Evaluation of Overhead Capitalization Methodology Proposed By:

Pacific Northern Gas Ltd. and Pacific Northern Gas (N.E.) Ltd.

November 22, 2010

Table of Contents

1.0 Summary of Findings 3

2.0 Purpose of the Report 5

3.0 Background 8

4.0 Summary of PNG's Proposed Overhead Capitalization Methodology 9

5.0 KPMG Evaluation Approach 11

6.0 Canadian Utilities Practices 13

7.0 KPMG Findings 15

Appendix A – PNG's 2010 Overhead Capitalization Study

Appendix B – Accounting and Regulatory Guidance

- A. Canadian Guidance
- B. International Guidance
- C. US Guidance
- D. Summary

Appendix C – References

1.0 Summary of Findings

KPMG was retained by Pacific Northern Gas Ltd. to conduct an evaluation of Pacific Northern Gas Ltd. and Pacific Northern Gas (N.E.) Ltd.'s (collectively "PNG" or the "Company") overhead capitalization methodology for purposes of reporting to the British Columbia Utilities Commission ("the Commission") as proposed in PNG's 2010 Overhead Capitalization Study attached as Appendix A (the "PNG Study").

No single regulatory guideline, statement or source exists that is universally accepted by utilities and regulators as the definitive statement, definition or standard that prescribes the types of overhead costs that should be considered for capitalization for purposes of regulatory and financial reporting. However, this topic has been the subject of discussion and comment and a body of evidence exists on the topic. From this evidence, a common principle arises:

> *That any assignment of indirect costs to a capital project should be done based upon some reasonable causal link or association with the capital activity.*

PNG's overhead capitalization methodology set out in the PNG Study is based on this principle.

KPMG finds that the PNG overhead capitalization methodology, presented herein to be a reasonable basis for the allocation of costs. This methodology is within the range of practice established by the external guidance (referred to in this evaluation) and observable capitalization allocation practices applied by Canadian utilities and utilities subject to the jurisdiction of the Commission (as observed through regulatory filings in various Canadian jurisdictions). Furthermore, the overhead capitalization methodology meets the criteria that PNG outline in Appendix C of their study. For additional analysis see section 7.0 KPMG Findings.

KPMG assessed PNG's proposed overhead capitalization methodology in the context of 2009 actual results. It is PNG's intention to apply this methodology commencing in 2011.

Table 1 below summarizes PNG's estimates of the amount of Operations, Maintenance, Administration and General ('O,M,A&G') costs related to capital in both PNG and PNG (N.E.) using 2009 actual results for illustrative purposes.

Table 1 - Summary of Illustrative Capitalized Overhead Costs for 2009

	Total Gross O,M,A&G	Total Capitalized Overhead	% of Total Gross O,M,A&G Capitalized
PNG/PNG (N.E.) 2009	21,453,260	1,391,516	6.49%

2.0 Purpose of the Evaluation

Purpose

KPMG was retained by PNG to conduct an evaluation of the overhead capitalization methodology proposed in the PNG report (attached as Appendix A). As noted earlier KPMG's assessment relied on 2009 actual figures provided by management as 2010 actual figures were not yet available.

Specifically, KPMG was engaged to assess the reasonableness of:

- PNG's proposed overhead capitalization methodology;
- the activities allocated to capital;
- the cost drivers; and
- the resulting overhead capitalization rate.

Report Structure

Tables 2 and 3 below describe the sections and appendices in this report.

Table 2 – Report Body Section Descriptions

Section	Description
1.0: Summary of Findings	Includes a brief discussion of KPMG's approach and summary of findings
2.0: Purpose of Report	Outlines the structure of the report and provides a brief explanation of each section
3.0: Background	Provides background on the reasons why PNG assessed their overhead capitalization methodology
4.0: Summary of PNG's Proposed Overhead Capitalization Methodology	Provides a high level summary of the components of the overhead capitalization methodology
5.0: KPMG Evaluation Approach	Provides an explanation of KPMG's approach to assessing PNG's overhead capitalization methodology including the criteria used by KPMG during our analysis. This scope of the evaluation was agreed per the terms of the engagement letter between KPMG and PNG and the evaluation's approach is based on KPMG's past practice of similar overhead capitalization methodology studies undertaken by Canadian utility companies.
6.0: Comparison to Other Utilities	Provides a summary of the publicly available information KPMG used during our analysis of the overhead capitalization methodology
7.0: KPMG Findings	Provides KPMG's findings as to the reasonableness of the overhead capitalization methodology

Table 3 – Report Appendices Section Descriptions

Appendix	Description
A: PNG's 2010 Overhead Capitalization Study	Contains a detailed description of the approach and detailed criteria used by PNG to develop its proposed overhead capitalization methodology
B: Accounting and Regulatory Guidance.	Contains a description of guidance provided by accounting bodies and regulators
C: References	Contains a description of the research

	documents representative of PNG's industry, which KPMG consulted to reach its findings

Scope Limitations

Management responsibility:
PNG's capitalization methodology report is the responsibility of management who also maintain responsibility for the accuracy and completeness of the data and information associated with the overhead capitalization methodology and associated costs.

KPMG engagement:
Our engagement is to comment on the reasonableness of the overhead capitalization methodology and undertake the steps outlined in section 5.0 of this report.

This evaluation does not constitute an audit of the overhead capitalization methodology, associated costs or capitalization rate. Accordingly, we do not express an opinion on such matters. For the avoidance of doubt, KPMG has neither audited nor reviewed the underlying O,M,A&G costs that form the basis of the percentages capitalized per PNG's report attached as Appendix A to this report.

KPMG assessed the proposed overhead capitalization methodology using 2009 actual figures, as provided by management, as 2010 actual figures were not yet available. Our findings and conclusions are therefore limited accordingly.

3.0 Background

In June 2010, PNG commenced preparation of the PNG Study as its overhead capitalization methodology had not been reviewed for several years. PNG will be applying the new methodology in the context of its 2011 revenue requirements application to the British Columbia Utilities Commission ("BCUC").

The Company will be transitioning from Canadian Generally Accepted Accounting Principles ("Canadian GAAP") to International Financial Reporting Standards ("IFRS") in the near future. IFRS is more restrictive than current accounting standards with respect to capitalization of capital overhead costs. PNG has considered IFRS requirements in its proposed methodology.

When the PNG Study was initiated, it was anticipated the Company would transition to IFRS effective January 1, 2011. However, in the intervening period the Canadian Accounting Standards Board approved an optional one year deferral of the mandatory date for first time adoption of IFRSs by entities with rate regulated activities. As such PNG now plans to defer its transition to IFRS to the year beginning January 1, 2012.

Despite the potential deferral, PNG intends to implement the overhead capitalization methodology proposed in the PNG Study effective 2011 to better align the Company's capitalization methodology for overheads in anticipation of the future transition to IFRS.

4.0 Summary of PNG's Proposed Overhead Capitalization Methodology

This section summarizes the key components of the overhead capitalization methodology proposed in the PNG Study.

In order to determine the overhead capitalization methodology, PNG first set out to update internal process and policy based on its consideration of a cross-section of current industry practices as observed through regulatory filings in various jurisdictions. Based on those developed policies, PNG:

- identified the activities that should be considered in its overhead capitalization calculations;
- identified drivers to be used to allocate the appropriate portion of cost directly to capital projects; and
- used 2009 data to model and test the overhead capitalization methodology.

Overhead Activities Allocated to Capital

Table 4 below, which is an extract from Appendices H and K of the PNG Study, provides a summary of the categories of indirectly tracked capital activities that are proposed to be allocated to capital, as well as the drivers applied to each to determine the percentage of the related costs to be allocated to capital. Additional detail of the methodology and rationale for capitalization is described in Appendix I of the PNG Study.

Table 4 – Overhead Activities Allocated to Capital

Activity/Category	Description	Drivers
Field operations (operating and administration): Support Field Employee Labour and Benefit Expense	• Estimated cost of staff time and associated benefit costs devoted to capital activities	• Apply estimated percentage of time on capital activities to identified staff labour and benefit costs

Activity/Category	Description	Drivers
Corporate (administration): Management Salary and Benefit Expense	• Estimated cost of staff time and associated benefit costs devoted to capital activities	• Apply estimated percentage of time on capital activities to identified management salary and benefit costs
Benefits on Direct Labor : Field Employee Benefit Expense	• Estimated field employee benefit costs as determined by a benefit load analysis	• Apply standard employee benefit load rate to field labour costs capitalized to specific capital projects
Warehouse and Shop Expense	• Estimated cost of staff time and associated benefit costs devoted to capital activities	• Apply estimated percentage of time on capital activities to identified warehouse and shop staff salary and benefit costs
Equipment Operating Expense	• Operating costs related to transportation and heavy work equipment used in capital projects (i.e., fuel, repairs, maintenance, insurance)	• Apply standard charge out rates to hours equipment utilized for specific capital projects
Equipment Depreciation Expense (see Appendix K of PNG report)	• Depreciation expense related to transportation and heavy work equipment used in capital projects	• Apply standard charge out rates to hours equipment utilized for specific capital project

5.0 KPMG Evaluation Approach

This section summarizes KPMG's approach to conducting our evaluation of PNG's overhead capitalization methodology. Our work plan was developed in collaboration with PNG management in order to meet the objectives of this evaluation.

Our work plan incorporated the following steps:

- **Step 1: Obtained an understanding of the proposed company policy and process documentation.** In this step, KPMG obtained and reviewed relevant documentation relating to the allocation of overhead costs to capital at PNG in order to obtain an understanding of PNG's overhead cost capitalization methodology.
- **Step 2: Participated in interviews with company officials.** In this step, KPMG participated in a workshop with PNG Finance staff and senior representatives from the operating areas. The purpose of this step was to gain an understanding of the specific activities and cost drivers within PNG that may be related to capital. This step also provided KPMG with a good understanding of PNG's organizational structure and its approach to the acquisition, construction and installation of capital assets.
- **Step 3: Summarized regulatory and accounting policy guidance researched by PNG and KPMG.** In this step, KPMG summarized guidance provided by various accounting and regulatory authorities on the topic of overhead capitalization. A summary of the sources referenced by PNG can be found in the PNG Study (per Appendix B of PNG's report). KPMG's sources are identified in Appendix B of the KPMG report.
- **Step 4: Assessed the reasonableness of PNG's overhead capitalization methodology against external guidance.** In this step, we assessed PNG's methodology for overhead capitalization, as documented in the PNG Study, against external guidance collected and summarized in Step 3 and the practices of other Canadian utilities as observed through a study of regulatory filings in various jurisdictions.
- **Step 5: Assessed the reasonableness of PNG's overhead capitalization methodology against the internal criteria established by PNG.** In this step, we assessed the alignment between PNG's methodology against the criteria established by PNG.
- **Step 6: Assessed the reasonableness of the activities included in the overhead capitalization methodology.** In this step we assessed the activities resulting in capitalized costs (in accordance with the overhead capitalization methodology) against examples in internal policy

and external guidance summarized in Step 3, as well as those observed in the practices of other Canadian utilities.

