

Minnesota Public Utilities Commission
Staff Briefing Papers

Meeting Date: October 18, 2016.....**Agenda Item # 5

Company: Minnesota Power

Docket No. E-015/M-14-962
In the Matter of Minnesota Power’s 2015 Renewable Resources Rider and
Factor

Issue: Should the Commission decide the basis to use in determining the amount of
North Dakota Investment Tax Credits (“ND ITCs”) to reflect in revenue
requirements, or should it defer this decision to Minnesota Power’s next
general rate case?

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Relevant Documents

Comment Filings required by Commission March 9, 2016 Order

Minnesota Power – Supplemental Reply Comments April 8, 2016
Department – Supplemental Response Comments April 22, 2016
Minnesota Power - LetterOctober 5, 2016

March 3, 2016 Agenda Meeting Documents

Commission Order March 9, 2016
Transcript of Commission March 3, 2016 Meeting discussion on Docket 14-962 ... March 7, 2016

Initial Documents for March 3, 2016 Agenda Meeting

Minnesota Power – Initial Filing (*ND ITCs: pp. 13 & 15*).....November 10, 2014
Department – Comments (*ND ITCs: p. 8*)..... March 11, 2015
Minnesota Power – Reply Comments (*ND ITCs: pp. 2 - 4*)..... March 23, 2015
Department – Response Comments (*ND ITCs: pp. 3 - 10*) December 16, 2015
Minnesota Power – Supplemental Reply Comments (*ND ITCs: pp. 1 - 4*)..... January 5, 2016
Staff Briefing Papers – Public (*ND ITCs: pp. 7 - 20*)..... February 24, 2016

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October 7, 2016

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Statement of the Issue

Should the Commission decide the basis to use in determining the amount of North Dakota Investment Tax Credits (“ND ITCs”) to reflect in revenue requirements, or should it defer this decision to Minnesota Power’s next general rate case?

Introduction

Minnesota Power (Minnesota Power, MP, or the Company) built the Bison Wind 1, 2, 3 and 4 electric generation facilities (“Bison Projects” or “Bison Wind”) in North Dakota (“ND”) and will earn approximately \$113.0 million in North Dakota Investment Tax Credits (“ND ITCs”) based on the amount expended to construct these plants. ND ITCs are not transferable or refundable, however, ND state income tax law allows ND ITCs to be applied against the aggregate income tax liability of all corporations included in a consolidated state tax return filing.¹ The Bison Projects’ costs, however, are wholly assigned to MP regulated operations.

To reflect this tax benefit in jurisdictional rates, MP proposed to credit its future Renewable Resources Rider (“RRR”) revenue requirements with the amount of ND ITCs equal to what MP operations could consume if it were to file a separate return. Under its approach, MP estimated the benefit amount to be \$10.7 million in tax credits over the limited life of the ND ITCs. MP avers that its proposal is consistent with the stand-alone accounting approved by the Commission, and that it is consistent with GAAP.

In practice, MP, as part of ALLETE, Inc. (“ALLETE”), files a consolidated federal tax return and a unitary (consolidated) North Dakota tax return along with its tax-jurisdictional affiliates. Although MP estimates that the utility would utilize \$10.7 million in ND ITCs from a separate return perspective, a total of \$22 million of these ND ITCs are estimated to be utilized on a unitary (consolidated) tax return basis. However, with MP’s proposal, the additional \$11.3 million in tax relief would not be reflected in rates. MP reasons that ratepayers have no financial interest in or operational risk for the affiliates that allow these additional ND ITCs to be monetized.

At issue are the additional \$11.3 million in ND ITCs tax benefits that are expected to be realized through the filing of a consolidated tax return. No ND ITCs have been utilized to date, are not expected to be used until 2020, and most of the ND ITCs earned will expire unused. An additional item to be decided is the timing as to when the ND ITCs should be included in the revenue requirement calculation.

Minnesota Power requests that the Commission order that only the ND ITCs utilized by

¹ NORTH DAKOTA CHAPTER 57-38 - INCOME TAX, 57-38-01.8(5): *If a taxpayer entitled to the credit provided by this section is a member of a group of corporations filing a North Dakota consolidated tax return using the combined reporting method, the credit may be claimed against the aggregate North Dakota tax liability of all of the corporations included in the North Dakota consolidated return.*

Minnesota Power on a separate return basis be credited to the Renewable Resources Rider revenue requirement. Alternatively, Minnesota Power would support the Commission deferring any decision on the treatment of the ND ITCs until Minnesota Power's next rate case.

Only the Department filed comments in this petition. The Department does not support MP's proposal, rather it recommended that the Commission require MP to reflect all ND ITCs used in ALLETE, Inc.'s consolidated North Dakota tax returns when determining revenue requirements.

Background

The ND ITC ratemaking issue, with respect to determining Minnesota Power's Renewable Resources Rider ("RRR") revenue requirements, was first discussed in a prior MP RRR docket, Docket No. E-015/M-14-349 (docket 14-349). In docket 14-349, the Commission deferred and transferred consideration of this ND ITCs issue from docket 14-349 to the present docket, Docket 14-962.

On November 10, 2014, in this instant docket, Minnesota Power filed for approval of its 2015 RRR rates to recover Minnesota jurisdictional costs of its four Bison Wind facilities, the associated transmission upgrades, and the RRR tracker balance.²

The Commission's Order issued March 9, 2016 in this docket resolved all issues raised except for the rate allotment for the ND ITCs. The two March 9, 2016 Ordering points relevant to ND ITCs read:

5. *Deferred action on the issue of the North Dakota investment-tax credits to permit the Company to file any additional information or argument that it may wish to offer concerning why it accounts for these tax credits in the way it does and why it believes that treatment is consistent with the relevant accounting rules and prior decisions of the commission.*
6. *Required the filing described in paragraph 5 within 30 days of the date of this order and required any responsive filing within 14 days thereafter.*

On April 8, 2016, Minnesota Power filed additional comments and information as directed in the above March 9, 2016 Order.

