

**Minnesota Public Utilities Commission**  
**Staff Briefing Papers**

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Meeting Date: May 30, 2013 ..... Agenda Item # **\*\*4**\_\_

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Company: **Minnesota Power**

Docket No. **E-015/D-12-378**

In the Matter of Minnesota Power's 2012 Remaining Life Depreciation  
Petition

Issue: Should the Commission approve Minnesota Power's 2012 Remaining  
Life Depreciation petition?

Should the Commission approve the Department's proposed correction  
of an error and require retrospective application of the correction?

Staff: Jerry Dasinger ..... 651-201-2235  
Ann Schwieger ..... 651-201-2238

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**Relevant Documents**

Minnesota Power Initial Filing..... April 16, 2012  
Department of Commerce Comments..... July 27, 2012  
Minnesota Power Reply Comments .....October 29, 2012  
Department of Commerce Response to Reply Comments..... December 28, 2012  
Minnesota Power Other Responsive Comments.....January 22, 2013  
Department Second Response Comments ..... March 12, 2013  
Minnesota Power Second Response Comments ..... March 25, 2013  
Department Letter ..... March 26, 2013

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### ***Statement of the Issues***

Should the Commission approve Minnesota Power's 2012 Remaining Life Depreciation petition?

Should the Commission approve the Department's proposed correction of an error and require retrospective application of the correction?

### ***Background and Party Positions***

#### **Minnesota Power**

On April 16, 2012, Minnesota Power (MP or the Company) filed its 2012 Remaining Life Depreciation Petition (Petition). The Petition requested approval of the proposed 2012 remaining lives and net salvage rates for all of MP's production plant assets and certain general plant accounts. The proposed lives and net salvage rates are presented on pages 4 – 5 of the petition. If approved by the Commission, the proposed remaining lives and net salvage rates would be used to determine depreciation expense for the assets effective January 1, 2012. The Company has proposed that the net salvage rates remain unchanged from the Company's last depreciation filing. The Company requested that the remaining lives of all facilities be adjusted to reflect one year's passage of time.

#### **Department of Commerce**

On July 27, 2012, the Department of Commerce (Department) submitted comments concluding that the remaining lives assumed in the 2012 Petition are reasonable.

The Department stated that in the 2011 Depreciation Study Order (11-327), the Commission ordered that "MP shall continue to provide in future depreciation studies an explanation and schedule of the differences between the depreciation remaining lives and IRP planning lives of electric generation plant." The Company provided that information on pages five through eleven of the 2012 Depreciation Petition. The Department concluded that the remaining lives assumed in the 2012 Depreciation Petition are generally consistent with the remaining lives assumed in the 2010 Resource Plan and that the Company has adequately explained any differences.

The Department also noted that the Company may be required to shorten the remaining lives of one or more of its generating plants in the near future depending on the outcome of MP's Baseload Diversification Study.

The Department expressed two additional concerns with the Petition filed by MP. The first is the Company's use of decommissioning probabilities in determining the decommissioning component of depreciation. MP first estimates the cost to decommission and then multiplies that amount by the decommissioning probability which reflects the likelihood that the unit will be retired at the end of its estimated remaining life. The Department questioned whether this

method is a straight line method as required by Minnesota Rule 7825.0800. The Department's concern is that as the probability of retirement of the plant increases, the adjusted decommissioning costs increases which increases the annual decommissioning accrual.

The Department's second concern is that there is an error in the Company's methodology of calculating salvage rates which may cause the Company to under accrue depreciation expense. The Department offered no recommendation to the Commission at this time and requested that the Company respond to these concerns in their reply comments.

### **Minnesota Power**

On October 29, 2012, MP submitted reply comments. MP stated that based on the Baseload Diversification Study, the Commission ordered it to look at a number of issues related to its small coal plants in its next Integrated Resource Plan ("IRP"). The Company stated that the issues related to differences between lives used for resource decisions and depreciation remaining lives would be best addressed in that filing which is due to be filed with the Commission on March 1, 2013. In addition to the IRP, the Commission ordered MP to conduct an external study for decommissioning to be submitted within 90 days after filing the IRP. MP stated that it plans to file these two documents concurrently.

MP stated it believes that the Commission approved method of incorporating decommissioning costs into depreciation accruals follows the straight-line method as required under Minnesota Rules 7825.0800. The current method has been consistently approved by the Commission for many years, based in large part on the Department's recommendation. The current method is also used by other utilities.

According to the Company, adopting the Department's proposed method would result in a significant increase in the annual depreciation accrual and would have a significant financial impact on Minnesota Power if the Company was not able to recover the impact for this proposed change. MP asserted the change would be a significant change in the rate making model from a cost of service perspective in establishing rates for utility customers. MP stated the change in method should not be explored in this docket. The change in method should be conducted in a generic document for all interested parties to comment and participate.

Regarding the Department's second concern about the Company's method for calculating salvage rates, MP stated that it agrees with the Department's recommendation that the salvage rate should be calculated using the gross estimated decommissioning costs adjusted for the estimated decommissioning probabilities divided by plant in service as long as the change to the calculation is made on a prospective basis beginning with the Company's 2013 depreciation studies.

### **Department**

On December 28, 2012 the Department filed response comments. The Department stated that it has not reached a final conclusion about the use of decommissioning probabilities to estimate

depreciation expense, but believes the issue is worth pursuing. According to the Department, it is appropriate to make adjustments to depreciation expense when more capital is invested to extend the life of a plant or when new facts are identified that materially change factors such as net salvage value. However, MP's probabilistic approach results in changes to depreciation expense due solely to the passage of time, which the Department stated it believes to be inconsistent with the requirement of straight-line depreciation.

