Service Date: November 7, 2013

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

IN THE MATTER OF the Application of Devon Gas Corporation and Havre Pipeline Company, LLC for Declaratory Ruling or for Approval of the Proposed Sale of Ownership Interests	)))))	REGULATORY DIVISION DOCKET NO. D2013.7.57

CONCURRING OPINION OF COMMISSIONER TRAVIS KAVULLA

The sale and transfer of Havre Pipeline Company LLC (HPC) might seem like an uncomplicated transaction—and were it not associated with a more significant, $70-million transaction, it would be. The Orders the Commission issues in this docket and in the related application for NorthWestern Energy ("NorthWestern") to own a subsidiary (Order 7300a (Oct. 22, 2013)) permit NorthWestern to become a more vertically integrated gas utility through the purchase of a substantial number of natural-gas wells currently in production, a gathering system and a transmission system ("HPC") whose predominant purpose is to accommodate those wells' production, and possibly further, undeveloped natural-gas reserves. Once Devon Gas Corporation ("Devon") and NorthWestern close on this purchase agreement, the state's largest natural-gas utility will own nearly half of the supply needed to serve its retail customers, who hitherto have relied largely on third-party purchases by NorthWestern.

The acquisition of these resources is largely consistent with Commission comments on the utility's biennial natural-gas procurement plans. *Comments on NorthWestern Energy's 2012 Natural Gas Biennial Procurement Plan*, ¶¶ 32-34, (May 22, 2013), Docket No. N2012.12.125. The historical volatility of the price of natural gas is well known; oil and electricity are stable by comparison. Natural-gas prices have reached historic lows in recent years owing to a glut of the commodity available on the market because of the technological revolution of the horizontal fractural drilling of natural gas in shale deposits and relatively low customer demands resulting from the troubled national economy. Because natural-gas prices are today low but subject to significant upward volatility, the Commission has encouraged the utility to acquire proven, physical assets to serve customer demands on a cost-of-service basis. The Commission has since approved a stipulation between NorthWestern and the Montana Consumer Counsel to act as a reference point regarding the conditions during which it makes sense for the utility to acquire gas-producing assets. Order 7210b (Nov. 15, 2012).

The Commission's previous comments and rulings, however, are not a blank check for the present transaction. There are two sets of questions that must be answered: the value these assets bring to NorthWestern consumers generally, and what NorthWestern has done to address the diverse concerns of those particularly affected by the company's purchase of these assets—one of the largest economic drivers of a large part of Montana.

In proceeding with this transaction, NorthWestern bears heavy expectations in each respect. As the company owns more natural-gas and electric assets, it is taking on greater responsibilities for which it must solely be accountable. Surely, one would hope, the utility recognizes this. Yet the roll-out of this acquisition has left something to be desired. At this Commission's Oct. 4, 2013, public meeting on this matter in Havre, more members of the public turned out than the Commission has seen for a decade at one of its meetings. Every member of the public who spoke at the meeting voiced concerns about the transaction. (A list of these concerns appears in the present Order, ¶ 9.) Such an outpouring does not happen when the T's have been crossed, and the I's have been dotted.

After an extensive review of the information that I have collected through my research related to the concerns expressed at the public meeting, I am convinced that many of those worries, if not all of them, could have been addressed in a forthright manner had NorthWestern pro-actively chosen to do so. At a minimum, the utility should have conducted more outreach to stakeholders subsequent to its public declaration that it would acquire the Devon properties. It is only in recent weeks that utility representatives have published an opinion column in the local newspaper, agreed to attend gatherings of mineral-rights owners, and otherwise have begun to be responsive to the public's concerns. It is wise of the Commission in this Order to direct the utility to address them in a filing it makes to rate-base these assets. *See Order,* ¶ 23.

I expect many of the public's concerns to be addressed more comprehensively in the context of the utility's eventual application to include the Devon assets in its natural-gas rates. It would be inappropriate for the Commission to rule on them here, without a formal hearing and substantially more information entered into the record. However, I would be remiss not to comment preliminarily on a number of the public's concerns, which I do below, based on research on these matters unearthed during the course of this proceeding.

Royalty Payments on Gas Production

Numerous mineral owners and county officials voiced concern at the Oct. 4 public meeting that NorthWestern would reduce its royalty payments to individual owners and government entities.

NorthWestern has committed to calculating the payments in the same manner as Devon has, where the royalty payment is based on the market price of gas, less permitted deductions including the cost of gathering compression fuel, transportation costs charged under the HPC tariff approved by the Commission, and transportation compression fuel. Order 7300a, ¶ 15; *see also* DR PSC-004 (Aug. 14, 2013). However, mineral owners in particular are concerned that in a vertically integrated setting, that methodology might allow NorthWestern to concoct its own baseline "market" price as the basis of royalty payments. After a review of the controlling law, I believe this kind of manipulation is prohibited by law.

