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April 15, 2005

Mr. R. J. Pellatt
Commission Secretary
British Columbia Utilities Commission
Box 250, Sixth Floor, 900 Howe Street
Vancouver BC V6Z 2N3

Dear Mr. Pellatt:

Re: Written Argument of FortisBC Inc. dated April 15, 2005

Please find enclosed for filing 20 copies of Written Argument of FortisBC Inc.

Should the Commission have any questions regarding the attached, or require further information in this matter, please contact the undersigned at (250) 869-8013.

Yours truly,

(original signed by Mr. Meyers)

Robert Meyers
Vice President Finance
and Chief Financial Officer

cc: Registered Intervenors

BRITISH COLUMBIA UTILITIES COMMISSION

IN THE MATTER OF THE UTILITIES COMMISSION ACT

S.B.C. 1996, CHAPTER 473

and

**An Application by FortisBC Inc.
For approval of 2005 Revenue Requirements,
2005-2024 System Development Plan and 2005 Resource Plan**

WRITTEN ARGUMENT OF FORTISBC INC.

Submitted: April 15, 2005

BEFORE:

Mr. L. Kelsey Chairperson

Dr. P. Bradley Commissioner

**Hearing: March 21-24, 2005
Kelowna, BC**

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1. INTRODUCTION

1.1 The Application

On November 26, 2004, FortisBC Inc. (“FortisBC” or the “Company”) filed its 2005 Revenue Requirements Application (the “November Application”) with the British Columbia Utilities Commission (“Commission” or the “BCUC”). The November Application can be found at Exhibit B-1. The 2005 forecast revenue requirement in the November Application of approximately \$184.4 million reflected a deficiency of \$7.8 million over revenue at 2004 approved rates, equivalent to a 4.4 percent general rate increase if effective January 1, 2005.

On March 10, 2005, FortisBC filed a Revised 2005 Revenue Requirements Application (the “Revised Application”). The Revised Application can be found at Exhibit B-19. The Revised Application reflects updated 2004 actual energy sales and financial results and revisions arising from certain events subsequent to the filing of the November Application. A summary and description of the change in forecast 2005 revenue requirements was provided in the letter which accompanied the Revised Application.

A second revised application was filed on March 18, 2005 reflecting updated 2004 power purchase incentive adjustments and 2005 income tax expense (the “Second Revised Application”). The Second Revised Application can be found at Exhibit B-25. The Second Revised Application also reflected revised issue costs related to FortisBC’s Series 04-1 Senior Unsecured Debentures. A summary and description of the change in forecast revenue requirements was provided in the letter that accompanied the Second Revised Application.

A third revised application was filed on March 22, 2005 (the “Third Revised Application”) which incorporates a correction to the 2004 Actual and 2005 Forecast Mid-Year Rate Base. The Third Revised Application can be found at Exhibit B-26. The Mid-

Year Rate Base had been understated in the Second Revised Application by approximately \$3 million in 2004 and \$8.3 million in 2005. The understatement of Rate Base was caused by the incorrect reduction of net additions to Plant in Service (Tab 4, Schedule 1, line 2) by the amount of new Contributions in Aid of Construction (“CIAC”). In fact, and as reflected in the Third Revised Application, net additions to Plant in Service should reflect gross capital expenditures net of retirements. Total CIAC is then deducted at line 11 (Tab 4, Schedule 1). A summary and description of the change in forecast revenue requirements was provided in the cover letter that accompanied the Third Revised Application. The 2005 forecast revenue requirements in Exhibit B-26 of approximately \$180 million reflected a deficiency of \$7 million over revenue at 2004 approved rates, equivalent to a 4.1 percent general rate increase if effective January 1, 2005.

The November Application together with the Revised Application, the Second Revised Application and the Third Revised Application will be collectively referred to as the “Application”. Table 1.1 following provides a summary 2005 revenue requirements analysis as per the Application:

Table 1.1
Revenue Requirement Analysis
(\$000s)

	2005				
	Approved 2004	November Application	Increase or (Decrease) ¹	Third Revised Application (Exhibit B-26)	Increase over 2004
1 COST CATEGORY					
2					
3 POWER SUPPLY					
4 Power Purchases and Wheeling	65,188	66,522	(3,193)	63,329	(1,859)
5 Water Fees	7,328	7,741	(60)	7,681	353
6	<u>72,516</u>	<u>74,263</u>	<u>(3,253)</u>	<u>71,010</u>	<u>(1,506)</u>
7					
8 OPERATION AND MAINTENANCE					
9 O&M Expense	32,845	36,293	(120)	36,173	3,328
10 Other Income	(3,861)	(3,785)	(185)	(3,970)	(109)
11	<u>28,984</u>	<u>32,508</u>	<u>(305)</u>	<u>32,203</u>	<u>3,219</u>
12					
13 Rate Base					
14 Cost of Debt	22,157	23,253	200	23,453	1,296
15 Cost of Equity	19,638	22,779	619	23,398	3,760
16 Income Taxes	6,134	6,972	(1,056)	5,916	(218)
17 Property and Capital Taxes	9,820	10,850	(572)	10,278	458
18 Depreciation and Amortization	16,805	18,766	(140)	18,626	1,821
19 AFUDC	(3,098)	(3,102)	-	(3,102)	(4)
20	<u>71,456</u>	<u>79,518</u>	<u>(949)</u>	<u>78,569</u>	<u>7,113</u>
21					
22 INCENTIVE ADJUSTMENTS	<u>(3,030)</u>	<u>(1,901)</u>	<u>110</u>	<u>(1,791)</u>	<u>1,239</u>
23					
24 TOTAL REVENUE REQUIREMENT	<u>169,926</u>	<u>184,388</u>	<u>(4,397)</u>	<u>179,991</u>	<u>10,065</u>
25					
26 Less: REVENUE AT APPROVED RATES		<u>(176,634)</u>	<u>3,661</u>	<u>(172,973)</u>	<u>(3,047)</u>
27 REVENUE DEFICIENCY		<u>7,754</u>	<u>(736)</u>	<u>7,018</u>	<u>7,018</u>
28					
29 RATE INCREASE		4.4%	-0.3%	4.1%	

30
31 1. Includes all changes reflected in the Revised Application, the Second Revised Application
32 and the Third Revised Application

1.2 Order Requested

Pursuant to the Application, FortisBC is seeking an Order of the Commission:

- a. Approving the revised 2005 Revenue Requirement for FortisBC in the amount of \$179,991,000.
- b. Approving the deferral of:
 - i. the cost of regulatory and related activities; and

- ii. the issue cost of the Series 04-1 Senior Unsecured Debentures in the amount of \$2,091,000.
- c. Approving the amortization of:
 - i. the issue cost of the Series 04-1 Senior Unsecured Debentures in the amount of \$2,091,000 over ten years commencing on January 1, 2005;
 - ii. the costs incurred in FortisBC's 2004 Revenue Requirements negotiated settlement process; and
 - iii. the costs of the 2005-2024 System Development Plan ("SDP") and 2005 Resource Plan ("Resource Plan") in an aggregate amount of \$900,000, over five years commencing on January 1, 2005.
- d. Approving the continuation of the current Demand Side Management and Power Purchase incentive mechanisms for 2005.
- e. Approving the continuation of flow through to customers of differences between forecast and actual property tax, provincial water fees, and the Power Purchase expense related to the Brilliant contracts for 2005.
- f. Approving the flow through treatment of the costs of capacity block power purchases forecast for November and December 2005.
- g. Approving an operating and maintenance ("O&M") expense as shown in the Application, with a forecast value of \$36,173,000 (the "O&M Expense") and a sharing mechanism whereby:
 - i. if actual O&M Expense is below this value, the difference will be shared equally between FortisBC and its customers, but
 - ii. if actual O&M Expense is above this value, there will be no sharing and the entire difference will be borne by the shareholder.
- h. Approving a cost of capital for rate making purposes which reflects:
 - i. return on equity which is 75 basis points above that set by the Commission for a benchmark low-risk utility; and
 - ii. common equity ratio of 40 percent of total capitalization.
- i. That the 2005 Capital Plan ("Capital Plan"), set out at Tab 9 of Exhibit B-1, satisfies the requirements of Section 45 (6.2) (a) and (b) of the Utilities

Commission Act (the “Act”) and that the capital projects listed in the following tables which are contained in the Capital Plan, except for the Big White Supply Project, which will be the subject of a Certificate of Public Convenience and Necessity Application in 2005, are in the public interest:

- Table 9.2.1 Generation;
- Table 9.3.1 Transmission;
- Table 9.4.1 Distribution;
- Table 9.5.1 Telecom;
- Table 9.6.1 Demand Side Management; and
- Table 9.7.1 General Plant.

- j. That the Resource Plan meets the requirements of Section 45 (6.2) (b) of the Act, and is in the public interest.
- k. That the 2005 Demand Side Management Expenditures Plan (“DSM Plan”) meets the requirements of Section 45 (6.2) (b) of the Act, and is in the public interest.
- l. Approving a change in the accounting treatment of certain PowerSense costs in the amount of \$85,000, such that these costs are charged to capital rather than operations.
- m. Approving deferral and recovery in 2006 of higher income tax expense that will arise in 2005 if the new Capital Cost Allowance (“CCA”) rates announced in the February 23, 2005 Federal Budget are not enacted prior to December 31, 2005.
- n. That FortisBC receive a general rate increase of 4.1 percent effective January 1, 2005.

2. OVERVIEW

2.1 General

FortisBC has provided evidence in the proceeding that a locally-managed, stand-alone operation with a strong focus on customers is key to the successful operation of a utility. A locally-managed, stand-alone utility recognizes the value of local knowledge and understanding of customer requirements while providing greater transparency to the Commission. It will also produce the lowest possible costs for our customers over the long term.

The Application focuses on four key principles that are instrumental to the operation of a successful utility. These principles and the sections of the overviews that address them are:

1. meeting customer expectations - (Section 2.2 Customer Service and Transition)
2. achieving efficient operations - (Section 2.3 Operating Efficiency)
3. implementing strategic and well thought out capital investment - (Section 2.4 Capital Expenditures)
4. maintaining financial integrity - (Section 2.5 Capital Structure and Return on Equity)

2.2 Customer Service and Transition

FortisBC has committed to transitioning the Company into a locally-based stand-alone utility with improved customer service. This transition will not only provide the least possible costs for customers over the long term, but also meet customer expectations. Customer satisfaction, as is quite clearly shown by Figure 10.3.A.1.2 in Exhibit B-1, Tab 10.3 has been declining for a number of years and, according to the testimony of Panel 2 (consisting of Mr. Cairns, Ms. Allen and Mr. Lee), has reached unacceptable levels.

Figure 10.3.A.1.2 in Exhibit B-1, Tab 10.3 also confirms what customers and stakeholders clearly told Fortis Inc. (“Fortis”) management during extensive consultations leading up to the May 31, 2004 acquisition date. That is, that the utility was not meeting customers’ expectations in several key areas that and customers expected Fortis to take immediate steps to rectify the problems once it acquired the utility.

Leading up to the approval of the acquisition Fortis committed, among other things, to:

- Improve every aspect of customer service, and
- Return management of the utility to British Columbia,

This Application addresses the funding necessary to fulfil those commitments. In particular (and as set out in Exhibit B-1, Tab 10.3 of the Application) FortisBC intends to resolve a number of long-standing customer issues as follows:

- Shortening waiting times for new connections and field services,
- Shortening the time between an outage and restored service,
- Increasing billing accuracy,
- Increasing meter reading frequency and meter reading accuracy,
- Increasing bill clarity,
- Providing more reasonable payment terms to customers,
- Increasing first call resolution, and
- Hiring and maintaining knowledgeable and long-serving staff.

To deliver on the commitment, it has been necessary to relocate corporate functions currently performed in Calgary, to Trail and Kelowna.