- **Step 7: Assessed the reasonableness of the drivers used to allocate overhead costs to capital.** In this step we assessed the reasonableness of drivers used in the overhead capitalization methodology.
- **Step 8: Assessed the reasonableness of the resulting overhead capitalization rate.** In this step we assessed the reasonableness of the resulting overhead capitalization rate against a cross-section of current industry practices as observed through a study of regulatory filings in various jurisdictions.
- **Step 9: Assessed the model used by PNG to calculate the overhead capitalization rate.** In this step we assessed the methodology utilized in the model against PNG's proposed and documented overhead capitalization methodology policy. We walked-through a number of items noted as capitalized costs back to source data, and validated a sample of 13 costs used in the overhead capitalization methodology against internal financial system reports.
- **Step 10: Prepared report.** In this step, KPMG prepared this report to summarize the results of the evaluation.

6.0 Canadian Utility Practices

KPMG obtained an understanding of other Canadian utility practices as observed through regulatory filings and regulator decisions.

The utilities considered are summarized in the Table 5 below.

Table 5 - Utility Research

Utility	Jurisdiction	Utility	Jurisdiction
TGVI	BCUC	Hydro One	OEB
TGI	BCUC	Fortis BC	BCUC
BC Transmission Co	BCUC	EPCOR	AUC
BC Hydro & Power Authority	BCUC	AltaGas	AUC
Ottawa Hydro	OEB	ENMAX	AUC
ENMAX	AUC	NB Power	NBEUB
ATCO	AUC	Union Gas	OEB
PUC Distribution	OEB	Fortis AB	AUC

At present, based on the research of other Canadian utility practices, all the utility organizations report under Canadian GAAP. However, there is a relatively wide range of practices with respect to capitalizing overhead among utilities. This reflects the considerable judgment inherent in accounting and regulatory guidance.

The review of other Canadian utility practices revealed the following observations:

- Overhead capitalization methodologies vary greatly and many apply a percentage to a capital expenditure amount;
- Some utilities use a single allocation factor (i.e. % of total Operating, Maintenance, Administrative and General costs (OMA&G) vs. capital), while others use multiple allocators (i.e. labour time estimate, composite averages etc) specific for each activity;

- Some utilities apply fully-allocated capital overhead cost allocation methodologies which is to say that capitalized overhead costs include a share of the indirect and fixed costs that do not vary directly with the level of capital activity (i.e. administration and general expenses); while others utilize an incremental capital overhead cost allocation methodology where eligible costs are defined as those that would not exist if capital activity ceased; and
- There is little consistency with respect to what cost components were included in the overhead capitalization rate; costs ranged from shared services, distribution, gas supply and transmission, to general administration and overhead.

A detailed list of the reference sources KPMG consulted is provided in Appendix C.

7.0 KPMG Findings

KPMG finds that the PNG overhead capitalization methodology, presented herein to be a reasonable basis for the allocation of costs. This methodology is within the range of practice established by the external guidance (referred to in this evaluation) and observable capitalization allocation practices applied by Canadian utilities and utilities subject to the jurisdiction of the Commission (as observed through regulatory filings in various Canadian jurisdictions).

Steps 1 through 3 of the KPMG approach address the gathering of data in order to perform assessment in Steps 4 through 8 found below:

Reasonability of the Overhead Capitalization Methodology against External Guidance

In Step 4 KPMG assessed the methodology PNG established in its policy for overhead capitalization against external guidance collected in Step 3 of section 5.0 and the practices of other Canadian utilities as observed through a study of regulatory filings in various jurisdictions.

<u>KPMG finds that the capitalization methodology used to be reasonable and within the range of practices represented by the external guidance summarized in Step 3 and a cross-section of current industry practices as observed through regulatory filings in various jurisdictions.</u>

Reasonability of the Overhead Capitalization Methodology against Internal Criteria Established by PNG

In Step 5 KPMG assessed PNG's overhead capitalization methodology against PNG's internal criteria.

Table 6 below summarizes KPMG's assessment of PNG's overhead capitalization methodology against PNG's criteria set out in the PNG Study.

Table 6 - Evaluation of Overhead Capitalization Methodology

Key: S = satisfies the evaluation criteria
SS = somewhat satisfies the evaluation criteria
NS = does not satisfy the evaluation criteria

Evaluation Criteria	Assessment	Explanation
Defensible Cost Causation Linkage	S	• Internal policy provides guidance requiring a reasonable causal link or association with the capital activity for costs to be allocated to capital.
Distinguishable from Directly Allocated Capital Costs	S	• Overhead costs allocated using this methodology are costs specific to capital activities but not allocated to projects.
Transparency	S	• The methodology relies on formal documentation at each step of the process. It thus addresses the criteria for transparency.
Freedom from Bias	S	• PNG's documented methodology and internal guidance in conjunction with PNG's finance group review of management's estimates, effectively safeguards the methodology from bias.
Stability	S	• The methodology can be applied consistently year over year without resulting in major variances in amounts capitalized.

Evaluation Criteria	Assessment	Explanation
Accuracy of Underlying Data	S	• KPMG was not engaged to conduct an audit or review of either the accuracy or completeness of the underlying O,M,A&G costs that form the basis of the percentages capitalized per PNG's report attached as Appendix A to this report • However, we assessed the methodology utilized in the model against PNG's proposed and documented overhead capitalization methodology policy. We walked-through a number of items noted as capitalized costs back to source data, and validated a sample of 13 costs used in the overhead capitalization methodology against internal financial system reports. • As detailed in the PNG Study, PNG undertook a detailed review of all non-direct employee time related to capital activities. The level of detail apparent in the data provided by management is significant which enhances reliability of the underlying data.
Flexibility / Adaptability	S	• The overhead capitalization methodology and integrated Excel model facilitates updates, and thus supports the criteria.
Cost-Effectiveness • Low implementation cost	S	• The overhead capitalization methodology requires limited time and effort for management to update. Additional time and effort was required in this iteration to understand the restrictions on activities eligible for allocation to capital under IFRS. • The Excel model used to implement the methodology is straightforward and easily updated.

Evaluation Criteria	Assessment	Explanation
• Low on-going costs	S	• The capital cost allocation methodology requires limited time and effort for management to update. • The Excel model requires little in the way of cost to maintain and update.

KPMG finds that PNG's proposed overhead capitalization methodology is reasonable as compared to PNG's established criteria.

Reasonability of the Overhead Activities Allocated to Capital

In Step 6 KPMG conducted a high level evaluation of the overhead activities allocated to capital against examples in internal policy and external guidance summarized in Step 3 of section 5.0

KPMG finds the overhead activities allocated to capital to be reasonable and within the range of guidance summarized in Step 3 of section 5.0 and observed in the practices of other Canadian utilities.

KPMG expects that PNG will evolve its overhead capitalization methodology, with respect to overhead activities allocated to capital, as clarity around IFRS guidance improves and the utility industry's interpretation of IFRS guidance matures.

Reasonability of the Drivers Used to Allocate Costs to Capital

In Step 7 KPMG assessed the reasonableness of the drivers used to allocate overhead costs to capital.

- **Field Employee Benefit Expense load rate applied to labour cost charged to specific capital projects (benefit rate / hour).**

  KPMG assessed the method that PNG management utilized in order to determine the Field Employee Benefit Expense and to allocate labour cost directly charged to specific capital projects.

  This driver was chosen as it most accurately reflects the key component of the overhead cost to be allocated to capital – labour benefit cost.

  KPMG finds that the use of a Field Employee Benefit Expense load rate applied to labour cost charged to capital is reasonable

- **Management and Support Field Employees Labour and Benefit Expense**

  KPMG assessed the labour-time estimate method that PNG management utilized in order to determine the amount of time spent by Management and Support Field Employees Labour and Benefit Expense on overhead activities related to capital.

  This driver was chosen as it most accurately reflects the key component of the overhead cost to be allocated - labour.

  <u>KPMG finds that the use of the labour time estimate to allocate Management and Support Field Employees Labour and Benefit Expense to capital is reasonable</u>

- **Equipment Operating Expense divided by hours used (operations and capital); multiplied by capital project hours (equipment operating hourly cost).**

  KPMG assessed the method that PNG management utilized in order to determine the Equipment Operating hourly expense and to allocate cost to capital projects by hours spent on specific capital projects.

  This driver was chosen as it most accurately reflects the key component of the overhead cost to be allocated to capital – equipment cost.

  <u>KPMG finds that the use of the Equipment Operating Expense to allocate equipment related overhead costs to capital is reasonable</u>

- **Equipment Depreciation Expense divided by hours used (operations and capital); multiplied by capital project hours (equipment depreciation hourly cost)**.

  KPMG assessed the method that PNG management utilized in order to determine the Equipment Depreciation hourly expense and to allocate cost to capital projects by hours spent on specific capital projects.

  This driver was chosen as it most accurately reflects the key component of the overhead cost to be allocated to capital – equipment depreciation cost.

  <u>KPMG finds that the use of Equipment Depreciation Expense to allocate equipment depreciation related overhead costs to capital is reasonable</u>

Reasonability of the Capitalization Rate

In Step 8 KPMG compared the capital overhead rate estimated by PNG's management to that applied by other Canadian utilities.

Our comments in this step are necessarily limited by our findings in Section 6 that the methodology followed by various members of the Canadian utilities industry varies widely. KPMG observed that generally, utilities in Canada (as observed through regulatory filings in various Canadian jurisdictions) historically capitalize 10 to 20 percent of gross OM&A costs; however some utilities capitalize fewer costs due to the nature of their businesses having relatively lower proportion of capital costs. Furthermore, KPMG observed that the utilities in Canada that have considered the IFRS guidelines when setting their overhead capitalization rate have determine their rates to be significantly lower than the historical levels mentioned above.

Table 7 summarizes the overhead capitalization rates recently proposed in GRA's filed by or approved for BC utilities.

Table 7 – Comparative Overhead Capitalization Rates

Utility	Jurisdiction	Rate (**)
Terasen Inc.	BCUC	8.17%
Terasen Vancouver Island Inc.	BCUC	5.22%
Hydro BC & Power Authority*	BCUC	19.1%
FortisBC*	BCUC	20%

** IFRS was not considered when setting the rate*

*** Source: regulatory filings*

Several factors should be taken into consideration when comparing the above rates to PNG's capitalization rate including changes resulting from the implementation of IFRS guidelines, the activities allocated to capital in those organizations and the overhead capitalization methodology they use. Due to the extended timeline for IFRS implementation, several of the examples above have not yet implemented IFRS and maintain higher rates than those companies that have already taken IFRS into consideration.

<u>Although the rates observed vary widely, KPMG finds the capitalization rate estimated by PNG is within the range of rates observed by other utilities under the jurisdiction of the British Columbia Utilities Commission</u>.

Reasonability of the Model Used by PNG to Calculate the Overhead Capitalization Rate

In Step 9 KPMG assessed the methodology utilized in the model against PNG's proposed and documented overhead capitalization methodology policy. We walked-through a number of items noted as capitalized costs back to source data, and validated a sample of 13 costs used in the overhead capitalization methodology against internal financial system reports.

<u>KPMG finds the PNG model used to be consistent with the overhead capitalization methodologies as proposed and documented within PNG's overhead capitalization methodology policy. The items used in our walk-through were consistently reflected in the model and the underlying financial system reports.</u>

Appendix A – PNG’s 2010 Overhead Capitalization Study

Pacific Northern Gas Ltd. and
Pacific Northern Gas (N.E.) Ltd.

