

Minnesota Public Utilities Commission

Staff Briefing Papers

Meeting Date: December 8, 2016..... Agenda Item # **3****

Company: Northern States Power Company, dba Xcel Energy (Xcel)

Docket No. E-002/M-15-891

In the Matter of the Petition of Xcel Energy for Approval of a
Modification to its Transmission Cost Recovery (TCR) Tariff, 2016 TCR
Rate Factors, and 2015 True-up and Compliance Filing

Issues: Should the Commission approve Xcel Energy's request to modify its
TCR Tariff, update its 2016 TCR rate factors and allow a true-up in the
TCR rider for 2015?

Should Accumulated Deferred Income Tax (ADIT) balances be
prorated or non-prorated when the Company forecasts its test year for
rate base. And, if the Commission decides proration of the ADIT
balances is required, must the true-up also be calculated using the
proration method when adjusting for actual ADIT?

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Relevant Documents

Xcel – Initial TCR FilingOctober 1, 2015
Xcel – Update to Petition..... November 6, 2015
Department - Comments April 21, 2016
Xcel – Reply Comments.....June 3, 2016
Department – Response to Reply CommentsSeptember 7, 2016
Xcel – Response to Reply Comments.....September 29, 2016
Xcel – Informational LetterOctober 6, 2016
Department – Response to Reply CommentsNovember 7, 2016

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December 2, 2016

Statement of the Issues

Should the Commission approve Xcel Energy's request to modify its TCR Tariff, update its 2016 TCR rate factors and allow a true-up in the TCR rider for 2015?

Additional Topic for Discussion

Should Accumulated Deferred Income Tax (ADIT) balances be prorated or non-prorated when the Company forecasts its test year for rate base. And, if the Commission decides proration of the ADIT balances is required, must the true-up also be calculated using the proration method when adjusting for actual ADIT?

Introduction

Generally, a public utility may not change its rates without undergoing a rate case in which the Commission comprehensively reviews the utility's costs and revenues. However, the Legislature has created exceptions to this general policy, allowing a utility to implement a rider to expedite recovery of certain costs not reflected in the company's current base rates.

The transmission-cost-recovery statute, Minn. Stat. § 216B.16, subd. 7b, authorizes a utility to recover, through a rider, the Minnesota jurisdictional costs of:

- new transmission facilities that the Commission has approved through a certificate of need or under the state transmission plan; and
- charges incurred by a utility under a federally approved tariff that accrue from other transmission owners' regionally planned transmission projects that have been determined by the Midcontinent Independent System Operator (MISO) to benefit the utility or integrated transmission system.

The Commission has established Xcel's TCR rider, referred to as a transmission cost adjustment mechanism, as the Company's mechanism to recover these costs.

Xcel files an annual petition to establish TCR rider rates for the upcoming year. The Company proposes new transmission projects for rider recovery and removes any projects whose costs have been incorporated into base rates. Xcel also reports on transmission costs and rider revenue from the preceding year and adjusts the current year's revenue requirement for any previous over- or under-recovery, a process referred to as a "true-up." Finally, the Company proposes per-kWh charges for each customer class (per-kW for demand-metered customers) designed to recover the total anticipated transmission cost over a proposed recovery period—commonly over the remainder of the year or over 12 calendar months.

The 1997 Legislature enacted the Renewable Energy Statute, Minn. Stat. § 216B.1645, authorizing the Commission to approve a tariff mechanism for an automatic annual adjustment of charges for costs associated with utility investments or costs to comply with renewable energy

mandates. The 2005 Legislature enacted the Transmission Statute, authorizing the Commission to approve a tariff mechanism for an automatic adjustment of charges for costs associated with eligible utility investments in transmission facilities. The Transmission Statute was amended in 2008 to allow inclusion of the costs of certain regional transmission facilities as determined by MISO.

The Commission's November 20, 2006 Order in Docket No. E002/M-06-1103 approved the Company's TCR Rider tariff, which combined recovery of eligible projects under the Renewable Statute, Greenhouse Gas Statute and the Transmission Statute in one annual automatic adjustment mechanism. The TCR Petition under consideration does not include any Greenhouse Gas projects nor any Renewable Statute projects for 2016.

Since 2006, the Company's TCR Rider mechanism has been modified several times to allow recovery of additional costs subsequently authorized by the Minnesota Legislature. First, the Commission's March 20, 2008 Order in Docket No. E002/M-07-1156 approved recovery of greenhouse gas infrastructure costs incurred for the replacement of circuit breakers that contain sulfur hexafluoride (SF₆). Second, the Commission's June 25, 2009 Order in Docket No. E002/M-08-1284 approved recovery of RECB revenues and costs. In 2013, the Transmission Statute was modified to allow TCR Rider eligibility of projects located in other states that also are approved by the regulatory commission of the state in which the new transmission facilities are to be constructed and determined by MISO to benefit the utility or integrated transmission system.

Background

October 1, 2015: Xcel Energy filed its initial petition and requested the Commission approve the 2016 TCR rider revenue requirements of \$19.2 million, the 2015 TCR rider true-up and the proposed revised TCR adjustment factors. Xcel proposed to remove the plant costs, revenues and expenses associated with the CapX2020 Brookings transmission line and the CapX2020 Fargo transmission line from the rider and recover the costs through interim rates in its pending General Rate Case.¹

November 6, 2015: Xcel submitted an updated filing to align with the proposal made in its electric rate case. The Company stated that it will transition the projects from the TCR rider into base rates at the time final rates are implemented. The update increases the 2016 rider revenue requirements from \$19.2 million to \$78.4 million and includes the CapX2020 Brookings transmission line and the CapX2020 Fargo transmission line.

