MINNESOTA
PUBLIC UTILITIES COMMISSION

Staff Briefing Papers

Meeting Date	March 5, 2019	Agenda Item #5 **
Company	Minnesota Energy Resources Corporation (MERC)	
Docket No.	**G-011/M-18-460** **In the Matter of the Petition of Minnesota Energy Resources Corporation for Approval for Recovery of Natural Gas Extension Project Costs through a Rider and for Approval of a New Area Surcharge for the Pengilly Project**	
Issues	Should the Commission approve MERC's proposed Pengilly Project and the proposed cost recovery through MERC's approved New Area Surcharge (NAS) tariff and through a new Natural Gas Extension Project (NGEP) Rider?	

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✓ **Relevant Documents**	**Date**
MERC – Initial Pengilly Project Petition (TS)	June 29, 2018
Department of Commerce (Department) – Comments (TS)	October 29, 2018
MERC – Reply Comments (TS)	November 7, 2018
Department – Response to MERC's Reply Comments (TS)	November 30, 2018
MERC – Additional Reply Comments	December 10, 2018

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

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Statement of the Issue

Should the Commission approve MERC's proposed Pengilly Project and the proposed cost recovery through MERC's approved New Area Surcharge (NAS) tariff and through a new Natural Gas Extension Project (NGEP) Rider?

Introduction

MERC originally filed a Petition for Approval of a New Area Surcharge ("NAS") for the Pengilly Project on July 25, 2017, in Docket No. 17-566, but subsequently requested withdrawal of that Petition on March 12, 2018. MERC stated that it asked to withdraw the original 17-566 petition because the NNG interstate pipeline tap upgrades would not be completed until late 2018. The Commission approved the withdrawal request by Notice and Order dated March 28, 2018.

On June 29, 2018, MERC filed its revised petition for the Pengilly project, in this docket. MERC is requesting approval for its cost recovery proposal. Based on feedback from the Pengilly town board and potential customers, MERC has re-evaluated and revised the project's boundaries. In addition, MERC revised its cost recovery proposal to include both its NAS tariff and the NGEP Rider Statute, Minn. Stat. § 216B.1638.

In its revised petition, MERC requests Commission approval for its proposed recovery of uneconomic project costs:

- To recover a portion uneconomic project costs through its current NAS tariff over a 25-year term; and
- To recover the remaining uneconomic projects costs through its proposed NGEP Rider over a one-year term.

MERC stated that the amount of its requested cost recovery through the NGEP Rider is less than 33 percent of the project's investment costs (less than the maximum amount that may be authorized) pursuant to the NGEP Rider Statute.[1]

On October 28, 2018, the Department submitted comments and noted that it and the Commission have supported reasonable efforts by natural gas utilities to expand service to previously unserved areas. The Department deferred making its recommendation until MERC provided additional information in Reply Comments.

On November 7, 2018, MERC submitted its Reply Comments.

November 30, 2018, the Department filed its Response. The Department recommended the Commission approve MERC's Pengilly project with modifications. Specifically, the Department recommended Commission approval for MERC's proposed NAS charges and recovery term of

[1] The actual percentage MERC requested to recover through the NGEP Rider is less than 33%, but has been marked as **Trade Secret**. See MERC's Initial Petition, p.1.

25-years. However, the Department recommended a 48-year recovery term for costs allocated to the NGEP.

On December 10, 2018, MERC filed Additional Reply Comments.

Background

At present, certain areas of Minnesota do not have natural gas services available. These areas historically have used propane, heating oil, or wood as their primary heat source. Because of the 2013-2014 polar vortex conditions during that winter heating season, then Governor Mark Dayton issued Emergency Executive Order 14-02 in response to propane supply issues. The Order provided new emphasis on developing natural gas projects whether economical or uneconomical to serve un-served or inadequately served areas.

The Commission has previously determined that natural gas utilities' service line extensions must be economical at tariffed rates; existing customers must not unduly subsidize service line and main extensions for a new customer(s). For extensions longer than the line allowance, the customer is required to pay a Contribution In Aid of Construction (CIAC).

For uneconomical natural gas projects under current tariffed rates, the Commission approved New Area Surcharge (NAS) tariffs. This tariff required customer(s) in the new area to be responsible for the "uneconomic" costs of providing service to the area. By permitting a utility company to collect a NAS factor in addition to the tariffed rates, the project(s) become economical. In Docket No. 11-1045, MERC petitioned the Commission for approval of its NAS tariff proposal.[2] MERC's NAS was designed to permit MERC to extend service into these new areas where it was previously uneconomical to serve.

This petition represents MERC's sixth NAS petition, other petitions included Ely Lake (15-776), Detroit Lakes, Fayal/Long Lake (16-221), Balaton (16-654) and Esko (16-655).

Relevant Statute - Natural Gas Extension Project Rider Statute

In 2015, the Minnesota Legislature passed into law Minn. Stat. § 216B.1638. This statute allows public utilities to petition the Commission outside of a general rate case for a Natural Gas Extension Project Rider. The NGEP Rider, if approved, allows a utility to recover a portion of its natural gas extension project's revenue deficiency from all of the utility's customers, including transport customers. Thus, making natural gas extension project's more economical for the utility and its potential customers to serve these previously un-served or inadequately areas.

A copy of Minn. Stat. § 216B.1638 is attached to these briefing materials.

[2] The Commission's July 26, 2012 Order approved the NAS tariff provision.

Is MERC's proposal in compliance with previous Commission Orders?

MERC claims that its Initial Petition (18-460) information meets all the Commission requirements for its NAS tariff and NGEP Rider Statute. MERC provided its proposed clean and redline tariff sheet amendments in its Initial Petition, Exhibit A.

