Minnesota Public Utilities Commission

Meeting Date: April 27, 2017 ....Agenda Item** # 4

Company: Greater Minnesota Gas, Inc.

Docket No. G022/S-16-931
In the Matter of the Petition of Greater Minnesota Gas, Inc. for Approval of 2017 Capital Structure and Permission to Issue Securities

Issue: Should the Commission modify GMG's petition for approval of 2017 capital structure and permission to issue securities as recommended by the Department?

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Relevant Documents

GMG Initial Petition (Trade Secret) ....November 15, 2016
Department of Commerce Comments (Trade Secret) ....February 16, 2017
GMG Reply Comments ....February 27, 2017

Statement of Issue

Should the Commission modify GMG's petition for approval of 2017 capital structure and permission to issue securities as recommended by the Department?

GMG Petition

On November 15, 2016, GMG filed a petition for approval of its 2017 capital structure and permission to issue securities.

GMG is specifically seeking Commission approval of the following:

1. total capitalization of up to $41 million, including the proposed contingency;
2. total capitalization contingency of $1.4 million, or 3.51 percent;
3. an equity ratio of 32.94 percent[1] and an equity ratio range of 31.59 percent to 38.61 percent;
4. ability to issue short-term debt not to exceed ten percent of total capitalization at any time while the 2017 capital structure is in effect;
5. long term debt flexibility to issue securities provided that the Company remains within the contingency ranges and does not exceed them for more than 60 days; and
6. approval of the 2017 capital structure until the Commission issues a 2018 capital structure order.

GMG provided the following summary (Attachment No. 3 of the filing) of GMG's actual and proposed capital structures:

	Actual September 30, 2016		Projected December 31, 2017	
	Amount ($)	Percent	Amount ($)	Percent
Common Equity	11,154,811	31.59%	13,047,669	32.94%
Preferred Shares		0%		0%
Short-Term Debt	1 ,030,800	2.92%	1,430,800	3.61%
Long-Term Debt	23,124,142	65.49%	25,130,551	63.45%
Total Capitalization	35,309,753	100.00%	39,609,020	100.00%
Contingency			1,390,890	3.51%
Total with Contingency			41,000,000	103.51%

[1] The petition does not explicitly request this ratio but is contained in Attachment 3 of the petition (reproduced on the table at this page of the briefing paper) and at p. 2 of the Department's comments.

GMG noted that its securities issuance was for capital expenditures for the maintenance and improvement of GMG's existing physical plant and for investment in physical plant to support continued customer growth.

GMG indicated that it does not anticipate receiving a paid in capital contribution from its parent company to finance the 2017 capital projects. However, GMG requests that the Commission authorize the contribution of additional paid in capital if necessary to maintain at least a 31.59% equity ratio contingency range in GMG's 2017 capital structure.

Department Analysis

There are two parts to the Department's analysis. One part pertains to the 2017 capital structure where the Department has proposed modifications to GMG's petition. The other part concerns the 2018 capital structure where the Department has recommended that GMG increase its equity ratio as well as the floor of the equity range.

The Department's main concern is general and prospective in that it highlights the risks associated with maintaining a low equity ratio for a sustained period of time. The Department reasons that GMG is subject to high risk in case of higher interest rates in combination with a negative shock such as another warm winter.

To mitigate the risk, the Department recommends that the Commission impose two requirements on GMG to increase the equity ratio in the 2018 capital structure filing: (1) a proposal to increase the equity ratio to 35.00 percent by December 31, 2018 (assuming normal weather) or an explanation why such an increase is not possible and (2) a proposal to increase the floor of the equity range from 31.59 percent in this filing to 33.00 percent beginning October 31, 2018.

The Department analyzed GMG's petition and determined that it satisfies the filing requirements of Minnesota Rules 7825.1000–7825.1500[2]; and the Commission's orders in E,G999/CI-08-1416[3] and G022/S-15-956[4] (GMG's 2016 Capital Structure Docket).