April 21, 2016: The Department submitted comments and concluded that all transmission projects included in Xcel's TCR rider are eligible for recovery under the Transmission Statute. The Department determined that the Company's proposed 2016 revenue requirements for the CapX2020 Brookings and the CapX2020 Fargo projects are reasonable and recommended the

¹ E-002/GR-15-826, *In the Matter of the Application of Northern States Power Company for Authority to Increase Rates for Electric Service in the State of Minnesota*, filed on November 2, 2015.

Commission approve these amount for recovery through the TCR rider.

The Department recommended that the Commission require Xcel to recalculate its proposed annual revenue requirement and resulting factors using the state jurisdictional allocators approved in its last rate case.

The Department recommended that the Commission require Xcel to replace its forecasted prorated ADIT balances with actual non-pro-rated ADIT balances in its beginning-of-month and end-of-month average ADIT balance calculation for true-up purposes in future TCR rider filings. Alternatively, the Commission could require Xcel to base its recovery through the rider on historical costs, since the issue applies only in cases with forward looking revenue requirement calculations and rates.

June 3, 2015: Xcel submitted reply comments and stated it agrees with the Department's recommendation to use the jurisdictional allocators approved in its last electric rate case rather than the allocators proposed in the Company's current electric rate case.

The Company stated that it will address the ADIT issue in its current rate case and the rate case will allow for a thorough discussion of the issue along with input from interested parties. The Company agreed continue to replace its pro-rated ADIT with actual balances for true-up purposes.

September 7, 2016: The Department submitted its response comments stated that the Commission should deny Xcel's request to explore the issue in its current general rate case rather than in this docket. Due to a "black box" settlement agreement which resolved all financial issues between Xcel and the Department, the Department is concerned this issue will be overlooked and recommended discussion of this issue in this proceeding.

The Department recommended that the Commission not allow Xcel to use any prorated ADIT balances or, in the alternative, require Xcel's TCR rider to be based solely on historical costs.

September 29, 2016: Xcel submitted response comments and continued to argue that a decision on treatment of the ADIT true-up should be deferred to a future proceeding. Deferral would allow additional development of the subject including potential guidance from the IRS, the FERC and Commission proceedings.

October 6, 2016: Xcel filed an informational letter and stated because decisions made by the Commission in the 2016 TCR rider could affect the calculation of its 2017 TCR rider, it would delay filing its 2017 petition until the Commission issues an Order in this proceeding.

November 7, 2016: The Department submitted additional response comments and stated it does not agree with Xcel that Internal Revenue Service regulations require proration of ADIT and recommended the Commission deny the Company's request for proration of ADIT.

The Department made an alternative recommendation in order to resolve the issue and minimize

the use of limited state resource. The Department's alternative recommendation is to:

- 1) allow the prorated ADIT only for recovery of forecasted costs (costs that are not historical, actual costs at the time the rates go into effect); and
- 2) require a true-up in the following year (once all amounts are historical/actual) by using actual non-prorated ADIT amounts.

The Department made an additional recommendation that if Xcel continues to pursue this issue to the detriment of ratepayers, the Commission should consider either denying rider recovery or limiting rider recovery to historical costs. Both of these approaches would eliminate the need for the Company to prorate its ADIT balances.

TCR Eligible Projects - Previously Approved²

- CapX2020 Fargo – Twin Cities
- CapX2020 La Crosse
- CapX2020 Brookings

The Department concluded that Xcel's proposed 2016 annual revenue requirements for all of the previously approved projects appear reasonable and recommended that the Commission approve the requested amounts for recovery through Xcel's 2016 TCR Rider.

New Out-of-State Projects - Proposed for Consideration

La Crosse – Madison addition of transmission facilities in La Crosse County Wisconsin to the greater Madison area in Dane County in partnership with American Transmission Company (ATC) and scheduled in-service date of 2018.

CapX2020 Big Stone – Brookings addition of transmission facilities in Grant and Deuel Counties South Dakota in partnership with Otter Tail Power Company and scheduled in-service date of 2017.

The Company stated that the La Crosse – Madison³ project and the Big Stone – Brookings⁴ project are recoverable under the TCR statute, Minn. Stat. 216B.16 7b, because:

- 1) Both projects have been approved by their state commission and
- 2) Have been certified by MISO⁵ as Multi-Value Projects (MVPs) to benefit the utility or

² Approved under Minn. Stats. §216B.16, Subd. 7b and 216B.1645 in Docket No. E002/M-09-1048, Order Dated April 27, 2010.

³ La Crosse to Madison granted Certificate of Public Need by WI Public Service Commission in Docket No. 5-CE-142, May 5, 2015.

⁴ Big Stone to Brookings – granted two Transmission Line Site Permits by SD Public Utilities Commission. Docket Nos. EL06-002 on May 10, 2013 and EL13-020 on February 20, 2014.

⁵ Both projects certified as Multi-Value Projects by MISO as part of the December 8, 2011 Transmission Expansion Plan.

the integrated transmission system.

The Company stated these projects also meet additional standards suggested by the Department in previous TCR rider filings:

The projects serve Minnesota customers – Xcel operates an integrated transmission system, under two companies, NSPW & NSPM, across state borders. The integrated system serves Minnesota customers and provides the benefit of cost-effective, safe and reliable service to all of its customers. Seventy-three percent of project costs are allocated to Minnesota under the FERC Interchange Agreement which is based on the load share ratio of the total NSP system. The allocation is the same whether the project is located in Minnesota or another jurisdiction.

Costs are similar to those that would be charged in a rate case – Project costs are similar whether they are recovered through the rider or base rates; the difference in recovery is timing.