The Department determined that MERC complied with the filing requirements for Docket No. G007, 011/M-11-1045,[3] Minn. Rules Part 7829.1300, and Minn. Stat. §216B.1638.[4] [5] The Commission's July 26, 2012 Order in Docket No. 11-1045 required that any miscellaneous rate change filing for a specific NAS project shall include at a minimum:

- an updated surcharge tariff sheet and its related spreadsheets with and without the proposed surcharge for each new surcharge area;
- the work papers showing all underlying assumptions concerning interest rates, costs, depreciation, demographics, rate structure, etc.;
- a surcharge rate for each customer class, even if no customers are anticipated for the class;
- the Company's proposed customer notice; and
- all pertinent contract demand entitlement change requests as soon as the required information is ascertained.

Staff believes that MERC's Pengilly project is compliant with its NAS tariff, the NGEP Rider Statute and all previous Commission Order requirements, including the attached statute and the following:

- Prior Commission Order Requirements, i.e. Docket No. 16-221 Order requiring the removal of the CCRC rate from its distribution rate and giving each customer the proper service line extension allowance;
- MERC's NAS tariff's model;
- MERC's use of its current reserve margin, MERC has sufficient natural gas supply to support these two projects.

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[3] The Department concluded that MERC provided the information required by the Commission's July 26, 2012 Order.

[4] See the attached Relevant Statue for the filing requirements.

[5] See the Department's October 29th Comments, pp. 5-6, and Attachment A.

Are MERC's proposed Pengilly Project costs reasonable overall?

MERC's 18-460 petition discusses its project investment costs and further discusses its costs breakdown between MERC system costs and the Northern Natural Gas (NNG) upgrade costs. MERC believes its project investment costs are reasonable. [6]

In its October 29, 2018 Comments, the Department compared MERC's original Pengilly petition's project investment costs in the 17-566 docket (subsequently withdrawn) and to the revised project investment costs in the 18-460 docket. The Department noted the investment costs had doubled from the 17-566 petition's investment costs, while its customer count increased by a much smaller percentage. [7] The Department question whether this increase in project investment costs caused MERC's use of the NGEP Rider, thus making MERC's other system customers responsible for a portion of Pengilly project costs.

The Department stated that it cannot determine whether MERC's proposed 18-460 project investment costs are reasonable. The Department requested that MERC explain the project investment cost differences in the 17-566 and 18-460 dockets in Reply Comments.

In its November 7, 2018 Reply Comments, MERC stated that based on Pengilly town board and potential customer feedback, MERC decided to reevaluate the Pengilly project boundaries.[8] MERC worked with the township to obtain additional information regarding customer interest in converting to natural gas service.[9] MERC claims that as a result of the expanded Pengilly project scope the number of potential customers will increase. The customer will have the option of converting to natural gas service if they choose to do so.

To determine the reasonableness of the Pengilly costs, MERC compared these costs to the Balaton project costs (16-654) on a per customer basis. MERC believes that the Pengilly per customer costs are not dissimilar to the Balaton costs.[10] The Commission's February 9, 2017 Order in the 16-654 docket concluded that the Balaton project costs were reasonable and prudent.[11]

MERC believes that its previous experience with NAS projects result in the need to adjust the Pengilly assumptions and expectations for customer connections with regard to a reasonable

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[6] See MERC's Initial Petition, p. 9 and Exhibit C, marked as **Trade Secret**.

[7] See Department's October 29, 2018, pp. 7-11, Table 2, Table 3, Table 4.

[8] See MERC's June 29, 2018 Petition.

[9] The township conducted a survey of residents in order to determine interest in the Pengilly project.

[10] See MERC's November 7, 2018 Reply Comments, p. 4, Table 1, marked as **Trade Secret**.

[11] *In the Matter of the Petition of Minn. Energy Res. Corp. for Approval of Nat. Gas Extension Project Costs through a Rider and for Approval of a New Area Surcharge for the Balaton Project*, Docket No. G011/M-16-654, Order Approving Cost Recovery for New Area Surcharge Tariffs for Balaton and Esko Projects (Feb. 9, 2017) ; see also Docket No. G011/M-16-655 (same order provided in Esko project docket).

NAS charge. MERC decided to supplement its 18-460 Petition by recovering a portion of the project costs through an NGEP Rider surcharge under Minn. Stat. § 216B.1638. MERC states the proposed expanded Pengilly Project and associated costs are reasonable, prudent, and appropriate to expand natural gas service into an unserved area.

In its November 30, 2018 Response to Reply Comments, the Department compared all of MERC's NAS projects investment costs on a per customer basis to the Pengilly costs and determine that the previous NAS project's per customer costs were similar to the Pengilly costs.

Staff believes that the project costs issue raised by the Department is resolved between the parties. The Commission may wish to determine that the Pengilly project costs are reasonable.

Are the proposed NNG interstate pipeline system upgrades for the Pengilly Project reasonable?

MERC's project cost estimates included NNG system enhancement costs and the Pengilly natural gas distribution system costs. NNG pipeline system enhancements are necessary to enable MERC to have additional gas supply delivered to its proposed receipt points.

MERC expects to use its existing NNG transportation contracts (demand entitlements) to transport the additional natural gas supply, with no additional NNG revenue. NNG is an open access interstate pipeline, but does not have an obligation to construct the necessary facilities, per Federal Energy Regulatory Commission (FERC) rules and regulations. MERC must pay NNG a CIAC to construct the additional facilities to make Pengilly deliveries. MERC proposes to recover a portion of the NNG's pipeline system enhancement costs through the NAS factor and the remaining portion of costs recovered through the NGEP Rider charge.[12] MERC's system-wide PGA mechanism will not be impacted by NNG's pipeline system enhancement costs.

The Department does not address how MERC should recover the NNG upgrade costs. Staff believes that the NNG enhancement costs are eligible for recovery. The Commission will need to decide how these costs will be recovered.

Is MERC's proposal for Cost Recovery Mechanisms reasonable?

The Pengilly project cannot proceed under MERC service line extension tariff provision because the project is uneconomical and would unfairly shift costs to all other system customers. MERC proposes to charge Pengilly customers the following combination of rates; base rates pursuant to its tariff, a NAS Rider surcharge, and a NGEP Rider Surcharge. The base rates and NAS Rider surcharge components will recover a portion of the uneconomical investment costs from the Pengilly area customers. The NGEP would recover the remaining investment costs from all system customers, sales and transportation. Staff notes that these rate components are cumulative.