2010 Overhead Capitalization Study

November 2010

Table of Contents

Background 3

Basis for Study 4

Study Approach....5

Summary of Key Findings 7

Comparison of Overhead Capitalization under Proposed and Current Methodologies 8

APPENDICIES

APPENDIX A – Current Capitalization Policies and Practices....10
APPENDIX B – Accounting and Regulatory Policy Guidance 12
APPENDIX C – Overhead Capitalization Evaluation Criteria....15
APPENDIX D – Budget Centre Input....16
APPENDIX E – Interview Background and Questionnaire....17
APPENDIX F – Overhead Capitalization Criteria 19
APPENDIX G – Budget Centre Interview Summary 21
APPENDIX H – Evaluation of Costs for Inclusion in Overhead Capitalization 26
APPENDIX I – Summary of Overhead Allocation Methodology 28
APPENDIX J – Comparison of Proposed vs Current Allocation Using 2009 Figures 30
APPENDIX K – Revisions to Capitalization Methodology for Depreciation 33

Background

Pacific Northern Gas Ltd. and its wholly-owned subsidiary, Pacific Northern Gas (N.E.) Ltd. (collectively "PNG" or "the Company"), operate over 3,500 kilometers of natural gas transmission and distribution pipeline and serve a base of more than 39,000 residential, commercial and industrial customers located in northern British Columbia.

The Company has established two operating divisions, PNG-West, which generally includes the assets of the parent company, and PNG (N.E.), which generally includes the assets of the subsidiary company and is comprised of three sub-divisions, Fort St. John ("FSJ"), Dawson Creek ("DC") and Tumbler Ridge ("TR"). The Company's activities are regulated by the British Columbia Utilities Commission ("BCUC"), with three separate revenue requirements applications being filed for consideration and approval based on operating area, including the PNG-West region, DC/FSJ and TR.

PNG's capital spending program to upgrade and maintain its capital assets is a major focus for the utility in terms of time and cost. Direct spending on capital projects for 2010 is estimated to be approximately $8 million, representing close to 4.5% of the net book value of property, plant and equipment as at December 31, 2009.

PNG's capital program requires significant support from all areas of the utility, including engineering, management, administration and infrastructure resources. These resources support both the operating activities and capital works projects carried out by the Company, and in many cases cannot be directly attributable to a specific capital project. Historically, PNG has allocated costs associated with these support activities to capital projects by means of a capital overhead allocation methodology that applied various cost drivers to a defined pool of costs.

Basis for Study

In June 2010, PNG commenced a study of its capital overhead allocation methodology.

The basis for this study was two-fold:

1) A study has not been completed for some time. This study will serve as the basis for the Company's new overhead capitalization methodology to be implemented in its 2011 revenue requirements applications; and

2) The Company will be transitioning from Canadian Generally Accepted Accounting Principles ("Canadian GAAP") to International Financial Reporting Standards ("IFRS") in the near future. IFRS is more restrictive than current accounting standards with respect to capitalization of overhead costs. This study proposes changes that align PNG's capitalization overhead methodology with IFRS requirements in this area.

   When this study was initiated, it was anticipated the Company would transition to IFRS effective January 1, 2011. However, in the intervening period the Canadian Accounting Standards Board announced an optional one-year deferral for regulated entities, postponing the transition to IFRS to January 1, 2012. The Company has made the decision to take the one-year deferral on this transition.

   Despite this deferral, the changes in capital overhead allocation methodology identified in this study are proposed for implementation effective 2011 to align the Company's accounting treatment in anticipation of the future transition to IFRS.

This study summarizes the approach used by PNG to complete its internal review and proposes a new capital overhead allocation methodology to be used on a go-forward basis.

Fiscal 2009 operating results have been used as the base year for the financial analysis presented in this study.

Study Approach

PNG's approach to this study incorporated the following steps:

- **Step 1: Document existing approach for capitalization of overhead costs**. In this step, PNG finance staff reviewed and summarized the existing processes and procedures for capitalization of costs, including overheads, to provide a context for this study. The current methodology is summarized in ***Appendix A***.

- **Step 2: Planning session with Company management**. In this step, PNG finance staff met with senior representatives from finance and field operations to discuss the project and to gain an understanding of those activities that appear to support, either directly or indirectly, capital projects at PNG. The purpose of this step was to identify specific activities within PNG that may be eligible to have costs allocated to capitalized overhead. Based on this activity, the decision was made to evaluate all budget centres as part of this project.

- **Step 3: Document regulatory and accounting policy guidance**. In this step, PNG researched guidance provided by various accounting and regulatory authorities on the topic of overhead capitalization. The objective of this step was to ensure that PNG's capital overhead allocation methodology was consistent with a cross-section of current industry standards and practices. A summary of the external guidance is provided in ***Appendix B***.

- **Step 4: Develop criteria for the capital overhead allocation methodology.** Based on the initial steps above, PNG developed a set of criteria to be used to evaluate its methodology for estimating the amount of overhead costs associated with capital projects. A summary of the evaluation criteria is included as ***Appendix C***.

- **Step 5: Budget centre interviews and discussion.** ***Appendix D*** provides a summary of budget centres included in this study. In this step PNG finance staff interviewed management of budget centres using standardized questionnaires to gain an understanding of budget centre activities that may be directly or indirectly related to the Company's capital projects. Information provided to interviewees in advance of scheduled meetings is included as ***Appendix E***. As supporting documentation for these interviews, the following information was compiled:
  - A written description of the activities performed by the budget centre, including specific activities that directly or indirectly support capital projects;
  - Estimates of the percentage of budget centre management's time related to capital activities budgeted for 2010; and
  - An indication as to whether there would be a reduction in human resources should all capital projects be discontinued.

- **Step 6: Document PNG's capital overhead capitalization criteria**. In this step, based on background research and budget centre interviews and discussion, PNG prepared a statement that summarizes PNG's guidelines for overhead capitalization. This statement is included as ***Appendix F***.

- **Step 7: Internal survey results.** In this step PNG finance staff reviewed and summarized data collected from all relevant departments, noting costs to be included in the new overhead allocation methodology. This information is provided in ***Appendix G***.

- **Step 8: Evaluation of costs.** In this step PNG finance staff evaluated and summarized indirect costs to be capitalized. ***Appendix H*** provides a summary of costs identified for capitalization. Appendix J discusses costs historically capitalized as compared to those proposed for capitalization under the new methodology.

- **Step 9: Develop new overhead allocation methodology.** In this step, PNG developed the proposed new overhead allocation methodology using 2009 actual financial information and the activities data obtained through the Step 5 interview process and as summarized in Step 8 above, including the percentage of time spent on capital activities. A common methodology is proposed for application at the divisional level, using cost and activity date for each division filing regulatory rate applications. The processes underlying the new overhead allocation methodology are summarized in ***Appendix I.***

- **Step 10: Write Study.** This step involved the writing of this report to document the process and results of the Company's internal review. ***Appendix J*** provides a comparison of how the proposed new overhead allocation methodology differs quantitatively from the current overhead allocation methodology.

- **Step 11: Proposed Revisions to Depreciation Capitalization.** An additional matter of note is that the capitalization of depreciation expense was also examined a part of this study. This step involved preparing a summary of the current process, the changes proposed to this methodology, and the financial effects of the proposed changes as documented in ***Appendix K***.

Summary of Key Findings

Based on the study undertaken, the following views have been incorporated into PNG's capital overhead allocation methodology:

1) Upon transition to IFRS, it is anticipated that IFRS capitalization methodology for overheads will be better aligned for ratemaking and regulatory reporting purposes.

- Implementation of the new overhead allocation methodology in the interim period will align the Company's capitalization approach with the more restrictive IFRS requirements for capitalized overhead.
- Harmonized treatment will avoid the requirement for a transactional two-ledger accounting, planning and reporting system with added cost and confusion that such systems would entail.
- This aligns with other Canadian regulatory jurisdictions (Ontario and Alberta) which will require utilities to adhere to IFRS capitalization accounting requirements on transition to IFRS.

2) Capitalized overhead costs are to reflect only those overhead costs that meet the definition of "directly attributable" as per the capitalization criteria presented in *Appendix F*.

Specifically, these costs would include:

- Field operations employee wages related to non-project-specific capital support and oversight (operations accounting and warehouse activities) directly related, or incremental to, capital projects;
- Field operations management and corporate management salaries related to non-project-specific capital support and oversight directly related, or incremental to, capital projects; and
- Employment benefit costs associated with employee wages and management salaries charged to capital projects.

3) Employee benefit costs are to be incorporated into the capital overhead allocation methodology.

- Employee benefit costs will be allocated to capital projects via the development and analysis of forecast employee benefit load rates that will be applied to capitalized wages and salaries.

4) A proportionate share of operating costs associated with vehicles and equipment involved in capital projects are to be allocated to capital projects.

- Costs will be allocated to capital projects on a pro rata basis using the historic percentage of equipment hours utilized for capital projects as a proportion of total equipment hours, with a periodic true-up to the actual capital utilization rate.
- All vehicle and equipment operating costs will be subject to allocation, including related insurance costs.

Comparison of Overhead Capitalization under Proposed and Current Methodologies

Overhead Capitalization

Under the proposed methodology, a detailed analysis of individual cost elements has been undertaken to determine amounts appropriate for capitalization. In addition, a detailed review of budget centre activity was also conducted to identify the appropriate percentage of costs to be capitalized.

A comparison of overhead amounts to be capitalized under the proposed new methodology based and the current methodology is provided in the tables below using 2009 figures for illustrative purposes. In addition to the overall impacts, information is provided on a disaggregated basis to reflect the impacts for each operating division for which a separate rate application is filed.

The percentage amounts capitalized as overhead is illustrative only and represents the total overhead capitalized divided by total operating, maintenance, administrative and general costs (“O,M,A&G”). The dollar figure for overhead capitalized is determined by application of the overhead capitalization methodology and not by application of this resultant percentage.

