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October 1, 2020

VIA ELECTRONIC FILING

Will Seuffert
Executive Secretary
Minnesota Public Utilities Commission
121 Seventh Place East, Suite 350
St. Paul, MN 55101

Re: Petition of Minnesota Energy Resources Corporation (MERC) for Approval of Farm Tap Customer-Owned Fuel Line Replacement Plan, Tariff Amendments, and Deferred Accounting

Docket No: G-011/M-17-409

Reply Comments of Minnesota Energy Resources Corporation

Dear Mr. Seuffert:

On December 30, 2019, Minnesota Energy Resources Corporation ("MERC" or the "Company") filed its Report of Farm Tap Planning and Design for Phase I and Procedural Proposal for Phase II ("MERC's Farm Tap Report" or "Report") with the Minnesota Public Utilities Commission (the "Commission"). In the Report, MERC provided responses to the questions raised in Phase I of this proceeding and offered a Modified Alternative Proposal ("Proposal") for Phase II for consideration by the Commission. On September 14, 2020, comments on the Report were filed by the Minnesota Department of Commerce, Division of Energy Resources ("Department") and the Minnesota Office of the Attorney General – Residential Utilities and Antitrust Division ("OAG").

Both the Department and the OAG overall were very supportive of the Proposal put forth by MERC to address the risks posed by customer-owned farm tap lines. Following the extensive analysis that has been performed to date by MERC, the Department, and the OAG, MERC is pleased to report that there are very few contested issues that remain to be resolved by this Commission. MERC thanks the Department and the OAG for their analysis and comments, and submits these Reply Comments to respond to the remaining contested issues.

1. **Extend Distribution System to Farm Tap Customers within One Mile**

MERC proposes to extend its existing distribution system to serve the approximately 210 farm tap customers within one mile of its facilities. This would include new mains, services, and meters at a cost of approximately $7.1 million to allow for the elimination of the current customer-owned lines. In their Comments, the Department supports this proposal and the OAG advocates that MERC go even further at the outset—replacing all farm tap customer-owned fuel lines for customers wishing to continue receiving natural gas service. Neither the Department nor the OAG raise concerns about the cost estimates themselves.

The Department, however, does take exception to the recovery of the costs of internal labor and contingency estimates. MERC believes that recovery of these costs is appropriate and explains its position below.

A. Recovery of Internal Labor Capital Expenditures

The Department at page 8 of its Comments incorrectly claims that MERC's estimated $800,000 of internal labor capital expenditures are not incremental and that they are already included in base rates. This is not the case.

Approximately 80 percent of the internal labor costs of MERC engineers are capitalized in a typical year. The other 20 percent of their work is expensed as operations and maintenance ("O&M") expense (non-productive time like vacation and training). The O&M component is included in base rates based on the historic year O&M expense because it is forecast to continue in the future test year. MERC, therefore, did ***not*** include those internal labor O&M costs in its Project estimate.

Capitalized internal labor costs are only recovered from customers in base rates as return on and of capital for projects that are in service or forecasted to be placed in service in the rate case test year, and are thus included in rate base. Unlike O&M expense, which continues to be recovered at a representative level in base rates based on the approved test year O&M expense, recovery of capital costs for projects placed in service after the test year are not included in base rates. Rather, capitalized internal labor costs are specific to a capital project and only the costs related to projects already in service are being recovered in current base rates.

No costs related to MERC's Proposal are included in the Company's current rate base or being recovered in base rates. Capitalized internal labor for any project that will be performed in a future test year, such as for these farm tap replacements, is ***not*** included in current base rates. Therefore, the internal labor capital expenditures to be incurred for this Project are truly incremental costs because they reflect costs to be incurred in the future that are not included in base rates.

Rate recovery of these incremental capitalized internal labor costs should be included in either a GUIC Rider or a future rate case proceeding.

B. Recovery of Contingency Estimates

The reasons for the contingency estimates provided by MERC in its Report were not disputed by the Department, they simply recommend that the costs not be recovered either through the GUIC Rider or in base rates until incurred and reviewed.[1] MERC requests that

[1] Department Comments at 8, 17-18.

the contingency estimates be included in the $7.1 million Project and subject to rate recovery under the GUIC Rider which would be trued-up to actuals and reviewed in the annual GUIC filings. While MERC understands the Department's rationale for recommending exclusion of contingency costs for recovery through a forecasted rider before they are incurred and reviewed, this Project presents unique challenges and uncertainty, as discussed in the Company's December 30, 2019, Filing, such that the overall $7.1 million Project cost estimate inclusive of contingency costs reflects a reasonable forecasted project cost .

