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October 13, 2016

VIA ELECTRONIC FILING

Daniel P. Wolf
Executive Secretary
Minnesota Public Utilities Commission
121 Seventh Place East, Suite 350
St. Paul, MN 55101

Re: Petition of Minnesota Energy Resources Corporation for Approval of Recovery of Natural Gas Extension Project Costs through a Rider and a New Area Surcharge for the Esko Project
Reply Comments of Minnesota Energy Resources Corporation

Docket No. G011/M-16-655

Dear Mr. Wolf:

On October 3, 2016, the Minnesota Department of Commerce, Division of Energy Resources (the "Department") submitted comments in the above-referenced docket regarding Minnesota Energy Resources Corporation's ("MERC's" or the "Company's") Petition for Approval of Recovery of Natural Gas Extension Project Costs through a Rider and a New Area Surcharge for the Esko Project. MERC has requested the Minnesota Public Utilities Commission ("Commission") approve a Natural Gas Extension Project ("NGEP") Rider and a 25-year New Area Surcharge ("NAS") for the Project. In its Comments, the Department recommends a 30-year NAS be approved for the Project with no NGEP Rider recovery. Additionally, the Department recommended that MERC submit additional information in Reply Comments regarding the accounting of Northern Natural Gas ("NNG") costs for the Esko Project.

MERC submits these Reply Comments to provide the additional information and respond to the Department's recommendations. At the outset, MERC notes the Department principally relies on two arguments to conclude an NGEP Rider and NAS cannot be used in tandem. First, the Department states that the NGEP Rider conflicts with the original goal of the NAS tariff, which is to not impose costs of an expansion on existing ratepayers. Second, the Department asserts that the NGEP statutory definition of a contribution in aid of construction ("CIAC") precludes the use of the NAS tariff. MERC does not agree with the Department's conclusion regarding the appropriateness of combining the NGEP Rider with an NAS. Nothing in the NGEP Statute, Minn. Stat. § 216B.1638, or the Commission's Orders approving

MERC's NAS tariffs would prohibit the use of both an NGEP Rider and NAS to finance a single extension project.[1] Rather, these tools are intended to serve the same goal of making natural gas extension to new areas more affordable for customers.

Moreover, even if MERC agreed with the Department's reasoning regarding the use of the NAS and NGEP rider, the Department's proposal to confine the recovery of the Esko Project to an NAS is not possible in this instance. The Department's proposal to implement a 30-year NAS with no NGEP Rider is not workable because the resulting NAS charge would be too high. MERC undertakes significant analysis in the evaluation of potential new town growth opportunities before determining which opportunities to pursue and present to the Commission for approval. The Department's alternative proposal is inconsistent with the Company's assessment of a workable extension project or an acceptable level of risk given expected customer participation and other factors. If the Commission adopts the Department's recommendation and only approves the 30-year NAS, MERC would not proceed with the Esko Project and would withdraw the petition in this docket.

The Esko Project qualifies for NGEP Rider recovery under the NGEP Statute and nothing prevents the Commission from approving both the NGEP Rider and NAS, as proposed. As set forth in the Company's Initial Petition and as further discussed below, MERC respectfully requests approval to (1) recover a portion of the Project costs through an NGEP Rider; (2) to implement an NAS for the Project, and (3) to amortize the interstate pipeline costs necessary for the Project.

A. *Use of the NGEP Rider in Conjunction with an NAS*

1. The Policies Supporting Both Mechanisms Are Consistent.

Along the first vein, the Department primarily states that the NGEP Rider conflicts with the original goal of the NAS tariff, which is to not impose costs of an expansion

[1] The Minnesota Supreme Court has consistently held "[i]f the Legislature's intent is clear from the statute's plain and unambiguous language, then [a court] interpret[s] the statute according to its plain meaning without resorting to the canons of statutory construction." *State v. Rick*, 835 N.W.2d 478, 482 (Minn. 2013) (citation omitted). While MERC believes the NGEP Statute, Minn. Stat. § 216B.1638, is unambiguous in that it does not prohibit the use of an NGEP rider in combination with a NAS, to the extent the Commission believes there is ambiguity regarding the use of an NGEP Rider in combination with an NAS, MERC addresses the history and legislative intent of the NGEP in these Reply Comments. That legislative history further supports a conclusion that the Legislature intended the NGEP Rider to be used in combination with an NAS.

on existing ratepayers. Contrary to the Department's conclusion, however, nothing in either the Commission's Orders approving or modifying MERC's NAS mechanism or the NGEP Statute prohibits the Commission from approving the use of NGEP Rider recovery and an NAS for the same project. In fact, these two tools are intended to serve the same purpose of making natural gas extension projects more affordable and the use of both mechanisms for a single project will help achieve the goal of extending natural gas service to currently unserved areas in the state of Minnesota.

