MINNESOTA
PUBLIC UTILITIES COMMISSION

Staff Briefing Papers

Meeting Date	October 24, 2019	Agenda Item 5**
Company	Minnesota Energy Resources Corporation (MERC)	
Docket No.	**G-011/D-19-377**	
	In the Matter of the Petition of Minnesota Energy Resources Corporation for the Annual Review of Depreciation Rates for 2019	

Issues

1. Should the Commission approve MERC's proposed depreciation lives and rates effective January 1, 2019?
2. Should the Commission approve MERC's proposal to establish a one-percent threshold of total net depreciable plant at year-end to determine whether structures are depreciated as a part of the Major group or the Minor group in FERC Account 390, Structures & Improvements?

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Relevant Documents	**Date**
MERC – Initial Filing	May 31, 2019
Department - Comments	August 9, 2019
OAG - Comments	August 9, 2019
MERC – Reply Comments	August 28, 2019
Department – Response Comments	October 4, 2019

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The attached materials are work papers of the Commission Staff. They are intended for use by the Public Utilities Commission and are based upon information already in the record unless noted otherwise.

✓ **Relevant Documents**	**Date**
MERC – Additional Comments	October 11, 2019

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I. Statement of the Issues

Should the Commission approve MERC's proposed depreciation lives and rates effective January 1, 2019?

Should the Commission approve MERC's proposal to establish a one-percent threshold of total net depreciable plant at year-end to determine whether structures are depreciated as a part of the Major group or Minor group in FERC Account 390, Structures & Improvements?

II. Introduction

On May 31, 2019, MERC filed its annual review of depreciation rates and requested the Commission approve its proposed lives and rates effective January 1, 2019. If approved, the proposal would increase MERC's annual depreciation expense by approximately $310,600.

MERC also addressed the Commission's Order from MERC's last rate case which directed the Company to *"propose a set of depreciation practices and adjustments for the separate depreciation of large assets, like office buildings or to provide explanation why no such modification from the Company's depreciation practices is warranted or appropriate."*[1] The assets in question are accounted for in FERC Account 390, Structures and Improvements.

Using its newly proposed criteria where if a newly built or acquired structure is one-percent or greater of total net depreciable plant at year-end, MERC stated it would be appropriate to include the Rosemount Service Center in the Major grouping. MERC argued that this building is similar in size and nature to the Rochester Service Center which is currently the only building depreciated in the Major group. MERC would introduce use of a life span method coupled with an interim retirement curve for buildings within the Major group.

On August 9, 2019, the Department filed comments and concluded that MERC's proposed depreciation parameters and rates for all accounts other than Account 390 (Structures and Improvements) are reasonable.

The Department argued that MERC's proposed one-percent threshold is not necessary because building additions to MERC's system are infrequent and evaluating them on a case-by-case basis would not be unduly burdensome. The Department argued that gross plant value is only one of the many characteristics of a building and adherence to a one-percent rule ignores all other differentiating characteristics. Use of the one percent threshold in isolation may result in improper classification and depreciation of the asset.

The Department recommended the Commission require MERC to use a holistic approach to depreciate the Rosemount, Rochester, Cloquet, and Albert Lea Service Centers individually, as

[1] *In the Matter of the Application of Minn. Energy Res. Corp. for Auth. to Increase Rates for Nat. Gas Serv. in Minn.*, Docket No. G011/GR-17-563, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at Order Point 15, p. 49 (Dec. 26, 2018).

part of the Major group and to depreciate the other 18 buildings in Account 390 as members of the Minor buildings group.

On August 9, 2019, the OAG submitted comments and stated that MERC's proposed one-percent threshold to determine if a building should be depreciated as part of the Major group or the minor group is unreasonable because the method is based solely on the building's monetary relationship to other assets. The proposal does not consider the asset itself, its value and its characteristics. The OAG suggested that instead of the one-percent threshold, the Commission should require the Company to identify newly in-serviced buildings and existing assets with additional capital investments that exceed a book value of $1 million. This would trigger an evaluation of the asset and its characteristics and a discussion of whether the asset should be depreciated as part of the Major or Minor group.

Like the Department, the OAG recommended that the Commission require MERC to depreciate the Rosemount, Rochester, Cloquet, and Albert Lea Service Centers individually, as part of the Major group and to depreciate the other 18 buildings in Account 390 as members of the Minor buildings group.

Second, the OAG objected to the Company's proposed survivor curve which would be used as a basis to depreciate the Major group of structures.

On August 28, 2019, MERC filed Response Comments and maintains a one percent threshold to trigger a review of the assets is reasonable, but proposed addition conditions if the Commission were to adopt the OAG's recommendation of a $1 million threshold. MERC proposed depreciation parameters for use in Account 390. MERC requested deferred accounting for the increase in depreciation expense if the Department and OAG's recommendation is adopted. MERC opposed the OAG's recommendation to require MERC to evaluate its other assets for an individual, as opposed to group method of depreciation.

On October 4, 2019, the Department continued to argue that because building additions to MERC's system are infrequent, there is no need to have a triggering threshold and reviewing additions on an individual basis would not be unduly burdensome. The Department agreed with MERC's proposed depreciation parameters for use in Account 390. The Department agreed with the OAG's recommendation for further review of its large assets.

On October 11, 2019, MERC filed additional Reply Comments and continued to advocate for its initial proposal to individually depreciate buildings when they are newly acquired or constructed and will constitute at least one percent of the Company's total depreciable net plant. MERC continued to argue that the Major group should include the Rochester and Rosemount service centers and that it is not appropriate to include either the Albert Lea or Cloquet Service Centers in the Major group. If the Commission requires MERC to include Albert Lea and Cloquet in the Major group, MERC agreed with the Department's recommendation that the depreciation parameter's set forth in its response to the OAG's Information Request Number 11 are reasonable.

MERC does not agree with the OAG and the Department's recommendation to require MERC to file a summary of the largest individual assets booked to each of its plant accounts and an explanation of why group accounting is not appropriate for those assets. MERC argued that its assets in plant accounts outside of Account 390 are not conducive to individual depreciation and asked the Commission deny the recommendation.

III. Relevant Statutes and Rules

A. Minn. Stat. § 216B.11. Depreciation Rates and Practices.

The commission shall fix proper and adequate rates and methods of depreciation, amortization, or depletion in respect of utility property, and every public utility shall conform its depreciation, amortization or depletion accounts to the rates and methods fixed by the commission.

B. Minn. Rules, pts. 7825.0500 – 7825.0900. Depreciation Certification.

1. Minn. Rules, pt. 7825.0600, subp. 1. Depreciation Certification.

Depreciation practices applicable to all utilities. All electric and gas utilities shall maintain, and have available for inspection by the commission upon request, adequate accounts and records related to depreciation practices as defined herein. Each utility has the prime responsibility for proposing the depreciation rates and methods that will be used. The commission shall certify by order to the utility the depreciation rates and methods which it considers reasonable and proper. Any allocation or adjustment of the depreciation reserve will require specific justification and certification by the commission.

Either the utility may submit or the commission may request a petition for depreciation certification because of unusual circumstances or unique situations.

