ENSTAR
Natural Gas Company

3000 Spenard Road
PO Box 190288
Anchorage, AK 99519-0288
www.enstarnaturalgas.com

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Regulatory Commission of Alaska
701 West Eighth Avenue, Suite 300
Anchorage, Alaska 99501

Subject: Tariff Advice Letter TA 310-4

Dear Commissioners:

The tariff filing described below is transmitted to you for filing in compliance with Sections 3 AAC 48.200 - 3 AAC 48.430 of the Alaska Administrative Code:

Tariff Sheet		Cancels Sheet		
Number	Revision	Number	Revision	Schedule or Rule Number
228	Third	228	Second	Section 2403 Homer Extension Surcharge

ENSTAR Natural Gas Company, a division of SEMCO Energy, Inc., ("ENSTAR") is proposing to revise the methodology for calculating the rate of return and income tax ("Carrying Costs") portion of the Net Total Actual Costs for the Homer Extension, detailed in Sheet 228 of ENSTAR's Tariff. ENSTAR's revision will reduce the Carrying Costs being applied to the Net Total Actual Costs of the Homer Extension. ENSTAR is not proposing to change the dollar amount of the Homer Extension Surcharge, which is $1 per thousand cubic feet ("Mcf") of natural gas. The proposed tariff provision revision will affect only ENSTAR's customers in the Homer Extension Surcharge Area, less than 1.5% of its total customer base.[1] ENSTAR respectfully requests that the Commission approve the methodology revision effective January 1, 2019.