The Department agreed with the Company that all interested parties should have an opportunity to comment and participate. The Department stated it plans to raise the issue with other utilities that use the method as those utilities file their remaining depreciation petitions. Depending on the results of further developing the issue, the Department may recommend initiating a generic docket, if and when appropriate.

The Department recommended the Commission accept MP's use of decommissioning probabilities in this docket. The Department also recommended that MP be required to provide a comparison of what the depreciation expense would be if the decommissioning probabilities were removed from its depreciation calculations as compared to the current method in the Company's next depreciation filing.

The Department's second concern with the Company's filing was a flaw in MP's calculation of salvage rates that would cause it to under-accrue depreciation expense over time. The parties are now in agreement of the formula to be used in the salvage rates calculation. The Department and the Company are now disputing the timing of the change. According to the Department, MP is agreeable to the change if the change begins in the Company's next depreciation filing and is applied on a prospective basis which would increase depreciation expense in the future but have no immediate effect on the Company's depreciation reserves. The Department stated that the timing of the change and whether the change should be applied on a prospective or retrospective basis is not a straightforward issue.

The Department stated that a prospective application would be appropriate if the Commission were to conclude that the proposed change in salvage rates was simply a change in method. Changes in accounting methods are generally intended to better align the pattern of annual expense with the pattern of the expected benefit of the asset. A change in method over time would yield the same result in depreciation expense.

The Department stated it believes in this instance the change represents a correction of an error within the formula more than a change in accounting method. The Company's current depreciation calculations have been producing incorrect annual depreciation expense amounts, causing the Company to under accrue the expense. The Department argued that if the Commission were to conclude that the proposed change represents a correction of an error a retrospective rather than prospective application of the proposed change would be appropriate. The Department stated that in order to correct the error, MP would need to make a one-time adjustment to set its depreciation reserve at the level that the Company would have been accruing if it used the proposed salvage rate calculation all along. The Department further stated

that the adjustment should be calculated as far back in time as practicable based on the available records.

In further support of its argument that the change should be made retrospectively, the Department argued that a change made prospectively would violate the ratemaking principle of intergenerational equity. Due to the flaw in MP's method of calculating depreciation rates, several of its generating units are under-depreciated. Prospective application of the proposed change would result in the current under-accrual being accounted for in future depreciation accruals. A prospective application would raise the issue of inter-generational equity as customers in the future would subsidize customers from the past.

The Department noted that MP's rates would not reflect the higher level of depreciation expense until the Company files a rate case. The Company's annual depreciation expense would be greater with a prospective application than it would be with a retrospective application encompassing many years. The Department maintained that it is reasonable to assume MP will file a rate case before the issue resolves itself. The issue needs to be resolved at this time to ensure that rates set in MP's next rate case are just and reasonable.

The Department further stated that the timing of correction of an error, with a retrospective application, would be irrelevant if the one-time adjustment is calculated correctly. By the end of 2013, the Company's depreciation reserves would be at the same level regardless of if the correction is implemented in the 2012 filing or the 2013 filing. In application of a retrospective change, the Department has no objection to the Company implementing the change in its next depreciation filing, provided that the one-time adjustment reflects an additional year of miscalculated depreciation expense.

According to the Department, the timing of a change in method would be relevant if the Commission approves a prospective application. If the Company would wait until 2013 to implement the change and apply the change prospectively, the depreciation reserves would be marginally lower than they would be if the Company implements the change in method in the 2012 filing. The Department recommended the Commission require the Company to update its salvage rates this year and again in its next depreciation filing, unless the Company can demonstrate that updating the salvage rates twice over the course of several months would be excessively burdensome.

The Department recommended that the Commission:

1. Approve Minnesota Power's 2012 Remaining Life Depreciation Petition
2. Require Minnesota Power to report in its next depreciation filing what depreciation expense would be if decommissioning probabilities were removed from its depreciation calculations
3. Require Minnesota Power, beginning with its 2013 Remaining Life Depreciation Petition, to change the calculation of its salvage rates to the following formula:

(Total Estimated Decommissioning Cost x Decommissioning Probability)  
Plant in Service

- 4a. Require Minnesota Power to include in its 2013 Remaining Life Depreciation Petition an adjustment to its depreciation reserves to set the reserves at the level they would be assuming the Department-proposed salvage rate calculation been used all along.

If the Commission does not adopt recommendation 4a and allows MP to make the change in the Company's salvage rate calculation prospectively, the Department recommends as an alternative that the Commission:

- 4b. Require Minnesota Power to submit to the Commission, within 30 days of the Commission's Order, either 1) a clear explanation of why updating its salvage rates once, pursuant to this Docket, and then a second time, following the planned decommissioning study, is excessively burdensome, or 2) a revised 2012 Remaining Life Depreciation Petition with updated salvage rates calculated using the following formula:

(Total Estimated Decommissioning Cost x Decommissioning Probability)  
Plant in Service

### **Minnesota Power**

On January 21, 2013, the Company submitted reply comments. The Company disagreed with the Department and believes the change in calculating salvage rates is a change in estimate rather than a correction of error based on the following:

- The current method has been consistently applied by the Company and approved by the Commission.
- A change would be a "change in accounting estimate" for which prospective application is the correct accounting method according to Generally Accepted Accounting Principles (GAAP).
- Retroactive application would burden the Company administratively and financially.

