Minnesota Public Utilities Commission

Staff Briefing Papers

Meeting Date: September 24**,** 2014 ....* Agenda Item # **3**

Company: Northern States Power Company, d/b/a Xcel Energy

Docket No. G-002/M-14-583

In the Matter of a Request by Northern States Power Company for Approval of New Area Surcharge Riders for the Cities of Barnesville, Holdingford and Pillager

Issue(s): Should the Commission approve the proposed New Area Surcharge Riders?

Should the costs of the GMT and GMG transmission agreements be recovered through the PGA or some other form of surcharge?

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Relevant Documents

Xcel Filing..July 9, 2014
Department Comments .... August 8, 2014
Xcel Reply Comments.. August 18, 2014
Department Response Comments .... August 27, 2014
Xcel Reply Comments..September 8, 2014
Department Supplemental Response...September 12, 2014

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September 17, 2014

Statement of the Issue

Should the Commission approve the proposed New Area Surcharge Riders?

Should the costs of the GMT and GMG transmission agreements be recovered through the PGA or some other form of surcharge?

Background

On July 9, 2014, Xcel filed a request for approval of New Area Surcharge (NAS) Riders for the Cities of Barnesville, Holdingford, Pillager and surrounding areas.

On August 8, 2014, the Department filed comments recommending approval of the Pillager NAS but proposed an alternative method for recovery of costs for Barnesville and Holdingford.

On August 18, 2014, Xcel filed comments disagreeing with the Department's alternative proposal and continued to support its NAS Riders as filed with the exception of changing the Barnesville residential class surcharge to $23.99 and potentially modifying some tariff language.

On August 27, 2014, the Department filed response comments recommending approval with modification.

On September 8, 2014, Xcel filed reply comments arguing that modification of the NAS tariff is necessary because it believes that there will be very few service extension projects that will be economically viable without a third party (such as Greater Minnesota Transmission) building and owning the transmission pipeline to the new distribution areas that the Company will own.

On September 12, 2014, the Department filed supplemental response comments stating that after considering Xcel's arguments, the Department concludes that the generic revision to the tariff supported by Xcel would be acceptable.

Party Positions

Xcel

Xcel stated that there are communities in Minnesota without natural gas service that have requested service from the Company. Service to these communities is not economically justified at the Company's present rates since the additional revenues would not cover the total cost of service.

Xcel Energy proposed to add new NAS Rider rates to new natural gas customers in the cities of

- Barnesville and the townships of Elkton, Humboldt, Riverton, Skree and Hawley.

- Holdingford and Opole and the townships of Holding and Brockway.
- Pillager and Sylvan Township (Cass Co.).

According to Xcel, the proposed surcharges were calculated in accordance with the methodology described in the Company's current NAS Rider tariff.

Xcel stated that it is committed to serving Barnesville, Holdingford, and Pillager and the NAS Rider is a mechanism to assist in providing service to those customers. The Company further stated that if the NAS Riders are not approved, it will not include any unjustified expenses in rate base.

The Company proposed a fixed rate NAS Rider to be included as part of the new customers' monthly bill until the revenue deficiency is recovered, up to a maximum of fifteen years. Xcel stated that the surcharge payments will be terminated early if the revenue collected recovers the total extension costs to the new community sooner than originally forecasted due to lower than projected installation costs or higher than projected service saturation.

The NAS rider tariff requires Xcel to use the overall rate of return from its most recent rate case. The Company compared its cost of capital from its last natural gas rate case to that in its current electric rate case. Xcel stated that the debt rates and capital structure could be updated. Xcel proposed to use in its NAS models the cost of capital in Table 2 on page 5 of the filing which has updated debt cost rates and the capitalization ratios to those used in its current electric rate case.[1] The overall rate of return from the last rate case, G-002/GR-09-1153, was 8.28 percent. The proposed updated rate of return is 7.56 percent.

The following table presents the proposed NAS for the three projects.

Proposed NAS Rider Rates

Class	Barnesville	Holdingford	Pillager
Residential	$24.99	$14.45	$13.50
Small Commercial Firm	$34.99	$35.00	$20.00
Large Commercial Firm	$395.00	$315.00	$200.00
Commercial Demand Billed	$1,150.00	$700.00	$1,000.00
Interruptible	$1,150.00	$700.00	$1,000.00
Firm Transportation	$1,150.00	$700.00	$1,000.00
Interruptible Transportation	$1,150.00	$700.00	$1,000.00

According to Xcel the proposed NASs are reasonable because it is currently estimated that alternate fuel prices will remain high for years to come such that residential customers are projected to save money with natural gas even with $15-$30 monthly NAS Rider charges.

[1] The updated debt cost rates and the capitalization ratios are for 2014, the first year of the multi-year rate case. The updates are from the initial filing and do not reflect updates from Xcel's July 7, 2014 rebuttal.

Barnesville Transportation Service from Greater Minnesota Transmission (GMT)

Xcel stated that it does not own pipeline near enough to Barnesville to economically extend service to the community with its existing pipelines. The Company signed a fifteen-year transportation service agreement with GMT to serve Barnesville. GMT will construct a new 36-mile transmission line that will service several interconnection points and provide service near Barnesville.

