# Minnesota Public Utilities Commission

***Staff Briefing Papers***

Meeting Date: October 7, 2015 ....................................................Agenda Item # **2***

Company: Minnesota Energy Resources Corporation (MERC)

Docket No. G-011/D-15-534

In the Matter of the Petition of MERC for its Annual Review of Depreciation Rates for 2015

Issues: Should the Commission require MERC to complete a full depreciation study of all accounts by June 1, 2016 to coincide with the timing of its rate case or, should the Commission maintain the current five-year schedule and require a full depreciation study to be completed June 1, 2017?

Should the Commission approve the Department's recommendation (as agreed to by MERC) and approve MERC's proposed service lives, salvage rates, and resulting depreciation rates effective January 1, 2015 including MERC's proposal for an average service life of eight years, an Iowa L3 curve, to use the General Plant composite depreciation rate of 4.47 percent for new investments in Trailers, Account 392, and a negative 25 percent salvage rate for Transportation Equipment, Account 392.2?

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***Relevant Documents***

MERC – Initial Filing....................................................................................June 1, 2015
MERC – Supplemental Filing .........................................................................July 2, 2015
Department - Comments..............................................................................July 20, 2015
MERC – Reply Comments ...........................................................................July 31, 2015
Department - Letter ................................................................................. August 13, 2015
MERC – Reply Comments ...................................................................... August 21, 2015
Department – Supplemental Comments ................................................ August 31, 2015

October 1, 2015

The attached materials are workpapers of the Commission Staff. They are intended for use by the Public Utilities Commission and are based upon information already in the record unless otherwise noted.

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***Statement of the Issues***

Should the Commission require MERC to complete a full depreciation study of all accounts by June 1, 2016 to coincide with the timing of its rate case or, should the Commission maintain the current five-year schedule and require a full depreciation study to be completed June 1, 2017?

Should the Commission approve the Department's recommendation (as agreed to by MERC) and approve MERC's proposed service lives, salvage rates, and resulting depreciation rates effective January 1, 2015 including MERC's proposal for an average service life of eight years, an Iowa L3 curve, to use the General Plant composite depreciation rate of 4.47 percent for new investments in Trailers, Account 392, and a negative 25 percent salvage rate for Transportation Equipment, Account 392.2?

***Background & Party Positions***

June 1, 2015: MERC filed its Annual Review of Depreciation Rates and requested the Commission approve the Company's proposed depreciation lives and rates effective January 1, 2015. The Company has requested one year's passage of time for its assets that are depreciated using the remaining life method.

MERC's proposal included changes in the parameters used to calculate the depreciation expense for its Transportation Equipment (Account 392.10) which is depreciated using vintage amortization as approved in Docket No. G-007, 011/D-08-614. The Company requested an eight year average service life and a twenty-five percent net salvage which results in a depreciation rate of 9.35 percent.

MERC bought numerous vehicles that were leased by MERC's prior owner, Aquila. The vehicles were recorded in MERC's Transportation Equipment account and reflect the year the vehicles were purchased and not the actual vintage of the vehicles. MERC performed an analysis of retirements and determined that the Iowa 8-L3 curve best reflected the actual retirements within the Transportation and Equipment account. The Company's currently approved Iowa curve used for Transportation Equipment is 6-R1.

MERC also reviewed the currently approved thirty percent Net Salvage rate used in the Transportation Equipment account and noted that the actual net salvage has been trending lower. MERC proposed to use twenty-five percent Net Salvage rate. The Company stated it will continue to monitor the salvage rate and may propose further updates in the future. With a proposed average service life of 8 years, an Iowa L3 curve, and twenty-five percent Net Salvage rate, the resulting proposed depreciation rate is 9.35 percent.

Based on the above, the Company proposed a $9,757,410 annual depreciation expense. This is an increase of $102,405, or approximately 1 percent over the Company's approved 2014 depreciation expense. .

