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**BRITISH COLUMBIA
UTILITIES COMMISSION**

**ORDER
NUMBER** G-112-05

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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 Reconsideration of the Commission Decision and Order No. G-84-05
Approval to Convert to an Income Trust**

BEFORE: R.H. Hobbs, Chair
L.A. Boychuk, Commissioner October 25, 2005
R.W. Whitehead, Commissioner

O R D E R

WHEREAS:

- A. On December 17, 2004, Pacific Northern Gas Ltd. ("PNG") filed an Application for approval to Convert to an Income Trust structure (the "Income Trust Application"); and
- B. Following a Pre-hearing Conference and an oral public hearing in Vancouver, the Commission by Order No. G-84-05 and Decision dated September 9, 2005, approved the Income Trust Application subject to the modifications, conditions and directions identified in the Decision (the "IT Decision"); and
- C. The IT Decision approved an interest rate on the fixed-rate subordinate notes of 11 percent and an interest rate on the variable-rate subordinate notes of 4.75 percent above long Canada bonds; and
- D. On October 7, 2005, PNG applied for Reconsideration and Variance of the IT Decision ("the Reconsideration Application") and requested review by way of an oral hearing. The Reconsideration Application stated that, in order for the PNG Income Trust to proceed, it was essential that the Commission approve the requests from the Income Trust Application for an interest rate of 12 percent on the fixed-rate subordinate notes and an interest rate of 5.75 percent above long Canada bonds for the variable-rate subordinate notes; and

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- E. The Commission, by letter dated October 17, 2005 (Exhibit A-1), advised PNG, the registered intervenors and interested parties of the Income Trust Application that a Procedural Conference would be held on Thursday, October 20, 2005 to determine if a reconsideration hearing should proceed; and
- F. In attendance at the Procedural Conference were PNG, the BC Old Age Pensioners' Organization, et al. ("BCOAPO"), Commission Counsel, and Commission staff. The Commission received submissions from PNG and BCOAPO on whether the Reconsideration Application met the criteria for reconsideration under the Commission's guidelines; and
- G. The Commission has considered the submissions of the parties on PNG's Reconsideration Application and considers that an amendment to the determinations in the IT Decision is warranted.

NOW THEREFORE the Commission orders as follows:

1. The Commission approves PNG's request that the determination on page 32 of the IT Decision be amended.
2. The Commission finds for PNG that the interest rate on the fixed-rate subordinate notes should be 12 percent. The interest rate for the variable-rate subordinate notes should be 5.75 percent above long Canada bonds.

DATED at the City of Vancouver, in the Province of British Columbia, this 28th day of October 2005.

BY ORDER

Original signed by:

Robert H. Hobbs
Chair

Attachment

PACIFIC NORTHERN GAS LTD. (“PNG”)
APPLICATION FOR RECONSIDERATION AND VARIANCE
OF COMMISSION DECISION DATED SEPTEMBER 9, 2005

REASONS FOR DECISION

On October 7, 2005 PNG applied (the “Reconsideration Application”) to the Commission pursuant to section 99 of the Utilities Commission Act (the “Act”), for reconsideration and variance of that portion of the Commission’s September 9, 2005 Decision (the “Decision”) approving PNG’s December 17, 2004 Income Trust Application (the “Application”) that determined that the interest rate on the fixed-rate subordinate notes to be issued by PNG to the PNG Income Trust should be 11 percent, and not 12 percent as applied for PNG, and that the interest rate on the variable-rate subordinate notes should be 4.75 percent above long Canada bonds, and not 5.75 percent as applied for by PNG.

On October 17, 2005 the Commission issued a letter to Registered Intervenor and Interested Parties in the previous Income Trust proceeding establishing an oral procedural conference to be held on Thursday, October 20, 2005. The procedural conference was held on that day and the participants included PNG, the BC Old Age Pensioners’ Organization et al. (“BCOAPO”) and Commission staff.

