SCHOOL ENERGY COALITION

CROSS-EXAMINATION MATERIALS

EB-2011-0210 - PANEL 4

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Union Gas Equity Structure Example

Existing Capital Structure (Ex. E1/1, p. 3 applied to settled rate base)

Long Term Debt	61.66%	$2,289,983	6.53%	$149,536
Short Term Debt	-0.89%	-$33,054	1.31%	-$433
Total Debt	60.77%	$2,256,929	6.61%	$149,103
Preferred Equity	3.23%	$119,959	3.05%	$3,659
Common Equity	36.00%	$1,336,999	9.58%	$128,085
Total Equity	39.23%	$1,456,958	9.04%	$131,743
Total Capital	100.00%	$3,713,887	7.56%	$280,846

As Currently Proposed (from Settlement Agreement)

Long Term Debt	60.17%	$2,234,646	6.53%	$145,922
Short Term Debt	-2.92%	-$108,446	1.31%	-$1,421
Total Debt	57.25%	$2,126,200	6.80%	$144,502
Preferred Equity	2.75%	$102,132	3.05%	$3,115
Common Equity	40.00%	$1,485,555	9.58%	$142,316
Total Equity	42.75%	$1,587,687	9.16%	$145,431
Total Capital	100.00%	$3,713,887	7.81%	$289,933

Conventional 60/40 Split (Based on Electricity Distributors)

Long Term Debt	56.00%	$2,079,777	6.53%	$135,809
Short Term Debt	4.00%	$148,555	1.31%	$1,946
Total Debt	60.00%	$2,228,332	6.18%	$137,755
Preferred Equity	2.75%	$102,132	3.05%	$3,115
Common Equity	37.25%	$1,383,423	9.58%	$132,532
Total Equity	40.00%	$1,485,555	9.13%	$135,647
Total Capital	100.00%	$3,713,887	7.36%	$273,402

UNION GAS LIMITED

Answer to Interrogatory from
Board Staff

Ref: Exhibit E3, Tab 1, Schedule 1

a) Please recreate Schedule 1 of Exhibit E3/Tab1 using the Board's current approved capital structure.

b) Please explain the negative unfunded short-term debt and the impact on this item if the schedule is recreated using the Board's current approved capital structure.

Response:

a) Attached is a hypothetical Summary of Cost of Capital assuming the Board's current approved capital structure and Union's 2013 forecasted rate base and cost rate percentages. Please see Attachment 1.

b) Please see Exhibit E1, Tab 1, Page 6 of 10, Lines 14 to 19 for an explanation of the negative unfunded short-term debt. Since the Board's current approved capital structure has a lower weighting to unfunded short-term debt than the 2013 proposed weighting the impact on the negative unfunded short-term debt component would be to decrease it. Please note that the application of the 2007 Board-approved structure results in long-term debt and preference share amounts that do not reflect Union's expected balances for these items.

Line No.	Particulars	Utility Capital Structure ($000's)	Utility Capital Structure (%)	Cost Rate %	Requested Return ($000's)
		(a)	(b)	(c)	(d)
1	Long-term debt	2,307,035	61.66	6.50%	149,957
2	Unfunded short-term debt	(33,300)	(0.89)	1.31%	(436)
3	Total debt	2,273,735	60.77		149,521
4	Preference shares	120,852	3.23	3.05%	3,686
5	Common equity	1,346,955	36.00	9.58%	129,038
6	Total rate base	3,741,542	100.00		282,245

UNION GAS LIMITED
Summary of Cost of Capital
Calendar Year Ending December 31, 2013

Line No.	Particulars	Utility Capital Structure ($000's)	Utility Capital Structure (%)	Cost Rate %	Requested Return ($000's)
		(a)	(b)	(c)	(d)
	As Filed				
1	Long-term debt	2,257,972	60.35	6.50%	146,868
2	Unfunded short-term debt	(115,296)	(3.08)	1.31%	(1,510)
3	Total debt	2,142,676	57.27		145,358
4	Preference shares	102,248	2.73	3.05%	3,117
5	Common equity	1,496,617	40.00	9.58%	143,376
6	Total rate base	3,741,542	100.00		291,851
	Per Settlement Agreement				
7	Long-term debt	2,234,597	60.17	6.53%	145,957
8	Unfunded short-term debt	(108,513)	(2.92)	1.31%	(1,422)
9	Total debt	2,142,676	57.25		144,535
10	Preference shares	102,248	2.75	3.05%	3,117
11	Common equity	1,485,555	40.00	9.58% (2)	142,316
12	Total rate base	3,713,887	100.00		289,969
13	Change	(27,655) (1)			(1,883)

Notes

(1)	Reductions to rate base	
	general	(12,000)
	gas in inventory	(15,655)
		(27,655)

(2) Per Section 4.3 of the settlement agreement

operational risks of a rapidly changing industry and that their decision-making will be fair and will have a significant degree of predictability.

