IN THE MATTER OF

PACIFIC NORTHERN GAS LTD.
APPLICATION FOR APPROVAL
TO RECAPITALIZE UNDER AN INCOME TRUST
OWNERSHIP STRUCTURE

DECISION

SEPTEMBER 9, 2005

Before:

Robert H. Hobbs, Chair
Lori A. Boychuk, Commissioner
Robert W. Whitehead, Commissioner

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1.0 BACKGROUND

1.1 Pacific Northern Gas

Pacific Northern Gas Inc. ("PNG", "Utility" or "Company") is a publicly traded company financed by a combination of common and preferred shares listed on the Toronto Stock Exchange, and by third party secured debt. PNG's secured debt was issued pursuant to a Trust Deed dated April 15, 1982 which has been amended several times through supplemental indentures (Exhibit B-1, p. 5). PNG has three operating divisions. The PNG-West Division operates in the region west of Prince George to tidewater at Kitimat and Prince Rupert and delivers natural gas to approximately 22,300 customers. Pacific Northern Gas (N.E.) Ltd. ["PNG(NE)"] is a wholly owned subsidiary of PNG and is comprised of two operating Divisions: the Fort St. John/Dawson Creek Division which serves approximately 15,500 customers; and the Tumbler Ridge Division which serves approximately 1,100 customers in the town of Tumbler Ridge.

On December 17, 2004, PNG applied to the British Columbia Utilities Commission ("BCUC" or "the Commission") for approval to convert from its current capital structure to an income trust structure ("the Application"). As proposed, the PNG Income Trust would qualify as a mutual fund trust under the Income Tax Act (Canada). The structure would include the amalgamation of PNG, PNG(NE) and Pacific Northern Gas Transition Ltd. ("PNGT") as one company under the name Pacific Northern Gas Ltd. PNGT has been incorporated for the purpose of facilitating the conversion of the income trust structure. The new operating company would continue to own and operate all of the existing natural gas transmission and distribution assets and would continue to be regulated by the Commission (Exhibit B-1, p. 11). PNG would not become an income trust itself but would be restructured to minimize taxes and flow income up to the sole owner, the PNG Income Trust.

Concurrently, PNG filed its 2005 Revenue Requirement Application ("PNG 2005 RR") for its PNG-West Division, seeking *inter alia* approval to increase the allowed common equity ratio from 36 percent to 51 percent. The Commission agreed to review the Application along with the cost of capital component of the 2005 Revenue Requirement Application by way of an oral public hearing held in Vancouver, B.C. from May 10, 2005 to May 13, 2005.

1.2 History of PNG

In May 2000, PNG's largest industrial customer, Methanex Corporation ("Methanex") announced closure of its methanol plant for 12 months. Methanex had accounted for 70 percent of PNG's total gas throughput and 40 percent of its total distribution margin. In response, PNG suspended dividend payments in mid 2000 and by the end of 2000 completed an internal reorganization to reduce its operating costs which led to a 40 percent reduction of its workforce (Exhibit B-1, pp. 5-6).

Debt rating of PNG's third party secured debt by Dominion Bond Rating Service ("DBRS") was reduced in two stages over the 2000 to 2001 period from BBB(high), an investment grade, to BB(high), which is below investment grade. By April 2001, the value of PNG's common shares traded at a low of $6.50 per share in comparison to a high of over $32 in earlier years (Exhibit B-1, p. 6).

Methanex restarted the methanol plant in July 2001; however, PNG's second largest industrial customer, Skeena Cellulose filed for bankruptcy protection and shut down its pulp mill operations in Prince Rupert in September 2001. By the end of 2001 PNG was able to arrange financing of $12 million to repay its Debentures that were coming due in mid 2002 but the terms and interest rates were much less favourable than previous long-term financing (Exhibit B-1, p. 6). In March 2002, PNG and Methanex entered into a Memorandum of Agreement for a new transportation service agreement for a seven-year term from November 2002 to October 2009 which provided for a fixed demand charge of $0.50 per Gigajoule. With this new agreement, Methanex represented approximately 25 percent of PNG's total distribution margin.

By the end of 2002, PNG had successfully reduced its operating costs through reorganization, entered into a seven year gas transportation service agreement with Methanex, and raised additional debt financing. In response, DBRS upgraded PNG's third party secured debt rating to BBB (low), which is the lowest investment grade rating (Exhibit B-1, p. 9).

PNG and its financial advisors concluded that in order to stabilize and improve PNG's financial situation, recapitalizing PNG under an income trust structure would be the best option to address PNG's financing challenges over the long-term. On January 30, 2004, PNG filed its first application with the Commission to recapitalize PNG under an income trust ownership structure. That application proposed that the Commission regulate PNG on a "deemed" capital structure equal to the capitalization prior to the proposed conversion. The Commission in its July 29, 2004 Decision denied PNG's recapitalization application, concluding *inter alia* that:

> “deeming a capital structure at such wide variance with the underlying reality of the actual capital structure would be a material departure from the Commission’s past regulatory practice” and that “deeming a component of the cost of service equivalent to income taxes otherwise previously payable by a taxable corporation that had put in place a financial structure to minimize those taxes would establish a regulatory precedent with unknown implications” (BCUC Decision-July 29, 2004, pp. 30-31).

The Commission, while denying PNG’s recapitalization application due to the magnitude of deeming for the capital structure and an income tax component, did encourage the Company to continue to find a resolution in addressing its current business risks. PNG’s current Application removes the deeming components and attempts to resolve PNG’s financing challenges.

1.3 Income Trusts in General

PNG outlined the general nature of income trusts in Tab 1 of its Application (Exhibit B-1, pp. 1-7). Income trusts are hybrid investment vehicles that allow investors to participate in the equity of an underlying business through the issuance of units. An income trust owns securities, both debt and equity issued by its underlying business. Typically, the underlying business, based on the cash flow generated, pays a large portion of cash distribution as interest and dividends on the debt and common shares held by the income trust. The operating business maintains financial flexibility with the ability and discretion to retain a prudent level of cash reserves to maintain and enhance the quality of the asset base. The income trust, in turn, would distribute the cash paid by the operating company to the unit holders which allows the trust to avoid paying corporate income tax. The income flows through to the unit holders and is taxed in their hands. Similar to a common share investment, an income trust does not have a contractual obligation to make distributions to its investors.

As noted by PNG, the income trust market in Canada started in the mid 1980’s and was dominated by oil and gas royalty trusts. With the changes in tax laws and greater investor demands in the early 1990’s, the market has since evolved to other energy-related assets, real estate assets and diversified business trusts. By 2004, the income trust market had grown to consist of 164 entities with an aggregate market capitalization of $111 billion compared to 51 entities with an aggregate market capitalization of $15 billion in 1997 (Exhibit B-1, Tab 1, p. 3). There are four broad types of income trusts currently in the market: pipeline and power assets, real estate, specialty businesses, and oil and gas (Exhibit B-1, Tab 1, p. 4).

The Application stated that the income trust market represents approximately 10 percent of the total equity capital market and the future for income trusts will continue to be a substantial and sustainable segment of the market (PNG 2005 RR, Exhibit B-1, Tab 1, p. 8).

1.4 PNG Income Trust

The Application stated that PNG's actual capital structure includes 51 percent common equity but its deemed common equity is only 36 percent of the capital structure. Given the difference between actual and deemed common equity, PNG's shareholders are receiving a reduced return on equity. However, if the allowed return on common equity for the higher common equity component is paid, PNG's costs would rise which would mean an increase in customer rates. PNG's solution to keeping customer rates from rising while providing investors with a fair rate of return on their investment, is to convert to an income trust structure (Exhibit B-1, pp. 1-2).

In addition, PNG and its experts testified that given PNG's business risk, the Company cannot obtain the debt necessary to reduce the equity component to the existing deemed ratio of 36 percent. In order for the Company to refinance its long-term debt over the next five years, PNG submits it should be allowed to earn a return on a higher equity component of 51 percent, or convert to an income structure (T3: 52).

2.0 BUSINESS RISKS AND ACCESS TO CAPITAL

PNG submits that it faces the highest level of business risk of any mature utility in Canada (PNG 2005 RR, Exhibit B-5, p. 17) since approximately 42 percent of PNG's 2005 margin is derived from only three large industrial customers with inherently unstable operations (i.e. Methanex Corporation, West Fraser Mills Ltd., Alcan Primary Metals Ltd.) (PNG 2005 RR, Exhibit B-6, p. 4).

The largest and most unstable of these three large industrial customers is Methanex, which operates a methanol plant in Kitimat. This contract alone accounts for 32 percent of PNG’s 2005 margin and the contact expires in October, 2009 (PNG 2005 RR, Exhibit B-6, p. 4). Additionally, Methanex has the option of terminating the contract earlier by the payment of a termination fee that varies directly with the amount of time remaining on the contract (Exhibit B-5, BCOAPO IR 87, 88). Methanex has stated that it may close the Kitimat facility and terminate the natural gas transportation contract if its operation is no longer cash positive (T3: 87).

PNG contends that the potential of a Methanex closure in the near future has created much uncertainty with financial lenders, creating the situation where PNG can no longer access long-term debt on reasonable terms. Reasonable terms, in PNG’s submission, are where the cost of debt is less than the cost of equity on a tax adjusted basis, and where the debt is structured such that it does not increase the risk of default on existing debt (T3: 110).

PNG states it has been unable to access sufficient third party debt to match its deemed capital structure. Instead, it has used retained earnings to replace third party debt (T4: 213; PNG 2005 RR, Exhibit B-3, BCUC IR 16.2), resulting in a capital structure comprising 51 percent common equity instead of 36 percent. PNG submits it has in the last few years pursued all avenues available to it in respect of obtaining debt financing, including approaching non-conventional lenders. Of these, only RoyNat Inc. (“RoyNat”), lastly in 2002, was willing to provide debt financing. The terms of the loan, however, are not typical for a regulated public utility, and include straight line amortization and a floating interest rate 300 basis points above Bankers’ Acceptances (PNG 2005 RR, Exhibit B-6, p. 6).

PNG further submits that most utilities do not have the stringent financing restrictions that PNG does. PNG indicates that prior to 2000, it could use its line of credit for bridge financing until sufficient short-term debt built-up to justify its replacement with a long-term debt issue, which is a common practice for utilities. However, PNG is now precluded from doing so and, thus, it has no access to additional short-term debt to allow it to finance the deemed short-term debt component of its regulated capital structure with actual short-term debt (Exhibit B-5, BCOAPO IR 218).

Since the last RoyNat issue, PNG states that it has continued to attempt to obtain more third party debt on reasonable terms, but to no avail (PNG 2005 RR, Exhibit B-6, p. 7).

BCOAPO believes that the deal PNG entered into with RoyNat was unnecessarily onerous and created issues that now restrict PNG's ability to acquire debt (BCOAPO Argument, p.19-20). However, PNG notes that the RoyNat financings were reviewed by the Commission and approved at that time (PNG Reply Argument, p. 7).

PNG attributes its inability to access on reasonable terms sufficient debt to match its deemed capital structure to the perception by lenders that there is a high probability that PNG's cash flow will not be sufficient to service even its existing debt obligations because of the business risks described above. The predominant concern is that Methanex will shut down by 2009, rendering PNG with insufficient cash flow to meet its debt obligations (PNG 2005 RR, Exhibit B-6, pp. 8-9). PNG forecasts that in the event Methanex shuts down in 2009, the revenue available to service its debt in 2010 would fall short by about $3.5 million (Exhibit B-5, BCUC IR 2, 54.2).

PNG also submits that without the Methanex contract it will be unable to finance the business without significantly increasing rates to its remaining customers. However, if it were to increase rates to other customers, PNG then incurs the risk that the delivered natural gas price may become unattractive relative to electricity, causing existing customers to switch to the lower cost energy alternative. Customers switching to alternative energy sources would exacerbate the problem for PNG by further reducing demand and creating the potential of a spiral into severe financial stress (Exhibit B-3, BCUC IR 1.0).

In support of the necessity and reasonableness of the current 51 percent common equity ratio, Ms. McShane on behalf of PNG notes, "What rational management would maintain a 51% common equity ratio when they have a 36% deemed common equity ratio, when they can't or aren't allowed to earn an equity return on the difference between 51 and 36%?" (T3: 156).

Because of the business risks it faces, PNG submits that in order for it to be permitted to earn a fair return, it requires a return on equity ("ROE") based on 51 percent common equity for 2005, climbing to 65 percent by 2009, or be allowed to convert to an income trust structure (T3: 134). If PNG converts to an income trust structure, it plans to redeem approximately $40 million of third party debt and preferred shares and replace it with subordinate debt (T3: 169).

Respecting the ratebase upon which PNG earns its return, BCOAPO submits that given the uncertainty related to Methanex, the issue of asset impairment pursuant to Section 55 of the Utilities Commission Act ("the Act") should be considered (T3: 71-72). PNG responds that all of its assets in ratebase are used and useful (PNG Reply, p. 15, para. 44) and Methanex has stated that it will continue to operate the plant as long as it is profitable (T3: 87).

Commission Panel Determinations

The Commission Panel acknowledges that PNG is in a difficult situation. It recognizes there is little that PNG can do to influence Methanex's decision respecting whether or not to continue operations since transportation costs are a small part of the total delivered natural gas cost to Methanex. In addition, natural gas prices have risen sharply relative to electricity over the past few years for residential and commercial customers. The Commission Panel accepts that conventional financial institutions are unwilling to extend new long-term financing on reasonable terms, given their concern that PNG may not have sufficient revenue to service debt in the future, as a result of the uncertainties surrounding the continued operation of Methanex's Kitimat plant and the possibility that remaining customers may switch to competing energy sources. **The Commission Panel accepts that PNG cannot access on reasonable terms new debt sources at the currently approved 36 percent common equity capital structure and given the restrictions in the RoyNat financing.** Although the RoyNat conditions are onerous, the Commission Panel rejects the arguments of BCOAPO in this regard because the approved financing was the best option available to PNG at the time.