On April 22, 2016, the Department of Commerce filed response comments.

² In Docket E-015/M-14-577, the Commission's approval permitted MP to revise its pending 2015 RRR filing (14-962) to incorporate the Thomson Restoration Project costs. On February 13, 2015, Minnesota Power filed a supplement to this instant docket to include the Thomson Restoration Project costs.

Minnesota Power

Tax Allocation Methods

ALLETE allocates tax expense based upon a separate return calculation; MP argued that this approach is consistent with the Commission's approved stand-alone method.

MP explained each subsidiary determines its tax liability as if it filed a separate return. Each subsidiary pays its respective separate-return tax liability to a "consolidation" company under ALLETE. The consolidation company retains/bears the differences should the sum of tax liabilities determined on a separate return basis differ from the actual, collective tax liability that resulted from filing a consolidated return.

The difference between a pure separate return calculation and a stand-alone methodology is how one treats the variance between the sum total of all separate return tax liability calculations and the actual total tax liability result on the filed consolidated tax return. The stand-alone methodology allocates back to each company, included in the consolidated or unitary return, a portion of the difference between the consolidated return and the separate return calculation. ALLETE does not allocate any difference back to each company. Instead, all net benefits and detriments that remain after the separate return allocations are made, reside at a consolidation company.³

MP's Tax Allocation Results

MP proposed to reflect \$10.7 million ND ITC in rates, as determined using its separate return approach. However, the ALLETE consolidated ND tax returns are expected to consume an estimated collective ND ITC total of \$22 million, or \$11.3 million more ND ITCs than MP could consume alone. MP concluded that the additional \$11.3 million in ND ITCs that ALLETE expects to realize due to ALLETE's combined ND operations is a benefit associated with filing on a unitary basis; MP pointed out that by definition, the single unitary return is not exclusively attributable to any one member.⁴

MP stated that if circumstances were different, in that the consolidated tax filings yielded lower use of ND ITCs than MP could have used on a separate return basis, the Company would still credit ratepayers with the \$10.7 million worth of ND ITCs, and the "consolidation" company would absorb the difference, whether positive or negative.⁵

MP argued against including the additional \$11.3 million tax credit in rates, stating:

[W]hen the stand-alone method is applied here, the ND ITCs utilized as a result of the income from the nonregulated operations cannot be used to reduce rates, as regulated rates should not be based on the financial information of nonregulated

³ MP Supplemental Reply Comments at Affidavit of Jamie Jago pp. 2-3 (Apr. 8, 2016).

⁴ MP Supplemental Reply Comments, pp. 11-12 (Apr. 8, 2016).

⁵ MP Supplemental Reply Comments, p. 16 (Apr. 8, 2016).

subsidiaries, further supporting Minnesota Power's proposal for how to treat the ND ITCs.⁶

MP Discussion of Prior Filings/Cases

MP's primary position and conclusion is that rates to be paid by ratepayers should not be reduced by contributions that stem from MP's relationship with nonregulated ALLETE affiliates, and to do so would be the taking of unregulated assets of shareholders. MP drew from several dockets to support its position and conclusion.

- MP referred to a 1994 Commission generic order that adopted explicit and specific cost separation requirements in order to prevent cross-subsidization between regulated and unregulated operations.⁷ MP suggests that not adopting MP's approach would be inconsistent with that order.⁸
- MP also referred to other dockets where the Commission did not incorporate into rates the consolidated tax return's tax savings that resulted from nonregulated affiliates' incurring net operating losses.⁹ MP cited the 2005 NSP Rate case, where the Commission reasoned that the stand-alone method prevents ratepayers from benefitting from or subsidizing a utility's nonregulated activities.¹⁰ MP argued that, consistent with the stand-alone objective, ND ITCs utilized as a result of the income from MP's nonregulated operations should not be used to reduce rates.¹¹
- MP referred to past Bison Wind related dockets to support its position. First, MP pointed to the Commission order in Docket 11-274, pertaining to the Bison 1 Wind project which stated,

“Minnesota Power shall return to ratepayers all of the federal, Minnesota, and North Dakota tax credits associated with the Bison 1 Wind Project;”¹²

⁶ MP Supplemental Reply Comments, p. 15 (Apr. 8, 2016).

⁷ *In the Matter of an Investigation into the Competitive Impact of Appliance Sales and Serv. Practices of Minn. Gas and Elec. Utils.*, Docket No. G,E999/CI-90-1008, ORDER SETTING FILING REQUIREMENTS at 6-7 (Sept. 28, 1994).

⁸ MP Supplemental Reply Comments, p. 9 (Apr. 8, 2016)

⁹ *In the Matter of the Application of N. States Power Co. d/b/a Xcel Energy for Auth. to Increase Rates for Elec. Serv. in Minn.*, Docket No. E002/GR-05-1428, ADMIN. LAW JUDGE'S FINDINGS OF FACT, CONCLUSIONS, AND RECOMMENDATION at 33-34 (July 6, 2006); and *In the Matter of the Complaint by Myer Shark et al. Regarding Xcel Energy's Income Taxes*, Docket No. E,G-002/C-03-1871, ORDER AMENDING DOCKET TITLE AND DISMISSING COMPLAINT at 5 (Oct. 1, 2004); see also *In re Complaint by Shark*, No. A05-21, 2005 WL 3527152, at *3 (Minn. App. Dec. 27, 2005) (affirming the Commission's decision in Docket No. C-03-1871).