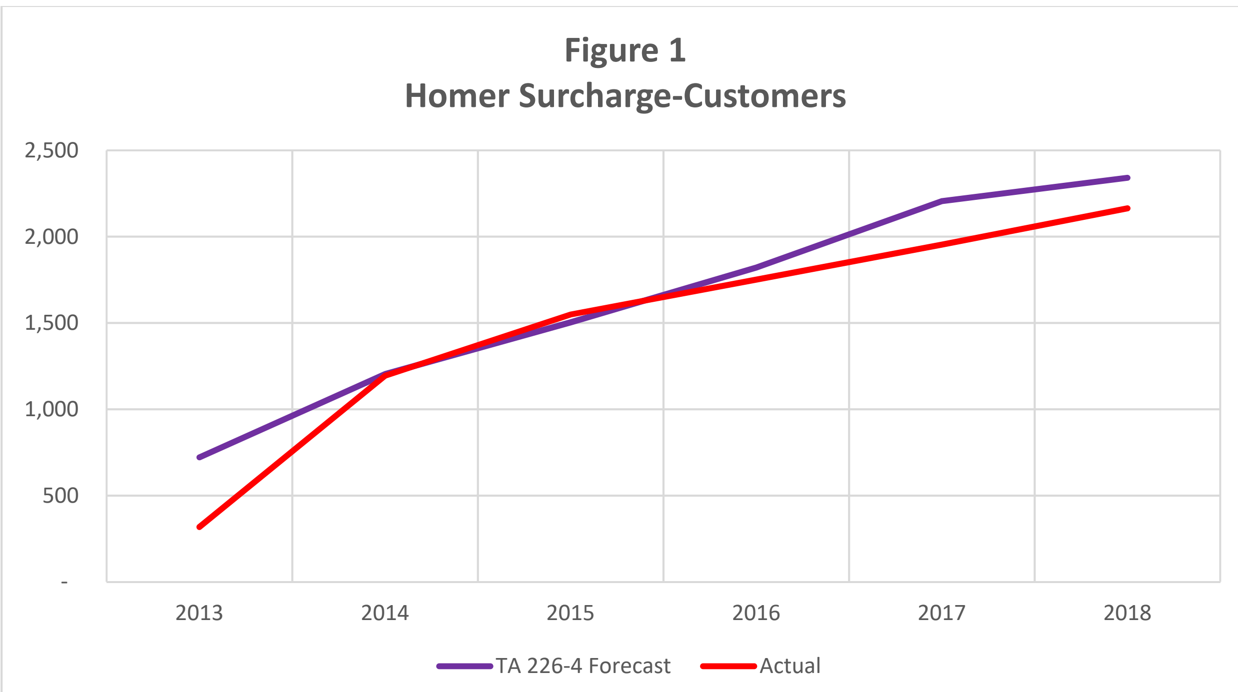
Summary

In the Homer Extension, ENSTAR constructed a 22-mile distribution pipeline transporting natural gas from ENSTAR's transmission system at Anchor Point, through the City of Homer, and terminating at the eastern boundary of Kachemak City. A portion of the Homer Extension was paid for by a state grant obtained by the City of Homer and committed to ENSTAR as a contribution in aid of construction ("CIAC"). The remainder of the Homer Extension was to be paid for through a $1 per Mcf "Homer Extension Surcharge" to be applied to all Gas Sales and

[1] ENSTAR had 2,178 customers in the Homer Extension Surcharge Area as of January 31, 2019. It has a total of 146,022 customers system wide.

Transportation Service bills for Gas delivered in the Homer Extension Surcharge Area until the costs associated with the project are recovered.[2]

Since ENSTAR began collection in October 2013, however, the Homer Extension Surcharge has not been sufficient to cover the Carrying Costs on ENSTAR's net investment in the Homer Extension, and it does not appear that the surcharge will be sufficient to retire the remaining balance of the project costs unless changes are made to the Surcharge amount or to the Surcharge methodology. While the customer count in the Surcharge area has been close to what was projected (*see* Figure 1), volumes have been significantly lower than forecast, including use per customer volumes, when compared to ENSTAR's overall system average (*see* Figure 2 and Figure 3).



[2] As will be discussed later, the original Homer Extension Surcharge tariff methodology was approved in Order U-03-84(7). The original Homer Extension Surcharge tariff provision language was conditionally approved by Order U-03-84(12), dated September 16, 2004 and final approval was granted in Order U-03-84(13). The Surcharge provision language was updated with TA 226-4, which was approved in Letter Order No. L1200583 dated August 17, 2012.

