STATE OF MINNESOTA

BEFORE THE OFFICE OF ADMINISTRATIVE HEARINGS

FOR THE MINNESOTA PUBLIC UTILITIES COMMISSION

In the Matter of the Application of Minnesota Energy Resources Corporation for Authority to Increase Rates for Natural Gas Service in Minnesota	MPUC DOCKET No. G-011/GR-13-617 OAH Docket No. 16-2500-21807-2

MINNESOTA DEPARTMENT OF COMMENRCE PROPOSED SUBSTITUTE FINDINGS, OF FACT, CONCLUSIONS, AND RECOMMENDED ORDER

July 11, 2014

Linda S. Jensen
Julia E. Anderson
Peter E. Madsen
445 Minnesota Street, Suite 1800
St. Paul, MN 55101-2134

Attorneys for the Minnesota Department of Commerce

TABLE OF CONTENTS

This matter came for evidentiary hearing before Administrative Law Judge ("ALJ") Eric L. Lipman on May 13, 2014, at the offices of the Minnesota Public Utilities Commission in St. Paul, Minnesota. Public hearings were held on March 12, 2014, in Rochester and Rosemount, and on March 13, 2014 in Cloquet. Public comments were received until March 19, 2014.

Michael J. Ahern, Kristin M. Stastny, and Kristin K. Berkland, Attorneys at Law, Dorsey & Whitney LLP, 50 South Sixth Street, Suite 1500, Minneapolis, Minnesota 55402, appeared on behalf of Minnesota Energy Resources Corporation ("MERC" or the "Company").

Chad T. Marriott, Attorney at Law, Stoel Rivers, LLP, 900 SW Fifth Avenue, Suite 2600, Portland, Oregon 97204, appeared for and on behalf of the Super Large Gas Intervenors.

Richard J. Savelkoul, Attorney at Law, Martin & Squires, P.A., 332 Minnesota Street, Suite W2750, St. Paul, Minnesota 55101, appeared for and on behalf of Constellation New Energy – Gas Division, LLC ("Constellation").

Julia E. Anderson, Linda S. Jensen, and Peter Madsen, Assistant Attorneys General, 445 Minnesota Street, Suite 1800, St. Paul, Minnesota 55101, appeared for and on behalf of the Department of Commerce, Division of Energy Resources, Energy Regulation and Planning ("Department").

Ian M. Dobson and Ryan P. Barlow, Assistant Attorneys General, 445 Minnesota Street, Suite 1400, St. Paul, Minnesota 55101, appeared for and on behalf of the Office of the Attorney General, Antitrust and Utilities Division ("OAG-AUD").

Robert Harding, Clark Kaml, Robert Brill, Ann Schwieger and Andrew Bahn, 121 Seventh Place East, Suite 350, St. Paul, Minnesota 55101, attended the hearings on behalf of the Staff of the Public Utilities Commission ("Commission").

STATEMENT OF ISSUES

On September 30, 2013, MERC filed a general rate case seeking an annual increase in its natural gas rates of $14,187,597, or 5.52 percent~~.~~[1] based on a test year ending on December 31, 2014 and using a 10.75 percent return on equity (“Petition”). On November 27, 2013, the Commission issued a Notice and Order for Hearing referring the matter to the Office of Administrative Hearings for contested case proceedings.[2] The Commission’s November 27, 2013 Order directed the parties to specifically and thoroughly address the following issues in the course of the contested case proceedings:

1) Is the test year revenue increase sought by the Company reasonable or will it result in unreasonable and excessive earnings?

2) Is the rate design proposed by the Company reasonable?

3) Are the Company’s proposed capital structure, cost of capital, and return on equity reasonable?

The Commission further requested that the parties address MERC’s test year forecast for late payment and other revenues in their prefiled direct testimony and address and fully develop the record on MERC’s proposed test-year regulatory assets and liabilities. The Commission also asked that the parties address the reasonableness of MERC’s joint rate service with respect to both gas and non-gas costs and rates, and whether MERC’s joint rate tariff language needs to be clarified to better explain how MERC administers this service.[3]

FINDINGS OF FACT

I. INTRODUCTION

A. Description of the Company

1. MERC is a corporation organized under the laws of the state of Delaware, authorized to do business in Minnesota, with its principal office located in Rosemount, Minnesota. MERC is a subsidiary of Integrys and is one of six subsidiaries of Integrys Energy Group, which also owns Wisconsin Public Service Corporation, Upper Peninsula Power Company, Michigan Gas Utilities Corporation, The Peoples Gas Light and Coke Company, and North Shore Gas Company, which provide natural gas and electric service in the states of Wisconsin, Illinois and Michigan.[4]

---

1 Ex. 16 at 5 (B. Nick Direct); Ex. 2 Initial Filing Volume 1: Summary of Filing.

2 Notice and Order for Hearing (Nov. 27, 2013) (Docket No. G-011/GR-13-617) (Doc. ID No. 201311-94140-01).

3 Notice and Order for Hearing (Nov. 27, 2013) (Docket No. G-011/GR-13-617) (Doc. ID No. 201311-94140-01).

4 Ex. 16 at 3 (B. Nick Direct).

2. MERC serves gas to approximately 213,000 customers in 51 counties and 165 communities throughout Minnesota. MERC's gas service territories include customers in the southern, east central and northern portions of the state.[5]

3. MERC's last rate case was Docket No. G-007,011/GR-10-977. The Commission issued its Findings of Fact, Conclusions, and Order approving final rates in that proceeding on July 13, 2012. The Commission authorized rate relief based on a 9.70 percent return on common equity.[6]

B. Jurisdiction

4. The Commission has general jurisdiction over MERC under Minn. Stat. §§ 216B.01 and 216B.02. The Commission has specific jurisdiction over the rate changes requested by the Company under Minn. Stat. § 216B.16.

5. The case was properly referred to the Office of Administrative Hearings under Minn. Stat. §§ 14.48-14.62 and Minn. Rules 1400.0200, et seq.

C. Overview and Procedural Background

6. On August 22, 2013, MERC filed with the Commission sales forecast data as required by the Commission in its final order in the Company's most recent general rate case, MPUC Docket No. G-007,011/GR-10-977 ("2010 Rate Case"), to be provided thirty days in advance of the filing of its next rate case.

7. On September 30, 2013, MERC filed an application for authority to increase natural gas rates in Minnesota, seeking an annual increase of $14,187,597, or approximately 5.52 percent over current rates.[7] MERC's application included proposed interim and final rate schedules, used -a 10.75 percent return on equity and was based on a 2014 test year.[8] The Company's proposed interim rate schedules identified an interim revenue deficiency of $12,401,502, or 4.82 percent, and requested an interim rate increase of $12,095,382, or 4.70 percent, beginning January 1, 2014.[9]

---

5 Ex. 16 at 3 and Schedule (BAN-1) (B. Nick Direct).

6 *In the Matter of the Application of Minnesota Energy Resources Corporation for Authority to Increase Rates for Natural Gas Service in Minnesota*, Docket No. G-007,011/GR-10-977, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 20 (July 13, 2012) (Doc. ID No. 20127-76778-01).

7 Ex. 2 Initial Filing Volume 1: Notice of Change in Rates, Interim Rate Petition, Summary of Filing (Sept. 30, 2013).

8 Ex. 2 Initial Filing Volume 1: Notice of Change in Rates, Interim Rate Petition, Summary of Filing (Sept. 30, 2013).

9 ORDER SETTING INTERIM RATES (Nov. 27, 2013) (Docket No. G-011/GR-13-617) (Doc. ID No. 201311-94139-01). MERC waived its right under Minn. Stat. § 216B.16 to have interim rates in effect no later than sixty days after the initial filing.

8. On October 2, 2013, the Commission issued its notice requesting comments on whether MERC's filing should be accepted as complete and referred to the Office of Administrative Hearings ("OAH") for a contested case proceeding.

~~6.~~9. On October 8, 2013, MERC submitted additional information to supplement its September 30 filing regarding a filing requirement in MERC's 2010 rate case stemming from the Commission's decision in MERC's 2008 rate case, pertaining to new material costs related to tampering and reconnection of gas service and abnormal construction charges, such as frost charges due to the winter construction period.

10. On November 27, 2013, the Commission accepted MERC's filing as substantially complete as of September 30, 2013, and suspended the operation of the proposed rate schedule under Minn. Stat. § 216B.16, subd. 2, until a final determination in this case.[10] The Commission also referred the case to the Office of Administrative Hearings for contested case proceedings.[11]

11. The Commission further ordered the Company to file within thirty days the following supplements to its direct testimony[12]:

1. Supplemental direct testimony reflecting the calculation of the applicable conservation cost recovery charge (CCRC) and conservation cost recovery adjustment (CCRA) charges since the inception of its ownership, July 2006. MERC shall also provide the applicable Northshore volumes, CCRC and CCRA rates, and the CCRC and CCRA amounts, by month for the stated period of time, July 2006 through December 31, 2013.

2. Additional information on the adequacy of the Vertex billing audit with respect to finding CIP-related and other billing errors. Parties shall also address the adequacy of the Vertex billing audit in finding these errors.

3. Supplemental testimony that explains how the Company administers joint rate service and the joint rates in its joint rate tariffs and includes the following:

    a. Examples of different billing scenarios that demonstrate how the joint rates are administered for sales and

---

10 *See* ORDER ACCEPTING FILING, SUSPENDING RATES, AND EXTENDING TIME FOR FINAL DETERMINATION (Nov. 27, 2013) (Docket No. G-011/GR-13-617) (Doc. ID No. 201311-94138-01); NOTICE AND ORDER FOR HEARING (Nov. 27, 2013) (Docket No. G-011/GR-13-617) (Doc. ID No. 201311-94140-01).

11 NOTICE AND ORDER FOR HEARING (Nov. 27, 2013) (Docket No. G-011/GR-13-617) (Doc. ID No. 201311-94140-01).

12 NOTICE AND ORDER FOR HEARING at 2–3 (Nov. 27, 2013) (Docket No. G-011/GR-13-617) (Doc. ID No. 201311-94140-01).

transportation joint rate customers compared to interruptible sales and transportation customers.

b. An explanation of how joint rate customers are charged for the interruptible and firm parts of the service they are taking and any credit MERC may provide to firm (or system) sales customers for the joint rate sales customer's use of MERC's entitlement to upstream firm pipeline capacity.

c. An explanation of the methodology MERC employs for the design of these rates, how all elements of these rates are calculated, how these rates are applied to the joint rate tariffs and to customer bills, and the billing arrangements MERC employs for charging joint rate customers the rates that appear in the joint rate tariff.

12. Further, the Commission, in addition to the above-listed supplements, required MERC to provide the following information:[13]

1. Additional information regarding the Company's tracking and handling of CIP expenses in the development of the test year operating expenses.

2. The potential impact of updated sales forecasts and commodity pricing forecast updates on the demand and commodity cost of gas rates. MERC shall provide updated sales forecasts and commodity pricing forecasts from its general rate case and information on the potential impact of these updates on its per-dekatherm demand and/or commodity cost of gas rates. These updates should be filed in this docket and the related base cost of gas matter, in Docket No. G-011/MR-13-732.

~~7.~~13. Minnesota Statutes section 216B.16, subd. 2(e) provides MERC with the statutory right to a final determination by the Commission within 10 months of the initial filing date. If the Commission finds that is insufficient time due to the need to make a final determination in any other pending rate case, the statute authorizes the Commission to extend the suspension period up to 90 additional calendar days. In its Order Accepting MERC's Filing, the Commission determined to extend the suspension period until October 28, 2014, to ensure adequate evidentiary development and informed decision-making.[14]

~~8.~~14. The Commission granted MERC's request for an interim rate increase, authorizing an interim rate increase of $10,755,973 and authorized MERC to put the interim

---

[13] NOTICE AND ORDER FOR HEARING at 3 (Nov. 27, 2013) (Docket No. G-011/GR-13-617) (Doc. ID No. 201311-94140-01).

[14] *See* Order ACCEPTING FILING, SUSPENDING RATES, AND EXTENDING TIME FOR FINAL DETERMINATION (Nov. 27, 2013) (Docket No. G-011/GR-13-617) (Doc. ID No. 201311-94138-01).

rates into effect on November 29, 2013. The Commission acknowledged MERC's request to not begin charging the authorized interim rates until January 1, 2014 and MERC's right to waive its right to charge interim rates for that period.[15]

~~9.~~15. The Commission also approved MERC's request to withhold collection of the full amount of the interim rate increase from its Super Large Volume ("SLV") customer class. The Commission found that MERC presented "exigent circumstances" under Minn. Stat. § 216B.16, subd. 3, because its SLV customers are sensitive to rate increases, and have the ability to bypass MERC's system, which would potentially result in increased rates for MERC's remaining customers.[16]

~~10.~~16. As part of the interim rate order, the Commission also authorized an incorporation of a new base cost of gas set in conjunction with the base cost of gas proceeding in Docket No. Docket No. G011/M-13-732.[17] The Commission required that MERC update the base cost of gas at least once during the contested case proceeding and file such update in both the base cost of gas docket, Docket No. G011/M-13-732, and this docket.[18]

~~11.~~17. In accordance with the Commission's order, MERC is collecting interim rates subject to refund if the rates exceed the final rates determined by the Commission.[19]

~~12.~~18. On December 10, 2013, ALJ Eric L. Lipman conducted a prehearing conference at the Public Utilities Commission, 350 Metro Square Building, 121 Seventh Place East, St. Paul, Minnesota.[20]

19. ALJ Lipman issued the first prehearing order on December 12, 2013 and protective order on December 23, 2013.[21] In the first pre-hearing order, ALJ Lipman established the following schedule:~~ordered that petitions for intervention be filed by February 14, 2014; that direct testimony of intervenors be filed by March 4, 2014; that~~

---

15 ORDER SETTING INTERIM RATES at 2, 5 (Nov. 27, 2013) (Docket No. G-011/GR-13-617) (Doc. ID No. 201311-94139-01).

16 ORDER SETTING INTERIM RATES at 3-4 (Nov. 27, 2013) (Docket No. G-011/GR-13-617) (Doc. ID No 201311-94139-01).

17 *In the Matter of the Petition of Minnesota Energy Resources Corporation for Approval of a New Base Cost of Gas for Interim Rates in Docket No. G011/M-13-732*, ORDER SETTING NEW BASE COST OF GAS, Docket No. G011/M-13-732 (Nov. 27, 2013) (Doc. ID No. 201311-94132-01).

18 *In the Matter of the Petition of Minnesota Energy Resources Corporation for Approval of a New Base Gas Cost for Interim Rates*, Docket No. G-011/M-13-732 , ORDER SETTING NEW BASE COST OF GAS (Nov. 27, 2013) (Doc. ID No. 201311-94132-01); *see* Ex. 9 (Compliance Filing – Update to Commodity Cost of Gas).

19 ORDER SETTING INTERIM RATES at 2 (Nov. 27, 2013) (Docket No. G-011/GR-13-617) (Doc. ID No. 201311-94139-01).

20 *See* First Prehearing Order (Dec 12, 2013) (OAH Docket No. 8-2500-31126; MPUC Docket No. G-011/GR-13-617) (Doc. ID No. 201312-94534-01).

21 *See* First Prehearing Order (Dec. 12, 2013) (OAH Docket No. 8-2500-31126; MPUC Docket No. G-011/GR-13-617) (Doc. ID No. 201312-94534-01); Second Prehearing Order (Protective Order) (Dec. 23, 2013) (Doc. ID No. 201312-94841-01).

~~rebuttal testimony of all parties be filed by April 15, 2014; and that the evidentiary hearing take place on May 13-16, 2014~~.

December 17, 2013	Deadline for Feedback to the Applicant on the Draft Protective Order
February 14, 2014	Deadline for Intervention
March 4, 2014	Intervenor's Pre-filed Direct Testimony
March 11–13, 2014	Public Hearings in Greater Minnesota (Rochester, Rosemount, and Cloquet)
April 15, 2014	All Parties' Rebuttal Testimony and the Applicant's Update on the Base Cost of Gas
May 7, 2014	All Parties' Surrebuttal Testimony
May 8, 2014	Deadline for Revisions to Pre-filed Testimony
May 9, 2014	Minn. Stat. § 216B.16 Conference
May 13–16, 2014	Evidentiary Hearing
June 6, 2014	Applicant Files Issue Matrix
June 24, 2014	Non-Applicants' Response to Issue Matrix
	Applicant's Proposed Findings of Fact and Conclusions of Law
	All Parties' Initial Briefs
July 11, 2014	Non-Applicants' Proposed Substitute Findings of Fact and Conclusions of Law
	All Parties' Reply Briefs
August 12, 2014	Report of the Administrative Law Judge

~~13.~~[22]

~~14.~~20. The initial parties to the proceeding were MERC, the Department, and the OAG-AUD.[23]

[22] *See* First Prehearing Order (Dec. 12, 2013) (OAH Docket No. 8-2500-31126; MPUC Docket No. G-011/GR-13-617) (Doc. ID No. 201312-94534-01).

~~15.~~21. On February 14, 2014, Constellation filed a Petition to Intervene.[24]

~~16.~~22. On February 14, 2014, the Hibbing Taconite Company, ArcelorMittal USA's Minorca Mine, Northshore Mining Company, United Taconite, LLC, the Minntac and Keewatin Mines of United States Steel Corporation, and USG Interiors, Inc., (collectively appearing as the "Super Large Gas Intervenors") filed a Petition to Intervene.[25]

~~17.~~23. ~~MERC did not~~ No party objected to the intervention of the Super Large Gas Intervenors or Constellation as parties to this matter.

~~18.~~24. On February 24, 2014, U.S. Energy Services, Inc. on behalf of itself and a group of industrial, commercial, and institutional customers (collectively the "ICI Group") filed a Petition to Intervene.[26]

~~19.~~25. On February 26, 2014, ALJ Lipman issued a Third Prehearing Order, granting the intervention of Constellation and the Super Large Gas Intervenors and requesting additional information from the ICI Group as to which interruptible transport service customers it sought to represent.[27]

~~20.~~26. The ICI Group filed a supplement to its Petition to Intervene on February 27, 2014.[28]

~~21.~~27. MERC filed an objection to the ICI Group's untimely petition to intervene on March 3, 2014.[29] No other party objected to ICI's untimely petition.

~~22.~~28. Oral arguments on the ICI Group's Petition to Intervene were held on March 14, 2014.[30]

~~23.~~29. An Order denying the intervention of the ICI Group was issued on March 24, 2014.[31]

---

23 *See* First Prehearing Order (Dec. 12, 2013) (OAH Docket No. 8-2500-31126; MPUC Docket No. G-011/GR-13-617) (Doc. ID No. 201312-94534-01).

24 *See* Petition to Intervene filed by Constellation New Energy – Gas Division, LLC (Feb. 14, 2014) (Doc. ID No. 20142-96453-03).

25 *See* Petition to Intervene filed by Super Large Gas Intervenors (Feb. 14, 2014) (Doc. ID No. 20142-96453-03).

26 *See* Petition to Intervene filed by U.S. Energy Services, Inc. (Feb. 24, 2014) (Doc. ID No. 20142-96752-01).

27 *See* Third Prehearing Order (Feb. 26, 2014) (Docket OAH 8-2500-31126; MPUC G-011/GR-13-617) (Doc. ID No. 20142-96812-01).

28 Supplement to Petition to Intervene (Feb. 27, 2014) (OAH Docket No. 8-2500-31126; MPUC Docket G-011/GR-13-617) (Doc. ID No. 20142-96880-01).

29 *See* Objection to Petition to Intervene of U.S. Energy Services, Inc. and Affidavit in Support (Mar. 3, 2014) (OAH Docket No. 8-2500-31126; MPUC Docket G-011/GR-13-617) (Doc. ID Nos. 20143-96996-01 and 20143-96996-02).

30 Fourth Prehearing Order (Mar. 11, 2014) (OAH Docket No. 8-2500-31126; MPUC Docket G-011/GR-13-617) (Doc. ID No. 20143-97235-01).

~~24.~~30. The Super Large Gas Intervenors, though a party to the proceeding, did not submit testimony or actively participate in this proceeding.

~~25.~~31. MERC filed direct testimony on September 30, 2013.[32]

~~26.~~32. MERC filed supplemental direct testimony on December 26, 2013.[33]

~~27.~~33. The Department, OAG-AUD, and Intervenor Constellation submitted direct testimony on March 4, 2014, March 20, 2014, April 21, 2014 and May 9, 2014.[34]

~~28.~~34. MERC, the Department, and the OAG-AUD filed rebuttal testimony on April 15, 2014 and April 21, 2014.[35]

~~29.~~35. Public hearings were held in Rochester and Rosemount on March 12, 2014.[36] Eight members of the public attended the meeting in Rochester and six spoke. One member of the public attended the meeting in Rosemount and spoke.[37]

~~30.~~36. An additional public hearing was held in Cloquet, Minnesota on March 13, 2014.[38] Three members of the public attended the hearing and all three spoke.[39]

---

[31] *See* Fifth Prehearing Order (Mar. 24, 2014) (OAH Docket No. 8-2500-31126; MPUC Docket No. G-011/GR-13-617) (Doc. ID No. 20143-97542-01).

[32] *See* Ex. 16 (B. Nick Direct); Ex. 19 (S. DeMerritt Direct); Ex. 38 (H. John Direct); Ex. 26 (C. Hans Direct); Ex. 14 (D. Kult Direct); Ex. 12 (T. Kupsh Direct); Ex. 13 (N. Cleary Direct); Ex. 10 (B. Kage Direct); Ex. 11 (M. Gerth Direct); Ex. 36 (J. Wilde Direct); Ex. 28 (L. Gast Direct); Ex. 17 (P. Moul Direct); Ex. 29 (J. Hoffman-Malueg Direct); Ex. 40 (G. Walters Direct).

[33] *See* Exs. 21-23 (S. DeMerritt Supplemental Direct and Exhibits to S. DeMerritt Supplemental Direct); Ex. 41 (G. Walters Supplemental Direct).

[34] *See* Ex. 125 (R. Haubensak Direct); Ex. 150 (Adopted Direct Testimony of V. Chavez by J. Lindell); Exs. 151-152 (J. Lindell Direct and Schedules); Exs. 155-157 (R. Nelson Direct, Errata and Schedules); Exs. 161-163 (P. Chattopadhyay Direct, Errata and Schedules); Ex. 200 (E. Amit Direct); Exs. 203-204 (S. Peirce Direct and Errata); Exs. 206-207 (S. Ouanes Direct and Attachments); Ex. 210 (M. Zajicek Direct); Exs. 212-13 (L. Otis Direct and Errata); Ex. 215 (L. La Plante Direct); Exs. 213, 217-218, 220 (M. St. Pierre Direct, Errata and Attachments).

[35] Ex. 15 (D. Kult Rebuttal); Ex. 18 (P. Moul Rebuttal); Ex. 24 (S. DeMerritt Rebuttal); Ex. 27 (C. Hans Rebuttal); Exs. 30-31 (J. Hoffman Malueg Rebuttal and Errata); Ex. 37 (J. Wilde Rebuttal); Ex. 39 (H. John Rebuttal); Ex. 42 (G. Walters Rebuttal); Ex. 153 (J. Lindell Rebuttal); Ex. 164 (P. Chattopadhyay Rebuttal); Ex. 201 (E. Amit Rebuttal); Ex. 208 (S. Ouanes Rebuttal).

[36] First Prehearing Order (Dec. 12, 2013) (OAH Docket No. 8-2500-31126; MPUC Docket No. G-011/GR-13-617) (Doc. ID No. 201312-94534-01).

[37] *See* Rochester Public Hearing Transcript (Mar. 12, 2014) (OAH Docket No. 8-2500-31126; MPUC Docket No. G-011/GR-13-617) (Doc. ID No. 20144-98117-01); Rosemount Public Hearing Transcript (Mar. 12, 2014) (OAH Docket No. 8-2500-31126; MPUC Docket No. G-011/GR-13-617) (Doc. ID No. 20144-98117-02).

[38] First Prehearing Order (Dec. 12, 2013) (OAH Docket No. 8-2500-31126; MPUC Docket No. G-011/GR-13-617) (Doc. ID No. 201312-94534-01).

[39] *See* Cloquet Public Hearing Transcript (Mar. 13, 2014) (OAH Docket No. 8-2500-31126; MPUC Docket No. G-011/GR-13-617) (Doc. ID No. 20144-98117-03).

~~31.~~37. MERC, the Department, and the OAG-AUD filed surrebuttal testimony on May 7, 2014 and May 9, 2014.[40]

~~32.~~38. The evidentiary hearing was held on May 13, 2014, at the Public Utilities Commission, Large Hearing Room, in St. Paul, Minnesota.

D. MERC's Requested Rate Increase

~~33.~~39. MERC requesteds~~s~~ an overall rate increase to earn what the Company believed was a reasonable and fair rate of return, based on its 2014 test year. MERC indicated that a ~~A~~ number of key factors have caused the need for a rate increase. First, the Company indicated that the 2012 historical year concluded with a $13,889,494 revenue deficiency for MERC's operations, and the Company's-projected 2014 test year indicated a revenue deficiency totaling $14,187,597.[41]

~~34.~~40. Second, MERC indicated that general inflation, not including Known and Measurable ("K&M") items, has increased Operations and Maintenance ("O&M") expenses at a rate of 3.74 percent. Because of the decreased margin and increased expenses, MERC stated that the Company will not be afforded a reasonable opportunity to earn its rate of return or maintain the safe and reliable operation of its distribution system.[42]

~~35.~~41. Third, MERC ~~has identified~~ stated that K&M changes from 2012 to 2014 ~~that~~ will impact MERC's 2014 costs of providing service. Overall, MERC stated that it~~'~~s capital project expenditures have increased and it has filled vacant positions, which will result in additional compensation expenditures.[43]

~~36.~~42. Fourth, MERC ~~has~~ included in the test year its 2014 approved Conservation Improvement Plan ("CIP") expenses.[44]

~~37.~~43. Fifth, MERC ~~has~~ projected a continual increase in Property Tax Expense as discussed in MERC's last rate case, Docket No. G007, 011/GR-10-977.[45]

~~38.~~44. Sixth, MERC ~~is~~ requested~~ing~~ amortization of rate case expenses to occur over a two year period due to anticipated construction activity that may necessitate a 2015 rate case filing.[46]

---

[40] Ex. 25 (S. DeMerritt Surrebuttal); Ex. 154 (J. Lindell Surrebuttal); Ex. 158-60 (R. Nelson Surrebuttal and Schedules); Ex. 165-66 (P. Chattopadhyay Surrebuttal and Schedules); Ex. 202 (E. Amit Surrebuttal); Ex. 205 (S. Peirce Surrebuttal); Ex. 209 (S. Ouanes Surrebuttal); Ex. 211 (M. Zajicek Surrebuttal); Ex. 214 (L. Otis Surrebuttal); Ex. 216 (L. La Plante Surrebuttal); Ex. 219-20 (M. St. Pierre Surrebuttal and Errata).

[41] Ex. 16 at 5 (B. Nick Direct); Ex. 19 at 3 (S. DeMerritt Direct).

[42] Ex. 16 at 5 (B. Nick Direct); Ex. 19 at 3 and Schedule (SSD-18) (S. DeMerritt Direct).

[43] Ex. 16 at 5-6 (B. Nick Direct); Ex. 19 at 14-15 (S. DeMerritt Direct).

[44] Ex. 16 at 6 (B. Nick Direct); Ex. 24 at Schedule (SSD-1) (S. DeMerritt Rebuttal).

[45] Ex. 16 at 6 (B. Nick Direct).

[46] Ex. 16 at 6 (B. Nick Direct); Ex. 24 at 16-17 (S. DeMerritt Rebuttal).

~~39.~~45. Seventh, MERC stated that the Company has a right to a reasonable opportunity to earn its authorized Return on Equity ("ROE") for its operations. MERC claimed that its currently authorized rates will not provide sufficient revenue to allow MERC a reasonable opportunity to earn its authorized ROE. MERC also stated that t~~T~~here are no significant cost cutting reductions that can be made without jeopardizing service quality, service reliability, and safety to the public or MERC's employees. MERC therefore believes it is necessary, just, and reasonable to request and obtain rate relief.[47]

~~40.~~46. MERC's initial filing indicated a need for an annual base rate increase of $14,187,597, or approximately 5.52 percent of total revenues.[48] Based on adjustments agreed to during this proceeding, MERC is requesting an annual base rate increase of $12,159,494, or approximately 4.1 percent.[49]

E. Summary of Public Comments

~~41.~~47. Public hearings on MERC's proposed rate increase were held on March 12, 2014, at Rochester, Minnesota (eight members of the public attended and six of the eight spoke); March 12, 2014, at Rosemount, Minnesota (one member of the public attended and spoke); and on March 13, 2014, at Cloquet, Minnesota (three members of the public attended and three spoke).[50]

~~42.~~48. At the public hearings individuals expressed concerns about fixed income hardship, transparency regarding rate changes, and the amount and frequency of rate increases. Other individuals raised questions regarding their customer bills and surcharges.[51]

~~43.~~49. Approximately six written comments from the public were also received, most of which were from residential customers.[52] A number of these recommended no rate increase, and at least one recommended a rate decrease.[53] Nearly all of the comments opposed the Company's proposed rate increase, and stated concerns such as the following: MERC's proposal is too large; is burdensome for low-income customers and those on fixed incomes; and is above the rate of inflation; further, Company is sufficiently profitable such that it does not need more money from its customers.

---

47 Ex. 16 at 6-7 (B. Nick Direct); Ex. 17 at 1-2, 11 (P. Moul Direct).

48 Ex. 40 at Schedule 3 (GJW-1) (G. Walters Direct).

49 Ex. 42 at Schedule 3 (GJW-1) (G. Walters Rebuttal).

50 *See* Cloquet Public Hearing Transcript (Mar. 13, 2014) (OAH Docket No. 8-2500-31126; MPUC Docket No. G-011/GR-13-617) (Doc. ID No. 20144-98117-03).

51 Rochester Public Hearing Transcript (Mar. 12, 2014) (OAH Docket No. 8-2500-31126; MPUC Docket No. G-011/GR-13-617) (Doc. ID No. 20144-98117-01).

52 *See, e.g.*, Public Comment, J. Eberhard (Doc. ID No. 20143-97433-01), Public Comment, PUC (Doc. ID No. 20143-97414-01), Public Comment, R. Bichel (Doc. ID No. 20143-97055-01), Public Comment, L. Rice (Doc. ID No. 20142-96533-01) and Public Comment, P. Pat (Doc. ID No. 20142-96117-01).

53 *See, e.g.*, Public Comment, P. Pat (Doc. ID No. 20142-96117-01); Public Comment, L. Rice (Doc. ID No. 20142-96533-01); Public Comment, R. Bichel (Doc. ID No. 20143-97055-01); Public Comment, J. Eberhard (Doc. ID No. 20143-96533-01).

II. MERC'S REVENUE REQUIREMENT

~~44.~~50. The revenue requirements portion of a general rate case seeks to determine what additional revenue is required to meet the utility's required operating income, based on a "test year" of operations. The required operating income is derived from determining the amount of investments in rate base that have been made by a utility's shareholders, and multiplying the approved rate base times the rate of return that is determined to be appropriate for the company.[54]

~~45.~~51. After determining the required operating income, the company's test year expenses and revenues are evaluated to determine the current operating income for the test year (in this case 2014). The difference between the required operating income and the test year operating income is the income deficiency. The income deficiency is converted into a gross revenue deficiency amount.[55]

52. This section of the Proposed Findings pertains to the issues that were raised by the parties regarding MERC's rate base, test year expenses and revenues, and rate of return ("ROR") (computed from the approved capital structure, cost of debt, and authorized return on equity).

III. COST OF CAPITAL: RETURN ON EQUITY AND OVERALL RATE OF RETURN (ISSUE IX, IN PART)

ROE and ROR

Disputed between DOC and MERC: DOC recommends an ROE of 9.29 percent rather than MERC's proposed 10.75 percent, with both percentages including an allowance for the same flotation cost adjustment. DOC recommends an ROR of 7.2745 percent on MERC's total capital, rather than MERC's proposed ROR of 8.0092 percent. Tr. at 199-200 (Amit). *Compare* DOC Ex. 202 at 8 (Amit Surrebuttal) *with* MERC Ex. 28 at 4 (Gast Direct).

Disputed between DOC and OAG: DOC disagrees that an ROE of 8.62 percent is reasonable. DOC Ex. 202 at 22–37 (Amit Surrebuttal); Tr. at 202 (Amit).

Flotation Costs

Resolved between DOC and MERC: DOC agrees that MERC's proposed flotation cost of 3.90 percent is reasonable. DOC agrees with MERC that the ROE should include flotation costs adjustment. DOC Ex. 200 at 27 (Amit Direct).

Disputed between DOC and OAG: DOC disagrees that it is reasonable to exclude flotation costs in determining MERC's ROE and ROR. DOC Ex. 201 at 25 (Amit Rebuttal); DOC Ex. 202 at 35–36 (Amit Surrebuttal); Tr. at 204 (Amit).

---

[54] Ex. 4 Initial Filing Volume 3: Informational Requirements, Document 1.

[55] Ex. 4 Initial Filing Volume 3: Informational Requirements, Document 1; Ex. 19 at Schedule (SSD-25) (S. DeMerritt Direct).

Capital Structure, Short-Term Debt, Long-Term Debt.

Resolved: Capital Structure, Short-term Debt: DOC agrees that MERC's proposed capital structure and costs of short-term and long-term debt are reasonable. No other party opposed MERC's proposals on these issues. DOC Ex. 200 at 35–44 (Amit Direct); DOC Ex. 202 at 12 (Amit Surrebuttal); *see* Tr. at 199–200 (Amit).

~~46.~~

A. Rate of Return

~~47.~~53. Minn. Stat. § 216B.16, subd. 6, requires the Commission to give due consideration to the utility's need for revenue sufficient to enable it to meet the cost of furnishing the service, including adequate provision for depreciation of its utility property, and an opportunity to earn a fair and reasonable return upon the investment in such property. The components of determining a fair and reasonable rate of return for MERC in this rate case include a determination of MERC's capital structure, MERC's cost of debt, and a reasonable return on common equity.

1. Capital Structure

~~48.~~54. To arrive at the cost of capital (overall rate of return), it is necessary to determine the amount of long-term debt, short-term debt, preferred stock, and common equity held by MERC. This represents MERC's capital structure. MERC proposed a projected capital structure consisting of 44.64 percent long-term debt, 5.05 ~~5.06~~ percent short-term debt, and 50.31 percent common stock equity.[56]

55. A well accepted premise in financial literature is that there exists for each company an optimal capital structure, *i.e.*, one that minimizes the overall cost of capital.[57] Determining whether MERC's capital structure is optimal, however, is not easy. Dr. Amit tested the reasonableness of MERC's capital structure by comparing the Company's long-term debt ratio and equity ratio to those ratios for companies in the comparison group.[58]

56. MERC does not have its own capital structure because it is a subsidiary company of Integrys. Rather, its capital structure is a hypothetical capital structure.[59] MERC's equity consists of MERC's retained earnings plus any equity infusion from its parent company, Integrys, minus any dividends paid by MERC to Integrys. MERC sets an equity ratio target of between fifty to fifty-five percent, and a short-term debt cap of 5 percent.[60] MERC borrows long-term debt internally from Integrys as needed to finance its capital expenditures while meeting its equity and short-term debt targets.[61]

---

[56] Ex. 28 at 3-5 and Schedule (LJG-1) (L. Gast Direct).

[57] ~~Ex.~~Ex. 200 at 36 (Amit Direct).

[58] *Id.*

[59] Ex. 200 at 35 (~~Amit~~E. Amit Direct).

[60] *Id.*

[61] *Id.*

~~49.~~57. The proposed capital structure reflected the Company's proposed 2014 average balances for long-term debt (13-month average), short-term debt (13-month average), and common equity (13-month average).[62]

~~50.~~58. The Department reviewed MERC's proposed capital structure and concluded that the proposed capital structure was reasonable.[63] Dr. Amit reasonably agreed with MERC's calculations of its common equity ratio and concluded that it is a reasonable equity ratio; he also agreed that MERC's proposed capital structure is similar to the average capital structure for his group of companies that are comparable in investment risk to MERC, the NGCG.[64]

In its Rebuttal Testimony, the Company did not change its proposed capital structure and costs of short-term and long-term debt, and the Department continued to agree that the proposal was reasonable.[65]

Regarding the cost of common equity, however, as addressed in subsequent proposed Findings, Dr. Amit's updated the DCF analysis in his Surrebuttal Testimony, as confirmed by his CAPM analysis, and showed that a required rate of return on equity of 9.29 percent for MERC is reasonable.[66]

Dr. Amit reviewed MERC's test-year hypothetical capital structure and its estimated costs of test-year capital structure components, and concluded that they were reasonable.[67] Further, Dr. Amit applied his recommended ROE to MERC's proposed capital structure to arrive at his recommended overall ROR for MERC.[68]

The Department reasonably recommended the capital structure and the cost of equity, short- and long-term debt for MERC, as follows:[69]

62 –Ex. 28 at 3-5 (L. Gast Direct).

63 Ex. 200 at 35-44 (E. Amit Direct); Ex. 202 at 12 (E. Amit Surrebuttal).

64 Ex. 200 at 35–44 (E. Amit Direct).

65 Ex. 202 at 12 (E. Amit Surrebuttal).

66 Ex. 202 at 12 (E. Amit Surrebuttal).

67 Ex. 200 at 35–44 (E. Amit Direct).

68 *Id.* at 44; Ex. 202 at 12 (E. Amit Surrebuttal).

69 Ex. 202 at 12 (E. Amit Surrebuttal).

Overall Cost of Capital for MERC (Surrebuttal Testimony)

Component	Capitalization Ratio (%)	Cost (%)	Weighted Cost (%)
Long-Term Debt	44.64%	5.6060%	2.4822%
Short-Term Debt	5.05%	2.3487%	0.1186%
Common Equity	50.31%	9.29%	4.6737%
Total 100.00%			7.2745%

~~51.~~59. The ALJ finds that the capital structure proposed by MERC is reasonable and should be adopted in this case. Dr. Amit's final recommended ROE for MERC of 9.29 percent results in an overall rate of return of 7.2745 percent and is reasonable.[70]

2. Cost of Debt

~~52.~~60. MERC proposed test-year cost of long-term debt of 5.5606 percent and short term cost of debt of 2.3487 percent, based on the 13-month average over the period December 1, 2013 through December 31, 2014.[71]

~~53.~~61. The Department reviewed MERC's proposed cost of long-term and short-term debt and concluded that it was reasonable.[72]

~~54.~~62. The ALJ finds that MERC's proposed cost of long-term and short-term debt is reasonable and should be approved.

3. Cost of Common Equity

~~55.~~63. The remaining variable in determining MERC's rate of return is to ascertain a reasonable rate of return on common equity, or ROE. Once determined, the resulting rate of return is applied to the authorized rate base of the company to determine MERC's required income.

a. Fair Rate of Return: Overall Principles

~~56.~~64. In the regulated setting, the role normally assumed by the market is assumed by regulators who must ensure that public utilities provide an appropriate supply of satisfactory services at reasonable rates. To provide these services, the utility must be able to compete for necessary funds in the capital markets. To raise funds, the utility must earn enough to offer competitive returns to investors. A fair return is one that enables the utility to attract sufficient capital, at reasonable terms.[73]

[70] *Id.*; Tr. at 199 (Amit).

[71] Ex. 28 at 3-5 and Schedule (LJG-1) (L. Gast Direct).

[72] Ex. 200 at 35-44 (E. Amit Direct); Ex. 202 at 12 (E. Amit Surrebuttal).

[73] Ex. 200 at 2 (E. Amit Direct).

~~57.~~65. Determination of reasonable rates involves balancing consumer and utility interests. A reasonable rate enables a public utility not only to recover total revenue requirement (i.e., operating expenses, depreciation and taxes), but also to compete for funds in capital markets.[74] Minnesota law recognizes this principle by defining a fair rate of return as the rate that, when multiplied by the rate base, will give a utility a reasonable return on its total investment.[75] Therefore, a fair rate of return is, by definition, the rate that, when multiplied by the rate base, will give the utility a reasonable return on its total investment to allow the utility to provide its ratepayers with reliable service at reasonable rates.[76]

~~58.~~66. Minn. Stat. § 216B.16, subd. 6, summarizes the factors that should be used to determine just and reasonable rates for a public utility, including the rate of return:

> The commission, in the exercise of its powers under this chapter to determine just and reasonable rates for public utilities, shall give due consideration to the public need for adequate, efficient, and reasonable service and to the need of the public utility for revenue sufficient to enable it to meet the cost of furnishing the service, including adequate provision for depreciation of its utility property used and useful in rendering service to the public, and to earn a fair and reasonable return upon the investment in such property.

~~59.~~67. These statutory requirements must be interpreted with regard to landmark United States Supreme Court decisions that set forth the constitutional tests used to determine the fairness or reasonableness of the rate of return. According to these cases:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties . . . The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.[77]

The Court concluded that a utility had no right to large profits similar to those realized in speculative ventures.[78]

---

[74] Ex. 200 at 2 (E. Amit Direct).

[75] Minn. Stat. § 216B.16, subd. 6 (2014).

[76] Ex. 200 at 2 (E. Amit Direct).

[77] Ex. 17, (P. Moul Direct), citing *Bluefield Water Works & Investment Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923).

[78] *Bluefield*, 262 U.S. at 693.

68. In *Fed. Power Comm'n v. Hope Natural Gas Co.* (*Hope*), 320 U.S. 591 (1944), the Court reiterated *Bluefield's* investor requirement for a return sufficient to cover operating expenses, including services on debt and dividends on stock and to assure confidence in the utility's ability to maintain credit and attract capital. The Court added that a just and reasonable return should be similar to returns on investments in other businesses having a corresponding risk.[79] In addition, regulation must attempt to strike an equitable balance between investors' and ratepayers' interests.[80] "The consumer interest cannot be disregarded in determining what is a 'just and reasonable' rate. Conceivably, a return to the company of the cost of service might not be "just and reasonable" to the public."[81]

~~60.~~69. The rate of return authorized for a public utility is directly related to the ability of the utility to meet its service responsibilities to its customers. A public utility is responsible for providing a particular type of service to its customers within a specific market area, and is not free to enter and exit competitive markets in accordance with available business opportunities. A regulated utility must compete for capital in the market, and the level of rates must carefully consider the public's interest in reasonably priced, as well as safe and reliable, service.[82]

b. Guidelines

~~61.~~70. A fair rate of return is, by definition, the rate that will give the utility a reasonable return on its total investment.

The cost of equity capital to MERC is the rate of return that it may pay to investors to induce them to invest in its regulated operations.[83]

71. To determine a fair rate-of-return on common equity capital for MERC, DOC appropriately followed economic guidelines set forth in the *Bluefield* and *Hope* cases.[84]

- The rate of return should be sufficient to enable the regulated company to maintain its credit rating and financial integrity.
- The rate of return should be sufficient to enable the utility to attract capital at reasonable terms.
- The rate of return should be commensurate with returns being earned on other investments having equivalent risks.

72. Investors are faced with many investment opportunities in the financial markets. To attract investors, MERC must pay an equity return similar to the equity return

[79] *Hope*, 320 U.S. at 603.

[80] *Covington and Lexington Turnpike Road Co. v. Sanford* (*Covington*), 164 U.S. 578 at 596 (1896).

[81] *Fed. Power Comm'n v. Natural Gas Pipeline Co. of Am.*, 315 U.S. 575, 607 (1942) (Black, J., concurring).

[82] *See* Ex. 28 at 10 (L. Gast Direct); Ex. 200 at 2 (E. Amit Direct).

[83] Ex. 200 at 3 (E. Amit Direct).

[84] Ex. 200 at 3 (E. Amit Direct).

that investors expect to earn (including a flow of future dividends) on investments of comparable risk.[85] This equity rate of return is the reasonable cost of equity capital to MERC.[86] When investors buy a utility's common stock, they acquire the right to share any dividends that the company may declare in the future, which serves as an inducement to investors.[87]

73. Dr. Amit reviewed investors' likely expectations of the cost of equity capital for MERC based largely on the likely rates of return of comparable companies, together with checks on the reasonableness of his analyses.[88]

~~62.~~74. Because MERC's stock is not traded in public markets, various financial models utilizing comparison groups must be used to estimate the reasonable return on common equity that should be authorized for MERC in this case.[89]

~~63.~~75. ~~In its expert testimony,~~ MERC presented a detailed analysis of the appropriate return on common equity, developed through the use of several accepted financial models, and updated this analysis in its rebuttal testimony.[90] MERC's analysis concluded that MERC's return on common equity should be set at 10.75 percent.[91] In Rebuttal Testimony, MERC stated that if the Commission does not agree with a 10.75 percent ROE for MERC, based on the increase in capital costs since MERC's last rate case, the equity return in this case should be at least 10.27 percent.[92]

76. The Department prepared an analysis of MERC's ROE in this case, To estimate this cost, Dr. Amit used a market-oriented approach and relied on the concept of "opportunity costs."[93] The Department initially recommended an ROE of 9.40 percent on MERC's common equity capital and an overall rate of return of 7.3299 percent on MERC's total capital.[94] In the Department's Surrebuttal Testimony, relying on the most recently available dividend yields and expected growth rates for companies in his comparable group,

[85] Ex. 200 at 3 (E. Amit Direct).

[86] *Id.*

[87] *Id.* at 3–4.

[88] *See generally id.* at 7–44; *see also* Ex. 202 at 2–12 (E. Amit Surrebuttal).

[89] Ex. 17 at 3-4 (P. Moul Direct).

[90] *See generally* Ex. 17 (P. Moul Direct) and Ex. 18 (P. Moul Rebuttal).

[91] This figure represents the results of Mr. Moul's updated analysis using data as of May 31, 2012. Ex. 18 at 3-5, 40 (P. Moul Rebuttal). Mr. Moul's original analysis was based on data as of May 31, 2012 and established a reasonable ROE of 10.75 percent. Ex. 17 at 1-2, 6, 46 and Schedule (PRM-1) (P. Moul Direct). *See also* Ex. 28 at 3, 10-11 (L. Gast Direct).

[92] Ex. 18 at 40 (P. Moul Rebuttal).

[93] Ex. 200 at 3 (E. Amit Direct).

[94] Ex. 200 at 2 (E. Amit Direct).