2. Minn. Rules, pt. 7825.0900. Petition for Certification Procedure (in part)

Depreciation rates and methods, once certified by order, are binding on all future rate proceedings and will remain in effect until the next certification or until the commission shall determine otherwise.

3. Minn. Rules, pt. 7825.0600, subp. 2 & 3. Depreciation Certification (in part)

[All utilities] shall: . . . review their depreciation rates annually to determine if they are still generally appropriate. Depreciation certification studies shall be made so that all primary accounts (class A & B utilities) or all functional groups of plant accounts (class C & D utilities) have been analyzed at least every five years.

IV. Background

A. Commission Practice

Depreciation methods, practices and rates are evaluated in depth once every five years in a depreciation study provided by the utility and then reviewed annually, usually in a request for certification of the remaining lives of the utility's assets. These stand-alone depreciation filings allow for a thorough examination of the Company's depreciation methods, practices and rates and set the utilities annual depreciation expense. This is important because utilities are highly capital intensive.

MERC is required to file comprehensive depreciation studies every five-years and an annual filing. MERC's last five-year depreciation study was filed in Docket No. G-011/D-17-442 (2017 Depreciation Docket). The five-year comprehensive study was used to set the rate currently in effect from MERC's last general rate case. Per MERC's request and due to the timing of the rate case, the Commission did not require the Company to file an annual depreciation study in 2018.

For all property accounts with the exception of Account 390, Structures and Improvements, the average service lives and salvage rates remain the same as those approved in the 2017 Depreciation Docket. The remaining lives have been updated to reflect a one-year passage of time adjustment and additions, retirements and transfers of plant. MERC has requested the Commission approve an effective date of January 1, 2019.

The Department reviewed MERC's filing for compliance with Minnesota rules, compliance with prior Commission Orders and the reasonableness of the proposed remaining lives, salvage rates and depreciation rates. The Department concluded that MERC has complied with Minnesota rules and prior Commission Orders and that the Company's depreciation parameters continue to be reasonable with the exception of Account 390, Structures and Improvements.

The OAG submitted comments and did not take a position or make a recommendation as to the reasonableness of MERC's proposed remaining lives, salvage rates and depreciation rates or compliance with Minnesota rules and prior Commission Orders. The OAG's comments focus on the treatment of Account 390, Structures and Improvements.

B. Account 390

Under Minn. Rule 7825.0020, Subp. 3 and Minn. Rule 7825.0300, Minnesota utilities are required to maintain their books and records in accordance with the Federal Energy Regulatory Commission's[2] Uniform System of Accounts (USoA). This account includes the cost in place of structures and improvements used for utility purposes, the cost of which is not properly includible in other structures and improvements accounts.

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[2] The rules refer to the Federal Power Commission (FPC). The FPC was dissolved in 1977 and superseded by the Federal Energy Regulatory Commission (FERC).

MERC has grouped its Account 390 and associated buildings into two subsets, the Major group and the Minor group. Currently, the Major group contains one asset, the Rochester Service Center which was placed in service in 2008. In this filing, MERC has proposed to include the brand new Rosemount Service Center in the Major group.

In the Major group, the asset is depreciated on a stand-alone basis. Buildings consist of large numbers of components and parts and it is not practical to separately track all of the components on an individual basis. The components, such as the heating, air, ventilation and cooling system, electrical wiring, roof, windows and doors, carpeting and tile, etc…, are typically inseparable from the building. This method is called composite depreciation and applies a single straight line depreciation rate and average useful life to the asset. Currently, there is only one building in the Major group, the Rochester Service Center.

In the Minor group, the asset is not depreciated on a stand-alone basis, the buildings and all of the component parts are grouped together and depreciated using one straight line depreciation rate and one average useful life which is applied to all of the assets within the group. MERC has approximately 20 service and work centers within this group.

C. MERC's 2017 Rate Case

Prior to the beginning of the 2018 test-year in MERC's last rate case (Docket No. G-011/GR-17-563), MERC built a new office building in Rosemount, Minnesota. MERC relocated its employees before the end of 2017 into the new Rosemount building from both a leased office space in Eagan and the "old" Rosemount building. The old Rosemount building was demolished sometime in April of 2018 and no longer met the standard of being used and useful on a going forward basis.

In the rate case, the Department and the OAG questioned whether group accounting was appropriate for large structures, such as MERC's office buildings and service centers. At issue in the rate case was the question of how to remove the "old" Rosemount building from rate base because the building was depreciated as part of the Minor group.

MERC argued that because the building was accounted for and depreciated as a group asset, the entries to remove the asset from rate base should also follow the procedure for group asset accounting. For accounting and ratemaking purposes using group depreciation, the asset is removed from the books at its original cost and an identical amount of accumulated depreciation is also removed. No gain or loss is ever recorded when grouped assets are disposed of.

The Department and the OAG disagreed that the office building is a group or mass asset and argued that its historical cost and associated accumulated depreciation needed to be adjusted to remove the asset from rate base. They argued an adjustment of approximately $1.1 million was needed to remove the asset completely from the test year rate base. The adjustment would be reflective of the building being depreciated as a stand-alone unit of property.

The Administrative Law Judge expressed doubt that group accounting for such large assets would be selected by the Commission in the first instance. The practice of including costly, operationally distinct and non-fungible items, under the banner of a single category, reduces the transparency of the costs of "furnishing [utility] service, including adequate provision for depreciation of . . . utility property used and useful in rendering service to the public. . . ."[3]

The ALJ cited the text of Minn. Stat. § 216B.16, subd. 6, which also makes it clear that "appropriate depreciation" is due on each item of capital that it placed into service of the public – and is rendered in some circumstances even after the useful life of the asset. The statute reads:

> In determining the rate base upon which the utility is to be allowed to earn a fair rate of return, the commission shall give due consideration to evidence of the **cost of the property when first devoted to public use**, to prudent acquisition cost to the public utility **less appropriate depreciation on each** . . . and to other expenses of a capital nature. **For purposes of determining rate base, the commission shall consider the original cost of utility property included in the base**. . . . If the commission orders a generating facility to terminate its operations before the end of the facility's physical life in order to comply with a specific state or federal energy statute or policy, the commission may allow the public utility to recover any positive net book value of the facility as determined by the commission.[4]

The ALJ stated that Implementation of the Department's and the OAG's proposal to exclude $1,107,671 of net book value from the test year rate base, would not result in "appropriate depreciation" as those words are used in Minn. Stat. § 216B.16, subd. 6. It is not reasonable to apply group depreciation when calculating the net book value of the asset without also applying group depreciation standards to the retirement of this asset.[5]

The Commission agreed with the ALJ's recommendation, and authorized MERC to reduce the asset and depreciation reserve accounts as the Company had proposed. However, the Commission agreed that the Department and OAG raised an important issue about whether using group accounting is an appropriate accounting practice for large assets like office buildings. The Commission required[6] MERC, in the earlier of its next (1) rate case or (2) depreciation filing, to propose accounting practices and adjustments that would separately depreciate these assets, or to explain why no change from its current accounting practice is warranted or appropriate.

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[3] Minn. Stat. § 216B.16, subd. 6.

[4] Id (emphasis added).