[12] See MERC's Initial Petition, p. 9, marked as **Trade Secret**.

Are the Balaton and Esko Projects in the Public Interest?

MERC believes that the proposed NAS project is in the public interest due to the lower cost of natural gas as compared to alternative fuel sources and the flexibility that the availability of an additional fuel choice brings to potential customers in Pengilly.

The Commission will have to decide whether the Pengilly project is in the public interest. Based on then Governor Dayton's Executive Order 14-02, giving un-served customers the ability to convert from their current alternative fuel (such as propane, electric, wood, and others) to natural gas would provide customers with a benefit. The Department did not directly address whether the Pengilly project was in the public interest.

The Pengilly project appears to be in the public interest because these customers will have an additional fuel alternative that could save them money. Also, the proposed Pengilly project is compliant the Governor's Executive Order.

Cost Recovery through Base Rates

MERC will charge Pengilly customers its current effective base rates for natural gas services just as any other customer. The Department believes this cost recovery mechanism is consistent with MERC's other NAS projects. Staff believes charging the Pengilly customers the current effective base rates is reasonable.

Cost Recovery through the NAS Rider Charge

MERC requested Commission approval for its sixth NAS Rider charge. The Commission's July 26, 2012 Order in Docket No. 11-1045, *Approving New Area Surcharge with Modifications and Requiring Revised Tariff Sheet* outlined the intent of the NAS Rider.[13]

> *New Area Surcharge (NAS) is designed to permit a natural gas company to extend service into a new area it would be uneconomic to serve at tariffed rates, by permitting the company to collect a surcharge in addition to the tariffed rate. This makes natural gas available to communities previously not served by a natural gas utility without imposing the costs of expansion on existing ratepayers.*

MERC states that in its previous approved NAS projects, MERC, the Department, and staff have proposed NAS model and approach refinements for setting NAS Rider charges to ensure the projects are successful, and the surcharges are fair and reasonable. MERC states that it used its tariffed NAS model, and that its proposed NAS charges are similar to previous NAS charges and are reasonable. See Table 1 for MERC proposed Pengilly NAS Rider charges:

[13] The MERC's NAS Rider tariff delineates the process under which it can extend natural gas service into an area. The tariff criteria is: 1) MERC does not currently provide natural gas distribution service in the area identified; 2) it would be uneconomic to serve the area at the Company's current tariffed rates.

Table 1: MERC's Proposed Monthly NAS Rider Charges (25-year term)

Customer Classes	Monthly NAS Rider Charge
Residential	$24.70
Small Commercial and Industrial	$46.82
Large Commercial and Industrial	$117.07
Small Volume Interruptible	$429.23
Large Volume Interruptible	$481.27

MERC designed its proposed residential NAS charge, to recover a reasonable portion of the project's uneconomical investment costs. [14] MERC calculated the remaining customer classes' NAS charges by using the customer charge allocation method approved in MERC's previous petitions to establish additional customer classes' NAS charges for the Detroit Lakes—Long Lake Project, Ely Lake Project, and Fayal Project. [15] [16] [17] MERC believes that the NAS charges are set at a reasonable level that will ensure customers make reasonable decisions to switch to natural gas service.

MERC proposes a NAS cost recovery period of 25-years.[18] MERC states that it will terminate the NAS charges when the projected revenue deficiency (uneconomical costs) is recovered or at the end of twenty-five years, whichever occurs first. MERC assumes any under-collection responsibility assuming the project does not attract MERC's customer count projections.[19]

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[14] See MERC's Initial Petition, pp. 8-9 for MERC's discussion on residential NAS surcharges, marked as **Trade Secret**.

[15] *See In the Matter of the Petition of Minn. Energy Res. Corp. for Approval for Recovery of Nat. Gas Extension Project Costs through a Rider and for Approval of a New Area Surcharge for the Balaton Project*, Docket No. G011/M-16-654, Petition for Approval of Natural Gas Extension Project Rider and New Area Surcharge at 11 (Aug. 2, 2016); *In the Matter of the Petition of Minn. Energy Res. Corp. for Approval for Recovery of Nat. Gas Extension Project Costs through a Rider and for Approval of a New Area Surcharge for the Esko Project*, Docket No. G011/M-16-655, Petition for Approval of Natural Gas Extension Project Rider and New Area Surcharge at 11 (Aug. 2, 2016).

[16] *In the Matter of Petitions of Minnesota Energy Resources Corporation for Approval of a Tariff Revision and Additional New Area Surcharge Customer Classes for the Ely Lake Project* (Docket No. G011/M-17-211), *Detroit Lakes-Long Lake Project* (Docket No. G011/M-17-210), and *Fayal Township Long Lake Project* (Docket No. G011/M-17-212), Order Approving New Area Surcharge and Requiring Compliance Filing (Sept. 18, 2017).

[17] MERC believes that approval for all customer classes prior to the commencement of a project is essential because circumstances frequently change and new customer participation benefits all participants in an NAS project.

[18] If gas service and billing to the Pengilly area commences in 2019, the surcharge would terminate in 2044.

[19] For project details, see MERC's Initial Petition, p. 6 and Exhibit B (map), marked as **Trade Secret**.

In its October 29, 2018 Comments, the Department stated that MERC concluded that the Pengilly project is financially viable only if the NAS charge for the residential class is set between $24 and $25 per month, and the other rate classes set accordingly, over no more than a 25-year period.[20] The Department noted that MERC's proposed Pengilly rates for the NGEP rider and NAS rider effectively allocate the project costs between customers in Pengilly and all ratepayers, with any unrecovered costs being borne by MERC's shareholders.

In its November 7, 2018 Reply Comments, MERC continued to support its proposed NAS Rider rate design.

In its November 30, 2018 Response, the Department recommended that the Commission approve MERC's proposed Pengilly New Area Surcharges and the proposed 25-year NAS term to recover its project investment.