¹⁰ MP Supplemental Reply Comments, p. 13 (Apr. 8, 2016)

¹¹ MP Supplemental Reply Comments, p. 15 (Apr. 8, 2016)

¹² *In the Matter of Minn. Power's Petition for Approval of its Renewable Res. Rider and 2011 Renewable Factor*, Docket No. E015/M-11-274, ORDER APPROVING COST RECOVERY PROPOSAL at Order Point 2 (Nov. 15, 2011).

MP put forth that the Commission 11-274 order requires MP to return to ratepayers the ND ITCs utilized by MP, and not the ND ITCs utilized by the ALLETE affiliates.¹³ Second, MP pointed to its own comments on record in its renewable resources rider Docket 13-410, which stated,

Minnesota Power confirms that it will offset future Renewable Resources Rider revenue requirements with ND ITCs once they have been realized, as stated in the original Petition, Exhibit B-2, footnote 6. (“Footnote 6” reads: *Eligible for 3% ND ITC per year for 5 years for a total of 15%. Will credit to revenue requirements as utilized.*)

MP explained that its comments relate to ND ITCs that will be utilized by the MP utility, not by ALLETE affiliates. Therefore, MP concluded that the Commission has not previously decided that MP is to offset rider revenue requirements with ND ITCs utilized by ALLETE affiliates.

- MP believes the Minnesota Supreme Court analysis in its decision in the *Minnegasco* case, with respect to the treatment of shared good will, applies to the ND ITC issue.¹⁴ In *Minnegasco*, the Commission reduced regulated rates by the value of good will in the Minnegasco name being used by an unregulated affiliate. Reversing the Commission’s decision, the supreme court explained that ratepayers acquired no ownership interest in the good will of a utility’s name, even though ratepayers’ purchases had helped establish the good will, providing:

[R]atepayers are no different in that regard than any consumer who purchases a product from a business. The simple act of purchasing a product or service from a business does not mean that the consumer becomes an owner of any of the business’ assets. Nor does it mean that the consumer bears the cost of creating good will. The relationship between the ratepayers, as a consumer, and the gas utility, as a business, does not change just because the gas utility provides regulated utility services. The ratepayer remains a consumer and the assets remain the property of the utility.¹⁵

The supreme court found no subsidization of unregulated operations because ratepayers had not borne the cost of creating the good will. In *Minnegasco*, the supreme court further provided that:

Because good will is not a “cost” of furnishing utility service
[and] because the ratepayers have not borne the cost of creating the

¹³MP Supplemental Reply Comments, p. 12 (Apr. 8, 2016): *In the Matter of Minn. Power’s Petition for Approval of its 2013 Renewable Res. Rider Factor*, Docket No. E015/M-13-410, COMMENTS OF THE MINN. DEP’T OF COMMERCE, DIV. OF ENERGY RES. at 7 (Sept. 30, 2013) and MINN. POWER REPLY COMMENTS at 3 (Oct. 14, 2013).

¹⁴See *Minnegasco v. Minn. Pub. Utils. Comm’n*, 549 N.W.2d 904 (Minn. 1996).

¹⁵ *Minnegasco*, 549 N.W.2d at 909.

good will, . . . the MPUC lacks the statutory authority to impute revenue to Minnegasco for the value of Minnegasco's good will used, but not paid for, by Minnegasco's affiliated appliance business.¹⁶

Drawing from the *Minnegasco* case, MP made the argument that while the cost of the Bison Wind Projects may be included in rates, it does not follow that ratepayers acquire an interest in the entirety of the ND ITCs that ALLETE's consolidated return has the potential to realize. MP concluded that rates to be paid by ratepayers should not be reduced by contributions that stem from MP's relationship with nonregulated ALLETE affiliates, and to do so would be the taking of unregulated assets of shareholders.

MP further argued that ratepayers are not paying more than their cost of service to cover any costs of nonregulated operations. MP concluded "without the payment of costs by ratepayers, there can be no subsidy, and without a subsidy by ratepayers, whatever benefit nonregulated ALLETE affiliates may receive from their association with MP's utility operations is of absolutely no significance in the ratemaking process."

Financial Reporting

At the Commission's Agenda Meeting held March 3, 2016 ("March 3rd Meeting"), MP raised a financial reporting concern and provided a more complete explanation in its subsequent filed comments.¹⁷ MP explained that accounting rules differ for regulated and unregulated businesses. The ND ITCs that ALLETE assigned to MP regulated operations have been recorded in a deferred regulatory liability account, benefits yet to be incorporated in rates; whereas, the ND ITCs that ALLETE assigned to its non-regulated operations must be recognized as income at the time the benefit is earned. Since ALLETE has already reflected in its financials the earned benefits it apportioned to non-regulated operations, if the Commission decides that all ND ITCs are to be reflected in MP's rates, ALLETE will have to reverse the previously reported benefit it assigned to its non-regulated operations. This reversal would cause ALLETE to report an increase to non-regulated operations' tax expense (about \$10 million) on its income statement.

Tax Sharing Agreement¹⁸

MP stated that the Company's Tax Sharing Agreement on file with the Commission applies to *subsidiaries* of ALLETE or Minnesota Power *Enterprises*, Inc. MP pointed out that it is not a subsidiary, but an operating division of ALLETE. Therefore, MP concluded the terms of the tax sharing agreement to "direct tax savings realized on a consolidated tax return due to use of a member subsidiary's tax credits... would be financially returned to that subsidiary" does not support any recommendation that all ND ITCs utilized on a consolidated tax return be returned to MP's customers.¹⁹

¹⁶ Minnegasco, 549 N.W.2d at 909.

¹⁷ MP Supplemental Reply Comments, pp. 4-5 (Apr. 8, 2016).