In this Application, a key area of discussion is what are the appropriate costs for the shareholder to bear and what is appropriate for the customer to bear, i.e. what should be included in customer rates.

The Company proposes that:

1. The shareholder bear the relocation and severance costs.
2. Customers bear the prudent and necessary costs of providing the currently required levels of customer service and establishing an operating environment where efficiency gains and customer service enhancements can be achieved to benefit customers further over the longer term.

2.3 Operating Efficiency

Total O&M expenses are forecast in the Application to be \$36.2 million in 2005. When the cost of the Brilliant Terminal Station (“BTS”) lease is excluded, the 2005 forecast O&M expense *decreases* 3.2 percent on a per customer basis from the 2002 actual. (Transcript Volume 2, page 78, line 6 -- 10). In accordance with Commission Decision and Order G-46-02, the BTS is owned by Columbia Power Corporation/Columbia Basin Trust, and FortisBC leases that portion of the facility that provides a direct benefit to its customers. The approved lease payments, which began in mid 2003 currently represent over 8 percent of FortisBC’s 2005 operating expenses. This significant expenditure skews the year to year comparison of O&M expenses for the purpose of demonstrating operating efficiency.

Technology is one means of allowing FortisBC to increase productivity while improving service. During the SDP workshops in January 2005, plans were presented for piloting distribution sub-station automation in two locations – the Crawford Bay area and the Orchard Park Mall area in Kelowna. The plans outlined how this automation is expected to improve productivity and increase service reliability. The workshops also outlines substation relay (protection) improvements that will reduce outage restoration time and minimize costs. These are two of the many initiatives being undertaken to improve operating efficiency in 2005 and beyond.

Power purchase costs are one of the Company’s major expenses. However, increases in these costs are minimized through the efficient operation, investment in and management

of FortisBC's own hydro generation resources. The true value of these resources was outlined during the presentation on power purchase costs at the workshops in January 2005. These generation assets, referred to by Mr. Hughes as the "Okanagan-Kootenay" advantage, if managed properly, will provide FortisBC customers with low-cost power in future years.

2.4 Capital Expenditures

FortisBC has an obligation to provide safe, reliable, cost-effective electrical service to its customers, and capital expenditures play a critical role in the fulfillment of that obligation. FortisBC must make appropriate capital investments to meet growing service requirements and must ensure that investments in the existing system are sufficient to maintain system integrity and reliability and to optimize the life of the Company's assets.

The Company's approach to planned replacement is a measured one, balanced with customers' expectations about cost and service. Planned replacement is targeted in areas where failure rates are highest and where deterioration due to age and exposure is most evident. Approaching capital investment in this way will benefit customers by extending asset life and improving service quality at the lowest cost.

The SDP and the Capital Plan detail investments, made up primarily of growth and sustaining expenditures that are necessary within the next six years to meet these obligations and to deliver the level of service that FortisBC customers expect and deserve.

2.5 Capital Structure and Return on Equity

The fourth significant aspect of the Application deals with FortisBC's financial integrity. In November 2004, in one of the best bond markets of all time, FortisBC was unable to access low cost 30-year bonds substantially due to low interest coverage rates. The use of 30-year bonds best matches the Company's financing needs by matching the term of

the debt more closely with the life of the Company's assets and thereby reducing the risk associated with refinancing (Transcript Volume 3, page 525, line 22 -- page 526, line 16).

FortisBC is seeking a return on equity for 2005 of 9.78 percent based on an equity risk premium of 75 basis points over the return on equity for a low-risk benchmark utility.

In addition, in order to avoid further deterioration of its interest coverages, the Company proposes that the current equity ratio of 40 percent be maintained.

Commission approval of these requests, assuming appropriate depreciation and amortization, will facilitate FortisBC's access to the capital markets on reasonable terms, and ensure that the Company's capital assets can be financed on a long-term least-cost basis, producing the lowest possible cost for customers.

3. 2005 CAPITAL PLAN AND 2005 - 2024 SYSTEM DEVELOPMENT PLAN

3.1 General

The Capital Plan and the SDP, filed in support of the Capital Plan, were presented at workshops in Trail on January 18, 2005 and in Kelowna on January 20, 2005. The Capital Plan and the SDP were also subject to Information Requests from Commission staff and registered intervenors. At the oral proceedings the SDP and Capital Plan were sponsored by Panel 3 (consisting of Mr. Debiegne, Mr. Sam and Mr. Ruse) and subject to cross-examination on March 21 and 22, 2005.

The SDP was filed in support of the Capital Plan. At Transcript Volume 3, page 345, line 11--15, Mr. Debiegne states:

As Mr. Macintosh mentioned, we're not seeking approval of the system development plan, we're seeking approval of the 2005 spend, but it's hard to consider that without considering the SDP, the system development plan and the philosophies in it.

Approximately 75 percent of the total SDP budget for 2005-2010 is allocated to growth projects (Exhibit B-2, Appendix C - Capital Forecast Summary). The growth and sustaining expenditures for "electrical delivery" assets are the core of FortisBC's Capital Plan and are required to meet the Company's obligation to serve. Through prudent and timely investment in these assets, FortisBC will meet its obligation to serve the growing load in an efficient and orderly manner. FortisBC expects the capital investment to contribute in the realization of operating efficiencies comparable to those experienced in Newfoundland Power as described by Mr. Meyers at Transcript Volume 3, page 519, line 10 -- 26 and page 520, line 1 -- 6.

The SDP, which builds on the 1998 Transmission and Distribution System Master Plan, is the most comprehensive system plan the Company has developed, and provides supporting documentation from a strategic, technical and impact assessment perspective.

Mr. Debiegne at Transcript Volume 3, page 346, line 2 -- 14, stated with respect to the SDP:

You know, it's fair to say, I think, that we are very confident right now that we could trot out and argue that every line item on this and feel that we are absolutely doing the right thing. On the other hand, we do acknowledge, and I mentioned this yesterday in my testimony, we do acknowledge the significant rate impacts that this creates for our customers and the difficulty that it presents for many of the customers. And I say that with all due seriousness. We've worked very hard in the last five or six months to economize with this plan and put it forward in such a way that there is efficiency embedded in it.

Mr. Debiegne goes on to state the perspective that should be taken when analyzing the SDP, at Transcript Volume 3, page 348, line 3 -- 11 as corrected at Transcript Volume 4, page 835, line 18 -- 21:

In terms of long-term perspective, we are taking a snapshot here of six years on assets that last 40 and 50 years. We've enjoyed some quite low rates in the past below 70 percent compared to B.C. Hydro, I think, at some point in time. And certainly there are benefits embedded. Now we are seeing a bulge in these rates and we are going to see that for six or seven years as we renew the system.

Mr. Debiegne also noted that these capital expenditures will ultimately result in increased efficiencies (Transcript Volume 3, page 348, line 12 -- 25).

With respect to the Capital Plan, approximately 50 percent of the 2005 capital budget has already been approved, or is expected to be approved, through separate CPCN processes (Exhibit 53, line 21 -- 24).

The Capital Plan is approximately 95 percent directed at Transmission, Distribution and Generation assets and only 5 percent at General Plant (Exhibit B-1 Tab 9, Table 9.1). As can be seen at the same table, over 50 percent of the Capital Plan is directed towards known growth.

The proposed CPCN criteria set out in Exhibit B-1, Tab 9, page 6, FortisBC respectfully submits, is consistent with Commission determinations found in Order G-103-04 regarding BCTC's capital plan.

FortisBC acknowledges the impact the SDP may have on rates, and although the Company has already taken steps to minimize the rate impact, it will continue to work at optimizing this plan year by year to ensure that cost effective solutions are implemented in a timely manner (BCUC IR1 Q160). There will be continued analysis, consistent with past practice, to assess the need for each project prior to commitment. (Transcript Volume 3, page 346, line 21 -- 26).

When asked by Mr. Miller what the impact on rates and system reliability would be if the SDP were to be spread out over ten years rather than five years, Mr. Debiegne acknowledged that the rate impact would be lower but that the Company has examined various timing options in developing the SDP at Transcript Volume 3, page 350, line 6 -- 23:

Certainly on rates it's pretty easy. You can just -- you're going to get lower rates. So the price tag will be higher, the overall price tag will be higher. Mr. Ruse can go into some examples. We've literally done a line-by-line deferral analysis. We've looked at what can we move out in addition, what would be the impact of it? And as I said earlier, the impact, Mr. Miller, is when you decide not to do a certain project, say the Bentley Substation, it affects Osoyoos, it affects Penticton. So the planners have gone through those scenarios and said, "Well, let's say, let's not do the -- let's move a big piece of capital out of here, lower the rates. What do we have to do?" So they have to put a band-aid here and band-aid here and they have to spend some capital to keep the system together and solve the other problems that were going to be solved by that one asset now been deferred.

Mr. Debiegne further explained at Transcript Volume 3, page 302, line 8 -- 13:

...The projects, although they're listed line by line, don't stand independent of each other. In this kind of a plan, when you change one of

the projects, if you choose not to do it or you change the scope, there are usually ramifications elsewhere in the list.

In order to help prioritize the projects, FortisBC created its priority matrix, the use of which is consistent with Commission Order G-103-04 which deals with the BCTC capital plan. The matrix was developed as a tool to help prioritize the projects that the Company plans over the next six years.

When asked by the Chairperson whether it would be possible to complete all of the projects detailed for this year in the Capital Plan anticipating a decision in a reasonable time following the hearing process, Mr. Debienne replied at Transcript Volume 3, page 405, line 17 -- 21:

And we did go through an exercise here not long ago to answer that question for ourselves...we've asked for this, can we do it? And we did come to the conclusion that we were going to be able to execute this plan in 2005.

In order to follow through with the Capital Plan, prior to receiving a decision from the Commission, FortisBC will, where prudent, do preliminary work on certain projects and, in exceptional cases, enter into dialogue with the Commission staff for guidance and possibly a process such as, for example, an expedited CPCN (Transcript Volume 3, page 406, line 1 -- 13).

Ensuring the reliability and quality of the power system is a significant challenge for FortisBC. The criteria used to determine an appropriate level of reliability is best described by Mr. Debienne at Transcript Volume 2, page 267, line 4 -- 17:

... That first system development plan we did in 1998, that was a fairly big leap to go from not having N minus 1 in a lot of our service territory, to N minus 1, and it made sense for us to be there because that's where North America is at. N minus 1 minus 1 is simply a refinement of that, and given the experience that we've had here, there are a lot of outages that occurred there. If it was the sort of thing that would never happen, then it's not perhaps a plausible planning scenario. But it has happened and it's certainly easy to think about ways that it could happen in the

future. And the results to the City of Kelowna obviously would be there'd be a huge effect on the City of Kelowna.

FortisBC's customers have benefited from low electrical rates (relative to other utilities) in the past due to aging depreciated assets remaining in service. Many of these assets must now be renewed in order to maintain a reliable efficient system. In the long run, the cost of the system will be no different than other utilities as the Company uses the same equipment, comparable standards and construction practices, etc., as other utilities. However, FortisBC's customers enjoy the unique advantages of the embedded low cost of generation and favourable power purchase contracts. With this in mind, even with the anticipated rate increases, FortisBC's customers, over the longer term, will continue to enjoy relatively low rates compared with other jurisdictions.

3.2 Submissions

In view of the compelling evidence provided by FortisBC through the course of these proceedings, FortisBC respectfully submits that its Application for an Order of the Commission with respect to the following be approved as requested:

That the Capital Plan, set out at Tab 9 of Exhibit B-1, satisfies the requirements of Section 45 (6.2) (a) and (b) of the Act and that the capital projects listed in the following tables which are contained in the Capital Plan, except for the Big White Supply Project, which will be the subject of a Certificate of Public Convenience and Necessity Application in 2005, are in the public interest:

- Table 9.2.1 Generation;
- Table 9.3.1 Transmission;
- Table 9.4.1 Distribution;
- Table 9.5.1 Telecom;
- Table 9.6.1 Demand Side Management; and
- Table 9.7.1 General Plant.