[5] See id. See also Ex. MERC-45 (Gas Plant Instructions).

[6] *In the Matter of the Application of Minn. Energy Res. Corp. for Auth. to Increase Rates for Nat. Gas Serv. in Minn.*, Docket No. G011/GR-17-563, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at Order Point 15, p. 49 (Dec. 26, 2018).

V. MERC's Proposal in this Docket

In the Commission's Order in the Company's last rate case, MERC was required to *"propose a set of depreciation practices and adjustments for the separate depreciation of large assets, like office buildings or to provide explanation why no such modification from the Company's depreciation practices is warranted or appropriate."* In compliance with the Order, MERC proposed to include new buildings in the Major grouping when they are newly acquired or constructed and will constitute at least one percent of the Company's total depreciable net plant based on the most recent year-end balance at the time of the addition. If the new building is less than one percent of depreciable plant, the building will be depreciated as part of the Minor building group.

MERC stated that at the end of 2018, the one-percent threshold would be approximately $3.5 million, or roughly one percent of $350.6 million in total depreciable net plant. MERC stated that by establishing a materiality threshold for Major buildings, it will avoid the unnecessary administrative burden of individual depreciation of many small, dispersed assets.

MERC proposed to categorize its new Rosemount Service Center as a Major building and depreciate it on an individual basis as its gross plant value is roughly $6.9 million and above the one-percent threshold. The remaining 20 buildings booked to Account 390 will continue to be depreciated in the Minor building group. MERC's proposal is shown in Table 1.

MERC's Proposal
Assets by Location & Cost
Table 1[7]

	Book Cost	% Of Acct 390
Major Grouping:		
Rochester Service Center	$3,241,517	
Rosemount Service Center	6,949,317	
Major Grouping Total	**$10,190,834**	52%
Minor Grouping:		
Albert Lea Service center	$1,340,956	
Bemidji Service Center	466,052	
Bemidji Warehouse	122,184	
Caledonia Work Center	591,870	
Chatfield Operations Building	319,773	
Cloquet Service Center	3,140,175	
Crosby Work Center	84,948	
Detroit Lakes Work Center	111,600	
Eveleth Work Center	369,467	

[7] May 31, 2019, MERC Initial Filing, Attachment 3, page 6. Note: there is a slight differences in the total due to Staff rounding.

	Book Cost	% Of Acct 390
Fairmont Service Center	640,994	
Grand Rapids Work Center	408,604	
International Falls Work Center	290,952	
Pine City Service Center	293,275	
Roseau Work Center	61,247	
Silver Bay Work Center	29,948	
Staples Work Center	13,373	
Thief River Falls Work Center	230,972	
Wadena Work Center	200,023	
Warroad Work Center	229,919	
Worthington Service Center	415,768	
Minor Grouping Total	**$9,362,100**	48%
Account 390 Total	**19,552,934**	

MERC stated that it proposed to include the Rosemount Service Center in the Major grouping because it is similar in size to the Rochester Service Center and, both buildings are recent additions to their system. Additionally, the two structures should remain in the Major grouping and depreciating them as separate units ensures that the Company is not changing its longstanding depreciation practices during the course of the life of the building. MERC states that this is important because the Company's past and current practices were consistent with GAAP and approved by the Commission through several annual depreciation filings.

MERC stated that these two buildings comprise $10.2 million, or 52% of the total book costs of Account 390. This is important because these structure represent a disproportionate share of the property booked to Account 390. Depreciating them separately from the structures in the Minor group would allow for an evaluation of the Major assets during routine depreciation studies. This would allow for appropriate adjustments to the depreciation parameters of the Major assets as circumstances are re-evaluated.

The Company noted that it has included the Cloquet Service Center in the Minor group. At $3,140,175, Cloquet represents a relatively large investment within Account 390. MERC stated that upon further examination, the initial investment in Cloquet was recorded in 1980 and an addition to the building was recorded in 1992. MERC stated that the remaining life attributes of the Minor group are representative of the Cloquet Service Center. Keeping the Cloquet Service Center in the Minor group is consistent with longstanding depreciation practices for this property. MERC stated that as a result, there is no need to separately depreciate the Cloquet building.

MERC proposed depreciation parameters for structure in both the Major and the Minor groups.

VI. Parties' Comments

A. Depreciation Method

1. MERC

MERC proposed to include new buildings in the Major grouping when they are newly acquired or constructed and will constitute at least one percent of the Company's total depreciable net plant based on the most recent year-end balance at the time of the addition. If the new building is less than one percent of depreciable plant, the building will be depreciated as part of the Minor building group.

2. Department

The Department expressed concerns with aspects of the Company's proposal. First, because building additions are infrequent, the Department proposed to evaluate them on a case-by-case basis. The Department stated individual evaluation of additions would not be unduly burdensome and would make MERC's one-percent rule unnecessary. The Department argued that adherence to the one-percent rule would ignore all other potential differentiating characteristics of a building. If the one-percent rule is used as the only determining factor, it may result in the inappropriate inclusion of a building with unique life and operational characteristic in either the Major or the Minor building group.

3. OAG

The OAG objected to MERC's proposed one-percent threshold to determine if a building should be depreciated as part of the Major group or the Minor group. The OAG argued the proposal is unreasonable because the method is based solely on the monetary relationship to other assets. The proposal does not consider the asset itself, its value and its characteristics. The OAG suggested that instead of the one-percent threshold, the Commission should require the Company to identify newly in-serviced buildings and existing assets with additional capital investments that exceed a book value of $1 million. This would trigger an evaluation of the asset and its characteristics and a discussion of whether the asset should be depreciated as part of the Major or Minor group.

4. MERC

MERC stated its proposal is reasonable and applies an objective standard to evaluate newly acquired or newly built structures when they constitute at least one percent of the Company's total depreciable plant. MERC stated that its proposal is preferable to the OAG's fixed dollar threshold of $1 million and the Department and OAG's subjective determination based upon an assets "characteristics."

MERC stated that if the Commission adopts the OAG's recommendation of a $1 million threshold, then further refinements are needed to recognize the impacts of inflation and exclude the impacts of periodic replacements. MERC proposed the following: [8]

1) The threshold should be adjusted annually to recognize the impact of year-over-year increases in the cost of construction. The Handy-Whitman Index of Public Utility Construction Costs is published annually, is widely used by utilities, and can be applied to inflate the threshold in future years. MERC would propose to use the North Central Region Gas Utility Construction January 2019 Structures and Improvements Index of 585 as the baseline index for this purpose.

2) The threshold should be applied at the time of acquisition or construction based upon the original cost of the building.

    a. Improvements may be made to existing buildings that result in the building's book value exceeding the threshold where those improvements are ongoing replacements expected to occur throughout the building's life such as replacements of roofs, HVAC equipment, etc. Such routine improvements do not extend the life of the building per se. Rather, such routine improvements are necessary repairs to keep the building in normal operation and should not cause a building to be reclassified from group depreciation to separate depreciation.

    b. In contrast, improvements resulting from an increase in the overall building footprint due to a building addition may be appropriate for consideration.