Dr. Amit updated his ROE recommendation~~,~~ and recommended that the Commission approve a ROE of 9.29 percent with an overall cost of capital of 7.2745 percent.[95]

c. ROE Methods: The Discounted Cash Flow Method

~~64.~~77. The OAG-AUD prepared an analysis of MERC's ROE in this case, and recommended that the Commission approve a ROE of 8.62 percent.[96]

~~65.~~78. MERC determined its recommended ROE in this case by considering the results of three well-recognized measures of the cost of equity applied to market and financial data developed from a proxy group of nine natural gas companies from The Value Line Investment Survey and four combination gas and electric companies that are primarily delivery companies (i.e., they have no significant generation assets).[97] The three financial models that MERC used to develop its cost of equity are the Discounted Cash Flow ("DCF") model, the Risk Premium ("RP") analysis and the Capital Asset Pricing Model ("CAPM"). MERC also considered as a check on the results of these models the Comparable Earnings ("CE") approach.[98] ~~The ROE must also reflect the risk factors that are unique to MERC for the ROE to be consistent with investor requirements.[99]~~

~~66.~~79. MERC updated the three models in Rebuttal Testimony and found that the updated cost of equity for the DCF model was 9.80 percent, the updated cost of equity for the RP model was 12.14 percent, and the updated cost of equity for the CAPM was 11.97 percent. The DCF results increased by .16 percent from MERC's Direct to Rebuttal Testimony. The RP results declined .25 percent from MERC's Direct to Rebuttal Testimony and the CAPM results increased by 1.08 percent from MERC's Direct to Rebuttal Testimony. With the results showing one increase, one decrease, and one result remaining mostly unchanged, MERC determined that the updated results continued to support the original 10.75 percent ROE recommendation.[100]

~~67.~~80. The DCF model attempts to explain the value of an asset as the present value of future expected cash flows discounted at the appropriate risk-adjusted rate of return. The DCF return therefore consists of a current cash yield (the dividend yield) and future price appreciation (growth) of the investment.[101]

---

[95] This figure represents the results of Dr. Amit's updated analysis. Ex. 202 at 1-12 (E~~D~~. Amit Surrebuttal). Dr. Amit's original analysis resulted in a recommended 9.40 percent ROE. Ex. 200 at 2, 27, 34 (E. Amit Direct); Ex. 201 at 27 (E. Amit Rebuttal).

[96] This figure represents the results of Dr. Chattopadhyay's updated analysis. Ex. 165 at 2 (P. Chattopadhyay Surrebuttal). Dr. Chattopadhyay's original analysis resulted in a recommended 8.90 percent ROE. Ex. 161 at 4, 57 (P. Chattopadhyay Direct).

[97] Ex. 17 at 4-5 (P. Moul Direct).

[98] Ex. 17 at 3-5 (P. Moul Direct); Ex. 18 at 3 (P. Moul Rebuttal).

~~[99] Ex. 17 at 8-11, 17 (P. Moul Direct); Ex. 18 at 4-5, 14-15 (P. Moul Rebuttal).~~

[100] Ex. 18 at 3-4 (P. Moul Rebuttal).

[101] Ex. 17 at 19-20 and Schedule (JPM-1) (P. Moul Direct).

~~68. While widely used as an input to rate of return determinations in utility rate cases, the DCF model has limitations. The DCF analysis has a certain circularity when applied to the utility industry, because investors' expectations for the future depend on decisions of regulatory bodies. In turn, the regulatory bodies depend upon the DCF model to set the cost of equity, relying on investor expectations that include an assessment of how regulators will decide rate cases.~~[102]

~~69.~~81. ~~Additionally, the DCF model has limitations that make it less useful in the rate setting process where the firm's market capitalization diverges significantly from the book value capitalization. Because this limitation leads to a mis-specified cost of equity when applied to a book value capital structure, an analysis needs to incorporate the required adjustment to correct this problem. MERC's updated DCF result was 9.80 percent.~~[103] Stock prices fully account for all publically available information including the discrepancy between market and book equity and debt. Therefore, the DCF results fully accounts for the discrepancy between market and book values of equity and debt (via the dividend yield), and no further artificial adjustment is needed.[104]

~~70.~~82. The Department also relied on the DCF method to determine an initial ROE for MERC of 9.40 percent and an updated ROE of 9.29 percent. In addition, the Department conducted two growth rate DCF analyses ("TGDCF"), using a comparison group of companies, to determine ROE. The Department used the CAPM model to support its DCF and TGDCF analyses.[105]

83. The ALJ determines that the Department's proposed ROE is reasonable, and its criticisms of other parties' ROE analyses are valid. Thus, the following proposed Findings of Fact rely on the Department's organization of its own analyses and the analyses of other parties.

d. The Department's Cost of Common Equity Analyses Are Reasonable and Should be Adopted

i. The Cost of Common Equity: The Discounted Cash Flow Method

84. Dr. Amit relied primarily on the DCF method of determining a reasonable cost of common equity for MERC.[106] Investors in common stocks expect to receive a flow of future dividends -and form certain expectations about future dividends, based on the company's past and current performance, the company's prospects for future growth, and investors' perceptions of the current and future economic environment. The expected

~~102 Ex. 17 at 19-20 (P. Moul Direct).~~

~~103 Ex. 18 at 4 (P. Moul Rebuttal).~~

104 Ex. 200 at 63-67 (E. Amit Direct).

105 Ex. 200 at 2-7, 24-26, 28-34 and Schedule (EA-12) (E. Amit Direct); Ex. 202 at 2 (E. Amit Surrebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 198-205 (E. Amit) (Doc. ID No. 20145-99937-01).

106 Ex. 200 at 3 (E. Amit Direct).

dividend divided by the purchase price of the stock (the expected dividend yield) is a critical component of the cost of equity capital.[107]

85. Financial theory postulates that the price of the stock in the present period equals the present value of all the expected future dividends discounted by the appropriate rate of return.[108] If annual dividends grow at a constant rate over an infinite period, the required rate of return on common equity capital can be estimated using the following formula:[109]

> The expected (required) rate of return on equity = the expected dividend yield + the expected growth rate in dividends.

86. The DCF method reflected in the formula above (also called the Constant Growth Rate DCF Method), applied to companies with comparable risk, is a reasonable market-oriented method for determining a fair ROE for MERC.[110]

87. A variation of the DCF model, the TGDCF, accounts for situations where, for a relatively short time period, the dividends may be expected to grow annually at a different rate than they may be expected to grow over the long-term (when both earnings and dividends are expected to grow at a constant, sustainable annual rate).[111] The short-term earnings growth rates may be either unusually low or unusually high relative to the Company's historical earnings and industry averages.[112] Accordingly, short-term earnings growth may result in unreasonably low or high DCF estimated ROEs. To the degree that such growth rates may not be sustainable in the long-run, the TGDCF method accommodates two different growth rates: short-term and long-term (sustainable) growth rates.[113] Growth rates outside an expected reasonable range may not be sustainable over the long run.[114] Therefore, a TGDCF analysis must be applied to companies with such expected growth rates.[115]

88. Dr. Amit appropriately applied the TGDCF to one company (NJR) in his Direct Testimony analysis because of the company's relatively low growth rate in comparison to the mean expected growth rate for a group of comparable companies he called the Natural Gas Distribution Comparison Group ("NGCG").[116] In Surrebuttal, Dr. Amit appropriately applied the TGDCF to three companies (ATO, NWN and PNY).[117]

---

[107] *Id.* at 4.

[108] *Id.*

[109] Ex. 200 at 4 (E. Amit Direct).

[110] Ex. 200 at 4-5, EA-12 (E. Amit Direct).

[111] Ex. 200 at 5, 24, EA-12 (E. Amit Direct).

[112] *Id.* at 24.

[113] *Id.* at 24.

[114] Ex. 202 at 9 (E. Amit Surrebuttal); *see also* Ex. 200 at 25 (E. Amit Direct).

[115] Ex. 200 at 20–23 (E. Amit Direct).

[116] *Id.* at 25–26.

[117] Ex. 202 at 9 (E. Amit Surrebuttal).

ii. DOC's Recommended ROE of 9.29 Percent Is Reasonable

89. The Department recommended that the Commission adopt an ROE of 9.29 percent for MERC based on the Department's DCF analysis, as confirmed by other analyses.[118] This section reviews chronologically Dr. Amit's selection of a group of companies with risks comparable to MERC, his DCF and TGDCF analyses included in Direct Testimony, his Surrebuttal Testimony update, and his use of other methods to check the reasonableness of his DCF results. This section also explains why Dr. Amit concluded that the analyses of Mr. Moul and Dr. Chattopadhyay would not result in a reasonable ROE.

(b) Selecting a Comparable Group with Similar Investment Risk

90. MERC is a subsidiary of Integrys Energy Group ("Integrys") and, as such, it is not publicly traded on any stock exchange. Therefore, no DCF analysis can be directly performed on MERC.[119] A DCF analysis could be performed on the parent company.[120] In 2012, Integrys received a fairly small percent of its net income from its natural gas distribution operations (33.1 percent).[121] A DCF analysis directly applied to Integrys could not provide important or useful information regarding the cost of equity for MERC. Moreover, a DCF analysis on one company alone may be more sensitive to the random nature of stock prices and the analyst's specific growth-rate predictions. Dr. Amit reasonably did not include a DCF analysis of Integrys.[122]

91. The Department chose a second alternative: to perform a DCF analysis on a group of companies with investment risks similar to that of the division company (MERC).[123] To estimate the cost of equity for MERC, Dr. Amit used DCF and TGDCF analyses for groups of companies with investment risks similar to those of MERC.[124] He used the CAPM to check the reasonableness of the results of his DCF and TGDCF analyses.[125]

92. Companies with similar investment risks are expected to have similar required rates of return; the goal of selecting a comparable group for a DCF analysis is to find companies with similar investment risks, from the perspective of investors, to MERC.[126]

---

[118] *Id.* at 2–11.

[119] Ex. 200 at 6 (E. Amit Direct).

[120] *Id.*

[121] *Id.*

[122] *Id.* at 7.

[123] Ex. 200 at 7 (E. Amit Direct).

[124] *Id.*

[125] *Id.*

[126] Ex. 200 at 7-8 (E. Amit Direct).

MERC's main line of business is natural gas distribution, which has the Standard Industrial Classification ("SIC") code of 4924.[127]

93. DOC selected a group of companies (NGCG) that have investment risk comparable to MERC by applying the following reasonable criteria or screens:[128]

- Are listed on the Compustat Research Insight data base as of September 30, 2013, and
  - Have an SIC code of 4924,
  - Are traded on one of the stock exchanges,
  - Have Standard & Poor's ("S&P") bond rating within the range of BBB to AA (the rating of MERC's parent company, Integrys, is A-);
- Of the companies that met the criteria above, in 2012 had at least than sixty percent of total net operating income from natural gas distribution operations;
- Added companies that were listed in Value Line Investment Survey of September 6, 2013 as natural gas utilities and met the criteria, above;
- Of the companies that met all of the criteria above, have both a beta and standard deviation of past price changes that deviated by no more than one standard deviation from the mean of the companies that met the five screens noted above (beta and standard deviation are measures of investment and financial risk, respectively).

94. Dr. Amit reasonably checked the comparability of the NGCG to that of MERC: because companies in the NGCG, like MERC, are mostly engaged in the distribution of natural gas and are similarly rate-of return regulated by the states in which they operate, their business risks are somewhat similar.[129] A specific quantitative measure of the risk of investing in common stock is the volatility of rates of return (measured by beta or the Standard Deviation of Price Changes ("STDPC") or a credit rating).[130] MERC is a subsidiary company and therefore, does not have beta, STDPC or a credit rating.[131] The only market-related quantitative risk measures readily available for comparison are the long-term debt ratios and the equity ratios.[132]

---

[127] *Id.* at 8.

[128] *Id.* at 8–11.

[129] Ex. 200 at 13 (E. Amit Direct).

[130] *Id.* a 11–13.

[131] *Id.* at 13.

[132] *Id.* at 12.

95. Based on his examination of 2012 common equity ratios and 2012 long-term debt ratios for NGCG and MERC, Dr. Amit reasonably concluded that NGCG and MERC have similar financial risks; further, taking into consideration that MERC and the companies in the NGCG are in the same line of business (natural gas distribution), and are similarly state-regulated, Dr. Amit also reasonably concluded that MERC's investment risks are reasonably similar to the investment risks of the companies in the comparison group, NGCG.[133]

(c) DCF Analysis Generally: The Expected Growth Rate of Dividends

96. Under DCF methodology, the required rate of return is equal to the expected growth rate of dividends plus the expected dividend yield.[134] For most companies, historical growth rates may be poor indicators of their future growth rates because most utilities' returns on equity and dividend payout ratios have not remained constant, and growth in book value has occurred due to retained earnings as well as to issuance of new shares of common stock.[135]

97. Dr. Amit used the projected growth rates in earnings per share ("EPS") provided by three widely-used and respected investor services: Zacks Investment Research ("Zacks"), The Value Line Investment Survey ("VL"), and First Call Consensus long-term earnings growth rate estimate provided by Thomson Financial Network ("Thomson").[136] Analysts' projected growth rates are superior to historical growth rates, and among projected growth rates the EPS growth rate is the most appropriate to use.[137] It is reasonable to rely only on the projected EPS growth rate for several reasons, including that the long-run sustainable growth in dividends is solely driven from the growth in earnings.[138]

98. In his Surrebuttal Testimony, Dr. Amit reasonably updated the expected growth rate of dividends for companies in the NGCG by using the most recently available projected growth rates of Zacks, Thomson and Value-Line.[139]

(d) DCF Analysis Generally: The Expected Dividend Yield

99. The second component of the DCF analysis is the expected dividend yield, D_1/P_0, where P_0 is the price today and D_1 is the dividend in the next year (assuming that dividends are distributed at the end of each year).[140] Recent prices must be used because the current price per share incorporates all relevant publicly available information.[141] Using non-

---

[133] *Id.* at 12–13.

[134] Ex. 200 at 21 (E. Amit Direct).

[135] *Id.* at 14; EA-13.

[136] Ex. 200 at 14 (E. Amit Direct).

[137] *Id.* at 16-19.

[138] *Id.* at 17.

[139] Ex. 202 at 3–4 (E. Amit Surrebuttal).

[140] Ex. 200 at 15 (E. Amit Direct).

[141] *Id.*

recent (historical) prices in calculating the expected dividend yield would be inappropriate.[142] Share prices are very volatile in the short run, however, such that one must use a recent period of time that is short enough to avoid irrelevant historical prices and long enough to avoid short-term aberrations in the capital market. [143]

100. To ensure that DOC's expected dividend yield is current and yet represents a long enough period of time to avoid very short-term aberrations in the capital market, Dr. Amit reasonably used the most recently available thirty day closing prices to calculate the expected dividend yield, September 1, 2013 through September 30, 2013.[144] Dr. Amit later updated the expected dividend yield for companies in the NGCG by using the most recently available thirty-two day period closing prices at that time.[145]

(e) DCF and TGDCF for the Comparable Group, NGCG: Direct Testimony

101. Based on DCF methodology, the required rate of return is equal to the expected dividend yield plus the expected growth rate.[146] In Dr. Amit's Direct Testimony, the expected growth rate for the NGCG ranged from a low of 4.21 percent to a high of 5.87 percent, with the best point estimate for the expected growth rate at 5.09 percent.[147] The expected dividend yield based on Dr. Amit's Direct Testimony analysis ranged from a low of 3.93 percent to a high of 3.96 percent, with the best point estimate for the expected dividend yield at 3.94 percent.[148] Combining the expected growth rates with the expected dividend yields resulted in the required rate of return for the group ranged from a low of 8.14 percent to a high of 9.83 percent, with the best point estimate for the required rate of return on equity for the group at 9.04 percent (the mean ROE).[149]

102. However, some analysts' projected growth rates for certain companies in the NGCG were not reasonable to be used as proxies for the DCF's excepted long-term sustainable growth.[150] The TGDCF analysis accounts for two different growth rates, short-term and long-term (sustainable), and it is reasonable to apply the TGDCF to situations where the short-term projected dividend growth rates for a company may not be expected to continue in the long run such that their use in a DCF analysis may result in unreasonably low or high DCF estimated ROEs.[151]

---

[142] *Id.*

[143] *Id.*

[144] Ex. 200 at 15 (E. Amit Direct).

[145] Ex. 202 at 3 (E. Amit Surrebuttal).

[146] Ex. 200 at 21 (E. Amit Direct).

[147] *Id.*

[148] *Id.*

[149] *Id.* at 21, EA-5.

[150] Ex. 200 at 21 (E. Amit Direct).

[151] Ex. 200 at 22–24 (E. Amit Direct).

103. In his Direct Testimony, Dr. Amit applied the TGDCF to one company for which use of the DCF analysis alone would result in an unreasonably low ROE for the comparison group (NJR, for which its short-term projected dividend growth rates may not be expected to continue in the long run).[152] Dr. Amit then used the projected five-year average EPS growth rates for the remaining companies in the NGCG as a proxy for sustainable growth rates.[153]

(f) Reasonableness of DOC's DCF/TGDCF Results Were Confirmed by the CAPM Analysis: Direct Testimony, Surrebuttal Testimony

104. The results of the DCF/TGDCF must be confirmed by other analyses such as the Capital Asset Pricing Model or simple CAPM, and the Empirical CAPM or ECAPM.[154] The basic premise of CAPM is that any risk that is company-specific can be diversified away by investors.[155] The only risk that matters is the systematic risk of the stock.[156] This systematic risk is measured by beta.[157] While the CAPM is theoretically sound, its use raises some difficult issues including difficulties in determining the appropriate beta, the appropriate riskless asset, and the effect of taxes.[158] For these reasons, the Department reasonably used the CAPM results *only* as a check on the reasonableness of its DCF analyses.[159]

~~71.~~105. Application of the CAPM to the NGCG resulted in an estimated ROE that was lower, 9.11 percent, than Dr. Amit's DCF/TGDCF-estimated ROE of 9.40 percent with flotation costs.[160] Application of the ECAPM analysis resulted in an estimated ROE mean for the NGCG of 9.96 percent with flotation.[161] The ECAPM's ROE was significantly higher than Dr. Amit's CAPM's ROE and is reasonably close to the mean of his DCF's ROE for the NGCG.[162] The CAPM and ECAPM results confirm the reasonableness of Dr. Amit's DCF/TGDCF results.[163] The CAPM and ECAPM results for MERC lie inside the range of Dr. Amit's DCF/TGDCF estimated ROEs. Moreover, the average of his CAPM and ECAPM for MERC results in an ROE of 9.43 percent, which is very close to the average DCF/TGDCF

---

[152] Ex. 200 at 24-25 (E. Amit Direct).

[153] Ex. 200 at 23, EA-5 (E. Amit Direct).

[154] Ex. 200 at 28, 32 (E. Amit Direct).

[155] *Id.* at 28.

[156] *Id.*

[157] *Id.*

[158] *Id.*

[159] *Id.*

[160] Ex. 200 at 32 (E. Amit Direct).

[161] *Id.* at 33.

[162] *Id.* at 33.

[163] *Id.* at 33–34.

ROE for MERC: 9.40 percent with flotation costs. Dr. Amit reasonably concluded that his CAPM and ECAPM results confirm the reasonableness of DOC's DCF/TGDCF results.[164]

106. Dr. Amit's updated CAPM and ECAPM in his Surrebuttal Testimony confirmed the reasonableness of his updated DCF result for the comparable group of companies and his final recommended ROE for MERC of 9.29 percent, including flotation costs. DOC Ex. 202 at 2–11 (Amit Surrebuttal).

(g) Flotation Costs

107. DOC agrees with MERC that DCF and TGDCF analyses must be adjusted to allow for flotation costs which are the costs of issuing new shares of common stock without causing dilution in order to avoid a decrease in the value of a stock due solely to the cost of issuing new stock.[165] Recovery of flotation costs is appropriate even if no new issuances are planned in the near future because failure to do so may deny MERC the opportunity to earn its required rate of return in the future. *Id.* at 27. Such a denial would be contradictory to the purpose of rate-of-return regulation. *Id.* Dr. Amit demonstrated the need for an issuance-cost adjustment.[166]

108. DOC agrees with the Company's flotation cost calculation of 3.90 percent.[167] The Department appropriately adjusted its DCF and TGDCF results by using flotation costs of 3.90 percent.[168]

109. The Department disagrees, however, with OAG witness Dr. Chattopadhyay's view that flotation costs should be excluded from MERC's ROE determination.[169] Dr. Chattopadhyay's basic premise for excluding flotation costs is based on his view that the DCF methodology produces an upward biased ROE when the market-to-book ratio ("M/B ratio") of comparable companies is greater than one, as it is in this case.[170] Dr. Amit demonstrated in his Rebuttal Testimony that the DCF does not produce an upward biased estimate of the cost of equity capital. Dr. Chattopadhyay's objection to the inclusion of flotation costs is without merit.[171]

(h) DOC Initial Recommended ROE: Direct Testimony (9.40 percent)

110. Based on Dr. Amit's DCF and TGDCF analyses for the NGCG group, the required rate of return for MERC ranged from a low of 8.61 percent to a high of 10.14

---

[164] *Id.* at 34.

[165] Ex. 200 at 26 (E. Amit Direct).

[166] *Id.* at 26, EA-14.

[167] Ex. 200 at 27 (E. Amit Direct) (*citing* MERC Ex. 17 at PRM-1, Schedule 9, Page 1 (Moul Direct)).

[168] Ex. 200 at 27 (E. Amit Direct).

[169] Ex. 201 at 25 (E. Amit Rebuttal); Ex. 202 at 35–36 (E. Amit Surrebuttal); Tr. at 204 (E. Amit).

[170] *Id.*

[171] Ex. 201 at 25 (E. Amit Rebuttal); Ex. 202 at 35–36 (E. Amit Surrebuttal).

percent, with flotation costs. Dr. Amit reasonably concluded in his Direct Testimony that the most reasonable required rate of return on common equity for MERC inside this range was the mean of 9.40 percent.[172]

(i) DOC Final Recommended ROE: Surrebuttal Update (9.29 percent)

111. Dr. Amit updated his recommended ROE to 9.29 percent and an overall rate-of-return of 7.27 percent for MERC.[173] It is necessary to update the ROE recommendation with current prices because it is important to use the most recently available expected dividend yields when relying on a DCF analysis,[174] and for consistency Dr. Amit also updated his DCF analysis with more recent projected growth rates.[175] He also updated his CAPM analysis.[176]

112. To calculate updated dividend yields, Dr. Amit used closing prices from the most recently available thirty-two day period (03/14/2014–04/14/2014). He also updated the annual dividend rates.[177]

113. Dr. Amit updated the expected growth rates of dividends for the NGCG based on the most recently available projected growth rates (projected earnings per share, EPS) of Zacks, Thomson and Value-Line.[178] While the expected growth rates of dividends are not likely to change significantly in such a short period between Direct and Surrebuttal Testimonies, consistency required the use of the most recently available projected growth rates.[179]

114. Dr. Amit used the same flotation costs in his Surrebuttal Testimony as in his Direct Testimony.[180]

115. As a check on the reasonableness of his updated DCF, Dr. Amit updated his CAPM estimates.[181] His updated CAPM with flotation costs was 9.79, which is reasonably close to Dr. Amit's updated DCF analysis result of 9.29 percent.[182] Dr. Amit reasonably concluded that when using expected risk premiums, the ex-ante CAPM is useful in confirming

[172] Ex. 200 at 34 (E. Amit Direct).

[173] Ex. 202 at 2 (E. Amit Surrebuttal).

[174] Ex. 502 at 1 (E. Amit Surrebuttal).

[175] *Id.* at 1, 3.

[176] Ex. 502 at 2, 10-11 (E. Amit Surrebuttal).

[177] Ex. 202 at 3 (E. Amit Surrebuttal).

[178] Ex. 202 at 3 (E. Amit Surrebuttal).

[179] *Id.*

[180] Ex. 202 at 10 (E. Amit Surrebuttal).

[181] Ex. 202 at 6–7 (E. Amit Surrebuttal).

[182] *Id.*

the reasonableness of his recommended DCF estimate for the required rate of return on equity for MERC.[183]

116. Based on the records in these proceedings, the Department's final recommendation for the Commission to authorize a return on equity for MERC of 9.29 percent is reasonable.[184]

(i) Mr. Moul's DCF and other Analyses Are Flawed

117. MERC failed to demonstrate that a 10.75 percent ROE, with flotation costs, is reasonable.[185]

(a) Summary of Dr. Amit's main disagreements with Mr. Moul's analyses

118. A key flaw in Mr. Moul's ROE analyses concerns his leverage adjustments for his DCF and CAPM analyses, and the size adjustment for his CAPM analysis.[186] Other flaws include Mr. Moul's choices of the yield and risk premium for his risk premium analysis, his risk-free yield and risk-free premium choices for his CAPM analysis and as well as other aspects of his analyses.[187]

(b) Mr. Moul's selection of his Delivery (comparable) Group was flawed

119. As part of his DCF analysis, Mr. Moul's selection of comparable group of companies he referred to as his "Delivery Group" was flawed.[188] A key error was Mr. Moul's inclusion in his Delivery Group of four non-natural gas utility companies with higher risk profiles than natural gas utilities such as MERC.[189] It is reasonable to expect a higher average required rate of return for the group of the four companies than for the Delivery group excluding the four companies.[190] An appropriate comparable group would result in a lower required rate of return than would be indicated by Mr. Moul's Delivery Group.[191] Mr. Moul provided no justification in his Rebuttal Testimony for inclusion of non-natural gas companies in his comparable group.[192] The comparable group for Mr. Moul's DCF analysis is flawed and is unreasonably because it does not have a comparable risk profile to that of MERC.[193]

---

183 *Id.* at 7.

184 Ex. 202 at 11 (E. Amit Surrebuttal); Tr. at 200 (E. Amit).

185 Ex. 200 at 45 (E. Amit Direct); Ex. 202 at 12–13 (E. Amit Surrebuttal).

186 Tr. at 200–201 (E. Amit).

187 Tr. at 201 (Amit).

188 Ex. 200 at 46–47 (E. Amit Direct); Ex. 202 at 13–14 (E. Amit Surrebuttal).

189 *Id.*

190 Ex. 200 at 47 (E. Amit Direct).

191 *Id.*

192 Ex. 202 at 14 (E. Amit Surrebuttal).

193 *Id.*

(c) Mr. Moul's Rate of Return Analyses were flawed

(i) Mr. Moul's DCF analysis included inappropriate dividend yield calculations and other flaws

120. Flaws in Mr. Moul's DCF analysis, in addition to the inappropriate comparable group discussed immediately above, concerned his dividend yield calculations, calculation of the adjustment for flotation costs (although Dr. Amit agreed with the flotation cost number itself, 3.90 percent) and, to a lesser degree, the projected growth rate.[194]

121. Mr. Moul's dividend yield calculations were flawed by his use of month-end prices of six-month (*i.e*., long-term historical prices) rather than current (recent historical) stock prices over a short period such as a one to three month period. It is important to use current rather than non-recent historical prices for the dividend yield under the basic financial premise that financial markets are efficient; that is, the current stock prices fully reflect all publicly available information.[195] Moreover, using a six-month average dividend yield may create a mismatch between such dividend yields and the more recent projected growth rates.[196]

122. Regarding the flotation cost adjustment Dr. Amit agreed with MERC's calculation of flotation costs of 3.90 percent, but not Mr. Moul's *adjustment* to the dividend yield which deviated from the well-recognized method used in the financial literature as follows: Dividend yield/1-F, where F is the percentage flotation cost or 0.039 in this case.[197]

123. Mr. Moul's projected growth rate in dividends appropriately used projected earnings per share, yet he used his subjective judgment to conclude that an expected growth rate of five percent is a reasonable growth rate to use for his DCF analysis.[198]

(ii) Mr. Moul's Risk Premium analysis is flawed for many reasons

124. Among the flaws in Mr. Moul's Risk Premium analysis, Dr. Amit explained, Mr. Moul used the wrong yield on A-rated utility bonds and the wrong risk premium for his Risk Premium analysis, for which his RP analysis should be rejected.[199]

1) Mr. Moul's yield on A-rated utility bonds is unreasonably biased upward

125. Mr. Moul used the wrong methodology to estimate the yield on A-rated utility bonds for his Risk Premium analysis, which caused his proposed yield on A-rated utility

---

194 Ex. 200 at 48–51 (E. Amit Direct); Ex. 202 at 14 (E. Amit Surrebuttal).

195 Ex. 200 at 15, 48 (E. Amit Direct).

196 Ex. 200 at 49 (E. Amit Direct).

197 *Id.* at 50.

198 Ex. 200 at 49 (E. Amit Direct); Ex. 202 at 14 (E. Amit Surrebuttal).

199 Ex. 200 at 51 (E. Amit Direct).

bonds to be biased upward.[200] Mr. Moul inappropriately used mismatched time periods (he added a yield spread between twenty-year Treasury bills and A-rated utility bonds to the yields on thirty-year Treasury bills), he did not calculate average yield spreads based on the most recently available information (his six-month or twelve-month averages may reflect outdated information), and he used estimated spreads rather than the preferable direct information on A-rated utility bonds.[201]

2) Mr. Moul used an incorrect approach to determine the yield for his risk premium

126. Mr. Moul's determination of the yield for his risk premium is somewhat arbitrary and is therefore inappropriate.[202] Based on recent financial literature, there is a consensus that risk premiums vary based on the specific financial and economic environments, and therefore, prospective risk premiums may be preferable to risk premiums estimated based on historical data.[203]

127. Although Mr. Moul used an historical risk premium approach, he failed to establish an exact analytical relationship between the level of interest rates and the level of risk premium.[204] Rather, his estimated risk premium is unreasonable because it is based on his own judgment that is not supported by any rigorous analysis.[205]

3) Mr. Moul incorrectly calculated his risk premium based on mismatched measurements

128. The risk premiums estimated by Mr. Moul are measured incorrectly as the return on large common stock minus the return on long-term corporate bonds.[206] The appropriate risk measures should be calculated as the difference between the return on common stock of A-rated utility companies and the return on long-term A-rated utility bonds. Applying the risk premium as estimated by Mr. Moul and adding it to the current yield on A-rated utility bonds results in a mismatch.[207]

4) Mr. Moul repeated the same Risk Premium errors in his Rebuttal Testimony

129. In his Rebuttal Testimony, Mr. Moul repeated the same errors committed in his Direct Testimony for his Risk Premium analysis. He provided no additional explanation

---

[200] *Id.* at 51.

[201] *Id.*

[202] Ex. 200 at 54–55 (E. Amit Direct).

[203] *Id.*

[204] *Id.*

[205] *Id.* at 55.

[206] Ex. 200 at 55 (E. Amit Direct).

[207] *Id.*

regarding his choice of the yield on A-rated utility bonds and the risk premium. Mr. Moul's Risk Premium analysis is unreasonable.[208]

(d) Mr. Moul misapplied the CAPM methodology

130. Dr. Amit explained in detail the significant flaws in Mr. Moul's CAPM analysis.[209] To perform a CAPM analysis there are three main parameters: beta, the risk-free rate, and risk premium.[210] Mr. Moul's CAPM analysis is flawed as to each of these three parameters, and he repeated the same errors in his Rebuttal Testimony.[211]

(1) MERC's Beta is unreasonably high

131. For beta, a risk measurement that reflects the price volatility of a company relative to the price volatility of the market as a whole, Mr. Moul appropriately selected Value Line's beta of 0.67, but then inappropriately adjusted it to 0.71 to account for an alleged higher financial risk due to the difference between market-debt/equity ratio and book-debt /equity ratio.[212] Because this difference is already accounted for by investors no additional adjustment on this account is reasonable.[213] Dr. Amit reasonably adjusted Mr. Moul's proposed beta by disregarding Mr. Moul's upward adjustment of the Value Line beta of 0.67.[214]

(2) MERC's risk-free rate is flawed

132. For the risk-free rate, Mr. Moul used 3.75 percent. He based his selection on the Blue-Chip forecast of 3.70 percent yield on thirty-year Treasury bills for the third quarter of 2014.[215] Dr. Amit identified two key concerns with Mr. Moul's risk-free rate. First, the yield on thirty-year Treasury bills includes significant interest risk premium and therefore does not represent a true risk-free yield.[216] Second, because current yields on long-term Treasury bills fully reflect current investors' expectations about the future economic and financial environment, Mr. Moul's use of Blue-Chip's forecast of *future* yields for *current* yields is inappropriate; doing so simply introduces another element of uncertainty in the application of the CAPM.[217]

[208] Ex. 202 at 15 (E. Amit Surrebuttal).

[209] Ex. 200 at 55–58 (E. Amit Direct); Ex. 202 at 15–16 (E. Amit Surrebuttal).

[210] Ex. 200 at 55 (E. Amit Direct).

[211] Ex. 202 at 15–16 (E. Surrebuttal).

[212] Ex. 200 at 56, 67 (~~Amit~~E. Direct).

[213] *Id.* at 60–68.

[214] *Id.* at 58.

[215] *Id.* at 56.

[216] *Id.* at 57.

[217] *Id.*

(3) MERC's risk premium is flawed

133. For the risk premium, Mr. Moul's methodology is inconsistent and unreasonable.[218] Mr. Moul inappropriately used a different risk premium for his Risk Premium analysis, 7 percent, than he did for his CAPM historical risk premium, 8.69 percent.

134. Further, Mr. Moul's use of a historical risk premium for his CAPM analysis is without merit.[219] In his CAPM calculation, Mr. Moul used the average of current and historical risk premiums.[220] Dr. Amit demonstrated that Mr. Moul's methodology of calculating the historical risk premium is incorrect, both for Mr. Moul's Risk Premium analysis and for his CAPM.[221]

135. Finally, although Mr. Moul's calculations of the market's rate of return are reasonable, his use of a risk-free rate of return of 3.75 percent rather than 3.53 percent was not.[222]

(4) Mr. Moul repeated the same CAPM errors in his Rebuttal Testimony

136. In his Rebuttal Testimony, Mr. Moul used the same methodology for CAPM as he used in his Direct Testimony and, thus, his updated CAPM continues to be unreasonable and must be rejected.[223]

(a) The Comparable Earning Analysis is without merit

137. To confirm his other Rate of Return analyses, Mr. Moul used a tool called "Comparable Earning." The results of his Comparable Earning analysis, together with his arbitrary elimination of companies from his comparison group, show that the analysis is without merit and must be rejected.[224] For example, the results of Mr. Moul's analysis "clearly indicate that his selected group includes many companies that are not risk comparable to the investment risks of his Delivery group."[225] For example, before he arbitrarily eliminated companies from the group with returns greater than 20 percent, his average returns were 48.9 percent and 17.9 percent for the historical and projected periods, respectively.[226]

---

[218] Ex. 200 at 57–58 (E. Amit Direct).

[219] *Id.*

[220] *Id.* at 56.

[221] Ex. 200 at 57–58 (E. Amit Direct).

[222] Ex. 200 at 57–58 (E. Amit Direct).

[223] Ex. 202 at 15–16 (E. Amit Surrebuttal).

[224] Ex. 200 at 59 (E. Amit Direct).

[225] *Id.*

[226] *Id.*

138. Other indicators that Mr. Moul's Comparable Earning analysis is without merit include:[227]

- His historical returns include returns as low as 3 percent and as high as 726.5 percent;
- His projected returns range from a low of 4.5 percent to a high of 41.5 percent;
- About thirty-nine percent of his companies have average historical returns above twenty percent; and
- About thirty-two percent of his companies have average projected returns greater or equal to twenty percent.

(b) Mr. Moul's upward ROE adjustments based on claimed risk-specific factors for MERC are unsupported and unreasonable.

139. The risk adjustments to ROE proposed by Mr. Moul are without merit. He included the same risk indicators in his Direct and Rebuttal Testimonies, divided into two groups:[228]

- Risk indicators for which Mr. Moul did not provide specific upward adjustments of his recommended ROE; and

- Risk indicators for which Mr. Moul provided specific upward adjustments of his recommended ROE a size and a leverage adjustment.

140. Regarding Mr. Moul's first group of claimed risk indicators, Dr. Amit showed that there is no valid basis to conclude that MERC's investment risk is greater than Mr. Moul's Delivery Group investment risk.[229] Mr. Moul's first group of claimed risk indicators for which he made no ROE adjustment include: 1) The high percentage of revenues received from large volume customers; 2) Volatility of ROE; 3) Operating ratios; and 4) Coverage rates.[230] Dr. Amit discussed each of these claimed risk factors in detail and showed there is no valid basis to conclude that MERC's investment risk is greater than Mr. Moul's Delivery group investment risk.[231]

141. As to the second group of claimed risk indicators, Dr. Amit's analysis clearly demonstrated that Mr. Moul's proposed upward adjustments to his ROE estimates are without merit.[232] Dr. Amit paid particular attention to Mr. Moul's two upward ROE adjustments, a

---

[227] Ex. 200 at 59 (E. Amit Direct).

[228] *Id.* at 60–68; Ex. 202 at 16 (E. Amit Surrebuttal).

[229] Ex. 202 at 16–17 (E. Amit Surrebuttal); *see also* Ex. 200 at 60–63 (E. Amit Direct).

[230] Ex. 200 at 60 (E. Amit Direct).

[231] *Id.* at 63.

[232] Ex. 202 at 17 (E. Amit Surrebuttal); *see also* Ex. 200 at 63–68 (E. Amit Direct).

size and a leverage adjustment, and explained in detail why there is no basis to support either upward ROE adjustment.[233]

(1) Selection of a comparison group requires a macro risk analysis, not the micro risk analysis proposed by Mr. Moul

142. Mr. Moul's micro risk analysis of companies in his comparable or Delivery group is an unreasonable basis for adjustment of MERC's ROE. The selection of a comparison group of companies with investment risks similar to MERC must be based largely on a macro risk analysis, not a micro risk analysis.[234]

143. A macro risk analysis is based on using well accepted and readily available business and financial risk indicators.[235] Companies in the comparison group must have similar business and financial risk indicators, which may include lines of business, credit rating, beta, and standard deviation of price changes.[236] Of course, each company in the comparison group may have unique characteristics that impact its investment risk.[237] Such characteristics may include the specific mix of customer classes, the amount of storage capacity, the locational density of its customers, and the age of its distribution facilities.[238]

144. Although each company may have unique risk characteristics, there are two key reasons why using micro risk analysis to identify such characteristics is not appropriate for the purpose of selecting a comparable group.[239] First, since each utility has a somewhat different set of risk characteristics, screening for micro risk factors would divide the group too finely such that no company would qualify to be selected for the overall comparison group. Second, the macro risk analysis uses well accepted risk measures that already reflect the unique characteristics of each company. Performing a micro analysis would overemphasize the micro characteristic and, thus, is unreasonable.[240]

(2) Mr. Moul's upward ROE adjustment based on MERC size is unwarranted

145. Mr. Moul did not show that his upward ROE adjustment for MERC's size, according to his CAPM analysis, is reasonable. He stated that, based on various studies and the financial literature, smaller size companies are riskier than larger size companies and therefore, smaller size companies' required rate of return is higher. He identified the risk

[233] Ex. 200 at 63–68 (E. Amit Direct); Ex. 202 at 17 (E. Amit Surrebuttal).

[234] Ex. 200 at 60 (E. Amit Direct).

[235] Ex. 200 at 60 (E. Amit Direct)

[236] *Id.*

[237] *Id.* at 60–61.

[238] *Id.*

[239] Ex. 200 at 61 (E. Amit Direct).

[240] *Id.*

premium for his CAPM projected ROE for a Mid-Cap company (1.12 percent) and used that risk premium as an adder for his CAPM result.[241]

146. Dr. Amit explained in detail why it is unreasonable to adjust MERC's ROE upward based on its size. As a general matter, there exists a "risk premium" for smaller size companies, but *only if* all other investment risk characteristics of a group of companies are the same.[242] For example, for two identical companies in all aspects other than size, the company that is significantly smaller would have a higher required rate of return.[243] Mr. Moul made no such showing as to MERC.

147. MERC's size is only one aspect of the Company's overall financial and business risk. It is inappropriate to choose one specific factor of the overall investment risk and use it increase MERC's required rate of return to a level that is higher than the rate of return for the comparison group.[244] Therefore, any "risk premium" associated with a size-only comparison for MERC is inappropriate.[245] To employ a micro risk analysis in order to account for size would require an examination of each company's unique factors that may impact investment risk.[246] Mr. Moul did not attempt such an examination. Even if one were to provide a micro risk analysis of each company's unique risk factors, it would be impractical and would defeat the purpose of using well-accepted common-risk factors to screen for risk-comparable groups.[247] No additional justification for a size adjustment was provided in Mr. Moul's Rebuttal Testimony.[248] Adding a small-size risk premium to the rate of return for MERC is not reasonable and should be denied.[249] The ALJ agrees.

(3) Mr. Moul's upward ROE adjustment based on a "leverage" adjustment is unreasonable

148. Mr. Moul's upward "leverage adjustment" to MERC's ROE of 48 basis points, based on his DCF and his CAPM analyses, is unreasonable. DOC Ex. 200 at 63 (Amit Direct). Dr. Amit provided the technical formulas used by Mr. Moul, together with various inputs based on companies in Mr. Moul's Delivery group, to show Mr. Moul's "leverage adjustment" calculations. *Id.* at 65.

149. Mr. Moul used two equations that would be appropriate equations to account for significant differences in the debt-to-equity ratios for two companies with otherwise similar investment risks, but neither equation is applicable for MERC and Mr. Moul's

---

241 *Id.* at 63 (*citing* MERC Ex.17 at PRM-1, Schedule 12, page 3 (Moul Direct)).

242 Ex. 200 at 64 (E. Amit Direct).

243 *Id.*

244 *Id.*

245 *Id.*

246 *Id.*

247 *Id.*

248 Ex. 202 at 21 (E. Amit Surrebuttal).

249 Ex. 200 at 64 (E. Amit Direct).

Delivery group. DOC Ex. 200 at 66 (Amit Direct). Mr. Moul's application of these equations contradicts the fundamental financial principle that financial markets are efficient, *i.e.*, the current stock prices fully reflect all publicly available information. *Id.* This principle applies as well to investors' expectations regarding risk premiums associated with financial leverage. *Id.*

150. Dr. Amit demonstrated that Mr. Moul's "leverage adjustment" is unreasonable. Making an upward "leverage adjustment" to MERC's ROE would double compensate MERC. Therefore it is not reasonable and should be denied.

(g) Mr. Moul's additional criticisms of Dr. Amit's Direct Testimony have no merit and should be rejected.

151. In his Rebuttal Testimony, Mr. Moul made three new arguments for a higher MERC ROE for MERC, but failed to demonstrate that any is warranted. In addition to recommending the risk adjustments discussed immediately above, Mr. Moul claimed that:[250]

- In view of the rates of return allowed by state utility commissions in 2013, Dr. Amit's recommendation of rate of return of 9.40 percent is too low;
- Dr. Amit's recommended rate of return of 9.40 percent is too low because Value Line projects an average rate of return of 11.49 percent for its natural gas utility companies over the 2017–2019 period; and
- Based on the Commission's Order in Docket No. G007,011/GA-10-977, the required rate of return for MERC should be 10.27 percent.

152. Mr. Moul's claims are unreasonable and must be rejected.[251]

(1) Recent state utility commission decisions do not support Mr. Moul's proposed ROE for MERC

153. Contrary to Mr. Moul's claim, recent commission decisions do not show that Dr. Amit's recommended ROE is too low.[252] The average ROE for the group of eleven natural gas rate cases determined in the fourth quarter of 2013 was 9.83 percent compared to Dr. Amit's Direct Testimony ROE of 9.40 percent.[253] However, the range of those allowed ROEs went from a low of 9.08 percent to a high of 10.25 percent.[254] This range means that some allowed ROEs were significantly below Dr. Amit's initial recommendation of 9.40

---

[250]- Ex. 202 at 18 (E. Amit Surrebuttal).

[251] *Id.* at 18-20.

[252] *Id.* at 18–19.

[253] *Id.* at 18.

[254] *Id.*

percent,[255] and lower than Dr. Amit's final recommended ROE of 9.29 percent. Based on Mr. Moul's own argument, his recommended ROE of 10.75 percent is unreasonably high.[256]

154. State utility commission decisions issued in the fourth quarter of 2013 are likely based on data from 2012 and early 2013.[257] Such decisions likely reflect outdated economic and financial data that are not relevant to the current MERC general rate case.[258]

(2) Value Line projected ROEs do not indicate that Dr. Amit's estimated ROE of 9.40 (or final, 9.29 percent) is too low.

155. There are at least two reasons why Mr. Moul's contention that Value Line's projected expected ROE of 11.49 percent for the period of 2017–2019 does not show Dr. Amit's recommended MERC ROE to be too low.[259] First, as Dr. Amit provided in his Rebuttal Testimony at pages 2 and 3, when the market-to-book (M/B) ratio is greater than one, as is the case for Dr. Amit's comparison group, then the *expected* rate of return is greater than the *cost* of common equity.[260] The issue in this rate case concerns a reasonable cost of common equity (the required rate of return or ROE) for MERC.[261] Dr. Amit's Value Line's average 2017–2019 *expected* ROE of 11.25 percent, only confirms his analysis that the expected rate of return is greater than ROE when the M/B ratio is greater than one; it does not indicate that Dr. Amit's estimated ROE of 9.40 percent is too low.[262]

156. Second, Dr. Amit provided specific examples of the Value Line data showing that such data is internally inconsistent.[263] Therefore, Mr. Moul's Value Line claim has no merit.[264]

(3) The Commission's Order in MERC's last rate case, Docket No. G007,011/GA-10-977, does not support an ROE in this case of 10.27 percent

157. Mr. Moul employed a circular argument to claim erroneously that the Commission's prior ROE, which was based on 2011 data, is appropriate to use in determining

---

255 *Id,*

256 *Id.* at 19.

257 Ex. 202 at 19 (E. Amit Surrebuttal).

258 *Id.*

259 Ex. 202 at 19 (E. Amit Surrebuttal).

260 *Id.*

261 *See id.*

262 *Id.*

263 Ex. 202 at 19 (E. Amit Surrebuttal).

264 *Id.*

the ROE in the present rate case of 10.27 percent.[265] Also, Mr. Moul assumed without support that today's interest rate environment required his historical risk premium that was incorrectly determined in the past to be adjusted downward by 50 basis points.[266]

158. Dr. Amit summarized the multiple flaws in Mr. Moul's "updating" argument, as follows:[267]

- The argument uses circular analysis because it uses a Commission-determined ROE from 2011 to estimate the *current* ROE for MERC; and
- Mr. Moul somewhat arbitrarily adjusts the incorrectly determined historical risk premium to estimate a current risk premium.

159. For these reasons, Mr. Moul's "updating" argument is unreasonable and must be rejected.

f. OAG Witness Dr. Chattopadhyay's ROE Analysis Was Flawed And Should Not Be Adopted.

i. Dr. Chattopadhyay's DCF Analysis Is Flawed

160. Dr. Chattopadhyay's recommendation of an 8.62 percent ROE is fundamentally unreasonable. His analysis to arrive at an ROE of 8.62 percent is based on the erroneous assumption that when the M/B ratio is greater than one, the DCF produces an upwardly biased DCF estimate of ROE. His projected growth rate is based on a subjective average of several growth rates that achieves a low ROE, but with no explanation of why it would not be reasonable to employ a similarly subjective average of growth rates to achieve a higher ROE. Investors' behavior does not support Dr. Chattopadhyay's analysis since, based on that analysis, investors should have made a run on utilities stocks in recent years. This clearly did not happen.[268]

161. Although both Dr. Amit and Dr. Chattopadhyay rely principally on DCF analysis for their recommended ROE for MERC, and both use CAPM as a check on the reasonableness of the DCF (Dr. Amit also uses ECAPM as a check), Dr. Amit demonstrated significant flaws in Dr. Chattopadhyay's DCF ROE analysis and recommendation.[269]

162. Dr. Amit's final recommended ROE for MERC of 9.29 percent differs from Dr. Chattopadhyay's 8.62 percent recommendation largely due to Dr. Chattopadhyay taking an average of the results of four different DCF methods and his fundamental view that application of DCF analysis results in an upward bias to ROE where, as here, the market-to-

[265] Ex. 202 at 20 (E. Amit Surrebuttal).

