

NOVA SCOTIA UTILITY AND REVIEW BOARD

IN THE MATTER OF THE GAS DISTRIBUTION ACT

- and -

IN THE MATTER OF AN APPLICATION by Heritage Gas Limited for approval of an amendment to Rate Class 4 and a negotiated rate for Northern Pulp Nova Scotia Corporation.

BEFORE: Peter W. Gurnham, Q.C., Chair
Murray E. Doehler, CA, P. Eng., Member
Roberta J. Clarke, Q.C., Member

APPLICANT: Heritage Gas Limited

INTERVENORS: **CONSUMER ADVOCATE**
William L. Mahody, LL.B.
NOVA SCOTIA POWER INC.
Nicole Godbout, LL.B.

FINAL SUBMISSIONS: June 27, 2013

DECISION DATE: **August 2, 2013**

DECISION: **The Board approves the application.**

TABLE OF CONTENTS

1.0	INTRODUCTION	2
2.0	CONFIDENTIALITY	4
3.0	CONSUMER ADVOCATE ISSUES	4
3.1	Risks.....	4
3.2	Calculation of Billing Demand	7
4.0	OTHER ISSUES.....	10
4.1	Future Cost Allocation Study.....	11
4.2	Feasibility Test.....	11
4.3	Revenue Deficiency Account	11
4.4	Community Feasibility Test.....	12
5.0	LETTERS OF COMMENT	13
6.0	FINDINGS.....	14
7.0	SUMMARY OF BOARD DIRECTIVES	14

1.0 INTRODUCTION

[1] In its submission filed April 8, 2013 ("Application") with the Nova Scotia Utility and Review Board ("Board"), Heritage Gas Limited ("Heritage" or "Company") outlined its plan to expand its natural gas distribution system into Pictou County, Nova Scotia ("Project").

[2] The Project includes construction of approximately 19 kilometres of high pressure steel pipe and associated equipment to deliver gas from a new Custody Transfer Station on the Maritimes & Northeast Pipeline to Northern Pulp Nova Scotia Corporation ("Northern Pulp" or "Customer").

[3] While Heritage expects that other commercial and residential customers are likely to be served with natural gas from the Project beginning as early as 2014, the Company has made no allowance for that in the Application. The Application considers that Northern Pulp will be the only customer and economically justifies the Project on a stand-alone basis.

[4] The Project total cost is estimated at \$17.8 million, partially offset by a contribution in aid of construction ("CIAC") of \$2.5 million. The targeted in service date is December 1, 2013. The Board is aware that subsequent to the Application, the Nova Scotia Department of Environment advised Heritage that the Project would be subject to an environmental assessment process under the *Environmental Assessment Regulations* and Part IV of the *Environment Act*. The Board anticipates that this may extend the in service date by some months,

[5] The Board approved construction of the pipeline portion of the Project under Permit to Construct NSUARB-NG-HG-PC-152, dated June 11, 2013. Condition 2

of that Permit reads “If Heritage proceeds with any activities associated with the proposed work prior to the Board issuing its decision on the Rate Class 4.1 application, all costs associated with such activities will be at Heritage's sole risk”.

[6] The Application requests Board approval of two items:

- An amendment to the Board approved Rate Class 4 – Extra Large User Rate (“ELRC”) that will reduce the minimum contract demand from 10,000 GJ per day per site to 7,000 GJ per day per site and remove the phrase “and who has a load factor of 100%” from the first line of the Rate Class 4 Schedule; and
- The negotiated confidential rate (“Rate Class 4.1”) for Northern Pulp which includes a ten year term, a minimum daily demand charge of 7,000 GJ per day and termination provisions associated with undepreciated capital costs.