For these reasons, rating agencies look for the consistent application of sound economic regulatory principles by utility regulators. If a regulatory body were to encourage a company to make investments based upon an expectation of the opportunity to earn a reasonable return, and then did not apply regulatory principles in a manner consistent with such expectations, investor interest in providing funds to such utility would decline, debt ratings would likely suffer, and the utility's cost of capital would increase.

Q. HAVE THE RECENT FINANCIAL AND OPERATIONAL CHALLENGES FACING ALL UTILITY MANAGEMENTS INCREASED THE FINANCIAL COMMUNITY'S FOCUS ON THE ACTIONS OF UTILITY REGULATORS?

A. Yes, without a doubt. The recent turmoil in the financial markets has tested the financial standing of the utility sector like never before. Liquidity, or access to cash when needed, has always been a major issue for regulated utilities, but it has leaped to the forefront of utility financial and operational concerns and has driven structural decisions on the part of utility executives. As the Wall Street Journal reported at the beginning of the financial crisis, "Disruptions in credit markets are jolting the capital-hungry utility sector, forcing companies to delay new borrowing or to come up with different – and often more costly – ways of raising cash."[5]

[5] "Utilities' Plans Hit by Credit Markets," Wall Street Journal, October 1, 2008.

Thus, while “Regulation” has always garnered the attention of the financial community, years ago it seemed to be a focus only during the days leading up to a regulator’s rate case decision. This began to change around the time that Fitch hired me in 1993 to serve in the role of regulatory analyst and assess regulatory, legislative and political factors that could affect a utility’s financial strength. When California announced its ultimately ill-fated restructuring plan in 1994, the entire financial community took much greater notice of regulators and how they carried out their responsibilities, not only with regard to rate-setting, but also the manner in which they considered restructuring of the entire utility industry. And of course the recent stresses within the credit markets I referred to earlier with their huge financial repercussions have increased the stakes substantially beyond regulators merely having to adjust their policies to deal with flawed restructuring initiatives.

Q. DO THE RATING AGENCIES AGREE THAT UTILITY REGULATORS AND THEIR DECISION-MAKING CONTINUE TO BE IMPORTANT WITHIN THE CREDIT RATING PROCESS?

A. Yes. S&P highlighted the critical role that regulators play in a November 26, 2008 report entitled “Key Credit Factors: Business and Financial Risks in the Investor-Owned Utilities Industry”:

> Regulation is the most critical aspect that underlies regulated integrated utilities’ creditworthiness. Regulatory decisions can profoundly affect financial performance. Our assessment of the regulatory environments in which a utility operates is guided by certain principles, most prominently consistency and predictability, as well as efficiency and timeliness. For a regulatory process to be considered supportive of credit quality, it must limit uncertainty in the recovery of a utility’s investment.

Q. IS IT REASONABLE TO EXPECT THAT THESE STATEMENTS ABOUT THE IMPORTANCE OF REGULATION FIND SPECIFIC APPLICABILITY WITH REGARD TO THE POLICIES OF THE OEB?

A. Yes, very much so. Virtually every time a rating agency modifies or affirms a utility credit rating, mention is made of the regulatory body within the relevant jurisdiction and how its policies are factored into the rating determination. For example, in a May 4, 2011 report issued on Union Gas, S&P stated:

> Our view that regulatory protection is robust reflects the OEB's power and the provisions in the undertakings agreement. The regulator has what we believe are exceptional powers (from the Minister of Energy) to ensure that Union Gas continues to operate safely and efficiently, through a sound financial base. This is particularly important in the event that the parent company faces financial distress. The undertakings agreement between Spectra Energy and the OEB governs the financial and business activity of Union Gas to ensure operating sustainability. Some major provisions include a minimum equity level requirement (which can limit dividend payouts), quarterly capital structure forecasts, asset sale restrictions, and financial penalties for noncompliance.[6]

With all of these protections, S&P goes on to note a refinement within its traditional consolidated rating methodology:

> We continue to equalize [Union Gas'] ratings with those of the parent, which is consistent with our consolidated rating methodology and our usual treatment of regulated subsidiaries. Nevertheless, in our view, regulatory protection (through the OEB) of Union Gas is such that the ratings on it might not remain limited by the ratings on Spectra Energy in the event that the latter begins to deteriorate – which is consistent with our rating methodology that allows the separation of a utility and its parent in specific circumstances. We base this on the premise that under financial distress, Spectra Energy would have limited ability to withdraw cash

[6] S&P Research: "Union Gas Ltd.," May 4, 2011.

> or increase debt at Union Gas, protecting the utilities' financial risk profile.