¹⁸ Provided in Attachment 4 to Department Comments (Dec. 16, 2015).

¹⁹ MP Supplemental Reply Comments, p. 18 (Apr. 8, 2016).

Asymmetrical Treatment

MP opposes the Department's recommendation on how to measure the amount of ND ITCs to credit to ratepayers (characterized by the Department as asymmetrical) because it would result in an inaccurate reflection of the cost of providing utility service and is inconsistent with stand-alone accounting principles.

Timing for ND ITC Benefit Recognition in Rates

Regarding when to reflect ND ITCs in rates, MP discussed two options: 1) use the estimated benefits figure and include them now, or 2) wait and include when the actual benefits are realized. MP raised several issues with the option to begin reflecting this benefit prior to realization. MP's primary concern was that the Company would essentially be financing any advancement of benefits, and if doing so, MP should receive a regulated return on any advanced amounts. Other issues surround the uncertainty of the estimated benefit amount. The amount of benefit derived from ND ITCs would be subject to changes in tax law, changes in future apportionment factors and other variables which could materially alter the current projected amount.

Department

After reviewing MP's supplemental reply and information, the Department maintains its recommendation that the Commission require MP to reflect all ND ITCs used in ALLETE, Inc.'s consolidated North Dakota tax returns when determining revenue requirements, not just the portion of the ND ITCs that are useable by MP on a separate return basis.

The Department addressed:

- The difference between the "separate return" and "stand-alone" methods;
- How all of MP's analyses of past Orders and rulings are flawed, and none supports MP's position;
- Why the impact to ALLETE's financial reporting is not relevant to the Commission's decision in this Docket; and
- How ratepayers are assured benefits from the ND ITCs used on ALLETE's North Dakota tax return;
- Use of amortization to flow ND ITC benefits to ratepayers;
- The asymmetrical aspect of the Department's proposal.

Stand-alone Method differs from MP's Proposal

First, the Department points out that MP's separate return method for allocating taxes differs from the stand-alone method. Unlike MP's proposal, the Department is proposing to apply the

stand-alone method of allocating income tax expense. Under the stand-alone method, all of the consolidated tax expense is allocated to individual members of the group, and there are no leftovers to be assigned to a “consolidation” company.

To aid in distinguishing the difference between MP’s technique and the stand-alone method, the Department cited the following guidance from the Federal Energy Regulatory Commission (FERC), as stated in its Accounting Guidance issued in Docket No. AI93-5-000 (which both MP and the Department referenced in earlier filings in this Docket):

The FERC has issued several decisions rejecting the use of the separate return method for determining income tax expense when an entity files as part of a consolidated group. Instead, the FERC relies on the standalone method of allocating income taxes between members of a consolidated group.

Under the standalone method the consolidated tax expense is allocated to individual members through recognition of the benefits/burdens contributed by each member of the consolidated group to the consolidated return. Under the standalone method, the sum of amounts allocated to individual members equal the consolidated amount.

The Department further explained, “The difference between the separate return and stand-alone methods lies at the heart of the issue facing the Commission. While MP acknowledged in a footnote that the separate return and stand-alone methodologies are different, in the body of its April 8th Comments, the Company defined the stand-alone method as one that calculates tax expense based on a separate return calculation...”²⁰

The Department provided additional FERC statements that describe how the stand-alone tax allocation method differs from a separate return method,²¹ with special emphasis on the test considered by the FERC stand-alone tax allocation approach,

“[T]he test is whether the expenses are included in the relevant cost of service. If they are, the associated deductions and their tax reducing benefits will be taken into account in calculating the tax allowance for that cost of service.”

Response to Dockets and Cases cited by MP

Docket E-002/GR-05-1428 (“2005 NSP-MN rate case”)

The Department is cognizant that in the 2005 NSP-MN rate case²² the report of the Administrative Law Judge (ALJ) and the Commission’s Order used the terms “separate return” and “stand-alone” interchangeably, which has led to the confusion of these two methods;

²⁰ Department Supplemental Response Comments at p. 3 (Apr. 22, 2016).

²¹ Department Supplemental Response Comments at pp. 4-5 (Apr. 22, 2016).

²² Docket No. E-002/GR-05-1428: Administrative Law Judge’s Findings of Fact, Conclusions, and Recommendation, dated July 6, 2006, pp. 33-34; Commission’s September 1, 2006 Findings of Fact, Conclusions of Law, and Order in NSP-MN’s 2005 Rate Case, pages 22-23.

nonetheless, given the facts in the 2005 NSP-MN Rate Case, the separate return and stand-alone methods would have produced the same result for NSP-MN's ratepayers.

While the referenced ALJ's Report and the Commission's Order did not draw a clear distinction between the separate return and stand-alone methods, the Department pointed out that the documents did clearly discuss the Commission's underlying principle to maintain financial separation between regulated and non-regulated operations. The Department concluded that assigning all the ND ITCs benefits realized to regulated operations upholds this principle, as discussed more in depth in the Department's December 16, 2015 Response Comments, pages 3 – 10. The Department argued that MP's proposal, to direct the tax benefits to shareholders even though none of the costs for the facility are allocated to shareholders, contradicts this principle. The Department pointed out that under MP's proposal, MP's shareholders would be allowed to earn their authorized return *plus* the value of these "leftover" ND ITCs.

Docket E-111/GR-14-428 ("Dakota Electric rate case")

In that case, the Department applied the Commission's principle of financial separation, therefore recommended reducing Dakota Electric's "other income" in order to remove non-regulated income activity for ratemaking. The Department reasoned that, because ratepayers bore none of the cost or risks associated with generating that net income, none of the benefits should be included in ratemaking.

