



Verlon G. Otto
Director, Regulatory Affairs

Pacific Northern Gas Ltd.
2550 - 1066 West Hastings Street
Vancouver, BC V6E 3X2
Tel: (604) 691-5680
Fax: (604) 697-6210
Email: votto@png.ca

Via E-File

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B.C. Utilities Commission
Suite 410, 900 Howe Street
Vancouver, BC V6Z 2N3

File No.: 4.2(2019)

Attention: Patrick Wruck
Commission Secretary and Manager, Regulatory Services

Dear Mr. Wruck:

**Re: Pacific Northern Gas Ltd.
Certificate of Public Convenience and Necessity for Watson Island Customer Tie-in
Establishment of Depreciation Rate
Response to BCUC Information Request No. 1**

Accompanying, please find a copy of PNG's responses to BCUC Information Request No. 1 on the referenced application.

Please direct any questions regarding the attached to my attention.

Yours truly,

A handwritten signature in black ink, appearing to read 'Verlon G. Otto', is written over a light grey rectangular background.

Verlon G. Otto

Attachment

Pacific Northern Gas Ltd.
Application for a Certificate of Public Convenience and Necessity
For Construction of Watson Island Customer Tie-In

INFORMATION REQUEST NO. 1 TO PACIFIC NORTHERN GAS LTD.

- 1.0 Reference: Depreciation**
Exhibit B-1, Application, p. 9;
Exhibit B-3, British Columbia Utilities Commission (BCUC) IR 3.1.1
Depreciation Rates

On page 9 of the Application for a Certificate of Public Convenience and Necessity For Construction of Watson Island Customer Tie-In (Application), Exhibit 2-2 presents an analysis whereby, “the WICT [Watson Island Customer Tie-In] assets have been depreciated at the depreciation rates applicable to distribution pipeline and regulating assets (base case). This reflects the expectation that this long-life asset will continue to be used and useful beyond the initial GSA [gas sales agreement] term.”

On page 9 of the Application, Exhibit 2-3 presents an analysis:

...For illustrative purposes... to demonstrate the impact on the NPV of the incremental margin if the WICT assets were to be depreciated evenly over the primary 20-year term of the GSA at a flat rate of 5% per year (test case, depreciate capital cost over 20 years). This conservative scenario has been presented to illustrate that the capital and operating costs of the WICT would be fully recovered over the primary term of the GSA under the established contractual arrangements, and that moderate incremental margin of \$ [redacted] million would be generated to the benefit of other customers.

In its response to BCUC IR 3.1.1, Pacific Northern Gas Ltd. (PNG) states, “... in reality, the depreciation of these assets would be in accordance with existing regulatory practice for the respective asset class. PNG is confident that these assets would remain in place and be used and useful for the life of the asset and beyond the initial contract term.”

- 1.1 Please describe the method of depreciation for the WICT assets if they are depreciated “in accordance with existing regulatory practice for the respective asset class” and provide the applicable depreciation rates by asset class.

Response:

PNG anticipates depreciating the WICT assets in accordance with its established regulatory practice of depreciating assets over their estimated useful lives. As the WICT assets are primarily distribution pipeline and regulating assets, they are comprised of assets classified to BCUC 475 – Distribution Mains and BCUC 477 – Regulating. BCUC 475 assets are depreciated over the estimated useful life of 65 years for assets in this class at a rate of 1.538%. BCUC 477 assets are depreciated over the estimated useful

life of 35 years for assets in this class at a rate of 2.857%. This is what has been modeled in PNG’s financial analysis presented in Exhibit 2-2a of the Application.

- 1.1.1 If depreciation rates based on “existing regulatory practice for the respective asset class” are used, please confirm the undepreciated plant balance of the WICT assets at the end of the 20-year GSA term.

Response:

The undepreciated plant balance of the WICT assets at the end of the 20-year GSA term is estimated to be \$2.386 million. This amount was illustrated in the revised Exhibit 2-2a filed in response to BCUC Confidential Staff Question 1.6.1 as the addition to the Stranded Asset Deferral Account in 2040, at the end of the 20-year GSA term, in Cell AD107 of worksheet “2-2a - WICT-Reg Dep”.

- 1.1.2 If the WICT assets are no longer used and useful at the end of the 20-year GSA term, please confirm the proposed regulatory accounting treatment for the undepreciated plant balance of the WICT assets, and the average annual rate impact of this treatment for PNG’s existing ratepayers.

Response:

In the unforeseen event that the WICT assets are no longer used and useful at the end of the 20-year GSA term, PNG would propose to retire the asset and defer the undepreciated plant balance of the WICT assets in the Ordinary Plant Gain and Loss deferral account to be amortized over five years. This would be consistent with PNG’s current BCUC-approved treatment for asset retirements.

