BEFORE THE MINNESOTA OFFICE OF ADMINISTRATIVE HEARINGS
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St. Paul, Minnesota 55101

FOR THE MINNESOTA PUBLIC UTILITIES COMMISSION
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MPUC Docket No. G011/GR-13-617

In The Matter Of a Petition by Minnesota Energy Resources Corporation for Authority to Increase Natural Gas Rates in Minnesota

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REPLY BRIEF OF THE OFFICE OF THE ATTORNEY GENERAL-ANTITRUST AND UTILITIES DIVISION

July 11, 2014

TABLE OF CONTENTS

Page

INTRODUCTION 1

I. MERC'S CLASS COST OF SERVICE STUDY IS INACCURATE AND SHOULD BE REJECTED. 1

A. **MERC'S CLASSIFICATION OF THE GAS MAINS ACCOUNT IS UNRELIABLE, AND THE COMMISSION SHOULD ACCEPT THE RECOMMENDATION OF THE OAG.** 1

B. **CUSTOMER SERVICE COSTS SHOULD BE ALLOCATED USING A WEIGHTED ALLOCATOR.** 7

II. MERC'S CUSTOMER CHARGES AND REVENUE APPORTIONMENT SHOULD BE MAINTAINED AT CURRENT LEVELS. 8

III. MERC'S TRAVEL AND ENTERTAINMENT EXPENSES MUST BE DISALLOWED BECAUSE THEY DO NOT MEET STATUTORY REPORTING REQUIREMENTS. 9

IV. MERC HAS FAILED TO DEMONSTRATE THAT ITS DEFERRED TAX ASSET FOR NET OPERATING LOSS IS REASONABLE. 12

V. MERC AGREED TO REMOVE COSTS FOR THE ICE 2016 PROJECT FROM RATE BASE, AND IT SHOULD BE REQUIRED TO DO SO BECAUSE THE ASSETS WERE NOT USED AND USEFUL. 13

VI. MERC MISSTATES THE OAG'S POSITION ON RATEPAYER-SUPPLIED FUNDS. 14

VII. MERC'S REQUESTED RETURN ON EQUITY IS UNREASONABLE AND UNSUPPORTED BY THE RECORD. 16

A. **MERC'S RECOMMENDED ROE SHOULD BE REJECTED BECAUSE IT INCLUDES UNREASONABLE INDIVIDUAL RISK FACTORS.** 16

B. **RELYING ON A SINGLE GROWTH METRIC PRODUCES A LESS ACCURATE RESULT.** 18

CONCLUSION 20

STATE OF MINNESOTA
OFFICE OF ADMINISTRATIVE HEARINGS
FOR THE
PUBLIC UTILITIES COMMISSION

In The Matter Of a Petition by Minnesota Energy Resources Corporation for Authority to Increase Natural Gas Rates in Minnesota	MPUC Docket No. G011/GR-13-617

REPLY BRIEF OF THE OFFICE OF THE ATTORNEY GENERAL

INTRODUCTION

The Office of the Attorney General – Antitrust and Utilities Division submits this Reply Brief in response to the Petition of Minnesota Energy Resources Corporation for Authority to Increase Rates for Natural Gas Service in Minnesota. The OAG will not address every issue raised in testimony in this Reply; rather, the OAG will respond to those issues raised by other parties that require a response. The fact that the OAG does not respond to a particular argument in this Reply does not indicate concurrence or waiver by the OAG of a position taken in testimony or briefing.

I. MERC'S CLASS COST OF SERVICE STUDY IS INACCURATE AND SHOULD BE REJECTED.

MERC submitted a class cost of service study ("CCOSS") in this case, but it is irreparably flawed because it improperly allocates many categories of expenses. Specifically, the testimony of the OAG's expert witnesses demonstrates that MERC has improperly classified the Mains account, and has used improper allocation methods for income tax and customer service expenses.

A. MERC'S CLASSIFICATION OF THE GAS MAINS ACCOUNT IS UNRELIABLE, AND THE COMMISSION SHOULD ACCEPT THE RECOMMENDATION OF THE OAG.