The Company proposed that those costs not go through the Purchased Gas Adjustment like other upstream costs, rather they would be put in a separate Barnesville NAS account. Revenue from the Barnesville NAS Rider will offset the future revenue requirements of the costs.

Holdingford Transportation Service from Greater Minnesota Gas (GMG)

The Company does not own pipeline near enough to Holdingford to economically extend service to the community with its existing pipelines. Xcel stated it entered into a firm transportation service agreement with GMG to serve Holdingford. GMG will transport gas through its existing Swanville distribution system which is currently being extended to serve Upsala, Minnesota to an agreed upon interconnect with Xcel near Holdingford, Minnesota.

Again, the Company proposed that these costs would not go through the Purchased Gas Adjustment like other upstream costs. Instead, they will be put in a separate Holdingford NAS account. Revenue from the Holdingford NAS Rider will offset the future revenue requirements of the costs.

Effective Date

The Company stated that in order to provide natural gas service to these three areas by the 2014-2015 heating season; it is requesting approval of these riders by October 1, 2014 with an effective date of November 1, 2014. According to the Company, it expects to have permitting completed and start construction on the Barnesville and Holdingford projects in July 2014. It began construction of the Pillager project in late June. Xcel projected that it will finish construction in October. Its intention is to have customers in service by November 1, 2014.

Department of Commerce Comments

The Department stated that the NAS Rider described in Xcel's tariff depends on a calculation of the present value of the project's revenue deficiency (or excess) over the life of the project. If this value is at or near $0, then the model indicates that the project is self-supporting and that the customer surcharge is at the proper amount. Several assumptions and calculations are used to calculate the net present value of the revenue deficiency, some of which are discussed below.

Xcel has negotiated contracts for service from pipelines owned by Greater Minnesota Transmission, LLC (GMT) for Barnesville and Greater Minnesota Gas (GMG) for Holdingford.

The Company proposes to recover the costs associated with these contracts through the NAS Riders assessed to customers in those communities. The Department stated it has reservations about using the NAS mechanism to fund demand charges and recommended an alternative for the Commission to consider.

Barnesville

The Department stated that the proposed Barnesville NAS Rider is significantly higher than the NAS Riders proposed for Pillager and Holdingford. This difference is almost entirely due to the cost of a transportation agreement with GMT.

At the Department's request, Xcel provided alternative calculations that project the NAS rate assuming the Company was allowed to collect the surcharge for up to 20 years. Those calculations showed that extending the surcharge period had little to no effect on the monthly rates. As a result, the Department stated it does not recommend extending the length of time the surcharge is in effect.

With the proposed rates, Xcel expects the present value of the revenue deficiency to be negative $96,639 (i.e., a revenue excess of $96,639). Because the model predicts a revenue excess and because the proposed NAS charges for Barnesville customers are high, the Department recommended reducing the residential surcharge by $1 to $23.99 if the Commission decides to approve the Barnesville NAS. This change results in the present value of the revenue deficiency increasing to negative $15,085, significantly closer to the $0 target.

Pillager and Holdingford

The Department reviewed Xcel's filing as it pertains to the Pillager and Holdingford riders and concluded that Xcel has complied with Commission rules and its NAS Rider tariff.

As no demand charges are included in Xcel's calculation of the Pillager NAS, the Department recommended approval of Xcel's Petition for a NAS in that community. However, demand charges are included in Xcel's calculation of the Holdingford NAS. The Department recommended an alternative Purchased Gas Adjustment (PGA) method for recovery of the demand costs. However, if the Commission decides that the NAS is the best mechanism for funding the extension of natural gas service to the community of Holdingford, the Department recommended no revisions to Xcel's filed model or surcharge amounts for Pillager and Holdingford.

NAS Rider Cost of Capital

The Department stated that the Company's tariff provides that the debt and equity return components of the revenue requirements model should be calculated using the costs and weights of debt and equity established in the company's most recent general rate proceeding. The Company's most recent natural gas general rate case had a 2010 test year and a pre-tax weighted cost of capital of 8.28%.

Xcel suggested using the costs and weights of debt and equity proposed in its current electric rate case with a pre-tax weighted cost of capital of 7.56%. The Department offered the following observations about this proposal:

1) The Company's proposal of using the cost of capital proposed in the 2014 electric rate case would result in lower surcharges for ratepayers than reliance on the cost of capital set in the company's most recent natural gas general rate case.

2) In general, it may not be appropriate to use a cost of capital that was calculated for Xcel's electric service in a natural gas proceeding; however, Xcel updated only the debt component of its capital structure. The debt component of Xcel's capital structure is more likely to be similar between the gas and electric sectors of Xcel's company.

3) Another reason why it was appropriate that Xcel updated only the debt portion of its cost of capital is because that is the only aspect of Xcel's cost of capital that has not been disputed in Xcel's current rate case.

4) Generally, the Department does not support updating one cost without updating others; however, in this case, the Department concluded that Xcel's proposal is reasonable.

