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July 11, 2014

VIA ELECTRONIC FILING

The Honorable Eric L. Lipman
Administrative Law Judge
Office of Administrative Hearings
P.O. Box 64620
St. Paul, MN 55101

Re: 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. 8-2500-31126

Dear Judge Lipman:

On behalf of Minnesota Energy Resources Corporation (MERC), enclosed for filing in the above matter, please find MERC's Post-Hearing Reply Brief.

Thank you for your attention to this matter. Please feel free to contact me at (612) 340-2881 if you have any questions.

Sincerely yours,

/s/ Michael J. Ahern

Michael J. Ahern

Enclosure

cc: Service List

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. 8-2500-31126

MINNESOTA ENERGY RESOURCES CORPORATION'S REPLY BRIEF

JULY 11, 2014

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I. INTRODUCTION

Minnesota Energy Resources Corporation ("MERC" or the "Company") files this Reply Brief in response to the Initial Briefs filed by the Minnesota Department of Commerce, Division of Energy Resources (the "Department") and the Minnesota Office of the Attorney General, Antitrust and Utilities Division (the "OAG"). In this Reply Brief, MERC addresses the important outstanding issues raised by other parties that require response beyond that already provided in MERC's Initial Brief. For all other issues, MERC relies on the positions set forth in its Initial Brief submitted June 24, 2014. MERC respectfully requests that the Administrative Law Judge ("ALJ") and the Minnesota Public Utilities Commission (the "Commission") adopt MERC's positions as set forth herein and in MERC's Initial Brief and Pre-Filed Testimony in this proceeding.

II. THE DEPARTMENT FAILED TO DEMONSTRATE THAT ITS PROPOSED RETURN ON EQUITY WILL PROVIDE MERC THE OPPORTUNITY TO ATTRACT INVESTORS IN A CAPITAL MARKET.

In its Initial Brief, as well as the testimony of MERC witness Mr. Paul Moul, MERC presented a full analysis of the appropriate return on equity ("ROE") and established that a ROE of 10.75 percent is necessary for MERC to balance the Company's interest with the interests of ratepayers.[1] At a minimum, based on the increase in capital costs since MERC's last rate case, MERC's analysis demonstrates that MERC's ROE should be at least 10.27 percent.[2] In their Initial Briefs, the Department and the OAG recommended unreasonably low ROEs because they failed to take into account MERC's unique risk factors. The preponderance of evidence shows that these additional risks must be considered in order for MERC's ROE to meet the tests set

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[1] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 5-25 (June 24, 2014); Ex. 17 at 1-2, 6, 9, 46 (P. Moul Direct); Ex. 18 at 4-5, 9, 40 (P. Moul Rebuttal).

[2] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 7 (June 24, 2014); Ex. 18 at 40 (P. Moul Rebuttal).

forth in *Bluefield* and *Hope*.[3] MERC recommends that the ALJ and the Commission accept MERC's proposed ROE of 10.75 percent as reasonable in this rate case.

A. MERC's Recommended ROE is Supported by Three Recognized Financial Models.

MERC presented the most thorough ROE analysis in this rate case because MERC considered the results of three recognized financial models, the Discounted Cash Flow ("DCF") model, Risk Premium ("RP") analysis, and the Capital Asset Pricing Model ("CAPM").[4] MERC's Comparable Earnings ("CE") model provided a further check on MERC's ROE analysis.[5]

The *Hope* Court determined that a just and reasonable return should be similar to returns on investments in other businesses having corresponding risk.[6] Contrary to the OAG's assertions, MERC's ROE does not "fl[y] in the face of recent trends both nationally and in Minnesota."[7] As explained in MERC's Initial Brief, the Department's and OAG's recommended ROEs are low as compared to the rates of return allowed by other state utility commissions in 2013.[8] In fact, in its Initial Brief, the Department acknowledges that the average ROE for the group of eleven natural gas rate cases discussed in MERC's rebuttal testimony for the fourth quarter of 2013 was 9.83 percent, with the highest ROE being 10.25 percent.[9] Thus, at least

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[3] *Federal Pwr. Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) ("*Hope*"); *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n or West Virginia et al.*, 262 U.S. 679, 692-93 (1923) ("*Bluefield*"); Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 7 (June 24, 2014).

[4] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 7-8 (June 24, 2014); Ex. 17 at 3 (P. Moul Direct).

[5] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 7-8 (June 24, 2014); Ex. 17 at 3-5 (P. Moul Direct); Ex. 18 at 3 (P. Moul Rebuttal).

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

[7] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 18 (June 24, 2014); Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 29 (June 24, 2014).

[8] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 18 (June 24, 2014).

[9] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 40 (June 24, 2014).

some of the allowed ROEs were significantly above even the Department's ***initial*** recommended ROE of 9.40 percent. The fact that the fourth quarter 2013 Commission decisions may be based on data from 2012 and early 2013 only substantiates MERC's assertion that the Company's ROE must necessarily increase to account for the increase in MERC's capital costs since the Company's last rate case. MERC further notes that the fourth quarter 2013 highest ROE of 10.25 percent is only 2 basis points lower than the 10.27 percent ROE that MERC has indicated it would accept.[10]

MERC explained in its Initial Brief that the Department's and OAG's recommended cost of equity is lower than Value Line's average rate of return of 11.49 percent for its natural gas utility companies over the 2017 through 2019 period and lower than the cost of equity that the Commission has awarded other natural gas local distribution companies since MERC's last rate case.[11] MERC's Initial Brief demonstrates that, based on the returns established in other natural gas and electric regulatory proceedings, the returns that investors expect gas utilities to achieve, and the general state of capital markets, an equity return of less than 10 percent would jeopardize MERC's ability to attract capital and meet the Company's service responsibilities to customers.[12]

The Department incorrectly asserts in its Initial Brief that MERC's "updating" argument is unreasonable and must be rejected.[13] MERC has sufficiently demonstrated that an update of the Commission's prior 9.70 percent approved equity return in MERC's last rate case results in a current return of 10.27 percent.[14]

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[10] Ex. 18 at 6 (P. Moul Rebuttal); Initial Post-Hearing Brief of the Minnesota Department of Commerce at 40 (June 24, 2014).

[11] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 18-19 (June 24, 2014).

[12] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 18-20 (June 24, 2014).

[13] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 41 (June 24, 2014).

[14] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 6-7, 18 (June 24, 2014); Ex. 18 at 8-9 (P. Moul Rebuttal).

Although the results of MERC's ROE methods changed in rebuttal testimony,[15] an adjustment to MERC's ROE was not required because with one increase in results, one decrease in results, and one result remaining mostly unchanged, MERC's recommended ROE of 10.75 percent remained reasonable.[16] Thus, MERC requests that the ALJ and the Commission approve a ROE of 10.75 percent, but no less than 10.27 percent, for MERC in this rate case.

B. The Department's and the OAG's Criticisms of MERC's DCF, RP, and CAPM Analyses are Unfounded and Should be Rejected.

MERC, the Department, and the OAG all confirmed their DCF results using the CAPM.[17] In addition, MERC confirmed its DCF results using the RP method,[18] and the CE method.[19]

1. The DCF Analysis

For MERC's dividend yield calculations, it was appropriate for the Company to use six month historical prices rather than shorter-term (i.e., one to three month) prices because the use of the six-month average dividend yield will reflect current capital costs, while avoiding spot yields.[20]

MERC and the Department agreed that the flotation cost calculation should be 3.90 percent.[21] The Department disagreed with MERC's adjustment procedure, but not the flotation

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[15] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 31 (June 24, 2014).

[16] Ex. 18 at 3-5 (P. Moul Rebuttal).

[17] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 7 (June 24, 2014); Initial Post-Hearing Brief of the Minnesota Department of Commerce at 22 (June 24, 2014); Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 21 (June 24, 2014).

[18] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 7 (June 24, 2014).

[19] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 7-8 (June 24, 2014).

[20] Ex. 17 at 20-21 (P. Moul Direct).

[21] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 24 (June 24, 2014).

cost adjustment amount.[22] As demonstrated by MERC, the DCF flotation adjustment is reasonable and is supported by the Company's analysis of natural gas utility stock.[23] Indeed, MERC's flotation adjustment of 0.14% is actually lower than the 0.15% flotation adjustment proposed by the Department.[24]

The Department's claim that MERC's projected growth rate is subjective and, therefore, unreasonable is false.[25] MERC engaged in a detailed growth rate analysis.[26] Further, MERC's expected growth rate of 5 percent falls within the array of earnings per share ("EPS") growth rates shown by the relevant analysts' forecasts, and is actually lower than Dr. Amit's 5.12% mean projected growth rate.[27]

Both MERC and the Department agree that the OAG's 8.62 percent ROE recommendation is fundamentally unreasonable, and is based on the erroneous assumption that when the market-to-book ratio is greater than one, the DCF produces an upwardly biased DCF estimation of ROE.[28] As detailed in MERC's and the Department's Initial Briefs, the OAG failed to show that when the market-to-book ratio is greater than one, there is an upward bias to the cost of common equity.[29] Rather, the empirical studies identified by the OAG produce unreasonably low ROEs when the market-to-book ratio equals one.[30]

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[22] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 30 (June 24, 2014).

[23] Ex. 17 at 31-32 and Schedules 1 and 9 (P. Moul Direct); Ex. 18 at 10 (P. Moul Rebuttal).

[24] Ex. 200 at 58 (E. Amit Direct).

[25] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 30 (June 24, 2014).

[26] Ex. 17 at 21-26 (P. Moul Direct).

[27] Ex. 17 at 25-26 (P. Moul Direct); Ex. 202 at 4 (E. Amit Surrebuttal).

[28] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 21-22 (June 24, 2014); Initial Post-Hearing Brief of the Minnesota Department of Commerce at 41, 49-52 (June 24, 2014).

[29] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 21-22 (June 24, 2014); Initial Post-Hearing Brief of the Minnesota Department of Commerce at 41, 49-52 (June 24, 2014).

[30] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 21-22 (June 24, 2014); Initial Post-Hearing Brief of the Minnesota Department of Commerce at 41, 49-52 (June 24, 2014).

With respect to the OAG's projected growth rate, the Department aptly points out that the growth rate is based on a subjective average of several growth rates that achieves a low ROE, with no explanation of why it would not be reasonable to employ a similarly subjective average of growth rates to achieve a higher ROE.[31] Both MERC and the Department determined that average EPS growth rates are the appropriate growth rates to use because they most accurately predict utilities' stock prices.[32]

As detailed by MERC in its testimony, the 2014 Value Line dividend growth rates used by the OAG must be rejected because: earnings are the source of dividend payments; with the constant price-earnings multiple assumption of the DCF, the value of the firm (i.e., its stock price) will grow at the earnings growth rate; and it has been established that analysts' earnings forecasts are the best input for the DCF.[33]

2. The RP Analysis

The Department improperly criticizes MERC's yield and risk premium for the Company's RP analysis and MERC's risk-free rate of return and market premium choices for the Company's CAPM analysis.[34]

Despite the Department's concerns,[35] MERC's historical risk premium approach is appropriate in this rate case and MERC did not use the wrong yield on A-rated utility bonds or the wrong risk premium.[36] The fact that recent financial literature indicates that prospective risk premiums ***may*** be preferable to risk premiums estimated based on historical data, the use of

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[31] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 41-42 (June 24, 2014).

[32] Ex. 17 at 21-25 (P. Moul Direct); Initial Post-Hearing Brief of the Minnesota Department of Commerce at 43-49 (June 24, 2014).

[33] Ex. 18 at 26-27 (P. Moul Rebuttal).

[34] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 27 (June 24, 2014).

[35] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 31 (June 24, 2014).

[36] Ex. 17 at 33-36 (P. Moul Direct).

historical data is appropriate here. As detailed in MERC's testimony, MERC appropriately considers the prospective yield on A-rated public utility debt using the Blue Chip Financial Forecasts, the forecast yields on long-term Treasury bonds published on June 1, 2013, and a yield spread based on recent historic data.[37] The use of yields on A-rated utility bonds is preferable for this case because it allows the RP approach to conform with a forward-looking cost of equity and aligns the premium derived from historical data with the prospective level of interest rates.[38]

3. The CAPM Analysis

The Department argues that MERC improperly increased its beta to account for the higher financial risk of MERC's proxy group.[39] As detailed in MERC's rebuttal testimony, the beta of 0.86 is appropriate and reflects the financial risk associated with a ratesetting capital structure that is measured at book value.[40]

Contrary to the Department's position,[41] the yield on thirty year Treasury bills does represent a risk-free yield and MERC's use of Blue-Chip's forecast of future yields is appropriate. As detailed in MERC's testimony, forecasts of interest rates must be emphasized in selecting the risk-free rate of return in the CAPM.[42] Hence, the Company's risk-free yield considers not only the Blue Chip forecasts, but also the recent trend in the yields on long-term Treasury bonds.[43]

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[37] Ex. 17 at 33-34 (P. Moul Direct).

[38] Ex. 18 at 19 (P. Moul Rebuttal).

[39] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 32 (June 24, 2014).

[40] Ex. 17 at 37-38 (P. Moul Direct); Ex. 18 at 16-17 (P. Moul Rebuttal).

[41] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 33 (June 24, 2014).

[42] Ex. 17 at 39 (P. Moul Direct).

[43] Ex. 17 at 39 (P. Moul Direct); Ex. 18 at 36-37 (P. Moul Rebuttal).

In testimony, MERC explained that the Company used a different risk premium for its RP analysis than its CAPM analysis because the equity risk premium component of MERC's RP model is aligned with the yields on A-rated public utility bonds, and the market premium in the CAPM is aligned with the risk-free rate of return.[44] Thus, the Department's concern regarding MERC's different risk premiums is irrelevant.[45]

The ten year Treasury Bond rates used by the OAG in its CAPM analysis are inappropriate because they result in a rate that is too low for the risk-free rate of return component of the CAPM for the 2014 test year and the rate effective period.[46] As explained in MERC's testimony, the forecasts show an increase in Treasury yields for the future that is not reflected in the OAG's CAPM analysis.[47]

4. The CE Analysis

The Department erroneously argues that MERC's CE analysis is without merit.[48] As explained in MERC's testimony, the CE method is valuable because, unlike the DCF and CAPM, the results of the CE method can be applied directly to the book value capitalization and do not contain the potential misspecification contained in market models when the market capitalization and book capitalization diverge significantly.[49] MERC is the only party that performed a CE analysis, and information detailing the appropriateness of MERC's CE analysis is provided in MERC's testimony.[50]

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[44] Ex. 17 at 33-39 (P. Moul Direct).

[45] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 33 (June 24, 2014).

[46] Ex. 18 at 36-37 (P. Moul Rebuttal).

[47] Ex. 18 at 36-37 (P. Moul Rebuttal).

[48] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 34 (June 24, 2014).

[49] Ex. 17 at 44 (P. Moul Direct).

[50] Ex. 17 at 42-45 (P. Moul Direct).

C. The Department's and the OAG's Analyses Fail to Properly Account for MERC's Unique Risk Factors and Improperly Underestimate MERC's ROE.

1. The Department's and the OAG's Proxy Groups Do Not Include a Size Adjustment and Do Not Properly Reflect MERC's Unique Risk Factors.