5. Department

In its Response Comments, the Department states that while it "understands MERC's concern, the Department maintains its position that a strict test would be unnecessarily limiting and that building additions are rare enough that reviewing them on a case-by-case basis will not be overly burdensome."[9]

6. MERC

In its additional Reply Comments, MERC argued that the Department's recommendation to allow ad hoc case-by-case review of the application of group or composite depreciation invites opportunistic proposals that could result in MERC being disallowed the ability to fully recover the costs of its reasonable, prudent, and necessary investments in utility plant. Such proposal is at odds with Minn. Stat. §216B.16, subd. 6, which requires the Commission to give due consideration to the need of the public utility for revenue sufficient to enable it to meet the cost of furnishing the service, including adequate provision for depreciation if its utility property

[8] MERC Reply Comments, page 4.

[9] Ibid, page 3.

is used and useful in rendering service to the public. MERC stated its proposed objective standard would ensure a consistent evaluation based upon a reasonable materiality standard that reflects changes over time.[10]

MERC argued that its method of recording and reporting of depreciation accruals and reserves is consistent with the explicit provisions of the Commission's regulations. Minn. R. 7825.0600 provides that Class A and B utilities (1) maintain continuing property records; (2) record depreciation accruals and reserves by functional group of plant accounts (e.g., distribution property) or on an optional basis, by primary plant account (e.g., meters) for corporate ledger and balance sheet supporting schedule purposes; (3) retain data in sufficient detail to conduct depreciation certification studies for the purpose of determining depreciation accruals and reserves by primary plant account; and (4) review their depreciation rates annually to determine if they are still generally appropriate. Attempting to allocate depreciation accruals and reserves to each particular asset is inconsistent with the nature of group or composite accounting and at odds with the specific requirements set forth in applicable Minnesota rules. The entire basis of group and composite accounting is to address those situations where it is impractical to separately track each individual asset or component and part. [11]

MERC also believes its concerns regarding the potential burden of an open-ended case-by-case evaluation are legitimate and supported. Given that the OAG recommended review for incremental investments to existing building locations and the Department is now advocating additional review of assets outside of Account 390 Structures and Improvements. The Company believes the establishment of a clear, bright line, objective standard, is necessary and appropriate to avoid the substantial expenditure of resources that would occur through a case-by-case assessment. Further, a clear standard ensures MERC is provided with the opportunity to recover its actual reasonable and prudent depreciation expense for utility investment by treating assets consistently throughout their lives and at retirement.[12]

7. Staff Analysis

Staff agrees with the Department's recommendation that newly acquired, constructed or significantly remodeled buildings are infrequent enough that review on a case-by-case basis would not impose a significant burden to interested parties. This is the most transparent option presented to the Commission in this docket.

Staff disagrees with MERC's argument that a case-by-case review would invite opportunistic proposals that could result in MERC being disallowed the ability to fully recover the costs of its reasonable, prudent, and necessary investments in utility plant and that the proposal is at odds with Minn. Stat. §216B.16, subd. 6. The Department's proposal to review these buildings on an individual basis is in-line with the statute which requires *"the Commission to give due consideration to the need of the public utility for revenue sufficient to enable it to meet the cost*

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[10] October 11, 2019, MERC Additional Reply Comments, page 2.

[11] Ibid.

[12] Ibid.

of furnishing the service, including adequate provision for depreciation if its utility property used and useful in rendering service to the public."

Staff disagrees with MERC's argument that the *"establishment of a clear, bright line, objective standard, is necessary and appropriate to avoid the substantial expenditure of resources that would occur through a case- by-case assessment."* Staff believes a case-by-case assessment is appropriate and that MERC's proposal could also be argued against by interested parties and require "substantial expenditures of resources." For example, if the Commission were to adopt MERC's proposal of using a one-percent threshold of total net depreciable, this does not preclude parties from arguing against use of the proposal in a future proceeding based on the characteristics of a building.

B. Rosemount Service Center

The Department and the OAG indicated their agreement with MERC's proposal to depreciate the Rosemount building in the Major building group. MERC will assign the Rosemount Building to its own group and depreciate it on an individual basis.

C. Cloquet Service Center

The Department and the OAG recommend the Cloquet Service Center be depreciated as a part of the Major Group. MERC maintains its position that Cloquet should continue to be depreciated as part of the Minor group.

1. Department

The Department disagreed with MERC's monetary threshold because it would cause the Cloquet Service Center to be depreciated as part of the Minor group. The Department stated that while Cloquet may be similar to the other buildings in the Minor building group, its gross plant value is $3.1 million and 16.1 percent of Account 390's total gross plant balance. An early retirement could have a significant impact on the accounts depreciation expense. Cloquet is essentially equal in size to the Rochester Service Center, which MERC has proposed to depreciate separately. Cloquet's gross plant value is also significantly larger than the Old Rosemount Office Building's gross plant value of $1.7 million. The treatment of the Old Rosemount building triggered the review of MERC's depreciation practices. Based on size alone, the Department concluded that Cloquet should be depreciated individually.

2. MERC

In response to a Department Information Request, MERC stated, "*Additionally, keeping the Cloquet Service Center in the minor grouping is consistent with longstanding depreciation practices for this property. As a result, there is no need to separately depreciate this building*."[13] The Department disagreed with MERC's reasoning that because Cloquet has been included in

[13] May 31, 2019, MERC Initial Filing, Attachment 3, page 8.

the Minor group in the past, it should remain in the Minor group going forward. The Department stated that in the Company's 2017 Rate Case, the Commission Ordered MERC to review its depreciation based on concerns that its existing practices are not reasonable.

3. Department

The Department stated it would not object to Cloquet being depreciated in either the Major or Minor group, but it has to be reasonable to include the property in either group.

> In the Department's view,
>
> "What matters is that 1) the assumed average service life for the group is appropriate for Cloquet, and 2) an unexpected early retirement of Cloquet wouldn't have a significant impact on the group's depreciation expense. While the former is likely true, the latter, given Cloquet's size relative to the rest of the buildings in Account 390, is not. Therefore, the Department recommends that the Commission require MERC categorize the Cloquet Service Center as a major building and depreciate it on an individual basis.[14]

4. OAG

The OAG argued that because the Cloquet building is older in age, and more likely closer to being replaced than the Rochester or Rosemount Service Centers, this building should be depreciated individually so that any shortfall identified in this time period can be recovered from ratepayers while the building is still used and useful.

5. MERC

In its additional Reply comments, MERC stated that it opposes moving Cloquet to the Major Group to depreciate the structure individually. MERC argued that its proposed one-percent test provides a reasonable and objective standard to determine which group a building should be depreciated. Cloquet does not meet the proposed standard.

6. Staff Analysis

Staff agrees with the Department and the OAG that the Cloquet Service Center should be depreciated as a part of the Major group in Account 390.

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[14] Department Comments dated August 9, 2019, page 9.

D. Albert Lea Service Center

1. Department

The Department and the OAG recommend the Albert Lea Service Center be depreciated as a part of the Major Group. MERC maintains its position that Albert Lea should continue to be depreciated as part of the Minor group.

The Department stated that the Albert Lea Service Center has a gross plant value of $1.3 million and that the value is close to that of the "old" Rosemount Office Building. Based on this reason, the Department concluded the Albert Lea Service Center should be depreciated in the Major group.