In its July 26, 2012, Order Approving New Area Surcharge with Modifications in Docket No. G007,011/M-11-1045, the Commission found, "A New Area Surcharge (NAS) is designed to permit a natural gas company to extend service into a new area it would be uneconomic to serve at tariffed rates, by permitting the company to collect a surcharge in addition to the tariffed rate." While the Department is correct that the Commission noted that an NAS "makes natural gas available to communities previously not served by a natural gas utility without imposing the cost of expansion on existing ratepayers," it does not follow that an NAS must stand alone or that an NAS cannot be implemented in combination with a rider that allows for the socialization of a portion of the costs of the project. Indeed, at the time of the Commission's July 26, 2012, Order, the NGEP Statute had not yet been enacted and there was no mechanism by which the Commission could authorize the socialization of such an extension project.

A review of the development of the NAS tariff and the legislative history of the NGEP Statute demonstrates the consistency between these two expansion mechanisms. The goal of the NAS mechanism is to provide a financing tool to allow for the extension of natural gas service to new areas. The Commission first addressed the NAS mechanism in Docket No. G011/M-91-296 and in its March 10, 1992, Order in that docket, the Commission concluded:

> The availability of natural gas service in Minnesota has brought significant benefits to customers and areas currently served. The Commission views the expansion of the availability of natural gas in areas of Minnesota not currently served as desirable, potentially bearing significant benefits to individual customers and enhancing the economic viability of these communities.
>
> At this time, however, it appears that most of the communities that can be economically served by existing LDC networks under current gas tariffs are being served. In the absence of significant economic growth in the communities that are not currently being served,

> expansion of natural gas service to those communities appears unlikely to occur unless the LDCs are allowed to recover their excess extension costs directly from customers.
>
> The Commission is determined to examine what encouragement it may appropriately provide these companies consistent with its regulatory responsibilities.[2]

Undoubtedly, the Commission approved the NAS tariffs for natural gas utilities to further the expansion of natural gas to unserved areas. Although the policy at that time was meant to ensure that extension costs should be recovered only from the customers to be served by the extension, the legislature shifted policy with the enactment of the NGEP Statute.

Following the winter of 2013-2014 and prior to enactment of the NGEP Statute, the Legislature requested that the Legislative Energy Commission ("LEC"), which evaluates state energy policy for the Legislature, investigate options for the Legislature to help users of propane convert to natural gas or other heating sources. One alternative suggested by the LEC report was to develop policies to promote the extension of natural gas service to communities that were still uneconomical to serve, even with an NAS rider.[3] The report noted that the maximum amount of NAS surcharge typically accepted by potential new area customers was about $25 per month. Given that NAS policy limits the duration of an NAS rider, the $25 a month charge necessarily limits the amount of revenue that can be collected from new area customers. In order to bridge this revenue deficiency, the LEC report suggested that the Legislature "direct the Public Utilities Commission to allow utilities to spread some or all of the costs of expansion among existing customers."[4]

The NGEP rider bill was intended to give utilities an additional tool to use, in combination with the NAS mechanism, to make system extensions and expansions affordable where they previously would not have been. The Senate Committee on Environment and Energy held a hearing on the NGEP bill shortly thereafter. At the hearing, a co-author of the NGEP bill explained the rationale behind the bill:

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[2] *In the Matter of a Request by Peoples Natural Gas for Approval of a New Town Least Cost Energy Rate,* Docket No. G011/M-91-296, ORDER REJECTING PROPOSED TARIFFS AND REQUIRING REPORT at 2 (March 10, 1992).

[3] *See* Legislative Energy Commission, *Propane Conversion Strategies* at 13 (Jan. 15, 2015) *available at* https://www.leg.state.mn.us/docs/2015/mandated/150040.pdf

[4] *Propane Conversion Strategies* at 15. ("To do this, utilities could be allowed to build an expansion fund in advance through a rider on customers' bills, and use the fund to subsidize the costs of expansion projects as they are proposed.").

