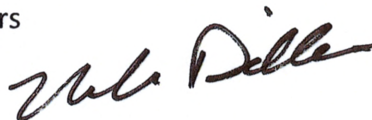
Memo

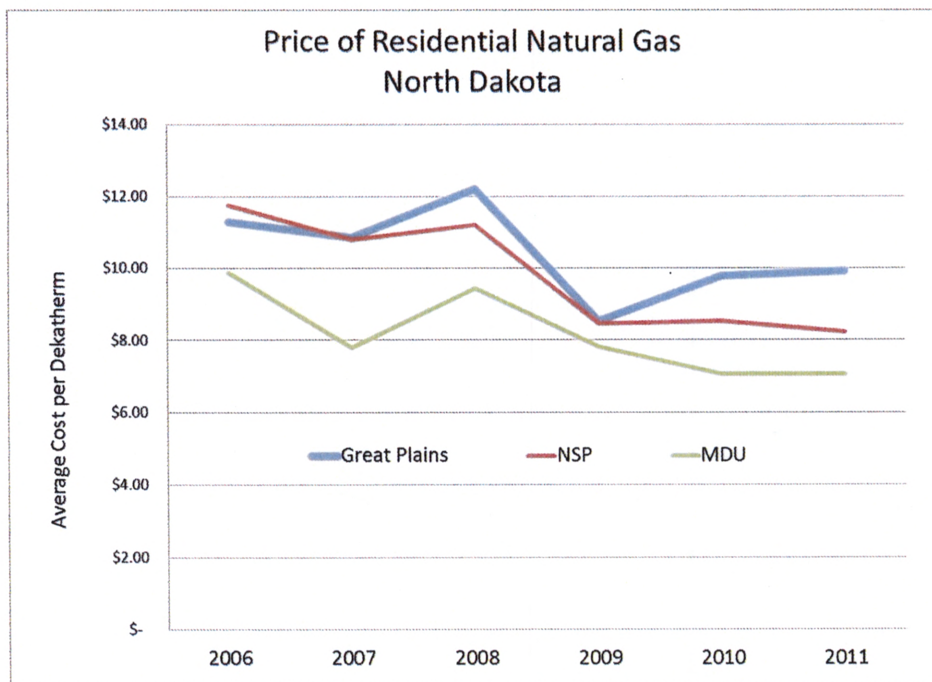
To: Commissioners

From: Mike Diller 

Date: November 12, 2012

Re: Recommendation to Close Great Plains Natural Gas Co.'s Annual Reports
Case Nos. PU-07-153, PU-08-168, PU-09-168, PU-10-134, PU-11-120, PU-12-153

Great Plains Natural Gas Co. (Great Plains) provides natural gas to Wahpeton, North Dakota. According to the U.S. Energy Information Administration's website, North Dakota has the lowest reported natural gas rates in the country. That said, Great Plains' rates are higher than NSP's rates and significantly higher than its sister company MDU.



The overall rate differential is primarily due to the wholesale cost of natural gas which represents about one-half of the cost to provide service. Natural gas price differentials between companies can be caused by a number of things including regional market prices, storage capabilities, hedging practices, contract periods, etc. Following is a chart of just the commodity price of gas by distributor.

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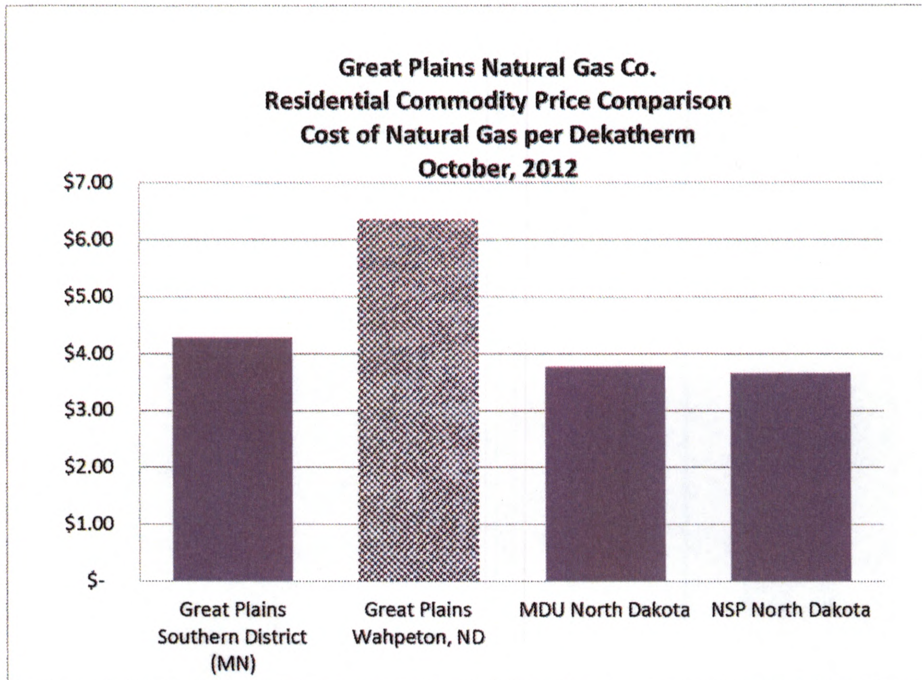