4. COST OF CAPITAL

4.1 General

In order to meet the obligation to serve, and to deliver the lowest possible cost for its customers over the long term, FortisBC must have access to capital markets on reasonable terms and ensure that the Company's assets can be financed on a least-cost basis for terms that match the life of the Company's assets to the extent possible. In this regard, the Company must have an appropriate capital structure that provides financing flexibility and a return on equity that reflects an appropriate risk premium relative to that applicable to a low risk benchmark utility.

Capital structure and return on equity are the primary determinants of interest coverage. Interest coverage is a key quantitative factor relied on by rating agencies in determining credit ratings which affect the cost of financing.

The inter-relationship between capital structure, return on equity and interest coverage is dynamic. Changes in either capital structure or return on equity will directly impact interest coverage.

FortisBC presented the evidence of Ms. Kathleen McShane (Exhibit B-1, Tab 5). The BC Old Age Pensioners Organization et al ("BCOAPO") presented the evidence of Dr. Laurence Booth (Exhibit C5-5). Both of these witnesses testified on Wednesday, March 23, 2005 and their oral evidence is found in Transcript Volume 4.

In summary, both Ms. McShane and Dr. Booth recommended leaving the FortisBC capital structure unchanged, with 40 percent common equity. With respect to the premium over the return on equity for a low risk benchmark utility however, Ms. McShane recommended increasing the premium from 40 basis points to 75 basis points whereas Dr. Booth recommended eliminating any premium whatsoever and treating FortisBC at the low risk benchmark. (Ms. McShane in her report recommended a

premium between 50 and 100 basis points and focused on a 75 basis points premium as the mid-point in her recommended range.)

The Commission observed and listened to Ms. McShane and Dr. Booth give their evidence and will be in a position to assess which of these two witnesses presented the more reasonable position when their opinion was tested in cross-examination.

FortisBC respectfully submits that Dr. Booth's opinion as to the risks FortisBC faces was seriously flawed both in assessing financial risk and in assessing business risk.

4.2 Capital Structure

Sound utility management dictates that the capital structure should attempt to balance the overall cost of capital, while also enabling the Company to access long-term debt through the capital markets. As noted by Ms. McShane in Exhibit B-1, Tab 5, page 2, the financing of the assets with a combination of debt and equity can lower the overall cost of capital because interest expense on debt is tax deductible. However, too much debt will increase the weighted average cost, as the costs associated with financial distress will outweigh the benefits of additional debt.

As noted above, FortisBC proposes to maintain its current capital structure, with a common equity ratio of 40 percent and the BCOAPO expert also recommends a common equity of 40 percent.

4.3 Return on Equity

As outlined by Ms. McShane in Exhibit B-1, Tab 5, page 3, there are two approaches that can be used to establish the appropriate capital structure and return on equity for FortisBC. The approach used by FortisBC is to establish a capital structure that is compatible with the business risks of the utility and is adequate for the utility to maintain an investment grade debt rating, but may not result in the same level of equity risk as faced by the low risk benchmark utility. Consequently, an incremental equity risk premium relative to the benchmark utility is required, in order to provide full

compensation for both business and financial risks to each utility. This is the approach that has effectively been adopted by the Commission.

FortisBC proposes an incremental risk premium of 75 basis points for a return on common equity of 9.78 percent. Dr. Booth recommends that no incremental risk premium be added to the return for a low risk benchmark utility.

In her evidence, Ms. McShane specified that “the determination of a reasonable capital structure should be premised on certain principles as outlined in Exhibit B-1, Tab 5, page 3 -- 4. These included (1) the stand-alone principle (2) business risk, and (3) debt rating.

Ms. McShane states on page 16 of Exhibit B-1, Tab 5, with respect to business risk:

In my opinion FortisBC faces above average risk relative to its Canadian electric and gas peers and, in context of the BCUC’s return on equity determination, relative to the low risk benchmark utility.

In his report (Exhibit C5-5, page 45, line 14 --17), Dr. Booth acknowledges that in 1994 he

.. felt that West Kootenay Power was above average risk based on two main factors: its small size and the gap between its internal generation and its customers’ needs leaving it open to generation risk. It has addressed this latter concern through long term contracting with the following ...

As the transcript demonstrates, Dr. Booth in 1994 had in fact testified that West Kootenay Power was at the “upper end of risk” along with PNG (Transcript Volume 4, page 732 -- 733 and Exhibit B-57) and Edmonton Power (Transcript Volume 4, page 729 -- 730 and Exhibit B-56).

What Dr. Booth endeavoured to do in his report (Exhibit C5-5, page 45) was distinguish West Kootenay Power’s circumstances in 1994 from those of FortisBC in 2005. He conceded that the small size remained (Exhibit C5-5, page 45, line 25) and endeavoured to focus instead on what he said was a narrowing or elimination of “the gap” in its energy

requirements. However, the evidence is to the opposite effect. FortisBC's risk regarding its energy needs is much greater now than it was in 1994.

First, with respect to his three points at Exhibit C5-5, page 45, line 18 -- 21 of his evidence, West Kootenay Power's two contracts with Cominco in 1994 gave it 170 megawatts as opposed to the 125 megawatts referenced in the Brilliant agreement (Exhibit C5-5, page 45, line 18 -- 19) and the related contract matrix in 1994 was basically equivalent in security for power purchasing as compared with the circumstances in 2005 (Transcript Volume 4, page 737, line 8 -- page 739, line 5).

Secondly, when Dr. Booth points to the 200 megawatt BC Hydro agreement at page 45, line 20, the fact is that agreement was in place in 1993 and therefore was in place when he gave his testimony in 1994 as to "the gap" West Kootenay Power was facing.

Thirdly, whereas Dr. Booth (Exhibit C5-5, page 45, line 17 and line 21) says FortisBC now has long-term power purchase agreements with smaller suppliers, there simply are no such agreements.

But there is a larger problem (Transcript Volume 4, page 739 -- 742) and that is the fact that FortisBC is far more reliant on the marketplace for energy in 2005 than it was in 1994. This is addressed by Mr. Egolf of FortisBC at Transcript Volume 3, page 433 -- 436 and as seen by referencing Dr. Booth's testimony, referenced above, in comparison with Exhibit B-4, Resource Plan and the diagram at page 19. The red band, which represents the amount of needed capacity required to be purchased at market, is up to four times greater now than it was in 1994. In other words, FortisBC is far more reliant on the market now than it was then. Furthermore, the market price is much higher now and is far more volatile.

There are additional circumstances regarding risk change for FortisBC from 1994, when Dr. Booth had regarded West Kootenay Power and PNG at the upper end of risk. In the rapidly growing areas of its service area, FortisBC now faces competition from natural

gas, particularly with respect to new housing starts, and FortisBC industrial customers now have the opportunity to switch to third parties for their electricity requirements (Transcript Volume 2, page 91 -- 93 and Transcript Volume 4, page 753 -- 755). Further, as the chart in Exhibit B-1, Tab 7, page 5 indicates, residential usage of electricity per customer has been declining steadily since 1988, and this trend is expected to continue. These factors, combined with the increased reliance of FortisBC on the volatile energy market, can only lead to a conclusion of increased risk.

Dr. Booth in his report devotes considerable effort to relating or comparing FortisBC to utilities in Alberta. This is addressed in his testimony at Transcript Volume 4, page 742 - - 747. In essence, he invites the Commission to conclude that FortisBC is like these utilities, which have lower equity components in their capital structures. In fact, however, these are extremely poor comparisons for FortisBC. Each of the Alberta utilities Dr. Booth references are “unbundled” utilities offering only a discrete service, transmission, distribution or generation. All of the Alberta utilities are larger than FortisBC. As Dr. Booth states in his filed evidence, the small size of FortisBC remains a problem (Exhibit C5-5, page 45, line 25).

Dr. Booth addresses transmission in Alberta in Exhibit C5-5, page 24, line 14 -- 15, observing that it is normally regarded as the least risky of the utility businesses, since the costs are almost entirely fixed and recovered as a fixed monthly charge from the ultimate customer. That is simply not the case for FortisBC. Dr. Booth purported to rely upon some perhaps ambiguous wording in a FortisBC prospectus in support of the proposition that transmission charges are fixed charges for FortisBC. However, if Dr. Booth had looked at a FortisBC residential customer bill (Exhibit B-58, Transcript Volume 4, pages 746 and 754 in the cross-examination of Dr. Booth and Transcript Volume 4, page 566, line 10 -- page 570, line 22, cross-examination of Ms. McShane by Mr. Gathercole) it would have been readily apparent that for FortisBC, a “bundled” utility, the fixed charge (customer charge) is very small relative to the variable charge for energy, from which it necessarily follows that the transmission, distribution and generation costs of FortisBC are recovered in variable charges and not fixed monthly charges.

For all these reasons, endeavouring to compare FortisBC to the Alberta utilities selected by Dr. Booth is unhelpful as Dr. Booth admitted in cross-examination (Transcript Volume 4, page 747, line 22 -- page 748, line 4):

MR. MACINTOSH: Q: All right. Now, and am I not correct, sir, that both Newfoundland Power and Maritime Electric are infinitely more comparable to FortisBC than any of these isolated, segregated utilities you've pointed us to in Alberta?

DR. BOOTH: A: That's probably true, but as I mentioned earlier on, I've never testified in those jurisdictions so I've never ever familiarized myself with Maritime Electric or Newfoundland Power.

In Ms. McShane's report (Exhibit B-1, Tab 5) at pages 18 and 19, are two charts which were discussed by Dr. Booth in his cross-examination at Transcript Volume 4, page 748 - 752.

Maritime Electric and Newfoundland Power are probably the best comparisons to FortisBC in all of Canada. Maritime Electric has a legislated minimum equity of 40 percent, and an actual equity of 45.8 percent in its capital structure. Although it is not rated by DBRS, it is equivalent to an A DBRS rating (Transcript Volume 4, page 752, line 9 -- 14). Newfoundland Power has an equity component of 45 percent and is rated A by DBRS.

FortisBC by contrast was downgraded in 1996 to DBRS BBB (high), lower than any utility in Ms. McShane's chart on page 18 of Exhibit B-1, Tab 5. The Moody's rating for FortisBC of Baa3 is lower still, equivalent to a DBRS rating of BBB (low).

On page 19 of her report, (Exhibit B-1, Tab 5) Ms. McShane's chart shows the actual common equity for a number of utilities, including Maritime Electric and Newfoundland Power, both of which, as mentioned above, have the DBRS A rating or the equivalent.

Dr. Booth has acknowledged that Maritime Electric and Newfoundland Power are probably the best comparisons for FortisBC. But they have significantly lower risk, as evidenced by their respective DBRS ratings.

It is respectfully submitted that Dr. Booth has consistently understated both the financial and business risks which FortisBC faces and that these risks are in fact greater now than they have been in its past. The Company's creditworthiness has been downgraded, its interest coverages are low and its business risks in facing the energy market are higher than at any point in its history. The two utilities with which it has the best comparison are rated as having significantly less risk. FortisBC, using any of these objective criteria for assessment is clearly in a high risk category probably not comparable to PNG at present (PNG has two significant applications pending before the Commission) but worse than any other utility which was discussed in the course of the evidence in this hearing.

4.4 Interest Coverage

The assumption of debt effectively magnifies the business risk to which the assets of the utility are exposed: the higher the debt ratio, the more potential volatility in the equity return. The financial risk of a utility can be captured in its capital structure ratios, interest coverage ratios and debt ratings (Exhibit B-1, Tab 5, pages 16 and 17). FortisBC's (1999-2003) pre-tax interest coverage of 2.1 is significantly less than the prior five year period (1994-1998) pre-tax interest coverage of 2.4.

