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August 25, 2014

The Honorable Eric L. Lipman  
Administrative Law Judge  
Office of Administrative Hearings  
600 North Robert Street  
P.O. Box 64620  
St. Paul, MN 55164-0620

**RE: *In the Matter of a Petition by Minnesota Energy Resources Corporation for Authority to Increase Natural Gas Rates in Minnesota***  
**MPUC DOCKET NO. G-011/GR-13-617**  
**OAH Docket No. 8-2500-31126**

Dear Judge Lipman:

Enclosed and e-filed in the above-referenced matter please find Exceptions to the Findings of Fact, Summary of Public Testimony, Conclusions of Law and Recommendation of the Minnesota Office of the Attorney General – Antitrust and Utilities Division.

By copy of this letter all parties have been served. An Affidavit of Service is also enclosed.

Sincerely,

*s/ Ryan Barlow*

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**BEFORE THE MINNESOTA OFFICE OF ADMINISTRATIVE HEARINGS  
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**FOR THE MINNESOTA PUBLIC UTILITIES COMMISSION  
121 Seventh Place East  
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St. Paul, Minnesota 55101-2147**

**MPUC Docket No. G-011/GR-13-617  
OAH Docket No. 8-2500-31126**

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*In the Matter of a Petition by Minnesota Energy Resources Corporation  
for Authority to Increase Natural Gas Rates in Minnesota*

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**EXCEPTIONS OF THE OFFICE OF THE MINNESOTA ATTORNEY GENERAL TO  
THE FINDINGS OF FACT, SUMMARY OF PUBLIC TESTIMONY, CONCLUSIONS  
OF LAW AND RECOMMENDATION OF THE ADMINISTRATIVE LAW JUDGE**

**August 25, 2014**

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## I. INTRODUCTION.

Pursuant to Minnesota Statutes section 14.61 and Minnesota Rules, part 7829.2700, the Antitrust and Utilities Division of the Office of the Attorney General (“OAG”) hereby files Exceptions to the Findings of Fact, Summary of Public Testimony, Conclusions of Law and Recommendation<sup>1</sup> (“Findings”) of the Administrative Law Judge (“ALJ”) dated August 14, 2014, addressing the request of Minnesota Energy Resources Corporation (“MERC”) for an increase in rates for natural gas service (“Exceptions”).

The contested issues in this case represent a wide variety of complex financial and policy matters, and the OAG appreciates the effort of the ALJ to complete the Findings in the limited timeframe available given the rate case schedule. The OAG disagrees, however, with many of the ALJ’s conclusions and recommendations and believes that several of the ALJ’s recommendations cannot be supported by the record in this case. Of even greater concern, the OAG believes that the ALJ’s Report does not fairly represent the OAG’s position on several issues and fails to state the reasoning that underlies many of the OAG’s recommendations in this case. The OAG offers these Exceptions in order to correct these errors and to ensure that the Commission is provided with an appropriate record of the analysis provided by the OAG’s expert witnesses. The OAG’s Exceptions will identify those areas in which the ALJ’s Findings require additional comments, but the failure to identify an issue or finding in these Exceptions does not indicate a waiver of the issue on the part of the OAG.

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<sup>1</sup> Findings of Fact, Summary of Public Testimony, Conclusions of Law and Recommendation, *In the Matter of a Petition by Minnesota Energy Resources Corporation for Authority to Increase Natural Gas Rates in Minnesota* MPUC Docket No. G-011/GR-13-617; OAH Docket No. 8-2500-31126 (August 14, 2014).



## **II. MERC'S CLASS COST OF SERVICE STUDY IS INACCURATE.**

Through its testimony and briefing, the OAG demonstrated that MERC's Class Cost of Service Study ("CCOSS") was inaccurate, and that it would be unreasonable to rely on the study for apportionment or rate design. The OAG disagrees with the ALJ's recommendation that the Commission should adopt MERC's CCOSS in this proceeding. Furthermore, the OAG believes that the ALJ has failed to present the full depth and breadth of the OAG's reasoning on several CCOSS issues. By failing to describe the OAG's analysis, the ALJ has presented the Commission with a report that does not fairly describe what took place during the proceeding.

### **A. DISTRIBUTION SYSTEM – MAINS ACCOUNT ALLOCATION.**

The allocation of MERC's Mains Account is of central importance to the CCOSS because it is MERC's single largest investment, and changes in its allocation have a significant impact on the result of the CCOSS. The OAG provided extensive analysis on the many ways in which MERC's zero-intercept model violates the basic principles of ordinary least squares regression analysis. It appears that the ALJ did not consider any of this testimony, as the ALJ made no findings describing the substance of the OAG's analysis. For that reason, the OAG recommends that the Commission review the testimony and briefs filed by the OAG so that they have a complete understanding of the record in this matter. The OAG will not restate all of the analysis submitted in this case in these Exceptions, but will limit its remarks to those specific findings that should be modified, removed, or inserted.

First, the OAG recommends that Finding 626 be modified to remove the reference to the practice of Integrys affiliates in other jurisdictions. The fact that other utilities may use similar methods in other jurisdictions is irrelevant to whether MERC's method in this case is correct. The OAG has demonstrated that MERC's zero-intercept method is incorrect and leads to

inaccurate results. The method cannot be salvaged merely because it was used elsewhere. The OAG recommends the following modifications to Finding 626:

626. MERC's zero-intercept study was based upon data that is available and complete. ~~The Company's assumptions, specifications and statistical techniques were similar to, and consistent with, those used by Integrys's other subsidiaries.~~

The OAG also recommends that Finding 628 be modified to provide a description of how the OAG demonstrated that MERC's zero-intercept method was incorrect. The OAG provided substantial analytical support for its recommendations, and omitting a description of that reasoning is unreasonable and fails to fairly present the OAG's position in this case. The OAG recommends that the following changes be made to Findings 628 and 629 to reflect that substance of this analysis:

628. The OAG-AUD argues that MERC's CCOSS analyses were flawed and produced unreasonable results. The OAG identified several flaws within MERC's zero-intercept study:

a. The OAG noted that MERC's model was incorrectly specified because it assumed that only one variable had any effect on the cost of a distribution main: the diameter of the main squared. The Integrys Gas Group Engineering Manual, the testimony of MERC witness Mr. Kult, bids from MERC's contractors, and common sense lead to the conclusion that other variables have an impact on the price of a distribution system, and should be included in the model. Failing to include these variables in the model leads to omitted variable bias, which OAG witness Mr. Nelson was able to confirm using statistical analysis. The result of omitted variable bias is that cost of a zero-inch main is incorrectly estimated.

b. The OAG also discussed MERC's data handling. MERC took several unreasonable steps with its data practices, including aggregating and averaging data before using it in its zero-intercept analysis. The OAG argued that by manipulating the data in this fashion, MERC had predetermined the results of the regression and that the results of the model were completely meaningless.

c. The OAG also determined using statistical analysis that MERC's regression contains heteroscedasticity, or that the error terms of the regression have different variances. Mr. Nelson confirmed the presence of heteroscedasticity using the Bruesch-Pagan test. A model with heteroscedasticity does not produce accurate results.

~~For this case, and on a going forward basis, the OAG AUD recommended that MERC:~~

- ~~(1) — Assess a greater number of cost related variables;~~
- ~~(2) — Maintain cost data at the project level;~~
- ~~(3) — Avoid aggregating or averaging this data; and~~
- ~~(4) — Change the percentages used to classify MERC's distribution mains, based upon the OAG AUD zero intercept study and the results of other available studies.~~

629. After providing evidence that MERC's zero-intercept study was flawed, OAG witness Mr. Nelson produced an alternative zero-intercept study that corrected some of the errors from MERC's model. Mr. Nelson's improved model indicated that 26% of the Mains account should be classified as customer costs. Given that his method was still limited to some extent by the problems with MERC's data, Mr. Nelson recommended that 30% of the Mains Account be classified as customer costs. The OAG AUD recommended a very different allocation of costs; specifically, a 30 percent customer classification for the Mains account and allocation of 70 percent in demand costs.

The OAG also takes exception to the ALJ's discussion of MERC's minimum sized studies because the ALJ's findings do not accurately describe the difference between the minimum sized method and the zero-intercept method, or the fact that the minimum size method classifies some capacity costs as customer costs. Additionally, the ALJ's description of MERC's minimum sized method does not fully explain how MERC designed the studies. The OAG recommends the following modifications to Findings 631 through 634:

631. The minimum size method serves a similar, but distinct, purpose from the zero-intercept method. The zero-intercept

method attempts to calculate a no load distribution system by analyzing the cost of a zero-diameter pipe that connects a customer to the system but carries no gas. In contrast, the minimum size method attempts to calculate the cost of a system that does carry load by calculating the cost of the “minimum” sized equipment. While serving the same purpose as a zero-intercept method study, a~~The~~ minimum size method study has an advantage: It does not rely upon regression analysis for its results, and is therefore easier to conduct. Instead, an analyst needs to consider whether the study should utilize the size of the equipment that is currently installed, historically installed, or the minimum size needed to meet safety standards. Additional criteria could include when the equipment was installed and whether the equipment is installed throughout the entire system or only in limited locations. While the minimum size method has the advantage of being easier than the zero-intercept method, it can also be less accurate because it calculates the cost of a distribution system that includes gas. By including load in its calculation, the minimum size method classifies some capacity costs as customer costs. While the zero-intercept method is more complex because it requires a regression, it more accurately calculates the customer costs because it estimates the cost of a system with no load.

632. MERC conducted three minimum size studies on the Company’s distribution mains. The first study used a 2-inch main as the minimum standard for installation and resulted in a distribution main classification of 74.1 percent to customer costs and 25.9 percent to demand costs.

633. The second study utilized a 2-inch main as the minimum standard for installation, as well as aggregates pipe sizes less than 2 inches in diameter with the 2-inch sized pipes, and resulted in a distribution main classification of 73.2 percent to customer costs and 26.8 percent to demand costs.

634. The third minimum size study allocated distribution main costs on the basis of the mains with the lowest unit cost to install that are installed in MERC’s system and without altering the size of any mains~~but did not utilize MERC’s minimum installation standards.~~ The study produced ~~very different results than the other studies~~— an allocation of 32.04 percent in customer costs and 67.96 percent in demand costs.

The OAG takes exception to Finding 636, as the ALJ made no findings on the substance of the OAG’s reasoning and analysis. Rather than reaching a conclusion on the merits of the OAG’s recommendation to classify 30% of the Mains Account as customer costs, the ALJ focuses on the OAG’s recommendation that MERC be ordered to collect additional data for its next rate case so that its zero-intercept model will be more accurate in the future. In contrast to the ALJ’s finding, the OAG does not recommend that MERC be ordered to collect all the data mentioned by Mr. Nelson. The OAG stated its recommendation clearly in its Initial Brief: “[T]he OAG recommends that the Commission order MERC to collect data on additional variables in order to run a superior, or at least valid, zero-intercept analysis in future cases.”<sup>2</sup> The OAG does not suggest that MERC be ordered to collect all the data discussed by Mr. Nelson; rather, Mr. Nelson discussed many types of data that could be useful, and the OAG recommends that MERC be instructed to include enough data in the future so that its zero-intercept study will meet the basic requirements necessary to be statistically accurate. The ALJ’s finding changes the focus of the OAG’s recommendation, and also fails to squarely address the OAG’s primary recommendation that the Commission accept Mr. Nelson’s superior zero-intercept study as the basis to classify the Mains Account. The OAG recommends the following modifications to Finding 636:

636. With the respect to the recommended approaches for the CCOSS, the ALJ believes that the analysis provided by the OAG has merit. The ALJ agrees that MERC should collect additional data for zero-intercept studies in future so that the Commission will be presented with more accurate and reliable analysis.~~the Administrative Law Judge concludes that the OAG AUD’s critiques are not well taken. Neither MERC, nor other utilities in Minnesota, have been required to maintain the types of historical data urged by the OAG AUD for CCOSS analysis. Moreover, only one utility in Minnesota maintains the type of data that the OAG AUD regards as “project level” detail. Lastly, some of the data points that OAG AUD would include in the analysis—such as~~

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<sup>2</sup> OAG Initial Brief, at 57.