2. OAG

The OAG argued that because the Albert Lea building is older in age, and more likely closer to being replaced than the Rochester or Rosemount Service Centers, this building should be depreciated individually so that any shortfall identified in this time period can be recovered from ratepayers while the building is still used and useful.

3. MERC

MERC stated that it opposes moving Albert Lea to the Major Group to depreciate the structure individually. MERC argued that its proposed one-percent test provides a reasonable and objective standard to determine which group a building should be depreciated. Albert Lea does not meet the proposed standard.

4. Staff Analysis

Staff agrees with the Department and the OAG that the Albert Lea Service Center should be depreciated as a part of the Major group in Account 390.

E. Depreciation Parameters

The Commission will need to set lives, salvage rates and beginning depreciation reserve amounts for the Rochester and Rosemount Service Centers if it approves MERC's proposal. If the Commission approves the Department and the OAG's recommendation to depreciate the Cloquet and/or Albert Lea Service Centers as part of the Major group in Account 390, than the Commission will need to set lives, salvage rates and beginning depreciation reserves for Cloquet and Albert Lea. Changes to the Minor group will need to be reflected as well. MERC and the Department agree on the proposed depreciation parameters. In Comments, the OAG disagreed with MERC's proposal.

1. MERC

MERC proposed the use of a life span coupled with an interim retirement curve for the buildings included in the major grouping. The life span method models retirements for depreciation expense and rate calculations assuming the remaining assets at a location will be retired simultaneously at a specific date or at the end of a period of time. The incorporation of an interim retirement component is necessary as the retirement of individual assets within the location will occur prior to the retirement of the overall group. The interim survivor curve is based on the dispersion pattern of assets within the group while the assets are in service. In the case of structures, this includes doors, roofs, windows, electrical systems, HVAC equipment, etc. MERC stated it determines this component through historical analysis and informed judgement.[15]

MERC proposed to assign the Account 390 book reserve[16] to the location (Major group) or Minor group level. MERC calculated the book reserve based on all prior depreciation accrual rates, retirements, cost of removal, and gross salvage from the date of first installation to December 31, 2018. As of December 31, 2018, the total Account 390 book reserve was $2,578,287.

MERC proposed to assign a total of $613,745 of book reserves to the Major group. MERC based its calculation on the 2008 construction of the Rochester Service Center, 2017 construction of the Rosemount Service Center and a 55-year life span of each service center. MERC assumed use of the 75-R2.5 interim survivor curve, and negative 10% net salvage value. MERC stated that the assignment of the actual book reserve proportionately allocated to the theoretical reserve[17] while maintaining past recovery patterns without changing total rate base insures appropriate future recovery consistent with the life parameters.[18] This amount is determined as a ratio of 68 percent of the theoretical reserve of these two facilities.

In a similar fashion, the minor structures with vintages 1965 through 2018, totaling $9.4 million in plant, a 45-R2 survivor curve, negative 10% net salvage, and 68 percent book reserve to theoretical reserve.

For the major structures, MERC proposes to separately depreciate the Rochester Service Center with a depreciation rate of 2.30 percent and the Rosemount Service Center with a depreciation rate of 2.15 percent. MERC proposes to continue depreciating the remainder of the assets within Account 390 together using a depreciation rate of 2.90 percent.[19]

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[15] May 31, 2019, MERC Initial Filing, Attachment 3, page 7.

[16] The book reserve reflects the portion of the cost of existing plant that has been expensed. For ratemaking purposes, this is considered the "return of" investment and is no longer available to earn a "return on" investment.

[17] Ibid.

[18] Ibid.

[19] Ibid.

MERC proposed the following parameters if the Commission decides to require MERC to include Cloquet and Albert Lea in the Major Grouping.

Depreciation Parameters and Rates for Major and Minor Buildings from MERC's Response OAG IR 11

Depreciable Unit	Proposed Probable Retirement Year	Life Span (Years)	Remaining Life (Years)	Survivor Curve	Interim Survivor Curve	Net Salvage Rate (%)	Depreciation Rate (%)
Major Buildings							
Rosemount	2072	55	50.1	n/a	75-R2.5	-10	2.15
Rochester	2063	55	41.5	n/a	75-R2.5	-10	2.32
Cloquet	2035	55	16.0	n/a	75-R2.5	-10	4.46
Albert Lea	2072	55	50.1	n/a	75-R2.5	-10	2.15
Minor Buildings Group	n/a	n/a	34.5	45-S0	n/a	-10	2.74

2. Department

The Department concluded that using a probable retirement year of 2035 for the Cloquet Service Center would be reasonable, and that the likely impact of any future adjustments should be small enough that they would not have significant negative impacts on either the Company or its ratepayers. For this reason, the Department recommended that the Commission approve the depreciation parameters and rates as proposed by MERC.

3. OAG

The OAG argued that MERC has selected the wrong interim survivor curve to determine the depreciation rate for the Rochester and Rosemount Service Centers. The OAG argued[20] that MERC's proposal is unreasonable because the Company's analysis does not support a survivor curve that is different from the survivor curve used in the last depreciation filing for the Major grouping. That survivor curve was selected based on a historical analysis of the amount of plant retirements for each age interval in a given time period.[21] The Company's historical analysis for the major grouping for FERC Account 390 is the same as it has provided in this proceeding.[22] Although the Company uses the same data points, it has proposed two different survivor curves that impact the remaining life calculation differently in each case. The Company used the

[20] August 9, 2019, Comments of the Office of the Attorney General, page 4.

[21] *In the Matter of the Application of Minnesota Energy Resources Corporation for Approval of its 2017 Five-Year Review of Depreciation Certification*, Docket No. G-011/D-17-442, PETITION at Exhibit 1 (May 31, 2017).

[22] Exhibit B.

survivor curve 55-R3 in its last depreciation proceeding.[23] It is now requesting to use the survivor curve 75-R2.5 in the instant proceeding. The effect is that the remaining life and associated depreciation rate will now be based on a survivor curve that predicts less of the individual building components will be retired at the end of the building's 55-year life span. This slows down the recovery of the cost of the building from ratepayers during the life of the building, and decreases depreciation expense in the instant proceeding.[24]

The OAG argued that the proposal has the potential to harm ratepayers because it creates a discrepancy between the theoretical reserve and the actual reserve collected from ratepayers. This difference is called the theoretical reserve imbalance and is a benchmark on how the current depreciation parameters (service life and net salvage estimates, which were approved at the last depreciation certification) compare to the actual reserves collected from ratepayers. This imbalance suggests that previous depreciation parameters were inaccurate, and that the depreciation expense collected from ratepayers in the past has been too low. [25]

While this imbalance exists temporarily at the specific point in time that it is calculated, there was also a theoretical reserve imbalance in the previous 2017 depreciation proceeding. The long term effect of not collecting sufficient reserves from ratepayers while an asset (in this case a building) is used and useful is that it can lead to stranded costs when the building is taken out of service (whether that occurs at the end of its useful life or earlier). The outcome would likely be the same as in the Company's last rate case. In that proceeding, the old Rosemount headquarters building required reserves from other assets that are still in-service to be transferred out in order to cover reserve shortfalls. This causes intergenerational inequities and results in ratepayers paying for an asset that is no longer used and useful.