Contingency estimates are commonly applied to construction project estimates because it is not possible to forecast the exact cost of this type of work. This Project is especially subject to forecast inaccuracy because the cost estimates are based only on a sample of actual customer surveys. Permitting contingency costs in the estimates will enable the Project to proceed as close to schedule as possible. For example, if cost overruns are prudently incurred because of actual conditions discovered in the field and MERC does not have access to contingency funding, the Project may have to proceed more slowly than planned. Likewise, if contingency funds are not needed for segments of the Project, it could proceed more quickly than planned. Ultimately, if the requested GUIC Rider recovery is approved, the cost estimates will be trued-up to actuals and customers will not pay more or less than the actual costs in any event. Given the unique nature of this Project, and the fact that MERC already has the obligation to demonstrate the reasonableness and prudence of all costs actually spent at the time of the true-up, inclusion of the contingency in the overall project costs is reasonable.

It is also helpful to note that this is a five-year Project. Under the GUIC Rider, each year MERC will file its plan for the next year and true-up the previous year's costs. The Department, OAG and Commission will thus be able to monitor progress and evaluate the use of contingency funding, making adjustments in future years as appropriate.

MERC prefers GUIC Rider treatment to allow for Project funding and focused review outside of a multi-issue rate case proceeding. However, in a rate case proceeding as well the Department and other parties will have an opportunity to opine on the overall reasonableness of forecasted project contingency costs to be included in rate base. Accordingly, the Commission should not disallow the inclusion of contingency in the Project and in rate recovery.

2. Contributions in Aid of Construction

The OAG recommends that all farm tap customers wishing to continue to receive natural gas service be required to pay a modest fee of $500 "in lieu of" a contribution in aid of construction ("CIAC"). MERC did not propose to require a CIAC for customers within one mile of the existing distribution system, but does not oppose this proposal. Any fees or CIAC collected would be used to reduce the capitalized project costs and this would ultimately reduce the costs borne by other ratepayers. As outlined in MERC's Report, the Company proposes that for farm tap customers who are not located within one mile of MERC's existing distribution to apply the existing Commission-approved customer extension model to evaluate any CIAC to be required.

3. Other Farm Tap Customers May Request Distribution Extension

MERC proposes, and the Department concurs, that distribution service could be extended to existing farm tap customers outside of the one-mile radius of MERC's existing distribution system but that a CIAC should be required from those customers. The OAG proposes that MERC replace all farm tap customer-owned fuel lines with utility-owned facilities, regardless of distance, and that the CIAC be limited to $500.

MERC appreciates the OAG's interest in pursuing the replacement of all farm tap customer-owned fuel lines, even at an estimated total cost in excess of $46 million to be socialized over all of MERC's customers. However, MERC believes that its proposed gradual approach is the preferred approach. Limiting this next phase to the 210 customers within one mile enables MERC to effectively and efficiently manage the construction process and extend the utility distribution system rather than just replacing customer-owned lines, while also managing ratepayer impacts. In the event that a more remote (greater than one mile) customer requests the installation of MERC facilities, perhaps due to safety concerns or load growth, the calculated CIAC, using the Commission-approved model as proposed by MERC in its Report, may or may not be cost prohibitive. At the very least, MERC's proposed gradual approach would limit the costs incurred in this phase and would provide information for use in the development of the next phase of the farm tap replacement project.

4. Inactive and New Farm Tap Service

MERC agrees with the Department's conclusion that the Commission may not have the authority to prevent a farm tap customer from exercising their easement rights with Northern Natural Gas ("NNG"). MERC also agrees with the Department that the Commission does *not* need to *require* MERC to install and service each and every new farm tap line requested by a potential customer with a valid easement agreement with NNG. In fact, a definitive order in this proceeding from the Commission that precludes MERC from servicing new customer-owned farm taps or re-initiating inactive customer-owned systems would be helpful to avoid increasing the scope of the issues to be addressed.

MERC therefore requests that the Commission require that MERC provide natural gas service to new farm taps only by extending Company-owned distribution facilities and that the Commission-approved customer extension model be used to determine the CIAC required for service to any new farm taps. Likewise, any previous farm tap customer that is currently inactive should have to comply with these same requirements as though they were a new farm tap customer.

