1993 NG92-005 ORD

BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF SOUTH DAKOTA

IN THE MATTER OF THE APPLICATION OF THE SOUTH DAKOTA INTRASTATE PIPELINE COMPANY FOR APPROVAL OF INITIAL RATES AND TARIFFS.	))))	**ORDER APPROVING REVENUE REQUIREMENT** **(NG92-005)**

On April 28, 1992, South Dakota Intrastate Pipeline Company (SDIPC) filed an application with the Public Utilities Commission (Commission) for approval of initial rates and tariffs. On May 29, 1992, the Commission issued an Order For And Notice Of Opportunity To Intervene Or Comment directing interested individuals or entities to intervene or comment in this matter on or before June 8, 1992.

At its regularly scheduled June 9, 1992, meeting, the Commission reviewed and granted Petitions to Intervene received, from Northwestern Public Service Company (NWPS), Montana-Dakota Utilities Co. (MDU) and the South Dakota Rural Electric Association (SDREA). The Commission's Order Granting Interventions was issued on June 17, 1992. By Order dated July 7, 1992, the Commission granted a petition for late intervention by the City of Pierre, South Dakota (Pierre).

At its regularly scheduled November 24, 1992, meeting, the Commission considered the setting of a procedural schedule. The Commission set a procedural schedule in this matter as follows:

Staff's and Intervenor's Prefiled Testimony shall be due in the Commission's office on or before December 7, 1992.

Rebuttal prefiled testimony of all the parties (optional) shall be due in the Commission's office on or before December 14, 1992.

The hearing shall be held December 17, 1992, at 9:00 a.m. (CST) in Room 412, State Capitol Building, Pierre, South Dakota.

The hearing was held as scheduled. James Robbennolt appeared on behalf of SDIPC; Warren May and Douglas Schultz appeared on behalf of MDU; Alan Dietrich appeared on behalf of NWPS; Gustave Jacob appeared on behalf of the Commission Staff; and Mary Lou Goehring, pro se, appeared on behalf of the City of Pierre. After the submission of briefs by SDIPC, Commission Staff and MDU, the Commission scheduled the matter for decision at its January 26, 1993, meeting. The Commission approved a revenue requirement for SDIPC as enumerated below.

Based on the record in this docket, the Commission makes the following:

FINDINGS OF FACT

1. On April 28, 1992, the Commission Received SDIPC's rate filing herein. SDIPC is a South Dakota corporation with its headquarters located in Pierre, South Dakota. SDIPC will engage in the transportation of natural gas within the State of South Dakota.

2. The Commission previously approved the siting application of SDIPC in NG92-002 by order dated December 9, 1992, which approved a construction permit for SDIPC's proposed pipeline pursuant to SDCL Chapter 49-41B. Pursuant to SDCL 1-26-19(3), the Commission hereby takes judicial notice of Docket NG92-002.

3. SDIPC will own and operate a natural gas transmission pipeline in Edmunds, Walworth, Potter, Sully, and Hughes Counties of South Dakota. SDIPC proposes to transport natural gas to distribution systems in towns along the pipeline route. Pierre is the terminus of the pipeline and the largest community to be served. Other potential towns to be served include: Agar, Bowdle, Gettysburg, Ipswich, Onida, Roscoe, Ft. Pierre, Mobridge, Selby and Glenham. SDIPC's pipeline will originate from a point on the existing Northern Border (NB) pipeline near NB's Compressor Station #9, which is located northeast of Ipswich, in Edmunds County, South Dakota. The SDIPC pipeline will terminate near the airport at Pierre, South Dakota. Sales taps will be installed along the route to serve distribution systems and rural customers. SDIPC's Exhibit Four introduced at the hearing in NG92-002 details the proposed pipeline route and is hereby incorporated by reference and attached as Appendix One. SDIPC has stated in this docket that it will file for an amendment to the construction permit granted in NG92-002, requesting Commission siting authority to extend the pipeline to Mobridge, South Dakota. The Mobridge extension would potentially serve the communities of Selby, Glenham, and Mobridge and rural customers along the route.

