

Minnesota Public Utilities Commission
Staff Briefing Papers

Meeting Date: January 26, 2017 ****Agenda Item #** 5

Company: Minnesota Energy Resources Corporation (MERC or the Company)

Docket No. G-011/M-15-992
In the Matter of MERC’s Petition for Authorization to Establish Amortization Periods Related to the Pre-Acquisition Pension and Other Postretirement Benefits Costs.

Issues: What amount, if any, of the pension and other post-employment benefit (OPEB) costs, that Minnesota Energy Resources Corporation (MERC) and Integrys realized as a result of WEC’s acquisition of Integrys, should the Commission allow MERC to amortize?

Should the Commission require MERC to transfer its share of allowed costs related to the IBS legacy benefit plans to MERC’s balance sheet, add this amount to the MERC-specific allowed costs, and amortize the combined balance over 14 years?

Should the Commission require MERC to ring-fence the costs such that none are eligible to be included in rate base?

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Relevant Documents

MERC – Petition November 20, 2015
Department - Comments April 20, 2016
MERC - Reply Comments May 2, 2016
Department – Response Comments July 25, 2016
MERC – Reply to Response Comments August 25, 2016
Department – Supplemental Response Comments November 21, 2016
MERC – Reply to Supplemental Response Comments December 1, 2016

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January 9, 2017

Statement of the Issue

What amount, if any, of the pension and other post-employment benefit (OPEB) costs, that Minnesota Energy Resources Corporation (MERC) and Integrys realized as a result of WEC's acquisition of Integrys, should the Commission allow MERC to amortize?

Should the Commission require MERC to transfer its share of allowed costs related to the IBS legacy benefit plans to MERC's balance sheet, add this amount to the MERC-specific allowed costs, and amortize the combined balance over 14 years?

Should the Commission require MERC to ring-fence the costs such that none are eligible to be included in rate base?

Background

On November 20, 2015, MERC petitioned the Commission for authorization to identify certain pre-acquisition net pension and other postretirement benefits as regulatory assets and establish their amortization periods.

On April 20, 2016, the Minnesota Department of Commerce, Division of Energy Resources (Department or DOC), filed comments requesting that MERC explain whether any of the pension amounts identified in the instant proceeding were included in MERC's concurrent rate case. The Department concluded that MERC's proposal to include the Legacy Integrys Business Services (IBS) components identified as Pension Restoration, Peoples Energy Supplemental Plan and Post Retirement Life should be denied. The Department also recommended that the Commission deny MERC's proposal to create a regulatory asset for Supplemental Executive Retirement Plan (SERP) costs for either the MERC or Legacy IBS Benefit Plans.

On May 2, 2016, MERC filed reply comments in which it provided additional information requested by the Department.

On July 25, 2016, the Department filed Response Comments. The Department concluded that MERC's request is a request for deferred accounting. The Department continued to recommend that the Commission deny MERC's proposal to defer the costs associated with Integrys' Supplemental Executive Retirement Plan (SERP) in either the MERC or IBS Legacy Plans. The Department also recommended that the remaining net IBS legacy assets of \$566,401 be added to the remaining MERC-specific costs of \$9,436,920, and that this combined total of \$10,003,321 be recognized as the amount of costs deferred as a result of this docket. Further, the Department recommended that the Commission apply a 14-year amortization period to the entirety of the pension and OPEB costs that the Commission allows the Company to defer.

On August 25, 2016, MERC replied to the Department's Response Comments. According to MERC, the deferred accounting standard does not apply, but it is met if applicable.