This approach was illustrated in the revised Exhibit 2-2a filed in response to BCUC Confidential Staff Question 1.6.1. Revised Exhibit 2-2a also illustrated the cost of service impact of this treatment for the years 2040 through 2044, specifically:

Year	2040	2041	2042	2043	2044
Year over year cost of service increase (decrease)	1.738%	(0.111%)	(0.111%)	(0.111%)	(0.111%)

Using the approved cost of service for 2019, the current residential delivery rate of \$12.16/GJ and the 2019 average residential customer use per account of 70.8 GJ/year, PNG estimates the average annual residential bill impact of amortizing the undepreciated plant balance over a five-year period is an increase of \$13.29 during the five-year amortization period. PNG notes that during the 20-year primary term of the GSA, the average annual residential bill impact is a decrease of \$2.32.

Please also see PNG’s response to BCUC Confidential IR 1.2 and the associated financial analysis exhibits.

- 2.0 Reference: Depreciation Accounting Standards Codification (ASC), Master Glossary, ASC 360-10-35-4¹; Exhibit B-1, p. 9; Exhibit B-3, BCUC IR 3.1.1 Useful Life and US GAAP**

The ASC Master Glossary defines Useful Life as “The period over which an asset is expected to contribute directly or indirectly to future cash flows.”

Further, ASC 360-10-35-4 states:

The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles (GAAP) required that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation.

- 2.1 Please identify the relevant factors from PNG’s perspective that should be considered in determining the useful life of an asset for the purpose of setting depreciation rates in accordance with US Generally Accepted Accounting Principles (GAAP).

Response:

PNG considers various factors in determining the estimated useful life of an asset which are discussed in US GAAP in ASC 350-30-35-3:

- The intended use of the asset by the entity;
- The expected useful life of another asset to which the useful life of the asset may relate;
- Any legal, regulatory, or contractual provisions that may limit the useful life;
- The entity’s own historical experience in working with similar assets;
- The effects of obsolescence, demand, competition, and other market conditions; and
- The level of maintenance required to obtain the expected future cash flows from the asset.

PNG notes that, similar to most other utilities, useful life estimates are supported by periodic depreciation studies undertaken by independent depreciation consultants. Depreciation studies give consideration to estimated lives for asset groups, including a peer review and consultation with utility staff to identify company-specific factors that may impact service lives. The last depreciation study for

¹ Accounting Standards Codification, Master Glossary retrieved from https://asc.fasb.org/help&cid=1175804734816#master_glossary_1176153627844.

PNG was completed in August 2017 with the resultant depreciation rates being implemented effective January 1, 2018. The 2017 Depreciation Study and the rates proposed therein were subject to BCUC review and approved as part of PNG's 2018-2019 Revenue Requirements Application.

- 2.2 Does PNG consider that setting depreciation rates using contract term as the basis for useful life is permitted under US GAAP? Please explain why or why not, with reference to the relevant factors that should be considered and the applicable US GAAP section.

Response:

PNG considers that setting depreciation rates using contract terms as the basis for useful life is not permitted under US GAAP. The US GAAP ASC Master Glossary defines the term "Useful Life" as "the period in which the asset is expected to contribute directly or indirectly to future cash flows."

PNG anticipates that terms will be renewed after the expiration of the primary contract term. Furthermore, the WICT assets are expected to generate cash flows after the primary and any renewal contract terms expire as the assets are expected to remain useful and in use. Considering the useful life of WICT assets as discussed in response to Question 1.1, useful life exceeds contract terms materially.

PNG notes that theoretically it is possible for contract terms and useful life to be the same under US GAAP if an entity does not intend to use assets for cash generating activities after contract terms end. As discussed above, this is not the case for the WICT assets.

As noted above, setting depreciation rates using contract terms is not permitted under US GAAP. PNG also believes that setting depreciation rates using contract terms could result in unintended consequences such as greater administrative efforts and intergenerational inequity in situations where the asset can be reused after the expiration of the contract term.

On page 9 of the Application, Exhibit 2-2 presents an analysis whereby “the WICT assets have been depreciated at the depreciation rates applicable to distribution pipeline and regulating assets (base case). This reflects the expectation that this long-life asset will continue to be used and useful beyond the initial GSA term.”

In its response to BCUC IR 3.1.1 PNG states, “... in reality, the depreciation of these assets would be in accordance with existing regulatory practice for the respective asset class. PNG is confident that these assets would remain in place and be used and useful for the life of the asset and beyond the initial contract term.”

- 2.3 Please provide PNG’s estimate of the useful life of the WICT assets by asset class, with a discussion of the rationale to support the estimate.

Response:

PNG anticipates depreciating the WICT assets in accordance with its established regulatory practice of depreciating assets over their estimated useful lives. As noted in response to Question 2.1, estimated useful lives of assets are established and reviewed periodically as part of the depreciation study process.

As the WICT assets are primarily distribution pipeline and regulating assets, they are comprised of assets classified to BCUC 475 – Distribution Mains and BCUC 477 – Regulating. BCUC 475 assets are depreciated over the estimated useful life of 65 years for assets in this class at a rate of 1.538%. BCUC 477 assets are depreciated over the estimated useful life of 35 years for assets in this class at a rate of 2.857%. This is what has been modeled in PNG’s financial analysis presented in Exhibit 2-2a of the Application.