5. Shut Off Service to Farm Taps Where Leaks are Identified

MERC and the Department[2] are in agreement with the Company's proposal to shut off service to farm taps where leaks are identified until and unless they are properly repaired within a 12-month period. MERC recommends that a "proper" repair be defined as follows by the Commission:

[2] Department Comments at 12.

(1) the customer has repairs performed by MERC or another contractor from a MERC-approved list of contractors and provides proof of the repairs, or

(2) the customer has repairs made by a contractor of their choosing and provides proof of the repairs along with a signed waiver indicating they have made repairs at their own risk.

MERC emphasizes that this is only a temporary solution to the safety issues inherent in farm tap customer-owned fuel line installations. Ultimately, the Company requests guidance and support from the Commission with regard to the eventual elimination of farm tap service on its system.

6. Cost Recovery – GUIC vs. Rate Case

Upon their review of the filing and of Minn. Stat. §216B.1635, the Department concludes that recovery of the costs of the farm tap replacement project as proposed by the Company qualify for GUIC Rider treatment.[3] Nevertheless, the Department concludes that "since the Direct Connect customers would not pay for the project if costs are recovered though the GUIC, and as this is a replacement for a safety issue for lines that were built to obtain easements to serve the Direct Connect customers, it is reasonable for all customers to pay for it, and thus recovery though a rate case would be more appropriate."

As this project qualifies for GUIC Rider recovery, there is no reason it should not be permitted to be recovered through the GUIC Rider in accordance with the GUIC statute. The possibility that Direct Connect customers could pay a larger proportion of project costs in base rates in a future rate case does not support disallowing rider recovery for GUIC Rider eligible costs. And while the Commission has determined that GUIC-eligible projects need not be funded by Direct Connect customers, ultimately, projects for which MERC receives GUIC Rider recovery will be rolled into base rates in a future rate case, with rate base recovery subject to the same revenue apportionment as authorized in such case. MERC notes, however, that historically, customers comprising MERC's Direct Connect class have not been subject to rate increases due to the fact that that class of customers poses as significant bypass risk on MERC's system.[4] Thus, the premise that the Direct Connect customer group would pay for a larger portion of overall project costs if the project is recovered through base rates rather than the GUIC rider is unsupported.

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[3] Department Comments at 26.

[4] In MERC's most recent rate case in Docket No. G011/GR-17-563, where the Commission adopted the revenue apportionment as proposed by the OAG, the OAG agreed that revenues collected from Class 5 customers should be held constant, in recognition of the bypass risk posed by those customers. *In the Matter of the Application of Minnesota Energy Resources Corporation for Authority to Increase Rates for Natural Gas Service In Minnesota*, Docket No. G011/GR-17-563, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 42 (Dec. 26, 2018) (adopting the OAG's finding that "Class 5 customers should not have their rates changed to account for any possible bypass threat."). *See also* ORDER SETTING INTERIM RATES at 3-4 (Dec. 5, 2017) (approving MERC's proposal to charge its Super Large Volume and FLEX-rate customers less than their pro-rate share of the interim revenue requirement due to the fact that those customers have the ability to bypass MERC's system and secure alternative energy supplies.).

MERC's rate design for the GUIC Rider excludes Direct Connects for two reasons: (1) because they do not benefit from the MERC distribution system and (2) because they are price sensitive. The farm tap project is consistent with the other GUIC projects for which MERC has received GUIC Rider recovery—it does not provide a quantifiable benefit to Direct Connects and, more importantly, it has been determined by both the Department and this Commission in prior GUIC proceedings that the Direct Connect customers pose a significant bypass risk and should not be subject to the additional costs.

A. The Project Does Not Benefit Direct Connect Customers

At page 26 of its comments, the Department states that this project "is a replacement for a safety issue for lines that were built to obtain easements to serve the Direct Connect customers." However, there is no evidence to suggest that the NNG pipelines were routed specifically to serve the Direct Connect customers or that they would not have service today if not for the farm tap customer easements.

Easements were obtained from all parties along the NNG pipeline whether they took natural gas service later or not. Most easements were probably obtained willingly but others may have been forced as a result of FERC authority. No evidence has been provided in this record to determine the circumstances underlying the granting of each NNG easement, and with the passage of time it is unlikely that any research would be fruitful. More importantly, NNG did not build the service lines as part of those easements - the customers arranged to have their own lines built. Those customer-owned service lines are the subject of this farm tap replacement project, not the NNG lines.

In a rate case proceeding, just as in the GUIC Rider, none of these additional distribution costs should be borne by Direct Connects since they do not benefit from MERC's distribution system.