MERC also clarified that:

- It does not object to the Department's recommendation that Integrys Business Services (IBS) – related costs be transferred to MERC's balance sheet rather than remain on separate financial statements, such that MERC would recognize both costs related to the IBS legacy benefit plans and MERC-specific costs as a combined regulatory asset to be amortized over 14 years.
- It is not seeking a deferral of new costs; rather, the pension and OPEB costs at issue have long existed as a regulatory asset as a result of the application of generally accepted accounting principles (GAAP) and associated ratemaking to the Company's pension and OPEB costs. The issue is therefore not whether deferral of new out-of-test-year costs is appropriate, but rather, what amortization period or periods should be established for these existing net regulatory assets and liabilities in light of their fixed valuation at the time of the WEC/Integrys merger.
- This is not a ratemaking petition, and MERC recognizes that its request for a particular amortization period does not guarantee cost recovery of these assets or a return on them in future rate cases. Therefore, MERC disagrees with the Department's proposal that the SERP costs should not be amortized because these costs are typically not recoverable. MERC's request for amortization in this docket has the sole purpose of aligning regulatory and GAAP books and records to reduce administrative costs. Further MERC disagrees with the Department's proposal to "ring-fence" these assets so they cannot be included in rate base or earn a return.

"Rather than create additional administrative costs by either excluding SERP costs from the amortization or requiring MERC to "ring-fence" the pension and OPEB assets," MERC recommended "that the Commission approve a common amortization for all assets and defer any cost recovery or ratemaking decisions to MERC's current and future rate cases."

On November 21, 2016, the Department filed Supplemental Response Comments. The Department noted that MERC notified the Department on November 21, 2016 that MERC would no longer oppose the concept of ring-fencing these assets. The Department concluded that all issues, except the Department's recommendation to require MERC to exclude the \$137,819 in SERP costs from the deferred account, are resolved.

The Department's recommendations are:

- Allow for the creation of an amortization of MERC's pension and OPEB assets equal to \$10,003,321 million;
- Set the amortization period at 14 years;
- Allow the amortization to begin January 1, 2016;
- Allow MERC to book \$566,401 in costs related to IBS legacy benefit plans to its balance sheet (this amount is included in the \$10,003,321 figure above);
- Require MERC to ring-fence the \$10,003,121¹ in costs it is being allowed to amortize such that none of those costs are eligible to be recovered in rate base, and

¹ It appears to staff that this is a typographical error and the amount should be \$10,003,321.

- Don't allow MERC to include its requested \$137,819 in SERP costs in the deferred account.

On December 1, 2016, MERC replied to the Department's Supplemental Response Comments. MERC stated that it believes the Department and the Company have reached agreement on the essential points, with one limited issue remaining outstanding. After further discussion with the Department and in light of recent rate case outcomes regarding the inclusion of pension and OPEB assets in rate base, MERC agrees with each of the Department's Supplemental Response recommendations, with the exception of the proposal to separate Supplemental Executive Retirement Plan (SERP) costs totaling \$137,819 from the deferred account.

MERC asked the Commission to approve amortization of MERC's and IBS's pre-acquisition pension and OPEB assets equal to the full \$10,141,140 million (\$10,003,321 + \$137,819 in SERP costs), amortized for a period of 14 years beginning January 1, 2016. MERC also recommended the inclusion of an order point acknowledging that "MERC will not seek recovery of pre-acquisition SERP costs in future rate cases or other cost-recovery proceedings."

What amount, if any, of the pension and other post-employment benefit (OPEB) costs, that Minnesota Energy Resources Corporation (MERC) and Integrys realized as a result of WEC's acquisition of Integrys, should the Commission allow MERC to amortize?

As a result of the merger of WEC Energy Group, Inc. (formerly Wisconsin Energy Corporation) (WEC) with Integrys Holding, Inc. (formerly Integrys Energy Group, Inc.) (Integrys), approved in Docket No. G011/PA-14-664, generally accepted accounting principles require WEC to assign fair market value to the assets and liabilities acquired in the transaction, including those related to pension and other postretirement benefits and costs.

Is this a deferred accounting request?

