BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Don Storm	Chair
Tom Burton	Commissioner
Marshall Johnson	Commissioner
Cynthia A. Kitlinski	Commissioner
Dee Knaak	Commissioner

In the Matter of a Request by Peoples Natural Gas Company for Approval to Change Its Pipeline Demand Entitlements and to Recover the Associated Costs in Its Monthly Purchased Gas Adjustment Pursuant to Federal Energy Regulatory Commission Order 636

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ORDER APPROVING PETITION WITH MODIFICATION

PROCEDURAL HISTORY

On October 29, 1994, Peoples Natural Gas Company (Peoples or the Company) filed a request to convert its pipeline demand entitlements on the Northern Natural Gas (Northern) pipeline to conform to Northern's restructured services and tariffs. Peoples also requested permission to recover charges for Northern's new services and transition costs in the Company's monthly purchased gas adjustment (PGA).

On January 11, 1994, Peoples responded to an information request from the Department of Public Service (the Department).

On June 2, 1994, the Department filed its report and recommendation. The Department supported the Company's request for authority to restructure its entitlements, but recommended modifications to the Company's cost recovery methods.

On June 10, 1994, Peoples filed a reply to the Department's comments.

On June 21, 1994, the Department filed a reply.

On July 18, 1994, the Residential Utilities Division of the Office of the Attorney General (RUD-OAG) filed comments in support of the Company's petition.

The matter came before the Commission for consideration on August 18, 1994.

FINDINGS AND CONCLUSIONS

I. Factual Background

A. Effects of FERC Order 636 on the Gas Industry

Federal Energy Regulatory Commission (FERC) Order 636 is part of an overall federal policy decision to let market forces operate more fully in the provision of gas services. Among other things, FERC Order 636 completely unbundles gas transportation and sales services; mandates equal and open access to pipeline transportation services; eliminates the pipelines' obligation to provide bundled gas ("the merchant function") and allows pipelines to pass through transition costs, subject to a prudence review by the FERC. FERC Order 636 required all interstate pipelines to restructure their services and tariffs by November 1, 1993, to reflect these changes.

Order 636 profoundly affected local distribution companies (LDCs) as well as the interstate pipelines. The required restructuring brought LDCs new responsibilities, opportunities, and costs.

Under Order 636, LDCs can no longer rely on pipelines to supply bundled gas sales service, nor can they rely on FERC to set rates for pipeline supply service. LDCs have new responsibilities to secure reliable, economic gas supplies and transportation services, to acquire storage facilities to cover short-term shortages, and to monitor pipeline systems to determine when to release unneeded capacity.

Order 636 has brought LDCs new opportunities as well as responsibilities. The capacity release program allows LDCs to manage and control costs. LDCs can take advantage of the new, more competitive market by developing and managing their own supply portfolios.

Order 636 has also brought additional costs to LDCs. The LDCs' stricter "balancing" responsibilities, which require the LDCs to nominate (tell the pipeline) the daily amount of expected gas, can bring penalty costs if the estimates are sufficiently inaccurate.

B. Transition Costs

Transition costs are another additional cost to LDCs resulting from Order 636. Transition costs are the pipelines' costs of conversion from bundled sales and transport functions to strictly transport service. Transition costs include such costs as stranded investment and contract buyouts. The FERC has said that pipelines may pass to their customers, the LDCs, the pipelines' prudently incurred costs of transition to their new status as providers of unbundled pipeline service.

Under Minn. Stat. § 216B.16, subd. 7, the Commission may allow a gas utility to pass the costs of "federally regulated wholesale rates for energy delivered through interstate facilities" to its customers through its PGA.

C. Identification and Allocation of the Transition Costs

If the Commission allows a gas utility to pass the transition costs to customers through the PGA, the next issues are the identification and the allocation of the costs. The costs may be billed as commodity (the amount paid by the utility for the gas supplies) or as demand (the amount paid by the utility to reserve capacity). Commodity charges are typically billed to all sales customers (both firm sales and interruptible sales). Demand charges are typically billed to all firm customers (firm sales and firm transportation).

II. The Petition

Peoples petitioned for authority to convert its demand entitlements to conform with Northern's services and tariffs as they were restructured under Order 636. Peoples did not request a change in its level of entitlements. Peoples also asked for authority to recover in its PGA approximately $11.8 million per year in charges from Northern for FERC Order 636 new services and transition costs.

In its petition, Peoples proposed to recover four Northern charges ("Canadian" capacity contract reservation charges, Account 191 direct charges, GSR surcharges and ANGTS direct charges) and the producer demand payments as commodity costs. Peoples argued that these costs should not be designated as demand because they did not represent capacity costs incurred to serve specific customers.