~~the length of the distribution main, or the reason why the pipe was installed contribute very little to development of “a hypothetical zero load or zero sized distribution main on MERC’s entire system.”~~

Finally, the OAG takes exception to the ALJ’s finding that a zero-intercept analysis should reflect “industry minimums for installation of such mains.” In both its Initial Brief and Reply Brief, the OAG discussed why similar statements made by MERC indicate that the company does not have an accurate understanding of zero-intercept theory, and the ALJ’s statements demonstrate a similar lack of understanding. As the OAG stated in its Reply Brief:

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.<sup>3</sup>

By recommending that a zero-intercept study be based on something other than a zero-inch, zero-load main, the ALJ reveals a lack of understanding about the basic purpose and theory of a zero-intercept study. As a result, the OAG recommends that the ALJ’s recommendation on how to conduct a zero-intercept study, contained in Finding 637, be removed entirely.

~~637. With respect to the reasonableness of the study results, the Administrative Law Judge concludes that a proper zero intercept analysis should reflect the costs of actual steel distribution mains and industry minimums for installation of such mains.~~

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<sup>3</sup> OAG Reply Brief, at 5.

Finally, the OAG takes exception to the ALJ's final recommendation on the classification of the Mains Account. First, the ALJ has selected a level of customer costs that no party has recommended as reasonable. MERC recommended that 63.3% be classified as customer costs, and the OAG recommended that 30% be classified as customer costs. There is no basis in this record for the ALJ's conclusion that 73% of the Mains Account should be classified as customer costs. Furthermore, the OAG presented extensive analysis demonstrating that 30% of the Mains Account should be classified as customer costs, and 70% of the Mains Account should be classified as capacity costs. Because the minimum size studies conducted by the company include load in calculating the cost of the system, they overstate the level of customer costs and are inaccurate. For these reasons, the OAG recommends the following modifications to Finding 638:

638. ~~MERC's minimum size analysis demonstrates that at least~~ Thirty percent of the distribution mains ~~would~~ should be classified as customer costs and ~~27~~ seventy percent to demand costs.

**B. CUSTOMER RECORDS AND COLLECTION EXPENSE ALLOCATION.**

The ALJ incorrectly states the OAG's recommendation on the allocation of FERC Account 903 and fails to present the OAG's reasoning as to why MERC's current allocation method is not based on the principles of cost causation. MERC currently allocates Account 903 based solely on the number of customers in each class. The ALJ discussed MERC's argument that its allocation is reasonable because MERC is charged a flat rate by its customer service contractor. But the ALJ did not include any discussion of the OAG's response to MERC's argument. The OAG introduced studies conducted by other utilities in this jurisdiction on the cost of customer services which all indicated that different customer classes create different

levels of customer service costs.<sup>4</sup> This conclusion is supported by common sense: it likely costs more to produce services to a large business than it does to a single resident. MERC has the burden to prove that its allocation methods are reasonable, but MERC has produced no evidence that a resident, a small business, and a large business all create the same amount of costs. The OAG recommends that further findings be inserted to reflect the record in this case, and that the ALJ's recommendation be modified given that MERC has failed to meet its burden of proof on this issue.

643. The OAG responded to MERC's argument by noting that other utilities in Minnesota have conducted studies demonstrating that customer classes cause costs at different levels per customer. Based on this evidence, the OAG argued that MERC's current allocation method was not based on the principles of cost causation, and that MERC should be instructed to use a weighted customer cost allocator.<sup>5</sup>

644. MERC has not met its burden of proof to demonstrate that its customer service costs should be allocated based only on the number of customers in a class. The ALJ recommends that MERC allocate its customer service costs using a weighted customer allocator that measures how different customer classes cause customer service costs. In addition, the ALJ recommends that MERC be ordered to perform a study before filing its next rate case to determine how to weight customer service costs.~~MERC's allocation of Customer Records and Collection Expenses follow directly from its actual, arms-length transaction with Vertex, and is reasonable.~~

### **C. METER READING ALLOCATION.**

The ALJ incorrectly states the OAG's position on the allocation of FERC Account 902, which represents meter reading costs. While the OAG is no longer pursuing the issue in this

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<sup>4</sup> OAG Initial Brief, at 35–36.

<sup>5</sup> Ex. 158, at 20 (Nelson Surrebuttal).



case, the OAG does not agree that MERC's allocation is reasonable.<sup>6</sup> The OAG recommends that Finding 649 be updated to reflect the OAG's position.

649. The Department, ~~OAG-AUD~~ and MERC agree on MERC's allocation of Account 902: Meter Reading Expense.

### III. RATE DESIGN.

#### A. APPORTIONMENT.

The OAG takes exception to the ALJ's recommended apportionment, because the OAG believes that it is unreasonable to modify the apportionment structure on the basis of a class cost of service study that the OAG has demonstrated is flawed.<sup>7</sup> In addition to disagreeing with the ALJ's recommendation, however, the OAG takes exception to the ALJ's complete failure to acknowledge the OAG's recommendation on this issue. The purpose of the ALJ's report and recommendation is to describe what took place during the proceeding and present the recommendations of the various parties to the Commission. The ALJ failed to do so because the ALJ did not represent the OAG's recommendation or the reasoning behind its position. The OAG recommends that additional findings be inserted to represent the OAG's position and reasoning. The OAG believes that these new findings could be inserted following Finding 659.