Department

According to the Department, MERC is seeking approval of deferred accounting treatment of approximately \$9.5 million of MERC-specific pension and OPEB assets and liabilities, along with the pro-rated equivalent of approximately \$604,000 of Integrys Business System (IBS)-related pension and OPEB assets and liabilities, as follows:

Table 1 – Description of Proposed Deferred Cost Components

Line No.	Acct No.	Account Description	Asset (Liab) @12/31/2015
<u>MERC Benefit Plans</u>			
1.	926060	Pension Expense	\$ 7,014,390
2.	926210	Pension Restoration	\$ 17,640
3.	926220	Integrys SERP	\$ 40,995
4.	926220	MERC SERP	\$ 59,370
5.	926180	Post Retirement Medical - Admin	\$ 2,271,360
6.	926180	Post Retirement Medical - Non-Admin	\$ 118,905
7.	926305	Postretirement life	\$ 14,625
8.	Total MERC Costs		\$ 9,537,285
<u>Legacy IBS Benefit Plans</u>			
9.	926300	Pension Expense	\$ 12,857,240
10.	926300	Pension Restoration	\$ 120,225
11.	926300	Integrys SERP	\$ 960,340
12.	926300	Peoples Energy Supplemental Plan	\$ (186,395)
13.	926300	Peoples Energy Retiree Welfare	\$ 1,318,436
14.	926300	Post Retirement Medical - Admin	\$ 395,920
15.	926300	Postretirement Life	\$ 17,687
16.	Total Legacy IBS Costs		\$ 15,483,453
17.	MERC Share of Legacy IBS Costs at 3.9 percent		\$ 603,855
18.	Grand Total MERC Costs (line 8 + line 17)		\$ 10,141,140

The above Table 1 is copied from the Department's July 25, 2016 Response Comments at page 6.

The Department corrected, in its November 21, 2016 Supplemental Response Comments, the statement from its July 25, 2016 Response Comments that "Consequently, MERC initiated this petition requesting that the Commission approve deferred accounting for the losses MERC and Integrys realized as a result of WEC's acquisition of Integrys." The Department stated that "That statement, by itself, is inaccurate; MERC has not requested approval of deferred accounting for the \$10.3 million liability the Company sustained as a result of marking its pension and OPEB assets to market at the time of WEC's acquisition of Integrys."

However, according to the Department, MERC's statement that "in the current docket, MERC requests only that the Commission approve the proposed amortization periods for the MERC and IBS pension and OPEB net regulatory assets and liabilities existing as of the time of the WEC/Integrys merger" is misleading. The Department stated:

That statement gives the impression that the Commission need only approve a change in the amortization period to 14 years. But MERC is also asking the Commission to allow it to recover an additional \$10.3 million from ratepayers that is required under GAAP to be expensed in the year recognized. As a result, the Department concludes that MERC's request for the additional \$10.3 million is a request for deferred accounting.

The Department explained that business combination accounting rules under GAAP require a company to recognize for financial reporting purposes the unrecognized gains and losses that had been included in Accumulated Other Comprehensive Income (AOCI) in the shareholder's equity section of the respective balance sheets if it is acquired as part of a business combination.²

The Department stated that:³

When Integrys was acquired by WEC Energy Group Inc, on June 29th, 2015, this "business" combination required WEC to recognize the gains and losses in AOCI on both MERC and Integrys' balance sheets that related to pension and OPEB assets. Consequently, MERC initiated this petition requesting that the Commission approve deferred accounting for the losses MERC and Integrys realized as a result of WEC's acquisition of Integrys.

The Department noted that "MERC's request changes the predominant accounting perspective on these assets from one solely concerned with financial reporting (GAAP) to a regulatory accounting perspective that is controlled by the Commission." The Department analyzed what it characterized as MERC's request for deferred accounting for these pension and OPEB-related costs according to three primary criteria for evaluating a Company's request for deferred accounting treatment. The criteria are that the costs in question are (1) unusual, (2) unforeseeable, and (3) large enough to have a significant impact on the utility's financial position.