Devon and a class of mineral owners entered years ago into a settlement, approved in U.S. District Court, on how royalty payments should be calculated. The market price in the settlement's methodology is established as "the first place where the gas produced from Devon Wells is sold in an arms length sale to a third party market." Order on Final Hearing, Final Certification of the Settlement Class, and Final Approval of Settlement agreement and Release of Claims, *Montana Land and Mineral Owners Association, Inc., et al. v. Devon Energy Corporation, et al.,* CV-05-30-H-DWM (D. Mont. Aug. 24, 2007), Exh. 1, p. 5.[1] NorthWestern will still be bound by the obligations that Devon committed to in the settlement. NorthWestern will still have to conduct this arms-length test, and given that the Commission already has ruled in the context of a ratemaking proceeding that producing wells' sales to HPC are not an arms-length transaction for the purpose of setting HPC rates, they presumably are not for the purposes of establishing the market point of royalty payments either. *See* Order 6869a, ¶ 4 (Dec. 23, 2008).

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[1] Accessible online (as of Oct. 30, 2013) at:
http://www.meitesmulder.com/CM/CurrentCaseUpdates/Devon%20Final%20Approval%20Order.pdf

In the meantime, the Commission already regulates the cost of the "permitted deductions" contemplated in the settlement agreement through its rate-setting authority over HPC. It did not regulate other costs associated with those deductions during the period of Devon's ownership, but the Commission will regulate all costs of the system (including the hitherto unregulated gathering and lost-and-unaccounted-for-gas costs) if they are owned for the service of retail customers of a public utility like NorthWestern. This, I hope, will provide more certainty for both HPC and NorthWestern customers, and for mineral owners also.

Treatment of Land-Owners

Similarly, NorthWestern will be bound by the same provisions that hold Devon accountable for surface damage that occurs in relation to accessing the gas-producing properties on ranchers' and farmers' land. NorthWestern made a commitment to this effect at the public meeting, but the proof of its representations will consist in how they perform that obligation. I hope landowners and mineral-rights owners, meanwhile, will keep the Commission informed about problems, if they encounter them, regarding these issues.

Development of Reserves

The only representative of NorthWestern at the Oct. 4 public meeting—the company's lawyer—speculated that the company would not develop gas reserves if it were to own them through a transaction like the present one, because doing so is outside the utility's risk profile. It is not clear if there are substantial undeveloped reserves associated with this acquisition. If there are, and if the company does not intend to develop non-producing gas reserves even when it is cost-effective to do so, it is difficult to conceive how NorthWestern will prove that the property as a whole is used and useful—and thus lawfully included in consumer rates. It is appropriate that the Commission has used this Order to direct NorthWestern to address this matter.

Employees

A major anxiety in any merger or acquisition is the workforce. Especially in the volatile oil and gas industry, where owners come and go on a frequent basis, workers face a level of uncertainty on issues ranging from whether they will have a job to what will happen to their 401k. The employees caught up in this transaction have been through this uncertainty before.

The ultimate result of this transaction, since NorthWestern intends to own the property for a longer time than a typical natural-gas exploration and production company likely would, is that the Devon-turned-NorthWestern employees will have greater-than-average certainty in this industry.

Property Taxes, Financing, & Other Issues

NorthWestern will continue to pay property taxes on the former Devon properties; it is unclear how, if at all, the tax classification of these properties will change. However, NorthWestern and other regulated utilities experience the highest property tax rate of any business in the State of Montana—expenses which, in NorthWestern's case, are directly passed on to the company's consumers. Depending on the property classification, taxes on the properties could increase as a result of the transaction (although, in my own view, it would be fair if those tax revenues simply remained the same, regardless of who owned the property).

Various members of the public inquired how NorthWestern was financing its recent spate of large acquisitions. The answer, generally, is that NorthWestern—like other regulated utilities—raises capital from a combination of equity investors (stockholders) and debt investors (bondholders) in roughly equal proportion. While NorthWestern may once have had difficulty raising funds, its credit ratings have improved since the utility emerged from bankruptcy roughly a decade ago. That factor, together with historically low interest rates and a turbulent economy where some investors seek returns in the lower-risk utility sector, have made it possible to borrow at relatively favorable rates. Both the principal and the return expected or the interest owed on that principal is re-paid through consumer rates over the course of time.

Conclusion

I hope some of the above explanations are helpful to members of the public who are concerned about the NorthWestern–Devon transaction. Clearly, NorthWestern should have conducted more outreach to the public, and it should have been more forthcoming in answering the honest, straightforward questions of customers, landowners, and employees who are affected by this transaction.

A Commission determination on the reasonableness of NorthWestern's investment in these properties, and how the utility plans to manage these properties, will properly be considered at a later date. At that time, the public will have an opportunity to judge the utility not by its word but by its deeds, after an initial period of NorthWestern ownership.

I therefor CONCUR with the Order.

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TRAVIS KAVULLA, Commissioner (concurring)