as of September 30, 2022.

It is my opinion that the December market data represented more normal market circumstances. The War in Ukraine, aggressive federal action on interest rates, historic high 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 I would not rely on spot market data to estimate the models, I consider current 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, I would be reluctant to change my ROE recommendations based solely on the September market data. I have been tracking the developments in the October market data, and it reinforces my views. I can provide an update of that data today if the BCUC would find it useful.

I am also recommending an increase in FEI's deemed equity ratio from 38.5% to 45%. My view is that FEI's existing deemed equity ratio of 38.5% is not appropriate, either by comparison to the actual or authorized equity ratios of the proxy group companies or with respect to FEI's Canadian and U.S. peer utilities and its risk profile. My analysis demonstrates that FEI's current deemed equity ratio of 38.5% is not sufficient for the business risk of a gas distribution utility that is subject to material risks due to the Energy Transition, including risks related to future growth prospects and earnings. My recommendation recognizes FEI's business and financial

[2] Ibid.

risks, allows the company to maintain its credit rating, is reasonable relative to the other investor-owned Canadian and U.S. gas distribution utilities, and satisfies all three requirements of the Fair Return Standard.

For FBC, I have employed a similar analysis, using the same regulatory standards, and recommend a 10% ROE on a 40% equity ratio, the same as its existing equity ratio. Although 40% is well below the U.S. proxy company average of 49.8%, it remains appropriate for a company of FBC's risk profile and comparable to its Canadian peers. With respect to the U.S. Electric proxy group, FBC has greater financial risk and slightly lower business risk.

RESPONSE TO DR. LESSER

The BCUC retained Dr. Jonathan Lesser to provide a report regarding the appropriate methodologies for purposes of estimating the cost of equity. While Dr. Lesser has provided the BCUC with advice and guidance regarding the method for selecting proxy groups, the financial models used to estimate the cost of equity, and the inputs to be used in those models, he was not tasked with providing his own ROE analysis or recommendations for FEI or FBC in this proceeding. I would therefore like to comment on his methodological recommendations.

There are several areas of agreement between Dr. Lesser and me regarding the methodologies used to estimate the cost of equity for regulated utilities. These include: 1) the use of groups of comparable risk North American gas and electric utility companies to estimate the cost of equity for FEI and FBC; 2) the use of the DCF and CAPM models to estimate the cost of equity for the proxy group; 3) the use of forecast earnings per share growth rates in the DCF model; 4) the use of recent average stock prices in calculating the dividend yield in the DCF model; 5) the use of adjusted Beta coefficients; and 6) the use of a forward-looking market risk premium in the CAPM analysis. Dr. Lesser also recommends adjusting the CAPM results for differences in financial leverage between the proxy group companies and the company for which the return is being set. While I have not made an adjustment for small size, the BCUC has previously found that the authorized ROE for FBC should be 40 basis points higher than that of FEI due, in part, to the small size of FBC. It is not clear to me from Dr. Lesser's report and responses to questions if he approves of a size adjustment, although I know he has argued for recognition of small size in his prior testimony.

There are several important areas where Dr. Lesser and I do not agree, and those account for the differences in my results and those I have calculated for Dr. Lesser based on his suggested methodologies and inputs. The key areas of disagreement are: 1) whether analysts' EPS growth rate forecasts are biased, which according to Dr. Lesser necessitates sole reliance on the Multi-Stage DCF model, or whether the results of the Constant Growth DCF model are also a reasonable indicator of the cost of equity for dividend paying companies in mature industries, such as regulated utilities; 2) whether to rely on a single source of EPS growth as Dr. Lesser recommends, or to consider multiple sources of EPS growth as I have done; 3) whether to use current average government bond yields as the risk-free rate as Dr. Lesser suggests, or to use projected government bond yields; 4) whether to use the Multi-Stage DCF model to compute the forward-looking market risk premium as Dr. Lesser recommends, or to use the Constant Growth DCF model for that purpose as I have done; 5) whether to consider the results of the bond yield plus risk premium model as I have done; and 6) whether the authorized ROE should be adjusted only for flotation costs as Dr. Lesser recommends, or the adjustment should also include financial flexibility, consistent with Canadian precedent and my approach.

As shown in Figures 66-68 of my direct evidence, the results of the Multi-Stage DCF model using Dr. Lesser's recommended inputs are similar to the results of my Multi-Stage DCF analyses for the gas and electric proxy groups, using market data through December 31, 2021. However, the results of the CAPM analysis using Dr. Lesser's recommended inputs are substantially lower than mine. This is mainly due to his suggested use of the Multi-Stage DCF model to estimate the forward-looking market risk premium. The results of the CAPM analysis using Dr. Lesser's suggested approach range from 7.5% to 8.4%, depending on the proxy group, and are below any authorized ROE for an investor-owned gas or electric utility in Canada. Even including an adjustment for differences in financial leverage between the gas proxy group companies and FEI, the CAPM results using Dr. Lesser's market risk premium only increase to a range of 8.2% to 8.6%. The DCF and CAPM results are further reduced by his recommendation to only allow flotation costs but not an adjustment for financial flexibility.

With respect to the deemed equity ratio, Dr. Lesser has not made any specific recommendations concerning an appropriate capital structure for FEI or FBC. He has, however, indicated that he does not view the Energy Transition as an important business risk. He also contends that

adjustments for business risk are generally made through the authorized ROE instead of the equity ratio, which has not been my experience in Canadian jurisdictions.

On the issue of business risk, I have provided evidence in both my report and my rebuttal testimony demonstrating that FEI has higher business risk now than in 2016, and higher business risk than other Canadian investor-owned gas utilities and companies in my U.S. Gas proxy group. Factors contributing to this higher risk profile include: 1) stringent environmental policy goals in British Columbia and at the Federal level with regard to reducing carbon emissions; 2) the impact of the energy transition on the growth prospects and earnings outlook for gas distribution companies; 3) an increase in stranded asset risk; 4) higher volumetric risk over the long term as customers leaving the system create the potential for a "death spiral"; and 5) higher operational risk due to opposition to new facilities, longer permitting times, and higher construction costs.

As discussed in my report, the Energy Transition has contributed to a significant increase in investor risk for the natural gas industry since 2016. This change is particularly important for FEI due to the policy mandates in BC that call into question the growth prospects of FEI. While FEI is taking steps to actively position itself in response to the Energy Transition, they do not eliminate the substantial increase in uncertainty created by the Energy Transition.

FEI faces a very challenging task to reduce carbon emissions, while continuing to provide safe and reliable service and sustain its earnings and credit quality. It is important for FEI to have the financial strength required to finance the necessary investments and to continue to attract both debt and equity capital to manage through this transition.

CONCLUSION

In summary, my recommended ROE of 10.1% for FEI and 10.0% for FBC, in combination with my recommended increase in the deemed equity ratio of FEI to 45%, will enable both companies to attract capital on reasonable terms, maintain their financial soundness and credit ratings, and compensate investors for higher business risk in the gas business due to the Energy Transition.

I look forward to this discussion and responding to your questions.