B. Direct Connect Customers Pose a Significant Bypass Risk

In its Commission Order dated August 26, 2020, Suspending GUIC Rider Surcharge for Direct Connect Customers and Declining to Reopen NGEP Cost Rider[5] ("the Order"), the Commission determined that the GUIC rate design which excluded Direct Connects was reasonable because of the risk of bypass posed by this class of price-sensitive customers:

> More substantively, the Commission concurs with the Department that Encore, MERC, and the SLGI make a persuasive case that the Direct Connect Customers can credibly threaten to bypass MERC's system, and that the combined effects of the GUIC and NGEP rider surcharges are sufficient to potentially motivate a Direct Connect customer to bypass MERC's system.[6]

Specifically, the Department's position in that proceeding was as follows:

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[5] Docket Nos. G-011/M-18-182, G-011/M-18-281, G-011/M-19-282, and G-011/GR-17-563
[6] Order at page 6.

> The Department is persuaded that the Direct Connect customers pose a credible threat to bypass MERC's system, and that the magnitude of the GUIC rider surcharge may provide a sufficient motivation for some or all of these customers to do so.[7]

Putting off recovery of these costs for a future rate case proceeding instead of a GUIC Rider does not provide any additional assurance that the Direct Connect class would ultimately bear any of these cost allocations because they are, in fact, extremely price sensitive.

Finally, delaying recovery of the costs from the GUIC Rider to a rate case can further delay or even deny MERC its ability to collect the return of and a reasonable return on this significant investment in the interim period. In addition, current customers would not be paying for the costs incurred if the costs are delayed recovery until some future test year, resulting in generational inequity of cost recovery.

MERC has already filed its 2021 GUIC Rider application in Docket G011/M-20-405. Farm Tap Phase I and II Project costs are not currently included in that request. MERC therefore asks the Commission to approve the continued deferral of farm tap costs for Phase I and to approve deferral of costs incurred in Phase II. MERC also requests that the Commission allow MERC the opportunity to recover those costs and forecasted costs in either a separate GUIC proceeding, which is MERC's preferred method of cost recovery, or a rate case proceeding.

7. Conclusion

MERC appreciates the efforts of the Department and OAG in reviewing MERC's Phase II filing. Both the Department and OAG recognize the need for the farm tap replacements. The Department has also agreed that the Company met the requirements set forth in the Phase I Order and, overall, agrees with MERC's Proposal with respect to the work to be performed and the cost estimate methodology. MERC continues to recommend GUIC Rider recovery as the preferred method of recovering the costs of this Project. It allows for an annual review of costs and a status update, it provides the needed funding for the ongoing Project, and ensures timely recovery and true-up of costs. In the meantime, MERC requests authorization to continue deferring costs incurred for both Phase I and Phase II until it files for rate recovery.

Socializing the costs of the Project over and above any CIAC is also deemed reasonable by both the Department and the OAG and should be approved. The proposed five-year $7.1 million Project should be approved in this phase for only customers within one mile of MERC's distribution system and extending to customers outside of that range could be considered in future phases. In the meantime, customers outside of the one-mile range desiring to have MERC install replacement services should pay a CIAC determined by the Commission-approved model.

[7] Order at page 5.

The Company admits that its proposed schedule was very optimistic, as suggested by the Department.[8] Outside of the safety aspects of this Project, which are clearly a factor in this request, the Commission has expressed an interest in projects that may promote economic recovery in the State of Minnesota.[9] MERC has included this Project in its comments in that proceeding. MERC, therefore, believes there may be a desire on the part of the Commission to move this Project forward rather quickly. Given the limited number of areas of disagreement it may be possible to proceed in a very timely manner.

DATED October 1, 2020

Respectfully submitted,

/s/ Mary L. Wolter
Mary L. Wolter
Director Gas Regulatory Planning & Policy
Minnesota Energy Resources Corporation

[8] Department Comments at 32.
[9] Docket No. E, G999/CI-20-492.

In the Matter of the Petition of Minnesota Energy Resources Corporation for Approval of Farm Tap Customer-Owned Fuel Line Replacement Plan, Tariff Amendments, and Deferred Accounting

Docket No. G011/M-17-409

CERTIFICATE OF SERVICE

I, Colleen T. Sipiorski, hereby certify that on the 1st day of October, 2020, 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 1st day of October, 2020.

/s/ Colleen T. Sipiorski
Colleen T. Sipiorski

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