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

December 9, 2022

British Columbia Utilities Commission
Suite 410, 900 Howe Street
Vancouver, B.C.
V6Z 2N3

Attention: Ms. Sara Hardgrave, Acting Commission Secretary

Dear Ms. Hardgrave:

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 BCUC Information Request (IR) No. 1 on Undertakings

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On January 18, 2021, BCUC initiated the proceeding referenced above. In accordance with the amended regulatory timetable established in BCUC Order G-327-22A for the review of FortisBC's Evidence, FortisBC respectfully submits the attached response to BCUC IR No. 1 on Undertakings.

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): Registered Parties

1.0 Reference: FORTISBC UNDERTAKING #2

Exhibit B1-50, Undertaking #2, p. 1; Transcript Volume 3, pp. 368, 370 Financial Flexibility

In response to Undertaking #2, FortisBC Energy Inc. (FEI) and FortisBC Inc. (FBC) (collectively FortisBC) stated "Mr. Coyne continues to believe that flotation costs and financial flexibility should be recovered through an adjustment to the authorized [return on equity (ROE)] of 50 basis points for each company."

In Transcript Volume 3, page 368 read:

> COMMISSIONER FUNG: But if the problem is that Canadian utilities are thinly capitalized, shouldn't you just fix the capital? Like why would you fix the problem by artificially including an adder for something that frankly, as Dr. Lesser said, is a cash cushion?
>
> MR. COYNE: A: Yes, it's a good question. And the answer is yes. You know, I think if you're looking -- if the objective is comparable returns for like risked assets, then I think that is the approach ultimately you take.

In Transcript Volume 3, page 370, Dr. Lesser stated:

> I think, Commissioner, that your comment about changing the capital structure directly is spot on. If the utility needs to raise money or needs to finance investments right away, having a -- you know, if it has a higher equity capital structure and basically it has cash to do that, to me that makes more sense than -- and I think Mr. Coyne and I agree, that makes more sense than basically an arbitrary adder to be allowed return.

1.1 Please reconcile Mr. Coyne's position that financial flexibility should be recovered as part of an adjustment to the authorized ROE of 50 basis points for each company as stated in Undertaking #2, rather than through the company's capital structure as stated at the Oral Hearing in response to Commissioner Fung's question.

<u>Response</u>

Concentric provides the following response:

In the Oral Hearing (as cited on pages 366-368, Volume 3) Mr. Coyne was making two points in response to Dr. Lesser, the Chair and Commissioner Fung:

1. If a Canadian regulator was looking to establish financial parity with U.S. peers, then establishing comparable equity ratios (in the 50-52% range) and comparable allowed ROEs (9.5-10.0% range) would accomplish that objective (and Dr. Lesser seemed to agree, lines 10-14, page 367).

2. And in doing so, in his opinion, this would obviate the need for a "financial flexibility" adder to the ROE, as the Canadian utility would now have financial comparability to its U.S. peers who do not have an equivalent adder. This was the meaning of his statement (page 368, lines 13-16) "if the objective is comparable returns for like risked assets, then I think that is the approach ultimately you take" and as he continued (on lines 18-20) "And I would say, but <u>both in the ROE and in the equity ratio</u>. Then you would be there and you'd have equivalency." (Emphasis added)

1.2 Please confirm, or explain otherwise, that the discussion regarding adjusting the capital structure rather than adding a "cash cushion" from Transcript Volume 3 as referenced in the preamble refers to the methodology to account for financial flexibility only, and not for flotation cost.

<u>Response:</u>

Concentric provides the following response:

Confirmed.

1.3 Please discuss the pros and cons of accounting for flotation costs and financing flexibility (i) as an adder to the ROE, (ii) by increasing the deemed equity thickness, and (iii) some combination of an ROE adder and an adjustment in the equity thickness. Please respond separately for each of flotation costs and financing flexibility, if there is any difference.

<u>Response:</u>

Concentric provides the following response:

As explained in response to BCUC Undertaking IR1 1.1 above, the optimal approach would be to establish financial parity with the U.S. peer group, so that from an investor perspective, they are receiving equivalent returns, and the utility would have comparable financial strength during all market conditions.

Recognizing that flotation cost and financial flexibility need to be accounted for in some manner, if the BCUC were to continue with the Canadian tradition of an explicit adjustment for flotation costs and financial flexibility, then Concentric believes the adjustment to ROE remains the preferred approach for adjusting for both flotation costs and financial flexibility:

Pros (for inclusion of financial flexibility adjustment and flotation cost in the ROE):

- Consistent with prior precedent
- Standard regulatory method for accounting for flotation costs and can be measured using the DCF model
- An increase in ROE directly improves:
  - EBITDA Interest Coverage
  - FFO to Cash Interest Coverage
- Allowed ROEs are typically reviewed more frequently than allowed equity ratios

Cons (for inclusion of financial flexibility adjustment and flotation cost in the ROE):

- None

Pros (for inclusion of financial flexibility adjustment and flotation cost in the equity ratio):

