

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

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

**FINDINGS OF FACT,
SUMMARY OF PUBLIC
TESTIMONY, CONCLUSIONS OF
LAW AND RECOMMENDATION**

This matter came before Administrative Law Judge Eric L. Lipman for an evidentiary hearing on May 13, 2014. The hearing record closed on July 11, 2014 following the receipt of the last of the post-hearing briefs.

Michael J. Ahern, Kristin M. Stastny and Kristin K. Berkland, Dorsey & Whitney LLP, appeared on behalf of the applicant, Minnesota Energy Resources Corporation (MERC, Applicant or the Company).

Andrew P. Moratzka and Chad T. Marriott, Stoel Rives LLP, appeared on behalf of the Hibbing Taconite Company, ArcelorMittal USA's Minorca Mine, Northshore Mining Company, United Taconite, the Minntac and Keewatin Mines of United States Steel Corporation, and USG Interiors, Inc., collectively appearing as the Super Large Gas Intervenors (Super Large Gas Intervenors or SLGI).

Richard J. Savelkoul, Martin Squires, P.A., appeared on behalf of Constellation New Energy – Gas Division, LLC (Constellation).

Ian M. Dobson and Ryan P. Barlow, Assistant Attorneys General, appeared on behalf of the Office of the Attorney General, Antitrust and Utilities Division (OAG-AUD).

Julia E. Anderson, Linda S. Jensen and Peter Madsen, Assistant Attorneys General, appeared on behalf of the Minnesota Department of Commerce, Division of Energy Resources, Energy Regulation and Planning (DOC-DER).

On September 30, 2013, MERC filed a general rate case seeking an annual increase in its natural gas rates of \$14,187,597. This sum represents an increase of 5.52 percent, based upon a test year that ended on December 31, 2014 and utilized a 10.75 return on equity (Petition).[†]

[†] See, Ex. 16 at 5 (B. Nick Direct); Ex. 2 Initial Filing Volume 1: Summary of Filing.

On November 27, 2013, the Commission issued a Notice and Order for Hearing referring the matter to the Office of Administrative Hearings for contested case proceedings.^{††} The Commission's November 27, 2013 Order directed the parties to address the following issues during the course of the contested case proceedings:

STATEMENT OF THE ISSUES

1. Is the test year revenue increase sought by the Company reasonable?
2. Is the rate design proposed by the Company reasonable?
3. Are the Company's proposed capital structure, cost of capital and return on equity reasonable?
4. Is MERC's test year forecast for late payment and other revenues reasonable?
5. Is MERC's estimate of regulatory assets and liabilities reasonable?
6. Are the features of MERC's joint rate service reasonable?^{†††}

SUMMARY OF CONCLUSIONS

The hearing record demonstrates that MERC will experience a revenue shortfall. MERC is entitled to recover this revenue shortfall through an adjustment of its natural gas rates. MERC's revenue deficiency is approximately \$3,300,164.

Needed adjustments to revenues and expenses result in test year operating income of (approximately) \$12,033,182.

MERC's updated capital structure and cost of debt is reasonable and should be utilized in the calculation of the rate of return.

Modifying MERC's natural gas rates in the manner described in the findings and conclusions below will result in just and reasonable rates that are in the public interest.

^{††} NOTICE AND ORDER FOR HEARING, MPUC Docket No. G-011/GR-13-617 (Nov. 27, 2013).

^{†††} *Id.*

FINDINGS OF FACT

I. Procedural Background

1. MERC is a corporation organized under the laws of the state of Delaware. It is authorized to do business in Minnesota and has its principal office in Rosemount, Minnesota.¹

2. MERC is one of six subsidiaries of Integrys Energy Group (Integrys). Integrys also owns Wisconsin Public Service Corporation, Upper Peninsula Power Company, Michigan Gas Utilities Corporation, The Peoples Gas Light and Coke Company, and North Shore Gas Company. These other firms provide natural gas and electric service in the states of Wisconsin, Illinois and Michigan.²

3. MERC serves gas to approximately 213,000 customers in 51 counties and 165 communities throughout Minnesota. MERC's gas service territories include customers in the southern, east central and northern portions of the state.³

4. MERC's next most-recent rate case was Docket No. G-007,011 / GR-10-977 (the 2010 Rate Case). In that case, the Commission issued Findings of Fact, Conclusions and an Order on July 13, 2012. This Order authorized new rates based upon a 9.70 percent return on common equity.⁴

5. On August 22, 2013, MERC filed sales forecast data as required by the Commission's Order in the 2010 Rate Case. The Commission directed that such data be provided thirty days in advance of the filing of a new rate case.⁵

6. On September 30, 2013, MERC filed an application for authority to increase natural gas rates in Minnesota. It sought an annual increase of \$14,187,597, or approximately 5.52 percent over current rates.⁶

7. The Company's proposed interim rate schedules identified an interim revenue deficiency of \$12,401,502, or 4.82 percent, and requested an interim rate increase of \$12,095,382, or 4.70 percent, beginning January 1, 2014.⁷

¹ Ex. 16 at 3 (B. Nick Direct).

² *Id.*

³ *Id.* and Schedule (BAN-1) (B. Nick Direct).

⁴ 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 20 (July 13, 2012).

⁵ Ex. 1 (Sales Forecast Prefiling).

⁶ Ex. 2 (Initial Filing Volume 1: Notice of Change in Rates, Interim Rate Petition, Summary of Filing) (Sept. 30, 2013).

8. MERC's proposed interim and final rate schedules used a 10.75 percent return on equity and were based upon a 2014 test year.⁸

9. On October 2, 2013, the Commission requested comments on whether MERC's filing should be accepted as complete and referred to the Office of Administrative Hearings (OAH) for a contested case proceeding.⁹

10. On October 8, 2013, MERC submitted additional information to supplement its September 30 filing. The update described material costs relating to tampering and reconnection of gas service and abnormal construction charges.¹⁰

11. On November 27, 2013, the Commission accepted MERC's filing as substantially complete and suspended the operation of the proposed rate schedule under Minn. Stat. § 216B.16, subd. 2, until a final determination in this case.¹¹

12. On the same date, the Commission referred the case to the Office of Administrative Hearings for contested case proceedings.¹²

13. As part of its determinations, the Commission ordered the Company to file certain supplements to its direct testimony:

- (a) Supplemental direct testimony reflecting the calculation of the applicable conservation cost recovery charge (CCRC) and conservation cost recovery adjustment (CCRA) charges since the inception of its ownership, July 2006. MERC shall also provide the applicable Northshore volumes, CCRC and CCRA rates, and the CCRC and CCRA amounts, by month for the stated period of time, July 2006 through December 31, 2013.
- (b) Additional information on the adequacy of the Vertex billing audit with respect to finding CIP-related and other billing errors. Parties shall also address the adequacy of the Vertex billing audit in finding these errors.

⁷ ORDER SETTING INTERIM RATES MPUC Docket No. G-011/GR-13-617 (Nov. 27, 2013). MERC waived its right under Minn. Stat. § 216B.16 to have interim rates in effect no later than sixty days after the initial filing. *Id.* at 4.

⁸ Ex. 2 Initial Filing Volume 1: Notice of Change in Rates, Interim Rate Petition, Summary of Filing (Sept. 30, 2013).

⁹ NOTICE OF COMMENT PERIOD, MPUC Docket No. GR-13-617 (October 2, 2013).

¹⁰ UPDATE, MPUC Docket No. GR-13-617 (October 8, 2013).

¹¹ See, ORDER ACCEPTING FILING, SUSPENDING RATES, AND EXTENDING TIME FOR FINAL DETERMINATION, MPUC Docket No. G-011/GR-13-617 (Nov. 27, 2013); NOTICE AND ORDER FOR HEARING, MPUC Docket No. G-011/GR-13-617 (Nov. 27, 2013).

¹² NOTICE AND ORDER FOR HEARING, MPUC Docket No. G-011/GR-13-617 (Nov. 27, 2013).

- (c) Supplemental testimony that explains how the Company administers joint rate service and the joint rates in its joint rate tariffs and includes the following:
- i. Examples of different billing scenarios that demonstrate how the joint rates are administered for sales and transportation joint rate customers compared to interruptible sales and transportation customers.
 - ii. An explanation of how joint rate customers are charged for the interruptible and firm parts of the service they are taking and any credit MERC may provide to firm (or system) sales customers for the joint rate sales customer's use of MERC's entitlement to upstream firm pipeline capacity.
 - iii. An explanation of the methodology MERC employs for the design of these rates, how all elements of these rates are calculated, how these rates are applied to the joint rate tariffs and to customer bills, and the billing arrangements MERC employs for charging joint rate customers the rates that appear in the joint rate tariff.¹³

14. In addition to the listed supplements, the Commission directed MERC to provide the following:

- (a) Additional information regarding the Company's tracking and handling of CIP expenses in the development of the test year operating expenses.
- (b) The potential impact of updated sales forecasts and commodity pricing forecast updates on the demand and commodity cost of gas rates. MERC shall provide updated sales forecasts and commodity pricing forecasts from its general rate case and information on the potential impact of these updates on its per-dekatherm demand and/or commodity cost of gas rates. These updates should be filed in this docket and the related base cost of gas matter, in Docket No. G-011/MR-13-732.¹⁴

¹³ NOTICE AND ORDER FOR HEARING, *supra*, at 2-3.

¹⁴ *Id.*

15. Minn. Stat. § 216B.16, subd. 2(e) grants MERC the right to a final determination by the Commission within 10 months of the initial filing date. However, the statute authorizes the Commission to extend the suspension period up to 90 additional calendar days. In its Order Accepting MERC's Filing, the Commission extended the suspension period until October 28, 2014.¹⁵

16. On Nov. 27, 2013, the Commission granted MERC's request for an interim rate increase. The Commission authorized an interim rate increase of \$10,755,973.¹⁶

17. While noting MERC's request to refrain from charging the new interim rates until the new calendar year, the Commission's Order permitted MERC to begin using the new rates as of November 29, 2013.¹⁷

18. The Commission also approved MERC's request to withhold collection of the full amount of the interim rate increase from its Super Large Volume (SLV) customer class. The Commission found that MERC presented "exigent circumstances," as those terms are used in Minn. Stat. § 216B.16, subd. 3 (b), because its SLV customers have the ability to bypass MERC's system. An exodus of several SLV customers could potentially result in increased rates for MERC's remaining customers.¹⁸

19. As part of the interim rate order, the Commission authorized a new base cost of gas. The Commission required that MERC update the base cost of gas at least once during the contested case proceeding and file such update in both the base cost of gas docket, Docket No. G011/M-13-732, and this docket.¹⁹

20. MERC is collecting interim rates. Those rates are subject to refund if the rates that are now charged exceed the final rates determined by the Commission.²⁰

21. On December 10, 2013, the Administrative Law Judge conducted a prehearing conference.²¹

22. The initial parties to the proceeding were MERC, the Department, and the OAG-AUD.²²

¹⁵ See ORDER ACCEPTING FILING, SUSPENDING RATES, AND EXTENDING TIME FOR FINAL DETERMINATION, MPUC Docket No. G-011/GR-13-617 (Nov. 27, 2013).

¹⁶ ORDER SETTING INTERIM RATES, *supra*, at 2 and 5.

¹⁷ *Id.*

¹⁸ *Id.* at 3-4.

¹⁹ ORDER SETTING NEW BASE COST OF GAS, *In the Matter of the Petition of Minnesota Energy Resources Corporation for Approval of a New Base Gas Cost for Interim Rates*, Docket No. G-011/M-13-732 (Nov. 27, 2013); Ex. 9 (Compliance Filing – Update to Commodity Cost of Gas).

²⁰ ORDER SETTING INTERIM RATES at 2.

²¹ See, FIRST PREHEARING ORDER, OAH 8-2500-31126; MPUC Docket No. G-011/GR-13-617 (Dec 12, 2013).

23. On December 12, 2013, the Administrative Law Judge issued a pre-hearing order which established the following schedule:

December 17, 2013	Deadline for Feedback to the Applicant on the Draft-Protective Order
February 14, 2014	Deadline for Intervention
March 4, 2014	Intervenor's Pre-filed Direct Testimony
March 11–13, 2014	Public Hearings in Greater Minnesota (Rochester, Rosemount, and Cloquet)
April 15, 2014	All Parties' Rebuttal Testimony and the Applicant's Update on the Base Cost of Gas
May 7, 2014	All Parties' Surrebuttal Testimony
May 8, 2014	Deadline for Revisions to Pre-filed Testimony
May 9, 2014	Minn. Stat. § 216B.16 Conference
May 13–16, 2014	Evidentiary Hearing
June 6, 2014	Applicant Files Issue Matrix
June 24, 2014	Non-Applicants' Response to Issue Matrix
	Applicant's Proposed Findings of Fact and Conclusions of Law
	All Parties' Initial Briefs
July 11, 2014	Non-Applicants' Proposed Substitute Findings of Fact and Conclusions of Law
	All Parties' Reply Briefs
August 12, 2014	Report of the Administrative Law Judge. ²³

²² *Id.*

²³ *Id.*

24. On December 12, 2013, the Administrative Law Judge issued a protective order.²⁴

25. On February 14, 2014, Constellation filed a Petition to Intervene.²⁵

26. On February 14, 2014, the Hibbing Taconite Company, ArcelorMittal USA's Minorca Mine, Northshore Mining Company, United Taconite, LLC, the Minntac and Keewatin Mines of United States Steel Corporation, and USG Interiors, Inc., (collectively appearing as the "Super Large Gas Intervenors") filed a Petition to Intervene.²⁶

27. No party objected to the intervention of the Super Large Gas Intervenors or Constellation as parties to this matter.

28. On February 24, 2014, U.S. Energy Services, Inc. on behalf of itself and a group of industrial, commercial, and institutional customers (collectively the "ICI Group") filed a Petition to Intervene.²⁷

29. On February 26, 2014, the Administrative Law Judge issued a Third Prehearing Order. The Order granted the petitions of Constellation and the Super Large Gas Intervenors and requested additional information from the ICI Group.²⁸

30. The ICI Group filed a supplement to its Petition to Intervene on February 27, 2014.²⁹

31. MERC filed an objection to the ICI Group's petition to intervene on the grounds that the ICI Group's petition was untimely.³⁰

32. Oral arguments on the ICI Group's Petition to Intervene were held on March 14, 2014.³¹

33. On March 24, 2014, the Administrative Law Judge issued an Order denying the ICI Group's petition for intervention.³²

²⁴ SECOND PREHEARING ORDER (Protective Order), OAH 8-2500-31126 (Dec. 23, 2013).

²⁵ See, PETITION TO INTERVENE FILED BY CONSTELLATION NEW ENERGY – GAS DIVISION, LLC, OAH 8-2500-31126 (Feb. 14, 2014).

²⁶ See PETITION TO INTERVENE FILED BY SUPER LARGE GAS INTERVENORS, OAH 8-2500-31126 (Feb. 14, 2014).

²⁷ See, PETITION TO INTERVENE FILED BY U.S. ENERGY SERVICES, INC., OAH 8-2500-31126 (Feb. 24, 2014).

²⁸ See, THIRD PREHEARING ORDER, OAH 8-2500-31126 (Feb. 26, 2014).

²⁹ SUPPLEMENT TO PETITION TO INTERVENE, OAH 8-2500-31126 (Feb. 27, 2014).

³⁰ See, OBJECTION TO PETITION TO INTERVENE OF U.S. ENERGY SERVICES, INC. AND AFFIDAVIT IN SUPPORT, OAH 8-2500-31126 (Mar. 3, 2014).

³¹ FOURTH PREHEARING ORDER, OAH 8-2500-31126 (Mar. 11, 2014).

34. -MERC filed direct testimony on September 30, 2013.³³
35. MERC filed supplemental direct testimony on December 26, 2013.³⁴
36. Public hearings were held in Rochester and Rosemount on March 12, 2014.³⁵
37. Eight members of the public attended the meeting in Rochester and six members of the public provided testimony.³⁶
38. One member of the public attended the meeting in Rosemount and used the opportunity to ask questions of agency staff and the company panel.³⁷
39. A public hearing was held in Cloquet, Minnesota, on March 13, 2014.³⁸ Three members of the public attended the hearing and all three provided testimony.³⁹
40. A summary of the public hearing testimony and the comments received during the public comment period appears below in Sections X and XI. In general, these commentators expressed concerns as to the need, amount and frequency of rate increases. Likewise, several commentators expressed concern as to the impact that higher natural gas rates will have upon those with fixed incomes.⁴⁰
41. The Department, OAG-AUD and Constellation submitted direct testimony on March 4, 2014, March 20, 2014, April 21, 2014 and May 9, 2014.⁴¹

³² See, FIFTH PREHEARING ORDER, OAH 8-2500-31126 (Mar. 24, 2014).

³³ See Ex. 16 (B. Nick Direct); Ex. 19 (S. DeMerritt Direct); Ex. 38 (H. John Direct); Ex. 26 (C. Hans Direct); Ex. 14 (D. Kult Direct); Ex. 12 (T. Kupsh Direct); Ex. 13 (N. Cleary Direct); Ex. 10 (B. Kage Direct); Ex. 11 (M. Gerth Direct); Ex. 36 (J. Wilde Direct); Ex. 28 (L. Gast Direct); Ex. 17 (P. Moul Direct); Ex. 29 (J. Hoffman-Malueg Direct); Ex. 40 (G. Walters Direct).

³⁴ See Exs. 21-23 (S. DeMerritt Supplemental Direct and Exhibits to S. DeMerritt Supplemental Direct); Ex. 41 (G. Walters Supplemental Direct).

³⁵ FIRST PREHEARING ORDER, *supra*.

³⁶ See, ROCHESTER PUBLIC HEARING TRANSCRIPT, OAH 8-2500-31126 (Mar. 12, 2014).

³⁷ See, ROSEMOUNT PUBLIC HEARING TRANSCRIPT, OAH 8-2500-31126 (Mar. 12, 2014).

³⁸ FIRST PREHEARING ORDER, *supra*.

³⁹ See, CLOQUET PUBLIC HEARING TRANSCRIPT, OAH 8-2500-31126 (Mar. 13, 2014).

⁴⁰ See, *infra* Sections X and XI.

⁴¹ See Ex. 125 (R. Haubensak Direct); Ex. 150 (Adopted Direct Testimony of V. Chavez by J. Lindell); Exs. 151-152 (J. Lindell Direct and Schedules); Exs. 155-157 (R. Nelson Direct, Errata and Schedules); Exs. 161-163 (P. Chattopadhyay Direct, Errata and Schedules); Ex. 200 (E. Amit Direct); Exs. 203-204 (S. Peirce Direct and Errata); Exs. 206-207 (S. Ouanes Direct and Attachments); Ex. 210 (M. Zajicek Direct); Exs. 212-13 (L. Otis Direct and Errata); Ex. 215 (L. La Plante Direct); Exs. 213, 217-218, 220 (M. St. Pierre Direct, Errata and Attachments).

42. MERC, the Department, and the OAG-AUD filed rebuttal testimony on April 15, 2014 and April 21, 2014.⁴²

43. MERC, the Department, and the OAG-AUD filed surrebuttal testimony on May 7, 2014 and May 9, 2014.⁴³

44. The evidentiary hearing was held on May 13, 2014 in the Large Hearing Room of the Commission's Saint Paul offices.⁴⁴

II. MERC's Requested Rate Increase

45. MERC requested a rate increase so as to eliminate a revenue deficiency and recover what it asserted was a fair rate of return.⁴⁵

46. Minn. Stat. § 216B.16, subd. 6, directs the Commission to give due consideration to the utility's need for revenue so as to enable the utility to meet the cost of furnishing service. This revenue should include provision for the depreciation of property and an opportunity for the utility to earn a fair return upon the investment in such property.⁴⁶

47. The revenue requirement portion of a general rate case seeks to determine what additional revenue is required to meet the utility's required operating income, based upon a "test year" of operations. The required operating income is derived from determining the amount of investments in rate base that have been made by a utility's shareholders, and multiplying the approved rate base times the rate of return that is determined to be appropriate for the company.⁴⁷

48. After determining the required operating income, the company's test year expenses and revenues are evaluated to determine the current operating income for the test year (in this case 2014). The difference between the required operating income and

⁴² Ex. 15 (D. Kult Rebuttal); Ex. 18 (P. Moul Rebuttal); Ex. 24 (S. DeMerritt Rebuttal); Ex. 27 (C. Hans Rebuttal); Exs. 30-31 (J. Hoffman Malueg Rebuttal and Errata); Ex. 37 (J. Wilde Rebuttal); Ex. 39 (H. John Rebuttal); Ex. 42 (G. Walters Rebuttal); Ex. 153 (J. Lindell Rebuttal); Ex. 164 (P. Chattopadhyay Rebuttal); Ex. 201 (E. Amit Rebuttal); Ex. 208 (S. Ouanes Rebuttal).

⁴³ Ex. 25 (S. DeMerritt Surrebuttal); Ex. 154 (J. Lindell Surrebuttal); Ex. 158-60 (R. Nelson Surrebuttal and Schedules); Ex. 165-66 (P. Chattopadhyay Surrebuttal and Schedules); Ex. 202 (E. Amit Surrebuttal); Ex. 205 (S. Peirce Surrebuttal); Ex. 209 (S. Ouanes Surrebuttal); Ex. 211 (M. Zajicek Surrebuttal); Ex. 214 (L. Otis Surrebuttal); Ex. 216 (L. La Plante Surrebuttal); Ex. 219-20 (M. St. Pierre Surrebuttal and Errata).

⁴⁴ EVIDENTIARY HEARING TRANSCRIPT, OAH 8-2500-31126, at 1 (May. 13, 2014).

⁴⁵ Ex 19 at 3 and 59 (S. DeMerritt Direct).

⁴⁶ Minn. Stat. § 216B.16, subd. 6.

⁴⁷ Ex. 4 Initial Filing Volume 3: Informational Requirements, Document 1.

the test year operating income is the income deficiency. The income deficiency is converted into a gross revenue deficiency amount.⁴⁸

49. The Company indicated that the 2012 historical year concluded with a \$13,889,494 revenue deficiency and its estimate of the 2014 test year projected a revenue deficiency totaling \$14,187,597.⁴⁹

50. MERC also maintained that general inflation, not including Known and Measurable (K&M) items, increased Operations and Maintenance (O&M) expenses at a rate of 3.74 percent.⁵⁰

51. MERC stated that K&M changes from 2012 to 2014 will impact MERC's 2014 costs of providing service. Overall, MERC stated that its capital project expenditures have increased and it has filled vacant positions, which will result in additional compensation expenditures.⁵¹

52. MERC included its 2013 approved Conservation Improvement Plan (CIP) expenses in the test year revenue requirements.⁵²

53. MERC projected a "continual" increase in Property Tax Expenses.⁵³

54. Projecting that a follow-on rate case may be filed as early as 2015, and that a large transmission project will be placed into service that year, MERC requested amortization of rate case expenses from this proceeding to occur over a two year period.⁵⁴

55. MERC's initial filing indicated a need for an annual base rate increase of \$14,187,597, or approximately 5.52 percent of total revenues.⁵⁵

56. Based upon adjustments agreed to during this proceeding, MERC is requesting an annual base rate increase of \$12,159,494, or approximately 4.1 percent.⁵⁶

⁴⁸ *Id.*, Ex. 19 at Schedule (SSD-25) (S. DeMerritt Direct).

⁴⁹ Ex. 16 at 5 (B. Nick Direct); Ex. 19 at 3 (S. DeMerritt Direct).

⁵⁰ Ex. 16 at 5 (B. Nick Direct); Ex. 19 at 3 and Schedule (SSD-18) (S. DeMerritt Direct).

⁵¹ Ex. 16 at 5-6 (B. Nick Direct); Ex. 19 at 14-15 (S. DeMerritt Direct).

⁵² Ex. 16 at 6 (B. Nick Direct); Ex. 24 at Schedule (SSD-1) (S. DeMerritt Rebuttal).

⁵³ Ex. 16 at 6 (B. Nick Direct).

⁵⁴ Ex. 16 at 6 (B. Nick Direct); Ex. 24 at 16-17 (S. DeMerritt Rebuttal).

⁵⁵ Ex. 40 at Schedule 3 (GJW-1) (G. Walters Direct).

⁵⁶ Ex. 42 at Schedule 3 (GJW-1) (G. Walters Rebuttal).

57. MERC asserted that its current rates will not provide sufficient revenue to allow MERC a reasonable opportunity to earn its authorized Return on Equity (ROE).⁵⁷

58. MERC likewise maintained that there are no significant cost cutting reductions that can be made without jeopardizing service quality, service reliability or pipeline safety.⁵⁸

59. The components of determining a fair and reasonable rate of return for MERC in this rate case include a determination of MERC's capital structure, MERC's cost of debt and a reasonable return on common equity.⁵⁹

III. Cost of Capital

60. To arrive at an appropriate overall rate of return, it is necessary to first determine the amount of long-term debt, short-term debt, preferred stock, and common equity held by MERC.⁶⁰

61. MERC proposed a projected capital structure consisting of 44.64 percent long-term debt, 5.05 percent short-term debt, and 50.31 percent common stock equity.⁶¹

62. MERC does not have its own capital structure because it is a subsidiary of Integrys. Its capital structure is thus a hypothetical capital structure.⁶²

63. MERC's corporate equity consists of its retained earnings and infusions of equity from its parent company, Integrys, minus any dividends paid by MERC to Integrys.⁶³

64. MERC sets an equity ratio target of between 50 to 55 percent, and a short-term debt cap of 5 percent.⁶⁴

65. MERC borrows long-term debt internally from Integrys as needed to finance its capital expenditures while meeting its equity and short-term debt targets.⁶⁵

⁵⁷ Ex. 16 at 6-7 (B. Nick Direct); Ex. 17 at 1-2, 11 (P. Moul Direct).

⁵⁸ Ex. 16 at 5 (B. Nick Direct); Ex. 19 at 3 and Schedule (SSD-18) (S. DeMerritt Direct).

⁵⁹ NOTICE AND ORDER FOR HEARING, *supra*, at 2.

⁶⁰ EVIDENTIARY HEARING TRANSCRIPT, at 199.

⁶¹ Ex. 28 at 3-5 and Schedule LJJ-1 (L. Gast Direct).

⁶² Ex. 200 at 35 (E. Amit Direct).

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.*

A. Overall Capital Structure

66. The proposed capital structure reflected the Company's proposed 2014 average balances for long-term debt (13-month average), short-term debt (13-month average), and common equity (13-month average).⁶⁶

67. The capitalization ratios for components of the capital structure are as follows:

Long-Term Debt	44.64%
Short-Term Debt	5.05%
Common Equity	<u>50.31%</u>
Total	100% ⁶⁷

68. Dr. Elon Amit, a Public Utilities Statistical Analyst with the Department, reviewed MERC's test-year hypothetical capital structure and the estimated test-year components. He persuasively testified that the features of the capital structure were reasonable.⁶⁸

69. MERC's proposed capital structure is reasonable and should be adopted in this case.⁶⁹

B. Costs of Long-Term Debt and Short-Term Debt

70. MERC proposed test-year cost of long-term debt of 5.5606 percent and short term cost of debt of 2.3487 percent, based on the 13-month average over the period December 1, 2013 through December 31, 2014.⁷⁰

71. MERC's proposed costs for long-term and short-term debt are reasonable and should be approved by the Commission.⁷¹

C. Cost of Common Equity

72. In order for public utilities to provide satisfactory services at reasonable rates, it must be able to obtain necessary funds in the capital markets. To raise funds, the utility must earn enough to offer competitive returns to investors.⁷²

⁶⁶ Ex. 28 at 3-5 (L. Gast Direct).

⁶⁷ Ex. 202 at 12 (E. Amit Surrebuttal).

⁶⁸ Ex. 200 at 1 and 35-44 (E. Amit Direct).

⁶⁹ Ex. 200 at 35-44 (E. Amit Direct); Ex. 202 at 12 (E. Amit Surrebuttal).

⁷⁰ Ex. 28 at 3-5 and Schedule LJJ-1 (L. Gast Direct).

⁷¹ Ex. 200 at 35-44 (E. Amit Direct); Ex. 202 at 12 (E. Amit Surrebuttal).

⁷² Ex. 28 at 10 (L. Gast Direct); Ex. 200 at 2 (E. Amit Direct).

73. Minnesota law recognizes these competing factors by defining a fair rate of return as the rate that, when multiplied by the rate base, will give a utility a reasonable return upon its total investment. Minn. Stat. § 216B.16, subd. 6 states:

The commission, in the exercise of its powers under this chapter to determine just and reasonable rates for public utilities, shall give due consideration to the public need for adequate, efficient, and reasonable service and 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 of its utility property used and useful in rendering service to the public, and to earn a fair and reasonable return upon the investment in such property.⁷³

74. A fair return on equity is one that enables the utility to attract sufficient capital, at reasonable terms. The cost of equity capital is the rate of return that MERC must pay so as to induce investors to provide capital to its regulated operations.⁷⁴

75. The rate of return should be sufficient to enable the regulated company to deliver safe and reliable service.⁷⁵

76. The rate of return should be sufficient to enable the regulated company to maintain its credit rating and financial integrity.⁷⁶

77. A just and reasonable return is similar to returns on investments that are enjoyed by other businesses facing similar risks.⁷⁷

78. Because MERC's stock is not traded in public markets, various financial models utilizing comparison groups must be used in order to estimate the reasonable return on common equity that should be authorized for MERC in this case.⁷⁸

⁷³ Minn. Stat. § 216B.16, subd. 6; see also, Ex. 17, (P. Moul Direct); *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) (a just and reasonable rate assures a "return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks); *Bluefield Waterworks & Improvement Co. v. Public Serv. Comm'n of West Virginia*, 262 U.S. 679, 693 (1923) (a utility's return "should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties).