MERC's Mains Account contains approximately $159 million in costs related to the network of underground pipes that MERC uses to distribute natural gas. According to the

Commission's prior orders, only the costs that are necessary to connect a customer to the gas system should be classified as customer costs; the remaining portion of the Mains Account should be classified as capacity costs and be allocated based on each class's contribution to peak demand.[1] There are several methods to determine how much of the Mains Account should be classified as customer costs, but the method that MERC chose to employ was the zero-intercept method.[2] The zero-intercept theory acknowledges that the decision of what size gas main to install is related, at least in part, to the utility's desire to ensure that the system has enough capacity to meet peak demand.[3] In other words, the zero-intercept theory recognizes that some of the costs of installing a 2-inch main, for example, are costs that the utility has incurred in order to meet peak demand, rather than to connect a customer to the gas system. To account for the capacity related costs inherent in a 2-inch main, the zero-intercept method uses an ordinary least squares regression to measure the cost of a hypothetical zero-inch main. The cost of this zero-inch main represents the cost to connect a customer to the system; all additional costs represent the need for the system to have enough capacity to meet peak demand. By identifying the cost of a hypothetical zero-inch main, the zero-intercept study is able to isolate the costs that are required to connect a customer to the gas system, and exclude the costs that are related to capacity.

In its Initial Brief, the OAG thoroughly demonstrated that MERC's zero-intercept study is inaccurate and should be rejected as a method for classifying the Mains Account. Without repeating the arguments made previously, the OAG's analysis indicated that MERC's study

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[1] Order, *In the Matter of the Petition of Northern States Power Gas Utility for Authority to Increase Rates for Retail Customers within the State of Minnesota,* Docket No. G-002/GR-92-1186, 146 P.U.R.4th 1, 44 (Sept. 1, 1993); *see also* Ex. 155, at 7 (Nelson Direct).

[2] The Commission recently ordered CenterPoint Energy to utilize a zero-intercept classification method in its future rate cases. Findings of Fact, Conclusions, and Order, *In the Matter of an Application by CenterPoint Energy Resources Corp. d/b/a CenterPoint Energy Minnesota Gas for Authority to Increase Natural Gas Rates in Minnesota,* Docket No. G-008/GR-13-316, at 37 (June 9, 2014).

[3] Ex. 155, at 9 (Nelson Direct).

violated several of the Gauss-Markov assumptions that are necessary in order to perform an accurate econometric regression. Of particular note, the OAG demonstrated that MERC's study contained heteroscedasticity. In the words of MERC's expert witness Dr. Harry John, the "the major consequences [of heteroscedasticity] are that the predicted values will have large errors, leading to imprecise estimates. The potential for large errors . . . will increase significantly in the presence of heteroscedasticity, and as a result all statistical tests of the model such as T-statistics, and F-test will be unreliable."[4]

The OAG's technical analysis is still uncontroverted. Neither MERC nor the Department has provided any technical evidence to rebut the fact that MERC's zero-intercept study is completely unreliable. Instead, in its attempt to defend its position, MERC argues that it should not be required to collect the data that is necessary to conduct a reliable zero-intercept study in the future. MERC argues that the effort of collecting data on additional variables would be so overwhelming that MERC should not be required bear the cost.[5] But MERC has not provided any evidence of how much such data collection might cost.

Additionally, MERC fails to recognize that as a regulated utility it is required to ensure that it allocates its costs accurately. MERC is obligated to collect any data that is necessary to produce an accurate allocation of its costs whether or not it has been specifically ordered to do so. By definition, any costs that are necessary to conduct an accurate zero-intercept study are costs that the utility should incur to make sure it is allocating its expenses properly. The OAG does not argue that MERC must collect data on every variable discussed in this case; MERC should collect data on at least enough variables to conduct a zero-intercept study that can satisfy the econometric assumptions that are necessary to produce an accurate result.

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[4] Ex. 39, at 9 (John Rebuttal).
[5] MERC Initial Brief, at 83–84.

MERC's second response to the OAG's technical challenge is that its method of aggregating and averaging data is the proper way to conduct a zero-intercept study. In making this argument, MERC's misinterpretation of the basic requirements of mathematics and econometric theory is astounding. In its initial brief, the OAG demonstrated that the aggregation and averaging that MERC used to conduct its ordinary least squares regression completely destroyed any relationship between the data in its original form.[6] MERC's data manipulation is simply inappropriate, and no statistician would ever condone such treatment or accept the results of a study in which similar data had been used.

MERC believes that its method is supported by the NARUC gas and electric manuals, but this claim further demonstrates that MERC simply does not understand the zero-intercept method. It is true that the NARUC Gas Manual discusses calculating the allocation of the gas distribution system using averages.[7] But in doing so, the NARUC Gas Manual is describing how to perform a minimum-size main study, *not* a zero-intercept study.[8] Specifically, the NARUC Gas Manual describes two methods to allocate the costs of a distribution system: the minimum size main study, and the zero-inch main method. The Manual then states, "A calculation of a minimum size main is shown in the illustrative cost allocation study."[9] The NARUC Gas Manual discusses aggregation and averages because that is how a minimum-size main study is performed. It is *not* how a zero-intercept study is performed, because to aggregate and average data in this fashion renders it completely useless in the ordinary least squares regression that is used to perform a zero-intercept study.