Costs are reasonable – Both Brookings to Big Stone have received regulatory approval from their respective state utility commissions where costs and prudence were examined. The projects were also examined by MISO and found to provide substantial net economic, reliability and policy benefits. And working with other utilities to construct MVPs helps to insure cost-effective construction and project planning.

The Department concluded that the CAPX2020 Big Stone – Brookings project is eligible for recovery under the TCR Statute and its cost recovery request is reasonable because:

- The project was approved by the SDPUC and determined by MISO to benefit the integrated transmission system as an MVP in MISO's MTEP Report; and
- Xcel's total estimated costs of \$81.3 million for the CAPX2020 Big Stone-Brookings project is below the total estimated costs of \$92.2 million provided to the SDPUC in Docket No. EL12-063. Since Xcel's current estimated costs included for recovery in the instant petition total approximately \$47.9 million through December 2016 and are below the total estimated project costs of \$92.2 million provided to the SDPUC, the DOC recommended that the Commission approve Xcel's cost recovery request.

The Department concluded that the La Crosse – Madison project is eligible for recovery under the TCR Statute and its cost recovery request is reasonable because:

- The project was approved by the Wisconsin Public Service Commission and determined by MISO to benefit the integrated transmission system as an MVP in MISO's MTEP; and
- Xcel's revised total estimated costs for the La Crosse-Madison project total \$179.1 million and match the total estimated costs provided to the PSCW. Since Xcel's current estimated costs included for recovery in the instant petition total approximately \$68.0 million through December 2016 and are below the total estimated project costs of \$179.1 million provided to the PSCW, the DOC recommended that the Commission approve

Xcel's cost recovery request.

MISO Revenue Requirements

The Transmission Cost Recovery statute allows TCR rider recovery of charges billed under a federal tariff associated with other transmission expansions being constructed in the MISO region by other utilities. Xcel projected the MISO Tariff Schedule 26 and 26A expenses to be \$121.3 million and expects the expenses to be offset by \$148.3 million in Schedule 26 and 26A revenues. The revenues are associated with regional rate recovery of NSP System project investments. The forecast results in an estimated negative revenue requirement of \$19.9 million after allocation based on the MISO load share ratio to Minnesota.

Accumulated Deferred Income Tax (ADIT) Proration

The Company stated that in addition to updating the 2016 TCR revenue requirements to include the CapX2020 Brookings and Fargo projects, it has also adjusted the 2016 estimated annual revenue requirements calculation to include the plant related ADIT offset to rate base in accordance with the proration formula in IRS regulation section 1.167(1)-1(h)(6) and consistent with the Company's electric rate case. The total impact of the ADIT adjustment in 2016 is \$150,830.

True-up

Xcel proposed to increase its 2016 TCR revenue requirement by \$8,807,398 to reflect prior under-recoveries. The Department reviewed Xcel's true-up and tracker balance calculations and noted that Xcel's calculations appear reasonable and consistent with past TCR Rider filings.

Minnesota Revenue Requirements

If the Commission approves the current proposal, it would be approving the following:

Project	2015 Actual/Forecasted Revenue Requirements	2016 Forecasted Revenue Requirements ⁶
CAPX2020 – Brookings	\$39,786,047	\$40,475,384
CAPX2020 – Fargo	\$17,948,587	\$18,611,685
CAPX2020 - La Crosse Local	\$2,638,065	\$5,827,371
CAPX2020 - La Crosse MISO	\$6,499,996	\$6,971,744
CAPX2020 - La Crosse MISO WI	\$10,319,386	\$13,522,327
CAPX2020 - Big Stone-Brookings (SD)		\$1,921,637
La Crosse - Madison (WI)		\$2,717,735

⁶ Per Xcel's November 6, 2015 Updated filing, Attachment 4.

Net RECB 26 & 26A Charges	(\$22,865,128)	(\$19,875,653)
ADIT Prorate		\$150,830
TCR True-Up Carryover	\$5,201,080	\$8,087,398
Total Revenue Requirements	\$59,528,034	\$78,410,459
Less Revenue Collections	\$51,440,636	
Balance (Over) Under	\$8,087,398	

Currently, the average residential customer using 750 kWh per month, pays approximately \$2.43 per month due to the currently TCR factors in effect. If Xcel's petition is approved as updated, the average residential would see a bill impact of \$2.35 per month. While the revenue requirement is increasing, the average residential customer will see a reduction of \$.08 per month over the 2015 TCR adjustment factors. The reduction is due, in part, to Xcel applying the demand and jurisdictional allocators based on the sales forecast used in Xcel's currently pending rate case. The table below compares the TCR adjustment factors currently in effect to the updated proposed factors.

	2015 Approved	2016 Proposed
Total Revenue Requirement	\$64.0 million	\$78.4 million
Residential Rate/kWh	0.003236	0.003131
Commercial Non-Demand/kWh	0.003073	0.003025
Demand/kW	0.906000	0.907000

Proposed Customer Notice

The Company plans to provide notice to customers regarding the change in the TCR Adjustment Factors reflected in their monthly electric bill. The following the Company's proposed updated language to be included as a notice on the customers' bill the month the TCR Adjustment Factors are implemented:

This month's Resource Adjustment includes a decrease in the Transmission Cost Recovery Adjustment (TCR) which recovers the costs of transmission investments, including delivery of renewable energy sources to customers. The TCR portion of the Resource Adjustment is \$0.003131 per kWh for Residential Customers; \$0.003025 per kWh for Commercial (Non-Demand) customers; and \$0.907 per kW for Demand billed customers. Questions? Contact us at 1-800-895-4999.

The Company stated they will work with the Department of Commerce and the Commission Staff if there are any suggestions to modify this proposed customer notice. The Department did not comment on the Company's proposed customer notice.