July 2, 2015: MERC responded to the Department's request to provide the Transportation

Equipment net salvage study.

July 20, 2015: The Department submitted its comments and recommended that the Minnesota Public Commission approve MERC's proposed service lives, salvage rates, and resulting depreciation rates effective January 1, 2015 including MERC's proposal for an average service life of eight years, an Iowa L3 curve, and a negative twenty-five percent net salvage rate for Transportation Equipment, Account 392.1.

The Department recommended that the Commission deny MERC's request to use the current depreciation rate of 0.18 percent for new investment in Trailers, Account 392. The trailer equipment in Account 392 is fully depreciated, but there may be new investment in this account in the future. The Department recommended the composite rate for General Plant of 4.47percent be used for any/all 2015 investment in trailers.

The sale of IPL's gas assets to MERC was approved by the Commission and an Order was issued on December 8, 2014. The transaction was completed on April 30, 2015. In its petition, the Company stated that it will use MERC's 2015 depreciation rates for depreciation expense and incorporate the IPL property into its 2016 depreciation filing:

> In Docket No. G-001,011/PA-14-107, MERC received Commission approval to purchase Interstate Power and Light Company ("IPL") natural gas distribution property, which will utilize MERC's existing depreciation rates and lives. The property was purchased subsequent to December 31, 2014 and therefore, was not incorporated in MERC's 2015 remaining life update. MERC will incorporate the IPL property into its 2016 depreciation filing.

In Docket No. E,G-001/D-15-248, MERC's June 5, 2015 letter stated:

> MERC has integrated the acquired [IPL] assets into its existing asset base and will incorporate these assets in MERC's next five-year depreciation study. MERC discussed the need for historical data on the acquired assets as part of the purchase transaction in order to facilitate MERC's future depreciation study and IPL has committed to work with MERC to facilitate obtaining the necessary data.

MERC's next five-year study is due up to two years from now (on or before June 1, 2017). Given this relatively unusual and extensive addition to MERC's assets, the Department suggested that it may be appropriate for the Commission to require the Company to complete a full study as soon as practicable. The Department requested that in its Reply Comments, MERC provide a discussion on whether a full study of all accounts including the purchased IPL property could be completed by June 1, 2016 rather than June 1, 2017.

July 31, 2015: MERC stated in reply comments that it agrees with the Department's recommendation to use the General Plant composite depreciation rate for future investment in Trailers, Account 392. MERC recognized that the account became fully depreciated in 2015 and agreed to use the proposed General Plant composite depreciation rate of 4.47 percent until

MERC files its next five-year depreciation study or upon separate filing by MERC requesting certification of a new rate.

MERC proposed to maintain the current depreciation schedule and complete a full, five-year study by June 1, 2017. While MERC acknowledged that a study could be undertaken in 2016, MERC questioned the benefit of doing so. Though the acquisition of IPL's gas assets may be unusual, the dollar amount of the acquired assets does not represent an extensive addition. The IPL assets acquired, $17,690,000 at cost, represented only 4.3% of MERC's plant assets at the time of purchase.

MERC stated it discussed the asset acquisition with John Spanos of Gannett Fleming, its depreciation consultant. Mr. Spanos also completed the most recent depreciation study for IPL's assets. In Mr. Spanos' opinion, the acquired assets would have an insignificant impact to the depreciable lives, curves, or net salvage percentages currently in place for MERC. Based on the above discussion, MERC believes the June 1, 2017, date remains appropriate.

