ISSUE DATE: January 10, 2000

DOCKET NO. G-002/PA-99-1268

ORDER APPROVING MERGER SUBJECT TO CONDITIONS

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Gregory Scott	Chair
Edward A. Garvey	Commissioner
Joel Jacobs	Commissioner
Marshall Johnson	Commissioner
LeRoy Koppendrayer	Commissioner

In the Matter of a Request for Approval of the Acquisition of the Stock of Natrogas, Incorporated (Natrogas), a Merger of Northern States Power Company (NSP) and Western Gas Utilities, Inc. (Western), and Related Affiliated Interest Agreements	ISSUE DATE: January 10, 2000 DOCKET NO. G-002/PA-99-1268 ORDER APPROVING MERGER SUBJECT TO CONDITIONS

PROCEDURAL HISTORY

On August 16, 1999, a merger agreement was signed between Northern States Power Company (NSP) and Natrogas, Incorporated (Natrogas), the parent company of Western Gas Utilities, Inc. (Western).

On September 1, 1999, Natrogas, Western and NSP filed a request for authorization to merge, pursuant to Minnesota Statutes §§ 216B.50, 216B.51, and related rules. NSP also requested approval of related affiliated interest agreements, including an Administrative Services Agreement and a Tax Sharing Agreement, pursuant to Minnesota Statutes, § 216B.48.

On November 1, 1999, the Department of Commerce (Department) submitted comments. The Department concluded that the merger was consistent with the public interest, and recommended approval subject to conditions. The Department also recommended approval of the affiliated interest agreements.

On November 10, 1999, NSP submitted reply comments responding to some concerns expressed by the Department.

On November 23, 1999, the Department and NSP filed a letter of understanding clarifying issues addressed in NSP's November 10 comments.

The Commission met on December 16, 1999, to consider the matter.

FINDINGS AND CONCLUSIONS

I. The Merger

A. The Companies

NSP is an investor-owned electric and gas utility, and is the second largest local distribution company (LDC) in Minnesota, serving approximately 345,000 customers within the state. Its shares are traded on the New York Stock Exchange.

Natrogas is a privately-owned company with the majority of its shares held by the estate of its founder who died in 1996. Western, its natural gas subsidiary, is the smallest Commission rate-regulated LDC, serving approximately 5000 customers. North American Energy, Inc., its other subsidiary, sells propane gas on a wholesale basis.

B. The Process

NSP proposes to acquire all of Natrogas' stock by issuing shares of NSP common stock in exchange. NSP would merge Western into NSP's gas operations, but continue North American Energy, Inc.'s non-utility propane operation as a separate subsidiary.

C. The Purpose and Intended Effects

In support of the merger, NSP asserts the following:

- The merger would harm neither NSP's nor Western's gas utility operations in Minnesota.
- The assumption of Western's debts would not harm NSP's capital structure.
- Synergies from integrating the gas operations would strengthen those operations.
- Integrating the gas operations would reduce, or at least not increase, the cost and rates to NSP and Western customers over the long term.
- NSP could provide enhanced options to Western's customers.
- The merger would provide more customers with the convenience of a combined gas/electric bill.
- NSP's superior access to capital markets would facilitate the expansion of gas service in the high-growth area west of the Twin Cities.

II. The Legal Standard

Under Minnesota law, the Commission is to approve the merger upon a showing that it is "consistent with the public interest." Minnesota Statutes § 216B.50 states:

> No public utility shall sell, acquire, lease, or rent any plant as an operating unit or

> system in this state for a total consideration in excess of $100,000, or merger or consolidate with another public utility operating in this state, without first being authorized so to do by the commission. Upon the filing of an application for the approval and consent of the commission thereto the commission shall investigate, with or without public hearing, and in case of a public hearing, upon such notice as the commission may require, and if it shall find that the proposed action is consistent with the public interest it shall give its consent and approval by order in writing....

The statute does not require that the proposed merger affirmatively benefit ratepayers or the public, or otherwise promote the public interest. The merger may not contravene the public interest, however, and must be shown to be compatible with it.

III. Issues and Commission Action

For the reasons set forth below, the Commission concludes that the proposed merger is consistent with the public interest subject to the conditions set forth below.

A. Consequence of the Merger

1. Consequences for the utilities

NSP and Natrogas argue that the proposed merger would be beneficial to both entities. The Department argues that the merger would have only a minor impact on NSP's credit rating, capital structure and cost of capital. In addition, the Department predicts that a merger would not dilute NSP's earnings. The Commission has reviewed the Department's analysis, and concludes that it supports a conclusion that the proposed merger would be consistent with the public interest.

2. Consequences for Western customers

The Department estimates that the proposed merger would reduce rates for Western's residential customers by an average of 10%, or $57.08 per year, and for all Western customers by an average of 12%.