In this Application, FortisBC submits that it was unable to access 30-year bonds, substantially due to low interest coverages. The BCOAPO expert provided evidence that concluded that the interest coverage was 2.74; however, further evidence provided by FortisBC showed that the calculations were fundamentally flawed for the purposes of assessing financial risk.

In Dr. Booth's report, at Exhibit C5-5, page 48, line 17 -- 19, he provided an opinion that FortisBC has financial flexibility with his recommendations (i.e. 40 percent equity and 0

basis points premium for ROE) and he endeavoured to demonstrate this opinion by referencing the interest coverage for the Company.

In Exhibit C5-5 at page 48, line 26 he concluded that the interest coverage is 2.74, and at the top of page 49 he claimed that even if the common equity was reduced to 36 percent, “the interest coverage would be lowered to a still healthy 2.47.”

Dr. Booth’s interest coverage calculations are fundamentally flawed from any reasonable perspective for the purpose of assessing financial risk. Exhibit B-55 sets out what FortisBC submits are the necessary corrections to the so-called interest coverages Dr. Booth calculated. (Exhibit B-55 and the related evidence is addressed at Transcript Volume 4 page 684 -- 721.) As this evidence demonstrates, four separate adjustments are needed to bring Dr. Booth’s unique calculation of interest coverages into accord with industry practice. He made three fundamentally-important departures from industry practice, each of which served to inflate the interest coverage figure to a higher number.

Firstly, Dr. Booth employed the marginal debt rate of 5.48 percent as opposed to the average embedded cost of debt of 6.66 percent. In calculating interest coverage, one must use the average embedded cost of debt, since the object of an interest coverage calculation is to determine whether the company in question has the financial ability to cover the interest costs of all its debt, not only the most recent borrowing it happens to have incurred.

Secondly, Dr. Booth imputed an income tax rate of 36 percent when the Company’s applicable tax rate is in fact only 23 percent.

Thirdly, Dr. Booth chose to exclude AFUDC from his interest coverage calculation.

When these three fundamental and necessary changes are made, as Exhibit B-55 demonstrates, Dr. Booth’s unique interest coverage calculation of 2.74 reduces to only 2.06.

In assessing the reliability of Dr. Booth's testimony, it is noteworthy that immediately following his reference to 2.74 in Exhibit C5-5, page 49, line 3, he proceeds to compare this with interest coverages for FortisBC and other Fortis entities from 1998 to 2002, without disclosing that these interest coverages were calculated on the normal industry basis, and in other words, have little indeed to do with Dr. Booth's calculation as a comparison.

There is a further distortion from Dr. Booth's interest coverage work as seen from his statement at Exhibit C5-5, page 49, line 10 -- 14, where he purports to assure the reader that the FortisBC debt covenants pose no problem to interest coverage assessment.

This is simply wrong and Dr. Booth took no steps to verify the accuracy of this evidence. As seen in Exhibit B-55, when the trust deed obligations for deriving interest coverage are taken into account, the interest coverage for FortisBC is further reduced from 2.06 to an unacceptably low 1.89. (Mr. Lorimer of FortisBC prepared Exhibit B-55 and confirmed that the interest coverage of 1.89 is in accordance with the FortisBC lending document requirements at Transcript Volume 5, page 782, line 15 -- page 783, line 11.)

Exhibit B-55 (at the bottom of the first page) is also instructive when it references the interest coverages which would result for FortisBC if Ms. McShane's recommendations were accepted. At 40 percent common equity, with a premium of 75 basis points as the ROE, the FortisBC interest coverage would be 2.14 when the three normal criteria are employed (i.e. average embedded cost of debt at 6.66 percent, tax at 23 percent and inclusion of AFUDC). Furthermore, when the FortisBC lending document obligations are taken into account, the governing interest coverage is a precarious 1.97.

When Philip Hughes, the President and Chief Executive Officer of FortisBC, testified at the beginning of the hearing on March 21, 2005, the following exchange occurred between the Chairperson and Mr. Hughes (Transcript Volume 2, page 128, line 4 -- page 129, line 3):

THE CHAIRPERSON: Just one other question, and it has to do with the bond issue which a number of the participants have asked you about. You've indicated there were, I think, three issues that were in the forefront in terms of impacting FortisBC's ability to raise 30-year money. What sort of priority might you place on those issues? Was there one that was the driving issue? One or two more important than the other?

MR. HUGHES: A: Probably the one where it all comes together is interest coverage. That's probably the one where it takes in all the factors. Because it's the coverages issue that's doing it. However -- and I'm not -- ROE and depreciation feed into it, but if you are looking for one measure, one place where it really hits, I would say it's the interest coverage.

In terms of -- you can't really be definitive as to the ROE number is X and it's a very precise number. I think what you've got to look at is that if the experience is that you are not getting the right result, and we've actually experienced this, then you know it needs to probably be changed. But I'm not sure that anybody can say that the number should be 978 as opposed to 981 or 970 or something, but I think you can get the region. So that's how I'd answer the question.

Dr. Booth in both his written evidence and his oral testimony endeavoured to suggest that FortisBC has no problem whatever accessing debt. This was addressed in his testimony at Transcript Volume 4, page 705 -- 707 and 721 -- 729. To bolster his evidence in this regard, Dr. Booth introduced in evidence the FortisBC document entitled "Management Discussion & Analysis" dated December 31, 2004 (Exhibit B-54) and read, out of context, a passage at page 11 which states: "The Company does not anticipate any issues with accessing the required capital." As a quick reference to that document indicates, that statement was confined to the FortisBC ability to raise money to finance the 2005 Capital Program. Without access to long-term debt markets, FortisBC will have increased difficulty in financing its capital program beyond 2005.

In his written report, Dr. Booth was equally reassuring, and equally inaccurate as applied to FortisBC when he said at Exhibit C5-5, page 37, line 16 --19:

However, the important point is that this market is robust and indicates that financing is readily available for low risk utility assets at currently

allowed ROEs. There is nothing in the behaviour of Canadian capital markets over the last few years that indicate any access problems for low risk utility assets.

The entire thrust of Dr. Booth's evidence was that this statement has application to FortisBC. However, the evidence is overwhelming that it does not. While it is clearly the case that the lending market was indeed robust in 2004, the evidence is equally clear that FortisBC was precluded from getting the 30-year debt financing it wanted and it was precluded from doing so because it is too high risk. The necessary inference from Dr. Booth's quoted evidence is of course that FortisBC is simply not a low risk utility.

The uncontradicted evidence of the FortisBC inability to enter the 30-year debt market is found in the testimony of Mr. Hughes at Transcript Volume 1, page 80, line 13 -- page 81, line 9 and the testimony of Robert Meyers, the Chief Financial Officer, at Transcript Volume 3, page 525 -- 528. This evidence is overwhelmingly clear in pointing out the advantage for the utility and its customers in being able to access long-term debt, and in demonstrating that FortisBC was, for all intents and purposes, precluded from accessing this debt because of its poor risk.

4.5 Submissions

FortisBC respectfully submits that Dr. Booth's evidence is fundamentally flawed and must be rejected and that the evidence provided by the Company, including the evidence of Ms. McShane, be accepted.

FortisBC further submits that the capital structure and Return on Equity requested in the Application is necessary and prudent, and strikes an optimal balance that is of benefit to customers, and requests and Order of the Commission:

Approving a cost of capital for rate making purposes which reflects:

- i. a return on equity which is 75 basis points above that set by the Commission for a benchmark low-risk utility; and
- ii. a common equity ratio of 40 percent of total capitalization.

5. 2005 REVENUE REQUIREMENTS

5.1 General

FortisBC's 2005 Revenue Requirement of \$179,991,000 yields a revenue deficiency of \$7,018,000 and a required rate increase, effective January 1, 2005, of 4.1 percent. The following table demonstrates the contribution by cost category to the overall increase in revenue requirements for 2005, and the resulting rate increase.

Table 5.1
Revenue Requirements Analysis
(\$000s)

	Approved 2004	2005 Third Revised Application (Exhibit B-26)	Increase or (Decrease)		Proportion of 2005 Revenue Requirement
				%	
1 COST CATEGORY					
2					
3 POWER SUPPLY					
4 Power Purchases and Wheeling	65,188	63,329	(1,859)	-1.1%	35.2%
5 Water Fees	7,328	7,681	353	0.2%	4.3%
6	72,516	71,010	(1,506)	-0.9%	39.5%
7					
8 OPERATION AND MAINTENANCE					
9 O&M Expense	32,845	36,173	3,328	2.0%	20.1%
10 Other Income	(3,861)	(3,970)	(109)	-0.1%	-2.2%
11	28,984	32,203	3,219	1.9%	17.9%
12					
13 Rate Base					
14 Cost of Debt	22,157	23,453	1,296	0.8%	13.0%
15 Cost of Equity	19,638	23,398	3,760	2.2%	13.0%
16 Income Taxes	6,134	5,916	(218)	-0.1%	3.3%
17 Property and Capital Taxes	9,820	10,278	458	0.3%	5.7%
18 Depreciation and Amortization	16,805	18,626	1,821	1.1%	10.3%
19 AFUDC	(3,098)	(3,102)	(4)	0.0%	-1.7%
20	71,456	78,569	7,113	4.2%	43.7%
21					
22 INCENTIVE ADJUSTMENTS	(3,030)	(1,791)	1,239	0.7%	-1.0%
23					
24 TOTAL REVENUE REQUIREMENT	169,926	179,991	10,065	5.9%	100.0%
25					
26 Less: REVENUE AT APPROVED RATES (LOAD GROWTH)		(172,973)	(3,047)	-1.8%	
27 REVENUE DEFICIENCY		7,018	7,018	4.1%	
28					
29 RATE INCREASE		4.1%			

Table 5.1 above (at line 24) indicates that 2005 Revenue Requirements have increased by 5.9 percent, or \$10,065,000 over the approved Revenue Requirements for 2004. Of that amount, load growth, based on the forecast as accepted by the Load Forecast Committee

(Exhibit B-18) will contribute one third, or approximately \$3.0 million, reducing the required increase in rates to 4.1 percent.

Rate Base costs as shown at Table 5.1, line 20 represent the largest component (43.7 percent) of the 2005 Revenue Requirement followed by Power Supply costs (39.5 percent at line 6) and Operation and Maintenance cost (17.9 percent at line 11), offset by Incentive Adjustments (-1.0 percent at line 22.) Each of these major cost categories will be addressed below.

5.2 Rate Base

A regulated utility's Rate Base represents the net investment in assets necessary to provide service. The utility finances its Rate Base through a combination of debt and equity, otherwise referred to as invested capital. The total of interest and return on equity required to finance the utility's investment in Rate Base is known as Return on Rate Base and forms a major component of revenue requirement.

FortisBC's Rate Base, as described in Exhibit B-1 at Tab 6, is comprised principally of Plant in Service, Accumulated Depreciation and Amortization, Deferred Charges and Credits, Allowance for Working Capital and an Adjustment for Capital Expenditures. The Company's actual Rate Base for 2002 to 2004, and forecast Rate Base for 2005 of \$598,105,000, is provided in Exhibit B-26, Tab 4, Schedule 1, page 4.

Included in the 2005 forecast Rate Base are amounts previously approved by the Commission including the Plant Acquisition Adjustment, deferred DSM and other deferred expenditures as well as expenditures for capital projects.

During the Information Request process and at the oral public hearing, Commission Counsel questioned the Company regarding the Adjustment for Capital Expenditures, and whether the adjustment should be calculated based on a 13-month weighted average versus a quarterly weighted average (BCUC IR1 Q37 and Transcript Volume 5, page 867, line 12 -- page 868, line 25). As stated in the transcript, either method should

provide similar results over the long term. Should the Commission prefer that the Company move to a 13-month average for calculating the Adjustment for Capital Expenditures in the determination of Rate Base, the Company would suggest that this change be introduced prospectively beginning in 2006 as part of the Company's 2006 revenue requirements application.