Minnesota Statutes §216B.03 requires the Commission to set rates in a manner in which "[a]ny doubt as to reasonableness should be resolved in favor of the consumer." As a result, the Department stated it would support *in this case* use of the updated cost of capital proposed by Xcel because Xcel's proposal would benefit ratepayers since the proposed electric pre-tax weighted cost of capital is lower than the same figure in the most recent natural gas general rate case. However, the Department stated it would not necessarily support such a proposal in the future due to the concerns noted in items 2 and 4 above

Inclusion of Demand Payments in the NAS Rider

The Department expressed concern that inclusion of the demand costs from the GMT and GMG contracts as Operating Expenses in the NAS Rider may not be appropriate. The Company's tariff describes the allowable operating expenses. Demand costs are not included in this category of expenses. The Department stated it agreed with Xcel that while it is fair to assign the costs of the GMT and GMG contracts to the customers in Barnesville and Holdingford who are causing them, there is an alternative to using the NAS Rider model to accomplish this goal.

Alternative to the NAS Rider

The Department proposed an alternative that is consistent with the way that pipeline demand costs are usually charged, i.e., through the PGA mechanism. Specifically, the Department recommended assigning the demand costs incurred on behalf of customers in Barnesville and Holdingford to those customers through a specific PGA for these communities, as a volumetric charge.

This proposal has several benefits for ratepayers, including:

- No need for a NAS Rider for these communities, as the distribution costs incurred by Xcel are economic and would be socialized with system costs in Xcel's next general gas rate case;
- Customers in Barnesville and Holdingford would not be required to directly fund Xcel's costs of capital incurred by constructing distribution infrastructure;
- Significantly lower average monthly charge to residential customers than under the proposed NAS Riders;
- The PGA true-up mechanism would prevent over or under collection of funding for the GMT and GMG contracts;
- The NAS would not be employed for a purpose for which it was not intended;
- The risk of under recovery of Xcel's distribution costs would be removed from ratepayers; and
- Residential customers would not subsidize commercial and industrial customers. (Under a volumetric charge, residential rates would decrease while commercial and industrial rates increase. This suggests that, under the Company's proposal, residential customers may be subsidizing commercial and industrial customers.)

Based on Xcel's estimated customer additions and per-customer demand projections, the Department estimated that average monthly bill impacts of the volumetric charges to customers over the 15-year period would be as follows:

Estimated Monthly Customer Charges
(Volumetric Cost Recovery)

Class	Barnesville	Holdingford
Residential	$19.71	$12.37
Small Commercial Firm	$60.69	$38.72
Large Commercial Firm	$728.30	$464.69
Commercial Demand Billed	$2,591.00	$1,417.31
Interruptible	$2,023.07	$611.42
Firm Transportation	$2,030.42	$0.00
Interruptible Transportation	$19.71	$12.37

Department Recommendations

After review of the Company's Petition, the Department recommended:

- that the Commission approve the request for approval of a NAS in the city of Pillager;
- that the Commission approve either:
  Xcel's proposed NAS surcharges for Barnesville and Holdingford or, preferably, the Department's recommended alternative of avoiding use of NAS surcharges for these cities and areas and instead use a PGA surcharge for the higher demand costs.

Xcel Reply Comments

The Company stated that while it understands the concerns of the Department, it continues to support the NAS Rider rates as filed with the exception of agreeing to change the Barnesville residential class rate to $23.99, as recommended by the Department.

Expenses Are Consistent with the Tariff

According to Xcel, the alternative to entering into the GMT and GMG agreements was for it to build distribution pipeline from its existing system to these communities. That option was determined to be more expensive and the larger scope would have delayed the in-service date of the projects. The Company stated it believes the intent of the tariff does cover the types of costs associated with the arrangement it made with GMT & GMG.

Xcel stated that the last sentence of the Operating Expenses paragraph in the tariff could be considered problematic as it is overly proscriptive. To clarify this, the Company proposed the following modification to the language would resolve any uncertainty:

> Operating Expenses. Operating expenses includes provisions for transmission and distribution system operation and maintenance expenses, and provisions to cover customer accounting expenses such as meter reading, customer accounting and collection. Property taxes are also included as a component of operating expenses. ~~All c~~Components of operating expense herein are driven by the amount of plant in service additions and other operating and maintenance expenses, including capacity entitlements if contracted only for purposes of extending service, needed to extend service (Column 3).

The Company argued that this clarification of the intent of the NAS tariff is a better solution as compared to creating new community-specific PGA adders as identified by the Department in their alternative proposal.

Lower Barnesville Residential Class Surcharge by $1

Xcel stated it is willing to lower the Barnesville residential class surcharge by $1.00 from $24.99 to $23.99 and agrees with the Department's analysis of the revenue sufficiencies under both rate levels.

Alternate Proposal - Mechanism Structure and Bill Comparisons

If the expenses for the GMT & GMG agreements were removed from cost justification calculations, the extensions would cost justify. Under the Department's alternate proposal, there would be no NAS Rider rates for Barnesville and Holdingford. Instead there would be community-specific PGA adders for Barnesville and Holdingford that, according to the Company, would be in place until final rates go into place with its next general natural gas rate case.

Xcel stated that community-specific PGA adders would be cost per therm rates which would be trued-up annually as a part of the AAA/True-up filed by September 1.