MERC appears to have used a round-robin approach to determine its residential Pengilly NAS charge that produced its pre-determined $24 - $25 result for the Pengilly NAS charge. MERC is of the opinion that the Pengilly project will not be competitive if MERC is required to recover the project costs through just the NAS charge. Staff believes that MERC's marketing personnel are in the best position to determine a reasonable residential NAS rate to make the project competitive with other fuel alternatives available in the Pengilly area. Staff compared MERC's previous approved NAS charges to the Pengilly project, see Table 2:

Table 2: Comparison of Pengilly Charges to Other MERC NAS Projects

	Ely Lake	Detroit Lakes	Fayal	Esko	Balaton	Pengilly
Residential	$25.45	$19.16	$21.16	$24.18	$24.14	$24.70
Small Commercial	$25.45	$36.30	$40.09	$45.81	$45.75	$46.82
NAS Term	20-years	15-year	20-year	25-year	25-year	25-year

The average residential NAS charge for MERC's previous project is $22.82, with range from $19.16 (Detroit Lakes) to $25.45 (Ely Lakes). The Pengilly NAS residential charge is within that range, but at the high end. Further, the Pengilly residential NAS charge of $24.70 is 8.24% higher than the average of the previous five NAS projects ($22.82), which appears to be reasonable.

Staff believes that all NAS Rider issues between the Department and MERC have been resolved. Staff is in agreement with the Department's recommendations regarding the NAS charges and recovery term.

[20] See Department October 29, 2018 Comments, p. 11.

Proposed NGEP Rider Statute Cost Recovery and Proposed NGEP Rider Tariff Provision

1. MERC

MERC's Pengilly NAS charge recovers only a portion of the uneconomical project costs from just the Pengilly customers, the remainder is proposed to be recovered from all of MERC's system customers pursuant to Minn. Stat. §216B.1638 (the NGEP Rider Statute).[21] The NGEP Rider Statute provides that "[a] public utility may petition the Commission outside a general rate case for a rider that shall include all of the utility's customers, including transport customers, to recover the revenue deficiency (uneconomic portion of costs) from a natural gas extension project." The revenue deficiency of an NGEP is defined as:

> *The deficiency in funds that results when [1] projected revenues from customers receiving natural gas service as the result of a natural gas extension project, plus [2] any contribution in aid of construction paid by these customers, fall short of the total revenue requirement of the natural gas extension project.*[22] [23]

The 18-460 petition represents MERC's third attempt to recover project costs through both the NGEP Rider Statute and through its NAS tariff, by allocating costs. In Docket Nos. 16-654 (Balaton) and 16-655 (Esko), MERC proposed to recover a percentage of these project costs through a NGEP Rider surcharge over a one-year period.

[Staff note: The Commission did not grant MERC authority to recover its proposed Esko and Balaton costs through the NGEP Rider Statute over the proposed one-year recovery period. Instead, the Commission granted MERC authority to defer these project costs (through a settlement process between MERC, the Department, and staff) and seek recovery in MERC's next rate case, Docket No. 17-563.]

In this docket (18-460), MERC again proposes a one-year recovery term. Instead of proposing to recover a certain percentage of project costs in a one-year period, MERC is proposing to recover the net present value of the project's 48-year cost stream in one year. MERC allocated a portion of the Pengilly investment costs to the NGEP Rider and divided that amount by 48-years (project life) to calculate the cost stream. The net present value was calculated using MERC's last approved Rate of Return (6.4141%) from the 15-736 docket. MERC divided the net

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[21] MERC's Initial Petition, p. 9, marked as **Trade Secret**.

[22] Minn. Stat. § 216B.1638, subd. 1(f). The "total revenue requirement" of a project means "the total cost of extending and maintaining natural gas service to a currently unserved or inadequately served area." Id., subd. 1(g).

[23] The calculation of the revenue deficiency "must include [1] the currently authorized rate of return, [2] incremental income taxes, [3] incremental property taxes, [4] incremental depreciation expenses, and [5] any incremental operation and maintenance costs." Minn. Stat. § 216B.1638, subd. 3(d).

present value amount by the sales forecast from the 15-736 docket to develop the proposed NGEP Rider per therm charge of $0.00013 that would be applied to all the MERC's customers.[24]

MERC believes that it proposed net present value methodology differs from what it proposed with the Esko and Balaton Projects to address concerns regarding recovery of the proposed project costs over a single year.

In addition, MERC proposed a new NGEP tariff provision defining its service under the Rider Statute. MERC's Initial Petition includes Original Sheet 9.20 through 9.22 explaining its NGEP proposal.[25]

MERC states that it has complied with Minn. Stat. § 216B.1638, Subdivision 2 filing requirements:

(1) a description of the natural gas extension project, including the number and location of new customers to be served and the distance over which natural gas will be distributed to serve the unserved or inadequately served area;[26]
(2) the project's construction schedule;[27]
(3) the proposed project budget;[28]
(4) the amount of any contributions in aid of construction;[29]
(5) a description of efforts made by the public utility to offset the revenue deficiency through contributions in aid to construction;[30]
(6) the amount of the revenue deficiency, and how recovery of the revenue deficiency will be allocated among industrial, commercial, residential, and transport customers;[31]
(7) the proposed method to be used to recover the revenue deficiency from each customer class, such as a flat fee, a volumetric charge, or another form of recovery;[32]
(8) the proposed termination date of the rider to recover the revenue deficiency; and[33]
(9) a description of benefits to the public utility's existing natural gas customers that will accrue from the natural gas extension project.[34]

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[24] MERC's NGEP Rider calculation is discussed in its Initial Petition, pp. 8-11, also see MERC's NGEP Rider Calculation table on p. 10, and Exhibit C, all marked as **Trade Secret**.

[25] See MERC's Initial Petition, Exhibit A, Original Sheet 9.20 through 9.22.

[26] See MERC's Initial Petition, pp. 6-7, marked as **Trade Secret**.