4. Three elements determine the retail rate of natural gas to a consumer. One is the cost of gas at the pipeline receipt point. The second element (at issue in this case) is the transportation cost to bring natural gas to the city gate. The third element is the cost to distribute natural gas to retail consumers. All of the above elements must be considered when determining whether or not natural gas will be competitive and economically beneficial to consumers in a new market.

5. SDIPC's application and testimony herein sets forth the estimated non-gas costs and associated non-gas initial rates for gas transportation services. The non-gas costs include: 1) the recovery of and a return on the cost to build the pipeline, 2) the cost to operate and maintain the pipeline, and 3) other administrative and overhead costs.

6. SDIPC estimates that the cost to construct the pipeline, inclusive of the Mobridge extension, will be approximately $12,013,000. SDIPC's estimate is contained in Exhibit WJW-R1 and Addendum to Exhibit 1, which were attached to Walter Woods' Rebuttal Testimony (WW RT) and the Addendum was submitted with SDIPC's initial brief. SDIPC has agreed to submit the actual cost of the plant placed in service after construction has been completed. SDIPC's estimated construction costs are appropriate to determine SDIPC's initial rates, except for the following adjustments. SDIPC estimated $500,000 each for omission and contingencies (O&C) and administration and general (A&G). Each of these items represent 5% of SDIPC's original construction estimate for a total of 10%. These amounts are speculative and appear to be overstated. $500,000 of SDIPC's stated O&C/A&G in plant should be eliminated consistent with Commission Staff's recommendation. SDIPC also estimated that $100,000 would be spent for environmental expenditures. Such an amount may be justified if the Commission or other agency had required SDIPC to prepare an environmental impact statement (EIS). However, SDIPC has not been required to produce an EIS. SDIPC also states there is the possibility of uncovering archeological finds during the construction of the pipeline. Since the pipeline will be built almost entirely in public right of way where the soil has previously been disturbed, the likelihood of uncovering an archeological find is remote. Therefore, $80,000 should be eliminated from SDIPC's estimate of environmental cost. After construction has concluded, the Commission will consider adjustments to SDIPC's initial rates based on prudently incurred final construction costs.

7. SDIPC has requested in Revised Statement J (attached to Terry Szklarski's Rebuttal Testimony (TS RT)) that its pipeline be depreciated over a 20 year period. SDIPC states that such a short period is economically necessary in order to build and finance the project. SDIPC Exhibit P (attached to TS RT) is a letter from Harris Bank, which is a potential financier of the SDIPC project. Exhibit P details Harris' concerns regarding the stability of SDIPC's future cash flows, SDIPC's ability to service the pipeline construction debt and SDIPC's ability to cover future out of pocket expenses. Harris indicates the project could be financed over a 10-20 year time frame. Commission Staff suggested a 40 year depreciation period which the Commission has consistently used in the past for natural gas transmission companies and which approximates the physical life of SDIPC's pipeline. SDIPC's concedes that its depreciation rates understate the physical life of the pipeline. However, the issue in this case is not the physical life of SDIPC's pipeline, but rather is capital recovery and cash flow. When considering the economics of SDIPC's pipeline, the Commission must consider: that SDIPC is proposing to furnish a new source of energy to new markets in central South Dakota; the risk of the project (four or five years of losses initially); SDIPC's ability to finance the project; and SDIPC's financial ability to provide natural gas service to the rural and relatively small communities along SDIPC's pipeline. Considering these

factors, SDIPC's pipeline should be depreciated over a 25 year period. Such a period is appropriate for the determination of initial rates. SDIPC has conceded in its Reply Brief that the Commission may revise the depreciation rates set herein after several years of operation if the Commission determines that the initial depreciation rate is in error or allows an inappropriate recovery of investment.