According to the Department, a fair rate of return is one that is sufficient to enable the regulated company to maintain its credit rating and financial integrity, enable the utility to attract capital at reasonable terms, and be commensurate with returns being earned on other investments having equivalent risks.[51] MERC's proxy group contained thirteen gas and electric companies.[52] Contrary to the Department's assertions,[53] MERC explained that the inclusion of combination gas and electric companies is appropriate because the electric companies included in MERC's proxy group are primarily delivery companies (i.e., they have no significant electric generation assets).[54] Contrary to the Department's position,[55] MERC has also demonstrated that the Company's investment risk is higher than that of MERC's proxy group.[56] Finally, the Department improperly recommends that the selection of MERC's proxy group should have been based on a macro, not micro, risk analysis.[57] It is necessary to consider MERC's unique risk factors to ensure that the Company's ROE is not understated.[58]

The Department incorrectly argues that MERC's proposed size adjustment would isolate a unique risk factor for MERC and would disregard all other risk factors that may be unique to

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[51] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 14-15 (June 24, 2014) (citing Ex. 200 at 3 (E. Amit Direct)).

[52] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 7 (June 24, 2014).

[53] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 28 (June 24, 2014).

[54] Ex. 17 at 5 and Schedule 2 (PRM-1) (P. Moul Direct); Ex. 18 at 25-26 (P. Moul Rebuttal).

[55] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 35 (June 24, 2014).

[56] Ex. 17 at 12-17 (P. Moul Direct).

[57] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 36 (June 24, 2014).

[58] Ex. 17 at 8-17 (P. Moul Direct).

other utilities in the Company's comparison group.[59] As detailed in MERC's Initial Brief, a size adjustment is necessary because MERC is several orders of magnitude smaller than the average size of MERC's proxy group and the Standard & Poor's Public Utilities Index.[60] MERC explains in its Initial Brief that the Department's proxy group does not appropriately reflect MERC's actual risk because the Department's proxy group contains mostly mid-cap companies, whereas MERC is a small cap company.[61] In addition, the Department has explicitly recognized that MERC has more financial risk than the proxy group used in the Department's equity analysis.[62]

The OAG admits that its proxy group contains several companies with substantial non-regulated activities that present a different risk profile than MERC.[63] However, contrary to the OAG's assertions, the difference in investment risk profiles between its proxy group and MERC's proxy group does not benefit MERC[64]. MERC has established that, all other things being equal, a smaller company is riskier than a larger company.[65] In MERC's Initial Brief, MERC demonstrated that the OAG's failure to recognize a size adjustment is flawed because the OAG relied on dated academic research and the removal of companies from the OAG's proxy group that would have made the OAG's risk portfolio more accurately reflect MERC's risk profile.[66]

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[59] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 27 (June 24, 2014).

[60] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 11-14 (June 24, 2014).

[61] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 12 (June 24, 2014).

[62] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 12 (June 24, 2014).

[63] Initial Post-Hearing Brief of Minnesota Office of the Attorney General at 22-23 (June 24, 2014).

[64] Initial Post-Hearing Brief of Minnesota Office of the Attorney General at 25 (June 24, 2014).

[65] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 11-14 (June 24, 2014).

[66] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 13-14 (June 24, 2014).

The record demonstrates that a size adjustment is necessary because MERC is smaller than the companies in MERC's, the Department's, and the OAG's proxy groups, and the average utility. Therefore the ALJ and the Commission should approved MERC's proposed size adjustment.

2. It is Reasonable to Include a Leverage Adjustment when Determining MERC's ROE.

As stated in MERC's Initial Brief, the leverage adjustment reflects the gap that must be bridged when using a market price in the DCF that relates to market value weights that differ from book value weights used in a public utility ratesetting.[67] Contrary to the Department's and the OAG's assertions, MERC's leverage adjustment does not ignore the fact that utility investors are aware that a utility's earnings are based on an allowed return granted by regulators on the utility's book value.[68] As MERC explained in its Initial Brief, a leverage adjustment is appropriate because it recognizes that a market determined cost of equity reflects a level of financial risk that is different from the capital structure stated at book value using standard ratesetting practices.[69]

The Department's and the OAG's failure to compute a leverage adjustment in their DCF and CAPM analyses results in a market-determined cost of equity that understates MERC's necessary return on common equity.[70] As a result, the ALJ and the Commission should accept MERC's recommended leverage adjustment in this rate case.

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[67] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 16-17 (June 24, 2014).

[68] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 27 (June 24, 2014); Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 32-33 (June 24, 2014).

[69] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 16 (June 24, 2014).

[70] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 16-17 (June 24, 2014).

D. The OAG's ROE Analysis is Flawed Because it Fails to Include a Flotation Cost Adjustment.

In its Initial Brief, the OAG improperly argues that the *Bluefield* and *Hope* standards can be fulfilled in the absence of a flotation cost adjustment.[71] As detailed in their Initial Briefs, both MERC and the Department agree that the DCF analysis must contain a flotation cost adjustment to account for the cost of issuing new shares of common stock.[72] Thus, flotation costs must be allowed for MERC to earn its required rate of return and must be approved in this rate case.[73]

Because MERC's ROE will not be sufficient to attract the capital the Company needs unless it is adjusted for flotation costs, the ALJ and the Commission should accept MERC's flotation cost adjustment.

III. MERC AND THE DEPARTMENT HAVE AGREED ON AN APPROPRIATE SALES FORECAST AND NO COMMISSION ORDERING POINTS ARE NECESSARY WITH RESPECT TO MERC'S USE OF METRIXND AND STATISTICALLY ADJUSTED END USE MODELS.

A. MERC's Methodology

MERC's proposed 2014 sales forecast was developed in MetrixND, a statistical software package developed by Itron, a utility consulting firm. The model design 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. Instead of constructing a regression model with many explanatory variables, this approach constructs a model with two high level end-use variables: Heating and Other Use. The model structure then embeds forecast drivers into these two constructed variables.[74]

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71 Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 28-29 (June 24, 2014).

72 Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 22-25 (June 24, 2014); Initial Post-Hearing Brief of the Minnesota Department of Commerce at 24-25, 52-53 (June 24, 2014).

73 Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 22-25 (June 24, 2014); Initial Post-Hearing Brief of the Minnesota Department of Commerce at 24 (June 24, 2014).

74 Ex. 38 at 5 (H. John Direct).

The SAE model structure also incorporates elasticity of demand, which is customers' behavior in response to changes in various explanatory variables, such as price, heating, cooling, income, etc. Customer behavior is based on research performed by Itron. MERC can focus on customer behavior by capturing the appropriate impacts of changes in the economic conditions and their interrelationship with other end-use variables. [75]

A detailed explanation of MERC's sales forecasting methodology and the related drivers and variables is provided in the Direct Testimony of Mr. Harry John.[76]

B. MERC and the Department Have Agreed to Work Collaboratively Regarding MERC's Forecasting Methodology and Statistically Adjusted End Use Models – No Commission Ordering Points are Necessary on These Matters

The Department has explicitly stated that no issues remain in dispute between MERC and the Department related to the sales forecast in this rate case.[77] MERC and the Department have agreed to work collaboratively to address any concerns regarding MetrixND, SAE modeling, or any other potential sales forecasting issues.[78] MERC is in the process of arranging meetings with the Department, the OAG and Commission Staff to address any concerns these parties may have regarding MetrixND and MERC's SAE modeling. Thus, no Commission ordering points are necessary in this rate case with respect to MERC's use of MetrixND and the SAE sales forecasting methodology.

1. MERC Provided Sufficient Information for the Department to Verify the Reasonableness of MERC's Forecasting Models and Is Actively

[75] Ex. 38 at 5 (H. John Direct).

[76] Ex. 38 at 5-20 (H. John Direct).

[77] Ex. 214 at 1 (L. Otis Surrebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 207-08 (L. Otis) ("I provided testimony on two topics on behalf of the . . . Department. . . .; the test year sales forecast and related revenue, and the test year base cost of gas. Both of these issues have been resolved between MERC and the Department."). Initial Post-Hearing Brief of the Minnesota Department of Commerce at 56 (June 24, 2014).

[78] Evidentiary Hearing Transcript (May 13, 2014) at 208 (L. Otis); Initial Post-Hearing Brief of the Minnesota Department of Commerce at 64 (June 24, 2014).

Working with the Department to Further Develop the Department's Understanding of the Models

MERC's sales forecast provides a reasonable basis for establishing rates in this case.[79] With respect to the modeling software used by MERC, Integrys has been using the MetrixND software product since 2006, and this tool is being used for forecasting not only in Minnesota, but for electric and gas sales in Wisconsin, Illinois, and Michigan.[80] It is irrefutable that MERC provided all the raw inputs and data used in the Company's sales forecast including, but not necessarily limited to, model formulations, estimations, statistics, raw inputs and data, and outputs.[81] All of this information was provided in MERC's response to the Department's pre-filed data request numbers 501 and 518.[82] MERC even provided the Department with all of the SAE inputs used in MERC's model, in a ready to use format, and an example of a derivation of one of the Company's SAE variables.[83] MERC's only difficulty in providing the Department of Energy – Energy Information Administration ("DOE-EIA") energy efficiency data was that the

[79] Ex. 38 at 30 (H. John Direct).

[80] Evidentiary Hearing Transcript (May 13, 2014) at 107 (H. John). In Docket No. G007,011/GR-10-977, MERC conducted its sales forecast by PGA; namely NNG-PNG, NNG-GLGT, NNG-VGT, and NMU. Then, for each PGA, the forecast was conducted by rate schedule, namely General Services Class ("GS"), Joint Services Class, Interruptible, and Transport Services. For each class, MERC conducted a total sales model and a fixed charge count forecast. However, in Docket No. G007,011/GR-10-977, MERC was granted approval to consolidate the four existing PGAs into two PGAs. The forecasts in this rate case were conducted based on the two PGAs and at the revenue class level within each PGA; namely Residential, Small Commercial & Industrial, Large Commercial & Industrial, Joint, Interruptible, Transport, and Company use. In these forecasts, the Residential and Small Commercial Interruptible models are based on a use-per-customer and customer count models. The remaining revenue classes are done at a total sales model. The Residential and Small Commercial & Industrial use-per-customer models are SAE models and include an energy efficiency index variable based on the Department of Energy-Energy Information Administration ("DOE-EIA") end-use energy efficiency projections from the EIA's Annual Energy Outlook. A detailed description of the SAE model is explained under the subsection of Mr. John's Direct Testimony titled "PROPOSED SALES FORECAST." Ex. 38 at 11-12 (H. John Direct).

[81] Ex. 39 at 2-3, 5-7 (H. John Rebuttal); Ex. 214 at 3-4 (L. Otis Surrebuttal) ("Dr. John was correct in stating that MERC provided all of the regression models used in the Company's test-year sales forecast….I have reviewed MERC's responses to DOC Information Request Nos. 518, 530, and 532, which relate to data used in the construction of the various SAE variables, and, based on this review, I found that I erred in my Direct Testimony when I stated that the Company did not provide the input data for these variables.")

[82] Ex. 1, Sales Forecast Prefiling, at Request Nos. 501, 518; *see also* Ex. 39 at 2-3 (H. John Rebuttal).

[83] Ex. 39 at 3, 5-7 (H. John Rebuttal).

data did not readily exist in the specific format (i.e., an Excel spreadsheet) requested by the Department. The Department's requests to provide a derivation of each individual SAE variable used in the Company's test year forecast would have been unduly burdensome.[84] MERC provided the Department with an Excel spreadsheet that contained the formulas intact as an example of how the MetrixND software derived one of the variables. With this information, the Department had the ability to replicate MERC's sales forecast by creating a derivation for each variable.[85]

In addition to the provision of this information, MERC is actively working with the Department to ensure complete understanding of the MetrixND software and the SAE sales forecasting methodology so the Department can fully replicate MERC's sales forecast in future rate cases, and understand why Integrys sees value in this software and methodology. It is not necessary for the Commission to include in its final order in this rate case specific ordering points regarding MERC's sales forecasting model and methodology for a future rate case. MERC is working with the Department, and any other regulators that wish to be involved, to address the Department's remaining concerns and ensure that the Department has the information it needs to verify MERC's future sales forecast filings.[86] Therefore, no Commission ordering point is necessary on this matter.

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[84] Ex. 39 at 3 (H. John Rebuttal).

[85] Ex. 39 at 3 (H. John Rebuttal).

[86] Evidentiary Hearing Transcript (May 13, 2014) at 107-108 (H. John).

2. Even though MERC's SAE End Use Models are Appropriate for Short-Term Forecasting MERC has accepted the Department's Alternative Sales Forecast in this Rate Case

Without providing any empirical evidence, the Department argues that the SAE model is inappropriate for short-term sales forecast modeling.[87] Contrary to the Department's position, MERC has demonstrated that the SAE methodology provides overall forecast benefits and is appropriate in the short-term, as well as the long-term. This is because the SAE model incorporates and captures short-term behaviors, such as fluctuations in gas prices, economic conditions, weather patterns, and energy efficiency or conservation. By its very operation, the SAE model captures short-term, as well as long-term, impacts. MERC used the SAE model because the Company believes it is important to capture energy efficiency, both as reflected in historical data, and also from new federal mandates. From MERC's perspective, it is also important to use one forecast for both short-term and long-term business operations for consistency purposes. Further, it is important to have once consistent forecast and set of assumptions for all of the Company's filings, i.e., rate cases, demand entitlement filings, annual gas report filings, etc., which are both short and long-term in nature.[88] The fact that other Minnesota utilities may not use this model for short-term forecasting in their rate case proceedings is not sufficient evidence to conclude that it is inappropriate for MERC to use the model for short-term forecasting.[89] Nor is the fact that replicating and verifying MERC's variables would take "an extensive amount of time."[90]

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[87] Ex. 212 at 5, 19, 21 (L. Otis Direct); Ex. 39 at 8 (H. John Rebuttal).

[88] Ex. 39 at 7 (H. John Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 107 (H. John).

[89] Ex. 212 at 20-21 (L. Otis Direct); Ex. 214 at 5-6 (L. Otis Surrebuttal).

[90] Ex. 214 at 4 (L. Otis Surrebuttal).

Although MERC's sales forecasting methodology provides the most reasonable basis for establishing rates in this case,[91] MERC accepted the Department's alternative sales forecast because it benefits from 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.[92] The OAG initially objected to the Transportation revenue piece of MERC's sales forecast, arguing that MERC's proposed Transportation sales were not representative of the Company's recent history for Transportation sales.[93] MERC successfully rebutted the OAG's argument, pointing out that the historical Transport sales that the OAG analyzed were not representative of the Company's historical Transport sales because they included a non-jurisdictional component, the Michigan Taconite mines.[94] However, because MERC agreed to use the Department's alternative sales forecast, MERC's proposed Transportation sales are a moot point. The Department's alternative sales forecast increased MERC's Transportation sales,[95] an increase to which the OAG has stated it has no objection.[96]

MERC's willingness to use the Department's alternative sales forecast in this rate case does not undercut MERC's position with respect to the MetrixND software and the SAE forecast model. MERC continues to believe that its sales forecast modeling and methodology are the most appropriate for short-term forecasting in future rate cases.[97] However, because MERC and

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[91] Evidentiary Hearing Transcript (May 13, 2014) at 107 (H. John).

[92] Ex. 39 at 2, 8, 13 (H. John Rebuttal). MERC had historical monthly data from January 2007 through January 2013, which was the most current data at the time the Company prepared its forecast. *Id. See also* Evidentiary Hearing Transcript (May 13, 2014) at 106 (H. John); Ex. 212 at 5, 22-29, 32 (L. Otis Direct).

[93] Ex. 151 at 14 (J. Lindell Direct).