With respect to the assets to be included in ratebase, the Commission is aware that there is a real risk that Methanex may terminate its contract earlier than 2009, possibly leaving some assets unused. However, the fact remains that the closure of the Methanex plant has not yet occurred and the termination payments by Methanex will substantially cover the costs of these assets through October 2009. For these reasons, **the Commission Panel determines that it is premature to consider removing the assets associated with Methanex delivery from ratebase.**

3.0 APPLICATION TO INCREASE EQUITY COMPONENT AND ROE

Introduction

PNG proposes that the cost of capital for inclusion in its 2005 revenue requirement be established on the basis of a conventional capital structure, comprising debt and equity. PNG applied for a common equity ratio of 51 percent for PNG-West, which is equal to its current actual common equity ratio. The approved common equity ratio for 2004 was 36 percent (PNG 2005 RR, Exhibit B-1, p. 23). The proposed 2005 after tax rate of return on common equity ("ROE") is 9.68 percent, and is determined based on the Commission's automatic Return on Equity ("ROE") formula, using a 65 basis point risk premium for PNG-West relative to the benchmark utility ROE of 9.03 percent. The approved ROE for 2004 was 9.80 percent (PNG 2005 RR, Exhibit B-1, p. 22). The pre tax return on common equity included in PNG's 2005 applied for revenue requirement is $6,576,000, which is an increase of $1,473,000 over the amount approved for 2004 (PNG 2005 RR, Exhibit B-3, Tab Application, p. 3).

PNG submits it was forced to finance approximately $20 million of the capital deemed as debt in 2004 with equity because it does not have sufficient access to debt markets due to business risks associated in large part with the uncertainty of some of its large industrial customers (PNG 2005 RR, Exhibit B-1, p. 23).

PNG views this capital structure simply as a "stop gap" measure for 2005, in the absence of conversion to an income trust structure (PNG 2005 RR, Exhibit B-5, pp. 2-3; Exhibit B-7, BCUC IR 2, 36.0). PNG submits it is necessary that the Commission approve, for the purposes of setting rates in 2005, a common equity ratio equal to its actual of 51 percent. If this is not the case, PNG contends it will not be permitted to have the opportunity to earn a fair return (PNG Argument, Schedule A, pp. 1-2).

PNG and BCOAPO agree there is a statutory obligation upon the Commission to permit PNG the opportunity to earn a fair return on equity approved for PNG by the Commission (PNG Argument, p. 1; BCPOAPO Argument, p. 39). This is based on section 59(5)(b) of the Act, R.S.B.C. 1996, c.473 (the "Act"), which states:

> "…a rate is unjust or unreasonable if the rate is insufficient to yield fair and reasonable compensation for the service provided by the utility, or a fair and reasonable return on the appraised value of its property…"

In order to reach a conclusion with respect to the appropriate return on equity, both in respect of the return on equity, and the common equity ratio, the Commission Panel considers that the following points need to be addressed:

- What constitutes a "fair and reasonable" return?
- Whether the actual equity ratio is relevant and/or should be approved for the purposes of setting the 2005 revenue requirement, and has PNG been prudent in its financing arrangements resulting in 51 percent equity?
- How can the reasonableness of the applied-for equity component be tested (i.e. other than by virtue of being the actual)?

The second point has been addressed in Section 2. The following sections discuss the remaining matters relevant to these questions.

<u>The Fair Return Standard and Case Law</u>

As part of the 2005 Revenue Requirement Application, PNG submitted expert testimony by Ms. McShane to support its proposal for the 2005 common equity ratio and ROE for ratemaking purposes (PNG 2005 RR, Exhibit B-5).

According to Ms. McShane's evidence, fair return is defined as one that: gives the utility the ability to attract capital on reasonable terms; maintain its financial integrity; and earn a return on the value of its property commensurate with that of comparable risk enterprises. There is also generally an inverse relationship between the level of business risks faced and the proportion of debt that would be considered prudent financing (PNG 2005 RR, Exhibit B-5, pp. 3-4). It is PNG's submission that, because of its business risks, it simply can not access sufficient debt on reasonable terms to achieve its common equity ratio of 36 percent.

Ms. McShane explains that it is not necessary for the Commission to deem a capital structure, that the practice of deeming a capital structure is primarily used in Canada, and, that deeming originated as a consequence of and at the time some utilities' parent companies were diversifying, so as to enable regulators to establish an appropriate capital structure for the utilities on a stand alone basis (T4: 217-218).

On behalf of PNG, Ms. McShane submits it is reasonable that the actual 2005 common equity ratio be approved for ratemaking purposes since it is precisely because of PNG's business risks that the Company, as currently structured, is unable to lower its common equity ratio by going to the debt market. Under the current structure, PNG's only option is to replace its amortizing debt as it is repaid with retained earnings (PNG 2005 RR, Exhibit B-5, p. 19).

Exhibit B-5 provides evidence that the approved common equity ratios of other high risk, mature, small, Canadian utilities (i.e. those whose business risk profiles are similar to PNG's) are in the range of 45 percent to 50 percent (PNG 2005 RR, Exhibit B-5, pp. 18, 20). Ms. McShane's evidence goes further to note that in fact PNG has higher business risks than those utilities, which warrants a higher equity ratio (PNG 2005 RR, Exhibit B-7, BCUC IR 2, 37.0). To date, however, PNG has only been allowed to earn a return on a deemed common equity ratio of 36 percent, leaving it in a position where it has not had the opportunity to earn a fair return. PNG submits it has on average only earned 77 percent of the allowed return from 2001 to 2004 (Exhibit B-5, BCOAPO IR 1, 206).

PNG further supports the request to use the actual common equity ratio for ratemaking purposes on the basis of *Hemlock Valley Electrical Services Ltd. v. British Columbia (Utilities Commission)* (1992), 66 B.C.L.R. (2d) 1(C.A.). In that case, the Court of Appeal found that the Commission had correctly exercised its discretion to determine what a just and reasonable rate was but, in directing a three-year phase-in, had wrongly failed to permit the utility to charge a rate which gave it an opportunity to earn that return. In PNG's submission, the Court in *Hemlock Valley* also confirmed the necessity of allowing a utility the opportunity to in fact earn the return on equity found by the Commission to be fair and reasonable (PNG Argument, Schedule A, para. 18, p. 6).

PNG's legal submission, therefore, is that the Commission has a duty to allow PNG the opportunity to earn a fair and reasonable rate of return on common equity which it is unable to do when the approved equity is at only 36 percent and actual equity is at 51 percent and the Company cannot reduce its actual equity level. PNG submits that this legal issue would become a non-issue if the PNG Income Trust were approved (PNG Argument, para. 21, p. 7). PNG argues, accordingly, that so long as it retains a conventional capital structure, the only solution, apart from significantly increasing the allowed return on equity to compensate for the discrepancy between the actual and deemed common equity, is to increase the approved equity level to the level of the actual equity component of 51 percent (PNG Argument, Schedule A, para. 3, p. 1).

PNG also submits that a rate of return is to be established without regard to the impact it might have on customers (PNG Argument, Schedule A, para. 21, p. 7).

BCOAPO is of the view that PNG, with a deemed 36 percent equity ratio, has in fact been afforded the opportunity to earn a return on "equity approved by the Commission", as required by the Act. BCPOAPO attributes PNG's inability to achieve the approved returns on ill advised financing arrangements with RoyNat, which BCOAPO suggests have prevented PNG from realizing the approved common equity ratio (BCOAPO Argument, p. 39).

BCOAPO draws a distinction between "opportunity" and what it suggests PNG is arguing for, and that is a "guaranteed entitlement" to fair returns. BCOAPO disagrees with PNG's assertion that the only solution for the Commission to reach statutory compliance is to increase the approved equity to the actual level, as there is no statutory obligation for the Commission to match the allowed capital structure to whatever the actual structure the utility may choose. BCOAPO further notes that, if that was all that was required, there would be no need for regulators to exercise judgment on such matters (BCOAPO Argument, pp. 39-40).

BCOAPO notes that PNG has been advocating for higher returns in recent years, and that the Commission has rejected such requests. BCOAPO submits that PNG's higher than average business risk (i.e. its dependency upon a few large customers) has already been recognized in past ROE awards, which have been higher than for the Commission's benchmark utility (BCOAPO Argument, p. 40). BCOAPO submits that the 36 percent common equity ratio should be retained until the Methanex situation is resolved. However, BCOAPO also submits that if any adjustment is to be made, it should be moderate. More specifically, it could be similar to the 3 percent increase in equity Trans Canada Pipeline Ltd. recently received from its regulator, in order to maintain PNG's relative position in the capital markets (BCOAPO Argument, p. 41, T6: 694).

PNG submits it has advocated increasing its return on equity in prior years primarily to be compensated for the business risks related to Methanex. PNG argues that, contrary to BCOAPO's submission that the risks have simply become more proximate in time (BCOAPO Argument, p. 40), circumstances have changed dramatically due to the high commodity price of natural gas in recent years, resulting in a reduced ability to pass the loss of the Methanex margin on to remaining customers, thereby increasing its overall risk (PNG Reply Argument, p. 15).

Impact on Customer Rates

PNG acknowledges that increasing the common equity percentage of the capital structure would have an impact on customer rates (Exhibit B-3, BCUC IR 1, 1.0). Notwithstanding this impact, PNG submits that it is not a legal basis to deny or curtail the rate of return simply because allowing the Utility the opportunity to earn a fair rate of return will have an adverse impact on rates (PNG Reply Argument, p. 15).

While both the Ministry of Energy and Mines ("MEM", "Ministry") and BCOAPO accept that PNG should be afforded the opportunity to earn fair and reasonable returns, both parties submit that the Commission must nevertheless take into account the impact on ratepayers in its determination of just and reasonable customer rates (MEM Argument, p. 25; BCOAPO Argument, p. 42).

MEM submits that it is appropriate for the Commission to consider, among other things, the minimization of the cost of service for the benefit of consumers, in the development of an appropriate capital structure for PNG (MEM Argument, p. 25).

BCOAPO accepts that the Commission should not take impacts on ratepayers into account in establishing the appropriate capital structure and ROE in the first instance, but submits that, the Commission must take into account the impacts on ratepayers in establishing just and reasonable rates (BCOAPO Argument, p. 42).

Return On Equity

PNG proposes for 2005 that the equity risk premium ("ERP") included in the ROE of PNG-West Division continues to be 65 basis points (PNG 2005 RR, Exhibit B-1, p. 22), which is the same as the ERP inherent in the ROE approved for 2004. Using the Commission's automatic adjustment formula and a benchmark utility ROE of 9.03 percent, PNG arrives at a proposed 2005 ROE of 9.68 percent.

At the same time, Ms. McShane's evidence submitted on behalf of PNG, suggests that an ERP of 125 basis points is commensurate with PNG's business risks and the proposed 51 percent common equity ratio (PNG 2005 RR, Exhibit B-5, p. 29). The Capital Asset Pricing Model ("CAPM") was relied on to support this determination (PNG 2005 RR, Exhibit B-5, p. 20). Ms. McShane suggests that the reason PNG proposed not to increase the ROE to incorporate a higher ERP was because of its concern about the impact on customer rates (T4: 231).

<u>Commission Panel Determinations</u>

The Commission Panel accepts that PNG simply cannot raise sufficient debt to balance its capital structure at a deemed common equity of 36 percent. Equally, PNG has 51 percent common equity in its 2005 actual capital structure and would, therefore, not have to raise debt this year if that actual capital were accepted for ratemaking purposes. However, it is not clear to the Commission Panel whether some other deemed capital structure with a common equity percentage between 36 percent and 51 percent would not allow PNG to borrow the remaining debt on reasonable terms, based on the improved cash flow of the higher deemed equity ratio. PNG did not lead compelling evidence in these circumstances to assist the Commission Panel to specify an optimal capital structure for 2005, or until an income trust structure can be put in place.

In the event that PNG's rates for 2005 are to be resolved by a Negotiated Settlement Process ("NSP"), the Commission Panel will allow the participants in that process to consider the most appropriate deemed capital structure to be approved for 2005. Commission Panel Determinations in Section 7.3 also address an NSP.

The Commission accepts PNG's request that the 2005 ROE for PNG-West be established at 65 basis points above the benchmark utility ROE (i.e. 9.68%).

4.0 APPLICATION FOR AN INCOME TRUST

4.1 Steps to be Taken to Recapitalize PNG

PNG acknowledges that “the income trust structure is new as a vehicle for utility regulation” (PNG Argument, para. 5, p. 2). If this Application is allowed, PNG would become the first income trust utility to be regulated in Canada (PNG Argument, para. 84, p. 22).

PNG has described the six steps which would be involved to recapitalize PNG under an income trust ownership structure (Exhibit B-1, para. 47, pp. 12-13, and Tab 2).

1. The PNG Income Trust would be created and would be the initial owner of PNGT. A Plan of Arrangement in respect of PNG would be approved by PNG’s shareholders and by the Supreme Court of British Columbia.

2. The existing common shareholders of PNG would exchange their shares of PNG for commons shares and subordinate notes of PNGT. As a result, PNGT would own all of the commons shares of PNG.

3. The PNG Income Trust would acquire all of the issued and outstanding common shares and subordinate notes of PNGT in exchange for units of the PNG Income Trust. As a result the former common shareholders of PNG would become the initial unit holders of the PNG Income Trust.

4. PNG, PNG(NE) and PNGT would be amalgamated under the name “Pacific Northern Gas Ltd.”. As a result, the assets and liabilities of PNG, PNG(NE) and PNGT would become the assets and liabilities of amalgamated PNG and the PNG Income Trust would become the sole shareholder and holder of subordinate notes of amalgamated PNG.

5. The PNG Income Trust would issue additional units for cash to new public investors through a public offering (“IPO”) of PNG Income Trust units. The PNG Income Trust would use the net proceeds of the IPO to invest in additional common shares and subordinate notes of amalgamated PNG.