- From a credit rating perspective, an increase in equity ratio directly improves:
  - Debt/Capital
  - FFO/Debt

Cons (for inclusion of financial flexibility adjustment and flotation cost in the equity ratio):

- Financial flexibility and flotation cost adjustment could become lost in broader business and financial risk considerations if evaluated with equity ratios
- No established precedent for the magnitude of the equity adjustment and quantification of the flotation cost component

Neutral

- Both an ROE adder and equity ratio adjustment improve the Debt/EBITDA ratio

Although the rating agencies say they look at both the authorized ROE and the allowed equity ratio, in Mr. Coyne's experience they tend to focus more on the authorized ROE than the regulatory capital structure when evaluating regulatory decisions.

2.0 Reference: FORTISBC UNDERTAKING #4

Exhibit B1-50, Undertaking #2, p. 1, Undertaking #4, p. 1; Transcript Volume 5B,

pp. 856, 857

Financial Flexibility

In Undertaking #4, FortisBC stated:

> As can be seen, in 2021 FEI's actual average common equity thickness was 39.90 percent or 140 basis points higher than its allowed equity thickness used for rate-making purposes. The same prudent capital structure management practice is applied to FBC although FBC does not provide the same reconciliation of average capital structure in its Annual Report. This is why most Canadian regulators apply a premium to the approved ROE to account for the needed financial flexibility. In contrast, the majority of U.S. regulators do not "deem" the equity thickness and rely upon the utility's actual stand-alone capital structure at the end of the test year. [Emphasis added]

In Transcript Volume 5B, page 856, lines 18 to 22, Mr. Lorimer stated:

> … how we would manage it is to ensure that we always have at least the allowed equity on our balance sheet at all times, and typically include also a conservative buffer to make sure that we never slip below that.

Mr. Lorimer further stated on page 857, lines 5 to 16:

> And carrying a small amount of buffer in our capital structure is, you know, to me a prudent and protective way to ensure that we're not overly leveraged and not unable to manage if things get, you know, a little volatile in the markets. And so carrying our capitalization that way I think is what I would characterize is part of the reason for financial flexibility in the computation of floatation costs and financial flexibility is that we manage our capitalization in way that's conservative and takes into account market disruptions so that we are never in a position where we're over levered.

In Transcript Volume 5, page 857 read:

> COMMISSIONER LOSKI: I have a follow-up question, Mr. Lorimer. That strategy you just described, do you anticipate that would be the same if you have an equity thickness of 38 and a half percent or 45 percent or something else?
>
> MR. LORIMER: A: You know, to me it's a good strategy in either case[…]

2.1 Please clarify whether the need to apply a premium to the approved ROE to account for financial flexibility arises due to the need to adhere to the "deemed equity structure" set by the regulator, whereas US regulators rely upon the utility's actual stand-alone capital structure at the end of the test year.

2.1.1 If yes, please elaborate on why, including (i) consideration for ringfencing, (ii) recovery of the actual equity component above the deemed equity ratio, and (iii) management of market volatility.

<u>Response:</u>

FortisBC agrees that the need to apply a premium to the approved ROE to account for financial flexibility arises, in part, due to the need to adhere to the "deemed equity structure" set by the regulator. The other reason is that Canadian utilities have relatively thin equity. A US utility's need for a financing flexibility adder is less than a Canadian utility, not because of what is stated in the question, but because the allowed equity ratio is so much thicker and therefore provides greater financial flexibility than exists for the FortisBC Companies.

Deemed Equity and Ring-fencing

As explained in the oral hearing, one of the reasons for the needed financial flexibility relates to the small cushion of equity over the approved equity thickness used for rate setting purposes to prudently manage financing needs and ensure that the utility is not over-leveraged (and as discussed below for specific case of FEI to be compliant with its ring-fencing provisions). For instance, as provided in the response to Undertaking #4 in 2021, FEI's actual average common equity thickness was 39.90 percent or 140 basis points higher than its allowed equity thickness used for rate-making purposes. In other words, FEI was not able to earn the allowed ROE on 140 basis points of invested equity despite the fact that this was needed to prudently manage its financing needs and at the same time comply with BCUC ring-fencing conditions.

Ring-fencing occurs when a regulated public utility business financially separates itself from a parent company that engages in non-regulated business in order to mitigate possible risks arising from the financial status of the parent companies and non-regulated affiliates. A common concern cited in support of ring-fencing is the potential for a parent company to leverage the utility beyond the allowed equity thickness so as to earn an equity return on what is, in reality, debt financing.

BCUC Order No. G-116-05 approved the Kinder Morgan, Inc. acquisition of the common shares of Terasen Inc. and established a set of ring-fencing conditions to ensure that Terasen Gas Inc. (now FEI) continued to operate as a stand-alone entity for its borrowing requirements. One of the ring-fencing provisions is as follows:

> Each Terasen Utility [i.e., FEI] shall maintain, on a basis consistent with BCUC orders and accounting practices, a percentage of common equity to total capital that is at least as much as that determined by the Commission from time to time for ratemaking purposes.