Concerns with the Alternate Proposal

1. Cost Distribution to Class

In footnote 16 of their comments, the Department said, “Under a volumetric charge, residential rates would decrease while commercial and industrial rates increase. This suggests that, under the Company’s proposal, residential customers may be subsidizing commercial and industrial customers.”

The Company stated that switching from a per-customer per-month charge to a volumetric charge may lower residential customers’ rates and increase commercial and industrial customers’ rates. Xcel argued that is not indicative of one class subsidizing another. The cost of extending service to these new towns is very dependent on the numbers of customers that sign-up for new service and, therefore, collection through a fixed monthly charge is appropriate. In addition, a fixed monthly charge should lead to more stable and consistent charges and recovery since they are not tied to sales which vary with weather.

When deciding the amounts of the NAS Rider rates, Xcel stated it also has to take into consideration what the market will bear. Commercial and industrial customers indicated in discussion that rates the Company was proposing were acceptable, but that higher rates would be less acceptable and if the rates got too high, they would not switch to natural gas service. As shown on Tables 1 and 2[2] the charges to some classes under the alternate proposal will be nearly doubled as compared to the charges under the NAS proposal.

2. Customer confusion

Xcel stated that the NAS Rider rates filed in the petition have already been communicated to customers in the Barnesville and Holdingford areas. Customers have agreed to take service based on that representation. The NAS Rider rate has always been described to them as a flat per month charge. Significantly changing the amount of the charge and changing it to a volumetric charge could cause confusion.

3. Administrative Concerns

According to the Company, data is not available at the level of granularity that would be required to achieve accuracy and assure parity between customers. There are also concerns about the administrative burden of setting up and tracking two new PGA adders.

<u>Grain Dryers:</u> Both extension projects have a few grain drying customers that only use gas in the fall and only when weather conditions have made mechanical grain drying necessary. This

[2] The pages of the comments are not numbered but the tables are found on the fourth page.

means there will be years when these customers have no usage and under the alternate proposal they would not pay anything towards the GMT & GMG agreement expenses. The true-up adjustment for the under recovery would be distributed across all the customers in the community not just the classes with the grain-drying customers.

Xcel stated it could consider class-specific community-specific PGA adder rates per area, but the extra calculations to have 12 new true-up factors and the potential billing issues for such small customer classes would increase concerns about accuracy of cost allocations and administrative burden.

<u>Forecast:</u> The Company does not forecast customer usage at a city level. Regular forecasts are done by state and class. Xcel argued that making forecasts for Barnesville and Holdingford (under 1,500 customers combined, which is about 0.3% of total Minnesota customers) for 15 years would set an unacceptable precedent. The annual forecasts filed in its petition are the only forecasts it is expecting to have for the duration of the GMT & GMG contracts.

<u>Administration of Two New True-ups:</u> Treating the GMT & GMG contract expenses as PGA costs of gas makes them subject to the PGA rules which include an annual true-up of expenses to revenues. The Company will have to add processes to the track expenses and revenue, and will have to expand the existing annual true-up file to include additional sections for the two new community-specific PGA adders. This will add to the administrative cost associated with these agreements.

4. Charging Demand Costs to Interruptible Customers

In the normal PGA process interruptible customers are not charged for demand costs. Under the Department's community-specific PGA adder proposal, firm and interruptible customers in the Barnesville & Holdingford areas will be charged for the GMT & GMG demand costs. This allocation of demand costs to interruptible customer in the community-specific PGA adder proposal is another concern.

Conclusion

For these reasons, the Company stated it continues to support its NAS Riders as filed with the exception of changing the Barnesville residential class surcharge to $23.99 and potentially modifying some tariff language.

Department Response Comments

NAS Tariff Language

The Department stated it continues to have reservations regarding the use of the NAS in cases in which another entity constructs the transmission line that will serve the new area and enters into a transportation agreement with the Company. If this approach is used for other service extensions in the future, it would be best if the approach is evaluated, and the tariff potentially amended, on a case-by-case basis. Therefore, the Department does not support Xcel's tariff modification as proposed but offers a modification that it can support. The Department recommends that Xcel's Tariff be amended as follows:

> Operating Expenses. Operating expenses includes provisions for transmission and distribution system operation and maintenance expenses, and provisions to cover customer accounting expenses such as meter reading, customer accounting and collection. Property taxes are also included as a component of operating expenses. ~~All c~~Components of operating expense herein are driven by the amount of plant in service additions <u>needed to extend service, with exceptions for the towns and surrounding areas of Barnesville and Holdingford, where capacity entitlements contracted only for the purpose of extending service may also be included</u> (Column 3).

The Department's proposed language ensures that use of the NAS in situations not falling squarely within the existing NAS tariff provisions are clearly noted.

Separate PGA Surcharge Proposal

As to the Department's recommendation to collect the higher demand costs for the Barnesville and Holdingford areas through a separate PGA surcharge rather than through the NAS, Xcel offered several arguments against the Department's proposal. These include:

1. Cost Distribution to Class

Xcel has concern that costs for commercial and industrial customers may increase to the point that these customers may opt not to take natural gas service. The Department agreed that the risk of under-recovery increases if fewer than anticipated commercial and industrial customers in the new area request service.