⁷⁴ Ex. 200 at 2-3 (E. Amit Direct).

⁷⁵ Ex. 200 at 3 (E. Amit Direct).

⁷⁶ *Id.*

⁷⁷ *Hope, supra*, 320 U.S. at 603.

⁷⁸ Ex. 17 at 3-4 (P. Moul Direct).

79. MERC presented a detailed analysis of the appropriate return on common equity that it developed through the use of several familiar financial models. It updated this analysis in its rebuttal testimony.⁷⁹

80. MERC's analysis concluded that the Company's return on common equity should be 10.75 percent.⁸⁰

81. In Rebuttal Testimony, MERC stated that if the Commission does not agree with a 10.75 percent ROE, based upon the increase in capital costs since MERC's last rate case, the equity return should be at least 10.27 percent.⁸¹

82. The Department prepared an analysis of MERC's ROE in this case. The Department initially recommended an ROE of 9.40 percent on MERC's common equity capital and an overall rate of return of 7.3299 percent on MERC's total capital.⁸²

83. In the Department's Surrebuttal Testimony, Dr. Amit updated his ROE recommendation. Pointing to a more recent set of dividend yields and expected growth rates for companies in the Department's suggested comparable group, he recommended that the Commission approve a ROE of 9.29 percent with an overall cost of capital of 7.2745 percent.⁸³

84. In the OAG-AUD's Surrebuttal Testimony, Dr. Chattopadhyay recommended that the Commission approve a ROE of 8.62 percent.⁸⁴

D. Calculating an Appropriate Return on Equity

85. MERC used three financial models to develop its cost of equity: the Discounted Cash Flow (DCF) model, the Risk Premium (RP) analysis and the Capital Asset Pricing Model (CAPM). To check these results, MERC also used the Comparable Earnings (CE) approach.⁸⁵

⁷⁹ See generally Ex. 17 (P. Moul Direct) and Ex. 18 (P. Moul Rebuttal).

⁸⁰ This figure represents the results of Mr. Moul's updated analysis using data as of May 31, 2012. Ex. 18 at 3-5, 40 (P. Moul Rebuttal). Mr. Moul's original analysis was based on data as of May 31, 2012 and established a reasonable ROE of 10.75 percent. Ex. 17 at 1-2, 6, 46 and Schedule (PRM-1) (P. Moul Direct). See also, Ex. 28 at 3, 10-11 (L. Gast Direct).

⁸¹ Ex. 18 at 40 (P. Moul Rebuttal).

⁸² Ex. 200 at 2 (E. Amit Direct).

⁸³ This figure represents the results of Dr. Amit's updated analysis. Ex. 202 at 1-12 (E. Amit Surrebuttal).

⁸⁴ This figure represents the results of Dr. Chattopadhyay's updated analysis. Ex. 165 at 2 (P. Chattopadhyay Surrebuttal). Dr. Chattopadhyay's original analysis resulted in a recommended 8.90 percent ROE. Ex. 161 at 4, 57 (P. Chattopadhyay Direct).

⁸⁵ Ex. 17 at 3-5 (P. Moul Direct); Ex. 18 at 3 (P. Moul Rebuttal).

86. MERC updated the three models in Rebuttal Testimony and found that the updated cost of equity for the DCF model was 9.80 percent, the updated cost of equity for the RP model was 12.14 percent, and the updated cost of equity for the CAPM was 11.97 percent.⁸⁶

87. MERC's DCF results increased by .16 percent between the filing of its Direct Testimony to the filing of its Rebuttal Testimony. The RP results declined .25 percent between the filing of its Direct Testimony to the filing of its Rebuttal Testimony. The CAPM results increased by 1.08 percent between the filing of MERC's Direct Testimony to the filing of its Rebuttal Testimony. Because the set of updated results produced one increase, one decrease and one result remaining mostly unchanged, MERC determined that the updated results supported the original 10.75 percent ROE recommendation.⁸⁷

88. The Department relied primarily on the DCF method of determining a reasonable cost of common equity.⁸⁸

89. The Department's initial calculation assigned an ROE of 9.40 percent. An updated ROE calculation produced a result of 9.29 percent.⁸⁹

90. In addition, the Department conducted two growth rate DCF analyses (TGDCF), using a comparison group of companies, to determine ROE. The Department likewise used the CAPM model to support its DCF and TGDCF analyses.⁹⁰

91. The OAG-AUD undertook two sets of DCF analyses: the single-stage (or "constant growth") DCF analysis and the market-to-book method. Additionally, Dr. Chattopadhyay conducted a CAPM analysis to establish (and check) a range of reasonable returns on equity.⁹¹

1. Discounted Cash Flow Methods

92. According to accepted financial theory, the price of a stock today equals the present value of all of the expected future dividends discounted by the appropriate rate of return.⁹²

⁸⁶ Ex 18 at 4 (P. Moul Rebuttal).

⁸⁷ *Id.* at 3-4.

⁸⁸ Ex. 200 at 3 (E. Amit Direct).

⁸⁹ Ex 202 at 2 (E. Amit Surrebuttal).

⁹⁰ Ex. 200 at 2-7, 24-26, 28-34 and Schedule (EA-12) (E. Amit Direct); Ex. 202 at 2 (E. Amit Surrebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 198-205 (May 13, 2014) (E. Amit) (Doc. ID No. 20145-99937-01).

⁹¹ Ex. 161, at 21-22 (Chattopadhyay Direct).

⁹² Ex. 200 at 3 (E. Amit Direct).

93. The DCF model operates upon a similar theorem – characterizing the value of an asset as the present value of future expected cash flows, which are discounted at the appropriate risk-adjusted rate of return. The DCF method uses both the current dividend yield and the expected growth rate of this yield to determine a required rate of return for a particular investment opportunity.⁹³

94. A variation of the DCF model, the TGDCF, is appropriate for use in situations when, for a short time period, the company's dividends are expected to grow at a different rate than they are expected to grow over the long-term. The short-term earnings growth rates may be either unusually low or unusually high relative to the Company's historical earnings and industry averages. Accordingly, in some circumstances, use of periods of unusual earnings growth as part of DCF analysis may result in unreasonably low or unreasonably high estimated ROEs.⁹⁴

(a) The Addition of Flotation Costs

95. The parties divide as to whether DCF and TGDCF analyses should be adjusted to allow for the costs of issuing new shares of common stock. Such costs commonly include the costs of underwriting the issuance of securities, legal fees and investment banking fees. Accounting for these costs avoids a decrease in the value of a stock due solely to the cost of issuing the new securities.⁹⁵

96. DOC and MERC assert that recovery of flotation costs of 3.90 percent should be separate from the DCF and TGDCF analysis.⁹⁶

97. On behalf of OAG-AUD, Dr. Chattopadhyay asserts that flotation costs should not be separated from MERC's ROE determination. Dr. Chattopadhyay argues 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 flotation costs is needed to counter-balance (and not further compound) the effects of the DCF model's upward bias.⁹⁷

98. Dr. Amit persuasively testified that the DCF model does not produce upwardly biased estimates of the cost of equity capital.⁹⁸

⁹³ Ex. 17 at 19-20 and Schedule (JPM-1) (P. Moul Direct).

⁹⁴ Ex. 200 at 5, 24, EA-12 (E. Amit Direct).

⁹⁵ *Id.* at 26.

⁹⁶ *Id.* at 27 (citing MERC Ex. 17 at PRM-1, Schedule 9, Page 1 (Moul Direct)).

⁹⁷ Ex. 161, at 5 (Chattopadhyay Direct). See also, Ex. 201 at 25 (E. Amit Rebuttal); Ex. 202 at 35–36 (E. Amit Surrebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 204 (E. Amit).

⁹⁸ Ex. 201 at 25 (E. Amit Rebuttal); Ex. 202 at 35–36 (E. Amit Surrebuttal).

99. Recovery of flotation costs is appropriate because without such an issuance cost adjustment MERC may be denied the opportunity to earn its required rate of return.⁹⁹

100. The DCF and TGDCF results are appropriately adjusted by using flotation costs of 3.90 percent.¹⁰⁰

(b) A Comparable Group with Similar Investment Risks

101. MERC is a subsidiary of Integrys Energy Group (Integrys) and, as such, it is not publicly traded on any stock exchange. Therefore, no DCF analysis can be directly performed on MERC.¹⁰¹

102. While a DCF analysis could be performed on the parent company, Integrys, there are a number of methodological risks of projecting an appropriate ROE for MERC from such an analysis. First, in 2012, Integrys received approximately one-third of its net income from natural gas distribution operations (33.1 percent). Thus, Integrys' other business lines have substantial impact upon its earnings. Further, when a DCF analysis is performed upon the financials from a single company, the results are particularly sensitive to an analyst's specific growth-rate predictions.¹⁰²

103. A better alternative is to perform a DCF analysis on a group of companies that have investment risks similar to that of MERC.¹⁰³

104. Companies in the comparison group should have similar business and financial risk indicators – such as similar lines of business, credit ratings, beta, and standard deviation of price changes.¹⁰⁴

105. On behalf of MERC, Paul R. Moul, an independent financial and regulatory consultant developed a proxy group to measure MERC's cost of equity. Mr. Moul began with gas utilities contained in the basic service of The Value Line Investment Survey – a listing of eleven companies. From this listing he screened out two companies: Mr. Moul eliminated NiSource, Inc. on the grounds that it had both natural gas pipeline and storage operations; and UGI Corporation, because of its highly diversified businesses.¹⁰⁵

⁹⁹ *Id.* at 26-27, EA-14.

¹⁰⁰ Ex. 200 at 27 (E. Amit Direct).

¹⁰¹ Ex. 200 at 6 (E. Amit Direct).

¹⁰² *Id.* at 6-7.

¹⁰³ *Id.* at 7.

¹⁰⁴ *Id.* at 60.

¹⁰⁵ Ex. 17 at 4-5 (P. Moul Direct).

106. To this group of nine companies, he added four combination gas and electric utilities that have no significant generation assets. The complete listing of Mr. Moul's "Delivery Group" was comprised of the following companies:

AGL Resources	Northeast Utilities	South Jersey Industries
Atmos Energy Corp	Northwest Natural Gas	Southwest Gas Corp
Consolidated Edison, Inc.	PEPCO Holdings, Inc.	UHL Holding Corporation
Laclede Group Inc.	Piedmont Natural Gas	WGL Holdings Inc. ¹⁰⁶
New Jersey Resource Corp		

107. Dr. Amit, for the Department, selected a group of companies that have investment risk comparable to MERC. For ease of description the Department's proposed Natural Gas Distribution Comparison Group is denominated below as NGCG. Dr. Amit assembled this group by applying a set of screening criteria to the Compustat Research Insight database and Value Line Investment Survey in September of 2013.¹⁰⁷

108. Dr. Amit included companies in the NGCG if they met the following criteria; the company had:

- (a) a Standard Industrial Classification (SIC) code of 4924 – signifying natural gas distribution;
- (b) its stock publicly traded on one of the exchanges; and
- (c) Standard & Poor's bond rating similar to that of Integrys – specifically within the range between BBB and AA;
- (d) obtained at least sixty percent of total net operating income from natural gas distribution operations; and
- (e) a beta and standard deviation of past price changes that deviated by no more than one standard deviation from the mean of the other companies in the comparison group.¹⁰⁸

109. Dr. Amit placed nine companies into the NGCG. They were:

¹⁰⁶ *Id.*

¹⁰⁷ Ex. 200, at 8-14 (E. Amit Direct).

¹⁰⁸ *Id.* at 8-11.

AGL Resources	New Jersey Resource Corp	South Jersey Industries
Atmos Energy Corp	Northwest Natural Gas	Southwest Gas Corp
Laclede Group Inc.	Piedmont Natural Gas	WGL Holdings Inc. ¹⁰⁹

110. Dr. Amit calculated the long-term debt ratio for MERC by excluding short-term debt from the capital structure.¹¹⁰

111. The average 2012 long-term debt ratio of NGCG is 42.90 percent as compared to 47.01 percent for MERC. The average 2012 common equity ratio for NGCG is 57.10 percent as compared to 52.99 percent for MERC.¹¹¹

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."¹¹²

113. On behalf of OAG-AUD, Dr. Pradip K. Chattopadhyay, a Utilities Economist with the Division, developed a proxy group to measure MERC's cost of equity. Dr. Chattopadhyay began with gas and electric utilities in the Value Line Survey. He screened from this listing those companies that did not have at least 50 percent of its revenues from gas distribution business during the years 2010, 2011 and 2012. Additionally, Dr. Chattopadhyay screened those companies that did not have at least 75 percent of its assets associated with the gas distribution business.¹¹³

114. Dr. Chattopadhyay placed six companies into his DCF Proxy Group. They were:

AGL Resources	Laclede Group Inc.	Piedmont Natural Gas
Atmos Energy Corp	Northwest Natural Gas	Southwest Gas Corp. ¹¹⁴

115. In the view of the Administrative Law Judge, because of the differing risk profiles, each of the proposed comparison groups has its drawbacks. For example, Mr.

¹⁰⁹ *Id.* at Attachment EA-2 at 2.

¹¹⁰ *Id.* at 12-13.

¹¹¹ *Id.*

¹¹² *Id.* at 13.

¹¹³ Ex. 161 at 24-25 (P. Chattopadhyay Direct).

¹¹⁴ *Id.* at 26.

Moul's Delivery Group includes four combination electric and natural gas delivery companies with higher risk profiles than MERC.¹¹⁵

116. Moreover, as noted above, Dr. Amit's NGCG included companies whose risk profiles were lower than MERC's – presumably with easier access to capital.¹¹⁶

117. Likewise, Dr. Chattopadhyay's DCF Proxy Group contained several companies that have substantial non-regulated activities. This grouping thus presents a very different risk profile than MERC.¹¹⁷

(c) Determining the Expected Growth Rate for Dividends

118. Under accepted DCF methodology, the required rate of return is equal to the expected growth rate of dividends plus the expected dividend yield.¹¹⁸

119. Dr. Amit projected expected growth rates based upon rises in earnings per share (EPS). He used EPS data from three widely-used investor services: Zacks Investment Research (Zacks), The Value Line Investment Survey (VL), and the long-term earnings growth rate estimate provided by Thomson Financial Network (Thomson).¹¹⁹

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

121. Dr. Chattopadhyay, on behalf of the OAG-AUD argued, 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.¹²¹

122. Because the rates of returns on equity and dividend payouts are oftentimes uneven for a utility, a utility's historical growth rate may be a poor indicator of future performance. To account for this volatility, it is a better practice to project growth rates based upon rises in earnings per share. Genuine, long-run and sustainable growth in dividends is driven by growth in earnings.¹²²

¹¹⁵ Ex. 17 at 4-5 (P. Moul Direct); Ex. 200 at 46-47 (E. Amit Direct); Ex. 202 at 13-14 (E. Amit Surrebuttal).

¹¹⁶ Ex. 200 at 13 (E. Amit Direct); Ex. 201 at 3-4 (E. Amit Rebuttal).

¹¹⁷ Ex. 161, at 25 (Chattopadhyay Direct).

¹¹⁸ Ex. 200 at 21 (E. Amit Direct).

¹¹⁹ *Id.* at 14.

¹²⁰ Ex. 202 at 3-4 (E. Amit Surrebuttal).

¹²¹ See, Ex 161 at 34-35 (Chattopadhyay Direct).

¹²² Ex. 200 at 14-19 (E. Amit Direct); Ex. 201 at 12-13 (E. Amit Rebuttal).

123. Likewise, any inequality, during the short-term, in the rates of growth of EPS, DPS and BPS is more appropriately resolved by assuming a convergence of these rates over the long-term than it is by an arithmetic averaging of the different rates today.¹²³

(d) Determining the Expected Dividend Yield

124. The second component of the DCF analysis is the expected dividend yield: D_1/P_0 – where P_0 is the price today and D_1 is the dividend in the next year (assuming that dividends are distributed at the end of each year).¹²⁴

125. When undertaking a DCF analysis, selection of the review period for share prices is important. It is the best practice to use a period that is both recent enough to reflect current conditions for the utilities and long enough to avoid short-term, aberrational volatility in prices.¹²⁵

126. MERC used a six-month average dividend yield for the period ending May 2013 for its DCF analysis.¹²⁶

127. This resulted in a dividend of 3.91 percent.¹²⁷

128. MERC then adjusted the dividend yield by the expected growth rate to arrive at an expected dividend yield of 4.02 percent.¹²⁸

129. The Department disagreed with MERC's dividend yield calculation for two reasons. The Department objected to the use of month-end prices to calculate the dividend yields, arguing that this method can result in one particular price having too much influence on the six-month average dividend yield. Second, the Department maintained that current stock prices fully reflect all publicly available information; such that using longer-term historical prices would result in biased dividend yields that reflect other, outdated information.¹²⁹

130. The OAG-AUD disagreed with MERC's dividend yield calculation, albeit for different reasons. It noted that MERC's choice of proxy companies had changed since its most recent rate case and that "it is unclear from Mr. Moul's analysis exactly

¹²³ Ex. 201 at 13 and 15-18 (E. Amit Rebuttal); Ex. 202 at 34-35 (E. Amit Surrebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 202-203 (Amit).

¹²⁴ Ex. 200 at 15 (E. Amit Direct).

¹²⁵ *Id.*

¹²⁶ Ex. 200 at 48 (E. Amit Direct).

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ Ex. 200 at 15, 48 (E. Amit Direct).

how he is blending the results of his various approaches to come to his overall recommendation¹³⁰

131. Dr. Amit reasonably used the thirty day closing prices to calculate the expected dividend yield, September 1, 2013 through September 30, 2013.¹³¹

132. Dr. Amit later updated the expected dividend yield for companies in the NGCG by using the then-most recently available thirty-two day period closing prices (between March 14 and April 14, 2014).¹³²

(e) Growth Rates and Dividend Yields

133. MERC used a six-month average dividend yield for the period ending May 2013 for its DCF analysis. This resulted in a dividend of 3.91 percent. MERC then adjusted the dividend yield by the expected growth rate to arrive at an expected dividend yield of 4.02 percent.¹³³

134. MERC's updated dividend yield is 3.94 percent, prior to the forward-looking adjustment that brings MERC's final dividend yield to 4.05 percent.¹³⁴

135. In Dr. Amit's Direct Testimony, the expected growth rate for the NGCG ranged from a low of 4.21 percent to a high of 5.87 percent, with the best point estimate for the expected growth rate at 5.09 percent.¹³⁵

136. The expected dividend yield based upon Dr. Amit's Direct Testimony analysis ranged from a low of 3.93 percent to a high of 3.96 percent, with the best point estimate for the expected dividend yield at 3.94 percent.¹³⁶

137. Dr. Amit's combination of expected growth rates with the expected dividend yields resulted in the required rate of return for the group ranged from a low of 8.14 percent to a high of 9.83 percent. Within this range, he asserted that the best point estimate for the required rate of return on equity for the group was 9.04 percent (the mean ROE).¹³⁷

¹³⁰ OAG-AUD'S POST HEARING SUBMISSION, at 28.

¹³¹ Ex. 200 at 15 (E. Amit Direct); see *also*, Ex. 161, at 30 (Chattopadhyay Direct).

¹³² Ex. 202 at 3 (E. Amit Surrebuttal).

¹³³ Ex. 200 at 48 (E. Amit Direct).

¹³⁴ Ex. 18 at 10 and Schedule PRM-2 (P. Moul Rebuttal).

¹³⁵ Ex. 202 at 3 (E. Amit Surrebuttal).

¹³⁶ *Id.*

¹³⁷ *Id.* at 21, EA-5.

138. In his Direct Testimony, Dr. Amit applied the TGDCF to one company for which use of the DCF analysis alone would result in an unreasonably low ROE for the comparison group (NJR, for which its short-term-projected dividend growth rates are not expected to continue in the long run). Dr. Amit applied the TGDCF to NJR's data because of the company's relatively low growth rate in comparison to the mean expected growth rate for the remainder of the NGCG.¹³⁸

139. Dr. Amit then used the projected five-year average EPS growth rates for the remaining companies in the NGCG as a proxy for sustainable growth rates.¹³⁹

140. In Surrebuttal testimony, Dr. Amit applied the TGDCF to the analyses of three companies (ATO, NWN and PNY).¹⁴⁰

141. Based upon Dr. Amit's DCF and TGDCF analyses for the NGCG group, the required rate of return for MERC ranged from a low of 8.61 percent to a high of 10.14 percent, with flotation costs.¹⁴¹

142. Dr. Amit concluded that the most reasonable required rate of return on common equity for MERC inside this range was the mean of 9.40 percent.¹⁴²

143. Dr. Chattopadhyay's "traditional" DCF analysis resulted in a recommended ROE of 8.21 percent. His market-to-book analysis resulted in a recommended ROE of 8.69 percent.¹⁴³

144. Dr. Chattopadhyay combined four different DCF analyses to produce his overall recommended ROE of 8.62 percent.¹⁴⁴

2. Capital Asset Pricing Model (CAPM)

145. The parties used pricing model analyses – such as the Capital Asset Pricing Model (CAPM) or the Empirical CAPM (ECAPM) – to check the results of their DCF calculations.¹⁴⁵

146. The basic premise of CAPM is that any risk that is company-specific can be diversified away by investors.¹⁴⁶

¹³⁸ Ex. 200 at 24-26 (E. Amit Direct).

¹³⁹ Ex. 200 at 23, EA-5 (E. Amit Direct).

¹⁴⁰ Ex. 202 at 9 (E. Amit Surrebuttal).

¹⁴¹ Ex. 200 at 34 (E. Amit Direct).

¹⁴² *Id.*

¹⁴³ Ex. 165, at 2 (Chattopadhyay Surrebuttal).

¹⁴⁴ *Id.*

¹⁴⁵ See, Ex. 17, at 6 (Moul Direct); Ex. 161, at 21-22 (Chattopadhyay Direct); Ex. 200 at 28 (E. Amit Direct).

147. To perform a CAPM analysis there are three main parameters: beta, the risk-free rate, and risk premium.¹⁴⁷

148. The principal risk is the systematic risk of the stock.¹⁴⁸

149. This systematic risk is measured by beta.¹⁴⁹

150. For beta, it is appropriate that a risk measurement for a particular company reflect the price volatility of the company's stock relative to the price volatility of the market as a whole.¹⁵⁰

151. Mr. Moul upwardly adjusted the CAPM risk measurement to account for the difference between MERC's market-debt/equity ratio and book-debt /equity ratio.¹⁵¹

152. Because this difference is already accounted for by investors no additional adjustment is needed.¹⁵²

153. Dr. Amit reasonably adjusted Mr. Moul's proposed beta by disregarding Mr. Moul's upward adjustment of the Value Line beta of 0.67.¹⁵³

154. Likewise, with respect to risk-free rates, Mr. Moul's Blue-Chip's forecast of *future* yields for thirty-year Treasury Bills as signifying *current* yields is inappropriate. Because current yields on long-term Treasury bills reflect investors' expectations about the future economic and financial environment, Mr. Moul's use of Blue-Chip's forecast overstates the risk-free rate in the CAPM.¹⁵⁴

155. Use of the CAPM raises some difficult issues – including difficulties in determining the appropriate beta and the appropriate riskless asset.¹⁵⁵

156. The best practice is to compare the results of a DCF and TGDCF analysis against the results produced by other analyses – such as CAPM or the ECAPM.¹⁵⁶

¹⁴⁶ Ex. 200 at 28 (E. Amit Direct).

¹⁴⁷ *Id.* at 55.

¹⁴⁸ *Id.* at 28.

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* at 2.

¹⁵¹ *Id.* at 56 and 67.

¹⁵² *Id.* at 60–68.

¹⁵³ *Id.* at 58.

¹⁵⁴ Ex. 200 at 57–58 (E. Amit Direct).

¹⁵⁵ *Id.* at 28.

¹⁵⁶ *Id.* at 28 and 32.

157. For these reasons, the Department reasonably used the CAPM and ECAPM results as checks upon the reasonableness of its DCF analyses.¹⁵⁷

158. Application of the CAPM to the NGCG resulted in an estimated ROE that was lower, 9.11 percent, than Dr. Amit's DCF/TGDCF-estimated ROE of 9.40 percent with flotation costs.¹⁵⁸

159. Dr. Amit's updated CAPM with flotation costs was 9.79.¹⁵⁹

160. Application of the ECAPM analysis resulted in an estimated ROE mean for the NGCG of 9.96 percent with flotation costs.¹⁶⁰

161. The ECAPM's ROE was appreciably higher than Dr. Amit's CAPM's ROE and somewhat close to the mean of his DCF's ROE for the NGCG.¹⁶¹

162. Dr. Amit's CAPM and ECAPM results for the NGCG lie within the range of Dr. Amit's DCF/TGDCF estimated ROEs – specifically, between 8.61 percent and 10.14 percent.¹⁶²

3. Risk Premium Analysis (RP)

163. In addition to its DCF analysis, MERC undertook a Risk Premium analysis to account for the fact that common equity represents a greater investment than debt capital. MERC's RP analysis utilized the Moody's index of A-rated Public Utility Bonds along with the forecast of interest rates provided in the Blue Chip Financial Forecast. For its equity risk premium, MERC looked to the SBBI (Morningstar) Classic Yearbook to identify the equity risk premium that is aligned with the prospective level of interest rates.¹⁶³

164. The analysis produced an updated ROE of 12.14 percent.¹⁶⁴

165. Dr. Amit persuasively testified that Mr. Moul's analysis results in an unreasonable "mismatch" of financial instruments. Mr. Moul calculates the differences

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.* at 33.

¹⁶¹ *Id.* at 33.

¹⁶² *Id.* at 34.

¹⁶³ Ex. 17 at 34-36 (Moul Direct).

¹⁶⁴ Ex. 18 at 30 (Moul Rebuttal).

in returns on large-cap common stocks, minus the return on long-term corporate bonds, which he applies as a risk premium to utility bonds.¹⁶⁵

166. The appropriate risk premium should be calculated as the difference between the return on common stock of A-rated utility companies and the return on long-term A-rated utility bonds.¹⁶⁶

4. Other Key Data Points

167. The average ROE determinations made by state utility commissions for the eleven natural gas rate cases resolved during the fourth quarter of 2013 was 9.83 percent.¹⁶⁷

168. The range of those allowed ROEs extended from a low of 9.08 percent to a high of 10.25 percent.¹⁶⁸

169. Dr. Amit's final recommended ROE of 9.29 percent is at the lower end of this range of recent determinations. Mr. Moul's suggested ROE of 10.75 percent is beyond this range. Likewise, Dr. Chattopadhyay's "DCF Construct" ROE of 8.62 percent is beyond this range.¹⁶⁹

5. The Administrative Law Judge's Recommendation as to the Appropriate Return on Equity

170. Because stock prices fully account for all publicly available information, use of the DCF model does not require later adjustments for the discrepancies between the market and book values of equity and debt.¹⁷⁰

171. The DCF model is a reasonable, market-oriented approach to determine a fair ROE for MERC.¹⁷¹

172. Yet, because MERC's risk profile is higher than the comparison group used by the Department, in the view of the Administrative Law Judge, Dr. Amit's recommendation of 9.40 percent understates the appropriate return on equity.¹⁷²

¹⁶⁵ Ex. 200 at 55 (E. Amit Direct).

¹⁶⁶ *Id.*

¹⁶⁷ Ex. 202 at 18.

¹⁶⁸ *Id.*

¹⁶⁹ Ex. 165 at 2 (Chattopadhyay Surrebuttal); Ex. 202 at 2 and 13 (E. Amit Surrebuttal).

¹⁷⁰ Ex. 200 at 63-67 (E. Amit Direct).

¹⁷¹ Ex. 200 at 4-5, EA-12 (E. Amit Direct).

¹⁷² See, Ex. 200 at 13 and 34 (E. Amit Direct); Ex. 201 at 3-4 (E. Amit Rebuttal).

173. In the view of the Administrative Law Judge, the results of Dr. Amit's updated CAPM with flotation costs – namely, a recommended ROE of 9.79 percent – yields a better and more reasonable result. This higher percentage is:

- (a) more reflective of the investment risks MERC presents when seeking capital;
- (b) one basis point from MERC's updated DCF analysis, which rendered a ROE of 9.8 percent;
- (c) supported by Dr. Amit's ECAPM analysis, which resulted in an estimated ROE mean for the NGCG of 9.96 percent with flotation costs;
- (d) comfortably within the overall range for Dr. Amit's DCF and TGDCF analyses (with a low of 8.61 percent to a high of 10.14 percent, including flotation costs); and
- (e) close to the average ROE determinations made by state utility commissions for the eleven natural gas rate cases that were resolved during the fourth quarter of 2013 – specifically, an average ROE of 9.83 percent.¹⁷³

174. Based upon the records in these proceedings, a return on equity for MERC of 9.79 percent is reasonable and appropriate.¹⁷⁴

IV. Features of the Test Year

175. During the course of these proceedings, the parties were able to reach accord on some, but not all, of the issues relating to the additional revenue that MERC would reasonably require in the future.¹⁷⁵

¹⁷³ See, Ex. 18 at 4 (P. Moul Rebuttal); Ex. 200 at 32-34 (E. Amit Direct); Ex. 202 at 11 and 18 (E. Amit Surrebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 200 (E. Amit).