8. SDIPC has requested an ownership fee be allowed once the pipeline investment is depreciated to 20% of its original value. SDIPC and Commission Staff have agreed that this issue should be deferred until a later time. Such an issue should be decided when the timing is relevant.

9. SDIPC's operation and maintenance (O&M) expenses, contained in Statement H Revised, and other taxes, contained in Statement L Revised, are attached to WW RT. Both statements set forth respective expenses for the first year and then reflect an increase of 4% for each subsequent year. SDIPC's estimates of O&M expenses and taxes other than income taxes are appropriate for the determination of initial rates, except for the following expense adjustments. SDIPC's O&M expenses (line three on Statement H Revised) are overstated: by $15,000 of estimated consultant expense; by $8,000 of estimated training expense; and by $5,000 of estimated advertising expense. These three items of expense should be eliminated from Statement H Revised. SDIPC's consulting and training expenses should be at a peak during the initial start-up of operations. Expenditures for consultants and training should decline significantly after the pipeline is operating and as the business matures. If a start-up level of consultant or training expenses were used to establish a ten year levelized cost of service, these two expenses would be overstated in the later years. A ten year levelized rate should not reflect start-up training or consultant costs that should continue to decline through the ten year period. Because of the levelized rate, SDIPC should have less regulatory involvement and fewer rate changes. Employees will need continuing training regarding the safety and operation of the pipeline. However, ongoing training expenses should be significantly less than what it will cost to train an entirely new work force in the start-up phase of operations. SDIPC has failed to substantiate the reasonableness of its estimate for consultant and training expenses. Commission precedent has consistently disallowed promotional advertising because such advertising is designed to benefit the owners of the utility by increasing sales and profits. Because promotional advertising is accomplished at management's discretion for the benefit of the owners, it has routinely been disallowed by this Commission. Further, on Statement L Revised, SDIPC inflates all other taxes by 4% per year. Commission Staff only inflated workers' compensation by 4% per year. The Commission adopts Commission Staff's position. Property taxes should decline over time as SDIPC's plant depreciates in value. Unemployment insurance rates have decreased or remained stable recently in South Dakota. However, workers' compensation

rates have advanced upwards. Last, SDIPC will incur an expense for the gross receipts tax, which the Commission will assess SDIPC pursuant to SDCL 49-1A-3. Any such assessment should be added to SDIPC's Statement L Revised.

10. SDIPC proposes a capital structure of 75% debt and 25% equity. The equity component shall be created by the issuance of common stock. SDIPC estimates the cost of its long term debt to be 10%. SDIPC estimates the cost of equity to be 14%. SDIPC proposes an overall rate of return of 11%. These amounts are set forth in Revised Statement G, which is attached to TS RT. SDIPC's capital structure and rate of return (ROR) are appropriate for the determination of initial rates. When SDIPC obtains financing, the Commission may review SDIPC's actual cost of debt and SDIPC's capital structure and make adjustments as appropriate.

11. In Revised Statement K (attached to TS RT) SDIPC estimates its annual income taxes. Income taxes are determined as a function of operating income and the methodology employed by both Staff and SDIPC is appropriate. However, SDIPC's request for an AFUDC-equity income tax allowance of $1,805 shall be eliminated because SDIPC has not substantiated the requirement for cost of service recovery.