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[6] OAG Initial Brief, at 48–52.
[7] *Gas Distribution Rate Design Manual*, NARUC Staff Subcommittee on Gas, at 32 (June 1989).
[8] *Id.*
[9] *Id.* at 22–23.

Further, MERC argues that the OAG's recommendations are improper because they are not based on MERC's current installation practices.[10] While MERC has failed to explain exactly what it means when it says that the zero-intercept study should reflect current installation practices, it appears that MERC means the zero-intercept study should be based, in some way, on MERC's current practice of installing primarily 2-inch mains. MERC's insistence that its classification method should reflect this preference for 2-inch main is yet another example of how MERC misunderstands the zero-intercept analysis and how it classifies gas main costs. The very purpose of the zero-intercept study is to determine the cost of connecting a customer to the gas system *without reflecting any costs that are related to the size of the pipe used to make the connection*. The zero-intercept study does this by measuring the cost of a theoretical pipe that is zero-inches in diameter, or has no size, because that theoretical pipe connects a customer to the system without including any capacity costs. A zero-intercept study that somehow reflected the costs of a 2-inch main instead of a zero-inch main would defeat the entire purpose of conducting the study. It would produce useless results that provided no information on the actual costs of connecting a customer to the gas system.

Finally, MERC argues that its proposed allocation is supported by the results of several minimum-size main studies. MERC believes that the similarity between the results of the minimum-size studies and its zero-intercept study indicate that the zero-intercept study was performed correctly. But this is simply not the case. The record in this case, as well as a basic understanding of the theory involved, demonstrates that the minimum-size main method overstates the cost of connecting a customer to the gas system.[11] Common sense reaches the

[10] MERC Initial Brief 84.

[11] Ex. 155, at 9 (Nelson Direct). MERC witness Ms. Hoffman-Malueg also confirmed that the purpose of determining the cost of a zero-inch pipe is to determine the cost of a pipe that does not allow any demand costs. Tr. Evidentiary Hearing, at 91-92 (May 13, 2014). For that matter, the NARUC Gas Manual notes that classifying any

same result: a 2-inch main, such as MERC used for its studies, costs more to install than a zero-inch main. But only the costs of the zero-inch main are necessary to connect a customer to the system, and the additional costs of the 2-inch main are costs that MERC has incurred in order to provide the capacity of a 2-inch main. For this reason, a minimum-size study based upon a 2-inch main overstates the cost of connecting a customer, and improperly shifts the costs of the Mains Account to the residential class.

In fact, MERC's third minimum-size main study demonstrates MERC's basic confusion about the theory of minimum system studies. MERC believes that the third study is flawed because it "did not consider MERC's minimum installation standards."[12] But the fact that MERC's other studies *did* reflect the minimum installation standards means that it included some costs that are related to the capacity of a 2-inch main, rather than calculating only the cost necessary to connect a customer to the gas system. When MERC finally conducted a study that *did not* reflect its claimed minimum installation standards, the results of the study were strikingly similar to the results of the OAG's zero-intercept analysis.[13] For that reason, MERC's third minimum-size study is likely the most accurate. Given that this third study reaches results that are very similar to the results of OAG witness Mr. Ron Nelson, the OAG recommends that the ALJ accept, and the Commission approve, Mr. Nelson's recommendation to classify 30% of the Main Account a s customer costs, and 70% of the Mains Account as capacity costs.

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distribution system costs as customer costs "can be controversial." *Gas Distribution Rate Design Manual*, NARUC Staff Subcommittee on Gas, at 22 (June 1989).
[12] MERC Initial Brief, at 85.
[13] Ex. 30, JCHM-4 (Hoffman Malueg Rebuttal).

B. CUSTOMER SERVICE COSTS SHOULD BE ALLOCATED USING A WEIGHTED ALLOCATOR.

In its Initial Brief, the OAG explained why MERC should be required to use a weighted allocator for the customer service costs in FERC Account 903. MERC currently allocates its customer service costs only on the basis of the number of connections in each customer class. Xcel Energy and CenterPoint Energy, the other two large natural gas utilities in Minnesota, both determined that MERC's method was inappropriate and created a weighted customer allocator to weigh the difference in costs between customer classes.[14] As a result, OAG witness Ron Nelson recommended that MERC be required to create a similar weighted allocator for the costs contained in Account 903.