[7] The Board decided that the matter warranted a paper hearing and on April 17, 2013, directed Heritage to publish Notice of Application in the Halifax Herald and the Pictou Advocate. Two parties, the Consumer Advocate (“CA”) and Nova Scotia Power Inc. (“NSPI”), registered as intervenors. Accordingly, the Board established the following timeline for submissions:

- Information Requests (“IRs”) to Heritage – May 30, 2013
- Heritage responses to IRs – June 6, 2013
- Intervenor submissions – June 20, 2013
- Reply submission – June 27, 2013

[8] IRs were submitted by the CA and Board staff’s consultant, Energy Consultants International Inc. (“ECI”) and responded to by Heritage. Both the CA and ECI made submissions, to which Heritage subsequently responded.

[9] NSPI made no submission on the matter.

[10] The Board received letters of comment in support of the Project from the Pictou Regional Development Agency, Pictou County Health Authority and Hon. Charlie

Parker (MLA for Pictou West), and opposed to it from Pam MacDonald and Jane Sproull Thomson.

2.0 CONFIDENTIALITY

[11] Some information in the Application was indicated to be confidential. The Board questioned the need for confidentiality in its April 17, 2013 letter to Heritage. In its April 22, 2013 response, Heritage provided its rationale for confidential treatment, along with a revised Attachment 4. In its April 30, 2013 response to Heritage, the Board said:

The Board approves your request, recognizing that there are currently no other parties formally participating in the proceeding. If, in future, other parties object to the confidential treatment, the Board may revisit the issue in accordance with the provisions of the *Board Regulatory Rules* on notice to Heritage.

[12] The Board received no objections to the confidential treatment.

3.0 CONSUMER ADVOCATE ISSUES

3.1 Risks

[13] In its June 20, 2013 submission, the CA indicated his support of this expansion of Heritage's natural gas distribution system; however, he perceived two areas of risk as follows:

- Northern Pulp not completing the initial 10-year term of the Distribution Service Agreement ("DSA"); and
- Inability to recover the undepreciated assets should the DSA not be continued after the initial 10-year term

[14] In the CA's view, Heritage's shareholder should bear these risks.

[15] Regarding the first point, the CA notes that while there is provision in the DSA for Northern Pulp to terminate early, there is a risk that if such termination is due to financial duress, Heritage may not be protected.

[16] Regarding both points, the CA stated:

...it is important for Heritage to be aware that, in the event that Northern Pulp terminates early or does not renew, it will be up to the Board to fashion an appropriate and fair regulatory remedy based on a full record available at that time.

The Consumer Advocate wishes to very clearly advise Heritage that the Consumer Advocate reserves the right to request removal of assets from rate base or the non-recovery of other costs, or both, in the event the full record supports such requests.

[CA Submission, p.3]

[17] ECI, in its June 20, 2013 submission, stated:

While the reasonableness of an investment should only be assessed using the information available at the time and reasonably foreseeable, the assessment or test of whether an investment is used and useful can be performed at any time. That is, an investment may be used and useful at one point in time but circumstances may find that it is no longer used and useful in the future.

Northern Pulp may terminate its service after the ten year contract expires. It is also possible that, due to extraordinary circumstance, Heritage is unable to recover Northern Pulp's obligation to Heritage in the event of early termination. In either circumstance, the assets constructed to serve Northern Pulp specifically, such as the pressure reduction and metering station on Northern Pulp's property, as well as the pipeline extending from the common junction to Northern Pulp, would no longer be used and useful. In this case, these assets would necessarily be removed from rate base, unless and until a replacement customer is found to make use of these assets. The question at hand then is whether Heritage is entitled to compensation for its investment that was deemed prudent at the time it was made.

...

ECI is of the view that Heritage and its shareholder are entitled to compensation of the undepreciated capital cost of the investment, although they should not be entitled to earn an equity return on this investment unless and until it is once again used and useful. To accomplish this, the Board may direct the undepreciated capital cost to be set up as a deferred asset or assets, to be amortized in customer rates at the previously determined depreciation rate or rates. The Board need then determine a carrying cost for this asset. A carrying cost equivalent to the full cost of capital would result in the same cost to Heritage's ratepayers as if the asset was left in rate base. A lower carrying cost, at Heritage's approved cost of debt, would result in Heritage being compensated for its original investment but it would not earn an equity return on it. ECI's view is that the latter is the appropriate compensation for Heritage.