12. SDIPC's revised Statement M and Second Revised Statement M (attached to TS RT and Terry Szklarski's Amended and Revised Rebuttal Testimony (TS ARRT)) contain SDIPC's cost of service, rate base, return and income tax estimates. SDIPC did not include any accumulated depreciation for the first year rate base in its initial application. At the recommendation of Commission Staff, SDIPC has now included first year accumulated depreciation of $300,325. In order to achieve a proper matching of test year investment, expenses, and revenues, one must determine both the depreciation as well as the accumulated depreciation arising therefrom. One-half of the depreciation, or an average of year beginning and ending depreciation amounts should be reflected. SDIPC did not include a materials and supplies (M&S) allowance in its initial application. At the recommendation of Commission Staff they have now included $150,000. Based on customary M&S inventories for other natural gas utilities $150,000 should be added to SDIPC's rate base. SDIPC initially asked for a cash working capital (CWC) allowance of $90,000, but then conceded the issue after being questioned by Commission Staff. Because of the timing of revenues and expenses the Commission has commonly found that utilities receive a positive cash flow from their customers. Therefore, offsets in rate base have often been necessary to account for the positive cash flow. SDIPC has agreed to do a lead-lag study when appropriate in the future. SDIPC's initial filing included an amount of $23,000 for line pack. SDIPC's response of July 22, 1993, to a Staff data request indicated that this amount should be $21,000. Therefore $2,000 should be eliminated from SDIPC's estimated cost to construct the pipeline. Further, SDIPC concurs that the actual cost of line pack gas should be determined

based upon actual expenditures after construction when the gas is purchased and pumped into the pipeline. In SDIPC's Second Revised Statement M, SDIPC requests that it be compensated for interest on short term debt. SDIPC states that it will need to borrow short term funds in the first few years of operation to cover losses and out-of-pocket expenses. SDIPC estimates that it will incur $450,600 of interest expense on short term debt. SDIPC would begin to pay back short term funds when SDIPC's revenues exceed out-of-pocket expenses, which should be in the third or fourth year of operation. SDIPC would continue to pay off all short term debt thereafter until all such debt was paid in full. SDIPC's equity infusion in the form of short term debt is above and beyond the cost of service. Ratepayers do not participate in the profits of SDIPC, and therefore they should not bear the burden of short term losses. Such risks should be shouldered by SDIPC's stockholders. The interest on short term debt should not be reflected in SDIPC's cost of service. In addition to the adjustments listed in this finding, the adjustments listed in the above findings must also be made to SDIPC's Revised Statement M and Second Revised Statement M.

13. The estimation of the volume of gas transported over SDIPC's pipeline is very important in determining the transportation rate. Transportation of greater volumes of gas will lower the per unit transportation rate. SDIPC's estimates of the volumes of gas that will be transported over the pipeline are contained in Second Revised Statement I (attached to TS ARRT). Second Revised Statement I uses SDIPC's estimate of sales volumes for Pierre and incorporates MDU's estimates for communities located outside of Pierre. The volumes estimated are based upon the number of residential and commercial customers in a community times the percentage of customers that convert to natural gas times the annual consumption level for each class. SDIPC's Second Revised Statement I establishes reasonable estimates of SDIPC's potential gas transportation volumes for the determination of initial rates.

14. SDIPC has proposed to use levelized rates because rates developed on a strict and traditional cost of service basis produce an unmarketable result. SDIPC and Commission Staff have agreed that rates should be levelized initially over a ten year period. By levelizing the cost of service and volumes over an initial ten year period, transportation rate volatility is mitigated and rate stability is provided to SDIPC's customers. Further, if initial rates were set on the lower volumes of the first four or five years, the rates derived may be noncompetitive with alternative fuels. Levelized rates appropriately mitigate rate variations in the initial years of operation and are necessary to economically deliver natural gas to the communities along SDIPC's proposed route. Levelized rates provide a conditional long term pricing intent which assists consumers in making economic choices regarding fuel supplies. Levelized rates are not, however, guarantees of an unchanged rate over the period averaged. After several years of operating experience, SDIPC's levelized rates may be reviewed by the Commission and amended as appropriate. SDIPC's levelized rate

stated on Second Revised Schedule O-1 (attached to TS ARRT) shall be revised to reflect the Commission's adjustments made herein.