6. Amalgamated PNG would use the proceeds from the issuance of additional common shares and subordinate notes to the PNG Income Trust to redeem approximately 36 percent of PNG’s existing third party secured long term debt (i.e. approximately $31 million of a total of $86 million) and to redeem all of PNG’s existing 6.75 percent preferred shares ($5 million). The preferred shares require 30 days notice of redemption, which would be given (and the funds deposited with the transfer agent) upon completion of the IPO. Transaction costs, including third

party debt early redemption fees, legal, accounting and underwriting fees would be paid at that time (Application, para. 47, pp. 12-13).

Each of these six steps is also depicted in the diagrams set out under Tab 2 of the Application. Steps 2, 3 and 4 would occur under the terms of a Plan of Arrangement under the Business Corporations Act (British Columbia). The remaining steps 5 and 6 would be completed immediately following the completion of the Plan of Arrangement, which is conditional upon the completion of the IPO (step 5).

PNG estimates that it would incur total costs in the range of $9 million to convert PNG to an income trust structure (Exhibit B-1, para. 49, p. 14).

The Application includes a Term Sheet related to Trust Deed Amendments and Debenture Holder Consent with respect to the Conversion (Exhibit B-1, Tab 3) and a draft Term Sheet for the subordinate notes (Exhibit B-1, Tab 4). PNG advises that the subordinate notes will be unsecured and subordinate to PNG's secured debt with terms that are less restrictive than PNG's secured debt (Exhibit B-1, para. 55, p. 17). The initial rate on the subordinate notes would be determined at the time of the initial IPO of PNG Income Trust Units, and PNG undertakes to file with the Commission, before the income trust conversion would be carried out, final details of the terms and conditions on which the various transactions will be undertaken. This would include, in the case of the subordinate notes, the principal amount and the term and interest rate on the debt and, in the case of the redemption of PNG's third party secured debt, the amount of debt to be redeemed (Exhibit B-1, para. 60, p. 18).

PNG advises that it has a verbal agreement with the existing debenture holders to redeem a portion of the outstanding debt. While the particulars of any "make-whole" reductions are commercially sensitive, PNG notes that it is very rare for fixed-rate lenders to negotiate such a reduction (Exhibit B-5, BCUC IR No. 2, 55). PNG has accepted that any "make-whole" payments to redeem existing third party debt will be a shareholder cost.

PNG confirmed its intent that the return on its common equity would continue to be fixed using the Commission's automatic adjustment formula (Exhibit B-1, para. 62(g), p. 21).

4.2 Capitalization with Income Trust

PNG's new capital structure would be made up of the third party secured debt remaining after the recapitalization, short term debt, unsecured subordinate debt (represented by the subordinate notes) and common shares (Exhibit B-1, para. 51, p. 16).

The following table compares PNG's capital structure before and after conversion to an income trust. [1]

	Actual Capital Structures under the Income Trust	Current Actual Capital Structure	2004 Capital Structure Deemed by the Commission
Third Party Secured Debt	30.0%	46.7%	54.8%
Short Term Debt	10.0%	(1.4%)	5.5%
Preferred Shares	n/a	3.7%	3.7%
Subordinate Debt	53.0%	Na	n/a
Common Shares	7.0%	51.0%	36.0%
Total	100%	100%	100%

Principal Changes

The recapitalization for which PNG is seeking approval in this Application is similar in structure to that proposed by PNG in its January 30, 2004 Application. The income trust structure proposed in this Application, however, is not conditional on the Commission approving rates for PNG based on a deemed capital structure and rates which include a deemed corporate income tax component. Rather, PNG is proposing that its rates be based on PNG's actual costs having regard to its actual capital structure, cost of capital and income tax expense under the income trust structure (Exhibit B-1, para. 45, p. 11).

Following conversion to an income trust structure, third party secured debt would be reduced from approximately $86 million to $54 million and all of the existing preferred shares would be redeemed. The two other principal changes would be the creation of subordinate debt, to occupy 53 percent of the structure and the reduction of common equity from the current actual level of 51 percent to 7 percent (Exhibit B-1, p. 16; PNG Argument, para. 4, p. 2).

[1] The current actual and 2004 Commission deemed capital structures shown above are in relation to the PNG-West operating Division. The proposed income trust actual capital structure would also apply to the PNG-West, Fort St. John/Dawson Creek and Tumbler Ridge operating Divisions post conversion for the purpose of determining the cost of capital for each Division.

These principal changes are discussed briefly below, followed by a discussion of the anticipated return/cost of capital under an income trust structure.

Redemption of Third-Party Debt

PNG's financial advisors believe that PNG can raise through the IPO approximately $50 million to redeem outstanding preferred shares and a substantial portion of the Company's debentures (Exhibit B-4, p. 8). The $50 million is a target amount for an offering in order to achieve a level of third party debt that would be sustainable on a long-term basis (Exhibit B-5, BCOAPO IR 1, 161, 166).

According to PNG, the redemption of a significant amount of its existing third party secured debt and its replacement with subordinate debt, is one of the main benefits to PNG and its customers of PNG converting to an income trust structure. The reduction in the proportion of secured debt on PNG's balance sheet (and the corresponding improvement in the credit quality of the remaining secured debt) would, according to PNG, significantly increase its financial flexibility and access to capital markets, particularly debt markets (Exhibit B-1, para. 54, p. 17).

PNG submits that the tax deductibility of servicing the subordinate debt reduces its income and therefore its tax burden by millions of dollars annually and this, in turn, can result in a capital structure containing approximately $31 million less third party debt leading, at the same time, to reduced customer rates (PNG Argument, para. 67, p. 19).

Creation of Subordinate Debt

The subordinate debt, which would make up 53.4 percent of the capital structure, would be divided into two parts, a fixed rate portion with a cost of 12.0 percent (30 percent of the total subordinate debt) and a variable portion (70 percent of the total). The actual cost of the variable rate component would be based on the actual yields on the benchmark 30-year Canada bond plus a spread of 5.75 percent (Exhibit B-12, p. 3 of 13). PNG's financial experts have advised that the required yield range is between 10 percent and 12 percent.

PNG suggests that the subordinate debt that is incurred in the conversion has provisions that will not result in default as quickly as typical for senior debt, thereby providing PNG with additional time and flexibility to resolve issues or refinance the business (PNG Argument, para. 77, p. 20). BCOAPO suggests, however, that the default terms of AltaLink appear to be more generous than those proposed by PNG (BCOAPO Argument, p. 12).

Equity Layer

What is unique in this application, is the unprecedented and in the submission of BCOAPO, ill-advised, proposed capital structure with a 7 percent equity layer (PNG Argument, para. 47, p. 14; BCOAPO Argument, p. 32).

Ms. McShane's expert opinion was that the 7 percent common equity under the income trust structure could not be compared to the minimum 51 percent common equity which she recommends for the conventional capital structure. She states that "what needs to be compared are the combined equity/equity-like capital structure components" and notes that "while the subordinate debt is not strictly common equity, its equity-like features more closely align it with the common equity than with the secured third-party debt for comparison with the conventional capital structure" (Exhibit B-12, p. 8, lines 14-18). She concludes that "it is the weighted average cost of the subordinate debt and the common equity combined that is relevant" (Exhibit B-12, p. 10, lines 3-4; PNG Argument, para. 29, p. 10).

BCOAPO submits that the subordinate debt is very much debt to the corporate PNG. In fact, it is essential to the tax efficiency that the subordinate debt should provide deductions to flow the cash to the trust (Exhibit C3-4, Question 29; BCOAPO Argument, p. 38).

Return/Cost of Capital

PNG is proposing that after completion of the income trust conversion, the Commission approve rates for PNG that are based on the actual capital structure ratios and costs of the capital structure components of the recapitalized company. At the time of conversion, it is anticipated that the actual structure ratios and costs of the capital structure components for PNG-West will be as follows:

Table 1

COST OF CAPITAL FOR PNG(WEST) UNDER INCOME TRUST STRUCTURE				
Capital Structure Component	**Proportion**	**Cost**	**Pre-Tax Cost[2]**	**Weighted Pre-Tax Cost[3]**
Short-Term Debt	9.8%	5.50%	5.50%	0.54%
Third-Party Secured Debt	29.8%	8.90%	8.90%	2.65%
Subordinate Debt				
Fixed Rate	16.0%	12.00%	12.00%	1.92%
Variable Rate	37.4%	11.28%	11.28%	4.22%
Common Shares	7.0%	9.68%	14.78%	1.03%
Total	**100%**		**Total**	**10.36%**

PNG suggests that the benchmark to assess the proposed capital structure should be the pre-tax weighted average cost of capital under the existing corporate structure of 11.95 percent as developed below (Exhibit B-12, p. 5):

COST OF CAPITAL FOR PNG(WEST) UNDER CONVENTIONAL CORPORATE STRUCTURE				
Capital Structure Component	**Proportion**	**Cost**	**Pre-Tax Cost[4]**	**Weighted Pre-Tax Cost[5]**
Short-Term Debt	(1.4%)	3.0%	3.0%	(0.04%)
Third-Party Secured Debt	46.7%	8.72%	8.72%	4.07%
Preferred Stock	3.7%	7.01%	10.70%	0.39%
Common Shares	51.0%	9.68%	14.78%	7.54%
Total	**100%**		**Total**	**11.95%**

PNG advises that the unit holders would receive a pre-tax return of approximately 11.4 percent per annum under the PNG Income Trust proposal (assuming IPO issuance at this same yield) and that the “required yield” would be a function of market conditions and would vary over time, as would the value of a units (Exhibit B-5, BCOAPO IR 1, 159).

[2] At the 34.5% statutory corporate tax rate
[3] At the 34.5% statutory corporate tax rate
[4] At the 34.5% statutory corporate tax rate
[5] At the 34.5% statutory corporate tax rate

PNG suggested the higher amount of senior debt in this Application than the previous 2004 application (from $53 to $55 million) is beneficial to customers since it carries a lower cost than the subordinate debt and common equity (Exhibit B-8, BCOAPO IR 2, 242).

PNG explains that the income trust structure offers PNG a lower cost of capital assuming that PNG is allowed to convert to an income trust structure on the basis applied for and in comparison to the status quo scenario with a 51 percent common equity ratio (Exhibit B-5, BCOAPO IR 1, 158). On this basis, the total cost of capital (expressed on a pre-tax basis) would be approximately 13 percent lower under the income trust structure versus the conventional common share capitalization at 51 percent common equity.

4.3 Advantages of an Income Trust

PNG not only sees many advantages in the proposed conversion to an income trust structure, but the Utility's testimony identifies so many challenges facing it under its existing capitalization, that the conversion to an income trust structure may be seen as a salvation. Unless the income trust structure proposed in the Application is approved, PNG sees no solution to the tension between paying investors a fair rate of return on their investment and keeping customer rates from rising to potentially prohibitive levels. PNG testified that it had tried to think of every option to alleviate the business challenges facing PNG and the conversion to an income trust structure was the only satisfactory solution (T6: 564).

The Application claims four "substantial advantages" in the proposed conversion: a) it would allow the Commission to fulfill its statutory obligation under the Act to permit investors to earn a fair rate of return; b) it would reduce overall costs to consumers with the results that rates could be reduced and stabilized; c) it would allow the Commission to regulate PNG employing conventional rate-making principles, and limits the need for a deemed capital structure; and d) it would enable PNG to gain access to new sources of capital and to refinance, on reasonable terms and conditions, existing long-term debt which is maturing and which must be financed in the next few years. PNG responded to a Ministry Information Request with respect to the fair return standard to state that: "A fair return is one that provides the Utility with an opportunity to: a) earn a return on an investment commensurate with that of comparable risk enterprises; b) maintain its financial integrity; and c) attract capital on reasonable terms" (Exhibit B-8, MEM IR 2, 2.7).

PNG restated the expected benefits from the conversion by stakeholder group:

> “Customers
>
> Rates are expected to be more stable and lower under the income trust structure compared to the existing corporate structure.
>
> Investors
>
> Investors will receive a fair return on their investment compared to the current situation where investors are receiving a rate of return on common equity that is much lower than the allowed rate of return on common equity.
>
> Debt Holders
>
> The long-term debt holders will have less capital at risk after PNG converts to an income trust.
>
> Government
>
> An income trust structure will make PNG a financially stronger entity which will be better able to provide secure and reliable service to its customers. It is in the best interests of the government to have a healthy natural gas utility serving remote areas of British Columbia which will complement potential future economic growth in these areas” (Exhibit B-5, MEM IR 1, 7.5).

In many respects the advantages of the income trust structure are accentuated by the very difficult business circumstances facing PNG under conventional capitalization. PNG testified that the rates under the conventional capitalization proposed by PNG would be considerably in excess of residential electricity prices (T5: 472) and that both customer accounts and use-per-customer in the PNG West service territory are declining. Although PNG was unwilling to accept that a “death spiral” could result from the high consumer prices, it acknowledged that those high prices would cause serious problems for the Company (T5: 474).

Another critical concern for PNG is its ability to access long-term debt markets to refinance its maturing third-party long-term debt. Over the next ten years PNG must refinance approximately $46 million of long-term debt, including $4.4 million of debt in 2005 and $4.9 million per year over the four year period from 2006 to 2009, inclusive. In its Application and as supported by the evidence of Mr. Bruce, PNG states that, “As currently capitalized and with its significant business risk, including the uncertainty of whether Methanex will continue to operate its methanol/ammonia complex at Kitimat after its transportation service agreement with PNG expires in October 2009, PNG is simply not able to raise the debt necessary to refinance this existing debt as it matures" (Exhibit B-1, p. 8).

In addition to the benefits previously articulated, PNG stated that the financial flexibility resulting from the conversion to an income trust structure will allow it to return the deferred income tax credits to customers to help lower and smooth out any rate increases in the future. PNG summarized the cost of service reductions from the conversion to the income trust structure compared with a status quo scenario of a conventional utility with 51 percent common equity in 2005, growing thereafter to offset maturing long-term debt. These calculations are identified in the Application and indicate total cumulative cost of service savings over the five year period from 2005 to 2010 for the PNG-West Division of approximately $23 million (Exhibit B-1, pp. 24-26).

