Minnesota Public Utilities Commission
Staff Briefing Papers

Meeting Date: August 28**,** 2014 ....*Agenda Item # **3**

Company: Minnesota Energy Resources Corporation (MERC)

Docket No. G-011/M-14-524

In the Matter of the Petition of Minnesota Energy Resources Corporation for Approval of a Tariff Revision and a New Area Surcharge for the Ely Lake Project

Issue(s): Should the Commission approve the proposed New Area Surcharge (NAS) for the Ely Lake project?

Should the Commission approve the proposed tariff change allowing the NAS to be charged for 30 years?

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Relevant Documents

MERC Filing ....June 20, 2014
MERC Amended Exhibits...July 11, 2014
Department Comments ....July 18, 2014
Department Attachment ....July 21, 2014
MERC Revised Filing .... August 1, 2014

The attached materials are workpapers of the Commission Staff. They are intended for use by the Public Utilities Commission and are based upon information already in the record unless otherwise noted.

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August 20, 2014

Statement of the Issue

Should the Commission approve the proposed New Area Surcharge (NAS) for the Ely Lake project?

Should the Commission approve the proposed tariff change allowing the NAS to be charged for 30 years?

Background

On July 26, 2012, the Commission approved MERC's request for a New Area Surcharge tariff in Docket No. G-007,011/M-11-1045. The Company is required to submit a miscellaneous rate change request prior to implementing any NAS.

On June 20, 2014, MERC filed a request for a miscellaneous rate change to allow it add a new area surcharge to its tariff book for the Ely Lake project. The Company also requested that the NAS tariff be modified to allow it to increase the term of a NAS from 15 years to 30 years.

On July 11, 2014, MERC filed an update to Exhibit C of its filing updating the information which was designated as Trade Secret in the filing.

On July 18, 2014, the Department filed comments recommending that the Commission approve MERC's petition.

On July 21, the Department filed the Attachment to its comments.

On August 1, 2014, MERC filed a revised Exhibit C showing a lower Contribution in Aid of Construction (CIAC) and surcharge.

Party Positions

MERC

Surcharge Term

The Company stated that under the NAS model, the term of service varies from area to area, depending on the service extension project. Under no circumstances, however, can the surcharge applicable to any project remain in effect for a term to exceed fifteen (15) years. MERC requested approval to modify its NAS tariff to allow a NAS to remain in effect for up to thirty (30) years. According to the Company, the extension of the surcharge term to thirty (30) years will result in lower surcharges, which will in turn increase customer participation in the Ely Lake Project. MERC stated that approving this modification to MERC's NAS will allow it to make extensions more affordable by lowering the monthly surcharge amount.

The Company stated that in reviewing MERC's Extension and New Area Surcharge policies in its most recent rate case (G-011/GR-13-617), the Department of Commerce, Division of Energy Resources (Department) recommended the Company modify its NAS to allow a longer surcharge term. Specifically, the Department stated that to make it easier for new areas to obtain natural gas service, rather than depend on propane service that may be unreliable, it might be reasonable for MERC's tariff to be revised to allow a period longer than fifteen (15) years when determining whether an extension is feasible.

NAS for Ely Lake Project

MERC proposed to construct the Ely Lake Project which would provide gas to customers living around Ely Lake which is located near the cities of Eveleth and Gilbert in Fayal Township, Minnesota. The costs of the project would largely be recovered through a NAS.

The Company stated that the NAS enables natural gas service to be extended to an area that would generate insufficient revenues under the Company's present rates and service extension policy. This is accomplished by setting a surcharge at a level that will bring the Net Present Value of the project to approximately $0 over the life of the Project.

The proposed surcharges for the Ely Lake Project were calculated according to the model described in MERC's NAS Rider approved by the Commission, except that the proposed surcharge rates were calculated over a 20-year term rather than a 15-year term.