[ECI Submission, pp. 10-11]

[18] Heritage did not disagree with ECI on this issue.

[19] The Board agrees with ECI that this is a reasonable approach. As ECI notes in its submission:

...To put Heritage and its shareholder at the risk of outright loss of the investment would be a compelling disincentive to invest in this or any expansion. ECI is of the view that while the entire amount or portions of the investment may one day no longer be used and useful, Heritage is still entitled to compensation on its investment, although not necessarily an equity return...

[ECI Submission, pp. 11-12]

[20] While there are risks associated with the Project, the larger question is whether or not a decision to proceed is prudent. In that regard, ECI's opinion was:

Heritage has structured the proposed expansion prudently for the following reasons:

1. The rates are structured and calculated to recover the incremental cost of service, with the majority of the revenues being fixed in nature and thus more certain than variable revenues from volumetric rates;
2. The contract is for a period of ten years;
3. The contract includes an obligation for Northern Pulp to pay an amount related to the undepreciated capital cost of the expansion if it terminates service prior to the conclusion of the contract;
4. Heritage negotiated a CIAC that is payable if another large industrial customer does not attach to the system and take gas service; and
5. The expansion will allow future connection to customers in New Glasgow and nearby communities. Without the revenues expected from Northern Pulp, it is possible that expansion to New Glasgow may not be possible.

In ECI's view, the proposed expansion to Northern Pulp as articulated in Heritage's Application is prudent. Once the construction phase of the expansion is complete, a further assessment of whether the assets were prudently acquired can be made. This assessment should be reviewed by the Board at a future Heritage rate hearing.

[ECI Submission, p.12]

[21] The Board agrees with ECI that the expansion of the system as contemplated in the Application is prudent. In the Board's view, Heritage has taken reasonable steps by developing and negotiating the DSA in a way that reduces risk to ratepayers and perhaps equally important allows it to expand the natural gas distribution

system to the Pictou County area economically and in fulfillment of its obligation to serve within its franchise area.

[22] The Board agrees with the CA to the extent that in the event of early termination or non-renewal, it will be necessary to review and determine the disposition of assets that are undepreciated and no longer used and useful.

3.2 Calculation of Billing Demand

[23] The CA expressed his concern that the proposed Rate Class 4.1 does not include a demand “ratchet” mechanism similar to that incorporated in Rate Class 3:

Heritage has not proposed a demand “ratchet” for service to Northern Pulp. This contrasts with Heritage’s existing tariff for service to Rate Class 3, which requires that Billing Demand be the larger of the contract demand or “the greatest amount of gas in GJ in any consecutive 24-hour period during the current and preceding eleven billing periods.” That is, a demand ratchet automatically resets the billing demand to the peak daily demand during the current month or the preceding 11 months.

In contrast, Heritage proposes that the billing demand for Northern Pulp will be based on the larger of the contract demand or “the greatest amount of gas in GJ in any consecutive 24 hour period during the current monthly billing period.” ...Thus, while smaller customers would have their billing demand automatically reset for the next year when a new daily peak is reached, Heritage proposes that this should not be the case for Northern Pulp. If Northern Pulp exceeds its contract demand (7,000 GJ per day), it would affect Northern Pulp’s billing demand only for the month in which it exceeded the demand. The next month’s demand would go back down to the contract demand level.

This strikes the Consumer Advocate as being unfair. The facilities being installed to serve Northern Pulp are quite expensive and have extra capacity designed into them. Some of that extra capacity is designed to serve Northern Pulp if it decides to expand; other capacity is available to other customers in Pictou County. See Confidential CA-IR-9 to CA-IR-19 for details of this additional capacity availability. It is not fair to allow Northern Pulp to use any of this capacity without having to pay for it. If Northern Pulp finds it expedient to increase its peak daily demand above 7,000 GJ, it should have to pay for the additional capacity it uses – not just for one month (a short-term rental, if you will), but for an extended period of time. That is what all other customers with demand-based rates must do, and it does not seem fair to write a special rule for Northern Pulp.