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[2] General filing requirements.
[3] Information regarding general projection of capital needs, projected expenditures, report of actual issuances and uses of the funds, and so forth.
[4] In docket 15-956, the Commission approved a total capitalization of up to $40.0 million (GMG's expected 2016 year-end capitalization of $36.3 million, and a contingency of $3.6 million above that) and an equity ratio contingency range of 31.00 percent to 38.61 percent. The Commission required GMG, among other things, that if its equity ratio was less than 31.59 percent on April 1, 2016 or thereafter, to inject equity or make other changes such that its equity ratio was at least 31.59 percent and required that GMG maintain an equity ratio of at least 31.00 percent at all times.

The Department is concerned by the persistent low equity ratio in GMG's capital structure. The Department notes that GMG is intent on maintaining its current equity ratio, the Department's recommendations seek to raise it in the future.

The Department observes that GMG's current and proposed equity ratios are significantly lower than the average equity ratio (48.2 percent) of publicly traded gas utilities with bond ratings from BBB- to A-.[5] GMG's equity ratio was also ten percentage points lower than the lowest equity ratio of that group (41.4 percent).

The Department's comments include an analysis of GMG's financial performance (see Table 3, p. 7, the Department's comments). From an analysis of GMG's income statements, the Department concluded:

- GMG's financial performance during the calendar year 2015 and during the 12 months ended fiscal year September 30, 2016 was noticeably worse than in 2013 and 2014;
- GMG's operating expenses as a percentage of gross margin rose significantly and its net operating income as a percentage of margin fell significantly, which resulted in much lower overall rates of return; and
- GMG's interest coverage ratio (net utility operating income divided by interest expense) fell from 3.2 (2013) and 2.1 (2014) to 1.5 (2015) and 1.7 (2016).

The Department noted it remains concerned, as in past capital structure dockets, about GMG's financial health, and the deterioration in GMG's financial performance during 2015 further underscores the Department's concerns. The Department added that GMG's results for the first nine months of 2016 were similar to 2015.

The Department noted that GMG's proposed capital structure, reflecting an increase in total capitalization of $4.3 million[6] (comprised of $1.9 million in equity and $2.4 million in total debt), is driven by GMG's continuing, aggressive system expansion efforts.

Although GMG believes that its current actions (increasing customer base, decreasing capital expenditures, and increasing debt principal payments) will result in an improved equity ratio over time, the Department feels that "none necessarily will." The Department added that "they will not contribute to an improved equity ratio over time if GMG continues to issue as much debt as possible while maintaining the Commission's minimum-approved equity ratio, as the Company [has] done for the last few years, and appears to want to do for the foreseeable future."

[5] In Standard and Poor's bond rating, BBB- denotes lower medium grade bordering noninvestment grade, and A- points to the lower end of upper medium grade.
[6] See GMG's Initial Filing, Attachment 3.

The Department noted that the decline in GMG's financial performance during 2015 and 2016, and the resulting need to inject equity to maintain the Commission's minimum-approved equity ratio, highlights the risk inherent in continually maintaining such a low equity ratio.

On the downside, the Department particularly indicated GMG's "high leverage leaves it with little capacity to endure a negative shock, such as another warm winter, an increase in interest rates, or any other type of unexpected expense." Further, "[a]s the Department has pointed out in past capital structure Dockets, much of GMG's improved financial performance in 2013 and 2014 was attributable to lower interest rates resulting in lower average debt costs. If interest rates rise, much of that improvement will vanish."

The Department noted that while the Department is not opposed to GMG's expansion plans which are driving its low equity ratio, the Department is concerned about the risks associated with maintaining such a low equity ratio indefinitely without any concrete plans to increase it.

Department's Recommendations

In light of GMG's financial performance in 2015 and 2016, the Department "still wants GMG to be able to pursue system expansion," but subject to "slightly stricter limits on that growth." The Department's recommendations are intended to nudge GMG to begin taking steps now to achieve a higher equity ratio by the end of 2018.

The Department notes that GMG's financial performance in 2015 and 2016 has resulted in the need for equity injections in order to keep the Company's equity ratio within the approved contingency range.