Likewise, under the Department's proposal in this petition, no income generated by MP's non-regulated operations will be used to reduce MP's regulated rates. Rather it recognizes that MP ratepayer's bear all of the expenses associated with generating the ND ITCs, therefore deserve all the benefits.

Docket E,G-002/C-03-1871 – Complaint by Myer Shark et al. Regarding Xcel Energy's Income Taxes and Docket E-015/M-99-416 – Request by Minnesota Power for Approval of its 1998 CIP Tracker Activity ("Lost Margins" case).

The Department indicated that these two cases do not support MP's proposal as they are not relevant to the issue herein, rather relate to retroactive ratemaking principles.²³

Docket G-008/CI-91-942 ("*Minnegasco*" treatment of good will)

The Department's discussion of MP's argument, found on page 8 of its comments, will not be repeated here. In summary, the Department pointed out that the conclusion upon which the Supreme Court relied in reaching its decision, that good will was not a cost of rendering utility service, cannot be said of taxes. Therefore, MP's attempt to equate these two issues is inappropriate.

²³ Department Supplemental Response Comments, pp. 7-8 (Apr. 22, 2016)

ALLETE's Financial Reporting

The Department thoroughly explained the financial reporting rules which will not be repeated here.²⁴ The Department explained that the immediate impact on ALLETE's financial reporting (to increase non-regulated operations tax expense) should the Commission determines that all ND ITCs be assigned to MP, is the direct result of "MP's erroneous interpretation of the Commission's stand-alone tax methodology." Had MP correctly and reasonably planned to credit ratepayers with all of the ND ITCs used on ALLETE's North Dakota tax return, ALLETE would not have recorded [non-regulated operations] net income pursuant to the ND ITCs, and no reversal would be necessary.

How ratepayers are assured benefits from the ND ITCs used on ALLETE's North Dakota tax return

The Department pointed to the transcript of the March 3rd Meeting wherein MP had explained that, as a requirement under the tax sharing agreement, MP would receive cash payments from affiliates for use of ND ITCs. Although these payments would not be included in revenue requirements, MP reasoned that ratepayers benefit because having more cash reduces borrowings when doing construction and other activities. The Department noted that MP did not revisit this stated benefit in its April 8, 2016 filed comments, rather that MP's ensuing written comments seemingly contradict its oral comments, by now stating its tax sharing agreement relates only to ALLETE and its subsidiaries, and not directly to MP (a division of ALLETE). Ultimately the Department determined that unless these additional ND ITCs are reflected in revenue requirements, ratepayers do not receive the benefit.

Asymmetrical Aspect of the Department's Proposal

In its December 16, 2015 comments, the Department recommended that:

[R]atepayers should be credited, at a minimum, with the ND ITCs that would be realized on a stand-alone basis, and if "extra" ND ITCs are consumed, ratepayers should be credited with those as well, because ratepayers paid the expenses that generated them.

While this appears to result in an asymmetrical treatment, as ALLETE bears all the risks associated with foregone tax benefits resulting from consolidation, but only reaps benefits associated with "extra" tax credits generated by nonregulated operations, the Department concludes that this asymmetry is appropriate . . .²⁵

In its April 22, 2016 comments, the Department stated that under its proposal, ratepayers would see benefits only equal to the additional ND ITCs used on consolidated return, and there would be no appropriation of shareholder investments.

²⁴ Department Supplemental Response Comments, pp. 9-10 (Apr. 22, 2016)

²⁵ *In the Matter of Minn. Power's Renewable Res. Rider and 2015 Renewable Factor*, Docket No. E015/M-14-962, RESPONSE COMMENTS OF THE MINN. DEP'T OF COMMERCE at 7-8 (Dec. 16, 2015).

Use of Amortization to reflect ND ITCs in rates

In the March 3rd Meeting, MP stated if the Department's recommendation was adopted, it had concerns related to including a greater amount of ND ITCs than ND tax expense in its revenue requirements. The Department did not agree this to be problematic, nor did the Company take the opportunity to further discuss this concern in its follow-up written comments.²⁶

The Department indicated that the proposal²⁷ to amortize ND ITCs in the same manner that was used for Otter Tail Power Company seems to solve MP's concern. To the extent that amortization requires MP to pass tax benefits back to ratepayers before they are realized, MP would need to record a deferred tax asset, which would be included in rate base and therefore earn a return. To the extent that MP realizes the tax benefits before passing them on to ratepayers, MP would need to record a deferred tax liability which would reduce rate base, and therefore reduce MP's overall return.

Staff Comments

Utilities with ND ITCs

MP is not the only jurisdictional utility earning ND ITCs. Otter Tail Power Company (OTP) and Xcel have also earned ND ITCs. OTP has a mechanism currently in place to pass this tax benefit to ratepayers.²⁸ Xcel has a pending docket 15-805 being evaluated wherein the issue appears to be "which (state's) ratepayers" get the benefit, not "whether ratepayers" get the benefit.

Tax Allocation Methods

Staff agrees with Minnesota Power's statement that the Commission's use of the stand-alone method to determine the level of income taxes to be included in "just and reasonable rates" is long-standing. However, staff does not agree that determining utility rates by employing the separate return method advocated by MP is the equivalent of, or interchangeable with, the stand-alone method. The Department discussed the distinction.

A separate return policy (or method), as described by FERC, ignores the consolidated tax return and reflects in the tax allowance none of the tax reducing benefits the group realizes from filing a consolidated return.²⁹ Whereas the stand-alone method, as described by FERC, does not ignore the consolidated return or the tax reducing benefits the group realizes; rather the stand-alone method allocates the consolidated tax liability to the members beneath the single tax return. Therefore, ALLETE's practice, to assign to a "consolidation" company the difference between the unified group's consolidated return tax burden and the aggregated outcomes of each

²⁶ Department Supplemental Response Comments, p. 11 (Apr. 22, 2016)

²⁷ See Staff's Briefing Papers, pages 12-13.