The Company stated it does not agree with the Department's recommendation that the Commission require MP to change its method of calculating salvage rates by applying the change retrospectively with a one-time adjustment to the depreciation reserve. Rather than a correction of an error, MP stated it believes that using a different method to calculate the decommissioning cost component included in the depreciation accrual is a change in estimate and should be applied on a prospective basis pursuant to GAAP. The establishment of a decommissioning cost value is inherently a significant estimate. Decommissioning cost estimates will be impacted by the method used, cost estimation, projected timing of the expense,

decommissioning probabilities, changes to remaining lives of assets, and additional capital expenditures, among other factors and estimates.

According to the Company, guidance is provided by FASB Accounting Standard Codification section 250-10-20 which defines a change in accounting estimate as follows: *A change that has the effect of adjusting the carrying amount of an existing asset or liability or altering the subsequent accounting for existing or future assets or liabilities. A change in accounting estimate is a necessary consequence of the assessment, in conjunction with the periodic presentation of financial statements, of the present status and expected future benefits and obligations associated with assets and liabilities. Changes in accounting estimates result from new information. Examples of items for which estimates are necessary are uncollectible receivables, inventory obsolescence, service lives and salvage values of depreciable assets, and warranty obligations.*

MP argued that this is a change in estimate that meets the FASB standard because if the salvage rate change as discussed in this proceeding is implemented going forward, this will alter subsequent accounting for existing and future assets and liabilities.

The Company also stated that changes in accounting estimates are applied prospectively and the proposed change in salvage calculation should also be applied prospectively in its next Remaining Life Depreciation Petition filing.

The Company asserted that the Department's proposal that the change be applied retrospectively and require MP to make a one-time adjustment to reach as far back as practicable would have a significant financial impact on the Company if the Company is not allowed to recover the impact of the proposed change. MP argued that if the Commission does require it to change its method of calculating salvage rates and apply the change retrospectively, the retrospective application should only reach back as far as the Company's 2010 rate case, and cover years 2010, 2011, and 2012, for the one-time adjustment to depreciation reserves. Minnesota Power asserted it should be allowed to record this one-time adjustment as a regulatory asset, and the impact deferred and recovered as part of its next general rate case.

The Company cited the 2008 Interstate Power and Light request for deferred accounting of flood related expense for its operations in Iowa (Docket No. E,G001/M- 08-728). MP stated that in the briefing papers, Commission Staff noted the following assessment criteria:

*“The Commission has articulated considerations by which it has judged requests for deferred accounting in a number of prior dockets. The costs should be:*

- 1. Related to utility operations for which ratepayer have incurred costs or received benefits;*
- 2. Significant in amount;*
- 3. Unusual or extraordinary items;*
- 4. Subject to review for reasonableness and prudence.”*

In those briefing papers Staff also stated as a preamble to these criteria:

*“The intent of the deferral is not to match costs with benefits, but to preserve the possibility for the utility to recover costs in a future rate case that have been incurred outside the test year used to establish rates. Because the use of deferred accounting for such a purpose is an exception to normal utility ratemaking concepts and general business accounting principles, it should be used with caution.”*

Minnesota Power stated it meet all four criteria. The accounting for decommissioning of generating plants is clearly utility operations for which ratepayers have incurred costs. Second, the amount is significant at approximately three million dollars only reaching back as far as the Company’s 2010 rate case, and covering years 2010, 2011, and 2012. Third, Minnesota Power has been utilizing its current method of accounting for these costs and recovering them in rates since at least 1994. This method has been repeatedly recommended by the Department and approved by the Commission for years and underscores and validates that a change now is unusual and extraordinary. Finally, if the Commission grants deferred accounting, the regulatory asset would be subject to ongoing review for reasonableness and prudence as well as future scrutiny in Minnesota Power’s next rate case. If the Commission were to adopt the Department’s retrospective application Minnesota Power stated it has met the criteria to record this one-time adjustment as a regulatory asset, with the impact deferred and recovered as part of its next general rate case.

According to the Company, the Department further argued that a reason for retrospective application of the proposed change is that prospective application would violate the rules of the ratemaking principle of intergenerational equity. The Company noted that decommissioning costs are inherently a significant estimate and will change over time for many factors. These changes will not result in equal decommissioning costs charged to the depreciation accrual over the life of an asset. From time to time, because of these changes in estimates, decommissioning costs may be collected from ratepayers at different rates. The previous decommissioning rates have been reasonable, and future rate payers will not be materially impacted by the proposed change. Future ratepayers may receive the benefit of other changes in estimates, for example, the extension of lives of assets.

### **Department**

On March 12, 2013, the Department filed second response comments.

The Department stated that in its responsive comments MP argued that the proposed change is a change in *estimate*, rather than a change in *method*. Those comments included the definition of a change in estimate from the FASB Accounting Standard Codification section 250-10-20 which includes the qualification that “Changes in accounting estimates result from new information.”

The Department argued that in this instance, there is no new information which has caused the Company to adjust its estimates of decommissioning costs. The problem the proposed change



would solve is not that the Company's estimates of decommissioning costs are incorrect or outdated, but rather that the Company's current depreciation expense calculations contain an error and, as a result of that error, do not correctly incorporate the Company's estimates of decommissioning costs. This distinction between new information and correction of an error is crucial.

There are two estimates used in the calculation of MP's salvage rates, total estimated decommissioning cost and decommissioning possibility, neither of which are affected by the proposed change. Further, the changes in salvage rates that will result from the proposed change in the formula will not be the result of a change in either of those two estimates. Thus, the Department argued that the proposed change is not a change in estimate, but rather a correction of an error.