The OAG argued that the Company's proposal to use survivor curve 75-R2.5 is not appropriate because the current survivor curve of 55-R3 follows a shorter remaining life, and therefore exacerbates the existing theoretical reserve imbalances. The Company should use a shorter remaining life for the major grouping such as the curve used for the minor grouping of 45-R2. This would be reasonable because the selection of the survivor curves and resulting depreciation rates do not need to (and should not be) based strictly on statistical modeling. The selection process should take into consideration recent Company behavior, industry practices, and informed judgment. [26]

The OAG argued that in addition the theoretical reserve imbalance in the major grouping of FERC Account 390 – Structures and Improvements, there are theoretical reserve imbalances in

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[23] *In the Matter of the Application of Minnesota Energy Resources Corporation for Approval of its 2017 Five-Year Review of Depreciation Certification*, Docket No. G-011/D-17-442, PETITION at Exhibit 1 (May 31, 2017).

[24] Petition at Attachment 1, Statement 2A.

[25] August 9, 2019, Comments of the Office of the Attorney General, page 5.

[26] Ibid.

the minor grouping of the same FERC account.[27] As with the major grouping, this imbalance is the result of the survivor curves that were previously selected and used lower depreciation rates than they should have. Since the Company previously used a group depreciation rate for all assets in FERC Account 390 – Structures and Improvements, this composite depreciation rate is one of the factors that caused this imbalance. This is because a composite depreciation rate calculated using the depreciation rates from each of the different curves for both the minor and major groupings has led to a weighted average depreciation rate that is lower than it would be if the groupings were depreciated separately. [28]

The OAG recommended that if the Commission does not require the Company to use the shorter remaining life from the 45-R2 survivor curve, it should, require the Company to use the same survivor curve of 55-R3 that was approved for the major grouping in its most recent depreciation filing.[29]

4. MERC

In response to the OAG, MERC stated that the proposed 55 year life span and 75-R2.5 interim survivor curve are appropriately supported by consideration of MERC's experience, industry practice, and informed judgment with respect to the specific assets being evaluated.[30]

- MERC's proposed methodology includes two components to model depreciation expense and rate calculations—a life span and an interim retirement curve. The life span models retirements assuming the remaining assets at a location will be retired simultaneously at a specific date or at the end of a period of time. The end of life is when the structure is economically in need of replacement due to functionality, condition, etc.[31] The Company employed an estimated end of life of 55 years for this purpose based on the Company's historic experience.[32]

- The Company used an interim survivor curve component to model retirements knowing that certain building assets (i.e., doors, roofs, HVAC equipment, etc.) will experience replacement prior to the retirement of the overall building. Based on an expected dispersion pattern of assets within the group while the assets are in service, the Company employed a 75-R2.5 survivor curve to represent the physical life characteristics for the 55 years until the rehabilitation or closure of the building is expected.[33]

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[27] Exhibit C.

[28] Ibid, page 6.

[29] Ibid.

[30] Ibid.

[31] See MERC's Response to Department Information Request No. 4, included as Attachment A to these Reply Comments.

[32] August 28, 2019, MERC Reply Comments, page 7.

[33] Ibid.

MERC argued that the 55-R3 survivor curve that had been approved in MERC's prior two depreciation studies for the major grouping of Account 390 was based solely on the Rochester Service Center. Because the Rochester Service Center was the only building in the grouping, had a recent vintage, and limited historical retirement activity, more limited data was available for the establishment of that survivor curve. [34]

MERC's proposed 55 year life span coupled with a 75-R2.5 interim survivor curve more accurately reflects the life characteristics of the larger service centers. The life characteristics of a large service center include the physical life of the components of the building while in service from year to year and the end of life when the structure is economically in need for replacement due to functionality or condition. The 75-R2.5 survivor curve represents the physical life characteristics for the 55 years until rehabilitation or closure of the building is expected.[35]

MERC stated that the OAG's claim that the 55-R3 survivor curve follows a shorter remaining life than MERC's proposed 75-R2.5 truncated survivor curve at 55 years is incorrect and reflects the OAG's general misunderstanding of depreciation parameters.[36]

MERC provided the table below to compare the attributes for the Rochester and Rosemount Service Centers which the Company proposed to depreciate individually. As reflected in the table, the vintage year remaining life presented for the 75-R2.5 truncated survivor curve with a life span of 55 years is shorter than those for the same vintage year for the 55-R3 survivor curve and thereby results in increased depreciation expense, contrary to the OAG's claim.[37]

Table 2: Remaining Life Comparison[38]

	Rochester Service Center	
Year	75-R2.5 Remaining Life	55-R3 Remaining Life
2008	41.53	44.82
2012	42.04	48.65
2014	42.27	50.59

[footnotes omitted]

	Rosemount Service Center	
Year	75-R2.5 Remaining Life	55-R3 Remaining Life
2017	50.12	53.52

[footnotes omitted]

[34] Ibid.

[35] Ibid

[36] Ibid.

[37] Ibid

[38] Ibid, page 8.

In further response to the OAG's assertion that the 75-R2.5 survivor curve is unsupported, MERC's consultant, Gannett Fleming, concluded as part of its analysis from OAG Information Request No. 11 that historical activity including all four buildings does support the selected 75-R2.5 interim survivor curve.[39]

Finally, the OAG argues the Company should use an even shorter remaining life from what was approved in Docket No. G011/D-17-442 for the major grouping, such as the 45-R2 survivor curve used for the minor grouping. The OAG's proposal to use a 45-R2 survivor curve would arbitrarily shorten the life of the major grouping, causing even higher depreciation rates and resulting depreciation expense. Despite advocating that selection of an appropriate survivor curve should take into consideration "recent Company behavior, industry practices, and informed judgment,"[40] the OAG provides no support for its recommendation of applying the minor grouping's survivor curve for the major grouping.[41]

Because the OAG's suggestion is unreasonable and unsupported by statistical analysis, industry practice, informed judgment, or any other relevant consideration, it should be rejected. Neither the 45-R2, the revised 45-S0 from OAG Information Request No. 11, nor similar survivor curve determined to be appropriate for the minor grouping of Account 390 is reasonable or appropriate to be applied to the major grouping. Rather, MERC's proposed 55 year life span coupled with a 75-R2.5 interim survivor curve is most appropriate for the separately depreciated buildings.[42]

Any change to the Company's current depreciation practices to remove existing assets from the Account 390 minor grouping will impact that grouping's depreciation parameters as well as the Company's annual depreciation expense.[43]

Specifically, the exclusion of the Cloquet and Albert Lea Service Centers from the minor grouping as recommended by the Department and OAG results in changes to the vintage surviving plant used in depreciation study analytics for the remaining minor grouping assets. As a result, the 45-R2 survivor curve for the minor grouping is no longer statistically supported. As discussed in MERC's response to OAG Information Request No. 11, a 45-S0 survivor curve would be more statistically appropriate for the remaining assets in that group.[44]

The resulting change to the minor grouping's survivor curve has further implications. The use of a 45-S0 survivor curve results in a revised calculated theoretical depreciation reserve and resulting ratio. As explained in response to OAG Information Request No. 11, the calculated

[39] Ibid.