The Commission and Intervenors asked a large number of Information Requests to test the assertions of PNG that the conversion to an income trust structure would be beneficial for all parties and appropriate in the circumstances. In response to a Commission Information Request to restate the financial tables in the Application using a test year 2005 based on the currently approved deemed capital structure and return on equity, PNG responded with a set of financials indicating that the pro forma 2005 Income Trust scenario was approximately equal to the financial results and cost of service under a test year 2005 based on a deemed equity of 36 percent (Exhibit B-3, BCUC IR 1, 27).

The Information Requests also attempted to measure the stability of the PNG Income Trust in the event of unfortunate circumstances and under several scenarios of plausible events (Exhibit B-3, BCUC IR 29, Exhibit B-6).

PNG's response was that:

> PNG has no flexibility today to deal with circumstances such as high interest rates, reduced industrial loads or higher natural gas commodity costs. PNG will have greater flexibility to deal with these types of circumstances in the future under the income trust structure as a result of the significant reduction in the proportion of secured debt on its balance sheet (and corresponding improvement in the credit quality of the remaining secured debt) and enhanced access to capital.

> It is clear that the income trust structure would be significantly more stable than a corporate structure with a deemed common equity component of 36 percent. The income trust structure allows PNG to significantly reduce its third-party debt leverage without having to increase rates to customers. This combination of effects will allow PNG to:
>
> a) absorb reduced cash flows, if necessary, resulting from reduced industrial loads with a much lower risk that it would not be able to service interest and principal payments on its third-party debt;
>
> b) maintain lower rates for customers and therefore remain more competitive with alternative fuels in an environment of high natural gas commodity prices while continuing to earn a fair and reasonable return on its investment; and,
>
> c) have significantly improved access to capital which will allow PNG to maintain more stable rates and to weather short-term negative events such as line breaks.
>
> The interest rate sensitivity of the subordinate debt and equity components combined, even assuming that a portion of the subordinate debt is periodically reset relative to long Canada bond rates as discussed in the response to question 28.3 above, will not be significantly greater than the interest rate sensitivity of the short-term debt and equity component of the 36 percent deemed equity capitalization. Again, since rates will be lower under the income trust structure, higher interest rates will have less detrimental effects on the competitiveness of PNG's rates under the income trust structure (Exhibit B-3, BCUC IR 29).

The expert witnesses of PNG claimed that income trusts provide improved access to capital markets for smaller companies like PNG.

PNG also identified the advantages that the New Debt Issuance Test and the Distribution Test that it had negotiated with existing third party debt holders:

> "The New Debt Issuance Tests were negotiated between PNG and its debenture holders, in the context of recapitalizing under an income trust structure, to provide flexibility to PNG while giving additional certainty to the debenture holders with respect to ongoing credit quality of

> PNG. Notably, PNG was able to maintain significant future flexibility to increase its third party debt leverage in the event that its business risks are reduced and its credit quality improves. For example, applying the tests using its 2004 financial results, PNG would have the ability to issue an additional $20-25 million of third party long-term debt, depending on interest rates for the new issues, relative to the amount of long-term debt proposed to be initially left outstanding under the income trust structure. This is slightly more than PNG could issue under the existing test relative to its current long-term debt levels. While PNG could not reach third party debt leverage levels under the New Debt Issuance Tests which are as high as theoretically possible under its existing debt issuance test, this is simply a reflection of capitalization and other differences between the income trust structure and the existing corporate structure. PNG believes that the reduced third-party debt levels under the income trust structure are very beneficial to PNG and its customers through the lower overall cost of capital that can be achieved under that structure.
>
> PNG currently has a Distribution Test in its short-term working capital facility but not in its Trust Deed. The proposed Distribution Test for the amended Trust Deed will not impact PNG's ability to raise debt in the future and will not add any risk for ratepayers. It is possible that a reduction in PNG's future cash flows would cause the Distribution Test to become restrictive requiring PNG to suspend payments on the subordinate debt and common equity held by the Trust under the income trust structure" (Exhibit B-3, BCUC IR 21.0).

Through Information Requests and cross-examination PNG provided an analysis of the impacts of six specific scenarios of possible events in the PNG service territory which could significantly impact the Utility (Exhibit B-6, T5: 518 to T6: 545). The impacts were evaluated based on the options of continuing the existing corporate structure or converting to an income trust structure.

The first scenario considered a possibility that Methanex would not renew its contract with PNG in 2009 and Skeena Cellulose would be permanently lost as a customer. PNG identified that under conventional capitalization, in 2010 it would have a cash shortfall for debt service of approximately $3.5 million. In the income trust alternative the Utility would be able to meet its reduced third-party debt obligations and have minimal cash available to service its subordinate notes. Interest payments on the subordinate notes can be deferred without default.

The second scenario anticipated the potential rise in long Canada bond yields over the next five years to a level of 10 percent. PNG identified that under the existing corporate structure the rate of return on common equity would increase in lock step with the rise in long Canada bond yields and PNG would be required to finance existing debt that is coming due with even higher price common equity through retained earnings. However, it was noted that interest coverage ratios would be expected to improve somewhat under the higher interest rate environment, resulting from the higher rate of return on common equity which more than offsets the increased interest expense.

The income trust scenarios were differentiated between one scenario where 100 percent of the subordinate debt is at fixed interest rates and the second scenario where 70 percent of subordinate debt is issued at floating rates. The fixed-rate debt scenario at an interest rate of 12 percent is approximately $2 million better than the scenario with 70 percent at floating rates. This obviously results from the floating rate subordinate debt rising in cost as interest rates rise. Even in the case where 70 percent of the subordinate debt is issued at floating rates, the before-tax cost of capital is similar to a conventionally structured utility with 36 percent deemed common equity and is approximately $3.4 million better than the 51 percent actual common equity structure when long Canada bond yields reach 10 percent.

The third scenario considered a circumstance where natural gas commodity prices rise at a rate of 5 percent real per year for the next five years while electricity prices remain constant in real dollar terms. PNG acknowledges that this circumstance could be devastating for the PNG-West service area. Under the income trust structure the rise in natural gas prices would only be offset by the lower cost of capital in the Income Trust scenario and the ability to finance the drawdown of deferred income taxes to help offset the impact of higher gas prices.

The last three scenarios would all be beneficial for the Utility. They include the potential of a Liquefied Natural Gas terminal at Kitimat, an oil pipeline from Alberta to Prince Rupert along the PNG right-of-way and a new large industrial customer similar in load to the historic Skeena consumption. PNG claims an incremental benefit from being capitalized as an income trust structure to be its ability to negotiate terms of new agreements from a sounder and more stable financial footing (Exhibit B-6, p. 9).

PNG identified another benefit from the proposed conversion to be a single rate application for all the Divisions of PNG since they would be commonly owned by the Income Trust.

PNG identified that the only negative future business risk event it could think of which would be worse under an income trust structure compared to conventional capitalization would be a change in tax laws unfavourable to income trusts. However, this would be a shareholder risk and in PNG's view is extremely unlikely (T5: 517-518).

BCOAPO argues that the Commission should not approve the conversion to an income trust structure, though it does not dispute that there could be benefits to ratepayers as a result of the income trust conversion. Instead, BCOAPO's objections to the PNG Application focus on the unprecedented nature of the requested approval, the unresolved Methanex issue at this point in time, the difficulty in establishing an appropriate return on equity and interest rate on the subordinate notes and potential regulatory problems between the Commission's regulation of PNG and the income trust ownership. BCOAPO argues that if the Methanex issue were clarified with Methanex committing to being a long-term customer of PNG, the Utility could be capitalized with less equity than currently exists, and, if an income trust structure were approved at that time, the interest rate on the subordinate notes would be lower. Essentially then, the need to convert to an income trust structure would be diminished and advantages could flow to customers under either a conventional capital structure or an income trust conversion at that time.

The Ministry of Energy does not support or oppose the Application. However, the Ministry states that it "agrees with PNG's expert witness, Ms. McShane, that in the development of an appropriate capital structure, it is a common and established practice in Canada for regulators to consider minimizing the overall cost to customers" (MEM Argument, p. 1).

Commission Panel Determinations

The Commission finds that there are advantages to both shareholders and customers from the proposed conversion to an income trust structure. These significant economic advantages are offset to some extent by the regulatory and other challenges which are discussed in other sections of this Decision. **In the unique business environment in which PNG finds itself**, **the Commission Panel finds that the income trust structure is preferable to a conventional structure because it will provide a fair opportunity to earn a reasonable return and minimize rates to customers.**

5.0 THE INITIAL PUBLIC OFFERING ("IPO")

5.1 The Income Trust Conversion

The six steps to convert PNG to an income trust structure are shown schematically and discussed in Tab 2 of the Application. Although the six steps appear sequentially, PNG's expert witness testified that: "All of the steps become contingent on each other. So if the IPO is not completed the other steps that we have talked about don't happen. Everything basically gets lined up so that, you know, in a boardroom all of these things close concurrently. There is no redemption of the debt without the IPO proceeds. There is no conversion without the redemption. They're interlinked. So in effect, it all does depend upon the success in being able to raise the equity proceeds" (T5: 498-499).

In considering the appropriate capital structure, PNG has had to balance the interests of the existing third-party debt holders who demand that their financial exposure be reduced by approximately $31 million before they will agree to the income trust structure conversion. At the same time the expected equity returns and interest on subordinate notes must be sufficient to induce the existing shareholders to exchange their shares for Income Trust units. Also, the income to the income trust needs to be sufficient to allow the IPO to be successful to obtain the funds to pay down the third-party debt and not dilute the interest of the existing shareholders unfairly. Finally, the common equity component is established considering the most efficient tax structure for PNG and the lowest rates possible for ratepayers.

With respect to the interest rate on subordinate notes, PNG stated:

> "The appropriate interest rate on debt is determined with reference to a number of factors, including the level of debt in the capital structure, the interest rate environment, and the availability of capital. The interest rate on the subordinate debt must be reasonable and appropriate, having regard to the risk to which debt is exposed and to the requirements of investors in the Income Trust markets who will indirectly be the purchasers of the debt. PNG will require the approval of the Commission prior to issuing the subordinate notes" (Exhibit B-3, BCUC IR 1, 9.1).

In considering the appropriate amount of common equity in the income trust structure, PNG responded to another Information Request to state:

> "The subordinate notes in the capital structure serves to support the secured debt which permits a lower common equity proportion than would otherwise be possible. The 7 percent common equity ratio is tailored to utilize the available income tax deductions (primarily capital cost allowance) within PNG in order to minimize PNG's income tax expense" (Exhibit B-3, BCUC IR 1, 28.1).

In considering the appropriate proportion of long-term debt in the new capital structure, PNG's financial advisors reviewed the stability of PNG's cash flows and business risks relative to comparable income trusts in the market and concluded that the market would accept a third-party debt level of two times EBITDA. PNG's experts agree that while the broad range of third-party debt in the capital structure could range from zero to four times EBITDA, the two times EBITDA was an upper limit in the case of PNG (Exhibit B-3, IR 1, 28.2). The PNG witness also agreed that the cash flow after the departure of Methanex was a "key consideration as to whether or not that third-party debt was sustainable" (T6: 648).

The elements of the proposed income trust structure were examined extensively through Information Requests and pursued vigorously by BCOAPO during the hearing. BCOAPO does not support the proposed conversion and believes that PNG has not met the onus upon it to establish that its Application meets the requirements of the Act, particularly taking into consideration the risks associated with the Methanex contract. BCOAPO believes that the reduction in the equity layer to 7 percent will result in a low equity layer unprecedented in Canadian regulatory experience and should be disallowed as being detrimental and not in the public interest, and runs the possibility of unanticipated consequences. BCOAPO is particularly concerned with the interest rates on the subordinate debt which it believes to be excessive. In addition, it opposes some of the terms and conditions on the subordinate notes, including the "make-whole" premium on the fixed rate subordinate debt.

PNG advised the Commission during the course of the proceeding that the "make-whole" provisions could be removed at the discretion of the Commission and that such removal would not impede the marketability of the PNG Income Trust. PNG states that the interest rate on the subordinate debt and return on the equity held by the PNG Income Trust must be at levels that will result in PNG's shareholders approving the plan of arrangement to convert to an Income Trust. PNG had replied to an Information Request of BCOAPO to state that the gross margin shown in Tabs 6, 7 and 8 of the Application is the minimum margin required for PNG to have comfort that the deal will be accepted by shareholders (Exhibit B-8, BCOAPO IR 230). PNG testified that the conversion would be expected to occur at about book value of rate base (Exhibit B-5, BCOAPO IR 1, 15 and Exhibit B-8, BCOAPO IR 1, 230).

Commission Panel Determinations

The Commission Panel recognizes that the establishment of the new capital structure for the Utility under an income trust ownership requires a careful consideration of the interests of all stakeholders. The Commission Panel finds that PNG and its financial advisors have balanced those interests. The existing third-party debt holders would see the interest payments to them falling to a level which can be sustained if Methanex leaves the system, the small level of equity is tax efficient to minimize rates for ratepayers and the level of income available to the income trust (which will be discussed further in the next subsection) should be no higher than needed to induce the existing shareholders to convert and to allow for a successful IPO. **The Commission accepts the proposed income trust structure.**

5.2 Forecast of Expected Yields to the Income Trust

It is common ground that at the income trust level, the return will be derived from the interest on the subordinate notes and the earnings on the common shares. This was perhaps best stated in the evidence of Mr. McCormick where he states that, "in economic terms, the subordinate notes appear to behave as a class of high yield tax deductible equity" (Exhibit C3-4, p. 22). He expanded on this statement in response to a Commission Information Request asking if common equity and subordinate notes should both be considered equity financing of PNG for regulatory purposes. The response indicates that the income trust structure would have a 60 percent effective equity layer in the Utility but that the subordinate notes should not be considered equity financing in the context of applying the BCUC equity return formula (Exhibit C3-5, BCUC IR 1, 15).

Equity Returns

The earnings of PNG will flow to the income trust by the interest payments on the subordinate debt and the earnings paid out on the 7 percent common equity.

PNG proposes that the return on PNG's common equity continue to be fixed using the Commission's automatic adjustment formula with a 65 basis points premium for PNG-West and Tumbler Ridge Divisions and 40 basis points for the Fort St. John/Dawson Creek Division (Exhibit B-1, p. 21).

