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October 11, 2016

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VIA MAIL AND ELECTRONIC FILING

The Honorable Jeanne M. Cochran
Administrative Law Judge
Office of Administrative Hearings
PO Box 64620
St. Paul, MN 55164-0620

Re: Minnesota Energy Resources Corporation's Initial Post-Hearing Brief

In the Matter of a Petition by Minnesota Energy Resources Corporation for Evaluation and Approval of Rider Recovery for Its Rochester Natural Gas Extension Project
MPUC Docket Nos. G011/M-15-895
OAH Docket No. 68-2500-33191

Dear Judge Cochran:

Enclosed please find the Initial Post-Hearing Brief of Minnesota Energy Resources Corporation in the above-referenced matter.

These documents have been filed via the e-docket system and served as specified by the enclosed service list. Please contact me at mkrikava@briggs.com or (612) 977-8566 if you have any questions regarding this filing.

Very truly yours,

/s/ Michael C. Krikava
Michael C. Krikava

Enclosures
Cc: Service List

STATE OF MINNESOTA
BEFORE THE OFFICE OF ADMINISTRATIVE HEARINGS
FOR THE MINNESOTA PUBLIC UTILITIES COMMISSION

In the Matter of a Petition by Minnesota Energy Resources Corporation for Evaluation and Approval of Rider Recovery for its Rochester Natural Gas Extension Project	MPUC Docket No. G011/GR-15-895 MPUC Docket No. G011/GR-16-315 OAH Docket No. 68-2500-33191

MINNESOTA ENERGY RESOURCES CORPORATION'S INITIAL BRIEF

October 11, 2016

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I. INTRODUCTION

Minnesota Energy Resources Corporation ("MERC" or the "Company") respectfully submits this Initial Brief ("Brief") in support of its October 26, 2015, Petition for Evaluation and Approval of Rider Recovery for MERC's Rochester Natural Gas Extension Project[1] (the "Rochester Project" or the "Project"). MERC filed the Petition pursuant to the Natural Gas Extension Project ("NGEP") statute, Minn. Stat. § 216B.1638, which allows a public utility to recover a portion of the costs to construct new or upgraded gas infrastructure to serve unserved or inadequately served areas.

The Rochester Project is a major initiative for MERC, consisting of major upgrades to its distribution infrastructure and a long-term capacity contract with Northern Natural Gas ("NNG") – together committing about $100 million of investment on behalf of MERC's customers. Because of the magnitude of this investment, regulatory review and approval of the Project is necessary and appropriate.[2]

In this proceeding, MERC is requesting evaluation and approval that the Rochester Project, as proposed, is prudent.[3] As discussed in greater detail in this Brief, the record

[1] Ex. 1 (MERC Initial Filing – Rochester Project Rider Petition).

[2] Ex. 5 at 8-9 (Lee Direct) ("Because of the magnitude of this investment, MERC believes it is important to seek and obtain regulatory confirmation that the Project is justified and reasonable."); Evidentiary Hearing Transcript, Vol. 1 at 34 (Lee) ("Certainly we want regulatory certainty before we invest these capital dollars, that's correct.").

[3] Specifically, MERC seeks:

1. Approval of MERC's proposed approximately $44 million Rochester Project to upgrade its natural gas distribution system to ensure reliable service to existing and future customers in the Rochester area;
2. Acceptance of the associated approximately $56 million (Net Present Value or "NPV") Precedent Agreement ("PA") with NNG to bring needed interstate pipeline capacity to the Rochester area; and
3. Approval of MERC's proposed recovery of the approximately $44 million of costs for its distribution system upgrades for the Project and for recovery of the $56 million (NPV) NNG contract costs as follows:
    a. Recovery of up to 33 percent of MERC's distribution system upgrade costs ($44 million) through an NGEP Rider from all MERC customers, including transportation customers, with the remainder of those costs recovered through base rates; and

developed in this proceeding supports a finding that MERC has demonstrated the Rochester Project is a reasonable and prudent way to meet the demonstrated need, and that the alternative phased proposals advocated by the Minnesota Office of the Attorney General – Residential Utilities and Antitrust Division ("OAG") are not more reasonable or prudent than the alternative proposed.

- MERC's proposed system upgrades and proposed NNG capacity contract are the best and least-cost available alternatives to meet the demonstrated need in the Rochester area.
- MERC's evaluation process of alternatives to the Project was a thorough process and established a competitive environment to ensure it was able to obtain the best possible cost and other terms for the benefit of its ratepayers.
- The result of the evaluation process was an overall Project that included MERC distribution system upgrades and NNG capacity upgrades that cost effectively address the needed improvements in the Rochester area.

A. Overview of the Rochester Project

The greater Rochester area has experienced population growth and commercial and industrial expansion in recent years, in part due to the growth of services supporting the expansion of healthcare facilities in and around the city as well as growth in other industries in the region.[4] As the City of Rochester noted, "[f]or the last several decades, the City of Rochester has been one of the fastest growing cities in the State of Minnesota. According to projections from the Olmsted County Planning Department and others that trend is projected to continue."[5]

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b. Recovery of the costs incurred under the PA ($56 million NPV) for additional capacity through the commodity portion of the NNG-Purchased Gas Adjustment ("PGA") from all of MERC's firm and interruptible system sales customers.

[4] Ex. 1 at 1 (Initial Filing – Rochester Project Rider Petition).

[5] Public Comment, Ardell F. Brede, Mayor of the City of Rochester, Randy Staver, Council President (July 26, 2016).

Additionally, in 2013, the Mayo Clinic announced its $6 billion plan to become a destination medical center ("DMC") for the country and the world.[6] The plan includes construction of new hospital space and the expectation that current staffing will substantially increase over the next twenty years. Projections of the number of new jobs associated with Mayo's DMC plan range from 35,000 to 45,000 over twenty years.[7] The Minnesota Legislature subsequently adopted legislation creating the Destination Medical Center Corporation ("DMCC") to develop its own Destination Medical Center plan ("DMC Plan") for the development and construction of public and private facilities and infrastructure in the City of Rochester that support the Mayo Clinic as a DMC.[8] The legislation earmarks approximately $585 million in state and local funds to pay for the facilities and infrastructure identified in the DMC Plan adopted by the DMCC.

The combined efforts of the Mayo Clinic, the City of Rochester, and the legislature underscore the need for MERC to have adequate utility infrastructure in place to support the anticipated increased demand for natural gas from the growing number of Rochester area residents and businesses. If the DMC's efforts are successful, it will further fuel demand growth in the coming years. Recent reports indicate that the DMC initiative is on track to hit $200 million in private investment by the end of 2016, triggering the release of $585 million in public funding to support infrastructure improvements for the DMC.[9] As the DMCC stated,

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[6] Ex. 1 at 19 (Initial Filing – Rochester Project Rider Petition).

[7] Ex. 1 at 19-20 (Initial Filing – Rochester Project Rider Petition).

[8] Ex. 1 at 20 (Initial Filing – Rochester Project Rider Petition); Ex. 5 at14-15 (Lee Direct) ("As stated on the DMC website: State officials determined there was compelling interest to authorize public investments in Rochester to help support Mayo Clinic in Rochester as a global medical destination center. These leaders worked together to develop DMC and create in statute the financing tools and public governance structure necessary to carry out the global destination vision.").

[9] Ex. 11 at 3-4 (Clabots Surrebuttal) (citing Matt McKinney, *Redoing Rochester: Where Has Investment for the DMC Gone So Far?*, STAR TRIBUNE (Aug. 11, 2016) (http://www.startribune.com/redoing-rochester-where-has-destination-medical-center-money-gone-sofar/389537791/)).

"[s]uccessful expansion of Minnesota Energy Resources' system in and around Rochester will be beneficial to the community and will support efforts to capitalize on economic development associated with the DMC initiative."[10]

The expansion efforts of the Mayo Clinic and the City of Rochester have raised the importance of ensuring adequate natural gas service in the Rochester area. Though the City of Rochester indicated its most recent energy plan includes a goal to supply 25 percent of energy from renewable resources by 2025, "that will not negate the need for additional natural gas resources either for the City of Rochester or this growing area of southeastern Minnesota."[11] Similarly, the Mayo Clinic noted "[a]s the Mayo Clinic campuses grow the energy needs will grow as well. The natural gas distribution system needs to be reliable 100 percent of the time and have the capacity to serve its customers for many years to come."[12]

Additional natural gas capacity will also be needed in the Rochester area to meet electric generation needs. As noted by Rochester Public Utilities ("RPU"), "[t]he Rochester area has seen robust growth and is forecast to continue growing in the coming years. RPU anticipates the need for additional electric generating capacity and steam to meet its increasing electric demand. . . . [U]se of natural gas for electric generation and production of steam remains an important part of RPU's portfolio and will remain so for the foreseeable future."[13]

[10] Public Comment, Lisa Clarke, Executive Director of the DMC (July 28, 2016).

[11] Public Comment, Ardell F. Brede, Mayor of the City of Rochester, Randy Staver, Council President (July 26, 2016). The Mayor of Rochester issued a non-binding declaration stating the City's renewable energy goal; nevertheless, natural gas remains a crucial aspect of the City's planning and development and the City wholeheartedly supports the Project. The record supports a finding that MERC's Rochester area customers will continue to need natural gas service in 2031.

[12] Public Comment, Brett Gorden, Mayo Clinic's Section Head of Facilities Operations, Douglas Holtan, Mayo Clinic's Chair of the Department of Facilities and Support Services (July 28, 2016).

[13] Public Comment, Walter D. Schlink, Chief Energy Supply Officer, Direct of Power Resources, Rochester Public Utilities (July 27, 2016).

As a result of historic growth in Rochester, MERC is currently unable to meet its design day requirements for existing firm customers in the Rochester area absent improvements to its natural gas distribution system and the acquisition of additional interstate natural gas capacity and anticipated future growth will only exacerbate the current problem.[14] All parties agree that MERC is currently operating with a negative reserve margin in the Rochester area and that upgrades to the transmission system are required to alleviate this situation.[15] In addition, MERC's Rochester distribution system has existing operational deficiencies that must be addressed to efficiently distribute natural gas across the Rochester area footprint.

The Rochester Project was designed to address both the shortfall of capacity and the Rochester system's operational deficiencies simultaneously. The Rochester Project modifies MERC's distribution system in two phases.[16] Phase II, which is the subject of this proceeding, involves upgrading MERC's town border station ("TBS") system for Rochester. This system receives natural gas from NNG's high-pressure interstate pipeline system and then transmits the gas at a reduced pressure for delivery to MERC's low-pressure distribution system in the Rochester area. Phase II involves the construction of a 13- or 14-mile long high-pressure pipeline that interconnects a rebuilt TBS with a new TBS and new high-pressure district regulator station ("DRS"), which will tie together the northern and southern portions of MERC's existing TBS system in Rochester. Without these upgrades MERC's distribution system will remain fractured, MERC will not be able to move gas to the areas experiencing growth, and

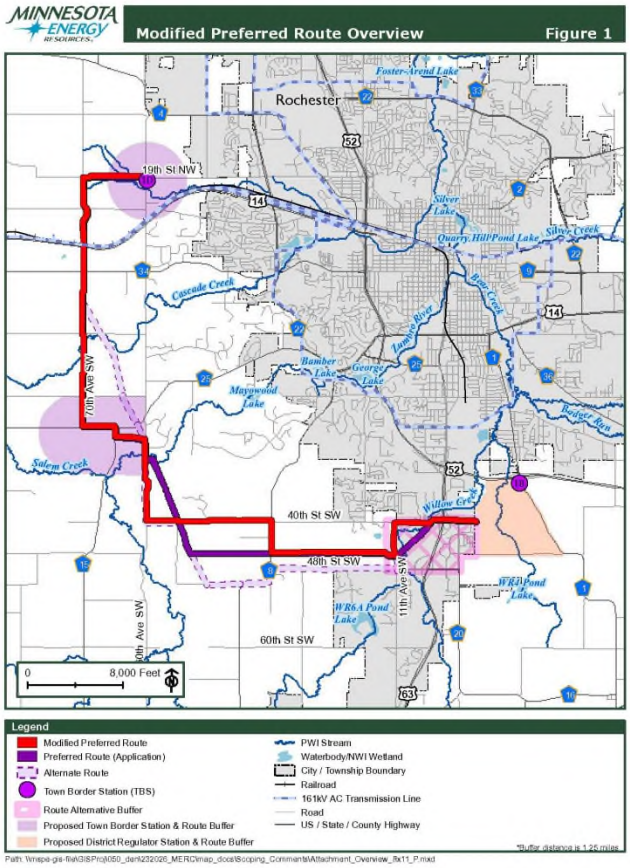
[14] Ex. 1 at 19 (Initial Filing – Rochester Project Rider Petition).