[266] *Id.*

[267] Ex. 202 at 20 (E. Amit Surrebuttal).

[268] Tr. at 203–204, 205 (Amit).

[269] Ex. 201 at 1–22 (E. Amit Rebuttal); Ex. 202 at 22–37 (E. Amit Surrebuttal); Tr. at 202–205 (Amit).

book (M/B) ratio of comparable companies is over one.[270] The four DCF methods Dr. Chattopadhyay averaged to arrive at his ROE recommendation were:[271]

- DCF with expected growth rates of dividends based on average earnings per share (EPS), dividend per share (DPS), and book value per share (BPS);
- DCF with EPS-projected growth rates;
- DCF with sustainable growth rates; and
- DCF analysis based on M/B ratio.

(a) Summary of key flaws in Dr. Chattopadhyay's ROE analyses

163. Dr. Amit summarized key flaws in Dr. Chattopadhyay's analyses that are "based on fairly involved technical analyses" as follows:[272]

> One, Dr. Chattopadhyay uses various expected growth rates as I stated above, and I only used average EPS projected growth rates. The superiority of using EPS projected growth rates over the average of various projected growth rates is strongly supported by the financial literature and by financial principles.
>
> Two, for the dividend yields, Dr. Chattopadhyay used Value Line projected 2014 dividend rates. I used annualized dividend rates increased by one half of the projected growth rate. However, for both of us, the average dividend yield is 3.86 percent.
>
> Three, Dr. Chattopadhyay based his overall recommendation on the premise that when [the] market to book ratio is greater than one, the DCF results in an upward bias estimate of the cost of equity. I disagree, as well-documented in my rebuttal testimony, and surrebuttal testimony.
>
> Four, the relationship between market-to-book ratio and the cost of equity capital is fairly complex. However, according to Dr. Chattopadhyay's hypothesis, for at least the last ten years investors in natural gas utilities received returns above the cost of equity. Such excessive returns for longer than ten years are counter to financial theory and common sense. The return, if excessive, should have caused investors to increase their demand for the stock of natural gas utilities, thus increasing the price and lowering dividend yields until excess profits are eliminated. This clearly has not happened, as market-to-book ratios remain significantly above one.

---

[270] *See id.* at 202–204.

[271] Tr. at 202 (Amit).

[272] Tr. at 202–204 (Amit).

> Five, flotation costs. Dr. Chattopadhyay's objection to the inclusion of flotation costs is solely based on his argument that the DCF produces an upwardly biased ROE when the market-to-book ratio is greater than one. Since his basic premise regarding the market-to-book ratio is not well supported, his objection to the inclusion of a flotation cost adjustment is without foundation.

164. The ALJ agrees with DOC that Dr. Chattopadhyay's ROE analysis is not reasonable.

(b) Dr. Chattopadhyay's method of calculating the expected growth rates of dividends is not reasonable

165. Dr. Amit filed extensive testimony concerning many reasons that Dr. Chattopadhyay's method of estimating the expected growth rates of dividends for comparable companies is not reasonable.[273] Essentially, Dr. Chattopadhyay calculated the expected growth rates for his DCF analysis by averaging the expected EPS, DPS and BPS rather than using only EPS.[274]

166. Dr. Amit identified in detail many flaws in Dr. Chattopadhyay's criticisms of Dr. Amit's screening methodology by which Dr. Amit selected companies for his TGDCF analysis.[275] While Dr. Amit disagreed with Dr. Chattopadhyay's criticism of his -application of the TGDCF, Dr. Amit's update of his DCF analysis in Surrebuttal rendered such criticisms inapplicable to Dr. Amit's final DCF recommendations.[276]

167. Other than the use of EPS, Dr. Amit showed that Dr. Chattopadhyay's rationale for relying on DPS , BPS, and sustainable growth rates and averaging those expected values to estimate expected growth rates of dividends was unreasonable.[277] Certain key reasons supporting the use of EPS-only projected growth rates and not also DPS or BPS projected growth rates or other factors are noted below.

(1) Econometric models support the use of projected EPS-only growth rates

168. Econometric models support the use of projected EPS growth rates alone.[278] Dr. Chattopadhyay's averaging of expected EPS, DPS and BPS rather than relying only on

---

[273] Ex. 201 at 10–24 (E. Amit Rebuttal); Ex. 202 at 29–30, 33–34 (E. Amit Surrebuttal).

[274] Ex. 201 at 10 (E. Amit Rebuttal).

[275] Ex. 202 at 30-34 (E. Amit Surrebuttal). Dr. identified additional flaws in Dr. Chattopadhyay's criticisms of Dr. Amit's screening methodology, but determined that other errors warranted greater attention. However, for in-depth discussion of Dr. Amit's testimony regarding Dr. Chattopadhyay's criticisms, *see* Ex. 202 at 22–29 (E. Amit Surrebuttal).

[276] Ex. 202 at 32–34 (E. Amit Surrebuttal).

[277] Ex. 201 at 12 (E. Amit Rebuttal).

[278] Ex. 201 at 12–13 (E. Amit Rebuttal).

projected EPS is based on a flawed assumption. Dr. Chattopadhyay argued incorrectly that because investors consider various factors when they price utility stock, it is reasonable to average expected earnings per share, dividends per share and book value per share values to reflect investors' expectations of dividend growth rates.[279]

169. Dr. Amit testified that empirical modeling of expected EPS and stock prices suggests that investors strongly relate their expectation of stock prices to the projected EPS growth rates.[280] He explained, as follows:[281]

> Dr. Chattopadhyay stated that, in his opinion, investors consider various factors when they price utility stock. That may be true; however, nobody knows all the various factors that may be considered by investors attempting to price a utility stock. No financial model that depends to some degree on human behavior can incorporate all such factors in the model. However, if an empirical model uses independent variables that successfully explain the behavior of the dependent variable, then we can conclude that, people (investors) act as if these independent variables are the ones they use in pricing the utility's stock (the dependent variable).
>
> Various econometric studies (referred to later in this rebuttal testimony) have shown a significant relationship between projected EPS and stock prices. Therefore, while it is impossible to read investors' minds regarding the issue of projected growth rates, the econometric studies have shown that investors form their expectation regarding stock prices as if they strongly relate them to the projected EPS growth rates.

170. The ALJ agrees with Dr. Amit.

171. Dr. Chattopadhyay also argued that, because the DCF equation relates price to earnings but not to dividends, it follows that we should expect an econometric model to show the relationship between price and earnings, but not between price and dividends.[282] This argument, however, supports rather than opposes the use of projected EPS growth rates over projected DPS growth rates.[283] As Dr. Amit pointed out, Dr. Chattopadhyay recognized that, "the relationship between dividends growth expectations and price is not that obvious."[284]

---

279 *See id.* at 12.

280 Ex. 201 at 12–13 (E. Amit Rebuttal).

281 *Id.*

282 *Id.* at 14.

283 *Id.*

284 *Id.* (*citing* OAG Ex. 161 at 34 (Chattopadhyay Direct)).

172. Dr. Chattpadhyay's testimony that "a strong relationship between price and earnings, while a weak relationship between price and dividends, would be completely consistent with the inference that investors do care not only about growth in earnings, but also growth in dividends" does not support his argument for use of projected DPS growth rates in a DCF analysis.[285] Given that projected EPS growth rates are the best predictors of stock price, it is reasonable to use EPS to reflect investors' expectations of dividend growth rates.[286]

(2) The DCF assumes the same growth rates for EPS, DPS and BPS, it is reasonable to assume that DPS and BPS would eventually equal the sustainable EPS growth rate

173. Dr. Chattopadhyay is correct that the DCF assumes the same growth rates for EPS, DPS and BPS, but he is incorrect to obtain the projected sustainable growth rate for DCF analysis by averaging projected EPS, DPS and BPS.[287] Importantly, the long-run (sustainable) growth of DPS and BPS *are derived from* the growth in EPS.[288] Conceptually, the issue of unequal short-term growth rates is more appropriately resolved by assuming convergence of the DPS and BPS growth rates to the sustainable EPS growth rates, not by averaging the EPS, DPS and BPS growth rates.[289]

(3) Financial literature strongly supports use of projected EPS growth rates to determine projected growth rates of dividends for the DCF analysis; literature does not support use of projected DPS or BPS.

174. Abundant financial literature supports a determination that growth in earnings is the main factor investors consider and that the use of projected EPS growth rates is preferred to the use of projected DPS or BPS growth rates.[290] While it is impossible to know what specific factors investors use to form their expectation regarding dividend growth rates, based on the studies in the financial literature the projected EPS growth rates are the best projected growth rates to use to predict utilities' stock prices.[291] No similar relationships between price valuation and projected DPS or BPS growth rates can be found anywhere in the

---

285 Ex. 201 at 14 (E. Amit Rebuttal).

286 *Id.* at 12–14.

287 Ex. 201 at 13 (E. Amit Rebuttal).

288 *Id.*; *see also* Ex. 200 at 17 (E. Amit Direct).

289 Ex. 201 at 13 (E. Amit Rebuttal).

290 Ex. 200 at 17–19 (E. Amit Direct); Ex. 201 at 15–18 (E. Amit Rebuttal).

291 *Id.* at 13–19.

financial literature.[292] Moreover, in the long run, "dividend growth is sustainable only via growth in earnings."[293]

(4) Importance of dividends to the investor community is irrelevant; the issue is which projected growth rate is appropriate for the DCF analysis.

175. Although Dr. Chattopadhyay testified that investors rely on factors other than earnings per share, including dividends, in making their investment decisions, Dr. Amit stressed correctly that Dr. Chattopadhyay's focus in this regard misses the point. Dr. Amit explained:[294]

> There is no doubt that investors make their investment decisions based, among other factors, on dividends. However, *the issue in this rate case is not the impact of dividends on investors' investment decisions.* Rather, *the issue to be addressed is which projected growth rate is the most appropriate to use in a DCF analysis.* Dr. Chattopadhyay's argument regarding the importance of dividends is simply irrelevant to the issue of the appropriate growth rate.

176. The Department showed that the most appropriate projected growth rate for the DCF analysis is the projected EPS growth rate.

(5) Dr. Chattopadhyay's growth rate regression analysis did not show that DPS or BPS projected growth rates are useful in predicting natural gas utilities' stock prices.

177. Dr. Amit discussed several flaws in the regression analysis performed by Dr. Chattopadhyay and, to be able to compare his regression analysis with Dr. Chattopadhyay's, Dr. Amit ran three regressions.[295] Dr. Amit's criticisms of Dr. Chattopadhyay's regression analysis is technical as is Dr. Amit's correction of that analysis. To summarize, Dr. Amit reasonably concluded that the results of his econometric models support his position that projected EPS growth rates are the most appropriate growth rates to be used in a DCF analysis.[296] Dr. Chattopadhyay's selection of the particular growth rates to use in his DCF analysis is not adequately supported by theory or by the regression analysis in

---

292 *Id.* at 16.

293 *Id.* at 17 (internal citation omitted).

294 Ex. 201 at 14 (E. Amit Rebuttal) (emphasis added).

295 Ex. 201 at 19–23 (E. Amit Rebuttal).

296 *Id.* at 22.

Dr. Chattopadhyay's Direct or Rebuttal Testimonies.[297] For example, the weights that Dr. Chattopadhyay assigned to each of his selected growth rates "are arbitrary." Further, "all of the analyses indicate that the EPS growth rate is the most appropriate to use in DCF analyses."[298]

178. Finally, in the OAG Initial Brief at page 24 the following statement appears: "It should be recognized, however, that Dr. Chattopadhyay's growth estimate is predominantly -- but not *exclusively* -- influenced by earnings growth. Earnings growth is assigned more than 80% of the weight in Dr. Chattopadhyay's growth estimate, and less than 17 percent of the weight is made up of dividend and book value growth." First, irrespective of whether this statement is correct, which it is not, it is an acknowledgement that the EPS growth rates dominates any other growth rate estimate. Second, the statement is not supported by Dr. Chattopadhyay's Surrebuttal Testimony. On page 2 of his Surrebuttal Testimony, Dr Chattopadhyay states that his recommendation of 8.62 percent is the average of his four DCF analyses. The growth rates for each of his four DCF are: 1) the average of EPS, BVPS, and DPS growth rates (*i.e.,* 33 percent EPS); 2) the EPS growth rate (*i.e.,* 100 percent EPS);. 3) br +sv (sustainable) growth rates (*i.e.,* 0 percent EPS); and 4) the Market- to-book method (which uses br+sv for the growth rate) (*i.e.,* 0 percent EPS). Dr Chattopadhyay averaged those four growth rates to arrive at his ROE recommendation. This average assigns the EPS a weight of only 33 percent (133 percent/4 = 33.25 percent), not the 80 percent claimed in the OAG Initial Brief.

(6) Summary of Dr. Amit's response to Dr. Chattopadhyay's testimony regarding the use of expected EPS growth rates

179. The superiority of using EPS growth rates over Dr. Chattopadhyay's use of the average of various projected growth rates is strongly supported by the financial literature and financial principles.[299]

180. Dr. Amit correctly stated that Dr. Chattopadhyay's Rebuttal regarding the appropriate growth rates to be used in a DCF analysis provided no new arguments to support his position. Dr. Amit's Direct Testimony at 16 through 19 and his Rebuttal Testimony at 10 through 23 fully support using solely the analyst's EPS projected growth rates for DCF analysis. Dr. Amit demonstrated in his Surrebuttal Testimony that Dr. Chattopadhyay's arguments in support of using combination projected growth rates rather than the projected EPS growth rates are not reasonable.[300]

(c) Dr. Chattopadhyay's Market-to-Book ratio analysis is unsupported

[297] *Id.* at 23.

[298] *Id.*

[299] Tr. at 202–203 (Amit).

[300] Ex. 202 at 34–35 (E. Amit Surrebuttal).

181. The market-to-book ratio compares the book value (historical accounting value) of the company's common equity to the market value of its common equity. The M/B ratio should not be used in the DCF analysis in rate cases.[301]

182. Dr. Chattopadhyay argued that when the M/B ratio is significantly higher than one, the DCF analysis would produce a required rate of return greater than the cost of equity capital.[302] He further argued that since his comparison group has an average M/B ratio significantly greater than one, a DCF analysis for his comparison group would result in an ROE greater than the cost of common equity, k, for his comparison group.[303]

183. Dr. Amit demonstrated that Dr. Chattopadhyay's M/B ratio argument is unreasonable and must be rejected. For ratemaking purposes application of DCF analysis with M/B over one would not result in an upward bias for the ROE estimate.[304]

184. The theory of an upward bias for ROE based on a M/B ratio greater than one fails to recognize that in a rate case *the issue is to determine a reasonable estimate of the cost of common equity* rather than to estimate investors' expected realized rate of return on their investment.[305]

185. Dr. Chattopadhyay did not show that the DCF analysis results in an upward bias in the estimate of the cost of equity.[306] Under the fundamental principal that financial markets are efficient, stock prices fully reflect all available public information.[307] Thus, the DCF analysis fully reflects all publicly available information via stock prices. Investors are fully aware of the fact that M/B ratios for gas utilities are greater than one.[308] Therefore, DCF analyses for the comparable groups of Dr. Chattopadhyay and Mr. Moul (which had M/B ratios for the last five years significantly above one and trended upward) as well as for Dr. Amit (whose comparison group had a M/B ratio that did not go below 1.719 for the last

---

[301] Ex. 201 at 2 (E. Amit Rebuttal).

[302] Ex. 201 at 2 (E. Amit Rebuttal).

[303] *Id.* Dr. Chattopadhyay's conclusion is based on the following formula involving the M/B ratio, the expected realized rate of return and the required rate of return on equity:

1. $$P/B = \frac{r_e - b_e x r_e}{k - b_e x r_e}$$

Where P/B = M/B ratio
r_e = expected realized rate of return
b_e = retention ratio (1 – dividend/earning)
k = required rate-of-return on equity

Ex. 201 at 2 (E. Amit Rebuttal). Dr. Amit easily converted Dr. Chattopadhyay's formula to the formula Dr. Amit relied on to determine the estimated cost of common equity for rate making purposes. *Id.* at 3.

[304] Ex. 201 at 3-10 (E. Amit Rebuttal); Ex. 202 at 35–37 (E. Amit Surrebuttal); Tr. at 203–204 (Amit).

[305] Ex. 201 at 3 (E. Amit Rebuttal) (emphasis added).

[306] Ex. 201 at 3–11 (E. Amit Rebuttal).

[307] *Id.* at 8.

[308] *Id.*

ten years) fully account for the information that M/B ratio is greater than one, and do not produce an upward biased estimate of the cost of common equity for MERC.[309]

186. Dr. Amit explained further the limitations of Dr. Chattopadhyay's reasoning, as follows:[310]

> Dr. Chattopadhyay's [M/B ratio] analysis only shows that when the M/B ratio is greater than one the expected realized rate of return, r_e, is greater than the cost of common equity, k. Nowhere in his testimony did he show that under such circumstances, the DCF analysis results in an upward bias in the estimate of the cost of equity, k.

187. The ALJ agrees.

188. Dr. Amit provided extensive discussion regarding flaws of Dr. Chattopadhyay's M/B ratio theory.[311] Dr. Amit summarized his conclusions regarding the flaws of Dr. Chattopadhyay's M/B ratio theory, as follows:[312]

- Dr. Chattopadhyay showed that when the M/B ratio is greater than one, the expected ROE is greater than the cost of equity capital; however, important for this proceeding, nowhere in his analysis did he show that under a DCF analysis, the estimated ROE would exceed the cost of equity capital.

- The financial literature, when reviewed carefully, does not support Dr. Chattopadhyay's claim that the DCF analysis would produce an upward biased estimate of ROE when the M/B ratio is greater than one.

- Dr. Chattopadhyay's own empirical studies produce unreasonably low ROEs, when the ROE equals the expected rate of return (i.e., when M/B ratio equals one).

- According to Dr. Chattopadhyay, investors in natural gas utility companies have earned returns above these companies' cost of equity capital for longer than a ten-year period and continue to do so currently. Such a phenomenon is counter to basic financial principal and should have produced a run on natural gas utility companies until such excessive profit was eliminated.

---

309 *Id.* at 4, 8.

310 *Id.* at 9.

311 Ex. 201 at 4–7 (E. Amit Rebuttal).

312 Ex. 201 at 9 (E. Amit Rebuttal).

189. Dr. Amit reasonably concluded that the DCF analysis does not result in an upward DCF-estimated ROE when the M/B ratio is greater than one.[313] He also correctly observed that even Dr. Chattopadhyay did not abide by his M/B ratio theory regarding Dr. Chattopadhyay's recommended rate of return for MERC since Dr. Chattopadhyay's recommendation included no downward adjustment to the DCF analysis.[314]

190. The ALJ recommends that the Commission determine that DCF analysis generally, and Dr. Amit's DCF analysis in particular, is reasonable and does not result in an upward bias to ROE due the M/B ratio of companies in the NGCG being greater than one.

(d) Dr. Chattopadhyay's elimination of flotation costs is not reasonable

191. The required rate of return on equity must include a flotation cost adjustment.[315] Dr. Chattopadhyay's erroneous view that flotation costs should be excluded from MERC's ROE determination is based in large part on his view that when the M/B ratio is greater than one the DCF produces an upward biased ROE estimate which, therefore, justifies exclusion of flotation costs.[316]

192. The DCF does not produce an upward biased ROE estimate.317 The DCF results still must be adjusted for flotation costs.[318] It would be unreasonable to disallow a legitimate cost to the Company to compensate for some other alleged excess revenue unrelated to flotation costs.[319]

193. Dr. Chattopadhyay also argued that adjusting ROE to include flotation costs is not necessary because investors buy new shares of stock knowing that the price is higher than the revenues per share received by the Company from the sale of new shares of stock.[320] This rationale, however, does not support eliminating an adjustment to ROE for flotation costs.[321]

194. As Dr. Amit testified, correctly, that, to the degree that utilities are allowed to recover flotation costs, the allowed rates of return on book equity inherently reflect the flotation cost adjustment. He explained that Dr. Chattopadhyay's flotation cost argument is redundant. Dr. Amit testified, "Investors buying new shares of stock clearly would buy them only if they expect to earn their required rate of return. However, absent allowance for

[313] Ex. 201 at 10 (E. Amit Rebuttal).

[314] *Id.* at 24.

[315] Ex. 200 at 26–27 (E. Amit Direct).

[316] Ex. 201 at 24–26 (E. Amit Rebuttal); Ex. 202 at 35–36 (E. Amit Surrebuttal); Tr. at 204 (Amit).

[317] Ex. 201 at 25 (E. Amit Rebuttal); Tr. at 203–204 (Amit).

[318] Ex. 201 at 25 (E. Amit Rebuttal).

[319] *Id.*

[320] Ex. 201 at 24 (E. Amit Rebuttal).

[321] *Id.* at 25.

flotation costs existing shareholders would not be able to receive their required rate of return, as demonstrated in DOC Ex. [200 at] EA-14 (Amit Direct)."[322] The ALJ agrees.

195. No party provided a reasonable argument to justify disallowance of flotation costs. *Id.*

196. [Although the Department presented its Cost of Capital proposed Findings, above, it includes as **Attachment 1** its attempt to respond directly to each of MERC's proposed Findings regarding the Cost of Equity in the event that doing so is helpful to the ALJ. That said, because the Department found that MERC's proposed Findings are not organized or presented in a manner that allows ready identification of issues, of problems identified by parties or of solutions presented to those problems, the Department recommends adoption of its proposed Findings as presented above.]

B. MERC's Test Year Sales Forecast

Resolved between DOC and MERC. The substantive issues regarding the sales forecast, test-year sales forecast and the test-year commodity cost of gas, are resolved. Ex. 214 at 1, 13 (L. Otis Surrebuttal).

197. MERC filed a forecasted 2014 test year.[323] MERC forecasted sales and fixed charge counts in the spring of 2013 using actual data from January 2007 through January 2013, and revenues were calculated based on this sales forecast.[324] MERC forecasted the test-year sales differently than it did in its previous rate case. The Company used Ordinary Least Squares ("OLS") regression analyses to estimate test-year sales, as in its last rate case; however, MERC made significant changes to the type of model specifications used in its regression analyses compared to the test-year sales forecast in the last rate case.[325] To develop its forecast, MERC used MetrixND, a statistical software package that considers billing sales, price, structural changes, appliance saturation and efficiencies trends. MetrixND then imposes a model structure through a Statistical Adjusted End-Use ("SAE") specification.[326]

198. In her analysis of MERC's test-year forecast, Department witness Ms. Otis was unable to determine whether MERC's proposed test-year sales were reasonable. She was unable to replicate the Company's forecasted test-year models using the inputs and methodology provided by MERC. The Department stated that verification of a utility's forecasting models is an integral part of the forecasting analysis and provides the first step in determining whether the forecast models are appropriate. If, using the utility's regression specifications, the Department cannot sufficiently replicate the outputs, the Department has serious concerns regarding the reasonableness of the sales forecasts. While there are minor differences between different regression packages, there should not be a meaningful

[322] Ex. 201 at 25 (E. Amit Rebuttal).

[323] Ex. 212 at 3 (L. Otis Direct).

[324] Ex. 19 at 8 (S. DeMerritt Direct).

[325] Ex. 212 at 5-6~~3~~ (L. Otis Direct).

[326] Ex. 38 at 5-11 (H. John Direct).

difference between the outputs produced by a utility and the results, using the utility's reported specifications, produced by the Department, or another party.[327]

199. While the Company used MetrixND to estimate its various regression models,[328] the Department used two packages, EViews 7.2 and STATA 11.1, to review the outputs reported by the Company in its Direct Testimony. The Department was unable to replicate MERC's regression outputs for the following models: Consolidated-Interruptible sales, Consolidated-LC&I sales, Consolidated-SC&I sales, Consolidated-Transport sales, NNG-SC&I average use per customer, and NNG-Interruptible sales.[329] A comparison of models specified by the Department to those the Company produced showed that various estimators in several models were the opposite sign from the estimators the Company provided.[330] The result concerned Ms. Otis because the presence of opposite signed coefficients between the Department and Company calculations indicates a disagreement between the calculations in not only the magnitude of the variable's effect but also in its direction.[331]

200. The Department attempted to verify other components of the Company's forecast in addition to attempting to verify the regression outputs reported by the Company using its data and methodology. Ms. Otis -also attempted to verify MERC's derivation of variables used in the regression models, but was unable to do so.[332]

201. The Department was unable to fully verify the SAE models used by the Company[333] and it had concerns regarding the appropriateness of the SAE model specification for short term forecasting, such as the forecasting of a test-year.[334] MERC used adjusted end use factors in several of its regression models. MERC developed three SAE variables for use in the sales forecasts for various customer classes, each one incorporating a unique set of input data.[335] –The Department evaluated the use of the SAE model in utility sales forecasting.[336]

202. Ms. Otis was also generally concerned that the SAE model specification was not suited for the short period (only twelve months) that was being forecasted in this case. The SAE model specification allows a forecaster to model a wide range of variables that affect sales for a given customer class and may allow for "fine tuning" of a long-term forecast.

---

[327] Ex. 212 at 10–11 (L. Otis Direct).

[328] Ex. 38 at 5 (John Direct),

[329] Ex. 212 at 11–12 (L. Otis Direct).

[330] *Id.* at 14.

[331] Ex. 212 at 14–15.

[332] *Id.* at 16–17.

[333] *Id.*

[334] *Id.* at 10, 18–21; Ex. 214 at 5 (L. Otis Surrebuttal).

[335] *Id.* at 18–19 (Otis Direct). Ms

[336] *Id.* at 19.

A wide range of factors can impact long term forecasts, but for a short term forecast, a concise forecast that assumed most impacts are embedded in the historical data was more appropriate.[337]

203. Ms. Otis also explained that several of the factors cited by the Company as being incorporated in SAE variables relate to appliance efficiency and saturation levels. While these factors have been included in long term forecasts in other utility proceedings, such as in electric utility integrated resources plans ("IRPs"), they are not commonly factored into the short term sales forecasts used in rate case proceedings.[338] She opined that, practically speaking, it was highly unlikely that appliance efficiency would change between the start and the conclusion of a test year.

204. Ms. Otis testified that she had investigated and was unable to find evidence that any utility, -other than MERC, has used the SAE model in short-term forecasts.[339] Ms. Otis concluded that MERC had not shown that it was appropriate to employ the SAE model in this docket and that the SAE methodology employed by MERC was not well suited to estimating test year sales.[340] She concluded that it was not reasonable to use such a model in a short-term, rate case forecast, to respond to the concerns she raised in her testimony.[341]

205. Finally, while the Department concluded that the methods MERC used to collect and construct its weather data were reasonable, it was concerned that MERC's forecast incorporated data only through January, 2013.[342]

206. The Department could not conclude that the test-year sales forecast proposed by MERC was reasonable for setting rates in this proceeding and instead devised an alternative to the test-year sales forecast proposed by MERC. [343]

~~72.~~207. The Department recommended an alternative sales forecast. The biggest difference between the Department's model and the Company's was that the Department's proposed forecast omitted the SAE variables developed by the Company and replaced them with a simple weather (heating degree day, or "HDD") variable. Other differences were that the Department's forecast incorporated monthly "dummy variables" for all months,[344] and relied on historical sales data for all of 2013, while the Company's most recent data was from

[337] *Id.*; Ex. 214 at 5 (Otis Surrebuttal).

[338] Ex. 212 at 20 (Otis Direct).

[339] *Id.;* Ex. 214 at 5 (L. Otis Surrebuttal).

[340] Ex. 212 at 20–21 (Otis Direct).

[341] Ex. 214 at 5 (L. Otis Surrebuttal).

[342] Ex. 212 at 8–9, 21 (L. Otis Direct).

[343] Ex. 212 at 5 (L. Otis Direct).

[344] The use of dummy variables for 11 months out of the year (excluding January) avoided the statistical problem of perfect multicollinearity, commonly referred to as the "dummy variable trap." Ex. 212 at 22 (L. Otis Direct).

January of 2013.[345] The type of forecast the Department recommended has been used in other proceedings and frequently recommended by the Department in previous dockets, including Docket No. G008/GR-08-1075.[346]

208. ~~The Department recommended an alternative test year sales forecast.[347]~~ Based on ~~the~~its alternative test year sales forecast, the Department recommended and MERC agreed to an increase in test-year sales of approximately 26,791,937 therms from the Company's originally filed figure of 662,833,577 therms, for a total of 689,625,514 therms.[348] The Department calculated test-year revenue in the same manner as MERC. The resulting test-year sales recommendations increased total test-year revenue by approximately $8,965,273 from the Company's revenue figure of $257,186,462, to a new total of $266,151,735.[349]

~~73.~~209.~~a total test year revenue figure of $266,151,734, which resulted in an increase to test year revenue of approximately $8,965,271 over MERC's originally filed revenue estimate of $257,186,463.~~ Ms. Otis also made an adjustment for increased natural gas cost expenses and changed CCRC revenues due to increased sales. Ms. Otis' alternative test-year sales estimates yielded a total test-year gas cost of $180,411,466, an increase of $6,999,406 over MERC's proposal.[350] After accounting for increased natural gas cost expenses and Conservation Cost Recovery Charge ("CCRC") revenues, the Department's total net revenue adjustment is approximately $1,965,865 greater than MERC's originally filed revenue estimate.[351]

~~74.~~210.MERC accepted the Department's recommended alternative test year sales forecast because it benefitted from having a full year of calendar year 2013 data, which was not available to MERC at the time the Company prepared its test year sales forecast.[352] Based on MERC's acceptance of the Department's alternative test year sales forecast, the Department determined that there were no issues related to test year sales forecasting that remain in dispute between MERC and the Department.[353]

~~75.~~211.Although MERC agreed to use the Department's alternative sales forecast in this proceeding, MERC and the Department still disagree regarding the appropriateness of

---

[345] Ex. 212 at 20-22 (L. Otis Direct). A matrix comparing the inputs used in her models to those used by the Company in its forecast were at Ex.212 at LBO-7. The data used in the Department's models was provided in Ex. 212 at LBO-8.

[346] Ex. 212 at 23.

~~[347] Ex. 212 at 5 (L. Otis Direct).~~

[348] *Id.* at LBO-11.

[349] *Id.*

[350] Ex. 212 at LBO-11 (L. Otis Direct).

[351] Ex. 212 at 28-29, 32 and Schedule (LBO-11) (L. Otis Direct).

[352] Ex. 39 at 2, 8 (H. John Rebuttal).

[353] Ex. 214 at 1 (L. Otis Surrebuttal).

MERC's initial ~~does not agree that its~~ forecasting model ~~is inappropriate~~.[354] MERC and the Department have agreed to work together to address future sales forecasting methodology.[355]

~~76.~~212. The Department and MERC agreed that MERC provided spreadsheets that fully linked together all raw data and inputs for MERC's sales forecast.[356]

~~77.~~213. The ALJ concludes that the sales forecast agreed to by MERC and the Department is reasonable and should be used for purposes of setting rates in this proceeding.

~~78.~~214. On April 15, 2014, MERC filed an updated cost of gas.[357] MERC's original cost of gas was updated using NYMEX data from May 15, 2013, as described in the Base Cost of Gas filing in Docket No. G011/MR-13-732.[358] MERC's cost of gas was updated a second time on April 15, 2014 using NYMEX data from March 17, 2014, as described in the Base Cost of Gas filing in Docket Nos. G011/GR-13-617 and G011/MR-13-732.[359] Because the approach used by the Company was similar to the approaches it had used in the past and to those used by other companies, the Department had no concerns with the projected prices MERC used in the April 15, 2014 filing to determine the base cost of gas.[360] The Department noted that MERC did not update its base cost of gas calculations with the Department forecast which the Company had agreed to in this docket. The Department brought this issue to MERC's attention and MERC provided the Department with updated calculations that included the agreed-upon forecast figures. The Department agreed with MERC's updated calculations and recommended that MERC's final rates be based on the level of commodity gas costs based on the Department's updated test year sales figure.[361] The update increased PGA revenue (which is a component of total revenue) from MERC's filed PGA revenue of $173,412,058 to $214,858,858, an increase of $41,446,798.[362]

215. The ALJ finds that MERC's final rates be based on the level of commodity gas costs based on the Department's updated test year sales figure.

---

[354] Ex. 39 at 8 (H. John Rebuttal).

[355] Evidentiary Hearing Transcript (May 13, 2014) at 106-108 (H. John) and 207-209 (L. Otis) (Doc. ID No. 20145-99937-01).

[356] Ex. 39 at 5-7 (H. John Rebuttal); Ex. 214 at 3-4 (L. Otis Surrebuttal).

[357] An updated cost of gas was required by Commission Orders in Docket No. G011/MR-13-732, Order Setting New Base Cost of Gas, issued November 27, 2013, at ordering para. 2, and, in this 13-617 docket, by the First Prehearing Order, issued December 21, 2013. Ex. 214 at 9–10 (L. Otis Surrebuttal).

[358] Ex. 19 at 8 (S. DeMerritt Direct).

[359] Ex. 24 at 29 (S. DeMerritt Rebuttal).

[360] Ex. 214 at 9–10 (L. Otis Surrebuttal).

[361] Evidentiary Hearing Transcript (May 13, 2014) at 208-209 (L. Otis) (Doc. ID No. 20145-99937-01).

[362] Ex. 214 at 11, LBO-S-6. Because the update also increases gas expense, the change does not impact the Department's recommended adjustment of $1,965,865 to operating income before taxes. Ex. 214 at 11 (L. Otis Surrebuttal).

216. The ALJ finds and recommends that -the Commission require the Company to continue to provide the following in its future initial rate case filings:[363]

- A summary spreadsheet that links together the Company's test-year sales and revenue estimates, its CCOSS, and its rate design schedules;
- A spreadsheet that fully links together all raw data, to the most detailed information available and in a format that enables the full replication of MERC's process, that the Company uses to calculate the input data it uses in its test-year sales analysis;
- If, in the future, MERC updates, modifies, or changes its billing system, a bridging schedule that fully links together the old and new billing systems and validates that there is no difference between the two billing systems;
- Any, and all, data used for its sales forecast 30 days in advance of its next general rate case; and
- Detailed information sufficient to allow for replication of any and all Company derived forecast variables.

~~79.~~

~~B.~~C. MERC's ~~Overall~~ Employee Benefit Cost Increase

~~80.~~217. MERC developed its 2014 test year employee benefits requested for rate recovery in four categories:

(1) 2014 costs that are not requested for rate recovery in 2014;

(2) forecasted 2014 costs that were estimated by MERC based on preliminary results and trend information from MERC's actuary;

(3) forecasted ~~2011~~ 2014 costs that were determined by inflating 2012 actual costs; and

(4) forecasted 2014 costs that were determined through actuarial analysis.

The first category contains costs related to MERC's share of Integrys Business Support's ("IBS") current costs related to non-qualified benefits. The second category contains MERC's dental benefits, medical benefits, and IBS benefits that are billed to MERC. The third category contains a number of sub-accounts that have been referred to in testimony as MERC's "other

[363] These recommendations are based on the Department's testimony at Ex. 212 at 29–30 (Otis Direct). The Department and MERC have agreed to address and work on other forecasting issues such as MERC's Statistically Adjusted End-Use, or SAE rate class sales estimates, ongoing refinement of weather-normalization and potentially other sales forecasting issues. Tr. at 208.

employee benefits." The fourth category contains the pension benefit costs for MERC and IBS.[364]

~~81.~~218.The Department recommended adjusting 2014 employee benefit costs determined by actuarial analysis by updating the measurement date and plan asset value date, and changing the discount rate assumption, making it equal to the expected return on plan assets.[365] Other than that, the Department did not recommend any changes to any of the other employee benefit expenses as compared to MERC's initial filing in this case.[366]

~~82. MERC agreed with the Department that actuarially determined costs should be based on the most recent and accurate data available.[367] MERC provided an actuarial analysis updated as of December 31, 2013 for the pension and post-retirement life plans, and updated as of March 1, 2014, for the post-retirement medical plan. MERC recommended that the updated actuarial analyses be included in the calculation of the 2014 test year revenue requirement.[368] The Department did not object to MERC's proposal.[369]~~

~~83.~~ MERC noted that the expected return on plan assets in the actuarially determined benefit costs for the 2014 test year was 8.00 percent and the Department did not recommend any changes to that percentage.[370]

219. MERC did not seek recovery of non-qualified employee benefit costs for Pension Restoration Plan (Account 926210) and Supplemental Executive Retirement Plan ("SERP") (Account 926220).[371] As noted below regarding Regulatory Assets, because MERC did not seek recovery of the expense portion of these accounts, the Department recommended removal of the related rate base portion of the accounts (Accounts 228300, 228305, 228310, and 242072),[372] MERC agreed to the removal of these accounts,[373] and the ALJ finds that Accounts 228300, 228305, 228310, and 242072) should be removed from rate base.

~~84. The Department concluded that MERC's discount rates may be too low because they were less than the expected return on plan assets. The Department cited Xcel Energy's 2012 rate case (Docket No. E002/GR-12-961) as support for its assertion that~~

364 Ex. 26 at 3-15 and Schedules (CMH-1 and CMH-2) (C. Hans Direct).

365 Ex. 217 at 29-30 (M. St. Pierre Direct).

366 Ex. 26 at 4 (C. Hans Rebuttal).

~~367 Ex. 27 at 5 (C. Hans Rebuttal).~~

~~368 Ex. 27 at 5-7 (C. Hans Rebuttal).~~

~~369 Ex. 219 at 25-26 (M. St. Pierre Surrebuttal).~~

370 Ex. 27 at 8 (C. Hans Rebuttal).

371 Ex. 26 at 3-4 (C. Hans Direct).

372 Ex. 217 at 7 (M. St. Pierre Direct).

373 Evidentiary Hearing Transcript (May 13, 2014) at 56 (C. Hans) (Doc. ID No. 20145-99937-01); Ex. 27 at Schedule (CMH-4) (C. Hans Rebuttal).

~~the discount and expected return on plan asset used to determine test year pension expense should be equal.~~[374]

~~85. Each of the two assumptions, the discount rate and the expected return on plan assets are independently determined in accordance with Generally Accepted Accounting Principles ("GAAP") and the discount rates for each plan are based on the specific expected benefit payments for the plan.~~[375] ~~Moreover, in MERC's last rate case the ALJ found that the discount rate should be set at 6.25 percent and the expected return on plan assets at 8.50 percent, as recommended by the Department.~~[376]

~~86. Regarding Xcel's 2012 rate case cited by the Department, the ALJ's decision in that case was plan specific and Xcel's plan does not resembles MERC's plan. MERC proposed that the Company's updated actuarial analyses, using the discount rates supported by GAAP, be included in the calculation of the 2014 test year revenue requirement.~~[377]

~~87. The ALJ finds that MERC's updated actuarial analyses, usingthe Department's calculation, setting the discount rates equal to the expected return on assets is supported by GAAP,and should be included in the calculation of the 2014 test year revenue requirement.~~ [Note: proposed findings for the discount rate are below]

D. Pension ~~Expense~~, Post-retirement Medical, and Post-Retirement Life Insurance Adjustments

Resolved: DOC and MERC agreed upon employee benefit plan valuation dates. DOC and MERC agree with the Department's recommendation to update the pension and post-retirement life plan asset values to reflect the balance on December 31, 2013. DOC Ex. 217 at 34 (St. Pierre Direct). Ex. 26 at 5, 7 (C. Hans Rebuttal). Ex. 219 at 25–26 (M. St. Pierre Surrebuttal).

Resolved: DOC and MERC agree upon MERC's proposal to update the post-retirement medical plan asset values and discount rates as of March 1, 2014. Ex. 219 at 26, 31–33 (M. St. Pierre Surrebuttal), which reduces by $140,720 MERC's proposed post-retirement medical expense. Ex. 219 at 33, MAS-S-12 (M. St. Pierre Surrebuttal).

Disputed: DOC and MERC disagree regarding MERC's proposal to use a discount rate that is lower than the expected return on assets to determine test-year costs. Ex. 217 at 34 (M. St. Pierre Direct); Ex. 219 at 25, 32, 34 (M. St. Pierre Surrebuttal).

~~**C.**~~

[374] ~~Ex. 217 at 30-31 (M. St. Pierre Direct).~~

[375] ~~Ex. 27 at 9 (C. Hans Rebuttal).~~

[376] ~~Ex. 27 at 10 (C. Hans Rebuttal).~~

[377] ~~Ex. 27 at 4-12 (C. Hans Rebuttal).~~

~~88.~~220. In Docket No. G007,011/GR-10-977, the Commission required MERC to fully support the reasonableness of having ratepayers pay for 100 percent of its pension obligation in this rate case.[378]

~~89.~~221. In 2008, MERC announced it was beginning an orderly transition from a defined benefit pension plan to a defined contribution plan. As part of that transition, rather than asking employees to contribute to their pension plans, MERC decided that the pension plan that had been offered to Administrative employees was closed to new entrants. At the same time, the Company, through the collective bargaining process, commenced negotiating the closing of the pension plan with the unions that represented a portion of MERC's work force. There are no longer any open pension plans at MERC. However, there are pension obligations that do remain in place for those employees who participated in the plans before they were closed. MERC believes it is reasonable to continue to have those previously promised obligations recovered through rates as those obligations arose from a time when ratepayers were supportive of pension programs for public utility employees.[379]

~~90.~~222. The Commission has emphasized that the goal of ratemaking is to reflect actual costs as accurately as possible in order to allow utilities recovery of their reasonable operating expenses. To do so, the Commission has stated that it is important to find the most accurate cost-measurement tools available. Which tools are the most accurate is a fact-specific inquiry, and the answers vary from case to case.[380]

~~91.~~223. On January 27, 2014, Towers Watson, MERC's actuary, completed an updated actuarial analysis for MERC's 2014 test year pension expense and found that MERC will have a 2014 pension expense of $126,771, which MERC included as its 2014 test-year pension expense.[381]

~~92.~~224. There are four components of the Statement of Financial Accounting Standards ("SFAS") No. 87 pension expense: (1) service cost; (2) interest cost; (3) expected earnings on plan assets; and (4) amortization of gains and losses, prior service costs, and any transitional amounts.[382]

~~93.~~225. In order to calculate the plan's total benefit obligation and annual ASC 715-30 (formerly SFAS No. 87) expense, the actuary uses a number of assumptions including: (1) mortality tables; (2) retirement rates for MERC; (3) anticipated salary increases; (4) expected return on plan assets; and (5) a discount rate.[383]

---

378 Ex. 13 at 14 (N. Cleary Direct).

379 Ex. 13 at 14 (N. Cleary Direct).

380 *See Application of Minnesota Power for Authority to Increase Rates for Electric Utility Service in Minnesota*, Docket E-015/GR-09-1151, FINDINGS OF FACT, CONCLUSIONS AND ORDER at 26 (November 2, 2010); *Application of Otter Tail Power Company for Authority to Increase Rates for Electric Service in Minnesota*, Docket E-017/GR-10-239, FINDINGS OF FACT, CONCLUSIONS AND ORDER at 25 (April 25, 2011).

381 ~~Ex. 26 at 11 and Schedule (CMH-1) (C. Hans Direct);~~ Ex. 27 at 5 and Schedule (CMH-1) (C. Hans Rebuttal).

382 Ex. 26 at 9-10 and Schedule (CMH-1) (C. Hans Direct).

383 Ex. 26 at 10-11 and Schedule (CMH-1) (C. Hans Direct).

~~94.~~226. These assumptions are determined by MERC with the concurrence of Towers Watson in accordance with Generally Accepted Accounting Principles ("GAAP"). The assumptions are then reviewed for reasonableness by MERC's external auditor, Deloitte and Touche.[384]

~~95.~~227. MERC's annual pension expense was $1,212,062 in 2012 and is projected to be $126,771 for 2014. Also included in pension expense for both 2012 and 2014 is an amortization of $474,223 per year as authorized by the Commission in Docket No. G-007,011/M-06-1287 on July 30, 2007 for pension and other post-retirement benefits acquired from Aquila.[385]

~~96.~~228. MERC has taken steps to help control pension costs. The most significant change was a shift from the traditional defined benefit pension plan to a defined contribution model integrated with the 401K plan. Also, effective January 1, 2008, the pension plan was closed to administrative (non-union) new hires.[386]

~~97.~~229. The Department does not take a position on MERC's change from a defined benefit to a defined contribution plan for union or non-union employees other than to note that the Department has not advocated for -reductions, increases, or other changes in pensions to be paid to utility employees.[387]

~~98.~~230. The Department has challenged the assumptions that utilities propose in rate cases to estimate the amounts to charge to ratepayers in current rates to fund pensions in future years and ~~T~~the Department had concerns with the reasonableness of the assumptions that were used in MERC's 2014 test year actuarial determined pension expense.[388]

231. Actuarial calculations are done at a specific point in time and can vary significantly year to year.[389] MERC's actuary, Towers Watson, calculated through actuarial analysis the 2014 employee benefit costs related to:

- Employee Pension Expense (pension),
- Post-Retirement Medical Plan Expense (post-retirement medical) and
- Post-Retirement Life Plan Expense (post-retirement life).[390]

The Company is ultimately responsible for proposing the discount rate and long-term growth rate assumptions used in the actuarial calculations. The types of actuarial assumptions proposed in

[384] Ex. 26 at 9, 11 (C. Hans Direct).

[385] Ex. 26 at 11 (C. Hans Direct).

[386] Ex. 26 at 11-12 (C. Hans Direct).

[387] Ex. 217 at 27 (M. St. Pierre Direct).

[388] Ex. 217 at 28~~9~~-34 (M. St. Pierre Direct).

[389] Ex. 217 at 30 (M. St. Pierre Direct).

[390] Ex. 217 at 28 (M. St. Pierre Direct) (*citing* Ex. 26 at 8 (C. Hans Direct)).

MERC's actuarial calculations included assumptions about the measurement date, plan asset value date, discount rate, and expected earnings (long-term growth rate) on plan assets.[391]

232. The Department investigated the actuarial assumptions MERC used to calculate its test-year employee benefit costs. The Department investigated whether MERC:

a) used a current measurement date and plan asset value date to determine the investment or plan asset level,
b) discounted future costs to today's rates, and
c) used a reasonable long-term growth rate.[392]

Based on her review of MERC's benefit cost proposal, Department Witness Ms. St. Pierre determined that the first two of these three assumptions -- assumptions a and b -- were not reasonable for rate making purposes.

