RECOVERY OF THE COSTS

OF

NATURAL GAS EXTENSION PROJECTS

Report to the Legislature

March 22, 2017

As required by

Minnesota Statutes § 216B.1638

Submitted by the Minnesota Public Utilities Commission

INTRODUCTION

Statutory Reporting Requirement

Minnesota Statutes (2016), Section 216B.1638, subd. 6 requires the Minnesota Public Utilities Commission ("Commission") to evaluate and report, beginning January 15, 2017 and every three years thereafter, to the Minnesota Legislature concerning the recovery of costs for projects to extend the provision of natural gas services.

This Report is to fulfill the reporting requirement of this section.

Costs of Preparing Report

Pursuant to Minnesota Statutes (2016), Section 3.197, it is estimated that the costs incurred by the Commission in preparing this Report are minimal. Special funding was not appropriated for the costs of preparing this report.

DESCRIPTION OF 2015 LEGISLATION

Minnesota Statutes, Section 216B.1638 was enacted in 2015. This section of law allows a utility to petition the Commission for a rider to recover, outside of a general rate case, the revenue deficiency from a natural gas extension project. The statutory section sets forth the information that must be contained in such a petition and establishes the scope and standards for review of the petition by the Commission. Among other requirements for Commission approval, such a rider must not be allowed to recover more than 33 percent of the costs of the natural gas extension project.

Even if the Commission approves such a petition, the utility is not committed to implement a project so approved. The public utility seeking to provide natural gas service must notify the Commission whether it intends to proceed with the project as approved.

Subdivision 6 of this statutory section requires the Commission, beginning January 15, 2017 and every three years thereafter, to report to the Legislature on the following:

(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.[1]

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[1] Minn. Stat. § 216B.1638, subd. 6

BACKGROUND: RELATED COMMISSION ACTIVITY ENCOURAGING EXPANDED AVAILABILITY OF NATURAL GAS SERVICE

Commission-Authorized New Area Surcharge (NAS) Projects

In 1990, the Commission initiated an investigation and, in 1991, a study group[2] that asked, among other questions, whether the Commission should encourage the use of natural gas fuel by facilitating the provision of pipelines to more towns. The study group explored how to extend gas service to communities that request gas service but cannot be served economically at tariffed rates.

On March 12, 1992, the Department of Commerce ("Department") and Commission staff submitted their Report on Issues for New-Area Rates. The report covered financial issues, rate design and various compliance and reporting issues concerning these new rates. Extensions under the New Area Surcharge tariffs would involve significant costs since the extensions would be to entire towns located in remote areas. Because the proposed surcharges would allow customers to pay the full incremental cost over a number of years (rather than one year), utilities could serve more areas without putting existing customers or stockholders at risk.

Subsequently, the Commission received, reviewed, and approved several New Area Rates proposals. Because these New Area Rates proposals were approved, the Commission decided this issue had been adequately addressed given conditions at that time.[3]

Minnegasco (now CenterPoint Energy) completed one large scale project in the 1990s under this tariff in the Alexandria lakes area. Xcel Energy completed approximately four projects in the 1990s under this tariff. The largest of the four was the Brainerd lakes area project; however, Xcel completed several other smaller projects, for example, in Taylor Falls.

The following tables provide a list of residential New Area Surcharge projects approved more recently by the Commission for various communities in Minnesota where natural gas service was not previously available.

Minnesota Energy Resources Corp.
Detroit Lake – Long Lake, Docket No. G-011/M-15-441
Ely Lake Project (revised), Docket No. G-011/M-15-776
Fayal Township – Long Lake, Docket No. G-011/M-16-221

[2] *ORDER INITIATING STUDY GROUP*, In the Matter of an Inquiry into Competition Between Gas Utilities in Minnesota, Docket G-999/CI-90-563 (June 4, 1991)

[3] *ORDER TERMINATING INVESTIGATION AND CLOSING DOCKET*, In the Matter of an Inquiry into Competition Between Gas Utilities in Minnesota, Docket G-999/CI-90-563 (March 31, 1995)

Xcel-Gas
Barnesville, Docket No. G-002/M-14 583
Holdingford, Docket No. G-002/M-14 583
Pillager, Docket No. G-002/M-14 583

Recent Commission-Authorized Exempt Small Gas Utilities

In addition to the five large investor-owned local distribution companies and the municipally-owned distribution companies that serve customers in Minnesota, there are several small natural gas distribution utilities that are exempt from certain aspects of state rate regulation, pursuant to Minn. Stat. § 216B.16, subd. 12.