[27] Ibid, p. 6.

[28] Ibid, pp. 8-10, marked as **Trade Secret**.

[29] Ibid, pp. 7-8, marked as **Trade Secret**.

[30] Ibid, p. 8, marked as **Trade Secret**.

[31] Ibid, p. 8, marked as **Trade Secret.**

[32] Ibid, p. 8, marked as **Trade Secret**.

[33] Ibid, pp. 11-12, marked as **Trade Secret**.

[34] Ibid, p. 12, marked as **Trade Secret**.

Further MERC states that it has complied with Minn. Stat. § 216B.1638, Subdivision 3 that provides the Commission must not approve a rider that allows a utility to recover more than "33 percent of the costs of a natural gas extension project." MERC states that it has met the filing requirements.[35]

2. Department

In its October 29, 2018 Comments, the Department noted the MERC provided two different calculations illustrating that it met Minn. Stat. § 216B.1638, Subdivision 3 requirement that the project not exceed the 33% statutory cost limit, the All Project Costs and Revenue Deficiency Approaches. The All Project Costs Approach divided the allocated NGEP costs by the total project costs to obtain the percentage recovered. The Revenue Deficiency Approach divided the allocated NGEP costs by the project's revenue deficiency.[36]

The Department had concerns regarding the Revenue Deficiency Approach because the denominator of the calculation is the revenue deficiency. The Department believes MERC calculation is not an "apples to apples" comparison. The Department requested MERC explain it calculation in Reply Comments.

The Department noted that MERC provided three different options of calculating the NGEP Rider charges:

1) The net present value approach (MERC's preferred), resulting in the per therm charge of $0.00013, as discussed above;
2) MERC recovers the entire Pengilly project costs allocated to the NGEP through the rider charges during the first year the rider is in effect (similar to MERC's proposal for the Balaton and Esko project); and
3) MERC calculates a NGEP charges by dividing allocated Pengilly project costs by life of the extension project (48-years in this docket).

All three options would be divided by a denominator equal to MERC's last Commission-approved annual sales forecast.

The Department preferred the cost recovery mechanism in which the Pengilly project costs allocated to the NGEP and are recovered over the useful life of the extension project (Option 3, above). The Department believes that this cost recovery mechanism matches the time-period over which the benefits of the project accrue to ratepayers. MERC's other two proposals, provide for an "accelerated cost recovery" of the NGEP Pengilly project costs, which is inequitable in that only current ratepayers would be required to pay costs while future ratepayers receiving the benefits would not pay.

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[35] Ibid, p. 9, marked as **Trade Secret**

[36] See the Department's October 29, 2018 Comments, pp. 12-13, and Tables 5 and 6, marked as **Trade Secret**.

Further, the Department believes Minn. Stat. § 216B.1638 supports MERC's tariff request to include a definition for a "Natural Gas Extension Project" and also includes tariff language stating that a utility "may petition the Commission outside of a general rate case for a rider . . . to recover the revenue deficiency from a natural gas extension project".[37] The Minnesota Legislature passed the NGEP statute in 2015.

3. MERC – reply comments

In its November 7, 2018 Reply Comments, MERC continues to support its initial petition proposal for a one-year rider recovery based on its net present value of the NGEP allocated project costs (Option 1, above). MERC believes that because the bill impact of the proposed NGEP rider would be relatively small over the one-year recovery period, such a recovery period is reasonable and appropriate.[38]

MERC acknowledged the importance of matching the recovery of utility costs with the timing of benefits in the case of capital investments (the Department preferred approach - Option3, above). But, in this particular instance such an extended surcharge collection period (48-years) is administratively burdensome and unnecessary in terms of materiality. The Company would need to further evaluate whether to proceed with the Project based on administrative challenges of such a surcharge.[39]

MERC provided a response to the Department question concerning appropriateness of its Revenue Deficiency Approach for determining whether Minn. Stat. § 216B.1638, subdivision 3 requirement that cost recovery would not exceed the 33% statutory cost limit. MERC explained that it calculated the contribution in aid of construction (CIAC) that would be required for the proposed Pengilly project assuming no socialization of costs through an NGEP Rider. The calculated CIAC is the revenue required in the first year of the Project from customers participating in the NAS Project to fund the revenue requirement that is not recovered in the base rates. MERC stated that it provided this calculation for informational purposes and is not relevant to a finding that MERC's proposal complies with the requirements of the NGEP Rider Statute. The plain language of the NGEP Rider Statute limits NGEP Rider recovery to 33 percent of the costs of a natural gas extension project and its proposed NGEP recovery is well below that statutory limitation. [40]

4. Department – response comments

In its November 30, 2018 Response, the Department recommended that the Commission approve MERC's proposed Pengilly project with modifications. The Department continued to

[37] Minn. Stat. § 216B.1638, subdivision 2.

[38] See MERC's November 7, 2018 Reply Comments, p. 7.

[39] Ibid., pp. 6-7.

[40] This assumes no portion of the Project was socialized and recovered through an NGEP rider or collected via the NAS.

disagree with MERC's NGEP cost recovery proposal. The Department argued that NGEP provides an incentive to MERC by allowing rider recovery of a portion of the project's costs. MERC's proposal is inconsistent with ratemaking principles. Requiring current ratepayers to pay in one year for the project costs that will provide service over decades would unfairly assign costs of the project.

The Department noted that MERC stated that it would incur higher administrative costs due to recovering the costs allocated to the NGEP over a 48-year time period. However, since such recovery is consistent with how MERC recovers the costs of all facilities, MERC already recovers its administrative costs in base rates. The Department assumes that the NGEP-related costs included in the rider would be zeroed out in MERC's next general rate case and recovered in base rates. MERC did not discuss this in its Reply Comments - this approach would lower the MERC's administrative costs.

As a result, the Department recommended that the Commission approve it preferred 48-year recovery period for the allocated Pengilly NGEP project costs.