<u>August 13, 2015:</u> The Department stated that if MERC were not expected to file a rate case in the near term, the Department might agree with the Company that the extensive review could wait. The Department argued that Minn. Stat. § 216B.16, subd. 4 states that "[t]he burden of proof to show that the rate change is just and reasonable shall be upon the public utility seeking the change." Given that a significant focus of the rate case proceeding will be to incorporate the costs of IPL's gas utility assets in rates, it is not clear how the record will be developed adequately for the Commission to make the determinations required in Minn. Stat. § 216B.16 subd. 4, which states:

> *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. In determining the rate base upon which the utility is to be allowed to earn a fair rate of return, the commission shall give due consideration to evidence of the cost of the property when first devoted to public use, to prudent acquisition cost to the public utility less appropriate depreciation on each, to construction work in progress, to offsets in the nature of capital provided by sources other than the investors, and to other expenses of a capital nature. For purposes of determining rate base, the commission shall consider the original cost of utility property included in the base and shall make no allowance for its estimated current replacement value.*

The Department recommended that if MERC is unable to provide a full depreciation study in time for its upcoming general rate case, the Commission may want to set rates in that proceeding on a provisional basis, subject to later review of MERC's depreciable lives, curves, or net salvage rates, in the June 1, 2017 study.

August 21, 2015: MERC responded to the Department's comments and stated, contrary to the Department's position, nothing in Minnesota Statutes 216B requires that a utility complete a depreciation study prior to or concurrent with a rate case filing. The requirement that MERC conduct a full depreciation study once every five years is not tied to MERC's burden of proof in a rate case proceeding. MERC disagreed with the Department's contention that MERC would be unable to meet its burden of proof to show that a proposed rate change is just and reasonable in the absence of a full depreciation study. MERC stated it will use the Commission-approved depreciation rates in the preparation of its initial rate case filing and as discussed below, the use of MERC's rates would benefit the former IPL ratepayers.

Even if a full study were necessary, it is not feasible to complete a full depreciation study before the filing of MERC's next rate case because there is insufficient time to adequately complete a study. MERC would have to integrate historical IPL plant balances and activity into MERC's records as well as undertake an analysis of MERC's own activity that has occurred since its last study. The Company stated that, simply put, it could not complete such a study before its next rate filing.

MERC acknowledged the Department's concerns regarding the incorporation of IPL's plant assets in rates but believes its proposal to maintain the previously approved schedule and to apply MERC's existing depreciation lives, curves, and net salvage values to the acquired IPL assets is reasonable and appropriate. As MERC discussed in its July 31, 2015, Reply Comments, although the acquisition of IPL's gas assets may be unusual, the dollar amount of the acquired assets does not represent an extensive addition.

The rate base of the IPL plant assets is equal to $8,860,000 (gross plant of $17,690,000 less accumulated reserve of $8,830,000) or 3.6 percent of MERC's total net plant as of July 31, 2015. The inclusion of IPL plant assets using IPL's currently approved rates would result in an annual depreciation expense of approximately $430,000 for those assets. MERC noted that depreciation expense calculated using MERC's depreciation rates as proposed by MERC in this docket would result in an approximately $310,000 reduction of expense over what the expense would be using IPL's depreciation rates, and the lower depreciation rates will be captured in MERC's 2016 rate case filing.

MERC stated it disagrees with the Department's position that a full depreciation study should be completed for its initial rate case filing. In any event, the Company would be unable to complete a depreciation study by the Company's anticipated filing date in late September 2015. However, MERC stated that although it proposes to maintain the original schedule to complete a study in 2017, the Company can initiate a full study for completion in 2016 if the Commission determines the schedule should be accelerated.

August 31, 2015: The Department noted that the Company did not propose a 2016 due date should the Commission Order the Company to accelerate its timeline. The Department stated its concern about MERC filing a depreciation study on June 1, 2016 or later is that the record may be closed for parties to testify in MERC's general rate case on that study. The Department noted that, ideally, a full study should be filed by January 4, 2016 (at the latest) so that Direct

Testimony on the study could be filed, if needed.

The inclusion of IPL's former assets into MERC's rate base represents a significant enough change in MERC's rate base such that a new depreciation study is warranted. While the Department recognized that the Commission generally allows the currently approved depreciation rates in interim rates, MERC's purchase of IPL's assets should require a reasonable level of analysis regarding the depreciation expense impact of combining those two entities' assets on the depreciable lives and salvage rates of those assets.