In the Reconsideration Application, PNG submits:

In PNG’s submission, it is clear on the face of the Decision that the Commission equated the appropriate rate of interest on the subordinate notes with the evidence of PNG’s expert witnesses that the market yield required by prospective investors in the units of the PNG Income Trust is between 10 and 12 percent (Reconsideration Application, para. 2).

In the Reconsideration Application, PNG further submits that it is essential in order for the PNG Income Trust to proceed to have the interest rate on the fixed-rate subordinate notes set at 12 percent and the interest rate on the variable-rate subordinate notes set at 5.75 percent above long Canada bonds. Further, PNG states that “The 100 basis point reduction in the interest rate on the subordinate notes from that applied for by PNG will, on its own, reduce PNG’s cash flow and EBITDA. The lower amount of EBITDA will require PNG to redeem more ... third party debt.” (Reconsideration Application, para. 18).

The Commission Panel does not accept that the interest rate on the subordinate notes will, on its own, reduce PNG’s cash flow and EBITDA. It follows that the Commission Panel also does not accept that the interest rate on the subordinate notes will, on its own, reduce the amount of third party debt in the capital structure assuming the amount of third party debt is determined by PNG’s cash flow and EBITDA. As stated in the Decision:

... 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 (Decision, p. 38).

PNG's cash flow is determined by the level of rates. Therefore, the interest rate on the subordinate notes could only determine the cash flow to PNG if the interest rate on the subordinate notes was relevant for rate making purposes. However, as expressly stated above, the interest rate on the subordinate notes is neither determinative of, nor relevant to, costs of capital that are recoverable in rates beyond the 2005 test year. Given the Negotiated Settlement for 2005, it follows that the interest rate on the subordinate notes is not material to customers.

During the Procedural Conference, PNG confirmed its position that without a 100 basis point increase to the interest rates on the subordinate notes the conversion cannot proceed and with the change the conversion may possibly proceed (T1: 30). PNG submits that the cash flow, will at a given market yield on the trust units, determine the value of PNG's common shares and hence the conversion price to be received by PNG's existing shareholders (Reconsideration Application, para. 3). Further, PNG submits that at the higher cash flow and at the anticipated required market yield on the trust units, conversion of PNG's existing common shares would occur at approximately book value (Reconsideration Application, para. 17).

PNG states that in the first instance the cash flow to the PNG Income Trust would be determined in large part by the interest rate on the subordinate notes, which will change over time, by future commission decisions that may deem third party debt so as to impact the interest rates coming from these subordinate notes (T1: 34-35). Further, PNG recognizes that the cash flow to PNG will be subject to future regulatory decisions that will establish the cost of capital recoverable in rates (T1: 43-44). The Commission will 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 (Decision, p. 41).

During the Procedural Conference in response to a question from the Chair, participants said that they would not object if the Commission was to revise the rates by this decision (T1: 70). The Commission Panel concludes that it should revise the rates in the Decision. In this regard, the Commission Panel agrees with counsel for BCOAPO that in these circumstances "it's probably in the best interests of all parties that the matter proceed and the utility determine whether or not it can proceed with a conversion based on what is the best situation for it" (T1: 73). The Commission Panel considers that the interest rate on the subordinate notes are not material to customers for test years beyond 2005 and notes that the conversion will minimize rates to customers. As stated in the 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 capital structure because it will provide a fair opportunity to earn a reasonable return and minimize rates to customers (Decision, p. 26).

Therefore, the Commission Panel increases the interest rate on the subordinate notes by 100 basis points from those found in the Decision, that is, the interest rate on the fixed-rate subordinate notes to be issued by PNG to the PNG Income Trust should be 12 percent as applied for PNG, and that the interest rate on the variable-rate subordinate notes should be 5.75 percent above long Canada bonds as applied for by PNG. The Decision is otherwise effective, and no other revisions to the Decision are made by this decision.