The appropriate return on the new common equity was pursued in Information Requests and in cross-examination. In Exhibit B-5, PNG provided its rationale for the equity returns:

> "…the cost rate on a 7 percent equity component is theoretically higher than the cost rate on the existing equity component, forecast to be 51 percent in 2005. However PNG chose not to request a different premium for the following reasons:
>
> (1) Given the relatively small common equity component under the income trust structure, PNG concluded that the analysis required to estimate the cost differential was not warranted.
>
> (2) The equity component maintained in PNG (the Corporation) under the income trust scenario will not be directly priced by the capital markets, rather it is the income trust units that will be priced. In other words, the 7 percent common equity component cannot be separated from the subordinate debt, and therefore it is the weighted average cost of the subordinate debt and common equity combined that is relevant.
>
> (3) While the true cost of equity at 7 percent common equity component would be, all other things equal, higher than the cost of equity at a 51 percent common equity component, there are offsetting benefits to PNG (e.g., improved access to capital) under the income trust structure. On balance, the cost of the 7 percent equity component would be at least as high as the cost of equity under PNG's existing corporate structure." (Exhibit B-5, BCUC IR 2, 36.1).

In cross-examination, PNG accepted that for the next five to ten-year time frame, the existing return on equity mechanism should continue to apply. However, PNG did acknowledge that the Commission might vary the return on equity level if it determined that the overall yields to the PNG Income Trust were inappropriate based on the income generated from the subordinate notes and common equity (T6: 581).

Subordinate Debt Interest Rates

The determination of an appropriate interest rate on the large portion of the capital structure (53 percent) made up by the subordinate notes was one of the most contentious aspects of the hearing. The issue was made more complex by the changes proposed by PNG as the hearing process developed. In the end, Exhibit B-14 identified that 70 percent of the subordinate notes would be issued at variable interest rates, while the remaining 30 percent of the subordinate notes would be at a fixed rate of 12 percent per annum. The variable-rate notes would attract an interest rate to be set annually at the beginning of each calendar year equal to the closing yield on the benchmark long Canada bond of the prior year plus 5.75 percent. Both the variable-rate notes and the fixed-rate notes would be issued in three equal tranches with maturities of ten years, 20 years and 30 years respectively. The variable rate notes could be repaid at any time conditional on PNG's directors determining that PNG had sufficient "free cash flow" to permit payment. The fixed-rate notes could be redeemed following the tenth anniversary of issuance with a "make-whole" payment, conditional on PNG's directors determining PNG had sufficient "free cash flow" to permit repayment. Although Exhibit B-14 identifies a "make-whole" provision, the testimony and Final Argument of PNG identified that "make-whole" premium was not critical and could be deleted, if so directed by the Commission (T6: 562).

PNG suggested that the variable-rate notes would be an attractive feature for investors in the IPO because they would provide a hedge against the potential rise in interest rates in future. PNG also maintained that the variable-rate notes might have some advantage from a customer and Commission perspective because they would tend to mimic the changes in allowed ROE under a conventional structure as long Canada interest rates changed.

PNG defended the significant portion of variable-rate notes as being desirable even in this historic low interest rate environment. The concern is that existing interest rates are at such a low level that they are more likely to rise over the next 30 year period than they are to decline significantly. PNG believes that the spread between the variable-rate notes and fixed-rate notes adequately compensates for the market's expectation of interest rate fluctuations.

With respect to the proposed interest rates there was considerable concern as to the comparability of the overall yield from subordinate notes and equity returns to the Income Trust compared to the yields on comparable Income Trusts. Extensive information was filed in response to Information Requests from BCOAPO on the yields of other Income Trusts. BCOAPO focused on the relatively low returns of the Clean Energy Income Trust in support of its argument that the yield to the PNG Income Trust and, hence, the appropriate interest rate on the subordinate notes should be below 10 percent. Exhibit B-31 was filed near the end of the hearing process in response to a request of the Panel Chair. It provides updated adjusted yields for Power and Pipeline funds and indicates a cash-on-cash yield averaging 8.2 percent and an adjusted yield averaging 9.2 percent.

In its Final Argument, BCOAPO observes that the Altalink subordinate notes have an 8 percent interest rate (Exhibit B-23, p. 2) for their ten year term, while PNG proposes a rate of approximately 12 percent for the fixed rate portion of the ten year notes (BCOAPO Argument, p. 11). BCOAPO recommends that the maturity on the subordinate notes should be no later than 2009 to coincide with the Methanex contract and that an appropriate rate on the fixed-rate subordinate notes should be deemed to be 6 percent. If the Commission approved a term as long as ten years, BCOAPO estimates the appropriate interest rate to be 7.15 percent.

Commission Panel Determinations

The Commission Panel appreciates the diligent efforts by all parties to try and establish an appropriate interest rate on the subordinate notes. However, in spite of the extensive information generated, the Commission Panel concludes that the establishment of the interest rate, at least at this point in time, is a matter of considerable judgment (T6: 630, 635). The Commission Panel accepts that Messrs. Bustos and Wallace are experts in this field and has given significant weight to their evidence in these circumstances. **The Commission Panel finds that the proposed variable and fixed-rate notes of 70 percent variable and 30 percent fixed is appropriate. In addition, the expected yield range estimated by the experts of 10 to 12 percent appears appropriate. The Commission Panel accepts the midpoint of this range in the current interest rate and business environment. The Commission Panel finds that the interest rate on the fixed rate subordinate notes should be 11 percent. The interest rate on the variable rate subordinate notes should be 4.75 percent above long Canada bonds.**

Finally, the Commission Panel believes that the subordinate note pre-payment conditions identified in Exhibit B-14 are particularly appropriate since the Commission may have to rebalance the capital structure in the future if it finds that the overall yields to the Income Trust have become inappropriate. The pre-payments would allow PNG to adjust its capital structure by varying the amount of third-party debt so as to conform with future Commission determinations. The “make-whole” conditions should not be included in the subordinate note conditions since this will maximize the flexibility for PNG to adjust its

capital structure for changing business conditions, and because PNG's experts do not believe it is a necessary condition to complete the conversion.

6.0 INCOME TRUST TAX CONSIDERATIONS

The principal advantage in the conversion to an income trust structure for PNG is that the interest on the subordinate notes is deductible for tax purposes within the Utility, resulting in minimal income tax paid at the Utility level and, therefore, a higher cash flow to the PNG Income Trust. Even though the pay-outs to the PNG Income Trust unit holders are fully taxable, the tax minimization at the Utility level has been valued as a significant benefit by investors. Those businesses which are seen to have a steady cash flow are desirable for income trust conversion.

In the case of PNG, the Utility will be expected to pay a substantial portion of its cash flows by way of interest on shareholder notes and dividends on common shares to the PNG Income Trust. However, PNG provided assurances that the Utility would retain a prudent level of cash reserves to maintain financial flexibility and make capital expenditures required to maintain and enhance the quality of the asset base.

Several tax-related issues were raised during the hearing. The first was identified in the evidence of BCOAPO's expert with respect to a consultation paper from the federal government relating to possible taxation changes of income funds. PNG and its experts were unable to provide an update with respect to that consultation paper. However, the President of PNG testified that, "We are certainly on the record as saying that if, certainly from the tax deductibility point of view, that the shareholders are prepared to take the risk if there's any change in the regulations in that regard" (T6: 544).

PNG believes that if future tax changes occur, existing Income Trusts might be "grandfathered" from the tax changes. PNG argues that income trusts are now a permanent part of Canada's equity market accounting for 10 percent of publicly traded equity in Canada with a market capitalized value of approximately $133 billion. PNG further states that the tax treatment of Income Trusts has been part of tax law for more than 30 years and there is no suggestion of the law changing in that regard (PNG Argument, p. 19).

BCOAPO disagrees with PNG's assertion that, "the Income Trust allows the tax burden to be shifted from the shoulders of PNG's customers to the shoulders of PNG's investors" (PNG Argument, para. 67). BCOAPO points out that a substantial portion of the tax benefits are not being returned to the customers. In addition, PNG investors, whether in debt or equity, have discreet tax positions. Some investors may be tax exempt like pension funds, others like resident Canadian individuals are taxable and, depending on the character of the distributions, will face tax on business income or dividends, or on a deferred basis as a return of capital (T4: 235-236).

BCOAPO also raised a concern that the Federal Department of Finance might invoke some rule or apply the general anti-avoidance provisions to recognize some aspects of the subordinate debt as equity. If this were to occur it might limit the tax deductibility of the interest on the subordinate notes and reduce the tax advantages of the income trust structure (Exhibit C3-4, p. 29). PNG's witnesses dismissed the likelihood of this occurring, but acknowledged that an advanced tax ruling in this regard was likely not possible. In its Argument PNG states that, "There is no basis whatever for concluding that the company has any particular risk that its income trust structure will be disallowed from a tax viewpoint" (PNG Argument, para. 69).

A separate tax issue relates to the use of deferred income tax credits to stabilize rates in the income trust scenario. In the period from July 1, 1978 through November 6, 1986 PNG used the normalized method of accounting for income taxes, and collected approximately $14.4 million of deferred income taxes from its customers to be used to pay income taxes once "crossover" was reached. The purpose of recording the deferred income tax balance under normalized taxation is to provide funds to draw down in a future period when deductions for tax purposes are less than those for book purposes. The arguments with respect to the appropriateness of utilizing the flow-through method of income tax calculations as opposed to the normalized method have been ongoing for many years but in PNG's case the Utility has been and is currently on the flow-through method, except for an identified period when the normalized tax accounting was used and the deferred income tax balance was built up.

In PNG's case, the amount of overhead that is capitalized for book purposes, but deducted immediately for tax purposes, is also taken into account in the calculation of income taxes payable and is effectively treated the same as Capital Cost Allowance ("CCA"). For the period 1993 – 1996, overhead was not allowed as a current deduction for tax purposes by the Canada Revenue Agency and resulted in equilibrium between depreciation and CCA in 1996. Beginning in 1997, overhead was again allowed as a deduction for tax purposes. Since 2000, depreciation has exceeded CCA plus deductible overhead (i.e. crossover) by an average of approximately $1 million per year.

The PNG-West Division currently has approximately $14.5 million of booked deferred income taxes which are deemed by the Commission to be zero cost capital financing the PNG-West Division rate base. The corresponding balances for the Fort St. John/Dawson Creek and Tumbler Ridge Divisions are $553,000 and $415,000 respectively. Under the income trust structure, PNG will have significantly reduced taxable income and the deferred income taxes will not be required to pay income taxes for the foreseeable future. PNG intends to apply to the Commission in future revenue requirement applications for approval to gradually draw down the deferred income tax balances by crediting each Division's deferred income tax balance to their respective cost of service over time. The portion of the deferred income taxes to be credited to the annual revenue requirement will be determined each year based on the overall objective of stabilizing and, in appropriate cases, reducing customer rates (Exhibit B-1, p. 22).

BCOAPO's expert undertook calculations intended to show that most of the tax-saving benefits would flow through to shareholders rather than customers (Exhibit C3-4, pp. 39-41). PNG countered that virtually all the benefits go to customers if one accepts that the fair equity capitalization in a conventional utility capitalization should be 51 percent in 2005.

BCOAPO did not take issue with PNG's proposal regarding the potential return of deferred income tax credits to customers in its Final Argument.

Commission Panel Determinations

The Commission Panel finds that the proposed income trust structure is more tax efficient for the Utility and can provide benefits to both customers and shareholders. The Commission Panel accepts PNG's position that the proposed PNG Income Trust would be reasonably structured to avoid any potential determination by the Canada Revenue Agency that the interest on the subordinate notes should be treated, for tax purposes, in any way other than the proposed interest deduction by the Utility.

The Commission Panel does not accept the BCOAPO submission that the tax savings should be split 50/50 or on any basis other than a fair allocation of cost to customers ensuring that the opportunity to earn a fair return on invested capital is provided to the owners of the Utility.

7.0 REGULATION OF THE INCOME TRUST STRUCTURE BEYOND THE INITIAL PUBLIC OFFERING

This section first addresses governance, particularly governance considerations relevant to the long-term viability of the Utility which requires reinvestment in the assets of PNG. Regulatory parameters that may ensure the financial stability of the Utility will also be considered in this section. Then issues related to the determination by the regulator of fair and reasonable returns will be considered. And the section will close with consideration of mechanisms for regulating fair and reasonable returns.

7.1 Regulatory Capacity and Governance

It is common ground between PNG and BCOAPO that the Commission does not have jurisdiction to regulate the income trust (T7: 804; T7: 808). PNG submits that because the Commission does not regulate a corporate parent, it does not need to regulate the income trust (PNG Reply, p. 3; T7: 808). BCOAPO submits that it is "fundamental that the Commission determines if it is to regulate PNG at the corporate level or at the income trust level" (BCOAPO Argument, p. 1).

The PNG Income Trust will be governed by trustees and the Utility to be owned by the income trust will be governed by a board of directors. The directors will be appointed by the Income Trust and the unit holders will elect the trustees. Therefore, the trustees and directors are expected to be the same individuals. PNG stated the fiduciary duties of trustees are similar to those of directors. (Exhibit B-1, Tab 1, p. 2, para. 2). During the proceeding, concerns were raised regarding capitalization decisions, principally distribution and allocation decisions, to be made by the trustees that may not be in the best interests of the Utility.

Payments on the subordinate notes can be reasonably expected to result in a much higher distribution to unit holders, than under a conventional capital structure where earnings are frequently retained. Moreover, the policy of the trustees will be to distribute all available cash to the income trust (Exhibit B-3, BCUC IR 1, 15.0). However, PNG asserts that in the exercise of their fiduciary duties the trustees may waive the requirement of the Utility to make interest payments on the subordinate notes where the waiver is in the best interests of the Utility. PNG states in its Application that the interest payments may be waived by the trustees because if it is in the best interest of the Utility for the payments not to be made, it follows that it will also be in the best interests of the unit holders. PNG testified that its paramount responsibility would remain with the operating Utility and that there would be no conflict of interest between the management and directors of the Utility and the PNG Income Trust (T6: 545). PNG agreed that it would put the security of the Utility operations first because it is that entity which feeds the income trust, and if the Utility were to be imperiled, the PNG Income Trust would have no ability to distribute income to the unit holders.