As commodity charges, the Northern costs and producer demand payments were assigned by Peoples to its interruptible sales customers as well as to its firm customers. Peoples argued that FERC Order 636 imposed higher costs on firm customers because pipelines were required to adopt a rate design which shifted all pipeline fixed costs into firm rates. Assigning some of the Northern and producer demand charges to interruptible customers would relieve some of the cost burden for smaller firm customers. It would also ensure that interruptible customers are paying for some of the firm capacity they use when capacity isn't being used by firm customers.

III. Comments of the Parties

A. The Department

The Department recommended that the Commission approve the Company's proposed level of demand entitlements, and its proposal to recover passed-through pipeline transition costs in its

PGA. The Department recommended three changes in the Company's specific cost recovery proposal:

1. The Company should classify Northern's charges and the producer demand payments as demand costs.

In its original comments the Department argued that the four Northern charges and the producer demand costs should be categorized as demand because they are designated as demand by Northern and because they represent the amount paid by the utility to reserve capacity. The Department continued to believe that the producer demand payments and one of Northern's charges, the "Canadian contracts," should be considered demand. The producer demand payments are the contracted, per-unit fees paid to reserve third-party supplies; the charges for "Canadian" contracts reserve pipeline capacity.

The Department moved from its original position that three of the Northern charges (Account 191, GSR and ANGTS) should be classified as demand because they reflect Northern's cost of terminating various supply contracts and recovery of certain other expenses. The Department later stated that these costs could be classified as either demand or commodity.

2. The Company should bill the Northern charges and producer demand payments only to firm and joint-volume sales customers in the monthly PGA, not to interruptible customers.

The Department gave three reasons that the Company should not bill these charges to interruptible customers. First, Order 636 has not changed the essential quality of interruptible customers: they can still be curtailed when capacity or supply is insufficient. Interruptible customers should therefore not be required to share in these demand costs. Second, the Department expressed concern about rate shock for interruptible customers, who might incur rate increases of approximately 20 percent under the Company's proposal. Third, the Department believed that Peoples plans its needs based on its projected sales to firm customers. Interruptible sales customers therefore do not cause Peoples to incur gas demand costs.

3. The Company should assign SBA and stranded 858 costs to Minnesota ratepayers based on Peoples' Minnesota contracted TF (firm transportation) entitlement level.

Although Peoples had proposed allocating these costs based on the ratio of Minnesota throughput to total throughput, the Company did not challenge this recommendation.

B. The RUD-OAG

The RUD-OAG supported the Company's proposal. The RUD-OAG stated that Order 636 has brought the gas industry into a new era, which will require rethinking of some fundamental cost allocation principles.

The RUD-OAG agreed with the Company's proposal to classify the four Northern charges and producer demand payments as commodity costs and to recover the costs from all sales customers, including both firm and interruptible sales customers. According to the RUD-OAG, this cost recovery methodology reflects the post-636 regulatory environment, properly allocates pipeline charges to interruptible sales customers, and results in more equitable rates paid by all customers.

The RUD-OAG agreed with the Company that interruptible sales customers under the old

meaning and expectations no longer exist. Formerly, LDCs served interruptible customers with excess firm capacity that would otherwise have gone unused. When the Order 636 capacity release concept is fully implemented, LDCs will be able to sell unused capacity at market price. At that time, according to the RUD-OAG, interruptible sales customers should pay the market value of unused firm capacity. The RUD-OAG stated that the Company's current cost recovery proposal appropriately allows the Company to recover a proxy "market value" of gas used by interruptible sales customers.

Finally, the RUD-OAG noted that under the Company's proposal interruptible rates would increase because interruptible customers will no longer benefit LDCs as they used to. The Company's cost allocation method, supported by the RUD-OAG, would result in residential rates approximately ten percent lower and interruptible sales rates approximately 20 higher than the rates that were in place immediately before Order 636 went into effect.

IV. Commission Analysis

The Company's proposed level of entitlements, restructuring of its entitlements to reflect Northern's restructured services, and recovery of transition costs in the PGA are not controversial. The parties differ on the classification and billing of charges as demand or commodity, and on the allocation of SBA and stranded 858 costs.

A. The Level of Entitlements

The level of entitlements requested in Peoples' petition is unchanged from previous proceedings. No party opposed or questioned the level of entitlements in the petition. The Commission has found the Company's entitlement level prudent in the past and continues to do so.

B. Restructuring of Peoples' Entitlements

The Commission finds that the Company's proposed conversion of entitlements to reflect Northern's restructured services is appropriate. The conversion to Northern's restructured services is necessary to implement the FERC Order 636 changes.