As a result of this error, all of the salvage rates that the Company has calculated using the current formula are incorrect, as are all of the depreciation accruals based on those salvage rates. The Department maintained its position that the proposed change is a correction of an error and a retrospective application, reaching as far back in time as is practicable, is appropriate.

The Department stated it disagrees with MP's proposal to limit the reach back to only 2010 and the request for deferred accounting.

#### Deferred Accounting

The Department stated MP has not met the Commission's criteria for deferred accounting (listed above on page 6).

The Department stated it agrees that MP has met the first deferred accounting criterion that the cost is related to utility operations for which ratepayers have incurred costs or received.

The Department argued that the Company has not satisfied the second criterion that the cost be significant in amount. The Company stated the cost for the period 2010 to 2012 is approximately \$3 million. According to the Department, in order for the comparisons to be meaningful, the time period over which the financial metric being used as a point of reference is calculated must be similar to the time period over which the adjustment is calculated. On page 6 of its comments, the Department compared the \$3million to the three year total for various financial metrics for 2009 through 2011, the most recent three years available. \$3 million is 0.16% of operating revenue and 2.00% of net income. The Department stated that viewed in this context, the adjustment does not appear to be significant in amount.

The Department concluded that the third criterion that the cost be unusual, extraordinary or unforeseen has not been met. The Department noted that the expense at issue is the cumulative difference between the depreciation amounts the Company *should* have expensed and the amount it *actually* expensed.

While this expense is unusual in the sense that it is rare for an error like this to persist for so long, it is not unusual, extraordinary, or unforeseen in the sense intended by this criterion. Depreciation expense is a large, important, recurring, and predictable expense that is always included in test years in rate cases. Utilities are required to make annual filings with the Commission (when remaining life methodology is used), which forces utilities to review their calculations regularly. The error which caused the incorrect depreciation accruals was fully within the Company's control, and it is reasonable to expect the Company to calculate depreciation rates and expense correctly both for regulatory purposes and to meet the fiduciary responsibility the Company has to its shareholders.

The Department noted that the fourth criterion that the cost is subject to review for reasonableness and prudence generally applies in instances in which the cost for which deferred accounting is being sought have not been fully incurred and there is a need for continued oversight by the Commission. In this Docket, all of the costs in question were incurred in the past, and there is no such need. The facts necessary for the Commission to make this decision are available and known now, and it is unlikely that new facts could arise that would have any impact on the Commission's assessment of the reasonableness and prudence of these costs.

The Department stated that the Commission has granted deferred accounting in instances in which utilities have incurred expenses to meet important public policy mandates. In these Dockets, the costs in question were generally caused by a specific Commission order or some sort of mandate from another governmental entity, and the nature of the costs were such that it would not have been reasonable to have expected the utilities to have foreseen the costs in their last rate case.

One example of deferred accounting for an important public policy mandate was the approval of deferred accounting for costs related to Xcel's Time-of-Use Pilot Project that Xcel had been ordered by the Commission to develop and implement. The issues in this proceeding do not contribute towards an important public policy mandate. In contrast, Xcel's Time-of-Use Pilot Project was a new and unique tool developed to support a public policy goal ("to positively impact residential customers' consumption of electricity"), and its costs were unforeseeable in a way that depreciation expense is not. Therefore, the Department concluded that the request in the instant docket is not comparable to Xcel's request for deferred accounting of costs related to its Time-of-Use Pilot Project, even though the depreciation rates were implemented pursuant to a Commission Order.

The Commission directed Peoples Natural Gas Company (Peoples) to continue its farm tap inspection program and granted deferred accounting for costs caused by the program, despite the fact that the costs were quite small (approximately \$43,000 per year). Similar to Xcel's Time-of-Use Pilot Project, Peoples' farm tap inspection program was new and unique, and its costs were unforeseeable in a way that depreciation expense is not. Therefore, the Department concluded that the request in the instant docket is not comparable to Peoples' request for deferred accounting of costs related to its farm tap inspection program.

The Department stated that in the instant Docket, there is no comparable, unforeseeable public policy mandate which caused the expenses for which the Company is now requesting deferred accounting. The Department concluded that this standard does not apply.

The Department reiterated its recommendations from its response comments found above on pages 4 -5.

In its Response Comments, the Department included an alternative recommendation related to the timing of the application of the proposed change in the event that the Commission ordered a prospective application. The Department stated that given the amount of time that has elapsed in this Docket, and the fact that the Company has likely closed its books for 2012, it no longer supports the alternative recommendation. If the Commission orders a prospective application of the proposed change, the Department agreed that the Company should be allowed to wait until its next depreciation study to implement the change.

### **Minnesota Power**

On March 25, 2013, MP filed second responsive comments.

The Department recommended that Minnesota Power change the method of calculation of its salvage rates used in determining depreciation expense to a different formula. Minnesota Power stated it accepts that the Department's proposed method of calculation is a better method for recovery of estimated decommissioning costs over the life of an asset. The Company accepts the Department's recommendation Number 3 in its March 12, 2013 Second Response Comments. The Company stated it intends to use this proposed method to calculate the salvage rates in its 2013 Remaining Life Depreciation Petition filing, which is expected to be filed on or before April 15, 2013. Adopting this change in method to calculate annual salvage rates will result in an increase to 2013 annual depreciation expense of approximately \$950,000.