Small exempt natural gas distribution utilities typically charge higher rates than the larger, state regulated distribution utilities for reasons that are due mainly to their size, but they are providing service to communities that previously did not have access to natural gas.

Over the past several years, the Commission has confirmed, by Order, the exempt status of several of these new, small natural gas utilities that serve customers in previously unserved areas. Several of these projects have required construction of small, intrastate pipelines that provide wholesale natural gas transportation service to the exempt distribution utilities. The rates charged by the intrastate pipelines are set under contracts approved by the Commission, pursuant to Minn. Stat. § 216B.045, subd. 4.

Company Name	Docket No.	Commission Order Date
Dooley's Natural Gas LLC[4]	G-6915/M-13-672	January 7, 2014
Community Co-ops of Lake Park[5]	G-6956/M-15-856	December 22, 2015
United Natural Gas, LLC[6]	G-6960/M-16-214	May 24, 2016
Dooley's Natural Gas II, LLC[7]	G-6915/M-16-756	request pending

COMMISSION ACTIONS UNDER 2015 LEGISLATION

Minnesota Energy Resources Corporation (MERC) has proposed three projects under Minnesota Statutes, Section 216B.1638. The Commission has acted on two of MERC's

4 Dooley's Natural Gas operates a natural gas distribution system bringing natural gas to the cities of Blomkest, Clara City, Maynard, Prinsburg, Raymond, Roseland, Svea, and Grove City, Minnesota.
5 Community Co-ops provides natural gas service to the towns of Twin Valley and Mahnomen.
6 UNG provides service to parts of Nicollet County including the communities of Lafayette and Courtland.
7 DNG II's request for confirmation of its exempt status as a small gas utility is for service provided within the cities of Belgrade and Brooten, Minnesota and incidental service to surrounding areas outside those municipalities.

proposed projects and the third is pending. No other public utility has requested authorization to recover costs associated with natural gas extension projects under this statutory provision.

Balaton Natural Gas Extension Project[8]

On August 6, 2016, MERC submitted its request for approval to recover the cost to extend natural gas service to customers in Balaton, Minnesota through a Natural Gas Extension Project Rider (NGEP) and a New Area Surcharge (NAS). MERC proposed to recover less than 33 percent of the project costs under the Natural Gas Extension Project Rider with a NAS, financing the remainder of project costs for a period of twenty-five years. MERC also requested approval to amortize the costs associated with upgrades to the interstate pipelines which are necessary to provide natural gas service to the Balaton Project area, over a period of twenty-five years - including carrying costs at MERC's currently authorized short-term cost of debt.

MERC treated the amount of money it proposed to recover through the NGEP and the overall cost of upgrades to the interstate pipeline to implement this project as trade secret. MERC did indicate that its proposal for the monthly New Area Surcharges for the Balaton area are as follows:

Balaton Project New Area Surcharges	
Residential	$24.14
Small Commercial and Industrial	$45.75
Large Commercial and Industrial	$114.37
Small Volume Interruptible	$419.34
Large Volume Interruptible	$470.17

On December 21, 2016, the Department, by its Division of Energy Resources, submitted comments stating that:

> Extending cost-effective natural gas service to previously unserved areas, under fair rates, is an important policy goal in Minnesota. However, MERC did not show that an NAS alone is insufficient to make the Balaton Project feasible, without charging ratepayers outside of Balaton for the costs of the extension. Since such issues are new for the Commission, the Commission should have a reasonable foundation to determine what portion of the project costs, if any, must be recovered from MERC's existing ratepayers in order for the Balaton Project to proceed. Given the costs of alternative fuels in this record, a 30-year NAS should be approved for the Balaton Project, with no recovery through an NGEP Rider,

[8] 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 Balaton Project, PUC Docket No. G-011/M-16-654

> as indicated on page 12 of the Department's October 3, 2016 Comments. If the Commission chooses to rely on the NGEP and the NAS, the Department requests that the Commission provide guidance for future proceedings on when to go beyond use of an NAS and require use of an NGEP.

At its January 19, 2017 meeting, the Commission (1) approved MERC's proposed Balaton cost recovery through MERC's 25-year New Area Surcharge cost recovery factors, and (2) accepted the agreement between the Department and MERC that rather than use the originally-proposed NGEP rider, it was in the interest of MERC customers' to recover the remaining costs ($488,516) over a longer time period through its next rate case.