Additional Topic for Discussion - Accumulated Deferred Income Taxes

Xcel and the Department have reached agreement on all of the issues presented in the rider, including requiring Xcel to replace its forecasted prorated ADIT balances with actual non-prorated ADIT balances in its beginning-of-month and end-of-month average ADIT balance calculation for true-up purposes.

There is the outstanding issue for discussion of whether ADIT balances are required to be prorated or non-prorated when the Company forecasts its test year for rate base. And, if the Commission decides proration of the ADIT balances is required, must the true-up also be calculated using the proration method when adjusting for actual ADIT.

The issue of ADIT proration has also been raised by at least two other Minnesota regulated utilities: Minnesota Power⁷ and Otter Tail Power.⁸ Xcel also posed the issue in its currently pending General Rate Case and its Renewable Energy Standards cost recovery filing⁹. The Department recommended the issue be considered in this proceeding.

While reading the discussion, please keep in mind the party positions:

Xcel Position

- ADIT proration is required because of IRS regulations when the Company forecasts its test year for rate base.
- The true-up must also be calculated using the proration method when adjusting for actual ADIT.

Department Initial Position

- Proration should not be applied when determining future revenue requirements.
- Proration should not be applied to the true-up.

Department Alternative Position

- If proration is applied when determining future revenue requirements;
- The true-up to actuals should not be prorated.

Staff notes that to remove one element of complexity from the issue, the issue will be addressed as it pertains to Xcel's rate case, and not the TCR rider. Xcel provided the background on Accelerated Depreciation and Normalization Rules in the following section.

Background & Definitions

Accelerated Depreciation

Accelerated depreciation refers to the depreciation method used for income tax purposes. This

⁷ See E-015/GR-16-664.

⁸ See E-017/GR-15-1033.

⁹ See E-002/15-805.

method accelerates tax depreciation in the early years of an asset's life, faster than the use of the straight line depreciation method. In contrast to accelerated depreciation, straight line depreciation recovers the cost of an asset in equal amounts each year over the asset's expected productive life. The difference between the income taxes based on straight-line book depreciation and accelerated tax depreciation are reflected as ADIT.

Bonus Tax Depreciation

Like accelerated tax depreciation, bonus tax depreciation is a depreciation method used for income tax purposes that reflects more depreciation in the early years of an asset's useful life compared to straight-line depreciation. Straight-line depreciation is used for financial accounting and regulatory purposes and is the method on which gas and electric utility rates are set. Bonus depreciation is used for federal tax accounting purposes and defers income taxes by reducing taxable income in the early years of an asset's life and increasing taxable income in the latter years. The difference between straight-line depreciation (constant through an asset's life) and bonus depreciation is a matter of timing, which in turn generates a deferred tax liability.

The revenue requirement is impacted by bonus depreciation as a decrease to rate base when the bonus depreciation is factored into the ADIT calculation. The ADIT generated by bonus depreciation represents government-supplied funds to the utility and, consequently, requires the balance to be credited to rate base. Under normalized accounting for income taxes, ADIT signifies amounts paid by customers for current taxes that the utility will not have to pay the government until a later period.

Accumulated Deferred Income Taxes

The ADIT deferral is a significant tax incentive that Congress adopted with the specific intent of encouraging businesses to make capital investments. In public utility rate cases, many regulatory agencies, including this Commission, consider the related accumulated deferred income tax liabilities to be cost-free capital available to the utility and, consequently, require that they be credited to rate base for ratemaking purposes.

The main issue being discussed in this case is whether the ADIT balances should be prorated or not prorated when the Company forecasts its test year for rate base. And, if the Commission decides proration of the ADIT balances is required, must the true-up also be calculated using the proration method when adjusting for actual ADIT.

Normalization

Deferred taxes are a result of an accounting process called "normalization", which is the timing difference between book and tax accounting. The difference is then multiplied at the current tax rate to determine the current deferred tax. This amount in turn is added to the Accumulated Deferred Income Tax (ADIT) balance. Deferred taxes derive from tax depreciation being greater than book depreciation (in the early years of an assets life.) The Company's ADIT balance has been growing in large part due to bonus tax depreciation. The Company strives to maximize the tax benefits by using accelerated methods to depreciate its assets, which are often taken in the early years of an asset's life. Deferred taxes, from a rate making perspective, allow the Company to share the early tax benefits with all customers equally over the asset's straight

line book life.

Congress has imposed specific requirements and restrictions on a utility's ability to use accelerated and bonus depreciation. Congress (and the IRS acting under Congressional authority and direction) have established specific preconditions for a utility to use accelerated and bonus depreciation for federal income tax purposes, which are called the Tax Normalization Rules.

Tax Normalization Rules encompass requirements from the Internal Revenue Code (IRC), Treasury Regulations and related guidance provided by the IRS, such as PLRs. Specifically, Tax Normalization Rules are set forth in IRC § 168(f)(2) and § 168(i)(9). These rules require that deferred taxes created based on accelerated tax methods cannot flow back any faster than straight line depreciation would provide for over book life. The associated regulations further define how the deferred tax balance for the federal portion of Federal Energy Regulatory Commission (FERC) Account 282 must be calculated for the future test year. (See Treasury Regulations Section 1.167(l)-1(h)(6)).

Congress did not directly prohibit regulators from using other methods to set rates; however, the consequences of a regulator doing so is the utility's loss of the ability to use accelerated depreciation, including bonus depreciation, for federal income tax purposes. In light of the potential loss of accelerated deductions and for other reasons, Minnesota and virtually all other jurisdictions have adopted the normalization method of tax accounting for rate setting purposes.