The Department concluded that:

- 1) The costs are unusual. The acquisition of Integrys, MERC's parent company, by WEC Energy Group is an unusual event, and MERC claims that the costs under discussion are the result of the acquisition of its parent company, Integrys, by WEC Energy Group on June 29, 2015. According to the Department, "If the acquisition had not taken place, MERC would have continued to debit or credit the difference between its expected return on pension assets and its actual return on pension assets in AOCI on its balance sheet and hoped that the annual credits and debits would offset themselves over time. Integrys' acquisition forced MERC to recognize those losses on its own pension and OPEB accounts as well as its prorated share of the losses on IBS's pension and OPEB accounts."
- 2) The costs were unforeseeable. MERC stated that "The fact of the merger itself, and

² Department's July 25, 2016 Response Comments at page 4.

³ Ibid.

therefore the future applicability of purchase accounting requirements was not foreseeable in the ordinary course of business.” The Department stated that, “[W]hile MERC should have been aware of the requirements of purchase accounting, the Department agrees with the Company that the extent of the costs may not have been foreseen, due to difficulty predicting markets. Thus, the costs [MERC] proposes to defer meet the Commission’s criteria in a broad sense and the Department concludes that MERC has met the Commission’s standard for allowing those pension-related costs to be deferred.”

- 3) The costs are large enough to have a significant financial impact on MERC’s financial condition. It is the Department’s understanding that purchase accounting rules would require that MERC recognize (write off) the approximately \$10.1 million in merger-related costs it identified in its petition “on its 2016 income statement if the Commission does not approve MERC’s request for deferred accounting.”^{4,5}

The Department stated that this amount appears to be large enough to require MERC to file another rate case.

MERC

MERC stated that it “is not seeking a deferral of new costs; rather, the pension and OPEB costs at issue have long existed as a regulatory asset as a result of the application of generally accepted accounting principles (“GAAP”) and associated ratemaking to the Company’s pension and OPEB costs. The issue is therefore not whether deferral of new out-of-test-year costs is appropriate, but rather, what amortization period or periods should be established for these existing net regulatory assets and liabilities in light of their fixed valuation at the time of the WEC/Integrys merger.”

According to MERC, the deferred accounting standard does not apply; these pension and OPEB costs existed prior to the WEC/Integrys merger. In the current docket, MERC stated that it requests only that the Commission approve the proposed amortization periods for the MERC and IBS pension and OPEB net regulatory assets and liabilities existing as of the time of the WEC/Integrys merger.

However, MERC stated that if the Commission determined that the Company should meet the standard for new deferrals, these costs meet that standard.

⁴ As the Wisconsin Public Service Commission noted in its Order in case number 6690-GF-136 at page 3 for one of Integrys’ other subsidiaries: “If WPSC (Wisconsin Public Service Company) were not a regulated entity, these costs and credits would be written off under the purchase accounting requirements of GAAP. Instead, WPSC is requesting to defer these costs and amortize them over a period of time.”

⁵ Department’s July 25, 2016 Response Comments at page 6.

Amount of costs to defer and amortize**Department**

The Department recommended that the Commission deny MERC's proposal to create a regulatory asset for SERP costs for either MERC or IBS Legacy Benefit Plans. The Department's reason for recommending this is based on the Commission having denied the recovery of SERP costs in several recent general rate cases.⁶

The Department recommended that the Commission remove the costs associated with SERP identified in Table 1 from the population of costs that MERC may be allowed to defer for the Minnesota jurisdiction. Table 2 below (copied from page 8 of the Department's July 25, 2016 Response Comments) summarizes the costs the Department recommends MERC be allowed to defer for the Minnesota jurisdiction.