The Company argued that this change in the method of calculating the salvage rates is a change in estimate and should be reflected on a prospective basis, like all other changes in estimates to depreciation factors.

According to the Company, decommissioning cost estimates used in calculating the salvage rates are impacted by many other factors and estimates over the lives of the assets to which they are applied. When these additional factors are updated, they are applied prospectively.

Changing the method of calculating salvage rates is just one of many factors in determining an estimate for a reasonable amount of decommissioning costs for which actual costs will not be known until sometime in the future. For these reasons, Minnesota Power believes changing one input in the method of calculation of estimated salvage rates to include in depreciation expense is a change in a significant estimate that should be applied prospectively as are all the other changes to the inputs to these costs.

MP stated that the current method of calculating estimated salvage rates has been consistently and transparently applied by the Company, and has been approved and certified by the Commission over the past 20 years. Furthermore, Minn. Rules 7825.0900 states in part that: “Depreciation rates and methods, once certified by order, are binding on all future rate proceedings and will remain in effect until the next certification or until the commission shall determine otherwise.” Therefore, if the Commission were to conclude that retroactive application of the change in method was appropriate, the Company believes this change should only reach back as far as this current 2012 Remaining Life Depreciation Petition.

### **Department**

On March 26, 2013, the Department submitted its response to the Company’s March 25, 2013 comments. The Department stated that Minnesota Power raises no new issues in its Comments; therefore, the Department has no further comments on this matter. The Department stated it maintains the recommendations made in its March 12, 2013 Second Response Comments.

### ***Staff Analysis***

The Department expressed two concerns regarding MP’s filing. The first was whether the Company’s method of incorporating decommissioning costs (salvage) into their depreciation accruals is a straight-line method, as required by Minnesota Rule 7825.0800 which states that the commission prescribes the straight-line method for calculating depreciation.

According to the Department in determining the decommissioning component of depreciation, MP first estimates the decommissioning cost of a particular generating unit. MP then multiplies that estimated cost by a decommissioning probability which reflects the likelihood that the unit will be retired at the end of its estimated remaining life.

The decommissioning probability varies from 50 percent early in the life of the plant to 100 percent towards the end of the life of the plant.

The Company responded to the Department’s concern, stating that its current method, which has been approved by the Commission for Minnesota Power and used by other utilities, considers a probability of decommissioning in the calculation that is based upon a scheduled increase in probability as an asset nears the end of its service life. MP argued that under its method, the depreciation accrual is level over the remaining service life of the asset until a future change in estimate is made, such as a change in estimated net salvage, the probable service life, or a change in the asset’s installed cost from items such as an additional capital investment.

The Company’s argument does not address the Department’s concern because the change in the annual decommissioning cost does not result from a change in estimate such as the estimated life of the plant or the estimated salvage cost.

The cost at issue is the salvage cost not the depreciation of the plant itself. The estimated salvage does not change. What does change is the amount of the total estimated salvage that is

included in the calculation of the annual expense. That amount changes as the probability of decommissioning changes. The salvage portion of the depreciation expense would not change during the period a specific probability of decommissioning was used so in that respect it could be considered straight line. However, it would change when the decommissioning probability changes which Staff believes is not consistent with Minn. Rules 7825.0500, subp. 14 which states:

Straight-line method" means the plan under which the original cost of an asset adjusted for net salvage is charged to operating expenses and/or to clearing accounts and credited to the accumulated provision for depreciation through equal annual charges over its probable service life.

The Company's use of the decommissioning probability does not result in equal annual charges over the probable service life. Further, the changes are not the result of a change in estimate for either the life of the plant or the actual salvage cost. Staff agrees with the Department that this practice is not straight line depreciation as contemplated by the rule.

Table 2 on page 4 of the Department's July 27, 2012 comments is an example of how the decommissioning accrual increases as the probability of decommissioning increases. That table shows that the amount of salvage cost expensed is low early in the life of the plant but dramatically increases toward the end of the life. The result of expensing the cost in this manner is that the ratepayers in the early years pay less than an equal share and the ratepayers in the later years pay more resulting in intergenerational inequity.

The use of a probability of decommissioning is not a normal part of determining depreciation expense. Staff was unable to find any information about the use of decommissioning probabilities in the reference material available at the Commission. Staff contacted Lisa Perrett at Xcel, who stated the use of decommissioning probabilities arose from Docket G,E-002/D-83-545. In its comments in that docket (attached), the Department<sup>1</sup> stated:

The DPS cannot state with certainty that the 5 steam plants will not need to be dismantled or demolished at final retirement. Neither can NSP state with certainty that these plants will be demolished. Whether or not plants will be demolished at or after final retirement depends on a number of factors such as demand for power, physical plant condition, rebuilding costs, new plant costs and future legal and environmental requirements. These factors are not known at this time. Therefore, DPS believes it is reasonable to allow partial recovery of the estimated decommissioning costs to begin now so that if demolition is necessary, the entire burden of that cost will not be placed on future ratepayers. On the other hand, if demolition is not required, current ratepayers will not have been burdened for the full cost of demolition which did not occur. As time goes on, we will learn more about the costs and the need for power plant demolition. Cost recovery can then be increased or decreased accordingly.

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<sup>1</sup> At that time the Department was the Department of Public Service.

The Commission's Order in that docket certified the remaining lives and net salvage percentages. It was not specifically stated that the Commission approved the use of decommissioning probabilities. However, based on the Department's comments the Commission was aware of their use in determining the annual depreciation expense.