5. MERC – additional reply comments

In its December 10, 2018 Additional Reply Comments, MERC continue to support its preferred NGEP Rider surcharge of $0.00013 per therm over a one-year period based on the net present value of the NGEP allocation. MERC continues to believe that the Department preferred NGEP cost recovery method would cause an administrative burden to the Company.

MERC recognized that approval of the proposed recovery over a single year on a net present value basis as it proposed for the Pengilly Project would not obligate the Commission to approve the same methodology in future NGEP Rider proposals. The Commission has broad authority to evaluate the design of any future NGEP Rider surcharge rates on a case-by-case basis. In this case, however, MERC believes the balancing of various considerations presented weighs in favor of its proposed methodology.

6. PUC Staff - comment

Staff believes that through the various rounds of comments the Department and MERC have reached agreement on all issues with the exception of whether the portion of Project costs recovered through the NGEP Rider should be recovered over a single year based on the net present value of the NGEP portion of Project costs at a surcharge rate of $0.00013 per therm (MERC) or over the useful life of the extension Project (48 years) at a surcharge rate of $0.00001 per therm (Department).

Staff is of the opinion that MERC's Pengilly Project meets the Minn. Stat. § 216B.1638 requirement, in that, the project is designed to extend natural gas service to an unserved or inadequately served area, Pengilly, MN. Further, it appears that the parties are in agreement that the project costs are reasonable and will be prudently incurred.

Staff believes that the Commission should approve MERC's proposed Pengilly NAS charges to recover a large portion of the proposed project costs. The Commission will need to decide how MERC will recover the remaining costs assigned by MERC to the NGEP Rider Statute.

MERC proposed to recover a portion of Pengilly costs through the use of a one-year NGEP Rider charge. MERC argues that its proposed net present value method would not violate the 33 percent requirement in Minn. Stat. § 216B.1638, Subd. 3, which states

> (c) The commission must not approve a rider under this section that allows a utility to recover more than 33 percent of the costs of a natural gas extension project.

The Department disagreed with MERC's approach, and believes the project costs should be recover through a $0.00001/therm surcharge over a 48-year period. Staff believes that under the Department proposed methodology, if approved, MERC would collect a surcharge of $0.00001/therm from all MERC customers for the first year, and if the surcharge continues, MERC would be required to file another surcharge petition. If and when MERC would file its next general rate case, the remaining unrecovered NGEP project costs would be included in that petition.

Staff also reviewed MERC's petition for a NGEP Rider charge for the Rochester project approved in Docket No. 15-895. In the 15-895 docket, the Commission approved the use of a NGEP Rider, but not an actual rider. In Docket No. 18-182, MERC proposed its first Rochester NGEP Rider, MERC requested a rider surcharge of $0.00150/therm based on its projected 2019 revenue deficiency related to the Rochester project.[41] This calculation appears to be different than MERC's proposed calculation in this docket (18-460).

The difference between the MERC dockets is that the 18-460 docket uses the net present value of actual NGEP project costs to calculate a NGEP Rider charge, whereas, 18-182 docket used the 2019 revenue deficiency to calculate the NGEP Rider charge. Minn. Stat. § 216B.1638, Subd. 3(d), states

> (d) the revenue deficiency from a natural gas extension project recoverable through a rider under this section must include the currently authorized rate of return, incremental income taxes, incremental property taxes, incremental depreciation expenses, and any incremental operation and maintenance costs.

It appears to staff that MERC is inconsistent and believes costs materiality controls how the NGEP Rider charge is applied. The 18-460 Pengilly NGEP charge was appropriate because the amounts to be recovered through the rider were much smaller than the Rochester costs to be recovered through that NGEP Rider, so its 18-460 docket calculation methodology makes more sense.

[41] See MERC's Initial Petition in Docket No. 18-182, Appendix B.

MERC believes that the Minn. Stat. § 216B.1638 statutory language (see attachment) is clear and unambiguous[42] — the cap applies to the overall costs of the natural gas extension project. Staff is of a different opinion and believes the statutory language is unclear and ambiguous, thus allowing for the possibility of a different calculation. As staff understands the docket, it believes that MERC's NGEP Rider calculations should be consistent from one docket to another.

Staff also believes that another NGEP Rider Charge calculation option exists, how the Commission approved MERC's Balaton (16-654) and Esko (16-655) projects' NGEP Rider Charges. These were MERC's first two projects to attempt to recover project costs through its NAS tariff (Commission approved) and Minn. Stat. § 216B.1638 – the NGEP Rider Statute (MERC proposed). In these two dockets, MERC attempted to recover a percentage of project costs over a one-year period, thus accelerating its recovery of project costs at the expense of current ratepayers. MERC proposed to recover these costs over a one-year period even though it recovers the cost of similar assets over a 48-year period. By recovering project costs through the NGEP Rider over a one-year term, assuming first year recovery, MERC's customer count would be at its lowest point in these new area, therefore, other subsequent customers will not pay their fair share of the NGEP project costs. It could be argued these late arriving customers are getting a free rider, however, the earlier the customer subscribes to these projects, the sooner they receive the benefit.

At the Commission's January 19, 2017 Agenda meeting (for the 16-654 and 16-655 dockets), the parties announced that they had reached an agreement, based on a Commission staff recommendation, on how to equitably resolve the issue of cost recovery for the Balaton and Esko projects. Under the proposed agreement, MERC would recover a large portion of project costs through the NAS from just the project customers, while the remaining costs would be recovered from all of its ratepayers through base rates in the Company's next rate case, rather than through an NGEP rider.

The settlement proposal recognized the importance of extending natural gas coverage to the Balaton and Esko areas. The proposal will allow MERC to get the financial assurance it needs to build these projects. Importantly, the terms of the settlement also provide protection for MERC's other ratepayers.

The Commission approved a regulatory asset for MERC to allow it to recover the remaining costs of each project in base rates in its next rate case (17-563): 1) For the Balaton project (16-654) $488,516; and 2) For the Esko project (16-655) $733,297. The Commission allowed MERC to charge the cost of short-term debt for the regulatory asset.