Table 2 – DOC Recommended Deferred Costs After Exclusion of SERP Costs

Line No.	Acct No.	Account Description	Merger Date Reg Asset (Liab) @12/31/2015
<u>MERC Benefit Plans</u>			
1.	926060	Pension Expense	\$ 7,014,390
2.	926210	Pension Restoration	\$ 17,640
3.	926180	Post Retirement Medical - Admin	\$ 2,271,360
4.	926180	Post Retirement Medical - Non-Admin	\$ 118,905
5.	926305	Postretirement life	\$ 14,625
6.		Total MERC Costs	\$ 9,436,920
<u>Legacy IBS Benefit Plans</u>			
7.	926300	Pension Expense	\$ 12,857,240
8.	926300	Pension Restoration	\$ 120,225
9.	926300	Peoples Energy Supplemental Plan	\$ (186,395)
10.	926300	Peoples Energy Retiree Welfare	\$ 1,318,436
11.	926300	Post Retirement Medical - Admin	\$ 395,920
12.	926300	Postretirement Life	\$ 17,687
13.		Total Legacy IBS Costs	\$ 14,523,113
14.		MERC Share of Legacy IBS Costs at 3.9 percent	\$ 566,401.41
15.		Total DOC Proposed Deferred Costs (line 8 + line 17)	\$ 10,003,321

The Department stated that its proposal reduces the amount of costs MERC would be allowed to defer by \$137,819 (or \$10,141,140 - \$10,003,321), about 1.36 percent.⁷

⁶ Department's April 20, 2016 Comments at page 5.

⁷ Id at page 8.

MERC

MERC argued that the Department's recommendation to deny the regulatory asset and amortization for SERP costs "does not recognize that (i) a regulatory asset for SERP costs existed prior to the merger due to application of general accounting and ratemaking rules and procedures; and (ii) the existence of a regulatory asset does not equate to rate recovery."

MERC stated that:⁸

[T]he request for amortization of these costs has no impact on whether MERC will be permitted to recover these costs in this or a future rate case. Rather, the Company seeks regulatory approval for amortization of these assets solely to avoid the administrative costs of accounting for them differently on its financial accounting books and records. As with any regulatory asset, MERC recognizes that the existence of a deferral or amortization does not guarantee rate recovery or create any presumption of rate recoverability.

There is a relatively small numerical difference between including or excluding the SERP assets in the amortization. The overall MERC/IBS asset would total \$10,141,140 if SERP assets are included, whereas excluding them only reduces the asset to \$10,003,321. Under either circumstance, the singular administration of these assets reduces administrative costs and burdens and does not affect rate recovery eligibility. As such, there is no reason to exclude SERP assets from the amortization.

In its December 1, 2016, Reply Comments, MERC stated that it agreed with each of the Department's recommendations (as summarized in the Department's November 21, 2016, Supplemental Response Comments), with the exception of the proposal to remove SERP costs totaling \$137,819 from the deferred account.

MERC further stated:

MERC has sought to be clear that its petition does not request cost recovery, but rather to establish an amortization period of previously deferred assets consistent with purchase accounting rules. Accordingly, this amortization petition was filed in an effort to reduce the customer costs of maintaining separate books and records for the assets in question, rather than to obtain any determinations regarding future recovery of these costs. With respect to the Department's SERP recommendation, we believe the parties are in agreement on the underlying principle that pre-acquisition SERP expenses or assets will not be part of MERC's cost recovery requests in current or future rate proceedings. As MERC noted in its August Reply Comments, MERC did not seek recovery of SERP costs in its 2013 rate case and excluded SERP costs in its rate case filed in 2015. Consequently, the requested amortization of these assets and liabilities is independent of their rate recoverability. The Company further agrees that it will not seek rate recovery of these pre-acquisition SERP costs in any future rate proceeding.

⁸ MERC's August 25, 2016 Reply to Response Comments at page 6.

In its November 21 Response Comments, the Department appears to continue to recommend exclusion of the SERP costs from the deferred account based on its understanding that MERC has already incurred external (Towers Watson) and internal costs to separate the SERP costs from other pre-acquisition costs. This is not the case, and MERC apologizes if it was unclear in communications with the Department. The purpose of MERC's petition is to avoid incurring the actuarial and administrative costs of creating a second set of actuarial valuations for current or future years, and MERC has not yet incurred those costs. Because the Company has agreed not to seek recovery of these SERP costs at any future time, MERC believes that the Department's proposed treatment of SERP costs creates future administrative burdens without yielding material benefits.