2. Customer Confusion

Xcel has already done outreach in the communities and has communicated the prices in its proposal to customers there. There is concern that changing the prices and the mechanism for assessing them would cause confusion. Xcel was well aware that their price calculations would not be firm until they received Commission approval, and therefore should have made that clear to those potential customers. The Department concluded that the Commission should place very little weight on Xcel's customer confusion argument since any confusion would have been avoided had Xcel provided sufficient and complete customer notification.

3. Administrative Concerns

The Department expected that its PGA recommendation could result in administrative difficulties. The Department stated it continues to conclude that a PGA approach to funding extension of service to Holdingford and Barnesville is the more theoretically correct alternative. However, after review of the administrative burden such an approach would create, the Department is convinced that the PGA alternative is not practical for this case. Further, the NAS approach would be more cost effective and directly charge the new customers all of the related costs.

4. Charging Demand Costs to Interruptible Customers

The Department stated it recognizes that this would be an unusual case if Interruptible customers were charged Demand Costs. However, the Commission has ordered that this be done in a few other cases.

5. Under-Recovery Risk

The Department would like to clarify what was meant by the statement on page 7 of our Comments regarding under-recovery risk. In the initial petition, Xcel stated that the costs for the GMG and GMT contracts will be funded by revenue from the NAS riders, but at the end of the Barnesville and Holdingford NAS riders' lifecycles the costs will be moved into the PGA via the Contract Demand Entitlement annual filing. The Department is concerned that by moving remaining contract costs into the PGA, the Company will be able to shift the risk of under-recovery from shareholders to all ratepayers on Xcel's natural gas service in Minnesota. Normally, the NAS model has a safeguard for system ratepayers; specifically, in the event that actual costs of extending service to the new area are not recovered by the end of the approved NAS term, shareholders would pay for the under-recovery. It is possible that when new contracts are negotiated with GMG and GMT, the costs relating to construction of the transmission pipeline used to serve the new area may not have been fully recovered due to cost overruns or other issues. If this were the case, it is the Department's concern that under-recovered construction costs may be embedded in these new contracts. The Department noted that the Company will be able to recover all contract related costs through the PGA at no risk to their shareholders. This matter must be scrutinized when new contracts are filed for Commission approval in 15 years.

Recommendations

Funding extension of service to Holdingford and Barnesville through a PGA mechanism is more theoretically correct but is too administratively burdensome to be a viable alternative to the Company's proposed NAS approach. As such, the Department stated it no longer recommends funding expansion of service to these towns through the PGA and now recommends that the Commission:

- Approve, for this case only, the update to Xcel's cost of capital as proposed by the Company;
- Approve the Pillager and Holdingford NAS riders as proposed by Xcel;
- Approve the proposed change to Xcel's Tariff (Section 5, Sheet 49 of Xcel's Minnesota Gas Rate Book—MPUC No. 2) as amended above by the Department; and

- Approve the Company's proposed Barnesville NAS rider, but with a $1 per month reduction to the residential surcharge.

Xcel September 8 Reply Comments

Xcel stated its preference is that the tariff language modification not be project specific or require PUC approvals on a case-by-case basis. Given its work this year investigating gas service extension projects, the Company believes that there will be very few service extension projects that will be economically viable without a third party (such as Greater Minnesota Transmission) building and owning the transmission pipeline to the new distribution areas that the Company will own.

In order to determine if it would be appropriate to file for a NAS Rider, Xcel argued that it must discuss service extension projects with communities to determine their interest in the project. Communities need to know definitively what the costs will be to customers when making their decision. It would be difficult to propose new projects when it is not reasonably certain that the NAS Rider recovery method will be allowed. If the community is not interested in taking natural gas service from the Company with the estimated customer costs included in the proposal to the community, it is not productive to file an NAS Rider petition.

Xcel stated it acknowledges the Department's discomfort with including capacity entitlement contracts in the NAS Rider rate. This type of cost was certainly not contemplated when the rider was created 20 years ago and does not fit neatly into the existing NAS tariff. The Company stated it continues to believe that the NAS Rider is the appropriate way to recover the service extension costs.

The Company stated it continues to support the NAS Riders as filed, with the exception of changing the Barnesville residential class surcharge to $23.99 as recommended by the Department and modifying some tariff language as it proposed

Department September 12 Supplemental Response

The Department stated that the sole issue remaining in dispute between it and the Company is how the Company's tariff should be modified to allow for recovery of capacity entitlement contract costs via the NAS Rider. Xcel supports its preference by noting that even with the generic tariff language regarding capacity entitlement contract costs it prefers, it will still be required to petition for and receive Commission approval of any new NAS Riders.

After considering Xcel's arguments, the Department concluded that the generic revision to the tariff supported by Xcel would be acceptable. By approving the generic tariff revision, the Commission avoids having to modify that section of Xcel's tariff for each new NAS Rider that includes capacity entitlement contract costs but is still able to review the contract and other costs as part of each NAS Rider petition that the Company files.

The Department also addressed the Company's assertion that "Communities need to know definitively what the costs will be…" It should be emphasized to communities that there is never certainty regarding the customer surcharge amount(s) related to a project until the Commission makes its decision.