In its attempt to rebut Mr. Nelson's recommendation, MERC twists Mr. Nelson's testimony to suit its argument by taking his statements out of context. MERC claims that Mr. Nelson and the OAG recommended that Account 903 be allocated on the basis of the average cost for meters.[15] But Mr. Nelson does not recommend allocating Account 903 on the basis of meters. Contrary to MERC's claim, Mr. Nelson primary recommendation was that "MERC be ordered to use a customer weighted allocation method for FERC account 903."[16]

According to Mr. Nelson, MERC should create a customer weighted allocator similar to the weighted allocators used by CenterPoint Energy and Xcel Energy because some customers "have much more complex billing, accounting, contracts, and complaints than do residential customers," and MERC's current allocation failed to take those differences into account.[17] Given the fact that MERC has not yet created such an allocator, Mr. Nelson noted that the NARUC Gas Manual, which also uses a weighted allocator, recommends an allocator that is also

[14] Ex. 155, at 41-42 (Nelson Direct).
[15] MERC Initial Brief, at 86.
[16] Ex. 158, at 20 (Nelson Surrebuttal).
[17] Ex. 155, at 41 (Nelson Direct).

used for Account 381, which contains expenses related to meters.[18] Mr. Nelson ultimately recommended using a customer weighted allocator by either creating its own allocator or using the allocator suggested by the NARUC manual.[19]

MERC's current allocation does not account for the differences in the cost of providing customer services to different customer classes. MERC has not provided any evidence demonstrating that its allocation method is reasonable. The OAG, however, has demonstrated that MERC's flat rate contract with Vertex does not represent the principles of cost causation, and should not be used to develop an allocation method for Account 903.[20] Instead, the OAG requests that the ALJ recommend, and the Commission approve, an order directing MERC to use a weighted customer allocator for Account 903. If MERC is unable to provide a weighted customer allocator of its own, the OAG recommends that MERC use the weighted allocator described in the NARUC Gas Manual.

II. MERC'S CUSTOMER CHARGES AND REVENUE APPORTIONMENT SHOULD BE MAINTAINED AT CURRENT LEVELS.

MERC and the Department have agreed on a revenue apportionment and customer charge increase that is based on the results of MERC's CCOSS. As discussed above, the OAG has demonstrated that a significant portion of the costs in MERC's CCOSS have been classified and allocated incorrectly. It is unreasonable to support any change in apportionment on the basis of a CCOSS that is rife with errors and technical inaccuracies. For that reason, customer charges and revenue apportionment should remain at their current levels.

In regards to customer charge, MERC presents several arguments that are unsupported by the record in this case. MERC continues to argue that a higher customer charge will result in

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[18] *Id.*; *see also Gas Distribution Rate Design Manual*, NARUC Staff Subcommittee on Gas, at 32 (June 1989).
[19] Ex. 158, at 20 (Nelson Surrebuttal).
[20] OAG Initial Brief, at 35–37.

less variability between winter and summer bills. But, as the OAG identified in its Initial Brief, this argument ignores the fact that MERC's customers already have an even payment program available to them.[21] MERC also claims, incredibly, that it does not have a full decoupling program, and, therefore, that a higher customer charge is necessary in order to stabilize the company's revenue.[22] It appears that MERC does not understand, or chooses to ignore, the meaning of "full decoupling." While MERC's revenue decoupling mechanism does have a 10% cap on revenues, as the Commission noted in MERC's 2010 rate case, "The mechanism is considered a full decoupling mechanism because the true-up amount is based on deviations from forecasted revenue for any reason, including weather, that differs from forecasted amounts."[23] MERC does not need a high customer charge in order to stabilize its revenues because, contrary to MERC's argument, MERC has a full decoupling program that protects the company's revenue from all deviations, including weather. The OAG recommends that the ALJ and the Commission reject any change to revenue apportionment and customer charges.

III. MERC'S TRAVEL AND ENTERTAINMENT EXPENSES MUST BE DISALLOWED BECAUSE THEY DO NOT MEET STATUTORY REPORTING REQUIREMENTS.

Minnesota Statutes section 216B.16, subdivision 17 provides, "[A] public utility filing a general rate case petition shall include a schedule separately itemizing all travel, entertainment, and related employee expenses . . . . [E]ach applicable expense incurred in the most recently completed fiscal year must be itemized separately, and each itemization must include the date of the expense, the amount of the expense, the vendor name, and the business purpose of the

[21] Minn. Stat. § 216B.098, subd. 2; Ex. 150, at 41 (Adopted Direct Testimony of Chavez by Lindell).
[22] MERC Initial Brief, at 69.
[23] Findings of Fact, Conclusions, and Order, *In the Matter of the Application of Minnesota Energy Resources Corporation for Authority to Increase Rates for Natural Gas Service in Minnesota,* Docket No. G-007, 011/GR-10-977, at 8 (July 13, 2012).

expense." MERC has failed to satisfy this statutory requirement in several ways, and as a result, all travel and entertainment expenses should be disallowed.