[15] It is undisputed on the record that on January 6, 2014, during the extreme weather "polar vortex", MERC utilized all of its contracted firm capacity establishing a new peak day and highlighting the capacity deficit. Ex. 1 at 28 (Initial Filing – Rochester Project Rider Petition).

[16] Phase I involved modernizing, standardizing, and interconnecting MERC's district regulator stations ("DRS") and piping in Rochester to more efficiently and effectively balance the flow of natural gas on this low-pressure distribution system. Phase I is complete and the $5.6 million cost of that phase is being addressed in MERC's pending rate case (Docket No. G011/GR-15-736). Ex. 1 at 1-2 (Initial Filing – Rochester Project Rider Petition).

MERC will not have the redundancy required to serve this region reliably.[17] These distribution system upgrades will also allow MERC to efficiently manage the increased supply of natural gas being delivered to its distribution system to meet customer demand.[18]

MERC's new pipeline is the subject of a separate route permit proceeding before the Commission in Docket No. G011/GP-15-858. The following Figure illustrates MERC's current modified preferred route near southwestern Rochester.[19]



[17] Ex. 5 at 11-12 (Lee Direct).

[18] Ex. 1 at 1-2 (Initial Filing – Rochester Project Rider Petition).

[19] Ex. 7 at 6:4 (Lyle Direct).

To address the capacity shortfall, MERC must obtain additional firm interstate pipeline capacity in the Rochester area. NNG is, today, the sole provider of interstate natural gas pipeline capacity to the Rochester area. Its system is fully subscribed and no incremental capacity is available for purchase. Therefore, to acquire additional capacity in the region, new interstate pipeline construction is required, whether by NNG or another transmission service provider.

Before contracting for the implementation of additional capacity, MERC undertook a request for proposal ("RFP") bid process to assess potential alternative supply options. MERC's goal for the RFP was to create a competitive environment to push NNG to make the most cost-effective proposal possible. Based on that RFP process, MERC selected NNG as the winning bidder and in October 2015, MERC entered into a long-term agreement with NNG to acquire additional firm capacity for the Rochester area and twenty-one other TBSs located in southeastern Minnesota. The contract provides a long-term solution to the capacity needs of the Rochester area and surrounding communities at a significant value for ratepayers.[20]

B. Notice of Hearing Issues

The Commission has requested the Office of Administrative Hearings ("OAH") to include three specific issues in the scope of the contested case:

1. Are the Rochester Project investments prudent, reasonable, and necessary to provide service to MERC's Rochester service area, taking into account the City of Rochester's announced goal of using 100% renewable energy by 2031?

2. Is it reasonable to recover the Rochester Project costs from all of MERC's ratepayers?

    a. If so, on what basis?
    b. If not, what other allocation method would be more reasonable?

[20] Ex. 12 at 11-12 (Mead Direct).

3. What other funds may be available to cover the project costs?[21]

With respect to the first issue identified, the record demonstrates the need for and appropriateness of the Project as proposed and the Rochester Project investments are reasonable, prudent, and necessary to provide service to MERC's customers. There is already a capacity shortage in the Rochester area that must be addressed. The Rochester Project, as proposed, addresses that shortage and positions MERC to provide reliable service in the Rochester area for the long term. No superior alternatives were proposed or evaluated by any party and the record does not show that a more reasonable and prudent alternative exists to meet the identified need.[22] Although the City of Rochester is striving to maximize renewable resources, natural gas is integral to its energy plan and the City and supports the Project as proposed.[23]

With respect to the issue of cost recovery, the record supports partial rider recovery of MERC's Rochester Project distribution upgrade costs from all customers, on a volumetric basis across all customer classes, with the remainder of these Project costs recovered in base rates. MERC submits that both the record and prior Commission policy support equal allocation across all customers, and prefers that the Commission not impose the type of 50/50 split described by the Department of Commerce, Division of Energy Resources (the "Department"). The record also supports MERC's proposal to recover the costs of the NNG upgrades through the commodity portion of the NNG PGA to firm and interruptible system sales customers on the NNG PGA.

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[21] *In the Matter of a Petition by Minn. Energy Res. Corp. for Evaluation and Approval of Rider Recovery for Its Rochester Nat. Gas Extension Project*, Docket No. G011/M-15-895, NOTICE OF AND ORDER FOR HEARING at 5 (Feb. 8, 2016).

[22] *See* Minn. R. 7851.0120, subp. 8 and Minn. R. 7849.0110 (in a certificate of need for electric and gas infrastructure, the Commission is only to consider alternatives that have been fully demonstrated on the record as meeting all of the criteria for a certificate of need). It is not sufficient to just criticize the Petitioner's alternatives.

[23] *See* Public Comment, Ardell F. Brede, Mayor of the City of Rochester, Randy Staver, Council President (July 26, 2016); Public Comment, Walter D. Schlink, Chief Energy Supply Officer, Direct of Power Resources, Rochester Public Utilities (July 27, 2016).

With respect to the issue of external funds, the record establishes that external funds are not available to cover Project costs. DMC funding is not available because the Project is not located within any of the DMC development zones and is unfortunately not eligible to receive DMC funding under the enabling statute and the DMC Plan.[24]

As discussed below, MERC's Rochester Project is integral to maintain reliable natural gas service for MERC's firm customers and to support the continued growth of southeastern Minnesota. Therefore, MERC respectfully requests that the Commission approve the Project and rider recovery under the NGEP Statute. The Company provides additional discussion of these issues to support approval of the Project and cost recovery as requested.

II. APPLICABLE LAW

MERC filed its Petition pursuant to the NGEP Statute, Minn. Stat. § 216B.1638, requesting a determination that the Project and costs as proposed are prudent and eligible for recovery under the NGEP rider. The NGEP Statute provides that "a public utility may petition the commission outside of a general rate case for a rider that shall include all of the utility's customers, including transport customers, to recover the revenue deficiency from a natural gas extension project."[25] An NGEP is defined under the statute as "the construction of new infrastructure or upgrades to existing natural gas facilities necessary to serve currently unserved or inadequately served areas."[26] "'Unserved or inadequately served area' means an area in this state lacking adequate natural gas pipeline infrastructure to meet the demand of existing or potential end-use customers."[27]

[24] Ex. 6 at 32-33 and ASL-R3 (Lee Rebuttal).

[25] Minn. Stat. § 216B.1638, subd. 2(a).

[26] Minn. Stat. § 216B.1638, subd. 1(e).

[27] Minn. Stat. § 216B.1638, subd. 1(i).

The NGEP Statute further provides the Commission "shall approve a public utility's petition for a rider to recover the costs of a natural gas extension project if it determines that (1) the project is designed to extend natural gas service to an unserved or inadequately served area; and (2) project costs are reasonable and prudently incurred."[28] Under the NGEP Statute, the Commission can approve a rider that allows a utility to recover up to 33 percent of the costs of a natural gas extension project.[29]

While MERC is not required to obtain a certificate of need for the Rochester Project, that process can still provide useful guidance on what analysis is commonly utilized to evaluate the prudence of a proposed capital project.[30] For example, with respect to the burden of proof in a certificate of need proceeding, it is well established that an applicant seeking a certificate of need bears the burden of demonstrating need for the project by a preponderance of the evidence and showing that the proposed project is a reasonable and prudent way to satisfy the articulated needs.[31] The petitioning party is not required to prove an absence of alternatives.[32] Rather, the burden falls on parties other than the applicant to come forward with actual alternatives and prove that any proposed alternative is more reasonable and prudent than the applicant's proposal.[33] If a more reasonable and prudent alternative is proposed, then the petitioning party

[28] Minn. Stat. § 216B.1638, subd. 3.

[29] Minn. Stat. § 216B.1638, subd. 3(c).

[30] Evidentiary Hearing Transcript, Vol. 1 at 170:12-21 (Urban) (acknowledging that the certificate of need procedures are analogous to the current proceeding and provide "useful guidance" on how to implement the NGEP Statute).

[31] Minn. R. 7851.0120.

[32] Pursuant to Minn. R. 7851.0110, "[t]he commission shall consider only those alternatives proposed before the close of the public hearing and for which there exists substantial evidence on the record with respect to each of the criteria listed in part 7851.0120."[32]

[33] Minn. R. 7851.0120, subp. B; *see also In the Matter of the Application of ITC Midwest LLC for a Certificate of Need for the Minnesota-Iowa 345 kV Transmission Line Project in Jackson, Martin and Faribault Ctys*, Docket No. ET-6675/CN-12-1053, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND RECOMMENDATIONS at 52-53 (Sept. 8, 2014) (explaining that Rule 7849.0120 "requires opponents of the proposed Project to come forward and establish the existence and characteristics of a more reasonable and prudent alternative. . . . If a party wants a particular

fails to meet its burden of proof.[34] "This regulatory scheme is simply a practical way to prevent the issuance of a certificate of need when there is a more reasonable and prudent alternative to the proposed facility without requiring the applicant to face the extraordinary difficulty of proving that there is not a more reasonable and prudent alternative."[35]

The Commission's evaluation and determination in this proceeding should also be guided by Minn. Stat. §§ 216B.01, 216B.03, and 216B.04, which require every public utility to provide "safe, adequate, efficient, and reasonable service,"[36] at just and reasonable rates. Under Minn. Stat. § 216B.04, a public utility must provide service within 90 days of a request for service. The Commission recognizes that in order for a natural gas distribution utility to do this, "they must be able to deliver gas to their customers when needed, especially on the coldest day of the year."[37]

III. THE RECORD ESTABLISHES NEED FOR THE PROJECT.

The record reflects a range of possible demand growth scenarios, each of which supports a conclusion that the Rochester Project, as proposed, is reasonable and necessary. In particular, MERC submitted a forecast based on statistically significant inputs and assumptions projecting

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alternative to be considered, that party must make sure that sufficient evidence is submitted to satisfy the Commission's requirement that 'only those alternatives proposed before the close of the public hearing and for which there exists substantial evidence on the record' be considered.").

[34] *See, e.g., In re Application of the City of Hutchinson for a Certificate of Need to Construct a Large Nat. Gas Pipeline*, No. A03-99, 2003 WL 22234703, at *7 (Minn. App. Sept. 23, 2003) ("Northern argues that because Minn. R. 7851.0210, subp. B, places the burden of proving the existence of a more reasonable and prudent alternative on a party other than the applicant, the rule conflicts with Minn. Stat. § 216B.243, which places the burden of proving the need for the proposed facility on the applicant. Northern contends that the statute places the burden of proof on the applicant, and a rule cannot change the burden. We do not agree that Minn. R. 7851.0120, subp. B, changes an applicant's burden of proof. Under the certificate-of-need process established by statute and rule, an applicant bears the burden of proving the need for a proposed facility. An applicant fails to meet this burden when another party demonstrates that there is a more reasonable and prudent alternative to the facility proposed by the applicant. Minn. Stat. § 216B.243, subd. 3; Minn. R. 7851.0120, subp. 8.").