Equity Ratio and Equity Range

The Department recommends approval of an equity ratio of 32.94 percent and an equity ratio range 31.59 percent to 38.61 percent, as proposed by GMG.

The Department recommends that the Commission require GMG to maintain this equity ratio range without any deviation.

The Department notes that the Commission often allows utilities to violate approved ranges for a period of 60 days without Commission notification. In this case, the Department does not recommend waiver of these values for 60 days without Commission approval.

The Department stressed that in recent years the Commission has not granted that extra flexibility to GMG with respect to its equity ratio, and required GMG to maintain an equity ratio at or above its approved floor at all times. Given GMG's current, low equity ratio and the risks inherent in the Company's expansion strategy, the Department recommends that the Commission impose this same restriction again in this Docket.

The Department also recommends continuation of the current requirement of GMG filing monthly compliance reports demonstrating that GMG's equity ratio remains at or above the approved floor.

Short Term Debt Ratio

The Department notes that GMG's requested short-term debt contingency cap of ten percent of its total capitalization to be reasonable. However, the Department emphasizes that GMG's equity ratio must remain at or above 31.59 percent at all times. The Department also adds that Given GMG's current equity ratio of 31.90 percent,[7] the Department feels that the Company currently has little flexibility to issue short-term debt.

The Department recommends that the Commission allow GMG to violate the proposed short term debt contingency cap of ten percent for up to 60 days, but not the proposed equity ratio floor.

Long Term Debt Ratio

GMG did not request a specific contingency range for its long-term debt ratio. GMG did, however, request the flexibility to issue long-term debt provided that it remains within its equity and short-term debt contingency ranges and does not exceed them for more than 60 days.

The Department noted that if GMG were to reduce its short-term debt ratio to zero, the maximum long-term debt ratio that would keep the Company within the proposed equity range would be 68.41 percent (equal to 100 percent minus the equity ratio floor of 31.59 percent).

The Department recommended that the Commission clarify that the Company is permitted to issue long-term debt provided that it remains within its equity contingency range at all times, and remains within its short-term debt contingency range and does not exceed it for more than 60 days.

Total Capitalization

The Department recommends a far higher contingency provision than requested by GMG.

[7] GMG's Feb. 14, 2017 Compliance Filing in Docket No. G022/S-15-956.

GMG is requesting a total capitalization of $39,609,020 with a contingency of $1,390,890 (3.51%) for a total capitalization of approximately $41 million for 2017. The Department notes that the roughly $1.4 million contingency is far below the 10 percent capitalization contingency approved by the Commission in GMG's four most recent capital structure Dockets.

The Department has concluded that a 10 percent contingency is appropriate to protect the Company from unforeseen capital needs and recommends a total capitalization of $39.6 million with a 10 percent contingency ($4.0 million) for a total of $43.6 million.

GMG's 2018 Capital Structure Filing

The Department recommends that the Commission require GMG to file its 2018 petition by January 1, 2018. That petition should include a plan to result in a 35.00 percent equity ratio by December 31, 2018, assuming normal weather, or an explanation why such an increase is not possible. It should also include a step-increase in GMG's equity ratio floor from 31.59 percent to 33.0 percent beginning October 31, 2018, or an explanation why such an increase is not possible.

The Department notes that imposing these requirements now on GMG's next capital structure petition will allow the Company to plan appropriately over the next year to meet the modest, 1.41 percentage point increase in the minimum allowed equity ratio, as well as the slightly more aggressive, though still small, 3.10 percentage point increase in its expected equity ratio.

The Department acknowledges that events may transpire between now and the time of GMG's next capital structure filing may make the increases impossible, and that the Department's recommendations are intended to set expectations with respect to GMG's next filing, but still allow for some flexibility.