However, while the merger would reduce rates for the average Western customer, the merger would increase rates 127.6% for two specific customers receiving Western's "Flexible Transport" service. NSP has agreed to meet with these two customers to see if they could qualify under NSP's tariff to receive service at an economical and competitive rate. If not, NSP has agreed to seek to adopt the relevant portions of Western's tariff, permitting NSP to serve these customers according to the same terms provided by Western. However, these terms would not be available to any other customer. NSP proposes to delete the new tariff terms during its next gas rate case, or earlier if the two customers stop taking service pursuant to those terms. The Department recommends approval of this proposal.

The Commission finds this proposed accommodation for the Flexible Transport customers generally reasonable. However, assuming NSP finds it necessary to adopt terms from Western's tariffs, the Commission will not at this time pass judgment on the propriety of NSP's subsequent deletion of those terms. The Commission cannot foresee what circumstances will arise if and when NSP ever files to eliminate those terms. The appropriate time to rule on that question is when NSP makes such a filing.

At hearing NSP acknowledged these concerns and expressed acceptance of this caveat. With no party opposing this proposed accommodation for the Flexible Transport customers, the Commission finds it reasonable. The Commission will direct the entity resulting from the NSP/Natrogas merger to file a compliance report relating the final rate determination for Western's two Flexible Transportation customers.

3. Consequences for NSP gas customers

The Department estimates that the merger would increase rates for NSP's gas customers on average by approximately $0.43 per year, or less than one tenth of one percent. The Department does not believe that this projected rate increase renders the proposed merger inconsistent with the public interest, given the increase's size, and the number of assumptions underlying it, and the offsetting benefits to the Western customers.

The rate that a customer pays for gas reflects a complicated analysis involving many factors: commodity costs, demand costs, and non-gas costs such as customer charges and distribution charges. The first two factors warrant further discussion here.

"Commodity costs" reflect the price of the gas itself, independent of the cost of transport or delivery. This price fluctuates. To help ensure that the amount customers pay tracks the amount the utility pays, gas utilities prospectively file Purchased Gas Adjustments to their rates to reflect current gas prices, and retrospectively file True-Ups to account for any difference between the costs incurred by the utility and the costs paid by ratepayers. NSP and Western made 1999 true-up filings on September 1, 1999;[1] presumably, a combined entity would make a consolidated 2000 true-up filing on September 1, 2000.

"Demand cost" refers to the cost of reserving space on interstate pipelines for transporting gas, and to the cost of storing the gas. A gas utility estimates the amount of capacity required to serve its customers, negotiates with pipelines to obtain the necessary capacity, allocates the resulting demand costs among various customer classes, and recovers the costs from ratepayers. The utility may not increase or decrease its demand, reallocate demand costs among customer classes, or substitute one source of capacity for another, until the utility makes a Demand Entitlement filing.[2]

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[1]See In the Matter of All Gas and Electric Utilities Annual Fuel Reports, Docket Nos. G,E-999/AA-99-1095, G-012/AA-99-1262 (Western), and G-002/AA-99-1263 (NSP).

[2]Minnesota Rules, part 7825.2910, subpart 2.

Both NSP and Western have already filed their 1999-2000 Demand Entitlement requests.[3] The estimated $0.43 per year increase reflects the difference between NSP's proposed demand rate and the estimated weighted average of NSP's and Western's demand rates.

The Department recommends that the Commission direct the combined entity to file a Demand Entitlement filing within 30 days of the date of this Order. With no party opposing the Department's proposal, the Commission finds it reasonable and will adopt it. The combined entity will limit its demand entitlement request to the levels that NSP and Western sought in their 1999-2000 Demand Entitlement filings. The combined post-merger Demand Entitlement filing will identify the date upon which the combined gas costs and rates will take effect.

The Commission will also direct the combined entity to address how the proposed combined demand rates affect customers after the November 1999 demand-related rate changes are factored into the analysis. In its filing, the combined entity must also address how it proposes to implement the consolidation of the1999 true-ups for Western and NSP, and how to implement the consolidated 2000 true-up.

B. Pooling-of-Interest Method of Accounting

The Accounting Principles Board Opinion No. 16 establishes two methods to account for a business combination: "purchase" or "pooling-of-interest."

Under the purchase method, the acquired company's identifiable assets and liabilities are assessed at fair market value (FMV) as of the time of the merger. Any excess of the purchase price over FMV is recorded as "goodwill." However, regulatory accounting requires the acquiring company to record the acquired assets at the acquired company's book value. The acquiring company then records an "acquisition adjustment" of sufficient size to reconcile the difference between FMV and book value. A rate-regulated utility might seek to recover this amount from ratepayers.