The inclusion of construction work in progress in rate base and the associated treatment of AFUDC, was also raised by Commission Counsel (BCUC IR1 Q85 and Transcript Volume 5, page 872, line 16 -- page 873, line 26). In response to BCUC IR1 Q85.10, the Company indicated that Terasen and PNG do not include AFUDC as a reduction to revenue requirement and exclude construction work in progress subject to AFUDC from rate base. FortisBC includes all construction work in progress in rate base but offsets revenue requirement by the amount of AFUDC. In response to the cross examination and consistent with the response to BCUC IR1 Q85.10, FortisBC indicated that the net result is the same. (Transcript Volume 5, page 873, line 20 -- 21). That is, either method yields the same revenue requirement.

FortisBC has included construction work in progress in the calculation of rate base, together with the corresponding deduction of AFUDC in the calculation of revenue requirements, since 1990 (Commission Order No. G-109-90). FortisBC does not propose to change its current treatment, and believes that its current treatment better reflects the actual income tax and accounting treatment of AFUDC. However, should the Commission wish to change the method of accounting for construction work in progress and AFUDC, FortisBC is of the position that any such change should be applied prospectively beginning in 2006 as part of the Company's 2006 revenue requirements application.

FortisBC respectfully submits that its forecast mid-year Rate Base for 2005 of \$598,105,000, as provided in Schedule 1 to the Third Revised Application (Exhibit B-26), be approved for purposes of establishing 2005 revenue requirements and setting rates to customers effective January 1, 2005.

5.3 Rate Base Costs

Rate Base costs for 2005, as shown in Table 5.1, line 20 are forecast to be \$78,569,000, and include cost of debt, cost of equity, income taxes, property and capital taxes, depreciation and amortization and AFUDC (Exhibit B-26).

5.3.1 Cost of Debt:

As shown in Table 5.1, line 14, the cost of debt in 2005 is forecast to be \$23,453,000. The majority of FortisBC's debt costs are associated with already existing long term debt (Exhibit B-1, Tab 8, page 18, Table 8.3.1 B). The balance of the Company's debt costs are based on forecast short and long-term borrowings and forecast interest rates.

The Revised Application (Exhibit B-19) reflected a reduction in the forecast cost of debt for 2005 due to a reduction in the forecast interest rate associated with the new long term debt issue planned for 2005, a reduction in forecast short-term interest rates for 2005 and a reduction in the interest rate assumed on 2005 deemed debt (Exhibit B-19, covering letter, page 6).

FortisBC has focused on reducing the cost of debt by transitioning to a stand-alone company. Issues with respect to the benefit of its stand-alone status, were raised in BCUC IR1 Q4 and BCOAPO IR1 Q45. FortisBC provided answers to both IR's supporting its view that cost savings realized of approximately \$1,065,000 attributable to its stand-alone status. Further support for raising debt on a stand-alone basis was provided by Mr. Hughes during his testimony on March 21, 2005. (Transcript Volume 2, page 129, line 15 -- 21):

Stand-alone you'll actually end up with a cheaper number, because if you go through the debt ratings you'll find that in a holding company they tend to have lower ratings than the stand-alone...

During the course of the oral public hearing, no Intervenor raised any issue with respect to the forecast cost of debt for 2005.

FortisBC respectfully submits that its 2005 forecast cost of debt of \$23,453,000, as filed in the Third Revised Application (Exhibit B-26), should be approved for purposes of establishing 2005 revenue requirements and setting rates to customers effective January 1, 2005.

5.3.2 Cost of Equity:

As shown in Table 5.1, line 15, the cost of equity for 2005 is forecast to be \$23,398,000. This is based on a capital structure which is comprised of 40 percent equity and 60 percent debt and a return on equity of 9.78 percent, further details of which are set out in Section 4 (Cost of Capital) of these submissions.

FortisBC respectfully submits that this capital structure and return on equity will assist in allowing the Company's assets to be financed on a least-cost basis and should be accepted by the Commission.

FortisBC further submits that its forecast cost of equity for 2005 of \$23,398,000 should be approved for purposes of establishing 2005 revenue requirements and setting rates to customers effective January 1, 2005.

5.3.3 Income Taxes:

As shown in Table 5.1, line 16, income tax expense for 2005 is forecast at \$5,916,000. A detailed income tax calculation as forecast for 2005 is provided in Schedule 3 of the Third Revised Application (Exhibit B-26).

Three specific issues raised during the hearing with respect to income taxes were:

1. The provision for income tax audits;
2. The treatment of AFUDC in the calculation of taxable income; and

3. The method of accounting for income tax expense.

With respect to the first issue raised, the Company has included an amount of \$100,000 in its 2005 revenue requirements as a provision for income tax audits. The Company has been audited by the Canada Revenue Agency (“CRA”) for the years up to and including 1998. The Company does expect that it will be audited for the years subsequent to 1998 in the very near future. Due to the long period of time since its last audit, and because of the increased level of scrutiny under which CRA audits are now performed, the Company believes it is both reasonable and prudent to include this provision in its 2005 income tax expense.

In Exhibit B-77 (Undertaking U-44), the Company indicated that a cumulative provision for income tax audits for the years 1999 through 2004 exists, in the amount of \$350,000. FortisBC proposes this provision be retained pending an audit by CRA for these years. Any unused provision upon completion of the audits would be credited to the benefit of customers in calculating the following year’s revenue requirement.

With respect to the second issue raised, on March 24, 2005 the Revenue Requirements Panel 6 (consisting of Mr. Sam, Mr. Lee, Mr. Meyers and Mr. Lorimer) was questioned by Commission Counsel with respect to the treatment of AFUDC in the calculation of taxable income (Transcript Volume 5, page 874, line 10 -- page 875, line 7). The Company wishes to clarify Mr. Meyers’ final response as follows:

If the question is whether there should be a deduction from AFUDC for the equity component, the answer is “No”, as stated.

If the question is whether there should be a tax deduction for the equity component of AFUDC, then the answer is “Yes”. There should be a tax deduction for the full AFUDC amount, which is shown as an offset to interest expense on the company’s financial statements. The company does pay income

taxes on the equity return for construction work in progress. The equity return for construction work in progress is included in Accounting Income on Schedule 3.

On March 24, 2005, Commission Counsel also requested clarification that AFUDC had been properly deducted in the forecast income tax expense calculation for 2005. (Transcript Volume 5, page 874, line 3 -- 7). The Company has provided a reconciliation of Accounting Income (as per Schedule 3 of Exhibit B-26) to Earnings before Interest and Taxes (on an income statement basis) to show that AFUDC has been properly accounted for in the forecast income tax calculation for 2005 (Exhibit B-79).

With respect to the third issue raised, Counsel for the Commission also cross-examined Panel 6 (consisting of Mr. Sam, Mr. Lee, Mr. Meyers, and Mr. Lorimer) on the method of accounting for income tax expense. Panel 6 confirmed that FortisBC accounts for income taxes according to the flow-through method (Transcript Volume 5, page 869, line 15). In Commission Order No. G-37-84, the flow-through method of accounting for income taxes by FortisBC was found to be in the public interest based on a detailed review at that time. The Company is of the position that any change in the method of accounting for income taxes on a go-forward basis can be considered only after a similar detailed review and assessment has been completed.

No other issues were raised during the oral public hearing with respect to forecast income tax expense for 2005.

FortisBC respectfully submits that forecast income tax expense for 2005 of \$5,916,000 should be approved for purposes of establishing 2005 revenue requirements and setting rates to customers effective January 1, 2005.

5.3.4 Property and Capital Taxes:

As shown in Table 5.1, line 17, Property and Capital Taxes for 2005 are forecast at \$10,278,000.

Subsequent to the filing on November 26, 2004, and as outlined in response to BCUC IR1 Q82.1, the Company received notice on February 11, 2005 that its appeal with respect to the BC Capital Tax had been allowed and that the Company anticipated a BC Capital Tax refund.

As part of the Revised Application, (Exhibit B-19, covering letter, page 7) the Company reduced its 2005 Revenue Requirements by \$292,000. This reduction reflects the BC Capital Tax refund amount, including interest, net of related income tax, shared equally between the Company and its customers (BCUC IR1 Q82.2).

Issues with respect to the sharing of the refund were raised by Counsel for the BCOAPO and the BCUC during cross-examination of the Revenue Requirements Panel 6 (consisting of Mr. Sam, Mr. Lee, Mr. Meyers and Mr. Lorimer) on March 22, 2005 and March 24, 2005, respectively (Transcript Volume 3, page 514, line 5 -- page 516, line 22 and Transcript Volume 5, page 842, line 17 -- page 846, line 17). Both parties questioned the rationale for sharing the refund, suggesting that the full refund should be credited against revenue requirement.

In view of the fact that the Company aggressively pursued the appeal, and in view of the fact that PBR is intended to provide incentives to the Company to find ways to reduce cost and to share these cost savings with Customer, the Company considers it reasonable that the refund be shared on a 50-50 basis (BCUC IR1 Q82.2). It is the Company's position that this sharing proposal is further supported by the fact that, since PBR was introduced in 1996, customers have benefited from receiving incentives totalling approximately \$7,000,000 while the Company has actually incurred additional costs totalling approximately \$500,000 (Transcript Volume 3, page 504, lines 2 -- 12).

No further issues with respect to Property and Capital Tax were raised during the hearing.

FortisBC respectfully submits that its forecast Property and Capital Taxes for 2005 of \$10,278,000 should be approved for purposes of establishing 2005 revenue requirements and setting rates to customers effective January 1, 2005.

5.3.5 Depreciation and Amortization:

As shown in Table 5.1, line 18, Depreciation and Amortization expenses for 2005 are forecast at \$18,626,000. Annual Depreciation expense is calculated for each asset class using rates approved by the Commission (Orders G-37-84 and G-134-99). Depreciation expense is added to Accumulated Depreciation and Amortization net of retirements as a reduction to rate base.

Issues were raised by Mr. Wait and by Commission Counsel with respect to depreciation related matters, as follows:

- (1) the low rate of depreciation used for transportation equipment (Transcript Volume 5, page 814, line 3 -- 6);
- (2) the length of time since the last depreciation study (Transcript Volume 5, page 863, line 9 -- 13); and
- (3) the fact that the deferral of depreciation expense results in future rate payers paying for both the amount that was deferred and the carrying cost of a higher rate base (Transcript Volume 5, page 865, line 25, page 866, line 9).

In response to these issues and similar questions raised in BCUC IR1 Q33.6 and Q33.7, FortisBC stated that it would not be appropriate to make any changes to depreciation rates or methodologies until a depreciation study has been completed. Furthermore, and in particular response to issue number (3) above, it is impossible to determine if there has been any deferral of depreciation expense pending completion of the depreciation study. If there has been, or alternately, if the opposite is in fact the case, the depreciation consultant's recommendations will address how to deal with that situation.

The Application states that FortisBC has initiated a formal and comprehensive Depreciation Study for completion in 2005 and submission with its 2006 Revenue Requirements Application. Current depreciation rates were last examined in 1983 (Commission Order No. G-37-84 and BCUC IR1 Q33.6.1). As outlined by Mr. Meyers under cross-examination by Mr. Miller (Transcript Volume 5, page 862, line 22 -- page 864, line 26), a depreciation study is required to determine an appropriate amortization period, not only for existing utility plant, but also for the significant plant additions forecast over the next several years.

The depreciation study will also address the appropriateness of certain issues arising from the Negotiated Settlement Agreement for 2000-2002. The Negotiated Settlement Agreement, as approved by Order No G-134-99, included a reduction in depreciation rates (and therefore depreciation expense) for Transmission and Distribution assets, and a further offset to depreciation expense in the form of a Rate Stabilization Provision. As stated in Exhibit B-1, Tab 6, page 9, line 6 -- 9:

Both the Rate Stabilization provision and the change in depreciation rates were grounded in a desire to mitigate rate increases during a period of very high rate base additions.