~~99.~~233. First, the Department concluded that MERC's assumptions about the measurement date was unreasonably biased, in that it –inflated MERC's proposed recovery of pension, post-retirement medical plan expenses, and post retirement life insurance costs.[393] The Department determined that MERC's proposed measurement date and plan asset valuation date of December 31, 2012 for the test year were outdated, and would unreasonably bias the results of the measurement and asset valuation because the financial markets had recovered significantly since the end of 2012, and use of a 2012 date would fail to capture the change. For this reason, ~~Because the Department does not believe that MERC's 2014 pension expenses are reasonable it recommended a reduction in MERC's test year pension expense of \$1,350,012. T~~the Department ~~also~~ recommended that plan asset values be updated to reflect the balance on December 31, 2013.~~and MERC's test year actuarially determined costs also be based on equal discount and long-term growth rates (i.e., 8% discount rate and long-term growth).~~[394]

~~100.~~ MERC agreed with the Department that actuarially determined costs should be based on the most recent and accurate data available.[395] MERC provided an actuarial analysis updated as of December 31, 2013 for the pension plan and post-retirement life insurance plan. MERC recommended that the updated actuarial analyses be included in the calculation of the

---

391 Ex. 217 at 28–29 (M. St. Pierre Direct) (*citing* Ex. 26 at 11, 14, 15 (C. Hans Direct)).

392 Ex. 217 at 30 (M. St. Pierre Direct)

393 *Id.*

394 Ex. 217 at 30, 34 (M. St. Pierre Direct).

395 Ex. 27 at 5 (C. Hans Rebuttal).

2014 test year revenue requirement.[396] For the post-retirement medical plan, MERC proposed to update the plan asset values and discount rates as of March 1, 2014.[397]

234. The Department did not object to MERC's proposal to update the post-retirement medical plan costs from December 31, 20143 to March 1, 2014).[398]

~~101.~~235. The ALJ finds that the pension plan asset values and post-retirement life insurance plan asset values should be updated to reflect the balance on December 31, 2013. The post-retirement medical plan costs should be updated from December 31, 2013 to March 1, 2014.

236. The Department also concluded that the discount rate MERC proposed for its Pension (and Post-Retirement Life Insurance Expense Discount Adjustment) was unreasonable for ratemaking purposes because MERC proposed a discount rate that was less than the expected rate of return on plan assets.[399]

237. Use of a discount rate that is less than the expected rate of return on plan assets was rejected in Northern States Power, d/b/a Xcel Energy's most recent rate case; there, the Commission agreed with the Department's position and ALJ's Recommendation that it is unreasonable for ratemaking purposes to select a discount rate that is less than the expected rate of return on plan assets when setting test-year pension expenses.[400] In the Xcel Energy rate case, the Department, ALJ and the Commission agreed, over Xcel's objections, that the discount and expected return on plan assets used to determine test-year pension expense should be equal. The ALJ explained the value of this approach:[401]

> This approach ensures that the discount rate, which is used to measure the time value of money, is consistent with the level of expected return on assets . . . if the two do not match, then the pension obligation will be overstated and unnecessarily increase the liability to be addressed.

396 Ex. 27 at 5-7 (C. Hans Rebuttal).

397 On March 25, 2014, MERC received an updated actuarial analysis from Towers for the post-retirement medical plans. MERC Ex. 27 at 5 (Hans Rebuttal). The reason for the update was that Integrys was "simplifying the current structure by offering a single Medicare Advantage plan to all eligible retiree groups starting in 2015." The plan change triggered an interim measurement of the affected plans as of March 1, 2014, the date the plan change was communicated to affected participants. Ex. 27 at 6 (C. Hans Rebuttal).

398 Ex. 219 at 25-26 (M. St. Pierre Surrebuttal).

399 Ex. 217 at 30 (M. St. Pierre Direct).

400 *In the Matter of the Application of Northern States Power company for authority to Increase Rates for Electric Service in the State of Minnesota*, Docket No. E002/GR-12-961 (Docket No. E002/GR-12-961).

401 Docket No. E002/GR-12-961, Finding of Fact, Conclusions, and Order, Dated: September 3, 2013, p. 33. MERC Witness Ms. Han -noted that the ALJ also stated that "this approach is consistent with the approach used by the Company for the NSPM plan." MERC Ex. 27 at 10 (Hans Rebuttal). This factual observation does not undercut the ALJ's reasoning.

The Commission agreed with the ALJ's finding, stating that "the challenged discount rate and earnings projections were neither adequately supported nor adequately correlated."[402]

238. The Department notes that the same circumstance is at issue in this MERC rate case, where MERC has proposed, for purposes of setting test-year pension expenses, a discount rate that is lower than the rate of return on plan assets.[403]

~~102.~~ MERC disagreed with the Department's recommendation to set the discount rate equal to the expected return on plan assets, stating that ~~. E~~each of the two assumptions, the discount rate and the expected return on plan assets, are independently determined in accordance with GAAP and the discount rates for each plan are based on the specific expected benefit payments for the plan. MERC proposed that the Company's updated actuarial analyses, using the discount rates supported by GAAP, be included in the calculation of the 2014 test year revenue requirement.[404]

239. MERC Witness Ms. Hans stated that the rate assumptions used in the pension and other post-retirement employee benefit ("OPEB") costs (post-retirement medical plan expense and post-retirement life plan expense) were consistent with the provisions of ~~Generally Accepted Accounting Principles (~~GAAP~~)~~, and, specifically the provisions of Accounting Standards Codification Topic 715 ("ASC" 715, formerly FAS 87). Ms. Hans argued that the discount rate and the Company's expected return on plan assets were independently determined in accordance with GAAP.[405]

240. The Department explained that it is not reasonable for ratemaking purposes to establish a level of pension expense in the test year based on ASC 715 because the Commission's ratemaking function of establishing a reasonable level of pension expense in rates materially differs from the utilities' financial reporting and accounting functions prescribed under ASC 715 in several respects.

241. First, companies annually change the level (update) of pension expense based on the requirements in ASC 715, (as well as for its post-retirement medical plan change). Thus, if the level of pension expense in rates is determined based on ASC 715, it is highly unlikely that the pension expense going forward will be the same over time because of the frequent updates.[406] Financial reporting for companies changes every year (and sometimes more often) to reflect changing circumstances.[407] In contrast, for ratemaking purposes, the level of pension expense in rates should reflect the likely and reasonable expense going forward over time, until the utility's next rate case.[408]

---

[402] Findings of Fact, Conclusions and Order, p. 7

[403] Ex. 219 at 29-31 (St. Pierre Surrebuttal).

[404] Ex. 27 at 4-12 (C. Hans Rebuttal).

[405] Ex. 219 at n. 7 (St. Pierre Surrebuttal).

[406] Ex. 219 at 26–27 (St. Pierre Surrebuttal).

[407] Ex. 219 at 29 (St. Pierre Surrebuttal).

[408] Ex. 219 at 26–27 (St. Pierre Surrebuttal).

242. Second, MERC provided no support for its proposition that the ratemaking function should anticipate that regulated utilities may experience severe financial distress, under which that utility company would be required to "settle" its pension benefits, as is specifically required to be taken into account under ASC 715.[409] Under the prescriptions of ASC 715,

> The discount rate is developed by selecting an actual bond portfolio *to settle* each plan's expected future benefit payments.[410]

Under ASC 715,

> …the discount rate is intended to represent the rate at which benefit obligations, payable by the plan in the future, *could be settled.* The rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of the benefits are used in determining the discount rate.[411]

243. The Department correctly observed that regulated utilities like MERC are not expected to need to "settle" (cash out) their pension benefits in the manner contemplated under ASC 715 and would be expected to inform the Commission about the occurrence of any severe financial distress that could compel a company into immediate settlement of its pensions. Further, unlike non-regulated companies, regulated utilities like MERC have the right under Minn. Stat. §216B.16 to request an increase in retail rates and receive interim-rate revenues, should they encounter severe financial distress. In any event, MERC has not shown that it is experiencing or is likely to experience severe financial distress or to be required to "settle" its pension benefits as contemplated under ASC 715.[412]

244. Discount rates are used to account for the time value of money. In employee benefit calculations, discount rates are used to discount future expected employee benefits, such as pension obligations, back into current dollars. The discount rate and the expected return on plan assets are inversely related to costs. That is, if either discount rate or the expected return on plan assets decreases then the employee benefit cost increases and vice versa.[413]

245. The Department showed that use of a discount rate developed under ASC 715 for the purpose of ratemaking would harm ratepayers by introducing a bias toward inflated expenses, because discount rates developed under ASC 715 are generally lower than the expected return on assets. The Department explained that the assumption under ASC 715 is that a company would pay more to settle each plan's expected future benefit payments, so the

---

[409] *Id.* at 28.

[410] Ex. 27 at 9:5-6 (Hans Rebuttal) (emphasis added).

[411] Ex. 27 at 8 (C. Hans Rebuttal) (emphasis added).

[412] Ex. 219 at 28 (M. St. Pierre Surrebuttal).

[413] Ex. 217 at 29 (M. St. Pierre Direct).

discount rate is lower than the long-term expected return on the investment assets.[414] Given the purpose of ASC 715 of protecting pension assets when a company is under financial duress and the ratemaking provisions under Minnesota statues, the Department stated that it is unreasonable for the rates set in this rate case to be determined based on requirements for annual financial statement purposes.[415]

246. Third, the Department showed that MERC's stated concern, that the Department's recommendation is not consistent with the pension plan's "target allocation," is misplaced. Ms. Hans noted that "[c]urrently, the pension plan assets have a target allocation of 70% equity and 30% fixed income."[416] The Department countered that, if no financial duress is presumed, however, there is also no need to determine an allocation of investment income to calculate a discount rate. The Department explained that its recommendation was not to change the underlying economics used to determine the two independent discount and return on plan assets rates in order to produce the same results, as suggested by Ms. Hans. The Department's recommendation was simply to match the discount rate to the eight percent expected return on assets to avoid unreasonably biased, inflated test-year expenses for ratemaking purposes.[417]

247. In its Initial Post Hearing Brief filed on June 24, 2014, at page 61, MERC proposed for the first time in this rate case, as an alternative to its proposed discount, that a "five year historical average" approach, such as was adopted by the Commission in CenterPoint Energy's most recent rate case, Docket No. G-008/GR-13-316, would more reasonably reflect MERC's actual anticipated expense, than would the Department's recommendation of using an eight percent discount rate that is equal to the Company's expected return on plan assets.

248. MERC's proposal has not been examined, vetted or subject to cross-examination in this proceeding on behalf of the public and thus is not ripe for consideration in this proceeding.

249. Further, the Department responded to MERC's new position in the Department's Post-Hearing Reply Brief, filed July 11, 2014, where it explained -that the Department strongly disagreed with the finding in the CenterPoint Energy, 13-316 docket and has taken the relatively unusual step of filing a request for reconsideration of this single finding by the Commission.

250. In the Department's Request for Reconsideration in the 13-316 rate case, the Department explained, among other things, that an approach that averages five years of discount rates is inappropriate if each of those annual discount rates is based on the factually erroneous assumption that CenterPoint must immediately "settle" its pension obligation; averaging several of such erroneous rates continues to overstate annual pension expenses. In

[414] *Id.*

[415] Evidentiary Hearing Transcript (May 13, 2014) at 217 (M. St. Pierre).

[416] Ex. 219 at 28 (M. St. Pierre Surrebuttal) (*citing* Ex. 27 at 11 (C. Hans Rebuttal)).

[417] Ex. 219 at 28 (M. St. Pierre Surrebuttal).

particular, the Department explained, in the 13-316 docket, -the use of an average of five figures of erroneous discount rate values merely results in an inappropriate, factually unsupported discount rate and inappropriately overstates pension expense to be charged to ratepayers.

251. The Department stated in its Post-Hearing Reply Brief filed on July 11, 2014 that in the present case, MERC presented no evidence that it must immediately "settle" its future pension obligation or that it is at imminent risk of having to do so. The Department stated that the record does not support selection of a test-year discount rate for ratemaking purposes that is based on an average of the past five "actual" booked discount rates (not actual annual pension expense) each of which were improperly calculated as if MERC had been required to immediately settle its future pension obligation, which it did not do.

252. The ALJ finds that MERC has not shown that it is reasonable for ratemaking purposes to overstate test-year pension expense by using such an average.

~~103.~~253. MERC also claimed at the hearing that ~~T~~the 2014 test year costs proposed by MERC are now known with a certainty; they are not an estimate.[418]

~~104.~~254. The Department disagrees that 2014 test year actuarial costs proposed by MERC are now known with a certainty and are not an estimate. The pension costs are estimated based on multiple assumptions. Similar to other expenses, the actual pension expense will not be known until after the year ends. The certainty is that the Company has calculated the pension amount that it will be reporting for financial statement purposes if no other changes are made to the plan.

255. At the Department's request, MERC recalculated the 2014 test year amounts, using updated plan asset values as of December 31, 2013 and changing the discount rate to equal MERC's expected rate of return of 8 percent.[419] Based on the recalculation, the Department recommended that MERC's test-year actuarially-determined costs be based on equal discount and long-term growth rates of eight percent. Eight percent is set forth as the Company's expected return on plan assets in its January 2014 update.[420]

~~105.~~256. The ALJ finds that it is not reasonable for the Commission to be guided by ASC 715 when deciding the reasonable discount rate when setting a regulated utility's pension expense in a retail ratemaking proceeding. The Commission is not required to follow GAAP's ASC 715 for ratemaking purposes, and it would be wrong in this circumstance to do so. ~~MERC~~ The Department has demonstrated that its ~~actuarial determined~~calculated 2014 test year pension benefit expense is reasonable ~~and most accurately reflects the cost that MERC will incur in the test year and until its next rate case~~ and should be accepted in this rate case.

418 Evidentiary Hearing Transcript (May 13, 2014) at 55 (C. Hans) (Doc. ID No. 20145-99937-01).

419 Ex. 217 at 31 (M. St. Pierre Direct); Ex. 218 MAS-21 (M. St. Pierre Direct Attach.) (MERC Resp. to DOC IRs 154, 155, 156, and 157).

420 Ex. 26 at 11, 14, 15 (C. Hans Direct).

~~106.~~257. The ALJ finds that MERC's test year pension expense should be decreased by $1,350,012 ~~$126,771~~ for 2014.

~~**D. Other Actuarially Determined Benefits**~~

~~107. MERC did not seek recovery of non-qualified employee benefit costs for Pension Restoration Plan (Account 926210) and Supplemental Executive Retirement Plan ("SERP") (Account 926220).[421]~~

~~108. Because MERC did not seek recovery of the expense portion of these accounts, the Department recommended removal of the related rate base portion of the accounts (Accounts 228300, 228305, 228310, and 242072).[422] MERC agreed to the removal of these accounts.[423]~~

~~109.~~258. MERC ~~has~~ proposed to include test year post-retirement medical plan expense of $278,962 and post-retirement life insurance expense of $(5,732).[424]

~~110. The Department had concerns with the reasonableness of the initial assumptions that were used in MERC's 2014 test year actuarially determined post-retirement medical and insurance plans and recommended that MERC's test year actuarially determined costs be based on a discount rate set equal to the long-term growth rate and also that plan asset values be updated to reflect the balances as of December 31, 2013.[425]~~

~~111. MERC agreed with the Department that actuarially determined costs should be based on the most recent and accurate data available.[426] MERC provided an actuarial analysis updated as of December 31, 2013 for the post-retirement life plan. MERC recommended that the updated actuarial analyses be included in the calculation of the 2014 test year revenue requirement.[427]~~

~~112. The Department did not object to MERC's proposal to update the post-retirement medical plan costs from December 31, 2013 to March 1, 2014.[428]~~

~~113. MERC disagreed with the Department's recommendation to set the discount rate equal to the expected return on plan assets. MERC explained that each of the two assumptions, the discount rate and the expected return on plan assets are independently determined in accordance with GAAP and the discount rates for each plan are based on the~~

~~421 Ex. 26 at 3-4 (C. Hans Direct).~~

~~422 Ex. 217 at 7 (M. St. Pierre Direct).~~

~~423 Evidentiary Hearing Transcript (May 13, 2014) at 56 (C. Hans) (Doc. ID No. 20145-99937-01); Ex. 27 at Schedule (CMH-4) (C. Hans Rebuttal).~~

424 Ex. 27 at Schedule (CMH-1) (C. Hans Rebuttal).

~~425 Ex. 217 at 28-34 (M. St. Pierre Direct).~~

~~426 Ex. 27 at 5 (C. Hans Rebuttal).~~

~~427 Ex. 27 at 5-7 (C. Hans Rebuttal).~~

~~428 Ex. 219 at 25-26 (M. St. Pierre Surrebuttal).~~

~~specific expected benefit payments for the plan. MERC proposed that the Company's updated actuarial analyses, using the discount rates supported by GAAP, be included in the calculation of the 2014 test year revenue requirement.~~[429]

~~114.~~259. The Department accepted MERC's updated post-retirement medical costs of $278,962 because the update provides the only available evidence that reflects the decrease in test year costs due to the change in post-retirement medical plans. ~~The Department did not accept MERC's position to use a discount rate lower than the expected return on assets.~~ The Department recommended that the Commission require MERC to reduce ~~rate base~~costs by ~~$139,077 for MERC's updated reduction in post-retirement medical expense and for MERC's share, plus IBS's share, for a total decrease of~~ $140,720 in post-retirement medical expense.[430]

~~115.~~260. Based on ~~The Department did not change its recommendation with respect to MERC's post retirement life insurance expense. since T~~the ~~Department used the~~ most recent actuarial update dated December 31, 2013 for the 2014 test year, ~~in its calculation. T~~the Department ~~continues to~~ recommended an increase of $3,853 for MERC's post retirement life insurance expense.[431]

261. The ALJ finds that ~~MERC's actuarial determined~~the Department's calculation of the 2014 test year post-retirement life insurance expense of $3,853 and post-retirement medical costs of $140,720 are~~is~~ reasonable ~~and most accurately reflects the cost that MERC will incur, in the test year and until its next rate case~~ and should be accepted in this rate case.

~~116.~~

E. Test Year Non-Fuel O&M Expense Methodology

~~117.~~262. This proceeding is based on a test year of 2014 for MERC's operations. To determine its test year non-fuel O&M expense, MERC used its actual 2012 non-fuel O&M costs, applied inflation factors for 2013 and 2014, and applied seventeen known and measurable ("K&M") adjustments to arrive at its test year or projected 2014 non-fuel O&M expenses.[432] Specifically, MERC has identified the following K&M adjustments to O&M expense:

1) increased costs from IBS-Customer Relations, related to increased third party costs from Vertex, the company that is under contract to provide MERC's third-party customer service functions (customer call center, dispatch, billing, and payment processing, etc.), and implementation of the Integrys Customer Experience ("ICE");

~~429 Ex. 27 at 4-12 (C. Hans Rebuttal).~~

430 Ex. 219 at 32 and Schedule (MAS-S-12) (M. St. Pierre Surrebuttal).

431 Ex. 219 at 33 (M. St. Pierre Surrebuttal).

432 Ex. 19 at 9 (S. DeMerritt Direct).

2) increased costs associated with vacant positions that existed at MERC and IBS during 2012;

3) increased costs associated with Uncollectible Expense;

4) increased costs associated with a Sewer Laterals Project;

5) increased costs associated with Gate Station Upgrades;

6) increased costs associated with a Mapping Project;

7) increased costs associated with Additional Positions at MERC;

8) increased costs associated with Depreciation and Return charges from IBS;

9) decreased costs associated with Memberships;

10) decreased costs associated with the General Allocation Factor;

11) decreased costs associated with Advertising Expense;

12) decreased costs associated with Long Term Incentive Pay, Restricted Stock, and Stock Option Expense;

13) decreased costs associated with Economic Development;

14) decreased costs associated with Incentives;

15) decreased costs associated with an audit of Vertex; and

16) decreased costs associated with Benefits.[433]

~~118.~~263. The OAG-AUD expressed concern with MERC's selection of a 2014 test year and recommended that $5,791,793, inclusive of inflation, be allowed for recovery rather than MERC's requested $6,615,783, which includes inflation and project costs that the OAG-AUD feels are not currently used and useful.

~~119.~~264. The OAG-AUD took the position that MERC's approach produces unreasonable costs for the test year. The OAG-AUD argued that MERC can add another year of inflation and adjustments by declaring that its test year is 2014 and project cost increases for both 2013 and 2014 based on its actual 2012 costs. The OAG-AUD recommended that the Commission reject MERC's 2014 test year designation and allow only a one-year inflation factor that encompasses both labor and general inflation based on MERC's historical O&M expenses.[434]

[433] Ex. 19 at 14-15 (S. DeMerritt Direct).

[434] Ex. 151 at 15, 21 (J. Lindell Direct); Ex. 154 at 6-7 (J. Lindell Surrebuttal).

~~120.~~265. MERC disagreed with the OAG-AUD's approach to calculating O&M expense. If MERC had intended to use 2013 as the test year for purposes of setting rates, MERC would have filed for a 2013 test year at a time that interim rates would have been in effect for 2013. Instead, MERC prepared its filing based on a 2014 test year, and based the O&M for the 2014 test year on a 2012 historical test year because 2012 was the most recent historical year.[435]

~~121.~~266. The OAG-AUD also expressed concern with MERC's K&M factors. The OAG-AUD took the position that MERC identified what it claimed is a known event in 2013 and 2014, estimated its cost impact and labeled it a K&M change. The OAG-AUD concluded that while there may be known projects for 2013 and 2014; they were estimated by MERC and lack the precision that is usually attributable to a K&M change.[436]

~~122.~~267. MERC disagreed with the OAG-AUD's conclusion that MERC's approach to K&M is unusual. The approach used by MERC in the current docket is the same approach MERC used in its last two rate cases, Docket Nos. G007,011/GR-08-835 and G007,011/GR-10-977. Based on MERC's forecast for the 2014 test year, MERC identified known events (labor hires, mapping project, sewer lateral project, etc.) that will have a measurable impact on the 2014 test year.[437]

~~123.~~268. MERC's inflation adjustment is based on an average of inflation from Value Line, Global Insight, Moore Inflation Predictor, Energy Information Administration, and International Monetary Fund. MERC used 2.6 percent as a labor inflator rate based on union contract wage increases. MERC's calculated inflation between 2012 and 2014 is 3.74 percent on non-labor and 5.27 percent on labor.[438]

~~124.~~269. The OAG-AUD argued that MERC's use of consumer price index projections (i.e., external inflation projections) was not appropriate and recommended an internal inflation rate it developed based on MERC's historical O&M cost changes. The OAG-AUD concluded that MERC's inflation assumption suggests that the same number of employees will be employed at the same pay level in 2012 as will occur in the test year, there will be no effort to improve efficiencies and lower costs, and costs will continually rise.[439]

~~125.~~270. The OAG-AUD recommended that 2012 O&M expenses be inflated by 2.2 percent to determine the test year level of O&M expenses based on the three year average annual inflation shown in its calculations. The OAG-AUD concluded that MERC's

[435] Ex. 24 at 21-22 (S. DeMerritt Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 24 (S. DeMerritt) (Doc ID No. 20145-99937-01).

[436] Ex. 151 at 16-17 (J. Lindell Direct); Ex. 154 at 5-6 (J. Lindell Surrebuttal).

[437] Ex. 24 at 21-22 (S. DeMerritt Rebuttal).

[438] Ex. 19 at 9, 12-27 and Schedules (SSD-2 through SSD-19) (S. DeMerritt Direct); Ex. 24 at 19-25 (S. DeMerritt Rebuttal); Ex. 4 Initial Filing Volume 3: Informational Requirements, Document 5, Schedule C-6.

[439] Exs. 151 at 17-19 (J. Lindell Direct); Ex. 152 at Schedule (JJL-7) (Schedules to J. Lindell Direct).

methodology to inflate costs over two years was not reliable and had led to overinflated costs.[440]

~~126.~~271. The OAG-AUD's recommended adjustment is not appropriate. MERC filed this rate case assuming a 2014 test year and using a 2012 historical year as the basis for non-fuel O&M. Therefore, the OAG-AUD's recommendation to inflate 2012 data for one year to 2013 levels is without merit.[441]

~~127.~~272. The ALJ finds that MERC's test year non-fuel O&M expense and its K&M factors are appropriate. Because the record reflects that the OAG-AUD's recommended adjustment to MERC's initially filed test year non-fuel O&M expenses has already been made, and that an additional reduction to MERC's revised test year non-fuel O&M expenses would not accurately reflect MERC's test year costs, the ALJ finds that the OAG-AUD's recommended additional six percent reduction is not reasonable.

F. IBS-Customer Relations

~~128.~~273. The increase in billings from IBS-Customer Relations is made up of two components. The first component is related to MERC's contract with Vertex under which Vertex provides third-party customer service functions for MERC (call center, dispatch, billing, payment processing, etc.). The contract between MERC and Vertex for these services is for a multiple year term and contains annual cost escalators. MERC estimates that the K&M increase associated with these services will be $408,455 in 2014.[442]

~~129.~~274. The second component in the IBS Customer-Relations increase is related to the ICE 2016 project. The ICE 2016 project intends to unify the various billing systems currently in use across the Integrys platform and will result in a single billing system for all six Integrys regulated utilities.[443] The overall K&M associated with ICE in IBS-Customer Relations is $322,226 in 2014.[444]

~~130.~~275. The total IBS-Customer Relations K&M included in MERC's 2014 test year O&M expense is $730,681.[445]

~~131.~~276. The OAG-AUD recommended that the increase for IBS Customer Relations costs be denied. The OAG-AUD argued that MERC's customers should not be charged for services for both ICE and Vertex as MERC transitions to its new ICE and while Vertex costs are used and useful, ICE costs are not used and useful at this time.[446] The OAG-

440 Ex. 151 at 19-20 (J. Lindell Direct).

441 Ex. 24 at 23 (S. DeMerritt Rebuttal).

442 Ex 19 at 15 (S. DeMerritt Direct).

443 Ex. 10 at 3 (B. Kage Direct); Ex. 11 (M. Gerth Direct).

444 Ex. 19 at 15 (S. DeMerritt Direct).

445 Ex. 19 at 15 (S. DeMerritt Direct).

446 Ex. 151 at 20-21 (J. Lindell Direct).

AUD recommended that MERC reduce O&M expense by $823,990 for IBS Customer Relations costs.[447]

~~132.~~277. MERC disagreed with the OAG-AUD's recommended adjustment. At a minimum the $408,455 cost increase associated with the Vertex contract is used and useful, as Vertex is currently providing the same billing and customer care services in 2014 as it has historically.[448]

~~133.~~278. The ICE 2016 project costs are used and useful in the provision of utility services and the Department has not raised a concern regarding these costs. Nonetheless, contingent on regulatory approval from the Commission, MERC would be willing to defer ICE costs totaling $322,226 annually as a regulatory asset until MERC's next rate case, with recovery of the regulatory asset from customers over a reasonable period (e.g., 3 years), to commence once the in-house customer service and billing systems has been implemented.[449]

~~134.~~279. The ALJ finds that MERC's total IBS-Customer Relations K&M of $730,681 is reasonable and should be accepted in this rate case.

G. IBS Vacancies

~~135.~~280. The K&M increase regarding the IBS vacancies creates a K&M of $240,583 in the 2013 projected test year and was appropriately inflated to 2014 levels. This adjustment relates to 72 positions that were either partially or fully vacated during the 2012 historical test year, and that IBS is forecasting to have filed in 2014.[450]

~~136.~~281. The ALJ finds that the K&M increase of $240,583 for IBS vacancies should be approved in this rate case.

H. Internal MERC Vacancies

~~137.~~282. The K&M increase for internal MERC vacancies creates a K&M of $392,647 in the 2013 projected test year and was appropriately inflated to 2014 levels. This adjustment relates to 6 positions that were either partially or fully vacated during the 2012 historical test year, and one position that was adjusted from a part time position to a full time position. MERC needs to fill these positions to maintain the level of service expected by its customers. MERC intends to have these positions filled by 2014.[451]

~~138.~~283. The ALJ finds that the K&M increase of $392,647 associated with internal MERC vacancies is appropriate and should be approved in this rate case.

---

447 Ex. 24 at 25 (S. DeMerritt Rebuttal).

448 Ex. 24 at 25 (S. DeMerritt Rebuttal).

449 Ex. 24 at 25 (S. DeMerritt Rebuttal).

450 Ex. 19 at 21 and Schedule (SSD-10) (S. DeMerritt Direct).

451 Ex. 19 at 16 (S. DeMerritt Direct).

I. Additional MERC Positions

~~139.~~284. The adjustment for eight additional MERC positions increased 2014 proposed O&M by $294,374.[452]

~~140.~~285. The ALJ finds that the O&M increase of $294,374 for additional MERC positions should be approved in this rate case.

J. Test Year Uncollectible Expenses

Disputed: The DOC and MERC disagree regarding the methodology for determining the test year uncollectible debt expense. DOC recommended use of the 2013 actual uncollectible expense ratio. MERC recommended a three-year average of historical years (2010, 2011, and 2012). Ms. St. Pierre and Mr. DeMerritt agree on the process for calculating the denominator used in the uncollectible expense ratio but not on the specific revenue deficiency amount because the revenue deficiency remains "in flux" until other items in the revenue deficiency calculation are resolved. Ex. 219 at 37, 44 (M. St. Pierre Surrebuttal).

~~J.~~

~~141.~~ MERC initially proposed to recover $1,765,884 for its test-year uncollectible debt expense. In Rebuttal, MERC forecasted $2,016,410 of uncollectible expense for the 2014 test year due to increased forecast sales.[453] Mr. DeMerritt explained that MERC calculated the 2014 test-year uncollectible expense using the same methodology approved in the Company's 2010 rate case,[454] using an average of the three past years 2010-2012; dividing those years' of uncollectible expense by tariff revenues generated a percentage of tariff revenues of 0.650401 percent. MERC then applied this percentage to MERC's 2014 test year forecasted tariff revenues plus an assumed rate increase of $14,000,000.[455] MERC explained that the $14,000,000 proposed rate increase is not equal to the revenue deficiency amount proposed in this docket because, by changing the bad debt expense, the revenue deficiency changes, and a "circular reference" is created. Therefore, MERC proposed a number in close proximity to the revenue deficiency to get what it proposed to be a reasonable uncollectible expense forecast.[456]

286. The Department expressed concern with MERC's proposed test year uncollectible expense ratio and recommended that MERC use the 2013 uncollectible expense ratio for purposes of uncollectible expense.~~-~~ The Department recommended that the Commission use MERC's *actual* 2013 uncollectible expense ratio of 0.549760 percent rather than MERC's *proposed* ratio of 0.650401 percent. The Department stated that, to determine the test-year amount in the compliance filing, MERC should multiply this actual 2013 uncollectible expense ratio (of 0.549760) by the Department's test-year tariffed sales revenue at present rates of $257,506,848 and add the revenue deficiency amount as determined by the

---

452 Ex. 19 at 19-20 and Schedule (SSD-8) (S. DeMerritt Direct).

453 Ex 24 at 9-10 and Schedule (SSD-3) (S. DeMerritt Rebuttal).

454 Docket No. G007,011/GR-10-977.

455 Ex. 19 at 16–17 (S. DeMerritt Direct); MERC Ex. 24 at 9 (S. DeMerritt Rebuttal).

456 Ex. 19 at 16–17 (S. DeMerritt Direct).

Commission. The Department noted that Ms. St. Pierre and Mr. DeMerritt agree on the process for calculating the denominator used in the uncollectible expense ratio but not on the specific revenue deficiency amount to include in the calculation of tariffed revenues.[457]

287. The Department stated that effect of its recommendation for the test-year uncollectible expense decreases Customer Accounts for uncollectible expense in the amount of $332,072.[458] This decrease would result in a test year uncollectible expense of $332,072 to $1,433,812.[459]

288. The Department offered four reasons for its disagreement with the Company's proposal. First, ~~The three-year uncollectible expense ratio proposed by~~ MERC offered as support for its position the fact that its proposal is consistent with what the Commission approved in MERC's 2008 and 2010 rate cases ~~. In fact,~~ an approach with which the Department ~~.~~ agreed.[460] The Department agreed that averaging several years' costs can be appropriate when costs vary significantly up and down from year to year because, in that circumstance, averaging allows for a leveling of booms and busts, which is a fair approach.[461] The Department explained that averaging several years' costs is not a reasonable methodology for projecting a future expense in circumstances as are presented here, however, where there is a clear downward trend, with lower -costs each year for several years. –The Department offered the following table, which illustrates that MERC's uncollectible ratio has been dropping year after year by approximately 0.10 percent each year since MERC's last general rate case test year, 2011. [462]

	Approved	**2011 Actual[463]**	**2012 Actual**	**2013 Actual[464]**
Uncollectible Exp.	$2,031,888	$1,984,374	$1,313,501	$1,481,318
Tariffed Revenue		$255,269,107	$200,736,162	$26,9448,208
% of Tariffed Rev.		0.777366%	0.654342%	0.549760%

457 Ex. 219 at 37, 44 (M. St. Pierre Surrebuttal). Similar to the interest synchronization, the final revenue deficiency amount remains "in flux" until other items in the revenue deficiency calculation are resolved.

458 Ex. 219 at 38, MAS-S-10 (M. St. Pierre Surrebuttal).

459 Ex. 219 at 35-38 and ~~Schedule (~~MAS-S-10~~)~~ (M. St. Pierre Surrebuttal).

460 Ex. 24 at 9 (S. DeMerritt Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 23 (S. DeMerritt) (Doc. ID No. 20145-99937-01).

461 Ex. 219 at 36 (M. St. Pierre Surrebuttal)

462 Ex. 219 at 36 (M. St. Pierre Surrebuttal). The table is from information shown in Ex. 218 MAS-25 (St. Pierre Direct Attach.). The table shows that the actual 2013 uncollectible expense ratio decreased from 2012 by approximately 0.105 percent (0.654342 - 0.549760). Further, the actual 2013 uncollectible expense ratio is also lower, by approximately 0.101 percent (0.650401 - 0.549760), than MERC's forecasted test year ratio.

463 MERC provided the 2011 and 2012 information in MERC Ex. 19 at SSD-4 (DeMerritt Direct).

464 MERC provided 2013 information in response to DOC IR 143. Ex. 218 MAS-24 (St. Pierre Direct Attach.). The actual 2013 uncollectible expense ratio was 0.549760 percent. Ex. 217 at 39 (St. Pierre Direct).

The Department stated that because doubt as to reasonableness must be resolved in favor of the consumer, Minn. Stat. § 216B.03 (2012), it is inappropriate to average when there is a trend of diminution in cost. The Department concluded that MERC's proposed test-year uncollectible expense ratio of 0.650401 percent is unreasonable and that the more current 2013 ratio of 0.549760 percent should be used.[465]

289. Second, the Department observed, the Company's 2010 data is old[466]~~.~~ and the Company has not shown that it is reasonable to use historical data from a period that began in 2010 and ended in 2012, or why 2013 data should not also be used for the 2014 uncollectable debt forecast.[467]

290. Third, the 2013 actual uncollectable expense was $1,481,318, whereas MERC's proposed recovery in the test year was an increased amount of $1,765,884.[468] The data indicates that the uncollectible expense rate has been going down, rather than up as MERC forecasted for the test year.[469] MERC provided no factual evidence to support a conclusion that uncollectable debts reasonably could be expected to be greater in the 2014 test year than in 2013. Also, in every year since 2011, MERC's actual uncollectible expense was less than the $2,031,888 amount approved in the last rate case.[470] The Department concluded that MERC's proposed test-year uncollectible expense ratio is unreasonable. The more current 2013 ratio of 0.549760 percent should be used.[471]

291. Finally, the uncollectible expense ratio is calculated by dividing bad debt expense by "tariffed revenues." Tariffed revenues is a combination of two figures: tariffed sales revenue at present rates of $257,506,848 plus the revenue deficiency. Regarding the tariffed sales revenue, the Department's calculation of the denominator used tariffed sales revenue at present rates of $257,506,848. In Rebuttal, MERC proposed "to update the uncollectible expense with revenues calculated in Rebuttal Exhibit ___ (GJW-1)."[472]

~~142.~~292. In Surrebuttal, the Department's calculation incorrectly did not update its calculation of uncollectable expense by including the tariffed sales revenue. Upon further investigation after completion of the evidentiary hearing, the Department determined that except for the sales margin, its calculation of the uncollectable expense did not incorporate updated tariffed revenues to include the agreed upon sales forecast and the updated cost of gas. The following updates the Department's position on uncollectable expense to include the

[465] Ex. 219 at 36 (M. St. Pierre Surrebuttal).

[466] Tr. at 229-230 (M. St. Pierre)

[467] Tr. at 229 (M. St. Pierre).

[468] Ex. 218 MAS-25 (M. St. Pierre Direct Attach.).

[469] Ex. 217 at 39 (M. St. Pierre Direct); Ex. 219 at 36 (M. St. Pierre Surrebuttal).

[470] Ex. 219 at 36 (M. St. Pierre Surrebuttal).

[471] Ex. 217 at 39 (M. St. Pierre Direct); Ex. 219 at 36 (M. St. Pierre Surrebuttal).

[472] Ex. 219 at 37 (M. St. Pierre Surrebuttal) (*citing* Ex. 24 at 9-10 (S. DeMerritt Rebuttal).

updated tariff revenues of~~:~~ $40,518,769 ($40,839,155 - $320,386 Michigan revenue):~~.~~[473] an uncollectible expense of $1,657,805, a decrease of $108,079 from the Company's proposal.

293. With respect to the problem that the calculation of uncollectible expense is "circular,"[474] MERC initially recommended using a revenue deficiency of $14,000,000 to calculate the amount of sales of $271,506,848.[475] -Department witness Ms. St. Pierre recommended that the revenue deficiency in the Department's Direct Testimony, an amount of $2,858,021, be used as the revenue deficiency proxy for calculating test-year uncollectible expense. Further, if there are material changes to that amount once the Commission determines the revenue deficiency, she noted that~~,~~ the Commission could require MERC to adjust the uncollectible expense in its compliance filing for final rates accordingly.[476] In Rebuttal, MERC Witness Mr. DeMerritt disagreed and proposed "to update the uncollectible expense with revenues calculated in Rebuttal Exhibit (GJW-1)" and to "include $12,000,000 for an assumed rate increase based on MERC's current position for the revenue requirement," referring to his Rebuttal Ex. 24 (SSD-3) for the calculation of his uncollectible expense.[477]

~~143. In addition~~its Direct Testimony~~, the Department recommended that the Commission decrease MERC's uncollectible expense to $1,431,381 (i.e., by $334,503).~~[478]

~~144.~~294. ~~MERC disagreed with the Department's recommendation to use the 2013 uncollectible expense ratio for purposes of uncollectible expense.~~ The OAG-AUD also supported the levelization approach in its Surrebuttal Testimony in the same docket. The OAG-AUD recommended including uncollectible expense of $1,350,000 in the test year. According to the OAG-AUD, using a historical average of uncollectible expense as MERC proposed can produce inaccurate estimates. The OAG-AUD concluded that MERC's historical analysis shows fairly significant fluctuations from year to year and does not provide a reasonable estimate of uncollectible expense for the test year.[479] The OAG-AUD maintained its opposition to MERC's levelization approach, stating that, unlike the Department, MERC had failed to include the most recently completed year (2013) in its levelization calculations.[480]

473 Ex. 24 SSD-3 (S. DeMerritt Rebuttal). MERC's tariffed sales revenue at present rates of $257,506,848 incorrectly included Michigan revenue of $320,286. Ex. 19 SSD-4 (S. DeMerritt Direct). Thus, the Minnesota tariffed sales revenue at present rates would have been $257,186,462.

474 Department Witness Ms. St. Pierre agreed with Mr. DeMerritt that the calculation of uncollectible expense was "circular" because cash working capital and interest synchronization calculations are also based on including the revenue deficiency amount. Ex. 219 at 37 (St. Pierre Surrebuttal).

475 Ex. 19 at 16–17 (S. DeMerritt Direct); Ex. 19 at SSD-4 (S. DeMerritt Direct); Tr. at 223–225 (M. St. Pierre).

476 Ex. 217 at 40 (M. St. Pierre Direct); Ex. 219 at 37 (M. St. Pierre Surrebuttal).

477 Ex. 219 at 37 (M. St. Pierre Surrebuttal) (*citing* Ex. 24 at 9–10 (S. DeMerritt Rebuttal)).

478 ~~Ex. 217 at 39-40 (M. St. Pierre Direct); Ex. 218 at Schedule (MAS-25) (Attachments to M. St. Pierre Direct); Ex. 219 at 35-36 (M. St. Pierre Surrebuttal).~~

479 Ex. 151 at 6-7 (J. Lindell Direct).

480 Ex. 154 at 3-4 (J. Lindell Surrebuttal).

~~145.~~295. MERC disagreed with the OAG-AUD's recommended adjustment. It was well documented in MERC's last rate case that uncollectible expense fluctuates from year to year. The OAG-AUD recognizes this fluctuation in its Direct Testimony in this case. In addition, the three year uncollectible expense ratio proposed by MERC is consistent with the approach taken by the Commission in MERC's past rate case filings. Therefore, MERC maintains that using an average ratio of uncollectible expense over revenues is the correct approach for calculating uncollectible expense.[481]

~~146.~~296. MERC proposed to update the uncollectible expense calculation and include $12,000,000 for an assumed rate increase based on MERC's current position for the revenue requirement.[482] The Department disagreed with MERC's proposal and stated that it will continue to calculate uncollectible expense based on the Department's position for revenue and the deficiency and recommended that the Commission decrease MERC's uncollectible expense by $332,072 to $1,433,812.[483] In its Post Evidentiary Hearing update, the Department corrected its uncollectible expense to be $1,657,805, which is a decrease of $108,079 from MERC's proposal.

~~147.~~297. The ALJ finds that ~~MERC's~~ the Department's ~~three-year~~ uncollectible expense ratio and forecasted $~~2,016,410~~$1,433,812 of uncollectible expense for the 2014 test year is reasonable and should be accepted in this rate case.

K. Sewer Lateral Expense

Resolved: DOC and MERC agree that MERC's proposed level of cost for the Sewer Laterals Pilot Program is reasonable. Ex. 219 at 39 (M. St. Pierre Surrebuttal).

~~**K.**~~

~~148.~~298. MERC's adjustment for sewer lateral expense increases 2014 proposed O&M by $340,000. The Sewer Lateral Pilot program is being done to comply with requests from the Minnesota Office of Pipeline Safety ("MNOPS"). The goal is to validate that MERC does not have conflicts with sewer lines that could present risk to its customers.[484] Details regarding the Sewer Laterals Pilot Program (e.g., start time, duration, employees, cost, etc.) are included in MERC's response to the Department's Information Request Document number 147.[485]

~~149.~~299. The Department initially concluded that the Sewer Laterals Pilot Program is a one-time project since the project was projected to be done by the end of the test year and affected only the community of Cannon Falls. The Department recommended that the Sewer

---

481 Ex. 24 at 20-21 (S. DeMerritt Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 24 (S. DeMerritt) (Doc. ID No. 20145-99937-01).

482 Ex. 24 at 9-10 and Schedule (SSD-3) (S. DeMerritt Rebuttal); Ex. 42 at Schedule (GJW-1) (G. Walters Rebuttal)

483 Ex. 219 at ~~37~~35-38 and ~~Schedule (~~MAS-S-10~~)~~ (M. St. Pierre Surrebuttal).

484 Ex. 19 at 17 and Schedule (SSD-5) (S. DeMerritt Direct).

485 Evidentiary Hearing Transcript (May 13, 2014) at 44 (S. DeMerritt) (Doc. ID No. 20145-99937-01).

Laterals Pilot Program costs be levelized over three years and recommended a reduction of $226,667 to rate base.[486]

~~150.~~300. MERC disagreed with the Department's proposed adjustment and pointed out that the Sewer Lateral Pilot Program is a multi-year project that will extend beyond 2014 and the community of Cannon Falls. Therefore, MERC maintained its position that inclusion of the $340,000 of Sewer Lateral Pilot Program costs in the 2014 test year is appropriate.[487]

~~151.~~301. In Surrebuttal Testimony, the Department determined that the Sewer Laterals Pilot Program is a multi-year project that extends beyond the community of Cannon Falls. As a result, the Department recommended that the Commission ~~accept~~ find MERC's proposed test year Sewer Laterals Pilot Program costs as reasonable costs.[488]

~~152.~~302. The ALJ finds that MERC's inclusion of $340,000 of Sewer Lateral Pilot Program costs in the 2014 test year is appropriate.

L. Gate Station Expense

Resolved: DOC and MERC agreed that the Gate Stations Project is a long-term rather than a one-time project, the Gate Stations Project O& M costs need not be levelized, and MERC's proposed recovery is reasonable. Ex. 217 at 48 (M. St. Pierre Direct); Ex. 24 at 28 (S. DeMerritt Rebuttal).

~~L.~~

303. The adjustment for the gate stations increases 2014 proposed O&M by $330,000. The Gate Station Project will add remote monitoring and some test measurement to the distribution delivery points where MERC receives its natural gas supply from the pipelines. Today, MERC does not have remote monitoring ("visibility") on the pressure, temperature or volumes on a real time basis. Remote monitoring will give MERC engineering and gas control more real time visibility to the performance of the Company's systems.[489] Details regarding the mapping project (e.g., start time, duration, employees, cost, etc.) are included in MERC's response to the Department's Information Request Document number 148.[490]

~~153.~~304. The gate station project began in January 2014. It primarily will be a capital project; the $330,000 represents the O&M portion of the project.[491] MERC anticipates that the project will be ongoing for a period of 5 years. The Company stated that MERC employees will be involved in the capital side of the project and will provide oversight of

[486] Ex. 217 at 40-43 (M. St. Pierre Direct); Ex. 218 ~~at Schedules (~~MAS-26, MAS-27~~)~~ (Attachments to M. St. Pierre Direct).

[487] Ex. 24 at 10 (S. DeMerritt Rebuttal).

[488] Ex. 219 at 39 (M. St. Pierre Surrebuttal).

[489] Ex. 19 at 17-18 and Schedule (SSD-6) (S. DeMerritt Direct).

[490] Evidentiary Hearing Transcript (May 13, 2014) at 45 (S. DeMerritt) (Doc. ID No. 20145-99937-01).

[491] Ex. 217 at 47 (M. St. Pierre Direct) *citing* Ex. 218 MAS-30 (M. St. Pierre Direct Attach.) (MERC Resp. to DOC IR 148).

contractors installing the equipment. The Company stated that the increase in O&M costs is primarily due to system operations costs that are not part of the capital project, including phone and electric bills, and monitoring and repair activity which, in the initial phase of this project, will be done primarily by outside contractors whose work will be overseen by MERC employees. The Company stated that the gate station equipment and installation costs will be capitalized; however, these costs represent incremental costs of operating and maintaining the equipment that are not capitalized.[492]

~~154.~~305. The Department concluded that the Gate Stations project is a long-term, rather than one-time project and because the gate station equipment and installation costs will be capitalized and the O&M costs represent incremental costs of operation and maintenance of equipment by outside contractors, with oversight from MERC employees, the Gate Stations Project O&M costs need not be levelized. The Department concluded that MERC's proposed recovery of costs related to the Gate Stations project was reasonable.[493]

~~155.~~306. Constellation requested that MERC complete the Gate Station project prior to October 1, 2014.[494]

~~156.~~307. The gate station project is a multi-year project that will not be completed in 2014.[495]

~~157.~~308. The ALJ finds that MERC's proposed recovery of costs related to the Gate Stations project is reasonable and should be approved in this rate case.

M. Mapping Project

Disputed: The DOC and MERC disagreed on the amount of the adjustment to the test year expense for the Mapping Project. The Department recommended that the Commission levelize the test year cost of this one-time project for a three year period, which reduced Distribution Expense by $220,000 ($330,000 - $110,000) for the Mapping Project. Ex. 217 at 46 (M. St. Pierre Direct). Ex. 218 at MAS-29 (M. St. Pierre Direct Attach.).