Staff Analysis

NAS Model

The purpose of a New Area Surcharge is to provide a mechanism to recover the uneconomic portion of the **capital costs** of an extension project. The model is designed to calculate the necessary surcharge taking into account the non-gas revenues and the normal incremental O&M costs.

Xcel claimed that the proposed surcharges were calculated in accordance with the methodology described in the Company's current NAS Rider tariff. As discussed that is not accurate.

The NAS model was developed to determine the amount of capital costs for a project that are not recovered by the non-gas portion of current rates, that is the uneconomic portion of the project. The model does that by comparing the non-gas revenues with the rate of return on the project capital costs and the non-gas costs including depreciation, property taxes, income taxes and incremental non-gas operating and maintenance expenses.

In a rate case, the cost of gas included as a test year expense is equal to the cost of gas included in the revenues. The cost of gas is a pass through so the net effect is zero. The revenues included in the NAS model are the non-gas revenues which recover all the utilities costs and rate of return other than the cost of gas. Because the cost of gas in revenues is zero, the cost of gas included as an expense should also be zero. That is not the case here because Xcel included gas costs as an expense. The result is that the model results are inaccurate.

Essentially what the Company is doing is putting a square peg in a round hole. The peg may go in but the end result is not the same as if the proper sized round peg were put in a round hole.

For the Barnesville and Holdingford projects, if the gas costs are removed, both projects are self-supporting. In other words, there are no uneconomic capital costs.

The following applies to both Barnesville and Holdingford, but Staff has used the Barnesville information in the explanation. The agreement with GMT provides that Xcel will pay an annual demand charge of $430,000 for fifteen years.[3] However, in the model Xcel shows that amount for seven years. In the eighth year the amount is a fraction of the $430,000 and for the remaining

[3] The costs of the GMT and GMG agreements were labeled Trade Secret in the initial filing; however they were disclosed on Schedule A of Xcel's August 18, 2014 Public Reply Comments.

seven years the cost is negative as if GMT was paying Xcel.

The reason the Company did this is because the surcharge for a NAS is recorded as a Contribution in Aid of Construction (CIAC). A CIAC is an offset to the plant capital costs; that is it reduces the amount of plant. Xcel manipulated the gas cost included in the model so the CIAC (surcharge) would be equal to the capital cost of the project. If the actual gas costs were input into the model, the CIAC would be $6,825,582 which is a considerably larger amount than the actual plant costs of $3,301,979.

Xcel also manipulated the surcharge in the calculation. By the eight year, the surcharge is $460,000 plus but Xcel used $106,773. In the ninth and tenth years, Xcel showed $23,462 and $8,379 as the surcharge. This is unrealistic because the surcharge would be in place until the costs were recovered at which time the surcharge would terminate. It would not drop off gradually.

Based on Xcel's proposal, the surcharge should end in the eighth year. If the actual gas costs were used in the model, the surcharge would be charged for the full fifteen years with annual recovery of $460,000 plus.

Because of Xcel's attempt to force the NAS model to do something it is not intended to do there is another issue. The demand charge in the GMT agreement is $430,000 for fifteen years or a total of $6,450,000. However, the total surcharge is $3,301,980. Therefore, Xcel is not recovering the full cost of the demand charge through the surcharge.[4] That happens because of Xcel's insistence in using the NAS model and including the gas costs in the model. Because the surcharge is limited to the actual capital costs in the model and the actual gas costs greatly exceed that amount, there will be an under-recovery.

Xcel has proposed that the NAS tariff be modified to allow the inclusion of gas costs. Staff strongly recommends that any changes to the NAS tariff not be approved. As discussed above, the Company had to manipulate the inputs into the model instead of using the actual costs in order to get it to work. Changing the tariff and allowing gas costs in the NAS model calculations will not solve the problem. Anytime the gas costs are greater than the total capital costs of the project, the model won't produce a rational outcome. Whether that would change if the capital costs were greater than the gas costs has not been determined and whether the project is self-supporting for capital costs might also influence the outcome.

PGA Recovery

The Department stated that the GMT and GMG costs are gas costs and the theoretically correct way is to recover them through the PGA. Staff agrees. The Company disagreed, raising a number of objections.

[4] For Holdingford, the surcharge is greater than the total demand costs but less than the total of the demand and commodity costs of the GMG agreement.

Xcel disagreed with the Department's proposal to recover the GMG and GMT costs through the PGA. In its August 18, 2014 Reply Comments, Xcel compared its proposed NAS recovery with the Department's proposed PGA recovery. For almost all classes, recovering these costs through the PGA would cost ratepayers more because 100 percent of the costs would be recovered. As noted above, all of the gas costs are not recovered through the surcharge. Therefore, the comparison is not valid.

Timing of the Filing

Staff is troubled by the fact that Xcel has put the Commission in an awkward position with this filing because it made the filing on July 9, 2014 and wants approval of the filing by October 1, 2014. That time frame limits the time available to resolve any issues, which puts the Commission in the position of having to approve a poorly developed filing or being the bad guy who didn't allow gas service for those communities for the upcoming winter.