In contrast, under a pooling-of-interest method, the financial statements of the merged entities are simply combined. There can be no dispute over the recovery of goodwill expense or an acquisition adjustment, because none are recorded.

The Department recommends that the Commission make any approval of the merger conditioned on its qualifying for the pooling-of-interest method of accounting. Both the Department and NSP expect that the transaction would qualify for pooling-of-interest treatment.

With no party opposing the Department's proposal, the Commission finds it reasonable and will adopt it.

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[3]See In the Matter of Western Gas Utilities, Inc., Demand Entitlement Filing, Docket No. G-012/M-99-1584; In the Matter of NSP Gas Utility Request for Change in Contract Demand Entitlements, Docket No. G-002/M-99-1548.

A. Recording of Merger-Related Transaction Costs

Although no acquisition adjustment or goodwill would be recognized as a result of a pooling-of-interest transaction, the proposed merger would nevertheless cause the companies to incur costs. The Commission must address how to account for these transaction costs.

The Federal Energy Regulatory Commission (FERC) directs energy utilities within its jurisdiction to maintain financial records according to its Uniform System of Accounts. FERC regulations describe what type of transactions to record within each type of account. However, the regulations leave some ambiguity about where to record certain transactions. The choice of where to record a transaction can influence a utility's ability to recover those costs from ratepayers in a future rate proceeding.

The Department proposes that NSP record its merger-related transactions "below the line" in FERC Account 426.5 Other Deductions. The cost of transactions recorded to this account may not be recovered from ratepayers. The Commission has included similar provisions in past merger dockets.[4] In Reply Comments, NSP agreed to the Department's proposal.

With no party opposing the Department's proposal, the Commission finds it reasonable and will adopt it.

A. Customer Notice

NSP says that it plans to notify Western's customers of the merger and resulting rate change, but that it has not yet drafted the relevant letter, bill insert or other notice. NSP agrees to submit to the Commission a draft of the rate change notification before effectuating the merger, and to work with the Commission and the Department to resolve the final text of the documents. The Department supports this proposal. With no party opposing the proposal, the Commission finds it reasonable and will adopt it. The Commission will direct the parties not to distribute the customer letter, notice or bill insert before the Commission's Executive Secretary has approved them.

A. Affiliated Interest Agreements

Various Minnesota law governs relations between a public energy utility and its affiliate. Minnesota Statutes § 216B.48, Relations with Affiliated Interest, says that in general,

> [n]o contract or arrangement between a public utility and any affiliated interest ... is valid or effective unless and until the contract or arrangement has received the written approval of the commission.

In addition, Minnesota Rules, part 7825.2200, sets forth minimum filing requirements for obtaining Commission approval. Finally, the Commission has by order established procedures for

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[4]See, for example, In the Matter of Request for Approval of the Merger of Interstate Power Company, IES Industries, Inc. and WPL Holdings, to be called Interstate Energy Corporation (IEC) or Interstate Energy, Docket No. E,G-001/PA-96-184 ORDER APPROVING MERGER WITH CONDITIONS (March 24, 1997).

allocating costs between regulated utilities and certain affiliates,[5] and also procedures for affiliated interest filings.[6]

NSP proposes to enter into arrangements with affiliates to provide administrative services and joint tax filing. Pursuant to the statute, NSP seeks approval of an unexecuted Administrative Services Agreement (ASA) and Tax Sharing Agreement (TSA) between NSP and Natrogas, on behalf of itself and North American Energy, Inc.

The ASA would provide management, supervisory, construction, engineering, accounting, legal and public affairs, financial, regulatory, auditing, general business forecasting, human and information resources, shareholder and investor relations resources, gas supply, office or other space, and similar services. It provides for charging interest on overdue bills at the daily commercial prime lending rate. According to NSP, the ASA complies with the Commission's cost allocation principles.

The TSA provides a framework for NSP to file consolidated federal and state income tax returns including Natrogas. Natrogas would be assessed its income tax liability as if it had filed separately; if Natrogas were to incur tax losses, NSP would reimburse Natrogas to the extent NSP had received a tax benefit from the consolidated return.

The Department analyzed the proposals, and reached the following conclusions:

- NSP has complied with the minimum filing requirements for obtaining Commission approval.
- The agreements do not constitute a "matter deserving greater attention" pursuant to the Commission's Procedures for Affiliated Interest Filings in Docket No. E,G-999/CI-98-651.

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[5] In the Matter of an Investigation into the Competitive Impact of Appliance Sales and Service Practices of Minnesota Gas and Electric Utilities, Docket No. G,E-999/CI-90-1008 ORDER SETTING FILING REQUIREMENTS (September 28, 1994).