659. The OAG recommended that any revenue increase be collected using MERC's existing revenue apportionment. The OAG noted that a CCOSS updated to incorporate the modifications suggested by Mr. Nelson and Mr. Lindell would show that residents are paying close to, or even greater than, 100% of costs under MERC's existing apportionment. For example, incorporating only Mr. Nelson's recommendation about reclassifying the Mains Account would reduce the residential class's cost of service by almost 2.5%, and reduce the revenue deficiency of the residential class by approximately 20%.<sup>8</sup>

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<sup>6</sup> Ex. 158, at 19 (Nelson Surrebuttal).

<sup>7</sup> OAG Initial Brief, at 58–59.

<sup>8</sup> OAG Initial Brief, at 58.

660. The OAG also reasoned that the myriad of flaws in MERC's CCOSS indicated that it was not accurate and should not be used for rate setting purposes. In particular, the OAG noted that the flaws it had identified with MERC's CCOSS had a tendency to overstate the costs caused by the residential and small C&I classes.<sup>9</sup>

661. Finally, the OAG identified several non-cost factors that supported using MERC's existing apportionment. The OAG noted that many members of the residential class have a limited ability to absorb rate increases because they are living on a fixed or limited income.<sup>10</sup>

Additionally, the OAG takes exception to the ALJ's recommendation because it is unreasonable to modify the apportionment based on a class cost of service study that is inaccurate, and recommends that Finding 660 be modified to reflect that any revenue increase should be collected using MERC's existing revenue.<sup>11</sup>

662. ~~The revenue apportionment agreed to by MERC and the Department is reasonable and should be adopted in this proceeding~~ not reasonable because it is based primarily upon a CCOSS that is inaccurate, and because it fails to take into account several non-cost factors. ~~MERC's proposed revenue apportionment summarized in Mr. Walters' Rebuttal Testimony, and reflected in SLP S 1 and SLP S 2 to Ms. Peirce's Surrebuttal Testimony, should be used to determine the final rate design after the Commission has determined the final revenue requirement. Because MERC has not met its burden of proof to show that its proposed apportionment is reasonable, the ALJ recommends that any revenue increase be collected using MERC's existing revenue apportionment.~~

## **B. CUSTOMER CHARGE.**

The OAG also takes exception to the ALJ's recommendation to increase the customer charge for both residential and small C&I customers. The OAG disagrees with the ALJ's

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<sup>9</sup> OAG Initial Brief, at 58–59.

<sup>10</sup> OAG Initial Brief, at 59.

<sup>11</sup> Based on the OAG's recommended modifications above, Finding 660 would become Finding 663.

recommendation, and also believes that the ALJ has not fully described the reasoning presented by the OAG's expert witnesses and briefs.

First, the ALJ did not describe the OAG's position that increasing the customer charge runs counter to the Commission's statutory requirement to "encourage energy conservation" to the "maximum reasonable extent."<sup>12</sup> A lower customer charge, by definition, will send stronger conservation price signals to customers and help achieve the conservation mandate established by the legislature.<sup>13</sup> The OAG recommends that a new finding be inserted to represent this position after Finding 665.

666. The OAG-AUD also noted that Minnesota Statutes section 216B.03 places on the Commission a statutory requirement to "encourage energy conservation" to the "maximum reasonable extent." According to the OAG-AUD, a comparatively lower customer charge would send a stronger conservation signal to customers.

Second, the ALJ's discussion of MERC's decoupling program is inconsistent and does not fairly represent the OAG's position. Findings 675 and 676, in which the ALJ discusses MERC's decoupling program, are located under the subheading Customer Charges for Larger Customers. There is no reason to limit the discussion about decoupling to the context of larger customers. For that reason, the OAG recommends that Findings 675 and 676 be moved to the discussion of residential customer charges, and suggests that they could be located immediately before the ALJ's Finding 666.

In addition, the OAG takes exception to ALJ Finding 676 because the ALJ has incorrectly stated that MERC does not have full decoupling. MERC does have full decoupling, as explained in the OAG's Initial Brief. As the Commission noted in MERC's 2010 rate case,

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<sup>12</sup> Minn. Stat. § 216B.03.

<sup>13</sup> OAG Initial Brief, at 60.

“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.”<sup>14</sup> MERC’s decoupling program *is* full decoupling, regardless of whether it includes the CCRC, is calculated on a use-per-customer basis, or is capped at any particular revenue. Finding 676 is incorrect, and the OAG recommends that it be modified to reflect the fact that MERC does have full decoupling, that the decoupling program stabilizes the company’s revenue, and that the revenue stabilization provided by decoupling indicates that the company does not also need to increase the customer charge to stabilize revenue.

667. The OAG-AUD recommended no increase to the customer charge for the Small C&I class. It maintained that any increase to the Small Commercial and Industrial customer charge is unnecessary because MERC has “full decoupling”; which assures collection of its fixed costs of providing service.

668. As noted by the Commission in MERC’s 2010 rate case, MERC does ~~not~~ have full decoupling for Small Commercial and Industrial customers. ~~MERC’s decoupling mechanism, which only applies to distribution revenues less the CCRC, is a use-per-customer calculation. The decoupling mechanism includes a 10 percent symmetrical cap on distribution revenues.~~ MERC’s full decoupling program provides the company with revenue stability, and, as such, the company has less need to increase customer charges in order to stabilize revenue.

The ALJ also failed to acknowledge the OAG’s response to the Company’s argument that an increased customer charge leads to level summer and winter bills. In its initial filing, MERC argued that a high customer charge has a leveling effect on winter and summer bills.<sup>15</sup> But, as the OAG pointed out in both direct testimony and in brief, a high customer charge “does not

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<sup>14</sup> 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).

<sup>15</sup> Ex. 40, at 13 (Walters Direct).

provide customers with any benefits that are not already mandated” by Minnesota law.<sup>16</sup> Customers already have access to a levelized monthly bill if they want it, because MERC offers an even payment plan as it is required to do.<sup>17</sup> As such, the OAG takes exception to Finding 669, and recommends that it be modified to reflect the fact that a high customer charge provides no benefit to customers who are interested in a level winter and summer bill. In addition, the OAG suggests that Finding 669 be modified to reflect the fact that MERC is provided sufficient revenue stability from its decoupling program, as discussed above.