[35] *In re Application of the City of Hutchinson for a Certificate of Need to Construct a Large Nat. Gas Pipeline*, No. A03-99, 2003 WL 22234703, at *7 (Minn. App. Sept. 23, 2003).

[36] Minn. Stat. § 216B.01.

[37] *In re Request by N. Minn. Utils. and Peoples Nat. Gas for Approval of a Change in Demand Related Costs on the N. Pipeline Sys.*, Docket No. G007/M-01-1631, G011/M-01-1633, ORDER APPROVING COMPANIES' REQUESTS AND REQUIRING ADDITIONAL FILINGS (July 17, 2002).

1.5 percent annual growth in peak demand in the Rochester area.[38] The Department provided an alternative need analysis based on certain modified assumptions and concluded that either MERC's or the Department's alternative need analyses support a finding that the Project as proposed is reasonable.[39] MERC has demonstrated by a preponderance of the evidence that the Project, as proposed, is necessary to support projected demand growth.

A. All Parties Agree Additional Capacity Is Needed Now.

All parties to this proceeding, including the OAG, agree that MERC needs added capacity now to meet existing demand.[40] MERC is operating at a negative reserve, meaning it does not have sufficient capacity to cover its firm customer demand in the Rochester area in the event of a design day scenario. Notably, on January 6, 2014, MERC exceeded its total firm contracted capacity at Rochester TBS 1D after interrupting all interruptible and transport customers.[41] Because of the shortage of firm capacity, MERC is at increasing risk of an unreliable supply of firm natural gas. If MERC experienced a cold weather event similar to the "polar vortex" in 2014, it is uncertain whether the Company could meet its firm customer needs even after curtailing interruptible customers.[42] MERC's need for additional capacity is real, immediate, and undisputed.

To project the extent of the demand for natural gas, MERC developed a sales forecast for the Rochester area, comprised of Olmsted County and the Dodge County communities of Kasson

[38] Ex. 9 at 7 (Clabots Direct).

[39] Ex. 405 at 25-37 (Heinen Direct).

[40] Ex. 300 at 35 (Urban Amended and Corrected Direct).

[41] Ex. 12 at 6-7 (Mead Direct) (noting total firm contracted capacity for MERC and all other parties with firm capacity at Rochester TBS 1D was exceeded by 3,342 dekatherms on January 6, 2014); Ex. 1 at 2 (Initial Filing – Rochester Project Rider Petition).

[42] Ex. 12 at 6-7 (Mead Direct).

and Blooming Prairie, for the period 2015 through 2025.[43] In evaluating need for natural gas in the Rochester area, both changes in firm customer counts (i.e., new residential, commercial, and industrial customers) and changes to existing customer usage (i.e., use per customer or "UPC") are relevant.

The Company used standard forecasting methodologies and statistically significant inputs in preparing its models.[44] In designing its models, MERC chose some inputs that were on the robust side but still statistically significant to account for the anticipated growth in the Rochester area, which is expected to exceed historic levels.[45] MERC used certain "*a priori*" or external information as a check on the reasonableness of its forecast assumptions.[46] MERC adjusted its forecast at the request of the Department to reflect Rochester-only weather[47] and ultimately forecasted an average annual sales growth rate of about 1.5 percent per year.[48]

MERC's forecast represents a reasonable prediction of demand growth in the Rochester area presented in this proceeding based on historic growth and the likely impact that the DMC initiative and related economic development will have on demand growth in the Rochester area. At this time, the success of the DMC initiative is not merely speculative, and the Rochester area is poised to rapidly develop. MERC's forecasted need most fully and accurately accounts for the demand that is expected to occur in the Rochester area.

[43] Ex. 1 at 20 (Initial Filing – Rochester Project Rider Petition).

[44] Ex. 26 at 1 (Clabots Opening Statement).

[45] Ex. 26 at 1 (Clabots Opening Statement).

[46] Ex. 9 at 13 (Clabots Direct).

[47] Ex. 26 at 1 (Clabots Opening Statement).

[48] Ex. 26 at 1 (Clabots Opening Statement).

B. The OAG's Forecast Criticisms Impose Unreasonable Risk.

Despite acknowledging "there is currently a need for additional capacity in Rochester,"[49] OAG witness Dr. Julie Urban argues that MERC's forecast of 1.5 percent growth in peak demand is too high and has an insufficient historical basis.[50] The OAG criticized MERC's forecast and requested a number of ad hoc adjustments to lower the projected growth rate. As discussed below, MERC disagrees with the OAG's criticisms and adjustments and continues to support its forecast as a reasonable prediction of continued growth in Rochester.

1. Historical Data

Dr. Urban first criticizes MERC for relying on only eight years of historical data to prepare its regression model and she concludes that MERC's forecast projections are unsupported by the historical data.[51] As discussed in Rebuttal Testimony, MERC stopped using pre-2007 consumption data due to concerns raised by the OAG and the Department in MERC's 2011 test year rate case[52] with respect to the quality of data from Aquila, MERC's predecessor.[53] Use of seven and one half years of data to prepare a ten-year sales forecast is adequate.[54] Moreover, the data constraints placed on the Company should not prevent MERC from seeking approval of the Project until the Company has accumulated more historical data.[55] Waiting to accrue more historical data would only exacerbate the capacity constraints and reliability concerns.[56]

[49] Ex. 300 at 35 (Urban Amended and Corrected Direct).

[50] Ex. 300 at 70 (Urban Amended and Corrected Direct).

[51] Ex. 300 at 28-29 (Urban Amended and Corrected Direct).

[52] Docket No. G007,011/GR-10-977.

[53] Ex. 10 at 12 (Clabots Rebuttal).

[54] Ex. 10 at 12 (Clabots Rebuttal).

[55] Ex. 10 at 12 (Clabots Rebuttal).

[56] Ex. 10 at 12 (Clabots Rebuttal).

Further, contrary to Dr. Urban's conclusions, the historical data supports MERC's projected growth and shows positive growth since 2007.[57] A review of historic average annual percentage change in actual sales supports the conclusion that there is an historical basis for MERC's forecast.[58] Contrary to Dr. Urban's conclusion, the existence of fluctuations in historic firm demand on MERC's system "helps *support* the Project since it is critical for MERC to be able to provide natural gas service during cold winter periods."[59]

Additionally, as discussed by MERC witness David Clabots in his Surrebuttal Testimony and during the Evidentiary Hearing, the trends in historical data, even when viewed on a weather-normalized basis, need to be considered in context.[60] Given the extreme weather conditions that occurred in 2014 with a "polar vortex" and in 2015 with a warm El Niño weather year, the growth rate of 0.27 percent for 2007-2015 is likely understated, just as the average growth rate calculated for 2007-2014 of 2.28 percent is likely overstated. Removing the extreme weather years yields an average historic growth rate of 1.14 percent for the period 2007-2013.[61] This historic data supports MERC's forecasted demand growth.

2. Time Trend Variable

Dr. Urban criticized MERC's Residential Use-Per-Customer model, noting that "[u]nlike the small commercial and industrial average use model, the residential average use model does not include a time trend variable."[62] According to Dr. Urban, including a time trend variable in

[57] Ex. 11 at 6-7 and Table 1 (Clabots Surrebuttal).

[58] Ex. 407 at 2-3 (Heinen Surrebuttal).

[59] Ex. 410 at 2 (Heinen Opening Statement) (emphasis added).

[60] Ex. 11 at 5-8 (Clabots Surrebuttal); Evidentiary Hearing Transcript, Vol. 1 at 80-81 (Clabots) ("You have to be careful with … weather normalization when you have extreme weather situations like a "polar vortex" or an El Nino, that it makes it more difficult for some weather normalization models to actually fully correct for all that weather.").

[61] Ex. 11 at 6-7 (Clabots Surrebuttal).

[62] Ex. 300 at 30 (Urban Amended and Corrected Direct).

the regression analysis is appropriate to capture the downward trend in average residential use and reflect that in forecasted future use[63] because "[e]nergy use per customer has been trending downward for years due to a number of factors including increased efficiency in heating, cooling, and lighting technology and insulation improvements in residential, commercial, and industrial construction."[64]

MERC's Residential UPC model was statistically significant as submitted in the Petition and MERC disagrees that a time trend variable is necessary.[65] Even if a time trend variable were used, however, the time trend variable to reflect declining use per customer suggested by the OAG would be inappropriate when added in isolation as Dr. Urban requested without reviewing the entire model. In other words, the variables in the forecast model work together and the addition or modification of particular variables without corresponding adjustments to other variables in the model can yield inconsistent and unsound results.

Moreover, a trend variable is just a time index variable and is a mechanism that attempts to measure a trend in the data. The purpose of a trend variable is to determine if the mean is increasing or decreasing gradually over time, i.e., that there is a constant trend. If so, then it might be appropriate to fit a sloping line rather than a horizontal line to the data series.[66]

Although trend lines have their uses as visual aids, they are often poor for purposes of forecasting outside the historical range of the data. Most time series do not behave as though there are straight lines fixed in space to which they want to return some day. Rather, their levels

[63] Ex. 300 at 30 (Urban Amended and Corrected Direct).

[64] Ex. 311 at 5 (Urban Amended Surrebuttal).

[65] Ex. 10 at 14 (Clabots Rebuttal).

[66] Ex. 26 at 2-3 (Clabots Opening Statement).

and trends undergo evolution. In other words, the linear trend model tries to give the best average fit to all past data but does not always produce a good forecast over the long term.

Importantly, in this instance, a decreasing linear trend for residential customer usage is not realistic over the long-term as per-customer usage cannot decrease forever.[67] Forward-looking independent variables or "*a priori"* information are better suited for use in long-term forecasts.[68] MERC disagrees that a time trend variable is necessary, and an economic trend variable, such as real personal income, would be more appropriate.[69]

3. A Priori Information

Dr. Urban criticized MERC's selection of more robust models to incorporate the anticipated growth related to the Mayo Clinic expansion and DMC project including "*a priori*" information.[70] MERC's forecasts were developed using historical data, based on valid statistical modeling, and *a priori* information was considered to corroborate the reasonableness of the results of the forecast modeling.[71] In this case, the *a priori* information considered was the growth that will be created, to some degree, by the expansion of the Mayo Clinic and the DMC initiative. Yet no specific data related to the DMC was used in the forecast modeling.[72]

As Mr. Clabots explained, use of *a priori* information in forecasting is not unusual.[73] It is important for a forecaster to use his or her experience or judgment in preparing a forecast as this experience assists in determining how a model should be set up or to develop a selection of

[67] Ex. 26 at 2-3 (Clabots Opening Statement); Evidentiary Hearing Transcript, Vol. 1 at 185-185 (Urban) (acknowledging uncertainty regarding whether residential use per customer would continue to decline at the same rate forever).

[68] Ex. 26 at 2-3 (Clabots Opening Statement).

[69] Ex. 10 at 14 (Clabots Rebuttal).

[70] Ex. 300 at 30-31 (Urban Amended and Corrected Direct).

[71] Ex. 10 at 15 (Clabots Rebuttal).

[72] Ex. 10 at 15 (Clabots Rebuttal).

[73] Ex. 10 at 15 (Clabots Rebuttal).

applicable variables.[74] Under the circumstances of this proceeding, it is reasonable for MERC to consider the Mayo Clinic's expansion plans and plans related to the DMC project in determining an appropriate forecast given the unprecedented nature of the DMC initiative and anticipated growth that is expected to result in the Rochester area.[75] As noted previously, recent reports indicate that the DMC initiative is on track to hit $200 million in private investment by the end of 2016, triggering the release of $585 million in public funding to support infrastructure improvements for the DMC.[76] Therefore, the likely success of the DMC initiative is not merely "speculative" as Dr. Urban suggests.[77] The record demonstrates the concerns raised by OAG witness Dr. Urban with respect to MERC's sales forecast are without merit.

