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Our File No.: 05497-0148

April 5, 2007

BY EMAIL

British Columbia Public Interest Advocacy Centre  
Suite 208- 1090 West Pender Street  
Vancouver, BC

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**Attention: Patricia MacDonald**

Dear Ms. MacDonald:

**Re: Application by Fortis Inc. ("Fortis") for Approval of the Acquisition of the Issued and Outstanding Shares of Terasen Inc. ~ Project No. 3698454**

**Response to the British Columbia Public Interest Advocacy Centre on behalf of the British Columbia Old Age Pensioners Organization *et al* ("BCOAPO") Information Request ("IR") No. 1**

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In accordance with the Amended Regulatory Agenda and Timetable established by the British Columbia Utilities Commission Order No. G-39-07, please find enclosed responses to BCOAPO's IR No. 1.

Yours truly,

FARRIS, VAUGHAN, WILLS & MURPHY  
LLP



Per:

George K. Macintosh, Q.C.

GKM/lcb  
Enclosure  
c.c. Mr. R.J. Pellatt, Commission Secretary  
Registered Intervenors

FARRIS, VAUGHAN, WILLS & MURPHY LLP

*Barristers & Solicitors*

Fortis Inc. ("Fortis") Application for Approval of the Acquisition of the Issued and Outstanding Shares of Terasen Inc. (the "Application")	Submission Date: April 5, 2007
Response to British Columbia Public Interest Advocacy Centre on behalf of the British Columbia Old Age Pensioners Organization <i>et al</i> ("BCOAPO") Information Request No. 1	Page 1

**1. Reference: B2, 1.3, 1.12, and 12.1 – Acquisition Premium and Transaction Costs**

Response 1.3 provides a calculation of the acquisition premium of \$706M, the unadjusted purchase price paid by Fortis above the net book value of the equity acquired. Response 1.12 states that the acquisition premium will not be recovered from Terasen Utilities' customers. Response 12.1 states that none of the fees incurred in connection with the Transaction and Acquisition Agreement will be recovered from Terasen Utilities' customers.

- a) Please confirm that, absent revenue increases or cost decreases associated with current Terasen Utilities' operations, these two responses taken together imply that Fortis will expect to earn less on its invested capital than the BCUC approved return on equity for Terasen Utilities. As an illustration, paying \$1.801B to acquire \$1.095 of net book equity, implies only getting 60.8% (1,095/1,801) of the pre-acquisition allowed return on equity: if the utilities had been allowed e.g., an overall 10% ROE (on a weighted average basis, i.e., with the separate allowed ROE for each entity weighted by its equity as a proportion of total equity), then, by paying the premium, the acquiring entity would only expect to realize an ROE of 6.08%. If unable to so confirm, please explain why not.

**Response:**

Fortis is unable to provide the confirmation requested.

This question implies that the *book* returns earned by the Terasen Utilities can, or should, mirror the *market* return on equity of Fortis. This implied correlation masks real differences in the cost of capital of the Terasen Utilities, on the one hand, and Fortis, on the other hand.

The Terasen Utilities' allowed returns on equity will be determined by orders of the BCUC. It is expected that those returns will be based on book equity in the Terasen Utilities in accordance with usual regulatory practice.

Fortis' returns on equity will be determined by a broader array of factors.

Following closing of the acquisition, Fortis will have equity investments in a total of 8 regulated Canadian utilities (including TGI, TGV and TGW), 3 regulated Caribbean utilities and a myriad of non-regulated enterprises. This results in a diverse mix of returns on equity, growth prospects and service territories. This diversification, in turn, results in Fortis' cost of capital being less than that of any of its subsidiary operations.

Fortis will substantially fund the acquisition before the Commission with Fortis' own common equity (please refer to Attachment 2.2 in the responses to BCUC Information Request No. 1 filed on March 19, 2007 ("BCUC IR No. 1")). In the illustration contained in this question, the 1.64x (1,801/1,095) *book* equity paid by Fortis appears to be equated to *market* values for Fortis' equity. On a *book* value basis Fortis' common

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equity was \$12.55 per share as at December 31, 2006.<sup>1</sup> The common equity raised to fund the acquisition was sold at a *market* price of \$26 per share, or 2.07x Fortis' December 31, 2006 book value per share.