As a result, MERC asks the Commission to approve amortization of MERC's and IBS's pre-acquisition pension and OPEB assets equal to the full \$10,141,140 million (\$10,003,321 + \$137,819 in SERP costs), amortized for a period of 14 years beginning January 1, 2016. MERC also recommends the inclusion of an order point acknowledging that "MERC will not seek cost recovery of pre-acquisition SERP costs in future rate cases or other cost-recovery proceedings."

PUC Staff Comment

Like the Department, staff also believes MERC would need to write off the costs it identified in its petition if the Commission does not approve deferral and amortization of the costs. In that respect, staff agrees this is a request for deferred accounting even though MERC does not characterize it as such. That said, the Department concluded the costs meet the Commission's criteria for deferral in a broad sense.

If the Commission agrees, then the question becomes, "What amount should the Commission allow to be deferred and amortized?"

MERC has requested that it be allowed to amortize \$9,537,285 in MERC costs along with MERC's \$603,855 share of Legacy IBS costs, for a combined total of \$10,141,140, as outlined in Table 1 above.

The Department has recommended that the SERP costs, both MERC's and its share of the legacy IBS benefits, be excluded from the deferred account (a combined total of \$137,819). Thus, the Department recommended that MERC be allowed to defer and amortize the remaining total of \$10,003,321, an amount which includes MERC costs of \$9,436,920 and MERC's \$566,401 share of legacy IBS costs.

Why the Department focused on SERP costs instead of all non-qualified plan costs is not clear to staff. In previous MERC rate cases it generally has been the non-qualified plan costs, which include, but are not limited to, the SERP costs, that have been disallowed from, or not requested for, recovery. If the Commission determines any costs should be excluded from the deferral and amortization, it may wish to consider having MERC identify and exclude all of the non-qualified

plan costs.

MERC argues that “this amortization petition was filed in an effort to reduce the customer costs of maintaining separate books and records for the assets in question, rather than to obtain any determinations regarding future recovery of these costs.” Yet the Company has requested that rather than exclude the SERP costs, the Commission include them in the 14 year amortization period and insert in its order a statement that “MERC will not seek cost recovery of pre-acquisition SERP costs in future rate cases or other cost-recovery proceedings.”

Staff is not sure what this would accomplish. If it is not probable that SERP costs will be included in allowable costs in a future period, the asset should probably be written-down anyway, rather than amortized. It is also unclear what administrative costs MERC would need to incur if the SERP costs were excluded from deferral and amortization and whether these would be one-time or on-going costs. Perhaps MERC should be asked to explain this at the Commission’s meeting on January 26.

Should the Commission require MERC to transfer its share of allowed costs related to the IBS legacy benefit plans to MERC’s balance sheet, add this amount to the MERC-specific allowed costs, and amortize the combined balance over 14 years?

MERC

MERC initially requested that it be allowed to amortize (1) the MERC-specific costs over 15 years in order to approximately align the annual amortization with historical actuarial recognition, and (2) the WBS (legacy IBS) net assets allocated to MERC over their remaining service lives of 5 to 11.5 years so that the WEC utilities account for these assets in the same manner for all jurisdictions.

Department

The Department reviewed the amortization periods approved for the WEC Energy Group subsidiaries in regulatory proceedings in other states and determined that the Company’s requested amortization periods are not unreasonable. However, the Department also noted that, in WEC’s very similar Wisconsin proceeding related to one of WEC’s other affiliates, Wisconsin Public Service Company, the Wisconsin Public Service Commission (W-PSC) modified the requested amortization periods. The Department quoted⁹ the following explanation from the W-PSC’s April 27, 2016 Order in Docket No. 6690-GF-136 at pages 4 and 5:

Wpsc [Wisconsin Public Service Company] asserted that it was important that the amortization period for the IBS costs be consistent among the various jurisdictions so that it would be easier to allocate the amortization expense among the jurisdictions. Commission [W-PSC] staff questioned why these costs would be continued to be allocated each year to the various jurisdictions over the amortization period. Since these unrecognized costs and credits relate to employee

⁹ Department July 25, 2016 Response Comments at page 12.

service that had already been performed, Commission staff suggested that the balance of IBS's unrecognized costs and credits at the time of the acquisition could be allocated to WPSC at the end of 2015 and held constant. Commission staff stated that it may not be appropriate for the allocation of such costs to be subject to change in the future if the ownership shares change because these costs related to employee service that has already occurred.