¹⁷⁴ The resulting recommended capital structure would be:

	Capitalization Ratio	Cost Percentage	Weighted Cost
Long-Term Debt	0.4464	0.055606	0.024823
Short-Term Debt	0.0505	0.023487	0.001186
Common Equity	0.5031	0.0979	0.049253
Total:	1	Rate of Return:	7.5262%

A. MERC's Test-Year Sales Forecast

176. MERC filed a forecasted 2014 test year.¹⁷⁶

177. MERC forecasted sales and fixed charge counts in the spring of 2013. It used actual data from the period of January 2007 through January 2013 to complete this forecast. MERC's revenues were calculated based upon this sales forecast.¹⁷⁷

178. As it had in its next most-recent rate case, MERC used Ordinary Least Squares (OLS) regression analyses to estimate test-year sales.¹⁷⁸

179. However, MERC made significant changes to the type of model specifications used in its regression analyses compared to the test-year sales forecast in the last rate case.¹⁷⁹

180. When developing its sales forecast, MERC used MetrixND, a statistical software package that considers billing sales, price, structural changes, appliance saturation and efficiencies trends. MetrixND then imposes a model structure through a Statistical Adjusted End-Use (SAE) specification.¹⁸⁰

181. While the Company used MetrixND to estimate its various regression models, the Department used two packages, EViews 7.2 and STATA 11.1, to review the outputs reported by the Company in its Direct Testimony.¹⁸¹

182. While differences between various regression software packages are to be expected, there should not be significant differences between the outputs produced by a utility and the results, using the utility's reported specifications, produced by other parties.¹⁸²

183. The Department was unable to replicate MERC's regression outputs for the following models: Consolidated-Interruptible sales, Consolidated-LC&I sales, Consolidated-SC&I sales, Consolidated-Transport sales, NNG-SC&I average use per customer, and NNG-Interruptible sales.¹⁸³

¹⁷⁵ See generally, EVIDENTIARY HEARING TRANSCRIPT, at 24, 49-50, 54, 55, 67 and 96.

¹⁷⁶ Ex. 212 at 3 (L. Otis Direct).

¹⁷⁷ Ex. 19 at 8 (S. DeMerritt Direct).

¹⁷⁸ Ex. 212 at 5-6 (L. Otis Direct).

¹⁷⁹ *Id.*

¹⁸⁰ Ex. 38 at 5-11 (H. John Direct).

¹⁸¹ *Id.* at 5.

¹⁸² Ex. 212 at 10-11 (L. Otis Direct).

¹⁸³ Ex. 212 at 11-12 and 16-17 (L. Otis Direct).

184. The results achieved by the Department using MERC's reported specifications were significantly different than those achieved by the Company.¹⁸⁴

185. The Department and MERC disagreed as to both the particular items assessed by the SAE model and its use in test-year forecasting.¹⁸⁵

186. As a compromise measure, the Department devised an alternative to the test-year sales forecast proposed by MERC. The alternative utilized the entire year of 2013 data – data that was not yet available to MERC at the time that the Company prepared its test year sales forecast.¹⁸⁶

187. The type of alternative forecast recommended by the Department has been used in other proceedings, including Docket No. G008/GR-08-1075.¹⁸⁷

188. Based on its alternative test year sales forecast, the Department recommended an increase in test-year sales of approximately 26,791,937 therms from the Company's originally filed figure of 662,833,577 therms, for a total of 689,625,514 therms.¹⁸⁸

189. The Department calculated test-year revenue in the same manner as MERC. The resulting test-year sales recommendations increased total test-year revenue by approximately \$8,965,273 from the Company's revenue figure of \$257,186,462, to a new total of \$266,151,735.¹⁸⁹

190. Ms. Otis also made an adjustment for increased natural gas cost expenses and changed Conservation Cost Recovery Charge (CCRC) revenues due to increased sales. Ms. Otis' alternative test-year sales estimates yielded a total test-year gas cost of \$180,411,466, an increase of \$6,999,406 over MERC's proposal.¹⁹⁰

191. After accounting for increased natural gas cost expenses and CCRC revenues, the Department's total net revenue adjustment is approximately \$1,965,865 greater than MERC's originally filed revenue estimate.¹⁹¹

¹⁸⁴ *Id.* at 14-15.

¹⁸⁵ *Id.* at 8-10, 18-22; Ex. 214 at 5 (L. Otis Surrebuttal).

¹⁸⁶ Ex. 39 at 2 and 8 (H. John Rebuttal); Ex. 212 at 5 (L. Otis Direct); Ex. 212 at LBO-7 and LBO-8.

¹⁸⁷ Ex. 212 at 23.

¹⁸⁸ *Id.* at LBO-11.

¹⁸⁹ *Id.*

¹⁹⁰ Ex. 212 at LBO-11 (L. Otis Direct).

¹⁹¹ Ex. 212 at 28-29, 32 and Schedule (LBO-11) (L. Otis Direct).

192. MERC accepted the Department's recommended alternative test year sales forecast.¹⁹²

193. The Department and MERC agree that MERC provided spreadsheets that fully linked together all raw data and inputs for MERC's sales forecast.¹⁹³

194. Based upon MERC's acceptance of the Department's alternative test year sales forecast, the Department determined that there were no issues related to test year sales forecasting.¹⁹⁴

195. Although MERC agreed to use the Department's alternative sales forecast in this proceeding, MERC and the Department disagree as to the appropriateness of using SAE modeling for future test year forecasts.¹⁹⁵

196. MERC and the Department have agreed to work together to address future sales forecasting methodology.¹⁹⁶

197. The Administrative Law Judge concludes that the sales forecast agreed to by MERC and the Department is reasonable and should be used for purposes of setting rates in this proceeding.¹⁹⁷

B. Base Cost of Gas

198. MERC's original cost of gas was updated using NYMEX data from May 15, 2013, as described in the Base Cost of Gas filing in Docket No. G011/MR-13-732.¹⁹⁸

199. MERC's cost of gas was updated a second time on April 15, 2014 using NYMEX data from March 17, 2014, as described in the Base Cost of Gas filing in Docket Nos. G011/GR-13-617 and G011/MR-13-732.¹⁹⁹

200. Because the approach used by the Company was similar to the approaches that it had used in the past, and those used by other companies, the

¹⁹² Ex. 39 at 2, 8 (H. John Rebuttal).

¹⁹³ *Id.* at 5-7; Ex. 214 at 3-4 (L. Otis Surrebuttal).

¹⁹⁴ Ex. 214 at 1 (L. Otis Surrebuttal).

¹⁹⁵ Ex. 39 at 8 (H. John Rebuttal).

¹⁹⁶ EVIDENTIARY HEARING TRANSCRIPT, at 106-108 (H. John) and 207-209 (L. Otis).

¹⁹⁷ *Id.*

¹⁹⁸ Ex. 19 at 8 (S. DeMerritt Direct).

¹⁹⁹ An updated cost of gas was required by Commission Orders in Docket No. G011/MR-13-732, Order Setting New Base Cost of Gas, issued November 27, 2013, at ordering para. 2, and, in this 13-617 docket, by the First Prehearing Order, issued December 21, 2013. Ex. 24 at 29 (S. DeMerritt Rebuttal); Ex. 214 at 9-10 (L. Otis Surrebuttal).

Department recommended that MERC's final rates be based on the revised commodity gas costs and the updated test year sales figures.²⁰⁰

201. The update increased Purchased Gas Adjustment revenue (which is a component of total revenue) from MERC's earlier estimate of \$173,412,058 to \$214,858,858. This is an increase of \$41,446,798.²⁰¹

202. The Administrative Law Judge recommends that MERC's final rates be based upon the updated commodity gas costs and the Department's updated test year sales figure.²⁰²

203. The Administrative Law Judge recommends that the Commission require the Company to continue to provide the following in its future initial rate case filings:

- (a) A summary spreadsheet that links together the Company's test-year sales and revenue estimates, its CCOSS, and its rate design schedules;
- (b) A spreadsheet that:
 - i. fully links together all raw data, to the most detailed information available; and
 - ii. enables the full replication of the process that the Company uses to calculate the input data for its test-year sales analysis.
- (c) A bridging schedule that:
 - i. fully links together the old and new billing systems; and
 - ii. validates that there is no difference in the results produced by the two billing systems.
- (d) Any, and all, data used for its sales forecast 30 days in advance of its next general rate case; and
- (e) Detailed information sufficient to allow for replication of any and all Company derived forecast variables.²⁰³

²⁰⁰ Ex. 214 at 9-10 (L. Otis Surrebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 208-209 (L. Otis).

²⁰¹ Ex. 214 at 11 and LBO-S-6. Because the update also increases gas expense, the change does not impact the Department's recommended adjustment of \$1,965,865 to operating income before taxes. See, Ex. 214 at 11 (L. Otis Surrebuttal).

²⁰² *Id.*

C. MERC's Employee Benefit Cost Increase

204. Integrys owns a service company, Integrys Business Support, LLC (IBS) that provides shared or common services to Integrys and its subsidiaries, including MERC.²⁰⁴

205. IBS began providing service to MERC and its regulated affiliates on January 1, 2008.²⁰⁵

206. MERC developed its 2014 test year employee benefits request for rate recovery in four categories:

- (1) 2014 costs that are not requested for rate recovery in 2014;
- (2) forecasted 2014 costs that were estimated by MERC based on preliminary results and trend information from MERC's actuary;
- (3) forecasted 2014 costs that were determined by inflating 2012 actual costs; and
- (4) forecasted 2014 costs that were determined through actuarial analysis.²⁰⁶

207. The first category contains costs related to MERC's share of IBS's current costs for non-qualified benefits. The second category contains MERC's dental benefits, medical benefits, and IBS benefits that are billed to MERC. The third category contains a number of sub-accounts that have been referred to in testimony as MERC's "other employee benefits." The fourth category contains the pension benefit costs for MERC and IBS.²⁰⁷

208. MERC noted that the expected return on plan assets for the 2014 test year was 8.00 percent and no party recommended changes to that percentage.²⁰⁸

²⁰³ These recommendations are based upon the Department's testimony at Ex. 212 at 29-30 (Otis Direct). The Department and MERC have agreed to address and work on other forecasting issues such as MERC's Statistically Adjusted End-Use, or SAE rate class sales estimates, ongoing refinement of weather-normalization and potentially other sales forecasting issues. See, EVIDENTIARY HEARING TRANSCRIPT, at 208.

²⁰⁴ Ex. 215 at 4 (L. La Plante Direct).

²⁰⁵ *Id.* at 6.

²⁰⁶ Ex. 23 at 3 (C. Hans Direct).

²⁰⁷ Ex. 26 at 3-15 and Schedules (CMH-1 and CMH-2) (C. Hans Direct).

²⁰⁸ Ex. 27 at 8 (C. Hans Rebuttal).

209. The Department did recommend other adjustments to the 2014 employee benefit cost amounts (as determined by the actuarial analysis). The Department suggested revising both the measurement date and the plan asset value date, and changing the discount rate assumption so as to align it with the expected return on plan assets.²⁰⁹

210. MERC did not seek recovery of non-qualified employee benefit costs for Pension Restoration Plan (Account 926210) or Supplemental Executive Retirement Plan (SERP) (Account 926220).²¹⁰

211. Because MERC did not seek recovery of the expense portion of these accounts, the Department recommended removal of the related rate base portion of the accounts (Accounts 228300, 228305, 228310 and 242072).²¹¹

212. MERC agreed to adopt this recommendation.²¹²

213. The Administrative Law Judge finds that Accounts 228300, 228305, 228310 and 242072 should be removed from rate base.²¹³

D. Pension, Post-Retirement Medical and Post-Retirement Life Insurance Adjustments

214. MERC has taken steps to help manage its pension costs. The most significant change was a shift from a traditional defined benefit pension plan to a defined contribution model integrated with the 401K plan.²¹⁴

215. As part of that transition, effective January 1, 2008, MERC closed the pension plan that had earlier been extended to administrative employees. There are no longer any open pension plans at MERC.²¹⁵

216. MERC argues in this proceeding that it is reasonable to continue to have the present costs of those earlier pension plans recovered through new rates.²¹⁶

217. On January 27, 2014, Towers Watson, MERC's actuary, updated an actuarial analysis for MERC's 2014 test year pension expense. The firm found that

²⁰⁹ Ex. 26 at 4 (C. Hans Rebuttal); Ex. 217 at 29-30 (M. St. Pierre Direct).

²¹⁰ Ex. 26 at 3-4 (C. Hans Direct).

²¹¹ Ex. 217 at 7 (M. St. Pierre Direct).

²¹² EVIDENTIARY HEARING TRANSCRIPT, at 56 (C. Hans); Ex. 27 at Schedule (CMH-4) (C. Hans Rebuttal).

²¹³ *Id.*

²¹⁴ Ex. 26 at 11-12 (C. Hans Direct).

²¹⁵ *Id.*; Ex. 13 at 14 (N. Cleary Direct).

²¹⁶ Ex. 13 at 14 (N. Cleary Direct).

MERC will have a 2014 pension expense of \$126,771. MERC included this sum as its 2014 test-year pension expense.²¹⁷

218. In order to calculate the plan's total benefit obligation and annual expense, the actuary combines a number of variables: (1) rates of death from mortality tables; (2) retirement rates for MERC; (3) anticipated salary increases; (4) expected return on plan assets; and (5) a discount rate.²¹⁸

219. There are four components of the Statement of Financial Accounting Standards (SFAS) No. 87 that govern calculations of pension expense: (1) service cost; (2) interest cost; (3) expected earnings on plan assets; and (4) amortization of gains and losses, prior service costs, and any transitional amounts.²¹⁹

220. These cost assumptions are determined by MERC with the concurrence of Towers Watson in accordance with Generally Accepted Accounting Principles (GAAP). The assumptions are then reviewed for reasonableness by MERC's external auditor, Deloitte and Touche.²²⁰

221. MERC's annual pension expense was \$1,212,062 in 2012 and is projected to be \$126,771 for 2014. Also included in pension expense for both 2012 and 2014 is an amortization of \$474,223 per year as authorized by the Commission in Docket No. G-007,011/M-06-1287 on July 30, 2007 for pension and other post-retirement benefits acquired from Aquila.²²¹

222. MERC's actuary, Towers Watson, calculated the 2014 employee benefit costs related to Employee Pension Expense (pension), Post-Retirement Medical Plan Expense (post-retirement medical) and Post-Retirement Life Plan Expense (post-retirement life).²²²

223. The Department investigated the assumptions MERC used to calculate its test-year employee benefit costs. The Department investigated whether MERC:

- (a) used an appropriate measurement date to determine the plan asset level;
- (b) appropriately discounted future costs; and

²¹⁷ Ex. 27 at 5 and Schedule CMH-1 (C. Hans Rebuttal).

²¹⁸ Ex. 26 at 10-11 and Schedule CMH-1 (C. Hans Direct).

²¹⁹ *Id.* at 9-10 and Schedule CMH-1 (C. Hans Direct). The matters of pension expense accounting addressed in SFAS No. 87 are now found in Accounting Standards Codification Topic 715-30.

²²⁰ *Id.* at 9, 11.

²²¹ *Id.* at 11.

²²² Ex. 217 at 28 (M. St. Pierre Direct) (*citing* Ex. 26 at 8 (C. Hans Direct)).

(c) used a reasonable long-term growth rate.²²³

224. Based upon the Department's review of MERC's benefit cost proposal, the Department disputed MERC's selection of measurement dates and MERC's discounting of future costs.²²⁴

1. Selection of Measurement Dates

225. MERC provided actuarial analyses for the pension plan and post-retirement life insurance plan that were updated to December 31, 2013.²²⁵

226. MERC recommended that the updated actuarial analyses be included in the calculation of the 2014 test year revenue requirement.²²⁶

227. Similarly, for the post-retirement medical plan, MERC proposed to update the plan asset values and discount rates as of March 1, 2014 – the end date of its most recent analysis.²²⁷

228. The parties agree that actuarially determined costs should be based on the most recent and accurate data available.²²⁸

229. MERC agreed to outwardly adjust the plan asset valuation date from December 31, 2012 to December 31, 2013.²²⁹

230. The Department concurs with MERC's proposal to update the post-retirement medical plan costs from December 31, 2013 to March 1, 2014.²³⁰

231. The Administrative Law Judge finds that the pension plan asset values and post-retirement life insurance plan asset values should be updated to reflect the

²²³ Ex. 217 at 30 (M. St. Pierre Direct)

²²⁴ *Id.*

²²⁵ Ex. 27 at 5-7 (C. Hans Rebuttal).

²²⁶ *Id.*

²²⁷ On March 25, 2014, MERC received an updated actuarial analysis from Towers for the post-retirement medical plans. MERC Ex. 27 at 5 (Hans Rebuttal). The reason for the update was that Integrys was "simplifying the current structure by offering a single Medicare Advantage plan to all eligible retiree groups starting in 2015." The plan change triggered an interim measurement of the affected plans as of March 1, 2014, the date the plan change was communicated to affected participants. Ex. 27 at 6 (C. Hans Rebuttal).

²²⁸ Ex. 27 at 5 (C. Hans Rebuttal).

²²⁹ *Id.*; Ex. 217 at 30, 34 (M. St. Pierre Direct).

²³⁰ Ex. 219 at 25-26 (M. St. Pierre Surrebuttal).

balance on December 31, 2013. The post-retirement medical plan costs should be updated from December 31, 2013 to March 1, 2014.²³¹

2. Appropriate Discounting of Future Pension Expenses

232. The parties divide as to the appropriate discount rate as to future pension expenses that should be included in the test year expenses.²³²

233. MERC asserted that the discount rates for each plan (the pension plan, post-retirement medical administrative plan, non-administrative plan, Peoples Energy Medical plan and post-retirement life plan) followed from the specific expected benefit payments for the plan. The discount rates for post-retirement employee benefit (OPEB) costs thus were both plan-specific and varied from accounting period to accounting period.²³³

234. MERC maintained that both the plan-specific nature and the variability of the discount rates were in accord with GAPP and the guidance in Accounting Standards Codification Topic 715.²³⁴

235. MERC proposed that the Company's updated actuarial analyses be included in the calculation of the 2014 test year revenue requirement.²³⁵

236. The Department argued that the pension account discount rates MERC proposed were unreasonable. The Department maintained that it was not appropriate to use MERC's proposed discount rates because each was less than the expected rate of return on the plan's assets.²³⁶

237. The Company's expected rate of return on pension plan assets is eight percent.²³⁷

238. In response to a request from the Department, MERC calculated the 2014 test year amounts using the asset values of the plan on December 31, 2013 and changing the discount rate to 8 percent.²³⁸

²³¹ *Id.*

²³² See generally, Ex. 27 (C. Hans Rebuttal) and Ex. 219 (St. Pierre Surrebuttal).

²³³ Ex. 27 at 5-6 (C. Hans Rebuttal).

²³⁴ *Id.*; Ex. 219 at n. 7 (St. Pierre Surrebuttal); Ex. 27 at 8-9 (C. Hans Rebuttal).

²³⁵ Ex. 27 at 4-12 (C. Hans Rebuttal).

²³⁶ Ex. 217 at 30 (M. St. Pierre Direct).

²³⁷ Ex. 26 at 11, 14, 15 (C. Hans Direct).

²³⁸ Ex. 217 at 31 (M. St. Pierre Direct); Ex. 218 MAS-21 (M. St. Pierre Direct) (MERC Resp. to DOC IRs 154, 155, 156 and 157).

239. While the parties make a variety of different policy and financial arguments as to the best and most appropriate method of selecting the post-retirement plan discount rate, at the crux of the dispute is the parties' very different assessments of the near-term risks to the plan.²³⁹

240. From MERC's perspective, the natural gas rates charged to its customers should reflect the costs of settling each post-retirement plan's "expected future benefit payments" and, being able to make that settlement in fairly short order. To accomplish this result, MERC's "BOND:Link model":

theoretically purchases individual high-quality corporate bonds to settle each plan's expected future benefit payments. From the theoretically purchased bonds, a single rate is determined that equates the market value of the bonds purchased to the discounted value of each plan's expected future benefit payments. The calculated discount rate is then rounded to the nearest 5 basis points.²⁴⁰

241. The performance that this theoretical collection of high-quality corporate bonds would be asked to match is a portfolio that now includes 70 percent equity stocks and 30 percent fixed income investments.²⁴¹

242. MERC also advances two alternative approaches to selecting the appropriate discount rate. On behalf of MERC, Christine Hans, the Manager of Benefits Accounting for Integry's, suggests that an alternative to its proposed discount rates would be to add amounts to the test-year pension totals so as to mirror the hoped-for performance of its portfolio with 70 percent equity stocks.²⁴²

243. Likewise, in its Initial Post Hearing Brief, MERC proposed use of a "five-year historical average" of earlier discount rates. Such an approach was approved by the Commission, after the close of the evidentiary hearing in this proceeding, *In the Matter of an Application by CenterPoint Energy Resources Corp.*²⁴³

244. In *CenterPoint*, the Commission held that "calculation of pension expenses requires actuarial assumptions appropriate to the factual circumstances in each case," and that "the discount rate determination in the [2013] Xcel rate case does not pertain to the pension expense calculation here." The Commission continued:

²³⁹ See generally, Ex. 27 at 7-12 (C. Hans Rebuttal); Ex. 219 at 26-31 (St. Pierre Surrebuttal).

²⁴⁰ Ex. 27 at 9 (C. Hans Rebuttal).

²⁴¹ *Id.* at 7, 8 and 11.

²⁴² See generally, Ex. 27 at 11 (C. Hans Rebuttal).

²⁴³ See, MERC'S INITIAL POST-HEARING BRIEF, at 61 (June 24, 2014); see also, *In the Matter of an Application by CenterPoint Energy Resources Corp. d/b/a CenterPoint Energy Minnesota Gas For Authority to Increase Natural Gas Rates in Minnesota*, Docket No. G-008/GR-13-316, FINDINGS OF FACT, CONCLUSIONS AND ORDER, at 12 (June 9, 2014) (Doc. ID No. 20146-100252-01).

When the facts and circumstances of a case support adopting a discount rate that differs from the discount rate dictated by accounting standards applied for other purposes, it is appropriate to adopt a rate that differs.

But even accepting the Department's argument that the Company's rate calculation is artificially low, the Company's evidence provides the best basis for establishing an appropriate rate. The Commission will therefore establish a discount rate with a basis in the record evidence. In this case, the Commission concludes that the Department's calculated historical five-year (2009 – 2013) average discount rate of 5.35% is appropriate.

The appropriate discount rate continuously varies, but changes are only reflected in utility rates periodically—when a rate case is decided. The Company's proposed discount rate is markedly lower than average. For rate setting purposes, in this case, it is appropriate to use a historical average to buffer the effect the recently-below-average discount rate would have on the overall test-year pension expense. Under these conditions, a discount rate based on the five-year average is more reasonable than a discount rate determined at a single point in time, the timing governed by Company's choice to initiate a rate case.²⁴⁴

245. From the perspective of the Department, to the extent that any discount rate that is applied to the expected future benefit payments is less than the plan's rate of return, the amounts that are allocated to satisfy pension obligations will be overstated. As the Department reasons, MERC's proposed discount rates reflect both the amounts that are needed for near-term payouts to beneficiaries and a premium paid by ratepayers so that the Company could fully resolve all of its future pension liabilities, in a short time, if it needed to do so.²⁴⁵

246. Arguing that the risk that MERC will need to resolve its long-term pension liabilities quickly, during the period that the new rates will be in effect, is quite low, the Department maintains that this added premium is unreasonable.²⁴⁶

²⁴⁴ *Id.* Compare also, *In the Matter of the Application of Northern States Power Company for Authority to Increase Rates for Electric Service in the State of Minnesota*, OAH Docket No. 68-2500-30266 at 33-34 (July 5, 2013) (Doc. ID No. 20137-88857-01); *In the Matter of the Application of Northern States Power Company for Authority to Increase Rates for Electric Service in the State of Minnesota*, Docket No. E-002/GR-12-961, FINDINGS OF FACT, CONCLUSIONS AND ORDER, at 7 (Sept. 3, 2013) (Doc. ID No. 20139-90902-01).

²⁴⁵ Ex. 217 at 29 (M. St. Pierre Direct); Ex. 219 at 28 (St. Pierre Surrebuttal) (Accounting Standards Codification Topic 715 recognizes discount rates that are lower than the expected rates of return on plan assets because "[t]he assumption is that a company would pay more to settle each plan's expected future benefit payments so the discount rate is lower than the long-term expected return on the investment assets").

²⁴⁶ *Id.*

247. In the view of the Administrative Law Judge, the Department has both the better policy argument and the weaker case law. To the extent that MERC maintains that its rates should reflect contingent plans for near-term settlement of its pension obligations (or, alternatively, adding enough to the test-year pension amounts so that it would mirror the hoped-for performance of a pension portfolio with 70 percent equity stocks), those arguments do not persuade this tribunal. This is because having a discount rate that is lower than the overall rate of return on plan assets, means that the test year pension amounts will include the costs of covering a contingent, and speedy resolution of MERC's pension liabilities.²⁴⁷

248. There is real doubt whether an otherwise reasonable ratepayer would pay (a good bit) more in order to address that contingency.²⁴⁸

249. With that said, the facts and circumstances described in *In the Matter of an Application by CenterPoint Energy Resources Corp.*, are indistinguishable from the case at bar. Use of a five-year historical average in this case will undoubtedly "buffer the effects" of any below-average discount rates and, in the Commission's view, "is more reasonable than a discount rate determined at a single point in time"²⁴⁹

250. Applying the principles announced in *CenterPoint*, the Administrative Law Judge concludes that use of a five-year historical average of discount rates is more appropriate than application of the expected rate of return on plan assets. This is because use of a single rate of return, as the discount rate, necessarily amounts to a "discount rate determined at a single point in time."²⁵⁰

251. Because the Order in *CenterPoint* was issued after the close of the evidentiary hearing in this case, the parties themselves will need to confer as to the appropriate adjustments to test-year pension expenses.²⁵¹

3. Additional Adjustments to OPEB Amounts

252. MERC proposed to include the test year post-retirement medical plan expense of \$278,962.²⁵²

²⁴⁷ Ex. 217 at 31-32.

²⁴⁸ See, *id.*; see also, *In the Matter of the Application of Northern States Power Company for Authority to Increase Rates for Electric Service in the State of Minnesota*, OAH Docket No. 68-2500-30266 at 33-34 (July 5, 2013) (Doc. ID No. 20137-88857-01); *In the Matter of the Application of Northern States Power Company for Authority to Increase Rates for Electric Service in the State of Minnesota*, Docket No. E-002/GR-12-961, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 7 (Sept. 3, 2013) (Doc. ID No. 20139-90902-01).

²⁴⁹ *In the Matter of an Application by CenterPoint*, *supra*, at 12.

²⁵⁰ *Id.*

²⁵¹ *Id.*

²⁵² Ex. 27 at Schedule CMH-1 (C. Hans Rebuttal).

253. The Department accepted MERC's updated post-retirement medical costs of \$278,962.²⁵³

254. Yet, because, as noted above, the Department and MERC do not agree as to the appropriate discount rate on such expenses, the Department also recommended that the Commission require MERC to reduce its rate base by \$140,720.²⁵⁴

255. With respect to MERC's proposed post retirement life insurance expense, the Department recommends an increase of \$3,853.²⁵⁵

256. The Administrative Law Judge finds that MERC's actuarial determined 2014 test year post-retirement medical plan expense and life insurance expense is reasonable and most accurately reflects the cost that MERC will incur during the test year.²⁵⁶

E. Test Year Non-Fuel O&M Expense Methodology

257. In order to determine its test year non-fuel O&M expense, MERC used its actual 2012 non-fuel O&M costs and applied inflation factors for calendar years 2013 and 2014. Additionally, MERC applied a series of known and measurable (K&M) adjustments to arrive at its test year non-fuel O&M expenses.²⁵⁷

258. Specifically, MERC identified the following K&M adjustments to O&M expense:

- (1) increased costs from IBS-Customer Relations, related to increased third party costs from Vertex, the company that is under contract to provide MERC's third-party customer service functions (customer call center, dispatch, billing, and payment processing, etc.), and implementation of the Integrys Customer Experience (ICE);
- (2) increased costs associated with vacant positions that existed at MERC and IBS during 2012;
- (3) increased costs associated with Uncollectible Expense;
- (4) increased costs associated with a Sewer Laterals Project;
- (5) increased costs associated with Gate Station Upgrades;

²⁵³ *Id.* at 1 and Schedule CMH-1.

²⁵⁴ Ex. 219 at 32-33 and Schedule MAS-S-12 (M. St. Pierre Surrebuttal).

²⁵⁵ Ex. 219 at 33 (M. St. Pierre Surrebuttal).

²⁵⁶ Ex. 27 at 4-12 .

²⁵⁷ Ex. 19 at 9 (S. DeMerritt Direct).