[6] In the Matter of a Commission Investigation into Procedures for Reviewing Public Utility Affiliated Interest Contracts and Arrangements, Docket No. E,G-999/CI-98-651, ORDER INITIATING REPEAL OF RULE, GRANTING GENERIC VARIANCE, AND CLARIFYING INTERNAL OPERATING PROCEDURES, Attachment A (Procedures for Affiliated Interest Filings) (September 14, 1998).

- The proposed ASA and TSA are substantively similar to affiliated interest agreements previously approved by the Commission.[7]
- The agreements lack any potential to harm the public interest. ASA serves to establish procedures which protect NSP (and its ratepayers) from any cross-subsidization. The TSA allows NSP to take advantage of the benefits of filing a consolidated tax return while assessing Natrogas' tax liability as if the subsidiary had filed a separate return.

For the foregoing reasons, the Department recommends approval of the affiliated interest agreements. With no party opposing the recommendation, the Commission finds it reasonable and will adopt it.

F. Compliance Filing.

As noted above, the Commission will direct the entity resulting from the NSP/Natrogas merger to file a compliance report relating the final rate determination for Western's two Flexible Transportation customers. To further facilitate Commission oversight of these public utilities during this transitional phase of their operations, the Commission finds it reasonable to direct them to submit additional compliance filings.

Specifically, the Commission will direct NSP to make a filing, before integrating services with Natrogas or Western, showing all of the changes to NSP's Gas Rate Book that result from the merger. Also, the Commission will direct the combined entity to make a filing within 90 days of the consummating the merger, showing all accounting entries used to record the merger, including transaction costs. This information will help reveal whether the entities have complied with the provisions of this Order.

ORDER

1. The Commission grants the petition for approval of the proposed merger, subject to the conditions that follow.

1. Regarding Western's two Flexible Transportation customers,

   - NSP must meet with the two customers to determine if any of NSP's tariffed services would provide these customers with an economical and competitive gas rate. If no NSP gas tariff would provide service at or below their total cost under the existing Western Flexible Transportation tariff, NSP shall file the current

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[7]See In the Matter of Northern States Power Company Petition for Approval of an Administrative Services Agreement and Tax Sharing Agreement Between NSP and First Midwest Auto Park, Inc., Docket No. E-002/AI-94–1041; In the Matter of NSP's Petition for Approval of Administrative Services Agreement and Tax Sharing Agreement, Docket No. E-002/AI-97-300 (between NSP and Seren Innovations, Inc.); In the Matter of NSP Petition for Approval of Administrative Services Agreement and Tax Sharing Agreement with Ultra Power Technologies, Inc., Docket No. E-002/AI-97-1677; In the Matter of Application for Approval of Merger of Northern States Power Company and Black Mountain Gas Company, Docket No. G-002/PA-98-109.

Western Flexible Transport tariff to be part of the NSP Gas Rate Book. The tariff would be available to the two customers, but closed to any new customers. Once the two customers convert to service under an existing NSP gas tariff, leave NSP service, or at the time of the next NSP gas rate case, the closed class tariff may be deleted from the NSP Gas Rate Book upon Commission review of an NSP request for such action.

- The combined entity must file a compliance report on the final rate determination of Western's two Flexible Transportation customers.

3. Regarding demand rates and future demand entitlement filings,

   - NSP may not begin billing NSP and Western customers a combined demand cost (and rate) until after a combined Demand Entitlement filing is made with the Commission. NSP may include only the entitlement levels that NSP and Western have already filed with the Commission in their 1999-2000 Demand Entitlement requests filed on or about November 1, 1999. The combined post-merger Demand Entitlement filing will identify the date upon which the combined gas costs and rates will take effect.

   - NSP must address how the proposed combined demand rates impact customers after the November 1999 demand-related rate changes are factored into the analysis. In its filing, NSP must also address how it proposes to implement the consolidation of year 1999 true-ups, filed on September 1, 1999, for Western and NSP, and NSP's consolidated year 2000 true-up (for the July 1, 1999 - June 30, 2000 period) on September 1, 2000.

4. The merger must qualify for the pooling-of-interest method of accounting.

5. Transaction costs and transition costs will be accounted for "below the line" in Account 426.5 Other Deductions, and the merged entity may not cite those costs in any rate-setting investigation.

1. NSP must prepare a draft rate change notice, letter and bill insert for Western customers, and submit these documents to the Commission's staff and the Department. NSP, the Commission's staff and the Department shall work to develop mutually-agreeable language for these documents. The documents must not be sent to customers before the Commission's Executive Secretary has approved them.

1. The Tax Sharing Agreement and Administrative Service Agreement are approved.

2. Regarding a compliance filing,

   - Before integrating services with Natrogas or Western, NSP shall make a filing showing all of the changes to NSP's Gas Rate Book that result from the merger.

   - Within 90 days of the consummating the merger, the combined entity shall make a filing showing all accounting entries used to record the merger, including transaction costs.

9. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

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