According to Rita Mulkern, Great Plains' 15 year gas supply and transportation contract expired October 31, 2012. The expiration of the contract provided an opportunity for Great Plains to negotiate better terms which will lower gas capacity costs by approximately $2 per dekatherm for its Wahpeton operations.

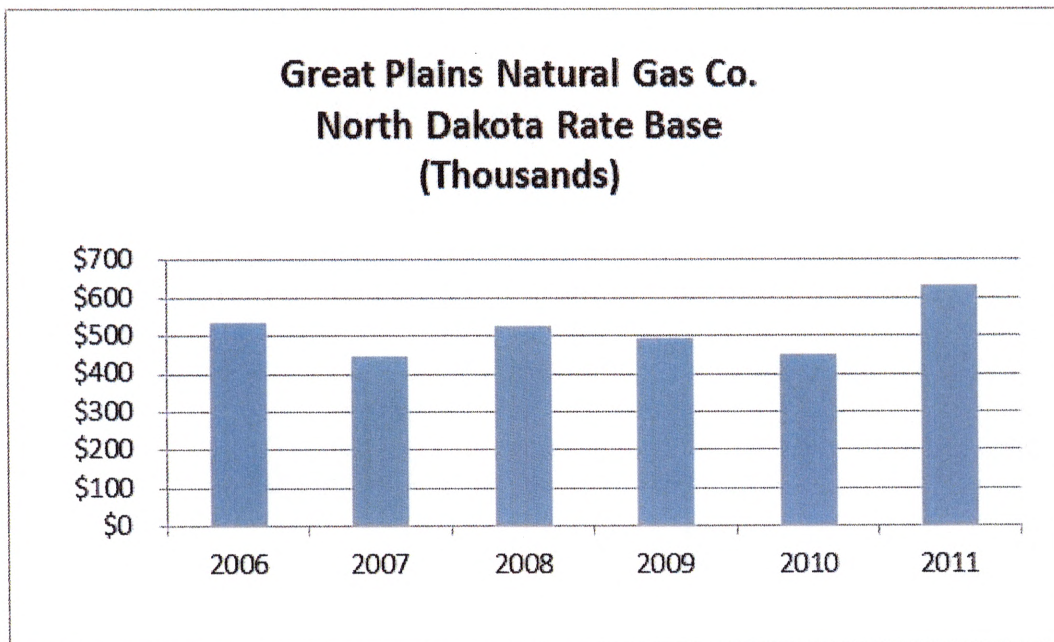
Under the old contract, gas supplies were transported from Canada via two different pipelines into the Viking Gas Transmission Company's pipeline for final delivery to the city of Wahpeton, ND. The transportation volumes for one of the Canadian pipelines (TransCanada) had diminished over time resulting in the reallocation of fixed costs to remaining customers as authorized by the National Energy Board resulting in high capacity costs. Under the new contract, Northern Natural will provide transportation service of gas supplies to Viking Gas Transmission Company at its Chisago Minnesota interconnect. Northern Natural already provides similar service to Great Plains' Southern Division.

The city of Wahpeton currently does not have an option for gas "delivery" from any other entity besides Viking Gas Transmission Company. Staff asked the Company to investigate the cost of building its own transmission line to the Montana-Dakota Hankinson line 19 miles away. However, the cost of doing so is estimated to be $6.5 million or about 10 times the current North Dakota rate base for Great Plains. The investment would require about $1 million more in revenue requirements from the city of Wahpeton. At this time, building an alternative route to a different gas delivery transmission line is not economically feasible but MDU will continue to monitor this option in the future.