4. The OAG's Alternative Assumptions Are Not Valid or Realistic.

At the request of the OAG, MERC adjusted its forecast model to modify isolated inputs and assumptions.[78] Specifically, the OAG requested the Company (1) use Rochester specific weather data; (2) use Mr. Heinen's customer count growth forecast; and (3) incorporate a time trend variable in the Residential UPC model. These adjustments resulted in a 10-year average total retail sales growth of negative 0.1 percent. As stated by Mr. Clabots in his Surrebuttal Testimony, the results of the modified forecast requested by the OAG are neither reasonable nor supportable[79] given the positive trends in historic growth in the Rochester area and the fact that this area is experiencing robust growth whether or not the DMC initiative is considered.

[74] Ex. 10 at 15 (Clabots Rebuttal).

[75] Ex. 10 at 15 (Clabots Rebuttal).

[76] Ex. 11 at 3-4 (Clabots Surrebuttal).

[77] Ex. 300 at 33 (Urban Amended and Corrected Direct) ("[T]he Mayo Clinic expansion and . . . the Development Plan for the DMC may not result in the kind of growth necessary to justify such a large expansion in capacity."); Ex. 307 at 3 (Urban Amended and Corrected Rebuttal) ("The expected impact of the Mayo Clinic is speculative and there is no historical basis for the forecast result.").

[78] Ex. 11 at DWC-S2 (Clabots Surrebuttal).

[79] Ex. 11 at 13 (Clabots Surrebuttal).

Changing variables in isolation risks inconsistent and potentially skewed results.[80]

To demonstrate the danger of manipulating individual inputs in isolation, MERC made the modifications and assumptions specified by the OAG and also updated the forecast tables to include 2015 weather-normalized actual sales (rather than forecasted 2015), which resulted in a 10-year average total retail sales growth rate of positive 1.1 percent.[81] This additional change swung the 10-year average growth rate from negative 0.1 percent to positive 1.1 percent – a significant change resulting from the modification of one data point.[82] This swing illustrates the caution that should be exercised when an isolated data point, as is the case with adding 2015 weather-normalized sales, or several variables, as is the case with the OAG's requested alternative forecast, are changed in isolation without reviewing the entire model.[83] The significant variation that results in changing a single variable also illustrates why ad hoc modifications to the assumptions, variables, or data within the forecast in isolation and outside the broader context of the forecasting process is likely to result in unreasonable and unreliable results. Forecasting is more than simply plugging numbers blindly into a model or growth-rate tables; it is a complex process with many inputs and variables, and must be evaluated based upon all of the information available at the time the forecast is formulated.

Given the uncertainty inherent in forecasting, it is reasonable and appropriate to evaluate not only the probability that growth will occur as projected but also the implications if growth occurs more quickly than projected. Not only is the OAG's alternative forecast of negative 0.1

[80] *See* Ex. 11 at 12-13 (Clabots Surrebuttal). MERC added the 2015 weather-normalized sales to the OAG's requested alternative forecast because "[i]n the normal course of business, if another full year of actuals were available, it would be appropriate to update the forecast tables with a full year of available weather-normalized data." Ex. 11 at Schedule DWC-S2 (Clabots Surrebuttal).

[81] Ex. 11 at 12-15 and DWC-S2 (Clabots Surrebuttal).

[82] Ex. 11 at 13-14 (Clabots Surrebuttal).

[83] Ex. 11 at 14 (Clabots Surrebuttal).

percent growth highly improbable given historic growth trends in the Rochester area, the projected population growth provided by the Rochester-Olmsted Council of Governments,[84] and the expansion plans of the Mayo Clinic and DMC initiative that are already underway, the record in this case demonstrates that if the Project is not undertaken and growth does occur more quickly than the OAG projects, ratepayers would be required to invest in significant future upgrades at even greater costs than the proposed Project.

Ultimately, the record fully demonstrates that MERC's forecast as filed represents a reasonable scenario to reflect the overall growth projected in the Rochester area and fully supports a finding of need for the Rochester Project.

C. MERC's and the Department's Forecasts Bookend Realistic Need.

In contrast to the OAG's isolated criticisms and manipulated variables, the Department conducted a full review of MERC's forecast and submitted an alternative forecast. Ultimately, Mr. Heinen concluded that the Company's projections represent an acceptable optimistic estimate of expected need for the Rochester area.[85] Mr. Heinen recognized that in integrated resource plans ("IRP") and certificate of need filings, the forecast or need analyses typically include low-growth, base-growth, and high-growth scenarios. Generally, forecast results in that range are acceptable with the base case being the most likely scenario.[86]

Based on Mr. Heinen's analysis, and despite some concerns with MERC's forecast, he concluded that MERC's need analysis represents an appropriate, if optimistic, view of expected growth, while his analysis represents a conservative or "status quo" view of growth.[87] In particular, Mr. Heinen notes that his analysis "assumed growth and system dynamics as they are

[84] Ex. 9 at DCW-2 (Clabots Direct).

[85] Ex. 407 at 6 (Heinen Surrebuttal).

[86] Ex. 407 at 6 (Heinen Surrebuttal).

[87] Ex. 407 at 3 (Heinen Surrebuttal).

now and did not factor in possible growth from the Destination Medical Center."[88] Based on the risks and costs of building a smaller project, Mr. Heinen concludes MERC's Rochester Project, as proposed, is reasonable.[89] As Department witness Mr. Heinen stated in Direct Testimony:

> Although smaller alternatives may be able to meet need in the Rochester Area, this outcome would only be possible if growth in the Rochester Area, and on the MERC system as a whole, remain relatively constant despite known upward pressure on throughput such as the DMC. In the event that growth increases, there is tangible risk that ratepayers would be required to invest in significant future upgrades that may have similar, or greater, costs to the proposed project. Any excess costs associated with the project as proposed by MERC were relatively small on an annual basis and were comparable to insurance against the potential costs of future system upgrades.[90]

Regardless of whether MERC's forecast projections are considered to be an optimistic or high-growth projection, the record in this proceeding supports a finding that there is a need for significant additional capacity in the Rochester area.

If growth occurs as MERC projects, or occurs more quickly than the Department's forecast, MERC would likely not be able to provide adequate and reliable natural gas service in Rochester in the absence of a project to add pipeline capacity and modify the distribution system to ensure delivery of natural gas where it is needed. Even under the Department's "status quo" demand forecast, MERC will need significant new capacity over the coming decades. Further, in the reasonably likely event that forecast demand increases more rapidly than the Department's "status quo" forecast predicts due to the DMC initiative or other causes, the Project will provide MERC with the ability to respond to those circumstances without compromising system reliability or placing ratepayers at risk for uncertain future costs of additional capacity upgrades.

[88] Ex. 410 at 1 (Heinen Opening Statement).

[89] Ex. 405 at 36 (Heinen Direct).

[90] Ex. 405 at 36-37 (Heinen Direct).

The Rochester Project is needed now to meet existing demand. Without the proposed distribution upgrades and additional capacity, MERC's service in the Rochester area could become unreliable and would be substandard in relation to MERC's other service areas. Approval of the Project is necessary to allow MERC to meet its obligation to existing customers to ensure the provision of safe, reliable, and adequate natural gas service. Under current conditions, MERC is operating with a negative reserve margin in Rochester and has been fortunate not to have experienced a design day situation since 2014 that would challenge the ability to meet firm customers' natural gas needs.[91]

IV. MERC'S SELECTION PROCESS WAS REASONABLE AND PRUDENT.

Overall, MERC's process for selecting the interstate pipeline capacity necessary to supply the Rochester Project was reasonable and prudent. Company witness Sarah Mead, independent expert Timothy C. Sexton, and Department witness Michael Ryan all evaluated the reasonableness of MERC's RFP process and concluded that MERC's RFP process, the selection of NNG as the least-cost bidder, and the negotiation of the final agreement were reasonable and prudent.[92] The record in this proceeding fully supports a finding that MERC's process for selecting the Rochester Project was reasonable, prudent, and resulted in the best and least-cost alternative to meet the demonstrated need.

A. Adding Interstate Pipeline Capacity Was the Only Viable Alternative.

Prior to developing its RFP for additional interstate capacity, MERC appropriately considered whether other alternatives were available to address the capacity constraint in the Rochester area. These options included alternative pipeline options, distribution system

[91] *See* Evidentiary Hearing Transcript, Vol. 1 at 103:22-24 (Mead).

[92] Ex. 17 at 52-53 (Sexton Direct); Ex. 402 at 14 (Ryan Direct) ("I conclude that MERC's RFP process was fair and reasonable, and that MERC negotiated provisions for ratepayers not only in Rochester, but in other areas of MERC's system as well.").

modifications, conservation, and a no-build alternative.[93] Ultimately, MERC concluded the only viable alternative was one that added interstate pipeline capacity to the system. There are limits on the natural gas that can be delivered to MERC's two Rochester TBSs from the upstream interstate pipeline. Distribution upgrades address only the downstream operational issues and thus the constrained interstate pipeline supply cannot be solely rectified through upgrades to MERC's distribution system.[94] As Mr. Sexton summarized in his Opening Statement:

> In a circumstance like this, where existing capacity is completely sold out, it means that in order to get more capacity in the area, new construction is required. There is no getting around that reality. From my perspective, the only real question to be debated is what is the most appropriate construction to implement and whether MERC did a reasonable job of pursuing it under the circumstances.[95]

OAG witness Dr. Urban argues MERC should have considered peak shaving as an alternative to new construction.[96] Dr. Urban presented the peak shaving idea at a "high level," acknowledging that she does not herself have "the expertise to determine whether peak shaving is a viable option."[97] Dr. Urban did not provide any support for peak shaving as a viable alternative, but instead continually suggested that MERC had failed to provide her with enough information to determine whether peak shaving was a viable alternative. Ultimately, Dr. Urban acknowledged that her criticism was rooted in the fact that MERC did not show how it concluded that other options were *not* viable.[98]

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[93] Ex. 1 at 26-30 (Initial Filing – Rochester Project Rider Petition).

[94] Ex. 402 at 4-5 (Ryan Direct).

[95] Evidentiary Hearing Transcript, Vol. 1 at 137:20-138:3 (Sexton).

[96] Ex. 307 at 12-17 (Urban Amended and Corrected Rebuttal).

[97] Evidentiary Hearing Transcript, Vol. 1 at 176:16-179:5 (Urban).

[98] Evidentiary Hearing Transcript, Vol. 1 at 179:1-5 (Urban).

Dr. Urban is incorrect in her assertion that MERC did not consider peak shaving. The trained professionals, including engineer Ms. Lindsay Lyle, considered peak shaving early in the planning process as an alternative to meet peak demand and determined that such facilities would solve MERC's capacity need in the Rochester area.[99] MERC's predecessor Aquila owned a few peak shaving plants but those facilities were all retired or sold because the systems were obsolete and costly to operate and maintain.[100] Moreover, to provide additional capacity to Rochester, a peak shaving alterative such as propane air or compressed natural gas would need to be injected into MERC's high pressure system, as opposed to the low-pressure system those systems previously supplied.[101] As a result, MERC dismissed a peak shaving option early in the decision process.

Under the certificate of need rules, which the parties agree provide a useful framework for evaluating MERC's Project in this proceeding,[102] the applicant bears the burden of demonstrating the need for the Project by a preponderance of the evidence. With respect to alternatives to the Project, MERC meets this burden by showing that the Project is a reasonable and prudent way to satisfy the articulated and demonstrated need. It is not MERC's burden to disprove other potential alternatives or to prove the absence of theoretical alternatives.