First, MERC did not even attempt to separately itemize its travel and entertainment expenses related to MERC's service company. This is a clear violation of the statute: MERC incurred travel and entertainment expenses but did not itemize them as required. As a result, the OAG recommended that all of the expenses that were not itemized be disallowed. The Department agreed, noting that it "recommended that the T&E expenses allocated from MERC's service company should have been filed for review in accordance with the statutory requirements."[24] Even MERC implicitly accepts that it should have separately itemized these expenses, as it has agreed that it will file the information in its next rate case.[25]

A further problem with service company expenses is that the record does not demonstrate the amount of expenses that should have been separately itemized. The Company may argue that the Commission should not deny recovery because it is not possible to determine exactly how much should be denied, but that argument is completely unreasonable. MERC should not be allowed recovery of these expenses only because they are difficult to measure, because the very reason that they are impossible to measure is that MERC failed to report the expenses as it was *required* to do. And MERC should not be allowed to defend its failure to separately itemize the service company expenses by arguing that the same failure protects it from any penalty. The OAG and the Department both agree that MERC should have separately itemized the expenses. Failing to do so violated Minnesota law, and there must be some consequence for this violation

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[24] Department Initial Brief, at 93-94.

[25] Ex. 25, at 3 (DeMerritt Surrebuttal). MERC claims that its agreement to separately itemize these expenses in the future should not be taken as an admission of incompleteness in this case, *id.*, but that position is unreasonable. If the expenses should have been itemized, as MERC appears to admit when it indicates it will file them in the future, then failing to itemize them was in error. It is illogical for MERC to both admit that the expenses should be filed in future cases and also argue that they did not need to be filed in this case.

in order for the statute to have meaning. For that reason, the OAG recommends that the Commission adopt MERC's reported travel and entertainment expenses as a reasonable proxy for those expenses from the service company that were not reported. In the event that the Commission does not agree with the OAG's proxy, the OAG recommends that the Commission develop an alternative proxy for the un-itemized funds and exclude them from recovery.

The second failing with MERC's travel and entertainment expenses was that MERC did not separately itemize "dues and expenses for memberships in organizations or clubs" as required by Minnesota law.[26] MERC paid membership dues to the Minnesota Chamber of Commerce, the Edison Electric Institute, and the American Gas Association, but MERC did not separately itemize the expenses as it is required to do. MERC's sole defense is its conclusory claim that, "Contrary to the assertions of the OAG, MERC has fully complied with the requirements."[27] MERC has not even attempted to provide a justification for failing to separately itemize the membership dues, and they should be excluded from recovery.

Finally, MERC failed to provide a reasonable business purpose for those expenses that it did itemize separately.[28] The OAG reviewed MERC's itemization report and identified many expenses where MERC's claimed business purpose was unreasonable or illogical. "Supper in Michigan" is not a business purpose, and neither is "Meal less than $75."[29] In defense, MERC again relies only on a blanket statement that it has complied with the statutory requirements. But Minnesota law provides a mandatory requirement that MERC provide a business purpose for its travel and entertainment expenses, and many of MERC's explanations are clearly insufficient to

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[26] Minn. Stat. §. 216B.16, subd. 17, (a)(6).
[27] MERC Initial Brief, at 44.
[28] Minn. Stat. §. 216B.16, subd. 17 (b) (requiring that "each itemization *must include* . . . the business purpose of the expense") (emphasis added).
[29] OAG Initial Brief, at 16.

describe the business purpose of the expense. MERC's failure to comply with the law leaves the ALJ and the Commission no realistic choice but to deny recovery.

MERC has failed in multiple ways to satisfy the legislature's requirement to separately itemize travel and entertainment expenses. To permit MERC to recover those expenses would grant MERC recovery of expenses that violate a clear statutory instruction and encourage similar violations by other utilities in the future. For that reason, the OAG recommends that the ALJ and the Commission reject MERC's request to recover travel and entertainment expenses.