Xcel could have made this filing concurrently with GMT's May 8, 2014 filing for approval of the transportation agreement.[5] Making the filing concurrently with the GMT filing would have helped in the analysis of the GMT and GMG filing by clarifying the proposed recovery of those costs. Xcel had already determined the surcharge amounts and was disclosing that to potential customers at the time of the GMT filing. A newspaper article immediately following Xcel's May 21, 2014 annual meeting in Fargo discussed Ben Fowke's comments at the meeting stating:

> The utility is interested in providing natural gas to customers in communities near pipelines who want to switch from propane.
>
> An early example is in Barnesville, Minn., where work will begin this summer to extend a pipeline about 20 miles to enable hookups in the town 25 miles southeast of Fargo.
>
> Even paying a $26 monthly fee to pay for the pipeline connection, customers should achieve significant savings by switching from propane, said Mark Nisbet, Xcel's principal manager in North Dakota.

In its initial filing, Xcel stated that the Company expects to have permitting completed and start construction on the Barnesville and Holdingford projects in July 2014. It began construction of the Pillager project in late June. Therefore, Xcel started construction of the extensions prior to requesting approval of the customer surcharge. In addition, Xcel's telling the customers that the rate would be some amount that had not been approved by the commission also creates problems.

Staff Recommendation for Surcharge

Staff initially intended to recommend that the Commission reject the NAS for Barnesville and

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[5] The GMG filing was made earlier on April 24, 2014.

Holdingford for all the reasons discussed. However, in the process of developing an alternative proposal that would be consistent with the intent of the NAS, Staff concluded that Xcel's proposal is more beneficial for ratepayers than the alternative proposal being considered.

First, because ratepayers would only be paying for a fraction of the costs of the GMT (Barnesville) and GMG (Holdingford) agreements, the surcharges are smaller than they would be if the full costs of those agreements were recovered from ratepayers.

There has been discussion in this docket regarding who bears risk of under-recovery of the costs. Under the heading Term, the tariff states: "The Company assumes the risk for underrecovery of expansion costs, if any, which may remain at the end of the maximum surcharge term." Both the Company and the Department appear to agree that the provision includes the gas costs included in the model. However, because gas costs are not "expansion costs," this could cause disputes in the future. To prevent that, Staff recommends that the Commission clarify that any of the gas costs (demand and commodity) from the GMT and GMG agreements that are not recovered by the surcharge cannot be recovered in a rate case or any other docket for the 15 year term of the agreements.

Based on Xcel's models, the surcharges may terminate prior to fifteen years. The non-recovery provision should still cover the entire fifteen years of the gas agreements because the model includes all the costs for the entire life of the project based on the depreciation life of the plant. For both Barnesville and Holdingford, that life is from 2014 through 2064.

Second, because these projects are proposed as NASs, the surcharge is a CIAC. For both Barnesville and Holdingford the CIAC equals the total capital costs of the project. Therefore, Xcel will not be recovering the capital costs of these projects in future rate cases. That is the case even though the projects are self-supporting. If the Company had excluded the gas costs from the calculation it would have recovered all of the capital costs.

Xcel is voluntarily foregoing recovery of millions of dollars that it otherwise would have been allowed to recover. That results in a benefit to the customers in Barnesville and Holdingford as well as all its customers in future rate cases. For that reason, Staff does not oppose Xcel's proposal in this docket.

Future Filings

There are two approaches that can be considered for future filings. Xcel has stated that it believes that there will be very few service extension projects that will be economically viable without a third party (such as Greater Minnesota Transmission) building and owning the transmission pipeline to the new distribution areas that the Company will own.

According to Xcel, it does not own pipeline near enough to Barnesville or Holdingford to economically extend service with its existing pipelines. GMT will construct a new 36-mile transmission line that will service several interconnection points and provide service near Barnesville. Barnesville is 25 miles from Fargo/Moorhead so the pipeline statement does not appear to be supported in that case.

Further, Staff notes that this filing is lacking an analysis that demonstrates that it is better for ratepayers to contract with GMT and GMG for transportation service rather than for Xcel to construct the transmission line. Without the necessary analysis it is difficult to understand how GMT and GMG can construct and operate the transportation lines at a profit at a lower cost than Xcel doing it at cost. If Xcel had constructed the line it would have been a capital cost of the type that the NAS was designed to recover which would have eliminated the gas cost issue.

Based on the contention that a third party agreement is required, the Commission could approve Xcel's requested revision to the NAS tariff that would allow inclusion of the gas costs in the NAS calculation. Depending of the level of capital costs, whether the project is self-supporting for capital costs, the overall level of gas costs, and the amount of gas costs in comparison with the amount of capital costs, a situation similar to the one here could result. The Commission may want to approve the tariff revision because it appears to benefit ratepayers. The Commission may not want to approve the revision because of the potential harm to the Company's financial health from foregoing recovery of costs that it is appropriate for it to recover from ratepayers.

Alternatively, the Commission could deny the request to revise the NAS tariff and require Xcel to use the NAS only for capital costs and require Xcel to develop an alternative proposal to recover the gas costs. There would be two separate calculations, the results of which would be added together to determine the surcharge for the expansion project. Any proposal should be made in a timely manner that allows enough time to evaluate that proposal and work out any issues that may arise.