- (6) increased costs associated with a Mapping Project;
- (7) increased costs associated with Additional Positions at MERC;
- (8) increased costs associated with Depreciation and Return charges from IBS;
- (9) decreased costs associated with Memberships;
- (10) decreased costs associated with the General Allocation Factor;
- (11) decreased costs associated with Advertising Expense;
- (12) decreased costs associated with Long Term Incentive Pay, Restricted Stock, and Stock Option Expense;
- (13) decreased costs associated with Economic Development;
- (14) decreased costs associated with Incentives;
- (15) decreased costs associated with an audit of Vertex; and
- (16) decreased costs associated with Benefits.²⁵⁸

259. The OAG-AUD had three principal critiques of MERC's claims for recovery of Non-Fuel O&M Expense: the breadth of MERC's inflation factor; MERC's characterization of certain project costs as "known and measureable;" and its selection of inflation rates.²⁵⁹

1. Inflation Factor

260. The OAG-AUD maintains that MERC's adjusting the 2012 cost experience, in the context of a 2014 test year, produces unreasonable results. It argues that MERC should not be able to include project cost increases over its actual 2012 costs for both 2013 and 2014. Instead, it urges the Commission to apply a one-year inflation factor to MERC's historical O&M expenses.²⁶⁰

261. Because this approach unreasonably excludes costs relating to events that do have an impact on the 2014 test year, and should be recoverable, the OAG-AUD's proposed inflation limitation is not appropriate.²⁶¹

²⁵⁸ Ex. 19 at 14-15 (S. DeMerritt Direct).

²⁵⁹ Ex. 151 at 16-17 (J. Lindell Direct); Ex. 154 at 5-6 (J. Lindell Surrebuttal).

²⁶⁰ Ex. 151 at 15 and 21 (J. Lindell Direct); Ex. 154 at 6-7 (J. Lindell Surrebuttal).

²⁶¹ Ex. 24 at 21-23 (S. DeMerritt Rebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 24 (S. DeMerritt).

2. Addition of Known and Measureable Costs

262. The OAG-AUD also expressed concern with MERC's K&M factors. In the OAG-AUD's view, the projection of costs for projects undertaken after the historical test year are not sufficiently precise to be characterized as "known and measurable" costs.²⁶²

263. The Administrative Law Judge disagrees. The categories of costs identified by MERC will all have a measurable impact upon the 2014 test year. Moreover, the methodology employed by MERC in this case was identical to the methods it used in its 2008 and 2011 rate cases.²⁶³

3. Use of External Inflation Projections

264. MERC's inflation adjustment is based on an average of inflation from Value Line, Global Insight, Moore Inflation Predictor, Energy Information Administration, and International Monetary Fund. MERC used 2.6 percent as a labor inflator rate based upon recent union contract wage increases.²⁶⁴

265. MERC's calculated inflation for the period between 2012 and 2014 is 3.74 percent on non-labor costs and 5.27 percent on labor costs.²⁶⁵

266. The OAG-AUD asserted that MERC's use of external inflation projections was not appropriate and instead recommended use of an "internal" inflation rate that it developed based upon MERC's historical O&M cost changes. Without such an adjustment, OAG-AUD argues that MERC will be relieved of the burden to improve operations and lower costs – the Company could safely assume that "costs continually rise nonstop"²⁶⁶

267. The Administrative Law Judge disagrees. First, the changes in O&M cost components reflect MERC's efforts to balance service with new efficiencies. Moreover, the Company's method of modifying external inflation projections to account for fluctuations in bad debt expense produces results that are both superior and particularized to MERC's cost experience. Lastly, the inflation rate methodology used by MERC in this case was identical to the methods it used in its 2008 and 2011 rate cases.²⁶⁷

²⁶² Ex. 151 at 16-17 (J. Lindell Direct); Ex. 154 at 5-6 (J. Lindell Surrebuttal).

²⁶³ Ex. 24 at 21-22 (S. DeMerritt Rebuttal).

²⁶⁴ Ex. 4 Initial Filing Volume 3: Informational Requirements, Document 5, Schedule C-6; Ex. 19 at 9, 12-27 and Schedules SSD-2 through SSD-19 (S. DeMerritt Direct); Ex. 24 at 19-25 (S. DeMerritt Rebuttal).

²⁶⁵ *Id.*

²⁶⁶ Ex. 151 at 17-20 (J. Lindell Direct); Ex. 152 at Schedule (JLL-7) (Schedules to J. Lindell Direct).

²⁶⁷ Ex. 24 at 23-25.

F. IBS Customer Relations Costs

268. MERC seeks recovery of \$730,681 of O&M expense in the test year for IBS-Customer Relations.²⁶⁸

269. This amount has two components: The first component is related to MERC's existing contract with Vertex. The second component relates to the Integrys Customer Experience (ICE) project.²⁶⁹

270. Vertex provides a variety of customer service functions for MERC – such as call center staffing, dispatch, billing and payment processing. The contract between MERC and Vertex is a multi-year agreement with annual cost escalators. MERC estimates that the K&M increase associated with these services will be \$408,455 in 2014.²⁷⁰

271. The ICE project intends to unify the various billing systems now used by the six Integrys utility subsidiaries. The overall K&M associated with ICE in IBS-Customer Relations is \$322,226 in 2014.²⁷¹

272. The OAG-AUD recommended that the increase for IBS Customer Relations costs be denied. The OAG-AUD argued that ratepayers should not be charged for both ICE and Vertex as MERC transitions to its new system. It maintains that Vertex costs and ICE costs cannot both be “used and useful,” and recoverable, at the same time.²⁷²

273. The OAG-AUD recommended that MERC reduce O&M expense by \$823,990 for IBS Customer Relations costs.²⁷³

274. As part of its rebuttal testimony, MERC offered, contingent upon regulatory approval from the Commission, to defer recovery of \$322,226 in annual ICE-related costs as a regulatory asset until MERC's next rate case.²⁷⁴

275. In the view of the Administrative Law Judge, the \$408,455 in costs relating to the Vertex contract is both “used and useful.” Vertex is now providing the same billing and customer relations services to MERC ratepayers that it has for many years.²⁷⁵

²⁶⁸ Ex. 19 at 16 (S. DeMerritt Direct).

²⁶⁹ *Id.* at 15-16.

²⁷⁰ *Id.* at 15.

²⁷¹ *Id.* at 16.

²⁷² Ex. 151 at 20-21 (J. Lindell Direct).

²⁷³ Ex. 24 at 25 (S. DeMerritt Rebuttal).

²⁷⁴ *Id.*

²⁷⁵ *Id.*

276. The Administrative Law Judge further recommends that the Commission accept MERC's conciliatory offer and permit designation of ICE-related costs as a regulatory asset and recovery of those costs from customers over a three-year period after the system has been successfully implemented.²⁷⁶

G. IBS Vacancies

277. The K&M increase regarding the IBS vacancies creates a K&M of \$240,583 in the 2013 projected test year and was appropriately inflated to 2014 levels. This adjustment relates to 72 positions that were either partially or fully vacated during the 2012 historical test year, and that IBS is forecasting to have filed in 2014.²⁷⁷

278. The Administrative Law Judge finds that the K&M increase of \$240,583 for IBS vacancies should be approved in this rate case.²⁷⁸

H. Internal MERC Vacancies

279. The K&M increase for internal MERC vacancies creates a K&M of \$392,647. This adjustment reflects 6 positions that were either partially or fully vacated during the 2012 historical test year and one position that was upgraded from a part-time position to a full-time position. MERC intends to have these positions filled by 2014.²⁷⁹

280. The Administrative Law Judge finds that MERC needs to fill these positions in order to maintain appropriate levels of service. The K&M increase of \$392,647 is appropriate and should be approved in this rate case.²⁸⁰

I. Additional MERC Positions

281. The adjustment for eight additional MERC positions increased 2014 proposed O&M by \$294,374.²⁸¹

282. The Administrative Law Judge likewise finds that MERC needs to fill these positions in order to maintain appropriate levels of service. The O&M increase of \$294,374 is appropriate and should be approved in this rate case.²⁸²

²⁷⁶ *Id.*

²⁷⁷ Ex. 19 at 21 and Schedule (SSD-10) (S. DeMerritt Direct).

²⁷⁸ *Id.*

²⁷⁹ *Id.* at 16.

²⁸⁰ *Id.*

²⁸¹ Ex. 19 at 19-20 and Schedule (SSD-8) (S. DeMerritt Direct).

²⁸² *Id.*

J. Test Year Uncollectible Expenses

283. MERC initially proposed to recover \$1,765,884 for its test-year uncollectible debt expense. In Rebuttal, MERC forecasted \$2,016,410 of uncollectible expense for the 2014 test year due to increased forecast sales.²⁸³

284. MERC divided the amount of uncollectable expenses in years 2010, 2011 and 2012 by the tariffed revenues in each of those years. This division yields a "percentage of tariffed revenues" for each of the expense years.²⁸⁴

285. MERC's recent uncollectable expense experience is set forth below:

	2010 Actual	2011 Actual	2012 Actual	2013 Actual
Uncollectible Expense	\$1,109,186	\$1,984,374	\$1,313,501	\$1,481,318
Tariffed Revenue	\$221,585,924	\$255,269,107	\$200,736,162	\$269,448,208
% of Tariffed Revenue	0.500567%	0.777366%	0.654342%	0.549760% ²⁸⁵

286. Mr. DeMerritt explained that MERC calculated the 2014 test-year uncollectible expenses by dividing the average uncollectable expenses by the average tariffed revenues for the years 2010, 2011 and 2012. This division yields a percentage of tariff revenues of 0.650401 percent.²⁸⁶

287. MERC then applied this percentage to MERC's 2014 test year forecasted tariff revenues plus an assumed rate increase of \$14,000,000.²⁸⁷

288. MERC explained that the \$14,000,000 proposed rate increase is not equal to the revenue deficiency amount proposed in this docket because, by changing the bad debt expense, the revenue deficiency will also change. To avoid a "circular reference," MERC proposed a number that is both close to the revenue deficiency and develops a reasonable uncollectible expense forecast.²⁸⁸

²⁸³ Ex. 24 at 9-10 and Schedule (SSD-3) (S. DeMerritt Rebuttal).

²⁸⁴ See, Ex. 24 at Schedule (SSD-3) (S. DeMerritt Rebuttal).

²⁸⁵ See, Ex. 24 at Schedule (SSD-3) (S. DeMerritt Rebuttal); Ex. 217 at 39 (St. Pierre Direct); Ex. 219 at 36-37 and 44 (M. St. Pierre Surrebuttal).

²⁸⁶ Docket No. G007,011/GR-10-977.

²⁸⁷ Ex. 19 at 16-17 (S. DeMerritt Direct); MERC Ex. 24 at 9 (S. DeMerritt Rebuttal).

²⁸⁸ Ex. 19 at 16-17 (S. DeMerritt Direct).

289. In pre-filed rebuttal testimony, MERC Witness Seth DeMerritt proposed “to update the uncollectible expense with revenues calculated in Rebuttal Exhibit (GJW-1)” and to “include \$12,000,000 for an assumed rate increase based on MERC’s current position for the revenue requirement,” for the calculation of uncollectible expenses.²⁸⁹

290. MERC’s proposed uncollectable expense amount for the test year is \$1,765,884.²⁹⁰

291. MERC asserted that its proposal is consistent with the approach approved by the Commission in MERC’s 2008 and 2010 rate cases.²⁹¹

292. The Department recommended that MERC use the 2013 actual uncollectible expense ratio of 0.549760 percent rather than MERC’s proposed ratio of 0.650401 percent. The Department argues that the averaging of uncollectible expenses (and percentages) is not appropriate when there is “a clear downward trend” in the levels of uncollectible expense.²⁹²

293. Specifically, the Department recommended that the 2013 percentage of tariffed revenue (0.549760%) be applied to corrected projections of tariffed revenue in the test year, for an uncollectible expense amount of \$1,657,805.²⁹³

294. Pointing to the wide fluctuation in the rates of bad debt from year to year, the OAG-AUD argues that the methods of averaging urged by MERC and the Department are not reliable. It maintains that the Commission should instead consider economic factors, such as “the much improved economy and the lower relative price of natural gas,” when assigning an uncollectible expense amount of \$1,350,000 for the test year.²⁹⁴

295. Moreover, the OAG-AUD opposed MERC’s levelization approach on the grounds that MERC did not include 2013 figures in its levelization calculations.²⁹⁵

296. 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. This method relies upon the most-recent figures, accounts for variability in

²⁸⁹ Ex. 219 at 37 (M. St. Pierre Surrebuttal) (*citing* Ex. 24 at 9–10 (S. DeMerritt Rebuttal)).

²⁹⁰ Ex. 19 at 16-17 (S. DeMerritt Direct).

²⁹¹ Ex. 24 at 9 (S. DeMerritt Rebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 23 (S. DeMerritt).

²⁹² Ex. 219 at 36 (M. St. Pierre Surrebuttal).

²⁹³ DEPARTMENT REPLY BRIEF, PART 2 OF 2, at 75.

²⁹⁴ Ex. 151 at 6-7 (J. Lindell Direct).

²⁹⁵ Ex. 154 at 3-4 (J. Lindell Surrebuttal).

the rates of uncollectible expense and best carries forward the Commission's earlier approaches to these issues.²⁹⁶

K. Sewer Lateral Expenses

297. MERC's adjustment for sewer lateral expense increases 2014 proposed O&M by \$340,000.²⁹⁷

298. The Sewer Lateral Pilot program is being done to comply with requests from the Minnesota Office of Pipeline Safety (MNOPS). The goal is to validate that MERC does not have conflicts with sewer lines that could present risk to its customers.²⁹⁸

299. While the Department initially urged a separate three-year cost levelization, and exclusion from rate base, for this project, it later determined that the Sewer Laterals Pilot Program is a multi-year project that extends beyond the community of Cannon Falls. As a result, the Department now joins MERC in recommending that the Commission find MERC's proposed test year Sewer Laterals Pilot Program costs as reasonable costs.²⁹⁹

300. The Administrative Law Judge finds that MERC's inclusion of \$340,000 of Sewer Lateral Pilot Program costs in the 2014 test year is appropriate.³⁰⁰

L. Gate Station Project

301. The Gate Station Project will add remote monitoring and some test measurement to the distribution delivery points where MERC receives its natural gas supply from the pipelines. Today, MERC does not have remote monitoring of the pressure, temperature or volumes of these supplies on a real time basis. Remote monitoring will provide MERC engineering and gas control more real time "visibility" of the performance of the Company's systems.³⁰¹

²⁹⁶ See generally, Ex. 19 at 16-17 (S. DeMerritt Direct); MERC Ex. 24 at 9 (S. DeMerritt Rebuttal); Ex. 218 MAS-25 (M. St. Pierre Direct Attachment); EVIDENTIARY HEARING TRANSCRIPT, at 229 (M. St. Pierre).

²⁹⁷ Ex. 19 at 17 and Schedule (SSD-5) (S. DeMerritt Direct).

²⁹⁸ Ex. 19 at 17 (S. DeMerritt Direct); see also, EVIDENTIARY HEARING TRANSCRIPT, at 44 (S. DeMerritt) (citing MERC's Response to the Department's Information Request Document Number 147).

²⁹⁹ Ex. 219 at 39 (M. St. Pierre Surrebuttal); see also, Ex. 24 at 10 (S. DeMerritt Rebuttal); Ex. 217 at 40-43 (M. St. Pierre Direct).

³⁰⁰ *Id.*

³⁰¹ Ex. 19 at 17-18 (S. DeMerritt Direct); see also, EVIDENTIARY HEARING TRANSCRIPT, at 44 (S. DeMerritt) (citing MERC's Response to the Department's Information Request Document Number 148).

302. The gate station project began in January 2014 and is primarily a capital project. The \$330,000 adjustment represents the O&M portion of the project.³⁰²

303. The O&M costs are system operations costs that are not part of the capital project, including phone and electric bills, and monitoring and repair activity. The Company stated that while the gate station equipment and installation costs will be capitalized; these other expenses represent the incremental costs of operating and maintaining the equipment that is not capitalized.³⁰³

304. While Constellation requested that MERC complete the Gate Station project prior to October 1, 2014, it is a multi-year effort that will not be completed in 2014.³⁰⁴

305. The Department concluded that the Gate Stations project is a long-term, rather than one-time project. The Department concluded that MERC's proposed recovery of costs related to the Gate Stations project was reasonable.³⁰⁵

306. The Administrative Law Judge finds that MERC's proposed recovery of costs related to the Gate Stations project is reasonable and should be approved in this rate case.³⁰⁶

M. Mapping Project

307. MERC has identified gaps with the maps that its field personnel utilize to locate lines, manage outages, determine flow modeling, and complete other critical infrastructure tasks.³⁰⁷

308. These mapping errors have come from a number of map conversions as companies were acquired, sold, and consolidated.³⁰⁸

309. Today, MERC does not have the ability to verify the age of pipe, materials or fittings within its gas network. This information is needed to complete required reports to the Minnesota Department of Transportation and MERC does not have this capability.³⁰⁹

³⁰² Ex. 19 at 17-18 and Schedule (SSD-6) (S. DeMerritt Direct); Ex. 217 at 47 (M. St. Pierre Direct) *citing* Ex. 218 MAS-30 (M. St. Pierre Direct Attach.) (MERC Resp. to DOC IR 148).

³⁰³ *Id.*

³⁰⁴ Ex. 24 at 28 (S. DeMerritt Rebuttal); Ex. 125 at 4 (R. Haubensak Direct).

³⁰⁵ Ex. 217 at 48-49 (M. St. Pierre Direct); Ex. 219 at 41-42 (M. St. Pierre Surrebuttal).

³⁰⁶ *Id.*

³⁰⁷ Ex. 19 at 18-19 (S. DeMerritt Direct).

³⁰⁸ *Id.*

³⁰⁹ *Id.*

310. To improve the quality and utilization of the mapping systems, MERC plans to validate the accuracy by verifying as built drawings and actual field data. The Company explained that the "Mapping Project" was designed to address "gaps" in the accuracy of the MERC mapping systems that are used by MERC's field personnel.³¹⁰

311. The adjustment for the Mapping Project increases 2014 proposed O&M by \$330,000.³¹¹

312. MERC specified that the Mapping Project was designed to begin in February 2014 and conclude eleven months later, in December 2014. This work is to be performed by independent contractors, not MERC staff.³¹²

313. Importantly, all of the costs identified to the project are non-labor O&M costs, consisting of payments of invoices of the contractors.³¹³

314. MERC employees will provide oversight for this project, but that expense is not included among MERC's requested "known and measurable" adjustments.³¹⁴

315. MERC explained that these costs are O&M costs rather than capitalized costs because MERC is not installing new software. The project aims to update information that is not currently in its existing mapping software. The updated data is from MERC's "main as-built records" and will augment detail in the GIS Small World application.³¹⁵

316. Because the Company acknowledged that the Mapping Project is a project that will only incur costs in 2014, it is apparent that the Mapping Project is a one-time project, expected to be finished by the end of the test year.³¹⁶

317. The Department concluded that the Mapping Project was a one-time project since it was projected to be done by the end of the test year. The Department recommended that the Mapping Project costs be levelized over the same time-frame as the Department's recommended rate case expense period – three years. The Department proposes an adjustment in annual expenses of \$110,000 (\$330,000/3). For purposes of the test year, the Department likewise recommends that the Commission

³¹⁰ *Id.*

³¹¹ *Id.* and SSD-7 (S. DeMerritt Direct); Ex. 217 at 44 (M. St. Pierre Direct); see also, Ex. 218 MAS-28 (Attachment to M. St. Pierre Direct) (MERC's Response to the Department's Information Request Document Number 149).

³¹² Ex. 218 MAS-28 (Attachment to M. St. Pierre Direct).

³¹³ Ex. 19 at SSD-7 (S. DeMerritt Direct).

³¹⁴ Ex. 218 MAS-28 (Attachment to M. St. Pierre Direct).

³¹⁵ Ex. 218 MAS-28 (Attachment to M. St. Pierre Direct).

³¹⁶ Ex. 219 at 40 (M. St. Pierre Surrebuttal) (*citing* Ex. 24 at 10-11 (S. DeMerritt Rebuttal)).

reduce Distribution Expense by \$220,000 (\$330,000 - \$110,000) to account for the Mapping Project.³¹⁷

318. MERC disagreed with the Department's proposed adjustments. It maintains that making such provisions for a single cost item, without regard to future costs, sales or capital requirements of other items, is punitive and inappropriate.³¹⁸

319. In the alternative, MERC argued that because it intends to file a new rate in 2016, at a minimum, \$165,000 of the mapping project adjustment should be divided between the two years between the test year and the new rate case.³¹⁹

320. The Administrative Law Judge finds that including \$165,000 of Mapping Project cost is appropriate and proper for calculating MERC's test year 2014 revenue deficiency in this case.³²⁰

N. Organization Membership Dues

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.³²¹

O. Depreciation and Return on Cross Charges from IBS

322. The K&M adjustment for depreciation and return on cross charges from IBS relates to two specific projects at IBS that are then cross-charged to the various Integrys subsidiaries. These two projects are GMS Software and ICE.³²²

323. This adjustment increases 2013 projected O&M expense by \$187,615, and 2014 O&M expense after inflation by \$92,855. The total O&M expense charged to MERC for these two projects in the 2014 proposed test year is \$280,470.³²³

324. The OAG-AUD argued that although the IBS charges are purportedly for increases in depreciation and a return on assets, MERC did not identify the scope of the project costs, nor how these projects would be applicable to MERC's operations. Under

³¹⁷ Ex. 217 at 46 (M. St. Pierre Direct); Ex. 218 at Schedules MAS-28, MAS-29 (M. St. Pierre Direct Attach.); Ex. 219 at 40-41 (M. St. Pierre Surrebuttal).

³¹⁸ Ex. 24 at 10-11 (S. DeMerritt Rebuttal).

³¹⁹ *Id.*

³²⁰ *Id.*

³²¹ Ex. 19 at 22 and Schedule (SSD-11) (S. DeMerritt Direct).

³²² *Id.* at 20 and Schedule (SSD-9) (S. DeMerritt Direct).

³²³ *Id.*

such circumstances, it asserts that an allocation to MERC (or any of the Integrys subsidiaries) is inappropriate.³²⁴

325. The Administrative Law Judge disagrees. The K&M adjustment related to depreciation and return on assets cross charged from IBS is sufficiently precise and set forth with detail like that for other K&M charges.³²⁵

326. The Administrative Law Judge finds that MERC's K&M adjustment related to depreciation and return on assets cross charged from IBS of \$280,470 should be approved for 2014.³²⁶

P. Economic Development Expenses

327. In order to be consistent with the costs allowed in Docket No. G007,011/GR-10-977, MERC has removed 50 percent of the 2012 Economic Development costs in the 2013 projected test year.³²⁷

328. By removing this amount in 2013, these costs are also effectively removed from the 2014 proposed test year.³²⁸

Q. Advertising Expense

329. MERC included a known and measurable adjustment to test year O&M expense for advertising costs.³²⁹

330. MERC has excluded all advertising costs associated with economic development and goodwill from the 2014 proposed test year. This adjustment reduces 2013 projected O&M expense by \$5,308. By removing this amount in 2013, these costs are also effectively removed from the 2014 proposed test year.³³⁰

331. MERC's filing includes a list of the advertisements for which MERC seeks cost recovery in this case, and an explanation of each advertisement.³³¹

332. MERC's advertising costs are appropriate and should be accepted in this rate case.³³²

³²⁴ Ex. 151 at 16-17 (J. Lindell Direct).

³²⁵ Ex. 24 at 22-23 (S. DeMerritt Rebuttal).

³²⁶ *Id.*

³²⁷ Ex. 19 at 23-24 (S. DeMerritt Direct).

³²⁸ *Id.* and Schedule (SSD-15) (S. DeMerritt Direct).

³²⁹ *Id.* at 22-23 and Schedule (SSD-13) (S. DeMerritt Direct).

³³⁰ *Id.*

³³¹ *Id.* at 23.

³³² *Id.*

R. General Cost Allocator

333. Since the date on which MERC was acquired by Integrys, IBS has employed a two factor formula for the General Cost Allocator (GCA).³³³

334. In past rate cases, MERC has requested authority to use the two factor formula as opposed to a one factor formula. Those requests were denied.³³⁴

335. In this case, MERC has agreed to decrease O&M expenses by \$3,371 in the 2013 projected test year to account for the difference between the one factor and two factor allocation methodologies. By removing this amount in 2013, these costs are also effectively removed from the 2014 proposed test year.³³⁵

S. Vertex Audit

336. In Docket No. G007,011/GR-10-977 MERC was ordered to perform an audit of its Vertex billing system and was not permitted to collect these costs from ratepayers.³³⁶

337. In 2012, MERC had invoices from the third party auditor of \$303,521, and removed these costs plus inflation from the 2013 projected test year. By removing this amount in 2013 these costs were effectively removed from the 2014 test year.³³⁷

T. Long Term Incentive Compensation

338. In Docket No. G007,011/GR-10-977, costs associated with Long Term Incentive Plan (LTIP), Restricted Stock and Stock Options were disallowed.³³⁸

339. In this case, MERC is decreasing O&M expenses by \$402,878 in the 2013 projected test year. By removing this amount in 2013, these costs are also effectively removed from the 2014 proposed test year.³³⁹

³³³ Ex. 19 at 22 (S. DeMerritt Direct).

³³⁴ *Id.*

³³⁵ *Id.* and Schedule SSD-12.

³³⁶ *Id.* at 24.

³³⁷ *Id.*

³³⁸ *Id.* at 23.

³³⁹ *Id.* and Schedule SSD-14.

U. Employee Incentive Compensation Plans

340. Integrys maintains a non-executive incentive plan. Its business support goals under the plan include incentives for improvements to System Reliability, Employee Safety and Customer Satisfaction.³⁴⁰

341. Non-union, non-executive employees of MERC and IBS participate in the non-executive incentive plan.³⁴¹

342. MERC's incentive plan-related costs are in proportion to the IBS costs that are allocated to MERC.³⁴²

343. The non-executive incentive plan assesses costs through a non-fuel O&M expense-adjusted metric. Customer service, system reliability, and employee safety measurements are weighted at a combined 50 percent of the total costs.³⁴³

344. With respect to the Executive Incentive Plan, improvements to Integrys' earnings per share comprise 70 percent of the Plan's goals. The remaining 30 percent of the goals are based upon measures of customer satisfaction, employee safety and environmental impact.³⁴⁴

345. MERC provided a listing of 23 employees of IBS and MERC whose incentive pay during the test year exceeded their base pay by more than 15 percent. The total of these payments was \$185,709. The Company proposal limited the amount of incentive compensation for these employees in the test year to thirty percent of this sum, or \$55,713.³⁴⁵

346. MERC states that it offers incentive compensation packages in order to attract and retain quality employees, improve service levels and reduce the overall costs paid by ratepayers.³⁴⁶

347. MERC's cash compensation goal is to pay its employees a total cash compensation package (base pay plus target incentive pay) that is anchored to market median levels as compared to other energy industry companies. MERC defines the market median as the 50th percentile median of comparable energy industry and general industry companies.³⁴⁷

³⁴⁰ Ex. 13 at 3-4 (N. Cleary Direct).

³⁴¹ *Id.*

³⁴² Ex. 12 at 7-8 (T. Kupsch Direct); Ex. 13 at 9 (N. Cleary Direct).

³⁴³ Ex. 13 at 6 (N. Cleary Direct).

³⁴⁴ Ex. 217 at 36 (M. St. Pierre Direct).

³⁴⁵ *Id.*

³⁴⁶ Ex. 13 at 4-5 (N. Cleary Direct).

³⁴⁷ *Id.* at 3-4.

348. During the Company's 2010 rate case, the Commission approved inclusion of MERC's non-executive compensation package in the test year amounts. In that case, it granted 100 percent recovery of non-executive compensation plan costs and 30 percent recovery of executive compensation plan costs.³⁴⁸

349. MERC stated that, consistent with that earlier holding, MERC proposed to recover from ratepayers the 30 percent of executive incentive compensation in the new rates.³⁴⁹

350. The Department argued that, consistent with more recent Commission decisions, recovery of executive incentive compensation costs should be capped at 15 percent – thereby cutting in half the \$55,713 expense proposed by MERC.³⁵⁰

351. To cap MERC's incentive pay at 15 percent, the Department recommended a \$27,857 reduction to expense for MERC's executive incentive compensation costs.³⁵¹

352. MERC agreed with the Department's recommendation to reduce administrative and general expense by \$27,857 for executive incentive compensation.³⁵²

353. The Department also recommended that MERC retain the existing incentive compensation refund mechanism.³⁵³

354. Under the existing incentive compensation refund mechanism the Company will provide customer refunds in the event the incentive compensation payouts are lower than the test-year level approved in rates. Ms. St. Pierre recommended that the Commission's *Findings of Fact, Conclusions and Order* in the instant matter specifically state the amount of incentive compensation approved in the test year.³⁵⁴

355. MERC agreed with the Department's recommendation that the Company retain the existing incentive compensation refund mechanism, but requested that the

³⁴⁸ *Id.* at 4 and 11-12.

³⁴⁹ *Id.* at 12; see also, Docket No. G-007,011/GR-10-977.

³⁵⁰ See, e.g., Docket Nos. E002/GR-12-961 (Xcel Electric's 2012 general rate case) and E002/GR-10-971 (Xcel Electric's 2010 general rate case); Ex. 217 at 37 (M. St. Pierre Direct)

³⁵¹ Ex. 219 at 34 (M. St. Pierre Surrebuttal).

³⁵² Ex. 24 at 8 (S. DeMerritt Rebuttal).

³⁵³ Ex. 217 at 37 (M. St. Pierre Direct).