	Overall			PNG (West)		
Capitalized Overhead Element	2009 Proposed Methodology	2009 Current Methodology	Change	2009 Proposed Methodology	2009 Current Methodology	Change
1) Capitalization of general overhead costs						
Field Operations (Operating and Administration)	415,295	754,984	(339,689)	382,266	539,304	(157,038)
Corporate (Administration)	129,144	1,096,955	(967,811)	129,144	885,194	(756,050)
Benefits on Direct Labour	552,507	-	552,507	378,088	-	378,088
	1,096,946	1,851,939	(754,993)	889,498	1,424,498	(535,000)
2) Capitalization of warehouse and shop expenditures	64,287	89,650	(25,363)	64,287	58,635	5,652
3) Capitalization of equipment operating expenditures	230,283	260,754	(30,471)	161,908	192,004	(30,096)
4) Capitalization of unallocated capital	-	90,541	(90,541)	-	75,987	(75,987)
Total Overheads Capitalized	1,391,516	2,292,884	(901,368)	1,115,693	1,751,124	(635,431)
Gross Operating, Maintenance, Administrative & General Costs	21,453,260	21,453,260		14,345,638	14,345,638	
Percentage of Operating, Maintenance, Administrative and General Costs	6.49%	10.69%		7.78%	12.21%	

	DC / FSJ			TR		
Capitalized Overhead Element	2009 Proposed Methodology	2009 Current Methodology	Change	2009 Proposed Methodology	2009 Current Methodology	Change
1) Capitalization of general overhead costs						
Field Operations (Operating and Administration)	29,726	211,641	(181,915)	3,303	4,039	(736)
Corporate (Administration)	-	208,111	(208,111)	-	3,650	(3,650)
Benefits on Direct Labour	166,299	-	166,299	8,120	-	8,120
	196,025	419,752	(223,727)	11,423	7,689	3,734
2) Capitalization of warehouse and shop expenditures	-	31,015	(31,015)	-	-	-
3) Capitalization of equipment operating expenditures	66,703	67,027	(324)	1,672	1,723	(51)
4) Capitalization of unallocated capital	-	14,554	(14,554)	-	-	-
Total Overheads Capitalized	262,728	532,348	(269,620)	13,095	9,412	3,683
Gross Operating, Maintenance, Administrative & General Costs	6,115,025	6,115,025		992,597	992,597	
Percentage of Operating, Maintenance, Administrative and General Costs	4.30%	8.71%		1.32%	0.95%	

As per the first table above, on an overall basis, illustrative amounts for 2009 indicate that overheads capitalized under the proposed methodology would be $1,391,516 or 6.49% of gross O,M,A&G costs, compared to $2,292,884 or 10.69% of gross O,M,A&G costs under the current methodology. A detailed analysis of items contributing to the decrease is provided in ***Appendix J***.

The decrease in amounts capitalized is as anticipated given adherence to the more restrictive IFRS guidance which specifically excludes certain costs from capitalization, including those related to safety and training, project investigation and approval, and general administrative activities. Management judgment has been applied in identifying activities and costs to be included in the proposed overhead capitalization methodology. Costs identified for capitalization in the proposed methodology are subject to audit for compliance with IFRS capitalization requirements.

Appendix A – Current Capitalization Policies and Practices

PNG has an annual budget process that involves the preparation of separate capital and operations, maintenance and administration budgets for the upcoming fiscal period for each budget centre within the organization.

Capital Budgeting
Specific projects are identified and included within capital budgets prepared by responsible budget centres. Capital budgets are created using a bottom-up approach on a cost element basis. Once approved, an Authority For Expenditure ("AFE") is raised and a specific project identification number is assigned to the project. This identification number is used as the basis for assigning all costs directly attributable to the project as they are incurred – this includes labour and materials costs.

Operations, Maintenance, Administration & General Budgeting
Responsible budget centres also prepare O,M,A&G budgets. Prior year budgets provide the basis for individual expense items to be included and accounted for in this process.

O,M,A&G expenditures are generally budgeted based on the function and nature of the expenditures, including:

Operating Costs
- Transmission
- Distribution
- General
- Sales
- Billing

Maintenance Costs
- Transmission
- Distribution
- Processing
- General

Administrative/General Costs

The build-up of these amounts reflect the roll-up of amounts budgeted in detail based on BCUC account codes and, in further detail, based on cost elements.

Capitalization of Indirect Costs
PNG's current approach to the capitalization of costs not directly charged to capital projects has four distinct streams:

1) Capitalization of general overhead

PNG presently includes certain O,M,A&G expenditures in amounts allocated to capital projects as general capital overheads. Specifically, a percentage of amounts recorded as general operating costs under system operations, safety, training, allowed time off without pay, vacation and shorter work year leave benefits are capitalized, as is a percentage of amounts recorded as administration costs under administration and employee benefits.

Historically, amounts have been capitalized at BCUC-approved rates that have been updated annually based on the percentage of labour costs budgeted for capital projects relative to total budgeted labour costs (total budgeted labour costs = field labour costs budgeted for direct capital + field labour costs budgeted for O,M,A&G). The rationale for this allocation methodology is that overhead costs have been budgeted for capital/non-capital activities in direct proportion to field labour costs budgeted for these activities.

For reference, actual general overhead capitalized in 2009 were **$1,851,939**. ***Appendix J*** includes a summary of amounts included in the capitalization of general overhead.

2) Capitalization of warehouse and shop expenditures

On the premise that the warehouse and shop operate predominantly to support capital projects, the costs associated with these activities are allocated to capital projects.

These costs are allocated amongst individual capital projects based on labour hours worked on a project as a proportion of total labour hours spent on all capital projects in the year.

For reference, actual warehouse and shop expenditures capitalized in 2009 were **$89,650**.

3) Capitalization of equipment operating expenditures

Vehicle and equipment operating costs are captured via invoices, VISA card summaries, employee expense claims and payroll reporting (for time spent on repairs and maintenance of vehicles).

Costs are allocated to capital projects and O,M,A&G by applying the number of hours the equipment is used for a specific project (based on time of employee operating equipment as captured by payroll reporting) to standard equipment charge-out rates set on a periodic basis based on operating costs incurred and total hours the equipment has been charged out in previous periods. Variances from standard over (under) allocated at the end of the period are cleared to capital projects at the end of each month.

For reference, actual equipment operating expenditures allocated to capital projects in 2009 were **$260,754**.

4) Capitalization of "unallocated" capital

During the course of the year, field operations incur costs identified as capital expenditures but are not specifically attributable to a particular individual project. These costs are accumulated in a balance sheet account called unallocated capital.

These costs are allocated amongst individual capital projects based on labour hours worked on a project as a proportion of total labour hours spent on all capital projects in the year.

For reference, actual "unallocated capital" capitalized in 2009 was **$90,541**.

Appendix B – Accounting and Regulatory Policy Guidance

The following is a summary of guidance provided by accounting and regulatory authorities on the topic of overhead capitalization. This information has been gathered and reviewed to ensure that PNG's proposed capital overhead allocation methodology is consistent with a cross-section of current accounting standards and industry practices.

Based on the review of relevant guidance, aligning current accounting treatment for overhead capitalization with the more restrictive provisions of IFRS would not be considered a change in accounting policy, as the underlying policy of capitalizing overhead remains unchanged. The proposed methodology is a change in accounting estimate of amounts to be capitalized as part of the cost of property, plant and equipment to be applied on a prospective basis.

Accounting Guidance

Accounting Standards

The Canadian transition to International Financial Reporting Standards (IFRS) for most entities is to be effective January 1, 2011. However, in September 2010 the Canadian Accounting Standards Board announced an optional one-year deferral for rate-regulated entities, allowing for the postponement of the transition to IFRS for these entities to January 1, 2012.

The Company has made the decision to take this optional deferral and is required to comply with Canadian GAAP in effect pre-IFRS (prior to the financial year commencing January 1, 2011) for the intervening period. Despite this deferral, the Company's intent is to align its accounting treatment of capital overheads with IFRS requirements in anticipation of the future transition to IFRS.

Relevant guidance on accounting for capital assets under Canadian GAAP is provided in the Canadian Institute of Chartered Accountant's "Handbook Section 3061: Property, Plant and Equipment". Section 3061 (par 20) states that the cost of an item of property, plant and equipment includes direct construction or development costs (such as material and labour), and overhead costs *directly attributable* to the construction or development activity. This guidance is general in nature and open to judgment in application.

Under IFRS, guidance on accounting for capital assets, including the capitalization of overhead, is governed by International Accounting Standard 16, Property, Plant and Equipment (IAS 16).

IAS 16 states that the cost of an item of property, plant and equipment comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;
(b) any costs *directly attributable* to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management; and
(c) the initial estimate of the costs of dismantling and removing the item.

IAS 16 is more prescriptive than guidance under Canadian GAAP in that it provides examples of "directly attributable" costs, including:

(a) costs of employee benefits (as defined in IAS 19 Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;
(b) costs of site preparation;
(c) initial delivery and handling costs;
(d) installation and assembly costs;
(e) costs of testing whether the asset is functioning properly, and

(f) professional fees.

IAS 16 also provides examples of costs that are not to be capitalized as part of an item of property, plant and equipment, including:

(a) costs of opening a new facility;
(b) costs of introducing a new product or service (including costs of advertising and promotional activities);
(c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and
(d) administration and other general overhead costs.

Accounting Firms

Additional guidance on the issue of capitalization of directly attributable costs under IFRS is provided by international accounting firm, Deloitte, in their publication "iGAAP: IFRS for Canada". In this publication, Deloitte suggests that costs that are directly incremental as a result of the construction of a specific asset can be considered to be directly attributable if they relate to bringing the asset to working condition. Deloitte goes on to say that where an entity regularly constructs assets it is possible that some element of apparently 'fixed' costs may also be directly attributable. In such circumstances, it may be helpful to consider which costs would have been avoided if none of those assets had been constructed (7:4.2.2).

Guidance under IFRS is also provided by international accounting firm, PricewaterhouseCoopers, in their "IFRS Manual of Accounting", where they suggest as a general rule for overhead capitalization only incremental costs that would have been avoided had the asset not been constructed can really be directly and conclusively attributed to bringing the asset to its working condition.

Regulatory Guidance

In anticipation of the transition to IFRS, certain Canadian regulatory agencies have published accounting rules and comment papers to assist regulated entities with various issues pertaining to the transition. The following summarizes the positions of the Alberta Utilities Commission (AUC) and the Ontario Energy Board (OEB) on the matter of overhead capitalization:

Alberta Utilities Commission

AUC Rule 026 – 6(2(b)) – Capitalization/Non-Capitalization of Costs: General and Administrative Overhead (IAS 16.16 and 16.19(d))

> *Utilities shall adhere to the IFRS requirements for capitalization of costs that are not directly attributable to an asset.* Any financial difference that arises as a result of the adoption of IFRS requirements is to be identified in a Utility's First IFRS-Compliant GRA/GTA, and the Utility shall also propose in that rate application the method for settling the difference**. In addition, the Utility will file a copy of its updated capitalization policy as a part of its First IFRS-Compliant GRA/GTA***.*
>
> ** IFRS does not allow the capitalization of costs that are not 'directly attributable' to the asset.*
> *** For example, the establishment of a regulatory asset or liability.*
> **** This request would be subject to review by the AUC and interested parties as part of the AUC's decision making process.*

Ontario Energy Board

EB 2008-0408 – Transition to International Financial Reporting Standards – Issue 3.3 Capitalization

The Board will require utilities to adhere to IFRS capitalization accounting requirements for rate making and regulatory reporting purposes after the date of adoption of IFRS. The utility will file a copy of its capitalization policy, identifying any updates to the policy, as part of its first cost of service rate filing after IFRS adoption. Revenue requirement impacts of any change in capitalization policy must be specifically and separately quantified.

Clarification of Accounting for Overhead Costs Associated for Capital Work (Feb 24 2010)

As stated in the Board Report at Issue 3.3, the Board is requiring full compliance with IFRS requirements (eg. IAS 16) as applicable to non-regulated enterprises and only where the Board authorizes specific alternative treatment for regulatory purposes is alternative treatment acceptable.

Based on IFRS consultations EB-2008-0104/0408 survey results this may mean a reduction in capitalized overhead for some electric utility distributors that have previously capitalized administration and other general overhead costs no longer permitted under IFRS. It may mean an increase for those that have capitalized little or no overhead costs in the past.

