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BRITISH COLUMBIA
UTILITIES COMMISSION

ORDER
NUMBER G-109-01

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IN THE MATTER OF
the Utilities Commission Act, R.S.B.C. 1996, Chapter 473

and

A Generic Hearing into Aspects of the Adjustment Mechanism
for Setting the Rate of Return on Common Equity for a Benchmark Utility

BEFORE:	P. Ostergaard, Chair	)	
	P.G. Bradley, Commissioner	)	October 10, 2001
	N.F. Nicholls, Commissioner	)	

O R D E R

WHEREAS:

A. In its Decision dated June 10, 1994, the Commission established rates of return on common equity (“ROE”) for BC Gas Utility Ltd. (“BC Gas”), Pacific Northern Gas Ltd., West Kootenay Power Ltd., and Centra Gas Fort St. John Inc.; and

B. In the same Decision the Commission established a mechanism for varying the ROE on an annual basis; and

C. The Commission, by Order No. G-49-97, amended the mechanism to correct for certain problems and to make it more consistent with the practices of other public utility tribunals; and

D. In 1998 there were requests from various parties to re-examine the mechanism to determine if further amendments were required. The Commission, by Letter No. L-73-98, advised interested parties that the Commission, in 1999, would be establishing a process for a comprehensive review of all issues surrounding the setting of the ROE; and

E. On April 7 1999, the Commission issued Order No. G-38-99 establishing an oral public hearing into the appropriate ROE for a low-risk benchmark utility and into future processes or mechanisms that may be employed to improve the determination of the ROE for the utilities in future years; and

F. Following a public hearing held in June 1999 the Commission issued a Decision dated August 26, 1999 and Order No. G-80-99 amending the automatic adjustment formula for establishing the ROE for a low-risk benchmark utility; and

G. On November 1, 2000, BC Gas applied to the Commission to adjust the application of the automatic adjustment formula to address the situation of yields on 10-year Government of Canada bonds exceeding the yields on 30-year Government of Canada bonds; and

H. In Letter No. L-55-00, dated November 3, 2000, the Commission requested the comments of other parties on the BC Gas request and what changes, if any, the Commission should make to its calculation of the 2001 low-risk benchmark ROE; and

I. On December 21, 2000, following a review of the submissions of interested parties, the Commission issued Letter No. L-61-00 stating that the ROE adjustment mechanism would not be amended at that time, and would continue to be applied in accordance with Order No. G-80-99; and

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J. In Letter No. L-61-00 the Commission also stated that it intended to further review the yield spread between medium and long-term bonds in 2001, as well as its practice of rounding the benchmark ROE to the nearest 25 basis points (0.25 percent), in order to consider whether amendments should be made to the mechanism prior to the calculation of the low-risk benchmark ROE for 2002; and

K. By way of Order No. G-62-01, the Commission established a written public hearing to review these aspects of the automatic adjustment formula; and

L. The Commission has reviewed the submissions of intervenors and finds that the current treatment of the yield spread between 30-year and 10-year bonds does not require adjustment at this time. The Commission also finds that the ROE for the low-risk benchmark utility, expressed as a percentage, should be rounded to two decimal points prior to adding the utility-specific risk premium.

NOW THEREFORE the Commission directs that the ROE mechanism will remain as set out in Order No. G-80-99 except that the ROE for the low-risk benchmark utility, expressed as a percentage, will be rounded to two decimal points prior to adding the utility-specific risk premium. Reasons for Decision are attached as Appendix A.

DATED at the City of Vancouver, in the Province of British Columbia, this 18th day of October 2001.

BY ORDER

Original signed by:

Peter Ostergaard
Chair

Attachment

A GENERIC HEARING INTO ASPECTS OF THE ADJUSTMENT MECHANISM FOR SETTING THE RATE OF RETURN ON COMMON EQUITY FOR A BENCHMARK UTILITY

REASONS FOR DECISION

1.0 Background

On November 1, 2000, BC Gas Utility Ltd. ("BC Gas") applied to the Commission to adjust the application of the formula used to calculate the Return on Common Equity ("ROE") to address the situation when yields on 10-year Government of Canada bonds exceed the yields on the 30-year Government of Canada bonds. Under the current formula, the yield spread between 10-year and 30-year bonds for trading days in October is added to a forecast for 10-year bonds to derive a forecast of long-term Canada bonds. When the yield on 30-year bonds is lower, the difference is subtracted. The Commission requested the comments of other parties on BC Gas' application by way of Letter No. L-55-00. After reviewing the submissions, the Commission decided not to vary the application of the ROE adjustment mechanism for the year 2001 (Letter No. L-61-00). The Commission did, however, indicate its intention to further review the bond yield spread between medium and long-term bonds in 2001 to consider whether amendments should be made to the mechanism prior to the calculation of the low risk benchmark ROE for 2002. The Commission also indicated its intention to review practices with respect to rounding to the nearest 25 basis points (0.25%) within the ROE adjustment mechanism.

Commission Order No. G-62-01 established a written public hearing regarding the automatic adjustment formula for setting the ROE for a low-risk benchmark utility. The hearing was limited to the following two issues:

(a) the appropriate treatment of the yield spread when the yields on 10-year Government of Canada bonds exceed the yields on 30-year Government of Canada bonds; and,

(b) whether the Commission should continue to round the ROE to the nearest 25 basis points (or any other number) and, if so, if it should apply the rounding to the low-risk benchmark ROE or the utility-specific ROE.