Neither amount was based on an expert-prepared depreciation study examined by the Commission.

The need for a depreciation study accords with Dr Booth's assertion that the depreciation rate should be based on the economic useful life of the assets and it shouldn't be fixed for other purposes (Transcript Volume 4, page 759, lines 12 -- 14).

The depreciation study will be carried out by an independent consultant at a cost of approximately \$30,000 (BCUC IR1 Q33.6.2) and will address various issues raised during the proceedings, which include the disposition of the Rate Stabilization Account (BCUC IR1 Q33.7.4), the existence of different depreciation rates between the Company's generating Plant 1 and Plants 2, 3, and 4 (BCUC IR1 Q31.2), and a need to

review the rates for fleet vehicles and computer software (BCUC IR1 Q33.6.3 and Q33.6.4 and Transcript Volume 5, page 814, line 7 -- 13), for example.

The Company does not propose any changes to depreciation rates or methodologies, and feels it inappropriate to do so, until the depreciation study has been completed and its recommendations have been appropriately reviewed and addressed by the Commission (BCUC IR1 Q33.7.4).

FortisBC respectfully submits that forecast 2005 expenditures of \$18,626,000 for Depreciation and Amortization expenses should be approved for purposes of establishing 2005 revenue requirements and setting electricity rates to customers effective January 1, 2005.

5.3.6 AFUDC:

As shown in Table 5.1, line 19, AFUDC is forecast to provide a credit to revenue requirements of \$3,102,000 in 2005.

AFUDC represents financing costs incurred by the Company while assets are under construction. AFUDC is deducted from revenue requirements and applied to capital, to be recovered through depreciation expense over the life of the asset.

In Section 5.2 of these submissions, issues related to the inclusion of construction work in progress in rate base and the associated treatment of AFUDC were discussed, and will not be repeated here.

FortisBC respectfully submits that forecast AFUDC of \$3,102,000 for 2005 should be approved for purposes of establishing 2005 revenue requirements and setting rates to customers effective January 1, 2005.

5.4 Power Supply

This category of expense, as outlined in Table 5.1, line 6 of these submissions, is forecast at \$71,010,000 for 2005. This is comprised of forecast power purchase expense including wheeling charges of \$63,329,000 and water fees of \$7,681,000.

The Company's Revised Application (Exhibit B-26) included a reduction in forecast Power Purchase Expense as compared to the November Application (Exhibit B-1). The reduction reflected the revised load forecast for 2005, the impact of recent discussions with Teck Cominco with respect to larger block purchases in November and December 2005, reduction of the January/February Call Option energy rate, and other changes as indicated in Exhibit B-19, covering letter, page 4 -- 5.

The primary drivers of the power supply costs are forecast load/sales and resource acquisition cost. The forecast load/sales for 2005 were accepted by the Commission in a letter dated March 17, 2005 (Exhibit A-16) based on the recommendations of the Load Forecast Committee (Exhibit B-18).

The forecast 2005 resource acquisition cost is based on the Company's resource acquisition policy as stated in Exhibit B-1, Tab 7.3, page 4:

The Company's resource acquisition policy continues to be to meet the customer's load requirements at low cost with minimal environmental impacts while recognizing ongoing uncertainties...

The forecast power purchase expense included in the 2005 revenue requirements has been determined using contract prices plus a forecast of future market rates. The 2005 market rates are based on the energy block rates forecast in the Avista Energy Report with an adjustment to account for the fact that these purchases are made for the most valuable hours in the energy block (Exhibit B-1, Tab 7.3, page 12).

The future market rate calculation mechanism is consistent, transparent and reasonable. This methodology was reviewed by the Power Purchases Technical Committee and is

documented in Exhibit B-21, Report of the Power Purchase Technical Committee. Any assumptions related to market pricing are clearly stated in that report.

The effects of the Entitlement Adjustment Agreement, although still subject to final signature by the parties involved, have been embedded in 2005 Revenue Requirements with the effect of lowering the 2005 power purchase expense. (Exhibit B-1, Tab 7.3, page 6 and BCUC IR1 Q52 and Transcript Volume 3, page 480, line 20 -- page 481, line 5.)

No intervenor raised issue with respect to the 2005 Power Supply costs forecast by FortisBC for purposes of determining its 2005 revenue requirements.

FortisBC respectfully submits that the forecast Power Supply costs for 2005 of \$71,010,000, as filed in Exhibit B-26, should be approved for purposes of establishing 2005 revenue requirements and setting rates to customers effective January 1, 2005.

5.5 Operations and Maintenance

5.5.1 General:

Included in the Application by FortisBC are 2005 forecast O&M Expenses of \$36,173,000, as shown in Exhibit B-26.

From 1996 through 2004 FortisBC's revenue requirements were approved by negotiated settlements which were based upon a performance-based revenue requirement and rate setting mechanism ("PBR"). PBR served to limit the level of O&M expense allowed in rates (Exhibit B-1, Tab 3, page 8, line 1 -- 5).

The Company has repeatedly expressed its position that base O&M targets have been too low and hence inappropriate on a go forward basis (BCUC IR1 Q6.1). In recent years the need to reassess or rebase FortisBC's O&M expense has been recognized by all parties

involved in the negotiated settlement process. However, it was concluded that the only way in which O&M expenses could be determined other than by way of the pre-defined formula was through a detailed cost of service review (Exhibit B-65, Undertaking U-32, page 1, line 28 -- page 2, line 4).

As stated by Panel 6 (consisting of Mr. Sam, Mr. Lee, Mr. Meyers and Mr. Lorimer), the approved O&M expenses used in the 2004 Negotiated Settlement were strictly a target driven calculated number based on a cost of service that was done a decade earlier and did not truly reflect the 2004 O&M cost reality. Many business practices and circumstances have changed in the intervening years. (Transcript Volume 5, page 824, lines 5 – 18 and Exhibit B-65, Undertaking U-32, page 1, line 8 -- 32 -- page 2, line 4). As stated by Mr. Lee, attempting a detailed comparison of 2005 forecast O&M expenses based on a true cost of service determination to a target driven number used in the 2004 negotiated settlement is difficult (Transcript Volume 5, page 849, line 16 -- page 850, line 2 and B-68, Undertaking U-35, line 9 -- 15), and in our submission, not helpful.

A material portion of the proposed increase in O&M Expense for 2005 reflects FortisBC's reassessment of the overall level of O&M expense required to meet service obligations to its customers in the areas of customer service, transmission and distribution, and administration and general costs (Exhibit B-1, Tab 3, page 8, line 5 -- 8).

5.5.2 Improving Customer Service:

Improved customer service is a priority for FortisBC. Increasing customer service from its current unsatisfactory level to the level that meets customer expectations requires increased operating expenditures (Exhibit B-1, Tab 3, page 8, line 21 -- 23).

When Fortis held consultations with customers and stakeholders prior to the acquisition of FortisBC, transforming the organization to one that is more customer focused was something that customers and stakeholders identified as being a very high priority for them as well. The Commission, in Order G-39-04 approving the acquisition, indicated

that it expected Fortis to deliver on that commitment (Transcript Volume 3, page 506, line 15 -- page 507, line 25 and Transcript Volume 5, page 825, line 4 -- 16 and Transcript Volume 2, page 173, line 3 -- 15).

Mr. Hughes, during cross examination by Mr. Gathercole on March 21, 2005, stated that a company based in BC with local management and operations would provide better customer service. (Transcript Volume 2, page 84, line 14 -- 20). Mr. Hughes indicated during his testimony that the cost of providing this improved customer service are properly borne by customers. The shareholder on the other hand has borne the cost of relocation and severance associated with moving aspects of the organization from Calgary to the FortisBC service area (Transcript Volume 2, page 82, Line 2 -- page 83, line 12, and Transcript Volume 5, page 825, line 17 -- 24).

During the cross-examination of Panel 2 (consisting of Mr. Cairns, Ms. Allen and Mr. Lee), (Transcript Volume 2, page 170) Mr. Miller expressed the opinion that while the Company was under PBR regulation, costs went down, and now that customers are paying 100 percent of the cost, the Company plans to give the customers whatever they want. Mr. Cairns pointed out that this was not the case and that the Revenue Requirements in this Application directly reflect the improvements in customer service that customers had demanded. Mr. Cairns responded (Transcript Volume 2, page 170, line 14 -- page 171, line 2):

...if your suggestions is that when the company is under a PBR mechanism they make expenditures based on that as opposed to when the company is under a cost of service based form of regulation, then we make expenditures based on that formula, we don't do that.

What we've done here is, through extensive consultation with customers, starting when Fortis acquired this company and leading up to the approval of the purchase of this utility by Fortis through extensive stakeholder and customer consultations, we've heard what customers have said and this request responds to what they're asking us to do. It really has nothing to do with PBR or a cost of service based model.

During cross-examination by Mr. Scarlett on March 23, 2005 (Transcript Volume 3) Mr. Meyers stated very clearly that controlling and managing costs is a FortisBC management philosophy that is on-going regardless of whether there is PBR or not (Transcript Volume 4, page 778, line 22 -- page 779, line 4).

5.5.3 Operating Efficiency:

The second key principle addressed in the Company's application with respect to O&M Expenses is operating efficiency (Transcript Volume 2, page 77, line 22 -- page 78, line 21). Mr. Hughes expressed the Company's view with respect to cost control when he testified (Transcript Volume 2, page 77, line 24 -- 26) that:

FortisBC is very focused on productivity and the management of operating and maintenance cost.

Mr. Hughes further stated: (Transcript Volume 2, page 78, line 3 -- 10):

We are working to achieve increased efficiencies in all facets (sic) of our business. Total operating and maintenance expenditures are currently forecast to be \$36.2 million in 2005. If the cost of the Brilliant Terminal Station lease is excluded, the 2005 O&M forecast decreases over 2002 on a per customer basis by 3.2 percent. So it decreases 3.2 percent from 2002 actual.

Labour costs including contract labour, comprise over 75 percent of FortisBC's controllable operating expense. The Company is focused on improving the efficiency of its processes and the productivity of its work force while improving customer service. The implementation of a pesticide management plan (Transcript Volume 3, page 509, line 18 -- page 511, line 16) and the sequencing of maintenance work in conjunction with the capital program (Transcript Volume 5, page 793, line 10 -- 26) are just some examples of the focus on improving efficiency and productivity.

While being cross-examined by Mr. Scarlett on March 23, 2005 Mr. Meyers re-iterated that the Company's management philosophy is to minimize and reduce costs wherever

possible in order to provide least cost service to its customers, and that there is nothing included in 2005 forecast O&M Expense that is not fully justified (Transcript Volume 4, page 769, line 18 -- page 770, line 3).

When cross-examined by Mr. Gathercole on March 22, 2005, Mr. Meyers drew a comparison between FortisBC's present situation and that of Newfoundland Power in the early 1990's stating that operating expenses there had decreased by 2.4 percent from 1998 to 2004 as a result of having made some strategic capital expenditures and investments in customer service (Transcript Volume 3, page 519, line 10 -- page 520 line 6). Over that same general timeframe Newfoundland Power had experienced an increase in customer satisfaction from 70 percent in 1996 to 90 percent in 2002.

Mr. Meyers stated at Transcript Volume 3, page 520, line 4 -- 6 that:

So, that is an example of the way that Fortis operates it's utilities and I would expect over time to see something very similar happen here in B.C.

5.5.4 Analysis of 2005 O&M Expenses:

FortisBC's 2005 forecast O&M Expenses are based on a budget process that has been developed from the ground up have undergone significant scrutiny by senior management, and are focused on the Company's core operating areas of safety, customer service, reliability and environmental responsibility (Exhibit B-64, Undertaking U-31).

