STAFF MEMORANDUM

TO: COMMISSIONERS AND ADVISORS

FROM: BRITTANY MEHLHAFF, JOSEPH REZAC, & AMANDA REISS

RE: NG16-015 - In the Matter of the Filing by NorthWestern Corporation dba NorthWestern Energy for Approval of a Contract with Deviations with Prairie Ethanol, LLC and Removal of South Dakota Wheat Growers Contract with Deviations

DATE: December 23, 2016

BACKGROUND

On December 16, 2016, NorthWestern filed a letter with the Commission requesting approval of a contract with deviations with Prairie Ethanol, LLC and to remove South Dakota Wheat Growers from the list of contract with deviations due to that contract with deviations expiring. NorthWestern requests approval on less than thirty days' notice with an effective date for the tariff revisions of January 3, 2017.

NorthWestern has contracts with deviations with several large ethanol plants in South Dakota[1]. These customers would normally be served under NorthWestern's transportation tariff Rate 87. Given these customers are very large volume users and given the length of pipeline extension required to serve these customers, the customers don't really "fit" under Rate 87. The rates were designed to allow NorthWestern to recover the costs associated with construction of the pipeline extension over a period of ten (sometimes fifteen) years, including a carrying charge, as well as recovery of O&M costs.

The contract with deviations with Prairie Ethanol was approved by the Commission in June 2007. The term of the contract was 10 years with an expiration date of December 31, 2016. Prairie Ethanol is the first large ethanol customers to reach the expiration date of its initial contract. The pipeline connects directly to the interstate pipeline therefore the customer is not served by NorthWestern's distribution system. Given the customer's pipeline costs have been recovered over the term of the contract, the asset on NorthWestern's books is fully depreciated with a net book value of zero. Since the customer has paid for the construction of the pipeline over ten years, it is no longer appropriate to charge the customer the current contract rate[2]. However, calculating a rate based on a zero rate base creates some problems as there is no depreciation expense and no return for the company.

Staff and NorthWestern have discussed this issue several times over the past ten years in order to come up with a solution that would be fair to NorthWestern, the ethanol customer, and NorthWestern's other customers. Staff believes NorthWestern and Staff have found a method that works for these direct connect customers in this situation. Staff explains this method in detail below.

[1] Refer to NorthWestern's Gas Rate Schedule, Section No. 4, Sheets No. 1 and 2

[2] It is also not appropriate to charge the customer the Rate 87B tariff rate given the customer is not connected to or using the rest of NorthWestern's distribution assets.

RATE CALCULATION

First of all, the rate calculation includes an allocation of operation and maintenance and administrative costs calculated using a system-wide average per foot rate multiplied by the length of Prairie Ethanol's pipeline. The customer also receives an allocation of common and general plant assets and related expenses. The customer will also be charged the Ad Valorem rate for the large Rate 87B customers. Recovery of administrative and general and common costs from this customer benefits other NorthWestern customers, as it reduces costs they must pay.

The most challenging part of determining this rate is calculating a fee in lieu of a return for the Company given the zero rate base. Staff and NorthWestern agree a method that has been utilized by FERC is appropriate in this situation. As stated in NorthWestern's filing, the FERC Cost-of-Service Rates Manual[3] includes a Management Fee section. This section of the FERC manual states:

> *"When a pipeline is fully depreciated and the pipeline continues to provide service, the Commission has permitted rates which provide for the recovery of operating expenses, taxes and a reasonable management fee that is equivalent to no more than 10% of the pipeline's average pre-tax return during the years prior to when the pipeline became fully depreciated."*

Applied to the Prairie Ethanol pipeline, the management fee is calculated as:

Original Cost X 50% X NorthWestern's Rate of Return (grossed up for taxes) X 10%

Staff believes the management fee as calculated above is reasonable in lieu of a return in this situation. It is NorthWestern and Staff's intention to create a new rate schedule for these ethanol customers in NorthWestern's next rate case, based on this method. However, Staff does not view approval of this contract with deviations as precedent setting as other parties not involved may have differing views and supporting facts that may need to be considered.

EFFECTIVE DATE

The requested effective date for the tariff revisions and new contract with deviations is January 3, 2017. The previous contract with deviations expires December 31, 2016. Given the gap between the two dates, Prairie Ethanol will be charged tariff rates for a couple days. Staff understands that Prairie Ethanol is aware of this. The contract was not signed in time for this docket to be filed and put on the December 20th Commission meeting agenda.

RECOMMENDATION

Staff recommends the Commission approve the contract with deviations with Prairie Ethanol, LLC effective January 3, 2017 and approve the associated tariff sheet on less than 30 days' notice, effective January 3, 2017.

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[3] This manual can be found at: https://www.ferc.gov/industries/gas/gen-info.asp