Summary of the Department's Recommendations

The recommendations as summarized by the Department:

1. approve GMG's proposed 2017 capital structure[8];
2. approve an equity ratio contingency range of 31.59 percent to 38.61 percent;
3. require that GMG maintain an equity ratio contingency range of at least 31.59 percent at all times;
4. require GMG make monthly compliance filings on or before the 15th of each month containing a balance sheet, income statement, and cash flow statement for the first of the prior two months, demonstrating that its equity ratio is at least 31.59 percent;
5. approve a short-term debt contingency cap of 10 percent (i.e., GMG's short-term debt is not to exceed 10 percent of its total capitalization, including the contingency, for more than 60 days);
6. approve a total capitalization contingency of $4.0 million above the estimated 2017 year-end total capitalization of $39.6 million, for a total capitalization of $43.6 million;
7. require GMG to file a new securities issuance and capital structure petition by January 1, 2018;
8. require GMG to propose in its next capital structure petition a plan that would be expected to result in a 35.00 percent equity ratio by December 31, 2018, assuming normal weather, or explain why such an increase is not possible; and
9. require GMG to propose in its next capital structure petition a step-increase in its equity ratio floor from 31.59 percent to 33.0 percent beginning October 31, 2018, or explain why such an increase is not possible.

Staff Note: The following recommendation is at p. 12 of the Department's comments but somehow omitted from the Department's summary above:

10. permit the company to issue long-term debt provided that it remains within its equity contingency range at all times, and remains within its short-term debt contingency range and does not exceed it for more than 60 days.

GMG's Reply Comments

On February 27, GMG filed reply comments. GMG objects to the Department's characterization of its financial performance and the recommendation that it increase its equity ratio floor by the year-end 2018.

GMG proposes that, rather than instituting an increased equity floor ratio without sufficient information now to do so, the Commission should only consider GMG's 2017 capital structure

[8] Staff Note: This provision refers to 32.94% equity, 3.61% short terms debt, and 63.45% long terms debt.

petition and on its own merits with respect to known factors and the current year. However, GMG agrees to submit its 2018 capital structure petition in December of 2017 with an eye toward meeting a 35 percent equity ratio as it engages in its 2018 planning.[9] At that time, GMG suggests, the Department, the Commission and GMG can assess the 2018 capital structure proposal based on actual knowledge of how the variables developed and their impact on GMG's ability to achieve its planned equity ratio.

GMG notes that the Department's concerns reflect theoretical arguments rather than doubts about GMG's business model. GMG argues that its financial performance should not be examined in a vacuum without examining all aspects of it. GMG maintains that the characterization of GMG's financial performance as deteriorating does not tell the whole story or even appropriately illustrate the benefits that GMG's growth has provided to its ratepayers and the citizens of rural Minnesota.

GMG contends that the winter of 2015-16 was very warm which adversely affected the Company but that GMG's growth over the last several years has allowed it to absorb the financial consequences of record warm weather while making system improvements to enhance customer service.

Although GMG is not opposed to plan for a 2018 year-end equity ratio of 35 percent, it pointed to many exogenous variables beyond its control: continued warm winters, changes in the property tax and income tax landscape, and other variables can significantly impact GMG's annual margins. GMG adds that none of that information is available at this time, nor is it part of the record or germane to the matter of GMG's 2017 capital structure in this docket.

As to the Department's proposal to increase the minimum equity ratio floor, GMG responded that it "does not believe that it has the legal right to obligate its shareholders to infuse equity into the Company to meet an arbitrarily set future equity ratio floor if those variables result in a situation where GMG falls short of the equity floor requirements." Further, GMG holds that imposing an October 31, 2018 increase in the equity ratio floor at this time, as proposed by the Department, is not appropriate. GMG notes that the late October timing for increasing the equity ratio floor, regardless of the year, does not make financial sense as GMG is at its maximum debt level at the end of the construction season and will never have had sufficient opportunity to generate revenue from the year's construction by October 31st of any given year.

In sum, GMG accepts the Department's proposal that it propose an equity ratio target of 35% by December 31, 2018 or explain why that is not possible, but asks the Commission to reject the

[9] GMG notes (p. 3 of Reply Comments): "GMG agrees that, in its 2018 capital structure petition, it will propose a plan that would result in an equity ratio of 35% by December 31, 2018, assuming normal weather, or will explain why that cannot be done."