Heritage attempts to justify the lack of a demand ratchet in its response to CA-IR-27. That response essentially states that a demand ratchet is not required for Northern Pulp because there would be so much extra capacity available in the new facilities. What Heritage fails to acknowledge, however, is that a substantial portion of that extra capacity is reserved for Northern Pulp, but Northern Pulp is not being required to pay for it until it uses it.

Specifically, para. 1.5 of the contract (Confidential) states that if Northern Pulp seeks to increase the capacity of certain facilities to [redacted] GJ per hour, it must provide Heritage with 120 days prior notice. Importantly, the same provision also states that once

Northern Pulp begins using that additional capacity, the agreement “shall be amended forthwith to increase the Contract Demand by the amount of the Additional Capacity so taken up by Customer.”

By failing to include a demand ratchet in the proposed rate, however, Heritage is effectively giving Northern Pulp the free (or nearly free) use of that additional capacity. Rather than having to increase contract demand immediately, as the contract appears to require, the proposed rate would permit Northern Pulp to use additional capacity on an as-needed basis without increasing its contract demand. That is not what the contract appears to require and, as stated above, it is not how other large customers on the system are treated.

The Consumer Advocate recommends that a demand ratchet be included in the tariff for service to Northern Pulp. It should use the same language as the tariff for Rate Class 3 quoted above. (Emphasis added).

[CA Submission, pp.3-4]

[24] In its reply, Heritage said:

Heritage Gas believes the inclusion of a ratchet mechanism to be inappropriate for this specific situation for the following reasons:

- The Demand Charge component of the proposed rate was determined on the basis that sufficient revenues would be generated, based on billing 7,000 GJ/day, to recover all costs to serve Northern Pulp whatever demand they require (up to the available capacity of the system).
- Inclusion of a ratchet mechanism would result in an over-recovery of the cost of service should Northern Pulp exceed the negotiated contract demand.
- Unused capacity is needed to ensure that Heritage Gas can provide service to future additional customers. Heritage Gas has maintained the right to allocate this capacity to these future customers while allowing for the occasional use of this capacity by Northern Pulp in the near term. The negotiated rate does require that Northern Pulp pay for the use of this capacity.

...

- Heritage Gas believes the inclusion of a ratchet mechanism in this case would be detrimental to the best interests of all potential customers in Pictou County. As demonstrated, the proposed rate is expected to generate sufficient revenues from Northern Pulp to recoup the cost of service both on an incremental and a fully allocated basis. The addition of a ratchet mechanism would unfairly burden Northern Pulp should the contract demand ever be exceeded thereby incenting Northern Pulp to over contract for capacity. Heritage Gas believes it is appropriate to ensure recovery of the cost of service from Northern Pulp while keeping capacity available for use by other customers in Pictou County.

[Heritage Gas Reply Submission, pp.12-13]

[25] The foregoing submissions were filed in confidence; however, Board staff have confirmed that the version presented in this Decision contains no confidential information.

[26] In simple terms, a ratchet works to increase the demand billing rate only when the demand is higher than its previous value. In the case of Northern Pulp, it is the Board's understanding, from Heritage's response to CA-IR-4, that Northern Pulp is converting its equipment to burn natural gas. At the billing commencement date, there may be no demand for natural gas. As Northern Pulp ramps up its consumption, the demand increases, and a demand ratchet would serve to maintain the billing demand at a high level. However, in the arrangement proposed by Heritage, the billing demand is already "ratcheted" up to 7000 GJ/day. Likewise, if Northern Pulp's future demand decreases, it is still contracted for the full 7000 GJ/day for 10 years. No other Heritage customer has a fixed billing demand set by contract. Rate Class 3 customers can have a year of high consumption and then a decade of lower consumption. Northern Pulp's contractual billing demand fixes the demand for ten years, no matter how little Northern Pulp may consume in any future month or year.