C. Recovery of Transition Costs in the PGA

The Commission approves the Company's request to recover People's share of Northern's transition costs in the PGA. Northern's transition costs and methods of recovery from its LDC customers have been approved by the FERC in a "global settlement" with Northern and in subsequent FERC proceedings. The costs are properly included in Peoples' PGA because they are "federally regulated wholesale rates for energy delivered through interstate facilities" under Minn. Stat. § 216B.16.

D. Classification and Billing of Charges as Demand or Commodity

All commenting parties agreed that the post-636 era will bring profound changes to the gas industry and to the regulation of retail and wholesale gas suppliers. As the industry moves to a more competitive and market-based structure, regulators will need to reevaluate traditional assumptions in light of the new realities.

In this time of industry change, reasonable utilities may differ in their characterization of service charges and in their allocation of costs. In this case, Peoples has designated the four Canadian costs and producer demand payments as commodity charges and allocated them to firm and interruptible sales customers. The Commission finds that the Company's designation and allocation is reasonable in this particular set of facts. Although other utilities might treat the charges differently, Peoples has offered a reasonable basis for its characterization of the charges.

1. Account 191 monthly charge. Under FERC Order 636, the pipelines exiting the merchant business were allowed to recover their outstanding balances in their PGA true-ups under this account. Northern is recovering its Account 191 balance as a monthly direct bill over a two-year period.

Because some of these expenses are capacity related and some are commodity related, Peoples' designation of the costs as commodity charges is reasonable.

2. Alaska Natural Gas Transmission System (ANGTS) monthly charge. Northern bills its share of the costs for the Alaska Natural Gas Transmission System as a monthly direct bill. Because this transmission cost is not related to gas used in the Minnesota jurisdiction, designation of this cost as either commodity or demand would have been reasonable.

3. GSR Surcharge. This surcharge relates to supply contracts Northern held with numerous small producers at the time of 636 restructuring. The FERC allowed Northern to use these supply contracts until they expire and to recover the excess of cost over market from its customers in the GSR surcharge. Although Northern bills these surcharges as demand, they are related to supply (commodity). Peoples' designation of these charges as commodity is reasonable.

4. Canadian capacity and producer demand payments. Peoples argued that interruptible customers under the post-636 system should share fixed costs, preferably through a volumetric rather than fixed monthly charge. The Company also argued that these costs could be designated as commodity because in Peoples' distribution pattern these costs are not clearly related to capacity needs for specified customers.

The Commission finds that Peoples has articulated a reasonable viewpoint of these charges. Post-636 gas utility rate design will require analysis of cost components and market forces. At the same time, rate design decisions will continue to be reached in the context of public policy

considerations, such as social value and ability to pay. In this case, the Department's concerns regarding rate shock for interruptible customers do not outweigh the basic equity of Peoples' position. The Commission will approve Peoples' proposal for designation and cost allocation of the Northern charges and producer demand costs.

The Commission notes that another utility may reasonably designate these costs as demand. The facts will differ among utilities. There may be significant differences among utilities in such factors as the FERC settlements reached with the LDCs' pipelines and suppliers, the transition costs being passed to the LDCs, and the LDCs' ratios of interruptible to firm customers.

Particularly in this stage of transition and development in the post-636 era, the Commission will carefully examine each utility's cost recovery mechanism and decide upon its merit in light of the utility's unique set of facts.

E. Allocation of SBA and Stranded 858 Costs

System Balancing Agreements (SBA) are drawn between Northern and shippers on its system. The shippers agree to use their facilities and supplies at the demand of Northern to maintain system integrity when receipts and deliveries on the system are not in balance.

Stranded 858 costs are the expenses incurred by the pipeline for third party pipeline capacity formerly used in providing merchant services.

Both SBA and stranded 858 costs to Northern are being recovered from Peoples through a surcharge.

Peoples proposed allocating these costs to the Minnesota jurisdiction on the basis of jurisdictional throughput, using an allocation factor of 31.95%.

The Department argued that these capacity related costs should be allocated based on the level of firm entitlements Peoples uses in Minnesota compared to the total amount of firm entitlement Peoples uses on Northern's system. This would lower the allocation factor to approximately 31.92%.

At the August 18, 1994, meeting, Peoples agreed with the Department, stating that the outcome was basically the same under the two alternatives.

The Department has offered a reasonable basis for its recommended allocation of these costs and the parties are in agreement regarding it. The Commission approves this modification of Peoples' proposal.

ORDER

1. The Commission approves Peoples' October 29, 1994, petition, as amended in its January 11, 1994, filing, with one modification: allocation of stranded 858 costs and SBA costs should be based on the level of firm entitlements Peoples uses in Minnesota compared to the total amount of firm entitlement Peoples uses on Northern's system.

2. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

(S E A L)