As articulated by the Commission's certificate of need rules and upheld by the Minnesota judiciary, the burden falls squarely on other parties to introduce alternatives into the record for

[99] Ex. 8 at 7-9 (Lyle Rebuttal); Ex. 25 at 1 (Lyle Opening Statement); Ex. 402 at MR-3 (Ryan Direct) (MERC Response to OAG Information Request No. 176).

[100] Ex. 402 at Schedule MR-3 (Ryan Direct) ("MERC no longer has any peaking facilities on its system. MERC retired or sold all of its peaking facilities due to age, reliability concerns, and their inability to provide additional firm capacity during peak demand times.").

[101] Evidentiary Hearing Transcript, Vol. 1 at 63-64 (Lyle).

[102] Evidentiary Hearing Transcript, Vol. 1 at 170:12-21 (Urban) (acknowledging that the certificate of need procedures are analogous to the current proceeding and provide "useful guidance" on how to implement the NGEP Statute).

consideration and then to establish that any such alternatives provide a more reasonable and prudent means of meeting the articulated needs than does the Project. In examining the Commission's certificate of need rules for natural gas pipelines,[103] the Minnesota Court of Appeals stated:

> Under the certificate-of-need process established by statute and rule, an applicant bears the burden of proving the need for a proposed facility. An applicant fails to meet this burden when another party demonstrates that there is a more reasonable and prudent alternative to the facility proposed by the applicant. Minn. Stat. § 216B.243, subd. 3; Minn R. 7851.0120, subp. 8. This regulatory scheme is simply a practical way to prevent the issuance of a certificate of need when there is a more reasonable and prudent alternative to the proposed facility without requiring an applicant to face the extraordinary difficulty of proving that there is not a more reasonable and prudent alternative.[104]

It is clear under the Commission's jurisprudence that the Commission need only consider alternatives that have been put fully into the record by parties who disagree with the options proposed by the applicant.

MERC reasonably considered whether alternatives to adding additional interstate capacity were available before it undertook the process to develop an RFP bid process. The record developed in this proceeding supports MERC's conclusion that the addition of interstate pipeline capacity was the only viable alternative to address the demonstrated need.

B. The RFP Process Ensured A Competitive Environment.

MERC currently has a contract for NNG to provide 55,000 Dekatherms per day ("Dth/day") to the Rochester area.[105] No other pipelines provide capacity to this area.[106] Any

[103] Minn. R. 7851.0120.

[104] *In the Matter of the Application of the City of Hutchinson for a Certificate of Need to Construct a Large Nat. Gas Pipeline*, No. A03-99, 2003 WL 22234703 at *11 (Sept. 23, 2003) (*citing State v. Paige*, 256 N.W.2d 298, 304 (Minn. 1977)).

[105] Ex. 12 at 11 (Mead Direct).

competing pipeline would need to build at least 80 miles of new pipeline, requiring a major capital expenditure.[107] As a result, MERC has been a captive customer of NNG and has lacked leverage in obtaining additional capacity through NNG. This situation created a significant competitive disadvantage for MERC because no other pipeline offers competition in the area.

MERC proceeded to seek proposals to add capacity to the system through a competitive RFP process. Through that process, MERC solicited approximately 100,000 Dth/day of capacity, either by expanding the existing NNG position or by replacing it with a new third-party pipeline.[108] By selecting 100,000 Dth/day as the target capacity, MERC served two important goals: (1) it provided sufficient capacity to serve customers for the long term; and (2) it provided a sufficiently large capacity position to entice other pipelines to submit competing proposals.[109] By structuring the request this way, MERC created a competitive environment that posed the realistic risk that NNG could lose its existing position and other pipelines could compete for the overall position.

If MERC were to simply seek a small growth quantity of capacity, MERC would have little leverage to extract advantageous terms from NNG; adding a small incremental amount onto the existing NNG position would not create sufficient incremental capacity for NNG to provide competitive pricing or other terms.[110] Further, requesting bids for a small incremental capacity project simply would not attract proposals from third-party pipelines because the resulting per-unit cost to build a new pipeline to the area would be too high; non-incumbent pipelines would

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[106] Ex. 12 at 17-18 (Mead Direct).

[107] Ex. 19 at 5 (Sexton Rebuttal).

[108] Ex. 17 at 39 (Sexton Direct).

[109] Ex. 19 at 7-8 (Sexton Rebuttal).

[110] Ex. 19 at 7 (Sexton Rebuttal).

have to build and pay for at least 80 miles of new pipeline simply to reach the Rochester area.[111] As discussed in Mr. Sexton's Rebuttal Testimony:

> This distance of 80 miles creates a significant hurdle for a third-party service provider to overcome in order to compete with the incumbent service provider. Thus, in order to foster a competitive environment for its RFP, MERC developed a life cycle approach where it sought capacity solutions that would meet long-term requirements in and around the area of Rochester, Minnesota.
>
> If MERC had issued an RFP that only supported near-term demand requirements, the quantity would not have been sufficient to enable third-party service providers to submit proposals that had any realistic chance of clearing the significant barrier to entry created by the required 80-mile pipeline construction requirement.[112]

However, MERC had one advantage that allowed the Company to significantly leverage NNG. MERC's current 55,000 Dth/day capacity contract with NNG in the Rochester area is set to expire in 2017.[113] This meant that MERC was able to design an RFP that not only requested incremental new capacity but also bid out the existing capacity currently provided by NNG. By doing so, MERC exposed NNG to competition that would not otherwise have existed.[114] As noted by Department witness Michael Ryan, "[w]hile the other pipelines may have difficulty serving Rochester, MERC made reasonable efforts to address this issue through the timing of the process and allowing other bidders the opportunity to provide competitive bids on the Project."[115] Similarly, as discussed by MERC witness Ms. Mead,

> [I]f a smaller project had been pursued, the RFP would not have attracted any non-incumbent third-party service providers to submit proposals for the capacity, and as a result, would have significantly limited MERC's negotiating power with Northern. It

[111] Ex. 19 at 5 (Sexton Rebuttal).

[112] Ex. 19 at 5 (Sexton Rebuttal).

[113] Ex. 16 at 7 (Mead Surrebuttal).

[114] Evidentiary Hearing Transcript, Vol. 1 at 127:17-138:3 (Mead).

[115] Ex. 402 at 15 (Ryan Direct).

> is important to keep in mind that MERC's existing Rochester capacity contracts with Northern were about to expire, meaning that MERC could put the entire Rochester load up for bid and expose Northern to competition. I believe the advantageous terms we negotiated are directly related to MERC's ability to leverage supply competition through the RFP process.[116]

MERC structured the RFP to place the entire Rochester position up for bid, engaging all active pipeline companies in the general vicinity of Rochester, Minnesota – five pipeline companies in all, including NNG,[117] and posting the RFP on its website to solicit additional responses.[118] MERC received proposals from three pipeline companies – Northern Border Pipeline, Twin Eagle, and NNG. Each of these companies was able to submit proposals that were sufficiently competitive to serve the purpose of creating risk for NNG and prompting NNG to make significant concessions in order to prevail.[119] "[I]n other words, if a competing pipeline made a cost effective proposal for the entire position, it could effectively displace Northern, thereby putting significant pressure on Northern to sharpen its pencil."[120] As recognized by Department witness Mr. Ryan, MERC's RFP process was a "comprehensive gauge of the market and potential alternatives for interstate pipeline services to the Rochester TBSs."[121] This long-term, life cycle approach allowed MERC to minimize the risk of need for additional capacity construction in a few years and created a competitive environment in which MERC was able to effectively exercise leverage to obtain the best possible terms from NNG.[122]

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[116] Ex. 27 at 2 (Mead Opening Statement).

[117] Ex. 17 at 38-39 (Sexton Direct) (stating that the five active pipeline companies in the vicinity of Rochester, Minnesota are NNG, Northern Border Pipeline Company, Viking Gas Transmission, Great Lakes Gas Transmission, and Encore Energy).

[118] Ex. 12 at 9-10 (Mead Direct).

[119] Evidentiary Hearing Transcript, Vol. 1 at 158:15-18 (Sexton).

[120] Ex. 28 at 2 (Sexton Opening Statement).

[121] Ex. 402 at 14-15 (Ryan Direct).

[122] Ex. 19 at 6 (Sexton Rebuttal).

C. MERC's Bid Evaluation Was Reasonable.

MERC reviewed the bid proposals and then met with each bidder to clarify the information already provided as well as the proposed costs and timing.[123] With this information in hand, MERC evaluated the proposals against a number of criteria and ultimately concluded that, on balance of all the factors, NNG's proposal to expand its existing system best met the firm transportation needs of Rochester and also addressed shortages at twenty-one other NNG TBSs in southeastern Minnesota.[124] The record demonstrates MERC's review of the RFP bids and the selection of NNG as the best and least-cost bidder were reasonable and supported.

Department witness Mr. Ryan reviewed MERC's internal review of the competitive bid process and evaluated MERC's RFP process to "assess whether it was inclusive of potential parties and if participating parties were held to a fair process."[125] Mr. Ryan has extensive experience in the natural gas industry and spent more than seven years preparing literally hundreds of RFPs very similar to the one MERC produced in this case.[126] Based on this review, Mr. Ryan concluded that "MERC's RFP process was fair and reasonable,"[127] and that MERC's evaluation criteria and "weights to each category appeared reasonable. Overall, the driving component was cost and the summary data confirms the decision made by MERC."[128]

In contrast, OAG witness Dr. Urban criticized MERC's evaluation and selection process, asserting that "MERC's analysis makes little sense because MERC proceeded to negotiate with

[123] Ex. 12 at 10 (Mead Direct).

[124] Ex. 12 at 10 (Mead Direct).

[125] Ex. 402 at 6 (Ryan Direct).

[126] Ex. 402 at 1:13-21 (Ryan Direct).

[127] Ex. 402 at 14 (Ryan Direct).

[128] Ex. 402 at 10 (Ryan Direct).

NNG using Proposal 3.0, while MERC's own analysis indicates that Phased Proposal 4.2 grades higher under both the weighted and non-weighted analyses."[129] Ms. Mead, however, testified:

> MERC negotiated the PA using various features and enhancements from various proposals and did not slavishly adhere to a single proposal. Proposal 3.0 was indeed the base case which showed MERC that NNG won the bid. Proposal 4.2 did indeed have some positive features that resulted in it scoring well, but also had problems that needed to be addressed. The end result was a combination approach that got MERC the capacity it needed, at specific locations where the capacity is needed most, phased in on a schedule that optimizes benefits, and with substantial cost certainty. This was far preferable to simply "accepting" one proposal or another without refinement.[130]

NNG was selected using the RFP process and was determined to be the most cost-effective option compared to the other companies. NNG's base-case proposal resulted in overall reasonable costs and a levelized payment stream that was attractive to MERC. Ultimately, the RFP was awarded to NNG because NNG's proposal had the lowest capital costs, shortest construction time, and allowed the most hourly flow flexibility.

D. MERC Negotiated Significant Additional Enhancements With NNG.

After selecting NNG as the winning bidder, MERC and NNG negotiated the PA, which included numerous enhancements to the base proposal. As discussed by Ms. Mead, this process of further contract negotiation was reasonable and appropriate:

> Importantly, MERC did not simply accept Northern's winning bid. Mechanically implementing one proposal would not have been in the best interest of the ratepayers and would have resulted in an inferior project compared to the final negotiated PA. Rather, MERC took the various bids that Northern proposed and negotiated a hybrid contract that maximized value to customers. The negotiated PA is superior to any individual offering.[131]

[129] Ex. 307 at 13 (Urban Amended and Corrected Rebuttal).

[130] Ex. 16 at 15 (Mead Surrebuttal).

[131] Ex. 27 at 2 (Mead Opening Statement).

