January 5, 2018

MEMORANDUM

TO: Energy and Telecommunications Interim Committee
FROM: Department of Public Service Regulation
SUBJECT: House Joint Resolution No. 28, Study of Natural Gas Consumer Choice

PURPOSE:

Pursuant to the provisions of House Joint Resolution No. 28, this memorandum provides an analysis of the responses of Montana-Dakota Utilities' ("MDU") to certain requests for information issued by the Energy and Telecommunications Interim Committee ("ETIC"). The analysis was conducted by staff of the Department of Public Service Regulation and the Public Service Commission.

BACKGROUND

In April 2017 the Legislature passed House Joint Resolution No. 28 to gather information on, among other things, the cost to utilities of opening their systems to consumer choice and the merits of deregulating natural gas utilities. The resolution tasks ETIC with identifying the costs incurred in opening utilities to choice and the potential costs that would be passed on to customers, as well as with identifying the merits and complications of deregulating utilities and implementing regulation of the customer choice process. The resolution further tasks ETIC with making recommendations to the 2019 Legislature on implementing competition with a level playing field for all buyers and sellers, while ensuring that existing regulatory and legal commitments are fairly and equitably addressed.

On November 2, 2017, MDU submitted responses to a number of questions posed by ETIC, which sought information on the utility system and operations changes, and associated costs, that could be incurred if MDU were required to open its system to customer choice. ETIC requested that the Public Service Commission (Commission) review and comment on MDU's responses from a regulatory perspective.

Given concurrent workload related to ongoing regulatory proceedings, Commission staff requested guidance from ETIC staff on where Commission analysis would be most useful. In response, ETIC staff provided Commission staff a subset of questions on which to focus its analysis. As a result, the following comments focus on questions 1, 4, 5, 9, 10, and 13.

COMMISSION COMMENTS

ETIC Information Request No. 1: *"Detail the potential costs incurred by integrating customer choice with MDU's natural gas infrastructure in Montana. What are the contributing factors to the projected costs?"*

ETIC requested that the Commission review and assess the reasonableness of MDU's cost estimates.

Upon review of MDU's response, Commission staff determined that the response does not provide sufficient information to determine the accuracy or reasonableness of the cost estimates and therefore is unable to assess the reasonableness of MDU's cost estimates. At a minimum, it would be necessary to review the underlying assumptions, work papers, and source data (e.g., specific capital investments and expenditures) used by MDU to develop its estimates in order to reasonably assess the resulting cost estimates. ETIC should continue conversations and inquiries with MDU personnel in order to obtain such information and a review of that information could be performed by the Commission at a later date. A reasonable goal would be to achieve a measure of confidence in the cost estimate and its associated magnitude of error, e.g., a floor and ceiling for expected costs, before deciding whether to implement a policy change.

Information Request No. 4: *"Detail the costs of natural gas transmission, supply, and storage on MDU's system in Montana"*

ETIC requested that the Commission assess whether the costs provided by MDU are viable and verifiable.

MDU reported that the bundled cost of natural gas supply to city gate[1] stations for residential service in October 2017 was $4.038 per dekatherm (Dth). In addition, MDU stated that, within this bundled amount, $1.489/Dth was related to fixed transmission and storage costs.

According to Commission-approved tariffs for MDU, the total rate per dekatherm for residential gas service in October was $5.186 (excluding the customer service charge of $7.00 per month). Subtracting applicable rates for distribution delivery ($1.134/Dth) and demand-side efficiency program funding ($0.014/Dth) results in a residual gas supply rate of $4.038/Dth, which matches the cost reported by MDU (*see* Rate Summary Sheet in MDU Gas Tariff on file with the Commission). Thus, Commission staff confirms that portion of the MDU response.

[1] A city gate is the intersection of a transmission line with a distribution system. At this point MDU receives measured volumes of natural gas from the transportation system to distribute to its customers.

Commission staff are unable to verify the $1.489/Dth portion of the bundled rate that MDU attributed to fixed transmission and storage costs because MDU has asserted in filings with the Commission that the underlying agreements with its third-party providers are subject to confidentiality provisions, and that detailed proprietary information will be provided upon the entry of an appropriate protective order and the issuance of a Commission order. (*See* Docket D2017.9.70., Application, p. 2; *Id*., Exhibit 7a). The Commission is in the process of requesting MDU to file a Motion for Protective Order. Once received, the Commission will act on the Motion, review the information provided by MDU, and supplement this response if staff cannot verify that $1.489/Dth is related to fixed transmission and storage costs.