This distinction is important, because, contrary to S&P's usual treatment of a regulated utility's ratings being tied to the ratings of its unregulated parent, the rating agency acknowledges that there is a degree of insulation for Union Gas' ratings vis-à-vis its parent, and also that financial support for Union Gas coming out of this proceeding could benefit the regulated utility's ratings without necessarily having any impact on the parent company's ratings.

Similarly, in January 2011, DBRS published its views on the importance of regulatory support:

> [T]he Company operates in a stable, supportive regulatory environment that allows it to recover prudently incurred operating expenses and capital expenditures in a timely manner and earn a reasonable return on its investments.[7]

Q. YOU DESCRIBED EARLIER THREE KEY QUANTITATIVE MEASURES USED BY THE RATING AGENCIES. CAN YOU DISCUSS HOW S&P FRAMES THE QUALITATIVE AND QUANTITATIVE FACTORS INTO A MATRIX TO ASSIST ANALYSTS AND INVESTORS?

A. Yes. As can be seen in the rating agency statements above, financial performance continues to be a very important element in credit rating analysis. Building upon the three indicative ratios, S&P has explained how it views the interplay between quantitative and qualitative factors. As part of its utility credit rating process, S&P arrives at a "Business Risk Profile" designation that it

[7] DBRS Research: "Union Gas Limited," January 31, 2011.

MR. JANIGAN: Now, I wonder if you could turn over to page 21?

MR. FETTER: I'm there.

MR. JANIGAN: And if you look at the answer to an interrogatory of Board Staff, Union indicates here in part b) of the answer that it is unlikely that going to 40 percent equity will be sufficient to result in a rating upgrade or significantly impact the cost of debt.

So if the credit quality is not going to be increased to the point where the cost of debt is going to be reduced, where are the benefits going to be reaped by the ratepayer?

MR. FETTER: We don't live in a static world. Credit quality can vary within a certain credit rating level, regardless of whether it leads to an upgrade or a downgrade.

I feel strongly that creating a credit profile which can withstand unforeseen events, such as we saw in 2008 and 2009 during the worldwide financial crisis, which Dr. Carpenter also did not predict -- I think it is important for every utility to be able to withstand such stress, and so even though this response to an IR states that there might not be immediate change as measured by an upgrade, it does not mean that Union Gas's credit quality has not improved and puts itself in a better stead on behalf of both its customers and its investors.

MR. JANIGAN: But as the time rolls on, that change that you have recommended costs customers $17 million a year. When are they going to get it back?

MR. FETTER: They will get it back if there is a financial crisis during which they're able to finance -- have access to the financial markets on a reasonable level, and also to just have access to the capital markets.

As we saw in 2008/2009, the commercial paper markets basically closed down for everyone for a short period of time.

MR. JANIGAN: I wonder if you could turn over the page to page 22, the interrogatory J.E-2-1-1.

The interrogatory asks:

> "Please indicate all cases in the last 5 years where Union Gas has had to defer or abandon expenditures needed to provide service due to an inability to raise the necessary capital under reasonable terms and conditions."

The answer is:

> "Union has not had a specific case where the Company has not been able to issue debt to finance capital investment within the last five years. Previously, there have been situations when the Company was limited by the interest coverage test to the timing and the amount of the debt issue."

And second part of that:

> "What will be the impact on Union's ability to raise capital if the Board do not approve Union's proposed rate structure?"

The answer is:

UNION GAS LIMITED

Answer to Interrogatory from
Energy Probe

Ref: Exhibit E2, Page 16 &
Exhibit F2, Page 28, Table 3

a) Please provide all available *Canadian* Comparables (at a minimum Enbridge Gas Distribution) showing Equity Thickness DBRS and S&P Ratings and Financial Risk indicators.

b) Where possible include financial ratios, especially Interest Coverage.

Response:

a) Please see Attachment 1.

b) Union is not able to provide the Financial ratios and interest coverages for the comparables as the work required to research this data is onerous.

Line No	Company	Deemed Equity Ratio	S&P	DBRS
		(a)	(b)	(c)
1	Terasen (Fortis BC)	40%	A-	A (low)
2	Pacific Northern Gas	40% - 45%		
3	ATCO Electric Disco	39%	A	A (low)
4	Enmax Disco	41%	BBB+	A (low)
5	Epcor Disco	41%	BBB+	A (low)
6	ATCO Gas	39%	A	A (low)
7	Fortis Alberta	41%	A-	A (low)
8	Alta Gas	43%	BBB	BBB
9	Gaz Metro	39%	A-	A
10	Gazifere	40%		
11	Nova Scotia Power	40%	BBB+	A (low)
12	Heritage Gas Ltd.	45%		
13	Enbridge Gas Distribution	36%	A-	A
14	Union Gas	36%	BBB+	A

Ratings were not found for Pacific Northern Gas, Gazifere, and Hertiage Gas Ltd.