Rate Base

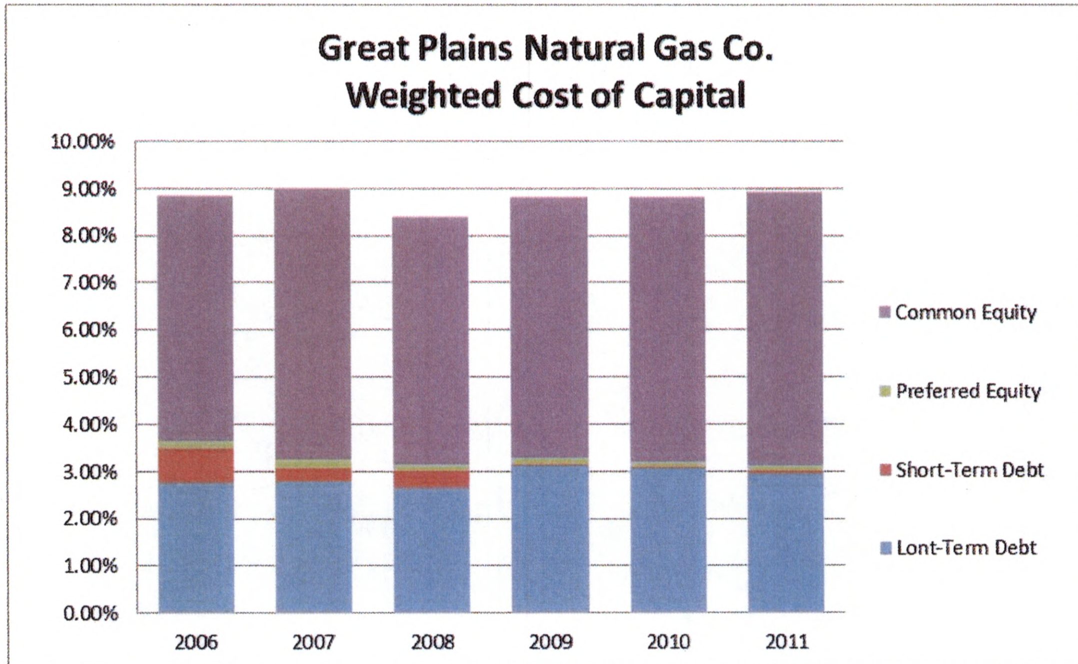
Costs recovered in rates include a return on rate base (investment) needed to compensate debt holders and stockholders. This cost is determined by multiplying rate base times the overall weighted cost of capital. The return component plus any needed expenses equals the total revenue requirements of the company.

Rate base remains low and stable for the most part. I say "low" based on the amount of capital invested per customer when compared to our other gas utilities. The largest decrease in rate base occurred in 2007 at the completion of the acquisition premium paid by MDU to acquire Great Plains. The largest increase occurred in 2011 as a result of the Highway 13 extension project approved by the commission estimated at the time to be $434,000 less cash contribution by users of $160,945. Please note that the new customers along Highway 13 are paying a surcharge so as to not impact preexisting customers.



Cost of Capital

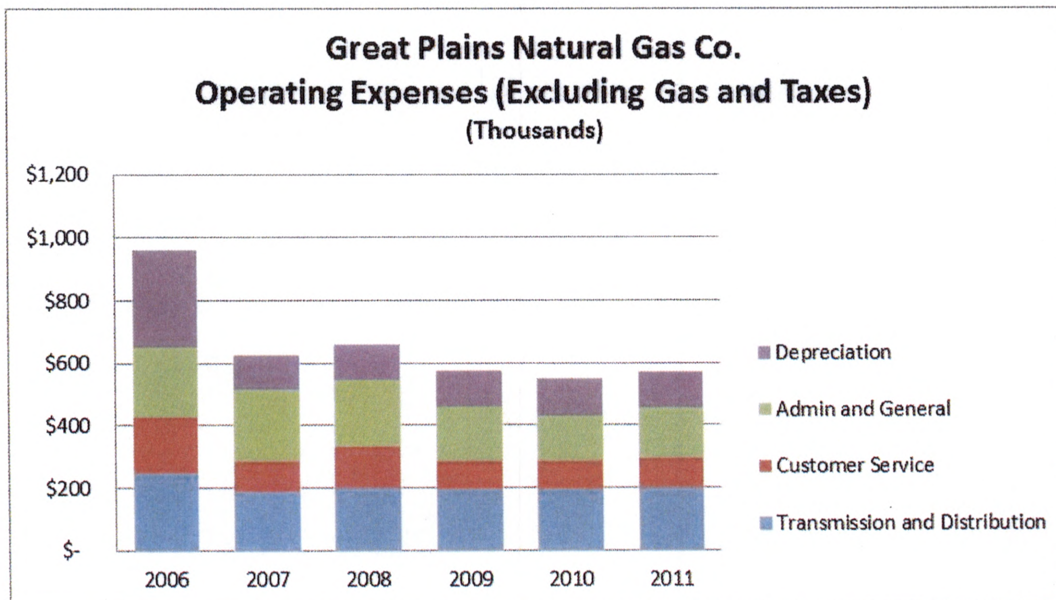
Great Plain's cost of capital has been stable in recent years. The stack bar to follow depicts the makeup of Great Plain's weighted average cost of capital using a 10.75% return on equity. While it is not evident from the stack bar, the ratio of common equity to total capital structure has increased to 54% in 2011 which of course is the most expensive form of capitalization. Also, not evident, due to its relative size, is the high cost of short-term debt due to relatively high commitment and negotiating fees.