> [T]he current process analyzes if there is a revenue deficiency or not and then allows the option of having a New Area Surcharge added on to help cover the deficiency. If that is not enough to cover the deficiency, the project does not go forward. So what we're proposing . . . is to, in order to cover that deficiency, to allow the current, existing member base to pay part of the cost of the expansion . . . up to 33 percent of the project cost, to help cover the deficiency in order to move natural gas usage forward in Minnesota.[5]

It is clear that the NGEP Statute was broadly drafted to cover a variety of circumstances, including being used in concert with the NAS mechanism in order to serve the legislative goals of enhancing natural gas service to unserved and inadequately served areas.

Adoption of the NGEP Statute reflects a state priority to develop and expand access to natural gas in Minnesota. With the passage of Minn. Stat. § 216B.1638, the legislature determined for the first time that natural gas extension and expansion projects did not need to be self-supporting to be recovered across all customers. Instead, the NGEP Statute authorizes recovery of natural gas extension and expansion project costs from customers in other areas, to support infrastructure development in the state. The policy and goals of the NAS and NGEP are not in conflict; rather, they are the same – to encourage the extension of natural gas service to inadequately served and unserved areas.

As additional support for the conclusion that the NGEP Rider is in conflict with an NAS, the Department argues that the NGEP Rider acts to subsidize an NAS project that by definition was meant to stand alone and be self-supporting. According to the Department's logic, partial recovery under the NGEP Rider would mitigate MERC's risks by allowing up-front recovery, but the NAS requires the Company and its shareholders to accept the monetary risk of an insufficient number of customers signing up during the term of the NAS. The Department's reasoning along these lines should be rejected. As discussed above, the legislature has added a mechanism to allow the partial subsidization of natural gas extension projects so projects that were borderline are now feasible. In other words, the landscape has changed and the Department's adherence to the principle that extension projects

[5] March 17, 2015 Hearing of the Senate Committee on Environment and Energy (Statement of Sen. Skoe) *available at* https://www.leg.state.mn.us/senatemedia/saudio/2015/cmte_envenergy_031715a.MP3 (7:40-8:24).

should not be socialized is no longer warranted. Moreover, the Company still bears significant risk under the NAS proposed in this proceeding.

2. *An NAS Can Be Considered a CIAC under the NGEP Statutory Framework.*

The Department also asserts that the statutory definition of “contribution in aid of construction” or CIAC in the NGEP Statute supports its conclusion that the NGEP Rider should not be used in combination with an NAS. In particular, the Department states:

> [T]he definition of CIAC for the NGEP Rider in Minn. Stat. § 216B.1638 does not include any recovery, or contribution, from another rider, such as a NAS, nor does it include recovery from the customers in the new area, nor does CIAC include contributions from the remaining ratepayers. Instead, the CIAC as defined by Minn. Stat. § 216B.1638 consists of contributions from the developer or local government.[6]

Nothing in the NGEP Statute either requires or prohibits any particular contribution in aid of construction for a natural gas extension project. Rather, the NGEP Statute merely requires that the utility requesting approval of an NGEP Rider include, in its initial petition, “the amount of any contributions in aid of construction [and] a description of efforts made by the public utility to offset the revenue deficiency through contributions in aid of construction.”[7] Further, contrary to the Department’s reading of the statute, the NGEP Statute’s definition of a “contribution in aid of construction” extends beyond just contributions from developers or local governments. The term “Developer” is defined under the NGEP Statute as “a developer of the project or a person that owns or will own the property served by the project.”[8] In this case, the customers who will be served by the proposed Esko Project will be making the contributions in aid of construction via the monthly NAS charges.

There is also nothing in the NGEP Statute that limits the use of an NGEP in combination with an NAS. The NGEP Statute requires that the Commission “shall approve a public utility’s petition for a rider to recover the costs of a natural gas extension project if it determines that: (1) the project is designed to extend natural

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[6] Department Comments at 10.
[7] Minn. Stat. § 216B.1638, subd. 2(4)-(5).
[8] Minn. Stat. § 216B.1638, subd. 1(c).

gas service to an unserved or inadequately served area; and (2) project costs are reasonable and prudently incurred."[9] Neither of these criteria prohibits approval of an NGEP Rider in combination with an NAS. Indeed, the only limitation provided in the NGEP Statute is that the Commission "must not approve a rider under this section that allows a utility to recover more than 33 percent of the costs of a natural gas extension project."[10] With respect to the Esko Project, MERC has demonstrated both that the Project is designed to extend natural gas service to an unserved area and that the Project costs, as proposed, are reasonable and prudent. Approval of the NGEP Rider recovery and NAS, as proposed in MERC's Initial Petition, is consistent with applicable statute, regulation, and prior Commission decisions.