As well as concerns about distributions, BCOAPO also raised capital allocation issues. BCOAPO was concerned that if the Utility was not the sole asset owned by the PNG Income Trust, then capital allocation considerations may result in decisions by trustees that are not in the best interests of the Utility. PNG submits that, at least initially, the Utility will be the sole asset owned by the PNG Income Trust. In other words, there will be no conflicting interests on the part of the income trust, to prefer one asset over another. The interests of the PNG Income Trust are synonymous with the interests of PNG (PNG Argument, p. 20, para. 75).

BCOAPO links "the need for close regulation and the concerns for governance" (BCOAPO Argument, p. 25). BCOAPO submits that only regulation at the PNG Income Trust level will ensure that the unit holders act in the best interests of the Utility (BCOAPO Argument, p. 24). BCOAPO also expressed concern about governance and submits that the need for regulation of the income trust is evident in the Utility's request for a make-whole premium on the subordinate notes (BCOAPO Argument, p. 25).

Commission Panel Determinations

The Commission does not regulate the parent corporate entities of utilities with a conventional capital structure, and the Commission Panel does not consider that the differences between a conventional capital structure and the income trust structure applied for in the Application create a need to specifically regulate the PNG Income Trust. However, the capitalization differences, particularly the financing requirements of the subordinate notes, do establish a need for conditions of approval for the income trust structure so as to ensure adequate capitalization.

The PNG Income Trust advances the subordinate notes; therefore, it cannot be assumed that the terms, including the interest rates, of the subordinate notes are comparable to market terms. Although those terms are relevant for the purposes of the IPO, the Commission Panel finds the interest rates should be neither determinative of, nor relevant to, costs of capital that are recoverable in rates beyond the 2005 test year.

The Commission Panel also accepts PNG's assurances that the Utility's management and directors will safeguard the security of Utility operations by retaining a prudent level of cash reserves to maintain financial flexibility and make capital expenditures required to maintain and enhance the asset base. The Commission has an ongoing responsibility to ensure all regulated utilities have the financial capability to maintain safe, reliable operations.

7.2 Determination of Fair and Reasonable Return

For conventional capital structures, the Commission allows returns for revenue requirement purposes based on returns achievable by comparable risk firms. The Commission determines returns by estimating expected returns, that is, by forward-looking estimates of a utility's cost of capital at a point in time. Current regulatory decisions rely on models ("standard tests") used by rate of return experts that provide the forward-looking estimates of the cost of capital.

PNG submits the actual yields can be used for determining fair and reasonable returns for the operating entity as follows:

> "It is simply a matter of comparing PNG's trading yields over a reasonable period of time to the returns being paid to the trust via the subordinate note and common equity" (PNG Reply, p. 12, para. 33).

During Oral Argument, counsel for PNG stated that the units trade values relative to book values are a significant factor to assess whether or not the cost of servicing the equity and subordinate notes held by the income trust should be recovered from the customer or not (T7: 785). PNG also submits that imputing a capital structure and calculating the appropriate cost of capital based on that imputed capital structure is a second means of determining the revenue requirement (T7: 790).

The use of actual yields of a parent entity needs to be contrasted with using expected yields at the operating level. The use of actual yields of a parent entity is a departure from previous approaches utilized by the Commission when approving returns. This departure needs to be considered in the context of the other approaches proposed by PNG for approving returns, and whether or not using actual yields together with the other approaches is appropriate until the other methodologies commonly used in setting returns can be adapted for income trusts.

BCOAPO submits that with 20 years of capital markets experience with income trusts the data was available to undertake the Equity Risk Premium and Comparable Earnings tests (BCOAPO, p. 31). BCOAPO further submits that the Commission should draw a negative inference from the fact that the applicant has not presented the analysis of these standard tests (BCOAPO, p. 32). In Reply, PNG states that "it is not possible to develop equity risk premium and comparable earnings model for the PNG Income Trust until there is a trading history" (PNG Reply, p. 13; PNG Argument, p. 22). PNG further asserts that "it is too early in the life of the income trust" market for the development of the standard tests (PNG Argument, p. 22, para. 83). PNG submits that focusing on yield at the income trust level is appropriate at this time (PNG Reply, pp. 4-5).

PNG and BCOAPO hold differing views regarding the effect of approval of the income trust structure. PNG asserts that it is not asking the Commission to approve its cost of capital for decades as asserted by BCOAPO (PNG Reply, p. 12). BCOAPO submits that if the income trust is approved, the Commission will lose the opportunity to apply the future adjustments it may make to the equity risk formula (BCOAPO Argument, p. 27). Specifically, the conversion will have profound influences on the cycle of review and the extent to which the Commission can adjust the costs of equity and debt capital (BCOAPO Argument, p. 27).

BCOAPO submits that the specific tests required to be met attach to the individual securities to be issued rather than their blended effect alone (BCOAPO, p. 34). BCOAPO submits that the Commission does not have the jurisdiction to approve a utility's debt issues, including their interest rates, as being appropriate and then subsequently limit the utility's ability to recover these costs from ratepayers because of changed circumstances, particularly if this possibility of these changed circumstances was in the consideration of the Commission in approving the debt issue (BCOAPO, p. 44).

The evidence of PNG's expert Ms. McShane was informative regarding the expected discretion of the Commission to adjust the approved capital structure of the Utility in the future, irrespective of having approved the amount of the subordinate notes and their interest rates at the time of conversion to the income trust structure (T4: 286-290). She agreed that regulators retain their discretion to establish efficient capital structures and she believes that the BCUC could adjust the amount of subordinate debt to achieve that end.

Commission Panel Determinations

The implication of PNG's submission regarding the subordinate notes is that approval of the subordinate notes will not determine the cost of capital for the notes for revenue requirement purposes, and the implication of the submissions of BCOAPO is that approval of the subordinate notes will determine the cost of capital for the Utility for the term of the subordinate notes. In this regard, the Commission Panel accepts the submission of PNG.

The Commission Panel considers that it should not approve the Application if the outcome would be the loss of authority to regulate returns for the Utility. For example, if approval of the subordinate notes resulted in the loss of authority, even in part, to make adjustments to the cost of capital, then the income trust structure should not be approved. In this regard, the Commission Panel accepts the evidence of the Utility's executives and the submissions of its counsel that approval of the Application, including the subordinate notes, will not result in the loss of authority to regulate returns for the Utility.

The Commission Panel accepts PNG's focus on yields at the trust level for the purposes of this Application and the initial IPO. Prior to the development of standard tests for income trusts, PNG should expect that the actual yields at the trust level will continue to be relevant to the determination of fair returns, and should not expect any relief from the conditions of approval, particularly Condition #1 (See Chapter 10). Prior to and after development of the standard tests, PNG should expect that the Commission will continue to compare the combined cost of the subordinate notes and equity with the rate of return on equity under a conventional capital structure as well as to comparable income trust yields. That is to say the weighted average cost of the subordinate notes and equity should not exceed a fair rate of return on equity on an imputed, conventional capital structure.

The Commission Panel concludes that it does not need to draw inferences from the lack of evidence presented by PNG regarding the standard tests because the effect of approving the income trust structure for future adjustments to returns is much more limited than BCOAPO submits.

7.3 Mechanisms for Regulating Fair and Reasonable Returns

The Commission has established an automatic adjustment mechanism, for calculating rates of return on approved capital structures that is applied to utilities that have regulated rates of return. The automatic adjustment mechanism annually adjusts rates of return.

PNG commits that when it "seeks changes in rates in revenue requirement applications, and seeks an adjustment in return on capital, it will provide evidence that the applied for weighted average return to the income trust is appropriate relative to the actual yield required by the market.…Further,…PNG will provide evidence that the income trust capital structure continues to result in a competitive cost of capital relative to the cost of capital under the conventional structure" (PNG Argument, p. 21, para. 82; T7: 822).

PNG submits the primary mechanism for regulating the rates to the approved revenue requirement should be to deem an appropriate portion of third party debt in the capital structure (PNG Argument, p. 21, para. 80). It follows that deeming a portion of the third party debt in the capital structure would be necessary each time the revenue requirement is approved.

Commission Panel Determinations

The Commission Panel accepts that deeming the portion of the third party debt will, as appropriate, be the principal mechanism for regulating the cost of capital included in rates. Adjusting the rate of return on equity may also be used as a mechanism for regulating the cost of capital included in rates.

The Commission Panel anticipates that following approval of the income trust structure conversion, the 2005 revenue requirements for PNG-West may be the subject of an NSP. For the purposes of a capital structure to be used in the automatic adjustment mechanism, the Commission Panel expects that the capital structure stated in a negotiated settlement will be used. In the alternative, the Commission Panel will determine the appropriate capital structure for 2005 from the evidence filed in this proceeding as part of the PNG-West application.

8.0 SHAREHOLDER/UNIT HOLDER RISKS AND COSTS

PNG has taken on most all of the risks and costs related to conversion to an income trust structure, thereby shielding customers from virtually all risks.

- The Application states that PNG estimates that it will incur total costs in the range of $9 million to convert PNG to an income trust structure. This includes an underwriting commission of approximately 6 percent with respect to the IPO, early redemption and restructuring costs related to the third-party secured debt, and legal and other transaction costs. PNG shareholders will bear all of these costs and none of these costs will be recovered through PNG’s customer rates (Exhibit B-1, Application, p. 14). PNG testified that the only cost that it could think of which would be borne by ratepayers was the cost of this proceeding, and other than that, the shareholders of the Company will cover all of the costs (T6: 557-558). However, in paragraph 81(iii) of the Application PNG accepts that no costs associated with this Application will be recovered through customer rates.

- At some point it may become desirable for PNG to convert to another capital structure from the income trust structure. In response to questioning on what could be done to unwind the income trust structure, PNG was equivocal in its responses since it could not speculate on the potential reason for such an unwinding. It was noted that PNG accepted the possibility for the Commission to deem a capital structure as it currently does for PNG (T6: 559). The Company also agreed that the Commission would have the same powers to ask the Utility to convert to another capital structure as it has under the Act today (T6: 561). PNG accepts that if the reason for such an unwinding is a result of changes in income taxes, that this is a risk that the Company has accepted (T6: 561). PNG has accepted the cost risk if shareholders do not convert their shares to income trust units and if the IPO is unsuccessful or is not issued.

- While PNG hopes that it would be grandfathered from any new tax requirements affecting income trusts, it accepts that if the laws do change that it would be a shareholder risk (T5: 517-518, T6: 544).

- BCOAPO’s expert speculated that the Federal Department of Finance might not consider the subordinate debt as debt and might deem it to be equity for tax purposes. PNG responded that it could not get advance tax rulings on such questions of fact but that it would be getting an opinion from its underwriters that the subordinate debt would in fact be tax deductible (T6: 555-556).

- PNG intends to establish the Income Trust under the laws of British Columbia. Although British Columbia has not yet enacted shareholder protection legislation similar to that in Ontario, Quebec and Alberta, PNG identified that a discussion paper was currently being circulated with respect to the potential for such legislation and the Company anticipates that such legislation will be brought into effect in British Columbia (T5: 500-501).

- Since the subordinate debt would rank below the priority of the third-party secured debt, there is an ongoing risk that PNG may need to withhold cash from the shareholder note payments for such things as unanticipated events like line breaks and the impact if Methanex were to close its plant. In Exhibit B-6 a scenario analysis identifies that there would be virtually no cash available for servicing of subordinate debt if Methanex closed after 2009. However the same scenario identifies that PNG would be in an even worse position under its existing capitalization if Methanex closed.

- A final risk to the Company was raised in oral argument when PNG agreed that it would be difficult, if not impossible, for the Commission to establish the fair trade in yields of the PNG Income Trust if the Trust owned assets other than PNG. PNG is prepared to accept a condition requiring approval of the Commission before the PNG Income Trust can acquire any other asset (T7: 800). This is further addressed in Chapter 10 of this Decision.