~~**M.**~~

309. The Company explained that the "Mapping Project" was designed to address "gaps" in the accuracy of the MERC mapping systems that are used by MERC's field personnel.[496] The adjustment for the Mapping Project increases 2014 proposed O&M by $330,000. MERC has identified gaps with its mapping accuracy that field personnel utilize to locate lines, manage outages, determine flow modeling, and other critical infrastructure tasks. These errors have come from a number of map conversions as companies were acquired, sold, and consolidated. To improve the quality and utilization of the mapping systems, MERC

[492] *Id.*

[493] Ex. 217 at 48-49 (M. St. Pierre Direct); Ex. 219 at 41-42 (M. St. Pierre Surrebuttal).

[494] Ex. 125 at 4 (R. Haubensak Direct).

[495] Ex. 24 at 28 (S. DeMerritt Rebuttal).

[496] Ex. 19 at 18-19 (S. DeMerritt Direct).

plans to validate the accuracy by verifying as built drawings and actual field data. Today MERC does not have the ability to verify age of pipe, materials, fittings, etc. This information is needed to complete required Department of Transportation reporting which is not available for MERC today due to the incomplete or inaccurate information.[497] Details regarding the Mapping Project (e.g., start time, duration, employees, cost, etc.) are included in MERC's response to the Department's Information Request Document number 149.[498]

310. MERC specified that the Mapping Project was designed to begin in February 2014 and conclude eleven months later, in December 2014, and that the work was to be performed by independent contractors, not MERC staff.[499] Importantly, all of the costs identified to the project are non-labor O&M costs[500] consisting of payments of invoices of the contractor(s). MERC employees will provide oversight for this project, but that expense is not part of the known and measurable adjustment.[501] MERC explained that these costs are O&M costs rather than capitalized costs because MERC is not installing new software, but rather is updating information that is not currently in its existing mapping software. The updated data is from MERC's "main as-built records" that will provide additional detail in the GIS Small World application.[502] The adjustment MERC proposed for the mapping project increased 2014 proposed O&M by $330,000.[503]

~~158.~~ Because the Company acknowledged that the Mapping Project is a project that will only incur costs in 2014,[504] it is apparent that the Mapping Project is a one-time project, expected to be finished by the end of the test year. The Department Witness, Ms. St. Pierre, explained that it is important to level costs of one-time projects for rate making purposes; with levelization, the Company will annually recover the same amount until its next rate case because rates do not change between rate cases.[505]

~~159.~~311. The Department concluded that the Mapping Project was a one-time project since it was projected to be done by the end of the test year. The Department recommended that the Mapping Project costs be levelized over the same period as the Department's recommended rate case expense period of three years. This adjustment results in an annual expense of $110,000 ($330,000/3). For purposes of the test year, the Department recommends that the Commission reduce Distribution Expense by $220,000 ($330,000 -

[497] Ex. 19 at 18-19 and Schedule (SSD-7) (S. DeMerritt Direct).

[498] Evidentiary Hearing Transcript (May 13, 2014) at 44 (S. DeMerritt) (Doc. ID No. 20145-99937-01).

[499] Ex. 218 MAS-28 (M. St. Pierre Direct Attach.) (MERC Resp. to DOC IR 149)

[500] Ex. 19 at SSD-7 (S. DeMerritt Direct))

[501] Ex. 218 MAS-28 (St. Pierre Direct Attach.) (MERC Resp. to DOC IR 149).

[502] Ex. 218 ~~at~~ MAS-28 (St. Pierre Direct Attach.) (MERC Resp. to DOC IR 149).

[503] Ex. 217 at 44 (M. St. Pierre Direct) (*citing* Ex. 19 at 18-19, SSD-7 (S. DeMerritt Direct)).

[504] Ex. 219 at 40 (M. St. Pierre Surrebuttal) (*citing* Ex. 24 at 10-11 (S. DeMerritt Rebuttal)).

[505] Ex. 219 at 41 (M. St. Pierre Surrebuttal).

$110,000) for the Mapping Project.~~The Department recommended that the Mapping Project costs be levelized over three years and recommended a reduction of $220,000 to rate base.~~[506]

312. MERC disagreed with the Department's proposed adjustment. Although the Mapping Project is a project that will only incur costs in 2014, when considering how the Department's proposed adjustment will impact MERC in future years, the Department proposes a single rate making adjustment for 2015 and 2016 (reducing revenues), with no consideration for any mere "potential" future increases in MERC's overall costs. ~~It would not be~~is not appropriate to set rates in a rate~~this~~ proceeding based on the potential for future increases in costs. MERC did not file a 2015 test year rate increase, and does not intend to. Nonetheless, if MERC incurs higher costs without offsetting revenues, it is the Company's option to file a rate case. Any increases and decreases in expenses that occur in 2015 as compared to test year 2014 will need to be managed appropriately by MERC management. MERC believes making an adjustment for a single item, with no consideration for the future costs, sales, or capital requirements of other items, is punitive and the Company does not agree with the adjustment. However, MERC's arguments about future costs and revenues are not appropriate to consider in deciding the reasonable ratemaking treatment for an item in the current case.

~~160.~~313. MERC has stated its intention to file a 2016 rate case so, at a minimum, argued that this adjustment should only be spread over two years at $165,000 per year versus the $~~113,333~~110,000 per year advocated by the Department. However, MERC does not agree with the Department's position and maintains the $330,000 Mapping Project cost originally proposed by MERC is appropriate and proper for calculating MERC's test year 2014 revenue deficiency.[507]

~~161.~~314. The ALJ finds that ~~MERC's $330,000~~the Department's $110,000 of Mapping Project cost is appropriate and proper for calculating MERC's test year 2014 revenue deficiency in this rate case. However, if the Commission approves a two year period for rate case expense, then the costs should be spread over two years rather than three.

N. Organization Membership Dues

~~162.~~315. MERC has excluded all organization membership dues from the 2014 proposed test year. This adjustment reduces 2013 projected O&M expense by $1,546. By removing this amount in 2013, these costs are also effectively removed from the 2014 proposed test year.[508]

O. Deprecation and Return Cross Charges from IBS

~~163.~~316. The K&M adjustment for depreciation and return on cross charges from IBS relates to two specific projects at IBS that are then cross charged to the various

506 Ex. 217 at 46 (M. St. Pierre Direct); Ex. 218 at Schedules ~~(~~MAS-28, MAS-29~~)~~ (~~Attachments to~~ M. St. Pierre Direct Attach.); Ex. 219 at 40-41 (M. St. Pierre Surrebuttal).

507 Ex. 24 at 10-11 (S. DeMerritt Rebuttal).

508 Ex. 19 at 22 and Schedule (SSD-11) (S. DeMerritt Direct).

subsidiaries. These two projects are GMS Software and ICE. This adjustment increases 2013 projected O&M expense by $187,615, and 2014 O&M expense after inflation by $92,855. The total O&M expense charged to MERC for these two projects in the 2014 proposed test year is $280,470.[509]

~~164.~~317. The OAG-AUD argued that although the IBS charges are purportedly for increases in depreciation and a return on assets, MERC did not identify the scope of the project costs, nor how these projects would be applicable to MERC's operations to justify an allocation to MERC along with MERC's other affiliates. The OAG-AUD takes the position that while there may be known projects for 2013 and 2014, they were estimated by MERC and lack the precision that is usually attributable to a K&M change.[510]

~~165.~~318. The Company's K&M adjustment related to depreciation and return on assets cross charged from IBS is precise. As previously discussed, the increase is due to two projects: GMS Software and ICE.[511]

~~166.~~319. The ALJ finds that MERC's K&M adjustment related to depreciation and return on assets cross charged from IBS of $280,470 should be approved for 2014.

P. Economic Development Expenses

~~167.~~320. To be consistent with the costs allowed in Docket No. G007,011/GR-10-977, MERC has removed 50 percent of the 2012 Economic Development costs in the 2013 projected test year. By removing this amount in 2013, these costs are also effectively removed from the 2014 proposed test year.[512]

Q. Advertising Expense

~~168.~~321. MERC included a known and measurable adjustment to test year O&M expense for advertising costs.[513]

~~169.~~322. MERC has excluded all advertising costs associated with economic development and goodwill from the 2014 proposed test year. This adjustment reduces 2013 projected O&M expense by $5,308. By removing this amount in 2013, these costs are also effectively removed from the 2014 proposed test year.[514]

---

509 Ex. 19 at 20 and Schedule (SSD-9) (S. DeMerritt Direct).

510 Ex. 151 at 16-17 (J. Lindell Direct).

511 Ex. 24 at 22-23 (S. DeMerritt Rebuttal).

512 Ex. 19 at 23-24 and Schedule (SSD-15) (S. DeMerritt Direct).

513 Ex. 19 at 22-23 and Schedule (SSD-13) (S. DeMerritt Direct).

514 Ex. 19 at 22-23 at Schedule (SSD-13) (S. DeMerritt Direct).

~~170.~~323. MERC's filing includes a list of the advertisements for which MERC seeks cost recovery in this case, and an explanation of each advertisement.[515]

~~171.~~324. MERC's advertising costs are appropriate and should be accepted in this rate case.

R. General Cost Allocator

~~172.~~325. Since MERC's acquisition by Integrys, IBS has employed a two factor formula for the General Cost Allocator ("GCA"). In past rate cases, MERC has requested authority to use the two factor formula as opposed to the currently authorized one factor formula. This request has previously been denied. Therefore, in this current docket, MERC is decreasing the O&M expense by $3,371 in the 2013 projected test year to account for the difference between the one factor and two factor allocation methodologies. By removing this amount in 2013, these costs are also effectively removed from the 2014 proposed test year.[516]

S. Vertex Audit

~~173.~~326. In Docket No. G007,011/GR-10-977 MERC was ordered to perform an audit via a third party of its Vertex billing system, and was not permitted to collect these costs from rate payers. In 2012, MERC had invoices from the third party auditor of $303,521, and removed these costs plus inflation from the 2013 projected test year. By removing this amount in 2013 these costs were effectively removed from the 2014 test year.[517]

T. Long Term Incentive Compensation

~~174.~~327. In Docket No. G007,011/GR-10-977, costs associated with Long Term Incentive Plan ("LTIP"), Restricted Stock and Stock Options were disallowed. Therefore, MERC is decreasing O&M expenses by $402,878 in the 2013 projected test year. By removing this amount in 2013, these costs are also effectively removed from the 2014 proposed test year.[518]

U. Employee Incentive Compensation

Resolved: DOC and MERC agreed on the amount of executive incentive compensation to be included in the test year, which reduced executive incentive compensation costs by $27,857. MERC. Ex. 217 at 37 (M. St. Pierre Direct); Ex. 24 at 8 (S. DeMerritt Rebuttal).

Resolved: DOC and MERC agreed that the Commission should retain the current refund mechanism, under which the Company will return the funds to ratepayers

[515] Ex. 19 at 23 (S. DeMerritt Direct).

[516] Ex. 19 at 22 and Schedule (SSD-12) (S. DeMerritt Direct).

[517] Ex. 19 at 24 (S. DeMerritt Direct).

[518] Ex. 19 at 23 and Schedule (SSD-14) (S. DeMerritt Direct).

in the event incentive compensation payouts are lower than the at the approved test-year level. Ex. 217 at 37 (M. St. Pierre Direct); Ex. 24 at 14 (S. DeMerritt Rebuttal).
~~U.~~

~~175.~~328. MERC initially requested recovery of 100 percent of its non-executive incentive plan compensation and 30 percent of its executive incentive plan compensation.[519]

~~176.~~329. Integrys maintains a non-executive incentive plan. Non-union, non-executive employees of MERC participate in the non-executive incentive plan. Employees of IBS also participate in the non-executive incentive plan as the IBS goals include the System Reliability, Employee Safety, and Customer Satisfaction metrics of MERC, weighed based on the proportion that IBS costs are generally allocated to MERC.[520]

~~177.~~330. MERC stated that it maintains compensation programs that are market-based so that it can attract and retain a qualified and motivated work force. MERC's cash compensation goal is to pay its employees a total cash compensation package (base pay plus target incentive pay) that is anchored to market median levels as compared to other energy industry companies. MERC defines the market median as the 50th percentile median of comparable energy industry and general industry companies.[521]

~~178.~~331. MERC stated that it ~~There are~~has two reasons ~~MERC needs~~ to use an incentive compensation package rather than pay employees exclusively through base pay. First, MERC stated, incentive pay is necessary in order to allow MERC to compete with other companies for quality employees because surveys have shown that a majority of companies provide incentive programs. Second, MERC stated, MERC's incentive plans are necessary to incentivize employees to improve service levels and reduce costs that impact the rates paid by customers.[522]

~~179.~~332. MERC stated that MERC's non-executive incentive compensation package directly benefits customers: it ensures there are highly proficient employees to perform customer work; maintaining and improving the productivity of and quality of work performed reduces overall costs to rate payers and improves customer satisfaction; MERC is able to avoid incurring the additional costs of hiring and training employees to replace workers; and employees that are familiar with MERC's systems and equipment tend to be more efficient in their performance.[523]

~~180.~~333. The Commission approved the inclusion of MERC's non-executive compensation package in the Company's 2010 rate case, where it granted MERC 100 percent

---

[519] Ex. 13 at 11-12 (N. Cleary Direct).

[520] Ex. 13 at 3 and Schedule (NEC-1) (N. Cleary Direct).

[521] Ex. 13 at 3-4 (N. Cleary Direct).

[522] Ex. 13 at 4-5 (N. Cleary Direct).

[523] Ex. 13 at 5 (N. Cleary Direct).

recovery of non-executive compensation and 30 percent recovery of executive compensation.[524]

~~181.~~334. MERC stated that MERC's non-executive incentive plan measures assess cost control via a non-fuel O&M expense-adjusted metric which is weighted at 50 percent of the total. Customer service, system reliability, and employee safety measurements are weighted at a combined 50 percent of the total.[525]

335. As to the Company's executive incentive compensation payments MERC stated that Integrys' earnings per share is 70 percent of the Executive Incentive Plan goals, and 30 percent of the goals are based on customer satisfaction, employee safety, and environmental impact. MERC provided a listing of 23 IBS and MERC employees that had incentive pay in the test year that exceeded base pay by more than 15 percent of their base pay, totaling $185,709. The Company proposal limited the amount of incentive compensation for these employees in the test year to thirty percent or $55,713.[526]

~~182.~~336. MERC stated that, ~~C~~consistent with MERC's practice in Docket No. G-007,011/GR-10-977, MERC proposed to recover from ratepayers the 30 percent of executive incentive compensation in rates.[527]

337. The Department stated that, consistent with more recent Commission decisions,[528] the Department recommended that the Commission reduce the executive incentive compensation costs from 30 percent to 15 per cent of the Company's executive incentive compensation, which reduced Administrate and General Expense to one-half of $55,713 proposed by MERC.[529] To cap MERC's incentive pay at 15 percent, the Department recommended a $27,857 reduction to ~~general~~ expense for MERC's executive incentive compensation costs.[530]

~~183.~~338. MERC agreed with the Department's recommendation to reduce administrative and general expense by $27,857 for executive incentive compensation.[531]

~~184.~~339. The Department also recommended that MERC retain the existing incentive compensation refund mechanism.[532] Under the existing incentive compensation refund mechanism the Company will provide customer refunds in the event the incentive

---

524 Ex. 13 at 4 (N. Cleary Direct).

525 Ex. 13 at 6-11 (N. Cleary Direct).

526 Ex. 217 at 36 (M. St. Pierre Direct).

527 Ex. 13 at 12 (N. Cleary Direct).

528 *See, e.g.*, Docket Nos. E002/GR-12-961 (Xcel Electric's 2012 general rate case) and E002/GR-10-971 (Xcel Electric's 2010 general rate case.)

529 Ex. 217 at 37 (M. St. Pierre Direct.)

530 Ex. 219 at 34 (M. St. Pierre Surrebuttal).

531 Ex. 24 at 8 (S. DeMerritt Rebuttal).

532 Ex. 217 at 37 (M. St. Pierre Direct).

compensation payouts are lower than the test-year level approved in rates. Ms. St. Pierre recommended that the Commission's *Findings of Fact, Conclusions and Order* in the instant matter specifically state the amount of incentive compensation approved in the test year.[533]

~~185.~~340. ~~MERC agreed with the Department's recommendation to reduce administrative and general expense by $27,857 for executive incentive compensation.~~[534] MERC ~~also~~ agreed with the Department's recommendation that the Company retain the existing incentive compensation refund mechanism, but requested that the refund be calculated beginning with test year 2014, based on the incentive compensation and customer counts approved in this rate case docket.[535]

~~186.~~341. The K&M decrease associated with incentive costs is $286,221. The 2014 incentive costs for non-executive employees was calculated at the target level expense.~~, and the executive employee incentives were included at 30 percent to be consistent with the costs approved in Docket No. G007,011/GR-10-977.~~[536]

342. The ALJ finds that administrative and general expense should be reduced by $27,857 with respect to executive incentive compensation.

343. The ALJ recommends that the Commission's *Findings of Fact, Conclusions and Order* in the instant matter specifically state the amount of non-executive and executive incentive compensation approved in the test year. MERC's proposed test year non-executive and executive incentive compensation plans as modified above are ~~have~~ reasonable, ~~performance goals, directly~~ benefit customers, and should be included in the test year revenue requirement.

344. The ALJ recommends that the Commission retain the current refund mechanism, under which the Company will return the funds to ratepayers in the event incentive compensation payouts are lower than the at the approved test-year level.

V. Aquila Transaction Costs

~~187.~~345. MERC has not included any acquisition or transaction costs associated with the sale of Aquila's Minnesota assets to MERC. MERC is basing its 2014 O&M forecast on 2012 actual plus K&M's. There were not any acquisition or transaction costs associated with the sale of Aquila's Minnesota assets to MERC in the 2012 historical year; therefore, there are no costs to inflate into the 2014 proposed test year.[537]

533 Ex. 217 at 37 (M. St. Pierre Direct).

~~534 Ex. 24 at 8 (S. DeMerritt Rebuttal).~~

535 Ex. 24 at 14 (S. DeMerritt Rebuttal).

536 Ex. 19 at 24 (S. DeMerritt Direct).

537 Ex. 19 at 25 (S. DeMerritt Direct).

W. Gas Storage Balance Adjustment

Resolved between DOC and MERC. The Department's agrees with MERC's proposal regarding the level of gas storage inventory, which results in a test-year adjustment that increases the rate base by $853,699. Ex. 216 at 8 (L. La Plante Surrebuttal) and Ex. 24 at SSD-4 at 3 (S. DeMerritt Rebuttal).

~~188.~~346. MERC's original cost of gas and gas in storage balances were updated using NYMEX data from May 15, 2013, as described in the Base Cost of Gas filing in Docket No. G011/MR-13-732.[538] MERC's cost of gas and gas in storage balances were updated on April 15, 2014, using NYMEX data from March 17, 2014, as described in the Base Cost of Gas filing in Docket Nos. G011/GR-13-617 and G011/MR-13-732. The increase in rate base for the updated Base Cost of Gas filing increased MERC's initially filed gas storage balance from $12,013,242 to $12,866,941.[539]

~~189.~~347. Based on the updated Base Cost of Gas filing in Docket Nos. G011/MR-13-372 and G011/GR-13-617, MERC recommended that its gas storage balance be set at the 13-month average balance of $12,866,941, which was $853,699 higher than the balance after the March 17, 2014 base cost of gas update.[540]

~~190.~~348. The Department agreed with MERC's recommendation, which results in a test-year adjustment that increases the rate base by $853,699.[541]

~~191.~~349. The ALJ finds that MERC's gas storage balance should be $12,866,941 for 2014.

~~W.~~X. Net Operating Loss Deferred Tax Asset

~~192.~~350. MERC included a deferred tax asset ("DTA") for a net operating loss ("NOL") carryforward in rate base. The DTA represents MERC's stand-alone operating income NOL that arose in 2012 and 2013 due primarily to bonus depreciation. MERC has experienced several consecutive years of NOLs, primarily due to bonus tax depreciation deductions. Until this rate case, MERC was not in the position of having to reflect the related allowance for deferred income taxes related to a carryforward of a NOL balance from any prior year. The consecutive years of a NOL have primarily been due to the continual extension of the federal economic incentive allowing for additional bonus depreciation deductions over that period.

~~193.~~351. A federal NOL can be carried back two years, and forward 20 years. If a utility has more tax deductions than taxable income in a given tax year, it has a tax NOL. Because MERC and Integrys have incurred NOLs during 2012 and 2013 greater than the

---

538 Ex. 19 at 8 (S. DeMerritt Direct).

539 Ex. 24 at 29 (S. DeMerritt Rebuttal).

540 Ex. 24 at 26 and Schedule (SSD-4) (S. DeMerritt Rebuttal); Ex. 216 at 8 (L. La Plante Surrebuttal).

541 Ex. 216 at 8 and LL-S-3 (L. La Plante Surrebuttal).

taxable income generated in 2010 and 2011 (the two year carryback period), MERC is in the position of carrying forward the NOL.[542]

~~194.~~352. If MERC does not include a DTA in its rate base, the Company will be in violation of the tax normalization rules. The normalization rules related to a federal NOL can be summarized as a requirement that the utility has to have realized the tax cash flow benefit of claiming accelerated depreciation before the deferred tax liability that results from claiming accelerated depreciation is included in rate base. Therefore, the tax normalization rules require MERC to carry a DTA for the NOL balance from 2012 and 2013 that resulted from claiming accelerated tax depreciation, until used during 2014. An example of a NOL situation similar to MERC's can be found in IRS Private Letter Ruling ("PLR") 8818040.[543]

~~195.~~353. A violation of the normalization rules would create severe detriment for both MERC and its customers. The normalization rules are long-standing and Congress has been unwavering in its mandate. These rules have been in force and the impact of noncompliance known to utilities and regulators for the past four decades. Compliance is not optional and the rules can be violated directly or indirectly. Thus, it is important not to take steps that would have the unintended consequence of MERC losing the ability to continue to claim the rate base reducing impacts of accelerated and bonus depreciation.[544]

~~196.~~354. The OAG-AUD rejected MERC's proposed adjustment for its DTA NOL carryforward. The OAG-AUD took the position that MERC's proposed adjustment is very rarely utilized to set rates and MERC's tax position does not support the proposed adjustment. The OAG-AUD further argued that MERC is not the taxpayer that can claim a NOL. According to the OAG-AUD, MERC did not demonstrate that it has contributed to the NOL carryforward of Integrys, nor has it shown whether, and to what extent, the tax NOLs are due to affiliates that are public utilities and to affiliates that are not public utilities. Thus, according to the OAG-AUD, MERC has not demonstrated that the normalization rules would be violated absent the adjustment for deferred taxes that the Company proposes. The OAG-AUD also took issue with the PLR relied upon by MERC to support MERC's DTA NOL adjustment. The OAG-AUD argued that the PLR is inapplicable to MERC because: 1) MERC is a member of a consolidated group for tax purposes whereas the taxpayer in the PLR was not; and 2) a normalization violation can only be attributed to a public utility and the utility's tax loss must be attributable to accelerated depreciation or other tax timing differences between book and tax reporting. The OAG-AUD stated that a PLR cannot be used or cited as precedent. The OAG-AUD asserted that the tax NOL carryforward will be utilized in 2014.[545]

~~197.~~355. While it is uncommon for a regulated public utility that is a member of a federal consolidated group to have a DTA NOL carryforward, it does not support exclusion of the DTA when it does occur. The tax normalization rules apply to NOLs for public utilities

[542] Ex. 36 at 3-4 (J. Wilde Direct).

[543] Ex. 36 at 5-6 (J. Wilde Direct).

[544] Ex. 36 at 6-7 (J. Wilde Direct).

[545] Ex. 151 at 7-11 (J. Lindell Direct); Ex. 154 at 9-12 (J. Lindell Surrebuttal).

and, as indicated in the OAG-AUD's testimony, the NOL DTA was included in at least one public utility's rate base. Each subsidiary of Integrys, including MERC is considered a taxpayer that has the ability to generate a tax liability, as well as avail itself of other tax attributes such as a net operating loss carryforward. The tax normalization rules have consistently been applied by the IRS at the individual regulated public utility level. MERC only considered the taxable income and NOL carryforward position of Integrys Consolidated Group to determine in what year MERC's regulated public utility operations would fully benefit from the accelerated tax deductions MERC claimed during 2012 and 2013. MERC will not fully realize and benefit from the NOL DTA until sometime during 2014. Although the PLR cannot be cited as precedent, taxpayers do refer the IRS to previously issued PLRs when applicable and the IRS does consider prior PLRs when reaching conclusions with respect to similarly-situated taxpayers.[546]

~~198.~~356. The ALJ finds that MERC's DTA NOL carryforward should be approved.

Y. Additional Property Tax Expense

Resolved: DOC and MERC agree that the Commission should require MERC to reduce Taxes Other Than Income by $118,260 related to property tax expense. The calculation of this adjustment is shown in Ex. 219 at MAS-S-11 (M. St. Pierre Surrebuttal). Ex. 219 at 21 (M. St. Pierre Surrebuttal) (*citing* Ex. 37 at 4 (J. Wilde Rebuttal)).

Resolved: DOC and MERC agree the Commission decision should require that MERC make a compliance filing upon resolution of the pending Kansas Ad Valorem litigation and refund the total amount of Kansas property taxes collected from customers for the years under appeal, less the total ultimately paid to Kansas for all years under appeal together with interest; Ex. 219 at 45 (M. St. Pierre Surrebuttal); Ex. 217 at 23 (M. St. Pierre Direct); Ex. 219 at 23–24, 45 (M. St. Pierre Surrebuttal) (*citing* Ex. 37 at 5 (J. Wilde Rebuttal)); Ex. 219 at 24 (M. St. Pierre Surrebuttal) (*citing* Ex. 37 at 5 (J. Wilde Rebuttal)).

Resolved: DOC and MERC agree the Commission decision should require that MERC notify the Commission of any court rulings issued regarding the Company's Kansas and Minnesota property tax appeals prior to the Commission's Final Order in this proceeding. Ex. 217 at 24 (M. St. Pierre Direct).

Resolved: DOC and MERC agree that ratepayers should be made whole for all Kansas Ad Valorem taxes they have paid that MERC does not pay to the Kansas Revenue taxing authorities, and the Company will make a compliance filing upon resolution of the pending Kansas Ad Valorem litigation and refund the amount of Kansas property taxes collected from customers for the years under appeal, less the amount ultimately paid to Kansas for all years under appeal. Ex. 217 at 23 (M. St. Pierre Direct); Ex. 219 at 23–24, 45 (M. St. Pierre Surrebuttal) (*citing* Ex. 37 at 5 (J. Wilde Rebuttal)).

[546] Ex. 37 at 11-21 (J. Wilde Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 96 (J. Wilde) (Doc. ID No. 20145-99937-01).

MERC also agreed with a Department recommendation to compute and pay interest at the authorized rate of return on the amount refunded to customers. Ex. 219 at 24 (M. St. Pierre Surrebuttal) (*citing* Ex. 37 at 5 (J. Wilde Rebuttal)).

~~X.~~

~~199.~~357. MERC filed this general rate proceeding with an estimated property tax expense of $7,314,733 (inclusive of $375,000 of property tax on storage gas and 5.08 percent inflation), or $712,679 more than the amount included in the 2012 historic test year.[547]

~~200.~~358. Department witness Ms. St. Pierre's review indicated that it appeared that Minnesota property tax expense on utility property would be decreasing in 2014.[548] In response to DOC discovery, MERC provided a revised estimate that decreased the inflation rate by 0.74 percent, from 5.08 to 4.35 percent for 2014, and MERC accordingly revised its estimate of Minnesota locally assessed and centrally assessed property tax.[549] These revisions reduced the test-year property tax expense by $48,260. The Department initially recommended[550] a reduction of $48,260 to MERC's property tax expense, reducing the amount from $7,314,129 to $7,265,869.[551]

~~201.~~359. MERC agreed with the Department's recommendation. In addition, MERC proposed an additional property tax decrease of $70,000 in its property taxes for the Company's Kansas property taxes on storage gas, from $375,000 to $305,000. This reduction reflected the revised tax assessment estimates from 2009 through 2013 that MERC received from the Kansas Attorney General.[552] MERC recommended a total reduction of its as filed estimate of $118,864, from $7,314,733 to $7,195,869.[553]

~~202.~~360. The Department agreed with MERC's additional adjustment of $70,000 to property tax expense for a total reduction of $118,260 related to property tax expense.[554] MERC agreed to this adjustment during the evidentiary hearing.[555]

547 Ex. 36 at 11 and Schedule (JRW-1) (J. Wilde Direct).

548 Ex. 217 at 25.

549 *Id.* at 24, DOC Ex. 218 MAS-18 (St. Pierre Direct Attach.) (MERC Response to DOC IR 152(c) and Attachment 152 Part A.xlsx).

550 Ms. St. Pierre noted in her Surrebuttal Testimony, at note 6, "In my Direct Testimony and Attachments, the DOC's property tax adjustment figure was inadvertently misstated as $48,864 when it should have been $48,260. Ex. 218 at 25, 52, col. (c) MAS-6 (St. Pierre Direct Attach.). Further, in Ex. 218 at MAS-19 (St. Pierre Direct Attach.), Ms. St. Pierre stated that "the DOC's property tax adjustment was inadvertently misstated as $48,233 when it should have been $48,260. These errors were corrected in my Surrebuttal Testimony and Attachments."

551 Ex. 217 at 25~~ and Schedule (MAS-19)~~ (M. St. Pierre Direct); Ex. 218 MAS-19 (M. St. Pierre Direct Attach.); Ex. 219 at 21 (M. St. Pierre Surrebuttal).

552 Ex. 37 at 4 and Schedule (JRW-1) (J. Wilde Rebuttal).

553 Ex. 37 at 5-6 (J. Wilde Rebuttal).

554 Ex. 219 at 21 (M. St. Pierre Surrebuttal).

555 Evidentiary Hearing Transcript (May 13, 2014) at 94-103 (J. Wilde) (Doc. ID No. 20145-99937-01).

~~203.~~361. The OAG-AUD proposed a reduction of $690,700 to MERC's property tax expense, reducing the amount from $7,314,733 to $6,624,033.[556] The OAG-AUD claimed that MERC attempted to over-inflate its costs by using a future test year – 2014 – based on the Company's base year 2012 actual costs. According to the OAG-AUD this produces an unreasonable increase in costs, including property taxes and the OAG-AUD recommends that property taxes for 2013 be used as test year property taxes. The OAG-AUD bases its recommendation on a review of sample property tax statements from Washington County for a single MERC property located in Scandia, Minnesota.[557]

~~204.~~362. MERC disagreed with the OAG-AUD's recommendation. MERC's actual tax liability for 2012, which was paid in 2013, was greater than the estimate the OAG-AUD relied on to calculate MERC's 2014 property tax expense. MERC provided support, using actual data, for the Company's expectation that its 2013 property tax should increase on a statewide basis, and provided a reasonable method to estimate property tax obligations for 2014 using actual valuation methods and assumptions utilized by the State of Minnesota when developing valuations of MERC's property for 2013.[558]

~~205.~~363. The Department recommended that the Commission require MERC to make a compliance filing upon resolution of the Kansas property tax appeal, and refund with interest all Kansas property taxes not paid to the Kansas Revenue taxing authorities but collected from ratepayers.[559]

~~206.~~364. MERC agreed with the Department's recommendations.[560]

~~207.~~365. MERC has formally appealed the Company's Minnesota property tax assessments for years 2008 through 2013. None of the years appealed were resolved through the administrative process and MERC is now pursuing resolution through the Minnesota Tax Court. The appeals were heard in Minnesota Tax Court from February 10, 2014 through February 19, 2014. Closing arguments were set for June 18, 2014 and MERC anticipates that the Minnesota Tax Court will issue its decision sometime this fall. MERC is unable to predict the outcome of these appeals. Pending a resolution of the appeals, MERC is obligated to pay its property tax obligations based on the increased property value assessments.[561]

~~208.~~366. MERC included $375,000 of Kansas Ad Valorem tax in base rates not only in this rate case, but also in the Company's last rate case (the 2011 test year) and has

[556] Ex. 151 at 13 (J. Lindell Direct).

[557] Ex. 151 at 12-13 (J. Lindell Direct).

[558] Ex. 37 at 7-9 (J. Wilde Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 94-103 (J. Wilde) (Doc. ID No. 20145-99937-01).

[559] Ex. 217 at 23 (M. St. Pierre Direct).

[560] Ex. 37 at 4-5 (J. Wilde Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 94-103 (J. Wilde) (Doc. ID No. 20145-99937-01).

[561] Ex. 36 at 10 (J. Wilde Direct); Ex. 37 at 3 (J. Wilde Rebuttal).

been collecting $375,000 annually of Kansas Ad valorem tax since 2009[562] but has not been paying the tax to the Kansas Revenue Department.[563] MERC has formally appealed a recent ruling of the Kansas Supreme Court that the storage gas of public utilities like MERC that is allocable to Kansas is subject to property taxation in Kansas. MERC has joined other public utilities with storage gas volumes allocated to Kansas to seek a review of the Kansas Supreme Court's decision by the U.S. Supreme Court. The decision by the U.S. Supreme Court whether to conduct a review of the Kansas Supreme Court ruling is expected towards the end of 2014. MERC is unable to predict the outcome of this appeal.[564]

~~209.~~367. The Department requested additional updates regarding the appeals, which MERC agreed to provide at the evidentiary hearing in May 2014. Pursuant to the Department's recommendations, MERC also agreed to notify the Commission of any court rulings issued prior to the Commission's Final Order in this proceeding.[565]

~~210.~~368. At the evidentiary hearing, MERC provided an update with respect to the Minnesota and Kansas property tax appeals. With respect to the Minnesota tax appeal, closing arguments are scheduled for the middle of June and a ruling is expected by the Court within 90 days of the closing arguments. The Minnesota Department of Revenue, in its post-trial brief to the Minnesota Tax court is actually seeking an increase in MERC's property tax assessment for 2008 through 2012. With respect to the Kansas appeal, the U.S. Supreme Court is expected to rule with respect to whether it will hear MERC's (and others') Kansas property tax appeal in late summer or early fall of this year.[566]

369. The Department recommended, and MERC agreed, that ratepayers should be made whole for all Kansas Ad Valorem taxes they have paid that MERC does not pay to the Kansas Revenue taxing authorities, and further, that the Company will make a compliance filing upon resolution of the pending Kansas Ad Valorem litigation and refund the amount of Kansas property taxes collected from customers for the years under appeal, less the amount ultimately paid to Kansas for all years under appeal.[567] MERC also agreed with a Department recommendation to compute and pay interest at the authorized rate of return on the amount refunded to customers.[568]

~~211.~~370. The ALJ finds that MERC's recommended property tax reduction of $118,260 is appropriate in this rate case.

---

[562] The years under appeal are 2009 through 2013. Ex. 218 MAS-17 (St. Pierre Direct Attach.) (MERC's Resp. to DOC IR 150); DOC. Ex. 219 at 23 (St. Pierre Surrebuttal).

[563] Ex. 217 at 22 (M. St. Pierre Direct).

[564] Ex. 37 at 3 (J. Wilde Rebuttal).

[565] Ex. 37 at 3 (J. Wilde Rebuttal); Ex. 217 at 24 (M. St. Pierre Direct).

[566] Evidentiary Hearing Transcript (May 13, 2014) at 97 (J. Wilde) (Doc. ID No. 20145-99937-01).

[567] Ex. 217 at 23 (M. St. Pierre Direct); Ex. 219 at 23–24, 45 (M. St. Pierre Surrebuttal) (*citing* Ex. 37 at 5 (Wilde Rebuttal)).

[568] Ex. 219 at 24 (M. St. Pierre Surrebuttal) (*citing* Ex. 37 at 5 (J. Wilde Rebuttal)).

371. The ALJ finds that MERC shall notify the Commission of any court rulings on the Company's Kansas and Minnesota property tax appeals issued prior to the Commission's Final Order in this proceeding and the Commission should take administrative notice of any decisions on MERC's property tax appeals made before the final order in this proceeding.

~~212.~~372. The ALJ finds that Ratepayers should be made whole for all Kansas Ad Valorem taxes they have paid that MERC does not pay to the Kansas Revenue taxing authorities, and the Company will make a compliance filing upon resolution of the pending Kansas Ad Valorem litigation and refund the amount of Kansas property taxes collected from customers for the years under appeal, less the amount ultimately paid to Kansas for all years under appeal. MERC should compute and pay interest at the authorized rate of return on the amount refunded to customers.

Z. IBS Cost Allocation Adjustment

~~Y.~~ **Resolved**: DOC and MERC agree that the method for allocation of costs for IBS is reasonable.

373. Utilities seeking rate increases must use the methodology for allocating costs between regulated and unregulated activities that was approved by the Commission in the 90-1008 Docket,[569] or, alternatively, demonstrate that:

- The utility's non-regulated activities are insignificant; or
- The utility's proposed cost allocation principles produce results similar to allocations that follow the Commission's recommended cost allocation principle; or
- The public interest would be better served by another method.

Should a utility wish to base its cost separations on different principles, the burden of proof is on that utility to prove that its cost allocation principles arrive at fully allocated costs, free of any cross-subsidization.[570]

374. There are specific reporting requirements for cost allocations in MERC rate cases.[571] Where that allocation method is not the same as the Commission's preferred general

[569] *ITMO an Investigation into the Competitive Impact of Appliance Sales and Service Practices of Minnesota Gas and Electric Utilities,* Docket No. G, E-999/CI-90-1008. (90-1008 Docket) "Order Setting Filing Requirements," Date issued: Sept. 28, 1994, at 6-7 and Ordering Clauses 1-3. *See also* 90-1008 Docket, "Order Finding Compliance, Exempting Northwestern Wisconsin, Requiring Preparation, and Closing Docket." Date Issued: March 1, 1995. (Commission requires: "all utilities to be prepared to demonstrate in future rate cases that a. it follows the cost allocation principles recommended by the Commission, or b. its non-regulated activities are insignificant, or c. its cost allocation principles produce similar results as would allocations following the recommended cost allocation principles, or d. the public interest is better served by another method.")(This order is unpublished; a copy is available from the Commission.)

[570] 90-1008 Docket, "Order Setting Filing Requirements," Date issued: Sept. 28, 1994, at p. 8.

[571] *ITMO a Request by Minnesota Energy Resources Corporation (MERC) For approval of Affiliated Interest Agreement Related to the Formation and Operation of Integrys Business Support, LLC*, Docket No. G007/011/AI-07-779 (Mar. 5, 2008).

allocation method, the Commission requires MERC to demonstrate that its allocation method provides similar results compared to the Commission's preferred general allocation method, or that the Company's method better serves the public interest.[572]

375. MERC is a wholly-owned subsidiary of Integrys. MERC consists of both regulated and non-regulated activities.[573] Integrys also owns a service company, Integrys Business Support LLC that provides shared or common services to Integrys and its subsidiaries, including MERC.[574] IBS began providing service to MERC and its regulated affiliates on January 1, 2008.[575]

~~213.~~376. The general, corporate allocation method used by MERC and IBS differs from the Commission's preferred general allocation method in that the IBS allocation method includes total assets, whereas the Commission's method does not.[576] The Commission's preferred general allocation method is computed by using the ratio of all expenses directly assigned or attributed to regulated and non-regulated activities, excluding the cost of fuel, natural gas, purchased power, and the purchased cost of goods sold.[577] MERC/IBS proposed to use a two-factor formula to account for how IBS allocates costs to MERC and its other regulated affiliates. Using this IBS method, IBS uses an average of two percentages for each entity to calculate its General/Corporate Allocation Factor: 1) total assets (with some exclusions for derivative assets, goodwill and other "non-ordinary" assets); and 2) total non-fuel O&M costs.[578]

~~214.~~377. MERC ~~seeks~~ sought to recover the costs allocated to the Company under the Regulated AIA in this rate case. The MERC 2014 gas revenue requirement includes actual amounts charged in 2012, inflated to 2014, and adjusted for K&M changes for the services that IBS provides to MERC. MERC did~~oes~~ not seek to recover the difference in costs calculated using the ~~General/Corporate Allocation~~IBS method in the Regulated AIA and the Commission's preferred general allocation method. MERC provided calculations showing that the Commission's preferred method resulted in a lower allocation factor,[579] and ~~T~~the two methods produced similar results, with a difference between the two methods of $3,314 in 2012.[580] MERC ~~is seeking~~proposed to recover the smaller amount provided by the Commission's preferred allocation method.[581]

---

[572] *Id*. at 8.

[573] Ex. 215 at 3 (La Plante Direct).

[574] Ex. 215 at 4 (L. La Plante Direct).

[575] *Id*. at 6.

[576] Ex. 215 at 3 (L. La Plante Direct) (*citing* Ex. 12 at 15–16 (T. Kupsh Direct)).

[577] Ex. 215 at 8–9 (L. La Plante Direct).

[578] Ex. 12 at 15-18 (T. Kupsh Direct).

[579] Ex. 215 at 9, LL-5 (L. La Plante Direct) (MERC Response to DOC IR 112).

[580] Ex. 215 at 9, LL-5 (L. La Plante Direct) (*citing* Ex. 12 at 3 (T. Kupsh Direct)).

[581] Ex. 12 at 2-3, 10-21 and Schedule (TLK-3) (T. Kupsh Direct).

~~215.~~378. ~~The Department testified that the Commission's preferred general allocation method is computed by using the ratio of all expenses directly assigned or attributed to regulated and non-regulated activities, excluding the cost of fuel, natural gas, purchased power, and the purchased cost of goods sold.[582] Because MERC is seeking to recover the smaller amount provided by the Commission's preferred general allocation method in this rate case~~Based on these facts, the Department concluded that this aspect of MERC's approach is reasonable.[583]

~~216.~~379. The ALJ finds that MERC's IBS Cost Allocation adjustment is consistent with the Commission's preferred general allocation method and should be approved in this rate case.

AA. MERC's Cost Allocations to ServiceChoice

~~**Z.**~~ **Resolved**: DOC and MERC agree that Commission may accept the result of MERC's cost allocations to ServiceChoice in this rate case. DOC Ex. 215 at 12 (La Plante Direct).

380. MERC's non-regulated operations are generally referred to as ServiceChoice (formerly known as Home Services) operation. ServiceChoice offers appliance repair, service protection plans, and heating, air conditioner and water heater repair and maintenance services to residential customers.[584] ServiceChoice sells appliance repair, service protection plans, and heating, air conditioner and water heater repair and maintenance services, primarily to residential customers. These services are available on an on-demand and contractual basis. MERC's field technicians perform both regulated and non-regulated work in the majority of Minnesota; but, in certain locations MERC has separate employees for the utility and non-utility business.[585]

~~217.~~381. In Direct Testimony, MERC explained that it uses three different means of allocating the costs to the utility and non-utility businesses: direct charge, allocation based on known factors, and general allocation.[586] The majority of costs (76.5%) are directly charged, 11.5% are charged based on known factors, and 12.0% are allocated based on the general allocator.[587]

~~218.~~382. The Department and MERC agreed that MERC's allocation methodology is not the Commission's methodology.[588] The Department reviewed MERC's information, however, reported on the results of the review, concluded that no adjustments were needed,

~~582 Ex. 215 at 5-6 (L. La Plante Direct).~~

583 Ex. 215 at 9 (L. La Plante Direct).

584 Ex. 215 at 4 (L. La Plante Direct).

585 Ex. 215 at 10 (L. La Plante Direct) (*citing* Ex. 40 at 34–36 (G. Walters Direct)).

586 Ex. 40 at 35 (G. Walters Direct).

587 Ex. 215 at 10 (L. La Plante Direct) (*citing* Ex. 40 at 35 (G. Walters Direct)).

588 Ex. 215 at 11 (L. La Plante Direct) (*citing* Ex. 40 at 37 (G. Walters Direct)).

and ~~The Department~~ recommended that the Commission accept the results of MERC's cost allocations to ServiceChoice in this rate case.[589]

~~219.~~383. The ALJ finds that MERC's Cost Allocations to ServiceChoice are reasonable and should be accepted in this rate case.

BB. Rate Case Expense

Resolved between DOC and MERC. Test Year Rate Case Expenses. MERC agrees with the Department's recommendation regarding the level of rate case expense for travel, which reduces MERC's rate case expense by $21,925. DOC Ex. 215 at LL-7 (La Plante Direct). (Issue II-17, in part)

Disputed between DOC and MERC. Amortization Period. Ms. La Plante recommended that MERC be allowed to recover its rate case expenses over a period of three years. This reduced the amount of rate case expenses included in the test year by $257,984. Ex. 215 at 14-16 and LL-9 (L. La Plante Direct); Ex. 216 at 10 (L. La Plante Surrebuttal) (Issue II-17, in part).

~~**AA.**~~ **Resolved between DOC and MERC**. Unamortized Rate Case Expenses and Related Deferred Taxes. MERC agrees with the Department's recommendation regarding the level of unamortized rate case expenses and the Department agrees with MERC's proposal regarding deferred taxes on the rate base, which reduces MERC's unamortized rate case expenses by $1,312,704 and increases deferred taxes by $540,106. The net effect of these adjustments reduces the rate base by $772,598. Ex. 216 at LL-S-1 (L. La Plante Surrebuttal). (Issue II-17, in part).

384. MERC forecasted total rate case expenses of $1,715,000 and proposed~~s~~ to amortize 87.7 percent, or $1,504,055, over a two-year period. The Company's proposed rate case expenses were:

Cost of capital expert - $35,000;
Legal expenses - $750,000;
State agency/ALJ fees - $700,000;
3rd party requests (vertex, Iltron, etc.) - $65,000;
Newspapers - $140,000; and
Travel expenses - $25,000.

~~220.~~385. The 87.7 percent reflects the removal of rate case expenses for MERC's non-utility business "ServiceChoice."[590] This amortization resulted in test year expenses of $752,028. The types of expenses included are costs for MERC's capital expert, legal fees,

[589] Ex. 215 at 12 (L. La Plante Direct).