669. MERC argues that a higher customer charge has a leveling effect upon winter and summer bills, provides better price signals to those customers who can respond to price signals, brings rates closer to the true cost of service, and provides incrementally more stable cash flow to the utility. However, as discussed by the OAG, MERC’s customers do not need a high customer charge to gain the benefit of a level winter and summer bill, and MERC gains significant revenue stability through its decoupling program.

Finally, the OAG takes exception to the ALJ’s recommendation on customer charges. It appears that the ALJ did not consider the OAG’s discussion of the need to encourage energy conservation or the OAG’s response to MERC’s argument about levelized bills. It also appears that the ALJ did not understand the basic facts of MERC’s decoupling program. Given that the ALJ did not take these facts into account, the OAG believes that the ALJ’s recommendation is not supported by the record. The OAG takes exception to Finding 670 and Finding 677, and makes the following recommendation:

670. Increasing the residential customer charge in the manner suggested MERC would further the Commission’s mandate to encourage conservation to the maximum reasonable extent. Given that MERC has significant revenue stability from its decoupling program, and taking into account the non-cost factors identified by the OAG-AUD, the ALJ recommends that there be no increase to

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<sup>16</sup> Ex. 150, at 41 (Adopted Direct Testimony of Chavez by Lindell).

<sup>17</sup> OAG Initial Brief, at 60.

~~the residential customer charge at this time. An increase in the residential customer charge to \$9.50 per month would move the residential customer charge closer to cost, reduce intra-class subsidies and not result in rate shock. The Administrative Law Judge recommends that the Commission approve MERC's proposal to increase the residential customer charge to \$9.50 per month.~~

677. The Administrative Law Judge finds that MERC's proposed increase to the customer charges for larger customers, including its proposal to increase the transportation administration fee is supported by the CCOSS. The Commission should adopt the proposed customer charges, as agreed to by MERC and the Department, with the exception of small commercial and industrial customers. Given that MERC has significant revenue stability from its decoupling program, and taking into account the non-cost factors identified by the OAG-AUD, the ALJ recommends that there be no increase to the small commercial and industrial customers customer charge at this time.

#### **IV. TRAVEL & ENTERTAINMENT.**

The OAG takes exception to the ALJ's recommendation on Travel and Entertainment expenses. The ALJ's description of the recommendations made by the OAG's witnesses and briefs is incomplete, and the ALJ's recommendation does not provide any consequence for MERC's failure to comply with the statutory requirements for reporting travel and entertainment expenses.

Minnesota Statutes section 216B.16, subd. 17 requires utilities to provide a list "separately itemizing all travel, entertainment, and related employee expenses." First, the OAG identified several individual travel and entertainment expenses that did not provide a sufficient description to justify rate recovery.<sup>18</sup> Descriptions such as "Supper in Michigan" or "Meal less

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<sup>18</sup> OAG Initial Brief, at 16–17.

than \$75” do not sufficiently explain the business purpose, and, therefore, do not comply with the statutory reporting requirements.<sup>19</sup>

Second, the ALJ’s findings also fail to describe the OAG’s recommendation related to membership dues. The OAG determined that MERC had requested recovery of \$63,245 in membership dues for the 2014 test year, but had not separately itemized the expenses as required by Minnesota Statutes section 216B.16, subdivision 17.<sup>20</sup> The OAG also determined that, based on prior Commission order, membership dues are recoverable “only to the extent that the activities they support directly benefit ratepayers.”<sup>21</sup> MERC has neither itemized the dues as required by statute nor met its burden to demonstrate that they directly benefit ratepayers.

The OAG also takes exception to the ALJ’s failure to fairly describe the OAG’s reasoning, the ALJ’s conclusion that it is reasonable to require ratepayers to pay for membership dues when MERC has not met its burden of proof, the ALJ’s recommendation to require ratepayers to pay for expenses which violated statutory reporting requirements, and the ALJ’s recommendation that MERC be permitted to recover expenses for which it did not sufficiently describe a legitimate business purpose. The OAG recommends that additional findings be inserted following Finding 696 to ensure that the OAG’s reasoning is fairly represented in the ALJ’s report.

697. The OAG identified that MERC’s travel and entertainment itemization was insufficient. MERC provided many business descriptions that did not provide any information about the purpose for the expense and that did not justify recovering the cost of the expense through rates.<sup>22</sup> The OAG recommended that MERC’s

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<sup>19</sup> *Id.*

<sup>20</sup> Ex. 151, at 24–25 (Lindell Direct); Ex. 152, Schedule JLL-10 (Schedules to Lindell Direct).

<sup>21</sup> In the Matter of the Application of Interstate Power Company for Authority to Increase its Rates for Electric Service in the State of Minnesota, Docket E-001/GR-91-605, 1991 WL 634712, at \*3 (Oct. 11, 1991).

<sup>22</sup> OAG Initial Brief, at 16–17.

travel and entertainment expenses be denied recovery because MERC had violated statutory reporting requirements.

698. The OAG also identified that MERC included \$63,245 in membership dues in the test year, but did not itemize them as required by statute or demonstrate that they directly benefited ratepayers as required by Commission precedent. The OAG recommended that the membership dues be denied.

The OAG also takes exception to the ALJ's recommendation that ratepayers be required to pay for travel and entertainment expenses that were not reported. MERC did not file separately itemized expenses that related to its affiliates, and in particular with Integrys Business Solutions.<sup>23</sup> The Department agrees that the expenses "should have been filed."<sup>24</sup> Despite the fact that the ALJ agrees with the OAG and the Department that the expenses should have been filed,<sup>25</sup> the ALJ found that it was reasonable for ratepayers to be required to pay for expenses which clearly violate Minnesota law. It is completely unreasonable to require ratepayers to pay for travel and entertainment expenses that violate Minnesota law, and that fact should not be ignored simply because it is difficult to determine the level of costs. Given that MERC has not reported the level of costs incurred from affiliates, the OAG recommended that the Commission use MERC's reported travel and entertainment expenses as a proxy for those expenses allocated from affiliates. The OAG recommends that Finding 699 be modified to reflect the fact that it is unreasonable for ratepayers to pay for travel and entertainment expenses that violate statutory reporting requirements:

699. Administrative Law Judge concludes that in future rate cases, travel and entertainment expenses that are allocated from MERC's service company must be submitted for review. Because MERC has not reported the level of these expenses, the ALJ recommends that the Commission use the reported level of travel

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<sup>23</sup> Ex. 152, JLL-9 (Schedules to Lindell Direct).