³⁵⁴ *Id.*

refund be calculated beginning with test year 2014, based upon the incentive compensation and customer counts approved in this docket.³⁵⁵

356. The K&M decrease associated with incentive costs is \$286,221. The 2014 incentive costs for non-executive employees was calculated at the target level expense.³⁵⁶

357. The Administrative Law Judge finds that administrative and general expense should be reduced by \$27,857 with respect to executive incentive compensation.³⁵⁷

358. The Administrative Law Judge recommends that the Commission retain the current refund mechanism, under which the Company will return the funds to ratepayers in the event incentive compensation payouts are lower than the approved test-year level.³⁵⁸

359. The Administrative Law Judge further recommends that the Commission's *Findings of Fact, Conclusions and Order* direct that any refunds from the incentive compensation refund mechanism be calculated beginning with the 2014 test year, based upon the incentive compensation and customer counts approved in this docket.³⁵⁹

V. Aquila Transaction Costs

360. MERC has not included any acquisition or transaction costs associated with the sale of Aquila's Minnesota assets to MERC.³⁶⁰

361. MERC is basing its 2014 O&M forecast on 2012 actual costs plus K&M's.³⁶¹

362. There were not any acquisition or transaction costs associated with the sale of Aquila's Minnesota assets to MERC in the 2012 historical year; therefore, there are no costs to inflate into the 2014 proposed test year.³⁶²

³⁵⁵ Ex. 24 at 14 (S. DeMerritt Rebuttal).

³⁵⁶ Ex. 19 at 24 (S. DeMerritt Direct).

³⁵⁷ Ex. 219 at 34 (M. St. Pierre Surrebuttal).

³⁵⁸ *Id.*

³⁵⁹ *Id.*

³⁶⁰ Ex. 19 at 25 (S. DeMerritt Direct).

³⁶¹ *Id.*

³⁶² *Id.*

W. Gas Storage Balance Adjustment

363. MERC's original cost of gas and gas in storage balances were developed using NYMEX data from May 15, 2013, as described in the Base Cost of Gas filing in Docket No. G011/MR-13-732.³⁶³

364. MERC's cost of gas and gas in storage balances were updated on April 15, 2014, using NYMEX data from March 17, 2014, as described in the Base Cost of Gas filing in Docket Nos. G011/GR-13-617 and G011/MR-13-732.³⁶⁴

365. The increase in rate base for the updated Base Cost of Gas filing increased MERC's initially filed gas storage balance from \$12,013,242 to \$12,866,941.³⁶⁵

366. Based upon the updated Base Cost of Gas filing in Docket Nos. G011/MR-13-372 and G011/GR-13-617, MERC recommended that its gas storage balance be set at the 13-month average balance of \$12,866,941, which was \$853,699 higher than the balance after the March 17, 2014 base cost of gas update.³⁶⁶

367. The Department agreed with MERC's recommendation, which results in a test-year adjustment that increases the rate base by \$853,699.³⁶⁷

368. The Administrative Law Judge finds that MERC's gas storage balance should be \$12,866,941 for 2014.³⁶⁸

X. Net Operating Loss Deferred Tax Asset

369. MERC included a deferred tax asset (DTA) for a net operating loss (NOL) carry-forward in its proposed rate base. The DTA represents MERC's stand-alone operating income NOL that arose in 2012 and 2013.³⁶⁹

370. MERC has experienced several consecutive years of NOLs, primarily due to bonus tax depreciation deductions. The consecutive years of a NOL have primarily been due to the continual extension of the federal economic incentive allowing for additional bonus depreciation deductions over that period.³⁷⁰

³⁶³ Ex. 19 at 8 (S. DeMerritt Direct).

³⁶⁴ Ex. 24 at 29 (S. DeMerritt Rebuttal).

³⁶⁵ *Id.*

³⁶⁶ Ex. 24 at 26 and Schedule (SSD-4) (S. DeMerritt Rebuttal); Ex. 216 at 8 (L. La Plante Surrebuttal).

³⁶⁷ Ex. 216 at 8 and LL-S-3 (L. La Plante Surrebuttal).

³⁶⁸ *Id.*

³⁶⁹ Ex. 36 at 3 (J. Wilde Direct).

³⁷⁰ *Id.*

371. A federal NOL can be carried back two years or carried forward 20 years. If a utility has more tax deductions than taxable income in a given tax year, it has a tax NOL.³⁷¹

372. Because MERC and Integrys have incurred NOLs during 2012 and 2013 that are greater than the taxable income generated in 2010 and 2011 (the two year carryback period), MERC is entitled to carry forward the NOL.³⁷²

373. Until this rate case, MERC was not required to reflect the allowance for deferred income taxes related to a carry-forward of NOL balances from any prior year.³⁷³

374. The federal normalization rules on net operating losses require that the utility must realize the tax cash flow benefit of accelerated depreciation before the deferred tax liability that results from these claims is placed into rate base.³⁷⁴

375. Because of MERC's earlier claims of accelerated tax depreciation, it must carry a DTA, or otherwise account for, the NOL balances from 2012 and 2013, until they are used during 2014.³⁷⁵

376. The OAG-AUD opposed MERC's proposed DTA adjustment. OAG-AUD asserted that: (a) the record does not show that MERC contributed to the NOL carry-forward balances; (b) exclusion of the DTA from MERC's rate base would not violate the tax normalization rules; and (c) the Private Letter Ruling upon which MERC relies – Number 8818040 – is distinguishable because the corporate relationship between Integrys and MERC makes those companies different from the taxpayer that sought the advisory ruling.³⁷⁶

377. In the view of the Administrative Law Judge, the key features of the analysis are that the tax normalization rules do apply to NOLs from public utilities; and because MERC is part of the Integrys Consolidated Group for tax purposes, it has the ability to generate tax liabilities as well as avail itself of net operating loss carry-forwards. Thus, notwithstanding the differences in corporate structure between MERC and the taxpayer that sought Private Letter Ruling 8818040, the guidance from that letter ruling is still instructive here.³⁷⁷

³⁷¹ *Id.* at 4.

³⁷² *Id.* at 3.

³⁷³ *Id.*

³⁷⁴ *Id.* at 5-6.

³⁷⁵ *Id.*; see generally, IRS Private Letter Ruling 8818040.

³⁷⁶ Ex. 151 at 7-11 (J. Lindell Direct); Ex. 154 at 9-12 (J. Lindell Surrebuttal).

³⁷⁷ Ex. 37 at 11-21 (J. Wilde Rebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 96 (J. Wilde); IRS Private Letter Ruling 8818040 (February 9, 1988); see generally, 26 U.S.C. § 6110 (b)(1)(A) and (k)(3) (Ordinarily, private letter rulings issued by the IRS may not be "used or cited as precedent" by other taxpayers to bind the federal government).

378. The Administrative Law Judge finds that MERC's DTA NOL carry-forward is a reasonable method of achieving compliance with the normalization rules and should be approved.³⁷⁸

Y. Estimated Property Tax Expense

379. MERC filed this general rate proceeding with an estimated property tax expense of \$7,314,733.³⁷⁹

380. This amount included \$375,000 of property tax on storage gas and 5.08 percent inflation.³⁸⁰

381. The proposed expense is \$712,679 more than the amount included in the 2012 historic test year.³⁸¹

382. In response to information requests from the Department, MERC provided a revised estimate that decreased the 2014 inflation rate by 0.74 percent.³⁸²

383. Lowering the inflation rate from 5.08 to 4.35 percent resulted in corresponding reductions in the amounts of locally assessed and centrally assessed property tax. These revisions reduced the test-year property tax expense by \$48,260.³⁸³

384. In addition, MERC proposed an additional property tax decrease of \$70,000 in its property taxes for the Company's Kansas property taxes on storage gas. This reduction reflected the revised tax assessment estimates from 2009 through 2013 that MERC received from the Kansas Attorney General.³⁸⁴

385. MERC recommended a total reduction of \$118,864 from its earlier-filed estimate. This recommendation reduced its initial request from \$7,314,733 to \$7,195,869.³⁸⁵

³⁷⁸ *Id.*

³⁷⁹ Ex. 36 at 11 and Schedule (JRW-1) (J. Wilde Direct).

³⁸⁰ *Id.*

³⁸¹ *Id.*

³⁸² Ex. 217 at 24 (M. St. Pierre Direct), DOC Ex. 218 MAS-18 (Attachment to M. St. Pierre Direct) (MERC Response to DOC IR 152(c) and Attachment 152 Part A.xlsx).

³⁸³ Ex. 217 at 24 (M. St. Pierre Direct).

³⁸⁴ Ex. 37 at 4.

³⁸⁵ Ex. 37 at 5-6 (J. Wilde Rebuttal); Ex. 217 at 25 (M. St. Pierre Direct); Ex. 218 MAS-19 (M. St. Pierre Direct Attachments); Ex. 219 at 21 (M. St. Pierre Surrebuttal).

386. The OAG-AUD proposed a reduction of \$690,700 to MERC's property tax expense, reducing the proposed amount from \$7,314,733 to \$6,624,033.³⁸⁶

387. The OAG-AUD argued that the proposed property tax expenses are inflated. Based upon its review of sample property statements for MERC property in Minnesota, it urges use of 2013 as test year property taxes. In its view, because MERC projects 2014 costs from the 2012 base year, the resulting figures overstate the likely liability.³⁸⁷

388. The Administrative Law Judge disagrees. MERC's actual tax liability for 2012, which was paid in 2013, was greater than the estimate the OAG-AUD makes for MERC's 2014 property tax expense. Moreover, the Company's expectation of still higher property tax obligations during the test year is well grounded in the hearing record.³⁸⁸

389. The Administrative Law Judge finds that MERC's recommended property tax reduction of \$118,864 is appropriate in this rate case.³⁸⁹

Z. Contingent Rebates From Tax Appeals

390. MERC has formally appealed recent property tax assessments from Minnesota and Kansas.³⁹⁰

391. With respect to the litigation in Minnesota, MERC has appealed its property tax assessments for years 2008 through 2013. Its claims were not resolved through the administrative process and it recently presented its requests for relief during a multi-day evidentiary hearing before the Minnesota Tax Court. A decision in this matter is expected during the autumn of 2014.³⁹¹

392. Depending upon the resolution of the appeals, MERC may be obligated to pay higher property tax obligations because of greater property value assessments.³⁹²

393. With respect to the litigation in Kansas, MERC has formally appealed a recent ruling of the Kansas Supreme Court to the United States Supreme Court. The Kansas Supreme Court decision holds that the storage of gas which is allocable to Kansas, by public a utility, is subject to property taxation in Kansas.³⁹³

³⁸⁶ Ex. 151 at 13 (J. Lindell Direct).

³⁸⁷ Ex. 151 at 12-13 (J. Lindell Direct).

³⁸⁸ Ex. 37 at 7-9 (J. Wilde Rebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 94-103 (J. Wilde).

³⁸⁹ *Id.* at 6; EVIDENTIARY HEARING TRANSCRIPT, at 95 (J. Wilde)

³⁹⁰ EVIDENTIARY HEARING TRANSCRIPT, at 97(J. Wilde).

³⁹¹ *Id.*

³⁹² *Id.*

³⁹³ Ex. 37 at 3 (J. Wilde Rebuttal).

394. The decision by the U.S. Supreme Court on MERC's petition for a writ of *certiorari* is expected near the end of calendar year 2014.³⁹⁴

395. MERC included \$375,000 of Kansas *ad valorem* tax in base rates in this rate case. This is the procedure it undertook in the last rate case, relying upon a 2011 test year.³⁹⁵

396. While its appeal is pending MERC has not been remitting these sums to the Kansas Revenue Department.³⁹⁶

397. MERC has agreed:

- (a) that ratepayers should be made whole for all Kansas *ad valorem* taxes which have been remitted to MERC, but for which it is later determined that MERC was not liable;
- (b) to refund the amount of Kansas property taxes collected from customers for the years under appeal, less the amount ultimately paid to Kansas for all years under appeal;
- (c) to remit any refunds due ratepayers with interest;
- (d) to notify the Commission of any court rulings issued prior to the Commission's Final Order in this proceeding; and
- (e) to make a compliance filing upon resolution of either the Minnesota property tax appeal or the Kansas *ad valorem* tax litigation.³⁹⁷

398. The Administrative Law Judge finds that MERC's compliance with the stipulations noted immediately above are important elements of establishing just and reasonable rates.³⁹⁸

AA. IBS Cost Allocation Adjustment

399. MERC proposed to use a two-factor formula to account for how IBS – its service company – allocates costs to MERC and other Integrys affiliates. IBS uses the

³⁹⁴ Ex. 37 at 3 (J. Wilde Rebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 97 (J. Wilde).

³⁹⁵ Ex. 218 MAS-17 (Attachment to M. St. Pierre Direct) (MERC's Response to DOC Information Request 150); Ex. 217 at 22 (M. St. Pierre Direct); DOC. Ex. 219 at 23 (St. Pierre Surrebuttal).

³⁹⁶ *Id.*

³⁹⁷ Ex. 37 at 3-5 (J. Wilde Rebuttal); Ex. 217 at 23-24 (M. St. Pierre Direct); Ex. 219 at 23-24 and 45 (M. St. Pierre Surrebuttal).

³⁹⁸ *Id.*

average of two different percentages for each entity to calculate the General/Corporate Allocation Factor. The percentages are: total assets (with some exclusions for derivative assets, goodwill and other "non-ordinary" assets); and total non-fuel O&M costs.³⁹⁹

400. MERC's operations consist of both regulated and non-regulated activities.⁴⁰⁰

401. The Commission's preferred general allocation method is computed by using the ratio of all expenses directly assigned or attributed to regulated and non-regulated activities, excluding the cost of fuel, natural gas, purchased power, and the purchased cost of goods sold.⁴⁰¹

402. The general, corporate allocation method used by MERC (and IBS) differs from the Commission's preferred general allocation method in that the Company's allocation method includes total assets, whereas the Commission's method does not.⁴⁰²

403. MERC sought to recover the costs allocated to the Company under the Regulated AIA in this rate case. The MERC 2014 gas revenue requirement includes actual amounts charged in 2012, inflated to 2014, and adjusted for known and measureable changes for the services that IBS provides to MERC. MERC did not seek to recover the difference in costs calculated using the IBS method in the Regulated AIA and the Commission's preferred general allocation method.⁴⁰³

404. Utilities that seek a rate increase must use the methodology for allocating costs between regulated and unregulated activities that was approved by the Commission in the 90-1008 Docket, or, alternatively, demonstrate that:

- (a) The utility's non-regulated activities are insignificant; or
- (b) The utility's proposed cost allocation principles produce results similar to allocations that follow the Commission's recommended cost allocation principle; or
- (c) The public interest would be better served by another method.⁴⁰⁴

³⁹⁹ Ex. 12 at 15-18 (T. Kupsh Direct); Ex. 215 at 4 (L. La Plante Direct).

⁴⁰⁰ Ex. 215 at 3 (La Plante Direct).

⁴⁰¹ Ex. 215 at 8-9 (L. La Plante Direct).

⁴⁰² Ex. 215 at 3 (L. La Plante Direct) (*citing* Ex. 12 at 15-16 (T. Kupsh Direct)).

⁴⁰³ Ex. 12 at 3 (Kupsch Direct).

⁴⁰⁴ See generally, ORDER FINDING COMPLIANCE, EXEMPTING NORTHWESTERN WISCONSIN, REQUIRING PREPARATION, AND CLOSING DOCKET, *ITMO an Investigation into the Competitive Impact of Appliance Sales and Service Practices of Minnesota Gas and Electric Utilities*, Docket No. G, E-999/CI-90-1008, (March 1, 1995) (Commission requires: "all utilities to be prepared to demonstrate in future rate cases that

405. In such a circumstance, the burden of proof is on that utility to prove that its cost allocation principles arrive at fully allocated costs, free of any cross-subsidization.⁴⁰⁵

406. There are specific reporting requirements for cost allocations in MERC rate cases.⁴⁰⁶

407. MERC provided calculations showing that the Commission's preferred method resulted in a lower allocation factor; but that the two methods produced very similar results. Applications of the two methods resulted in a difference of \$3,314 for 2012.⁴⁰⁷

408. MERC proposed to recover the smaller amount, as would have resulted from the Commission's preferred allocation method.⁴⁰⁸

409. The Administrative Law Judge finds that MERC's IBS Cost Allocation adjustment is consistent with the Commission's preferred general allocation method and should be approved in this rate case.⁴⁰⁹

BB. MERC's Cost Allocations to ServiceChoice

410. MERC's non-regulated operations are generally referred to as ServiceChoice (formerly known as Home Services). ServiceChoice offers appliance repair, service protection plans and maintenance services to residential customers.⁴¹⁰

411. These services are available on an on-demand and contractual basis. MERC's field technicians perform both regulated and non-regulated work in the majority of Minnesota; but, in certain locations, MERC divides employees between its utility and non-utility businesses.⁴¹¹

a. it follows the cost allocation principles recommended by the Commission, or b. its non-regulated activities are insignificant, or c. its cost allocation principles produce similar results as would allocations following the recommended cost allocation principles, or d. the public interest is better served by another method.”).

⁴⁰⁵ *Id.*

⁴⁰⁶ *ITMO a Request by Minnesota Energy Resources Corporation (MERC) For Approval of Affiliated Interest Agreement Related to the Formation and Operation of Integrys Business Support, LLC, Docket No. G007/011/AI-07-779 (Mar. 5, 2008).*

⁴⁰⁷ Ex. 12 at 3 (T. Kupsh Direct); Ex. 215 at 9, LL-5 (L. La Plante Direct).

⁴⁰⁸ Ex. 12 at 2-3, 10-21 and Schedule (TLK-3) (T. Kupsh Direct).

⁴⁰⁹ Ex. 215 at 9 (L. La Plante Direct).

⁴¹⁰ *Id.* at 4.

⁴¹¹ *Id.* at 10 (*citing* Ex. 40 at 34-36 (G. Walters Direct)).

412. MERC uses three different means of allocating the costs to the utility and non-utility businesses: direct charge, allocations based upon known factors, and general allocation.⁴¹²

413. The majority of costs (76.5 percent) are directly charged. 11.5 percent of costs are charged based upon known factors. The remaining 12.0 percent of costs are allocated based upon a general allocator.⁴¹³

414. MERC's allocation methodology is not the Commission's cost allocation methodology.⁴¹⁴

415. The Department reviewed MERC's cost allocations and concluded that use of MERC's methodology did not result in significant differences from the Commission's preferred methods. It recommends that the Commission accept the results of MERC's cost allocations to ServiceChoice in this rate case.⁴¹⁵

416. The Administrative Law Judge finds that MERC's Cost Allocations to ServiceChoice are reasonable and should be accepted in this rate case.⁴¹⁶

CC. Rate Case Expense

i. Amount of Rate Case Expense

417. MERC forecasted total rate case expenses of \$1,715,000. The expenses include costs for MERC's capital expert, legal fees, charges from Vertex for changes to the billing system, state agency and Administrative Law Judge fees, newspaper notices and travel expenses. Specifically, the Company's proposed rate case expenses are:

- (a) Cost of capital expert - \$35,000;
- (b) Legal expenses - \$750,000;
- (c) State agency/ALJ fees - \$700,000;
- (d) 3rd party requests (vertex, Iltron, etc.) - \$65,000;
- (e) Newspaper notice publication costs - \$140,000; and
- (f) Travel expenses - \$25,000.⁴¹⁷

⁴¹² Ex. 40 at 35 (G. Walters Direct).

⁴¹³ Ex. 215 at 10 (L. La Plante Direct) (*citing* Ex. 40 at 35 (G. Walters Direct)).

⁴¹⁴ Ex. 215 at 11 (L. La Plante Direct) (*citing* Ex. 40 at 37 (G. Walters Direct)).

⁴¹⁵ *Id.* at 11-12.

⁴¹⁶ *Id.*

⁴¹⁷ Ex. 19 at 27 and Schedule (SSD-20) (S. DeMerritt Direct).

418. MERC proposes to amortize 87.7 percent, or \$1,504,055, of these expenses over a two-year period. The 87.7 percent share reflects the removal of rate case expenses for MERC's non-utility business "ServiceChoice."⁴¹⁸

419. This amortization resulted in test year expenses of \$752,028.⁴¹⁹

420. In the prior rate case, MERC was ordered to track rate case expense recoveries exceeding the authorized test year expense. This tracking was undertaken to permit crediting against the revenue requirement in this next rate case.⁴²⁰

421. MERC's current proposed rate case proposes new rates, either final or interim, to take effect January 1, 2014. These rates include MERC's rate case expenses from this docket. Therefore, no recovery for rate case expenses authorized in Docket No. G007,011/GR-10-977 is included in this rate case.⁴²¹

422. As noted above, the Company included \$25,000 of travel expenses to be included in the rate case expense for this proceeding.⁴²²

423. The Department recommended that \$21,925 of this amount be removed from the proposed test year rate case expenses. The \$21,295 sum represents an 87.7 percent (regulated business) share of the \$25,000 amount.⁴²³

424. The Department determined that MERC included \$10,500 of travel expenses in its last rate case, Docket No. G007,011/GR-10-9772010, but had no actual travel expense related to rate expenses in the that case.⁴²⁴

425. Likewise, the Department maintained that because the Company has a travel and entertainment expenses account included for recovery in this proceeding, there would be a double recovery if travel expenses were also an element of rate case expenses.⁴²⁵

426. MERC agreed with this adjustment.⁴²⁶

⁴¹⁸ Ex. 215 at 12 (L. La Plante Direct).

⁴¹⁹ Ex. 19 at 27 and Schedule (SSD-20) (S. DeMerritt Direct).

⁴²⁰ *Id.*

⁴²¹ *Id.*

⁴²² Ex. 215 at LL-8 (L. La Plante Direct).

⁴²³ *Id.* at 13-14.

⁴²⁴ *Id.* at 13.

⁴²⁵ *Id.*

⁴²⁶ Ex. 24 at 15 (S. DeMerritt Rebuttal).

427. As a result, the Administrative Law Judge concludes that inclusion of \$1,482,130 in rate case expenses (\$1,504,055 - \$21,925) is reasonable.⁴²⁷

ii. Amortization Period for Expenses

428. Many factors can impact the utility's decision to file a rate case – including the rate of inflation, cost-of-money, construction activity, customer's usage and changes to accounting practice. Additionally, balanced against these considerations, utilities weigh the fact that rate applications are time consuming and costly to present.⁴²⁸

429. In this proceeding, MERC proposed a two-year amortization period for rate case expenses.⁴²⁹

430. MERC noted that it has proposed to acquire Interstate Power and Light's (IPL) natural gas distribution assets – an action that is subject to Commission approval. If approved, MERC anticipated that the revenues, cost, rate base, as well as rate consolidation with the IPL customers would be addressed in the next rate case.⁴³⁰

431. On June 30, 2014, the Commission issued an Order regarding the joint petition of IPL and MERC for approval of the sale of IPL's Minnesota natural gas distribution system to MERC. The Commission has requested further comments in order to determine whether material facts regarding the sale are genuinely contested.⁴³¹

432. MERC likewise asserted that it is preparing a project to expand a natural gas transmission line. The estimated cost of this project is \$11 million. This sum would consume more than two-thirds of MERC's historic average for annual construction expenditures.⁴³²

433. MERC stated that it "anticipates rate recovery to be needed in 2016" and that as a result it would likely file a rate case in 2015.⁴³³

434. The Department recommended a three-year amortization period for rate case expenses.⁴³⁴

⁴²⁷ *Id.*

⁴²⁸ *Id.* at 15-16.

⁴²⁹ Ex. 24 at 15-16 (S. DeMerritt Rebuttal).

⁴³⁰ Ex. 19 at 9-10 (S. DeMerritt Direct); Ex. 40 at 29 (G. Walters Direct).

⁴³¹ ORDER REQUIRING ADDITIONAL RECORD DEVELOPMENT, *ITMO Request for the Approval of the Asset Purchase and Sale Agreement Between Interstate Power and Light Company and Minnesota Energy Resources Corporation*, MPUC Docket No. G-001, G-011/PA-14-107 (June 30, 2014).

⁴³² Ex. 19 at 10 (S. DeMerritt Direct)

⁴³³ *Id.* EVIDENTIARY HEARING TRANSCRIPT, at 22.

⁴³⁴ Ex. 215 at 6 (L. La Plante Direct).

435. As the Department reasons, because the amount of time between rate cases can vary from the time initially estimated by a utility, the Department prefers to calculate an average time period over which the utility may recover rate case expenses. The Department maintains that this approach is the method most often used in such matters. It also argues that is a reasonable method because neither utilities nor regulators can forecast with certainty when a particular company will file its next rate case.⁴³⁵

436. The Department noted that a three-year recovery period was approved by the Commission in MERC's 2008 and 2010 rate cases. Based upon its recommended three-year recovery period, the Department recommended that test year rate case expenses be reduced by a net amount of \$257,984.⁴³⁶

437. While MERC asserted that reliance upon the recent history of rate filings was not appropriate in this instance, it argued that if the Department's recommendation was adopted still other adjustments would be required. Specifically: (a) debiting the unamortized rate case balance of \$257,985 on an annualized basis, and crediting amortization expense for the same amount; (b) use of a normalized level of rate case costs in test year expenses, but one that is not an asset in rate base such that the Company earns a return on this item; (c) a corresponding removal of \$541,188 in deferred taxes from rate base; and (d) allocating only the associated "Minnesota jurisdiction" share of these expenses.⁴³⁷

438. The net effect of these adjustments reduces the rate base by \$772,598.⁴³⁸

439. The OAG-AUD agreed with the Department's recommendation.⁴³⁹

440. Notwithstanding these alternatives, the Administrative Law Judge concludes that selection of a two-year amortization period is appropriate in this case. MERC's statement regarding the filing of a new rate case, while not a firm commitment, is both sufficiently definite and a likely outcome. A key part of the uncertainty as to the timing of the next rate case is that it is not now clear whether the Commission will approve the purchase of IPL's natural gas operations. This acquisition, and the consolidation that will follow, is a significant driver upon a new and early rate filing.⁴⁴⁰

⁴³⁵ *Id.*

⁴³⁶ *Id.* at 15-16; Ex. 216 at 9-10 (L. La Plante Surrebuttal).

⁴³⁷ Ex. 24 at 16-17 (S. DeMerritt Rebuttal); Ex. 215 at 15-19 (L. La Plante Direct); Ex. 216 at 4-5 and Schedule (LL-S-1) (L. La Plante Surrebuttal); See MERC Issues Matrix at 11 (June 6, 2014) (OAH Docket No. 8-2500-31126, MPUC Docket No. G-011/GR-13-617) (Doc. ID No. 20146-100192-01).

⁴³⁸ Ex. 216 at LL-S-1 (L. La Plante Surrebuttal).

⁴³⁹ Ex. 153 at 1-2, 6 (J. Lindell Rebuttal).

⁴⁴⁰ Ex. 19 at 10 (S. DeMerritt Direct).

441. Likewise, MERC notes that a large transmission project will be placed into service in 2015, making the shorter amortization period particularly appropriate.⁴⁴¹

—442. The Administrative Law Judge finds that a two-year amortization period is appropriate in this case. However, in the event that the Commission concludes that a three-year amortization period is more appropriate, the ALJ further recommends that the rate base balance of \$257,985 be debited on an annual basis and amortization expenses credited for the same amount.⁴⁴²

DD. Charitable Contributions

443. The Commission limits recovery of charitable contribution expenses. The Commission allows as operating expenses only those charitable contributions which are prudent. Of the prudent expenses, it permits only recovery of 50 percent of the donated amounts.⁴⁴³

444. MERC included the amount of its actual charitable contributions from 2012, plus inflation, in its test year income statement.⁴⁴⁴

445. The test-year amount based on the actual 2012 contributions – \$31,050 – plus 1.708 and 1.993 percent inflation, for the subsequent years, equals \$32,209.⁴⁴⁵

446. The Department recommended reducing this amount by 50 percent.⁴⁴⁶

447. MERC accepted the Department's recommended reduction to \$16,105.⁴⁴⁷

448. The Administrative Law Judge finds that MERC's Charitable Contributions should be reduced by \$16,105 for the 2014 test year.⁴⁴⁸

EE. Corporate Aircraft Adjustment

449. MERC included \$956 in corporate aircraft costs as part of its test year general and administrative expense.⁴⁴⁹

⁴⁴¹ Ex. 16 at 6 (B. Nick Direct); Ex. 24 at 16-17 (S. DeMerritt Rebuttal).

⁴⁴² Ex. 24 at 16-17 (S. DeMerritt Rebuttal).

⁴⁴³ MINNESOTA PUBLIC UTILITIES COMMISSION'S STATEMENT OF POLICY ON CHARITABLE CONTRIBUTIONS, (June 14, 1982); Ex. 215 at LL-13 (L. La Plante Direct).

⁴⁴⁴ Ex. 4 Initial Filing Volume 3: Informational Requirements, Document 15; Ex. 19 at 25 (S. DeMerritt Direct); Ex. 24 at 17 (S. DeMerritt Rebuttal).

⁴⁴⁵ Ex. 215 at 19 (L. La Plante Direct) (*citing* MERC's Volume 3, Document 5 (Informational Requirements)).

⁴⁴⁶ *Id.* at 20; Ex. 216 at 5 (L. La Plante Surrebuttal).

⁴⁴⁷ Ex. 24 at 17 (S. DeMerritt Rebuttal); Ex. 216 at 5 (L. La Plante Surrebuttal).