²⁸ See Staff Briefing papers pp. 12-13, 17-18 (issued Feb. 24, 2016, in this docket).

²⁹ *Columbia Gulf Transmission Company*, 23 FERC ¶ 61,396 (1983) pages 61,852-61,853

members' tax burden calculated on a separate return basis, is not the stand-alone tax allocation method.

When using the stand-alone tax allocation method, the method takes into account the revenues and the burdens that enter into determining an operation's cost of service. With the stand-alone approach, the consolidated tax savings (or benefits) would be ascribed to the regulated utility if it bears the costs (or burdens) that generated the tax benefits in question. Because the cost responsibility for the Bison Projects is solely assigned to MP's regulated operations, the Commission's long-standing stand-alone tax method would be upheld by likewise assigning all the consolidated return's ND ITCs benefits realized to MP's regulated operations.

Staff agrees with the Department's conclusion that under the stand-alone method, Minnesota Power would receive the full \$22 million in ND ITC benefits utilized through a consolidated return filing. This method of tax credit assignment is also used by Xcel Energy, as evident in Xcel's tax allocation agreement³⁰, which states in part:

"Tax Credits: [...] Any tax credits [...] shall be allocated directly to the members of the Group giving rise to them. [...]"

"Payments: If the Group is unable to utilize all of the tax credits available for a taxable year, [...], payment for the tax credits shall be as follows:

- (1) Tax Credits Actually Used. Payment for credits actually used in the current or carryback year shall be made to those members who generated the credits...
- (2) Tax Credits Carried Forward. The unused portion of any tax credits being carried forward shall be allocated [...] to the members of the group generating such tax credits..."

There is no dispute that MP's construction of the Bison Projects generated the ND ITCs. The overarching dispute to be resolved by the Commission is whether all ND ITC benefits realized on the ALLETE consolidated return should be recognized in ratemaking.

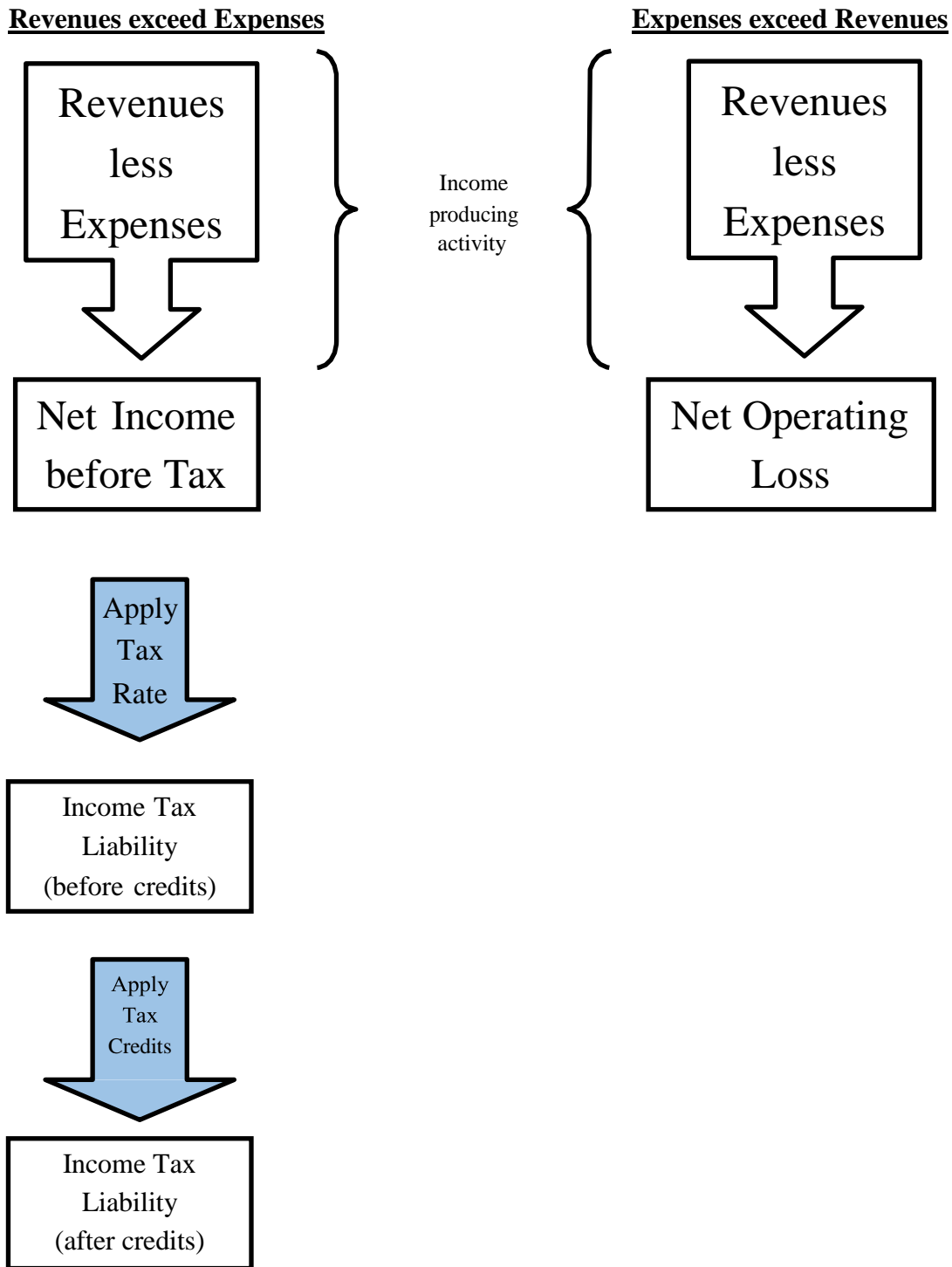
Financial Separation of Regulated and Nonregulated Operations

MP stated that income from nonregulated operations should not be used to reduce rates and suggested that including the additional ND ITCs utilized on the consolidated return in ratemaking, would do just that.³¹ In response, Staff points out that: The ND ITCs are a product of MP's investments in the Bison Wind facilities; ND ITCs are not a product of income generation or income taxes; ND ITCs do not offset taxable income, nor alter the statutory tax rate applied to taxable income.