The consequences of violating Tax Normalization Rules are severe. The Company stated if it were to lose the ability to use accelerated tax depreciation on utility assets, it would significantly reduce the ADIT offset to rate base. The ADIT offset provides a significant benefit for Xcel's customers in the form of lower rates. The ADIT offset to rate base is forecasted to be in excess of \$2 billion on a Total Company basis for the electric business.

Benefit of ADIT

ADIT provides the Company access to cost-free capital it would not otherwise have. ADIT is subtracted from rate base and reduces the financing costs included in the revenue requirement. Annual deferred tax expense is part of the revenue requirement, and there is an equal and offsetting decrease to current tax expense. Thus, all customers benefit from the tax deduction of the asset cost ratably over its useful life.

Proration of ADIT

Department Position

The Department stated it agreed with the Company's explanation of deferred taxes and bonus depreciation and how it affects the rate case revenue requirements. The Department disagreed with Xcel's statement that ADIT generated by bonus depreciation or any accelerated tax method represent government-supplied funds to the utility. Rather, it is the ratepayer that has prepaid normalized deferred income taxes before the taxes are due. This fact is why ratepayers received an ADIT credit, which reduces rate base, because ratepayers have pre-paid the tax amount owed by the Company to the Internal Revenue Service (IRS).

The Department and Xcel agreed that the Internal Revenue Code (IRC) sets the standards that apply to tax normalization and cited IRC Section 168(i)(9)(B)(i) as follows:

*[T]he taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes...*¹⁰

The Effect of Changing to Prorated ADIT

The Department's initial position is that proration should not be applied when determining future revenue requirements and proration should not be applied to the true-up.

Since at least 2005 and likely much earlier, the Company has included non-prorated ADIT balances in its forecasted test-year rate base. The Company is now proposing to prorate the ADIT balances in its forecasted test-year rate base. The Department objected to the Company's proposal to change how it calculates the forecasted test-year ADIT balances in its rate case. The Department stated it is concerned with the change because ratepayers are continuing to pay the same depreciation and related taxes on investment. If the change is allowed, ratepayers will not be receiving the full ADIT offset or credit to rate base.

The Department argued that it is inappropriate and inconsistent to require ratepayers of a fully regulated utility such as Xcel to pay for higher income tax expenses based on an assumption of straight-line depreciation (rather than accelerated depreciation used for tax purposes) and to lose the long-standing offsetting ADIT credit to rate base. Instead of treating ADIT as the timing issue it has always been, Xcel is now proposing to charge higher rates to ratepayers by charging ratepayers a tax expense that is higher and to no longer provide a matching ADIT credit for rate base because of the one-sided proration to only the rate base credit and not the tax expense.

The Department argued that since the Company is not agreeing to the true-up in the following year when amounts become actual, the Company would be inappropriately keeping for its shareholders the benefits of tax expense being higher than the ADIT credit. Charging ratepayers for a full tax expense that is not prorated and at the same time lowering the credit for ADIT due to proration without a true-up in the following year when costs become actual results in the Company unreasonably overcharging ratepayers. The Department stated that Xcel's proposal does not meet the requirement of Minnesota Statute section 216B.03, that rates must be just and reasonable.

The Department argued that Xcel's proposal would charge ratepayers for more than the costs of a utility-owned facility, by never returning to ratepayers the prepaid income taxes that ratepayers provided to the utility in early years of a facility's life. The Department stated its alternative proposal to:

¹⁰ 28 U.S.C.A. § 168(i)(9)(B)(i) (West 2015).

- 1) allow the prorated ADIT only for recovery of forecasted costs (costs that are not historical, actual costs at the time the rates go into effect); and
- 2) require a true-up in the following year (once all amounts are historical/actual) by using actual non-prorated ADIT amounts;

would allow Xcel to keep the prepaid income taxes only temporarily and only for any forecasted costs. Xcel would have to refund the overcharge in the subsequent year.

The Department's alternative proposal would be a timing issue, where ratepayers would receive refunds soon after prepaying Xcel's income taxes, as opposed to Xcel's proposal to overcharge ratepayers by keeping the prepaid taxes and never refunding the money to ratepayers and charging ratepayers for more than the cost of the utility-owned facility.

Prepaid taxes are recognized in the ADIT rate base account; ADIT is an offset to rate base, and thus reduces the costs charged to ratepayers. Prorating the ADIT account, for forecasted costs, reduces the rate base credit to ratepayers. Under the Department's alternative proposal, Xcel would give ratepayers a reduced prorated ADIT credit amount for forecasted costs in the forecasted year, but require a true-up to actual non-prorated ADIT in the following year when amounts are historical/actual. This true-up restores to ratepayers the amount by which they have prepaid Xcel's income taxes in the prior year, which would then be consistent with past practice. By contrast, Xcel's request to allow pro-ration of ADIT but defer the decision to require a true-up is unreasonable and one-sided to the benefit of Xcel and would harm ratepayers.

In response to a Department information request, the Company stated that Xcel Energy on a consolidated tax basis last paid material federal income taxes in 2008 of approximately \$22.3 million. Since 2008, Xcel Energy has paid very small amounts of federal income taxes totaling less than \$1 million in total for the period 2009 to 2015.

The Department compared Xcel's position to ratepayers who are paying millions of dollars in income taxes in rates just based on the tax gross up of the revenue requirement in current and past rate cases. The Department stated that if this issue is viewed from an equity perspective, Minnesota electric utilities are not paying a significant amount of federal income taxes. This is a result of the tax legislation that has allowed significant amounts of bonus tax depreciation over one and two years. Yet, ratepayers continue to pay the full amount of income taxes imputed with the assumption that someday the utility will have to pay the tax amount.