Commission Panel Determinations

The Commission Panel notes that PNG's shareholders and future Income Trust unit holders have accepted virtually all risks and costs related to the proposed conversion to an income trust structure. **The Commission Panel is satisfied that the ratepayers will be well protected from unanticipated costs if the income trust structure is approved.**

9.0 APPROVAL OF INCOME TRUST

The PNG Application details the approvals being sought under Sections 50, 53, 54, 58 and 89 of the Act. Due to the many changes to the Application since it was filed, the Commission wrote to PNG on April 29, 2005 requesting that the Utility revise Exhibit B-1, pages 30-32 inclusive, as may be determined to be necessary by PNG. Exhibit B-14 provides the revisions to paragraphs 80 to 83 of the Application with respect to the approvals being sought from the Commission. The revised filing with respect to Commission approvals is as follows:

"APPROVALS SOUGHT

80. PNG hereby applies to the Commission:

(i) for approval of the acquisition by PNGT of all of the issued and outstanding common shares of PNG in exchange for common shares and subordinate notes of PNGT, pursuant to section 54 of the Act (See Step 2 on page 12 of the Application and Tab 2, page 2 which describe the initial step where PNGT acquires a "reviewable interest", as defined in section 54(4)(b) of the Act, in PNG. Under section 54(5)(c) of the Act PNG must not, without the approval of the Commission register a transfer of shares to a person if it causes the person to have a reviewable interest. Section 54(4)(b) of the Act states that a person has a reviewable interest in a public utility if the person owns or controls in the aggregate more than 20 percent of the voting shares outstanding of any class of shares of the utility. Upon completion of Step 2, PNGT will own 100 percent of the outstanding common shares of PNG);

(ii) for approval of the acquisition by the PNG Income Trust of indirect control of PNG upon the acquisition by the PNG Income Trust of all the issued and outstanding common shares and subordinate notes of PNGT in exchange for units of the PNG Income Trust, pursuant to section 54 of the Act (See Step 3 on page 12 of the Application and Tab 2, page 3 for a description of this step where the PNG Income Trust indirectly acquires a reviewable interest in PNG through its acquisition of PNGT, the direct owner of PNG);

(iii) for consent of the Lieutenant Governor in Council to the amalgamation of PNG, PNG(N.E.) and PNGT under the name "Pacific Northern Gas Ltd.", pursuant to section 53 of the Act (After the completion of Steps 2 and 3 as described in paragraphs (i) and (ii) above, the PNG Income Trust will own PNGT which in turn will own PNG which in turn owns PNG(N.E.). To complete the reorganization of the ownership of PNG by the PNG Income Trust requires that PNG, PNG(N.E.)

and PNGT amalgamate to form PNG, the utility to be regulated by the Commission. See Step 4 on page 13 of the Application and Tab 2, page 4. Section 53(1) of the Act provides that a public utility (i.e. PNG) must not amalgamate with another person (i.e. PNGT and PNG(N.E.)) unless the Lieutenant Governor in Council has first received from the Commission a report stating that the amalgamation would be beneficial in the public interest and then by order consenting to the amalgamation);

(iv) for approval of the acquisition by the PNG Income Trust of all the issued and outstanding common shares of amalgamated PNG, pursuant to section 54 of the Act (PNG Income Trust will become the holder of all of the common shares of amalgamated PNG following the amalgamation of PNG, PNG(N.E.) and PNGT as described in paragraph (iii) above);

(v) for approval of the issuance of additional common shares and subordinate notes by amalgamated PNG to the PNG Income Trust, pursuant to section 50 of the Act, the proceeds of which are to be used by amalgamated PNG to redeem all of its issued and outstanding preferred shares and approximately $31 million of its existing third party secured debt (See Step 5 on page 13 of the Application and Tab 2, page 5. Section 50(1) of the Act provides that a public utility must not issue a security without first obtaining approval of the Commission. Section 50(7) provides that the Commission may give is approval subject to the conditions and requirements considered necessary or desirable in the public interest);

(vi) for approval that the subordinate notes specified under paragraphs (i) and (v) above be issued in two blocks with one block equal to 70 percent of the total issue amount with a variable rate of interest ("Variable Rate Notes") and the other block equal to 30 percent of the total issue amount with a fixed rate of interest ("Fixed Rate Notes") with the following terms and conditions in respect of each issue:

Variable Rate Notes

Principal Amount:	70% of the principal amount of the subordinate notes issued by PNG to the PNG Income Trust in accordance with the foregoing transactions.
Interest Rate:	The interest rate to be set annually at the beginning of each calendar year equal to the closing yield of the benchmark long Canada bond of the prior year plus 5.75 percent.
Term:	Three equal tranches with bullet maturities of 10 years, 20 years and 30 years, respectively.
Prepayment:	Right to prepay in whole at any time and in part from time to time, with no make-whole payment, and conditional on PNG's Directors determining that PNG has sufficient "free cash flow" to permit repayment.

Principal Payments:	No mandatory principal payment obligations before maturity.

Fixed Rate Notes

Principal Amount:	30% of the principal amount of the subordinate notes issued by PNG to the PNG Income Trust in accordance with the foregoing transactions.
Interest Rate:	12% per annum.
Term:	Three equal tranches with bullet maturities of 10 years, 20 years and 30 years, respectively.
Prepayment:	The 20 year and 30 year tranches to be prepayable in whole at any time and in part from time to time, with the applicable make-whole payment, following the 10th anniversary of the issuance and conditional on PNG's Directors determining that PNG has sufficient "free cash flow" to permit repayment. The make-whole provisions to be determined in accordance with market practice at the time of issuance of the notes and subject to final Commission approval at that time.
Principal Payments:	No mandatory principal payment obligations before maturity.

(vii) for approval of the redemption by amalgamated PNG of all of its issued and outstanding preferred shares and approximately $31 million of its existing third party secured debt, subject to the Commission's approval of the final amount to be redeemed, pursuant to section 50 of the Act (See Step 6 on page 13 of the Application and Tab 2, page 6);

(viii) for approval for rate making purposes that amalgamated PNG's actual capital structure, after giving affect to the foregoing transactions, will apply to the three operating Divisions of PNG (i.e. PNG-West, Fort St. John/Dawson Creek and Tumbler Ridge) (See page 16 and page 20, paragraph 62(c) of the Application for the expected actual capital structure); and

(ix) for approval for rate making purposes that the return on PNG's actual common equity will continue to be fixed using the Commission's automatic return on equity adjustment formula as may be modified by the Commission from time to time and that the risk premiums relative to the low risk benchmark utility be 65 basis points for the PNG-West and Tumbler Ridge Divisions and 40 basis points for the Fort St. John/Dawson Creek Division.

81. The approvals sought by PNG are subject to the following conditions:

(i) that PNG files with the Commission, before any of the foregoing transactions are carried out, final details of the terms and conditions on which the foregoing transactions will be carried out, including in the case of the issuance of securities, the principal amounts of such securities to be issued and, in the case of the redemption of securities, the amount of such securities to be redeemed. This information will be made available to the Commission by PNG filing all of the documents required to carry out the foregoing transactions, including the final draft of the Plan of Arrangement described in paragraph 47 on page 12 of the Application prior to seeking approval of this document by PNG's shareholders and the Supreme Court of British Columbia and the final draft of the preliminary prospectus for the IPO described under Step 6 on page 13 of the Application;

(ii) that the Commission confirms with PNG, before any of the foregoing transactions are carried out, that it is satisfied with the terms and conditions on which the foregoing transactions are to be carried out; and

(iii) that no costs associated with this Application and no transaction costs, including amalgamation and securities issuance and redemption costs, related to the foregoing transactions shall be recovered through customer rates.

82. PNG also hereby applies to the Commission for an order pursuant to sections 58 and 89 of the Act making amalgamated PNG's existing rates (other than the rates charged to Methanex Corporation and West Fraser Mills Ltd.) interim effective as of the income trust conversion completion date, together with a direction that amalgamated PNG file a revenue requirement application with the Commission for final rates for all three operating Divisions, effective from the date the interim rates go into effect, reflecting the new actual capitalization, weighted average cost of capital and income tax expense of amalgamated PNG as a result of conversion to the income trust structure.

83. For all the reasons set out in this Application, PNG submits that PNG and the users of the services of PNG will not be detrimentally affected by the acquisition of a reviewable interest in PNG by the PNG Income Trust (section 54(9) of the Act) and the amalgamation of PNG, PNG(N.E.) and PNGT will be beneficial in the public interest (section 53(1)(a)(i) of the Act)."

Relevant Statutory Provisions and Tests

Briefly, PNG's Application and the associated requested approvals relate to the proposed acquisition of reviewable interests, the amalgamation of PNG, PNG(NE) and PNGT, and the issuance of securities under sections 54, 53 and 50, respectively, of the Act.

BCOAPO submits that to approve the Application, the Commission must find that: (1) the terms of the issued securities are reasonable and prudent and in the public interest; (2) the proposed capital structure is reasonable and prudent and in the public interest; and (3) the equity return at the trust level is fair and reasonable, meaning that it is neither "more than a fair and reasonable charge for service of the nature and quality provided," nor less (BCOAPO Argument, p. 31).

PNG submits that the law is not in dispute that the two relevant tests are absence of detriment for the customers and the public interest. The Company notes that the law is well-established that matters of public interest assessment in utility regulation are substantially within the purview of the Commission and are to be determined on the particular facts of the individual application (PNG Reply, para. 15, p. 5).

The amalgamation of PNG, PNG(NE) and PNGT is required to complete the reorganization of the ownership of PNG by the PNG Income Trust. Section 53(1) of the Act provides that a public utility must not amalgamate with another person unless the Lieutenant Governor in Council has first received from the Commission a report stating that the amalgamation would be beneficial in the public interest.

PNG submits for all the reasons set out in the Application, the amalgamation of PNG, PNG(NE) and PNGT will be beneficial in the public interest. BCOAPO sees no objection to the amalgamation of the PNG companies proceeding without regard to the decision on this Application (BCOAPO Argument, p. 46).

Commission Panel Determinations

The Commission Panel has reviewed the Application and evidence related thereto and has assessed the benefits identified by PNG and the proposed allocation of related risk and concludes that the proposed conversion to the income trust structure will not result in the users of the Utility service being detrimentally affected and the Commission Panel finds that the conversion is beneficial in the public interest. This being the case, **the**

Commission Panel is prepared to issue the approvals requested by PNG with the modifications and conditions which are further elaborated in this Decision. The Commission Panel will submit this Decision to the Lieutenant Governor in Council pursuant to Section 53(5) of the Act and will request that the LGIC issue an Order pursuant to Section 53(1) of the Act, including the conditions and requirements in this Decision to ensure that the proposed amalgamation will be beneficial in the public interest.

The Commission Panel has found that the proposed capital structure of the new PNG is both tax efficient and appropriate as a starting point for the income trust structure. The Commission Panel finds that the redemption of all of PNG's preferred shares and the reduction in third-party secured debt of approximately $31 million as proposed by PNG will add significant financial stability to the Utility in the event that Methanex closes. The Commission Panel also finds that the proposal to have 7 percent common equity in the new capital structure is tax efficient and that an equity risk premium relative to the low-risk benchmark Utility of 65 basis points for the PNG-West and Tumbler Ridge Divisions and 40 basis points for the Fort St. John/Dawson Creek Division is reasonable at this time.

With respect to the subordinate notes which will make up 53 percent of the capital structure, the Commission Panel has accepted that the issuance of 70 percent of the principal amount of these notes as variable-rate notes and 30 percent of the principal amount as fixed-rate notes is appropriate. Even though the interest payments on the variable-rate notes could rise with changes in the long Canada bond rate, PNG provided evidence that the spread between the variable-rate notes and the fixed-rate notes was appropriate.

As for the repayment conditions on the fixed-rate notes, PNG testified that the proposed "make-whole" payment was not necessary and that the Utility was prepared to delete that requirement. **The Commission Panel finds that the "make-whole" payment conditions should be deleted from the subordinate note conditions.**

The Commission Panel has discussed the appropriate returns to PNG on its common equity and subordinate notes and has concluded that the interest rate on the fixed-rate subordinate notes should be 11 percent per annum and the premium above the benchmark long Canada bond should be 4.75 percent for the floating rate subordinate debt.

The Commission Panel approves the conditions identified by PNG in paragraph 81 of the revised Application. In addition to those conditions, PNG has accepted that the owners of PNG will take on the risk with respect to costs resulting from tax changes as they may impact income trusts and the tax

deductibility by PNG of the subordinate notes in the future. This additional condition is required by the Commission Panel to ensure that ratepayers will continue to be held harmless from the proposed conversion to an income trust structure.

A number of additional conditions were identified by the Commission Panel during Oral Argument and were accepted by PNG. These additional conditions are discussed in Chapter 10 of this Decision and are to be part of the approval of the proposed conversion.

The next steps will be for PNG to file with the Commission, before any of the conversion transactions are carried out, final details of the terms and conditions on which the transactions will be carried out, including in the case of the issuance of securities, the principal amounts of such securities to be issued and, in the case of the redemption of securities, the amount of such securities to be redeemed. PNG will file with the Commission all of the documents required to carry out the transactions, including the final draft of the Plan of Arrangement and the preliminary prospectus for the IPO.

Once satisfied with the foregoing details, the Commission will issue an Order making PNG's rates interim (except for the fixed retention rates of Methanex and West Fraser Mills Ltd.) effective the date of the income trust conversion, and requiring PNG to make a revenue requirement filing based on the new cost structure.

10.0 CONDITIONS OF APPROVAL

BCOAPO submits that regulation of the PNG Income Trust is necessary to ensure adequate regulatory capacity. The Commission has concluded that regulation of the income trust is not necessary, and has also concluded that approval of the conversion of the Utility to an income trust structure should be subject to certain conditions (T7: 794). The conditions and their purpose are identified in this section.

Counsel for PNG submits that PNG's control over the conditions does not in any way limit the Commission's jurisdiction to impose conditions on PNG and that the Commission can, at any time, direct conversion back to a conventional capital structure (T7: 804).

During Oral Argument, counsel on behalf of PNG agreed to, and accepted, the potential conditions proposed by the Chair as revised with the benefit of submissions at that time. The conditions are to be incorporated by reference into the prospectus and the trust indenture. For greater certainty, the conditions do not need to be repeated in the prospectus and trust indenture but should be referred to in the prospectus and trust indenture.

Condition #1 - Prior Approval of Acquisition of Other Assets

Without first obtaining the Commission's approval, the PNG Income Trust shall not hold an interest in any entity or property other than PNG. If the PNG Income Trust does hold an interest in any entity or property other than PNG, then the Commission can require PNG to appear before it and demonstrate that the PNG Income Trust structure continues to be in the public interest and otherwise complies with the Act. If the Commission determines that the PNG Income Trust structure is no longer in the public interest or otherwise does not comply with the Act, on notice to PNG and after a hearing, the Commission may make an order imposing on PNG conditions or requirements respecting the ownership of PNG and any other conditions or requirements the Commission determines to be appropriate.

Purpose – The purpose of Condition #1 is to ensure that the Commission can determine fair and reasonable returns, particularly prior to the development of standard tests, and to ensure that capital allocation decisions by the PNG Income Trust are not detrimental to the management and operation of the Utility. Once standard tests to determine fair and reasonable returns to be paid by PNG to the PNG Income Trust are established with sufficient trading history to make them workable, PNG may apply to have Condition #1 removed.

Condition #2 - Third Party Debt Issued as Directed by Commission

If the Commission, after inquiry, considers that it is necessary and reasonable that PNG issue to any party other than the PNG Income Trust any bond, debenture, note or other debt instrument, then the Commission may require the Utility to issue such securities and PNG shall issue such securities and seek such approvals as are required by the Act.

Purpose – The purpose of Condition #2 is to ensure that the capital structure of PNG is in the public interest and otherwise complies with the Act.

Condition #3 – Issue and Call of Subordinate Notes

If the Commission, after inquiry, considers that it is necessary and reasonable that PNG either issue or call subordinate notes, then the Commission may require PNG to issue or call such securities and PNG shall issue or call such securities and seek such approval as are required by the Act.