<sup>24</sup> Ex. 216, at 6 (LaPlante Surrebuttal).

<sup>25</sup> ALJ Report, Finding 699.



and entertainment expenses as a reasonable proxy for those expenses that were unreported.

The OAG also recommends that Finding 700 be modified because it is not reasonable for ratepayers to be required to pay for MERC's travel and entertainment expenses.

700. ~~The Administrative Law Judge finds that, subject to the modifications agreed to by MERC, the Company's travel, entertainment and other employee expenses are not reasonable and should not be approved in this rate case. The Company did not provide sufficient business purposes in its itemization, completely failed to itemize travel and entertainment expenses related to affiliates, and failed to itemize membership dues. As a result, it is not reasonable for ratepayers to collect the expenses from ratepayers. The ALJ recommends that \$284,725 in travel and entertainment expenses be denied. The ALJ recommends that membership dues in the amount of \$63,245 be denied. The ALJ finds that a further \$248,725 be excluded from recovery as a proxy for the travel and entertainment costs from MERC affiliates.~~

Furthermore, the OAG takes exception to ALJ Finding 321, which indicates that the ALJ believes MERC has removed all membership dues from the 2014 test year. The OAG raised the issue in direct testimony, and while MERC responded to other travel and entertainment issues, MERC did not argue that there were no membership expenses.<sup>26</sup> Additionally, responses to information requests introduced into the record by the OAG clearly demonstrate that MERC has included membership dues in the 2014 test year.<sup>27</sup> The OAG recommends that Finding 321 be removed, as it is factually inaccurate.

~~321. MERC has excluded all organization membership dues from the 2014 proposed test year. This adjustment reduces 2013 projected O&M expense by \$1,546. By removing this amount in 2013, these costs are also effectively removed from the 2014 proposed test year.<sup>28</sup>~~

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<sup>26</sup> Ex. 151, at 24–25 (Lindell Direct).

<sup>27</sup> Ex. 152, Schedule JIL-10 (Schedules to Lindell Direct).

<sup>28</sup> Ex. 19 at 22 and Schedule (SSD-11) (S. DeMerritt Direct).

## V. THE FINDINGS RECOMMEND AN EXCESSIVE RETURN ON EQUITY.

The record in this case supports a return on equity (“ROE”) substantially lower than the 9.79 percent recommended by the ALJ.<sup>29</sup> The ALJ’s recommendation, which was not supported by any of the three expert witnesses in this case, is based on an incomplete analysis of the record, a misunderstanding of witness testimony, and an overreliance on several irrelevant facts.

As a threshold matter, the ALJ rejected the OAG’s positions regarding several aspects of a proper ROE analysis, including whether floatation costs should be added to DCF results<sup>30</sup> and whether the dividend growth rate used in the DCF model should be based exclusively on earnings growth.<sup>31</sup> In addition, while not explicitly rejecting the OAG’s positions on other matters, the ALJ appears to have relied on the proxy group selected by the Department, the DCF analysis conducted by MERC, and the Department’s ECAPM and TGDCF analyses.<sup>32</sup> While the OAG takes exception to these specific findings and maintains that its analysis produces the most reasonable ROE for MERC, it will not repeat the points already made in testimony and briefing. The OAG urges the Commission to consider these issues as it reviews the full record in this proceeding.

Notwithstanding these issues, the Findings contain several critical flaws that lead to the ALJ’s excessive ROE recommendation. First, while the ALJ correctly concluded that “[t]he DCF model is a reasonable, market-oriented approach to determine a fair ROE for MERC,”<sup>33</sup> his recommended ROE is not the result of any party’s DCF analysis. Rather, the ALJ chose to recommend the result of the Department’s CAPM analysis after apparently concluding that

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<sup>29</sup> ALJ Report Finding 174.

<sup>30</sup> ALJ Report Findings 98–100.

<sup>31</sup> ALJ Report Findings 122–123.

<sup>32</sup> ALJ Report Finding 173.

<sup>33</sup> ALJ Report Finding 171.

Department witness Dr. Amit had not appropriately considered MERC’s risk profile when making his recommendation. Specifically, the ALJ concluded that the 9.29% ROE resulting from the Department’s DCF analysis—and recommended by Dr. Amit—understated the appropriate ROE for MERC “because MERC’s risk profile is higher than the comparison group used by the Department.”<sup>34</sup>

The record does not demonstrate, however, that MERC’s risk profile is higher than the Department’s comparison group or, for that matter, the comparison groups of any of the three ROE witnesses in this case. Rather, the ALJ’s conclusion that MERC’s risk profile is higher than these companies is based on a partial sentence in Dr. Amit’s Direct Testimony, taken out of context, that “MERC appears to be somewhat riskier than the [Department’s comparison group].”<sup>35</sup> But this partial sentence addressed only MERC’s financial risk—not its overall investment risk—and was based on an admittedly limited number of quantitative risk measures. With respect to business risk, Dr. Amit stated that MERC was “somewhat similar” to his comparison group.<sup>36</sup> Regarding MERC’s financial risk, Dr. Amit noted that, since MERC is a subsidiary of Integry’s, several measures of financial risk were not available.<sup>37</sup> Therefore, after reviewing the only quantitative risk measures available, the long-term debt ratios and equity ratios, Dr. Amit concluded that “. . . based on the *only available* market quantitative *financial risk* measures for MERC, MERC appears to be somewhat riskier than [the Department’s comparison group].”<sup>38</sup> Most importantly, when Dr. Amit considered business and financial risk together, he concluded that “. . . MERC’s investment risks are reasonably similar to the

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<sup>34</sup> ALJ Report Finding 172. Finding 172 also refers to the Department’s ROE recommendation of 9.40%, which was contained in Dr. Amit’s Direct Testimony. As Finding 169 indicates, Dr. Amit’s final recommendation was 9.29%.