The difference between the 1.64x multiple paid by Fortis for the book equity of the Terasen Utilities and the 2.07x multiple paid by Fortis' shareholders for the equity used to fund the acquisition is broadly reflective of current differences in the *market* value of the common equity of Terasen Utilities and the *market* value of the common equity of Fortis.

Fortis expects that the Terasen Utilities will continue to earn returns on equity as allowed by the BCUC.

Returns on equity for Fortis, on the other hand, will continue to reflect factors such as its overall diversification and prevailing capital market conditions. As a result, returns on equity (or invested capital) for Fortis will not reflect book equity returns earned in any of its regulated utility investments, including investments in the Terasen Utilities.

- b) Please confirm that Fortis' shareholders will absorb the acquisition premium.

**Response:**

Confirmed, the acquisition premium will be on account of Fortis' shareholders.

- c) Assuming current operations of the utilities continue after Fortis acquires Terasen Inc. and given the current approved ROE's for the acquired utilities, please provide the expected return on Fortis' investment (including the acquisition premium) in acquiring the utilities that Fortis expects to realize.

**Response:**

Fortis expects the Terasen Utilities to earn a fair and reasonable return on the book values of investment in the Terasen Utilities. Such return will be based on the risks associated with the Terasen Utilities.

Please refer to the response to Question 1 a).

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<sup>1</sup> This is calculated from Attachment 11.2 in the response to BCUC IR No. 1, which is Fortis' 2006 financial statements. See value of shareholders' equity, less preference shares, at p.41 of Attachment 11.2 (\$1,398,102,000 – \$122,466,000 = \$1,275,636,000) divided by the number of common shares outstanding, at p. 51 of Attachment 11.2 (104,091,542).

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- d) Please provide Fortis' business case for acquiring the Terasen Utilities.

**Response:**

Please refer to the section titled *Acquisition Rationale* on page 15 of Attachment 2.2 in the response to BCUC IR No. 1.

Capital markets disclosure requirements provide, in effect, that issuers of securities funding a transaction, such as the acquisition before the Commission, must make full, plain and true disclosure of the business case supporting the acquisition.

- e) Please provide Fortis' views as to the opportunities for revenue growth and costs savings in Terasen Utilities' operations that Fortis anticipates will arise under Fortis' control. Please include shared services in this discussion.

**Response:**

Fortis has not at this time identified any specific revenue growth or cost savings opportunities. Fortis intends to maintain the *status quo* following closing in respect of Shared Services provided to the Terasen Utilities.

Please refer to the responses to BCUC IR No. 1, Questions 3.1, 3.4 and 3.7 for further information on Shared Services.

**2. Reference: B2, 3.1 and 3.7 – Shared Services and Head Office Services**

Please confirm that Fortis expects that corporate cost allocations to Terasen Utilities are not expected to increase post-acquisition.

**Response:**

Confirmed.

Please refer to the response to BCUC IR No. 1 , Question 3.4.

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**3. Reference: B-2, 18.1 and 18.2**

These responses indicate that Terasen Inc. will unwind all of the derivative instruments prior to closing and that the unwinding will not expose Terasen Utilities' customers to hedged commodity or financial costs.

- a) Please provide a list of the derivatives to be unwound and indicate for each which ones are in the money and which ones are not.

**Response:**

There are 2 such Terasen Inc. derivatives which are listed at page 41 of Seller's Disclosure Schedule to the Acquisition Agreement (Schedule "A" to the Application).

Both derivatives are interest rate swaps related to the non-regulated debt of Terasen Inc.

- b) Please indicate whether Terasen Inc. expects to realize a financial gain on unwinding the instruments. If so, please provide an estimate of the proceeds, net and gross, and indicate the beneficiary of the proceeds.

**Response:**

A determination of whether the unwinding of each derivative instrument will give rise to a financial gain can only be determined at the time the instruments are unwound and cannot be made at this time. The derivative instruments to be unwound relate to Terasen Inc. and not to the business of the Terasen Utilities.

Please refer to the responses to BCUC IR No. 1, Questions 18.1 and 18.2.

- c) Please indicate whether the unwinding and subsequent purchase of new hedging instruments is expected to visit any incremental costs on Terasen Utilities and its ratepayers.

**Response:**

The unwinding of the hedging instruments (and any subsequent potential purchase of new hedging instruments) will not visit any incremental costs on Terasen Utilities and its ratepayers.

Please refer to the responses to BCUC IR No. 1, Questions 18.1 and 18.2.