Staff agrees with the Department's concern about using the probability of retirement in the depreciation calculation. It has been 30 years since that analysis was done. It would be reasonable to revisit the issue to determine if those conclusions continue to be appropriate. In addition, it would provide an opportunity to determine if adequate salvage is being accrued and how that is impacted by the use of decommissioning probabilities. Staff supports the Department's intent to further investigate this issue with other companies.

The Department has agreed to accept the use of decommissioning probabilities in this docket. That would be an acceptable position until the issue has been investigated further. Staff suggests that the Commission encourage the parties to address the appropriateness of those initial conclusions and the continued use of probabilities in determining salvage costs in either a generic docket established for that purpose or a future depreciation filing.

#### Formula for Salvage Expense

The Department's second concern was the formula used by MP to calculate the salvage portion of the depreciation expense. The following is the formula currently used by the Company:

$$\frac{(\text{Total Est Decom Cost} \times \text{Decom Probability}) - \text{Accum Decom Cost}}{\text{Plant in Service}}$$

The values in the formula for the accumulated decommissioning cost and plant in service are actual amounts from the Company's books and records. The total estimated decommissioning cost is an estimated value. According to the Company, the decommissioning probability percentages were developed from internal decommissioning studies and analysis done over the years. Principles used to determine decommissioning probabilities are plant and unit specific based on a combination of equipment condition, regulatory environment, environmental obligations and customer needs considered in the resource planning process and other pertinent factors.

The Company and the Department have reached agreement that the portion of the depreciation expense for the recovery of the projected costs of removal (salvage) should be calculated using the following methodology:

$$\frac{(\text{Total Estimated Decommissioning Cost} \times \text{Decommissioning Probability})}{\text{Plant in Service}}$$

This revision of the formula removes the accumulated decommissioning cost. The two estimated values in the formula are retained. The Department's recommendation revises only the formula. It does not change the estimated values for the decommissioning cost nor the decommissioning

probability used by the Company in the calculation.

Attachment 2, page 2 in the Department's July 27, 2012 comments presents an example of the Company's methodology. In the example, the decommissioning cost portion of the plant in service is not held constant and decreases each year by the initial annual salvage cost accrual. However, the annual salvage expense is also included in the accumulated reserve balance so the net depreciable amount to be recovered is understated resulting in the cumulative depreciation expense being less than the total cost.

Based on the Department's analysis, the existing formula does not result in the correct annual expense and should be revised as recommended. As noted the Company has agreed to the change subject to the implementation date. Because the present formula does not accrue the correct amount of decommissioning costs, it should be modified so it does collect the correct amount of estimated costs.

The remaining disagreement between the company and the Department is the time period to which the revised methodology will apply. It should be noted that it's not the estimate of the total decommissioning costs that changes here. Rather it's the timing of when the costs are included in the current depreciation expense that would change.

According to the Department, the recommended change in the salvage portion of the depreciation change is the result of correcting an error in the formula. The Department argued that a correction of an error should be applied retrospectively, that is back as close to the in-service date for the plant as is possible based on the availability of historical records. As shown in the Department's comments, using the agreed upon methodology would have resulted in a higher depreciation expense than the expense actually recorded by the Company in those prior years.

The Company argued that the change is a change in estimate which would be implemented prospectively. According to the Company's quote, the FASB definition of a change in estimate specifies that changes in accounting estimates result from new information. However in this instance, there is no new information which has caused the Company to adjust its estimate of decommissioning costs. Therefore, this situation does not appear to meet the criteria for a change in accounting estimate. All this supports the Department's contention that this is an error not a change in estimate.

A major concern from the Company's point of view is that retrospective application would require it to record the entire adjustment in the current year. Retrospective application would also affect recovery of the costs from ratepayers.

Because the Company has never recognized and recorded the higher expense, the additional cost has never been included in a rate case so the additional cost has never been recovered in rates. The Department's recommendation would require the Company to increase the depreciation reserve by the amount under-recorded as a result of the error in the formula. Making an adjustment to the depreciation reserve to record the higher expense now would mean that MP

would not recover that additional depreciation expense unless the Commission provided some way for that to occur such as deferring the cost to a future rate case. The Company indicated in its response comments that for 2010, 2011 and 2012 the adjustment would be approximately \$3 million or \$1 million per year.

The Company argued that if the Commission were to adopt the Department's recommendation that it should be allowed to defer the additional depreciation expense for recovery in a future rate case. If that were allowed it could result in a significant increase in depreciation expense in that rate case especially if the amortization period for the deferred cost was relatively short.

The Department argued on pages 5 - 9 of its March 12, 2013 comments that MP does not meet the requirements for deferred accounting. To qualify for deferred accounting, a cost must meet **all** of the criteria. It cannot meet just some of them. In this case, the cost definitely does not meet the significance test. The Department's Table 1 on page 6 of the March 12 comments demonstrates that fact. In addition, the total 2011 depreciation expense is approximately \$55 million and the proposed adjustment for one year is approximately \$1 million so the increase would be less than 2 percent.

It must be emphasized that as the Department stated, the comparison periods must be the same. For example, if the adjustment were \$20 million covering a 20 year period, the comparison amount must also be for a 20 year period. It would not be appropriate to compare the 20 year adjustment to the current income for a single year.

As the Department noted that the expense for which Minnesota Power is seeking deferred treatment is the cumulative difference between the depreciation amounts the Company should have expensed and the amount it actually expensed. The error should have been identified by the Company or its auditors when the depreciation calculation and accruals were analyzed both for whether the calculation was correct and whether an adequate expense was being accrued. Staff agrees that the cost is not unusual, extraordinary, or unforeseen. A cost would meet this criterion if it is notably different from the normal operating activities of the utility and one which would not be expected to recur frequently. The cost in this case does not meet the criterion.