Appendix C – Overhead Capitalization Evaluation Criteria

Methodologies for overhead capitalization address a set of formal, objective criteria that speak to company and policy objectives. In consideration of regulatory and accounting policy guidance presented in ***Appendix B***, PNG has established the following criteria for its capital overhead allocation methodology:

- **Defensible Cost Causation Linkage.** To conform to accounting guidelines, the methodology should show a direct causal link between capitalized overhead and capital activity.

- **Distinguishable from Directly Allocated Capital Costs.** The overhead costs must be distinguished from those that are directly charged to capital.

- **Transparency.** The methodology and calculations should be easy to follow and to understand by internal users and by external observers (i.e. regulators). This will facilitate acceptance of the methodology.

- **Freedom from Bias.** The methodology should not tend to allocate an undue proportion of costs toward either operating or capital activities.

- **Stability.** The methodology should not result in disproportionately large variations in the amounts of capitalized overhead from year-to-year.

- **Accuracy of Underlying Data.** Any data used in the methodology should be accurate and able to be relied upon. The data should provide an appropriate measure of the underlying volume of activity or output.

- **Flexibility/Adaptability.** The methodology should accommodate changes in organizational structure, business processes, and information systems with reasonable ease. Thus, the methodology should be dynamic: it should be relatively easy to update and keep current as the organization evolves. To the extent possible, it should automatically adjust for changes in circumstance.

- **Cost-effectiveness.** In evaluating different methodologies, PNG should ensure that they are cost-effective to implement. Additional accuracy may require significant additional cost, and thus an appropriate balance is required between precision and cost. In evaluating cost-effectiveness, two different perspectives are relevant:

    - ***Low implementation cost.*** All else being equal, the methodology should be capable of being implemented at a reasonable cost.

    - ***Low on-going costs.*** The methodology should have relatively low costs of upkeep. Further, it should reduce the administrative, recordkeeping and reporting burden imposed on operating staff. The methodology should also integrate easily with the process used to prepare the Company's financial statements.

Appendix D – Budget Centre Input

The input of all budget centre managers has been sought for this study. While some departments may not have a direct connection to capital activities, the decision to include all departments in the review process was made to ensure completeness of the study.

Area	Budget Centre	Description	Indicative Headcount
PNG-West	100	Regional Operations	**63**
	200	Customer Service	**16**
	300	Marketing & Lands	**1**
	410	Operations Accounting	**6**
	420	Customer Care	**13**
	500	Community Relations & Admin	**1**
	600	Construction Maintenance	**15**
	700	Technical Services	**7**
	720	Technical Services – Warehouse	**1**
	800	Engineering and Special Projects	**2**
PNG (N.E.)	9X1	Regional Operations	**26**
Head Office	90	President & CEO	**7**
	88	Human Resources	**2**
	89/91/92	Operations & Engineering	**3**
	93/99/900	Finance	**10**
	94/96	Regulatory Affairs	**2**
	095/798	Corp. Develop., Treasury & IT	**5**
	97	Information Technology	**3**

Appendix E – Interview Background and Questionnaire

The interview process was initiated with the circulation of the following background information on the project along with pre-established questions in the form of the questionnaire replicated below.

In addition, summary financial information for the relevant budget centre was provided as a reference point in the discussion. Telephone and in-person interviews were subsequently held to discuss the process and go through the questionnaires.

Background
PNG has made a significant investment in property, plant and equipment to serve its customer base.

The ongoing capital spending program to upgrade and maintain these assets is a major focus for the Company in terms of time and cost.

Direct spending on capital projects for 2010 is estimated to be approximately $8 million, representing 4.5% of the net book value of property, plant and equipment as at December 31, 2009.

PNG's capital program requires significant support from all areas of the utility, including engineering, management, administration and infrastructure resources. These resources support both the operating activities and capital works projects carried out by the Company, and in many cases cannot be directly attributable to a specific capital project.

As allowed under its regulatory model and current Canadian accounting standards, PNG has developed a capital overhead allocation methodology to allocate certain overhead costs to capital projects. This methodology applies various cost drivers (i.e. labour hours spent on capital project as a percentage of total labour hours) to an identified pool of overhead costs (i.e. supervisory time, employee benefits) as a means of allocating these costs to capital projects.

Reason for Current Study
PNG has commenced a review and update to its capital overhead allocation methodology.

The basis for this initiative is two-fold:

1) An update has not been completed for some time. The updated review will serve as the basis for the Company's overhead capitalization policy to be filed with the British Columbia Utilities Commission ("BCUC") for regulatory purposes; and

2) The Company is transitioning from Canadian accounting standards to International Financial Reporting Standards ("IFRS") effective January 1, 2011, and IFRS are more restrictive than current accounting standards with respect to capitalization of overhead costs.

Required Assistance
To assist with the study, we are undertaking interviews with senior representatives from each department to understand and identify those activities that appear to support, either directly or indirectly, capital projects at PNG.

The purpose of this step is to gain an understanding of the specific activities within PNG that may be eligible to have costs allocated to capitalized overhead.

Outputs from this activity will be:

- a list of budget centers to be included in the cost allocation methodology;
- a description of specific activities within budget centres that support capital projects;
- estimates of the percentage of the 2010 and 2011 budgeted cost of activities that should be allocated to capitalized overhead; and
- recommendations with respect to the basis for allocating these costs.

This project will be an iterative process:

- The results of the interview will be summarized;
- Preliminary financial analysis will be undertaken; and
- This information will then be circulated back for your review and comment.

Questionnaire

Human Resources	Self	X
	Mgmt Reports	X
	Other FTEs	X
	Total	X

1) Please describe the activities for this Budget Centre.

2) Please describe the capital activities that are <u>directly charged</u> to capital projects by this Budget Centre.

3) Please describe the process by which these costs are charged directly to capital projects.

   Do you think this approach is reasonable/appropriate? How could it be improved?

4) Please describe activities of this Budget Centre that might be considered to <u>indirectly</u> relate to capital projects.

   What would be an appropriate basis on which to allocate these costs to capital projects? (i.e. proportion of time spent, proportion of total dollars spent, by geographic cost centre, percentage of fleet)

   Approximately what percentage of the Budget Centre's management time is spent on indirect capital activities?

Individual	High (%)	Low (%)	Average (%)
Name	X%	X%	X%

5) Would your Budget Centre operate with fewer staff if the Company ceased to undertake all capital projects?

   If so, how many and why?

Appendix F – Overhead Capitalization Criteria

Internal Guidelines

Accounting and regulatory guidance (***Appendix B***) with respect to capitalization of overheads is general in nature. PNG has prepared its own internal guidelines to provide more specific direction as to the nature, type, and quantum of costs that should be included in costs to be capitalized.

The definition of capitalized overhead that has been adopted for this study is as follows:

<u>Capitalized Overhead</u>
Those items that are directly attributable to bringing the capital asset to the "location and condition necessary for its intended use" should be recognized as a capital cost. In addition to costs charged directly to the capital asset, other costs which are directly attributable to bringing the assets to their location and condition necessary for intended use but are not directly charged to the asset should be allocated to the asset cost.

Overheads capitalized represent a reasonable and appropriate amount of costs that are directly linked to capital activity (new assets acquired or constructed) but, due to the onerous nature of capturing these costs, are not directly assigned to individual capital projects.

In order to qualify as capitalized overhead:

- ***there must be an established causal link or association of these costs with capital activity;***
- ***these overhead costs must be distinguished from those that are directly charged to capital.***

Based on these criteria, overheads capitalized would include incremental costs associated with non-project specific capital support and oversight of activities directly related to capital projects.

Overhead Capital Activities

Activities that have costs to be included in capitalized overhead generally fall into one of the three categories noted below. While the boundaries between these types of activities are not always clear, the categories do help to provide a conceptual framework to help identify and evaluate those costs eligible for capitalized overhead:

1. Costs Specific to Capital Support but Not Allocated to Projects

This includes formulating, evaluating, initiating, designing, approving and implementing capital additions. These costs are captured in capitalized overhead because:

- These functions relate to many capital projects rather than specific or identified ones; and
- It is impractical to capture costs directly to specific capital projects.

An example of this would be the capital budgeting and capital risk assessment processes of ongoing capital projects.

2. **Oversight of Activities Directly Related to Capital Projects but Not Allocated to Projects**
   These costs include the direct supervision, cost control and reporting that are in direct support of capital projects.

   An example of this would be the supervision of construction departments.

3. **Support Functions and Infrastructure**
   This category covers the support functions and infrastructure networks that enable departments that are directly involved in performing capital work.

   An example of this would be found in the areas of Human Resources and IT.

Nature of Capitalized Overhead

Costs considered for inclusion in capitalized overhead can be distinguished from:

- **Costs charged directly to capital.** These are costs that are charged directly to capital projects and that therefore form part of the direct capital cost of the associated assets. Such costs include the costs of materials and construction labour, as well as any purchased services (e.g. outside contracting) that may be associated with installation of the asset.
- **Operating, maintenance, administrative and general expenses.** These costs appear in the income statement for PNG in the period concerned. These costs include any costs that are not identified as being related to capital projects. They thus encompass a wide range of costs, including costs associated with customer billing and service, most administrative and general costs, and costs associated with maintenance activities.

Capitalized overhead, in contrast to the cost elements above, reflects those costs that relate to capital projects but that have not been specifically identified with any individual capital project.

Appendix G – Budget Centre Interview Summary

The following table summarizes budget centres activities related to capital projects as identified in the study interview process, as well as the estimated time that management spends on capital-related activities, and an assessment of the appropriateness for capitalization of the costs associated with such activities.