The Department stated that in the past, ratepayers would receive the full offsetting ADIT balance or credit to rate base for this tax amount. Xcel is now proposing to reduce this offsetting ADIT balance or credit to rate base as well. Additionally, ratepayers are paying for the costs of these assets in rate base along with a return on plant investment while paying the full amount of deferred income tax expenses, but are now being denied the full offsetting ADIT balance or credit to rate base.

Xcel Position

The Company stated that if it is ordered to violate Tax Normalization rules by not being allowed to prorate the ADIT, customers would be harmed. If the Company is not able to use accelerated depreciation, then tax depreciation would revert to straight-line depreciation over the useful life of the assets, or what is commonly known as book depreciation. Using book depreciation for tax purposes would eliminate any increase in ADIT rate base deduction going forward. Thus, the beginning deferred balance would stop increasing and would decrease causing a substantial increase to revenue requirements. For 2016, the average ADIT offset to rate base is forecasted to be in excess of \$2 billion on a Total Company basis. A violation would cause this \$2 billion balance to systematically go away, which would increase the return on rate base in general rates. Additionally, the Company and ratepayers would not have access to any accelerated depreciation, including bonus depreciation resulting from the Protecting America from Tax Hikes (PATH) Act or enacted by Congress going forward. Therefore, proration of ADIT is in the best interests of customers to keep their rates lower.

IRS Regulations Require Proration of ADIT

Xcel stated the proration method is required by the Tax Normalization Rules. The purpose of the proration requirement is to prevent the flow-through of the benefits of accelerated depreciation to ratepayers any earlier than realized. The IRS assumes the benefits are received on the last day of the period over which the deferral is recognized (monthly for NSPM). The Company stated that if were to follow the Department's recommendation to not use proration, the Company would be in violation of the Tax Normalization Rules and, as previously discussed, would no longer be able to take advantage of accelerated depreciation.

The Company stated that the requirements and the formulas are described in Treasury Regulation Section 1.167(l)-1(h)(6)(ii), and examples are provided in Treasury Regulation Section 1.167(l)-1(h)(6)(iv). Section 1.167(l)-1(h)(6)(ii) of the Treasury regulations mandate the use of a very specific proration procedure in measuring the amount of future test period ADIT that can reduce rate base. This regulation requires that, if a utility uses a "future" test period to determine depreciation, "the amount of the reserve account for the period is the amount of the reserve at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during such period."

The Company stated that it is not alone in its understanding of the IRS guidance on proration requirements. The proration requirements of Treasury Regulation Section 1.167(l)-1(h)(6) became a source for a number of inconsistent positions by different utilities. Consequently, some electric utilities requested rulings from the IRS regarding the calculation of ADIT when using forward-looking ratemaking and a true-up mechanism. In July and August 2015, the IRS Chief Counsel's Office (the National Office) issued four PLRs that, for the first time in many years, addressed the ADIT proration requirement and some of the circumstances under which it applies.¹¹

¹¹ PLR 201531010, 201531011, and 201531012 released in July of 2015 and PLR 201532018 released in August of 2015.

Xcel stated that four IRS PLRs were published in July and August 2015 and address the ADIT proration requirement and the specific normalization requirement for forecasted rate setting. In these PLRs, the IRS reasserts that in cases of future test periods, the ADIT proration methodology described in Treasury Regulation Section 1.167(l)-1(h)(6) must be used. Xcel provided a citation and discussion summary of each of the four PLRs, as well as an additional fifth PLR¹² that was released in October.

Proration of True-up Required by Recent PLRs

Xcel Position

Xcel stated that while the Company must prorate its ADIT balances, it understands that there is some level of inconsistency in the industry regarding treatment of the ADIT true-up. The Company stated its understanding of the IRS regulations is that the true-up balances also must be prorated, in contrast to the Department's position that the true-up should not be prorated.

The Company's position is that proration of ADIT is required due to recent PLRs issued by the IRS. Xcel stated because it proposed a forecasted test year in the rate case proceeding, the private letter rulings indicate that a utility must pro-rate the monthly incremental increases to the ADIT balance. As a result of this change, Xcel's test-year ADIT balance would be reduced.

The Company further argued that the true-up must use the proration method when adjusting a forecasted rate even if the adjustment is to actuals. Recent IRS rulings as well as FERC rulings indicate this is the necessary calculation method. Xcel stated it does not plan to true-up or replace its forecasted prorated ADIT balances in the following year when the balances are no longer forecasted and actual balances are known. Xcel's position is that the IRS requires Xcel to keep the prepaid income taxes provided by ratepayers for its shareholders, even after the test year has passed and actual costs are known.

Xcel stated a true-up is determined by reference to what was used to originally set customer rates. If a rate proceeding uses a forecast period and the rates are charged to the customers before the forecast period becomes actuals, proration must be used. The test is whether a historical or a future test period was used to set the general rates and if the rates were first charged to customers before the forecasted test year was complete. Performing a true-up at a later date does not change the fact that when rates were collected from customers, they were reduced by the benefits of accelerated depreciation before the Company received those benefits.

Department Position

The Department objected to Xcel's use of PLRs as support for its position as the PLRs were issued to other companies, not Xcel specifically. The Department stated that at the end of all private letter rulings, the IRS provides the following statement, which basically says the IRS decision is only to be used by the entity requesting the decision:

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code

¹² PLR 201541010 released in October 2015.

provides it may not be used or cited as precedent.

The Department stated that under the code, an exception to the general rule that PLRs may not generally be relied upon as precedent exists if the IRS, by Regulations, determines that a particular PLR will be precedential. The Department stated it is not aware that the IRS has specifically determined that any PLRs that Xcel refers to have been made precedential under the law.

The Department argued that Xcel's proposal to prorate the ADIT balances must be supported by the IRC, or a PLR that applies directly to Xcel. The Department stated that it is not aware that Congress has made any such change to the IRC, nor did the Company cite any such change to the IRC to support its position.