³⁰ Exhibit 42 of Docket E-002/GR-05-1428.

³¹ MP Supplemental Reply Comments, p. 15 (Apr. 8, 2016)

Provided below is a basic illustration of the general order of activity that gives rise to income and income taxes; and at what stage ND ITCs would be applied. The core of an entity's activity includes investments, revenues and expenses.



MP had cited a 2005 Xcel case where there was an issue about sharing the consolidated tax return benefits derived from Xcel's nonregulated operations net operating loss with its regulated operations. As illustrated in the chart above, when an entity's operating costs exceed revenues, it results in negative income, i.e., a *net operating loss*. In the cited 2005 Xcel case decision, the ALJ and the Commission rejected an intervenor's recommendation to apply the net operating loss (negative income) that resulted from an unregulated operation against the regulated operation's positive income. The intervenor wanted to lower the income tax expense included in jurisdictional rates: by reducing the utility's taxable income (by the unregulated operation's losses). However, it was pointed out that the unregulated operation's revenues/expenses were not charged to ratepayers. The Commission's decision appropriately decided against using the unregulated entity's "income" to reduce the regulated operation's pre-tax income, thus maintained financial separation of regulated and nonregulated operations. As for ND ITCs, they are applied post-income-tax-generation and do not alter nonregulated operations' core activity results. Nor are ND ITCs sourced from nonregulated operations. Rather cost recovery of the investments that gave rise to the ND ITCs are solely charged to MP's operations.

The Department's position is to recognize that all of these ND ITCs are due to the Bison Wind farms, facilities that are included in the regulated cost of service. In response, MP argued that the additional \$11.3 million in ND ITCs it expects to use are not a result of the cost of furnishing utility service but are the result of the requirement that ALLETE file a unitary North Dakota tax return. Staff observes that the predominant focus in ratemaking is establishing rates to allow utilities to recover necessary costs for these essential services. Now we have a situation that an incentive has been granted to the utility for its actions, and these directly-tied benefits are overflowing.

One of MP's arguments against inclusion of the additional \$11.3 million tax benefit in rates is that ratepayers are not paying more than their cost of service to cover any costs of nonregulated operations. Therefore, MP concluded that there is no subsidization of nonregulated operations, and whatever benefit nonregulated ALLETE affiliates may receive from their association with MP's utility operations is of absolutely no significance in the ratemaking process.

Staff disagrees with MP's assessment that "ratepayers are not paying more than their cost of service." First, it is important to point out that all realized investment tax credits essentially reduce the cost of the capital project (plant); and second, the existing rates were developed using the upfront investment outlay to construct this plant without consideration of the potential return of this capital outlay through investment tax credits. In the absence of competitive market forces, regulators may act to recognize that the realized investment tax credits have indeed lowered cost of service, and could justify a rate adjustment accordingly.

Interpretation of Commission Order in Docket E-015/M-11-274 ("Docket 11-274")

When making its decision, the Commission may want to discuss MP's interpretation of the Commission order in Docket 11-274, pertaining to the Bison 1 Wind project which reads,

“Minnesota Power shall return to ratepayers all of the federal, Minnesota, and North Dakota tax credits associated with the Bison 1 Wind Project;”³²

MP commented that the Commission 11-274 order requires MP to return to ratepayers the ND ITCs utilized by MP, and not the ND ITCs utilized by ALLETE affiliates; by extension, one could infer that MP may also apply that same interpretation and argument to federal tax credits earned from its energy investments. Federal tax credits, such as the Production Tax Credit, have a much larger impact on revenue requirements.^{33,34}

ND ITC Recognition Alternatives

Staff believes it is important to acknowledge that there is more than one benchmark that could be used to set the appropriate measure for tax credit recognition in rates – such as the total credits granted, total credits usable, or total credits built into a project’s cost-effectiveness analysis. The “total credits granted” or the “total credits built into a project’s cost-effectiveness analysis” could be reasonable bases; for example, if a company assured certain expectations, or reflected these tax savings in the development of a project’s cost proposal and the inclusion influenced the Commission decision to select and approve the project build over other resource options. However, taking into account MP’s statement³⁵ was not disputed (that ND ITCs benefits were not a large driver of the cost-effectiveness decision to build wind facilities in North Dakota), and absent documentation to suggest otherwise, staff does not recommend inclusion of the full \$113.0 million ND ITC in rates for these projects. Rather, both the Department’s and MP’s proposals are premised upon credit utilization.

The Department’s recommendation is to recognize the higher of the total used on the consolidated return or what could have potentially been used against MP’s separate return tax liability; in other words, the better of the two at any given time. The Company’s recommendation is to recognize the credits that could be utilized on MP’s separate return tax liability, without regard to what is actually utilized on the consolidated return. Staff offers a third alternative to recognize the total actually used on the consolidated return (FERC standalone approach).