. . . , the Commission [W-PSC] also finds that it is reasonable to authorize transfer of WPSC's share of the balance on IBS's balance sheet of unrecognized costs and credits related to the pension and OPEB plans to the balance sheet of WPSC. The Commission [W-PSC] further finds that it is reasonable for the WPSC balance and the allocated portion of the IBS balance of the unrecognized costs and credits relating to the pension and OPEB be combined into one number on WPSC's balance sheet. It is reasonable that the balance . . . be amortized over 9.3 years beginning in 2016, which is the amortization period that results in the annual amortization expense being the closest to the level included in rates for the 2016 test year without being lower than that amount.

In this instance, the Department largely concurred with the W-PSC's logic regarding the transfer of the IBS-related costs to MERC's balance sheet, and the resulting combination and amortization of those costs. The Department recommended that the Commission require MERC to transfer MERC's allocated share of the IBS legacy benefit plans assets and liabilities of \$566,401, excluding the SERP-related plans, to MERC. The Department further recommended this amount be added to the MERC-specific costs of \$9,436,920 (excludes SERP) and that this combined total of \$10,003,321 (as shown in Table 2 above) be recognized as the amount of costs deferred as a result of this docket.

The Department noted that MERC's current annual amortization for these accounts appears to be \$707,449.¹⁰ Based on this, the Department recommended that a 14-year amortization period apply to the entirety of the pension and OPEB costs that the Commission allows the Company to defer.¹¹

MERC

MERC stated that it "does not object to the Department's recommendation that Integrys Business Services ("IBS")-related costs be transferred to MERC's balance sheet rather than remain on separate financial statements, such that MERC would recognize both costs related to the IBS legacy benefit plans and MERC-specific costs as a combined regulatory asset to be amortized over 14 years."¹²

Further, in its December 1, 2016 Reply Comments, MERC requested the Commission approve amortization of MERC's and IBS's pre-acquisition pension and OPEB assets equal to the entire

¹⁰ Department July 25, 2016 Response Comments at pages 12-13; MERC's petition at Exhibit 3, page 9 of 14.

¹¹ Id at 13. \$10,003,121 divided by \$707,449 = 14.14, which the Department rounded to 14.

¹² MERC's August 25, 2016 Reply Comments at page 1 of cover letter.

\$10,141,140¹³ amount (\$10,003,321 + \$137,819 in SERP costs) amortized for a period of 14 years beginning January 1, 2016.

PUC Staff Comment

It appears that MERC and the Department are in agreement over transferring MERC's allocated share of the IBS legacy benefit plan assets and liabilities to MERC and amortizing the combined balance over 14 years beginning January 1, 2016. The remaining disagreement is over the amounts to be transferred and amortized, that is, whether or not the amounts should include SERP costs as discussed above.

Should the Commission require MERC to ring-fence the costs such that none are eligible to be included in rate base?