⁴⁴⁸ *Id.*

450. The Department argues that such costs should not be defrayed by ratepayers because such costs were not reasonable or consistent with the public interest.⁴⁵⁰

451. While MERC disagreed with the Department's characterization and conclusion, it agreed to the adjustment for this proceeding because the corporate aircraft amounts were not a material cost.⁴⁵¹

452. The Administrative Law Judge finds that MERC's reduction of \$956 in general and administrative expense for corporate aircraft costs should be approved in this case.⁴⁵²

FF. Transportation Revenue

453. MERC initially proposed \$5,880,151 in transportation sales.⁴⁵³

454. The Department proposed an alternative test year transportation sales forecast amount of \$6,123,364.⁴⁵⁴

455. MERC accepted "because Ms. Otis' forecast benefits from having a full year of calendar 2013 data, which was not available to MERC at the time the Company prepared its test year sales forecast."⁴⁵⁵

456. The OAG-AUD expressed concern that MERC's estimate does not reflect the recent history of transportation sales. It recommended increasing the transportation sales forecast by \$2 million to \$7,880,151.⁴⁵⁶

457. The historical transport sales that the OAG-AUD analyzed included a non-jurisdictional component, the Michigan Taconite mines. To correct for the Michigan Taconite mines, MERC reduced its total transport sales by removing volumes from the non-jurisdictional customers.⁴⁵⁷

⁴⁴⁹ Ex. 24 at 18 (S. DeMerritt Rebuttal).

⁴⁵⁰ Ex. 216 at 6-7 (L. La Plante Surrebuttal); Ex. 215 at 23-24 (L. La Plante Direct).

⁴⁵¹ Ex. 24 at 18 (S. DeMerritt Rebuttal).

⁴⁵² *Id.*

⁴⁵³ Ex. 151 at 14 (J. Lindell Direct).

⁴⁵⁴ EVIDENTIARY HEARING TRANSCRIPT, at 106-108 (H. John).

⁴⁵⁵ *Id.* at 106 (H. John).

⁴⁵⁶ Ex. 151 at 14 (J. Lindell Direct).

⁴⁵⁷ Ex. 39 at 12 (H. John Rebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 106-107 (H. John).

458. The Administrative Law Judge finds that MERC's proposed transportation sales forecast, updated based on the Department's alternative estimates, is reasonable and appropriate. A forecast of in the amount of \$6,123,364 should be approved in this rate case.⁴⁵⁸

GG. Lobbying Expenses

459. MERC did not have any expenses related to gifts and lobbying. MERC incurs labor costs for employees who engage in lobbying activity, but did not have any external expenses related to lobbying activities.⁴⁵⁹

HH. Research Expenses

460. MERC has not included any research costs in the 2012 historical year. Because recovery of these costs is not requested, no further detail regarding these costs was provided.⁴⁶⁰

II. Interest Synchronization

461. Interest synchronization is used for ratemaking in order to determine the amount of interest expense to be used in the calculation of income tax. Thus, when an adjustment is made to MERC's weighted cost of debt, test-year rate base, or operating income statement, it is also necessary to make an interest synchronization adjustment.⁴⁶¹

462. MERC used interest synchronization when it calculated income tax. When determining test-year net operating income, MERC calculated a \$98,779 tax effect from interest expense. This calculation was based upon the proposed cost of debt, instead of the booked interest expense included in the income tax accruals.⁴⁶²

463. The Department recommended that MERC's test year interest synchronization be adjusted as detailed in the Direct Testimony of Department witness Michelle St. Pierre.⁴⁶³

464. MERC accepted this recommendation regarding the methodology for calculating interest synchronization, but suggested that to the extent the final revenue

⁴⁵⁸ *Id.*

⁴⁵⁹ Ex. 19 at 49 (S. DeMerritt Direct).

⁴⁶⁰ *Id.* at 25.

⁴⁶¹ Ex. 217 at 49 (M. St. Pierre Direct).

⁴⁶² Ex. 4 at Volume 3, Doc. #5, Sched. C-1 (Information Requirements); Ex. 217 at 49 (M. St. Pierre Direct).

⁴⁶³ Ex. 218 at Schedule (MAS-7) (M. St. Pierre Direct).

requirement is different from the position stated in the Department's Direct Testimony, the interest synchronization will change accordingly.⁴⁶⁴

465. The Department agreed to MERC's additional proviso.⁴⁶⁵

466. The Administrative Law Judge finds that MERC's Interest Synchronization methods set forth in the Department's Direct Testimony are reasonable and any recalculated adjustments are to be modeled in MERC's final compliance filing.⁴⁶⁶

JJ. Regulatory Assets and Liabilities

467. MERC initially proposed to include \$19,642,806 (\$19,682,037 less \$39,230 allocated to Michigan) representing MERC's net regulatory assets in rate base.⁴⁶⁷

468. The majority of the accounts, which also represent the most significant dollars, (\$18,837,482 of the \$19,682,037) are related to items involving employee benefits.⁴⁶⁸

469. The Department recommended the removal of \$11,281,942 of regulatory assets and liabilities related to seventeen accounts.⁴⁶⁹

470. The majority of the regulatory assets and liabilities the Department proposed to remove from rate base were associated with employee benefits; and particularly the funded status of the pension expense (FAS 158) account.⁴⁷⁰

i. Stipulations Between MERC and the Department

471. MERC and the Department are in agreement regarding the treatment of non-benefit regulatory assets and liabilities.⁴⁷¹

⁴⁶⁴ Ex. 219 at 41 (M. St. Pierre Surrebuttal) (*citing* Ex. 24 at 11 (S. DeMerritt Rebuttal)).

⁴⁶⁵ *Id.* at 42.

⁴⁶⁶ *Id.*

⁴⁶⁷ Ex. 4 Initial Filing Volume 3: Informational Requirements, Document 2, Schedule B-6.

⁴⁶⁸ Ex. 217 at 7 (M. St. Pierre Direct). Other significant amounts relate to the forecasted rate case regulatory asset balance of \$1,315,335 (Account 182513) and the forecasted injuries and damages accrual balance, a credit of \$217,943 (Account 228200). The list of regulatory assets and liabilities included in the test year is set forth in Ex. 218 MAS-13 (M. St. Pierre Direct Attachments).

⁴⁶⁹ Ex. 217 at 9 (M. St. Pierre Direct); Ex. 218 at Schedule (MAS-13) (Attachments to M. St. Pierre Direct); Ex. 219 at 10-11 (M. St. Pierre Surrebuttal).

⁴⁷⁰ See *generally*, Ex. 218 at Schedule MAS-13 (Attachment to M. St. Pierre Direct).

⁴⁷¹ MERC'S POST-HEARING BRIEF, at 47.

472. Additionally, the Department concluded that Account 182901, Cloquet Plant Amortization, should not be removed from rate base. In MERC's last rate case, the Commission required MERC to include the regulatory asset Cloquet Plant Amortization (Account 182901) in rate base.⁴⁷²

473. MERC and the Department likewise agreed that Account 186591 (Account Receivable Arrearage) was erroneously included in rate base. The Company concurred that a rate base reduction of \$17,066 was appropriate.⁴⁷³

474. Further, MERC and the Department agreed that because derivative assets were excluded from rate base, Regulatory Liabilities-Derivatives, in the amount of \$244,050 (Account 254450) should be excluded as well.⁴⁷⁴

475. Because of this exclusion, the same treatment should occur as to the associated deferred taxes in Account 254400 (Regulatory Liabilities Deferred Taxes).⁴⁷⁵

476. Following these adjustments, MERC increased its proposed rate base amount by \$226,984 (\$17,066 - \$244,050).⁴⁷⁶

477. After a series of discussions between the parties, MERC agreed with the Department's proposed adjustment to remove from rate base the recovery of unamortized rate case expense in the amount of \$1,315,335 (regulatory asset Account 182513). MERC acknowledged that these costs are not prepaid costs.⁴⁷⁷

478. MERC likewise proposed a corresponding additional adjustment to remove the deferred taxes that are associated with the unamortized rate case expense. Adjusting for the deferral that is properly allocable to MERC's Minnesota operations, this adjustment is \$540,106.⁴⁷⁸

479. Removing MERC's unamortized rate case expenses in the amount of \$1,312,704, and its related deferred taxes \$540,106, results in net reduction to rate base of \$772,598.⁴⁷⁹

480. During the evidentiary hearing MERC also agreed to remove four accounts pertaining to nonqualified employee benefit costs from rate base:

⁴⁷² Ex. 217 at 10 (M. St. Pierre Direct).

⁴⁷³ Ex. 24 at 4 (S. DeMerritt Rebuttal); Ex. 217 at 10 (M. St. Pierre Direct).

⁴⁷⁴ Ex. 24 at 4-5 (S. DeMerritt Rebuttal).

⁴⁷⁵ Ex. 24 at 5 (S. DeMerritt Rebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 216 (S. DeMerritt).

⁴⁷⁶ Ex. 219 at 5 (M. St. Pierre Surrebuttal).

⁴⁷⁷ Ex. 216 at 3-5 (L. LaPlante Surrebuttal)

⁴⁷⁸ *Id.*; Ex. 24 at 17 (S. DeMerritt Rebuttal).

⁴⁷⁹ EVIDENTIARY HEARING TRANSCRIPT, at 56.

- (a) Account 228300 for \$163,731;
- (b) Account 228305 for \$19,719;
- (c) Account 228310 for \$53,763; and
- (d) Account 242072 for \$2,556.⁴⁸⁰

481. Lastly, the Department agreed that Account 254391 (Regulatory Liability – 2010 Health Care Legislation) which was an element of the rate base in MERC’s last rate case, should remain in the Company’s rate base.⁴⁸¹

482. Based upon adjustments agreed to during this proceeding, MERC has proposed to include \$18,794,224 of regulatory assets and liabilities in rate base or a reduction of \$848,582 (\$19,642,806 - \$18,794,224).⁴⁸²

483. The Administrative Law Judge finds that each of the stipulated adjustments is reasonable and appropriate.⁴⁸³

ii. Inclusion of Pension Benefit Assets in Rate Base

484. The remaining employee benefit related items, taken as a whole, represent the cumulative difference between the contributions funded by MERC to the various benefit trusts and the actuarially calculated expense recognized by MERC.⁴⁸⁴

485. During the period from 2012 through the 2014 test year, MERC contributed more to the pension and post-retirement benefit trusts than it recognized in expenses. This is the primary reason for its proposed rate base adjustment for employee benefits.⁴⁸⁵

486. MERC argued that its proposal in this proceeding follows directly from the treatment of cumulative funding and cumulative expense in the Company’s prior rate case. MERC noted that, although it did not include cumulative funding and cumulative expense in its initial filing in that case, at the urging of other parties, it included these sums in rate base.⁴⁸⁶

⁴⁸⁰ EVIDENTIARY HEARING TRANSCRIPT, at 56 (C. Hans); Ex. 27 at Schedule (CMH-4) (C. Hans Rebuttal); Ex. 217 at 7-11 (M. St. Pierre Direct).

⁴⁸¹ Ex. 219 at 4 (M. St. Pierre Surrebuttal).

⁴⁸² DEPARTMENT’S POST-HEARING BRIEF, PART 2 OF 2, at 112.

⁴⁸³ *Id.*

⁴⁸⁴ Ex. 27 at 13 (C. Hans Rebuttal).

⁴⁸⁵ *Id.* at 13-16.

⁴⁸⁶ *Id.*; Ex. 217 at 7-11 (M. St. Pierre Direct).

487. Moreover, MERC maintains that because the contributions that it makes towards the various benefit plans are “out-of-pocket” expenditures, and provide value to ratepayers by reducing the future liabilities for benefit payments, these are expenditures as to which the company should rightfully earn a rate of return.⁴⁸⁷

488. MERC and the Department disagreed on the inclusion of the benefit trust funds in rate base.⁴⁸⁸

489. In the view of the Administrative Law Judge, the Department has the better of the two arguments. First, notwithstanding the practice agreed to in MERC’s prior rate case, the multi-year averaging of cumulative amounts that occurred in that case is both different from what is proposed for this test year and not ideal.⁴⁸⁹

490. It bears mentioning that the averaging of cumulative amounts, in the prior case, resulted in a reduction to the size of the rate base.⁴⁹⁰

491. Second, generally, a utility’s rate base does not include accounts receivable or accounts payable. These costs are reflected in the company’s cash working capital.⁴⁹¹

492. To the extent that employee benefit expenses are reflected in cash working capital, MERC will earn a reasonable rate of return on these amounts.⁴⁹²

493. Including employee benefit accruals in both cash working capital and a separate asset in rate base risks conferring a double recovery on those amounts.⁴⁹³

494. Third, segregation of employee benefit amounts as a regulatory asset in rate base is not an accounting practice of any other Minnesota utility.⁴⁹⁴

495. Fourth, the employee pension amounts are “externally funded.” MERC pays pension expenses to a separate entity, a benefit trust, in favor of an account maintained outside of the Company. Once the contributions are made, the Company no

⁴⁸⁷ Ex. 27 at 15-16 (C. Hans Rebuttal).

⁴⁸⁸ Ex. 219 at 9 (M. St. Pierre Surrebuttal).

⁴⁸⁹ Ex. 27 at 14-16 (C. Hans Rebuttal); see also, Ex. 219 at 8–9 (M. St. Pierre Surrebuttal).

⁴⁹⁰ *Id.*

⁴⁹¹ Ex. 217 at 50 (M. St. Pierre Direct); EVIDENTIARY HEARING TRANSCRIPT, at 213–214 (St. Pierre).

⁴⁹² EVIDENTIARY HEARING TRANSCRIPT, at 215 and 225–226 (St. Pierre).

⁴⁹³ Ex. 219 at 6 (M. St. Pierre Surrebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 215 (M. St. Pierre).

⁴⁹⁴ Ex. 217 at 7-11 (M. St. Pierre Direct); EVIDENTIARY HEARING TRANSCRIPT, at 215 (M. St. Pierre).

longer has use of the trust funds, nor of earnings on the trust funds, for its ordinary business purposes.⁴⁹⁵

496. Under such circumstances, it is not reasonable to regard the pension funds (FAS 158 Account 182312) as part of the Company's business assets – as to which ratepayers should pay a return.⁴⁹⁶

497. Lastly, it does not appear that accepted accounting standards oblige the recovery of pension costs in the way urged by the Company.⁴⁹⁷

498. The Administrative Law Judge recommends that the Commission require MERC to reduce rate base by \$11,281,942 for the Regulatory Assets and Liabilities adjustment.⁴⁹⁸

499. If the Commission removes the assets and liabilities associated with the benefits plans, then the corresponding deferred taxes should be removed from rate base.⁴⁹⁹

500. The deferred tax adjustment amount is \$4,294,542.⁵⁰⁰

501. The net adjustment that reduces the rate base by \$6,987,400.⁵⁰¹

KK. Gas Affordability Program

502. Minn. Stat. § 216B.16, subd. 15, provides that the Commission may establish affordability programs in order to ensure affordable, reliable, and continuous utility service to low-income residential customers.⁵⁰²

503. MERC's Gas Affordability Program (GAP), first established in 2008, was created to fulfill the purposes of Minn. Stat. § 216B.16, subd. 15.⁵⁰³

504. A four year extension of the program was approved in Docket No. G007,011/M-07-1131, with an expiration date of December 31, 2015.⁵⁰⁴

⁴⁹⁵ EVIDENTIARY HEARING TRANSCRIPT, at 58–59 (C. Hans).

⁴⁹⁶ Ex. 219 at 6–9 (M. St. Pierre Surrebuttal).

⁴⁹⁷ Ex. 217 at 7–11 (M. St. Pierre Direct).

⁴⁹⁸ Ex. 218 MAS-13 (M. St. Pierre Direct).

⁴⁹⁹ Ex. 24 at 4 (S. DeMerritt Rebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 216 (M. St. Pierre).

⁵⁰⁰ Ex. 219 at 10–11 (M. St. Pierre Surrebuttal).

⁵⁰¹ ATTACHMENT 1 TO DEPARTMENT'S POST-HEARING BRIEF, at 4.

⁵⁰² Minn. Stat. § 216B.16, subd. 15.

⁵⁰³ Docket No. G007,011/M-07-1131; Ex. 40 at 30 (G. Walters Direct).

⁵⁰⁴ *Id.*

505. MERC asserts that GAP is an excellent program with high retention rates.⁵⁰⁵

506. MERC does not propose any changes to GAP at this time. MERC intends to make any proposals at the end of the program authorization period on December 31, 2015.⁵⁰⁶

507. The Administrative Law Judge finds that no changes are needed to MERC's GAP program for purposes of this rate case.⁵⁰⁷

LL. New Area Surcharge

508. The Department recommended that, in a separate proceeding, MERC assess whether utility extensions could be made more affordable by extending the period of the New Area Surcharge (NAS). Currently, the surcharge period is a maximum of 15 years.⁵⁰⁸

509. Eager to lower the annual surcharge amounts that are charged to ratepayers in new areas, the Department urged MERC to explore these issues in a new proceeding.⁵⁰⁹

510. MERC agreed with the Department's recommendation. On June 20, 2014, MERC filed its initial NAS filing for approval of a tariff revision and a new area surcharge for the Ely Lake Project.⁵¹⁰

511. The Administrative Law Judge finds that the examination of MERC's NAS in a separate proceeding is appropriate.⁵¹¹

MM. Miscellaneous Service Revenues

512. MERC used seven months of 2012 data (for the months of January through July, 2012) in order to calculate the Company's test-year miscellaneous service revenues.⁵¹²

⁵⁰⁵ Ex. 40 at 30-31 (G. Walters Direct).

⁵⁰⁶ *Id.*

⁵⁰⁷ *Id.*

⁵⁰⁸ Ex. 210 at 11-13 (M. Zajicek Direct); Ex. 211 at 5 (M. Zajicek Surrebuttal).

⁵⁰⁹ Ex. 211 at 5 (M. Zajicek Surrebuttal).

⁵¹⁰ Ex. 42 at 13 (G. Walters Rebuttal); see In the Matter of the Petition of Minnesota Energy Resources Corporation for Approval of a Tariff Revision and a New Area Surcharge for the Ely Lake Project (June 20, 2014) (Doc. ID No. 20146-100673-01).

⁵¹¹ *Id.*

⁵¹² Ex. 215 at 3.

513. The Department expressed concern that MERC's methods of calculating these revenues understated the forecast.⁵¹³

514. The Department recommended that the test year other revenue from miscellaneous services be increased by \$51,493. It maintained that this upward adjustment more reasonably reflected the average the annual revenue over the most-recent four-year period (2010 through 2013).⁵¹⁴

515. MERC agreed with the Department's recommended adjustment.⁵¹⁵

516. The Administrative Law Judge finds that an increase of \$51,493 to MERC's test-year other revenue from miscellaneous services is appropriate and proper in this rate case.⁵¹⁶

NN. Rate Base Disallowances Relating to Service and Main Extensions

517. On March 31, 1995, the Commission requested that during each general rate case, the Department investigate every gas utility company's service additions to rate base due to new service extensions. The Commission requested this inquiry in order to ensure that:

- (1) LDCs are applying their tariffs correctly and consistently;
- (2) Service extensions are appropriately cost and load justified; and
- (3) Wasteful additions to facilities are not placed into rate base.⁵¹⁷

518. MERC conducted an audit of its main and service extensions to determine whether its extension tariff had been correctly and consistently applied since its last rate case.⁵¹⁸

519. Based upon the findings of this audit, MERC removed \$29,170 of plant items from its rate base in this rate case proceeding. Specifically, MERC proposed a

⁵¹³ *Id.*

⁵¹⁴ Ex. 215 at 3 and Schedule (LL-3) (L. La Plante Direct)(MERC Response to DOC IR 128); Ex. 216 at 2 (L. La Plante Surrebuttal).

⁵¹⁵ Ex. 24 at 15 (S. DeMerritt Rebuttal).

⁵¹⁶ *Id.*

⁵¹⁷ ORDER, Docket No. G999/CI-90-563. See *generally*, Ex. 14 (D. Kult Direct); Ex. 210 at 6-7 (M. Zajicek Direct).

⁵¹⁸ Ex. 14 at 3-12 and Schedules (DGK-1 and DGK-2) (D. Kult Direct); Ex. 19 at 28 (S. DeMerritt Direct).

reduction of \$12,859.52 to rate base for service line extensions and a reduction of \$16,310.50 to rate base for main extensions.⁵¹⁹

520. The Department examined a representative sample of MERC's records relating to the main line and service line extension projects. Based upon the results of this analysis, the Department recommended an additional reduction of \$6,633.16 to rate base for main and service extensions, for a total reduction of \$35,803.18 for unbilled extension costs.⁵²⁰

521. MERC agreed with the Department's recommendation.⁵²¹

522. MERC also provided a quantitative analysis showing that its service-related additions are appropriately cost and load justified. MERC proposed to continue its currently-approved 75-foot allowance for each stand-alone service extension and its feasibility model for other residential and all commercial and industrial extensions.⁵²²

523. The Department concurred that MERC should continue to apply the 75-foot allowance for each stand-alone service line extension and the approved feasibility model for other residential, commercial and industrial extensions.⁵²³

524. So as to address potentially wasteful additions to plants and facilities, MERC proposed that \$29,170.02 of extension-related costs be disallowed.⁵²⁴

525. The Department concurred in part. It recommended applying the \$29,170.02 in disallowances proposed by MERC, plus an additional \$6,633.16 in reductions, for a total of \$35,803.18.⁵²⁵

526. MERC agreed with the Department's recommendation.⁵²⁶

527. The Administrative Law Judge finds that MERC's Service and Main Extension reduction, allowance, and feasibility model are reasonable and should be

⁵¹⁹ *Id.*; Ex. 14 at 10-11 (D. Kult Direct); Ex. 4 Initial Filing Volume 3: Informational Requirements, Document 2, Schedule B-3.

⁵²⁰ Ex. 210 at 2, 22, 23, 25, 30-31 and Schedules (MZ-1 through MZ-4) (M. Zajicek Direct); Ex. 211 at 1-2 (M. Zajicek Surrebuttal).

⁵²¹ Ex. 15 at 2-3 (D. Kult Rebuttal).

⁵²² Ex. 14 at 11-12 (D. Kult Direct).

⁵²³ Ex. 210 at 10, 26, 31 (M. Zajicek Direct); Ex. 211 at 3 (M. Zajicek Surrebuttal).

⁵²⁴ Ex. 14 at 12 (D. Kult Direct); Ex. 4 Initial Filing Volume 3: Informational Requirements, Document 2, Schedule B-3.

⁵²⁵ Ex. 210 at 25, 27, 31 (M. Zajicek Direct); Ex. 211 at 3 (M. Zajicek Surrebuttal).

⁵²⁶ Ex. 15 at 4 (D. Kult Rebuttal).

approved by the Commission after taking into account the Department's recommendations.⁵²⁷

OO. Rate Base Disallowances Relating to Winter Construction Charges

528. In its Order in Docket No. G007,011/M-07-1188, the Commission required MERC to make certain reports regarding winter construction charges in its next general rate case. Specifically, the Company was directed to demonstrate that no winter construction charges:

- (a) were assessed to customers outside of the tariff winter construction charge period; and
- (b) incurred by the Company from any contractors outside the tariffed winter construction charge period, are proposed to be recovered from other ratepayers.⁵²⁸

529. MERC found no invoices for winter charges for work done outside the tariffed Winter Construction Charges period. As a result, MERC removed \$0 for winter charges for work done outside the tariffed Winter Construction Charges period.⁵²⁹

530. The Department agreed with this assessment and proposed no further disallowances on winter construction.⁵³⁰

531. The Department recommended that MERC continue to show in the Company's rate case that no winter construction costs were assessed outside the winter construction period, and that no winter construction charges incurred by MERC from any contractors outside the winter construction period are proposed to be recovered from other ratepayers.⁵³¹

532. MERC agreed with the Department's recommendations.⁵³²

533. The Administrative Law Judge finds that the Commission should accept MERC's proposed rate base disallowance as to winter construction charges. The Administrative Law Judge also recommends that the Company make a like set of assessments and reports in its next general rate case.⁵³³

⁵²⁷ *Id.*

⁵²⁸ Ex. 14 at 13 and Schedule (DGK-3) (D. Kult Direct). The Commission included similar requirements in its ORDER AFTER RECONSIDERATION, in Docket No. G007,011/GR-08-835.

⁵²⁹ Ex. 14 at 13 (D. Kult Direct); Ex. 19 at 29 (S. DeMerritt Direct).

⁵³⁰ Ex. 211 at 4 (M. Zajicek Surrebuttal).

⁵³¹ Ex. 210 at 27-28 (M. Zajicek Direct); Ex. 211 at 4 (M. Zajicek Surrebuttal).

⁵³² Ex. 15 at 5 (D. Kult Rebuttal).

⁵³³ *Id.*

PP. Disallowances Relating to Supplemental-Executive Retirement Plan

534. The only SERP-related costs for which MERC is seeking recovery in this proceeding are those that were earlier-approved by the Commission in Docket No. G007,011/M-06-1287.⁵³⁴

535. The Administrative Law Judge finds that MERC's recovery of SERP costs that were earlier-approved in Docket No. G007,011/M-06-1287 is appropriate in this rate case.⁵³⁵

QQ. Rate Base Disallowances Relating to Gas Affordability Program

536. In MERC's last rate case, Docket No. G007,011/GR-10-977, balances associated with the Gas Affordability Program were removed from rate base and, therefore, were removed from rate base in this current rate case.⁵³⁶

RR. Test Year Working Capital

537. MERC developed the 2014 test year working capital forecast in this case so that it would be synchronized with the working capital calculated in the lead/lag study.⁵³⁷

538. The Department recommended that MERC's test year working capital be adjusted as detailed in the Direct Testimony of Department witness Ms. St. Pierre – principally an increase of \$112,753 for the lead/lag adjustment.⁵³⁸

539. MERC accepted this recommendation, but suggested that the final cash working capital amount remain in flux until other items in the revenue deficiency calculation are resolved.⁵³⁹

540. MERC likewise accepted the Department's recommendation that in future rate cases the Company provide a schedule that reconciles the expenses in the cash working capital to the expenses in MERC's test year income statement.⁵⁴⁰

⁵³⁴ Ex. 19 at 32 (S. DeMerritt Direct).

⁵³⁵ *Id.*

⁵³⁶ Ex. 19 at 32 (S. DeMerritt Direct).

⁵³⁷ Ex. 19 at 8, 33-40 and Schedule (SSD-21) (S. DeMerritt Direct).

⁵³⁸ Ex. 217 at 50-52 (M. St. Pierre Direct); Ex. 218 at Schedules (MAS-8, MAS-8a) (Attachments to M. St. Pierre Direct).

⁵³⁹ Ex. 24 at 12-13 and Schedule (SSD-4) (S. DeMerritt Rebuttal).

⁵⁴⁰ Ex. 24 at 12 (S. DeMerritt Rebuttal); Ex. 217 at 50-51 (M. St. Pierre Direct); Ex. 219 at 42 (M. St. Pierre Surrebuttal).

541. MERC also agreed with the Department's recommendation that in future rate cases MERC's cash working capital schedule be based upon the number of days, rather than specific percentages.⁵⁴¹

542. The Administrative Law Judge finds that MERC's Test Year Working Capital adjustment should be adjusted as described in Ms. St. Pierre's Direct Testimony. The Administrative Law Judge likewise finds that it is reasonable and prudent for MERC to recalculate the needed adjustment after the other items in the revenue deficiency calculation are resolved.⁵⁴²

SS. Intervenor Constellation Issues

543. Intervenor Constellation New Energy – Gas Division, LLC (Constellation) expressed concern that during some emergencies, firm-supply customers are subject to curtailment of gas deliveries before the supplies to interruptible customers are curtailed.⁵⁴³

544. To address this concern, Constellation urged MERC to establish a process for reconciling the amounts that are purchased for firm capacity on the interstate pipeline and the capabilities of MERC's own distribution system. Constellation suggested that if a demand was made by a customer, or a customer's broker, by October 1, MERC would reconcile the capacity differences before the start of the heating season.⁵⁴⁴

545. MERC agreed that, if a customer or customer's broker provides the Company with details as to the amount of purchased firm capacity on the interstate pipeline by August 1, the Company would complete the necessary evaluation of its distribution system prior to the start of the heating season.⁵⁴⁵

546. The Administrative Law Judge finds that formally providing for such a reconciliation service to firm service customers would be a useful addition to MERC's tariff.⁵⁴⁶

TT. Uncontested Adjustments

547. MERC filed testimony as part of its application on a number of uncontested financial matters involving various adjustments to the test year. The

⁵⁴¹ Ex. 24 at 12 (S. DeMerritt Rebuttal). Ex. 217 at 51 (M. St. Pierre Direct); Ex. 219 at 42 (M. St. Pierre Surrebuttal).

⁵⁴² *Id.*

⁵⁴³ See generally Ex. 125 (R. Haubensak Direct).

⁵⁴⁴ 42 at 16-17 (G. Walters Rebuttal).