Submissions were made by BC Gas, Pacific Northern Gas Ltd. ("PNG"), Centra Gas British Columbia Inc. ("Centra"), West Kootenay Power Ltd. ("WKP"), the Consumers' Association of Canada (B.C. Branch) et al. ("CAC (BC) et al.") and the Large Industrial Gas Customers.

2.0 Appropriate Treatment when 10-Year Yields Exceed 30-Year Yields

Submissions

Ms. Kathleen McShane provided evidence on behalf of WKP. Ms. McShane indicated that a normal yield curve is upward sloping and that the shape and steepness of the yield curve at any point in time reflects multiple factors including monetary and fiscal policy, risk aversion, inflationary and economic growth expectations and credit quality. Ms. McShane noted that negative spreads between 30-year and 10-year bonds have occurred historically, but that they are relatively unusual. Ms. McShane suggested that the negative spreads that occurred during 2000 arose from concerns that the supply of 30-year government bonds would dwindle in the face of budget surpluses. Investors scrambled to buy 30-year bonds thereby driving the price up and the yield down. This created a "scarcity premium" for 30-year bonds. The existence of the scarcity premium was supported by evidence that the yield curve for Canadian corporate bonds had retained a normal positive slope and that the August 2001 spread between yields on 30-year corporate bonds and yields on 30-year government bonds was considerably higher than the historical spread. Ms. McShane noted that the phenomenon that gave rise to the negative spreads is not of a transitory nature, and that the Commission's ROE adjustment mechanism should be specified so as to mitigate the effects of a scarcity premium. Specifically, Ms. McShane recommended replacing the current spread between 30-year and 10-year government bonds with the 35 basis point average historical spread from 1990-1999.

Dr. W.R. Waters provided evidence on behalf of the Large Industrial Gas Customers. Dr. Waters indicated that the comparability of the 30-year bond to utility common shares is much greater than that of the 10-year bond, and that the longest term to maturity bond continues to be appropriate regardless of the shape of the yield curve. Dr. Waters agreed with Ms. McShane that multiple factors affect the yield curve. He also agreed that, at first blush, the scarcity premium described by Ms. McShane seems plausible. Dr. Waters questioned, however, the probable magnitude of a scarcity premium given the availability of close substitutes for 30-year government bonds. Dr. Waters also indicated that due to the global economic slowdown, investors have begun to question the future ability of the governments to pay down debt to the extent that had been confidently anticipated only a short time ago. Dr. Waters indicated that the scarcity premium is an unsubstantiated hypothesis that would have contributed very little, at most, to the atypical yield relationship observed in 2000, and concluded that there is no basis to discard the present method for setting the ROE for the benchmark utility.

WKP and PNG supported Ms. McShane's recommendation to replace the current yield spread between 30-year and 10-year government bonds with the 35 basis point historical average. Centra supported a slightly modified adjustment whereby the current yield spread between 30-year and 10-year government bonds would be replaced with a 10-year rolling average yield spread. BC Gas initially supported Ms. McShane's proposal but, in a letter dated October 2, 2001, changed its position in favour of retaining the current yield spread. The CAC (BC) et al. and the Large Industrial Gas Customers both argued against changing the ROE mechanism.

Commission Determination

The Commission finds that a perceived shortfall in the supply of 30-year bonds may have resulted in a scarcity premium for these bonds, but that there is a large degree of uncertainty surrounding the size of any scarcity premium and the likelihood that it caused the inverted yield curve. Given this uncertainty and the recent return to a more normal yield curve, the Commission finds no compelling evidence to support changing the yield spread adjustment in the ROE mechanism at this time.

3.0 Rounding in the ROE Adjustment Formula

Submissions

Ms. McShane noted that rounding to the nearest 25 basis points is not biased and avoids the perception of spurious accuracy. If rounding is to occur, Ms. McShane indicated that it should occur at the benchmark utility level rather than the individual utility level.

Dr. Waters suggested that there is no imperative to change from the current practice of rounding up or down to the nearest 25 basis points. Dr. Waters noted that rounding might avoid giving the impression of undeserved accuracy, but that not rounding might be somewhat more fair since it avoids potential consecutive roundings favouring one or the other party.

WKP and PNG supported continuing to round to the nearest 25 basis points with the rounding occurring at the benchmark utility level. BC Gas thought that rounding to the nearest 25 basis points should continue, but took no position with respect to whether the rounding should occur at the individual utility or the benchmark utility level. The CAC (BC) et al. indicated that it has no objection to continuing to round to the nearest 25 basis points. Centra suggested that there is little merit in rounding, but indicated that any rounding that is done should be done at the benchmark utility level.

Commission Determination

The Commission agrees with Dr. Waters that rounding may avoid the perception of spurious accuracy, but that not rounding might be slightly more fair since it avoids potential consecutive roundings favouring one or the other party. Rounding is not biased towards any party, and the Commission finds that there is no clear basis to prefer one approach to the other. Most ROE mechanisms used by other utility regulators in Canada are not rounded to the nearest 25 basis points. The Commission is aware that awarded ROEs in various Canadian jurisdictions are often compared and that consistency between ROE mechanisms is a desirable outcome absent other considerations. The Commission finds that the ROE for the low-risk benchmark utility, expressed as a percentage, should be rounded to the nearest two decimal points prior to adding the utility-specific risk premium.