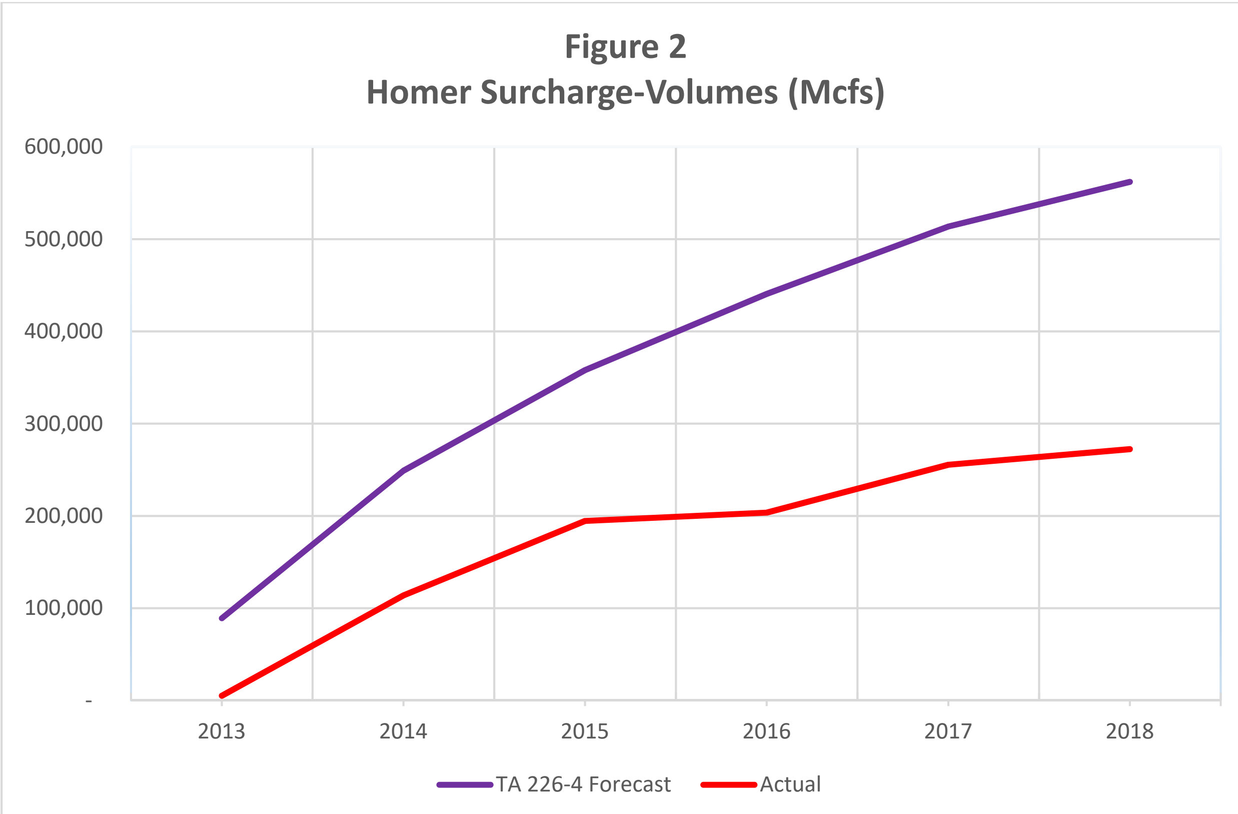


Figure 2
Homer Surcharge-Volumes (Mcfs)
600,000
500,000
400,000
300,000
200,000
100,000
-
2013
2014
2015
2016
2017
2018
TA 226-4 Forecast
Actual

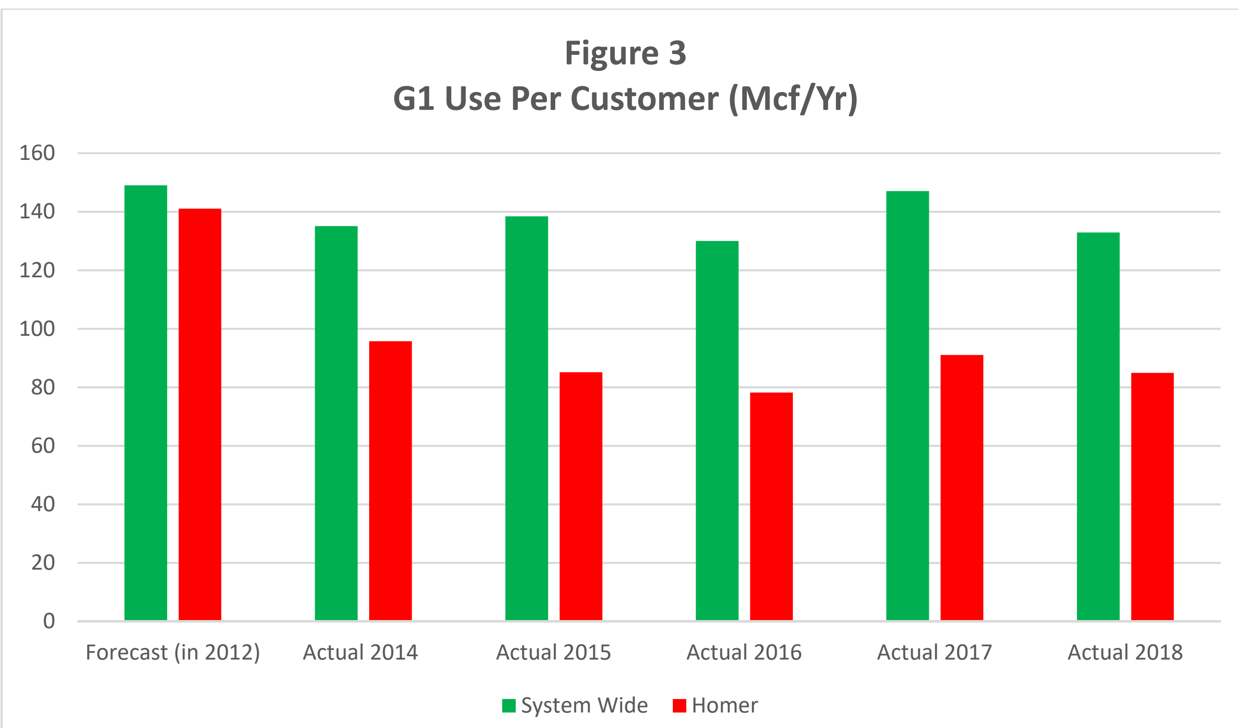


Figure 3
G1 Use Per Customer (Mcf/Yr)
160
140
120
100
80
60
40
20
0
Forecast (in 2012)
Actual 2014
Actual 2015
Actual 2016
Actual 2017
Actual 2018
System Wide
Homer