Xcel presented administrative and other reasons why recovery through the PGA would not be practical. Among those reasons are the PGA collects costs based on usage which changes how the costs are recovered from the various customer classes compared to how recovery occurs in a NAS. Also demand costs are not normally recovered from interruptible customers so they would not contribute towards the gas costs incurred to provide them gas service. Because the gas costs are being incurred in lieu of Xcel constructing the transmission line for this specific purpose they could be considered to have characteristics of capital costs. There it seems that PGA recovery is not a viable alternative.

A possibility for the gas cost recovery would be forecasting the demand and commodity costs for the life of the agreement and calculating an average annual cost. That cost would be allocated to the various customers classes in a similar fashion to what the Company did for the NAS. Xcel described this as follows: "Once the net present value is determined, the monthly surcharge by customer class is then developed based upon the economic factors for the community being modeled and what the market will permit for each customer class." The class cost would be divided by the average annual number of customers for that class to determine the annual cost per customer from which the monthly cost would be derived.

Rate of Return for Model

The NAS tariff requires that "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 Company's most recent general rate proceeding." In this case, Xcel proposed to substitute the debt rates and capital structure from its pending electric case (13-868) for those approved in the last gas rate case. The Department raised concerns about the proposal but agreed to it for this docket because it results in a lower surcharge. If the Commission wants to allow this substitution in this docket, it should take into consideration that fact that it would likely create a precedent.

Decision Alternatives

Barnesville

1. Approve the proposed New Area Surcharge as proposed by the Company but with a $1 per month reduction to the residential surcharge.

2. Approve the proposed New Area Surcharge as proposed by the Company but with a $1 per month reduction to the residential surcharge and determine that any of the gas costs (demand and commodity) from the GMT agreement that are not recovered by the surcharge cannot be recovered in a rate case or any other docket for the 15 year term of the agreements.

3. Do not approve the NAS for Barnesville because gas costs should not be included in the calculation.

Holdingford

4. Approve the proposed New Area Surcharge as proposed by the Company.

5. Approve the proposed New Area Surcharge as proposed by the Company and determine that any of the gas costs (demand and commodity) from the GMG agreement that are not recovered by the surcharge cannot be recovered in a rate case or any other docket for the 15 year term of the agreements.

6. Do not approve the NAS for Holdingford because gas costs should not be included in the calculation.

Pillager

7. Approve the proposed New Area Surcharge as proposed by the Company.

8. Do not approve the proposed New Area Surcharge as proposed by the Company.

Cost of Capital

9. Approve, for this case only, the update to Xcel's cost of capital as proposed by the Company.

10. Do not approve the update to Xcel's cost of capital as proposed by the Company because it is not allowed by the NAS tariff.

Future Filings

11. Approve the Company's proposed change to its Tariff (Section 5, Sheet 49 of Xcel's Minnesota Gas Rate Book—MPUC No. 2) to allow the inclusion of gas costs in the NAS model as follows:

    Operating Expenses. Operating expenses includes provisions for transmission and distribution system operation and maintenance expenses, and provisions to cover customer accounting expenses such as meter reading, customer accounting and collection. Property taxes are also included as a component of operating expenses. ~~All c~~Components of operating expense herein are driven by the amount of plant in service additions and other operating and maintenance expenses, including capacity entitlements if contracted only for purposes of extending service, needed to extend service (Column 3).

12. Approve the Department's proposed change to Xcel's Tariff (Section 5, Sheet 49 of Xcel's Minnesota Gas Rate Book—MPUC No. 2) to allow the inclusion of gas costs in the NAS model as follows:

    Operating Expenses. Operating expenses includes provisions for transmission and distribution system operation and maintenance expenses, and provisions to cover customer accounting expenses such as meter reading, customer accounting and collection. Property taxes are also included as a component of operating expenses. ~~All c~~Components of operating expense herein are driven by the amount of plant in service additions needed to extend service, with exceptions for the towns and surrounding areas of Barnesville and Holdingford, where capacity entitlements contracted only for the purpose of extending service may also be included (Column 3)

13. Determine that the NAS tariff and model are only to be used for the recovery of capital costs. Xcel is to file a proposal to recover the gas costs from agreements such as the GMT and GMG agreements no later than its next expansion project under a NAS.

Annual Report

14. Require Xcel to file an annual report on each March 1 that includes an update on the projects comparing what was projected to happen and what actually happened with the expansion and provide the following information as provided in the tariff:

> The model will be run each year subsequent to the initial construction phase of a project wherein actual amounts for certain variables will be substituted for projected values to track recovery of expansion costs and potential to discontinue the customer surcharge before the full term. The variables which will be updated in the model each year will be:
>
> 1. Number of customers used to calculate the surcharge revenue and the retail margin revenue,
> 2. The actual surcharge and retail revenue received to date and the projected surcharge revenue for the remaining term of the surcharge, and
> 3. The actual capital costs and projected remaining capital costs for the project

Recommendation

Staff recommends 2, 5, 7, 13, and 14. Staff has no recommendation on 9 or 10.