Information Request No. 5: *"What is required of MDU to service a customer who buys gas from an independent supplier in Montana if the law changes?"*

MDU described several changes to its current practice that would be necessary to implement gas supplier choice. ETIC requested that the Commission assess whether those changes are representative of Commission policies and procedures. Each change is addressed below.

1) *MDU stated it would need to enter into transportation agreements with suppliers to deliver gas from city gate stations to choice customers.*

   This change would conform to policies and procedures the Commission has implemented for other gas utilities that currently allow customer choice (NorthWestern Energy and Energy West Montana). For example, the Commission has authorized and approved standards for such agreements pursuant to Mont. Code Ann. § 69-3-1403 and -1404. In addition, pursuant to Mont. Code Ann. § 69-3-1405, the Commission has statutory authority to license non-utility gas suppliers, including rulemaking authority to ensure that the natural gas supply is provided as offered and is adequate in terms of quality, safety, and reliability (*see* Admin. R. Mont. 38.5.7010 through 7016). The Commission has rules that define standards of conduct for utility interactions with non-utility gas suppliers, including affiliates of a utility (*See* Admin. R. Mont. 38.5.7005 and 38.5.7006).

2) *MDU stated it would need to aggregate energy consumed by choice customers on a daily basis in order to properly allocate expenses to suppliers.*

   This change would conform to policies and procedures the Commission has implemented for other gas utilities that currently allow customer choice. Because many potential choice customers are not metered on a daily basis, it would be necessary to estimate the daily requirements of the aggregate set(s) of choice customers being served by non-utility suppliers in order to account for the respective supply responsibilities of

MDU and non-utility suppliers. These daily estimates would be trued up periodically (typically monthly) based on actual meter information, with under/over gas deliveries managed through imbalance accounts.

3) *MDU stated it must allocate total commodity and pipeline penalty costs to suppliers, and implement a cash in/cash out program to reconcile invoices.*

   This change would conform to policies and procedures the Commission has implemented for other gas utilities that currently allow customer choice. Non-utility suppliers should be responsible for all commodity-related costs of serving their customers; MDU and its supply customers should not be responsible for pipeline penalties caused by the actions of a non-utility supplier. Developing a workable system to manage supplier cash balances would be a necessary element of a proper penalty-related cost allocation methodology.

4) *MDU must retain all upstream capacity, storage, and supply to ensure delivery to all customers in the event suppliers fail to deliver gas to the city gate, or a choice customer returns to MDU bundled service in the future.*

   This would conform to existing Commission policies and procedures for other gas utilities that currently allow customer choice. In general, MDU would not be able to curtail individual choice customers in the event that a supplier fails to deliver sufficient gas. MDU would need to step in to ensure adequate supply and system integrity. Thus MDU would need to control, if not retain, sufficient upstream capacity to serve all customers, choice and non-choice. *See* default supplier rule, Mont. Admin. R. 38.5.6007.

5) *MDU currently uses an automatic meter reading system that is not designed for daily metering. Therefore a new data management system will need to be acquired and employed to accommodate choice customer suppliers and billing.*

   As described above in part (2), MDU would need to design and implement measures to accurately balance supplier gas deliveries and actual choice customer usage. MDU would need to ensure that total system deliveries match customer usage in order to prevent cross subsidies between choice and non-choice customers.

Information Request No. 9: *"What are MDU's current rate structures and how might those rate structures change after customer choice?"*

ETIC requests a description of the methodology the Commission uses to set MDU's rate structure.

The Commission sets a utility's natural gas supply rates to recover the utility's prudently incurred supply costs. For example, NorthWestern's natural gas supply rate is designed to recover the cost of its owned gas production facilities as well as the cost of gas purchased from other suppliers. In addition, NorthWestern's natural gas supply rate is designed to recover transmission charges for gas purchased in Alberta, Canada. NorthWestern owns natural gas storage, transmission, and distribution facilities used to serve customers, and its supply rate does not reflect the costs of those facilities. These costs are recovered through separate rates for storage, transmission, and distribution service.