PNG notes that the 2017 Depreciation Study was filed as Appendix D to Exhibit B-1-1 of the PNG-West 2018-2019 Revenue Requirements Application proceeding.

**3.0 Reference: Depreciation Rates
Exhibit B-1, p. 9; PNG Application Regarding Process for Allocation of
Reactivated Capacity (RECAP) and Approval of Large Volume Industrial
Transportation Rate proceeding (PNG RECAP Proceeding), Exhibit B-4, BCUC
IR 27.13
Contract Term**

On page 9 of the Application, Exhibit 2-3 presents an analysis “for illustrative purposes... to demonstrate the impact on the NPV of the incremental margin if the WICT assets were to be depreciated evenly over the primary 20-year term of the GSA at a flat rate of 5% per year (test case, depreciate capital cost over 20 years).”

In its response to BCUC IR 27.13, in the PNG RECAP Proceeding, PNG states:

PNG is not aware of any situation where it uses a depreciation rate based on agreement terms for any other assets in its revenue requirements. PNG has often provided financial analysis using depreciation rates based on contractual terms to demonstrate that the revenues to be received from agreements negotiated with customers will cover all operating and capital costs during the term of the contract. PNG has provided this for illustrative purposes only.

- 3.1 If PNG were directed to use a depreciation rate based on the GSA contract term for the WICT assets, please discuss the mechanics of how the accounting for this would be implemented and if there would be any associated administrative considerations or costs.

Response:

If PNG were directed to use a depreciation rate based on the GSA contract term, PNG would consider setting up the asset under BCUC 479 – Other asset. This asset grouping allows for the isolation of an asset to facilitate the use of a depreciation rate that is different from those established for similar pooled assets by depreciation studies. This treatment would be an administrative consideration only and would not have a material incremental cost to PNG.

Please also see the response to Question 3.2.

- 3.2 If PNG were directed to use a depreciation rate based on the GSA contract term for the WICT assets, please discuss if this would result in a different accounting treatment for regulatory accounting purposes as compared to financial reporting. If so, are there any administrative considerations or costs associated with this?

Response:

PNG believes there would be a difference in the accounting treatment for regulatory purposes and financial reporting under US GAAP if PNG were directed to use a depreciation rate based on the GSA contract term. Per US GAAP ASC 360-10-35-4, depreciation “aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the useful life of the unit.” As discussed in PNG’s response to Question 1.1, assets related to the WICT have an estimated useful life ranging from 35 to 65 years. In contrast, the GSA contract term is only 20 years. The use of a depreciation rate based on the contract term would result in accelerated depreciation of assets and recognition of amortization expenses that would be materially different than what is permitted under US GAAP.

If PNG were directed to use a depreciation rate based on the primary term, it could result in PNG keeping two sets of accounting records – one for financial reporting under US GAAP and one for regulatory purposes – to track differences in asset value and amortization expenses, thus doubling the administrative time and effort required to account for the WICT assets. PNG would track the accounting records for financial reporting purposes using its financial system and will likely require spreadsheets to manually track and maintain the regulatory accounting records. The incremental cost to PNG of this would not be material.

**4.0 Reference: Project Justification and Financial Benefits
Exhibit B-1, p. 8, Appendix E; Exhibit B-3, BCUC IR 3.1.1
Watson Island Future Development**

On page 8 of the Application, PNG states:

A significant secondary benefit from construction of the WICT is that PNG will have an asset in place that has the potential to be used as a platform to serve other new customers in the Watson Island development... Pembina's LPG project will be the first major project for the Watson Island redevelopment, with Pembina's project sites in Phase I of the five-phase redevelopment by the City of Prince Rupert.

In its response to BCUC IR 3.1.1, PNG states, "PNG is confident that these assets would remain in place and be used and useful for the life of the asset and beyond the initial contract term."

- 4.1 Please discuss the planned future developments on Watson Island that could utilize natural gas service from the WICT Project assets.

Response:

Competition for land and other resources, which have viable access to tidewater is currently very high and therefore project developers are keeping their development plans quiet. A number of project developers have spoken to PNG over the past year regarding projects that are in the exploratory stages but they have not proceeded further and/or are still in the early planning stages. Consequently, PNG cannot name any prospective customers, aside from Pembina, who have publicly announced projects to be built on Watson Island. PNG notes that the City of Prince Rupert is actively marketing this site for industrial development and PNG expects most of these projects would require natural gas.

In Appendix E, the City of Prince Rupert provides a letter of support for the WICT Project. The City of Prince Rupert writes, "PNG is seeking approval for capital expenditures to design and construct the Pembina Watson Island customer tie-in which is to provide natural gas service to the Pembina Watson Island Propane export terminal project and potentially other prospective customers on Watson Island." [*emphasis added*].

- 4.2 Please confirm any potential prospective customers on Watson Island for PNG's natural gas service that PNG is currently aware of.

Response:

Please see the response to Question 4.1.

PNG has had conversations with several project developers, however, the projects are at very early stages and are not yet public. PNG has provided a summary of these projects in its response to BCUC Confidential IR No. 1.