Purpose – The purpose of Condition #3 is to ensure that the capital structure of PNG is in the public interest and otherwise complies with the Act. With Conditions #2 and #3 acting together, the Commission will have the authority to direct PNG to replace the subordinate notes with third party debt.

Condition #4 - Regulatory Capacity and Change in Law

PNG acknowledges that the Commission has the authority to either: 1) deem the portion of third party debt in the capital structure so that the weighted average cost of the subordinate notes and equity for setting rates provides an opportunity to earn the fair rate of return on equity, assuming an imputed conventional capital structure; or 2) deem the portion of third party debt in the capital structure for setting rates to provide an opportunity to earn the fair rate of return on the subordinate notes and equity, assuming the subordinate notes are equity-like. If a court decision restricts the powers of the Commission to deem the portion of third party debt for the purposes of calculating rates, then the Commission can require PNG to appear before it and demonstrate that the income trust structure is still in the public interest and otherwise complies with the requirements of the Act.

Purpose - The purpose of Condition #4 is to ensure that the Commission can deem third party debt as a means to ensure that rates are in compliance with the Act. A further purpose of Condition #4 is to ensure that the interest payments due to the PNG Income Trust pursuant to the terms of the subordinate notes, as may be approved by the Commission, are neither determinative of nor relevant to the cost of capital recoverable in rates.

Condition #5 – PNG Acceptance of Condition

By converting to the income trust structure, PNG accepts that the conversion to an income trust structure is subject to the above conditions and undertakes to do whatever may be within its powers to ensure the conditions are satisfied. If at any time the conditions are not satisfied, PNG accepts that the Commission may, on notice to PNG and after an inquiry, direct PNG to call the subordinate notes and recapitalize under a conventional capital structure.

Purpose – Condition #5 is necessary because the PNG Income Trust is not regulated. In this regard, the Commission Panel acknowledges that PNG may not be able to ensure that the conditions are satisfied. However, if the conditions are not satisfied at any time in the future, then the Commission may order the recapitalization of the Utility with a conventional capital structure.

Dated at the City of Vancouver, in the Province of British Columbia, this 9 day of September 2005.

Robert H. Hobbs
Chair

Lori A. Boychuk
Commissioner

Robert W. Whitehead
Commissioner

BRITISH COLUMBIA
UTILITIES COMMISSION

ORDER
NUMBER G-84-05

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

and

An Application by Pacific Northern Gas Ltd.
For Approval to Convert to an Income Trust

BEFORE: R.H. Hobbs, Chair
L.A. Boychuk, Commissioner
R.W. Whitehead, Commissioner

September 9, 2005

O R D E R

WHEREAS:

A. On December 17, 2004, Pacific Northern Gas Ltd. ("PNG") filed for approval of its 2005 Revenue Requirements Application to amend its rates on an interim and final basis, effective January 1, 2005, pursuant to Sections 89 and 58 of the Utilities Commission Act ("the Act"); and

B. On December 17, 2004, PNG also filed an "Application for approval to Convert to an Income Trust" ("Income Trust Application") (collectively "the Applications"); and

C. The PNG 2005 Revenue Requirements Application proposes to increase delivery rates to all customers, except West Fraser Mills and Methanex Corporation, as a result of increases in cost of service and lower gas deliveries to most customers classes; and

D. By Order No. G-114-04 the Commission approved an interim rate increase in the delivery rates for all classes of customers, except West Fraser Mills and Methanex Corporation, effective January 1, 2005 subject to refund with interest; and

E. By Order No. G-114-04 the Commission also established a Pre-hearing Conference ("PHC") in Vancouver which was held January 20, 2005 to address procedural matters related to the Applications, including the identification of principal issues and the process options for review of the Applications; and

. . ./2

F. At the PHC, some Intervenors raised concerns regarding PNG's request to review its Income Trust Application prior to the fall 2005 General Review of Return on Equity ("ROE") and Capital Structure that has been scheduled by Commission Order No. G-88-04 ("the General ROE Review"); and

G. The Commission, by letter dated January 26, 2005 to PNG and the Registered Intervenors (Exhibit A-3), addressed the issues raised at the PHC. The Commission determined that the review of the PNG Income Trust Application will precede the General ROE Review and that the expert evidence and testimony at the hearing into PNG's Income Trust Application is to address the cost of capital under the 2005 Revenue Requirements Application and the Income Trust Application; and

H. An oral public hearing was held in Vancouver from May 10, 2005 to May 13, 2005, to review the Income Trust Application, along with the capital component of the 2005 Revenue Requirement Application; and

I. The Commission has considered the Income Trust Application and the capital component of the 2005 Revenue Requirements Application along with evidence and arguments, all as set forth in the Decision issued with this Order.

NOW THEREFORE the Commission orders as follows:

1. The Income Trust Application is approved subject to the modifications, conditions and directions identified in the Decision dated September 9, 2005 issued concurrently with this Order.

DATED at the City of Vancouver, in the Province of British Columbia, this 9 day of September 2005.

BY ORDER

Robert H. Hobbs
Chair

GLOSSARY AND ABBREVIATIONS

Acronym	Term
Amalgamated PNG	Amalgamation of PNG, PNG(NE) and PNGT as one company under the name Pacific Northern Gas Ltd.
Application	Pacific Northern Gas Ltd.'s Application for approval to recapitalize under an income trust ownership structure dated December 17, 2004
BCOAPO	The BC Old Age Pensioners' Organization et al.
BCUC or Commission	British Columbia Utilities Commission
CAPM	Capital Asset Pricing Model
CCA	Capital Cost Allowance
CRA	Canadian Revenue Agency
DBRS	Dominion Bond Rating Service
EBITDA	Earnings before Income Tax, Depreciation and Amortization
ERP	Equity Risk Premium
IPO	Initial Public Offering
LGIC	Lieutenant Governor in Council
MEM or Ministry	Ministry of Energy and Mines
Methanex	Methanex Corporation
NSP	Negotiated Settlement Process
PNG 2005 RR	PNG 2005 Revenue Requirements Application
PNG, Utility or Company	Pacific Northern Gas Ltd.
PNG(NE)	Pacific Northern Gas (N.E.) Ltd.
PNGT	Pacific Northern Gas Transition Ltd.
PNG-West	Pacific Northern Gas Ltd. (West)
ROE	Return on Common Equity
RoyNat	RoyNat Inc.
UCA or Act	Utilities Commission Act

LIST OF APPEARANCES

G.A. FULTON P. MILLER	Commission Counsel
G.K. MACINTOSH, Q.C. C.P. DONOHUE K. TEITGE	Pacific Northern Gas Ltd.
D. HUMBER	West Fraser Mills Limited
G. BIERLMEIER	Ministry of Energy and Mines, Gas & Oil Division
R.J. GATHERCOLE	B.C. Old Age Pensioners' Organization Council of Senior Citizens' Organization of BC Senior Citizens Association of British Columbia West End Seniors Network Federated Anti-Poverty Groups of BC End Legislated Poverty Society Tenants Rights Action Coalition

EXHIBIT LIST

Exhibit No.	**Description**
Commission Documents	
A-1	Letter dated December 22, 2004 and Order No. G-114-04
A-2	Letter dated January 18, 2005 enclosing a Draft Pre-hearing Conference Issues List and two alternative draft regulatory timetables
A-3	Letter dated January 26, 2005 addressing issues raised at the Pre-hearing Conference
A-4	Order No. G-15-05 and Letter dated February 1, 2005 establishing an oral public hearing for the Income Trust Application and a Pre-hearing Conference for the 2005 Revenue Requirements
A-5	Letter and Commission Information Request No. 1 dated February 4, 2005
A-6	Letter and Commission Information Request No. 2 dated March 4, 2005
A-7	Letter and Commission Information Request No. 3 dated March 24, 2005
A-8	Letter and Commission Information Request No. 1 dated April 12, 2005 on the Expert Evidence of John McCormick filed on behalf of The BC Old Age Pensioners Organization *et al*.
A-9	Letter dated April 29, 2005 regarding the public hearing process for the Pacific Northern Gas Ltd. Application to Convert PNG to an Income Trust
A-10	Letter dated June 29, 2005 setting the Oral Phase of Closing Argument
Applicant Documents	
B-1	**Pacific Northern Gas Limited -** Application dated December 17, 2004 for Approval to Convert to an Income Trust
B-2	Letter and proposed regulatory timetable dated January 28, 2005
B-3	Response dated February 18, 2005 to Commission Information Request No. 1
B-4	Written Evidence of David Bustos and Alan Wallace dated February 25, 2005
B-5	March 18, 2005 Responses to Information Requests for the following: BCUC IR-2 BCOAPO IR-1 BCMEM IR-1

Exhibit No.	Description
B-6	March 24, 2005 Response to BCUC Information Request No. 2, Question 47
B-7	March 30, 2005 Amended Response to BCOAPO Information Request No. 1, Question 184
B-8	Response dated April 1, 2005 to Commission Information Request No. 3, and The BC Old Age Pensioners Organization et al. and Ministry of Energy and Mines Information Requests No. 2
B-9	Revised response to The BC Old Age Pensioners Organization et al. Information Request No. 2, (Exhibit No. B-8) Pages 24 and 25
B-10	Information Request No. 1 dated April 12, 2005
B-11	Rebuttal Supplemental Evidence of Pacific Northern Gas Ltd. dated April 21, 2005
B-12	Rebuttal Supplemental Evidence of Kathleen McShane dated April 21, 2005
B-13	Rebuttal Supplemental Evidence of David Bustos and Alan Wallace dated April 21, 2005
B-14	Letter dated May 3, 2005 and revisions to the Application pages 30 to 32 in response to the Commission letter of April 29, 2005 (Exhibit A-9)
B-15	Letter dated May 3, 2005 identifying witness panels for Pacific Northern Gas Ltd.
B-16	Letter dated May 5, 2005 providing the Curriculum Vitae for R.G. Dyce, E.A. Fletcher, K.R. Teitge and C.P. Donohue
B-17	PNG Undertaking – Transcript Reference: Page 130 – 131
B-18	PNG Undertaking – Transcript Reference: Page 138 – 139
B-19	PNG Undertaking – Transcript Reference: Page 167
B-20	PNG Undertaking – Transcript Reference: Page 137 - 138
B-21	Schedule of Activities to complete PNG Income Trust Conversion
B-22	PNG Undertaking – Transcript Reference: Page 252
B-23	Credit Rating Report – AltaLink, L.P. dated November 24, 2004
B-24	Alberta Energy and Utilities Board - Decision 2003-061 ~ AltaLink Management Ltd. and TransAlta Utilities Corp, Transmission Tariff for May 1, 2002 – April 30, 2004 and TransAlta Utilities Corp, Transmission Tariff for January 1, 2002 – April 30, 2002 dated August 3, 2003
B-25	Pacific Northern Gas Ltd. – Income Trust Conversion Application Hearing ~ D. Bustos/A. Wallace Undertakings from Day 3, May 12, 2005

Exhibit No.	**Description**
B-26	PNG Undertaking – Transcript Reference: Page 522
B-27	Witness Aid – John McCormick – Calculation of the Account Based ROE – Clean Power 2004
B-28	2004 Financial and Operating Highlights
B-29	Illustrative Impact of Levelized Revenue on Earned Returns
B-30	PNG Undertaking – Transcript Reference: Page 426
B-31	PNG Undertaking – Transcript Reference: Page 624 - 626

Intervenor Documents

C1-1	**TERASEN GAS INC.** – Notice of Intervention dated January 5, 2005 from Scott Thomson
C2-1	**MINISTRY OF ENERGY AND MINES** – Notice of Intervention dated January 11, 2004 from Stirling Bates
C2-2	Letter and Information Request No. 1 dated March 9, 2005
C2-3	Letter and Information Request No. 2 dated March 24, 2005
C2-4	Witness Aid spreadsheets prepared by Grant Bierimeier, Ministry of Energy and Mines
C3-1	**THE BC OLD AGE PENSIONERS ORGANIZATION ET AL.** – Notice of Intervention dated January 13, 2005 from Richard J. Gathercole
C3-2	Letter and Information Request No. 1 dated March 9, 2005
C3-3	Letter and Information Request No. 2 dated March 24, 2005
C3-4	Letter and written evidence of John McCormick dated April 6, 2005
C3-5	Response dated April 19, 2005 to Commission IR-1 on the Expert Evidence of John McCormick filed on behalf of The BC Old Age Pensioners Organization et al.
C3-6	Response dated April 19, 2005 to PNG Information Request on the Expert Evidence of John McCormick filed on behalf of The BC Old Age Pensioners Organization et al.
C3-7	Letter dated April 26, 2005 advising that BCOAPO will not being filing further information requests or evidence
C3-8	The Canadian Institute of Chartered Business Valuators Export Reports - Standards No. 310 entitled "Report Disclosure Standards and Recommendations"

Exhibit No.	Description
C3-9	The Canadian Institute of Chartered Business Valuators Export Reports - Standards No. 320 entitled "Scope of Work Standards and Recommendations"
C3-10	Fair Market Curve Analysis Sector 351 dated May 6, 2005, Copyright 2005 Bloomberg L.P.
C3-11	Fair Market Curve Analysis Sector 297 dated May 6, 2005, Copyright 2005 Bloomberg L.P.
C3-12	The BC Old Age Pensioners Organization *et al.* Undertaking – Transcript Reference: Page 680 - 681 and 713 - 714
C4-1	**AVISTA ENERGY INC.** – Notice of Intervention dated January 27, 2005 from Nick Caumanns
C5-1	**METHANEX CORPORATION** – Notice of Intervention dated February 1, 2005 from Vincent Tong

Letters of Comment

E-1	Letter of Comment dated May 5, 2005 from Steve Thorlakson
E-2	Letter of Comment dated May 5, 2005 from Mayor Richard Wozney, District of Kitimat
E-3	Letter of Comment dated May 9, 2005 from Victor Kumar, City Manager, City of Prince Rupert
E-4	Letter of Comment dated May 9, 2005 from Mayor Jack Talstra, City of Terrace