15. SDIPC believes that in order to be competitive with other existing fuels in Pierre that the price of natural gas to the consumer should not exceed $6.00/mcf. In Exhibit WJW-R2, (attached to WW RT) SDIPC witness Woods sets forth a price comparison of alternative fuels based upon BTU content. If customers act rationally they will convert to natural gas only if and when natural gas proves to be a lower cost fuel than alternative sources of fuel supplies. Therefore, it is important that SDIPC's rates remain relatively stable over time. If a customer wishes to convert to natural gas, that customer needs to be able to calculate the long term economic pay-back to convert. Customers need some assurance in a transition period that their conversion will or will not be a good economic choice for them. Therefore, stability in SDIPC's transportation rates help consumers make long range fuel decisions with reasonable expectations of benefitting from their conversion to natural gas.

16. SDIPC has proposed one set of rates for the first ten years of operation. On SDIPC's Second Revised Schedule O-1 (attached to TS ARRT), SDIPC proposes a ten year levelized commodity rate and interruptible rate of $2.4204 a Mcf. Said rate must be adjusted to both reflect the Commission's adjustments herein as well as any subsequent changes in rate design.

17. There was considerable testimony from SDIPC, MDU and Commission Staff regarding SDIPC's rate design. Much of the testimony related to SDIPC requiring a demand rate or minimum take provision in addition to a commodity rate. The issue of whether a demand or minimum take provision should be included in SDIPC's tariffs is best resolved by good faith negotiations between SDIPC and any distributor(s). Once SDIPC and any potential distributor(s) have come to an agreement, the Commission will hold further proceedings to determine the actual rate design and its conformance to the cost of service based upon this Order.

18. SDIPC has proposed that its final transportation rates be trued-up based on actual construction costs after the pipeline is constructed and all construction costs are known. Such a procedure may eliminate concerns about the inaccuracies of the project estimates herein, although it may create additional concerns about marketability.

CONCLUSIONS OF LAW

1. The Commission has jurisdiction over the subject matter and parties to this proceeding pursuant to SDCL Chapter 49-34A, specifically SDCL 49-34A-4, 49-34A-6, 49-34A-8, 49-34A-10, 49-34A-11, 49-34A-12, 49-34A-13, 49-34A-19 and 49-34A-21.

2. Consistent with the above findings of fact, the

Commission's findings herein establish a just and reasonable revenue requirement for SDIPC's natural gas transportation services pursuant to SDCL 49-34A-6.

3. The Federal Energy Regulatory Commission (FERC) has determined 25 years to be an appropriate period for the depreciation of interstate natural gas transmission lines based on the lines economic lives, Altamont Gas Transmission Company, 54 FERC ¶61,028 (January 17, 1991) page 61,061; Kern River Gas Transmission Company and Mojave Pipeline Company Orders, 50 FERC ¶61,069 (January 24, 1990) page 61,150; Iroquois Gas Transmission System, 52 FERC ¶61,091 (July 30, 1990), 61,393.

Based on the above findings of fact and conclusions of law, it is therefore,

ORDERED, that SDIPC shall file proposed rate schedules with the Commission by April 23, 1993, in conformance with this Order.

FURTHER ORDERED, that SDIPC shall file its actual construction costs, including line pack costs, with the Commission within 30 days after completing pipeline construction to allow review and possible revision of SDIPC's initial rates, dependent on Commission review of the appropriateness of any cost changes.

FURTHER ORDERED, that SDIPC shall submit a lead-lag study to determine its need for a CWC allowance in their next rate case before the Commission.

Pursuant to SDCL 1-26-32, this order becomes effective ten days after the date of receipt or failure to accept delivery of the decision by the parties.

Dated at Pierre, South Dakota, this 25th day of March, 1993.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that this document has been served today upon all parties of record in this docket, as listed on the docket service list, by facsimile or by first class mail, in properly addressed envelopes, with charges prepaid thereon.

By: Stephanie Stocking

Date: March 25, 1993

(OFFICIAL SEAL)

BY ORDER OF THE COMMISSION:

Laska Schoenfelder

LASKA SCHOENFELDER, Chairman

Kenneth Stofferahn

KENNETH STOFFERAHN, Commissioner

James A. Burg

JAMES A. BURG, Commissioner