⁵⁴⁵ *Id.*

⁵⁴⁶ *Id.*

findings above describe the areas where parties who audited MERC's filing had issues with the treatment of certain amounts and expenses in MERC's filing. No party filed testimony challenging any other aspects of MERC's financial filings.⁵⁴⁷

548. The Administrative Law Judge finds the uncontested portions of MERC's filing will contribute to establishment of reasonable rates and should be approved.⁵⁴⁸

UU. Revenue Requirements Summary

549. With the adjustments to rate base and test year operating expenses and revenues agreed to by the parties through the course of testimony exchanged in this proceeding, MERC calculates the gross revenue deficiency to be \$12,159,454.⁵⁴⁹

550. The Department calculates the gross revenue deficiency to be \$3,480,421.⁵⁵⁰

551. Because of the changes from the initial filing, and the later agreements of the parties, these numbers require recalculation. The Commission is in the best position to produce a final calculation of the revenue deficiencies, following a final determination in this case.⁵⁵¹

V. Conservation Improvement Program (CIP) and Cost Recovery Mechanisms

552. MERC has an approved CIP on file with the Department of Commerce.⁵⁵²

553. The legislature requires utilities to make certain conservation-related expenditures and permits recovery of these expenses through utility rates.⁵⁵³

554. During the 2010 rate case, MERC received approval to update the Conservation Cost Recovery Charge (CCRC) factors so as to permit the company to recover annual CIP program costs. The charges would be updated through a Conservation Cost Recovery Adjustment (CCRA).⁵⁵⁴

555. The Commission initially set the CCRA factors for MERC-NMU and MERC-PNG at \$0.0000 per therm.⁵⁵⁵

⁵⁴⁷ DEPARTMENT REPLY BRIEF, PART 2 OF 2, at 119.

⁵⁴⁸ *Id.*

⁵⁴⁹ Ex. 24 at 30 (S. DeMerritt Rebuttal).

⁵⁵⁰ MERC's ISSUES MATRIX, at Schedule 3 (June 6, 2014).

⁵⁵¹ *See, id.*

⁵⁵² Ex. 19 at 41 (S. DeMerritt Direct); Ex. 217 at 12 (M. St. Pierre Direct).

⁵⁵³ Minn. Stat. §§ 216B.16, subd. 6b and 216B.241.

⁵⁵⁴ ORDER, G011/M-10-407 and G007/M-10-409 on October 11, 2010.

⁵⁵⁵ Ex. 19 at 42 (S. DeMerritt Direct).

556. The Commission later approved a CCRA of \$0.00475 for MERC-NMU effective January 1, 2014.⁵⁵⁶

557. The current CCRA factor for MERC-PNG is \$0.04200 per therm.⁵⁵⁷

558. MERC stopped collecting the CCRA factor for NMU customers effective with May 2014 billing because the MERC-NMU CIP tracker balance reached zero.⁵⁵⁸

559. On May 1, 2014, MERC proposed a consolidated CCRA factor of \$0.00148 to be effective January 1, 2015. The Commission has yet to issue an Order approving MERC's proposed consolidated CCRA factor.⁵⁵⁹

A. CIP Tracker Account Balances

560. MERC stated that, based on Department recommendations related to test year CIP expenses, MERC determined that a slight adjustment will need to be made to the CIP tracker at the time of final rates.⁵⁶⁰

561. Currently, in interim rates, MERC is collecting revenue from customers and crediting the CIP tracker balance at MERC's filed CCRC of \$0.02432 per therm.⁵⁶¹

562. If MERC's proposed CCRC of \$0.02462 is approved in this proceeding, MERC will have under-collected CIP expense during the time that the Company's interim rates were in effect.⁵⁶²

563. In the event that MERC under-collects CIP expense, the Company recommends crediting the CIP tracker balance (Account No. 182705):

- (1) \$0.00030 (\$0.02462 - \$0.02432) multiplied by the actual sales during the period interim rates were in effect; and
- (2) debiting the CIP Amortization account (Account No. 407710) for this same amount.⁵⁶³

⁵⁵⁶ See, PETITION FOR APPROVAL OF CONSOLIDATED CIP TRACKER ACCOUNT, MPUC M-14-36, at 8 (May 1, 2014).

⁵⁵⁷ *Id.*

⁵⁵⁸ *Id.*

⁵⁵⁹ See, Docket No. G011/M-14-369 (2013 Consolidated CIP Tracker Account, DSM Financial Incentive, and Conservation Cost Recovery Adjustment).

⁵⁶⁰ Ex. 219 at 6-7 (M. St. Pierre Surrebuttal).

⁵⁶¹ *Id.* at 14.

⁵⁶² *Id.*

564. This adjustment would increase the amount of CIP expenses (and revenue requirements) that MERC should recognize during the period for interim rates. This increase would be offset by a lower refund to customers.⁵⁶⁴

565. The Administrative Law Judge finds that MERC's proposal to credit the CIP tracker balance, in the event that it under-collects CIP expense during interim rate period, is reasonable.⁵⁶⁵

566. At the time that its final rates are established, MERC should update its CIP tracker carrying charge based upon the overall rate of return approved in this case.⁵⁶⁶

567. Additionally, MERC should report in its final rates compliance filing the calculation of the CCRC rate based upon terms of the Commission's Order.⁵⁶⁷

B. Test Year CIP Expenses

568. MERC proposed to include CIP expenses in the Company's base rates via the test year in this proceeding. Initially, MERC proposed to include in the test year CIP expenses of \$8,920,481.⁵⁶⁸

569. MERC did not propose to include the unamortized balance of CIP in rate base since MERC recovers a return on the balance in the CIP tracker.⁵⁶⁹

570. Department witness Ms. St. Pierre recommended that the 2014 CIP budget of \$9,396,422 approved in Docket No. 12-548, should be used in this rate case. This adjustment would increase CIP expense by \$475,941.⁵⁷⁰

571. The Department also recommended that MERC's CCRC be recalculated based upon the Commission's Order as to CIP expenses, divided by the approved level of sales.⁵⁷¹

572. MERC agreed to the increase in CIP expense as proposed by the Department. MERC recalculated the CCRC using the Department's recommended update to CIP expense and the CCRC-applicable sales.⁵⁷²

⁵⁶³ *Id.* at 7-8.

⁵⁶⁴ *Id.*

⁵⁶⁵ Ex. 219 at 18 (M. St. Pierre Surrebuttal).

⁵⁶⁶ *Id.* at 44.

⁵⁶⁷ *Id.* at 13-14; *see also*, Ex. 217 at 15-17 (M. St. Pierre Direct).

⁵⁶⁸ Ex. 19 at 10, 41-44 and Schedule (SSD-24) (S. DeMerritt Direct).

⁵⁶⁹ *Id.* at 43.

⁵⁷⁰ Ex. 217 at 14 (M. St. Pierre Direct).

⁵⁷¹ *Id.* at 14-16; Ex. 219 at 11 (M. St. Pierre Surrebuttal).

573. The CCRC rate of \$0.02462 is \$0.00949 greater than MERC's CCRC as approved in Docket No. G007,011/GR-10-977.⁵⁷³

574. The Department also recommended that the test-year CIP revenue be increased to the level of CIP expense approved in the test year. Using the 2014 Approved CIP budget (\$9,396,422), the Department maintained that the Commission require MERC to increase Natural Gas Revenue by \$3,758,090 (\$3,538,432 - \$256,283 + \$475,941) for CIP revenue.⁵⁷⁴

575. The adjustment to CIP revenue included recalibration of the Department's recommended sales forecast by \$256,283, as well as an increase in CIP expense of \$475,941.⁵⁷⁵

576. MERC expressed the concern that by imputing CIP revenues of \$3,758,090 to offset the increase in CIP expense, the Department's proposal would effectively reduce MERC's revenue requirement – and do so based upon revenue that will never, in fact, be collected.⁵⁷⁶

577. Under the Department's proposal, MERC's revenue deficiency would be lowered and a corresponding amount would be included in the CCRA. In this way, CIP expense would move from the Distribution Rate to the final approved CIP Rate on the customer's bill.⁵⁷⁷

578. Through such an approach, the CCRA would be adjusted between rate cases so as to address any significant under-recoveries or refund any over-recoveries.⁵⁷⁸

579. MERC testified that it would not be opposed to this approach provided that the dockets related to the CCRA are finalized and an order is issued in a timely fashion. In addition, if changing the CCRC to \$0.00000 were to occur in the current docket, MERC requests that its proposed CCRC of \$0.02462 be added to the CCRA on January 1, 2015, or with implementation of final rates, whichever occurs later, so as not to delay the recovery of these expenses.⁵⁷⁹

⁵⁷² Ex. 24 at SSD-1 (S. DeMerritt Rebuttal).

⁵⁷³ Ex. 219 at 11 (St. Pierre Surrebuttal) (*citing* Ex. 24 at 6-7 (S. DeMerritt Rebuttal)).

⁵⁷⁴ Ex. 217 at 15 (M. St. Pierre Direct); Ex. 218 MAS-16 (M. St. Pierre Direct).

⁵⁷⁵ Ex. 217 at 15 (M. St. Pierre Direct); Ex. 219 at 12-15 (M. St. Pierre Surrebuttal).

⁵⁷⁶ Ex. 24 at 5-8, 13-14 and Schedule (SSD-2) (S. DeMerritt Rebuttal).

⁵⁷⁷ Ex. 219 at 14 (M. St. Pierre Surrebuttal).

⁵⁷⁸ *Id.*; Ex. 24 at 6 (S. DeMerritt Rebuttal).

⁵⁷⁹ Ex. 24 at 6 and Schedule (SSD-1) (S. DeMerritt Rebuttal).

580. The Administrative Law Judge finds that balancing test-year CIP revenue with test-year CIP expenses, and reflecting the appropriate charges as part of the final approved CIP rate, will increase transparency in ratemaking and potentially reduce future audit costs and rate case expenses.⁵⁸⁰

581. The Administrative Law Judge recommends setting the CIP revenue equal to the CIP expense so that final rates include CIP revenue and CIP costs of \$9,396,422.⁵⁸¹

582. Additionally, the Administrative Law Judge recommends that the CCRC should be added to the CCRA on January 1, 2015, or with implementation of final rates, whichever occurs later.⁵⁸²

C. Carrying Charges for CIP Tracker Accounts

583. MERC proposed a carrying charge for use in the CIP tracker.⁵⁸³

584. The Department recommended that MERC update its CIP tracker carrying charge to the rate of return that is approved in this case.⁵⁸⁴

585. MERC agreed with the Department's recommendation.⁵⁸⁵

586. The Administrative Law Judge finds that the Commission should require MERC to update the carrying charge used in the CIP tracker to the rate of return approved in this rate case.⁵⁸⁶

D. CIP Exempt Customers and Uncollected CIP Revenues

587. A "CIP-exempt customer" is a customer that has been granted an exemption by the Department from paying for, or participating in, CIP projects.⁵⁸⁷

588. MERC recently discovered that a significant Taconite customer, Northshore Mining, has, in error, been treated as exempt from the CIP charges.⁵⁸⁸

⁵⁸⁰ Ex. 219 at 12-14 (M. St. Pierre Surrebuttal).

⁵⁸¹ *Id.* at 14.

⁵⁸² *Id.* at 17.

⁵⁸³ Ex. 19 at 43 (S. DeMerritt Direct).

⁵⁸⁴ Ex. 217 at 15 (M. St. Pierre Direct).

⁵⁸⁵ Ex. 24 at 13 (S. DeMerritt Rebuttal).

⁵⁸⁶ *Id.*

⁵⁸⁷ See, Minn. Stat. § 216B.241.

⁵⁸⁸ Ex. 19 at 44 (S. DeMerritt Rebuttal).

589. Upon discovery of this error, MERC notified Northshore and Northshore applied for a CIP exemption.⁵⁸⁹

590. MERC will absorb this under recovery and not seek the one-year back-payment of CIP charges allowed by the billing error rules.⁵⁹⁰

591. Northshore is a SLV transportation customer whose gas is directly supplied by Northern Natural Gas's interstate pipeline.⁵⁹¹

592. MERC prepared the test year CIP schedules assuming Northshore would be granted an exemption.⁵⁹²

593. Northshore's petition for exemption was granted effective January 1, 2014.⁵⁹³

594. The Department recommended a one-time carrying charge be applied to the unrecovered CIP balance. For the carrying charge rate, it recommended use of MERC's approved overall rates of return for the period of under collection (July 2006 through December 2013). Additionally, the Department urged that the Commission require MERC to credit the CIP tracker for uncollected amounts (CCRC and CCRA) during the period between July 2006 and December 2013; a period corresponding to the dates before Northshore's CIP exemption was effective. Lastly, the Department suggested that the Commission require MERC to report this information in its final rates compliance filing in this docket.⁵⁹⁴

595. MERC agreed with the Department's recommendations and pledged to complete a series of reviews to prevent the recurrence of similar errors.⁵⁹⁵

596. The Administrative Law Judge finds that due to MERC's absorption of the under-recovery of CIP charges from Northshore, its crediting the CIP tracker for these uncollected amounts and the completion of improvements to the Company's billing system, the Commission should approve MERC's overall approach to uncollected CIP expense in this rate case.⁵⁹⁶

⁵⁸⁹ *Id.*

⁵⁹⁰ *Id.*

⁵⁹¹ *Id.*

⁵⁹² *Id.*; EVIDENTIARY HEARING TRANSCRIPT, at 35-36 (S. DeMerritt).

⁵⁹³ Ex. 217 at 19 (M. St. Pierre Direct); ORDER, *In Re Northshore Mining for Conservation Improvement Program Exemption*, Docket Nos. E015/CIP-13-852 and G011/CIP-13-853, at 5 (Dec. 20, 2013).

⁵⁹⁴ Ex. 217 at 20-21 (M. St. Pierre Direct).

⁵⁹⁵ Ex. 24 at 8 and 13-14 (S. DeMerritt Rebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 36-37 (S. DeMerritt).

⁵⁹⁶ *Id.*

E. Calculation of Conservation Cost Recovery Charge (CCRC)

597. In MERC's last rate case, for the purposes of the interim rates, MERC imputed revenues to offset the increases in CCRC, and overall, in CIP expenses.⁵⁹⁷

598. While this imputation of revenue had the effect of balancing (or creating revenue neutrality within) the interim rates, the practice resulted in confusion for those who were reviewing the Company's rate-related filings. As a result, prior to the filing of the instant case, MERC representatives sought advice from the Commission staff as to the best way to reflect increases in CCRC in interim rates. Commission staff advised MERC to reflect increase expenses in the interim rate calculation.⁵⁹⁸

599. MERC initially proposed a CCRC of \$0.02432 per therm.⁵⁹⁹

600. The Department initially expressed concern that MERC had not changed its CCRC factor to reflect the CIP recovery from interim rates.⁶⁰⁰

601. The Department recommended that MERC update the CCRC rate based on the Commission Order in MERC's final rates compliance filing, and further that MERC do so at the beginning of interim rates and again at final rates in future rate cases.⁶⁰¹

602. The Department maintained that this approach would synchronize the CIP tracker with changes in interim rates and final rates.⁶⁰²

603. MERC agreed with the Department's recommendation.⁶⁰³

604. MERC has updated the CCRC rate for interim rate and has recognized the increased CIP amortization expense associated with the higher rate being collected by the Company.⁶⁰⁴

605. The Department also recommended that, at the time of final rates in this proceeding, the Commission require MERC to update its CIP tracker carrying charge. The update would reflect the overall rate of return approved in this general rate case;

⁵⁹⁷ *Id.*

⁵⁹⁸ *Id.*

⁵⁹⁹ Ex. 19 at Schedule (SSD-24) (S. DeMerritt Direct).

⁶⁰⁰ Ex. 217 at 16 (St. Pierre Direct).

⁶⁰¹ Ex. 217 at 17 (St. Pierre Direct); Ex. 219 at 17 (M. St. Pierre Surrebuttal).

⁶⁰² Ex. 219 at 17 (M. St. Pierre Surrebuttal).

⁶⁰³ Ex. 24 at 13 (S. DeMerritt Rebuttal).

⁶⁰⁴ *Id.* and Schedule SSD-2.

and the calculation of the CCRC rate from the Commission's Order divided by the approved level of sales.⁶⁰⁵

606. MERC agreed to these recommendations.⁶⁰⁶

607. MERC also proposed to update the CCRC in final rates based upon: (a) the higher CIP expense and change in sales forecast from filing; and (b) an adjustment to the CIP tracker balance (expense Account 182705) for any under recovery during the interim rate period, in the event that the Commission approves an increase in the CCRC factor above the interim rate for CCRC.⁶⁰⁷

608. The Department agreed that this was a reasonable approach – and would potentially avoid the need for any later “true up” of under-recovered tracker balances.⁶⁰⁸

609. MERC provided evidence to show that the Company increased its CCRC factor when interim rates were implemented on January 1, 2014.⁶⁰⁹

610. As noted above, MERC agreed to credit the CIP tracker inclusive of carrying charges for the under-recovery of CIP charges from Northshore. The credit would be to MERC's Consolidated CIP Tracker because MERC-PNG's CIP tracker is projected to be reduced to a zero balance by the end of November 2014.⁶¹⁰

611. The CCRC factor for the purpose of final rates would be \$0.02462 (\$9,396,422/381,721,852), if the Commission approves MERC's proposal, for a test-year 2014 CIP program budget of \$9,396,422 and CCRC applicable sales volumes of 381,721,852 therms.⁶¹¹

612. The Administrative Law Judge finds that MERC's CCRC is reasonable. Contingent upon MERC updating the CCRC in final rates and making a CIP tracker balance adjustment, this CCRC should be approved.⁶¹²

613. The Administrative Law Judge recommends that:

⁶⁰⁵ Ex. 217 at 15–16 (M. St. Pierre Direct).

⁶⁰⁶ Ex. 24 at 13 (S. DeMerritt Rebuttal)

⁶⁰⁷ Ex. 24 at 7-8, 13 and Schedule (SSD-2) (S. DeMerritt Rebuttal).

⁶⁰⁸ Ex. 219 at 18 (M. St. Pierre Surrebuttal); CenterPoint Energy made a similar adjustment in its 2008 general rate case compliance filing. *CenterPoint Energy 2008 Rate Case*, Docket No. G008/GR-08-1075, Correspondence, filed July 26, 2010, Attachment A at 6 (CIP Tracker True-up, Final Rates for Test Year).

⁶⁰⁹ Ex. 219 at 16 (M. St. Pierre Surrebuttal).

⁶¹⁰ Ex. 24 at 8 (S. DeMerritt Rebuttal). EVIDENTIARY HEARING TRANSCRIPT, at 36 (S. DeMerritt); *see also*, *In Re MERC's 2013 Consolidated CIP Tracker Account, DSM Financial Incentive and Conservation Cost Recovery Adjustment (CCRA)*, MPUC Docket No. G011/M-14-369, at Attachment C, n. 1 (May 1, 2014).

⁶¹¹ Ex. 24 at SSD-1 (S. DeMerritt Rebuttal).

⁶¹² *Id.*

- (1) MERC should report in its final rates compliance filing the calculation of the CCRC rate based upon the Commission's Order, with respect to the level of CIP expenses divided by the level of sales approved by the Commission;
- (2) CIP would be recovered through one line item on a customer's bill (MERC CCRA); and
- (3) in future general rate-case filings, MERC should change the CCRC rate at the beginning of interim rates and again at final rates.⁶¹³

F. Responses to Commission Requests for Additional Information

614. In the Notice and Order for Hearing the Commission asked MERC to provide the following information:

- (1) A calculation of the CCRC and the CCRA charge since the inception of MERC's ownership;
- (2) The applicable Northshore volumes, CCRC and CCRA rates, and CCRC and CCRA amounts, by month, for the period July 2006 through December 31, 2013
- (3) Information on the adequacy of the Vertex billing audit with respect to finding CIP-related and other billing errors;
- (4) Information on the tracking and handling of CIP expenses in the development of the test year operating expenses; and
- (5) The potential impact of updated sales and commodity pricing forecasts on the demand and commodity cost of gas.⁶¹⁴

615. The calculations for the CCRC and CCRA since Integy's ownership of MERC are provided in Seth DeMerritt's Supplemental Direct Exhibit SSD-1.⁶¹⁵

616. The volumes for Northshore, the CCRC and CCRA rates and amounts, by month, from July 2006 through December 2013, are provided in Mr. DeMerritt's Supplemental Direct Exhibit SSD-2.⁶¹⁶

⁶¹³ *Id.*

⁶¹⁴ Ex. 21 at 2-3 (S. DeMerritt Supplemental Direct).

⁶¹⁵ *Id.* at 3; Ex. 23 at Schedule (SSD-1) (Exhibits to S. DeMerritt Supplemental Direct).

⁶¹⁶ Ex. 21 at 4 (S. DeMerritt Supplemental Direct); Ex. 23 at Schedule (SSD-2) (Exhibits to S. DeMerritt Supplemental Direct).

617. With respect to the Vertex audit, while MERC worked collaboratively with the Department and OAG-AUD on the development of the Statement of Work for the audit, at that time the audit was planned, issues with CIP were not identified as a special area for concern.⁶¹⁷

618. No audit tests specifically related to CIP issues were set out in the auditor's Statement of Work and no billing errors related to CIP were discovered during the audit process.⁶¹⁸

619. While the billing audit identified no significant issues, MERC did note that the revenue deficiency in Docket G007,011/GR-10-977 should have been reduced by \$9,710. In accordance with Commission Order, MERC has reduced the revenue deficiency in this current docket by that amount inclusive of carrying charges.⁶¹⁹

620. As to MERC's tracking and handling of CIP expenses in the development of the test year operating expenses, MERC used the 2013 expenses approved in Docket No. G007,011/CIP-12-548 for the test year amounts. MERC acknowledges that use of the 2014 proposed CIP expenses would have been more appropriate when developing test year operating expenses.⁶²⁰

621. As to the potential impact of updated sales and commodity pricing forecasts on the demand and commodity cost of gas rates, to the extent that commodity pricing changed, the associated commodity gas rates were adjusted accordingly, with no change to the demand rates.⁶²¹

VI. Rate Design

622. In Minnesota, a key purpose of rate design is to determine which customer classes should pay the costs that are reflected in the revenue deficiency and what kinds of rates should be used to recover those costs.⁶²²

A. Class Cost of Service Study

623. The purpose of a Class Cost of Service Study (CCOSS) is to identify the revenues, costs and profitability for each class of service. The CCOSS analysis should

⁶¹⁷ Ex. 21 at 4 (S. DeMerritt Supplemental Direct).

⁶¹⁸ *Id.*

⁶¹⁹ *Id.*

⁶²⁰ Ex. 21 at 4-5 (S. DeMerritt Supplemental Direct); Ex. 23 at Schedule (SSD-3) (Exhibits to S. DeMerritt Supplemental Direct).

⁶²¹ Ex. 21 at 5 (S. DeMerritt Supplemental Direct).

⁶²² See, *Matter of Request of Interstate Power Co. for Authority to Change Rates*, 559 N.W.2d 130, 133 (Minn. Ct. App. 1997), *aff'd* 574 N.W.2d 408 (Minn. 1998).

result in an appropriate allocation of the utility's total revenue requirement among the various customer classes.⁶²³

624. In its initial filing, MERC presented a CCROSS for its Minnesota service territory. This CCROSS applied general principles of cost allocation from the National Association of Regulatory Utility Commissioners (NARUC) and the American Gas Association (AGA) to arrive at estimated costs of service and individual components of cost for each customer class.⁶²⁴

i. Zero-Intercept and Minimum Size Analyses

625. The purpose of the zero-intercept study is to provide a hypothetical zero-load or zero-sized distribution main on MERC's entire system. The end result of this analysis is then used to classify MERC's distribution mains as an entire system, separating the distribution mains between the classifications of customer and demand.⁶²⁵

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.⁶²⁶

627. Based upon MERC's study, the Company determined that 68.3 percent of its distribution mains should be classified as customer costs and 31.7 percent should be classified as demand costs.⁶²⁷

628. The OAG-AUD argues that MERC's CCROSS analyses were flawed and produced unreasonable 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.⁶²⁸

⁶²³ Ex. 29 at 5 (J. Hoffman Malueg Direct).

⁶²⁴ Ex. 29 at 7 (J. Hoffman Malueg Direct).

⁶²⁵ Ex 30 at 6-7 (L. Hoffman Malueg Rebuttal).

⁶²⁶ EVIDENTIARY HEARING TRANSCRIPT, at 68-69 (J. Hoffman Malueg); Ex. 32 (IR Response 700); Ex. 33 (IR Response 702); Ex. 43 (IR Response 703); Ex. 34 (IR Response 704); Ex. 35 (IR Response 711).

⁶²⁷ Ex. 30 at 19 (J. Hoffman Malueg Rebuttal).

629. 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.⁶²⁹

630. In light of the large differences between the OAG-AUD's distribution main classifications and MERC's distribution main classifications, and the questions raised by the OAG-AUD as to the reliability of MERC's regression analyses, the Department requested that MERC complete additional analysis. The Department asked MERC to use the minimum size method to classify the costs of distribution mains.⁶³⁰

631. While serving the same purpose as a zero-intercept method study, a minimum size method study has an advantage: it does not rely upon regression analysis for its results. 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.⁶³¹

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.⁶³²

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.⁶³³

634. The third minimum size study allocated distribution main costs 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.⁶³⁴

635. The OAG-AUD testimony, thus, raises two distinct issues: the appropriate CCOSS methodology and the reasonableness of the resulting allocations.⁶³⁵

⁶²⁸ Ex. 155 at 2-3, 16 and 34-36 (R. Nelson Direct).

⁶²⁹ *Id.* at 37-40; Ex. 158 at 10-12, 17-18 (R. Nelson Surrebuttal).

⁶³⁰ Ex. 208 at 10-11 (S. Ouanes Rebuttal).

⁶³¹ Ex. 208 at 11 (S. Ouanes Rebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 195 (S. Ouanes).

⁶³² Ex. 30 at 13-17 and Schedule (JCHM-3) (J. Hoffman Malueg Rebuttal).

⁶³³ *Id.*

⁶³⁴ Ex. 30 at 3 and Schedules (JCHM-1 and JCHM-4) (J. Hoffman Malueg Rebuttal).

⁶³⁵ See, Ex. 155 at 2-3, 16 and 34-40 (R. Nelson Direct); Ex. 158 at 12-23 (R. Nelson Surrebuttal).

636. With the respect to the recommended approaches for the CCROSS, 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 CCROSS 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 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."⁶³⁶

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.⁶³⁷

638. MERC's minimum size analysis demonstrates that at least 73 percent of the distribution mains would be classified as customer costs and 27 percent to demand costs.⁶³⁸

ii. Customer Records and Collection Expense

639. The costs in Account 903 are costs associated with labor, materials, and expenses related to working on customer applications, contracts, orders, credit investigations, billing and accounting, collections, and complaints.⁶³⁹

640. The Department and MERC agreed on MERC's allocation of Account 903: Customer Records and Collection Expense.⁶⁴⁰

641. The OAG-AUD recommended that MERC allocate Account 903 based on a weighted customer allocator. The customer count allocation method is weighted by the average cost per customer for meters in each respective rate schedule.⁶⁴¹

642. MERC disagreed with the OAG-AUD's recommendation. While acknowledging that MERC incurs additional customer records and collections costs relating to its transportation customers, it allocates these costs separately to those customers. The remaining amounts in Account 903 are primarily the costs of retaining Vertex, an external service provider, to perform MERC's customer service and billing

⁶³⁶ Compare, Ex. 30 at 5-13 and 23-25 (J. Hoffman Malueg Rebuttal) with Ex. 155 at 17 (R. Nelson Direct) and Ex. 158 at 6 (R. Nelson Surrebuttal).

⁶³⁷ Ex. 30 at 19-23 and Schedule (JCHM-4) (J. Hoffman Malueg Rebuttal).

⁶³⁸ Ex. 208 at 12SO-R-4 (S. Ouanes Rebuttal); Ex. 30 at 13-17 and Schedule (JCHM-3) (J. Hoffman Malueg Rebuttal).

⁶³⁹ Ex. 30 at 32-33 (J. Hoffman Malueg Rebuttal).

⁶⁴⁰ Ex. 208 at 8-10 (S. Ouanes Rebuttal).

⁶⁴¹ Ex. 155 at 3, 41-42 (R. Nelson Direct); Ex. 158 at 19-20 (R. Nelson Surrebuttal).

functions for all of MERC's customers. Vertex charges MERC a flat, per account rate to perform customer services and there is no difference in the flat rate charge amongst the different types of MERC customers.⁶⁴²

643. MERC's allocation of Customer Records and Collection Expenses follow directly from its actual, arms-length transaction with Vertex, and is reasonable.⁶⁴³

iii. Allocation of Income Taxes

644. The Commission, in Docket No. G-007,011/GR-08-835, required that MERC's future CCOSSs allocate income taxes on the basis of taxable income attributable to each customer class.⁶⁴⁴

645. MERC allocated the Company's income taxes on the basis of class percentage shares of rate base. This allocation is mathematically equivalent to allocating the income taxes on the basis of taxable income by class that fully and only reflects the CCOSS.⁶⁴⁵

646. The tax rate across customer classes is the same as the tax rate applied to the Minnesota jurisdiction.⁶⁴⁶

647. The OAG-AUD disagreed with MERC's and the Department's conclusions regarding the calculation of income taxes. The OAG-AUD recommended that the income taxes should be calculated and assigned to customer classes based upon taxable income for revenues and expenses for each class.⁶⁴⁷

648. The Administrative Law Judge finds that the allocation of taxes is consistent with MERC's prior rate cases, the methodology used by other utilities, and produces reasonable allocations in this instance.⁶⁴⁸

iv. Meter Reading Expenses

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

⁶⁴² Ex. 30 at 32-35 (J. Hoffman Malueg Rebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 70-71 (J. Hoffman Malueg).