<sup>35</sup> ALJ Report Finding 112, quoting Ex. 200, at 13 (Amit Direct).

<sup>36</sup> Ex. 200, at 12 (Amit Direct).

<sup>37</sup> Ex. 200, at 12 (Amit Direct).

<sup>38</sup> Ex. 200, at 12–13 (Amit Direct).

investment risks of the companies in my comparison group.”<sup>39</sup> Accordingly, the ALJ’s conclusion that Dr. Amit testified that MERC presented a greater investment risk than its peers is incorrect, and led to his unreasonable ROE recommendation.

Moreover, as the OAG explained in its Initial and Reply Briefs, several factors serve to lower MERC’s risk as compared to the companies in each party’s proxy group. Specifically, 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.<sup>40</sup> Further, each analyst’s proxy group contained several companies with substantial non-regulated business activities.<sup>41</sup> 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.<sup>42</sup> The ALJ ignored all of these factors from the record other than the non-regulated activities of comparable companies, which the ALJ characterized as presenting a very “different” risk profile than MERC.<sup>43</sup> If anything, the record demonstrates that MERC’s risk profile is likely *lower* than the companies included in the parties’ proxy groups. For these reasons, the ALJ’s decision to ignore the “reasonable, market-oriented approach” of using a DCF analysis because he believed Dr. Amit and other experts failed to consider MERC’s supposedly higher risk profile is unreasonable, and should be rejected.

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<sup>39</sup> Ex. 200, at 13 (Amit Direct).

<sup>40</sup> See OAG Initial Brief, at 23; OAG Reply Brief at 17. All of the companies contained in Dr. Chattopadhyay’s proxy group were contained in the Department’s comparison group relied on by the ALJ.

<sup>41</sup> See OAG Initial Brief, at 23; OAG Reply Brief at 17.

<sup>42</sup> Ex. 151, at 28–29 (Chattopadhyay Direct).

<sup>43</sup> ALJ Report Finding 117.

Second, the Findings refer to “Other Key Data Points” that the ALJ appears to have considered in making his ROE recommendation of 9.79%.<sup>44</sup> Specifically, the Findings note that eleven natural gas rate cases were resolved during the fourth quarter of 2013, and that the average awarded ROE for these cases was 9.83% while the range of ROEs awarded to these companies extended from 9.08% to 10.25%.<sup>45</sup> From this information, the ALJ appears to have concluded that his ROE recommendation of 9.79% is reasonable because it is “close to the average” of these eleven ROE determinations.<sup>46</sup> But the record does not demonstrate that using the average of eleven recent ROE decisions (or, for that matter, ten or twelve or any other number) is a suitable alternative to selecting a proxy group of companies with a comparable risk profile and performing a thorough analysis applying sound economic modeling. Nor does the record demonstrate that the average ROE of several recent rate case decisions can appropriately inform or even provide a “check” on the ROE awarded in this case.<sup>47</sup> Put simply, the record does not demonstrate that these eleven companies are similar to MERC in any way other than that they are also natural gas distribution utilities. Presumably, since one of these decisions awarded an ROE of 9.08% while another awarded an ROE of 10.25%, these companies have very different risk profiles from each other. The ALJ’s apparent conclusion that MERC’s specific risk profile falls near the average of these companies is simply an unsupported guess that is not supported by the record.

For these reasons, as well as the reasons set forth in the OAG’s Initial and Reply Briefs, the OAG recommends that the Commission reject the ALJ’s ROE recommendation and approve

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<sup>44</sup> See ALJ Report Findings 173(e), 167–169.

<sup>45</sup> ALJ Report Findings 167, 168.

<sup>46</sup> ALJ Report Finding 173(e).

<sup>47</sup> While the OAG referred to these eleven decisions in its Initial Brief, it did not suggest that these decisions can be used to determine or inform a reasonable ROE. Rather, the OAG referred to these decisions to rebut MERC witness Mr. Moul’s assertion that an ROE below 10% is *de facto* unreasonable. In addition, the OAG noted that the highest ROE awarded among these eleven decisions was 50 basis points below Mr. Moul’s recommendation.

an ROE for MERC consistent with the OAG's previous recommendations in this matter. Moreover, while the OAG does not agree that the Department's recommended ROE of 9.29% is reasonable, it acknowledges that this ROE would be preferable to the ALJ's recommendation, and better supported by the record in this case. To effectuate its recommendation, the OAG recommends that paragraphs 98, 99, 100, 116, 122, and 172-174 be removed from the Findings, and that other paragraphs be changed as follows:

97. On behalf of the OAG-AUD, Dr. Chattopadhyay persuasively explained why ~~asserts that~~ floatation costs should not be separated from MERC's ROE determination. Dr. Chattopadhyay ~~argues~~ explains that the DCF methodology already produces an upwardly biased ROE, in cases such as this, where the market-to-book ratio (M/B ratio) of comparable companies is greater than one. ~~In his view,~~ Inclusion of floatation costs is needed to counter-balance (and not further compound) the effects of the DCF model's upward bias.

112. Based upon his examination of 2012 common equity ratios and 2012 long-term debt ratios for companies in the NGCG and MERC, Dr. Amit concluded that the NGCG and MERC present similar investment risks, ~~although "MERC appears to be somewhat riskier than NGCG."~~

120. In his Surrebuttal Testimony, Dr. Amit ~~reasonably~~ updated the expected growth rate of dividends for companies in the NGCG by using the most recent available projected growth rates of Zacks, Value-Line and Thomson.