[27] The billing demand rate is established to recover the fixed costs allocated to Northern Pulp over ten years. As long as the costs of serving Northern Pulp are recovered, the rates are fair. In the case of Rate Class 3 customers, the system is sized and constructed to meet their peak demand, so they should pay for their fair allocation of those costs. But Rate Class 3 customers are not bound to the ratchet indefinitely: they can reduce their consumption in future years and potentially no longer pay what was once their fair share of the costs.

[28] The Board disagrees with the CA that a demand ratchet mechanism should be part of Rate Class 4.1.

[29] The CA makes the point that there is extra capacity reserved for Northern Pulp that is not paid for by Northern Pulp. In the Board's view, it is probable that the cost of that extra capacity may not be significant. Heritage stated, in its response to ECI-IR-5(a), that sizing the pipeline to serve only Northern Pulp would save only 4-5% of the capital cost. Typically, pipelines and associated facilities are designed to serve not only existing contracted customers, but also to serve future customers who may be reasonably expected to contract for service once the system is in place. The incremental cost to accommodate those future customers is relatively small – in this case, 4-5% of total cost. This is a significant savings, compared to the cost of building a complete additional system to serve future customers, which Heritage estimates at approximately \$9,000,000.

[30] It follows that initially, and perhaps for the life of the Project, there will be excess capacity available. The Board sees no reason why that capacity should not be made available to Northern Pulp under the proposed DSA.

4.0 OTHER ISSUES

[31] In its June 20, 2013 submission, ECI presented several conclusions and recommendations with which, for the most part, the Board agrees. The Board has the following comments on some individual items in the ECI submission.

4.1 Future Cost Allocation Study

[32] ECI recommended, and Heritage agreed, that “a full cost of service study including the costs allocated to Northern Pulp be undertaken when Heritage amends the Rate Class 4.1 rates following the conclusion of the ten year contract.”

4.2 Feasibility Test

[33] ECI made several observations regarding the Feasibility Test (“FT”) calculation. Of greatest concern was that Heritage’s capital cost estimate did not reflect any costs associated with land acquisition or land rights. ECI recommended that Heritage make some refinements to the FT calculation and resubmit it, although ECI also indicated that it expected the recalculated FT would still meet minimum requirements.

[34] In its reply submission, regarding a recalculated FT, Heritage stated:

No change to capital was made as it already includes land rights within the estimated cost of the other asset classes and includes a contingency that Heritage currently believes to be sufficient.

[Heritage Gas Reply Submission, p.11]

[35] Heritage provided a recalculated FT with its reply submission as Confidential Attachment 1. As expected, the results were slightly lower, but in the Board’s view, the difference is not significant. Accordingly, the Board finds that the Project meets the FT.

4.3 Revenue Deficiency Account

[36] ECI was concerned that the Project would add to the Revenue Deficiency Account (“RDA”), albeit only slightly. This concern was partly based on adding land costs. As noted above, land costs were in fact already included, although not evident. With the recalculation of the FT, Heritage concludes that “The results of the revised

Feasibility Test continue to indicate that the RDA will not be negatively impacted at any point by this project.”

[37] The Board accepts that the RDA will not increase, using the existing estimates. However, as noted above, the unexpected requirement for an environmental assessment process will delay start of construction, possibly pushing it towards the more costly winter construction period. Additionally, there is always a possibility of cost overruns on any project.

[38] The Board directs Heritage to file a new FT calculation and RDA forecast as soon as final construction costs and billing commencement date are known.

4.4 Community Feasibility Test

[39] In its reply to ECI-IR-6(e), Heritage said:

Heritage Gas currently expects the future expansion to New Glasgow / Stellarton will be assessed using a Community Feasibility Test (“CFT”) for Pictou County. Heritage Gas proposes to use the commitment from Northern Pulp and any other large industrial customers to be included in the CFT for Pictou County. The thresholds set for the CFT are the same as those used for the mains feasibility test. That is, the seventh year revenue-to-cost ratio and the 25 year NPV ratio must both be 1.0 at a minimum. The CFT requires signed Distribution Service Agreements (“DSA”) from customers representing 35% of the revenue required to meet the feasibility test thresholds whereas the mains feasibility test requires DSAs from customers representing 100% of the revenue required.