[590] Ex. 215 at 12 (L. La Plante Direct).

charges from Vertex for changes to the billing system, state agency and Administrative Law Judge fees, newspaper notices, and travel expenses.[591]

~~221.~~386. In Docket No. G007,011/GR-10-977, MERC was ordered to track rate case expense recoveries exceeding the authorized test year expense for possible crediting against the revenue requirement in the next rate case. MERC's current proposed rate case proposes new rates, either final or interim, to take effect January 1, 2014, inclusive of MERC's rate case expenses in this current docket. Therefore, no recovery for rate case expenses authorized in Docket No. G007,011/GR-10-977 is included in this rate case.[592]

~~222.~~387. The Department recommended that $21,925 of MERC's estimated travel expenses be removed from the proposed test year rate case expenses. ~~Based on a review of MERC's rate case expenses, t~~The Department determined that MERC had included $10,500 of travel expenses in its last rate case, Docket No. G007,011/GR-10-9772010~~MERC has~~ but had no actual travel expense related to rate expenses in the last case.[593]~~, Docket No. G007,011/GR-10-977~~.~~; however t~~The Company ~~estimated an amount of~~included $25,000 of travel expenses to be included in the rate case expense in this proceeding.[594] ~~Further review showed that MERC had included $10,500 of travel expenses in its 2010 rate case expenses. Thus, it appeared to the Department that there could be double recovery since t~~The Company also has a Travel and Entertainment ("T&E") expenses account included for recovery in this proceeding. It appeared to the Department that there could be double recovery and ~~T~~the Department~~'s~~ recommended removal of $21,925 from rate case expense, which is the result of allocating 87.7 percent of $25,000 to MERC.[595]

~~223.~~388. MERC agreed with this adjustment.[596]

389. The Department recommended a three-year amortization period for rate case expenses. The Department explained that because the amount of time between rate cases typically varies from the time estimated by utilities in their rate cases, the Department generally calculates an average time period over which to recover rate case expenses. The Department stated that this approach is the normal method used in rate cases and it is reasonable because no one—utilities or regulators—can say for certain when a utility will file its next rate case.[597] Estimating a reasonable amortization period is difficult because many things can impact the utility's decision to file a rate case, including inflation, cost-of-money, construction activity, and customer's usage, accounting changes, and other factors that can

591 Ex. 19 at 9, 27 and Schedule (SSD-20) (S. DeMerritt Direct).

592 Ex. 19 at 28 (S. DeMerritt Direct).

593 Ex. 215 at 13 (L. La Plante Direct).

594 Ex. 215 at LL-8 (L. La Plante Direct).

595 Ex. 215 at 13-14 (L. La Plante Direct).

596 Ex. 24 at 15 (S. DeMerritt Rebuttal).

597 Ex. 215 at 15 (L. La Plante Direct)

impact the timing of a rate case. In addition, utilities consider the fact that rate cases are time consuming and costly when deciding when to file a rate case.[598]

~~224.~~390. The Department applied this averaging calculation to MERC's previous general rate case filings and recommended that MERC be allowed to recover its rate case expenses over a period of three years. The Department noted that this is the same recovery period approved by the Commission in MERC's 2008 and 2010 rate cases. Based on its recommended three-year recovery period, the Department recommended that test year rate case expenses be reduced by a net amount of $257,984.[599]

~~225.~~391. MERC disagreed with the Department's recommendation and calculation of the amortization period. MERC ~~concluded that the Department's recommendation inappropriately used simple averaging and~~ stated that use of MERC's 2008 through 2013 ~~was~~ history of rate cases is ~~based on a very~~too narrow of a history. ~~of MERC rate cases~~. MERC ~~also concluded that the~~did not dispute the Department's testimony ~~acknowledgement~~ that estimating a reasonable amortization period is difficult because many things can impact a utility's decision to file a rate case ~~undercut the Department's simple average analysis~~.[600] ~~MERC provided support in its testimony for the possibility that the Company may file a rate case in 2015 using a 2016 test year.~~[601]

392. ~~A two-year amortization period is appropriate because~~ The only evidence MERC provided to support a change from a three-year amortization period to a two-year amortization period was speculative; it stated that there is a possibility that the Company may file a rate case in 2015 using a 2016 test year.[602] First, MERC stated that it is currently preparing ~~for an increase in capital expenditures.~~a project to expand a transmission line, but it also acknowledged that that project has not been fully developed.[603] ~~In addition, MERC has announced the proposed acquisition of Interstate Power and Light's ("IPL") natural gas distribution assets which is subject to Commission approval. If approved, it is anticipated that the revenues, cost, rate base, as well as rate consolidation with the IPL customers will also be addressed in the next rate case.~~[604]

~~226.~~393. Second, MERC stated that it has proposed to acquire the Interstate Power and Light's ("IPL") natural gas distribution assets which is subject to Commission approval. If approved, MERC anticipated that the revenues, cost, rate base, as well as rate consolidation with the IPL customers would be addressed in the next rate case.[605] The ALJ takes notice that in MPUC Docket 14-107, the Commission issued a June 30, 2014 Order regarding a joint

---

[598] *Id.*

[599] Ex. 215 at 15-16 (L. La Plante Direct); Ex. 216 at 9-10 (L. La Plante Surrebuttal).

[600] Ex. 215 at 15 (L. La Plante Direct); Ex. 24 at 15-16 (S. DeMerritt Rebuttal).

~~[601] Evidentiary Hearing Transcript (May 13, 2014) at 22 (S. DeMerritt) (Doc. ID No. 20145-99937-01).~~

[602] Evidentiary Hearing Transcript (May 13, 2014) at 22 (S. DeMerritt) (Doc. ID No. 20145-99937-01).

[603] Ex. 19 at 10 (S. DeMerritt Direct)

~~[604] Ex. 19 at 9-10 (S. DeMerritt Direct); Ex. 40 at 29 (G. Walters Direct).~~

[605] Ex. 19 at 9-10 (S. DeMerritt Direct); Ex. 40 at 29 (G. Walters Direct).

petition of IPL and MERC seeking approval of the sale of IPL's Minnesota natural gas distribution system to MERC. The Commission's Order indicates that, despite having taken comments, it remains unclear whether the issues raised by the petition turn on contested material facts that require contested case proceedings, and the Commission has requested further comments to determine what material facts may be contested.[606]

394. A three-year amortization period is appropriate because the amount of time between rate cases typically varies from the time estimated by utilities in their rate cases, and it is appropriate to calculate the average time period over which to recover rate case expenses. The average time for MERC's recovery has been approximately three years, which is consistent with the Company's current recovery period, as approved by the Commission in MERC's 2008 and 2010 rate cases. MERC did not show any reasonable support to depart from the normal method for determining the amortization period. MERC's prediction that it may file a rate case in 2015 using a 2016 test year is too speculative to support a finding that a two-year amortization period is reasonable. Where doubt exists, it should be resolved in favor of ratepayers. Minn. Stat. § 216B.03 (2012).

~~227.~~395. MERC proposed that if the Commission agrees with the Department's recommendation for a three-year amortization period, MERC recommends debiting the unamortized rate case balance of $257,985 on an annualized basis, and crediting amortization expense for the same amount.[607]

~~228.~~396. The Department initially recommended the removal from rate base of what MERC characterized as "unamortized rate case expenses" in the amount of $1,315,335 ~~from rate base~~.[608] According to the Department, rate case costs are not prepaid costs nor assets to be amortized and should not be included in rate base.[609] A normalized level of rate case costs should be included in test year expenses, but should not be included as assets in rate base and amortized, such that the Company can earn an allowed rate of return on them.[610] The OAG-AUD agreed with the Department's recommendation.[611]

~~229.~~397. MERC agreed with the removal of unamortized rate case expenses from rate base, but noted that if the unamortized rate case expenses are removed then the associated deferred taxes of $541,188 also need to be removed from rate base.[612] The deferred taxes

606 *ITMO Request for the Approval of the Asset Purchase and Sale Agreement Between Interstate Power and Light Company and Minnesota Energy Resources Corporation,* MPUC Docket No. G-001, G-011/PA-14-107, Order Requiring Additional Record Development, Issued June 30, 2014.

607 Ex. 24 at 16-17 (S. DeMerritt Rebuttal).

608 Ex. 215 at LL-10 (L. La Plante Direct).

609 Ex. 215 at 1~~8~~6-19 (L. La Plante Direct).

610 *Id.*

611 Ex. 153 at 1-2, 6 (J. Lindell Rebuttal).

612 Ex. 24 at 17 (S. DeMerritt Rebuttal).

related to unamortized rate case expenses and represented a 13-month average of deferred taxes.[613]

~~230.~~398. The Department agreed with MERC's additional adjustment of $541,188, but reduced it slightly to reflect the allocated amount for the Minnesota Jurisdiction. Specifically, the Department recommended that rate base exclude unamortized rate case expenses of $1,312,704 and its related deferred taxes of $540,106. The Department's revised adjustment is the result of allocating 99.8 percent to the Minnesota Jurisdiction.[614] The net effect of these adjustments reduce the rate base by $772,598.[615]

~~231.~~399. MERC agreed with the Department's revised adjustment.[616]

~~232.~~400. The ALJ finds that the ~~a two-year~~ amortization period that is appropriate in this case~~. However, if the Commission approves~~ is the three-year amortization period recommended by the Department. ~~, the rate case balance of $257,985 must be debited on an annualized basis and amortization expense credited for the same amount.~~

~~233.~~401. The ALJ finds that MERC inappropriately included in its proposed rate base a 13-month average of 2014 unamortized rate case expenses totaling $1,312,704; this amount and the corresponding related deferred taxes totaling $540,106 should be excluded from rate base.

~~BB.~~CC. Charitable Contributions

~~CC.~~ Resolved between DOC and MERC. MERC agrees with the Department's recommendation regarding the level of charitable contributions, which reduces general and administrative expenses by $16,105. Ex. 215 at 20 (L. La Plante Direct).

~~DD.~~

402. The Commission limits charitable contribution expenses, and allows as operating expenses only those charitable contributions which the Commission deems prudent and which qualify under Minn. Stat. 290.21, subd. 3 (b). Only fifty percent of the qualified contributions shall be allowed as operating expenses.[617]

[613] Ex. 216 at LL-S-2 (L. La Plante Surrebuttal).

[614] Ex. 216 at 4-5 and Schedule (LL-S-1) (L. La Plante Surrebuttal).

[615] *Id.* at LL-S-1.

[616] *See* MERC Issues Matrix at 11 (June 6, 2014) (OAH Docket No. 8-2500-31126, MPUC Docket No. G-011/GR-13-617) (Doc. ID No. 20146-100192-01).

[617] Minnesota Public Utilities Commission's Statement of Policy on Charitable Contributions dated June 14, 1982. Ex. 215 at LL-13 (L. La Plante Direct).

~~234.~~403. ~~MERC~~ MERC included 2012 actual charitable contributions of $31,050 in its test year income statement.[618] The test-year amount based on the actual 2012 cost of $31,050 plus 1.708 and 1.993 percent inflation would be $32,209.[619]

~~235.~~404. The Department recommended a reduction by 50 percent of charitable contributions, which ~~that MERC~~ reduced the test year charitable contributions by $16,105.[620]

~~236.~~405. MERC accepted the Department's recommended reduction of $16,105.[621]

~~237.~~406. The ALJ finds that MERC's Charitable Contributions should be reduced by $16,105 for 2014.

DD. Corporate Aircraft Adjustment

Resolved between DOC and MERC. MERC agrees with the Department's recommendation regarding -the level of corporate aircraft expenses, which results in a test-year adjustment that reduces general and administrative expenses by $956. Ex. 215 at 24 (L. La Plante Direct).

~~**EE.**~~

~~238.~~407. The Department reviewed Corporate aircraft expenses, concluded that the corporate aircraft costs should not be paid for by ratepayers because MERC -provided no evidence that the use of its corporate aircraft is reasonable and consistent with the public interest, and– recommended that MERC reduce its test year A&G Expense by $956 for corporate aircraft costs.[622]

~~239.~~408. ~~Although~~ MERC witness Mr. DeMerritt stated that he ~~continues to~~ believes the corporate aircraft costs are prudent, but MERC accepted the adjustment for this proceeding because it is not a material cost.[623]

~~240.~~409. The ALJ finds that MERC's reduction of $956 in A&G expense for corporate aircraft costs should be approved in this rate case.

~~FF.~~EE. Transportation Revenue

~~241.~~410. MERC proposed $5,880,151 in transportation sales.[624]

---

618 Ex. 19 at 25 (S. DeMerritt Direct); Ex. 24 at 17 (S. DeMerritt Rebuttal); Ex. 4 Initial Filing Volume 3: Informational Requirements, Document 15.

619 Ex. 215 at 19 (L. La Plante Direct) (*citing* MERC's Volume 3, Document 5 (Informational Requirements)).

620 Ex. 215 at 20 (L. La Plante Direct); Ex. 216 at 5 (L. La Plante Surrebuttal).

621 Ex. 24 at 17 (S. DeMerritt Rebuttal);~~.~~ Ex. 216 at 5 (L. La Plante Surrebuttal).

622 Ex. 216 at 6-7 (L. La Plante Surrebuttal); Ex. 215 at 23-24 (L. La Plante Direct).

623 Ex. 24 at 18 (S. DeMerritt Rebuttal).

624 Ex. 151 at 14 (J. Lindell Direct).

~~242.~~411. The OAG-AUD expressed concern that MERC's projection is not representative of recent history for transportation sales and recommended a $2 million increase in transportation sales to $7,880,151.[625]

~~243.~~412. MERC disagreed with the OAG-AUD's conclusion. The historical Transport sales that the OAG-AUD analyzed included a non-jurisdictional component, the Michigan Taconite mines. To correct for the Michigan Taconite mines, MERC reduced the Company's total Transport sales for this rate case filing by removing the volumes from the non-jurisdictional customers. MERC notes that the Department's alternative test year Transport forecast would be more appropriate than the OAG-AUD's proposal since it removes the Michigan Taconite mine sales in its analysis.[626]

~~244.~~413. The ALJ finds that MERC's proposed transportation sales forecast in the amount of $6,123,364, updated based on the Department's alternative sales forecast, is appropriate and should be approved in this rate case.

~~GG.~~FF. Lobbying Expenses

~~245.~~414. MERC did not have any expenses related to gifts and lobbying. MERC incurs labor costs for employees who engage in lobbying activity, but did not have any external expenses related to lobbying activities.[627]

~~HH.~~GG. Research Expenses

~~246.~~415. MERC has not included any research costs in the 2012 historical year. Because recovery of these costs is not requested, no further detail regarding these costs is provided.[628]

HH. Interest Synchronization

Resolved between DOC and MERC. DOC and MERC agreed upon the methodology for calculating interest synchronization. Ex. 219 at 41 (M. St. Pierre Surrebuttal) (*citing* Ex. 24 at 11 (S. DeMerritt Rebuttal)).

~~**H.**~~

416. Interest synchronization is used for ratemaking to determine the amount of interest expense to be used in the calculation of income tax. Thus, when an adjustment is made to MERC's weighted cost of debt, test-year rate base or operating income statement, it is also necessary to make an interest synchronization adjustment.

417. MERC used interest synchronization when it calculated income tax. DOC Ex. 217 at 49 (St. Pierre Direct). MERC calculated a $98,779 tax effect of interest expense, based

625 Ex. 151 at 14 (J. Lindell Direct).

626 Ex. 39 at 2, 12 (H. John Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 106-108 (H. John) (Doc. ID No. 20145-99937-01).

627 Ex. 19 at 49 (S. DeMerritt Direct).

628 Ex. 19 at 25 (S. DeMerritt Direct).

on the proposed cost of debt rather than the booked interest expense included in the income tax accruals, to determine the test-year net operating income shown on MERC Ex. 4 at Volume 3, Doc. #5, Sched. C-1 (Information Requirements).[629]

~~247.~~418. The Department recommended that MERC's test year interest synchronization be adjusted as detailed in the Direct Testimony of Department witness Michelle St. Pierre.[630]

~~248.~~419. MERC accepted this recommendation regarding the methodology for calculating interest synchronization, but suggested that to the extent the final revenue requirement is different from the position stated in the Department's Direct Testimony, the interest synchronization will change accordingly.[631]

~~249.~~420. The Department agreed to MERC's recommendation.[632]

~~250.~~421. The ALJ finds that MERC's Interest Synchronization should be adjusted pursuant to the Department's Direct Testimony and MERC must recalculate the adjustment as part of MERC's final compliance filing.

II. Regulatory Assets and Liabilities

Disputed: DOC and MERC disagree regarding the DOC recommendation that MERC remove from rate base 17 accounts for certain Regulatory Assets and Liabilities in the total amount of $11,281,942. *See* Ex. 219 at 4, Table S1 (M. St. Pierre Surrebuttal) (Summary of DOC's and MERC's Recommendations). The principal part of this disputed adjustment is the $16,587,916 amount in Account 182312, which is the balance in FAS 158; this balance represents the projected test-year funded status (plan assets minus obligations) of MERC's defined benefit pension as of a certain point in time. Ex. 217 at 8–9 (M. St. Pierre Direct); Ex. 219 at 8 (M. St. Pierre Surrebuttal).

Resolved: MERC agreed to DOC's recommended adjustment as to only 2 of the 17 accounts, Accounts 186591 and 254450, the adjustment of which increased rate base by $226,984 ($17,066 - $244,050). Ex. 219 at 5 (M. St. Pierre Surrebuttal)

Resolved: DOC and MERC agreed that, if the Commission ultimately removes the assets and liabilities associated with the benefit plans, then the corresponding deferred taxes should be removed from rate base. Ex. 219 at 9–10 (M. St. Pierre Surrebuttal) (citing Ex. 24 at 4 (S. DeMerritt Rebuttal)). This adjustment is in the amount of $4,294,542 ($4,303,114 x 99.8 percent MN jurisdiction). Ex. 219 at 10–11 (M. St. Pierre Surrebuttal).

---

[629] Ex. 217 at 49 (M. St. Pierre Direct).

[630] Ex. 218 at Schedule (MAS-7) (M. St. Pierre Direct).

[631] Ex. 219 at 41 (M. St. Pierre Surrebuttal) (*citing* Ex. 24 at 11 (S. DeMerritt Rebuttal)).

[632] Ex. 219 at 42 (M. St. Pierre Surrebuttal).

Resolved between DOC and MERC. MERC agrees with the Department's recommendation to remove from MERC's proposed test year regulatory assets and liabilities in rate base recovery of unamortized rate case expenses in the amount of $1,312,704 and its related deferred taxes $540,106. The net effect of these adjustments reduces the rate base by $772,598. Ex. 216 at LL-S-1 (L. La Plante Surrebuttal).

~~**JJ.**~~

~~251.~~422. MERC noted in its Initial Brief at page 46, that FERC account 182.3 (Other Regulatory Assets) allows for regulatory assets. It states, in part, that:

> A. This account shall include the amounts of ***regulatory-created assets***, not includible in other accounts, resulting from the ***ratemaking actions*** of regulatory agencies. (emphasis added).

423. The Department in its Reply Brief responded, indicating that nothing in the record suggests that the Commission has taken "ratemaking actions" on MERC's Account 182.3 (FAS 158), and the Commission did not create through regulatory action MERC's FAS 158 Account, The Department continued to maintain that the FAS 158 account is not a regulatory asset that should be included in the test year rate base.

424. MERC initially proposed to include $19,642,806 ($19,682,037 less $39,230 allocated to Michigan) representing MERC's net regulatory assets in rate base.[633] -The majority of the accounts, which also represent the most significant dollars, ($18,837,482 of the $19,682,037) -related to items involving employee benefits.[634]

~~252.~~425. The Department recommended the removal of $11,281,942 of regulatory assets and liabilities related to seventeen accounts.[635] The majority of the regulatory assets and liabilities the Department proposed to remove from rate base were associated with employee benefits. Of the $11,281,942 proposed adjustment, $11,571,256 related to employee benefits, and particularly the funded status of the pension expense (FAS 158) account.

~~253.~~ MERC and the Department are in agreement regarding the treatment of other non-benefit regulatory assets and liabilities.

~~254.~~426. The Department concluded that Account 182901, Cloquet Plant Amortization should not be removed from rate base because in MERC's last rate case, the

633 Ex. 4 Initial Filing Volume 3: Informational Requirements, Document 2, Schedule B-6.

634 Ex. 217 at 7 (M. St. Pierre Direct). Other significant amounts relate to the forecasted rate case regulatory asset balance of $1,315,335 (Account 182513) and the forecasted injuries and damages accrual balance, a credit of $217,943 (Account 228200). The list of regulatory assets and liabilities included in the test year is at Ex. 218 MAS-13 (M. St. Pierre Direct Attach.).

635 Ex. 217 at 9 (M. St. Pierre Direct); Ex. 218 at Schedule (MAS-13) (Attachments to M. St. Pierre Direct); Ex. 219 at 10-11 (M. St. Pierre Surrebuttal).

Commission accepted and adopted the ALJ's findings on this issue and required MERC to include the regulatory asset Cloquet Plant Amortization (Account 182901) in rate base.[636]

~~255.~~ MERC initially agreed to only two of the Department's seventeen recommended adjustments to regulatory assets and liabilities. MERC and the Department agreed that Account 186591 (Account Receivable Arrearage) was erroneously included in rate base and agreed to a rate base reduction of $17,066.[637]

~~256.~~427. MERC and the Department have agreed that because derivative assets were excluded from rate base, Regulatory Liabilities-Derivatives, in the amount of $244,~~040~~ 050 (Account 254450) should be excluded as well.[638] By agreeing to only these two adjustments of the seventeen recommended by the Department, MERC increased its proposed rate base amount by $226,984 ($17,066 - $244,050).[639]

428. MERC initially proposed to include in rate base a 13-month average of 2014 rate case expense totaling $1,315,335.[640] The amount of rate case expenses included in MERC's test year rate base was "unamortized rate case expenses."[641]

429. The Department disputed the proposal, explaining that it is not appropriate to include unamortized rate case expenses in the test year rate base because rate case costs are neither prepaid costs nor assets to be amortized. A normalized level of rate case costs should be included in test year expenses, but should not be included as assets in rate base and amortized, such that the Company can earn an allowed rate of return on them.[642]

~~257.~~430. MERC ~~also~~ agreed with the Department's proposed adjustment to remove from rate base the recovery of unamortized rate case expense in the amount of $1,315,335 (regulatory asset Account 182513) because these costs are not prepaid costs appropriate for inclusion in rate base.[643] MERC proposed an additional adjustment to remove deferred taxes associated with the removed unamortized rate case expense in the amount of $541,188, which the Department agreed was appropriate, but should be adjusted to $540,106 to reflect the amount allocated to Minnesota.[644]

---

636 Ex. 217 at 10 (M. St. Pierre Direct).

637 Ex. 24 at 4 (S. DeMerritt Rebuttal); Ex. 217 at 10 (M. St. Pierre Direct).

638 Ex. 24 at 4-5 (S. DeMerritt Rebuttal).

639 Ex. 219 at 5 (M. St. Pierre Surrebuttal).

640 Ex. 215at LL-11, LL-12

641 *Id.* at 17.

642 Ex. 215 at 14 (L. La Plante Direct)

643 ~~Ex. 217 at 11 (M. St. Pierre Direct).~~Ex. 216 at 3-5 (L. LaPlante Surrebuttal)

644 Ex. 216 at 3-5 (L. La Plante Surrebuttal); Ex. 24 at 17 (S. DeMerritt Rebuttal).

~~258.~~431. Finally, as discussed below, during the evidentiary hearing MERC agreed to remove ~~certain amounts~~four accounts pertaining to nonqualified employee benefit costs from rate base. Collectively, this resulted in an increase to rate base of $239,769.[645]

~~259.~~432. The remaining employee benefit related items, taken as a whole, represent the cumulative difference between the contributions funded by MERC to the various benefit trusts and the actuarially calculated expense recognized by MERC.[646]

~~260.~~433. MERC stated that MERC's treatment of the cumulative amount in this rate case is consistent with MERC's treatment in the Company's prior rate case. MERC noted that, ~~A~~although MERC did not include cumulative funding and cumulative expense in its initial filing in the prior rate case, MERC agreed to the inclusion in rate base. Thus, MERC stated, the difference between cumulative funding and cumulative expense was appropriately included in rate base in the last case and is being consistently included in the current case. MERC acknowledged that ~~D~~during the period from 2012 through the 2014 test year, MERC contributed more to the pension and post-retirement benefit trusts than it recognized in expense, ~~. This~~which is the primary reason for the proposed rate base adjustment related to employee benefits.[647]

434. MERC and the Department disagreed on the inclusion of the benefit trusts~~Company supplied~~ funds in rate based. MERC stated that it proposed to include the cumulative excess funding in rate base because MERC's customers will benefit via lower benefit costs.

~~261.~~435. ~~and t~~The Department recommended removing $~~11,508,474~~11,281,942 mainly related to ~~employee benefits~~the funded status of pension expense (FAS 158) from rate base.[648]

436. As an initial matter, the Department explained, Regulatory Assets and Regulatory Liabilities are "rate base" items. Tr. at 214 (St. Pierre). To analyze regulatory assets, it is important to recognize that a utility's rate base is not the same as a non-utility's balance sheet used for financial statement purposes; to the contrary, rate base represents the plant, facilities, and other investments required for supplying utility service to customers. Tr. at 213 (St. Pierre). The Department offered the following as examples of differences between a utility's rate base and a non-utility's balance sheet:

- First, generally, a utility's rate base does *not* include accounts receivables and accounts payable. For utility ratemaking, those costs are reflected in the cash working capital ("CWC").[649]

---

[645] Evidentiary Hearing Transcript (May 13, 2014) at 56 (C. Hans) (Doc. ID No. 20145-99937-01); Ex. 27 at Exhibit CMH-4 (C. Hans Rebuttal).

[646] Ex. 27 at 13 (C. Hans Rebuttal).

[647] Ex. 27 at 13-16 (C. Hans Rebuttal).

[648] Ex. 26 at 8-13, 15-16 (C. Hans Direct); Ex. 27 at 4-17 (C. Hans Rebuttal); Ex. 217 at 7-11, 28-34 (M. St. Pierre Direct); Ex. 219 at 2-4, 7-9, 25-33 (M. St. Pierre Surrebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 23, 54-56, 213-216 (C. Hans and M. St. Pierre) (Doc. ID No. 20145-99937-01).

- Second, a utility's rate base includes CWC determined from a lead/lag study whereas a balance sheet does not.

- Third, a utility includes in its rate base certain items referred to as "regulatory assets and liabilities," which reflect the differences in expense and revenue recognition between ratemaking, on the one hand, and GAAP~~)~~, on the other.

Tr. at 213–214 (St. Pierre). Department witness Ms. St. Pierre recommended that the Commission require MERC to reduce the test-year rate base by $11,281,942 for an adjustment to the Regulatory Assets and Liabilities.[650] Specifically, the Department recommended that all of the regulatory liabilities MERC proposed should be removed from rate base except for Account 254391, Regulatory Liability – 2010 Health Care Legislation, which account was allowed in rate base in MERC's last rate case. Similar to employee retirement benefits, these liability balances are caused by temporary timing differences and should be removed from the test-year rate base.

437. The Department stated that the seventeen disputed accounts are not reasonably included in rate base for several reasons. First, MERC's inclusion of these regulatory assets in rate base was not reasonable, where MERC provided no authority, other than its agreement with the OAG in its last rate case to adjust rate base to justify the "ratepayer supplied funding" for the inclusion of the benefit assets and liabilities in the current rate case. The Department observed that MERC cited no Commission Order that authorized this approach.[651] MERC's agreement with OAG regarding the "ratepayer supplied funding" adjustment in MERC's last rate case was the Company's sole rationale for its proposal to include the benefit assets and liabilities in rate base in the current case. That rationale is inapplicable to this case, however, because, in MERC's last rate case, the calculation of the ratepayer supplied funding adjustment used a cumulative amount based on data from a five-year period of 2007-2011.[652] In contrast, in this rate case, MERC's valuation of net benefit assets and liabilities was at one

---

[649] The Department explained that the purpose of cash working capital in ratemaking is to allow the utility to recover money needed to meet current operating expenses prior to collecting revenues for the service provided, essentially the time value of money between when the Company incurs costs and when they are reimbursed, as determined by the lead/lag study. This objective is accomplished by including an appropriate cash working capital requirement in rate base. Ex. 217 at 50 (M. St. Pierre Direct).

[650] Ex. 217 at 7–11 (M. St. Pierre Direct).

[651] *Id.* at 7–11; Ex. 219 at 9 (M. St. Pierre Surrebuttal).

[652] In MERC's last rate case, inclusion reduced the test year rate base. The funding amount agreed to between MERC and the OAG was a reduction to rate base of $71,159. MERC witness Ms. Han stated that in the last rate case: "during the proceedings, MERC agreed to make a rate base adjustment for ratepayer-supplied funds – specifically, the difference between MERC's actual cumulative contributions to benefit trusts and the cumulative expense recognized by MERC. In that case, cumulative funding for other post-retirement benefits exceeded the recognized cumulative expense by $56,468; and cumulative funding for pension benefits was less than the recognized cumulative expense by $127,627. The net result was a reduction to rate base of $71,159 [calculated as $56,468 - $127,627]. Ex. 219 at 8–9 (M. St. Pierre Surrebuttal) *citing* MERC Ex. 27 at 15:1-7 (Hans Rebuttal).

moment in time: a projected thirteen-month average as of the end of the test year, December 31, 2014. Thus, the Department reasoned, the current rate case calculation is not based on cumulative amounts for multiple years, which was the rationale for the agreement in MERC's prior rate case.[653]

438. The Department observed further, that no adjustment was made to the related deferred tax in MERC's prior rate case, as MERC has proposed in this case, if the regulatory assets and liabilities are removed.[654] Here, the Company acknowledged that "if the Commission ultimately removes the assets and liabilities associated with the benefit plans, then the corresponding deferred taxes also need to be removed from rate base."[655]

439. Second, the Department observed, MERC's proposed inclusion of the employee benefit assets and liabilities in rate base is an approach that MERC has not proposed in the past. The benefit assets and liabilities were not included in MERC's initial rate base in its last rate case even though the accounts were included in the Company's financial books and records.[656]

440. Third, the Department stated, the proposal here is novel; the funding status of employee benefits (FAS[657] 158, Account 182312) has not been included in the rate base of any other Minnesota utilities to the Department's knowledge.[658]

441. Fourth, the Department explained, MERC's proposal to include the regulatory assets in rate base is unreasonable because ~~The Department expressed concern that MERC could be receiving a double recovery on benefit assets and liabilities because~~ MERC is already provided recovery for employee benefits in its proposed test year income statement, as well as a return on the employee benefit costs through the lead/lag study.~~.~~[659] Including employee benefit accruals in rate base in addition to cash working capital would provide a second or double recovery of the return on those amounts.[660] Specifically, MERC is already allowed to recover employee benefits in its proposed test-year income statement; here MERC also proposes to be allowed to earn a return on the employee benefit costs through the lead/lag study.[661] According to the Department, the CWC is determined by a lead/lag study (DOC Ex.

---

[653] Ex. 219 at 9 (M. St. Pierre Surrebuttal).

[654] Ex. 219 at 9-10 (M.St. Pierre Surrebuttal); Transcript at 216 (St Pierre).

[655] Ex. 24 at 4 (S. DeMerritt Rebuttal). MERC provided the amount of the corresponding deferred taxes in discovery. The Company's calculation of the corresponding deferred taxes is that the 13-month average for 2014 is a liability of $4,303,114 (total MERC). The request for this amount and calculation of this liability are shown in Ex. 219 MAS-S-1 (St. Pierre Surrebuttal).

[656] Ex. 217 at 7–11 (M. St. Pierre Direct).

[657] Financial Accounting Standard (FAS).

[658] Ex. 217 at 7-11 (M. St. Pierre Direct); Tr. 215:18-21 (M. St. Pierre opening statement).

[659] The Department explained that FAS 158 does not run through the lead/lag study because it is not an accrual. Tr. at 225-226 (St. Pierre).

[660] Tr. at 215 (M. St. Pierre).

[661] Ex. 217 at 9 (M. St. Pierre Direct).

217 at 50 (St. Pierre Direct)), which calculates a receivable or payable amount based on the related test-year expense that is added to rate base to earn a return. MERC's regulatory assets and liabilities are receivables and payables, which (along with accruals) are included in test-year income statement expenses and MERC earns a return on these amounts through CWC.[662] Thus, including receivables and payables in rate base in addition to CWC would provide a second or *double recovery of the return* on those amounts.[663] The Department does not oppose recovery from ratepayers of reasonable employee expenses, but it is not reasonable to require MERC's ratepayers to also pay a return to MERC on such amounts included in rate base.[664] ~~the lead/lag study calculates a receivable or payable amount based on the related test year expense that is added to rate base to earn a return. MERC's regulatory assets and liabilities are receivables and payables. Moreover, receivables and payables or accruals are included in test year income statement expenses and MERC earns a return on those amounts through cash working capital. Thus,~~ The Department believes that including receivables and payables in rate base in addition to cash working capital would provide a second or double recovery of the return on those amounts.[665]

~~262.~~442. MERC disagreed with the Department's position on double recovery. MERC argued that ~~R~~regulatory assets and liabilities are not a function of benefit expenses. Rather, benefit expenses are a function of assets and liabilities. Typically, the greater the return on assets, the lower the benefit expense MERC recognizes on its income statement. When contrasting the benefits expense with the accounts payable account, which is included in the lead/lag study, MERC recognizes an expense on the income statement at the time of the purchase of materials and supplies, for example, but the invoice itself may not be paid until a later date. The lead/lag study calculates that delay in payment and creates a liability, or reduction in rate base, for that accounts payable expense. Benefit assets and liabilities are more like construction costs than accounts payable. For benefits expenses, MERC must make an out-of-pocket cash expenditure to create the asset, but the asset is then used to earn a return and offset benefit costs. While the benefit asset earns a return, this return is used to reduce benefit costs, not to repay shareholders for their prepayment of benefit costs. Instead, including these assets and liabilities in rate base is how shareholders earn a return on this funding activity.[666]

443. The Department did not agree with the Company's position. The Department explained that the cash working capital does not include most of the regulatory asset amount for FAS 158 since FAS 158 is not an accrual.[667] Rather, FAS 158 reflects the projected test-year funded status of MERC's defined benefit pension.[668] On the other hand, cash working

[662] With the exception of FAS 158 (Account 182312). Tr. at 225–226 (St. Pierre).

[663] Ex. 219 at 6 (M. St. Pierre Surrebuttal).

[664] Ex. 219 at 7 (M. St. Pierre Surrebuttal).

[665] Ex. 219 at 6 (M. St. Pierre Surrebuttal).

~~[666] Ex. 24 at 3-4 (S. DeMerritt Rebuttal).~~

[667] Tr. 225-226 (M. St. Pierre).

[668] Ex. 217 at 8 (M. St. Pierre Direct).

capital includes accrued expenses that are included in the income statement such as the Labor Loader (regulatory asset 186390).[669]

~~263.~~444. Moreover, the Department emphasized, the retirement benefits trust plan balance in FAS 158 is temporary, due to Company funding and financial market conditions, and should not be included in rate base. The Department stated that it does not consider temporary timing differences as sufficient justification for rate base recovery.[670] The balance in FAS 158 represents the projected test-year funded status (plan assets minus obligations) of MERC's defined benefit pension as of a certain point in time.[671] The Company's pension plan is projected to be *overfunded* as of the end of the test year, and the projected $16,587,916 amount is an average 13-month balance.[672] The funding activity at a given moment in time is merely a temporary timing difference. The retirement benefits trust plan assets may go up or down depending upon Company funding and investment returns due to changes in the market or investment activity of the plan administrators.[673] In other words, depending upon funding and market conditions, trust plan assets may be greater or less than the plan's liabilities at a specific point in time.[674] Similarly, pension benefit obligations can change due to changes made to the plan benefits and/or various actuarial assumptions.[675]

~~264.~~445. Also, the Department explained, the employee pension is "externally funded," meaning that MERC pays pension expenses to a separate entity, a benefit trust, in an account maintained outside of the Company. The current trustee is BNY Mellon. Once the contributions are made, the Company no longer has use of the trust funds, nor of earnings on the trust funds, for its ordinary business purposes.[676] As a result, it is unreasonable for ratepayers to fund not only the pension expense, but also to treat the pension fund (FAS 158 Account 182312) as though it remained part of the Company's rate base upon which ratepayers must pay a return.

~~265.~~446. And, finally, the Department reported, there have been no changes in accounting standards that suggest a change in how pension costs should be recovered in rates. Ms. St. Pierre stated:[677]

---

[669] Tr. 226 (M. St. Pierre).

[670] Ex. 217 at 7–11 (M. St. Pierre Direct); Tr. at 215 (M. St. Pierre).

[671] Ex. 217 at 8–9 (M. St. Pierre Direct).

[672] Ex. 219 at 8 (M. St. Pierre Surrebuttal) (*citing* Ex. 6 Volume 4, Detail Balance Sheet (S. DeMerritt Workpapers)).

[673] Ex. 217 at 9 (M. St. Pierre Direct).

[674] *Id.*

[675] Ex. 219 at 8 (M. St. Pierre Surrebuttal).

[676] Tr. at 58–59 (C. Hans).

[677] Ex. 217 at 7–11 (M. St. Pierre Direct).

> [I]n 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") 158, changed the balance sheet *presentation* for companies with defined benefit pensions plans. The pension balance sheet account now includes and shows the funded status (plan assets minus obligations) of a company's pension plan, whereas before, the funded status information was generally reported only in the footnotes to the financial statements. This change merely revises how the information is presented in financial statements and cannot be used to justify including the over/under funded status of a pension plan in rates. Pension plans have always been over or under funded and, to my knowledge, these differences have not been included in rates. The fact that the funded status of a pension plan is now reported on the balance sheet rather than in the footnotes does not change the ratemaking treatment of these temporary balances.

~~266.~~447. Despite MERC's disagreement with the Department's recommendation, MERC proposed that if the Commission ultimately removes the assets and liabilities associated with the benefits plans, then the corresponding deferred taxes also need to be removed from rate base.[678] The Department agreed with MERC's recommendation. Using information provided by MERC, the Department determined that the deferred tax adjustment amount totals $4,294,542.[679]

~~267.~~448. The Department concluded that Account 182351, Purchase Accounting Effect on Benefits should not be removed from rate base because in Docket No. G007,011/M-06-1287, the Commission authorized MERC to create a regulatory asset for the pension and other post retirements acquired from Aquila.[680]

~~268.~~449. At the Evidentiary Hearing, MERC agreed to the removal of four of the seventeen disputed accounts from rate base. MERC had initially disagreed with the Department's recommendation for all accounts in the 228 range, as well as accounts 242070 and 242072 based on MERC's argument for inclusion of benefit assets and liabilities in rate base.[681] Account 254400 (Regulatory Liabilities Deferred Taxes) should also be included in rate base. To the extent that regulatory assets and liabilities are included in rate base, the associated deferred taxes should also be included in rate base to offset them.[682] The Department stated that as to the accounts that pertained to non-qualified benefit plans; MERC was (appropriately) not requesting recovery of non-qualified employee benefit costs for Pension Restoration Plan and SERP (Account 926210) and SERP (Account 926220).[683] It

---

678 Ex. 24 at 4 (S. DeMerritt Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 216 (M. St. Pierre) (Doc. ID No. 20145-99937-01).

679 Ex. 219 at 10-11 (M. St. Pierre Surrebuttal).

680 Ex. 217 at 10 (M. St. Pierre Direct).

681 Ex. 24 at 4-5 (S. DeMerritt Rebuttal).

682 Ex. 24 at 5 (S. DeMerritt Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 216 (S. DeMerritt) (Doc. ID No. 20145-99937-01).

683 Ex. 26 at 3, 4 (C. Hans Direct). The approved amortization for account 926220 is included in the costs estimated by MERC. Ex. 26 at 5 (C. Hans Direct).

follows, the Department noted, that the related rate base accounts (Accounts 228300, 228305, 228310, 242072) should be removed from rate base.[684] Because MERC did not seek recovery of the expense portion of these accounts, the Department recommended removal of the related rate base portion of the accounts (Accounts 228300 for $163,731, 228305 for $19,719, 228310 for $53,763, and 242072 for $2,556).[685] At the evidentiary hearing, MERC agreed to the removal of these four accounts from rate base.[686]

~~269.~~450. At the evidentiary hearing, MERC ~~explained~~ acknowledged that the Labor Loader regulatory asset (Account 186390), the Injuries & Damages Reserve regulatory liability (Account 228200), and the Workers Comp Claim Reserve regulatory liability (Account 228210) are all accounts that exist on MERC's balance sheet.[687] as accruals. Labor Loader (regulatory asset 186390) is the monthly residual balance of an accrual used for adding nonproductive time to labor. Injuries and Damages (regulatory liability 228200) and Workers' Comp Claim Reserve (regulatory liability 228210) are accrual or liability accounts that not recognized on the income statement when costs are accrued.[688] Last, Deferred Taxes (regulatory liability 254400) is the FAS 109 (now ASC 740) piece of deferred taxes which is the grossed up difference in tax from regulatory accounting and accounting for GAAP purposes.[689]

~~270.~~451. In Surrebuttal Testimony, the Department provided a table listing each of the seventeen ~~17~~ adjustments that it recommended to MERC's regulatory assets and liabilities. ~~MERC agreed to remove two accounts, Deferred Debit-Long Term Account Receivable Average (Account 186591) and Regulatory Liabilities-Derivatives (Account 254450) from rate base. By agreeing to these two adjustments, MERC increased its proposed rate base amount by $226,984. MERC and the Department agreed that Account 186591 was erroneously included in rate base.[690]~~

	Regulatory Assets	Account Name	MERC Filed	DOC Direct & Surrebuttal	MERC Rebuttal	MERC Post hearing ~~DOC Surrebuttal~~
1	182515	Post retirement Life	$19,777	$0	$19,777	$19,777
2	182312	FAS 158	$16,587,916	$0	$16,587,916	$16,587,916
3	186390	Labor loader	$2,304	$0	$2,304	$2,304

684 Ex. 219 at 7–8 (M. St. Pierre Surrebuttal); Tr. at 216 (M. St. Pierre).

685 Ex. 217 at 7-11 (M. St. Pierre Direct).

686 Evidentiary Hearing Transcript (May 13, 2014) at 56:13-18 (C. Hans) (Doc. ID No. 20145-99937-01); Ex. 27 at Schedule (CMH-4) (C. Hans Rebuttal).

687 Evidentiary Hearing Transcript (May 13, 2014) at 26-30 (S. DeMerritt) (Doc. ID No. 20145-99937-01).

688 Tr. 26-27 (S. DeMerritt).

689 Tr. 99-100 (J. Wilde).

~~690 Ex. 219 at 4-5 (M. St. Pierre Surrebuttal).~~

	Regulatory Assets	Account Name	MERC Filed	DOC Direct & Surrebuttal	MERC Rebuttal	MERC Post hearing ~~DOC Surrebuttal~~
4	186591	Deferred Dr.-LT A/R	$17,066	$0	$0	$0
5		TOTAL ASSETS	$16,627,063	$0	$16,609,997	$16,609,997
	Regulatory Liabilities					
6	228200	Injuries & Damages Reserve	$(217,943)	$0	$(217,943)	$(217,943)
7	228210	Workers Comp Claim Reserve	$(6,054)	$0	$(6,054)	$(6,054)
8	228300	Deferred Cr-Sup Ret Select(SERP)	$(163,731)	$0	$(163,731)	$0
9	228305	Sup Remp ret Plan (SERP)	$(19,719)	$0	$(19,719)	$0
10	228310	Pension Restoration	$(53,763)	$0	$(53,763)	$0
11	228315	Post Ret Health Care-Admin	$(2,590,545)	$0	$(2,590,545)	$(2,590,545)
12	228320	Post Ret Health Care-NonAdmin	$(749,060)	$0	$(749,060)	$(749,060)
13	228331	Accr Pens Liab-CHI Retire Plan	$(1,214,798)	$0	$(1,214,798)	$(1,214,798)
14	242070	Current Pension Obligation	$(20,572)	$0	$(20,572)	$(20,572)
15	242072	Current Pension Restoration	$(2,556)	$0	$(2,556)	$0
16	254009	Reg Liab-Cost to Fwd External	$(255)	$0	$(255)	$(255)
17	254400	Reg Liability – Deferred Taxes	$(39,556)	$0	$(39,556)	$(39,556)
18	254450	Reg Liability-Derivatives	$(244,050)	$0	$0	$0
19		TOTAL LIABILITIES	$(5,322,602)	$0	$(5,078,552)	$(4,838,783)
20		TOTAL ASSETS/ LIABILITIES	$11,304,461	$0	$11,531,445	$11,771,214
21		**Minnesota Jurisdiction 99.8007934%**	**$11,281,942**	**$0**	**$11,508,474**	**$11,747,765**

452. Based on adjustments agreed to during this proceeding, MERC has proposed to include $18,794,224 of regulatory assets and liabilities in rate base or a reduction of $848,582 ($19,642,806 - $18,794,224).

~~271.~~453. Based on its analysis, the Department recommends that the Commission require MERC to reduce rate base by $11,281,942 for the Regulatory Assets and Liabilities adjustment; this amount is calculated as shown in Ex. 218 MAS-13 (M. St. Pierre Direct).

454. The ALJ finds that the Commission should require MERC to reduce rate base by $11,281,942 for the Regulatory Assets and Liabilities adjustment and its related deferred taxes $4,294,542 for a net adjustment that reduces the rate base by $6,987,400.~~regulatory assets and liabilities in the amount of $18,794,224 should be included in rate base.~~

~~272.~~455. The ALJ finds that the Commission should remove from MERC's proposed test year regulatory assets and liabilities in rate base recovery of unamortized rate case expenses in the amount of $1,312,704 and its related deferred taxes $540,106 for a net adjustment that reduces the rate base by $772,598.

~~KK.~~JJ. Gas Affordability Program ("GAP")

~~273.~~456. Minnesota Statutes Section 216B.16 subsection 15 provides that the Commission must consider ability to pay as a factor in setting utility rates and may establish affordability programs for low-income residential customers in order to ensure affordable, reliable, and continuous service to low-income utility customers. This describes the purpose of MERC's GAP, which was approved by the Commission on February 27, 2008 in Docket No. G007,011/M-07-1131. A four year extension of the program was approved in Docket No. G007,011/M-07-1131, with an expiration date of December 31, 2015.[691]

~~274.~~457. MERC believes the GAP continues to be an excellent program and is highly encouraged by the retention rate. MERC believes the success of GAP indicates that, with a little help, customers are able to make timely payments and the program prevents customers from falling so far behind in their bills that they feel helpless. MERC does not propose any changes to GAP at this time. MERC intends to make any proposals at the end of the GAP on December 31, 2015.[692]

~~275.~~458. The ALJ finds that no changes are needed to MERC's GAP program for purposes of this rate case.

~~LL.~~KK. New Area Surcharge

~~276.~~459. The Department recommended that, in a separate proceeding, MERC examine its New Area Surcharge ("NAS"), and assess whether extensions could be made more affordable by extending the surcharge period longer than the current 15 year limit,

[691] Ex. 40 at 30 (G. Walters Direct).

[692] Ex. 40 at 30-31 (G. Walters Direct).

thereby lowering the annual surcharge amount.[693] The Department recommended that MERC provide such a filing as soon as possible.[694]

~~277.~~460. MERC agreed with the Department's recommendation. On June 20, 2014, MERC filed its initial NAS filing for approval of a tariff revision and a new area surcharge for the Ely Lake Project.[695]

~~278.~~461. The ALJ finds that the examination of MERC's NAS in a separate proceeding is appropriate.

LL. Miscellaneous Service Revenues

Resolved between DOC and MERC. MERC agreed with the Department's recommendation regarding the level of other gas revenue from miscellaneous service receipts, which results in a test-year adjustment that increases MERC's other gas revenue by $51,943. Ex. 215 at 3, LL-2 (L. La Plante Direct).