MERC proposed a $34.10 monthly surcharge for all customer classes. The Company stated that although no customers are expected to take interruptible or transport service, a surcharge is proposed to comply with the Commission's requirements and to prevent a duplicate filing in the event customers in those classes request services in the future. According to the Company, the NAS rates are set at a reasonable level that will ensure, to the extent possible, that the Ely Lake project is load and cost justified and that existing customers will not subsidize new area customers over the life of the project.

MERC proposed that the surcharges be in effect for a period not to exceed twenty (20) years. The Company stated it anticipates that the gas service to the Ely Lake area will commence on approximately November 1, 2014, so the surcharge is proposed to expire on November 1, 2034. MERC will terminate the surcharge when the projected revenue deficiency is satisfied or at the end of twenty (20) years, whichever occurs first.

MERC argued that the proposed NAS is in the public interest because natural gas costs less than alternative fuels so customers will benefit from the additional fuel choice.

The Commission's July 20, 2012 Order required that all pertinent contract demand entitlement change requests be made as soon as the required information in ascertained. MERC stated it anticipates no demand entitlement changes as a result of this project.

MERC requested that the Commission rule on this filing within sixty (60) days of filing so that construction of a service extension for the Ely Lake Project may begin promptly. The Company estimated construction can be completed in approximately two months. The intent is to have gas service available to the customers in the Ely Lake Project by November 1, 2014. However, in order to maintain the projected construction costs, construction must begin no later than September 1, 2014.

Revised Surcharge

On August 1, 2014, MERC submitted a revised NAS model to reflect interim distribution and customer charges and incorporate discussions with Commission staff regarding the independence of the NAS model from MERC's general extension Contribution in Aid of Construction (CIAC) model. As a result of these changes, the CIAC is now $702,850 and the NAS is $33.50 for all rate classes.

Department

The Department stated that the service life of the installed equipment is likely to exceed 30 years. Therefore, the Department concluded that a maximum of 30 years is a reasonable term for a NAS. The longer allowable term may result in more affordable surcharges which may allow MERC to make more service extensions. Thus the Department recommended that the Commission approve MERC's proposed extension of the maximum term for its NAS Rider.

The Department stated that MERC included the exhibits required by the July 26, 2012 Commission Order in Docket G-007,011/M-11-1045, including an updated tariff sheet, customer notice, and the work papers the Company used to calculate the surcharge.

The Department reviewed MERC's filing and concluded that MERC has met all of the Commission's filing requirements established in Docket No. G-007, 011/M-11-1045. Further the proposed surcharge was calculated using the methodology approved by the Commission in that Docket. Finally, the 20-year term is reasonable based on the Department's conclusions above. The Department recommended that the Commission approve MERC's proposed NAS for the Ely Lake Project.

Staff Analysis

Surcharge Term

On February 27, 1992, the Commission considered proposals to allow utilities to assess surcharges which would recover extension costs in remote areas.

While the Commission found the overall idea appealing; there were numerous unresolved financial and rate design issues in each of the tariff applications. Thus, the Commission rejected the filings without prejudice and requested that staff of the Minnesota Department of Public Service[1] (Department), along with Commission staff, develop a list of overall policy matters for the Commission to address. The result was a March 12, 1992 memo from Commission and Department staff. Included in that Memo was the following:

> How long should the surcharges be in place?
>
> Staff believes three to 15 years would be a reasonable time period for the surcharges to be in place. By allowing some flexibility, the Commission would help utilities work with a wider range of communities than if they were required to recover the revenues in a fixed time period. Staff also believes the recovery period should not be longer than 15 years, since the utility would face more risk of failing to recover costs of the extensions.

All of the NAS tariffs approved by the Commission have included a maximum term of 15 years. Staff believes that term was approved because it allowed the Company enough time to recover the project costs without the surcharge being too large. Further, it limited the amount of time the customers would have to pay this extra charge which is over and above the normal gas bill.