[94] Ex. 39 at 12 (H. John Rebuttal).

[95] Ex. 39 at 12 (H. John Rebuttal).

[96] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 19 (June 24, 2014).

[97] Evidentiary Hearing Transcript (May 13, 2014) at 107 (H. John).

the Department agree on the sales forecast to be used in this rate case, no Commission ordering point is necessary on this matter.

C. MERC has Complied with the Commission's Sales Forecasting Requirements In This Rate Case and will Continue to Comply with the Commission's Sales Forecasting Recommendations In Future Rate Cases

In MERC's last rate case, the Company agreed to:

- Work with the Department prior to Company's next rate case filing to specify the appropriate level of detail required in future general rate case proceedings;[98]
- Prepare a summary spreadsheet that links together the Company's test year sales and revenue estimates, Class Cost of Service Study, rate design schedules, and, any and all, other rate case items that are impacted by the sales and revenue forecasts;
- Provide 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 the Company's data collection process, that MERC uses to calculate the input data it uses in its test year sales analysis;
- If, in the future, the Company updates, modifies, or changes its billing system, provide, in its initial rate case filing, 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;
- Retain and provide in future rate case filings, all information related to its billing cycle sales and customer counts, cancellations/re-bills, customer bills, and weather data (adjusted for billing errors) in a format that allows for independent verification of any, and all, data used by MERC and also to be used to independently analyze the reasonableness of MERC's test year sales; and
- Provide sales forecasting data 30 days prior to the filing of MERC's next rate case.[99]

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[98] *See 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, Rebuttal Testimony of H. John at 4 (June 2, 2011). The subsequent conversations between MERC and the Department resulted in an agreement that MERC prepare the sales forecast in this rate case, and future rate cases, at the Revenue Class level. *See* Ex. 38 at 4, 8-9, 12-13, 17 (H. John Direct).

[99] *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, Direct Testimony of A. Heinen at 76 (May 3, 2011), Rebuttal Testimony of Harry John at 4-5 (June 2, 2011); *see also* Ex. 212 at 29-30 (L. Otis Direct).

There is no question that MERC has complied with all of the Commission's sales forecasting requirements in the current rate case. MERC conducted informal discussions with the Department regarding MERC's data and new forecasting methodology.[100] As previously discussed, the Department has conceded that MERC provided all the raw inputs and data used in the Company's sales forecast.[101] The separate sales and revenue forecasts by individual revenue classes for each PGA system are detailed in Exhibit HWJ-1, Schedule E-1, of Dr. John's Direct Testimony.[102] The revenue forecasts for each revenue class are included in the Direct Testimony and Exhibits of MERC witness Mr. Gregory Walters.[103] An explanation of the differences in MERC's sales forecasting methodology in this rate case, as opposed to the Company's last rate case, are provided in the Direct Testimony of Dr. John.[104] Finally, MERC provided sales forecast data to the Department and the OAG in advance of this filing in the form of MERC's responses to the pre-filed data requests submitted to the Department on August 20, 2013 and to the OAG on August 22, 2013.[105]

MERC has committed to complying with all of the Commission's previous sales forecasting requirements in the Company's future rate cases.[106] In addition, MERC has committed to provide detailed information sufficient to allow for the replication of any and all Company-derived forecast variables.[107] Because MERC is committed to educating the Department, the OAG, and Commission Staff on MetrixND and the SAE sales forecasting

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[100] Ex. 38 at 4, 5-20 (H. John Direct).

[101] Ex. 39 at 2-3, 5-7 (H. John Rebuttal); Ex. 214 at 3-4 (L. Otis Surrebuttal).

[102] Ex. 38 at Schedule E-1 (HWJ-1) (H. John Direct).

[103] Ex. 38 at 4 (H. John Direct).

[104] Ex. 38 at 11-20 (H. John Direct).

[105] Ex. 38 at 4 (H. John Direct).

[106] Ex. 39 at 6 (H. John Rebuttal).

[107] Ex. 212 at 30 (L. Otis Direct); Ex. 39 at 6 (H. John Rebuttal).

methodology, it is not necessary at this time for the Commission to require MERC to provide the SAE input data in a readily replicable manner or explore methods to simplify the calculation and independent verification of SAE variables for future regulatory filings.[108] Nor is it necessary for the Commission to require MERC to provide further justification for the use of the SAE model in a short-term rate case forecast to respond to the Department's concerns,[109] as this will necessarily be addressed as the Department works with MERC and Itron to understand the MetrixND software and SAE sales forecasting model, and determine whether the Department would support this methodology in future rate cases. In fact, it is important to note that the Department completely omitted these recommendations from its Initial Brief in this rate case.[110]

Thus, the only Commission ordering point required for this matter is that the sales forecast proposed by the Department and agreed to by MERC is reasonable for purposes of setting rates in this matter.

IV. THE DEPARTMENT'S PROPOSED ADJUSTMENT TO GAS REVENUE TO ACCOUNT FOR CONSERVATION IMPROVEMENT PROGRAM EXPENSES IS UNJUSTIFIED AND WOULD NOT BE REVENUE NEUTRAL.

In its Initial Brief, the Department continues to propose that MERC should increase natural gas revenue by $3,758,090 to offset for the Company's increase in CIP expense for the test year. According to the Department, "[t]he ultimate effect of the recommendation is to allow the Company to recover CIP costs in a manner similar to the base cost of gas."[111] As MERC explained in its Initial Brief, MERC's Conservation Cost Recovery Charge ("CCRC") adjustment is not like the base cost of gas charge. As a result, the Department's recommended adjustment would incorrectly lower MERC's revenue deficiency, while expenses related to CIP

[108] Ex. 214 at 4, 14 (L. Otis Surrebuttal).

[109] Ex. 214 at 6, 14 (L. Otis Surrebuttal).

[110] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 64 (June 24, 2014).

[111] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 104 (June 24, 2014).

actually increase. In other words, the Department is recommending an overall rate increase of approximately $3.3M, while CIP expense alone is increasing approximately $3.8M. Therefore, if approved, this adjustment would have the effect of reducing MERC's rates by $0.5M for all of MERC's other costs included in this case. By imputing CIP revenues of approximately $3.8M to offset the increase in CIP expense, the Department is effectively reducing MERC's revenue requirement based on revenue that will never be collected.[112]

The Department argues, in its Initial Brief, that MERC did not include the cost of gas in its revenue requirement.[113] That is because the base cost of gas, unlike the CCRC, is not included in MERC's distribution rates and is a true one-to-one revenue-to-expense. MERC's CCRC is embedded within MERC's base distribution rate.[114] This difference is significant in how the Department's recommended treatment affects MERC's rate recovery. On the one hand, if the Commission approves a higher base cost of gas, which is a separate bill charge *not* embedded in MERC's base distribution rates, MERC would recover more revenue associated with that adjustment, regardless of approved rates. In contrast, even if the Commission approves a higher CCRC at the conclusion of MERC's rate case, because this adjustment is embedded in MERC's base distribution rates, MERC would still be limited in its overall rate recovery to the final rates approved by the Commission, even though a larger portion of those rates would be booked to MERC's CIP tracker.

The Department argues, in its Initial Brief, that because MERC has already increased its CCRC with the implementation of interim rates, higher recovery is already taking place. The calculation used for MERC's interim rates did not artificially adjust revenue, as the Department

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[112] Ex. 24 at 5 (S. DeMerritt Rebuttal); Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 26 (June 24, 2014).

[113] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 104 (June 24, 2014).

[114] *See* Evidentiary Hearing Transcript (May 13, 2014) at 221 (M. St. Pierre).

is now proposing to do with respect to final rates and, therefore, allowed MERC to recover its CIP expense. The Department's claim that the CCRC will be adjusted at the end of the rate case to reflect the Commission's Order on CIP expense and CIP related sales[115] does *not* ensure MERC recovery of its additional CIP expense. By imputing CIP revenues of approximately $3.8M to offset the increase in CIP expense, the Department is effectively reducing MERC's revenue requirement based on revenue that will never be collected.[116]

In its Initial Brief, the Department states that it is recommending "that MERC remove all CIP expenses from the revenue deficiency."[117] This is contrary to the Department's recommendations since the Department has recommended CIP expenses should be increased to $9.4M and that the CCRC be adjusted, which increases expenses. If the Department were truly advocating for removal of CIP expense from the revenue deficiency, the CCRC should be set to $0.00000, and CIP expenses should flow through the Conservation Cost Recovery Adjustment ("CCRA") as proposed in the Rebuttal Testimony of Mr. Seth DeMerritt.[118]

Contrary to the Department's arguments, the Department's proposed adjustment to revenue would not result in CIP expense being "revenue neutral" but instead would reduce MERC's revenue requirement based on revenue that will never be collected. The evidence in the record demonstrates that this adjustment would be unreasonable, arbitrary, and without justification. MERC respectfully requests that the Commission accept its proposed CIP expense and reject the Department's proposal.

[115] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 105 (June 24, 2014).

[116] Ex. 24 at 5 (S. DeMerritt Rebuttal).

[117] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 105 (June 24, 2014).

[118] Ex. 24 at 6 (S. DeMerritt Rebuttal).

V. MERC'S PROPOSED TWO YEAR AMORTIZATION PERIOD FOR RATE CASE EXPENSE IS MORE APPROPRIATE THAN THE DEPARTMENT'S PROPOSED THREE YEAR AMORTIZATION PERIOD BASED ON LIMITED HISTORICAL DATA.

As MERC explained in its Initial Brief, a two year amortization period is appropriate and should be adopted in this case because MERC is currently preparing for an increase in capital expenditures and anticipates the possibility that the Company may file a rate case in 2015 using a 2016 test year.[119] In its Initial Brief, the Department continues to argue that rate case expense should be amortized over a three year period, claiming that MERC "did not provide evidence to support the proposal or show a compelling reason to depart from the normal method for determining the amortization period."[120]

The Department's claim that MERC has not provided support for its position is without merit. MERC has submitted testimony to support the use of a two year amortization period based on anticipated upcoming costs and the resulting probability that MERC will file a rate case in 2015 using a 2016 test year.[121] Among other supporting factors, the Company plans to undertake significant capital investments at a rate that would plausibly motivate it to make more frequent rate case filings.

The Department also argues, in its Initial Brief, that MERC's proposed amortization period is inconsistent with the "normal method" for determining the amortization period. Contrary to the Department's arguments, however, the Commission has consistently taken into consideration both the historical trend and factual information regarding the likely timing of

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[119] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 64 (June 24, 2014).

[120] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 88-89 (June 24, 2014).

[121] *See* Evidentiary Hearing Transcript (May 13, 2014) at 22 (S. DeMerritt); Ex. 24 at 16 (S. DeMerritt Rebuttal).

future rate cases to determine the appropriate amortization period to apply.[122] The Department's recommendation of a three year amortization period inappropriately relies on simple averaging and is based on a very narrow history of MERC rate cases. While the Department has acknowledged that estimating a reasonable amortization period is difficult because many things can impact a utility's decision to file a rate case,[123] it refuses to take into consideration factual evidence that would support a two year amortization period in this case. Reasonable, prudently incurred rate case expenses are properly included in test year costs and built into rates for recovery from ratepayers. The Commission tries to set the cost-recovery (or, amortization) period—which determines the percentage of total rate case costs built into rates on an annual basis—to coincide with the time period between rate cases. It is important for these two time periods to match as closely as possible, to ensure that the utility recovers its authorized rate case costs without over-recovering them.

Further, in its Initial Brief, the Department states with regard to the amortization period that "where doubt exists, it should be resolved in favor of the ratepayers."[124] The Commission has exercised its discretion in past cases to ensure that if a utility delays filing a rate case beyond the amortization period set, the over-recovery of rate case expense be returned to ratepayers through credit to the revenue requirement.[125] In contrast, the Department's proposal could negatively impact MERC shareholders and likely will not accurately reflect MERC's actual

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[122] *See In the Matter of an Application by CenterPoint Energy for Authority to Increase Natural Gas Rates in Minnesota*, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 27-28, Docket No. G-008/GR-13-316 (June 9, 2014).

[123] Ex. 24 at 15-16 (S. DeMerritt Rebuttal); Ex. 215 at 15 (L. La Plante Direct).

[124] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 89 (June 24, 2014).

[125] *In the Matter of the Application of Northern States Power for Authority to Increase Rates for Electric Service in Minnesota*, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 36, Docket No. E-002/GR-10-971 (May 14, 2012) ("The Company shall return any over-recovery of rate case expense if the collection continues beyond the two-year amortization period, by crediting the revenue requirement in its next rate case.").

costs. If the Commission grants a three year amortization period, and MERC files its rate case, as it plans to, after two years, then MERC's shareholders bear the cost of the third year of expenses. The Commission can prevent the risk of any over-recovery by MERC, by providing that any over-recovery in the event MERC does not file its next case within two years is credited to the revenue requirement in MERC's next rate case.

In addition to making clear its reason for selecting a two year amortization period because of the anticipated rate case filing, MERC also demonstrated in its Initial Brief that the math used by the Department to calculate a three year amortization period suffered from a lack of appropriate sample size.[126] In fact, with an average amortization of 2.5 year, rounding down to two years is no more compelling than MERC's position of rounding up to three years.[127] Based on the arguments presented in testimony, MERC's Initial Brief, and this Reply Brief, MERC has demonstrated that a two year amortization period for rate case expenses best reflects the current information regarding likely timing of MERC's next rate case filing.

VI. MERC'S CALCULATION OF OPERATIONS AND MAINTENANCE COSTS REFLECT THE MOST ACCURATE CALCULATION OF MERC'S ACTUAL COSTS.

A. The OAG's Restrictive Definition of Allowable Known and Measurable Adjustments is Unreasonable.

The OAG, in its Initial Brief, incorrectly argues that MERC has misused the known and measurable ("K&M") expense exception to request recovery of costs outside the proposed test year.[128] To the contrary, MERC's approach to K&M adjustments 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). Additionally, contrary to the OAG's position, K&M changes must occur after the historic test

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126 Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 65-66 (June 24, 2014).

127 Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 65-66 (June 24, 2014).

128 Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 4 (June 24, 2014).

year, otherwise there would be no need for the adjustment.[129] As MERC discussed in its testimony, the Company made 24 adjustments for known and measurable changes to operations and maintenance expenses in the test year, recognizing that for those items, simply applying inflation to the base year amount would overstate some expenses and understate others.

No party has raised any objection to the majority of MERC's proposed K&M adjustments, and those proposed adjustments should be adopted by the ALJ and Commission as reasonable based on the information and support provided in MERC's pre-filed testimony and during the Evidentiary Hearing. As outlined below, and in MERC's Initial Brief, the Department and the OAG proposed adjustments or recommended that some of the proposed K&M adjustments be removed from O&M expense. For the reasons outlined below and in MERC's Initial Brief, MERC's proposed K&M adjustments are reasonable and should be adopted by the ALJ and the Commission.

B. Expenses for the ICE 2016 Project Are Properly Included in O&M Expense.

In its Initial Brief, the OAG has argued that the ICE 2016 Project costs should be removed from MERC's O&M expense because, according to the OAG, ICE 2016 is an in-house customer service system that is not "used and useful" for MERC's customers.[130] Contrary to the OAG's position, as explained in MERC's Initial Brief, the ICE 2016 Project provides specific benefits to customers and is properly included as an adjustment to O&M expense.[131]

The ICE 2016 Project is a project to unify the various billing systems currently in use across the Integrys platform. The ICE 2016 Project will result in a single billing system for all

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[129] *See* Ex. 24 at 22 (S. DeMerritt Rebuttal). The OAG classifies known and measurable changes as "specific measurable cost changes due to known events that occur during or in some cases shortly after the historical test year." Ex. 151 at 16 (J. Lindell Direct).