~~**MM.**~~

~~279.~~462. The Department expressed concern ~~with~~ that the methodology used by MERC to calculate the Company's test-year miscellaneous service revenues was not reasonable because it was based on annualizing only ~~on~~ seven months of 2012 data for the months of January through July, 2012. The Department recommended that the test year other revenue from miscellaneous services be increased by $51,493 to more reasonably average the annual revenue over a four-year period of historical data (2010-2013).[696]

~~280.~~463. MERC agreed with the Department's recommended adjustment.[697]

~~281.~~464. The ALJ finds that an increase of $51,493 to MERC's test-~~-~~year other revenue from miscellaneous services is proper in this rate case.

~~NN.~~MM. Rate Base Disallowances Relating to Service and Main Extensions

~~282.~~465. In its March 31, 1995, Order in Docket No. G999/CI-90-563, the Commission requested that the Department investigate every gas utility company's service additions to rate base due to new service extensions during a general rate case to make sure: 1) LDCs are applying their tariffs correctly and consistently; 2) that they are appropriately

[693] Ex. 210 at 11-13 (M. Zajicek Direct); Ex. 211 at 5 (M. Zajicek Surrebuttal).

[694] Ex. 211 at 5 (M. Zajicek Surrebuttal).

[695] Ex. 42 at 13 (G. Walters Rebuttal); *see* In the Matter of the Petition of Minnesota Energy Resources Corporation for Approval of a Tariff Revision and a New Area Surcharge for the Ely Lake Project (June 20, 2014) (Doc. ID No. 20146-100673-01).

[696] Ex. 215 at 3 and Schedule (LL-3) (L. La Plante Direct)(MERC Response to DOC IR 128).; Ex. 216 at 2 (L. La Plante Surrebuttal).

[697] Ex. 24 at 15 (S. DeMerritt Rebuttal).

cost and load justified; and 3) that wasteful additions to plant and facilities are not allowed into rate base.[698]

~~283.~~466. MERC conducted the required audit of its main and service extensions to determine whether its extension tariff had been correctly and consistently applied since its last rate case. MERC has removed $29,170 of plant items from its rate base in this rate case proceeding based on MERC's study of compliance with its main and service extensions since the last rate case and proposed adjustments to rate base to reflect these findings.[699] Specifically, MERC proposed a reduction of $12,859.52 to rate base for service line extensions and a reduction of $16,310.50 to rate base for main extensions.[700]

467. The Department concluded that MERC had not shown that the Company correctly and consistently applied the extension tariff since its 2010 rate case. While MERC's performance has not improved since the 2010 rate case, it has remained relatively stable. The Department examined a representative sample of MERC's records relating to the main line and service line extension projects. Based on the results of this analysis, t~~T~~he Department recommended an additional reduction of $6,633.16 to rate base for main and service extensions where customer contributions were not collected, for a total reduction of $35,803.18 for unbilled extension costs.[701]

468. While the Company is still recovering the vast majority of required contributions-in-aid-of-construction ("CIACs") from the customers who impose those costs on the system, MERC should further increase efforts to improve the application of its tariff to ensure that errors are minimized and corrected. MERC should also improve its record keeping to ensure that any errors are caught during the processing of service and main extension projects.[702]

~~284.~~469. MERC agreed with the Department's recommendation.[703]

~~285.~~470. MERC also provided a quantitative analysis showing that its service-related additions are appropriately cost and load justified. MERC proposed to continue its currently approved 75-foot allowance for each stand-alone service extension and its feasibility model for other residential and all commercial and industrial extensions.[704]

~~286.~~471. The Department recommended that MERC continue to apply the Company's currently approved 75-foot allowance for each stand-alone service line extension,

---

698 *See generally* Ex. 14 (D. Kult Direct); Ex. 210 at 6-7 (M. Zajicek Direct).

699 Ex. 14 at 3-12 and Schedules (DGK-1 and DGK-2) (D. Kult Direct); Ex. 19 at 28 (S. DeMerritt Direct).

700 Ex. 14 at 10-11 (D. Kult Direct); Ex. 4 Initial Filing Volume 3: Informational Requirements, Document 2, Schedule B-3.

701 Ex. 210 at 2, 22, 23, 25, 30-31 and Schedules (MZ-1 through MZ-4) (M. Zajicek Direct); Ex. 211 at 1-2 (M. Zajicek Surrebuttal).

702 Ex. 210 at 24-25 (M. Zajicek Direct).

703 Ex. 15 at 2-3 (D. Kult Rebuttal).

704 Ex. 14 at 11-12 (D. Kult Direct).

and MERC's currently approved feasibility model for other residential, commercial and industrial extensions.[705]

472. Due to the recent propane emergency, another approach might help reduce the number of customers affected by such an occurrence in the future. The New Area Surcharge tariff determines how much each new area would have to pay to obtain natural gas service. The tariff, however, limits the new areas that might be able to obtain natural gas service through such provisions by limiting to fifteen years the time over which a surcharge could be charged to customers in new areas. To make it easier for new areas to obtain natural gas service rather than depend on propane service that may not be reliable, it might be reasonable to revise MERC's tariff to allow a period longer than fifteen years. The Department recommended using a separate proceeding to address this question, which would provide the opportunity for MERC to make a specific proposal and allow all parties adequate time to analyze the proposal.[706]

~~287.~~473. MERC agreed with the Department's recommendation.[707]

~~288.~~474. MERC addressed the issue of whether its extension practices prevent wasteful additions to plant and facilities. MERC's proposed disallowance of $29,170.02 would prevent such additions from being included in this proceeding.[708]

~~289.~~475. The Department did not believe that MERC had fully addressed the Commission's concern. The Department determined that appropriate adjustments to correct for errors in MERC's tariff application ~~can~~ were required and could be made by applying the $29,170.02 of disallowances proposed by MERC plus the Department's recommended reduction of $6,633.16 for a total of $35,803.18.[709]

~~290.~~476. MERC agreed with the Department's recommendation.[710]

~~291.~~477. The ALJ finds that MERC's Service and Main Extension reduction, allowance, and feasibility model are reasonable and should be approved by the Commission after taking into account the Department's recommendations.

~~OO.~~NN. Rate Base Disallowances Relating to Winter Construction Charges

~~292.~~478. In its Order in Docket No. G007,011/M-07-1188, the Commission required MERC to show in its next general rate case that no winter construction charges were assessed to customers outside of the tariff winter construction charge period and that no

---

705 Ex. 210 at 10, 26, 31 (M. Zajicek Direct); Ex. 211 at 3 (M. Zajicek Surrebuttal).

706 Ex. 210 at 12-13 (M. Zajicek Direct).

707 Ex. 15 at 3 (D. Kult Rebuttal); Ex. 42 at 13 (G. Walters Rebuttal).

708 Ex. 14 at 12 (D. Kult Direct); Ex. 4 Initial Filing Volume 3: Informational Requirements, Document 2, Schedule B-3.

709 Ex. 210 at 25, 27, 31 (M. Zajicek Direct); Ex. 211 at 3 (M. Zajicek Surrebuttal).

710 Ex. 15 at 4 (D. Kult Rebuttal).

winter construction charges incurred by the Company from any contractors outside the tariffed winter construction charge period are proposed to be recovered from other ratepayers. The Commission included similar requirements in its Order after Reconsideration in Docket No. G007,011/GR-08-835.[711]

479. MERC found no invoices for winter charges for work done outside the tariffed Winter Construction Charges period. As a result, MERC removed $0 for winter charges for work done outside the tariffed Winter Construction Charges period.[712]

~~293.~~480. The Department agreed with the disallowance and proposed no further disallowances on winter construction.[713]

~~294.~~481. The Department recommended that MERC continue to show in the Company's rate case that no winter construction costs were assessed outside the winter construction period, and that no winter construction charges incurred by MERC from any contractors outside the winter construction period are proposed to be recovered from other ratepayers.[714]

~~295.~~482. MERC agreed with the Department's recommendations.[715]

~~296.~~483. The ALJ finds that the Commission should accept MERC's proposed rate base disallowance related to winter construction charges and require that MERC continue to show in the Company's rate case that no winter construction costs were assessed outside the winter construction period, and that no winter construction charges incurred by MERC from any contractors outside the winter construction period are proposed to be recovered from other ratepayers.

~~PP.~~OO. Rate Base Disallowances Relating to Supplemental Executive Retirement Plan

~~297.~~484. MERC is not seeking recovery of costs associated with the SERP, except those costs that were approved by the Commission in Docket No. G007,011/M-06-1287.[716]

~~298.~~485. The ALJ finds that MERC's recovery of SERP costs approved in Docket No. G007,011/M-06-1287 is appropriate in this rate case.

711 Ex. 14 at 13 and Schedule (DGK-3) (D. Kult Direct)

712 Ex. 14 at 13 (D. Kult Direct); Ex. 19 at 29 (S. DeMerritt Direct).

713 Ex. 211 at 4 (M. Zajicek Surrebuttal).

714 Ex. 210 at 27-28 (M. Zajicek Direct); Ex. 211 at 4 (M. Zajicek Surrebuttal).

715 Ex. 15 at 5 (D. Kult Rebuttal).

716 Ex. 19 at 32 (S. DeMerritt Direct).

~~QQ.~~PP. Rate Base Disallowances Relating to Gas Affordability Program

~~299.~~486. In MERC's last rate case, Docket No. G007,011/GR-10-977, balances associated with the Gas Affordability Program were removed from rate base and, therefore, were removed from rate base in this current rate case.[717]

QQ. Test Year Working Capital

Resolved between DOC and MERC.

DOC and MERC agreed on the methodology and future rate case reporting. In its future general rate cases, MERC will: provide a schedule that reconciles the expenses in the CWC to the expenses in its test-year income statement; and base the CWC schedule on the number of days rather than percentages. Ex. 217 at 50-51 (M. St. Pierre Direct); Ex. 219 at 42 (M. St. Pierre Surrebuttal).

DOC and MERC agreed to the Department's proposed methodology for future rate case reporting. Ex. 217 at 51 (M. St. Pierre Direct); Ex. 219 at 42 (M. St. Pierre Surrebuttal).

DOC and MERC agreed that the final CWC amount necessarily remains in flux until other items in the revenue deficiency calculation are resolved. Ex. 219 at 42 (M. St. Pierre Surrebuttal) (*citing* Ex. 24 at 12 (S. DeMerritt Rebuttal)).

~~**RR.**~~

~~300.~~487. MERC developed the 2014 test year working capital forecast in this case by adjusting MERC's Working Capital Accounts such that the 2014 proposed working capital would be synchronized with the working capital calculated in the lead/lag study.[718]

~~301.~~488. The Department recommended that MERC's test year working capital be adjusted as detailed in the Direct Testimony of Department witness Ms. St. Pierre (i.e., an increase of $112,753 for the lead/lag adjustment).[719]

~~302.~~489. MERC accepted this recommendation, but suggested that the final cash working capital amount remains in flux until other items in the revenue deficiency calculation are resolved.[720]

490. MERC agreed with the Department's recommendation that in future rate cases MERC provide a schedule that reconciles the expenses in the cash working capital to the expenses in MERC's test year income statement.[721]

---

717 Ex. 19 at 32 (S. DeMerritt Direct).

718 Ex. 19 at 8, 33-40 and Schedule (SSD-21) (S. DeMerritt Direct).

719 Ex. 217 at 50-52 (M. St. Pierre Direct); Ex. 218 at Schedules (MAS-8, MAS-8a) (Attachments to M. St. Pierre Direct).

720 Ex. 24 at 12-13 and Schedule (SSD-4) (S. DeMerritt Rebuttal).

721 Ex. 24 at 12 (S. DeMerritt Rebuttal); ~~.~~Ex. 217 at 50-51 (M. St. Pierre Direct); Ex. 219 at 42 (M. St. Pierre Surrebuttal).

~~303.~~491. MERC also agreed with the Department's recommendation that in future rate cases MERC's cash working capital schedule be based on number of days, rather than percentages.[722]

~~304.~~492. The ALJ finds that MERC's Test Year Working Capital adjustment should be adjusted pursuant to the Department's Direct Testimony and MERC must recalculate the adjustment once the other items in the revenue deficiency calculation are resolved.

~~SS.~~RR. Intervenor Constellation Issues

~~305.~~493. Intervenor Constellation New Energy – Gas Division, LLC ("Constellation") expressed concern that firm customers are curtailed before all interruptible customers are curtailed. In addition, Constellation requested either confirmation or clarification that gas should be allowed to flow to interruptible customers at any city gate where there are no delivery or pressure problems even though there could be problems downstream at another city gate that would require firm service to be partially curtailed.[723]

~~306.~~494. MERC explained that Constellation referenced a one-time occurrence and that MERC followed the priority of service as shown in its tariff on 1st Revised Sheet No. 8.41 during that occurrence. MERC declined to confirm Constellation's statement regarding the flow of gas to any city gate. MERC is responsible for providing safe and reliable service to its customers. If, in MERC's opinion, it is necessary to curtail upstream customers to protect service to those downstream, MERC believes it is the Company's right and obligation to protect the reliability of services to all customers pursuant to the tariff requirement. MERC, by default, becomes the provider of service when a customer's or broker's gas does not show up at the city gate.[724]

~~307.~~495. Constellation stated that MERC has no process for reconciling between the interstate pipeline and MERC's distribution system for a customer's firm capacity purchases. Constellation suggested that MERC, upon demand of a customer or a customer's broker, be required to reconcile these differences once each year before the start of the heating season, possibly by October 1 of each year.

~~308.~~496. MERC agreed with Constellation's recommendation with modifications. MERC noted that the Company relies on customers or the customer's broker to provide the Company with the amount of purchased firm capacity on the interstate pipeline and Constellation had not provided such a list to MERC during the past two to three years. MERC expressed its preference that this be an annual process between MERC and the customers and brokers instead of this occurring only on the demand of the customer or broker. MERC prefers that customers and brokers share this information with MERC no later than

[722] Ex. 24 at 12 (S. DeMerritt Rebuttal). Ex. 217 at 51 (M. St. Pierre Direct); Ex. 219 at 42 (M. St. Pierre Surrebuttal).

[723] *See generally* Ex. 125 (R. Haubensak Direct).

[724] Ex. 42 at 14-15 (G. Walters Rebuttal).

August 1 of each year in order for MERC to complete the necessary evaluation of its distribution system prior to the start of the heating season.[725]

~~TT.~~SS. Uncontested Adjustments

~~309.~~497. MERC filed testimony as part of its application on a number of uncontested financial matters involving various adjustments to the test year. The findings above describe the areas where parties who audited MERC's filing had issues with the treatment of certain amounts and expenses in MERC's filing. No party filed testimony challenging any other aspects of MERC's financial filings. As a result, the uncontested portions of MERC's filing should be approved.

~~UU.~~TT. Revenue Requirements Summary

~~310.~~498. With the adjustments to rate base and test year operating expenses and revenues agreed to by the parties through the course of testimony exchanged in this proceeding, MERC calculates the gross revenue deficiency to be $12,159,454.[726] The Department calculates the gross revenue deficiency to be $~~3,480,421~~3,330,164.[727]

~~311.~~499. These numbers are approximate, and because of the changes from the initial filing, the numbers need to be recalculated to reflect the agreement of the parties as to certain issues and the recommended return on common equity established in these findings. As a result, while an estimated figure is provided in these findings, the concepts embodied in these findings should govern. The Commission is in a better position to produce a final calculation of the revenue deficiencies once it makes its final determination in this case.

IV. Conservation Improvement Program and Cost Recovery Mechanisms

Resolved: MERC and DOC agree on the amount of the CIP expense: MERC agreed with the Department to increase its CIP expense by $475,941, from $8,920,481 to $9,396,422, to include the correct test year CIP expense amount. Ex. 219 at 11 (M. St. Pierre Surrebuttal).

Resolved: DOC and MERC agree that MERC should be required to update, at the time of final rates, its CIP tracker carrying charge based on the overall rate of return approved in this general rate case; MERC should report in its final rates compliance filing the calculation of the CCRC rate based on the Commission's Order; and MERC should change the CCRC rate at the beginning of interim rates and again at final rates in future rate cases. Ex. 219 at 13–14 (M. St. Pierre Surrebuttal). Ex. 217 at 15–17 (M. St. Pierre Direct).

---

[725] Ex. 42 at 16-17 (G. Walters Rebuttal).

[726] Ex. 24 at 30 (S. DeMerritt Rebuttal).

[727] Department Summary of Issues at Schedule 3 (Dec. 14, 2011) (Doc. ID No. 20146-100192-01).

Disputed: MERC disagreed with DOC's recommendation that MERC be required to increase Natural Gas Revenue by $3,758,090 for CIP revenue. Ex. 217 at 15 (M. St. Pierre Direct); Ex. 219 at 11–19 (M. St. Pierre Surrebuttal).

Resolved: DOC and MERC agree that the Commission should require MERC to: (a) credit the CIP tracker for uncollected amounts from July 2006 through December 2013 before Northshore Mining's CIP exemption was effective January 1, 21 2014; (b) add a carrying charge on the credit balance of Northshore Mining's unrecovered CIP at the Company's approved overall rate of return during the period July 2006 through December 2013; and (c) report the unrecovered CIP information in its final rates compliance filing. Ex. 219 at 20–21 (M. St. Pierre Surrebuttal).

~~III.~~

~~312.~~500. MERC has an approved CIP on file with the Department of Commerce.[728]

~~313.~~501. The legislature requires utilities to make certain CIP expenditures pursuant to Minn. Stat. § 216B.241, and it has established a requirement for cost recovery of these expenses in utility rates. Minn. Stat. § 216B.16, subd. 6b, mandates recovery of CIP expenses in utility rates, and allows a public utility to file rate schedules providing for annual recovery of the cost of CIP programs.

~~314.~~502. Specifically, Minn. Stat. § 216B.16, subd. 6b(a) allows utilities to recover costs of relevant conservation improvements:

> Except as otherwise provided in this subdivision, all investments and expenses of a public utility . . . incurred in connection with energy conservation improvements shall be recognized and included by the commission in the determination of just and reasonable rates as if the investments were directly made or incurred by the utility in furnishing utility service.

~~315.~~503. In the 2010 rate case, MERC received Commission approval to update the CCRC factors for MERC to recover its annual CIP program costs. In addition MERC received Commission approval in Docket No. G007,011/GR-08-835 to implement a Conservation Cost Recovery Adjustment ("CCRA") factor to recover the amount by which actual CIP expenditures are different from the amount recovered through the CCRC factor plus the amount of any Commission-approved CIP financial incentive on an annual basis.[729]

504. The Commission initially set the CCRA factors for MERC-NMU and MERC-PNG at $0.0000 per therm. MERC's request to update the CCRA factors set in the last rate case was approved by the Commission in G011/M-10-407 and G007/M-10-409 on October 11, 2010. The current CCRA factor is $~~0.0000~~0.02715 per therm for MERC-NMU

[728] Ex. 19 at 41 (S. DeMerritt Direct); Ex. 217 at 12 (M. St. Pierre Direct).

[729] Ex. 19 at 41-42 (S. DeMerritt Direct).

and $0.0420~~0~~0.01719 for MERC-PNG. The Commission approved a CCRA of $0.00475 for MERC-NMU effective January 1, 2014.[730]

~~316.~~505. MERC stopped collecting the CCRA factor for NMU customers effective with May 2014 billing because the MERC-NMU CIP tracker balance reached zero. On May 1, 2014, MERC proposed a consolidated CCRA factor of $0.00148 to be effective January 1, 2015. The Commission has yet to issue and Order approving MERC's proposed consolidated CCRA factor.[731]

A. CIP Tracker Account Balances

~~317.~~506. MERC stated that, ~~B~~based on Department recommendations related to test year CIP expenses, MERC determined that a slight adjustment will need to be made to the CIP tracker at the time of final rates. Currently, in interim rates, MERC is collecting revenue from customers and crediting the CIP tracker balance at MERC's filed CCRC of $0.02432. If MERC's CCRC of $0.02462, as recommended in MERC's Rebuttal Testimony, is approved in this proceeding, MERC will have under-collected CIP expense during the time frame that the Company's interim rates were in effect. In the event that a CCRC of $0.02462 is approved and MERC has under-collected CIP expense, MERC recommends crediting the CIP tracker balance (Account No. 182705) by $0.00030 ($0.02462 - $0.02432) x actual sales during the period interim rates were in effect, and debiting the CIP Amortization account (Account No. 407710) for this same amount. This adjustment would increase MERC's CIP expenses that should have been recognized during interim rates, which would be offset by a lower refund to customers because of the higher revenue requirement generated by the increased CIP expenses.[732]

~~318.~~507. The Department concluded that MERC's request to credit the CIP tracker balance in the event MERC under collects CIP expense during interim rates is reasonable.[733] DOC and MERC agreed that MERC should be required to update, at the time of final rates, its CIP tracker carrying charge based on the overall rate of return approved in this general rate case; MERC should report in its final rates compliance filing the calculation of the CCRC rate based on the Commission's Order; and MERC should change the CCRC rate at the beginning of interim rates and again at final rates.[734]

~~319.~~508. The ALJ finds that MERC's request to credit the CIP tracker balance in the event MERC under collects CIP expense during interim rates is reasonable.

~~730 Ex. 19 at 42 (S. DeMerritt Direct).~~

731 ~~Ex. 19 at 42 (S. DeMerritt Direct); S~~See ~~*also*~~ Docket No. G011/M-14-369 (2013 Consolidated CIP Tracker Account, DSM Financial Incentive, and Conservation Cost Recovery Adjustment).

732 Ex. 24 at 7-8 (S. DeMerritt Rebuttal).

733 Ex. 219 at 18 (M. St. Pierre Surrebuttal).

734 Ex. 219 at 13–14 (M. St. Pierre Surrebuttal). Ex. 217 at 15–17 (M. St. Pierre Direct).

B. Test Year CIP Expenses

~~320.~~509. MERC proposed to include CIP expenses in the Company's base rates via the test year in this proceeding. Initially, MERC proposed to include in the test year CIP expenses of $8,920,481~~ in rate base~~.[735] MERC did not propose to include the unamortized balance of CIP in rate base since MERC recovers a return on the balance in the CIP tracker.[736]

~~321.~~510. Department witness Ms. St. Pierre recommended that, to be consistent with the projected test year and past Commission practice, the 2014 CIP budget of $9,396,422 approved by the DOC Director in Docket No. 12-548, should be used in this rate case. This recommendation would increase CIP expense by $475,941.[737] ~~The Department recommended increasing CIP expense in this case from the $8,920,481 initially proposed by MERC to $9,396,422 to reflect approved 2014 CIP expense.~~ The Department also recommended that MERC's CCRC be recalculated based on the Commission's Order regarding the level of CIP expenses divided by the approved level of sales.[738]

511. MERC agreed to the increase in CIP expense as proposed by the Department. MERC recalculated the CCRC using the Department's recommended update to CIP expense and the CCRC-applicable sales. The CCRC factor for the purpose of final rates would be $0.02462 ($9,396,422/381,721,852), if the Commission approves MERC's Rebuttal position, for a test-year 2014 CIP program budget of $9,396,422 and CCRC applicable sales volumes of 381,721,852 therms.[739] ~~A~~The CCRC rate of $0.02462 ~~was calculated, which~~ is $0.00949 greater than MERC's CCRC approved in Docket No. G007,011/GR-10-977.[740]

512. In her Direct Testimony, Department witness Ms. St. Pierre recommended that the test-year CIP revenue also be increased to the level of CIP expense approved in the test year, to reflect that MERC will recover these costs in their CIP tracker and thus to be "revenue neutral," similar to the cost of gas, where the revenue from sale of gas is equal to the cost. By requiring the expense to be "revenue neutral" with the related revenue, any change in the expense is taken out of the revenue requirement to reflect that any difference between costs and recovery will be collected through a separate revenue mechanism. Because she had recommended using the 2014 Approved CIP budget ($9,396,422), Ms. St. Pierre also recommended that the Commission require MERC to increase Natural Gas Revenue by

---

735 Ex. 19 at 10, 41-44 and Schedule (SSD-24) (S. DeMerritt Direct).

736 Ex. 19 at 43 (S. DeMerritt Direct).

737 Ex. 217 at 14 (M. St. Pierre Direct).

738 Ex. 217 at 14, 16 (M. St. Pierre Direct); Ex. 219 at 11 (M. St. Pierre Surrebuttal).

739 Ex.24 at SSD-1 (S. DeMerritt Rebuttal).

740 Ex. 219 at 11 (St. Pierre Surrebuttal) (*citing* Ex. 24 at 6-7 (S. DeMerritt Rebuttal)).

$3,758,090 for CIP revenue.[741] The ultimate effect of the recommendation is to allow the Company to recover CIP costs in a manner similar to the base cost of gas.[742]

513. ~~The Department recommended that the test year CIP revenue be increased to the level of CIP expense approved in the test year to be revenue neutral.~~ According to the Department, in MERC's proposed rate case, the sales revenue that is related to the base cost of gas is treated differently than CIP revenue. MERC does not include the cost of gas in the revenue requirement because the test year sales revenue related to gas costs is matched to the projected gas costs rather than calculated at present rates. CIP, on the other hand, is in the revenue requirement because the test year sales revenue is calculated at present rates rather than forecasted final rates. The Department explained that a new base cost of gas rate is implemented at the beginning of a rate case and again is implemented at final rates. Also, a separate base cost filing for CIP is not required by the rules as it is for the cost of gas. Minn. Rule 7825.2700, subp. 2. The Department believes that the differences in the treatment of these two costs and revenues, both of which have riders, causes some confusion. The Department's recommendations were intended to address that issue.[743] The Department recommended using the same method for CIP costs as used for gas costs, since both cost categories have trackers that run through rate cases and subsequent to rate cases. Thus, the Department recommended that a new CCRC be implemented at the beginning of the rate case as well as at final rates. The Department recommended this approach for consistency since the more consistently that the trackers are treated, the less confusion and time that needs to be spent on auditing the tracker.[744]

514. The Department recommended increasing natural gas revenue by $3,758,090 ($3,538,432 - $256,283 + $475,941), as was shown on Ex. 218 MAS-16 (M. St. Pierre Direct). The adjustment to CIP revenue included a CIP revenue adjustment related to the Department's recommended sales forecast of $256,283, as well as an increase in CIP expense of $475,941.~~in relation to CIP expense~~.[745]

[741] Ex. 217 at 15 (M. St. Pierre Direct).

[742] MERC disagreed with the Department's CIP revenue adjustment, stating that "By imputing CIP revenues of $3,758,090 to offset the increase in CIP expense, Ms. St. Pierre is effectively reducing MERC's revenue requirement based on revenue that will never be collected." Ex. 24 at 5 (DeMerritt Rebuttal). In her Surrebuttal, Ms. St. Pierre explained that she imputed CIP revenues to offset the increase in CIP expense. This adjustment is needed and reasonable, because, to be revenue neutral, the test-year CIP revenue must be equal to the test year CIP expense. Because MERC's CIP revenue was less than its CIP costs, MERC's proposed test-year deficiency of approximately $14 million included $3,538,432 or approximately 25 percent for CIP costs. Ms. St. Pierre explained that, "[b]y requiring the expense to be "revenue neutral" with the related revenue, any change in the expense is taken out of the revenue requirement." Ex. 217 at 15 (M. St. Pierre Direct). Her recommendation is to account for the change in the Conservation Cost Recovery Charge (CCRC), similar to how the cost of gas is accounted for in base rates since both the cost of gas and CIP costs are in trackers. Ex. 219 at 12–13 (M. St. Pierre Surrebuttal).

[743] Ex. 219 at 13 (M. St. Pierre Surrebuttal).

[744] Ex. 219 at 13–14 (M. St. Pierre Surrebuttal).

[745] Ex. 217 at 15 (M. St. Pierre Direct); Ex. 219 at 12-145 (M. St. Pierre Surrebuttal).

515. MERC disagreed with the Department's recommendation based on what appears to be a misunderstanding by MERC that the Company would not be able to collect CIP costs through the CIP tracker and CCRA. MERC believes that, b~~B~~y imputing CIP revenues of $3,758,090 to offset the increase in CIP expense, the Department effectively reduced MERC's revenue requirement based on revenue that will never be collected.[746] At the evidentiary hearing, MERC explained that the Department's recommended increase incorrectly lowers the revenue deficiency while the expenses related to CIP actually increases. In other words, MERC believes that the Department is recommending an overall rate increase of $3.3 million, while CIP expenses alone are increasing $3.8 million. This would have ~~has~~ the effect of reducing rates $500,000 for all of MERC's other costs included in this case.[747]

516. The Department disagreed~~s~~ that its recommendation has the effect of reducing rates $500,000 for all of MERC's other costs included in this case. The Department's recommendation would lower the revenue deficiency but a corresponding amount would be included in the CCRA. In other words, the Department's recommendation would remove CIP from the Distribution rate but include the final approved CIP rate in the CCRA on the customer's bill. Nothing requires that the CCRA be included in the Distribution rate. Moreover, including all CIP on one line item on the bill is more transparent as to how much CIP costs. Currently, MERC's residential bill includes the following categories:

- Customer Charge (the fixed portion of base rates);
- Distribution Charge (the volumetric portion of base rates including the CCRC);
- Base Gas Cost (rate included in the test year);
- Cost of Gas (the monthly PGA adjustment); and
- MERC CCRA (the CIP adjustment filed between rate cases).

~~322.~~517. Thus, under the Department's recommendation, all CIP would be recovered on one line item on the bill (MERC CCRA). Alternatively, a new line item on the bill titled "Base CIP Cost" to reflect that it is similar to the Base Gas Cost would also be appropriate. This new line item would include only the CCRC and MERC CCRA would include only the CIP adjustments.

~~323.~~518. Because MERC has increased CIP recovery since the beginning of interim rates and, at the end of the rate case, when final rates are implemented, the CCRC factor would change to reflect the Commission's Order on CIP expenses and CIP-related sales, the Department disagreed that MERC would never collect the revenue.[748]

~~324.~~519. ~~Based on subsequent discussions between MERC and the Department following the submission of the Department's Direct Testimony,~~ MERC stated that it believed ~~understood~~ that the Department's ultimate goal was to remove the CCRC from base rates completely, thereby allowing all CIP expenses to flow through the CCRA.[749] The Department

[746] Ex. 24 at 5-8, 13-14 and Schedule (SSD-2) (S. DeMerritt Rebuttal).

[747] Evidentiary Hearing Transcript (May 13, 2014) at 23 (S. DeMerritt) (Doc. ID 20145-99937-01).

[748] Ex. 219 at 14 (M. St. Pierre Surrebuttal).

[749] Ex. 24 at 6 (DeMerritt Rebuttal).

indicated that this is an incorrect understanding; rather, the recommendation was to set the CIP revenue equal to the CIP expense in the rate case so that final rates would include CIP revenue and CIP costs of $9,396,422. It is more accurate to state that the Department is proposing to treat CIP costs similarly to gas costs. Ms. St. Pierre stated that "MERC does not include the cost of gas in the revenue requirement because the test-year sales revenue related to gas costs is matched to the projected gas costs rather than calculated at present rates."[750] Similarly, she recommended ~~In order to accomplish this, MERC understood the Department to propose~~ that MERC remove all CIP expenses from the revenue deficiency.[751] Ms. St. Pierre further explained that, in the same way that gas expenses are "removed" from the determination of the revenue deficiency, MERC would recover CIP expenses other than via the revenue deficiency in the rate case.[752] The proposal was to adjust CIP revenues to match CIP expenses in the test year. The Department stated that this approach is reasonable and similar to the treatment of the base cost of gas. Further, the CCRA would continue to be adjusted between rate cases if needed to ensure that MERC is allowed to recover any under-recoveries and refund any over-recoveries.[753] MERC would then seek recovery for any under-collection of CIP expenses via a separate docket filed for the CCRA.[754]

~~325.~~520. MERC testified that it would not be opposed to this approach provided that the dockets related to the CCRA are finalized and an order is issued in a timely fashion. In addition, if changing the CCRC to $0.00000 were to occur in the current docket, MERC would request that its currently recommended CCRC of $0.02462 be added to the CCRA on January 1, 2015, or with implementation of final rates, whichever occurs later, so as not to delay the recovery of these expenses.[755]

~~326.~~521. ~~In Surrebuttal Testimony, the Department stated that its recommendation is not to remove the CCRC from base rates completely, thereby allowing all CIP expenses to flow through the CCRA. Rather, t~~The Department's recommendation is to set the CIP revenue equal to the CIP expense so that final rates would include CIP revenue and CIP costs of $9,396,422.[756] ~~In the alternative, the Department suggested that MERC could remove CIP completely from base rates, so total CIP revenue and total CIP expenses would both be set at~~

---

[750] Ex. 219 at 13 (M. St. Pierre Surrebuttal).

[751] Ex. 219 at 14 (M. St. Pierre Surrebuttal) (*citing* Ex. 24 at 6:7–8 (S. DeMerritt Rebuttal)).

[752] *Id.* at 15. The Department explained that the difference between total CIP revenue and total CIP expenses is what is included in the revenue deficiency that forms the basis of the rate increase. MERC's filing included a revenue deficiency of $3,538,432 related to CIP expenses (CIP revenue of $5,382,049 minus CIP expenses of $8,920,481). Since CIP costs increased, the CCRC set at the end of the rate case will also increase. *Id.*

[753] *Id.*

[754] Ex. 24 at 6 (S. DeMerritt Rebuttal).

[755] Ex. 24 at 6 and Schedule (SSD-1) (S. DeMerritt Rebuttal).

[756] Ex. 219 at 14 (M. St. Pierre Surrebuttal). In the alternative, the Department suggested that MERC could remove CIP completely from base rates, so total CIP revenue and total CIP expenses would both be set at zero for present rates, interim rates, and final rates. Although MERC stated that it would not be opposed to this approach, the Department does not recommend this method because it is easier to understand and accept if the CCRC is determined similar to the way that base cost of gas is determined. Ex. 219 at 14-16 (M. St. Pierre Surrebuttal).

~~zero for present rates, interim rates, and final rates. Although MERC stated that it would not be opposed to this approach, the Department does not recommend this method because it is easier to understand and accept if the CCRC is determined similar to the way that base cost of gas is determined.~~[757] The Department's recommended method essentially takes the CCRC out of the Distribution Rate[758] and sets the CCRC rate at zero. Further, the Department's recommendation would add the CCRC to the CCRA. Thus, the Department agrees with MERC that the CCRC should be added to the CCRA on January 1, 2015, or with implementation of final rates, whichever occurs later.

522. The ALJ finds that MERC should increase CIP expense by $475,941;

~~327.~~523. The ALJ finds that the Department's proposed adjustment to revenue based on MERC's updated CIP expense ~~would not be revenue neutral and~~ is ~~not~~ justified, MERC should be required to increase Natural Gas Revenue by $3,758,090 for CIP revenue, and the CCRC should be added to the CCRA on January 1, 2015, or with implementation of final rates, whichever occurs later. ~~The~~ Additionally, the ALJ concludes that MERC's proposed CIP expense of $9,396,422 should be accepted.

C. Carrying Charges for CIP Tracker Accounts

~~328.~~524. MERC proposes a carrying charge equal to the overall rate of return approved in the instant case.[759]

~~329.~~525. The Department recommended that MERC update its CIP tracker carrying charge to the rate of return that is approved in this general rate case.[760]

~~330.~~526. MERC agreed with the Department's recommendation.[761]

~~331.~~527. The ALJ finds that the Commission should require MERC~~'s proposed~~ to update the carrying charge used in the CIP tracker to the rate of return approved ~~is appropriate~~ in this rate case.

D. CIP Exempt Customers and Uncollected CIP Revenues

~~332.~~528. A "CIP-exempt customer" is a customer that has been granted an exemption by the Commissioner of the Department from paying for, or participating in, the CIP projects offered by the utility providing retail electric or gas service to that facility, pursuant to Minn. Stat. § 216B.241.

~~757 Ex. 219 at 15-16 (M. St. Pierre Surrebuttal).~~

758 Both the "Distribution Rate" and Customer Charge are a component of the "Base Rate."

759 Ex. 19 at 43 (S. DeMerritt Direct).

760 Ex. 217 at 15 (M. St. Pierre Direct).

761 Ex. 24 at 13 (S. DeMerritt Rebuttal).

529. MERC recently discovered that a significant Taconite customer, Northshore Mining, has, in error, been continuously treated as exempt from the CIP charges dating back at least to the days of Aquila's gas operations (MERC's predecessor). Upon discovery of this error, MERC notified Northshore and Northshore applied for a CIP exemption. MERC will absorb this under recovery and not seek the one-year back payment of CIP charges allowed by the billing error rules. Northshore is a SLV transportation customer whose gas is directly supplied by Northern Natural Gas's interstate pipeline. Accordingly, Northshore is a very serious bypass threat. MERC prepared the test year CIP schedules assuming Northshore would be granted an exemption.[762]

~~333.~~530. In MERC's last rate case the Company also failed to collect CIP charges from three of its non-exempt customers and the Commission required MERC to credit its CIP tracker for uncollected amounts going back to July 2006, when MERC acquired Aquila's assets. The Commission stated that on that date, MERC had the obligation to identify and correct the billing error.[763] The Commission agreed with the Department's recommendation that MERC needed not include a carrying charge in its CIP tracker credit.[764] Department witness Mr. Bryan Minder's recommendation was based on the fact that MERC brought the issue forward.[765]

~~334.~~531. The Department noted that Northshore's CIP petition for exemption was granted effective January 1, 2014.[766] The Department recommended a one-time carrying charge be applied to the unrecovered CIP balance. For the carrying charge rate, the Department recommended use of MERC's approved overall rate of return in effect during the period of under collection (July 2006 through December 2013). The Department recommended that the Commission require MERC to credit the CIP tracker for uncollected amounts (CCRC and CCRA) from July 2006 through December 2013 before Northshore's CIP exemption was effective January 1, 2014. The Department also recommended that the Commission require MERC to report this information in its final rates compliance filing in the present docket.[767]

~~335.~~532. MERC agreed with the Department's recommendations.[768]

~~336.~~533. At the evidentiary hearing, MERC reiterated that it would absorb this under recovery and not seek the one-year back payment of CIP charges allowed by the billing error rules. MERC also confirmed that the Company is analyzing the situation by going back

762 Ex. 19 at 44 (S. DeMerritt Direct); Evidentiary Hearing Transcript (May 13, 2014) at 35-36 (S. DeMerritt) (Doc. ID No. 20145-99937-01).

763 *MERC 2010 Order* at 38.

764 *MERC 2010 Order* at 38.

765 GR-10-977, DOC Ex. 104 at 21 (Minder Direct).

766 Ex. 217 at 19 (M. St. Pierre Direct);~~.~~ *ITMO the Petition of Northshore Mining for Conservation Improvement Program Exemption* (*Northshore 2013 Order*), Docket Nos. E015/CIP-13-852 and G011/CIP-13-853, Decision at 5 (Dec. 20, 2013).

767 Ex. 217 at 20-21 (M. St. Pierre Direct).

768 Ex. 24 at 8, 13-14 (S. DeMerritt Rebuttal).

and reviewing its similarly-situated customers that could be CIP exempt, as well as making sure it more clearly identifies the customers that are CIP exempt to prevent this situation from happening again.[769]

~~337.~~534. The ALJ finds that, given MERC's willingness to absorb the under-recovery related to Northshore, credit the CIP tracker for the uncollected amounts and continue to improve the Company's billing system to properly identify CIP exempt customers, the Commission should approve MERC's approach to uncollected CIP expense in this rate case.

E. Calculation of Conservation Cost Recovery Charge ("CCRC")

~~338.~~535. In MERC's last rate case, MERC inputted revenues to offset the increase in CIP expense due to an increased CCRC for interim rate purposes. This created a revenue neutral effect in interim rates for purposes of the increased CCRC, but created confusion among the parties. Therefore, prior to this current rate case, MERC contacted Commission staff to work on how to address the increase in the CCRC in interim rates. Commission staff gave the guidance that MERC should include the increased expense in the interim rate calculation, so that is the approach that MERC took in this current docket.[770]

~~339.~~ MERC initially proposed a CCRC of $0.02432 per therm.[771] ~~In addition, MERC agreed to credit the CIP tracker inclusive of carrying charges related to the Northshore Mining issue.[772]~~

~~340.~~536. The Department initially expressed concern that MERC had not changed its CCRC factor to reflect the CIP recovery from interim rates.[773] The Department recommended MERC update the CCRC rate based on the Commission order in MERC's final rates compliance filing, and recommended that MERC do so at the beginning of interim rates and again at final rates in future rate cases.[774] The Department explained that this approach would keep the tracker in sync with the change in interim rates as well as for final rates, and is an approach that is similar to the methodology used for the base cost of gas.[775]

769 Evidentiary Hearing Transcript (May 13, 2014) at 36-37 (S. DeMerritt) (Doc. ID No. 20145-99937-01).

770 Ex. 19 at 44 (S. DeMerritt Direct).

771 Ex. 19 at Schedule (SSD-24) (S. DeMerritt Direct).

~~772 Ex. 24 at 8 (S. DeMerritt Rebuttal).~~

773 Ex. 217 at 16 (St. Pierre Direct).

774 Ex. 217 at 17 (St. Pierre Direct); Ex. 219 at 17 (M. St. Pierre Surrebuttal).

775 Ex. 219 at 17 (M. St. Pierre Surrebuttal).

537. MERC agreed with the Department's recommendation.[776] In particular, MERC noted that it has already updated the CCRC rate for interim rate and has recognized the increased CIP amortization expense associated with the higher rate that is being collected in the Company's current revenues.

538. The Department also recommended that, at the time of final rates in this proceeding, the Commission require MERC to update, at the time of final rates, its CIP tracker carrying charge based on the overall rate of return approved in this general rate case; and, to report in its final rates compliance filing, the calculation of the CCRC rate based on the Commission's Order regarding the level of CIP expenses divided by the approved level of sales.[777] MERC agreed to these recommendations.[778]

~~341.~~ MERC ~~is willing~~also proposed to update the CCRC in final rates based on the higher CIP expense and change in sales forecast from filing, along with making an adjustment to the CIP tracker balance (expense Account 182705) ~~adjustment~~ for any under recovery during interim rates in the event that the Commission approves an increase in the CCRC factor above the interim rate for CCRC .[779] The Department agreed that this is a reasonable proposal, explaining that, if no adjustment was made to the CIP tracker balance at the time of final rates then a subsequent true up of the tracker balance would take into account the under-recovery.[780] Also, a request by MERC to adjust the CIP tracker balance based on recovery during the interim rate period would be reviewed in the final compliance filing for the rate case, when all adjustments to the refund plan are scrutinized.[781]

539. In Surrebuttal Testimony, the Department concluded that MERC had provided evidence to show that the Company increased its CCRC factor when interim rates were implemented on January 1, 2014.[782]

~~342.~~540. In addition, MERC agreed to credit the CIP tracker inclusive of carrying charges related to the Northshore Mining issue "well over a million dollars."[783] The credit

[776] Ex. 24 at 13 (S. DeMerritt Rebuttal). (Mr. DeMerritt stated: MERC has already updated the CCRC rate for interim rates and has recognized the increased CIP amortization expense associated with the higher rates that is being collected in the Company's current revenues, as can be seen in Rebuttal Exhibit [24] (SSD-2). MERC is willing to update the CCRC in final rates based on the higher CIP expense and change in sales forecast from filing, along with making a CIP tracker balance adjustment.)

[777] Ex. 217 at 15–16 (M. St. Pierre Direct).

[778] Ex. 24 at 13 (S. DeMerritt Rebuttal)

[779] Ex. 24 at 7-8, 13 and Schedule (SSD-2) (S. DeMerritt Rebuttal).

[780] CenterPoint Energy made a similar adjustment in its 2008 general rate case compliance filing. *CenterPoint Energy 2008 Rate Case,* Docket No. G008/GR-08-1075, Correspondence, filed July 26, 2010, Attachment A at 6 (CIP Tracker True-up, Final Rates for Test Year).

[781] Ex. 219 at 18 (M. St. Pierre Surrebuttal).

[782] Ex. 219 at 16 (M. St. Pierre Surrebuttal).

[783] Ex. 24 at 8 (S. DeMerritt Rebuttal). Tr. 36 (S. DeMerritt).

would be to MERC's Consolidated CIP Tracker since MERC-PNG's CIP tracker is projected to be reduced to a zero balance by the end of November 2014.[784]

541. The CCRC factor for the purpose of final rates would be $0.02462 ($9,396,422/381,721,852), if the Commission approves MERC's Rebuttal position, for a test-year 2014 CIP program budget of $9,396,422 and CCRC applicable sales volumes of 381,721,852 therms.[785]

542. The ALJ finds that MERC's CCRC is reasonable and should be approved, contingent on MERC updating the CCRC in final rates and making a CIP tracker balance adjustment. MERC should report in its final rates compliance filing the calculation of the CCRC rate based on the Commission's Order, with respect to the level of CIP expenses divided by the level of sales approved by the Commission. The ALJ also finds that all CIP would be recovered on one line item on the bill (MERC CCRA).

~~343.~~543. The ALJ finds that in MERC's future general rate-case filings, the Commission should require MERC to change the CCRC rate at the beginning of interim rates and again at final rates.

F. Responses to Commission Requests for Additional Information

~~344.~~544. In the Commission's November 27, 2013, Notice and Order for Hearing, the Commission asked MERC to address various CIP items in further detail. Accordingly, MERC provides information regarding the Commission's questions related to CIP and associated rates, as well as the effect of an updated sales forecast and commodity pricing forecast on the demand and commodity cost of gas rates.[786]

~~345.~~545. The Commission asked MERC for the following information:

- A calculation of the CCRC and the CCRA charge since the inception of MERC's ownership;
- The applicable Northshore volumes, CCRC and CCRA rates, and CCRC and CCRA amounts, by month, for the period July 2006 through December 31, 2013;
- Information on the adequacy of the Vertex billing audit with respect to finding CIP-related and other billing errors;

---

[784] Docket No. G011/M-14-369, *Petition for Approval of MERC's 2013 Consolidated CIP Tracker Account, DSM Financial Incentive, and Conservation Cost Recovery Adjustment (CCRA)* dated May 1, 2014, at Attachment C, fn. 1.

[785] Ex.24 at SSD-1 (S. DeMerritt Rebuttal).

[786] Ex. 21 at 2 (S. DeMerritt Supplemental Direct); Ex. 22 at Schedules (SSD-1 through SSD-3) (Exhibits to S. DeMerritt Supplemental Direct).