On February 9, 2017, the Commission issued its *Order Approving Cost Recovery for New Area Surcharge Tariffs for Balaton and Esko Projects*.[9]

Esko Natural Gas Extension Project[10]

On August 6, 2016, MERC submitted its request for approval to recover the cost to extend natural gas service to customers in Esko, Minnesota through a NGEP and a NAS. MERC proposed to recover less than 33 percent of the project costs under the NGEP with a NAS financing the remainder of project costs for a period of twenty-five years. MERC also requested approval to amortize the costs associated with upgrades to the interstate pipelines which are necessary to provide natural gas service to the Esko Project area, over a period of twenty-five years - including carrying costs at MERC's currently authorized short-term cost of debt.

MERC treated the amount of money it proposes to recover through the Natural Gas Extension Project Rider and the overall cost of upgrades to the interstate pipeline to implement this project as trade secret. MERC did indicate that its proposal for the monthly New Area Surcharges for the Esko area are as follows:

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[9] 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 Balaton Project, Docket NO. G-011/M-16-654, and 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 Esko Project, Docket no. G-011/M-16-655.

[10] 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 Esko Project, PUC Docket No. G-011/M-16-655

Esko Project New Area Surcharges	
Residential	$24.18
Small Commercial and Industrial	$45.81
Large Commercial and Industrial	$114.53
Small Volume Interruptible	$419.95
Large Volume Interruptible	$470.85

The Minnesota Department of Commerce raised similar concerns in this proceeding as it did with respect to the Balaton project described above.

MERC and the Department subsequently agreed to a settlement similar to that for Balaton. At its January 19, 2017 meeting, the Commission (1) approved MERC's proposed Esko cost recovery through MERC's 25-year New Area Surcharge cost recovery factors, and (2) allowed MERC to recover remaining costs associated with the Balaton project of $733,297 in its next rate case. On February 9, 2017, the Commission issued its *Order Approving Cost Recovery for New Area Surcharge Tariffs for Balaton and d Esko Projects*.[11]

Rochester Natural Gas Extension Project[12]

MERC requested authorization to recover a portion of its Rochester Natural Gas Expansion Project costs under this statute. According to MERC, its natural gas distribution system is currently at capacity in the Rochester area and must be upgraded to meet current needs as well as expected growth in customer demand. The Project includes two phases, which involve improvements to MERC's distribution system and acquiring additional interstate pipeline capacity for delivery to its Rochester distribution system.

Phase I of the Project was completed in 2015. Phase I cost approximately $5.6 million, and involved improvements to MERC's delivery system in the Rochester area. The Commission authorized recovery of the Phase I costs in MERC's most recent rate case.

Phase II of the Project consists of changes to MERC's local distribution system, which are expected to be completed by 2023. This phase involves upgrading MERC's town border station (TBS) system and constructing a new 13-mile long high-pressure pipeline that will tie together

[11] 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 Balaton Project, Docket NO. G-011/M-16-654, and 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 Esko Project, Docket no. G-011/M-16-655.

[12] 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, Docket No. G-011/M-15-895

the northern and southern portions of the TBS system. MERC has requested approval of the Phase II costs, which are estimated to total about $44 million. MERC seeks to recover 33 percent of the Phase II costs from all of MERC's ratepayers through future NGEP rider filings, with the balance of the Phase II costs recovered in future rate cases.

In addition, MERC has contracted with its wholesale natural gas supplier, NNG, to build new infrastructure that will supply MERC with increased interstate pipeline capacity. In its petition, MERC requested Commission approval of the NNG costs, which the company stated would total approximately $55 million on a net present value (NPV) basis. MERC has proposed to recover these NNG costs through MERC's Purchased Gas Adjustment (PGA) mechanism.[13]

The rate impacts of the cost recovery mechanism will not be known until the Commission makes its decision and an assessment of the effectiveness of the cost recovery mechanism will not be known until the project is in service and the cost recovery mechanism is implemented.

The Commission expects to hear this matter on March 23, 2017.

[13] Adapted from the Administrative Law Judge's Findings of Fact, Conclusions of Law and Recommendation, 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, PUC Docket No. G-011/M-15-895, OAH Docket No. 68-2500-33191, pp. 3-4, November 30, 2016