While under cross examination by Mr. Scarlett on March 23, 2005 Mr. Meyers stated that the Company's O&M budget for 2005 is based on the best information available at the present time (Transcript Volume 4, page 778, line 1 -- 9 and Transcript Volume 5, page 821, line 10 -- 24).

An analysis of the increased level of O&M Expense required to meet service obligations to customers is outlined in the Company's response to Undertaking U-33 (Exhibit B-66).

As stated in Undertaking U-33, the increase in the 2005 O&M expense, after accounting for transition related expenses, is \$2,766,000.

Normal wage increases, inflation and increases in employee benefit costs relate to medical coverages and vacations for example are approximately \$1.2 million (Exhibit B-66, Undertaking U-33, page 1, line 23 -- page 2, line 17).

Increases in Generation related O&M Expenses relate to transformer oil conditioning and dam safety and potable water regulations are approximately \$200,000 (Exhibit B-66, Undertaking U-33, page 2, line 25 -- 32).

Increases in Transmission and Distribution related O&M Expenses, including line operation and maintenance, substation maintenance, Cominco facility rental and Brilliant Terminal Station expenses are approximately \$1.6 million (Exhibit B-66, Undertaking U-33, page 2, line 34 -- page 4, line 3). When queried by Mr. Wait regarding the increase in transmission and distribution cost, Mr. Sam gave a detailed explanation which outlined the reasonableness of the expenditure and the diligence used in preparing the operating and maintenance budgets (Transcript Volume 5, page 791, line 5 -- page 796, line 5).

A reduction in 2005 O&M Expense of \$500,000 is being realized due to savings related to FortisBC's ability to purchase lower cost insurance coverage through its participation in the Fortis Inc. insurance program, offset by increased fire suppression insurance costs provided through the BC Government (Exhibit B-66, Undertaking U-33, page 4, line 6 -- 9).

A reduction in Vehicle Lease costs of \$700,000 for 2005 will be realized due to savings related to the buy-out of certain leased vehicles (Exhibit B-66, Undertaking U-33, page 4, line 11 -- 13).

Increases in Environmental, Health & Safety related O&M Expenses are approximately \$350,000 (Exhibit B-66, Undertaking U-33, page 4, line 15 -- 34).

Increases in general and administrative expenses related to increased internal audit, corporate governance and financial reporting requirements are approximately \$500,000 (Exhibit B-66, Undertaking U-33, page 4, line 36 -- page 5, line 12).

Increases in general and administrative expenses related to corporate administration, corporate communications and customer relations are approximately \$150,000.

FortisBC believes that the forecast O&M Expense included in its 2005 Revenue Requirement is the minimum necessary for it to improve customer service and reliability (Exhibit B-1, Tab 3, page 11, lines 18 -- 20), and respectfully submits that the 2005 forecast O&M Expense of \$36,173,000, as filed in Exhibit B-26, should be approved for purposes of establishing 2005 revenue requirements and setting electricity rates to customers effective January 1, 2005.

5.6 Final 2004 Incentive Adjustments

In Order No. G-20-05, the Commission approved the sharing of FortisBC's 2004 Incentive Adjustments.

The final adjustments arising from the 2004 Negotiated Settlement agreement, as referred to in the Second and Third Revised Applications (Exhibits B-25 and B-26 respectively) reduce the 2005 Revenue Requirement by \$1,791,000.

FortisBC submits that the final incentive adjustments for 2004 of \$1,791,000 should be approved by the Commission for inclusion in revenue requirements for 2005.

5.7 Submissions

FortisBC respectfully submits that the evidence presented in the course of these proceedings indicates that the proposed Revenue Requirement is reasonable, prudent and

necessary in order for the Company to provide the level of service required and expected by customers, and is seeking an Order of the Commission approving that the 2005 Revenue Requirement in the amount of \$179,991,000.

6. PROPOSED 2005 INCENTIVE SHARING MECHANISMS

6.1 General

FortisBC has proposed that only certain aspects of incentive sharing be retained for 2005. In particular, it is proposing that the DSM and Power Purchase incentive sharing mechanisms be retained and that various expenses which have been flow-through costs to customers continue to receive that treatment.

Incentive mechanisms that FortisBC proposes to eliminate for 2005 are:

1. The 50/50 sharing mechanisms related to O&M Expense, other income, and base capital volume variance; and
2. The flow-through of variances in AFUDC and income tax expense (BCUC IR1 Q6.1)

FortisBC is proposing a temporary asymmetrical sharing mechanism for 2005 with respect to forecast O&M Expense.

6.2 Demand Side Management Incentive

In the Application, FortisBC has proposed the continuation of the current DSM incentive mechanism for 2005.

As outlined in Exhibit B-1, Tab 10.1, page 15, lines 1 -- 4, FortisBC is of the view that the DSM incentive “has increased the Company’s focus on meeting and exceeding the energy efficiency targets.” Consequently, the Company proposes to retain the existing DSM incentive for 2005.

The benefits of the DSM incentive were addressed in the Report of the DSM Technical Committee, Exhibit B-17, which also recommended continuation of the current incentive mechanism for 2005. In a letter dated March 17, 2005 (Exhibit A-16) the Commission accepted the DSM Technical Committee’s recommendations.

Neither the Company's proposal nor the DSM Technical Committee's Report was subject to cross-examination during the oral public hearing.

6.3 Power Purchase Incentive

The Company has proposed to retain the existing power purchase incentive mechanism, under which (a) the full advantage of cost savings either currently embedded in contracts, or which are anticipated, are included in the Power Purchase Forecast, and are therefore to the full benefit of customers, and (b) variances, other than load variances, from the Revenue Requirements forecast are applied 65 percent to customer rates in the subsequent year (75 percent for variances in excess of \$1,000,000).

The November Application (Exhibit B-1, Tab 8, page 3, line 11 -- 18) stated that:

...forecast 2005 Power Supply costs are reduced primarily by (1) the return to customers, on a flow through basis, of the difference between forecast and actual 2004 costs under the Brilliant Power Purchase Agreement, (2) a return to customers of the reduced cost of supply from BC Hydro resulting from a decrease in their rates in 2004 and (3) the anticipated successful negotiations with BC Hydro related to the Canal Plant Agreement, which are forecast to result in higher entitlements for FortisBC's generating plants in the amount of 28 GW.h.

The 2005 forecast Power Purchase Expense reflected in the Revised Application (Exhibit B-19, covering letter, page 4 -- 5) also included the benefit of confirmed and anticipated block purchases in March, November and December of 2005; a reduction in the forecast rate of Call Options in response to stakeholder feedback at the January 21, 2005 Revenue Requirement Workshop; a recently negotiated agreement for summer surplus energy sale at favourable rates; and revisions to forecast market prices and exchange rates to reflect more recent information.

As noted in the quotation from Tab 8 above, the Company proposes to continue the treatment of actual costs under the Brilliant Power Purchase Agreement as a flow-through to customers.

During the course of the oral public hearing, no intervenor opposed or otherwise commented on the Company's proposal.

6.4 *Flow-through Costs*

In addition to the Brilliant Power Purchase Agreement expense noted in the Section 6.2 above, the Application also proposes the continuation of flow-through treatment for certain other costs over which the Company has limited or no control as follows:

- a. the continuation of flow through to customers of differences between forecast and actual property taxes, provincial water fees, and the Power Purchase expense related to the Brilliant contracts for 2005; and
- b. the flow through treatment of the costs of capacity block power purchases forecast for November and December 2005.

The flow-through of variances in AFUDC and income tax expense is proposed to be discontinued.

During the course of the oral public hearing, no opposition to the Company's proposals was raised.

6.5 *Operating Expense Incentive*

As stated in Section 6.1 above, FortisBC is proposing a temporary asymmetrical sharing mechanism for 2005 with respect to forecast O&M Expense. Under this proposal, to the extent that 2005 O&M Expense, net of capitalized overheads, are lower than the forecast O&M Expense of \$36,173,000 (Exhibit B-26), the variance will be shared equally with customers (Exhibit B-1, Tab 8, page 30, line 18 -- 23). Actual O&M Expense in excess of the forecast O&M Expense of \$36,173,000 will be entirely to the account of the shareholder (BCUC IR1 Q86.0 and Transcript Volume 3, page 505, line 21 -- 26).

In a cost of service year, as is the case in 2005, there would normally be no sharing whatsoever with respect to O&M Expenses (Transcript Volume 4, page 768, lines 16 -- 22). In that case, if the costs exceeded budget the shareholder would pay those additional costs, but if the costs were below budget the shareholder would receive all the benefit (Transcript Volume 3, page 508, line 13 -- 15). The Company has proposed an asymmetrical sharing mechanism for 2005 whereby customers will share in the benefit associated with any O&M Expense reductions as a gesture of good faith and in recognition of stakeholder concerns with respect to PBR (Transcript Volume 2, page 94 line 23 -- page 95, line 14).

6.6 Review of PBR

PBR has given customers the opportunity to share in efficiency gains and has also greatly decreased regulatory costs relative to annual hearing processes (IMEU IR1 Q6.1 and Transcript Volume 3, page 503, line 15 -- page 504, line 26).

FortisBC intends to complete a comprehensive review of PBR with a view to engaging in stakeholder consultation by the fourth quarter of 2005; and will propose implementation, at the earliest, in 2006 if a fair and workable mechanism can be determined (Exhibit B-1, Tab 3, page 11, line 26 -- page 12, line 4 and KOECA IR1 Q1 and Transcript Volume 2, page 97, line 25 -- page 99, line 3).

6.7 Submissions

FortisBC respectfully submits that the incentive mechanisms proposed for 2005 are fair and reasonable, and therefore requests an Order of the Commission:

- (a) Approving the continuation of the current DSM and Power Purchase incentive mechanisms for 2005;

- (b) Approving the continuation of flow through to customers of differences between forecast and actual property tax, provincial water fees, and the Power Purchase expense related to the Brilliant contracts for 2005;
- (c) Approving the flow through treatment of the costs of capacity block power purchases forecast for November and December 2005;
- (d) Approving the O&M Expense as shown in the Application, with a forecast value of \$36,173,000 and a sharing mechanism whereby
 - i. If actual O&M Expense is below this value, the difference will be shared equally between FortisBC and its customers, but
 - ii. If actual O&M Expense is above this value, there will be no sharing and the entire difference will be borne by the shareholder.

7. 2005 RESOURCE PLAN

7.1 General

FortisBC submits that the Resource Plan meets the requirements of Section 45 (6.2) (b) of the Act, and is in the public interest. As stated in Section 45 (6.1) (b) of the Act, a public utility must file a plan with the Commission of how the utility intends to meet the demand for energy by acquiring energy from other persons , and the expenditures required for that purpose.

In compliance with Section 45 (6.1) (b) of the Act, FortisBC filed its Resource Plan (Exhibit B-4). The Resource Plan addresses how FortisBC intends to meet its load and energy requirements over the 2005-2024 period.

The Resource Plan concluded that:

1. Additional long-term firm resources are not needed until when and if the Power Purchase Agreement (“PPA”) with BC Hydro expires, potentially in 2013; and
2. FortisBC should consider reducing its exposure to short-term market purchases.

To address those issues FortisBC proposed an action plan (Exhibit B-4, page 11) as follows:

ACTION PLAN

1. The Company will begin discussions with BC Hydro with a view to gaining certainty regarding the status of the PPA beyond 2013.
2. The Company will conduct a more detailed study of a much shorter time frame than was assessed in this Resource Plan study, approximately five years, to optimize a new market strategy that provides more protection from market volatility and improved reliability. Modeling the market is a complex undertaking and involves a variety of possible strategies and products that

could be purchased. It is possible that some combination of medium-term capacity purchases from TeckCominco and peaking purchases from others can provide a similar level of protection from market volatility and improved reliability at lower cost than the energy block purchases that were simulated in the Resource Plan study.