Budget Centre	Activities related to capital projects		Management's estimate of their time spent on capital activities			Assessment of Appropriateness for Capitalization
			Low	High	Average	
100 – Regional Operations (West)	Direct:	None	20.0%	30.0%	25.0%	**Capital Overhead** Management time on capital activities is considered to be incremental to capital projects
	Indirect:	Management time on: annual capital plans; annual capital risk assessment; AFE review and monitoring; and unexpected events requiring evaluation and subsequent capital expenditures				
200 – Customer Service	Direct:	None	5.0%	10.0%	7.5%	**Not Capital** As costs are generally recovered, management time is not considered to be incremental to capital projects
	Indirect:	Management involvement in third-party requests (i.e. main alterations); costs are generally recovered from third parties				
300 – Marketing & Lands	Direct:	None	35.0%	40.0%	37.5%	**Capital Overhead** Management time on capital activities is considered to be incremental to capital projects
	Indirect:	Considerable time spent in support of construction maintenance, including: management and administration of applications and permits required for new capital projects and upgrades to existing plant; coordination of Hearing of Intent process with Oil & Gas Commission for capital projects; coordination of notification to landowners				

Budget Centre	Activities related to capital projects		Management's estimate of their time spent on capital activities			Assessment of Appropriateness for Capitalization
			Low	High	Average	
		affected by capital projects				
410 – Operations Accounting	Direct:	AP clerk has first aid certification and occasionally provides first aid services to construction projects; time spent on this activity is charged direct to capital	10.0%	20.0%	15.0%	**Capital Overhead** Nature of activities identified as being indirectly related to capital projects for this budget centre are incremental to capital activities; time devoted to these activities would be freed up if capital activities ceased, potentially eliminating one FTE staff position.
	Indirect:	Entry, processing and review of AP, payroll and equipment costing entries for capital transactions; setting up and closing capital projects; review, analysis and reporting on capital AFEs; consolidation/ review of capital field budgets; review of purchasing and inventory transactions for capital				
420 – Customer Care	Direct:	None	0.0%	10.0%	5.0%	**Not Capital** Activities in themselves are not capital in nature as budget centre capital projects are generally purchased systems, not developed in-house; time involved would be for scoping requirements, training, etc.
	Indirect:	Occasionally time might be required on customer-service related capital projects (i.e. new phone system)				
500 – Community Relations and Administration	Direct:	None	10.0%	20.0%	15.0%	**Not Capital** Nature of activities identified as being indirectly related to capital projects for this budget centre are of an administrative nature associated with activities that precede capital activity rather than a support function for departments directly involved in performing capital work
	Indirect:	Manager is "go-to-guy" on many matters: - litigation support, where legal costs are capitalized but internal time and costs are not - support for third-party initiatives related to capital projects (PTP-related programs) - business cases and feasibility				

Budget Centre	Activities related to capital projects		Management's estimate of their time spent on capital activities Low	High	Average	Assessment of Appropriateness for Capitalization
		studies re: billing and metering system replacement				
600 – Construction Maintenance	Direct:	Budget centre capital projects (services, mains, signs, posts, markers, investigative digs, painting, piping, equipment and heavy equipment purchases) support for all large capital projects	70.0%	80.0%	75.0%	**Capital Overhead** Management time on capital activities is considered to be incremental to capital projects
	Indirect:	By nature, most of groups activities relate to capital projects				
700 – Technical Services	Direct:	Budget center specific capital projects (capital upgrades, source and purchase materials for capital projects, SCC program costs, EVC computer and system upgrades)	60.0%	60.0%	60.0%	**Capital Overhead** Management time on capital activities is considered to be incremental to capital projects
	Indirect:	Significant amount of management time is spent on capital projects, including project studies and troubleshooting issues related to capital projects as they arise				
720 – Technical Services Warehouse	Direct:	No costs presently charged direct to capital projects	50.0%	50.0%	50.0%	**Capital Overhead** Employee time related to sourcing and purchasing of capital items is considered to be incremental to capital projects
	Indirect:	The warehouse department is responsible for the sourcing and purchasing of all materials for capital projects				
800 – Engineering and Special Projects	Direct:	Costs related to design and drafting for capital projects	25.0%	35.0%	30.0%	**Capital Overhead** Management time on capital activities is considered to be incremental to capital projects

Budget Centre	Activities related to capital projects		Management's estimate of their time spent on capital activities Low	High	Average	Assessment of Appropriateness for Capitalization
	Indirect:	Budget centre management's time on planning, administration and supervision, as well as time spent on actual design work related to capital projects				
9X1 – Regional Operations NE	Direct: Indirect:	All direct costs related to construction and/or purchase of property, plant and equipment items for the region Management time on: annual capital plans; annual capital risk assessment; AFE review, approval and monitoring; and unexpected events requiring evaluation and subsequent capital expenditures	20.0%	30.0%	25.0%	**Capital Overhead** Management time on capital activities is considered to be incremental to capital projects
88 – Human Resources	Direct: Indirect:	No direct involvement in capital projects Time and activities related to search and hiring of staff/project managers (i.e. KSL Project); time spent on HR related capital projects (Great Plains HR module)	0.0%	0.0%	0.0%	**Not Capital** Nature of activities identified as being indirectly related to capital projects for this budget centre are of an administrative nature rather than a support function for departments directly involved in performing capital work
90 – President and Chief Executive Officer	Direct: Indirect:	None – no direct involvement in capital projects Time spent on capital budgeting, cost monitoring and regulatory process	3.0%	5.0%	4.0%	**Not Capital** Nature of activities identified as being indirectly related to capital projects for this budget centre are of an administrative nature rather than a support function for departments directly involved in performing capital work

Budget Centre	Activities related to capital projects		Management's estimate of their time spent on capital activities: Low	High	Average	Assessment of Appropriateness for Capitalization
93/99/90 – Finance	Direct:	None – no direct involvement in capital projects	3.0%	6.0%	4.5%	**Not Capital** Nature of activities identified as being indirectly related to capital projects for this budget centre are of an administrative nature rather than a support function for departments directly involved in performing capital work
	Indirect:	Time spent on capital budgeting, fixed asset accounting and rate and regulatory applications				
91/92/89 – Operations & Engineering	Direct:	None – no direct involvement in capital projects	33.0%	50.0%	41.5%	**Capital Overhead** Management time on capital activities is considered to be incremental to capital projects
	Indirect:	Management time spent on: - capital budgeting process - annual capital risk review and assessment; - capital project/capital budget oversight; - regulatory process related to capital projects				
95/798 – Corporate Development, Treasury, IT	Direct:	None – no direct involvement in capital projects	8.0%	12.0%	10.0%	**Not Capital** Nature of activities identified as being indirectly related to capital projects for this budget centre are of an administrative nature rather than a support function for departments directly involved in performing capital work
	Indirect:	Capital project financing; rate applications; investor relations				
97 – Information Technology	Direct:	No activities charged; capital purchases made	0.0%	0.0%	0.0%	**Not Capital** Nature of activities identified as being indirectly related to capital projects for this budget centre are of an administrative nature rather than a support function for departments directly involved in performing capital work
	Indirect:	IT-related capital projects (product assessment, supplier quotes, coordination of install)				
94/96 – Regulatory Affairs	Direct:	None – no direct involvement in capital projects	3.0%	5.0%	4.0%	**Capital Overhead** Management time on capital activities is considered to be incremental to capital projects; activities are key to the advancement and approval of capital projects
	Indirect:	CPCN applications; capital-related legal matters (i.e. Porpoise Harbour); rate applications for capital projects				

Appendix H – Evaluation of Costs for Inclusion in Overhead Capitalization

The following table summarizes costs proposed for capitalization based on this study, as well as the rationale for capitalizing these costs and the proposed allocation bases on which amounts to be capitalized are determined. ***Appendix I*** provides additional detail of the methodology to be applied.

Category	Description	Rationale	Allocation base
Field Operations (operations and administration): **Support field employee labour and benefit expense**	Estimated cost of staff time and associated benefit costs devoted to capital activities	▪ Costs specific to capital support but not allocated to projects ▪ Time spent by field operations on administration and processing of capital project transactions (AFE administration; payments processing, etc)	Apply estimated percentage of time on capital activities to identified staff labour and benefit costs
Corporate (administration): **Management salary and benefit expense**	Estimated cost of management time and associated benefit costs devoted to capital activities	▪ Costs specific to capital support / oversight directly related to capital projects but not allocated to projects ▪ A considerable amount of management time has been identified as devoted to capital projects, including time for ongoing capital planning, capital risk assessment, AFE monitoring and contingency planning ▪ This time and the associated costs have been assessed as incremental to capital works undertaken by the Company, and therefore it is considered appropriate to capitalize a portion of these costs	Apply estimated percentage of time on capital activities to identified management salary and benefit costs
Benefits on Direct Labour: **Field employee benefit expense**	Estimated field employee benefit costs as determined by a benefit load analysis	▪ Directly related to capital projects ▪ Field employee time spent on capital projects is charged directly to capital projects ▪ Employee benefits attributable to this time are also considered directly related to these capital projects, therefore it is appropriate to capitalize a portion of these costs	Apply standard employee benefit load rate to field labour costs capitalized to specific capital projects
Warehouse and Shop Expense	Estimated cost of staff time and associated benefit costs devoted to capital activities	▪ Costs specific to capital support but not allocated to projects ▪ Time spent by warehouse staff related to sourcing and purchase of materials for capital projects	Apply estimated percentage of time on capital activities to identified staff labour and benefit costs
Equipment Operating Expense	Operating costs related to transportation and heavy work equipment used in capital projects (i.e. fuel, repairs, maintenance, insurance)	▪ Directly related to capital projects ▪ Transportation and heavy work equipment are directly used in performance of capital activities ▪ Operating costs can be considered directly related to the underlying activity, therefore it is appropriate to capitalize a portion of these costs	Apply standard charge out rates to hours equipment utilized for specific capital projects

As noted previously, the study considered all cost categories, including those historically allocated to capital projects. Some of these costs have an incremental relationship to capital projects undertaken, and it can be difficult to establish a reasonable basis on which to allocate the costs to projects.

General Administrative and Overhead Costs

Historically, a wide range of operating and administrative costs have been included in PNG's overhead capitalization methodology. Many of these costs are specifically excluded from capitalization as per IAS 16:19(d), including administration and general costs.

Based on this study, certain management and staff (operations accounting and warehouse) time has been identified as being dedicated to non-project specific capital support and/or oversight directly related to capital projects, and as being incremental to the Company's capital projects. In addition, the associated employee benefit costs related to time and labour charged direct to capital projects have been proposed for capitalization.

Other than these salary and employee benefit costs identified, no additional administrative, support or infrastructure costs have been identified as meeting the capitalization criteria established in ***Appendix F***. This evaluation is based on interview feedback and difficulty in attributing specific incremental costs of this nature to capital activity. While individuals interviewed were generally able to attribute a percentage of their time as being capital-related, they were reluctant to prescribe a percentage of support/administrative costs on the basis that these costs would be incurred regardless of the level of capital activity.

Warehouse and Shop Expenditures

The activities of the warehouse and shop provide general support for all of the Company's operations, including operations, maintenance and capital activities. On this basis, expenditures related to warehouse and shop activities have historically been allocated to capital. Warehouse labour costs and related employee benefits associated with time on sourcing and purchase of materials for capital projects have been identified for capitalization (see "support field employee labour and benefits" included in table above). On a cost-benefit basis, no further analysis has been undertaken to identify what additional costs related to these activities, if any, might be considered directly attributable to capital activities.

Equipment Operating Expense

A divergence from historic practice is that the cost of vehicle and equipment insurance (2009 – $69,000) has been incorporated into the analysis of equipment operating expenditures allocated to capital projects (see "equipment operating expense" included in table above).

Unallocated Capital

Amounts historically charged to this account included amounts related to capital projects but not specifically attributable to any one project. A review of costs accumulated indicates a diverse mix of items. On a go-forward basis, the day-to-day allocation of expenditures will be refined to ensure project costs are charged to specific projects and the use of this account will be discontinued.

Appendix I – Summary of Overhead Allocation Methodology

The allocation methodology for each of the costs identified in ***Appendix H*** for inclusion in the overhead capitalization is summarized below:

Capitalization of general overhead costs

Field Operations (Operating and Administration):
Support Field Employee Labour and Benefit Expense

1) Annual review and update of operations accounting budget centre activity to identify and validate those involved in capital activities.
2) Obtain management estimate of percentage time devoted to capital activities for identified budget centre.
3) Obtain field staff salary expense for budget centre as well as employee benefit load rate compiled by Human Resources.
4) Calculate total compensation for budget centre.
5) Apply estimated percentage time devoted to capital activities to total compensation and allocate cost to capital projects on a pro rata basis of project capital cost over total capital costs for period.