The Staff analysis of these three alternatives, is discussed more fully on pages 14-17 of the February 24, 2016 briefing papers, so is briefly summarized here. Staff raised concern that the cumulative result of the Department’s approach may lead to recognizing a higher tax benefit in rates than actually realized, whereas MP’s approach, which does not attribute the tax benefit wholly as MP’s, may do just the opposite. Taking into account that ND ITCs were not a promoted factor in resource selection process, Staff believes the third alternative recognizes that

³² *In the Matter of Minn. Power’s Petition for Approval of its Renewable Res. Rider and 2011 Renewable Factor*, Docket No. E015/M-11-274, ORDER APPROVING COST RECOVERY PROPOSAL at Order Point 2 (Nov. 15, 2011).

³³ The PTC for Bison Projects reduced revenue requirements by over \$68 million in one year alone (2015). Exhibit B-1, p. 4, MP’s Initial Filing (Nov. 10, 2014).

³⁴ See also Staff Briefing papers, p. 14, and discussion of the influence of tax benefits on resource selection (issued Feb. 24, 2016 for Mar. 3, 2016 Agenda meeting).

³⁵ MP Reply Comments at 3 (March 23, 2015)

ND ITCs are attributed wholly and directly to MP; and, by applying the standalone approach (as described by FERC) to the consolidated return results, would uphold the separation of regulated and non-regulated operations.

Timing and Method Used to Include ND ITCs in Rates

Three possible options on the timing and methods available to incorporate ND ITCs into rates are discussed next. However, the Commission may consider other options beyond what is presented here.

MP's proposal was to reflect the ND ITC benefit in revenue requirements when the credits are utilized. MP does not anticipate utilization of credits to begin until the year 2020.³⁶ Besides ease of administering through a rider mechanism, another advantage to the immediate flow through of benefits as they are realized is that there would be no financing costs (i.e., rate base adjustments) for timing differences. Disadvantages could include a period mismatch between payers of project costs and recipients of the project's benefits (i.e., intergenerational inequity); and potential year-to-year rate fluctuation, however, MP suggested that the average monthly billing impact tied to ND ITCs was relatively small.³⁷

As an alternative, the Commission could consider amortization of ND ITC benefits.³⁸ Some advantages of amortization are: better alignment of the cost recovery and benefit flow periods; minimization of potential rate fluctuations; and ease to incorporate a 'level' amount into base rates. Some disadvantages would be an increase in recordkeeping requirements and added financing costs to account for timing differences between rate recognition of benefit and actual tax credit realization. If amortization of the benefit over remaining plant life is used, the Commission could direct the Company to:

- (1) begin amortizing the estimated total benefit into rates in MP's next rider rate (or base rate) change; or,
- (2) begin amortizing at the onset of the actual realization of the benefit, through a rider mechanism, adding the credits realized from year-to-year to the amortizable balance.

The second amortization option avoids the need for any true up due to differences between estimated benefit and actual benefit realized.

Future Reporting Consideration

Staff suggests that the Commission may want to be kept informed should the estimated ND ITC benefit materially change or other monetization opportunities arise. An optional reporting requirement decision option is available for consideration.

³⁶ MP Supplemental Reply Comments, p. 31 (Apr. 8, 2016)

³⁷ MP Supplemental Reply Comments, p. 5 (Apr. 8, 2016) stated that should entire \$22 million of ND ITCs be credited to MP customers, the average customer monthly bill would decrease approximately five cents.

³⁸ The Commission approved amortization of ND ITCs for Otter Tail Power Company in Docket No. E-017/M-09-1484.

Decision Options

1. Defer the North Dakota Investment Tax Credit (ND ITC) issue to Minnesota Power's next general rate case and take no further action at this time. [MP] **or**
2. Decide the North Dakota Investment Tax Credit (ND ITC) issue and:
 - A. Require MP to reflect in the revenue requirements of MP's Minnesota ratepayers the greater of (1) the value of the ND ITCs MP would consume on a stand-alone [separate-return] basis, and (2) the value of all ND ITC tax credits used in ALLETE's consolidated North Dakota tax returns, not just the credits consumed by MP on a stand-alone [separate-return] basis. [DOC] **or**
 - B. Find that only the ND ITCs that would be used by Minnesota Power on a separate-return basis shall be credited to the revenue requirement calculation. [MP] **or**
 - C. Decide that all Bison Wind Projects' ND ITCs actually realized in tax return filings, or monetized through other permissible means shall be reflected in MP's revenue requirements. [Staff]

If an Option 2 is selected, then consider options to incorporate the ND ITCs into rates

3. Direct MP to reflect in revenue requirements the ND ITC tax benefit amount utilized year-to-year; [MP] **or**
4. Direct MP to amortize the total estimated ND ITC benefit over the remaining life of Bison Wind Projects; and to commence amortization, and the tax credit inclusion in revenue requirements, in its next renewable resource rider filing (i.e., the 2017 RRR petition). Permit the appropriate adjustment to rate base to account for the net difference between the cumulative amount of amortized ND ITCs included in rates and the cumulative amount of the ND ITCs actually realized; [Staff, DOC accepts] **or**
5. Direct MP to amortize the actual ND ITC benefit realized over the remaining life of Bison Wind Projects; and at the onset of the actual realization of the benefit, to commence amortization and the tax credit inclusion in revenue requirements, in its next renewable resource rider filing. Credits realized from year-to-year shall be added to the amortizable balance. Permit the appropriate adjustment to rate base to account for the unamortized balance of the actual ND ITCs realized. [Staff]

Future Reporting Requirement

6. Require Minnesota Power to submit supplemental compliance filings with the Commission in this docket if there are: (1) material changes (greater than 10 percent or \$2.2 million) to the estimated ND ITC utilization on a consolidated/unitary tax return, and/or (2) legislative changes that allow additional means to monetize these credits.

Concurrent with the supplemental compliance filing, require MP to submit in a new docket any request for deferrals, and/or proposals on how these changes may be reflected, or treated, in rates. [Staff]