121. Dr. Chattopadhyay, on behalf of the OAG-AUD ~~argued~~ explained that, ~~that~~ because investors consider various factors when they price utility stock, it is reasonable to average expected earnings per share (EPS), dividends per share (DPS) and book value per share (BPS) to reflect investors' expectations of dividend growth rates.

123. ~~Likewise, a~~ Any inequality, during the short term, in the rates of growth of EPS, DPS and BPS is more appropriately resolved by incorporating each growth metric into an overall growth estimate, as done in Dr. Chattopadhyay's analysis. This methodology also considers the fact that different investors place different values on varying growth metrics. ~~assuming a~~

~~convergence of these rates over the long term than it is by an arithmetic averaging of the different rates today.~~

Finally, the OAG recommends that the Commission adopt the following paragraph in lieu of the ALJ's findings 172–174:

172. The Commission will approve a Return on Equity of 8.62 percent, as recommended by the OAG. This ROE is within the range of results from the DOCs analysis, takes into account the legitimate needs of the Company to attract capital and remain competitive while also resolving any questions in favor of ratepayers, as required by the legislature and the courts.

## **VI. THE ALJ'S RECOMMENDATION ON UNCOLLECTIBLE EXPENSES IS INCONSISTENT.**

MERC has requested recovery of \$1,765,884 in uncollectible expenses.<sup>48</sup> Both the OAG and the Department submitted testimony challenging MERC's calculation.<sup>49</sup> In forming his recommendation, the ALJ deviated from the recommendations of the Company, the OAG, and the Department. While the OAG recommends that the Commission adopt the OAG's recommended level of uncollectible expenses, the OAG also has concerns about apparent inconsistencies within the ALJ's method for calculating uncollectible expenses.

The ALJ recommended determining the average percentage of uncollectible expenses for the three most recent calendar years, and applying that percentage to MERC's forecasted tariffed revenues in order to estimate uncollectible expenses for the 2014 test year. The ALJ also recommended adding an "assumed rate increase of \$12,000,000" to MERC's forecasted tariffed revenues. This recommendation is at odds with the ALJ's final summary in this case, in which the ALJ indicates that "MERC's revenue deficiency is approximately \$3,300,164."<sup>50</sup> Based on the ALJ's conclusion that MERC is entitled to increase rates by only \$3.3 million, it is

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<sup>48</sup> Ex. 19, at 16–17 (DeMerritt Direct).

<sup>49</sup> Ex. 151, at 6–7 (Lindell Direct); Ex. 217, at 39 (St. Pierre Direct).

<sup>50</sup> ALJ Report, Conclusion 13.

unreasonable to assume a rate increase of \$12 million for purposes of calculating uncollectible expenses. The OAG takes exception to the ALJ's finding, and recommends modifying Finding 296 to represent MERC's reduced rate increase.

669. The Administrative Law Judge agrees with each of the parties, in part. In his view, the Commission should use the average percentage of tariffed revenue from the three most-recent years (2011, 2012 and 2013) and then apply this percentage to MERC's 2014 test year forecasted tariff revenues, plus an assumed rate increase of ~~\$12,000,000~~3,300,164. This method relies upon the most-recent figures, accounts for variability in the rates of uncollectible expense and best carries forward the Commission's earlier approaches to these issues.

## **VII. THE ALJ'S FINDING ON DEFERRAL OF ICE 2016 EXPENSES IS UNSUPPORTED BY THE RECORD.**

MERC has requested recovery of \$322,226 for expenses resulting from the ICE 2016 project to develop an internal customer service system.<sup>51</sup> The OAG objected to this recovery because the ICE 2016 project is not completed and is not used and useful. In Rebuttal, MERC offered to defer the costs of the ICE project as a regulatory asset until MERC's next rate case.<sup>52</sup> The ALJ recommends that the Commission accept MERC's offer, and the OAG agrees.<sup>53</sup> However, the ALJ also recommended that the Commission permit recovery of the ICE 2016 costs over a three-year period after the system has been implemented.<sup>54</sup> The OAG does not agree with this recommendation, and believes that it is not supported by the record.

The OAG's first concern is that the ALJ's finding appears to award MERC full recovery of the reported costs of \$322,226 plus all costs that are incurred in the future. This would be unreasonable, as MERC has not yet satisfied its burden to demonstrate that the expenses were

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<sup>51</sup> Ex. 19, at 16 (DeMerritt Direct).

<sup>52</sup> Ex. 24, at 25 (DeMerritt Rebuttal).

<sup>53</sup> ALJ Report, Finding 276.

<sup>54</sup> *Id.*



reasonable before requesting recovery. The OAG recommends that Finding 276 be modified to reflect that cost recovery will be determined at the time of MERC's next rate case.

The OAG's second concern is that the ALJ's finding establishes a three-year period for recovery, even though there is no testimony in the record demonstrating that a three-year period is reasonable. It may be more reasonable to recover the costs over another period, such as the length of time that the ICE project will be useful. Even the company did not recommend a recovery period, in that it simply mentioned that one potential period could be three years.<sup>55</sup> There is no record in this case to reach a reasoned conclusion as to the recovery period. The ALJ's recommendation to permit recovery over three years is not supported by the record, and the OAG recommends that Finding 276 be modified to reflect that the recovery period will be determined at the time of MERC's next rate case.

276. The Administrative Law Judge further recommends that the Commission accept MERC's conciliatory offer to defer recovery of the ICE 2016 costs and permit designation of ICE-related costs as a regulatory asset. The ALJ recommends that the reasonableness of the ICE 2016 costs and the period for recovery be determined at the time of MERC's next rate case. ~~and recovery of those costs from customers over a three year period after the system has been successfully implemented.~~<sup>56</sup>

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<sup>55</sup> Ex. 19, at 25 (DeMerritt Rebuttal).

<sup>56</sup> *Id.*

**VIII. CONCLUSION.**

For the foregoing reasons, the OAG specifically recommends that the Commission remove, modify, and insert Findings as recommended above.

Dated: August 25, 2014

Respectfully submitted,

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