3. The Company will update and file its DSM Potential study and complete a new DSM plan covering the period 2005 -- 2014. This study will investigate whether a more aggressive program is more cost effective.
4. That Company proposes to update the Resource Plan on a bi-annual basis. It is essential that, with the dependence on the market to meet some of its requirements, the Company needs to detect shifts in load growth and market trends as soon as possible in order to make the necessary adjustments to its Resource Plan.
5. The Company will investigate options other than addition of a new long-term firm clean resource for complying with the BC Energy Plan.

The Resource Plan was presented at workshops in Trail on January 18, 2005 and Kelowna on January 20, 2005. The Resource Plan was also subject to Information Requests from the BCUC and registered intervenors. At the oral proceedings the Resource Plan was sponsored by Panel 4 (consisting of Mr. Debienne, Mr. Koschik, and Mr. Egolf) and subject to cross-examination on March 22, 2005.

Issues were raised with respect to two aspects of the Resource Plan. These were:

1. Finalizing the PPA with BC Hydro for long term firm resources; and
2. The proposed strategy to reduce exposure to short-term market purchases.

The risk associated with finalizing the PPA with BC Hydro was subject to several Information Requests. These include BCUC IR1 Q202.1-3 and BCOAPO IR1 Q70.1.

As well, the issue was covered in cross-examination of Panel 4 by Mr. Scarlett. (Transcript Volume 3, page 415, line 17 -- 21).

The evidence with respect to this issue is clear and consistent. FortisBC is of the view that while there is risk associated with finalizing an agreement, successful negotiations can be concluded, prior to its expiration in 2013. This was articulated by Mr. Debiegne in his response to Mr. Scarlett. (Transcript Volume 3, page 416, line 22 -- page 417, line 2):

And as you know, we've had some really good experiences; I'll say this right now, with doing the bilateral negotiations with Hydro. The entitlement adjustment agreement which was -- it was huge as far as our business was concerned, you know, it took a matter of months to conclude. So I have every optimistic hope that it won't be a protracted negotiation.

The second issue raised through Information Requests and the oral proceedings related to the Company's proposed strategy to address its exposure to short-term market purchases. As outlined on page 26 of Exhibit B-4, the Company has forecast a peak load of 905 megawatts by 2024. As shown in response to BCOAPO IR1 Q82.1, the Company has forecast that the shortfall in its ability to meet peak load through firm long-term contracts will increase from 169 megawatts in 2005 to 301 megawatts in 2024. This clearly shows that the Company's market exposure is increasing. To manage this market exposure, the Company, through the Resource Plan, proposed to study a power purchase strategy that relied on short and medium-term contractual agreements with less reliance on the spot market to meet expected loads.

FortisBC conducted extensive analysis with respect to this strategy and concluded that subject to the assumptions, there is a reasonable likelihood of financial benefits to the customer by moving to a new market strategy that lessens exposure to the spot market. Recognizing that such a strategy is very sensitive to market factors, the Company proposed as Action Item #2, (Exhibit B-4, page 11), that it conduct a more detailed study of a shorter time frame than was assessed in this Resource Plan study, approximately five

years, to optimize a new market strategy that provides more protection from market volatility and improved reliability. The necessity for such a study has been confirmed through responses to BCUC IR1 Q199.1-6 and Exhibit B-52 (Undertaking U-25).

7.2 Submissions

FortisBC respectfully submits that its Resource Plan is reasonable and prudent, and requests an Order of the Commission that the Resource Plan meets the requirement of Section 45 (6.2) (b) of the Act, and is in the public interest.

8. 2005 DEMAND SIDE MANAGEMENT EXPENDITURE PLAN

8.1 *General*

Section 45 (6.1) (c) of the Act states that a public utility must file a plan with the Commission of how the utility intends to reduce the demand for energy, and expenditures required for that purpose.

In compliance with Section 45 (6.1) (c), and in conjunction with the November Application, FortisBC filed its DSM Plan as Tab 10.1 of Exhibit B-1.

The DSM Plan was presented at workshops in Trail on January 18, 2005 and in Kelowna on January 20, 2005. Following the pre-hearing conference on January 21, 2005, the Commission issued Order No. G-14-05, which provided direction for FortisBC to organize a Technical Committee to consider issues associated with the DSM Plan. The Technical Committee filed its report on March 9, 2005 (Exhibit B-17) and recommended the continuation of both the DSM Incentive Mechanisms and the DSM Incentive Committee for 2005. In a letter dated March 17, 2005 (Exhibit A-16) the Commission accepted the recommendation of the DSM Technical Committee.

No issues with respect to the DSM Plan were raised during the oral public hearing.

8.2 *Submissions*

FortisBC respectfully submits that the DSM Plan, filed in compliance with Section 45 (6.1) (c) of the Act, is reasonable, prudent, and in the public interest, and therefore requests an Order of the Commission that the 2005 DSM Plan meets the requirements of Section 45 (6.2) (b) of the Act and is in the public interest.

9. OTHER ACCOUNTING PROPOSALS

9.1 General

Through the Application, and over the course of these proceedings, a number of other accounting issues have been raised before the Commission. These issues include items such as:

- i. Proposals to defer and amortize certain costs; and
- ii. A Proposal related to accounting for PowerSense costs which are currently being expensed.

9.2 Deferrals

As outlined in Exhibit B-1, Volume 1, Tab 6, Pages 10 – 11, deferred charges and credits represent costs and credits that will be recognized as expense or income in future periods.

In the Application, FortisBC is proposing:

- i. Deferral of the cost of certain regulatory and related activities;
- ii. Deferral of issue costs related to the Company's Series 04-1 Senior Unsecured Debentures; and
- iii. Deferral and recovery in 2006 of higher income tax expense that will arise in 2005 if the new Capital Cost Allowance ("CCA") rates announced in the February 23, 2005 Federal Budget are not enacted prior to December 31, 2005.

Regulatory activities eligible for cost deferral include the 2005 Revenue Requirements Application, and the 2005 Generic Return on Equity Hearing. Also included in the Application is a provision for the cost of participating in other regulatory proceedings as may be required, for example the BC Hydro Rate Design Application which is expected to be filed in mid-2005.

Issue costs related to the Company's Series 04-1 Senior Unsecured Debentures consist of legal and underwriting fees and other costs which, in total, are forecast to be in the amount of \$2,091,000 (Exhibit B-26). The Company is requesting approval to defer these costs and amortize them over a 10 year period beginning in 2005 (as referred to in Section 9.3 below). This treatment is consistent with the manner in which debenture issue costs have been treated previously.

Income tax expense in the Revised Application reflects changes in Capital Cost Allowance ("CCA") rates that were announced in the February 23, 2005 Federal Budget in relation to new Transmission and Distribution assets. While the legislation giving effect to these changes has not yet been substantially enacted, the benefit to customers has been reflected in 2005 income tax expense. Based on recent events, and the possibility of a federal election, the likelihood of the budget changes being substantially enacted prior to December 31, 2005 is much lower than when the Revised Application (Exhibit B-26) was filed. Should the proposed rates not be implemented during 2005, FortisBC would be required to record its 2005 income tax expense on the basis of the currently enacted CCA rates. If this results FortisBC would expect and requests Commission approval to defer the higher income tax expense for recovery or resolution in 2006.

Counsel for the Commission questioned Panel 6 (consisting of Mr. Sam, Mr. Lee, Mr. Meyers, and Mr. Lorimer) regarding the tax treatment of deferred charges. FortisBC records deferred costs related to DSM net-of-tax, as required by Commission Order No. G-55-95. Other deferred charges are recorded on a gross basis. At Transcript Volume 5, page 887, Mr. Miller questioned the appropriateness of recording deferred charges on a net-of-tax basis. Mr. Meyers responded that, in his opinion, this treatment is appropriate to ensure proper matching of costs and benefits.

The Company proposed in response to BCUC IR1 Q34.5.4 that deferred amounts related to the proposed 2005 O&M Expense and power purchase sharing mechanisms be recorded net-of-tax so that the associated income tax is correctly matched either to the

customers or the shareholder. The Company did not propose to extend this treatment to other deferral accounts. Furthermore, the Company is of the position that any change in the treatment of other deferred charges must apply on a prospective basis only, and should be made only after a full assessment of the impact has been completed.

9.3 Amortization of Deferred Charges

FortisBC is seeking approval to:

- i. amortize the issue costs related to the Series 04-1 Senior Unsecured Debentures, which are forecast to be \$2,091,000, over ten years commencing on January 1, 2005;
- ii. amortize the costs incurred in FortisBC's 2004 Revenue Requirements negotiated settlement process; and
- iii. amortize the costs of the SDP and Resource Plan, in an aggregate amount of \$900,000, over five years, commencing on January 1, 2005.

FortisBC's practice is to request disposition of deferred charges such that, so far as possible, the amortization period of deferred costs matches the period over which the related benefit is received. In this Application approval is requested to amortize the issue costs for Series 04-1 Debentures over the life of the debenture issue (i.e., ten years) and to amortize in 2005 \$60,000 in deferred charges incurred in the 2004 Revenue Requirements Application and Negotiated Settlement Process, detail of which is provided in response to BCOAPO IR1 Q2.0. No objections to the amortization of these items were raised during the hearing process.

The Company also proposes to amortize the costs of developing the SDP and the Resource Plan over five years commencing in 2005. These planning activities are carried out at intervals of approximately five years, and are considered to be an ongoing, although intermittent, operating expense. Therefore the Company proposes to include the amortization of the costs in O&M expense. Intervenors questioned the Company in regard to the amortization period with respect to these costs (BCOAPO IR1 Q1.0), but

did not challenge the underlying concept of deferring and amortizing the costs as proposed.

9.4 *PowerSense Costs*

FortisBC is proposing a change in the accounting treatment of certain PowerSense costs in the amount of \$85,000, such that these costs are charged to capital rather than operating.

As documented at Exhibit B-1, Volume 1, Tab 10.1 Page 6, the treatment of the \$85,000 as an operating expense follows the practice used prior to 1996. However, the appropriateness of treating these amounts in the same manner as other DSM expenses has since been identified. For consistency of target-driven O&M expenses under PBR the change was delayed until a cost-of-service review could be undertaken.

No questions or comments regarding this change in accounting practice were raised during the proceedings.

9.5 *Submissions*

FortisBC respectfully submits that the above proposals are necessary, reasonable and prudent, and therefore request an Order of the Commission:

- a. Approving the deferral of:
 - ii. the cost of regulatory and related activities; and
 - iii. the issue cost of the Series 04-1 Senior Unsecured Debentures in the amount of \$2,091,000.

- b. Approving deferral and recovery in 2006 of higher income tax expense that will arise in 2005 if the new CCA rates announced in the February 23, 2005 Federal Budget are not enacted prior to December 31, 2005.

- c. Approving the amortization of:
 - i. the issue cost of the Series 04-1 Senior Unsecured Debentures in the amount of \$2,091,000 over ten years commencing on January 1, 2005;
 - ii. the costs incurred in FortisBC's 2004 Revenue Requirements negotiated settlement process; and
 - iii. the costs of the SDP and Resource Plan in an aggregate amount of \$900,000, over five years commencing on January 1, 2005.

- d. Approving a change in the accounting treatment of certain PowerSense costs in the amount of \$85,000, such that these costs are charged to capital rather than operations.


10. GENERAL RATE INCREASE

FortisBC respectfully submits that all of the materials before the Commission, including the Application, the Information Requests, the Transcripts and the Undertakings summarized in this submission support a general rate increase of 4.1 percent effective January 1, 2005.

FortisBC is seeking an Order of the Commission approving a general rate increase of 4.1 percent effective January 1, 2005.

ALL OF WHICH IS RESPECTFULLY SUBMITTED.

FORTISBC INC.

Per:  _____

Robert Meyers, Vice President
Finance and Chief Financial Officer