Corporate (Administration):
Management Salary and Benefit Expense

1) Annual review and update of budget centre activity to identify and validate those involved in capital activities.
2) Obtain management estimate of percentage time devoted to capital activities for identified budget centres.
3) Obtain management salaries for budget centres as well as management employee benefit load rate compiled by Human Resources.
4) Calculate total compensation for budget centre.
5) Apply estimated percentage time devoted to capital activities to total compensation and allocate cost to capital projects on a pro rata basis of project capital cost over total capital costs for period.

Benefits on Direct Labour:
Field Employee Benefit Expense

1) Identify field employee labour costs budgeted as being directly charged to capital projects.
2) Obtain field employee labour employee benefit load rate updated annually by Human Resources.
3) Apply labour benefit load rate to labour costs charged to specific capital projects and allocate benefit cost to capital project.

Warehouse and Shop Expenditures

1) Annual review and update of operations warehouse budget centre activity to identify and validate those involved in capital activities.
2) Obtain management estimate of percentage time devoted to capital activities for identified budget centre.
3) Obtain field staff salary expense for budget centre as well as employee benefit load rate compiled by Human Resources.
4) Calculate total compensation for budget centre.
5) Apply estimated percentage time devoted to capital activities to total compensation and allocate cost to capital projects on a pro rata basis of project capital cost over total capital costs for period.

Equipment Operating Expense

1) Identify historic equipment operating costs by equipment class.
2) Obtain details of historic equipment usage, including total hours charged to projects and total hours charged to capital projects.
3) Calculate historic operating cost per hour charged to projects and allocate to capital projects based on total hours charged to specific capital projects.
4) True up allocation of overhead at year end based on actual costs and equipment usage.

The proposed methodology developed to effect the allocation of overhead costs is considered to meet all of the evaluation criteria established in ***Appendix C***.

Appendix J – Comparison of Proposed vs Current Overhead Allocation Using 2009 Figures

The following table summarizes the proposed allocation of costs based on this study compared to costs historically allocated to capital projects:

Capitalized Overhead Element	Overall 2009 Proposed Methodology	2009 Current Methodology	Change
1) Capitalization of general overhead costs			
Field Operations (Operating and Administration)	415,295	754,984	(339,689)
Corporate (Administration)	129,144	1,096,955	(967,811)
Benefits on Direct Labour	552,507	-	552,507
	1,096,946	1,851,939	(754,993)
2) Capitalization of warehouse and shop expenditures	64,287	89,650	(25,363)
3) Capitalization of equipment operating expenditures	230,283	260,754	(30,471)
4) Capitalization of unallocated capital	-	90,541	(90,541)
Total Overheads Capitalized	1,391,516	2,292,884	(901,368)
Gross Operating, Maintenance, Administrative & General Costs	21,453,260	21,453,260	
Percentage of Operating, Maintenance, Administrative and General Costs	6.49%	10.69%	

The following is a summary of items giving rise to the change in amounts proposed for capitalization from those historically capitalized:

1) Capitalization of general overhead costs – decrease of $754,993

- Historically, a diverse mix of administrative and overhead costs have been captured by the capitalization process
- Management and staff (operations accounting and warehouse) time and benefit costs considered to relate to non-project specific capital support and/or oversight directly related to capital projects, and considered incremental to the Company's capital projects, have been proposed for capitalization
- No other administrative, support or infrastructure costs have been identified as meeting the capitalization criteria established
- Key elements of this decrease are summarized in the following table:

	Cost Centre	Proposed Methodology	Current Methodology	Net Increase (Decrease)
Field Operations (Operating and Administration)				
100	Regional Operations - West	40,486	238,101	(197,615)
200	Customer Service	-	60,133	(60,133)
300	Marketing & Lands	36,225	153	36,072
410	Operations Accounting	97,157	73,927	23,230
420	Customer Care	-	34,253	(34,253)
500	Community Relations & Admin.	-	15,411	(15,411)
600	Construction Maintenance	89,496	66,013	23,483
700	Technical Services	79,268	39,744	39,524
800	Engineering & Special Projects	39,634	11,569	28,065
		382,266	539,304	(157,038)
931/951/961	Regional Operations – NE	33,029	427,441	(394,412)
	Less: Shared Services	-	(211,761)	211,761
		415,295	754,984	(339,689)
Corporate (Administration)				
90	Chief Executive Officer	-	361,354	(361,354)
88	Human Resources	-	395,879	(395,879)
091/092/089	Operations and Engineering	120,636	33,835	86,801
095/798	Corp. Development, Treasury, IT	-	24,869	(24,869)
97	Information Technology	-	90,261	(90,261)
093/099/900	Finance	-	142,441	(142,441)
094/096	Regulatory	8,508	28,705	(20,197)
	Unallocated	-	19,611	(19,611)
		129,144	1,096,955	(967,811)
Benefits on Direct Labour				
	Regional Operations - West	378,088	-	378,088
	Regional Operations – NE	174,419	-	174,419
		552,507	-	552,507
		1,096,946	1,851,939	(754,993)

No comparative amounts are presented for amounts proposed for capitalization related to benefits on direct labour. An element of these expenditures would have been captured in the historic allocation methodology by virtue of the inclusion of these expenditure amounts in the cost pools to which the approved capitalization rates were applied. However, these amounts cannot be broken out in the summary above.

2) Capitalization of warehouse and shop expenditures – decrease of $25,363

- Historically, all warehouse and shop expenditures have been capitalized; proposed methodology includes warehouse staff labour and benefit costs but excludes other costs of this budget centre

3) Capitalization of equipment operating expenditures – decrease of $30,470

- Variance arises due to fact that previous standard rates were updated annually using the greater of the historic rate and the rate based on current expenditures, as well as the inclusion of operating expenditures related to non-tracked equipment of $68,087 in the current allocation – this resulted in an higher capitalization of costs in prior years

- This has been partially offset by $63,000 in vehicle insurance costs being capitalized in the proposed amounts – insurance was not capitalized in the past

4) Capitalization of unallocated capital – decrease of $90,541

- Historically, full amount accumulated in “unallocated capital” account has been capitalized
- Account includes a diverse mix of costs (freight charges, bug repellant, antifreeze, cleaners for shop, office supplies, inventory count adjustments)
- Going forward, the allocation of expenditures will be refined to ensure all project costs are charged to specific projects and the use of this account will be discontinued

Appendix K – Revisions to Capitalization Methodology for Depreciation

As part of the study of overhead capitalization, the capitalization of depreciation expense was also examined.

Historically, a portion of the annual depreciation expense for certain asset classes has been allocated to the cost of capital projects at rates based on historic precedent, including the following:

484 – Transportation equipment	18% of expense capitalized
485 – Heavy work equipment	100% of expense capitalized
486 – Small tools and work equipment	48% of expense capitalized

Depreciation capitalized is allocated amongst individual capital projects based on labour hours worked on a project as a proportion of total labour hours spent on all capital projects in the year.

For reference, actual depreciation expense capitalized in 2009 was **$289,896**.

Based on a review of the underlying methodology, PNG will continue to capitalize depreciation expenditures related to equipment directly involved in capital projects, however, as a refinement to the methodology:

- the actual percentage of equipment hours used for capital work of the total equipment hours will be used as the basis for allocating these costs; and
- depreciation expense related to small tools and work equipment (2009 – $61,759) will no longer be capitalized, as from a cost-benefit perspective, the tracking and allocation of these costs to specific projects cannot be done efficiently.

The allocation methodology is substantively the same as that applied for equipment operating expenditures as per ***Appendix I***:

Category	Description	Rationale	Allocation base
Equipment depreciation expense	Depreciation expense related to transportation and heavy work equipment used in capital projects	▪ Directly related to capital projects ▪ Transportation and heavy work equipment are directly used in performance of capital activities ▪ Depreciation expense can be considered directly related to the underlying activity, therefore it is appropriate to capitalize a portion of these costs	Apply standard charge out rates to hours equipment utilized for specific capital projects

For illustrative purposes, with this refinement, depreciation expense capitalized in 2009 would have decreased by $104,894, primarily due to:

- the exclusion of small tool depreciation from costs historically capitalized ($62,000 decrease); and
- the charge-out of costs being based on actual use of heavy equipment in capital projects being 76.9% of time used compared to current allocation to capital projects equal to 100% of depreciation expense ($41,000 decrease).

Appendix B – Accounting and Regulatory Guidance

In this Appendix, we provide references to a variety of Canadian and US sources of guidance on the capitalization of overhead costs. This listing is not comprehensive, but does capture the key sources that are likely to be of interest or relevance to PNG.

A. Canadian Guidance

1. British Columbia Utilities Commission (BCUC)

While the BCUC does not publish an accounting procedures handbook with further guidance for utilities, they recognize Canadian GAAP when assessing overhead costs allocated to capital.

2. Alberta Utilities Commission (AUC) Rule 026 Rule Regarding Regulatory Account Procedures Pertaining to the Implementation of the International Financial Reporting Standards

Section 6(2) of Rule 026 provides guidance related to Specific Regulatory Accounting Items relating to Property Plant & Equipment as follows:

> "(b) Capitalization/Non-Capitalization of Costs: General and Administrative Overhead (IAS 16.16 and 16.19(d))
>
> Utilities shall adhere to the IFRS requirements for capitalization of costs that are not directly attributable to an asset. Any financial difference that arises as a result of the adoption of the IFRS requirements is to be identified in a Utility's First IFRS-Compliant GRA/GTA, and the Utility shall also propose in that rate application the method for settling the difference. In addition, the Utility will file a copy of its updated capitalization policy as a part of its First IFRS-Compliant GRA/GTA.
>
> (f) Capitalization/Non-Capitalization of Costs: Pre-Operating Costs (IAS 16.19, 16.20 (a) and 16.20(b))
>
> Utilities shall adhere to the IFRS requirements regarding the treatment of pre-operating costs. Any financial difference that arises as a result of the adoption of the IFRS requirements is to be identified in a Utility's First IFRS-Compliant GRA/GTA. The Utility shall propose in that rate application the method for settling the difference. In addition, the Utility shall file a copy of its updated capitalization policy as a part of its First IFRS-Compliant GRA/GTA.
>
> (g) Capitalization/Non-Capitalization of Costs: Training Costs (IAS 16.19 (c))
>
> Utilities shall adhere to the IFRS requirements regarding the capitalization of training costs. Any financial difference that arises as a result of the adoption of the IFRS requirements is to be identified in a Utility's First IFRS-Compliant GRA/GTA. The Utility will propose in that rate application the method for settling the difference. In addition, the utility will file a copy of its updated capitalization policy as a part of its First IFRS-Compliant GRA/GTA."