[130] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 6 (June 24, 2014).

[131] Ex. 24 at 25 (S. DeMerritt Rebuttal); Ex. 10 at 3-8 (B. Kage Direct).

six Integrys regulated utilities, which will provide benefits to MERC customers via improved efficiency and productivity resulting from the conversion of MERC's current Customer Information System technology platform onto the Open-C technology platform.[132] Additionally, the ICE 2016 Project will provide overall standardization of internal delivery processes and system technology platforms, which will improve customer satisfaction, increase productivity, and increase efficiency by lowering overall operating costs.[133] Therefore, these known expenses should be included in MERC's O&M expense calculation.

C. If the Commission Determines the Expense for the ICE 2016 Project Is Not Used and Useful, That Expense Should be Approved as a Regulatory Asset for Recovery in a Future Rate Case Proceeding.

If the Commission determines that the costs associated with the ICE 2016 Project are not to be recovered in the 2014 test year, the OAG, in its Initial Brief, has agreed that these costs may properly be deferred as a regulatory asset until MERC's next rate case.[134] If these costs are not included for recovery in this proceeding, MERC has proposed 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 system is implemented.[135] The OAG objects to MERC's proposed amortization period, proposing that any decision on the appropriate amortization period be resolved during MERC's next rate case.[136] MERC accepts this recommendation, as well as the OAG's recommendation that these expenses be subject to reasonableness review in a subsequent rate proceeding. If the Commission decides to exclude MERC's costs related to the

[132] Ex. 10 at 3-4 (B. Kage Direct).

[133] Ex. 10 at 4 (B. Kage Direct).

[134] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 6 (June 24, 2014).

[135] Ex. 24 at 25 (S. DeMerritt Rebuttal).

[136] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 7 (June 24, 2014).

ICE 2016 Project in this rate case, MERC requests that the final Order in this proceeding state that these costs are approved for regulatory asset treatment in MERC's next rate case, to be recovered over an amortization period to be determined in MERC's next rate case.

D. MERC's Proposed Calculation of Uncollectable Expense is Consistent with Prior Decisions and Results in a More Predictable Level of Expense.

Both the Department and the OAG oppose MERC's methodology for determining its test year uncollectible expense and propose alternative expense calculations, claiming that MERC's methodology results in an overestimate of uncollectible expense. The Department recommends that MERC use the 2013 uncollectible expense ratio to set test year uncollectible expense[137] and the OAG recommends that uncollectible expense be set at $1,350,000.[138] As explained in MERC's Initial Brief, MERC has proposed to calculate uncollectible expense based on a three year uncollectible expense ratio, consistent with the approach approved by the Commission in MERC's 2008 rate case, Docket No. G007,011/GR-08-835, and MERC's 2010 rate case, Docket No. G007,011/GR-10-977.[139] Both the Department's and OAG's recommendations are unreasonable and inconsistent with Commission precedent on this issue. MERC's levelization approach is consistent with Commission precedent, benefits customers by minimizing the possibility that uncollectible expense may be significantly over-recovered, and should be adopted by the Commission in this case.

As explained in MERC's Initial Brief, the Department has completely shifted its position on the appropriate methodology for calculating uncollectible expense from MERC's 2010 case to this current proceeding. According to the Department, this shift in approach is justified by what

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[137] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 126-127 (June 24, 2014).

[138] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 7-9 (June 24, 2014).

[139] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 36 (June 24, 2014).

the Department calls a "clear downward trend, with lower and lower costs every year."[140] But three years of data hardly indicates a "trend." Further, what the Department refers to as a clear downward trend actually shows decreases from 2011 to 2012, but an increase from 2012 to 2013.

Not only is the Department's shift in position not well justified, it is inconsistent with Commission precedent. As previously stated, the calculation using a three year average is consistent with Commission treatment of this issue in MERC's previous rate case. As the Department recognized in MERC's last rate case, levelization through the proposed average is more reasonable because it accounts for year-to-year fluctuations.[141] Ratepayers benefit from use of a three year average because, while actual expense may vary significantly from year to year, this approach ensures a more stable calculation. While the Department also asserts that the 2010 data included in MERC's average is old and should not be used in calculation of uncollectible expense, 2010 data was used because that was part of the latest three years available when MERC prepared its filing in this proceeding.

The OAG similarly asserts MERC's proposed uncollectible expense calculation is too high given the economy, the weather, and the relative price of gas.[142] Rejecting MERC's calculation methodology, the OAG selects an arbitrary proposed uncollectible expense of $1.35 million.[143] Rather than basing this figure on any calculation methodology, the OAG reaches what it calls a "more reasonable" estimate based on applying an arbitrary upward adjustment to MERC's 2012 bad debt expense. The OAG provides no analysis or support for the

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140 Initial Post-Hearing Brief of the Minnesota Department of Commerce at 126 (June 24, 2014).

141 Ex. 24 at 9 (S. DeMerritt Rebuttal) (citing *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, Direct Testimony of Department witness Mark Johnson at 24, Docket No. G007,011/GR-10-977, (May 3, 2011)).

142 Ex. 151 at 6 (J. Lindell Direct).

143 Ex. 151 at 7 (J. Lindell Direct).

proposed amount of the adjustment applied to the 2012 figure, stating generally that it takes into consideration an improved economy and lower relative price of natural gas.[144] The Commission should disregard this unreasonable and seemingly arbitrary proposal by the OAG. Despite acknowledging the volatility of the debt expense from year to year,[145] the OAG's proposal fails to consider the need to account for such volatility. Both the Department's and OAG's recommendations are unreasonable and inconsistent with Commission precedent on this issue. MERC's proposed uncollectible expense is supported by substantial evidence in the record. It is derived from accurate data and based on a reasonable method of calculation.

E. MERC's Costs Associated with the Mapping Project Are Used and Useful and Reasonably Assigned in Their Entirety to 2014.

In its Initial Brief, the Department recommends that the costs associated with MERC's Mapping Project be levelized over a three year period.[146] The Department takes the position that because the Mapping Project is a one-time project, expected to be finished at the end of the test year, the cost of the project should be levelized over the same period as the Department is recommending for rate case expense.

This recommendation is not reasonable and making an adjustment for a single item as proposed by the Department, with no consideration for the future costs, sales, or capital requirements of other items, would be punitive. Generally, it is understood that many expenses go up in the period between rate cases, and that some expenses may also go down. These expense levels are not adjusted until the next rate review, which determines whether the new proposed level of rates is reasonable on a going-forward basis, as retroactive ratemaking is not allowed. While the Mapping Project will only incur costs in 2014, the Department's proposal

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[144] Ex. 151 at 7 (J. Lindell Direct).

[145] Ex. 154 at 3-4 (J. Lindell Surrebuttal).

[146] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 130 (June 24, 2014).

fails to consider how its proposed adjustment will impact MERC in future years.[147] The Department is effectively proposing a single item ratemaking adjustment for 2015 and 2016 without consideration for any future increases in MERC's overall costs.[148]

Further, as discussed above and in MERC's Initial Brief, MERC has already stated an intention to file a 2016 rate case; therefore, at a minimum, if the ALJ and the Commission determine the costs associated with the Mapping Project should be spread over multiple years, the appropriate period over which the adjustment should be spread is two years, not three.[149]

VII. MERC HAS DEMONSTRATED BY A PREPONDERANCE OF THE EVIDENCE THAT ITS PROPOSED TEST YEAR PROPERTY TAX EXPENSE REFLECTS A REASONABLE CALCULATION OF THOSE AMOUNTS AND IS NOT INFLATED.

At the close of pre-filed testimony, MERC proposed property tax expenses of $7,195,869 for the 2014 test year.[150] The Department is in agreement that this estimated test year property tax expense is reasonable and should be approved.[151] The OAG asserts in its Initial Brief that MERC's property tax expenses are unreasonably inflated.[152] The OAG recommends that the Commission use a 2013 test year value of $6,624,033 for property tax expenses.[153] As explained in MERC's Initial Brief, the OAG's proposed adjustment is inaccurate because it fails to account

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[147] Ex. 24 at 10-11 (S. DeMerritt Rebuttal).

[148] Ex. 24 at 11 (S. DeMerritt Rebuttal).

[149] Ex. 24 at 11 (S. DeMerritt Rebuttal).

[150] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 29 (June 24, 2014); Ex. 37 at 3-6 (J. Wilde Rebuttal) (MERC originally proposed to include $7,314,129, but agreed to reductions totaling $118,864 based on the testimony of Department witness Ms. St. Pierre). Additionally, MERC has agreed to notify the Commission of any court rulings regarding the Company's Kansas and Minnesota property tax appeals and to make a compliance filing upon resolution of the pending Kansas Ad Valorem litigation and to refund the total amount of Kansas property taxes collected from customers for the years under appeal, less the total amount paid to Kansas, together with interest.

[151] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 111-15 (June 24, 2014); Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 29-31 (June 24, 2014).

[152] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 11 (June 24, 2014).

[153] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 11 (June 24, 2014); Ex. 151 at 11-13 (J. Lindell Direct).

for any change in MERC's property tax expense for the 2013 accrual payable in 2014, or any change in the expense for the 2014 accrual payable in 2015.[154] The flawed nature of the OAG's calculation is demonstrated by the fact that MERC's actual tax liability for 2012, which was paid in 2013, was greater than the OAG's estimate for MERC's 2014 property tax expense.

The OAG argues that MERC has not provided sufficient information to demonstrate a foundation that would make its proposed property tax expenses reasonable.[155] MERC has provided such information. MERC witness Mr. John Wilde explained that the actual tax liability paid in 2013, for year 2012, was greater than the estimate OAG witness Mr. Lindell relied on for MERC's 2014 property tax expenses.[156] In so explaining, Mr. Wilde pointed to MERC's response to Department Information Request 152, which provided a roll forward of MERC *actual* property tax liability for 2012 to provide an estimate for 2014.[157] The calculation that MERC provided in its response to Department Information Request 152 is based on the same methodology used by the State of Minnesota in performing the calculation for 2013.[158] As MERC explained in testimony and its Initial Brief, MERC's calculations are reasonable because they are based on actual data, as opposed to estimates like the OAG's proposal.[159] Further, contrary to the OAG's assertion, by showing these calculations, MERC has demonstrated by a preponderance of the evidence that its calculation is reasonable.

In addition, while in its response to Department Information Request 152, MERC demonstrated that the Company's 2014 estimate for the market value of its properties was

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[154] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 29-30 (June 24, 2014).

[155] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 11-12 (June 24, 2014).

[156] Ex. 37 at 7 (J. Wilde Rebuttal).

[157] Ex. 37 at 7, Exhibit (JRW-1) (J. Wilde Rebuttal).

[158] Ex. 37 at 7-8 (J. Wilde Rebuttal).

[159] Ex. 37 at 8-9 (J. Wilde Rebuttal).

$177,330,800, [160] a preliminary assessment received from the Minnesota Department of Revenue on June 27, 2014 assessed the market value of MERC's Minnesota property at $183,754,600, demonstrating further that the property tax expenses are not inflated as asserted by the OAG.

MERC has demonstrated through its testimony and response to Department Information Request 152 that its proposed test year property tax expense is reasonable and based on actual data. Therefore, MERC's proposed test year property tax expense should be accepted by the ALJ and the Commission in this case.

VIII. MERC'S PROPOSED NET OPERATING LOSS CARRY FORWARD DEFERRED TAX ASSET IS PROPERLY DOCUMENTED IN THE RECORD AND INCLUDED IN RATE BASE.

As explained in MERC's Initial Brief, MERC has proposed to include a deferred tax asset ("DTA") for a Net Operating Loss ("NOL") carry forward in its 2014 test year rate base.[161] The DTA represents MERC's stand-alone operating income NOL that arose in 2012 and 2013, due primarily to bonus depreciation.[162] Inclusion of the DTA is necessary to accurately reflect MERC's cost of service and average rate base estimate for the test year. Additionally, inclusion of the DTA is consistent with a normalized method of accounting such that exclusion of the DTA would not allow MERC to remain in compliance with federal tax normalization rules.[163]

In its Initial Brief, the OAG takes the position that the Commission should deny MERC's inclusion of the DTA NOL because, according to the OAG, MERC has not produced evidence to show that the Company contributed to the new operating loss held by Integrys.[164] Contrary to the OAG's claim, however, MERC has fully documented and supported its DTA. MERC's

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[160] Ex. 37 at Exhibit (JRW-1) (J. Wilde Rebuttal)

[161] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 31 (June 24, 2014).

[162] Ex. 36 at 4-5 (J. Wilde Direct).

[163] Ex. 36 at 5-7 (J. Wilde Direct); Ex. 37 at 11-13, 15-20 (J. Wilde Rebuttal).

[164] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 12-13 (June 24, 2014).

response to OAG Information Request 128 demonstrates that MERC generated a taxable NOL for 2012 and 2013, and this NOL was generated due to deductions MERC claimed for accelerated tax depreciation including bonus. MERC's response to OAG Information Request 128 further demonstrates that the Integrys Group of Companies also generated a NOL for 2012 and 2013, and that the NOL was generated by regulated utilities, including MERC, claiming accelerated tax depreciation including bonus.[165] MERC has also shown that, as a subsidiary of Integrys, MERC is jointly and severally liable for Integrys' tax obligations; therefore it is entirely appropriate to include the NOL DTA in MERC's rate base.[166]

The OAG also argues in its Initial Brief that MERC should not receive a rate base adjustment for its DTA in the test year because MERC will effectively utilize the NOL carry forward from the first day of 2014.[167] However, this reflects the OAG's incorrect understanding of MERC's federal tax obligations as a regulated public utility. As explained in MERC's Initial Brief, the cash benefit of a NOL DTA is earned over time throughout each year.[168] Therefore, contrary to the OAG's assertions, MERC will not realize the savings from the NOL DTA in 2014 until the point in the year when MERC or the Integrys Consolidated Group generates sufficient federal taxable income to do so.[169]

If MERC followed the OAG's recommendation and reduced rate base for the DTA that results from claiming accelerated tax depreciation without reflecting the offsetting DTA for the NOL carry forward, MERC would violate federal tax regulations by overstating the amount of

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[165] Ex. 37 at 2 and Exhibit (JRW-2) (J. Wilde Rebuttal).

[166] *See* 26 CFR §§ 1.1502 - 1.1506.

[167] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 14 (June 24, 2014).

[168] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 32 (June 24, 2014); *see also* 26 CFR §§ 1.167(l)-1(h)(6).

[169] Ex. 37 at 11 (J. Wilde Rebuttal).

interest-free funding that MERC possesses, resulting in an inaccurate representation of MERC's financial position.[170] If MERC fails to comply with federal tax normalization rules, MERC risks losing the benefits of accelerated federal tax depreciation, which would ultimately result in higher rates for its customers.[171] Including MERC's proposed NOL DTA in rate base is consistent with past Commission precedent and is necessary to allow MERC to comply with federal tax normalization policies.[172]

MERC, as well as other utilities claiming accelerated tax depreciation, take every precaution not to violate the normalization rules, for a violation would have drastic negative consequences for the utilities and their ratepayers. Utilities would become ineligible to utilize accelerated federal tax deprecation, including bonus depreciation. Instead, utilities would be required to compute their tax depreciation using the same lives and methods they use to compute depreciation for ratemaking purposes. Thus, the tax benefits arising from the timing differences would no longer exist. This would result in significant negative impacts to ratepayers. The Commission should allow MERC to include its proposed NOL DTA in rate base to ensure that MERC's customers continue to benefit from federal tax policies that ultimately will reduce the customers' rates.

IX. MERC'S TRAVEL AND ENTERTAINMENT EXPENSES ARE PRUDENTLY INCURRED AND REPORTED CONSISTENT WITH THE MINNESOTA STATUTE.

In its Initial Brief, the OAG argues that the Commission should deny MERC recovery of all Travel and Entertainment ("T&E") expenses because MERC did not separately itemize

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[170] Ex. 37 at 11-12 (J. Wilde Rebuttal).

[171] Ex. 37 at 19-20 (J. Wilde Rebuttal).

[172] *See In the Matter of the Application of Northern States Power Company d/b/a Xcel Energy for Authority to Increase Rates for Electric Service in Minnesota*, Docket No. E-002/GR-10-971, FINDINGS OF FACT, CONCLUSIONS AND ORDER at 35 (May 14, 2012); *see also* Ex. 36 at 5-7 (J. Wilde Direct).

expenses from MERC's service company, Integrys Business Services ("IBS"), or certain expenses for membership dues in organizations and clubs.[173] Specifically, the OAG recommends disallowance of $569,450 of MERC's T&E expense and $63,245 of MERC's expense for membership dues in organizations and clubs.[174] The OAG claims that it requested information regarding MERC's IBS-related expenses and that MERC refused to provide it.[175] Contrary to the OAG's position, MERC has fully complied with the requirements of Minn. Stat.§ 216B.16, subd. 17 with respect to the Company's T&E expenses. The plain language of Minn. Stat.§ 216B.16, subd. 17, which applies reporting requirements only to "the utility" filing a rate case, does not require MERC to disclose the information requested by the OAG, which relates to MERC's service company, or affiliates of MERC.

The OAG also objects to MERC's inclusion of membership dues for several organizations in its T&E expense: the Minnesota Chamber of Commerce, the Edison Electric Institute, and the American Gas Association.[176] Because these membership dues were paid through IBS, they were not included as itemized expenses in MERC's informational filing. MERC did provide requested information regarding these expenses in response to information requests from the OAG.[177] It is appropriate to include these dues in MERC's operating expense because MERC's membership in these organizations strengthens MERC's relationships with the communities it serves and ultimately benefits ratepayers. Specifically, membership dues to the Minnesota Chamber of Commerce allow MERC to work with Minnesota communities to help

[173] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 15-18 (June 24, 2014).

[174] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 15-18 (June 24, 2014).

[175] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 16 (June 24, 2014).

[176] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 17 (June 24, 2014).

[177] *See* Ex. 152 at (JJL-10) (S. DeMerritt Response to OAG IR No. 139.1) (Feb. 17, 2014) (J. Lindell Schedules to Direct Testimony).

attract new business opportunities, strengthen the economy, and help create job growth. Additionally, while Minnesota ratepayers benefit from IBS' memberships in the Edison Electric Institute and the American Gas Association, MERC is not required by Minn. Stat. § 216B.16, subd. 17 to report these memberships, because both are associated with IBS and not MERC, the "utility" filing the rate case.[178] Especially in light of MERC's commitment to provide this information in future rate cases, MERC's recovery of these membership expenses is reasonable.

Despite the OAG's objections, MERC and the Department are in full agreement about the appropriate amount of T&E expense.[179] While Department witness Ms. La Plante agreed with the OAG in surrebuttal testimony that MERC's T&E expenses allocated from its service company should have been filed in this rate case, the Department did not make any recommendation regarding that issue.[180] MERC has agreed to provide additional information regarding all T&E expenses, including expenses related to its service company and employees who work for affiliates of MERC, in future rate case filings. MERC does not believe this additional information is required by the applicable statute, but will nonetheless provide the information to assist the Department and OAG in review of MERC's data.[181] MERC has met its obligations under Minn. Stat. § 216B.16, subd. 17, and has fully documented and justified its proposed test year T&E expense. MERC therefore respectfully requests that the ALJ and the Commission accept the agreement between MERC and the Department and find MERC's proposed T&E expense reasonable.

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[178] As discussed in further detail in this section, MERC has nonetheless agreed to provide this information in future rate cases.

[179] *See* Ex. 216 at 11 (L. La Plante Surrebuttal); Initial Post-Hearing Brief of the Minnesota Department of Commerce at 93 (June 24, 2014).

[180] Ex. 216 at 6-7 (La Plante Surrebuttal); Initial Post-Hearing Brief of the Minnesota Department of Commerce at 92-94 (June 24, 2014).

[181] Ex. 25 at 3 (S. DeMerritt Surrebuttal).

X. MERC'S INCLUSION OF COMPANY SUPPLIED BENEFIT FUNDS IN RATE BASE IS REASONABLE AND CONSISTENT WITH PRIOR COMMISSION DECISIONS.

In its Initial Brief, the Department argues that MERC included seventeen specific regulatory assets and liabilities, mostly related to employee benefits, which should not be included in rate base.[182] As explained in MERC's Initial Brief, MERC proposed to include benefit assets and liabilities in the amount of $11,769,457 in rate base to be consistent with the agreement reached with the OAG and approved by the Commission in MERC's last rate case, Docket No. G007,011/GR-10-977.[183] These employee benefit-related items, taken as a whole, represent the cumulative difference between contributions funded by MERC to the various benefit trusts and the actuarially-calculated expense recognized by MERC.[184] In its Initial Brief, the Department expresses concern that MERC's agreement with the OAG in MERC's last rate case does not provide a sufficient basis for MERC's current proposed benefit assets and liabilities 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 (2007-2011), whereas, in this rate case, MERC's valuation of net benefit assets and liabilities uses a projected thirteen-month average as of the end of the test year, December 31, 2014.[185] To clarify, when MERC was acquired by Integrys, MERC had a starting balance of $0. The same five year period from MERC's last rate case is still included in the balance sheet in this case, but the balance sheet also contains activity reflected through December 31, 2014 (not just December 31, 2011 as in the last rate case). Thus, the only difference from MERC's last rate case is that the Company

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[182] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 95-96 (June 24, 2014).

[183] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 48 (June 24, 2014); Ex. 27 at 13, 17 (C. Hans Rebuttal).

[184] Ex. 27 at 14 (C. Hans Rebuttal).

[185] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 97 (June 24, 2014).

is using a thirteen-month average to value the Company's net benefit assets and liabilities. Inclusion of these regulatory assets and liabilities in rate base is reasonable, benefits ratepayers, and is consistent with prior Commission treatment.

The Department, in its Initial Brief, states that a utility's rate base does not include accounts receivable or accounts payable.[186] But the pension assets and liabilities MERC has proposed to include in rate base are neither accounts receivable, nor accounts payable. Additionally, the Department states that a utility's rate base includes cash working capital ("CWC") determined from a lead/lag study.[187] Again, the pension assets and liabilities MERC has proposed to include are not included in CWC. As explained in MERC's Initial Brief, the regulatory assets and liabilities are not a function of benefit expense, such as other working capital accounts. Instead, it is the other way around. Benefit expense is a function of the assets and liabilities.[188] For benefits expense, MERC makes an out-of-pocket cash expenditure to create the asset prior to any benefit expense being recognized on the income statement, but the asset then earns a return and offsets benefit costs.[189] MERC notes that while the benefit assets earn a return, this return is used to reduce benefit costs, not to repay shareholders for their prepayment of benefit costs.[190] Instead, including these assets and liabilities in rate base is how shareholders earn a return on this funding activity.[191] Therefore, inclusion of these amounts in rate base will not result in any double recovery as claimed by the Department.

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[186] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 96 (June 24, 2014).

[187] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 96 (June 24, 2014).

[188] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 51 (June 24, 2014).

[189] Ex. 24 at 3 (S. DeMerritt Rebuttal).

[190] Ex. 24 at 4 (S. DeMerritt Rebuttal).

[191] Ex. 24 at 4 (S. DeMerritt Rebuttal).

The Department also argues that MERC did not cite to a single Commission Order to support its proposed inclusion of regulatory assets and liabilities in rate base. MERC has cited Commission support for its proposed treatment. First, as discussed in detail in MERC's Initial Brief, MERC's proposed treatment in this rate case is consistent with the treatment in MERC's last rate case, Docket No. G007,011/GR-10-977.[192] Additionally, MERC specifically cited to Xcel Energy's 2010 rate case, Docket No. E002/GR-10-971, in which the Commission authorized inclusion of prepaid pension contributions in rate base as part of Xcel's overall settlement.[193]

In its Initial Brief, the Department also claims that MERC has never previously proposed to include employee benefit assets and liabilities in rate case.[194] This should not provide a basis for denying inclusion in this case. As explained in testimony and MERC's Initial Brief, while MERC did not include cumulative funding and cumulative expense in its initial filing in Docket No. G007,011/GR-10-977, MERC ultimately agreed to include it in its rate base based on the recommendation of the OAG, which the Department did not oppose.[195]

The Department also continues to characterize MERC's inclusion of the retirement benefits trust plan balance in FAS 158 as inappropriate because these assets may increase or decrease over time, and because the Department feels that this "temporary timing difference"

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[192] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 48 (June 24, 2014); *In the Matter of the Application of Minnesota Energy Resources Corporation for Authority to Increase Rates for Natural Gas Service in Minnesota*, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 30, Docket No. G-007,011/GR-10-977 (July 13, 2012).

[193] *In the Matter of the Application of Northern States Power Company d/b/a Xcel Energy for Authority to Increase Rates for Electric Service in Minnesota*, FINDING OF FACT, CONCLUSIONS AND ORDER, Docket No. E002/GR-10-971 (May 14, 2012).

[194] Initial Post-Hearing Brief of Minnesota Department of Commerce at 98 (June 24, 2014).

[195] *See* Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 48-49 (June 24, 2014); *In the Matter of the Application of Minnesota Energy Resources Corporation for Authority to Increase Rates for Natural Gas Service in Minnesota*, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 30, Docket No. G-007,011/GR-10-977 (July 13, 2012).

does not justify rate base recovery.[196] As explained in MERC's Initial Brief, the Department's recommendation is both inconsistent with prior treatment and potentially detrimental to MERC's customers.[197] MERC's earnings on these assets reduce MERC's overall revenue requirement, thereby benefiting ratepayers. Disallowing recovery of these assets in rate base has the potential to increase rates for MERC's customers.[198] In its Initial Brief, the Department further asserts that MERC should not recover several rate base accounts because they are associated with non-qualified benefit plans.[199] MERC agreed to the removal of these rate base accounts during the Evidentiary Hearing and does not believe there is a disputed issue remaining regarding these accounts.[200]

Finally, the Department argues that it is unreasonable to include pension assets in rate base because "[o]nce the contributions are made, the Company no longer has use of the trust funds, nor earnings on the trust funds, for its ordinary business purposes."[201] Even though MERC cannot withdraw the prepaid pension asset or otherwise use it, the earnings on the asset are considered income to the utility, which reduce the overall revenue requirement, thereby benefiting ratepayers. These contributions are used in the calculation of net periodic benefit cost, which resulted in reduced pension costs for the 2014 test year of approximately $1.1 million and reduced test year costs for other post-retirement benefits costs of approximately $0.1 million.[202]

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[196] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 99-100 (June 24, 2014).

[197] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 49-50 (June 24, 2014);

[198] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 50 (June 24, 2014); *see also* Evidentiary Hearing Transcript (May 13, 2014) at 56 (C. Hans) ("It is precisely the cumulative excess funding to the benefit plan that MERC proposes to include in rate base. Customers benefit from this excess funding via lower benefit costs.").

[199] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 100-101 (June 24, 2014).

[200] Evidentiary Hearing Transcript (May 13, 2014) at 56 (C. Hans).

[201] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 100 (June 24, 2014).

[202] Ex. 27 at 16 (C. Hans Rebuttal).

Contrary to the Department's claims, inclusion of the proposed regulatory assets and liabilities in rate base will not result in any double recovery, is reasonable, benefits ratepayers, and is consistent with prior Commission treatment.

XI. MERC'S PROPOSED TEST YEAR EMPLOYEE BENEFIT COSTS REPRESENT MERC'S REASONABLE COST OF DOING BUSINESS.

In its Initial Brief, the Department argues that the pension expense submitted by MERC in this proceeding is flawed because it is based on unreasonable assumptions.[203] The Department concluded that the discount rate MERC proposed for its Pension and Post-Retirement Life Insurance Expense was unreasonable for ratemaking purposes because MERC selected a discount rate that was less than the expected rate of return on plan assets.[204] As explained in detail in MERC's Initial Brief, MERC's proposed employee benefit expense was determined based on the actuarial expense using generally accepted accounting principles ("GAAP") and most accurately reflects MERC's reasonable costs of doing business. Setting the discount rate equal to the expected return on plan assets, as proposed by the Department, would not accurately reflect MERC's reasonable costs of doing business and would not be representative of the specific facts and circumstances relative to MERC's pension and other employee benefit plans.[205]

The Department cites Xcel Energy's 2012 rate case in Docket No. E002/GR-12-961 as support for the general proposition that the discount rate should be set equal to the expected return on plan assets. However, as explained in MERC's Initial Brief, the Northern States Power - Minnesota ("NSPM") and Xcel Energy Services ("XES") pension plans in the Xcel Energy 2012 rate case are in no way similar or applicable to MERC's plans here. In CenterPoint

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[203] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 117-118 (June 24, 2014).

[204] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 118 (June 24, 2014).

[205] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 52-63 (June 24, 2014).

Energy's 2013 rate case, the Commission expressly rejected the application of the Xcel discount rate in all cases, concluding: "The calculation of pension expenses requires actuarial assumptions appropriate to the factual circumstances in each case. The factual record that resulted in the discount rate determination in the Xcel rate case does not pertain to the pension expense calculation here."[206] In order to get the most accurate calculation of expense, the appropriate discount rate should be independently calculated and not just set equal to the assumed return on plan assets.[207]

The facts presented in the record and arguments set forth here and in MERC's Initial Brief fully support MERC's proposed discount rates for calculation of pension and other employee benefit expenses. MERC has demonstrated that its pension is not similar to the pension plans at issue in Xcel's 2012 rate case, Docket No. E002/GR-12-961.[208] Additionally, MERC's proposed discount rate calculations are most appropriate because they were calculated based on real market conditions and "actuarial assumptions appropriate to the factual circumstances in [MERC's] case."[209] MERC calculated the relevant discount rate by selecting an actual bond portfolio to settle each plan's expected future benefit payments.[210] MERC's assumptions are carefully selected in consultation with its actuary and are reviewed and approved by external auditors. It is unreasonable for the Department to suggest arbitrarily setting a discount rate that is equal to the return on plan assets with little more support than the

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206 *In the Matter of an Application by CenterPoint Energy Resources Corp. d/b/a CenterPoint Energy Minnesota Gas for Authority to Increase Natural Gas Rates in Minnesota*, Docket No. G-008/GR-13-316, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 12 (June 9, 2014).

207 Ex. 27 at 8-9 (C. Hans Rebuttal).

208 *See* Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 57-60 (June 24, 2014).

209 *See In the Matter of an Application by CenterPoint Energy Resources Corp. d/b/a CenterPoint Energy Minnesota Gas for Authority to Increase Natural Gas Rates in Minnesota*, Docket No.G-008/GR-13-316, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 12 (June 9, 2014).

210 Ex. 27 at 9 (C. Hans Rebuttal).

fact that such a method has been reasonable in one other factually dissimilar rate case. The Department has presented no actuarial or other analysis that supports its discount rate conclusions. In contrast, the record reflects MERC has performed a thorough and objective analysis in setting its discount rate, which should be adopted by the ALJ and the Commission.

XII. THE OAG'S CLASS COST OF SERVICE STUDY RECOMMENDATIONS ARE NOT SUPPORTED BY THE RECORD, ARE NOT CONSISTENT WITH COMMISSION PRECEDENT, AND SHOULD BE REJECTED.

As explained in MERC's Initial Brief, MERC's class cost of service study ("CCOSS") is only in dispute between MERC and the OAG. The CCOSS prepared by MERC is a fully allocated, embedded CCOSS similar to the CCOSS filed by MERC in its last rate case.[211] Because MERC and the Department agree that MERC's CCOSS is a useful tool for the purposes of setting rates, MERC requests that the ALJ and the Commission accept MERC's proposed CCOSS.[212]

A. MERC's Distribution Mains are Correctly Classified and the OAG's Criticism of MERC's Zero-Intercept Study is Baseless.

Calculating cost of service involves a degree of subjectivity and, as a result, there is no one singularly correct CCOSS for a utility.[213] The OAG acknowledges that the CCOSS is a highly subjective tool.[214] As stated by the OAG, "the Commission has previously recognized that cost of service studies 'cannot establish precise values,' because they 'require considerable judgment and employ certain assumptions that might affect the results.'"[215] It is for the ALJ and the Commission to determine whether MERC's CCOSS is reasonable. As discussed in MERC's

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[211] Ex. 29 at 5-8 (J. Hoffman Malueg Direct); Ex. 30 at 44 (J. Hoffman Malueg Rebuttal).

[212] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 149-50 (June 24, 2014) (citing Ex. 209 at 4 (S. Ouanes Rebuttal)); Evidentiary Hearing Transcript (May 13, 2014) at 66-67 (J. Hoffman Malueg).

[213] Evidentiary Hearing Transcript (May 13, 2014) at 70 (J. Hoffman Malueg).

[214] Ex. 155 at 5 (R. Nelson Direct); Evidentiary Hearing Transcript (May 13, 2014) at 175 (R. Nelson).

[215] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 34 (June 24, 2014).

Initial Brief, the Department has concluded that MERC's CCOSS is a useful tool for the purpose of setting rates.

The OAG, in its Initial Brief, argues that in order for MERC's zero-intercept study to produce reliable results, the Company's Ordinary Least Squares ("OLS") regression must satisfy a series of assumptions, known as the Gauss-Markov assumptions.[216] The OAG also argues that MERC's OLS regression is "incorrectly specified" because neither MERC, nor the Department, conducted a "specification error test for omitted variables."[217] The OAG further argues that MERC's data set is unreliable because MERC did not perform a stem and leaf plot test to check for outliers.[218]

MERC satisfied the technical requirements of the zero-intercept study in three ways. First, in its regression analysis, MERC utilized data similar to that utilized by other Integrys subsidiaries in their zero-intercept studies; the same specifications and the same data parameters.[219] Second, MERC addressed the OAG's technical concerns by responding to OAG Information Requests 700, 702, 704, and 711.[220] Finally, MERC addressed the OAG's technical concerns by performing multiple minimum-size studies. As discussed in greater detail below, and in MERC's Initial Brief, the results of MERC's minimum-size studies produced results similar to MERC's zero-intercept study.[221]

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[216] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 43 (June 24, 2014).

[217] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 47 (June 24, 2014) (citing Mr. Nelson as the sole authority for the OAG's assertion).

[218] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 52-53 (June 24, 2014).

[219] Evidentiary Hearing Transcript (May 13, 2014) at 82 (J. Hoffman Malueg).

[220] Evidentiary Hearing Transcript (May 13, 2014) at 83 (J. Hoffman Malueg); Ex. 32 (J. Hoffman Malueg Response to OAG IR No. 700); Ex. 33 (J. Hoffman Malueg Response to OAG IR No. 702); Ex. 34 (J. Hoffman Malueg Response to OAG IR No. 704); Ex. 35 (J. Hoffman Malueg Response to OAG IR No. 711).

[221] Evidentiary Hearing Transcript (May 13, 2014) at 83 (J. Hoffman Malueg).

The OAG completely mischaracterizes the opinions of Department witness Ms. Laura Otis and MERC witness Mr. Harry John when it argues in its Initial Brief that according to Ms. Otis and Mr. John, the presence "heteroskedasticity means that MERC's regression is totally unreliable."[222] Mr. John accurately stated that the presence of heteroskedasticity does not cause the OLS regression to become biased, nor does it cause the coefficient estimates produced within a regression analysis to be biased.[223] Additionally, MERC conducted best fit plots, which confirmed the goodness of fit of the regression equation produced from the Company's zero-intercept model.[224]

The OAG places improper emphasis on its stem and leaf plot analysis, alleging that MERC's data set consists of 30 percent outliers. As detailed in MERC's responses to OAG Information Requests 700, 703, 704, and 707,[225] Ms. Joylyn Hoffman Malueg looked for outliers when she initially conducted MERC's zero-intercept study.[226] She did not find 30 percent of the data to be outliers.[227]

As demonstrated by MERC in the testimony and schedules of Ms. Hoffman Malueg, MERC's zero-intercept regression analysis is technically accurate and supports MERC's distribution main classifications. The ALJ and the Commission should accept MERC's regression analysis as accurate and reliable.

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222 Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 53 (June 24, 2014).

223 Evidentiary Hearing Transcript (May 13, 2014) at 110 (H. John).

224 Evidentiary Hearing Transcript (May 13, 2014) at 76 (J. Hoffman Malueg).

225 Ex. 32 (J. Hoffman Malueg Response to OAG IR No. 700); Ex. 34 (J. Hoffman Malueg Response to OAG IR No. 704); Ex. 43 (J. Hoffman Malueg Response to OAG IR No. 703); Ex. 156 at (REN-3) (J. Hoffman Malueg Response to OAG IR No. 707) (R. Nelson Direct Schedules).

226 Evidentiary Hearing Transcript (May 13, 2014) at 75, 84 (J. Hoffman Malueg); Ex. 32 (J. Hoffman Malueg Response to OAG IR No. 700).

227 Evidentiary Hearing Transcript (May 13, 2014) at 75, 84 (J. Hoffman Malueg).

1. MERC's Zero-Intercept Study Regression Model is Correctly Specified and Does Not Suffer from Omitted Variable Bias.

MERC's regression model is correctly specified and does not suffer from omitted variable bias. As detailed in the Rebuttal Testimony of Ms. Hoffman Malueg, and explained in MERC's Initial Brief, many of the variables recommended by the OAG are already included in the Company's zero-intercept analysis.[228] Those that were not included were omitted due to limited data availability.[229] This is particularly true given the installation dates of MERC's distribution mains, 85 percent of which have installation dates prior to 2006.[230] The OAG's attempts to discredit MERC's zero-intercept study on the basis of omitted variable bias are baseless. OAG witness, Mr. Ron Nelson, failed to determine whether the utilities he compared to MERC used all of the variables he argued MERC should have used in the Company's zero-intercept analysis.[231] Further, as discussed in MERC's Initial Brief, the OAG concedes that the zero-intercept study may include any number of variables, and the variables that are included in the analysis are subject to availability.[232] It is for the individual utility to determine which variables are most appropriate to include in the utility's zero-intercept analysis.[233] The OAG's variables are simply suggested variables and the OAG confirms that not every one of Mr. Nelson's suggested variables needs to be in the zero-intercept model.[234]

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[228] Ex. 30 at 4-9 (J. Hoffman Malueg Rebuttal).

[229] Ex. 30 at 4-9 (J. Hoffman Malueg Rebuttal).

[230] Ex. 30 at Schedule (JCHM-1) (J. Hoffman Malueg Rebuttal). This is why Mr. Nelson's reference to the project level data maintained by CenterPoint Energy is particularly inapplicable in this rate case. CenterPoint provides project level data for the period from 2008-2013, which does not accurately portray the majority of MERC's main installations, 85% of which took place prior to 2006. *Compare* Ex. 30, Schedule (JCHM-1) (J. Hoffman Malueg Rebuttal) *with* Ex. 155 at Schedule REN-15 (R. Nelson Direct).

[231] Evidentiary Hearing Transcript (May 13, 2014) at 161 (R. Nelson).

[232] Ex. 155 at 15 (R. Nelson Direct).

[233] Evidentiary Hearing Transcript (May 13, 2014) at 161 (R. Nelson).

[234] Evidentiary Hearing Transcript (May 13, 2014) at 161 (R. Nelson).

The OAG incorrectly argues that MERC assumes that only the diameter of the main squared impacts the cost of distribution.[235] MERC's regression analysis evaluated not only the diameter of the main squared, but also the Handy-Whitman Escalated Cost ("UHWICOST") variable and a weighted form of the quantity variable.[236] In its Initial Brief, the OAG asserts that MERC's own authority and witnesses indicate that costs from construction and bids from contractors affect cost and should have been included in MERC's model, but cites no authority to substantiate this statement.[237] While other MERC witnesses testified regarding main costs, they did not testify regarding the use of main costs within a zero-intercept study or their inclusion in the CCOSS. Only Ms. Hoffman Malueg testified regarding the zero-intercept study and the variables utilized in MERC's zero-intercept analysis.

MERC's zero-intercept model does include the proper variables, and for items that are not specified as unique variables, those items are still included within the model in book costs. The OAG grossly mischaracterizes Ms. Hoffman Malueg's testimony on this subject.[238] Regarding the cost of fittings and valves, Ms. Hoffman Malueg's Rebuttal Testimony states that the number of fittings and valves are not tracked by MERC on a historical basis.[239] Ms. Hoffman Malueg explains that any costs of fittings or valves are already included in the book costs MERC utilized in its zero-intercept study.[240] MERC never analyzed the costs attributable to fittings or valves such that the Company could say with any certainty whether they have an

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[235] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 44 (June 24, 2014).

[236] Evidentiary Hearing Transcript (May 13, 2014) at 79 (J. Hoffman Malueg); Ex. 34 (J. Hoffman Malueg Response to OAG IR No. 704).

[237] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 45 (June 24, 2014) (citing no authority for Mr. Nelson's statement and taking out of context a statement by MERC witness Mr. David Kult regarding varying construction costs across the state of Minnesota).

[238] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 46-47 (June 24, 2014).

[239] Ex. 30 at 6 (J. Hoffman Malueg Rebuttal).

[240] Ex. 30 at 6 (J. Hoffman Malueg Rebuttal).

effect on the cost of MERC's distribution mains. To claim otherwise is to completely misrepresent Ms. Hoffman Malueg's testimony, as well as the facts in this case.

MERC performed its zero-intercept study based on available, complete, and pertinent data.[241] MERC requests that the ALJ recommend, and the Commission approve, MERC's classification of the Distribution Mains account as accurate and reasonable.

2. MERC's Data Forms a Reliable Basis for the Results of MERC's Zero-Intercept Analysis.

The OAG also argues, in its Initial Brief, that MERC's data has been manipulated and, therefore, results in an unreliable result.[242] To the contrary, and as explained in pre-filed testimony and MERC's Initial Brief, the aggregation and averaging of MERC's data produces the most accurate representation of MERC's entire distribution mains system.[243] In its Initial Post-Hearing Brief, MERC explained why averaging in MERC's zero-intercept study is appropriate:

> [T]he purpose of the zero-intercept study is to provide a hypothetical zero-load or zero-sized distribution main on MERC's entire system. MERC uses the end result of this analysis to classify MERC's distribution mains as an entire system, separating the distribution mains between the classifications of customer and demand.[244] MERC's approach is supported by both the [National Association of Regulatory Commissioners ("NARUC")] Electric Manual and the NARUC Gas Distribution Rate Design manual. The NARUC Electric Manual clearly states the data one would need to perform a zero-intercept analysis on various electric assets and each time the NARUC states that average installed book cost should be utilized. As gas utilities commonly consult the NARUC Electric Manual for guidance on cost allocation, there is no reason

[241] Ex. 30 at 9 (J. Hoffman Malueg Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 68-69 (J. Hoffman Malueg); Ex. 32 (J. Hoffman Malueg Response to OAG IR No. 700); Ex. 33 (J. Hoffman Malueg Response to OAG IR No. 702); Ex. 34 (J. Hoffman Malueg Response to OAG IR No. 704); Ex. 43 (J. Hoffman Malueg Response to OAG IR No. 703).

[242] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 48 (June 24, 2014).

[243] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 82-83 (June 24, 2014).

[244] Ex. 30 at 17-19 (J. Hoffman Malueg Rebuttal).

> that gas utilities could not follow the NARUC Electric Manual's methodologies for performing a zero-intercept study on gas distribution assets. Both manuals state that the minimum-size and zero-intercept analyses will have similar results and that a minimum size analysis utilizes the average cost of data.[245] Mr. Nelson's own Direct Testimony in CenterPoint Docket No. 13-316 implies acknowledgement of this concept, as page 11 of Mr. Nelson's testimony states that the minimum sized main method simply uses the average unit cost of the smallest main. Therefore, it only makes sense that, if conducted properly, in order for a minimum size analysis and a zero-intercept analysis to have comparable results, both must utilize average unit costs.[246]

The OAG's assertions that MERC's data set is "meaningless" and aggregation can "destroy the relationship that a regression is attempting to model," are supported by nothing more than Mr. Nelson's opinion and are baseless.[247]

As for the OAG's unsubstantiated claim that MERC "intentionally altered" the Company's data sets by relabeling mains that were less than 2 inches as 2 inch mains,[248] The OAG conveniently fails to mention that MERC utilized the Handy-Whitman Index ("HWI") against book value costs to arrive at the current cost of all distribution main assets.[249] The HWI converts all book costs to "current costs," because book costs vary by year of installation. Using HWI translates all book costs into current costs, thereby removing any bias or irregularities that could potentially be brought into the regression analysis attributable to the year of installation.[250]

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[245] Ex. 30 at 18-19 (J. Hoffman Malueg Rebuttal).

[246] Ex. 30 at 17-19 (J. Hoffman Malueg Rebuttal).

[247] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 48 (June 24, 2014) (citing Mr. Nelson as the sole authority for the OAG's assertions).

[248] Initial Post-Hearing Brief of the Office of the Attorney General at 48 (June 24, 2014) (providing no authority for Mr. Nelson's claim).

[249] Ex. 34 (J. Hoffman Malueg Response to OAG IR No. 704); Ex. 43 (J. Hoffman Malueg Response to OAG IR No. 703) (noting that the Handy-Whitman Index is a widely used method of indexing a utility's assets from book value to current value, or in layman's terms, stating what it would cost the utility to replace those assets in today's dollars. The advantage to using the Handy-Whitman Escalated Cost rather than the Book Cost in the regression analysis is that it provides a more accurate and true picture of the costs the utility would incur today if it had to replace all of its distribution mains).

[250] *See* Ex. 156 at Schedule (REN-10) (Schedules to Direct Testimony of R. Nelson).

MERC did not manipulate the data for unit cost through the use of averaging, as claimed by the OAG.[251]

MERC has demonstrated that it did not predetermine a relationship between the size of the main and the unit cost.[252] The ALJ and the Commission should find that MERC's data forms a reliable basis for the results of MERC's zero-intercept study.

3. MERC Should Not be Required to Maintain the Project Level Data Recommended by the OAG.

The OAG's recommendation that MERC maintain project level data is wholly unsupportable. As previously discussed, the CenterPoint project level data identified by the OAG only consists of 2008 through 2013 data. Utilizing only a few years of current data, as recommended by the OAG, is not appropriate when 85 percent of MERC's distribution main installations occurred prior to 2006. In addition, the OAG improperly seeks to hold MERC to a higher standard than the Company's Minnesota utility counterparts by advocating that MERC maintain distribution main data at the project level.[253] The OAG only identified one Minnesota utility, CenterPoint Energy, which collects the type of data the OAG considers to be project level data.[254] MERC has not been required to maintain this level of detailed information in the past. Nor, to MERC's knowledge, is collection of this data required of other Minnesota utilities, a point which the OAG concedes.[255] Most importantly, maintaining data at the project level

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[251] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 48 (June 24, 2014).

[252] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 82-83 (June 24, 2014).

[253] Ex. 155 at 16-17, 38 (R. Nelson Direct); Ex. 158 at 6-7 (R. Nelson Surrebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 156-57 (R. Nelson).

[254] Ex. 155 at 17 & n.10 (R. Nelson Direct).

[255] Ex. 30 at 11, 13 (J. Hoffman Malueg Rebuttal); Ex. 158 at 6 (R. Nelson Surrebuttal).

simply for use in periodic rate case zero-intercept studies is not a cost that MERC can, or should be required to, justify to its customers.[256]

MERC requests that the ALJ and the Commission find that MERC should not be required to maintain project level data for the purposes of the Company's zero-intercept study.

4. The Results of MERC's Zero-Intercept Study are Supported by the Company's Minimum System Study.

The results of MERC's zero-intercept study are supported by the Company's minimum system study. Based on the dramatic difference between OAG witness Mr. Nelson's Distribution Main classification recommendation (30% of Distribution Mains to be classified as customer cost) and MERC's proposed Distribution Main classification (68% of Distribution Mains to be classified as customer cost), and given the OAG's assertions regarding the reliability of MERC's zero-intercept method, the Department requested that MERC classify the Company's Distribution Mains costs using the minimum-size method as contemplated in the NARUC Gas Manual.[257] As explained by the Department:

> While serving the same purpose as the zero-intercept method, the minimum-size method has the added advantage that it does not rely on regression analysis. In the most recently decided general rate case by the Commission (Docket No. 13-316), even Mr. Nelson believed that one should verify the results of a costs study under [the] zero-intercept method with the results of a costs study under the minimum-size method because it is difficult to calculate the exact costs of a zero diameter main.[258]

MERC has demonstrated that to accurately portray the cost causation of the Company's current customers, MERC must use a 2 inch pipe in its minimum-size study to reflect MERC's

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[256] Ex. 30 at 10-12 (J. Hoffman Malueg Rebuttal).

[257] Ex. 208 at 11 (S. Ouanes Rebuttal).

[258] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 147 (June 24, 2014) (citing Ex. 208 at 11 and Trial Vol. 1 at 165); Evidentiary Hearing Transcript (May 13, 2014) at 165 (R. Nelson).

current installation standards.[259] A zero-inch pipe does not exist and is purely theoretical in nature.[260] One-inch, two-inch, three-inch pipes, and sometimes even larger sizes, are what are actually used in in MERC's distribution system today,[261] with the majority of MERC's distribution mains being 2-inches in size.[262] Thus, using anything less than a 2 inch pipe in MERC's minimum-size study would be inaccurate and improper.

The OAG's complete exclusion of steel distribution mains from the minimum system study ignores MERC's actual installation practices.[263] Steel mains can be, and in fact are, just as much a minimum installation requirement as plastic. Because there are fixed and variable costs associated with both plastic and steel distribution mains, the exclusion of these mains from MERC's minimum system study would result in an inaccurate cost causation picture of MERC's current customers, which would result in improper customer rates.[264]

The results of MERC's minimum size study unfailingly support MERC's zero-intercept analysis. MERC's analysis, which is detailed in MERC's response to the Department's Information Request 725, demonstrates that under a minimum-size study using 2 inch pipes, at least 73 percent of MERC's distribution mains would be classified as customer costs.[265] This is consistent with the 68.3 percent customer Distribution Main classification from MERC's zero-

[259] Ex. 30 at 16, 20 and Schedule (JCHM-2) (J. Hoffman Malueg Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 69 (J. Hoffman Malueg).

[260] Evidentiary Hearing Transcript (May 13, 2014) at 87 (J. Hoffman Malueg).

[261] Evidentiary Hearing Transcript (May 13, 2014) at 87 (J. Hoffman Malueg); Initial Post-Hearing Brief of the Minnesota Department of Commerce at 148 (June 24, 2014).

[262] Ex. 30 at 16, 20 (J. Hoffman Malueg Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 89-90 (J. Hoffman Malueg); Initial Post-Hearing Brief of the Minnesota Department of Commerce at 148 (June 24, 2014).

[263] Ex. 30 at 19-23 and Schedule (JCHM-4) (J. Hoffman Malueg Rebuttal).

[264] *See* Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 84-85 (June 24, 2014); Ex. 30 at 19-23 and Schedule (JCHM-4) (J. Hoffman Malueg Rebuttal).

[265] Ex. 30 at 15-16 (J. Hoffman Malueg Rebuttal); Ex. 156 at Schedule (REN-14) (Schedules to Direct Testimony of R. Nelson).

intercept study. The Department aptly points out that "[i]n the end, 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. It is a judgment call."[266] In this case, MERC has provided ample support to demonstrate that the use of a 2 inch main is reasonable. The Department agrees and recommends that the Commission accept MERC's classification of Distribution Main costs and reject the OAG's classification of Distribution Main costs.[267]

5. The OAG's Zero-Intercept Study is Fatally Flawed and Must be Rejected by the ALJ and the Commission.

The OAG's zero-intercept study is flawed and must be rejected by the ALJ and the Commission. MERC provided the OAG with the raw data that was used in MERC's regression analysis. This was raw data that was not manipulated in any way and was taken directly from MERC's accounting system.[268] If MERC's accounting data and regression analyses truly suffered from the inefficiencies that the OAG claims, the OAG should have been able to take the raw data provided by MERC, conduct all the statistical testing and processes referenced in Mr. Nelson's Direct and Rebuttal Testimonies, and perform what the OAG and Mr. Nelson considered a more efficient regression analysis. Yet, they were not able to do so. Mr. Nelson did compute a regression analysis that produced a negative zero-intercept, or negative zero-sized pipe value.[269] However, there are fixed and variable costs associated with both plastic and steel distribution mains and to have a negative coefficient of the size-squared variable is equivalent to

[266] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 149 (June 24, 2014).

[267] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 149-150 (June 24, 2014).

[268] Ex. 32 (J. Hoffman Malueg Response to OAG IR No. 700).

[269] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 84 (June 24, 2014).

stating that there is a negative-sized pipe diameter.[270] This clearly demonstrates that the results of the OAG's zero-intercept analysis are not appropriate.

Rather than cross-check his zero-intercept analysis with a minimum-size analysis, as Mr. Nelson advocated in CenterPoint Docket No. 13-316,[271] Mr. Nelson chose to ignore his own professional advice and improperly cross-checked the reasonableness of his zero-intercept results by comparing them to the results of zero-intercept studies conducted by other utilizes across the nation.[272] However, at the Evidentiary Hearing Mr. Nelson admitted that he did not conduct any research regarding the specific steps the utilities in his review used to conduct their zero-intercept studies.[273] Nor did he determine whether these utilities averaged costs or collected project level distribution data of the type he recommends MERC maintain for use in the Company's zero-intercept study.[274] Mr. Nelson admits that part of the reason he did not find any utility that has recommended anything close to the 68.3 percent of customer costs classified by MERC when using the zero-intercept analysis is that there are few utilities that use the zero-intercept analysis, and none in Minnesota.[275] Yet, Mr. Nelson determined that his zero-intercept analysis was "superior" to MERC's analysis, even though Mr. Nelson cannot confirm that the utilities he used to cross-check the results of his zero-intercept analysis determine their distribution main classifications in a manner similar to MERC.

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[270] Ex. 30 at 21-22 (J. Hoffman Malueg Rebuttal).

[271] *In the Matter of the Application of CenterPoint Energy Resources Corp. for Authority to Increase Natural Gas Rates in Minnesota*, Docket No. G-008/GR-13-316, Direct Testimony and Exhibits of Minnesota Office of the Attorney General Witness Ron Nelson at 15 (November 26, 2013); Ex. 158 at 15 (R. Nelson Surrebuttal).

[272] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 55 (June 24, 2014).

[273] Evidentiary Hearing Transcript (May 13, 2014) at 159-60 (R. Nelson).

[274] Evidentiary Hearing Transcript (May 13, 2014) at 160 (R. Nelson).

[275] Evidentiary Hearing Transcript (May 13, 2014) at 157-58, 173 (R. Nelson) (stating a percentage of 70 percent); Evidentiary Hearing Transcript (May 13, 2014) at 68 (J. Hoffman Malueg) (stating MERC's actual percentage of 68.3 percent).

The Department and MERC did not reject the OAG's analysis because they didn't like the results;[276] they rejected it because it is entirely inappropriate. MERC's third minimum-size study, which most closely approximates the results of the OAG's zero-intercept study, does not take into consideration the Company's minimum installation standards and was provided by MERC to show the extreme results that occur when current minimum installation practices are not considered.[277] The fact that the OAG's zero-intercept study produces results that are similar to MERC's third minimum-size study discredits the OAG's zero-intercept analysis and demonstrates that it is inappropriate to determine mains distribution in the current rate case.[278]

MERC requests that the ALJ and the Commission approve MERC's Distribution Mains account classification of 68.3 percent customer costs and 31.7 percent capacity costs.

B. A Weighed Allocator is Neither Appropriate Nor Desirable for FERC Account 903: Customer Records and Collection Expenses.

In its Initial Brief, the OAG's argues that MERC assumes that the Company's customer service accounts cost the same to administer for each customer.[279] This assertion is wholly inaccurate. MERC has repeatedly explained to the OAG that the only significant cost differences between MERC's customer classes related to FERC Account 903 are the costs from administering MERC's transportation program.[280] MERC recognizes that transportation customers require more account administration and should be allocated more Account 903 costs than a sales customer.[281] MERC accomplishes this by segregating the costs from administering

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[276] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 56 (June 24, 2014).

[277] Ex. 30 at 3, 14-17, 20-21 and Schedules (JCHM-1, JCHM-3 and JCHM-4) (J. Hoffman Malueg Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 83-84 (J. Hoffman Malueg).

[278] Ex. 30 at 3, 14-17 and Schedules (JCHM-1, JCHM-3 and JCHM-4) (J. Hoffman Malueg Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 83-84 (J. Hoffman Malueg).

[279] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 35 (June 24, 2014).

[280] Ex. 30 at 33-34 (J. Hoffman Malueg Rebuttal).

[281] Ex. 30 at 33-34 (J. Hoffman Malueg Rebuttal).

MERC's transportation program from Account 903, and allocating those segregated costs to MERC's transportation customers within the CCOSS.[282] The costs that remain in Account 903 are primarily related to MERC's engagement of its third party external service provider, Vertex.[283] There are no significant costs differences among MERC's customer classes with respect to Vertex costs and MERC allocates the costs within MERC's CCOSS based on customer counts.[284]

The OAG's argument that other utilities factor in class complexity when allocating Account 903 lacks merit for the simple reason that there is no complexity in the way that MERC is assessed costs by Vertex.[285] The treatment of these expenses by other natural gas companies in Minnesota is inapplicable to MERC. As explained above, MERC addresses the additional cost associated with transportation customers by segregating these costs from Account 903.

Mr. Nelson claims that he is aware that CenterPoint and Xcel outsource their customer service because Ms. Hoffman Malueg stated this in her Rebuttal Testimony.[286] Yet, nowhere in any of Ms. Hoffman Malueg's testimony (including the Evidentiary Hearing) does she ever make such a statement. Mr. Nelson is in no position to assume that MERC's customer service costs are similar to those of other utilities, when Mr. Nelson has made no effort to determine whether other utilities outsource their customer service. As a company that outsources its customer service functions, a weighted allocator is not appropriate for MERC and it would be unreasonable for MERC to use one.

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[282] Ex. 30 at 33-34 (J. Hoffman Malueg Rebuttal).

[283] Vertex performs customer service and billing functions for all of MERC's customers. Ex. 30 at 34 (J. Hoffman Malueg Rebuttal).

[284] Ex. 30 at 33-34 (J. Hoffman Malueg Rebuttal).

[285] Ex. 30 at 33-35 (J. Hoffman Malueg Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 69-70 (J. Hoffman Malueg).

[286] Evidentiary Hearing Transcript (May 13, 2014) at 163 (R. Nelson).

The OAG's reference in its Initial Brief to a customer service study conducted by Xcel is unpersuasive in this case.[287] The Xcel study shows that interruptible customers' cost of administering customer service is 20 times larger than residential, and yet those interruptible customers are only allocated 1.89 percent of total customer service costs (whereas residential is allocated 69.75 percent of costs).[288] This confirms that even when a weighting factor is incorporated for large customers, they still comprise a very small amount of the total customer service costs. Even assuming a 12 percent cost shift, Account 903 only makes up 2.7 percent of MERC's Total Operating Expenses for test year 2014, and a 12 percent shift away from residential customer classes to non-residential customer classes would equate to approximately $800,000 in expense, or 0.32 percent of Total Operating Expenses for test year 2014.[289] As illuminated by ALJ Lipman's line of questioning at the Evidentiary Hearing, the benefits of conducting such a large, time and resource intensive study are diminished by the minimal impact on customer service costs.[290] The OAG concedes that it is up to the ALJ and the Commission to determine how much weight to place on the CCOSS.[291] Thus, MERC cannot (and should not be required to) cost-justify such a study to its customers when the study identifies such marginal differences in cost. In addition, MERC notes that performing such an intensive study would be made even more difficult by the fact that MERC would need to examine Vertex's records and procedures to formulate any type of study as to how Vertex administers MERC's customer service function.

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[287] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 37 n.157 (June 24, 2014).

[288] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 37 n.157 (June 24, 2014).

[289] *See* Ex. 4, Initial Filing Volume 3: Informational Requirements, Document 5 at Schedules C-3, C-6.

[290] *See generally* Evidentiary Hearing Transcript (May 13, 2014) at 166-171.

[291] Evidentiary Hearing Transcript (May 13, 2014) at 170-171 (R. Nelson).

The OAG, in its Initial Brief, engages in unbridled speculation, arguing that Ms. Hoffman "misses the point" of the OAG's weighted allocator argument because she does not address a hypothetical scenario created by Mr. Nelson where Vertex may have spread the increased cost of serving large commercial customers across the residential customers by pricing all customers equally.[292] However, Mr. Nelson has provided no evidence that Vertex has spread the increased cost of serving his "imaginary" large commercial customers across the "imaginary" residential customers as set forth in his hypothetical scenario. It is just as likely that it costs Vertex more to serve MERC's residential customers, and MERC's large commercial customers subsidize such costs. MERC has entered into an arms-length transaction with a third party vendor to provide a defined set of services.[293] MERC has determined that the Vertex contract is reasonable and there are no significant costs differences amongst MERC's customer classes for the Vertex costs.[294] Thus, a weighted allocator is not appropriate for MERC.