In order to consistently comply with this condition and to manage market volatilities, FEI maintains a cushion in its equity structure since its actual capital structure is not constant and will inevitably fluctuate depending on its financing needs.

The financial flexibility adder to the allowed ROE recognizes this fact and provides some compensation to the equity investor for the added layer of equity it provides above the regulated common equity ratio. In the absence of the financial flexibility adder, FEI would not be compensated for the additional margin of equity above approved equity ratio that it must maintain to remain compliant with this provision.

FBC does not have the same ring-fencing provisions however it too strives to maintain a cushion in its capital structure to be prudent and manage potential volatilities.

US Utilities Have Somewhat More Flexibility in Managing their Capital Structures

It is common practice for US regulators to consider several factors in setting allowed capital structures: actual and allowed capital structures for peer companies; actual capital structures maintained by the utility; business risk of the target company in relation to peer companies; and maintenance of credit quality. Emphasis is placed on the ability to raise capital on reasonable terms on a stand-alone basis. This regulatory approach provides some discretion by utility financial managers to determine their optimal capital structures, but proposed capital structures must be defended to regulators and stakeholders as being in the public interest and satisfy the tenets of a fair return.

Setting the allowed ROE based on actual stand-alone capital structure at the end of the test year, on its own, does not eliminate the need for a premium for financial flexibility since the problem with the need to maintain a cushion in the equity structure exists irrespective of whether the allowed capital structure for rate-making purposes is set based on actual equity or deemed equity.

Allowing the utilities the ability to periodically go below the allowed equity ratio can partially mitigate the need for a premium for the financial flexibility; however, this would tend to go against the policy underlying ring-fencing and would also jeopardize the company's credit standing.

Canadian Utilities Are More Thinly Capitalized Relative to US Utilities

As discussed in Concentric's evidence, another reason for the allowance of a financial flexibility adder to the ROE simply relates to the fact that Canadian utilities are too thinly capitalized. As discussed in the oral hearing, another approach for this issue to is to directly increase the equity thickness rather than adding a premium to the allowed ROE, but as explained by Mr. Coyne in response to BCUC Undertaking IR1 1.1 and 1.2, if financial parity is the objective, awarding comparable ROEs and capital structures would be necessary.

2.2 Please discuss whether relying upon the utility's actual stand-alone capital structure at the end of the test year as is the case for the majority of U.S. regulators would eliminate the need to apply a premium to the approved ROE to account for financial flexibility. If yes, please elaborate on why.

Response:

Please refer to the response to BCUC Undertaking IR1 2.1.

In response to Undertaking #2, FortisBC states:

> Mr. Coyne was also asked to use a Weighted Average Cost of Capital analysis to determine the effect of accounting for recovery of flotation costs and financial flexibility through the deemed capital structure of FEI and FBC rather than by applying a 50 basis points adder to the authorized ROE of each company... As shown, the deemed equity ratio would need to increase by 2.0 to 2.3 percent for FEI and by 2.1 percent for FBC.

2.3 Please confirm that increasing the deemed equity ratio by 2.0 to 2.3 percent for FEI and by 2.1 percent for FBC would eliminate the need to apply a premium to the approved ROE to account for financial flexibility and flotation cost.

2.3.1 If not confirmed, please elaborate on why and explain what the appropriate amount of the ROE adder to account for financial flexibility and flotation cost should be if the deemed equity ratio is increased by 2.0 to 2.3 percent for FEI and by 2.1 percent for FBC to account for flotation cost and financial flexibility. Please provide a breakdown of the adder for financial flexibility and flotation cost, respectively.

Response:

Concentric provides the following response:

Confirmed. If the BCUC decides to account for flotation costs and financial flexibility through an adjustment to the deemed equity, then there would be no need for an adjustment to the authorized ROE. However, as explained in response to BCUC Undertaking IR1 1.3, the adjustment to ROE remains the preferred approach for both flotation costs and financial flexibility.

2.4 Assuming that the BCUC determines the magnitude of a 35 to 40 bps ROE adder for financial flexibility is appropriate, holding all else equal, please calculate using a Weighted Average Cost of Capital analysis the effect of accounting for recovery of financial flexibility through the deemed capital structure of FEI and FBC rather than by applying an ROE adder of (i) 35 bps and (ii) 40 bps, respectively, to the authorized ROE of each company.

<u>Response:</u>

Concentric provides the following response:

Please refer to BCUC Undertaking IR 2.4, Attachment 1 for the live spreadsheet with the requested analyses. The first worksheet calculates the equity ratio that would be equivalent to a 40 bps ROE adder for financial flexibility. The second worksheet provides the same calculation assuming a 35 bps ROE adder for financial flexibility.

Attachment 2.4

REFER TO LIVE SPREADSHEET MODELS

Provided in electronic format only

(accessible by opening the Attachments Tab in Adobe)