Generally when the Commission has granted deferred accounting, it has limited the costs that can be deferred to those incurred on or after the date of the request for deferred accounting.

The purpose of deferred accounting is to preserve a cost for potential recovery in a future rate case. Therefore, there is one other factor that applies to this situation. Applying the correction retrospectively would mean that the time period being corrected would go back many years. Deferring the costs from the correction to a future rate case would result in adjusting future rates to recover costs from prior years which would be prohibited retroactive making. Therefore, even if the Commission were to determine that the cost qualifies for deferred accounting, Staff believes that retroactive ratemaking would prevent those costs from being recovered thwarting the purpose of deferred accounting.

As noted, retrospective application of the change would effectively prevent the Company from



recovering the additional depreciation expense from ratepayers. The Commission has traditionally allowed recovery of depreciation expense and the related decommissioning costs (negative salvage) in rate cases. Prospective application of the change in the formula would allow the Company to recover the costs from ratepayers starting with the Company's next rate case.

If the Commission were to agree with the Department that this is a correction of an error, it could still approve prospective application of the change. The Commission may want to do that if it believes that this is a correction of an error and the Company should be allowed to recover the additional expense resulting from the change from ratepayers.

The Company's position is the change should be implemented prospectively which according to MP means starting in 2013. It appears the Company would rather make the change in salvage recovery agreed to in this filing in the 2013 filing for two reasons. First is would delay the increase in depreciation expense for another year so it would not affect 2012 earnings. Second, it would not have to recalculate the 2012 expense.

If this change were considered to be a normal change in expense in a depreciation filing, the effective date should be with this filing which was the Department's alternative recommendation. The Department changed in recommendation because this filing was not resolved prior to the Company closing its books for 2012. Staff believes it would still be appropriate for prospective implementation to start with this filing

In its reply comments, the Company did not address the Department's question as to whether it would be an excessive burden to recalculate the 2012 expense reflecting this change. Staff does not believe it would be an excessive burden so that would not be a reason to delay implementation until 2013.

#### Early Retirement of Power Plants

The Department noted that continuing proceedings in MP's 2010 Resource Plan involving the Company's Baseload Diversification Study may result in changes to the remaining lives of five of MP's generating plants. MP filed its 2013 Resource Plan on March 1, 2013 in Docket No. E-015/RP-13-53. Appendix L<sup>2</sup> of the filing provided the Company's proposal for the accounting for proposed retirements and decommissioning study discussion.

MP stated that it uses the composite method for depreciation, additions and retirements of utility plant. Under the FERC USoA, additions and retirements of plant are accounted for using either retirement units or minor items of property. When a retirement unit is retired from electric plant, the book cost net of salvage is recorded as a credit to the plant account, and as a debit to the accumulated provision for depreciation. As a result, gains and losses are generally not recorded in the retirement of utility plant. The embedded gains and losses are flowed back to the customer through depreciation rates adjusted regularly through updated depreciation studies, consistent

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<sup>2</sup> Appendix L is found starting on page 51 of part 4 of 4 public filing.

with Commission requirements.

The Company further stated that upon approval of the 2013 Plan, it will continue to depreciate Laskin Energy Center (LEC) and Taconite Harbor Energy Center (THEC) each as one facility with one remaining life. At the conversion and retirement of LEC and THEC3, assets retired in 2015 will be accounted for as normal retirement units of utility plant. Approximately \$5 million in net remaining plant balance for LEC and \$15 million in net remaining plant balance for THEC3 are expected to be retired. LEC and THEC1&2 will continue operations, and the remaining net plant balances retired will be recovered over the remaining lives of those plants.

### ***Decision Alternatives***

#### **Current Petition**

1. Approve the proposed remaining lives and accept the use of decommissioning probabilities in this docket.
2. Approve the proposed remaining lives and deny the use of decommissioning probabilities in this docket. Require Minnesota Power to file updated salvage rates calculated without the use of decommissioning probabilities within 45 days from the date of the Order.

#### **Change in the Calculation of Salvage Rates**

3. Require Minnesota Power to use the Department recommended formula for calculating salvage rates which removes the accumulated decommissioning cost from the calculation.
4. Allow Minnesota Power to continue to use its current formula for calculating salvage rates which includes the accumulated decommissioning cost in the calculation.

#### **Implementation of the Change in the calculation of the Salvage Rates**

5. Require Minnesota Power to make a one-time adjustment to set the depreciation reserve to the level it would have been had the Company used the proposed salvage rate calculation all along. Require the change be made on a retrospective basis reaching as far back in time as practicable.
6. Require Minnesota Power to make the change retrospectively back to 2010 (encompassing 2010, 2011 & 2012).
7. Require Minnesota Power to use the agreed upon change in the calculation of salvage rates in the current depreciation filing and file revised 2012 salvage and depreciation rates no later than 45 days from the date of the Order.

8. Require Minnesota Power to implement the agreed upon change in the calculation of its salvage rates effective with its 2013 filing.

If the Commission selects alternative 5 or 6, it may wish to consider the following.

9. Approve Minnesota Power's request for deferred accounting for the one-time adjustment of the depreciation expense resulting from the retrospective application of the change in the calculation of the salvage portion of the expense.
10. Deny the request for deferred accounting for the one-time adjustment of the depreciation expense resulting from the retrospective application of the change in the calculation of the salvage portion of the expense.