Department witness Mr. Ryan similarly concluded, "Given that NNG was the most competitive bid based on its Proposal 3.0, and given that the enhancements 'continued to show significant savings over the life of the project', it was not unreasonable that the other bidders were not allowed to refresh proposals."[132]

These enhancements included fixed rates associated with the extension of existing firm delivery entitlement to the Rochester area; firm growth capacity rights to other MERC markets in southeast Minnesota; ability to utilize capacity on the NNG system at fixed rates for alternative TBSs; and extension rights.[133] MERC is confident that these concessions from NNG would not have been possible without the competitive bidding process.[134]

V. MERC'S PROPOSAL BEST MEETS CUSTOMER NEEDS.

The record demonstrates that MERC's proposed system upgrades and proposed NNG capacity contract are the best and least-cost available alternatives to meet the demonstrated need in the Rochester area. As discussed above, MERC undertook a thorough process to evaluate alternatives to the Project as proposed and to establish a competitive environment to ensure it was able to obtain the best possible cost and other terms for the benefit of its ratepayers. The result of that process was an overall Project including MERC distribution system upgrades and NNG capacity upgrades that cost effectively address the needed improvements in the Rochester area. The record developed in this proceeding supports a finding that MERC has demonstrated the Rochester Project is a reasonable and prudent way to meet the demonstrated need, and that the alternative phased proposals advocated by the OAG are not more reasonable or prudent than the alternative proposed.

[132] Ex. 402 at 11 (Ryan Direct).

[133] Ex. 17 at 45-50 (Sexton Direct).

[134] Ex. 27 at 2 (Mead Opening Statement); Ex. 28 (Sexton Opening Statement).

A. The Project is the Most Reasonable Alternative on the Record.

MERC determined that NNG's Proposal 3.0, as a base proposal, represented the best and least-cost alternative to meet MERC's customer needs in the Rochester area. MERC negotiated various additional features and enhancements in the final PA, resulting in an even more advantageous contract. Mr. Sexton also found that the NNG proposal was the best alternative, concluding the NNG proposal and final contract results in at least $50 million of NPV savings over any of the other pipeline companies' proposals.[135]

Nevertheless, OAG witness Dr. Urban disagreed that the Project represents the best and least-cost alternative for MERC's customers. Instead, Dr. Urban argues MERC should have taken a "more modest proposal,"[136] although she does not suggest what more modest proposal might have been available, feasible, or cost effective under the circumstances. Rather, Dr. Urban criticizes MERC for not providing her with more alternatives to consider, such as designing a project with less capacity or the incremental implementation of capacity increases.[137]

For example, Dr. Urban concludes that because the average annual cost of excess capacity, as calculated by Department witness Mr. Heinen, would be $3 million per year, "the entire additional cost of the smaller project will be less than the excess capacity costs for one year for the project size proposed by the Company."[138] However, Dr. Urban's reasoning is flawed and her conclusion is incorrect. To the contrary, MERC submitted analysis demonstrating that limiting expansion capacity to 30,000 Dth/day would have resulted in an *increased* NPV of costs of approximately $1 million.[139] As explained by Ms. Mead,

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[135] Ex. 17 at 45 (Sexton Direct).

[136] Ex. 307 at 10 (Urban Amended and Corrected Rebuttal).

[137] Ex. 307 at 12-17 (Urban Amended and Corrected Rebuttal).

[138] Ex. 307 at 10-11 (Urban Amended and Corrected Rebuttal).

[139] Ex. 13 at 8 (Mead Rebuttal).

> Although the Department's conclusion that "the average amount of excess capacity may cost approximately $3 million," is based on the unit cost of the Project as proposed, it simply does not follow that these costs could have been avoided by avoiding the excess capacity. To the contrary, in this scenario, customers are paying the contracted amount whether that "excess" capacity is realized or not. In other words, had MERC selected the 30,000 Dth/day alternative, MERC customers would have paid 101 percent of the costs as under the PA while receiving less total capacity. And customers would receive substantially less capacity for that higher cost, putting them at significant risk of having to endure future upgrades and potential capacity shortfalls if demand exceeds MERC's forecast. There simply is no $3 million additional capacity charge that could have been avoided. In other words, in the scenario Dr. Urban poses of the smaller incremental project, ratepayers would be paying *both* the $3 million/year "excess" charge, *plus* paying the $1 million of additional capital cost.[140]

By any measure, paying more money for less capacity is not a good deal for MERC's customers. Indeed, the cost of smaller upgrades would, on an apples-to-apples comparison, result in more costs to ratepayers overall.[141] Further, many of the phased approaches discussed by Dr. Urban would have exposed MERC to uncapped costs during the second phase of construction.[142] NNG's bid was explicit: the second phases of capacity under the phased-in approach Dr. Urban discusses would be based on actual costs incurred at the time of construction and in light of then-current circumstances. In other words, MERC and its customers would have borne the risk of NNG extracting additional, increased compensation for the subsequent phases. Under that scenario, MERC would have had little leverage as it would have no other option than to work with the incumbent pipeline. As Mr. Sexton succinctly concluded: "it is a near certainty that costs of a later incremental capacity expansion negotiated in a non-competitive environment with Northern would result in higher costs than will be paid for this growth capacity in the

[140] Ex. 16 at 13 (Mead Surrebuttal).

[141] Evidentiary Hearing Transcript, Vol. 1 at 116:17-22 (Mead).

[142] Ex. 28 at 4 (Sexton Opening Statement); Evidentiary Hearing Transcript, Vol. 1 at 129-130 (Mead).

current transaction."[143] Indeed, during the Evidentiary Hearing, Dr. Urban candidly acknowledged that the phased approaches she advocated imposed price risk on MERC.[144] MERC reasonably concluded that this pricing risk was unacceptable and that it was preferable to lock down cost certainty for the entire transaction on the front end. This would ensure that MERC and its customers would receive the value bargained for, and would not include otherwise unacceptable price risk arising out of an uncompetitive environment.[145]

Contrary to Dr. Urban's criticism, MERC did "consider" Phased Proposal 4.2 in its analysis. In fact, MERC adopted a modified phased approach as reflected in the final as-negotiated PA. But MERC did not, as urged by Dr. Urban, slavishly "accept" Phased Proposal 4.2 as proposed. As described in Ms. Mead's Surrebuttal Testimony, Phased Proposal 4.2 (as proposed) contained two problems: (1) the new capacity would be provided at TBS 1B, which is not where MERC has experienced substantial growth and (2) the timing of the second phase was too late to meet MERC's needs.[146] As a result, it would not have been prudent for MERC to simply "accept" Phased Proposal 4.2 without modification as urged in Dr. Urban's testimony.

Nevertheless, MERC recognized that Phased Proposal 4.2 contained features that were attractive. It spread the work over time and resulted in modest cost savings compared to the base-case Proposal 3.0. Further, NNG agreed to a fixed price schedule for Phased Proposal 4.2 to give MERC price certainty. As a result, in negotiating the final PA, MERC took a hybrid approach that essentially took the best features of a number of NNG's proposals, including base-

[143] Ex. 28 at 3 (Sexton Opening Statement).

[144] Evidentiary Hearing Transcript, Vol. 1 at 175:19-176:1 (Urban) ("Q.… Would you agree with me that under the Northern package of bids as proposed, … that would allow MERC to stop and not implement the second phase, … came with the price risk that the second phase would be at actual costs at the time incurred? A. Yes.").

[145] *See generally* Ex. 20 at Schedule TCS-R1 (Sexton Rebuttal Schedules) (Response to Department IR 37) (discussing in detail the various NNG proposals and the price risk inherent in the phased proposals that allowed MERC to forego the second phase).

[146] Ex. 16 at 16-17 (Mead Surrebuttal).

case Proposal 3.0 and Phased Proposal 4.2. This hybrid approach resulted in MERC obtaining (1) fixed cost certainty, (2) a phased approach, (3) timing of delivery that met MERC's needs, and (4) delivery of gas to the new TBS where MERC needed it most.[147]

In an effort to provide a complete record, MERC took the additional step of retaining Mr. Sexton to provide an independent analysis of the bids and to determine whether the negotiated PA reflected the best and least-cost alternative available. Mr. Sexton's review confirmed that NNG's base-case proposal was fully compliant with the requirements of the RFP and Proposal 3.0 was about $50 million cheaper than the other suppliers.[148] Mr. Sexton concluded that MERC properly took elements of other NNG bids and converted Proposal 3.0 into a fixed-price phased-in proposal that resulted in an additional $7.3 million in savings to customers.[149]

During the course of the proceeding, the Department asked MERC to provide a good-faith estimate of the relative cost if MERC had initiated a series of smaller incremental expansions to meet long-term growth requirements. The Department indicated that additional analysis of potential alternatives would enhance the record and would aid in the assessment of whether the selected project was the most reasonable alternative proposed on the record. MERC provided that analysis in a supplemental response to Department Information Request No. 37.[150] As discussed in that Supplemental Response, an incremental approach would have cost approximately $8 million (NPV) more compared to the approach that was taken by MERC. If

[147] Evidentiary Hearing Transcript, Vol. 1 at 145-147 (Sexton) (describing MERC's process for developing a hybrid approach).

[148] Ex. 17 at 42:1-5 and 45:8 (Sexton Direct).

[149] Ex. 17 at 46:5 (Sexton Direct).

[150] Ex. 20 at Schedule TSC-R1 (Sexton Rebuttal Schedules).

MERC were to have limited the expansion capacity to 30,000 Dth/day, it would have increased the costs by approximately $1 million (NPV).[151]

The record developed in this proceeding fully supports the conclusion that the Project, as proposed, is the best and least-cost alternative to meet the demonstrated need in the Rochester area and should therefore be approved.

B. The Resulting Reserve Margin Is Reasonable.

Given the long lead times and fixed costs associated with construction of interstate pipelines, increases in interstate pipeline capacity tend to result in uneven infrastructure development.[152] Pipeline counterparties rarely accommodate capacity additions that just keep pace with increased customer demand, particularly where construction is required to provide the additional capacity.[153] Instead, capacity expansions require purchases of increments that may exceed customer growth for several years. Although it may take time to grow into the added capacity, the economies of scale from larger projects are expected to offset this concern.[154]

It is far more cost effective to build a larger facility to accommodate for future growth than to continually accommodate capacity additions to keep pace with current demand. As a result, there are larger capacity reserve margins in the years directly after the capacity addition. The negotiated capacity addition was the best and least-cost option, even given the higher short-term capacity reserve margins relative to a smaller or phased approach.[155]

Further, under the circumstances, it is most appropriate to view the reserve margin in the context of the entire MERC NNG PGA. The Department and the Commission have always

[151] Ex. 20 at Schedule TSC-R1 (Sexton Rebuttal Schedules).

[152] Ex. 5 at 32 (Lee Direct).

[153] Ex. 12 at 26 (Mead Direct).

[154] Ex. 12 at 26 (Mead Direct).

[155] Ex. 12 at 27 (Mead Direct).

reviewed demand entitlements, design day requirements, and reserve margins on a PGA-wide basis. This is largely due to the nature of the interstate pipeline system and the ability to move natural gas to alternative delivery points within that system. As discussed by Ms. Mead during the Evidentiary Hearing, "MERC will have the ability to use up to 20 percent of the *total* Rochester existing and expansion entitlement and 100 percent of the Southeastern Minnesota expansion entitlement (nearly 53 percent of the total expansion volume) on an alternative basis to locations throughout MERC's service area on NNG's system."[156]

When considering the additional NNG capacity from the broader perspective of MERC's entire NNG PGA area, the additional capacity does not result in an unreasonable reserve margin. As shown in the Direct Testimony of Ms. Mead, the design day reserve margin in Winter Period 2019/20 is about 17 percent, declining substantially to less than 6 percent by 2026/27.[157]

Under the circumstances, an initial 17 percent reserve margin is reasonable. Department witness Mr. Heinen explained that there can be a range of acceptable or reasonable reserve margin levels. "For example, as I discussed in my Direct Testimony, MERC's proposal is reasonable to meet the current and expected need for the Rochester area and MERC's system, given the facts in this proceeding."[158] Mr. Heinen conducted an analysis of the reserve margin and found that

> although the excess capacity costs appear large . . . it is important to put these costs into the context of annual demand and commodity costs. On an annual basis, MERC purchases approximately $24 million of demand and approximately $120 million commodity costs, while the average amount of excess capacity may cost approximately $3 million, which means that the

[156] Ex. 27 at 2 (Mead Opening Statement) (emphasis added).

[157] Ex. 12 at 24-25 (Mead Direct).

[158] Ex. 406 at 2-3 (Heinen Rebuttal).

> excess capacity costs may approach 2.5 percent of the total PGA costs incurred.[159]

Mr. Heinen concluded, therefore, that the size of the Project was reasonable.[160]

The OAG's alternative conclusion that the resulting reserve margin is too high is without merit. The OAG incorrectly focuses its analysis only on the Rochester area, despite the fact that the PA allows for a significant portion of the contracted capacity to be utilized at alternative delivery points. Additionally, the OAG's baseline premise that any reserve margin in excess of five percent is de facto unreasonable, regardless of the facts and circumstances, would be untenable. The record developed in this case demonstrates that pipeline counterparties simply do not accommodate construction of small capacity additions that merely keep pace with increased customer demand. Further, MERC submitted substantial analysis demonstrating that a smaller incremental approach would have resulted in significant additional cost to MERC customers.

C. MERC Will Mitigate Costs of Capacity in the Near Term.

MERC has also committed to take additional steps to mitigate the overall costs of the Project by actively participating in the capacity release market and exploring long-term capacity release contracts in order to mitigate near-term costs of capacity.[161] Through negotiations of the PA and sizing of the Project, MERC also anticipates the possibility of mitigating some MERC system-wide costs by redirecting up to 20 percent of its Rochester capacity entitlement to other delivery points on MERC's NNG PGA.

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[159] Ex. 405 at 35-36 (Heinen Direct).

[160] Ex. 405 at 36 (Heinen Direct).

[161] Ex. 13 at 10-11 (Mead Rebuttal); Ex. 27 at 3 (Mead Opening Statement) ("MERC is active on the capacity release market and is committed to continue to release capacity in the market when it deems there is not an operational need for it. MERC has also agreed to evaluate the availability and feasibility of entering into longer-term capacity release contracts. While MERC is committed to try to obtain the highest compensation the market will allow for released capacity, the nature of the capacity release market likely will mean that released capacity would be sold at a discount relative to what MERC must pay for it. This is because of the nature of interstate capacity markets and the fact that open access requirements substantially limit MERC's ability to extract higher capacity release prices.").

1. MERC Will Actively Participate in the Capacity Release Market.

In Mr. Heinen's Direct Testimony, the Department expressed concern that MERC's transport customers may benefit from the additional capacity added by NNG's pipeline upgrades but may not be charged for the costs associated with the Project.[162] MERC agrees that all customers receiving benefits should pay an appropriate share of the costs. However, MERC expressed concern with the proposal to charge NNG costs directly to transport customers through the PGA because those customers do not purchase either their interstate capacity or natural gas commodity from MERC.[163] Additionally, MERC's transportation customers, which account for more throughput than any other customer class, are highly sensitive to volumetric rate increases and, because of their location, pose a bypass risk. If a customer bypasses MERC's system, its share of MERC's overall revenue requirement must be absorbed by MERC's remaining customers, resulting in higher rates for all.[164]

MERC proposed that each "transportation customer would pay only for the per-therm charges related to the improvements to MERC's distribution system, but not any portion of the NNG upgrade costs."[165] In Surrebuttal Testimony, Mr. Heinen clarified that the Department was not suggesting MERC's transport customers get charged NNG costs, but rather that the transportation customers may be charged if/when they purchase capacity on the NNG system when MERC sells capacity on the capacity release market.[166] As Ms. Mead acknowledges, the price that can be negotiated for capacity release prices is ultimately subject to market forces.[167]

[162] Ex. 405 at 49-50 (Heinen Direct).

[163] Ex. 6 at 21, 23-24 (Lee Rebuttal).

[164] Ex. 6 at 20-25 (Lee Rebuttal).

[165] Ex. 6 at 20 (Lee Rebuttal).

[166] Ex. 407 at 11 (Heinen Surrebuttal).

[167] Evidentiary Hearing Transcript, Vol. 1 at 100:14-101:10 (Mead).

MERC and the Department agree that transport customers "will pay for the Rochester Project to the extent that they purchase capacity on the NNG system when MERC sells capacity on the capacity release market."[168] MERC agrees "that transport customers should be charged at a level that appropriately reflects the benefits they will receive as a result of the overall project" and that MERC "will make every effort to obtain the best available contract terms for release of excess capacity acquired from Northern."[169] MERC also agrees with Mr. Heinen's recommendations regarding future AAA filing information.[170] MERC will provide specific data for each capacity release associated with the Rochester area so that the Department may review the release to determine whether the terms of the capacity release were consistent with market conditions.[171] This will allow MERC to mitigate near-term costs of capacity to the extent MERC is able to sell capacity on the capacity release market.

2. The PA Allows MERC to Redirect 20 Percent of the Capacity.

As discussed above, the negotiated PA allows MERC to redirect a significant portion of the capacity to alternative delivery points within NNG's market zone EF on an alternate basis at a fixed rate.[172] This provision will help mitigate near-term costs of capacity by allowing MERC to use up to 20 percent of its total Rochester capacity entitlement at any receipt point in MERC's NNG PGA with no price upcharge.[173] This means that about 20,000 Dth/day can be moved around the entire NNG system to any TBS, with the possible exception of Worthington which is

[168] Ex. 24 at 3 (Lee Opening Statement).

[169] Ex. 24 at 3 (Lee Opening Statement).

[170] Ex. 24 at 3 (Lee Opening Statement) (referring to Ex. 407 at 13-14 (Heinen Surrebuttal)).

[171] *See* Ex. 407 at 14 (Heinen Surrebuttal).

[172] Ex. 17 at 49 (Sexton Direct).

[173] Ex. 12 at 12 (Mead Direct).

subject to a unique capacity constraint.[174] The Parties generally agree that this provision is beneficial to MERC's ratepayers, both in the Rochester area and elsewhere.[175]

3. The Project May Avoid Other Infrastructure Projects.

The Project was designed to have sufficient capacity in the long-term to ensure that MERC does not have seek additional and potentially duplicative infrastructure in the foreseeable future.[176] The Project also helps free up capacity on the NNG system that can be used by MERC customers at other delivery points that are not physically constrained.[177] In other words, the Project will have beneficial impacts throughout the NNG system and help mitigate future capacity costs by making more capacity available, thereby reducing MERC's capacity needs elsewhere on the system.[178] This system-wide benefit has the potential to avoid or defer construction of additional capacity and/or additional distribution system infrastructure upgrades elsewhere on MERC's system.[179]

D. <u>The Project Should Be Approved.</u>

As discussed in detail above, MERC has fully demonstrated that the Project, as proposed, is reasonable and prudent. In accordance with the NGEP Statute, the Commission should make a determination with respect to the prudence of the Project and estimated costs. While the costs provided in this record are estimates and actual costs incurred will not be established until a future rider filing or rate case, regulatory concurrence that the Project and estimated costs of the project, as proposed, are reasonable and prudent, is appropriate and consistent with the NGEP

[174] Evidentiary Hearing Transcript, Vol. 1 at 104:12-25 (Mead).

[175] Ex. 402 at 13 (Ryan Direct); Evidentiary Hearing Transcript, Vol. 1 at 174:14-16 (Urban) (agreeing that allowing a captive customer to redirect capacity on its system is better than the FERC-approved maximum tariff rate).

[176] Ex. 27 at 3 (Mead Opening Statement).

[177] Ex. 12 at 23-24 (Mead Direct).

[178] Ex. 12 at 23-24 (Mead Direct).

[179] Ex. 6 at 13-14 (Lee Rebuttal).

Statute.[180] The Commission and other interested parties will have the opportunity in future rider and rate case filings to review (1) what costs were incurred; (2) whether those costs were prudently incurred in furtherance of the Project; and (3) whether any deviations from the proposed costs were justified under the circumstances.

VI. MERC'S PROPOSED RATE DESIGN IS REASONABLE.

MERC has proposed to recover its costs for upgrades to its distribution system in Rochester as part of the Rochester Project through a combination of base rates and rider recovery under the NGEP Statute, Minn. Stat. § 216B.1638, across all MERC customers.[181] Additionally, MERC is proposing to recover the costs of the NNG upgrades through the commodity portion of the NNG-PGA from all firm and interruptible system sales customers on the NNG-PGA. While MERC and the Department are in agreement that the Project qualifies for recovery under the NGEP Statute,[182] and also agree with respect to the proposed rate recovery of the NNG capacity costs,[183] the Department has proposed an alternative rate design for the recovery of MERC's Project costs under the NGEP Rider.[184] MERC continues to believe equal allocation of these

[180] MERC's estimate of $44 million for MERC system upgrades should be considered the baseline against which actual circumstances should be measured. MERC and the Department agree that the $44 million estimate for MERC system upgrades may be treated as a "soft cap" and that MERC retains the burden of proving that costs in excess of the estimated $44 million are reasonable. MERC agrees it is appropriate that any "soft cap" include MERC's calculated contingency, which represents 20 percent of MERC's total proposed Rochester Phase II Project costs. Twenty percent is the standard contingency that MERC uses in capital cost estimates and is a reasonable contingency level that has been used by others in the natural gas construction arena. MERC notes that in Surrebuttal Testimony, Department witness Mr. Heinen proposed that the "soft cap" should not include MERC's 20 percent contingency, but during the Evidentiary Hearing, Mr. Heinen revised his recommendation to propose the soft cap include the contingency. Evidentiary Hearing Transcript, Vol. 2 at 10:24-25 and 11:1-2 (Heinen).

[181] Ex. 5 at 21 (Lee Direct).

[182] Ex. 405 at 45-46 (Heinen Direct).

[183] Ex. 24 at 2-3 (Lee Opening Statement); Ex. 410 at 5 (Heinen Opening Statement).

[184] Ex. 400 at 3 (Peirce Direct); Ex. 401 at 1-2, 5 (Peirce Surrebuttal).

costs across all MERC customers is a reasonable rate design outcome and a more appropriate policy outcome for the recovery of costs related to the Project.[185]

A. Recovery of Natural Gas Extension Project Rider Costs.

With respect to the proposed recovery of MERC's Rochester Project costs, MERC supports equal rider recovery from all MERC customers on a volumetric basis.[186] In contrast, Department witness Susan Peirce proposes that, with respect to the portion of Project costs to be recovered through the NGEP Rider, at least fifty percent of the revenue deficiency should be apportioned to MERC's Rochester area customers with the remainder to be recovered from non-Rochester customers.[187]

The basis for the Department's recommendation is primarily that the Rochester Project will most directly benefit customers in the Rochester area and, therefore, those customers should pay for a larger portion of the costs. But socialization of the costs of system integrity and reliability across all customers has generally been the policy and practice in Minnesota, and such policy is reasonable and appropriate to ensure all customers are provided with safe, adequate, and reliable natural gas service. During the Evidentiary Hearing, Ms. Peirce acknowledged she was not aware of any previously situation where the Commission has required customers from one portion of a utility's service territory to pay a greater percentage of the infrastructure costs than the rest of the customers in the utility's service area.[188]

1. The Rider Statute Specifies Recovery from All Customers.

MERC proposes to recover up to 33 percent of the Phase II costs of the Rochester Project pursuant to the NGEP Statute and requests that the natural gas infrastructure costs that flow

[185] Ex. 24 at 2 (Lee Opening Statement).