IV. MERC HAS FAILED TO DEMONSTRATE THAT ITS DEFERRED TAX ASSET FOR NET OPERATING LOSS IS REASONABLE.

MERC has included a deferred tax asset in rate base as a result of a net operating loss carryforward it claims to have generated as a result of bonus depreciation. But MERC has failed to demonstrate that including the deferred tax assets in rate base is reasonable given MERC's unique tax position. MERC does not pay income taxes, because it is part of a consolidated group for tax purposes.[30] Integrys Energy Group, rather than MERC, pays income taxes for MERC and all of the other utility companies that it owns. Because it is not a taxpayer, MERC should not be permitted to include net operating loss deferred tax assets in rate base before satisfying two conditions: MERC must first demonstrate that it had a net operating loss as a stand-alone company. Second, MERC must demonstrate that Integrys, the taxpaying entity, was not paying income taxes due to the net operating loss carryforward created by MERC. The record in this case demonstrates that MERC has failed to satisfy this second condition. The OAG asked MERC to provide documentation of Integrys's net operating loss in 2012 and 2013, but MERC refused to provide it.[31] As the OAG noted in its initial brief, without this information it is not possible to verify which of Integrys's affiliated companies contributed to the Integrys net

[30] Ex. 151, at 11 (Lindell Direct).
[31] Ex. 152, Schedule JJL-2 (Schedules to Lindell Direct).

operating loss, and therefore, it is impossible to tell whether MERC's claimed net operating loss was actually utilized by the entity that actually pays taxes. Without this showing, it is unreasonable for MERC to include the deferred tax asset in rate base.

The OAG has also demonstrated that excluding the asset from rate base will not harm MERC because it has utilized the full effect of the asset from the beginning of 2014. MERC will use the entire net operating loss carryforward in 2014.[32] MERC will make estimated income tax payments throughout 2014, and MERC incorporated the full amount of the net operating loss carryforward when it calculated its estimated payments at the beginning of the year. In other words, MERC subtracted the entire net operating loss from its estimated income tax liability for the entire year, and then divided the remaining amount by the number of income tax payments it will make throughout the year. At the time MERC performed this calculation, it had fully realized the benefit of the net operating loss, and for that reason MERC will not be harmed if the associated deferred tax asset is not included in rate base. The OAG requests that the ALJ recommend, and the Commission approve, removing deferred tax assets related to net operating loss carryforward from rate base.

V. MERC AGREED TO REMOVE COSTS FOR THE ICE 2016 PROJECT FROM RATE BASE, AND IT SHOULD BE REQUIRED TO DO SO BECAUSE THE ASSETS WERE NOT USED AND USEFUL.

MERC has incurred expenses related to developing an in-house customer service program, a project referred to as ICE 2016. In direct testimony, OAG witness Mr. John Lindell noted that MERC has requested recovery for these expenses even though the ICE 2016 project was not completed and thus the assets were not used and useful.[33] Mr. Lindell stated that it would be unreasonable for ratepayers to pay for both the third-party contractor Vertex and ICE

[32] *See* Ex. 37, at 17-18 (Wilde Rebuttal).
[33] Ex. 151, at 20-21 (Lindell Direct).

2016 at the same time.[34] Given that ICE 2016 was not used and useful, Mr. Lindell recommended that the ICE 2016 costs not be allowed.[35]

In response, MERC offered to remove the ICE 2016 expenses from rate base. MERC witness Mr. Seth DeMerritt stated:

> [C]ontingent on regulatory approval from the Commission, MERC would be willing to defer ICE costs totaling $322,226 annually as a regulatory asset until MERC's next rate case . . . .[36]

After the evidentiary hearing, and after the record closed, MERC has attempted to modify its position. In its Initial Brief, MERC argues that "the ICE 2016 project is also used and useful."[37] MERC's argument is unreasonable because it does not provide a single reason that the project is either used or useful. Furthermore, it is unreasonable for MERC to change its position after the record has closed because the other parties have not had the opportunity to respond to MERC's argument revised argument. For that reason, the ALJ and the Commission should hold MERC to the position it initially agreed to: the ICE 2016 costs should be removed from rate base until MERC's next general rate case filing.[38]

VI. MERC MISSTATES THE OAG'S POSITION ON RATEPAYER-SUPPLIED FUNDS.

In its brief, MERC repeatedly claims that its treatment of company supplied benefit funds is consistent with an agreement MERC claims to have reached with the OAG during a previous rate case.[39] The OAG did not enter any testimony on the issues of pensions or employee benefits

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[34] *Id.*
[35] *Id.*
[36] Ex. 24, at 25 (DeMerritt Rebuttal).
[37] MERC Initial Brief, at 40.
[38] While the OAG agrees that the ICE 2016 costs should be removed from rate base, the OAG does not agree to any provisions regarding the recovery of those costs in MERC's future rate case. Specifically, the OAG does not agree that MERC should be allowed to recover any return on the ICE 2016 expenses or that that a three-year amortization period would be reasonable in a future rate case. Additionally, the OAG does not waive any future arguments as the reasonableness of the ICE 2016 expenses.
[39] *See* MERC Initial Brief, at 48–50.

in this case, and has not taken any position on the issues. But the OAG must respond to MERC's brief in order to clarify that MERC does not have any agreement with the OAG in regard to pension or employee benefit expenses.