### **Generic Docket on Decommissioning Probabilities**

11. Open a generic docket to investigate the use of decommissioning probabilities in calculating the salvage portion of depreciation expense.
12. Do not open a generic docket to investigate the use of decommissioning probabilities in calculating the salvage portion of depreciation expense.

### **Future Filing Requirements**

13. Require Minnesota Power to provide a comparison explaining any differences between the remaining lives used in its next depreciation filing compared to the Company's most current Integrated Resource Plan.
14. Require Minnesota Power to provide a comparison of what the depreciation expense would be if the decommissioning probabilities were removed from its depreciation calculations as compared to the current method in the Company's next depreciation filing.

### **Recommendation**

Staff recommends 1, 3, 10 if applicable, 11, 13 and 14. Staff has no recommendation on 5 through 8.

# Department of Public Service

## REPORT OF INVESTIGATION AND RECOMMENDATION

PETITION FILED August 30, 1983 AGENDA NO. \_\_\_\_\_ DOCKET NO. G, E002/D-83-545

PETITIONER Northern States Power Company  
ADDRESS Mr. J. R. Robinson  
414 Nicollet Mall  
Minneapolis, Minnesota 55401

### COMMISSION DISPOSITION

Approved.....   
Denied.....   
Held.....

By \_\_\_\_\_ Date \_\_\_\_\_

In the matter of NSP's request for certification of remaining life depreciation rates and nuclear power plant decommissioning accrual.

### Background and Findings:

NSP has filed annual reviews of remaining life and salvage value for electric and gas plant accounts in accordance with PSC 361 (D) 4. The remaining lives reflect a one year passage of time adjustment, interim retirement rate adjustments, and several minor changes in remaining lives due to reevaluation of the final retirement date.

In addition, NSP has studied the costs of demolishing its five largest coal fired steam plants at the time of decommissioning. The DPS has examined the study and makes the following findings:

1. The estimated costs of demolition are reasonable.
2. The current generating sites will be reused after retirement of the existing facilities except for the Allen King plant.
3. The company should begin recovering 50% of the estimated demolition costs at this time.

A comparison of the present and proposed net salvage rates is shown below:

<u>Plant</u>	<u>Current</u>	<u>Proposed</u>
Sherco	-10	-12
High Bridge	-10	-13
Riverside	-10	-17
Black Dog	-10	-20
King	-10	-40

The net salvage rates shown above apply only to Account 311 (Bldgs and Struct). The financial impact of the proposed salvage rates is to increase the annual depreciation expense for these steam plants from \$25,061,320 to \$25,591,863. Calculations are included in the workpapers.

The rationale for recommending that net salvage rates be increased for the 5 steam plants is as follows:

The DPS cannot state with certainty that the 5 steam plants will not need to be dismantled or demolished at final retirement. Neither can NSP state with certainty that these plants will be demolished. Whether or not plants will be demolished at or after final retirement depends on a number of factors such as demand for power, physical plant condition, rebuilding costs, new plant costs and future legal and environmental

requirements. These factors are not known at this time. Therefore, DPS believes it is reasonable to allow partial recovery of the estimated decommissioning costs to begin now so that if demolition is necessary, the entire burden of that cost will not be placed on future ratepayers. On the other hand, if demolition is not required, current ratepayers will not have been burdened for the full cost of demolition which did not occur. As time goes on, we will learn more about the costs and the need for power plant demolition. Cost recovery can then be increased or decreased accordingly.

DPS and the company agree that the most likely scenario is that some plants will be demolished in part or total at final retirement, while other plants will not, but specific plants cannot be identified at this time. In that event, depreciation reserves associated with plants not demolished can be shifted to plants that require demolition so that future ratepayers will bear only minimal, if any, costs associated with plants from which they receive no benefit. The increase in accruals annually is about \$530,000. NSP's current depreciation accrual annually is about \$75 million. Earlier this year the MPUC certified new depreciation rates for NSP's other plant which resulted in about a \$3 million decrease in annual accruals. Thus, on balance, NSP's total depreciation accrual for 1983 will be about \$2.5 million less than if 1982 depreciation rates were used in 1983.

NSP has also filed its annual review of the financial plan used for determining nuclear plant decommissioning accrual. The company used the most recently authorized rate of return (E002/GR-81-342) and capital structure with a 7% inflation rate for determining future dollars. DPS recommended that NSP reexamine the inflation assumption and use the actual capital structure based on beginning of year financial data. The NSP study of inflation rates indicated that 7% is still an appropriate long term inflation rate. DPS examined the NSP study of inflation rates and concurs with their conclusion. NSP agreed to use financial data as of 1/1/83 for computing the after tax rate of return. As a result of these changes, monthly decommissioning accruals will decrease from the proposed \$911,772 to \$905,184.

Earlier this year, the MPUC recertified depreciation rates for NSP's 5 year study (Docket G, E002/D-83-104). NSP has noted that for 10 plant accounts, incorrect service lives, salvage values or depreciation rates were certified. DPS has examined the order and found that typographical errors were made in 10 plant accounts. Therefore, we are submitting corrected rates for these plant accounts. There is no financial impact resulting from this action.

The remaining lives, net salvage rates, nuclear decommissioning accruals and depreciation rates are reasonable and should be certified.

Alternatives:

1. Certify the remaining lives
2. Reject the study

Policy References:

PSC 361D(4)  
E002/D-79-956

Recommendation:

Alternative 1 (Certify)

Prepared by:

Date:

Approved by:

Date: