



2005 Revenue Requirements

3. Application Overview

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1. Introduction: FortisBC in 2005

This Application is the first full review of FortisBC’s revenue requirement in a decade. In addition, the Application is FortisBC’s first major rate proceeding since its acquisition by Fortis Pacific Holdings Inc. in May 2004.

In this Application, FortisBC has applied to the Commission for a general rate increase of 4.4 percent.

This general rate increase principally reflects an increased rate base and an increase in the cost of financing that rate base. It also reflects an increase in 2005 expenses, including operating expenses and power purchases.

FortisBC has put forward a *2005 - 2024 System Development Plan* (“System Development Plan”) and *2005 Capital Plan* (“Capital Plan”) that addresses high priority work that is needed to maintain and expand the electrical system to meet its obligation to provide reliable electricity service to its customers. The System Development Plan can be found in Volume 2 of this Application and the Capital Plan is presented in Tab 9 of this Application.

FortisBC has also put forward a Transition Plan that outlines the steps being taken to move to a stand-alone utility based in its service territory focused on reliability and customer service. The Transition Plan is found in Tab 10 of this Application.

2. Cost of Service

2.1 General

FortisBC's cost of service is forecast to increase in 2005. While the increased cost of service is attributable to a number of factors, there are four key underlying drivers. They are; (1) FortisBC's increased utility rate base, (2) the costs associated with financing that rate base, (3) increases in power purchases and (4) increases in operating and maintenance costs ("O&M Costs").

Each of these key drivers is outlined below.

2.2 Utility Rate Base

Details of FortisBC's actual and forecast utility rate base for 2002 through 2005 forecast are found in Tab 6 to this Application.

Table 3.2.2 summarizes FortisBC's capital expenditures and utility rate base from 2002 through 2005 forecast. Capital expenditures, which are primarily related to improving service reliability and meeting increased customer energy demands, are the cause of the growth in FortisBC's utility rate base.

Table 3.2.2
Capital Expenditures and Utility Rate Base
2002 to 2005
(\$million)

	2002	2003	2004F	2005F
1 Capital Expenditures ⁽¹⁾	80.3	54.1	90.0	120.4
2 Rate Base (Mid-Year)	382.5	442.7	494.7	582.2
3 (1) Capital Expenditures are reduced by contributions in aid of construction .				

FortisBC's 2005 capital expenditures are forecast to increase by \$40.1 million from 2002 actuals. The primary drivers of capital expenditures in the 2002 to 2005 period are two critical transmission projects already approved by the Commission.

1 The Kootenay 230 kV System Development Project, which has been completed (at a cost
2 of approximately \$90 million), and the South Okanagan Supply Reinforcement Project,
3 which will be completed after 2005 (at a cost of approximately \$75 million), are
4 cornerstones of FortisBC's fulfillment of its obligation to provide reliable service to its
5 customers.

6
7 Details of proposed capital expenditures for the 2005 test year are contained in the *2005*
8 *Capital Plan* which is under Tab 9 to this Application. The plan provides further detail
9 regarding major transmission work associated with the South Okanagan Supply
10 Reinforcement Project as well as the Kelowna Area Upgrade Project. The plan also
11 includes upgrade and life extension work on hydro generation plants. Finally, the plan
12 includes distribution work focused on improving reliability and meeting customer
13 growth. FortisBC's approach to capital planning is to focus on replacing deteriorated and
14 inefficient plant while building new capacity which meets the needs of its customers.
15 FortisBC is proposing that the Commission approve the *2005 Capital Plan*.

16 2.3 Financing Rate Base

17 Details of FortisBC's earned return for 2002 through 2005 forecast are found in Section 3
18 of Tab 8 of this Application. The earned return (or return on rate base) represents the
19 cost of financing FortisBC's utility rate base and is the sum of its cost of debt and equity.
20

21 Table 3.2.3 summarizes FortisBC's earned return for 2002 through 2005.

22
23 **Table 3.2.3**
24 **Earned Return Components**
25 **2002 to 2005**
26 **(\$million)**
27

		2002	2003	2004	2005
		Actual	Actual	Forecast	Forecast
1	Return on Equity	14.6	20.3	22.6	22.8
2	Return on Debt	15.2	19.1	19.6	23.2
3		29.8	39.4	42.2	46.0

1 FortisBC's earned return is forecast to increase by approximately \$3.8 million from 2004
2 to 2005 under the proposed revenue requirements. This increase in the required return
3 on rate base principally reflects the increase in the utility rate base.

4
5 On November 30, 2004, FortisBC will issue \$140 million Senior Unsecured Debentures
6 at a coupon rate of 5.48 percent. This ten-year debt was issued publicly on a stand-alone
7 basis and is the largest financing ever undertaken by FortisBC. The coupon rate of the
8 issue is the lowest in FortisBC's long-term debt portfolio. The issue will represent
9 almost 50 percent of the forecast long-term debt outstanding at the end of 2004 and will
10 substantially reduce FortisBC's average cost of borrowing, which benefits customers
11 through lower costs and over the longer term contributes to rate stability.

12
13 FortisBC's current rates are based upon an allowed return on equity of 9.55 percent and a
14 ratio of equity to total capitalization of 40 percent. The cost of equity in current rates
15 reflects a return on equity which is 40 basis points above the return on equity established
16 by the Commission for a benchmark low-risk utility.

17
18 In the Application, FortisBC is requesting that the Commission approve an increase in the
19 allowed return on equity to 75 basis points above the return on equity established by the
20 Commission for a benchmark low-risk utility. In addition, it is proposed that the current
21 equity ratio of 40 percent be maintained. If these requests are approved by the
22 Commission, they should allow FortisBC's continued access to capital markets on
23 reasonable terms and ensure that the growing utility rate base can continue to be financed
24 on a least cost basis.

25
26 The expert evidence of Ms. Kathleen McShane, which is filed in support of this aspect of
27 the Application, is found under Tab 5.

28 **2.4 Power Purchases**

29 Details of FortisBC's actual and forecast power purchase expense are provided in Tab 7
30 to this Application.

Table 3.2.4 summarizes FortisBC's cost of power purchases from 2002 through 2005 forecast.

Table 3.2.4
Cost of Power Purchases
2002 to 2005
(\$million)

	2002	2003	2004 Forecast	2005 Forecast
Cost of Power Purchases	52.3	58.4	60.4	62.6

The increase in FortisBC's cost of power purchases over the period reflects increases in customer actual and forecast load.

FortisBC's cost of power purchases is expected to increase by \$2.2 million from 2004 to 2005.

2.5 O&M Costs

Details of FortisBC's actual and forecast O&M Costs for 2002 through forecast 2005 are provided in Section 2 of Tab 8 of this Application.

Table 3.2.5 A summarizes FortisBC's O&M Costs from 2002 through 2005 forecast.

Table 3.2.5 A
O&M Costs
2002 to 2005
(\$million)

	2002	2003	2004 Forecast	2005 Forecast
O&M Costs	32.1	30.1	35.0	36.3

The most significant increase in cost from 2002 actual to 2005 forecast is the \$3.2 million lease cost for the Brilliant Terminal Station ("BTS"), already approved by the Commission. These lease payments commenced in 2004.

1 Since 1996 FortisBC's revenue requirements have been approved by negotiated
 2 settlements which were largely based upon a performance-based revenue requirement and
 3 rate setting mechanism (the "PBR"). The PBR served to limit the level of O&M Expense
 4 allowed in rates. In recent years the need to reassess or rebase FortisBC's O&M Expense
 5 has been apparent to FortisBC. A material portion of the proposed increases in O&M
 6 Expense for the 2005 test year reflect FortisBC's reassessment of the overall level of
 7 O&M Expense required to meet service obligations to its customers in the areas of
 8 Customer Service, Transmission and Distribution, and Administration and General costs.

9
 10 Improved customer service is a priority for FortisBC and plans to move the Company
 11 towards this are set out in the Transition Plan, which is under Tab 10.3 to this
 12 Application. Table 3.2.5 B below summarizes FortisBC's Customer Satisfaction Index
 13 ("CSI") for the period 2002 through October 31, 2004.

14
 15 **Table 3.2.5 B**
 16 **Customer Satisfaction Index**
 17 **2002 to 2004**
 18

1	Customer Satisfaction Index	2002 ¹	2003 ¹	2004 ²
2		89.2%	80.2%	78.4%

19 ¹ Three year rolling average

20 ² Ten months ended October 31, 2004

21 Proposed improvements to address this decline in customer satisfaction, including the
 22 return of the full customer service function to British Columbia will increase 2005 test
 23 year O&M Costs by approximately \$0.9 million over 2002.

24
 25 System reliability performance indicators are set out in Tab 10.2 to this Application.
 26 Improving system reliability is a priority for FortisBC. To address this issue, the
 27 Company plans to increase system maintenance and brushing. Plans to improve system
 28 maintenance and brushing are presented in Section 2 of Tab 8

29
 30 Administrative and general costs will increase in the 2005 test year as FortisBC becomes
 31 fully established as a stand-alone utility. In the 2005 test year, administrative and general

1 costs are forecast to increase by approximately \$ 1.0 million over 2002. The increase is
 2 related in part to the rising costs of insurance and public accountability. To offset these
 3 increases, FortisBC has taken steps to reduce costs. For example, the Company has
 4 bought out the lease on a number of vehicles and plans to operate them over a longer
 5 period. The decrease in O&M associated with this initiative is \$1.0 million. Also, the
 6 Company has reduced the cost of insurance from 2003 through participation in the Fortis
 7 Inc. insurance program. Finally, the increased cost of administration and general costs
 8 have been offset by the lower cost of debt provided by its stand-alone status.

9
 10 Details of O&M Expense are contained in the Revenue Requirement which is found at
 11 Tab 8 of this Application. Details of FortisBC's customer service improvement plans and
 12 costs associated with constituting FortisBC's operations on a stand-alone basis are also
 13 contained in the Transition Plan which is item 10.3 under Tab 10 of this Application.