[ECI - IR-6(e)]

[40] In this regard, ECI said:

...The committed revenue from Northern Pulp is likely to be at least 35% of the revenues required in the Community Feasibility Test for expansion to New Glasgow and Stellarton. Heritage will still need to forecast enough additional customers and resulting revenues to meet the profitability and NPV ratios of the feasibility test. However, since it already has 35% of committed revenue as required by the Community Feasibility Test, Heritage will not need to obtain any additional revenue commitments in the form of signed Distribution Service Agreements in New Glasgow and Stellarton prior to further expansion. Heritage could meet the feasibility test ratios with Expressions of Interest from potential customers and estimates of high probability customers, instead of securing commitments through Distribution Service Agreements. Accordingly, the Board may wish to consider alternative thresholds for the Community Feasibility Test in this instance.

[ECI Submission, pp.9-10]

[41] Heritage disagreed with ECI:

Heritage Gas does not agree that the Board should consider alternative thresholds for the Community Feasibility Test. Heritage Gas will not proceed with further expansion without additional customer commitments from the Towns of New Glasgow, Stellarton and Trenton. In addition, Heritage Gas will not move forward until such time as an appropriate assessment of the market has been completed which provides Heritage Gas with the confidence that sufficient additional revenue can be eventually secured within the Towns to support the required capital investment. As a result, the existing guidelines and/or framework for the CFT are appropriate and do not require amendment.

[Heritage Gas Reply Submission, p.12]

[42] The Board notes that further expansion cannot proceed without a Permit to Construct. The application for such a permit must show that the expansion is both technically and economically sound. Without commenting at this time on any feasibility test or its parameters (such as whether Northern Pulp should be included), the Board agrees with Heritage that the Company should not proceed with an expansion until it is convinced the economics justify it. Similarly, the onus will be on Heritage to convince the Board that such an expansion is economic.

5.0 LETTERS OF COMMENT

[43] The Board received three letters of comment in support of the Project and two opposing the Project.

[44] Both opponents did not object to the idea of serving the area with natural gas *per se*, but took issue with the customer that will be served, for reasons that are mainly environmental and social. These considerations are not within the Board's jurisdiction.

[45] As always, the Board appreciates and welcomes the time and effort to provide comments.

6.0 FINDINGS

[46] Heritage requested Board approval of an amendment to the Board approved Rate Class 4 – ELRC that will reduce the minimum contract demand from 10,000 GJ per day per site to 7,000 GJ per day per site and remove the phrase “and who has a load factor of 100%” from the first line of the Rate Class 4 Schedule. Having considered the Application and submissions, the Board hereby approves the amendment.

[47] Heritage requested Board approval of the negotiated confidential rate (“Rate Class 4.1”) for Northern Pulp which includes a ten year term, a minimum daily demand of 7,000 GJ per day and termination provisions associated with undepreciated capital costs. The Board has reviewed the application and various submissions and finds that the rate is fair and reasonable, and has no adverse impact on existing Heritage customers and rate classes. The Board hereby approves the rate.

7.0 SUMMARY OF BOARD DIRECTIVES

[48] A full cost of service study including the costs allocated to Northern Pulp is to be undertaken when Heritage amends the Rate Class 4.1 rates following the conclusion of the ten year contract.

[49] Heritage shall file a new FT calculation and RDA forecast as soon as final construction costs and billing commencement date are known.

[50] With its next rate hearing application, Heritage shall include relevant evidence assessing whether the expansion was prudently undertaken and the assets prudently acquired.

[51] Future expansions to the system must be supported by suitable economic tests, which shall accompany Permit to Construct applications.

[52] An Order will issue accordingly.

DATED at Halifax, Nova Scotia, this 2nd day of August, 2013.

Peter W. Gurnham

Murray E. Doehler

Roberta J. Clarke