In its February 9, 2017 Order, the Commission reasoned:

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[42] Under Minn. Stat. § 645.16, "[w]hen the words of a law in their application to an existing situation are clear and free from all ambiguity, the letter of the law shall not be disregarded under the pretext of pursuing the spirit." "The objective of statutory interpretation is to ascertain and effectuate the Legislature's intent. If the Legislature's intent is clear from the statute's plain and unambiguous language, then [a court] interpret[s] the statute according to its plain meaning without resorting to the canons of statutory construction." *State v. Rick*, 835 N.W.2d 478, 482 (Minn. 2013) (citation omitted)

> *The settlement proposal ensures full recovery for the two projects for MERC, but without use of the new NGEP rider. While the Commission recognizes that recovery of the Balaton and Esko costs over and above the 25-year NAS tariff amount would have been appropriate under the NGEP rider, the Company's proposal requested recovery of the remaining costs over a one-year period. The settlement proposal provides MERC with recovery of all of its additional costs, but over a longer period of time through base rates set in MERC's next rate case, thus spreading out the ratepayer impact of the projects' costs.* [43]
>
> *Having reviewed the parties' settlement proposal, the Commission believes that, in this instance, recovery of the costs using the 25-year NAS in addition to deferral of the remaining amount for recovery through base rates in MERC's next rate case is reasonable, giving the Company more certainty as to cost recovery and increasing MERC ratepayers' rates by a smaller amount spread over a longer period.*[44]
>
> ***Order Point 2*** *- The Commission approves a regulatory asset for MERC to allow MERC to recover the remaining Balaton costs, $488,516, in its base rates in the next rate case. MERC may charge the cost of short-term debt for the regulatory asset.*
>
> ***Order Point 4*** *- The Commission approves a regulatory asset for MERC to allow MERC to recover the remaining Esko costs, $733,297, in its base rates in the next rate case. MERC may charge the cost of short-term debt for the regulatory asset.*

As previously mentioned, MERC proposes NGEP cost recovery through its net present value calculation, while the Department is proposing cost recovery through its 48-year recovery plan with a one-year NGEP Rider rate. Another option the Commission may wish to consider is the Balaton and Esko settlement methodology already approved by the Commission. This alternative would allow MERC to recover a large portion of project costs through its NAS tariff and allow MERC to recover the remaining project costs in its next general rate case. MERC would establish deferred accounting treatment for these remaining project costs and would be allowed to collect its short-term debt for the regulatory asset until its next rate case. Staff believes this option is similar to the Department's recommendation.

Staff believes the Commission has the authority to approve different NGEP Rider surcharges for different NGEP projects.

[43] Docket Nos. G011/M-16-654 and G011/M-16-655, *Order Approving Cost Recovery for New Area Surcharge Tariffs* for Balaton and Esko Projects at 4 (Feb. 9, 2017).

[44] Ibid.

Disclosure of NAS factors and the NGEP Rider factors to Customers

In Docket No. 14-524, the Commission required MERC to disclose, at a minimum, to its Ely Lake project customers the monthly NAS factor, the annual cost of the NAS, and a statement that the NAS is expected to be charged for the Commission chosen recovery term and the related NAS amount charged for that period. PUC staff believes that the Commission may wish to continue requiring MERC to fully disclose this information to it's the Pengilly, which would help make the NAS customers more knowledgeable and possibly forestall future complaints. The customer disclosure would include, at a minimum, the following information:

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

Compliance Filings

The Commission has required annual compliance filings for MERC's other NAS projects. If the Pengilly project is approved and NAS factors are approved, staff believes MERC should file annual reports on this project at the same time MERC files annual reports on its other NAS projects.

In addition, if the Commission approves MERC's request for a NGEP Rider, staff recommends the Commission require MERC to submit annual reports at the same time as the NAS project annual reports so that that the Commission will be able to prepare evaluations and reports for the Legislature that are required by the NGEP statute. The next report to the Legislature is due on January 15, 2020.[45] Staff recommends MERC include the following information in its reports:

- the number of NGEP projects proposed and approved;

[45] Minn. Stat. 216B.1638, Subd. 6. Recovery of Natural Gas Extension Project Costs. Evaluation and Report. By January 15, 2017, and every three years thereafter, the Commission shall report to the chairs and ranking minority members of the Senate and House of Representatives committees having jurisdiction over energy policy:

(1) the number of public utilities and projects proposed and approved under this section;
(2) the total cost of each project;
(3) rate impacts of the cost recovery mechanism; and
(4) an assessment of the effectiveness of the cost recovery mechanism in realizing increased natural gas service to unserved or inadequately served areas from natural gas extension projects.

- MERC's total cost for each project and the amount of cost recovered through base rates, an NAS surcharge, if applicable, and the NGEP Rider cost recovery mechanism;
- rate impact in total and by customer class of the NGEP Rider; and
- MERC's assessment of the effectiveness of the cost recovery mechanism (NGEP Rider) in realizing increased natural gas service to unserved or inadequately served areas from natural gas extension projects.

If any of the cost or other information in MERC's annual reports is claimed to be trade secret, non-public information that the Commission is required to provide in reports to the Legislature pursuant to Minn. Stat. 216B.1638, subd. 6, MERC should explain the reason for keeping the information trade secret in sufficient detail so that the Commission is able to comply with the Legislature's request for an evaluation and report on MERC's extension projects.

Decision Alternatives

Public Interest

1. Determine that the Pengilly natural gas extension project will serve an inadequately or un-served area in Minnesota; (MERC and Department) <u>or</u>

2. Determine that the Pengilly natural gas extension project will not serve an inadequately served or un-served area in Minnesota.

Project Costs Reasonableness

3. Determine that MERC's Pengilly estimated project costs (both MERC system costs and NNG upgrade costs) are reasonable and will be prudently incurred; (MERC and Department) <u>or</u>

4. Determine that MERC's Pengilly estimated project costs (both MERC system costs and NNG upgrade costs) are not reasonable and will not be prudently incurred.