[40] OAG Comments at 5.

[41] Ibid

[42] Ibid.

[43] Ibid, page 9.

[44] Ibid.

theoretical reserve would increase from $3,790,607 to $3,976,776 and a corresponding change would have to be made in the ratio from 68% to 65%. The change in the ratio further impacts the calculated remaining life and annual depreciation rate for each building in the major grouping as well as the minor grouping.[45]

5. Staff Analysis

It is not clear whether the OAG maintains its position after reviewing MERC and the Department's additional comments on this issue as the OAG did not submit additional comments. The Commission may want to ask the OAG to confirm its position when this item is heard.

F. Impacts to Annual Depreciation Expense - Request for Deferred Accounting

1. MERC

MERC requested authorization for deferred accounting treatment to track the increase in annual depreciation expense for recovery in its next rate case. Acceptance of the proposal to separate Rochester, Rosemount, Cloquet and Albert Lea result in an increase to annual depreciation expense for 2019 of approximately $64,000.[46] Because this financial impact will occur outside of a general rate case proceeding, the Company will not be provided an opportunity to recover the resulting additional annual expense.

> Deferred accounting is a regulatory tool used primarily to hold utilities harmless when they incur out-of-test-year expenses related to utility operations for which ratepayers have incurred costs or received benefits that, because they are unforeseen, unusual, and large enough to have a significant impact on the utility's financial condition, should be eligible for rate recovery in the next rate case. Expenses for which deferral is requested must also be subject to review for reasonableness and prudence.[47]

MERC argued that deferred accounting treatment is appropriate because the increase in annual depreciation expense costs are (1) related to MERC's operations for which ratepayers have

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[45] Ibid.

[46] As discussed in MERC's Response to OAG Information Request No. 11 (included as Attachment 3 to the Department's Comments), separation of the Rochester and Rosemount buildings would result in an increase in annual depreciation expense of approximately $32,000. If the Commission's actions determine it is appropriate to individually depreciate additional buildings as proposed by the Department and the OAG, depreciation expense is anticipated to increase an additional $32,000 using the depreciation parameters of 75-R2.5 for major building and 45-S0 for minor buildings for a total of $64,000 annually.

[47] *In the Matter of a Petition for Approval of Deferred Accounting Treatment of Costs Related to the 2016 Storm Response and Recovery*, Docket No. E015/M-16-648, Order Denying Petition for Deferred Accounting Treatment at 2 (Jan. 10, 2017).

incurred costs or received benefits; (2) significant in amount, (3) unusual and extraordinary, and (4) will be subject to review for reasonableness and prudence in a future rate proceeding.[48]

First, the assets in Account 390, Structures and Improvements, are necessary and related to MERC's operations and the provision of natural gas service to customers. The Department and OAG have advocated that separation of the Rochester, Rosemount, Cloquet, and Albert Lea buildings for depreciation purposes will benefit ratepayers by more closely tracking the anticipated retirement of such assets to avoid the impact of undepreciated plant balance at the end of the building's life.[49]

Second, while the annual impact to depreciation expense is only $64,000, absent authorization for deferral, MERC will be denied the ability to recovery that amount each year until it files a subsequent rate case. Because the proposed modifications to the Company's existing depreciation practices are occurring outside of a rate case, MERC should be allowed an opportunity to recovery the resulting increase in annual expense. The intent of the proposed changes to depreciation practices is to ensure the recovery of depreciation expense most accurately aligns with the useful lives of the assets. To order such changes without providing the company an opportunity to recover the actual increase in expense would be unreasonable.[50]

Third, to make such changes to existing depreciation practices outside a rate case (as well as outside of a full depreciation study) is unusual. While the Company agreed in Docket No. G011/GR-17-563 to evaluate the continued reasonableness of its depreciation practices for larger buildings, the separate depreciation of four buildings is a significant change from current practice.[51]

Finally, MERC agrees that its actual depreciation expense will be subject to review for prudence and reasonableness in a future rate proceeding.[52]

2. Department

The Department agrees with MERC that the costs are related to utility operations, and that they would be subject to review in a future rate proceeding. However, the Department does not agree that a $64,000 per year increase in expense is significant and does not believe deferred accounting should be authorized. In several prior Orders, the Commission has stated:

[48] Ibid, page 10.

[49] Ibid.

[50] Ibid.

[51] Ibid.

[52] Ibid.

> Traditionally, deferred accounting has been reserved for costs that are unusual, unforeseeeable, and *large enough to have a significant impact on the utility's financial condition*. [emphasis added.][53]

MERC's annual depreciation accruals in 2017 and 2018 were $11.9 million and $10.1 million, respectively, and will likely be well over $12.0 million in 2019. An increase of $64,000 amounts to an increase of only a half of a percent of overall depreciation expense and an even smaller amount compared to total expenses.[54] Further, in its most recent Jurisdictional Annual Report, MERC reported net utility operating income of $28.1 million for 2018. A decrease of $64,000 would be a decrease of less than a quarter of a percent, and would not have a significant impact on MERC's financial condition.[55]

Additionally, while the Department agrees that the specific circumstance of the Commission requiring a utility to change a depreciation methods outside of a rate case is not common, changes to depreciation expense outside of rate cases are common, and are often much larger than $64,000. For example, in MERC's last depreciation docket (Docket No. G-011/D-17-442), the Company requested, and the Commission approved, depreciation rates that were expected to decrease depreciation expense by $1.2 million annually, beginning January 1, 2017. That reduction was not reflected in MERC's rates until January 1, 2018, when MERC implemented interim rates in its most recent rate case (Docket No. G-011/GR-17-563), and MERC did not request deferred accounting for that change in expense.[56]

3. OAG

The OAG did not address MERC's request for deferred accounting treatment of its increased depreciation expense.

4. Staff Analysis

Staff agrees with the Department's recommendation that the Commission deny MERC's request for deferred accounting. While the increase in expense is related to MERC's operations for which ratepayers have incurred costs or received benefits, it is not significant in amount or unusual and extraordinary. Rates are set using a test year level of expense within a rate case. It is expected that relative to the test year levels set, some expenses will be over-recovered and some of the expenses will be under-recovered. It is thought that the over/under-recovery will even itself out in the end.

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[53] See, for example, Docket Nos. E002/M-03-1463, E,G-001/M-08-728, E-002/M-11-1263, and E-015/M-11-1264.

[54] Petition, Statement 1C.

[55] The impact on MERC's net utility operating income would be less than $64,000 as a result of tax effects.

[56] *In the Matter of the Application of Minnesota Energy Resources Corporation for Authority to Increase Rates for Natural Gas Service in Minnesota*, Docket No. G011/GR-17-563, Order Setting Interim Rates at 4, December 5, 2017.

G. Evaluation of Other Assets

1. OAG

The OAG recommended the Commission require the Company to look at its other large transmission or distribution assets outside of Account 390, as well as any future large or unique assets to see if the separate, or individual depreciation methodology would apply.