The surcharge in MERC's tariff is calculated in a similar fashion as a loan. In this case the Contribution in Aid of Construction (CIAC) is the principal, the interest rate is the rate specified in the tariff and the term is the length of the surcharge in years. There are two ways of viewing affordability of the surcharge.

Like a loan, the longer the term of a loan, the lower the monthly payment will be. For example, a 30 year loan has a lower monthly payment than a 15 year loan. So in terms of the monthly payment, extending the term makes the project more affordable.

However, with a 15 year loan the total amount of interest paid will be less because of the shorter term. So in terms of the total overall cost, a shorter term is more affordable.

The Company's proposal for a 20 year term has a monthly (surcharge) payment of $33.50, total interest of $561,880 for a total cost of $1,264,290. If the term was 15 years, the monthly payment would be $40.20 with interest of $404,170 for a total cost of $1,107,108.

If the goal is to make the surcharge more affordable in terms of a lower monthly payment, then extending the term would be the way to achieve that goal. However, if the goal is to have the lowest overall cost, then the term should not be extended.

Ely Lake Project Surcharge Term

MERC proposed that the surcharge for this project be in effect for a period not to exceed twenty (20) years. Based on gas service to the Ely Lake area commencing on approximately November

[1] Now the Department of Commerce

1, 2014, the surcharge is proposed to expire on November 1, 2034. The Company stated it will terminate the surcharge when the projected revenue deficiency is satisfied or at the end of twenty (20) years, whichever occurs first. Because the proposed change to the tariff would allow a project to be in place for up to 30 years, the Commission's order should state that the Ely Lake project can be in effect for up to 20 years to prevent any confusion in the future.

Surcharge

In previous NAS projects approved for Xcel and CenterPoint, the NAS surcharge was approximately the same as the monthly customer charge. MERC is proposing a surcharge of $33.50 per month for all customer classes for the Ely Lakes Project. The table below presents MERC's currently approved customer charges. The proposed surcharge for the residential class is four times the customer charge of $8.50 per month. That fact along with the proposed extended term of the surcharge provides an indication of the economics of this project. The required CIAC of $702,850 for this project is 78.3 percent of the cost of the project.

As required by the Commission, MERC has proposed surcharge rates for all its customer classes even if no customers are anticipated for the class. MERC is proposing the same surcharge rate for all classes. The Commission has required that the surcharge rates for the customer classes be in the same proportion as the customer charges because the monthly customer charge is representative of the cost to serve that class. Staff believes that the costs imposed by this project on each class are similar to those represented by the monthly customer charge. The following table shows what the surcharges would be if they were proportional to the monthly customer charges. Staff recommends that the Commission require that the surcharge rates set in this docket be proportional to the monthly customer charge. The Company's forecast of customers to be added for this project includes only residential customers. Therefore, this recommendation will not change the model results. However, it will provide guidance to the Company for future filings.

Class	Customer Charge	Ratio to Res Cust Chg	Surcharge
Residential	$8.50	1.0000	$33.50
Small Commercial	$14.50	1.7059	$57.15
Large Commercial	$35.00	4.1176	$137.94
Small volume Interruptible	$150.00	17.6471	$591.18
Large Volume Interruptible	$175.00	20.5882	$689.70
Small Volume Joint	$150.00	17.6471	$591.18
Large Volume Joint	$175.00	20.5882	$689.70
Small Volume Transport	$150.00	17.6471	$591.18
Large Volume Transport	$175.00	20.5882	$689.70

CIAC

The model description in the NAS tariff provides:

> The Net Present Value (NPV) of the yearly revenue deficiencies or excesses will be calculated using a discount rate equal to the overall rate of return authorized in the most recent general rate proceeding. Projected customer CIAC surcharge revenues are then introduced into the model and the resultant NPV calculation is made to decide if the project is self-supporting. A total NPV of approximately zero ($0) will show a project is self-supporting.