- Information on the tracking and handling of CIP expenses in the development of the test year operating expenses; and

- The potential impact of updated sales and forecast and commodity pricing forecast updates on the demand and commodity cost of gas rates.[787]

~~346.~~ 546. The calculations for the CCRC and CCRA since the inception of ownership of MERC by Integrys are provided in MERC witness Seth DeMerritt's Supplemental Direct Exhibit SSD-1.[788]

~~347.~~ 547. The volumes for Northshore, the CCRC and CCRA rates and amounts, by month, from July 2006 through December 2013 are provided in Mr. DeMerritt's Supplemental Direct Exhibit SSD-2.[789]

~~348.~~ 548. Regarding the Vertex audit, as indicated in the May 1, 2013 briefing papers filed in Docket No. G007,011/GR-10-977, MERC worked with the Department and the OAG on a Statement of Work ("SOW") related to an audit of the Vertex billing system. No audit tests specifically related to CIP issues were explicitly identified in the SOW. Thus, to the extent that any billing errors related to CIP were not discovered in the audit process, no specific CIP issues were specifically sought out. The results of the billing audit were submitted on October 12, 2012 with no significant issues, but MERC did note that the revenue deficiency in Docket G007,011/GR-10-977 would have been reduced by $9,710. In accordance with Commission Order, MERC has reduced the revenue deficiency in this current docket by that amount inclusive of carrying charges.[790]

~~349.~~ 549. Regarding MERC's tracking and handling of CIP expenses in the development of the test year operating expenses, the test year operating expenses included in the test year for CIP were the 2013 expenses approved in Docket No. G007,011/CIP-12-548. Per MERC's response to Department Information Request 105, MERC more appropriately should have used the 2014 proposed CIP expenses in developing the test year operating expenses.[791]

~~350.~~ 550. Regarding the potential impact of updated sales and forecast and commodity pricing forecast updates on the demand and commodity cost of gas rates, historically any change in the sales forecast has not had an effect on the demand or commodity gas rates within a rate case proceeding. To the extent that commodity pricing was

---

787 Ex. 21 at 3 (S. DeMerritt Supplemental Direct).

788 Ex. 21 at 3 (S. DeMerritt Supplemental Direct); Ex. 23 at Schedule (SSD-1) (Exhibits to S. DeMerritt Supplemental Direct).

789 Ex. 21 at 4 (S. DeMerritt Supplemental Direct); Ex. 23 at Schedule (SSD-2) (Exhibits to S. DeMerritt Supplemental Direct).

790 Ex. 21 at 4 (S. DeMerritt Supplemental Direct).

791 Ex. 21 at 4-5 (S. DeMerritt Supplemental Direct); Ex. 23 at Schedule (SSD-3) (Exhibits to S. DeMerritt Supplemental Direct).

changed, the associated commodity gas rates were adjusted accordingly, with no change to the demand rates.[792]

~~IV.~~V. RATE DESIGN

~~351.~~551. In the rate design portion of a general rate case, the Commission determines what portion of the revenue requirement should be met by the various customer classes that receive service from the utility company. This division of responsibility for producing the required revenues among the customer classes is called revenue apportionment. In addition to revenue apportionment, the Commission considers how to design the rates within each customer class to collect the amount of revenue that has been apportioned to that class.

~~352.~~552. As a starting point, the Commission utilizes an analysis of the class cost of service, which evaluates both the cost imposed by each customer class as a whole, and also determines the cost of each relevant component of service that is separately charged by the Company's tariffs.

~~353.~~553. In the rate design phase of the proceeding, the Commission considers cost, as well as other non-cost factors, in designing final rates for the utility. These rates must be designed to recover the revenue requirement that has been determined for the utility, and thus when non-cost factors are applied to reduce a rate for one class, the revenues need to be collected in some manner from other customer classes. Similarly, when different types of costs imposed by one class of customers are not recognized in one part of that customer class's rates, those costs must then be recovered by other components of that customer class's rates.

A. Class Cost of Service Study

~~354.~~554. The purpose of a Class Cost of Service Study ("CCOSS") is to identify the revenues, costs and profitability for each class of service, as required by Minn. R. 7825.4300(C). The CCOSS analysis should result in an appropriate allocation of the utility's total revenue requirement among the various customer classes.[793]

~~355.~~555. In its initial filing, MERC presented its CCOSS for the entire Minnesota service territory. This CCOSS applied general principles of cost allocation from both the National Association of Regulatory Utility Commissioners ("NARUC") and the American Gas Association ("AGA") to arrive at estimated costs of service for the various customer classes and individual components of cost within each customer class.[794]

---

792 Ex. 21 at 5 (S. DeMerritt Supplemental Direct).

793 Ex. 29 at 5 (J. Hoffman Malueg Direct).

794 Ex. 29 at 7 (J. Hoffman Malueg Direct).

~~356.~~556. Based on MERC's CCOSS, the Company determined that 68.3 percent of its distribution mains should be classified as customer costs and 31.7 percent should be classified as demand costs.[795]

~~357.~~557. The OAG-AUD reviewed the CCOSS filed by MERC and concluded that MERC's zero-intercept analysis violated multiple econometric assumptions that resulted in MERC incorrectly estimating its Mains account distributions. The OAG-AUD recommended that the Commission disregard MERC's zero-intercept analysis and require the Company to improve its model in the next rate case.[796] In addition, the OAG-AUD recommended a 30 percent customer classification for the Mains account and that MERC make the following changes to the Company's zero-intercept study:

- Take into account more variables;
- Maintain data at the project level;
- Do not aggregate or average data; and
- Change the percentages used to classify MERC's distribution mains (based partially on the results of a zero-intercept study the OAG-AUD performed and partially on the results of other zero-intercept studies of other utility companies in other states).[797]

The OAG-AUD acknowledged that the CCOSS is a subjective tool but focused its attention on the classification of the Distribution mains account because it is MERC's largest investment in the Company's entire distribution plant.[798]

~~358.~~558. MERC disagreed with the OAG's recommendations. The OAG-AUD's calculations are based on a theoretical, not realistic, equation and MERC already considers many of the variables recommended by the OAG-AUD in the Company's zero-intercept analysis. Those variables that were not included were omitted due to limited data availability.[799] Maintaining data at the project level simply for purposes of a rate case zero-intercept study is neither practical nor cost justified. Gathering of MERC's historical distribution main data would be time-intensive and/or would require MERC to invest in costly Information Technology assets. MERC has not been required to maintain this level of detail information in the past nor, to MERC's knowledge, is its collection required of other Minnesota utilities, a point which the OAG-AUD concedes.[800] Despite the OAG-AUD's statement that project level data is collected by other Minnesota utilities, the OAG-AUD was

[795] Ex. 30 at 19 (J. Hoffman Malueg Rebuttal).

[796] Ex. 155 at 34 (R. Nelson Direct).

[797] Ex. 155 at 2-3, 16, 34-36 (R. Nelson Direct).

[798] Ex. 155 at 5-6 (R. Nelson Direct).

[799] Ex. 30 at 4-9 (J. Hoffman Malueg Rebuttal).

[800] Ex. 30 at 5-13 (J. Hoffman Malueg Rebuttal); Ex. 158 at 6 (R. Nelson Surrebuttal).

only able to identify one Minnesota utility, CenterPoint Energy, which collects the type of data the OAG-AUD considers to be project level data.[801]

~~359.~~559. MERC conducted three minimum size studies on the Company's distribution mains. The first study, which used a 2" main as the minimum standard for installation, resulted in a distribution main classification of 74.1 percent to customer and 25.9 percent to demand. The second study, which utilized a 2" main as the minimum standard for installation, as well as aggregates pipe sizes less than 2" in diameter with the 2" sized pipes, resulted in a distribution main classification of 73.2 percent to customer and 26.8 percent to demand. These two minimum size studies demonstrated the reasonableness of the results of MERC's zero-intercept study.[802] The third minimum size study contained information from a minimum size study performed by MERC on the Company's distribution mains that did not consider MERC's minimum installation standards. The study was provided to illustrate the extreme results that can occur when minimum installation standards are not considered and illustrates why MERC views the third study as inappropriate for the current rate case.[803]

~~360.~~560. MERC disagreed with the OAG-AUD's recommendation that MERC not aggregate or average data in the Company's zero-intercept study. The OAG-AUD's recommendation is not practical given MERC's distribution main data and application of the zero-intercept study results in MERC's CCOSS. The purpose of the zero-intercept study is to provide a hypothetical zero-load or zero-sized distribution main on MERC's entire system. The end result of this analysis is then used to classify MERC's distribution mains as an entire system, separating the distribution mains between the classifications of customer and demand. NARUC's guidance is to use average unit costs when conducting a zero-intercept analysis. Finally, both the NARUC Electric Manual and the NARUC Gas Distribution Rate Design Manual state, and the OAG-AUD's own Direct Testimony implies, that the minimum size and zero-intercept analyses will have similar results and that a minimum size analysis utilizes the average cost of data. Therefore, it only makes sense that, if done properly, in order for a minimum size analysis and a zero-intercept analysis to have comparable results, both must utilize average unit cost.[804]

~~361.~~561. Based on a zero-intercept study performed by the OAG-AUD and zero-intercept analyses completed in other jurisdictions, the OAG-AUD recommended changing the classification percentages applied to MERC's distribution assets in the CCOSS to 30.0 percent customer and 70.0 percent capacity.[805]

~~362.~~562. MERC disagreed with the OAG-AUD's recommendation for a number of reasons. First, MERC properly used average unit costs in its analysis. Second, MERC properly considered MERC's standard installation practices in its analysis. MERC does not

[801] Ex. 155 at 17 (R. Nelson Direct); Ex. 158 at 6 (R. Nelson Surrebuttal).

[802] Ex. 30 at 13-17 and Schedule (JCHM-3) (J. Hoffman Malueg Rebuttal).

[803] Ex. 30 at 3 and Schedules (JCHM-1 and JCHM-4) (J. Hoffman Malueg Rebuttal).

[804] Ex. 30 at 17-19 (J. Hoffman Malueg Rebuttal).

[805] Ex. 155 at 37-40 (R. Nelson Direct); Ex. 158 at 10-12, 17-18 (R. Nelson Surrebuttal).

feel it is appropriate to conduct the zero-intercept analysis, or a minimum size analysis, without considering the current minimum installation practices. MERC's installation standards consider current industry standards and practices, safety measures, as well as what is most appropriate given MERC's service territory. Third, MERC noted that the results of MERC's third minimum size study, which MERC feels is inappropriate, produces results that are similar to the recommendations made by the OAG-AUD. Finally, MERC determined that the negative values in Exhibit REN-13 from the OAG-AUD's Direct Testimony clearly demonstrated that the results of its zero-intercept analysis are not appropriate. Contrary to the OAG-AUD's conclusions, there are fixed and variable costs associated with both plastic and steel distribution mains. Moreover, to have a negative coefficient of the size-squared variable is equivalent to stating that there is a negative-sized pipe diameter, which is an obvious error in the OAG-AUD's analysis. The OAG-AUD's choice to completely exclude steel distribution main costs from the minimum system study ignores actual installation practices. To conduct a minimum system study that does not consider that steel main can be, and is, just as much a minimum installation requirement as plastic, is erroneous.[806]

~~363.~~563. Regarding the zero-intercept analyses completed in other jurisdictions, MERC does not feel they offer a sound basis for the OAG-AUD's recommended change to the classification percentages applied to MERC's distribution mains. MERC has its own distinct service territory, comprised of its own unique customers and their associated demands, unique geographic terrain, and, accordingly, its own unique distribution system requirements on which the Company's distribution main installations have been based. For this reason, it is illogical to compare the minimum system analyses performed by other gas utilities in other parts of the nation to MERC's system analysis. In addition, individual state regulation and/or different processes or steps taken by these utilities when conducting their studies could impact the results of those studies, making them inapplicable to MERC. There is no guarantee that comparison of MERC's zero-intercept study results would be an apples-to-apples comparison to the utilities listed in the OAG-AUD's Exhibit REN-16. Thus, to rely on such a comparison, and to potentially base MERC's customer rates on the analyses, would be unsupportable and unwise.[807]

~~364.~~564. MERC's zero-intercept study is based on data that is available, complete, and relevant to the analysis. As stated in MERC's responses to the OAG-AUD's utility information request numbers 700, 702, 703, 704 and 711, the assumptions, specifications, and statistical techniques utilized by MERC in its zero-intercept study are similar to and consistent with those used by Integrys subsidiaries other than MERC.[808]

565. In light of the large ~~Based on the drastic~~ difference between the OAG-AUD's distribution main classifications and MERC's distribution main classifications, and given the questions raised by OAG-AUD regarding the reliability of MERC's and OAG-AUD's

806 Ex. 30 at 19-23 and Schedule (JCHM-4) (J. Hoffman Malueg Rebuttal).

807 Ex. 30 at 23-25 (J. Hoffman Malueg Rebuttal).

808 Evidentiary Hearing Transcript (May 13, 2014) at 68-69 (J. Hoffman Malueg) (Doc. ID No. 20145-99937-01); Ex. 32 (IR Response 700); Ex. 33 (IR Response 702); Ex. 43 (IR Response 703); Ex. 34 (IR Response 704); Ex. 35 (IR Response 711).

regression analyses for the zero-intercept method used to classify distribution mains, the Department requested that MERC use another method, the minimum size method, to classify the Company's distribution mains.[809]

566. While serving the same purpose as the zero-intercept method, the minimum size method has the added advantage that it does not rely on a regression analysis. An analyst needs to consider whether the pipe size under the minimum size method should be based upon the minimum size equipment currently installed, historically installed, or the minimum size necessary to meet safety regulations.[810]

~~365.~~567. MERC's minimum size analysis showed that at least 73 percent of the distribution mains would be classified as customer costs under the minimum size method based on two-inch pipes. In support of the reliability of its study, MERC demonstrated that a minimum sized pipe of two inches is the most appropriate pipe size to use under the minimum size method. As a result, the Department recommended no change in MERC's proposed classification of distribution mains.[811]

~~366.~~568. The Department and MERC agreed on MERC's allocation of Account 902: Meter Reading Expense.[812]

~~367.~~569. The OAG-AUD and MERC initially disagreed regarding the allocation of Account 902.[813] However, the OAG-AUD later rescinded its objection to MERC's allocation methodology.[814]

~~368.~~570. The Department and MERC agreed on MERC's allocation of Account 903: Customer Records & Collection Expense.[815]

~~369.~~571. The OAG–AUD recommended that MERC allocate Account 903 based on a weighted customer allocator.[816]

~~370.~~572. MERC disagreed with the OAG-AUD's recommendation. The allocation method recommended by the OAG-AUD is based on a customer count allocation method that is weighted by the average cost per customer for meters in each respective rate schedule. The OAG-AUD's recommendation does not provide an accurate cost causation representation. The costs in Account 903 are costs associated with labor, materials, and expenses related to

---

[809] Ex. 208 at 10-11 (S. Ouanes Rebuttal).

[810] Ex. 208 at 11 (S. Ouanes Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 195 (S. Ouanes).

[811] Ex. 208 at ~~11-~~12~~ and Schedule (~~SO-R-4~~)~~ (S. Ouanes Rebuttal).

[812] Ex. 208 at 6-8 (S. Ouanes Rebuttal).

[813] Ex. 30 at 26-31 (J. Hoffman Malueg Rebuttal); Ex. 155 at 40-43 (R. Nelson Direct).

[814] Ex. 158 at 19 (R. Nelson Surrebuttal).

[815] Ex. 208 at 8-10 (S. Ouanes Rebuttal).

[816] Ex. 155 at 3, 41-42 (R. Nelson Direct); Ex. 158 at 19-20 (R. Nelson Surrebuttal).

working on customer applications, contracts, orders, credit investigations, billing and accounting, collections, and complaints.[817]

~~371.~~573. MERC recognizes that transportation customers require more account administration and should be allocated more Account 903 costs than a sales customer. MERC incurs additional costs from its transportation customers, and appropriately allocates those costs to those customers. After removing the costs from administering MERC's transportation program, the remaining costs in Account 903 are primarily related to MERC's employment of Vertex, and external service provider, to perform MERC's customer service and billing functions for all of MERC's customers. There is no merit to the OAG-AUD's argument that other Minnesota gas utilities factor in class complexity when allocating Account 903 because Vertex charges MERC a flat, per account, rate to perform customer services and there is no difference in the flat rate charge amongst the different types of MERC customers. Even assuming the OAG-AUD is correct that using a meters weighted allocator for Account 903 is recommended by the NARUC in the NARUC gas manual, the OAG-AUD's recommendation has no merit in this case. The NARUC gas manual, while a good tool for guidance on cost of service allocations, was created in 1989, when a utility outsourcing its customer information systems function was rarely the "norm." While the NARUC Gas Manual may be appropriate for a gas utility that performs its own customer information systems and services function, it is not appropriate for MERC.[818]

~~372.~~574. MERC allocated the Company's income taxes on the basis of rate base, which was mathematically equivalent to allocating the income taxes on the basis of taxable income by class that fully and only reflects the CCOSS.[819]

575. The Department expressed only one concern with MERC's CCOSS; the Company's allocation of income taxes by class.[820] The Department determined that the proposed CCOSS appeared to allocate income taxes on the basis of rate base and agreed with the OAG-AUD that income taxes should instead be allocated on the basis of the taxable income attributable to each customer class.

576. ~~However, t~~The Department was able to verify that allocating income taxes by class on the basis of taxable income that fully and only reflects the CCOSS resulted in an allocation identical to a rate base allocation and concluded that MERC's proposed allocation of income taxes by class was reasonable under MERC's current circumstances.

~~373.~~577. Because the issues raised in this proceeding by any party (the allocation of income taxes, FERC accounts 902 and 903, and the classification of FERC account 376) were resolved between MERC and the Department, t~~T~~he Department recommended that the

[817] Ex. 30 at 32-33 (J. Hoffman Malueg Rebuttal).

[818] Ex. 30 at 33-35 (J. Hoffman Malueg Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 70-71 (J. Hoffman Malueg) (Doc. ID No. 20145-99937-01).

[819] Ex. 29 at 4 (J. Hoffman Malueg Direct); Ex. 4 Initial Filing Volume 3: Informational Requirements, Document 2, Schedules 1 and 9.

[820] Ex. 206 at 10 (S. Ouanes Direct).

Commission accept MERC's proposed CCOSS as a useful tool for the purpose of setting rates. The Department also recommended that the Commission require MERC in future rate cases to calculate and allocate income taxes by class, on the basis of taxable income by class that fully and only reflects the CCOSS.[821]

~~374.~~578. The OAG-AUD disagreed with MERC's and the Department's conclusions regarding the calculation of income taxes. The OAG-AUD expressed concern that, contrary to Commission requirements, MERC allocated the Company's income taxes to customer classes based on rate base instead of taxable income. The OAG-AUD argued that allocating income taxes by class that fully and only reflects the class cost of service study means that revenues are not considered to determine taxable income because the class cost of service study only allocates costs. The OAG-AUD recommended that MERC comply with the intent of the Commission's prior decisions and allocate income taxes for each class using the same methodology as MERC calculates income taxes for the total Minnesota jurisdiction. The OAG-AUD recommended that the approach to calculation of income taxes should be the same for total company and individual classes, i.e., income taxes should be calculated and assigned to customer classes based on taxable income for each class that reflects revenues and expenses for each class.[822] The Department was able to determine that the tax rate across customer classes was the same as the tax rate applied to the Minnesota jurisdiction.[823]

~~375.~~579. MERC does not claim that allocating income taxes based on rate base is the same as allocating on taxable income. Income taxes should be allocated on the basis of taxable income by class that fully and only reflects the CCOSS. MERC has shown through Informational Requirements Document 12, Schedule 9, that allocating income taxes on the basis of taxable income by class that fully and only reflects the CCOSS is mathematically equivalent to a proportion of rate base. MERC allocates income taxes by using the rate base allocation methodology, which the Company believes is the most appropriate allocation method. MERC did comply with the intent of prior Commission decisions. The Commission, in Docket No. G-007,011/GR-08-835, through its incorporation of the agreement between MERC and the Department required that MERC's future CCOSSs allocate income taxes on the basis of taxable income attributable to each customer class. The Department was able to verify that MERC's allocation of income taxes by class on the basis of taxable income that fully and only reflects the CCOSS results in an allocation identical to a rate base allocation under MERC's current circumstances. MERC used the same approach in its 2010 rate case. As approved by the Commission in that rate case, the Department and MERC agreed that in future rate cases, MERC allocate income taxes by class on the basis of taxable income that fully and only reflects the CCOSS.[824]

---

821 Ex. 206 at 10-13, SO-3 (S. Ouanes Direct); Ex. 208 at 5~~2-3~~, 6 (S. Ouanes Rebuttal); Ex. 209 at 4 (S. Ouanes Surrebuttal).

822 Ex. 151 at 26-28 (J. Lindell Direct); Ex. 153 at 6-9 (J. Lindell Rebuttal); Ex. 154 at 12-15 (J. Lindell Surrebuttal).

823 Ex. 208 at 4 (S. Ouanes Rebuttal).

824 Ex. 30 at 36-41 (J. Hoffman Malueg Rebuttal).

~~376.~~580. MERC supports its use of fully distributed embedded CCOSS. MERC's CCOSS fully and correctly demonstrates the embedded fixed costs of residential service. Moreover, calculating a CCOSS involves a degree of judgment and, therefore, there will not be one singularly correct CCOSS for a utility.[825]

~~377.~~581. MERC's CCOSS should be adopted in this proceeding, and used as a basis for revenue apportionment and rate design.

B. Revenue Apportionment

~~378.~~582. MERC's proposed revenue apportionment considered the following primary objectives:

- collect total revenues sufficient to allow the Company to recover its cost of operations for the test year, including a reasonable return on investment;
- reflect the cost of providing service to each customer class, as supported by the CCOSS, while giving consideration to non-cost factors where appropriate, e.g., value of service;
- provide overall revenue stability to the Company;
- encourage sound economic energy use;
- minimize cross-subsidization between rate classes;
- avoid large bill impacts or "rate shock;"
- rates should be understandable and easy to administer;
- limit the impact of the proposed rates on low-income customers; and
- provide flexibility on pricing and service conditions, which will allow the Company's natural gas services to be competitive with other energy sources.[826]

~~379.~~583. The CCOSS was the starting point for the apportionment of the retail revenue requirement among the rate classes. Other rate design goals were then considered, as noted above, such as maintaining competitive pricing for competitive services, and limiting large bill impacts or "rate shock." The Company's goal was to recover as closely as possible the costs imposed by each class, while avoiding unacceptably high billing impacts.[827]

---

[825] Ex. 29 at 5 (J. Hoffman Malueg Direct); Ex. 30 at 25, 44 (J. Hoffman Malueg Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 70 (J. Hoffman Malueg) (Doc. ID No. 20145-99937-01).

[826] Ex. 40 at 6 (G. Walters Direct).

[827] Ex. 40 at 8, 28 (G. Walters Direct).

~~380.~~584. MERC's proposed revenue apportionment was presented in a graphic format that compared current revenues from a customer class to proposed revenues and the revenue that would be justified by a full movement to the cost as indicated by the CCOSS.[828]

~~381.~~585. The Department reviewed MERC's proposed revenue apportionment and recommended adoption of the Department's proposed revenue apportionment as detailed in Tables 2 and 3, and Attachment SLP-3 of the Direct Testimony of Susan Peirce.[829]

~~382.~~586. The Department recommended that if the Commission approves a lower revenue requirement than that requested by the Company, the remaining revenue requirement be apportioned proportionally to all classes, consistent with the approved apportionment of revenue responsibility.[830]

~~383.~~587. MERC generally agreed with the Department's proposed apportionment of revenue responsibility, but concluded that the SLV Customer Class and Flex customers should not change from proposed rates due to the revenue apportionment, except for MERC's updated proposal related to the CCRC. MERC pointed out that this is a very cost-sensitive customer class and any unintended increase could result in customer loss to MERC.[831]

~~384.~~588. MERC noted that it had accepted the Department's updated sales forecast, but the sales adjustments made by the Department fluctuate between customer classes. This discrepancy in sales increase makes it impossible for MERC to hold revenue apportionment at the class by PGA level as recommended by the Department and keep the distribution and customer charge rates for all residential customers the same. Therefore, MERC proposed to group customers together that have the same distribution rates for revenue apportionment purposes.[832]

~~385.~~589. The Department agreed with MERC's updated revenue apportionment with MERC's modification for the SLV and Flex customer classes.[833]

~~386.~~590. The revenue apportionment agreed to by MERC and the Department is reasonable and should be adopted in this proceeding. MERC's proposed revenue apportionment summarized in Mr. Walters' Rebuttal Testimony, and reflected in SLP-S-1 and SLP-S-2 to Ms. Peirce's Surrebuttal Testimony, should be used to determine the final rate design after the Commission has determined the final revenue requirement.[834]

---

[828] Ex. 40 at 9-10 and Schedule (GJW-1), Schedule 3, Summary (including gas costs), and Schedule 5, Summary (not including gas costs) (G. Walters Direct).

[829] Ex. 203 at 10-11, 13 (S. Peirce Direct).

[830] Ex. 203 at 13 (S. Peirce Direct).

[831] Ex. 42 at 4 (G. Walters Rebuttal).

[832] Ex. 42 at 4-5 (G. Walters Rebuttal).

[833] Ex. 205 at 2-3 (S. Peirce Surrebuttal).

[834] Ex. 205 at 3-4 (S. Peirce Surrebuttal).

C. Rates

~~387.~~591. The Department disagreed with one of MERC's proposed customer charges in this rate case, the residential customer charge. MERC agreed to the Department's recommend change. Thus, MERC and the Department have reached agreement regarding all rate components. The OAG-AUD maintains that the customer charges for the Residential and Small Commercial and Industrial classes should not be increased.[835]

1. Residential Customer Charge

~~388.~~592. MERC's existing residential customer charge is $8.50 per month.[836] MERC initially proposed to increase the monthly residential customer charge to $11.00 per month.[837]

~~389.~~593. The Department recommended raising the residential customer charge to $9.50 per month. The Department reasoned that the increase to $9.50 would move the residential customer charge closer to cost without resulting in rate shock and would reduce intra-class subsidies. The Department further reasoned that the increase is consistent with other increases in residential customer charges.[838]

~~390.~~594. MERC accepted the Department's recommendation that the residential customer charge be increased to $9.50.[839]

~~391.~~595. The OAG-AUD recommended retaining the existing residential customer charge.[840]

~~392.~~596. Because the customer charges are below the customer cost, it is necessary to recover the unrecovered customer costs through the distribution charge. As a result, customers with higher than average usage pay more than their proportional share of these costs. The proposed increase in the residential customer charge addresses this inconsistency.[841]

~~393.~~597. A higher customer charge will result in more level winter and summer bills, provides a more accurate price signal to customers by bringing their rates closer to the true cost of service, and provides incrementally more stable cash flow to the utility.[842]

---

835 Ex. 150 at 36-47, 59-60 (V. Chavez Direct, adopted by J. Lindell); Ex. 154 at 15-20 (J. Lindell Surrebuttal).

836 Ex. 40 at 11 (G. Walters Direct).

837 Ex. 40 at 10 (G. Walters Direct); Ex. 42 at 6 (G. Walters Rebuttal).

838 Ex. 203 at 16-19 (S. Peirce Direct).

839 Ex. 42 at 7-8 (G. Walters Rebuttal).

840 Ex. 154 at 15 supporting the testimony of V. Chavez (J. Lindell Surrebuttal); Ex. 150 at 38 (V. Chavez Direct, adopted by J. Lindell).

841 Ex. 40 at 12-13, 17 (G. Walters Direct).

842 Ex. 40 at 13, 15 (G. Walters Direct).

~~394.~~598. An increase in the residential customer charge to $9.50 per month appropriately assigns costs to that class and avoids rate shock. The ALJ recommends that the Commission approve MERC's proposal to increase the residential customer charge to $9.50 per month.

2. Joint Service

~~395.~~599. Joint Service allows an interruptible customer to designate a portion of its interruptible service as firm service. Thus, Joint Service customers could have their service curtailed down to the level of usage designated as firm. Joint service customers pay a per therm rate for daily firm capacity based on the amount of capacity designated as firm.[843]

~~396.~~600. In the November 27, 2013 Notice and Order for Hearing in this proceeding, the Commission requested that MERC provide supplemental testimony explaining how Joint Service customers are billed for service. On December 26, 2013, MERC filed supplemental testimony explaining how joint service customers are charged for their designated firm service.[844]

~~397.~~601. The Department determined that MERC's firm rate customers do not appear to be subsidizing the Company's Joint Rate customers and recommended that the Commission accept MERC's explanation on administering the Company's Joint Service.[845]

3. Customer Charges for Larger Customers

~~398.~~602. MERC proposed to increase the customer charges for its larger customers, including the Small Commercial and Industrial ("C&I"), Large Commercial and Industrial ("Large C&I"), Small Volume Interruptible ("SVI"), Large Volume Interruptible ("LVI"), and SLV customers. In addition, MERC proposed a monthly charge for the SLV Town Plant Transportation rate class, and to increase the administrative charge from $70.00 to $100.00 per metered account.[846]

~~399.~~603. The Department agreed with MERC's proposed changes.[847] The table below shows the customer charges, MERC's proposed customer charges, and the charges agreed upon by MERC and the Department.[848]

	Current Customer Charge	MERC Proposed Customer Charge	Charge Agreed to by MERC and Department
General Service	$8.50	$11.00	$9.50

[843] Ex. 203 at 20 (S. Peirce Direct).

[844] Ex. 203 at 20-21 (S. Peirce Direct).

[845] Ex. 203 at 21-22 (S. Peirce Direct).

[846] Ex. 40 at 15-29 and Schedule (GJW-1) (G. Walters Direct).

[847] Ex. 205 at 3 (S. Peirce Surrebuttal).

[848] Ex. 40 at 7-8 (G. Walters Direct); Ex. 205 at 3 (Peirce Surrebuttal).

Residential Consolidated Sales			
General Service Small Commercial & Industrial Consolidated Sales	$14.50	$18.00	$18.00
General Service Large Commercial & Industrial Consolidated Sales	$35.00	$45.00	$45.00
Small Volume Interruptible Consolidated Sales	$150.00	$165.00	$165.00
Large Volume Interruptible Consolidated Sales	$175.00	$185.00	$185.00
Super Large Volume Town Plant Transportation	$300.00	$350.00	$350.00

~~400.~~604. The OAG-AUD recommended no increase to the customer charge for the Small C&I class.[849] The OAG-AUD recommended that any increase in the residential class required revenues should be recovered through the variable per therm rate, rather than an increased customer charge.[850] The OAG-AUD also assumed that any increase to the residential or small C&I customer charge is unnecessary because MERC has full decoupling which assures collection of its fixed costs of providing service.[851]

~~401.~~605. In addition to increased customer charges for larger customers, MERC proposed to increase the Transportation Administration Fee from $70 to $110.[852]

~~402. This proposal was not addressed by any party, so MERC assumes agreement by all parties.[853]~~

~~403.~~606. The ALJ finds that MERC's proposed increase to the customer charges for larger customers, including its proposal to increase the transportation administration fee is supported by the CCOSS. The Commission should adopt the proposed customer charges, as agreed to by MERC and the Department.

[849] Ex. 154 at 15 supporting the testimony of V. Chavez (J. Lindell Surrebuttal).

[850] Ex. 154 at 15-16 (J. Lindell Surrebuttal).

[851] Ex. 154 at 16 (J. Lindell Surrebuttal).

[852] Ex. 40 at 24 (G. Walters Direct).

~~[853] Ex. 42 at 8 (G. Walters Rebuttal).~~

~~V.~~VI. Tariff Changes

~~404.~~607. MERC requests only that the rate tariff sheets and base cost of gas sheets be changed. MERC proposes no other tariff changes.[854]

~~405.~~608. The ALJ finds that MERC's request to change the Company's rate tariff sheets and base cost of gas sheets is appropriate and should be approved in this rate case.

~~VI.~~VII. REVENUE DECOUPLING

~~406.~~609. MERC does not request any changes to the methodology of how its pilot decoupling mechanism works. However, MERC does note that the sales and customer counts used in the decoupling calculation need to be consistent with the final sales and customer counts approved in this case.[855]

~~407.~~610. Contrary to the testimony of the OAG-AUD,[856] MERC does not have full decoupling for Residential and Small C&I customers. MERC's decoupling mechanism, which only applies to distribution revenues less the CCRC, is a use per customer calculation, and the decoupling mechanism includes a 10 percent symmetrical cap on distribution revenues.[857]

~~VII.~~VIII. OTHER COMMISSION REQUIREMENTS

A. Telemetry Installation

~~408.~~611. In the Commission's August 26, 2010 Order setting reporting requirements in Docket No. G-999/CI-09-409, the Commission required MERC to provide a status report on implementation of telemetering for the Company's small volume, large volume, and SLV customers, as well as the status of automated meter reading, if applicable, for the Company's other customers.

~~409.~~612. MERC has completed the installation of all the telemetering for its interruptible and transportation customers (i.e., small volume, large volume, and SLV). MERC does not intend to pursue the installation of automated meter reading at this time because the Company has determined that it is not currently economically feasible.[858]

B. Farm Tap Inspection Program

~~410.~~613. In Docket No. G011/M-91-989, the Commission required MERC to file in each general rate case a five-year report on the cumulative results of the Farm Tap Safety Inspection Program and any recommendations for future improvements. MERC stated that

---

854 Ex. 40 at 32 (G. Walters Direct).

855 Ex. 16 at 4 (B. Nick Direct); Ex. 19 at 51 (S. DeMerritt Direct); Ex. 24 at 27 (S. DeMerritt Rebuttal).

856 Ex. 154 at 1 adopting the testimony of Victor Chavez (J. Lindell Surrebuttal).

857 Ex. 24 at 27 (S. DeMerritt Rebuttal).

858 Ex. 40 at 33 (G. Walters Direct).

the Company is at the end of a five-year farm tap inspection plan, and included the inspection report in its initial filing in this proceeding.[859]

~~411.~~614. The South Dakota Farm tap customers were sold in May 2011, and are no longer customers of MERC. Therefore, these customers are no longer included in MERC's corporate structure and are not included in this filing.[860]

~~412.~~615. MERC concluded that its farm tap inspection program continues to be an effective way to discover and repair leaks in the farm tap customers' lines.[861]

~~413.~~616. The Department recommended that MERC be required to continue the farm tap inspection program and submit in the Company's next rate case the most recent five-year farm tap inspection reports, together with a discussion of the results of the reports, and any recommendations for improvements to the farm tap safety inspection program.[862]

~~414.~~617. MERC agreed with the Department's recommendations.[863]

~~415.~~618. The ALJ finds that the Commission should approve MERC's five-year farm tap inspection report and the proposed continuation of the farm tap program.

IX. ~~FILING REQUIREMENTS FOR~~ TRAVEL, ENTERTAINMENT AND OTHER EMPLOYEE EXPENSES

Resolved between DOC and MERC. MERC agrees with the Department's recommendation regarding travel and entertainment expenses, which reduces general and administrative expenses by $7,770. Ex. 215 at LL-14 (L. La Plante Direct). Further, MERC agrees with the Department's recommendation in future rate cases to file for review in accordance with the statutory requirements, the T&E expenses allocated from MERC's service company. Ex. 216 at 6-7 (L. La Plante Surrebuttal).
Disputed between OAG and MERC.

~~416.~~619. In 2010, Minn. Stat. § 216B.16 was amended to include subdivision 17 (a), which specifies the filing requirements for travel, entertainment and other employee expenses.[864]

> The commission may not allow as operating expenses a public utility's travel, entertainment, and related employee expenses that the commission deems unreasonable and unnecessary for the provision of utility service. In order to assist the commission in

[859] Ex. 14 at 14-15 and Exhibit (DGK-4) (D. Kult Direct); Ex. 210 at 28-29 (M. Zajicek Direct).

[860] Ex. 19 at 29 (S. DeMerritt Direct).

[861] Ex. 14 at 15 (D. Kult Direct).

[862] Ex. 210 at 30, 32 (M. Zajicek Direct); Ex. 211 at 4-5 (M. Zajicek Surrebuttal).

[863] Ex. 15 at 6 (D. Kult Rebuttal).

[864] Minnesota Laws, 2010, Chapter 328, Section 2.

evaluating the travel, entertainment, and related employee expenses that may be allowed for ratemaking purposes, a public utility filing a general rate case petition shall include a schedule separately itemizing all travel, entertainment, and related employee expenses as specified by the commission, including but not limited to the following categories:

(1) travel and lodging expenses;
(2) food and beverage expenses;
(3) recreational and entertainment expenses;
(4) board of director-related expenses, including and separately itemizing all compensation and expense reimbursements;
(5) expenses for the ten highest paid officers and employees, including and separately itemizing all compensation and expense reimbursements;
(6) dues and expenses for memberships in organizations or clubs;
(7) gift expenses;
(8) expenses related to owned, leased, or chartered aircraft; and lobbying expenses.

620. In its initial filing, MERC provided ~~the~~ information required by Minn. Stat. § 216B.16, subd. 17, including the travel, entertainment, related expenses and separately itemized expenses for MERC's board of directors and ten highest paid employees.[865] Items totaling $284,725 were included in the test year at the MERC level:[866]

- Travel/Lodging - $217,802;
- Corporate Aircraft - $956;
- Food/Beverage - $64,666; and
- Recreation and Entertainment - $1,301.

~~417.~~621. Minn. Stat. § 216B.16, subd. 17(c), allows for the salary of one or more of the ten highest paid officers and employees, other than the five highest paid, to be treated as private data on individuals. Specifically, Minn. Stat. § 216B.16, subd. 17(c), provides:

> (c) Except as otherwise provided in this paragraph, data submitted to the commission under paragraph (a) are public data. The commission or an administrative law judge assigned to the case may treat the salary of one or more of the ten highest paid officers and employees, other than the five highest paid, as private data on individuals as defined in section 13.02, subdivision 12, or issue a

865 Ex. 19 at 47 (S. DeMerritt Direct); Ex. 4 Initial Filing Volume 3: Informational Requirements, Document 14 at 1.

866 Ex. 215 at 21 (L. La Plante Direct) (*citing* Ex. 4, Volume 3, Document 14 at 3–51)).

protective order governing release of the salary, if the utility establishes that the competitive disadvantage to the utility that would result from release of the salary outweighs the public interest in access to the data. Access to the data by a government entity that is a party to the rate case must not be restricted.

~~418.~~622. MERC requested that the salaries of the sixth through tenth highest paid employees be kept nonpublic for competitive reasons related to the compensation of MERC's employees. Publicly disclosing this information could give competitors an advantage in terms of hiring and retaining key employees. Additionally, it would be inappropriate to ignore the employees' right to keep this information private.[867]

~~419.~~623. The salaries of the sixth through tenth highest paid employees should be treated as private data as individuals, as contemplated by Minn. Stat. § 216B.16, subd. 17(c).

624. The Department witness Ms. La Plante reviewed MERC's T&E expenses; she searched for blank or vague descriptions, as well as items related to more than one hundred key words such as anniversary, appreciation, award, celebration, farewell, birthdays, alcohol, and the like. Such descriptions may indicate expenses that would not be reasonable to charge to Minnesota ratepayers. The test year regulated expenses appeared to include expenses that are not recoverable from ratepayers, listed expenses of $7,770 for travel and entertainment that did not appear to be reasonably related to Minnesota regulated utility operations, such as appreciation, award, gifts, golf, parties and recognition.[868]

~~420.~~625. The Department recommended that MERC remove from the Company's General and Administrative expenses $7,770 for to travel and entertainment.[869]

~~421.~~626. MERC agreed with this recommendation.[870]

627. The Department further recommended that T&E expenses allocated from MERC's service company should have been filed for review in accordance with the statutory requirements in the rate case.[871]

628. MERC agreed to provide in future rate case filings all T&E expenses, including expense related to employees who work for affiliates of MERC.[872]

~~422.~~629. The OAG-AUD recommended a reduction of $569,450 for travel and entertainment expenses. In addition, the OAG-AUD recommended that dues totaling $63,245 for three organizations that it determined were lobbying organizations also be disallowed.[873]

---

[867] Ex. 19 at 49-50 (S. DeMerritt Direct).

[868] Ex. 215 at 21 and LL-14 (L. La Plante Direct) (citing MERC Ex. 4, Volume 3, Document 14 at 3–51).

[869] Ex. 215 at 23 (L. La Plante Direct).

[870] Ex. 24 at 17-18 (S. DeMerritt Rebuttal).

[871] Ex. 216 at 6-7 (La Plante Surrebuttal).

[872] Ex. 25 at 3 (S. DeMerritt Surrebuttal).

~~423.~~630. The OAG-AUD argued that MERC provided unreadable information, did not include T&E expenses allocated to the Company by IBS and failed to provide a business purpose for the Company's expenses sufficient to support recovery. The OAG-AUD also argued that MERC failed to provide dues and expenses for memberships in organizations or clubs as required by the statute. In particular, the OAG-AUD argued that MERC sought recovery of dues and expenses for lobbying organizations, for which gas customers should not have to pay.[874]

~~424.~~631. MERC disagreed with the OAG-AUD's recommended T&E reduction which appears to be based on the OAG-AUD's opinion that MERC failed to meet the Minnesota statutory requirements for travel and entertainment expenses.[875] MERC believes it has met the statutory requirements and feels its travel and entertainment expenses are reasonable.[876]

~~425.~~632. In Rebuttal Testimony, the OAG-AUD made four recommendations for future MERC filings related to T&E expenses: 1) provide better descriptions for the business purposes of expenses, including the event or activity that the employee was attending or conducting; 2) include all T&E expenses, including T&E for employees who work for affiliates of MERC; 3) exclude all expenses incurred outside of Minnesota unless the description justifies an allocation to Minnesota; and 4) allocate only a portion of T&E expenses for items not specific to Minnesota such as for the Vertex T&E.[877]

~~426.~~633. MERC disagreed with the OAG-AUD's first recommendation. MERC found the term "better" to be subjective and determined that there is no reason to believe that any additional information above what was already provided would meet the needs of the OAG-AUD. MERC believes it met the requirements of Minnesota Statute § 216b.16, subd 17.[878]

~~427.~~634. MERC agreed to the OAG-AUD's second recommendation but emphasized that its agreement should in no way be construed as an admission of incompleteness in the current docket.[879]

~~428.~~635. MERC disagreed with the OAG-AUD's third recommendation. MERC incurs legitimate T&E expenses outside of Minnesota, and simply because these expenses do not occur within Minnesota state borders is no reason to deny recovery of these expenses.

---

873 Ex. 151 at 25-26 (J. Lindell Direct); Ex. 153 at 2-3 (J. Lindell Rebuttal); Ex. 154 at 9 (J. Lindell Surrebuttal).

874 Ex. 151 at 23-25 (J. Lindell Direct); Ex. 154 at 7-9 (J. Lindell Surrebuttal).

875 Ex. 24 at 26 (S. DeMerritt Rebuttal).

876 *See* Sections U and KK of the Proposed Findings; Evidentiary Hearing Transcript (May 13, 2014) at 25 (S. DeMerritt) (Doc. ID No. 20145-99937-01).

877 Ex. 153 at 4 (J. Lindell Rebuttal).

878 Ex. 25 at 2-3 (S. DeMerritt Surrebuttal).

879 Ex. 25 at 3 (S. DeMerritt Surrebuttal).

Some examples of these expenses include travel to Green Bay for MERC Board of Director meetings or training.[880]

~~429.~~636. MERC agreed with the OAG-AUD's fourth recommendation and specified that any costs not specific to Minnesota will be allocated to MERC based on the allocation factors discussed in MERC's Direct Testimony.[881]

637. The ALJ finds that, subject to the modification agreed to by MERC above, MERC's travel, entertainment and other employee expenses are reasonable and should be approved in this rate case.

~~430.~~638. The ALJ further finds that in future rate case filings MERC shall file for review, in accordance with the statutory requirements, the T&E expenses that are allocated from MERC's service company.

~~431.~~639. Based on these Findings of Fact, the Administrative Law Judge makes the following conclusions:

~~VIII.~~X. CONCLUSIONS

1. The Minnesota Public Utilities Commission and the ALJ have jurisdiction over the subject matter of this proceeding pursuant to Minn. Stat. Chapter 216B and §14.50.

2. Any of the foregoing findings that is more appropriately deemed to be a conclusion is hereby adopted as a conclusion.

3. Use of the year ending on December 31, 2014 as the projected test year for determining MERC's revenue requirement is reasonable. MERC's projected test year rate base for the twelve-month period ending December 31, 2014, is approximately set at $199,192,236. MERC's test year operating revenues and expenses should be determined as set forth in Schedule 1 ~~in~~ to ~~MERC's~~ the Department's Issues Matrix filed June ~~6~~24, 2014. The adjustments to revenues and expenses made by the ~~Company~~Department throughout the proceeding result in a test year operating income for MERC of approximately $~~8,817,851~~12,033,182. MERC's updated capital structure and cost of debt is reasonable, and should be utilized in the calculation of the rate of return.

4. MERC has demonstrated that its proposed ROE strikes an appropriate balance between the interests of shareholders and rate payers, and should be adopted in this matter.

5. With the adoption of the capital structure, cost of debt and cost of equity, the rate of return should be ~~8.0092~~7.2745 percent, as updated in Schedule (~~SSD-4~~MAS-S-2) of ~~Mr. DeMerritt's~~Ms. St. Pierre's Surr~~R~~ebuttal Testimony.

880 Ex. 25 at 3-4 (S. DeMerritt Surrebuttal).

881 Ex. 24 at 4 (S. DeMerritt Rebuttal).

6. MERC's request for recovery of its 2014 approved CIP program budget is reasonable and should be adopted. The CCRC factor calculated at the end of this rate case should be based upon these amounts.

7. MERC will need to make an adjustment to the CIP tracker at the time of final rates. If MERC's CCRC of $0.02462 is approved in this proceeding, MERC will have under-collected CIP expense during the time frame that the Company's interim rates were in effect. MERC will then credit the CIP tracker balance (Account No. 182705) by $0.00030 ($0.02462 - $0.02432) x actual sales during the period interim rates were in effect, and debit the CIP Amortization account (Account No. 407710) for this same amount.

8. MERC will apply a one-time carrying charge to the unrecovered CIP balance related to Northshore Mining. For the carrying charge rate, MERC will use the Company's approved overall rate of return in effect during the period of under collection (July 2006 through December 2013). MERC will credit the CIP tracker for uncollected amounts (CCRC and CCRA) from July 2006 through December 2013, before Northshore's CIP exemption was effective January 1, 2014. MERC will also report this information in its final rates compliance filing in the present docket.

9. The record in this matter shows that MERC will experience a ~~substantial~~ revenue shortfall. MERC is entitled to recover this revenue shortfall through an adjustment of its natural gas rates. MERC's revenue deficiency is approximately $~~12,159,454~~3,300,164.

10. MERC's proposed rate design should be adopted. This includes setting the monthly residential customer charge for both MERC-PNG and MERC-NMU at $9.50. It also includes increases in the customer charges for MERC's larger customers. The Small C&I charge will be increased to $18.00; Large C&I, SVI will increase to $45.00; LVI will increase to $165; and Super Large Volume customers will increase to $185.

11. Modifying MERC's natural gas rates in the manner described in the findings and conclusions above results in just and reasonable rates that are in the public interest.

12. Based on the foregoing findings and conclusions above, it is recommended that the Public Utilities Commission issue the following:

RECOMMENDATION

The ALJ recommends that the Commission issue an Order providing that:

1. MERC is entitled to increase gross annual revenues in accordance with the terms of the Report.

2. Within ten days of the service date of this Report, MERC shall file with the Commission for its review and approval, and serve on all parties in this proceeding, revised schedules of rates and charges reflecting the revenue requirements and the rate design decisions based on the recommendations made herein.

3. MERC shall make further compliance filings regarding rates and charges, rate design decisions, and tariff language as ordered by the Commission.

4. MERC shall in future rate cases, comply with the recommendations herein[882].

Dated: ___________________

ERIC L. LIPMAN
Administrative Law Judge

Reported: Transcript Prepared (one volume)
Shaddix & Associates

[882] These include recommendations regarding forecasting,