⁶⁴³ Ex. 208 at 8-10 (S. Ouanes Rebuttal).

⁶⁴⁴ Ex. 29 at 3-4 (J. Hoffman Malueg Direct).

⁶⁴⁵ Ex. 4 Initial Filing Volume 3: Informational Requirements, Document 2, Schedules 1 and 9; Ex. 29 at 4 (J. Hoffman Malueg Direct).

⁶⁴⁶ Ex. 208 at 4 (S. Ouanes Rebuttal).

⁶⁴⁷ Ex. 151 at 26-28 (J. Lindell Direct); Ex. 153 at 6-9 (J. Lindell Rebuttal); Ex. 154 at 12-15 (J. Lindell Surrebuttal).

⁶⁴⁸ Ex. 30 at 36-41 (J. Hoffman Malueg Rebuttal).

⁶⁴⁹ Ex. 208 at 6-8 (S. Ouanes Rebuttal); Ex. 158 at 19 (R. Nelson Surrebuttal).

v. Conclusion

650. MERC's CCOSS fully and correctly demonstrates the embedded fixed costs of residential service.⁶⁵⁰

651. MERC's CCOSS should be adopted in this proceeding, and used as a basis for revenue apportionment and rate design.⁶⁵¹

B. Revenue Apportionment

652. MERC's proposed revenue apportionment considered the following primary objectives:

- (a) collect total revenues sufficient to allow the Company to recover its cost of operations for the test year, including a reasonable return on investment;
- (b) reflect the cost of providing service to each customer class, as supported by the CCOSS, while giving consideration to non-cost factors where appropriate, e.g., value of service;
- (c) provide overall revenue stability to the Company;
- (d) encourage sound economic energy use;
- (e) minimize cross-subsidization between rate classes;
- (f) avoid large bill impacts or rate shock;
- (g) rates should be understandable and easy to administer;
- (h) limit the impact of the proposed rates on low-income customers; and
- (i) provide flexibility on pricing and service conditions, which will allow the Company's natural gas services to be competitive with other energy sources.⁶⁵²

653. The CCOSS was the starting point for the apportionment of the retail revenue requirement among the rate classes. Other rate design goals were then

⁶⁵⁰ Ex. 29 at 5 (J. Hoffman Malueg Direct); Ex. 30 at 25, 44 (J. Hoffman Malueg Rebuttal); EVIDENTIARY HEARING TRANSCRIPT, at 70 (J. Hoffman Malueg).

⁶⁵¹ *Id.*

⁶⁵² Ex. 40 at 6 (G. Walters Direct).

considered, as noted above, such as maintaining competitive pricing for competitive services and limiting large bill impacts (colloquially known as "rate shock").⁶⁵³

654. MERC's proposed revenue apportionment compared current revenues from a customer class, to the proposed revenues and the revenue that would be justified by a full movement to the cost of service.⁶⁵⁴

655. The Department reviewed MERC's proposed revenue apportionment and recommended adoption of the Department's proposed revenue apportionment as detailed in Tables 2 and 3, and Attachment SLP-3, of the Direct Testimony of Susan Peirce.⁶⁵⁵

656. Additionally, the Department recommended that if the Commission approves a lower revenue requirement than that requested by the Company, the remaining revenue requirement be apportioned proportionally to all classes, consistent with the approved apportionment of revenue responsibility.⁶⁵⁶

657. MERC generally agreed with the Department's proposed apportionment of revenue responsibility, but concluded that the rates for the SLV Customer Class and Flex customers should not change from proposed rates due to the revenue apportionment, with the exception of MERC's updated proposal as to the CCRC. MERC maintained that a set of steeper increases would result in these large customers abandoning the MERC system, a move that would be detrimental to other customer classes.⁶⁵⁷

658. MERC noted further that while it accepted the Department's updated sales forecast, it was not able to hold revenue apportionment at the class by PGA level as recommended by the Department and maintain the distribution and customer charge rates for all residential customers. Accordingly, for revenue apportionment purposes, MERC proposed to group customers together that have the same distribution rates.⁶⁵⁸

659. The Department agreed with MERC's updated revenue apportionment as modified for the SLV and Flex customer classes.⁶⁵⁹

660. The revenue apportionment agreed to by MERC and the Department is reasonable and should be adopted in this proceeding. MERC's proposed revenue

⁶⁵³ Ex. 40 at 8, 28 (G. Walters Direct).

⁶⁵⁴ Ex. 40 at 9-10 and Schedule (GJW-1), Schedule 3, Summary (including gas costs), and Schedule 5, Summary (not including gas costs) (G. Walters Direct).

⁶⁵⁵ Ex. 203 at 10-11, 13 (S. Peirce Direct).

⁶⁵⁶ Ex. 203 at 13 (S. Peirce Direct).

⁶⁵⁷ Ex. 42 at 4 (G. Walters Rebuttal).

⁶⁵⁸ Ex. 42 at 4-5 (G. Walters Rebuttal).

⁶⁵⁹ Ex. 205 at 2-3 (S. Peirce Surrebuttal).

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.⁶⁶⁰

C. Rates

661. The parties divided over the appropriate monthly charges to be allocated to Residential and Small Commercial and Industrial classes.⁶⁶¹

i. Residential Customer Charge

662. MERC's existing residential customer charge is \$8.50 per month.⁶⁶²

663. MERC initially proposed to increase the monthly residential customer charge to \$11.00 per month.⁶⁶³

664. Arguing that Residential customers were in "a state of fatigue after three rate cases and continued increases in customer charges since 2007," OAG-AUD urged retaining the existing residential customer charge in the new rates.⁶⁶⁴

665. As the OAG-AUD reasoned, any increase in the residential class required revenues should be recovered through the variable per therm rate rather than an increased customer charge.⁶⁶⁵

666. The Department recommended raising the residential customer charge to \$9.50 per month. The Department maintained that the increase to \$9.50 would move the residential customer charge closer to cost, reduce intra-class subsidies and would not result in rate shock. The Department further asserted that proposed charge is consistent with other residential customer charges for utility service in Minnesota.⁶⁶⁶

667. MERC accepted the Department's recommendation that the residential customer charge be increased to \$9.50.⁶⁶⁷

⁶⁶⁰ Ex. 205 at 3-4 (S. Peirce Surrebuttal).

⁶⁶¹ Ex. 150 at 36-47, 59-60 (V. Chavez Direct, adopted by J. Lindell); Ex. 154 at 15-20 (J. Lindell Surrebuttal).

⁶⁶² Ex. 40 at 11 (G. Walters Direct).

⁶⁶³ Ex. 40 at 10 (G. Walters Direct); Ex. 42 at 6 (G. Walters Rebuttal).

⁶⁶⁴ Ex. 154 at 15 (supporting the testimony of V. Chavez) (J. Lindell Surrebuttal); Ex. 150 at 38-40 (V. Chavez Direct, adopted by J. Lindell).

⁶⁶⁵ Ex. 154 at 15-16 (J. Lindell Surrebuttal).

⁶⁶⁶ Ex. 203 at 16-19 (S. Peirce Direct).

⁶⁶⁷ Ex. 42 at 7-8 (G. Walters Rebuttal).

668. Because the customer charges for residential service are below the customer cost, unrecovered customer costs are now recovered through the distribution charge. As a result, customers with higher than average usage (and, in many instances, limited ability to reduce the amount of gas they consume) pay more than their proportional share of these costs.⁶⁶⁸

669. 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.⁶⁶⁹

670. 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.⁶⁷⁰

ii. Customer Charges for Larger Customers

671. MERC proposed to increase the customer charges for its larger customers, including the Small Commercial and Industrial (C&I), Large Commercial and Industrial (Large C&I), Small Volume Interruptible (SVI), Large Volume Interruptible (LVI), and SLV customers.⁶⁷¹

672. In addition, MERC proposed a monthly charge for the SLV Town Plant Transportation rate class and increasing the administrative charge from \$70.00 to \$100.00 for each metered account.⁶⁷²

673. Further, MERC proposed to increase the Transportation Administration Fee from \$70 to \$110.⁶⁷³

674. The Department agreed with MERC's proposed changes. The table below shows the customer charges, MERC's proposed customer charges, and the charges agreed upon by MERC and the Department.⁶⁷⁴

	Current	MERC Proposed	Charge Agreed to by
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⁶⁶⁸ Ex. 40 at 12-13, 17 (G. Walters Direct).

⁶⁶⁹ Ex. 40 at 13, 15 (G. Walters Direct).

⁶⁷⁰ *Id.*

⁶⁷¹ Ex. 40 at 15-29 and Schedule (GJW-1) (G. Walters Direct).

⁶⁷² *Id.*

⁶⁷³ Ex. 40 at 24 (G. Walters Direct).

⁶⁷⁴ Ex. 40 at 7-8 (G. Walters Direct); Ex. 205 at 3 (Peirce Surrebuttal).

	Customer Charge	Customer Charge	MERC and Department
General Service Residential Consolidated Sales	\$8.50	\$11.00	\$9.50
General Service Small Commercial and Industrial Consolidated Sales	\$14.50	\$18.00	\$18.00
General Service Large Commercial and Industrial Consolidated Sales	\$35.00	\$45.00	\$45.00
Small Volume Interruptible Consolidated Sales	\$150.00	\$165.00	\$165.00
Large Volume Interruptible Consolidated Sales	\$175.00	\$185.00	\$185.00
Super Large Volume Town Plant Transportation	\$300.00	\$350.00	\$350.00

675. 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.⁶⁷⁵

676. 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.⁶⁷⁶

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.⁶⁷⁷

iii. Joint Service

678. Joint service allows an interruptible service customer to designate a portion of its service as firm service. Thus, Joint Service customers could have their service curtailed down to specified minimum level of usage designated as firm service. Joint service customers pay a per therm rate for daily firm capacity based on the amount of capacity that is designated as firm.⁶⁷⁸

⁶⁷⁵ Ex. 154 at 15-16 (adopting the testimony of V. Chavez) (J. Lindell Surrebuttal).

⁶⁷⁶ Ex. 24 at 27 (S. DeMerritt Rebuttal).

⁶⁷⁷ *Id.*

⁶⁷⁸ Ex. 203 at 20 (S. Peirce Direct).

679. In the Notice and Order for Hearing for this proceeding, the Commission requested that MERC provide supplemental testimony detailing how Joint Service customers are billed for service.⁶⁷⁹

680. On December 26, 2013, MERC filed supplemental testimony detailing features of the joint service charges for designated firm service.⁶⁸⁰

681. The Department concluded that MERC's firm rate customers are not cross-subsidizing the Company's Joint Rate customers. Further, it recommended that the Commission accept MERC's explanatory detail on Joint Service.⁶⁸¹

VII. Tariff Changes

682. MERC requests only that the rate tariff sheets and base cost of gas sheets be changed. MERC proposes no other tariff changes.⁶⁸²

683. The Administrative Law Judge finds that MERC's request to change the Company's rate tariff sheets and base cost of gas sheets is appropriate and should be approved in this rate case.⁶⁸³

VIII. Revenue Decoupling

684. MERC does not request any changes to the methodology of how its pilot decoupling mechanism works.⁶⁸⁴

685. However, MERC asserts that the sales and customer counts used in the decoupling calculation should be consistent with the final sales and customer counts approved in this case.⁶⁸⁵

IX. Travel, Entertainment and Other Employee Expenses

686. In its initial filing, MERC provided information regarding its "travel, entertainment, and related employee expenses," as required by Minn. Stat. § 216B.16, subd. 17. Included in this submission were details as to the travel, entertainment

⁶⁷⁹ NOTICE AND ORDER FOR HEARING, *supra*, at 2.

⁶⁸⁰ Ex. 203 at 20-21 (S. Peirce Direct).

⁶⁸¹ *Id.* at 21-22.

⁶⁸² Ex. 40 at 32 (G. Walters Direct).

⁶⁸³ *Id.*

⁶⁸⁴ Ex. 16 at 4 (B. Nick Direct); Ex. 19 at 51 (S. DeMerritt Direct); Ex. 24 at 27 (S. DeMerritt Rebuttal).

⁶⁸⁵ *Id.*

expenses and separately itemized expenses for MERC's Board of Directors and ten highest paid employees.⁶⁸⁶

687. —MERC placed items totaling \$284,725 in the proposed test year amounts. These sums included:

- (a) Travel/Lodging - \$217,802;
- (b) Corporate Aircraft - \$956;
- (c) Food/Beverage - \$64,666; and
- (d) Recreation and Entertainment - \$1,301.⁶⁸⁷

688. As permitted by Minn. Stat. § 216B.16, subd. 17(c), MERC petitioned to designate the salaries of the sixth through the tenth highest paid employees as nonpublic information on individuals. MERC maintains that publicly disclosing this information could give competitors an advantage in terms of hiring and retaining key employees. Additionally, the employees themselves would prefer that this information is not in the public domain.⁶⁸⁸

689. The Administrative Law Judge agrees. The salaries of the sixth through tenth highest paid employees shall be designated as private data on individuals.⁶⁸⁹

690. The Department witness Ms. La Plante reviewed MERC's travel and entertainment expenses. Following her review, the Department concluded that MERC's proposed test year expenses of \$7,770 for travel and entertainment did not appear to be reasonably related to Minnesota regulated utility operations. These items included gifts, golf outings and parties.⁶⁹⁰

691. The Department recommended that MERC remove from the Company's General and Administrative expense \$7,770 in travel and entertainment costs.⁶⁹¹

692. MERC agreed with this recommendation.⁶⁹²

⁶⁸⁶ Ex. 4 Initial Filing Volume 3: Informational Requirements, Document 14 at 1; Ex. 19 at 47 (S. DeMerritt Direct).

⁶⁸⁷ Ex. 215 at 21 (L. La Plante Direct) (*citing* Ex. 4, Volume 3, Document 14 at 3–51)).

⁶⁸⁸ Ex. 19 at 49-50 (S. DeMerritt Direct).

⁶⁸⁹ Minn. Stat. § 216B.16, subd. 17(c).

⁶⁹⁰ Ex. 215 at 21 and LL-14 (L. La Plante Direct) (*citing* MERC Ex. 4, Volume 3, Document 14 at 3–51).

⁶⁹¹ Ex. 215 at 23 (L. La Plante Direct).

⁶⁹² Ex. 24 at 17-18 (S. DeMerritt Rebuttal).

693. The travel and entertainment expenses of MERC's service company affiliate IBS were not filed for review in this rate case.⁶⁹³

694. Both the Department and OAG-AUD recommended that in future rate case filings all travel and entertainment expenses, including expenses related to employees working for MERC affiliates, be submitted for review.⁶⁹⁴

695. The OAG-AUD further recommended a reduction of \$569,450 for travel and entertainment expenses and exclusion of dues totaling \$63,245.⁶⁹⁵

696. In Rebuttal Testimony, the OAG-AUD refined its recommendation, urging the exclusion of all expenses incurred outside of Minnesota unless the description justifies an allocation to Minnesota, and that only a portion of travel and entertainment expenses that were not specific to Minnesota be allocated in this case.⁶⁹⁶

697. MERC agreed that any costs not specific to Minnesota will be allocated to the Company based upon the allocation factors in MERC's Direct Testimony.⁶⁹⁷

698. With respect to the recommended exclusion of all expenses that were incurred outside of the boundaries of Minnesota, the Administrative Law Judge does not agree. For a wholly-owned subsidiary like MERC, whose parent company has significant central office operations in Wisconsin, travel to other states can fulfill an important purpose that benefits ratepayers.⁶⁹⁸

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.⁶⁹⁹

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 reasonable and should be approved in this rate case.⁷⁰⁰

⁶⁹³ Ex. 216 at 6-7 (La Plante Surrebuttal).

⁶⁹⁴ Ex. 25 at 3 (S. DeMerritt Surrebuttal).

⁶⁹⁵ Ex. 151 at 25-26 (J. Lindell Direct); Ex. 153 at 2-3 (J. Lindell Rebuttal); Ex. 154 at 9 (J. Lindell Surrebuttal).

⁶⁹⁶ Ex. 153 at 4 (J. Lindell Rebuttal).

⁶⁹⁷ Ex. 24 at 4 (S. DeMerritt Rebuttal).

⁶⁹⁸ Ex. 25 at 3-4 (S. DeMerritt Surrebuttal).

⁶⁹⁹ See, Minn. Stat. §§ 216B.02, subd. 4 and 216B.16, subd. 17.

⁷⁰⁰ See generally, Ex. 216 at 6-10 (La Plante Surrebuttal).

X. Summary of the Testimony at the Public Hearings

Pursuant to Minn. R. 7829.1100, the Administrative Law Judge conducted public hearings on March 13 and March 14, 2014. The public hearings were held to elicit public comment regarding the proposed rate increase by MERC.

The first public hearing on MERC's proposed rate increase was held on March 12, 2014 at Rochester City Hall in Rochester, Minnesota. The second public hearing was held on March 12, 2014 at Dakota County Technical College in Rosemount, Minnesota, and a third public hearing was held on March 13, 2014 at the Cloquet Chamber of Commerce in Cloquet, Minnesota. The public was allowed to submit testimony until 4:30 p.m. by the closing date of March 27, 2014.

At the beginning of the public hearings, Administrative Law Judge Eric L. Lipman made introductory remarks followed by short remarks from the Commission Staff, MERC, the Department of Commerce's Division of Energy Resources and the Office of the Attorney General. At each hearing, a staff member from the Commission explained the role of the Commission in public utilities matters. A representative from MERC explained features of, and basis for, the Company's rate increase request. Comments from MERC were followed by brief statements from the DOC-DER and the OAG-AUD. Following these agency presentations, members of the public and staff of the DOC-DER and OAG-AUD dialogued with participants at the hearing.

A summary of the testimony rendered at these hearings follows below:

Rochester, Minnesota Public Hearing – Rochester City Hall

At the public hearing in Rochester, Minnesota, six members of the public in attendance offered testimony for the hearing record.

Konrad Schulz-Fincke, a ratepayer from Rochester, Minnesota, expressed concern over the increase in price of service for utilities and gas.⁷⁰¹

Paul Weber shared his disappointment regarding MERC's presentation of the proposed rate increase and the per therm distribution charge in the notice that was sent to ratepayers. In his view, key details regarding the proposal were not clearly expressed.⁷⁰²

Donald Johnson, a ratepayer from Claremont, Minnesota, opposed the rate increase and pointed to the increased difficulty of the community to afford utility bills.⁷⁰³

⁷⁰¹ Rochester Public Hearing Transcript, at 22-23.

⁷⁰² *Id.*, at 23-29.

⁷⁰³ *Id.*, at 30-31.

Rich Horihan, a ratepayer from Lanesboro, Minnesota, expressed his concern as to rapidly increasing natural gas rates, and was critical of the presentation of MERC's proposal in the notices that were sent to the public.⁷⁰⁴

Raymond Schmitz, a ratepayer from Rochester, Minnesota, challenged the proposed increase on the basis that MERC has asked for increases the last several years.⁷⁰⁵

James Rentz questioned the user charge on his monthly bill and the dividend return to investors.⁷⁰⁶

Rosemount, Minnesota Public Hearing - Dakota County Technical College

At the public hearing in Rosemount, Minnesota, one member of the public in attendance offered testimony for the hearing record.

Mark Tschida inquired of the Company and agency panel as to the nature of MERC's business operations, components of MERC's billing system and the time-frame for the ratemaking proceedings.⁷⁰⁷

Cloquet, Minnesota Public Hearing – Cloquet Chamber of Commerce

Carol Strom recommended that MERC change the regulators on gas meters more often and expressed concern over prices continuing to rise despite a continued abundance of natural gas. She likewise urged better maintenance practice for gas meters and better use of the company's local facilities.⁷⁰⁸

Howard Strom concurred that the proposed rate increase was too great – particularly at a time when there is an abundance of natural gas.⁷⁰⁹

Susan Pedersen, a ratepayer from Moose Lake, Minnesota, made a series of inquiries regarding MERC's customer base and billing process. She also detailed her concerns over the increase in the BTU factor of gas, application of the affordability surcharge and the availability of rebates.⁷¹⁰

⁷⁰⁴ *Id.*, at 31-47.

⁷⁰⁵ *Id.*, at 47-51.

⁷⁰⁶ *Id.*, at 51-52.

⁷⁰⁷ Rosemount Public Hearing Transcript, at 15-27.

⁷⁰⁸ Cloquet Public Hearing Transcript, at 16-18, 21-30, 51, 53-60.

⁷⁰⁹ *Id.*, 18-19

⁷¹⁰ *Id.*, 29-54, 56-59; see also, Public Hearing Exhibit A.

XI. Summary of the Written Comments

In addition to the testimony at the hearings, 17 ratepayers submitted written comments by electronic or first class mail before the close of the comment period on March 27, 2014.

Robert and Carol Anderson, ratepayers from Rosemount, Minnesota, asked the request for a natural gas rate increase be denied because they are retired and cannot afford an increase.

Rick Bichel, a ratepayer from Cannon Falls, Minnesota, recommended that the request for a natural gas rate increase be denied on the grounds that the revenues from such increases are used by the Company primarily to pay higher salaries for its own employees.

Roger Crawford, a ratepayer and former member of the Minnesota House of Representatives from Mora, Minnesota, detailed the unsatisfactory customer service he has received from MERC. He recommended that any rate increase be denied until such time as MERC "changes its gangster policies on taking money."

Bruce Drone asked that the rate increase be denied on account of the abundance of natural gas in North Dakota and the natural gas being exported out of the county.

Pat Haley described her struggle to pay monthly utility bills and recommended a rate increase not be pursued until July or August when gas bills are low.

Don B. Heikkila, a ratepayer from Parkville, Minnesota, expressed skepticism over the need for the proposed rate increase; particularly when supplies of natural gas are abundant.

Daniel Hodny, a ratepayer from Thief River Falls, Minnesota, urged the Commission to deny the rate increase. He detailed the serial increases in the price of natural gas and a monthly customer service charge he has experienced.

Richard Horihan expressed concern regarding "the methodology for public disclosure" which he described as "obscure and misleading at best." He suggested that more detailed information, including rate histories, be provided to the public.

Richard Houle shared his skepticism as to the need for a rate increase. Mr. Houle noted that he has been charged a greater amount each month for the last several months, notwithstanding the fact that his home is used only in the summer, and he did not consume any natural gas during the time frame when his bills were on the rise.

Robert Langen, a ratepayer from La Crescent, Minnesota, argued that the Commission should deny the rate increase. He urged the Company to instead trim wages and operating costs.

Megan Lent, a ratepayer from Aitkin, Minnesota, detailed the “crippling” rise in home heating bills this past winter and urged that a compromise on new charges to ratepayers be reached.

Sonya Lillis, a ratepayer from Silver Bay, Minnesota, shared her concern over winter heating costs and her disappointment as to the notice provided to MERC’s customers.

Renee A. Pearson, a ratepayer from Silver Bay, Minnesota, asked that the request for a natural gas rate increase be denied because wages have not kept pace with the cost of utilities. She maintained that increased rates pose a special hardship upon those with fixed incomes. Accompanying Ms. Pearson’s letter were the signatures of 78 ratepayers from Silver Bay who joined her in opposing MERC’s rate increase application.

Susan M. Pederson, a ratepayer from Moose Lake, Minnesota, argued that the BTU Factor has substantially increased since 2009. She asserts that MERC is retaining these rate factor increases – and is not remitting the associated revenues to other vendors as the Company maintains.

Amy Rients noted that it was the “worst time to raise rates.”

Nathan Severson, a ratepayer from Rochester, Minnesota, expressed concern that the rate increase would make turning on heat and water more difficult. Because the United States is the leading supplier of natural gas, he expressed skepticism over the need for any increases.

Aaron Thun, a ratepayer from Silver Bay, Minnesota, urged that MERC’s proposed rate increase be rejected in its entirety. He maintains that MERC’s reasons for the increase are not believable.

Based upon these Findings of Fact, and the public hearing testimony, the Administrative Law Judge makes the following:

CONCLUSIONS OF LAW

1. The Minnesota Public Utilities Commission and the Administrative Law Judge have jurisdiction over the subject matter of this proceeding pursuant to Minn. Stat. §§ 14.50, 216B.045 and 216B.08.
2. Any finding that is more appropriately designated a conclusion is hereby adopted as a conclusion of law.
3. Use of the year ending on December 31, 2014 as the projected test year for determining MERC’s revenue requirement is reasonable.

4. MERC's projected test year rate base for the twelve-month period ending December 31, 2014, is approximately set at \$199,192,236.

5. MERC's test year operating revenues and expenses should be determined as set forth in Schedule 1 to the Department's Issues Matrix filed June 24, 2014.

6. The adjustments to revenue and expense result in (approximately) \$12,033,182 in operating income for the test year.

7. MERC's updated capital structure and cost of debt is reasonable, and should be utilized in the calculation of the rate of return.

8. Based upon the records in these proceedings, a return on equity for MERC of 9.79 percent is reasonable and appropriate. This ROE strikes an appropriate balance between the interests of shareholders and rate payers and should be adopted.

9. With the adoption of the capital structure, cost of debt and cost of equity, the rate of return should be 7.5262 percent.

10. MERC's request for recovery of its 2014 approved CIP program budget is reasonable and should be adopted. The CCRC factor calculated at the end of this rate case should be based upon these amounts.

11. MERC will need to make an adjustment to the CIP tracker at the time of final rates. If MERC's CCRC of \$0.02462 is approved in this proceeding, MERC will have under-collected CIP expense during the time frame that the Company's interim rates were in effect. MERC will then credit the CIP tracker balance (Account No. 182705) by \$0.00030 (\$0.02462 - \$0.02432) multiplied by actual sales during the period interim rates that were in effect, and debit the CIP Amortization account (Account No. 407710) for this same amount.

12. MERC will apply a one-time carrying charge to the unrecovered CIP balance related to Northshore Mining. For the carrying charge rate, MERC will use the Company's approved overall rate of return in effect during the period of under collection (July 2006 through December 2013). MERC will credit the CIP tracker for uncollected amounts (CCRC and CCRA) from July 2006 through December 2013, before Northshore's CIP exemption was effective January 1, 2014. MERC will also report this information in its final rates compliance filing in the present docket.

13. The record in this matter shows that MERC will experience a revenue shortfall. MERC is entitled to recover this revenue shortfall through an adjustment of its natural gas rates. MERC's revenue deficiency is approximately \$3,300,164.

14. MERC's proposed rate design should be adopted. This includes setting the monthly residential customer charge for both MERC-PNG and MERC-NMU at \$9.50. It also includes increases in the customer charges for MERC's larger customers. The Small C&I charge should be increased to \$18.00; Large C&I, SVI should be

increased to \$45.00; LVI should be increased to \$165; and Super Large Volume customers should be increased to \$185.

15. Modifying MERC's natural gas rates in the manner described in the findings and conclusions above will result in just and reasonable rates that are in the public interest.

16. Based on the foregoing findings and conclusions above, it is recommended that the Public Utilities Commission issue the following:

RECOMMENDATION

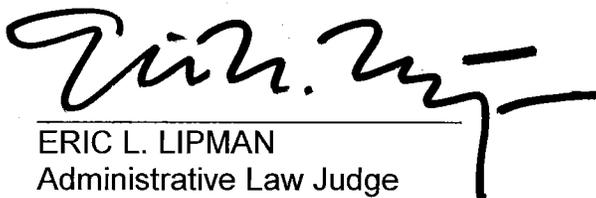
The ALJ recommends that the Commission issue an Order providing that:

1. MERC is entitled to increase gross annual revenues in accordance with the terms of the Report.

2. Within ten days of the service date of this Report, MERC shall file with the Commission for its review and approval, and serve on all parties in this proceeding, revised schedules of rates and charges reflecting the revenue requirements and the rate design decisions based on the recommendations made in this Report.

3. MERC shall make further compliance filings regarding rates and charges, rate design decisions, and tariff language as ordered by the Commission.

Dated: August 12, 2014


ERIC L. LIPMAN
Administrative Law Judge

Reported: Transcript Prepared (one volume)
Shaddix & Associates



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August 12, 2014

See Attached Service List

**Re: In the Matter of the Application by MERC for Authority to Increase
Natural Gas Rates in Minnesota**

**OAH 8-2500-31126
MPUC G-011 / GR-13-617**

To All Persons on the Attached Service List:

Enclosed herewith and served upon you is the Administrative Law Judge's
**FINDINGS OF FACT, SUMMARY OF PUBLIC TESTIMONY, CONCLUSIONS OF
LAW AND RECOMMENDATION** in the above-entitled matter.

Sincerely,

s/Eric L. Lipman

ERIC L. LIPMAN
Administrative Law Judge

ELL/ry
Enclosure

STATE OF MINNESOTA
OFFICE OF ADMINISTRATIVE HEARINGS
ADMINISTRATIVE LAW SECTION
PO BOX 64620
600 NORTH ROBERT STREET
ST. PAUL, MINNESOTA 55164

CERTIFICATE OF SERVICE

In the Matter of the Application by MERC for Authority to Increase Natural Gas Rates in Minnesota	OAH Docket No.: 8-2500-31126
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Rachel Youness, certifies that on August 12, 2014 she served a true and correct copy of the attached **FINDINGS OF FACT, SUMMARY OF PUBLIC TESTIMONY, CONCLUSIONS OF LAW AND RECOMMENDATION** by eService (in the manner indicated below) to the following individuals:

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