In the updated model (Exhibit C) submitted on August 1, 2014, the sum of the NPV is $17 which meets the requirement of being approximately zero. Staff has reviewed the August 1 revision and agrees that the resulting CIAC of $702,850 is the required amount for the Ely Lake project. Staff also agrees that the monthly surcharge for the residential class should be $33.50.

The Commission's order[2] approving the NAS tariff directed that the discount rate used for calculating the net present value of the surcharge to determine the Contribution in Aid of Construction shall be the cost of long-term debt from the most recent rate case.[3] MERC used a rate of 6.55 percent which was the long term debt from docket 10-977. Staff agrees that MERC used the appropriate rate.

Gas Supply

The Commission's order approving MERC's NAS (11-1045) required that the application for a NAS project would include all pertinent contract demand entitlement change requests as soon as the required information is ascertained. MERC stated it anticipates no demand entitlement changes from this project.

The Ely Lake project will be served off of the Northern Natural Gas pipeline. According to MERC's NNG 2013 demand entitlement filing[4] the design day forecast per customer is 1.38 dekatherms. MERC forecasts that 100 customers will be added in 2014 and 2015 so the forecasted design day usage would be 138 dekatherms. The 2013 demand entitlement filing show a reserve margin of 7,607 dekatherms so the usage of the new customers should be able to be absorbed with the reserve margin.

Disclosure to Customers

This project is relatively expensive. A surcharge of $33.50 per month would cost a customer $8,040.00 over the twenty year term. Therefore if the Commission approves this petition, Staff believes MERC should be required to provide the customers full disclosure to assist them in

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[2] ORDER APPROVING NEW AREA SURCHARGE WITH MODIFICATIONS AND REQUIRING REVISED TARIFF SHEET dated July 26, 2014 in Docket No. G-007,011/M-11-1045

[3] This calculation is a different one than the NPV described above which uses the overall rate of return.

[4] G-011/M-13-670

deciding whether to commit to receiving natural gas service and to prevent future complaints about not knowing what the cost would be. At a minimum, that disclosure should include:

- The monthly surcharge rate and that the rate is in addition to the regular bill for gas service. Provide a pro forma gas bill for the month of January based on average customer use for that month in that area of Minnesota and also include the surcharge as a separate line item.
- The annual cost of the surcharge.
- A statement that the surcharge is expected to be charged for 20 years and what the total cost of the surcharge would be for that time period.

This list is not intended to be all inclusive. If the Commission or any party has additional suggestions for disclosures, they can be disclosed at the agenda meeting.

Decision Alternatives

Tariff Change

1. Approve the Company's request to change the maximum term of the surcharge from 15 years to 30 years. (MERC, Department)

2. Approve a change of the maximum term of the surcharge from 15 years to some other term the Commission believes is reasonable.

3. Determine that the maximum term of the surcharge should remain at 15 years.

Ely Lake Project

4. Approve the proposed Ely Lake project with a surcharge of $33.50 for all customer classes for a period of 20 years.

5. Approve the proposed Ely Lake project with a surcharge of $33.50 for residential customers and the other customer classes' surcharge proportional to the monthly customer charges as shown in the table on page 5 for a period of 20 years.

6. Approve the proposed Ely Lake project with a surcharge of $40.20 for residential customers and the other customer classes' surcharge proportional to the monthly customer charges for a period of 15 years.

Disclosure

7. Require the Company to disclose to potential customers the following at a minimum:

- The monthly surcharge rate and that the rate is in addition to the regular bill for gas service. Provide a pro forma gas bill for the month of January based on average customer use for that month in that area of Minnesota and also include the surcharge as a separate line item.
- The annual cost of the surcharge.
- A statement that the surcharge is expected to be charged for 20 years and what the total cost of the surcharge would be for that time period.

8. Do not require the Company to provide the suggested information to potential customers.

Recommendation

Staff recommends 1, 5 and 7.