3. The Department's Recommendation to Deny Rider Recovery and Extend the NAS Term Is Not Workable.

The Department's recommendation to deny the NGEP Rider and approve a longer NAS term would result in higher NAS charges and lower participation rates and the Project overall would no longer be feasible from the Company's view.

MERC conducts significant customer outreach and engages in discussions with relevant local government officials before proceeding with potential new area growth and expansion projects. This outreach includes discussions with prospective customers regarding their interest in conversion to natural gas service, the use of consumer surveys to gauge participation, and an evaluation of alternative fuel costs to develop a reasonable set of assumptions regarding the likely number of customers who would convert at any particular surcharge rate. Additionally, the Company undertakes a thorough evaluation of possible new growth opportunities before determining which opportunities to pursue and under what parameters, and which to reject or postpone for potential future consideration. Such evaluation includes consideration of the relative costs and risks of available growth opportunities. Based on these efforts and analysis, MERC developed its proposal for partial NGEP Rider recovery and a 25-year NAS for the Esko Project. MERC continues to believe the proposed NGEP Rider recovery and 25-year NAS, as set forth in the Company's Initial Filing, are the most reasonable approach to encourage individuals and businesses in the Esko area to participate in the Project.

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[9] Minn. Stat. § 216B.1638, subd. 3(b)(1)-(2).
[10] Minn. Stat. § 216B.1638, subd. 3(c).

MERC believes the charges under the Department's alternative proposal would likely deter participation in the Project and, as noted above, MERC would not proceed with the Project under the alternative recommendation.[11]

In its Comments, the Department notes that "the NAS only increases by approximately $5 per month if you increase the term to 30 years without the NGEP Rider, which results in a Residential Rate of $29.21 per month."[12] An additional cost of $5 per month for an average residential customer in the Esko Project area is not insignificant.

Further, the NAS rates calculated under the Department's alternative recommendation assume only the term of the NAS changes and holds the remainder of assumptions in the model constant. As a practical matter, MERC would not expect the same participation rate with the charges the Department proposes and the assumptions regarding the number of customers participating in a 30-year NAS would need to be lowered, which would result in even higher surcharges across all customer classes. Though the Department notes an approximate $5 per month difference for residential customers, the cost differentials for other customer classes under the Department's alternative recommendation are even more significant, as shown in the table below:

	MERC Proposed 25 Year NAS/Rider	**DOC Recommendation 30 Year NAS/No Rider**	**Difference**
Residential	$24.18	$29.21	$5.03
Small C&I	$45.81	$55.35	$9.54
Large C&I	$114.53	$138.38	$23.85
SVI	$419.95	$507.39	$87.44

[11] As recognized in the LEC publication *Propane Conversion Strategies* ("When the investor-owned utility is confident it has signed up enough customers to make the economics feasible, it will go before the state Public Utilities Commission and make the case for the expansion and accompanying New Area Surcharge.")
[12] Department Comments at 10.

LVI	$470.85	$568.90	$98.05

The Department claims the Project would still be economical for consumers at the increased rates and asserts that "each of the five prior years would have resulted in a savings had Esko Residential customers had the option to be served by natural gas, even with the addition of the $29.21/month NAS."[13] This analysis does not appropriately capture customers' decision-making processes in determining whether to participate in an NAS project and convert to natural gas. Notably, propane prices fluctuate significantly over time, as shown in Attachment 4 to the Department's Comments, from a low of $0.668/gallon in October 1998 to a high of $4.61/gallon in January 2014. An average residential customer likely does not consider a five-year average of propane prices in determining whether to convert to natural gas. Instead they likely consider current pricing. Further, conversion to natural gas service requires conversion of existing home appliances, likely resulting in an immediate additional cost to customers. Though the cost of such conversion will depend on the alternative fuel used, the age of the appliances, and other factors, the costs of conversion are an upfront cost that customers do consider in determining whether to participate in an NAS project.