The recommendations of the NARUC Rate Design Manual that suggest using a weighted customer allocator are also inapplicable to MERC. While a good tool for guidance on cost of service allocations, the NARUC Gas Manual was published in 1989 when utilities did not outsource their customer service functions and is unsuitable for a utility that does not perform its own customer information systems and services function.[295] These types of reference manuals cannot be viewed by MERC as the final authority or only way to perform a CCOSS simply

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[292] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 36 (June 24, 2014).

[293] Evidentiary Hearing Transcript (May 13, 2014) at 166 (R. Nelson).

[294] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 87 (June 24, 2014).

[295] Ex. 30 at 35 (J. Hoffman Malueg Rebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 70-71 (J. Hoffman Malueg).

because there are instances where the operations of utility companies today are different than when the NARUC Gas Manual was published in 1989.[296]

Requiring MERC to use the weighted meters customer allocator for FERC Account 381 is nonsensical because the costs in Account 903 are not costs associated with meters.[297] Rather, they are costs associated with labor, materials, and expenses related to working on customer applications, contracts, orders, credit investigations, billing, collection, and complaints.[298] Thus, a weighted customer allocator that is based on the average cost per customer for meters results in an inaccurate cost causation allocation that has no correlation to the actual costs associated with Account 903.[299]

It would be neither desirable, nor appropriate, for the ALJ and the Commission to determine the reasonableness of MERC's allocation of Account 903 costs based on the OAG's speculative and unsubstantiated analysis. Where customer cost differs, MERC has appropriately accounted for those differences. The Department agrees with MERC's allocation of costs in Account 903.[300] Therefore, the ALJ and the Commission should find MERC's allocation of Account 903 costs reasonable.

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[296] Evidentiary Hearing Transcript (May 13, 2014) at 70 (J. Hoffman Malueg).

[297] Ex. 155 at 42 (R. Nelson Direct) ("The NARUC Manual allocates FERC accounts 902 and 903 on the basis of meter count, which is the weighted customer allocator created for FERC account 381. For this case, I recommend that the Commission Order MERC to follow the NARUC Manual's recommended allocation method. FERC accounts 902 and 903 should be allocated using the same weighted customer allocator that is used for FERC account 381."); Ex. 158 at 20 (R. Nelson Surrebuttal) ("I recommend that MERC be ordered to use a customer weighed allocation method for FERC account 903. I note that the NARUC gas manual uses the same allocator for this account as FERC account 381."); Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 38 (June 24, 2014) ("If MERC is unable to produce a weighted allocator, the OAG recommends that MERC be ordered to use the allocator used for FERC account 381….")

[298] Ex. 30 at 32 (J. Hoffman Malueg Rebuttal).

[299] Ex. 30 at 32-34 (J. Hoffman Malueg Rebuttal).

[300] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 146 (June 24, 2014).

C. MERC and the Department Agree that MERC Properly Allocated Income Taxes in the CCOSS.

In an effort to discredit MERC's allocation of income taxes in the current rate case, the OAG's Initial Brief attempts to paint a picture where MERC deliberately fails to comply with prior Commission orders and instructions, and "selectively" ignores the expenses within the CCOSS to allocate income taxes only on the basis of rate base.[301] To the contrary, as reflected in the May 22, 2012 and May 24, 2012 transcripts memorializing the Commission's deliberations in MERC's last rate case, the Commission concluded that it was unnecessary to take a position on this issue.[302] The OAG's argument in its Initial Brief that "MERC claims that it was unable to allocate income taxes based fully and only on the CCOSS" completely misstates MERC's testimony.[303] MERC has advocated from the start that income taxes must be allocated based upon taxable income that fully and only reflects the CCOSS, and has shown in its testimony how this allocation is mathematically equivalent to the rate base allocation method in this rate case.[304] Mr. Lindell continues to confuse the terms "net taxable income" with "taxable income that fully and only reflects the CCOSS." In her Rebuttal Testimony, Ms. Hoffman Malueg explains in clear detail the two terms, their meanings, and why there is a significant distinction between them.[305] Similarly, the OAG incorrectly states in its Initial Brief that "MERC is unable to allocate income taxes based fully and only on the CCOSS because of a circular reference problem."[306] MERC cannot allocate income taxes on the basis of ***net taxable income*** due to

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[301] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 39 (June 24, 2014).

[302] Ex. 30 at 40-41 (J. Hoffman Malueg Rebuttal).

[303] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 39 (June 24, 2014).

[304] *See* Ex. 4, Initial Filing Volume 3: Informational Requirements, Document 12 at Schedule 9; Evidentiary Hearing Transcript (May 13, 2014) at 67 (J. Hoffman Malueg).

[305] Ex. 30 at 36-39 (J. Hoffman Malueg Rebuttal).

[306] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 40 (June 24, 2014).

circular reference problems.[307] MERC ***is able*** to allocate income taxes on the basis of taxable income that fully and only reflects the CCOSS by mathematically proving that it is equal to a proportion of rate base, and MERC, therefore, utilizes the rate base method to allocate income taxes in the CCOSS.

The Department has also determined that the OAG's arguments are erroneous. As explained by the Department, MERC has complied with the Commission's requirement in the current rate case.

> At first blush, [MERC's] proposed CCOSS appears to allocate income taxes on the basis of rate base. The Department was, however, able to verify that allocating 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.[308]

The Department's review of the formulas used by MERC to calculate income taxes led the Department to conclude that MERC's calculated income taxes are not only mathematically equivalent to a fixed proportion of the rate base, but that the allocation via the rate base method produces a tax rate across customer classes that are the same tax rate that is applied to MERC's Minnesota jurisdiction.[309] The Department concluded that MERC's proposed allocation of income taxes by class is reasonable in the current rate case because MERC showed that the Company allocated income taxes by class on the basis or taxable income that fully and only reflects the CCOSS. Moreover, the Department determined that MERC's proposed classification and allocation of the functionalized accounts are generally consistent with NARUC Gas Manual

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[307] Ex. 30 at 36-37 (J. Hoffman Malueg Rebuttal).

[308] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 139 (June 24, 2014) (citing Ex. 206 at 11 (S. Ouanes Direct)).

[309] Ex. 208 at 4 and Exhibit SO-R-1 (S. Ouanes Rebuttal Testimony).

and cost-causation principles and MERC made the relevant updates to its input data.[310] Thus, MERC requests that the ALJ and the Commission accept MERC's proposed CCOSS as a useful tool for the purpose of setting rates.[311]

D. MERC, the Department and the OAG are in Agreement with Respect to FERC Account 902: Allocation of Meter Reading Expenses

MERC addresses FERC Account 902 only to provide clarification in the record on this matter. The Department and MERC agreed on MERC's allocation of Account 902: Meter Reading Expense.[312] The OAG and MERC initially disagreed regarding the allocation of Account 902.[313] However, the OAG later rescinded its objection to MERC's allocation methodology.[314] Therefore, the Commission should approve MERC's proposed allocation of this Account.

XIII. MERC'S PROPOSED RATE DESIGN IS REASONABLE.

A. The Proposed Revenue Apportionment Agreed to by MERC and the Department Is Reasonable and Should be Adopted.

MERC and the Department have agreed on a proposed revenue apportionment that reasonably allocates costs among MERC's customer classes based on the CCOSS. The proposed revenue apportionment continues to move the Residential and Small Commercial and Industrial ("C&I") classes closer to cost while at the same time maintaining the general contribution for the Transport classes to MERC's overall revenue requirement, which is necessary to prevent bypass. The OAG, in its Initial Brief, argues that revenue apportionment should remain stable and that

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[310] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 140 (June 24, 2014) (citing Ex. 206 at 11-13 (S. Ouanes Direct)).

[311] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 140 (June 24, 2014) (citing Ex. 206 at 11-13 (S. Ouanes Direct)).

[312] Ex. 208 at 6-8 (S. Ouanes Rebuttal).

[313] Ex. 30 at 26-31 (J. Hoffman Malueg Rebuttal); Ex. 155 at 40-43 (R. Nelson Direct).

[314] Ex. 158 at 19 (R. Nelson Surrebuttal).

MERC's and the Department's proposed revenue apportionment should be rejected in large part because the OAG does not support MERC's CCOSS. For the reasons already explained above, and in MERC's Initial Brief, MERC's CCOSS should be adopted in this proceeding and used as a basis for revenue apportionment and rate design.

The OAG argues, in its Initial Brief, that MERC's CCOSS overstates the costs caused by the Residential and Small C&I customer classes and, therefore, any adjustment to MERC's current revenue apportionment is not appropriate.[315] As discussed above, MERC's proposed allocations under its CCOSS are reasonable and demonstrate that the current revenue apportionment for the Residential and Small C&I customer classes is below the actual cost attributable to those classes.

The OAG further argues that non-cost factors must be considered in determining an appropriate revenue apportionment.[316] MERC and the Department are in agreement that non-cost factors must be taken into account in determining a reasonable revenue apportionment. Relevant non-cost factors were incorporated into MERC and the Department's proposed revenue apportionment. Specifically, the potential for rate shock with respect to the Residential and Small C&I customers, the potential for bypass or alternative fuel options to ensure rates remain competitive with other available alternatives, and the need to send accurate "price signals" were all considered in the development of the proposed revenue apportionment.[317] As the Department states in its Initial Brief, "[i]n addition to addressing concerns about large customers leaving MERC's system, MERC's proposed apportionment ensures that distribution rates for similar

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[315] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 58 (June 24, 2014).

[316] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 59 (June 24, 2014).

[317] *See* Ex. 203 at 12-16 (S. Peirce Direct).

sales and transportation classes remain the same."[318] The revenue apportionment agreed to by MERC and the Department is the most reasonable approach to ensure inter-class subsidies are minimized and each rate class is moved closer to actual cost, thereby ensuring appropriate and accurate price signals are provided.

B. MERC Has Met Its Burden To Support Higher Customer Charges for the Residential and Small C&I Customers.

MERC proposes to increase its monthly customer charge to $9.50, and to increase the monthly customer charge for its Small C&I class to $18.00. These proposed customer charges bring MERC's customer charges slightly closer to cost and help to reduce intra-class subsidies. The Department agrees that MERC's proposed customer charge increases are reasonable. The OAG recommends no increase in the monthly customer charge for Residential and Small C&I customers, arguing that an increase is unnecessary and would result in confusion and alienation of customers.

Contrary to the OAG's assertion that MERC proposes to collect the majority of its fixed costs from residential customers through the monthly customer charge, a $9.50 monthly customer charge would only recover 37% of MERC's fixed costs, as determined in MERC's CCOSS. MERC's proposed increases to the customer charges are reasonable and further valid rate design goals. As the Commission has previously stated, customer charges serve two main functions: (1) to help stabilize utility revenues and reduce the risk that the utility will over or under recover its revenue requirement due to weather-related fluctuations in gas usage and sales; and (2) to ensure that each customer bears responsibility for a certain level of the utility's fixed

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[318] Initial Post-Hearing Brief of the Minnesota Department of Commerce at 162-163 (June 24, 2014).

costs regardless of usage.[319] The proposed customer charges agreed to by MERC and the Department are reasonable and achieve these goals.

The OAG, in its Initial Brief, argues that "[m]oderating increases to the customer charge achieves the Commission's important directive to 'encourage energy conservation' by increasing the incentive to conserve. . . . [W]hen the customer charge is kept stable, customers have a greater incentive to conserve."[320] While the Commission has recognized that a significant increase in the customer charge can act as a disincentive to conservation, the increases MERC has proposed would not be so significant to have such an impact. Further, the Commission has previously made clear that the statutory directive "to the maximum reasonable extent, the commission shall set rates to encourage energy conservation,"[321] is but one factor in setting the appropriate level of customer charges. As the Commission recognized in CenterPoint Energy's most recent rate case, where it approved an increase in CenterPoint's residential customer charge to $9.50,

> Maintaining the customer charge at its current level would effectively increase intra-class subsidies for low-usage customers, so the principle of intra-class rate design equity supports some increase…. [T]he Department-recommended residential customer charge amount of $9.50 best balances the many remaining concerns identified by all the parties. These concerns include, but are not limited to: the principle of moving the fixed cost charge closer to the class's average fixed cost; promoting intra-class equity; minimizing rate shock that certain customers may experience in response to a large, sudden change in the fixed

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[319] *In the Matter of the Application of CenterPoint Energy Minnesota Gas for Authority to Increase Natural Gas Rates in Minnesota*, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER at 41, Docket No. G-008/GR-05-1380 (Nov. 2, 2006).

[320] Initial Post-Hearing Brief of the Minnesota Office of the Attorney General at 60 (June 24, 2014).

[321] Minn. Stat. § 216B.03.

> monthly charge; and the Commission's mandate to set rates that to the maximum reasonable extent encourage energy conservation.[322]

When customer charges are kept artificially low and do not accurately reflect the true cost of service, customers are provided with inappropriate "price signals" about the true cost of their gas use. Moving the Residential and Small C&I customer charges closer to cost will provide more appropriate price signals as to the true cost of the energy consumed, while also taking into consideration concerns regarding rate shock and energy conservation.

The OAG also incorrectly argues that increases to MERC's customer charges are not necessary to ensure revenue stability because MERC's revenue is guaranteed under the Company's decoupling mechanism. As previously stated in the testimony of Mr. St. DeMerritt and in MERC's Initial Brief, this argument is simply not true. Contrary to the OAG's claims, MERC does not have full decoupling for Residential and Small C&I customers.[323] MERC's decoupling mechanism, which only applies to distribution revenues less the CCRC, is a use per customer calculation and includes a 10% symmetrical cap on distribution revenues.

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. A higher customer charge to recover fixed costs will minimize the over or under collection of costs from different customers within a class. Therefore, the proposed increase in the residential customer charge will help to alleviate this intra-class subsidy.[324] An increase in the Residential customer charge

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[322] *In the Matter of an Application by CenterPoint Energy Resources Corp. for Authority to Increase Natural Gas Rates in Minnesota*, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 52, Docket No. G-008/GR-13-316 (June 9, 2014).

[323] Initial Post-Hearing Brief of Minnesota Energy Resources Corporation at 70 (June 24, 2014); Ex. 24 at 27 (S. DeMerritt Rebuttal).

[324] Ex. 40 at 13 (G. Walters Direct); Ex. 42 at 6-7 (G. Walters Rebuttal); Ex. 203 at 7-8, 12 (S. Peirce Direct).

to $9.50 per month and in the Small C&I customer charge to $18.00 appropriately assigns costs to those classes and avoids rate shock.

XIV. CONCLUSION

For all of the reasons set forth above, and in the Initial Post-Hearing Brief and Proposed Findings, MERC respectfully requests that the Commission adopt its positions in this proceeding.

Dated this 11th day of July, 2014.

MINNESOTA ENERGY RESOURCES CORPORATION:

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Kristin M. Stastny hereby certifies that on the 11th day of July, 2014, on behalf of Minnesota Energy Resources Corporation (MERC) she electronically filed a true and correct copy of MERC's Post-Hearing Reply Brief on www.edockets.state.mn.us. Said document was also served via U.S. mail and electronic service as designated on the attached service list.

/s/ Kristin M. Stastny______
Kristin M. Stastny

Subscribed and sworn to before me
this 11th Day of July, 2014.

/s/ Sara Garcia_________
Notary Public, State of Minnesota

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