ENSTAR's projections prepared prior to the construction of the Homer Extension in 2012 took into account that the Homer area is warmer than the rest of its service area (accounting for approximately 5% fewer heating degree days[3] on average), but it did not anticipate such a significant deficit in annual usage. Anecdotal evidence suggests that the customers in the Homer area are behaving differently than those in other areas ENSTAR has expanded into and are not fully converting their buildings to gas when hooking up for service. Instead, it appears that many are waiting until their existing heating units and other appliances need replacement before fully converting their systems.

After reviewing numerous options, including increasing the $1 per Mcf Surcharge, ENSTAR proposes a methodology change that: 1) lowers the rate of return component of the Carrying Costs from this point forward from ENSTAR's approved average weighted cost of capital (currently 8.59%) to its approved cost of debt (currently 5.06%), and 2) breaks out the current balance of the Surcharge balance account between the CIAC amount and the unrecovered carrying cost, amortizing the current balance of unrecovered Carrying Costs ($2.2 million) over the current estimated remaining life of the Surcharge.[4] The change will reduce the Carrying Costs applied to the Homer Expansion Surcharge balance from $53,000 per month to approximately $26,000 per month (including the amortization of the unrecovered carrying costs).

Homer Extension Surcharge History

The Homer Extension Surcharge was first proposed by ENSTAR in TA 125-4 dated August 8, 2003, in conjunction with a new gas supply agreement from the North Fork gas field located north of Homer.[5] The original Homer Extension, described in the filing,[6] was to be an approximately 11 mile, 4-inch plastic distribution pipeline that would run from Anchor Point to the northern boundary of the City of Homer.[7] The estimated original cost of the pipeline, which

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[3] Heating degree days are the number of degrees that a day's average temperature is below 65° Fahrenheit, which is the temperature below which buildings need to be heated.

[4] ENSTAR has prepared new estimates of future gas use volumes in the Homer Extension Surcharge area based upon its experience since it began service in the area, current normalized use per customer, 10-year average weather and customer growth projections that are more conservative than it has experienced thus far.

[5] The gas supply contract was with NorthStar Energy Group. Under the gas supply agreement, NorthStar was to construct a pipeline from the North Fork gas field to Anchor Point to interconnect with ENSTAR's distribution system and the Homer Extension.

[6] TA 125-4 included prefiled testimony describing the proposed Surcharge from Daniel M. Dieckgraeff of ENSTAR, and Dr. Bruce Fairchild, regulatory consultant for ENSTAR. A proposed Homer Expansion Surcharge tariff provision was also included. The TA letter and with all attachments including prefiled testimony and the proposed Surcharge provision are included as Attachment A.

[7] ENSTAR had been awarded a service area amendment that included the Homer area subject to certain conditions in Order U-96-108(6), dated November 3, 1997, included as Attachment B.

was to be recovered via the Surcharge, was $3.5 million. The proposed Homer Extension Surcharge provision filed with TA 125-4 stated:

> "§2403a The Homer Extension Surcharge is a surcharge applied to all gas sales and transportation bills for gas delivered in the Homer Service Area until the total actual costs associated with the Anchor Point to Homer pipeline (including construction costs, rate of return and income taxes) are recovered. The rate of return used will be the most recent Commission determination of weighted average cost of capital of the Company."

In prefiled testimony that accompanied TA 125-4 (see Attachment A), ENSTAR's regulatory consultant, Dr. Bruce Fairchild, described how the mechanics of the provision would work:

> "Each month, the balance in the account will be increased by multiplying it times the monthly rate of return ENSTAR was authorized in its last rate case, plus the state and federal income taxes associated with the preferred stock and common equity portions of the return. The account will then be reduced by the receipts received from the line extension surcharge." (TA 125-4 Direct Testimony of Bruce H. Fairchild, p. 6)

Schedule BHF-1 to Dr. Fairchild's Direct Testimony provided an example of how the calculations would work.