3. *Ontario Energy Board's Accounting Procedures Handbook for Electric Distribution Utilities*

Article 410 of the Ontario Energy Board Accounting Procedures Handbook states:

> "Property, Plant and Equipment should be recorded at cost, which includes the purchase price and other acquisition costs such as: option costs when an option is exercised, brokers' commissions, installation costs including architectural, design and engineering fees, legal fees, survey costs, site preparation costs, freight charges, transportation insurance costs, duties, testing and preparation charges."[1]

Further guidance is provided by Article 230, Definitions and Instructions, No. 20. This document defines the components of construction cost as follows:

> "the cost of construction properly included in the electric plant accounts shall include where applicable, the cost of labour; materials and supplies; transportation; work done by others for the utility; injuries and damages incurred in construction work; privileges and permits; special machinery services; allowance for funds used during construction; and such portion of general engineering, administrative salaries and expenses, insurance, taxes, and other similar items as may be properly included in construction costs."[2]

4. *Ontario Energy Board's Uniform System of Accounts for Class A Gas Utilities*

According to the Ontario Energy Board's Uniform System of Accounts for Class "A" Gas Utilities, Appendix A, Plant Accounting Instructions:

> "Overhead Charged to Construction: includes engineering, supervision, administrative salaries and expenses, construction engineering and supervision, legal expenses, taxes and other similar items. The assignment of overhead costs to particular jobs or units shall be on the basis of a reasonable allocation of actual costs. The records supporting the entries for overhead charged to construction costs shall be maintained so as to show the total amount for each element of overhead for the year and the basis of allocation."

5. *CICA Handbook Section 3061 Property, Plant and Equipment ("PP&E")*

This Section of the Handbook of the Canadian Institute of Chartered Accountants ("CICA") discusses measurement of PP&E. Section 3061.16 indicates that PP&E should be recorded at cost. Cost is defined in Section 3061.05 as "the amount of consideration given up to acquire, construct, develop or better an item of PP&E and includes all costs directly attributable to the acquisition, construction, development or betterment of the asset".

When an asset is constructed or developed over time, Section 3061.20 indicates that "The cost of an item of property, plant and equipment includes direct construction or development costs (such as materials and labour), and overhead costs *directly attributable* to the construction or development activity." [Emphasis ours]

The Handbook does not define the term "directly attributable"; however, this term is used throughout the handbook in various sections with reference to cost allocations.

---

[1] *Ontario Energy Board, Accounting Procedures Handbook, Article 410, p. 7.*
[2] *Ontario Energy Board, Accounting Procedures Handbook, Article 230, p. 5.*

The accounting standard does not go into further details on how the overhead costs should be identified or the actual determination of an overhead rate.

6. REALpac Accounting Practices Handbook

The Real Property Association of Canada ("REALpac") has published a manual to provide practical and professional interpretations of accounting principles as they relate to Canadian real estate investment and development companies.

REALpac recommends that general and administrative costs directly attributable to construction of a property should be capitalized as a cost of the project. The section describes general and administrative costs to include the following:

- Salaries and benefits of officers of company;
- Travel and automotive costs;
- Audit and legal fees;
- Occupancy costs;
- Stationery;
- Office expenses,;
- Directors' fees;
- Insurance;
- Computer facility costs;
- Subscriptions;
- Capital and business taxes and;
- Donations.

General and administrative costs that cannot be identified with a specific project or projects should not be allocated as a capitalized cost. REALpac gives the example of corporate stewardship costs as a cost that would not be capitalized.

If general and administrative costs (that qualify for capitalization) relate to a number of construction projects, then REALpac recommends that they be allocated to the projects using judgment and well supported methodology. REALpac advises that a time basis would be the most appropriate basis for allocation in most cases. The allocation method should be used on a consistent basis.

B. International Guidance

1. International Financial Reporting Standards - General

The Accounting Standards Board of Canada ("AcSB") issued an amendment to Part I of the CICA Handbook, providing an optional one-year deferral of the mandatory date for adoption of IFRSs by entities with rate regulated activities , thereby allowing such enterprises an election to continue applying the accounting standards in Part V of the CICA Handbook for an additional year.

As a result of recent initiatives PNG expects to be required to report under International Financial Reporting Standards ("IFRS") by 2012, but may early adopt IFRS. Therefore, at the time of this report, there is still some uncertainty regarding the details of the application of IFRS to regulated Canadian utilities.

The guidance for capitalization in IFRS is based on the standard IAS16, an extract of which is included below. IFRS is more restrictive than Canadian GAAP accounting standards for regulated utilities with respect to the capitalization of overhead costs. IFRS and Canadian standards may evolve in the period leading up to the adoption of IFRS.

2. IAS 16 Property, Plant and Equipment

The guidance under IAS 16 from the International Accounting Standards Board (IASB) prescribes the accounting treatment for property, plant and equipment so that users of the financial statements can discern information about an entity's investment in its property, plant and equipment and the changes in such investment. The principal issues in accounting for property, plant and equipment are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognized in relation to them. Among other guidance, the standard states that:

> "The cost of an item of property, plant and equipment comprises:
>
> (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
>
> (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
>
> (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period."

C. US Guidance

1. Uniform System of Accounts – Federal Energy Regulatory Commission

Under the Uniform System of Accounts prescribed for public utilities and licensees subject to provisions of the Federal Power Act, capital overhead is defined as:

"Overhead Construction Costs"

A. All overhead construction costs, such as engineering, supervision, general office salaries and expenses, construction engineering and supervision by others than the accounting utility, law expenses, insurance, injuries and damages, relief and pensions, taxes and interest, shall be charged to particular jobs or units on the basis of the amounts of such overheads reasonably applicable thereto, to the end that each job or unit shall bear its equitable proportion of such costs and that the entire cost of the unit, both direct and overhead, shall be deducted from the plant accounts at the time the property is retired.

B. As far as practicable, the determination of payroll charges included in construction overheads shall be based on time card distributions thereof. Where this procedure is impractical, special studies shall be made periodically of the time of supervisory employees devoted to construction activities to the end that only such overhead costs as have a definite relation to construction shall be capitalized. The addition to direct construction costs of arbitrary percentages or amounts to cover assumed overhead costs is not permitted.

C. For Major utilities, the records supporting the entries for overhead construction costs shall be so kept as to show the total amount of each overhead for each year, the nature and amount of overhead expenditure charged to each construction work order and to each electric plant account, and the bases of distribution of such costs.

D. Summary

All of this guidance has a common theme. Overhead that can be directly attributed to the construction project should be capitalized as part of the cost of the project. Limited guidance is given to determine which items of overhead would be considered to be "directly attributed" to a project. It seems clear that each entity must assess its overhead expenses by type and determine if the cost is necessary to perform the construction project and if so, a portion of the cost should be capitalized. A reasonable basis of allocation must be determined. No guidance is given on allocation methods.

No single regulatory guideline, statement, or source exists that is universally accepted by utilities and regulators as the definitive statement, definition, or standard that prescribes what types of overhead costs should be considered for capitalization. However, this topic has been the subject of discussion and comment among regulators and a body of evidence exists on the topic and a number endorse a common principle: that any assignment of indirect costs to a capital project should be done based upon some reasonable causal link or association with the capital activity.

Appendix C – References

The following table details the research KPMG conducted to assess regulatory guidance and practices in other Canadian utilities.

Utility	Commission	Year	Reference/Source	Order / Decision
TGVI	BCUC	2004	Application for Approval of 2003 Actual Revenue Surplus, Forecast 2005 Royalty Adjusted Cost of Gas, Amortization of the Gas Cost Variance Account Balance and 2005 Customer Rates	G-113-04
TGI	BCUC	2009	Approval of Revenue Requirements and Delivery Rates Application	G-191-08
TGI	BCUC	2004	Approval of 2005 Revenue Requirements and Delivery Rates	G-112-04
TGI	BCUC	2004	Approval of 2004 Revenue Requirements and Delivery Rates	G-80-03
TGI	BCUC	2009	Application for Approval of 2010 and 2011 Revenue Requirements	G-141-09
TGVI	BCUC	2009	Application for Approval of 2010 and 2011 Revenue Requirements, Rates, Cost of Service, Rate Design and Revenue Deficiency Deferral Account	G-140-09
BC Gas	BCUC	1997	1998 to 2002 PBR Application Volume 1, Section F	
BC Gas	BCUC	1997	Settlement Agreement	G-85-97
TGI	BCUC	2003	2003 Revenue Requirement - Section 6 Accounting Issues Write up : Page E-13 Table - Section H - Tab 9, Page 2.2	
TGI	BCUC	2003	Section 6 - Accounting Issues Section 6.1 - Overhead Capitalized (2005)	G-7-03
TGI	BCUC	2003	Settlement Agreement for 2004–2007 Multi-Year Performance-Based Rate Plan Page 8, Appendix A	G-51-03
TGI	BCUC	2007	Approval of 2 year extension of the Settlement (G-51-03) for 2008 and 2009	G-33-07
BCTC	BCUC	2007	BCTC 2007 Revenue Requirement application with Capital Overhead Study	G-139-06 G-145-06
BCTC	BCUC	2008	BCTC 2009/2010 Revenue Requirement with updated Cap Overhead methodology information	G-105-08
BCTC	BCUC	2008	BCUC Negotiated Settlement to BCTC including section on Capital Overhead	
BC Hydro	BCUC	2008	BCH F09/10 Rev Req	
BC Hydro	BCUC	2006	BCH F07/08 Rev Req	
BC Hydro	BCUC	2009	2009/10 Revenue Requirements Decision	

Utility	Commission	Year	Reference/Source	Order / Decision
FortisBC	BCUC	2009	Preliminary 2010 Revenue Requirement Application	
Ottawa Hydro	OEB	2007	Application by Hydro Ottawa Limited for an Order or Orders approving just and reasonable rates and other service charges for the distribution of electricity, effective May 1, 2008. Issue 3.4	EB-2007-0713
ENMAX	AUC	2006	ENMAX Power Corporation 2005-2006 Distribution Tariff	2006-002
ENMAX	AUC	2006	ENMAX Power Corporation 2006 TFO Tariff	2006-079
ATCO	AUC	2005	ATCO Electric 2005-2007 General Tariff Application	
ATCO	AUC	2003	ATCO Electric 2003-2004 General Tariff Application	2003-071
PUC Distribution	OEB	2007	Application by PUC Distribution Inc. for an order approving just and reasonable rates and other charges for electricity distribution to be effective May 1, 2008.	EB-2007-0931
Hydro One	OEB	2005	In the matter of an application by Hydro one networks inc. For electricity distribution rates 2006 Section 4.5	RP-2005-0020 EB-2005-0378
Hydro One	OEB	2007	Application by Hydro One Networks Inc. for an order or orders approving or fixing just and reasonable rates and other charges for the distribution of electricity commencing May 1, 2008.	EB-2007-0681
Hydro One	OEB	2008	2009/10 Transmission Revenue Requirement and Rate Application	EB-2008-0272
Pacific Northern Gas	BCUC	2009	2009 Revenue Requirements Application	G-39-09
EPCOR	AUC	2004	EPCOR Distribution - 2004 DT Part B 2004 Final Distribution Tariff	2004-067
EPCOR	AUC	2006	EPCOR Energy Inc. & EPCOR Energy Alberta Inc. - 2005-2006 Regulated Rate Tariff Non-Energy Charge	2006-055
AltaGas	AUC	2006	AltaGas Utilities Inc. 2005/06 GRA Phase 1 2nd Compliance Filing + Errata	2006-117
AltaGas	AUC	2007	AltaGas Utilities Inc. 2007 GRA Phase I	2007-094