14
 15 Table 3.2.5 C presents FortisBC's O&M Expense from 2002 through 2005 forecast on a
 16 per customer basis.

17
Table 3.2.5 C
O&M Expense per Customer
2002-2005

	Actual 2002	Actual 2003	Forecast 2004	Forecast 2005	Increase (Decrease) 05 vs 02
1 O&M Expense (\$000)	32,093	30,062	34,991	36,293	13.1%
2					
3 Average Number of Customers	89,890	91,736	93,953	96,267	7.0%
4					
5 Expense per Customer (\$)					
6 Nominal	357	328	372	377	5.7%
7 Inflation-adjusted (BC CPI)					
8 (2002 = 100)	357	321	356	354	(0.7%)
9					
10 Expense per Customer (\$)					
11 Adjusted for BTS					
12 Nominal	357	328	339	343	(3.9%)
13 Inflation-adjusted (BC CPI)					
14 (2002 = 100)	357	321	324	322	(9.8%)

18

1 The 2005 forecast O&M expense of \$377 per customer has increased \$20 or 5.7% over
2 the 2002 actual. When adjusted for inflation, 2005 O&M expense is forecast to decrease
3 by \$3 per customer or 0.7% over the 2002 actual.

4
5 When the cost of the approved Brilliant Terminal Station (“BTS”) lease is removed, the
6 2005 O&M forecast decreases \$14 or 3.9% on a per customer basis from 2002 actual.

7 With inflation and the impact of BTS lease removed, 2005 forecast O&M per customer is
8 \$35 or 9.8% lower than 2002 actual.

9

3. PBR and INCENTIVE SHARING

3.1 2005 Incentive Sharing

Incentive sharing through the PBR mechanism has played a central role in establishing FortisBC's revenue requirement since 1996.

In the Application, FortisBC is proposing that only certain aspects of incentive sharing be retained for 2005. In particular, it is proposed that the current demand side management and power purchase incentive sharing mechanisms be retained. It is also proposed that various expenses which have been flow-through costs to customers, continue to receive that treatment.

FortisBC is proposing that 2005 O&M Expense variations be treated in a manner different than under previous mechanisms. Essentially, FortisBC is proposing to share all reductions in 2005 forecast O&M Expense included in revenue requirement on an equal basis with its customers; costs above the forecast will not be passed onto customers.

FortisBC's asymmetrical incentive sharing mechanism proposal for 2005 reflects its conviction that the 2005 test year should provide a full review, or rebasing, of costs, including O&M Expense. FortisBC believes that the forecast expense in its 2005 Revenue Requirement is the minimum necessary for it to improve customer service and reliability. FortisBC also believes that regulatory incentives to cost reduction are beneficial to both customers and the utility.

3.2 Future PBR

FortisBC's 2005 incentive sharing mechanism proposal is intended as a temporary measure.

During 2005, FortisBC intends to prepare a comprehensive PBR proposal with a view to engaging in stakeholder consultation by the fourth quarter of 2005. FortisBC continues to believe that PBR can provide tangible benefits to customers and utilities. However, FortisBC is mindful that any PBR arrangement, if it is to be effective, must not only be

1 fair, they must also be seen as such by all stakeholders. For these reasons, FortisBC is
2 proposing the settlement of the next generation of PBR be undertaken after the
3 Commission deals with this Application, with a view that the implementation of any
4 mechanism would take place, at the earliest, in 2006.

4. Transition Plan

1 FortisBC is committed to transition to a stand-alone utility focused on quality customer
2 service and reliability. Commission Order G-39-04 directed the Company to file
3 quarterly reports on the progress of this transition and to file with the Commission a
4 definitive plan, including timelines and costs with its next Revenue Requirement
5 Application. This Transition Plan is a roadmap for FortisBC over the next two years.
6 The Transition Plan is consistent with the commitments made. The costs of the initiatives
7 outlined in this plan are reasonable and prudent and represent the base costs of operating
8 a utility.

5. Capital Expenditures and Resource Planning

5.1 General

Section 45 of the *Utilities Commission Act* governs capital expenditure and resource planning.

FortisBC is proposing that the Commission consider its 2005 - 2024 System Development Plan and 2005 Resource Plan in concert with its consideration of the Application.

5.2 The 2005 - 2024 System Development Plan

FortisBC's long term outlook on the capital expenditure requirements necessary for it to fulfill its service obligations to customers over the long term is provided in the System Development Plan which is filed with the Application.

The System Development Plan provides a comprehensive twenty year review of transmission system requirements and a five year review of distribution system requirements. In addition, the plan includes consideration of protection and control facilities, communication facilities, and maintenance requirements.

5.3 2005 Resource Plan

FortisBC's *2005 Resource Plan* will be filed within 30 days of the filing of the Application.

The *2005 Resource Plan* provides a comprehensive review of alternative resources and strategies necessary to meet customers' electricity requirements to 2024.

5.4 Demand Side Management Expenditures Plan

The Company's 2005 Demand Side Management Expenditures Plan is included at Tab 10.3 of this Application.