The Department stated it considers "guidance" through the Company's interpretation of PLRs as significantly less requisite than Xcel's claim that proration is "required by the IRS." The Department disagreed with Xcel's use of PLRs to support its position that it would commit a normalization violation if it does not prorate ADIT. The Department argued that Xcel must support its position and show a change is required under Internal Revenue Code or Treasury Regulation.

Even though Xcel concluded that the private letter rulings are basically IRS regulations, the Department's understanding is that is not the case. As noted above, the IRS states that private letter rulings are for the individual tax entity that requested the tax ruling, since the decision was made based on the facts in that particular case. Notably, just because the IRS has concluded one way in certain private letter rulings (based on particular facts that are expressly not precedential) this does not mean that "the IRS has not disallowed" a certain method under different facts.

FERC Requires ADIT True-up to Actuals

Department Position

Tax Normalization Rules encompass requirements from the Internal Revenue Code (IRC), Treasury Regulations. These rules require that deferred taxes created based on accelerated tax methods cannot flow back any faster than straight line depreciation would provide for over book life. The associated regulations further define how the deferred tax balance for the federal portion of Federal Energy Regulatory Commission (FERC) Account 282 must be calculated for the future test year. (See Treasury Regulations Section 1.167(l)-1(h)(6)).

The Department stated that the Company is inconsistent in applying ADIT prorate between the current proceedings in Minnesota and proceedings at the FERC. The Department specifically referenced the July 25, 2016 compliance filing on behalf of Xcel Energy Transmission Development Company, LLC. (XETD), which is part of the same consolidated tax entity as NSPM.¹³ The purpose of the compliance filing was to address specific issues identified in the FERC Order issued on June 23, 2016, which were unrelated to the ADIT topic.

¹³ FERC Docket No. ER14-2752-004.

The Department noted that the Company is not pro-rating its ADIT credit for rate base for XETD. This fact is inconsistent with Xcel's claim that NSP-M must pro-rate its ADIT balance. The Department argued that because Xcel Energy files its taxes on a consolidated tax basis, the Department does not see how the Company can claim non-prorated ADIT for XETD and prorated ADIT for NSP-M, except to conclude that the Company's claim that the IRS private ruling requires them to pro-rate the ADIT balance is not supported.

The Department stated that the FERC, which regulates wholesale electric rates has also addressed this issue. FERC's December 2015 Order in Docket No. ER16-197 rejected NSP's Attachment O¹⁴ filing and required NSP to correct its ADIT true-up amount in its Attachment O filing. Basically, FERC allowed the pro-ratio for current forecasted ADIT, but once the balances become historical (actual) amounts in the following year, NSP/Xcel was required to true-up to actual by using beginning-of-year and end-of-year ADIT amounts.

In response to a Department IR, the Company mentioned that Ameren Illinois and NSP (which are MISO transmission owners) both raised concerns about FERC not accepting their Attachment O filing. Xcel noted in its FERC filing that Virginia Electric Power Company (which is a PJM transmission owner) was allowed not to true-up to actual ADIT amounts in the following year in Docket No. ER14-1831-001.

According to the Department, there are 24 MISO¹⁵ transmission owners and only two (NSP and Ameren) of the 24 transmission owners took what the Department believes is an aggressive tax position. The other 22 transmission owners did not take this position and agreed to apply the ADIT true-up in the following year once balances become actual and are no longer "future."

The Department noted that for 2016 all of the MISO transmission owners that had forecasted revenue requirements, including Xcel and Ameren, were allowed to use prorated ADIT for forecasted costs but were required to use non prorated ADIT balances for purposes of the true-up once the amounts become actual/historical. The Department noted that of the MISO transmission owners, only Xcel and Ameren are taking this aggressive tax position and requesting that they be allowed to continue prorating ADIT amounts for true-up purposes, which results in permanent tax differences that harms ratepayers.

The Department stated that FERC denied Xcel and Ameren's request to prorate ADIT amounts for true-up purposes in their 2016 transmission rates, but left the door open for Xcel and Ameren to again request and support their position in future filings. Additionally, utilities are not incurring additional tax costs (and are actually paying less than ever)¹⁶ yet they are proposing to unfairly reduce the ADIT credit provided ratepayers (so it is no longer equal to deferred income

¹⁴ Attachment O is the mechanism used by each Transmission Owner to annually report transmission revenue requirements to MISO. Revenue requirements include transmission related costs and a rate of return on transmission rate base.

¹⁵ Based on MISO's website

¹⁶ The Department noted that Xcel has paid less than \$1,000,000 in total federal income taxes from 2009 to 2015 per the Company's response to IR 1168 in Docket No. E-002/GR-15-826. See Campbell Direct, page 22.

tax expense ratepayers continue to pay). On November 3, 2016, Xcel made an additional filing at FERC to support its continued ADIT proration for true-up purposes.¹⁷

The Department stated that two Minnesota regulated utilities, Minnesota Power and Otter Tail Power, filed their Attachment O at FERC with a pro-rated ADIT balance for current year forecasted amounts, but then agreed to true-up back to beginning and end-of-year balances the following year. As a result, this issue is really a timing issue (where the Company gets a one-year temporary loan based on the current year ADIT balance) and not a permanent change in how ADIT is recovered for ratemaking.

Additionally, since a significant majority of MISO and PJM transmission owners are taking the position that they should pro-rate the current ADIT forecasted amount but then do a true-up to non-prorated actuals based on beginning-of-year and end-of-year ADIT balances in the following year, the Department believes the majority of MISO and PJM transmission owners do not seem to have a concern with the tax normalization violations that NSP is claiming. Moreover, even the IRP private letter ruling quoted above is clear that prorating is not applicable in the true-up.