2. MERC

MERC responded that the Company reviews its assets as part of this annual depreciation update process and has already concluded that group depreciation continues to be the most appropriate method for depreciating transmission and distribution assets. MERC disputed the recommendation that additional review is necessary.[57]

MERC explained that in the context of utility accounting there are two independent justifications for the application of group accounting for utility assets: (1) with respect to certain fixed assets such as utility poles and other components of the transmission and distribution system, the components are too numerous to practically track on an individual basis given the small relative value of each individual asset; and (2) with respect to larger assets like buildings that are comprised of numerous components and parts, it is impractical to separately track all components, especially when the components are typically inseparable from the building (e.g., a roof or HVAC system).[58]

As support for its argument, MERC cited PwC interpretive guidance regarding utility asset retirement, and depreciation:

> Two methods of depreciating multiple-asset accounts are employed: the group method and the composite method. The term "group" refers to a collection of assets that are similar in nature. "Composite" refers to a collection of assets that are dissimilar in nature.
>
> …
>
> Utilities often apply the mass-asset convention of accounting (also known as the “group” method) to certain fixed assets such as utility poles and other components of their transmission and distribution systems which are too numerous to practically track on an individual basis given the small relative value of each individual asset. Similarly, many utility companies utilize the composite convention of accounting for component parts of larger assets such as electric generating stations which also contain numerous components and parts which are impractical to separately track.[59]

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[57] August 28, 2019, MERC Reply Comments, page 10-11.

[58] Ibid. page 11.

[59] PriceWaterhouseCoopers, Questions and Answers, Interpretations for the Utility Industry, Accounting

As MERC is a gas distribution company, its distribution and transmission property includes many dispersed but interrelated assets. These assets, numbering in the tens of thousands, are recorded at a vintage year, size, material type, and municipal tax reporting level. As such, these assets represent a large number of similar assets for which additions and retirements occur continually and systematically over time and the life of any one unit is not dependent on the life of any of the other units. As a result, the assets are widely dispersed and have a variety of costs which are not conducive to individual depreciation.[60]

Unlike an electric utility, which may own generating stations or other similar large facilities, MERC does not own any assets outside of Account 390 that would support separate accounting treatment. Group depreciation continues to be the most appropriate method for depreciating MERC's natural gas transmission and distribution assets.[61]

3. Department

The Department generally agrees with MERC that it is likely that group depreciation is the appropriate depreciation methodology for the majority of its plant. For example, there is little doubt that group depreciation is the appropriate method for services, meters, AMI devices, and house regulators (Accounts 380, 381, 381.01, and 383, respectively). However, the Department agrees with OAG that there may be individual assets booked to accounts other than Account 390 for which individual depreciation may be the best option. During its review of MERC's Petition, the Department focused on Account 390, but, for example, Account 378 Measuring & Regulating Station Equipment or Account 379 City Gate Stations may include larger assets for which a different depreciation methodology may be appropriate (although the Department understands that group accounting may indeed be appropriate for certain large assets).

Thus, the Department recommends that the Commission require MERC to include in its next depreciation filing a summary of the largest individual assets booked to each of its plant accounts and an explanation of why group accounting is or is not appropriate for those assets.

4. MERC

In its additional Reply comments, MERC continued to support is argument that assets in plant accounts outside of Account 390 are not conducive to individual depreciation. MERC urged the Commission to deny the Department and the OAG's recommendation to require MERC to include in its next depreciation filing a summary of the largest individual assets booked to each of its plant accounts and an explanation of why group accounting is or is not appropriate for those assets.

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for Property, Plant and Equipment, Asset Retirement Obligations and Depreciation (available at https://www.pwc.com/gx/en/energy-utilities-mining/pdf/ppe.pdf).

[60] Ibid.

[61] Ibid.

5. Staff Analysis

Staff agrees with MERC's position that an in-depth review of its assets is unnecessary.

VII. Decision Alternatives

Housekeeping Issues

1) Approve the depreciation parameters and rates proposed in MERC's Petition for all plant accounts other than Account 390 Structure and Improvements. (MERC, Department, OAG) and

2) Require MERC to file its next annual depreciation study by June 1, 2020; and require MERC to file its next five-year study by June 1, 2022. (Department, MERC & OAG did not object)

Account 390 – Major Group

3) Require MERC to depreciate the Rosemount and Rochester Service Centers individually in the Account 390 Major group and depreciate the Cloquet and Albert Lea Service Centers in Account 390 as members of the Minor buildings group. (MERC) or

4) Require MERC to depreciate the Rosemount, Rochester, Cloquet, and Albert Lea Service Centers individually in the Account 390 Major group and to depreciate the other 18 buildings in Account 390 as members of the Minor buildings group. (Department, OAG)

Depreciation Test

5) Approve MERC's proposal that new buildings be depreciated as a part of the Major group in Account 390 only when they are newly acquired or constructed and will constitute at least one percent of the Company's total depreciable net plant. (MERC) or

6) Approve the Department's proposal to review new buildings on a case-by-case basis. (Department) or

7) Approve to OAG's proposed rule for depreciating buildings individually, and require the Company to identify new or existing buildings that exceed a total book value of $1,000,000 in its future depreciation filings. (OAG)

8) If the Commission approves the OAG's proposed threshold (alternative #7), it may also want to consider whether it wants consider the modifications to the OAG's recommendation proposed by MERC:

a) Use the North Central Region Gas Utility Construction January 2019 Structures and Improvements Index to adjust the threshold annually to recognize the impact of year-over-year inflation.

b) The threshold should be applied at the time of building acquisition, construction or improvements based upon the original cost of the building.

Depreciation Parameters

9) Require the Company to use depreciation parameters from MERC's response to OAG IR 11. (Department & MERC Alternative)

Depreciable Unit	Proposed Probable Retirement Year	Life Span (Years)	Remaining Life (Years)	Survivor Curve	Interim Survivor Curve	Net Salvage Rate (%)	Depreciation Rate (%)
Major Buildings							
Rosemount	2072	55	50.1	n/a	75-R2.5	-10	2.15
Rochester	2063	55	41.5	n/a	75-R2.5	-10	2.32
Cloquet	2035	55	16.0	n/a	75-R2.5	-10	4.46
Albert Lea	2072	55	50.1	n/a	75-R2.5	-10	2.15
Minor Buildings Group	n/a	n/a	34.5	45-S0	n/a	-10	2.74

or

10) Require the Company to use a shorter remaining life for the major grouping in FERC Account 390 – Structures and Improvements, such as the curve used for the minor grouping of 45-R2. (OAG)
[Staff comment: If the Commission chooses alternative #10 it may want to verify the OAG's recommendation.]

Deferred Accounting

11) Authorize MERC's request for deferred accounting treatment to track the $64,000 increase in annual depreciation expense for recovery in its next rate case. (MERC) or

12) Deny MERC's request for deferred accounting. (Department)

Additional Review of Large Assets

13) Require MERC to include in its next depreciation filing a summary of the largest individual assets booked to each of its plant accounts and an explanation of why group accounting is or is not appropriate for those assets. (Department, OAG) or

14) Do not require MERC to include in its next depreciation filing a summary of the largest individual assets booked to each of its plant accounts and an explanation of why group accounting is or is not appropriate for those assets. (MERC)