The Department alternatively recommended a study filed later than January 4, 2016 but with a reasonable opportunity for the parties to comment prior to closing the evidentiary record may be workable. In determining final rates, the Commission has allowed final rates to reflect the effect of depreciation studies filed and approved during a general rate-case proceeding.

The Department recommended if a full study of the lives and savage rates is filed after the close of the evidentiary record, the Commission may wish to set rates in MERC's general rate-case proceeding on a provisional basis. In that case, the Commission could set final rates with the understanding that rates may change based on a later decision on the Company's 2016 depreciation study.

***Staff Analysis***

The parties have agreed that the Commission should approve MERC's proposed service lives, salvage rates and the resulting depreciation rates effective January 1, 2015. This includes MERC's proposal to use a negative 25 percent salvage rate to be applied to the Transportation Equipment Account 392.2. The parties have also agreed to use the General Plant composite depreciation rate of 4.47 percent for new investments in the Trailers Account 392, derived from using an Iowa L3 curve and an average service life of eight years.

The parties also agree that MERC's accounting treatment to reflect the acquisition of IPL's assets at historical cost less depreciation was done properly. Additionally, the parties agree that in this docket it would be proper to apply MERC's depreciation rates to IPL's former assets to reflect the acquisition in MERC's annual depreciation expense and allow MERC a return on its investment in IPL.

Due to the expectation that MERC will file a rate case on September 30, 2015 (which it did file, in Docket No. G-011/GR-15-736), and the fact that the Company has newly acquired assets, the Department has recommended that the Commission require MERC to accelerate the schedule of its five-year depreciation study to coincide with the timing of the rate case. In an annual depreciation study, the utility usually requests one year's passage of time and may or may not propose minor changes to the depreciation parameters. The five-year study is an in-depth analysis of the Company's asset records and attempts to better predict, or realign, the depreciation parameters based on the Company's actual experience with those assets. The analysis would include examination of the depreciable lives of the assets, analysis of the survivor curves and analyzing net salvage percentages, all of which are inputs used in the calculation of depreciation expense. MERC disagreed with the Department's recommendation and proposed remaining on its five-year schedule.

One of the largest single categories of public utility expense is the depreciation expense and the largest determinant of rate base is the original cost of the assets less the amount of depreciation expense that has already been recovered.

Staff attempted to quantify the annual depreciation expense, as reported in the Minnesota Annual Jurisdictional Reports, in the chart below as a point of reference for the Commission to consider. For comparison purposes the test year depreciation expense from each Company's most recent rate case is also included.

| Docket No. | MERC | IPL |
|---|---|---|
| IPL 1995 Rate Case | | $348,357[1] |
| 11-04 | $9,634,436 | $463,112 |
| 12-04 | $10,049,071 | $497,779 |
| 13-04 | $10,417,474 | $488,529 |
| MERC 2013 Rate Case | $9,347,278[2] | |
| 14-04 | $6,667,286[3] | $523,488 |
| 15-04 | $9,282,331 | $527,071 |

According to the table above and excluding the anomaly in Docket No. 14-04, IPL's depreciation expense, calculated using IPL's depreciation parameters would represent a range of 4.69 percent to 5.67 percent of MERC's annual depreciation expense. MERC uses its own parameters to calculate its annual depreciation expense, so the comparison is made based on a simple percentage basis.

According to the 2014 Minnesota Jurisdictional Annual Reports, at the end of 2014 IPL had approximately $19,125,000 of Gas Plant in Service. MERC's end of year Gas Plant in Service was approximately $398,475,000. As a percentage, the IPL assets are about 4.8 percent of MERC's Plant in Service.