In contrast, MDU does not own natural gas production, storage, or transmission facilities. Instead, it purchases those services from others and its natural gas supply rate includes the costs of purchasing the services. MDU stated that its public utility service obligation requires it to purchase sufficient storage and transmission services to ensure service to all of its customers on peak winter days. MDU stated that if non-utility suppliers can serve a portion of MDU's customers without an obligation to provide storage and transmission services for these customers, then MDU's costs would be imposed on a smaller set of customers, which would increase costs to its remaining customers and potentially jeopardize MDU's cost recovery.

MDU stated that the commodity cost of gas should be unbundled from its total supply rate in the event that the Legislature requires natural gas customer choice on its system. That way, according to MDU, fixed costs associated with ensuring adequate and reliable service would be non-bypassable in a customer choice environment, which would mitigate cost risk for MDU and its full service customers. Effectuating such unbundling would require the Commission to conduct a contested natural gas delivery and supply cost rate case.

Information Request No. 10: *"How do MDU's natural gas rates compare to other utilities and suppliers in the state?"*

MDU provided a graph developed by the Commission that compares the total residential rates of NorthWestern, Big Sky Gas, MDU, and Energy West Montana, from September 2016 through October 2017. ETIC requests the Commission to determine whether the provided prices are still accurate and whether there are price trends or other information of value.

Commission staff confirms that the rates in the chart provided by MDU are accurate (prices are derived from approved tariffs) and that rates charged by the Companies shown in the chart did not materially change in November and December 2017. Importantly, however, the charted rates are total rates designed to recover commodity, storage, transportation, distribution, and regulatory (e.g. Universal System Benefit Charge) costs. NorthWestern, Big Sky Gas, and Energy West Montana depend upon NorthWestern's storage and transmission systems to deliver gas to their respective city gates. MDU depends upon other parties to deliver gas to its city gates. Consequently, the cost of delivery to city gate will differ between MDU and the other entities. MDU also relies heavily on natural gas supplied from the Bakken and Wyoming/Colorado, while NorthWestern and Energy West Montana rely on natural gas supplied from Alberta and north-central Montana. Because these gas supply sources are not generally fungible, comparisons of these entities commodity purchase costs has limited value. Notably, in the recent past, gas supplied from Alberta has consistently been priced lower (in U.S. dollars) than other natural gas trading hubs in the Western U.S.

Information Request No. 13: *"Are there structural differences between NorthWestern Energy and MDU that complicate consumer choice on the MDU system?"*

ETIC requests that the Commission describe the policy structure and market conditions alluded to in MDU's response. The Commission staff responds to each of the primary structural differences identified by MDU other than the anticipated need for a transition plan.

1) *MDU stated that NorthWestern owns the transmission lines used to transport gas to the city gates, whereas MDU does not. Therefore NorthWestern can capture in rates the capacity and commodity costs of transporting gas to choice customers.*

   Commission staff confirms that MDU does not own natural gas transmission facilities and, as a result, currently recovers the cost of purchasing transmission services through a bundled natural gas supply rate. This rate structure exposes MDU to potential stranded costs unless such transmission service costs are unbundled from the supply rate and incorporated into a non-bypassable transmission service rate. As indicated above, such unbundling could be achieved through a Commission natural gas rate proceeding.

2) *MDU stated that gas choice at Montana Power was implemented as part of the deregulation of its gas production and transmission operations and across its entire customer base.*

   Commission staff generally agrees that the Montana Power/NorthWestern Energy gas operations were and are larger than the MDU's current gas operation, and that MDU's smaller size might affect the per customer cost of implementing choice. Whether the ultimate costs for MDU would be materially impacted by its smaller size is not clear from the information MDU provided. As indicated above, further investigation of MDU's cost estimates is necessary to achieve confidence in those estimates. Comparisons to Montana Power/NorthWestern Energy records, if available, might further clarify this issue.

3) *MDU stated that its current market and industry conditions are very different from the conditions that Montana Power faced in 1997, especially regarding the cost of service pricing applied to Company-owned sources of supply*.

   Commission staff agrees that the natural gas industry has transformed significantly in the last two decades. Wholesale natural gas markets are generally competitive and resistant to the formation of market power and pricing leverage. For instance, NorthWestern typically obtains most of its market supplies at indexed rather than fixed prices, so that its market supply costs (i.e. supply costs other than its owned gas production asset costs) generally track competitive daily market prices. Since the Commission does not currently receive detailed commodity purchase information from MDU, due to the proprietary concerns noted above, Commission staff cannot confirm, at this time, that MDU commodity purchases generally track daily market prices.