Department

As discussed above, the Department recommended that MERC be allowed to defer and amortized \$10,003,321 in pension and OPEB costs. The Department further recommended that the Commission require MERC to "ring-fence"¹⁴ these assets and liabilities, to prohibit the Company from including those assets in MERC's rate base and from earning a return on those assets.¹⁵

The Department stated at page 8 of its July 25, 2016 Response Comments:

The rationale for the Department's recommendation to ring-fence this \$10.0 million in pension and OPEB-related assets recognizes the perverse incentive that approval of the Company's proposal could create if those assets were allowed to be included in MERC's rate-base and, by extension, the Company was allowed to earn a return on those assets.¹⁶

MERC

MERC initially disagreed with the Department's proposal to ring-fence these assets so they cannot be included in rate base or earn a return, and recommended that the Commission approve a common amortization for all assets and defer any cost recovery or ratemaking decisions to MERC's current and future rate cases.¹⁷

¹³ The \$10,141,140, as shown in Table 1, represents \$9,537,285 in MERC costs, plus MERC's \$603,855 of Legacy IBS Costs, and includes SERP costs. This is comparable to the Department's recommended 14 year amortization of \$9,436,920 of MERC costs, plus MERC's \$566,401 share of Legacy IBS costs, and excludes SERP (See Table 2).

¹⁴ Wikipedia defines a "ring-fence" as an instance in which a portion of a company's assets or profits are financially separated without necessarily creating a separate entity.

¹⁵ Department July 25, 2016 Response Comments at page 8.

¹⁶ For example, inclusion of these assets including AOCI in MERC's rate base would allow the Company to earn a return on the losses incurred on its pension plan. The Commission would be rewarding MERC's inability to earn its expected return on those assets.

¹⁷ MERC's August 25, 2016 Reply Comments at page 2 of the cover letter.

However, in its December 1, 2016 Reply Comments, MERC stated that “After further discussion with the Department and in light of recent rate case outcomes regarding the inclusion of pension and OPEB assets in rate base,” it agrees with the Department’s November 21, 2016 Response Comments’ recommendation to require MERC to ring-fence these costs.

PUC Staff Comment

It appears the issue of ring-fencing is resolved for the purpose of this docket. However, if this issue were in dispute, staff does not believe there is an agreed upon generic methodology for effectuating or enforcing such a decision.¹⁸

Decision Options

Amount of pre-closing pension and OPEB assets and liabilities to amortize

1. Allow MERC to amortize the \$10,141,140 of assets and liabilities (including SERP costs) shown in Table 1 of the Department’s July 25, 2016 Response Comments. MERC shall not seek recovery of pre-acquisition SERP costs in future rate cases or other cost-recovery proceedings. [MERC]

Or

2. Allow MERC to amortize the \$10,003,321 of assets and liabilities (excluding SERP costs) shown in Table 2 of the Department’s July 25, 2016 Response Comments. [DOC]

Or

3. Require MERC to identify and exclude all non-qualified plan amounts. Allow MERC to amortize the remaining assets and liabilities.

Or

4. Do not allow MERC to defer and amortize any of the costs discussed in this docket.

¹⁸ “‘Ring-fencing’ is often touted as a regulatory solution to problems in banking, finance, public utilities, and insurance. However, both the precise meaning of ring-fencing as well as the nature of the problems that ring-fencing regulation purports to solve, are ill-defined. This Article examines the functions and conceptual foundations of ring-fencing. In a regulatory context, the term can best be understood as legally deconstructing a firm in order to more optimally reallocate and reduce risk. So utilized ring-fencing can help to protect certain publicly beneficial activities performed by private-sector firms, as well as to mitigate systemic risk and the too-big-to-fail problem inherent in large financial institutions. If not structured carefully, however, ring-fencing can inadvertently undermine efficiency and externalize costs.” Ring-Fencing, by Steven L. Schwarcz, Southern California Law Review, Vol. 87:69, pp. 69-110, http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=5531&context=faculty_scholarship

Amortization period(s)

5. Require MERC to transfer to its balance sheet its share of the IBS legacy benefit plans costs allowed above, to add this amount to the MERC-specific allowed costs, and to amortize the combined balance over 14 years. [DOC, MERC agreed]
6. Allow the amortization to begin January 1, 2016. [MERC, DOC]

Ring-fencing

7. Require MERC to ring-fence the pre-acquisition pension and OPEB costs it is being allowed to amortize such that none of those costs are eligible to be included in rate base. [DOC, MERC agreed]
8. Take no action.