In MERC's 2010 rate case, Docket No. 10-977, the OAG recommended that the Commission reduce rate base to reflect differences in the level at which MERC funded its obligation for pensions and post-employment benefits and the level of expenses it included for recovery of rates.[40] The OAG determined that the cumulative difference from 2007 to 2011 was $74,159, and recommended that the Commission reduce rate base by that amount to reflect ratepayer-supplied funds.[41] In response, MERC argued that the correct adjustment would be somewhat less, and ultimately agreed to adjust rate base by more than $70,000.[42]

It appears that MERC is now using the OAG's recommendation to defend its argument that company-supplied funds should be included in rate base as a regulatory asset. But MERC's argument misstates the position the OAG has taken in the past. In this case, MERC argues that company-supplied funds should be included in rate base. The OAG's recommendation to *exclude* ratepayer-supplied funds from rate base in the 2010 rate case does not lend any support to MERC's argument to *include* a different source of funds in this case. The two positions are entirely distinct. The OAG has never supported including company-supplied funds in rate base, and MERC's attempt to attribute this this position to the OAG is a misrepresentation.

Further, the OAG and MERC did not reach any continuing agreement on accounting for pension funds in the 2010 case. The OAG advocated for reducing rate base on a particular issue in a particular case, and MERC's eventual acquiescence to the OAG's position should not be

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[40] Findings of Fact, Conclusions of Law, and Order, *In the Matter of the Application of Minnesota Energy Resources Corporation for Authority to Increase Rates for Natural Gas Service in Minnesota*, Docket No. G-007, 011/GR-10-977, at 30–31 (July 13, 2012).
[41] *Id.*
[42] *Id.*

construed as reaching some kind of greater agreement. MERC has not produced any document memorializing any agreement on a going-forward basis, and the ALJ and the Commission should not interpret the OAG's position in a previous case on a distinct issue as representative of a position in this case. MERC's statements to the contrary are confusing and a misrepresentation.

VII. MERC'S REQUESTED RETURN ON EQUITY IS UNREASONABLE AND UNSUPPORTED BY THE RECORD.

A return on equity ("ROE") greater than the minimum necessary for MERC to attract the capital it needs to perform its public functions would result in an inappropriate transfer of wealth from ratepayers to shareholders. The ROE recommendations by the Department and MERC are excessive because their recommendations are based on flawed analysis. In contract, the analysis of the OAG demonstrates that an ROE of 8.62 will allow MERC to attract the capital that it requires.

A. MERC'S RECOMMENDED ROE SHOULD BE REJECTED BECAUSE IT INCLUDES UNREASONABLE INDIVIDUAL RISK FACTORS.

MERC argues that the recommended ROEs of both the Department and the OAG are too low because Drs. Amit and Chattopadhyay did not explicitly consider several of MERC's supposedly "unique" risk factors in their respective ROE analyses.[43] MERC then points to a handful of specific factors—such as size, customer makeup, and earnings variability—to argue that its overall investment risk exceeds the overall investments risk of the companies in its own proxy group as well as the companies in the proxy groups used by the Department and the OAG.[44] MERC's suggestion that its investment risk is higher than the companies in each party's proxy group, and that its ROE should therefore by higher, due to a few self-selected factors is not reasonable for multiple reasons.

[43] MERC Initial Brief, at 10–17.
[44] *Id.*

First, a company's investment risk cannot be properly evaluated by reviewing a selection of individual risk factors. Dr. Amit notes that including individual risk factors "would require an examination of each company's unique factors that may impact investment risk."[45] According to Dr. Amit, "such an approach is not only impractical, but also defeats the whole purpose of using well-accepted common-risk factors to screen for risk-comparable groups.[46] For that reason, analysts should incorporate broad-based risk indicators into their proxy screening, rather than attempting to compare the individual risk factors for every utility company. For example, both Drs. Amit and Chattopadhyay reviewed S&P credit ratings, a broad-based risk factor, in establishing their respective proxy groups.[47] The use of these broad-based risk indicators appropriately accounts for the varied individual risks affecting different companies.

Second, even if analysts could review each individual risk factor for every comparable company, the record in this case reflects several risk factors ignored by MERC that would serve to lower MERC's investment risk as compared to the companies in each party's proxy group. As noted in the OAG's initial brief, MERC's parent, Integrys, demonstrated superior performance in generating internal funds, superior interest coverage, and a superior operating revenue when compared to members of Dr. Chattopadhyay's proxy group.[48] Further, each analyst's proxy group contained several companies with substantial non-regulated business activities.[49] Finally, the economic conditions in Minnesota are superior to regions where many of the companies in which Dr. Chattopadhyay's proxy group operate, which indicates a comparatively lower risk than utilities in other regions.[50] Notably, unlike Mr. Moul's analysis, neither Dr. Amit or Dr.