Cost Recovery – NAS charges

5. Approve MERC's proposed Pengilly cost recovery through its 25-year NAS factors and its NGEP Rider factor (trade secret), see Table 3 below; (MERC, Department)

Table 3: MERC's proposed Pengilly 25-year NAS Factors

Customer Classes	Monthly NAS Rider Surcharge
Residential	$24.70
Small Commercial and Industrial	$46.82
Large Commercial and Industrial	$117.07
Small Volume Interruptible	$429.23
Large Volume Interruptible	$481.27

or

6. Deny MERC's NAS cost recovery proposal, instead adopt some other cost recovery NAS methodology.

Cost Recovery – NGEP Rider charges

7. Approve MERC's proposed NGEP Rider Surcharge for a one-year period; (MERC) or

	NGEP Rider Surcharge
NGEP Rider Surcharge per therm	$0.00013

8. Approve the Department's proposed NGEP Rider Surcharge for a one-year period; (Department)

	NGEP Rider Surcharge
NGEP Rider Surcharge per therm	$0.00001

or

9. Approve a regulatory asset for MERC to allow MERC to recover the remaining Pengilly costs, (amount has been marked as Trade Secret), in its base rates in the next rate case. MERC may charge the cost of short-term debt for the regulatory asset. Under this alternative, no NGEP Rider Surcharge is calculated; (Staff) or

10. Approve some other one-year NGEP Rider Surcharge.

NGEP Rider Tariff Provision

11. If a NGEP Rider is approved, approve MERC's proposed tariff sheets Original Sheet No. 9.20 through 9.22; (MERC, Department) or

12. Do not approve MERC's proposed NGEP tariff sheets.

Customer Notice

13. Direct MERC to work the Commission's Consumers Affair Office to establish a customer notice to be sent to all MERC customers. (Staff)

True-up Mechanism for the NGEP Rider

14. If MERC's proposed NGEP Rider is approved, approve MERC's requested NGEP true-up mechanism, as proposed by MERC; or

15. If the proposed NGEP Rider is approved, do not approve MERC's requested NGEP true-up mechanism as proposed by MERC. Instead, direct MERC to stop collecting the NGEP Rider factor if its investment is recovered before the expiration of the one-year recovery period. Further, require MERC to stop collecting its NGEP Rider factor at the end of its one-year recovery term.

Carrying Costs

16. Approve MERC's carrying cost proposal to use its currently authorized short-term debt percentage through the one-year NGEP Rider period; (MERC) or

17. Do not approve MERC carrying cost proposal to use its currently authorized short-term debt percentage through the one-year NGEP Rider period.

Minn. Stat. § 216B.1638. Recovery of Natural Gas Extension Project Costs.

Subdivision 1. Definitions.

(a) For the purposes of this section, the terms defined in this subdivision have the meanings given them.

(b) "Contribution in aid of construction" means a monetary contribution, paid by a developer or local unit of government to a utility providing natural gas service to a community receiving that service as the result of a natural gas extension project, that reduces or offsets the difference between the total revenue requirement of the project and the revenue generated from the customers served by the project.

(c) "Developer" means a developer of the project or a person that owns or will own the property served by the project.

(d) "Local unit of government" means a city, county, township, commission, district, authority, or other political subdivision or instrumentality of this state.

(e) "Natural gas extension project" or "project" means the construction of new infrastructure or upgrades to existing natural gas facilities necessary to serve currently unserved or inadequately served areas.

(f) "Revenue deficiency" means the deficiency in funds that results when projected revenues from customers receiving natural gas service as the result of a natural gas extension project, plus any contributions in aid of construction paid by these customers, fall short of the total revenue requirement of the natural gas extension project.

(g) "Total revenue requirement" means the total cost of extending and maintaining natural gas service to a currently unserved or inadequately served area.

(h) "Transport customer" means a customer for whom a natural gas utility transports gas the customer has purchased from another natural gas supplier.

(i) "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.

Subd. 2. Filing.

(a) 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.

(b) The petition shall include:
(1) a description of the natural gas extension project, including the number and location of new customers to be served and the distance over which natural gas will be distributed to serve the unserved or inadequately served area;

(2) the project's construction schedule;

(3) the proposed project budget;

(4) the amount of any contributions in aid of construction;

(5) a description of efforts made by the public utility to offset the revenue deficiency through contributions in aid to construction;

(6) the amount of the revenue deficiency, and how recovery of the revenue deficiency will be allocated among industrial, commercial, residential, and transport customers;

(7) the proposed method to be used to recover the revenue deficiency from each customer class, such as a flat fee, a volumetric charge, or another form of recovery;

(8) the proposed termination date of the rider to recover the revenue deficiency; and

(9) a description of benefits to the public utility's existing natural gas customers that will accrue from the natural gas extension project.

Subd. 3. Review; approval.

(a) The commission shall allow opportunity for comment on the petition.

(b) 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.

(c) The commission must not approve a rider under this section that allows a utility to recover more than 33 percent of the costs of a natural gas extension project.
(d) The revenue deficiency from a natural gas extension project recoverable through a rider under this section must include the currently authorized rate of return, incremental

income taxes, incremental property taxes, incremental depreciation expenses, and any incremental operation and maintenance costs.

Subd. 4. Commission authority; order.

The commission may issue orders necessary to implement and administer this section.

Subd. 5. Implementation.

Nothing in this section commits a public utility to implement a project approved by the commission. The public utility seeking to provide natural gas service shall notify the commission whether it intends to proceed with the project as approved by the commission.

Subd. 6. Evaluation and report.

By January 15, 2017, and every three years thereafter, the commission shall report to the chairs and ranking minority members of the senate and house of representatives committees having jurisdiction over energy policy:

(1) the number of public utilities and projects proposed and approved under this section;

(2) the total cost of each project;

(3) rate impacts of the cost recovery mechanism; and

(4) an assessment of the effectiveness of the cost recovery mechanism in realizing increased natural gas service to unserved or inadequately served areas from natural gas extension projects.