TA 125-4 was suspended into Docket U-03-084, and the Homer Surcharge discussion was also subsumed into Docket U-96-108. A public hearing was held in January 2004, and Dr. Fairchild was cross-examined on ENSTAR's proposed surcharge methodology by legal counsel from the Department of Law's Regulatory Affairs and Public Advocacy section ("RAPA"). Dr. Fairchild stated that, "a separate accounting would continue on, but for the fact that changes in the rate of return, any changes in income tax rates both state and federal. Basically whatever was authorized in the general rate case would be carried over into the separate accounting." (U-03-084 Hearing Transcripts, Volume III at page 345, lines 4-9-January 14, 2004, (an extract of the hearing transcript covering all of Dr. Fairchild's testimony is included as Attachment C). Dr. Fairchild also responded to questions about the methodology asked by all three Commissioners on the panel. For example, Commissioner Strandberg asked Dr. Fairchild about the appropriateness of using the weighted rate of return (beginning at line 19 of Transcript page 346, Attachment C page 8 of 14).

Order U-03-84(7)/U-96-108(12) approved the surcharge and methodology proposed by ENSTAR (see Attachment D). Order U-03-84(13) approved the First Revision of Sheet 228 (effective October 11, 2004), which states, "[t]he rate of return used will be the most recent Commission determination of weighted average cost of capital by the Company."[8]

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[8] Order U-03-84(13) is included as Attachment E, the approved First Revision of Sheet 228 is included in Attachment F.

Unfortunately, the developer of the North Fork field, NorthStar Energy, did not perform on its gas supply contract, and ENSTAR could not go forward with construction of the Homer Extension without a gas supply. Given the high cost of fuel oil and propane in Homer, a large group of residents and business owners began lobbying ENSTAR and the State of Alaska to revive efforts to bring natural gas to the Homer area and help reduce the cost of space and water heating in the 2008-2010 timeframe. This was made possible, in part, due to the natural gas discoveries at the North Fork gas field being made commercially available by a new developer, Anchor Point Energy, LLC in 2009, and when ENSTAR extended its system to Anchor Point to obtain access to the North Fork field. ENSTAR updated its Homer Extension design and at the request of the local group, reconfigured it to not stop at the northern boundary of the City of Homer, but extend through the City of Homer to eastern boundary of Kachemak City. This length was double that of the earlier design, and the updated estimated cost was $10,700,000.

In May 2012, then-Governor Parnell signed a capital budget bill that included a state grant of $8,150,000 to the City of Homer for Homer's South Peninsula Natural Gas Pipeline project (the "Homer Grant"), with the understanding that the remaining amount needed for the extension would be paid for by ENSTAR upfront, and that ENSTAR would be reimbursed via the $1 per Mcf "Homer Extension Surcharge" already in ENSTAR's tariff.[9] The City of Homer committed the Homer Grant funds to ENSTAR in a CIAC for the Homer Extension (the "Homer CIAC").

In July 2012, ENSTAR filed TA 226-4 (see Attachment H), amending the "Homer Extension Surcharge" provision to reflect the Homer CIAC. It revised the definition of Net Total Actual Costs include the total net construction costs less the Homer CIAC, plus rate of return and income taxes. As approved, the provision provides for a $1 per Mcf surcharge to be "applied to all Gas Sales and Transportation Service bills for Gas delivered in the Homer Extension Surcharge Area until the Net Total Actual Costs associated with the Anchor Point to Homer pipeline (the "Homer Extension") are recovered."[10] The revision did not alter the overall calculation methodology for return and income tax that was approved in Order U-03-84(7)/U-96-108(12). Attachment A to TA 226-4 shows how the calculations work. It is clear from the illustration that the rate of return is calculated on the uncollected balance, and the income taxes are calculated on the rate of return. Attachment A to TA 226-4 was created from Dr. Fairchild's original Schedule BHF-1 from his U-03-84 testimony. Attachment A to TA 226-4 is the basis of ENSTAR's annual reconciliation of the Homer Extension Surcharge, which has been filed with the RCA each year

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[9] As noted above, the original tariff provision language was approved by the Commission in Order U-03-84(7), dated March 23, 2004. That Order noted that the $1 per Mcf surcharge "…permits a delayed recovery of the contribution customers must make for ENSTAR to build its line extension from Anchor Point to Homer, termed CIAC. This CIAC is normally required to be paid before a customer can receive service under ENSTAR's current tariff…." The Order also notes that the surcharge was expected to be in place approximately ten years. p.7. See Attachment D for Order U-03-84(7). See Attachment G for a letter from the Office of the Governor concerning the Surcharge.