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[45] Ex. 200, at 64 (Amit Direct).
[46] *Id.*
[47] *See* Ex. 200, at 9 (Amit Direct); Ex. 151, at 25 (Chattopadhyay Direct). Mr. Moul did not review any credit rating in developing his proxy group. *See* Ex. 17, at 4–5 (Moul Direct).
[48] *See* OAG Initial Brief, at 23.
[49] *See* OAG Initial Brief, at 23.
[50] Ex. 151, at 28–29 (Chattopadhyay Direct).

Chattopadhyay adjusted their ROE recommendations based on these or other isolated risk factors.[51] For these reasons, MERC's suggestion that its ROE should be increased due to a few specific and isolated risk factors is not reasonable and should be rejected.

B. Relying on a Single Growth Metric Produces a Less Accurate Result.

Dr. Chattopadhyay incorporates multiple growth metrics in forming the growth component for his discounted cash flow ("DCF") model because it reflects the reality that investors look at many factors.[52] The Department, on the other hand, continues to argue that the DCF method should rely on only a single growth metric, earnings growth. The Department did not support its position by explaining why investors who consider dividend or book value growth should be ignored or why Dr. Chattopadhyay's overall growth component was flawed.[53] Rather, the Department simply argues that financial literature, economic theory, and econometric analysis supports the use of earnings growth. But the OAG does not dispute that earnings growth is important for the DCF method. That is why more than 80% of Dr. Chattopadhyay's growth component is made up of earnings growth. Dr. Chattopadhyay's growth component also recognizes that reasonable investors may also look at other growth metrics, and includes consideration of those metrics to ensure that those investors are represented in the DCF results.[54]

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[51] In its initial brief, MERC speculates that Dr. Chattopadhyay "seems inclined toward a low return because he bases his ROE recommendation, at least in part, on the fact that the Minnesota economy is performing well in comparison to other regions of the U.S." MERC Initial Brief, at 20. MERC ignores that Dr. Chattopadhyay's review of Minnesota's economic conditions was used simply to "corroborate[] that it is reasonable to use [his] chosen proxy," and that Dr. Chattopadhyay did not adjust his ROE analysis to account for Minnesota's economy. Ex. 151, at 29 (Chattopadhyay Direct).

[52] *See* OAG Initial Brief, at 24.

[53] *See* Department Initial Brief, at 42, 48. The Department also mischaracterizes how Dr. Chattopadhyay calculated his growth component in its initial brief: "Essentially, Dr. Chattopadhyay calculated the expected growth rates for his DCF analysis by averaging the expected EPS, DPS, and BPS rather than using only EPS." Department Initial Brief, at 44. Dr. Chattopadhyay's growth component assigned more than 80% weightage to earnings growth and was not "essentially" an average of EPS, DPS, and BPS rates. OAG Initial Brief, at 24-25. Notably, the Department properly explained Dr. Chattopadhyay's growth component in a footnote. Department Initial Brief, at 44 n.16.

[54] OAG Initial Brief, at 24-25.

In addition, the Department suggests that only earnings growth should be used in a DCF analysis because earnings growth forecasts are published by many investment services, whereas only Value Line provides comprehensive long-term dividend growth forecasts.[55] The Department's position of ignoring dividend growth entirely, however, suggests that Value Line is—for some unexplained reason—publishing a dividend growth forecast that is not considered by *any* investors. On the contrary, the fact that Value Line perceives a market for dividend growth forecasts indicates that these forecasts are valuable to some investors, and therefore should be incorporated into a DCF analysis.

Ultimately, Dr. Chattopadhyay's growth component has a stronger statistical relationship with a company's price-to-earnings ratio than using earnings growth alone because it contemplates the values of different investors.[56] The Department has failed to demonstrate that it is reasonable to ignore growth metrics other than earnings growth, such as dividend growth and book value growth. Accordingly, the OAG's growth component is reasonable and should be considered in a proper DCF analysis.

[55] DOC Initial Brief, at 47 n.17.
[56] OAG Initial Brief, at 28.

CONCLUSION

For the reasons set forth in this Reply Brief and in the OAG's Initial Brief, the OAG respectfully requests that the ALJ adopt the OAG's Proposed Findings of Fact and Conclusions accompanying this brief.

Dated: July 11, 2014

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