Net Operating Income

Net operating income is comprised of revenues less expenses. Gas usage and customer levels have remained flat over the review period with some growth occurring in 2011. As a result, net margins (revenues less cost of gas) have remained flat with some growth occurring in 2011.

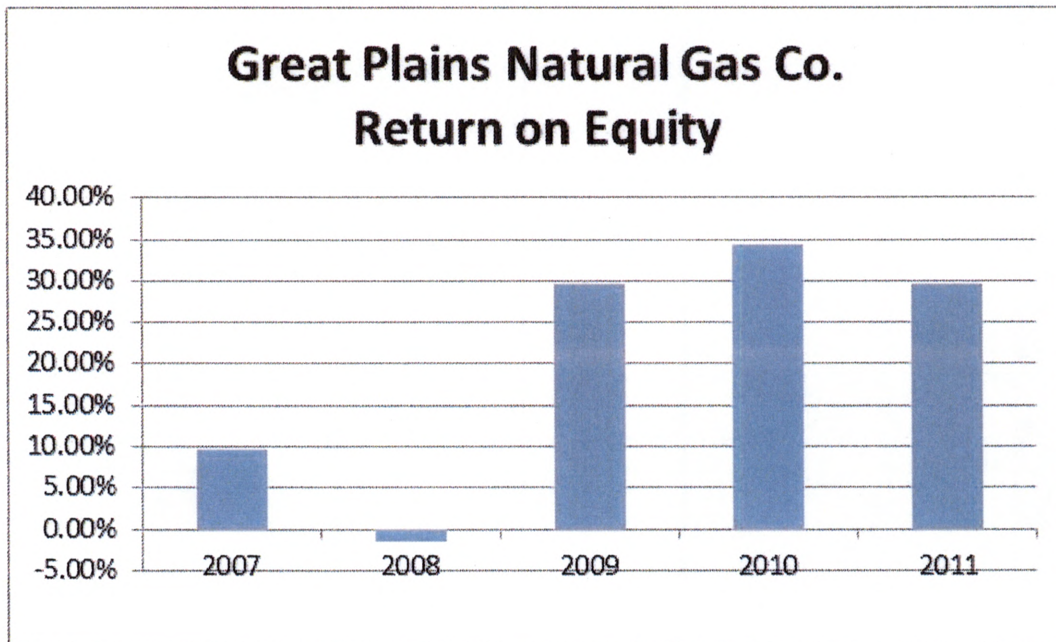
Great Plains has done a good job of managing its operating expenses as can be seen in the following chart:



The large reduction in depreciation in 2007 was due to the completion of the amortization of the acquisition premium paid by MDU to acquire Great Plains. That said, the other operating expenses have been managed down and offers some "after-the-fact" support for the acquisition.

Excess Earnings

Significant negative earnings were reported during 2002 through 2006 while Great Plains wrote-off the acquisition premium paid by MDU to acquire the company. Beginning in 2009, earnings on equity have increased to about 30% per year in recent years.



Conclusion

Now that the acquisition premium has been fully amortized, I believe over-earnings will likely continue and perhaps grow larger. Even if 2011 rate base was doubled, Great Plains would have still earned a reasonable rate of return on its investment. The $2 per dekatherm reduction in demand costs may result in additional margins as interruptible customers move to firm service and new customers move from an alternative fuel source to natural gas.

Despite the over-earnings, I am recommending the cases be closed. Instead of initiating a rate reduction case against the Company, I recommend that the commission allow staff to work with Great Plains in order to submit a plan to bring earnings down to a more reasonable level. Staff believes that such a plan can be filed by the end of January, 2013. This kind of approach will foster cooperation and allow the Company maximum flexibility in its approach.