Department's proposal to increase the floor of the equity range. GMG asks that the Commission consider GMG's future equity ratios in each year's respective docket based on the most complete information then available.

Staff Comment

The Commission has closely examined GMG's securities issuance in the annual capital structure petitions over the past several years because of GMG's small size, GMG's, and its affiliate GMT's, aggressive expansion plans, and GMG's low equity ratio.

GMG notes that the Department's concern about GMG's risk profile is largely academic as it has absorbed the consequences of the recent (2015-2016) warm winter and also generated earnings. Nevertheless there are on-going risks with a highly leveraged capital structure in that payments on debt are required on a periodic basis regardless of fluctuations in revenue.

GMG's petition (p. 6) notes that "[t]he interest rate on notes issued to commercial banks and any other institutional lenders will be determined and negotiated with the lending bank or institution as the respective loans are made and will be dependent on market condition at the time of issuance." Further, "[t]he interest on notes issued through private persons will be dependent on the term of the note and market conditions at the time of issuance, and will be at rates prevailing at the time of issuance for commercial paper of comparable quality."

While, by historical standards, interest rates are still very low, there is widespread speculation that they are bound to rise in the future. The Federal Reserve's target short term interest rate is presently in the range of 0.75-1.00 percent and the market-determined effective federal funds rate is 0.91 percent (this rate changes daily). The Federal Reserve increased its target for the short term interest rate from the range of 0.50-0.75 percent to a range of 0.75-1.00 percent on March 16, 2017. The effective market-determined federal funds rate increased from 0.66 percent (on March 2, 2017) to 0.91 percent (April 5, 2017), an increase of 25 basis points.

The Department's main concern is prospective in that the Department reasons GMG may not be able to meet its debt payments in case of higher interest rates in combination with a negative shock such as another warm winter. Staff views this as a serious concern simply because, in that event, if GMG cannot raise its equity level, GMG's interest payment obligations may require a rate increase.

GMG's actual equity position has remained near the 31.59% equity floor GMG proposed in its 2015 capital structure filing (dkt 15-956). In that filing, GMG's actual equity ratio on August 31, 2015 was reported to be 31.13% and the projected equity ratio for December 31, 2016 was 32.24%. In this petition, the actual equity ratio, as of September 30, 2016, was 31.59 percent and the projected equity ratio, as of December 31, 2017, is shown to be 32.94 percent. GMG's actual equity ratio has not risen substantially above 31% in the recent past and the Department's recommendation to raise it to 33.0 percent beginning October 31, 2018 does not appear unreasonable especially in light of the grace it allows in terms of an explanation why the goal is infeasible.

Decision Alternatives

Staff Note:

Minn. Stat. 216B.49 subd. 3 states:

It is unlawful for any public utility organized under the laws of this state to offer or sell any security or, if organized under the laws of any other state or foreign country, to subject property in this state to an encumbrance for the purpose of securing the payment of any indebtedness unless the security issuance of the public utility is first approved by the commission, either as an individual issuance or as one of multiple possible issuances approved in the course of a periodic proceeding reviewing the utility's proposed sources and uses of capital funds.

Consistent with this requirement, if the Commission thinks it is appropriate, it may wish to explicitly approve the securities issuances by adopting the following language:

Allow GMG to issue securities in 2017 subject to the conditions adopted by the Commission.

1. Approve the Company's petition including the specific requests in items 1-6 at page 2 of this briefing paper and allow GMG to issue securities in 2017.

2. Adopt all of the Department's modifications and approve items 1 through 10 at page 8 of this briefing paper and allow GMG to issue securities in 2017 subject to the conditions adopted by the Commission.

3. Adopt the Department's modifications, with the exception of item 9 (equity floor), and approve items 1-8 and 10 at page 8 of this briefing paper and allow GMG to issue securities in 2017 subject to the conditions adopted by the Commission.