[10] TA 226-4 was approved in Letter Order L1200583 dated August 17, 2012 and is included as Attachment I.

since the Homer Extension went into service. ENSTAR constructed the Homer Extension in 2012 and 2013, and began service in Homer in October 2013. With final construction costs of $11,780,072 and the $8,150,000 Homer CIAC, a balance totaling $3,630,072, plus return and taxes, was to be funded by the Surcharge (the "Surcharge CIAC").

In ENSTAR's last rate case, Docket U-16-066, ENSTAR noted that the surcharge was insufficient to cover the carrying costs of its net investment in the Homer Extension and to retire the amount of the Homer CIAC. ENSTAR presented a proposal that included placing the costs associated with the Homer Extension in its rate base, to be paid for by all ENSTAR customers. The Commission denied ENSTAR's proposal in Order U-16-066(19) and invited ENSTAR to propose a revised surcharge. An extract of the Order that includes the Homer Extension discussion is included as Attachment J.

Proposed Carrying Cost Rate Changes

The weighted average rate of return and income tax recovery rates used for the Carrying Costs applied to the Surcharge CIAC from the time the collections began in October 2013 through September 2017 were the rates shown on Attachment A to TA 226-4 (9.25% and 4.5% respectively) and were based upon the rates accepted by the Commission in Docket U-09-069. Both rates were dropped beginning October 2017 to 8.59% for the rate of return and 4.29% for the income tax recovery, reflecting the Commission's decision in Order U-16-066(19), ENSTAR's recent rate case docket. The income tax recovery rate applied was further reduced to 2.44% beginning January 2018 to reflect the decrease in the federal income tax rate to 21% as a result of the Tax Cut and Jobs Act of 2017.

As discussed above, ENSTAR's proposed change reduces the rate of return applied to the Surcharge CIAC going forward from the weighted cost of capital (currently 8.59%) to the cost of debt (currently 5.06%[11]). The reduced rate of return also results in a reduction in the income tax recovery rate, from the current 2.44% to 1.04%.

Because the Surcharge receipts have not recovered the Carrying Costs, the balance of the Surcharge CIAC account has steadily risen. As part of its methodology change, ENSTAR is breaking out the portion related to the uncollected Carrying Costs of $2.2 million and amortizing that balance over the current estimated remaining life of the Surcharge. Breaking out the uncollected Carrying Costs as of January 1, 2019 will reduce the balance of the Surcharge CIAC back to the original balance of $3,630,072. Under ENSTAR's revised methodology, the revised Carrying Costs will be calculated on the new balance, net of collections, amortization and the prior month's Carrying Costs. A detailed, step by step example of the monthly calculation using ENSTAR's new proposed methodology is attached as Attachment K.

[11] From Order U-16-066(19), p. 55.

Specific Tariff Sheet Revisions

All of the proposed revisions are in Section 2403b on tariff sheet 228. The first revision is to the second sentence of the paragraph, changing the rate of return from "weighted average cost of capital" to "cost of debt". A third line has been added to acknowledge that the unrecovered carrying costs as of December 31, 2018 will be amortized over the estimated remaining life of the Surcharge.

Effective Date

ENSTAR respectfully requests that the Commission approve the methodology revision effective January 1, 2019. Adoption of the new methodology as of that date will only affect ENSTAR's customers in the Homer Extension Surcharge area. For Homer Extension customers, the proposed methodology change represents an advantage, as it will reduce the amount of unrecovered carrying costs that will need to be amortized. As noted above, the change in methodology reduces the monthly Carrying Costs by approximately $26,000 per month.

Please feel free to contact me at 334-7661 if you have any questions.

Sincerely,

ENSTAR Natural Gas Company

Daniel M. Dieckgraeff
Director of Rates and Regulatory Affairs

Phone: 907-334-7661
Fax: 907-334-7657
Dan.dieckgraeff@enstarnaturalgas.com

Attachments