Additionally, the Department asserts that MERC's proposed NGEP Rider recovery "serves as an additional buffer against the protections provided by the NAS Rider to ensure that the Company does not build an uneconomic project. The NAS requires the Company and its shareholders to accept the monetary risk of an insufficient number of customers signing up during the term of the NAS."[14] As discussed in detail above, the purpose of the NAS is to provide a mechanism to allow for the affordable extension of natural gas service to new areas. To the extent the structure of the NAS mechanism serves to require MERC and its shareholders to accept the monetary risk of an insufficient number of customers signing up during the term of the NAS, MERC's proposed NGEP and NAS for the Esko Project would achieve that goal. MERC's proposal balances competing interests to ensure that the Company and the customers who participate bear some responsibility for the Project. Further, MERC developed its proposal based on its evaluation of likely customer participation at various NAS surcharge rates. MERC's experience with new area extension projects and customer outreach in the Esko Project area supports MERC's proposed surcharge amounts, as requested in MERC's Initial Petition.

[13] Department Comments at 11.
[14] Department Comments at 9.

Ultimately, the Department's alternative recommendation is inconsistent with the plain language and legislative intent of the NGEP Statute and would undermine the policy of encouraging increased natural gas service to unserved or inadequately served areas because it would not ensure adequate participation to justify the Project.

B. Accounting and Recovery of NNG Pipeline Costs

In addition to its recommendations discussed above, the Department, in its Comments, requested that MERC provide, in its Reply Comments, complete information regarding the accounting and recovery of the NNG charges and a full description of the charges. In particular, the Department notes that "[t]he Petition does not address whether any of the NNG charges for the enhancements associated with the Esko Project will be assessed later through the Company's Purchased Gas Agreement (PGA), whether those costs would be assessed to the customers subject to the NAS, or a mix of those two recovery options."[15]

In order to connect the Esko Project area to the interstate pipeline system, NNG needs to install a town border station, associated piping, a meter, line heater, and electronic flow measurement. As set forth in MERC's Initial Petition, MERC would recover a portion of the necessary NNG upgrade costs associated with the Esko Project through the proposed NGEP Rider and the remainder of costs through the NAS as operations and maintenance expense ("O&M"), amortized over the proposed 25-year term of the NAS. MERC has also requested approval to apply a carrying charge at MERC's authorized short-term cost of debt on the amortized NNG costs. The portion proposed for recovery through the NGEP Rider is the same percentage proposed for overall NGEP recovery for the Project.

None of the NNG costs would be subsequently recovered through MERC's PGA. This is because NNG would require recovery of its capital costs upfront through a contribution in aid of construction from MERC rather than providing for recovery of such costs through a capacity contract. As noted in MERC's Initial Petition, at this time, no demand entitlement changes are anticipated to be required because MERC anticipates the demand needs of the Esko Project customers will be served off existing demand contracts.

MERC believes this proposal is consistent with both the NGEP Statute and MERC's approved NAS tariffs. In particular, the NGEP Statute provides, "The revenue deficiency from a natural gas extension project recoverable through a rider under this section must include the currently authorized rate of return, incremental income

[15] Department Comments at 8.

taxes, incremental property taxes, incremental depreciation expenses, and *any incremental operation and maintenance costs*."[16] The costs associated with the NNG upgrades are incremental O&M costs that are necessary for the Esko Project area to be connected to the interstate pipeline system to receive natural gas service. Similarly, MERC's approved NAS tariff includes a provision for NAS recovery of O&M expense. MERC's NAS model inputs, as set forth in MERC's Tariff Sheet No. 9.16 includes "O&M expense," which "[i]n any year shall be based on average incremental cost per customer." The cost MERC must pay to NNG to connect to the interstate pipeline at Esko is incremental O&M necessary to extend natural gas service to customers in the Esko Project area.

Please contact me at (651) 322-8965 if you have any questions regarding the information in this filing. Thank you for your attention to this matter.

Sincerely yours,

/s/ Amber S. Lee

Amber S. Lee
Regulatory and Legislative Affairs Manager
Minnesota Energy Resources Corporation

cc: Service List

[16] Minn. Stat. § 216B.1638, subd. 3(d) (emphasis added).

In the Matter of a Petition of Minnesota Energy Resources Corporation for Approval of Recovery of Natural Gas Extension Project Costs through a Rider and a New Area Surcharge for the Esko Project

Docket No. G011/M-16-655

CERTIFICATE OF SERVICE

I, Kristin M. Stastny, hereby certify that on the 13th of October, 2016, on behalf of Minnesota Energy Resources Corporation (MERC), I electronically filed a true and correct copy of the enclosed Reply Comments on www.edockets.state.mn.us. Said documents were also served via U.S. mail and electronic service as designated on the attached service list.

Dated this 13th day of October, 2016.

/s/ Kristin M. Stastny
Kristin M. Stastny

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