If MERC were to use IPL's depreciation rates to calculate annual depreciation expense on IPL's newly acquired assets only, it would result in an annual depreciation expense of approximately $430,000. If MERC applied its current depreciation rates, which are lower, to the IPL assets, it would result in a $310,000 reduction of expense, or an approximately $120,000 annual depreciation expense attributable to the IPL assets. When applied to MERC's annual depreciation expense of $9,282,331, the $120,000 attributable to IPL's assets would represent

[1] Order After Reconsideration Affirming & Clarifying Order of February 29, 1996, Docket No. G-001/GR-95-406, Page 10, July 2, 1996.
[2] Findings of Fact, Conclusions, and Order, October 28, 2014, Docket No. G-011/GR-13-617, Page 55.
[3] Per the Company, the reduction in depreciation expense was due to the timing as to when the rates were approved by the Commission and resulted in an approximately $2.2 million adjustment to the expense recorded in Docket No. 14-04. This would bring the annual expense to approximately $8.9 million.

approximately 1.29% of MERC's annual depreciation expense. MERC stated that the lower depreciation rates will be captured in MERC's 2016 rate case. The Commission will have to determine if the acquisition of IPL's assets is significant enough to warrant an acceleration of the five-year depreciation schedule.

MERC stated it discussed the asset acquisition with its depreciation consultant, who also completed the most recent depreciation study for IPL's assets. In the Consultants opinion, incorporating the acquired assets into a five year study would not significantly impact the depreciable lives, curves, or net salvage percentages that are currently in place for MERC.

If the Commission does not determine that an accelerated study is necessary, Staff would caution the Company about presenting the Commission with a large change in depreciation expense when the study is completed. Because a level of depreciation expense is set in the rate case, a large fluctuation, especially lower than the test year level, would not be viewed favorably by the Department, Staff, or the Commission.

The Department recommended that if MERC does not file a full depreciation study in time for its upcoming rate case, the Commission may want to set rates in that proceeding on a provisional basis, subject to later review of MERC's depreciable lives, curves, or net salvage rates, in the June 1, 2017 study.

Another issue for the Commission to consider is the amount of lead time the Company, the Department and Commission Staff would need to complete and review the study. The Commission may want to ask the Company about the timeline the Company would need to accelerate the study and what it would entail. Additionally, MERC filed its rate case on September 30, 2015. According to the timeline for the rate case, a final Order would be due on July 30, 2016 unless the timeline is extended, which the Commission may do for up to 90 days. This does not leave a large amount of time for the Company to commission and complete a study, nor does it leave much lead time for the Department and Staff to complete their analysis. Couple this with the fact that the Department and Staff will have four ongoing rate cases filed between August 2015 and November 2015, with final Orders due between June 2016 and February of 2017. Based on timing only, requiring the Company to maintain its June 1, 2017 schedule makes sense.

## *Decision Alternatives*

2015 Depreciation Rates

1.) Approve MERC's proposed service lives, salvage rates, and resulting depreciation rates effective January 1, 2015, including MERC's proposal to use an eight year average service life and a twenty-five percent net salvage rate and resulting depreciation rate of 9.35 percent for its Transportation Equipment Account 392.10. (MERC, Department)

2.) Approve the Department's recommendation to apply the General Plant composite rate of 4.47 percent to any new investments in the Trailers Account 392. (MERC, Department)

3.) Require MERC to submit a compliance filing within 10 days of the Commission Order to reflect the decisions made in this docket. (MERC, Department)

Timing of MERC's Next Five-year Depreciation Study

4.) Require MERC to accelerate the due date of its five-year depreciation study to a date agreed upon by the Commission and the Company, with input from the Department.

5.) Require MERC to accelerate the due date of its five-year depreciation study (DOC) to

   a. January 4, 2016, or
   b. March 1, 2016, or
   c. June 1, 2016.

6.) Require MERC to file its next five-year depreciation study by June 1, 2017. (MERC)

## *Recommendation*

1, 2, 3, and 6