[186] Ex. 5 at 26 (Lee Direct); Ex. 24 at 2 (Lee Opening Statement).

[187] Ex. 401 at 8-9 (Peirce Surrebuttal).

[188] Evidentiary Hearing Transcript, Vol. 1 at 207-208 (Peirce).

through the rider be recovered from all of MERC's customers, as specified in Minn. Stat. § 216B.1638. Specifically, the NGEP Statute authorizes rider recovery from "all of the utility's customers, including transport customers."[189] The statutory language of Section 216B.1638 authorizes equal cost recovery from all customers consistent with the purpose for which the statute was recently adopted.

Further, the NGEP Statute suggests a policy preference for spreading costs of the Rochester Project to all customers across MERC's system, as Minn. Stat. § 216B.1638 illustrates a legislative intent to support the socialization of natural gas infrastructure projects across a utility's entire service territory to enhance service to inadequately served areas, such as Rochester. In enacting Minn. Stat. § 216B.1638, the Minnesota Legislature determined for the first time that natural gas expansion projects did not need to be self-supporting to be recovered across all customers. The NGEP Statute authorizes recovery of natural gas extension and expansion project costs from customers in other areas to support infrastructure development, and reflects a state priority to develop and expand access to natural gas in Minnesota. Creation of a separate Rochester area rate, as the Department suggests, would be directly contrary to this legislative intent.

2. MERC's Cost Allocation Is Supported by Precedent and Policy.

MERC's proposed allocation across all MERC customers is consistent with past Commission precedent that generally treats system integrity and reliability projects as general rate base projects to be recovered from all customers through rate base. This policy has been the case even for projects that occur in a specific community or geographic region. As discussed in MERC witness Ms. Amber Lee's Direct and Rebuttal Testimonies, MERC undertakes capital

[189] Minn. Stat. § 216B.1638, subd. 2(a).

projects each year that repair, replace, or upgrade portions of the distribution system in various service areas across Minnesota to ensure continued safe and reliable natural gas service to all firm service customers.[190] These previous and ongoing system integrity projects that address aging infrastructure and system reliability issues have historically been included in rate base and are spread across all MERC ratepayers regardless of the location of the specific project or the customers directly served by those projects. Other Minnesota natural gas utilities have similarly included such system integrity projects in rate base for recovery from all customers.[191]

As a system integrity and reliability project, the Rochester Project can be considered similar to other infrastructure projects included in rate base and recovered through base rates. Many of these upgrades are necessary to modernize MERC's distribution infrastructure and are therefore comparable to the many other system repairs and upgrades MERC makes every year. And to the extent the Rochester Project is unique in that it is also expanding MERC's natural gas distribution system in order to meet growing demand, the NGEP Statute suggests a policy preference for spreading costs of the Rochester Project to all customers across MERC's system.

3. All Customers Benefit from the Rochester Project.

The Department has indicated that it is in agreement that all of MERC's customers "benefit in some way from this particular project."[192] Nevertheless, the Department concludes

[190] Ex. 5 at 22-23 (Lee Direct) ("For example, in MERC's 2010 rate case, Docket No. G007,011/GR-10-977, MERC included approximately $7 million in capital costs for 2010 and 2011 for main replacement in southeastern Minnesota in its rate base. Those capital costs were approved and recovered from all customers through base rates."); Ex. 6 at 11 (Lee Rebuttal).

[191] For example, CenterPoint Energy has included reinforcement projects to maintain adequate pressure and support additional load demands on its system that result from growth and rehab/replacement in capital growth included in rate base. *See generally In the Matter of the Application of CenterPoint Energy Res. Corp., d/b/a CenterPoint Energy Minn. Gas for Auth. to Increase Nat. Gas Rates in Minn.*, Docket No. G008/GR-13-316, DIRECT TESTIMONY, SCHEDULES, AND WORKPAPERS OF CENTERPOINT ENERGY WITNESS KIRK R. NESVIG (Aug. 2, 2013).

[192] Evidentiary Hearing Transcript, Vol. 1 at 208 (Peirce).

that its rate design recommendation for allocation of rider costs is justified because Rochester customers benefit more directly.

All of MERC's customers benefit from the addition of new customers. As Ms. Lee stated in her Rebuttal Testimony, the Rochester Project will allow MERC to continue to add new customers and load in the southeastern area of Minnesota, which in theory will allow MERC to spread its costs over more customers and reduce costs for the Company's existing customers.[193] Customers also benefit because the Rochester economy, which is dependent on a reliable natural gas supply, is an economic driver for the State of Minnesota as a whole. All Minnesota citizens will benefit from the continued growth of tax revenues from the Rochester area.

Additionally, customers throughout the state could benefit from the availability of capacity that would obviate the need for future infrastructure upgrades on MERC's distribution system. For example, the robust construction contemplated with the Rochester Project provides all customers with the potential to avoid or defer construction elsewhere on the system. The NNG PA allows MERC to move up to 20 percent of its NNG capacity to alternative locations. As Department witness Mr. Adam Heinen correctly observed in his Direct Testimony, the presence of excess capacity in and around Rochester may assist in mitigating other construction.[194] In fact, Mr. Heinen noted that it may be more cost effective for MERC to redirect excess capacity (at maximum rates) than it would be to build infrastructure projects elsewhere.[195] Consistent with Mr. Heinen's observation, the Company will certainly consider the viability and cost-effectiveness of redirecting excess capacity as an alternative to future

[193] Ex. 6 at 13 (Lee Rebuttal).

[194] Ex. 405 at 48:12-20 (Heinen Direct).

[195] Ex. 405 at 48:15-18 (Heinen Direct).

construction projects – a feature that provides benefits to all customers that suggests it is appropriate to spread costs across the entire rate base.

4. Separate Geographic Rate Zones Would be Unreasonable.

A disproportionate split, like the one proposed by the Department, would effectively create separate rate zones within MERC's system. This would be inconsistent with the Commission's stated preference that MERC move toward a single, unified system. In Docket No. G007,011/GR-10-977, the Commission approved MERC's proposal to consolidate four of its PGAs into two, and two separate operating divisions into one, concluding: "The consolidation proposal reasonably results in a system that more directly matches MERC's operations, and reduces MERC's costs of administering its PGA systems."[196] Similarly, in approving MERC's purchase of the Albert Lea assets from Interstate Power & Light Company ("IPL"), the Commission was clear that it preferred, long term, to have the former IPL customers become fully integrated into MERC's unified system.[197] While cognizant of the transition period required to integrate former IPL customers into MERC's rate structure, the Commission required that MERC work toward integration in its pending rate case, Docket No. G011/GR-15-736, and MERC has proposed a plan for the integration of the former IPL customers. The creation of a functionally separate rate zone for Rochester is inconsistent with the Company's and the Commission's shared goal of integrating MERC's customers into a common rate structure.

Not only does the creation of separate rate zones contradict Commission preference, it is also inconsistent with Minn. Stat. § 216B.03. Section 216B.03 generally precludes rates that are "unreasonably preferential, unreasonably prejudicial, or discriminatory." Such rates would result

[196] *In the Matter of the Application of Minn. Energy Res. Corp. for Auth. to Increase Rates for Nat. Gas Serv. in Minn.*, Docket No. G007,011/GR-10-977, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 36 (July 13, 2012).

[197] *In the Matter of a Request for the Approval of the Asset Purchase and Sale Agreement Between Interstate Power and Light Co. and Minn. Energy Res. Corp.*, Docket No. G001,G011/PA-14-107, ORDER APPROVING SALE SUBJECT TO CONDITIONS at 6 (Dec. 8, 2014).

if the Department's proposal for separate rate zones were approved. Minn. Stat. § 216B.03 further explicitly recognizes that "[f]or rate-making purposes a public utility may treat two or more municipalities served by it as a single class wherever the populations are comparable in size or the conditions of service are similar." MERC has recently consolidated its operating companies and PGAs and prefers that this proceeding not distinguish a new rate zone that imposes rate disparities among the Company's customers and adds administrative expense.

Further, a 50/50 split increases the cost disproportionately to Rochester customers. In response to the Department's request, MERC prepared a complete bill impact analysis.[198] The result of MERC's analysis demonstrated that the 50/50 split substantially increases the bill impact to Rochester customers. On a percentage basis, the rider increase is over 300 percent for customers in the Rochester area compared to MERC's proposed rate design. And because of the overall size of MERC's system, the bill impact to the Company's other customers is substantially reduced by approximately half. MERC's analysis suggests that spreading the cost of the Project over the entire rate base is an appropriate way to mitigate the rate increase for all customers.

It is most appropriate to charge the cost across its system on a unified basis from the beginning. A disproportionate split creates separate rate zones within MERC's system and it is best for a utility system to operate on a consolidated basis for the benefit of all customers.

B. Recovery of NNG Upgrade Costs.

With respect to the recovery of NNG's costs to upgrade its interstate pipeline system in order to provide additional capacity to the Rochester area, MERC proposes to recover those capacity costs through the PGA from all customers on the NNG-PGA. In Rebuttal Testimony, MERC indicated agreement with the Department's recommendation to recover the NNG

[198] Ex. 6 at Schedule ASL-R1 (Lee Rebuttal).

capacity costs through the commodity portion of the PGA, which would ensure recovery of those costs from both firm and interruptible system sales customers.[199] MERC and the Department are also in agreement that while transport customers should be charged at a level that appropriately reflects the benefits they will receive as a result of the overall Project, those customers do not purchase either their natural gas commodity supply or interstate natural gas transportation services from MERC. Therefore, transport customers cannot be charged any portion of NNG upgrade costs through the PGA. Rather, those customers will pay for the NNG upgrade costs to the extent that they purchase capacity on the NNG system when MERC sells capacity on the capacity release market. MERC has indicated its intent to make every effort to obtain the best available contract terms for release of excess capacity acquired from NNG but has also clarified that the nature of the capacity release market makes it unlikely MERC will obtain maximum rates for any of the released capacity.

In Surrebuttal Testimony and at the Evidentiary Hearing, Mr. Heinen clarified that the Department is not proposing to charge NNG costs to transport customers through the PGA. Rather, those customers will pay for the Rochester Project to the extent they purchase capacity on the NNG system when MERC sells capacity on the capacity release market.[200]

VII. CONCLUSION

Based on the record and the arguments, MERC requests that the Commission find MERC's Rochester Project reasonable and prudent and approve recovery of the Project through the NGEP Rider and recovery of NNG costs through the commodity portion of the NNG PGA.

[199] Ex. 6 at 24-25 (Lee Rebuttal).

[200] Ex. 24 at 3 (Lee Opening Statement); Ex. 407 at 10 (Heinen Surrebuttal); Ex. 410 at 5 (Heinen Opening Statement).

Dated this 11th day of October, 2016.

MINNESOTA ENERGY RESOURCES CORPORATION:

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In the Matter of a Petition by Minnesota Energy Resources Corporation for Evaluation and Approval of Rider Recovery for Its Rochester Natural Gas Extension Project	MPUC Docket No. G011/M-15-895 OAH Docket No. 68-2500-33191

CERTIFICATE OF SERVICE

I, Kristin M. Stastny, hereby certify that on the 11th of October, 2016, on behalf of Minnesota Energy Resources Corporation (MERC), I electronically filed a true and correct copy of the enclosed Initial-Post Hearing Brief on www.edockets.state.mn.us. Said documents were also served via U.S. mail and electronic service as designated on the attached service list.

Dated this 11th day of October, 2016.

/s/ Kristin M. Stastny
Kristin M. Stastny

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