On November 22, 2016, the Department¹⁸ was part of a petition filed at FERC opposing revisions to Attachment O formula rates by MISO as proposed by Xcel Energy Services and Ameren Services Company. Despite this activity at FERC, the Department recommended that the Commission make its own decision based on the facts of ADIT proration in Minnesota cases and avoid a bad policy decision which would negatively impact ratepayers if ADIT proration is allowed for true-up purposes.

Xcel Position

The Company responded that in addition to the recent IRS guidance, the latest FERC actions also support its interpretation of ADIT balance treatment. The FERC initially decided that there should be no prorate on true-up in their December 30, 2015 Order in Dominion's MISO case (Docket No. ER14-1831-001). While FERC also rejected the Company's request to clarify that there should be prorate on true-up in its MISO case (December 30, 2015 in Docket No. ER16-197), the reasoning was different as the FERC did not rule that there should be no prorate at true-up. Instead, the FERC stated that the Company did not fully justify its request.

On February 23, 2016, the FERC reversed its ruling in the Dominion case. The FERC issued an Order on Revised ADIT Treatment and accepted Dominion's proposal to continue to apply the proration methodology to the originally projected ADIT balances in performing the annual true-up calculations. In its September 22, 2016 Order Denying Rehearing, in the Dominion docket, the FERC upheld its February 23, 2016 Order accepting the ADIT proration at true-up.

The FERC has taken additional action that supports the Company's proration on true-up approach. On April 12, 2016, the FERC issued an order for formula rates for two of

¹⁷ Docket No. ER17-305-000.

¹⁸ The Motion to Intervene and Comments were filed by the Joint Consumer Advocates (JCA). The JCA includes the states of Illinois, Indiana, Iowa, Michigan Minnesota, Missouri and Wisconsin.

Xcel Energy's subsidiaries, PSCo (Public Service Company of Colorado) and SPS (Southwestern Public Service Company) in Docket Nos. ER16-236 and ER16-239. The PSCo and SPS formula rates use proration for the calculation of ADIT in the forecast and the true-up. The proration was approved by the FERC for ADIT true-up in line with the method that was approved for Dominion in February 2016.

In response to the December 30, 2015 Order in the Company's MISO case where the FERC said the Company did not fully support its request, the Company filed a Motion to Lodge with the FERC on March 11, 2016 and provided additional support for its position. In addition, on September 22, 2016, the FERC issued its Order in the MISO docket clarifying that the December 30, 2015 Order does not prevent the Company from submitting tariff revisions that reflect ADIT proration at true-up. As a result, the Company intends to submit tariff revisions to the FERC providing additional support for the ADIT proration calculation. The Company stated it expects FERC action on that filing before the end of 2017.

Xcel stated because additional IRS guidance has been issued through the PLRs regarding ADIT proration, the XETD tariff will be updated to reflect the same treatment as used in Xcel Energy's recent Minnesota regulatory filings. Because XETD does not yet own operational transmission facilities (i.e., there are no assets to include in the formula rate), the ADIT treatment is not being applied by XETD to any assets at this time. The tariff will be updated to reflect the ADIT proration methodology when it is administratively appropriate at a time when other changes need to be made to the formula rate template.

Benefits of Deferring a Commission Decision – Xcel Recommendation

Xcel is advocating for the Commission to defer making a decision on the ADIT proration issue in this docket. Xcel stated that the TCR rider in this filing does not include a true-up of the ADIT balance and that its 2016 revenue requirements can be approved as proposed even if the Commission defers a decision on the treatment of the true-up

Xcel stated that a number of proceedings are in progress which may bring more clarity to the ADIT proration treatment issue. It may be beneficial to wait to have a further developed record on this issue in other currently pending Commission proceedings. In addition, the FERC has clarified that the Company may submit a revised tariff applying the ADIT proration to the true-up. Xcel stated it expects a FERC decision approving its revised tariff, consistent with the PSCo and SPS tariff treatment of the ADIT true-up proration, by the end of 2017. Further IRS guidance may also be forthcoming. The Company stated that if necessary it could potentially submit its own PLR to the IRS for a definitive ruling.

If additional guidance from the IRS, the FERC, or Commission proceedings showed that Xcel's ADIT treatment is unsupported, the Company would credit customers any difference through the TCR tracker. The Company stated it would also agree to bring forward to the Commission any newly issued guidance as it emerges to help clarify the issue.

Use of Historical Costs in Future Cost Recovery Filings

Department Position

The Department recommended that the Commission consider denying rider recovery or limiting rider recovery based on historical costs. Both approaches would eliminate the need to prorate ADIT balances.

The Department argued that requiring Xcel's TCR Rider (and other riders) to be based solely on historical costs would fully address the ADIT issue, as described in the Private Letter Ruling of the IRS:

Congress was explicit: normalization "in no way diminishes whatever power the [utility regulatory] agency may have to require that the deferred taxes reserve be excluded from the base upon which the utility's permitted rate of return is calculated." H.R. Rep. No. 413, 91st Cong., 1st Sess. 133 (1969).

...
[T]he second interpretation of section 1.167(l)-1(h)(6)(ii) of the regulations [that "the historical period is that portion of the test period before rates go into effect, while the portion of the test period after the effective date of the rate order is the future period"] is consistent with the purpose of normalization, which is to preserve for regulated utilities the benefits of accelerated depreciation as a source of cost-free capital. The availability of this capital is ensured by prohibiting flow-through. But whether or not flow-through can even be accomplished by means of rate base exclusions depends primarily on whether, at the time rates become effective, the amounts originally projected to accrue to the deferred tax reserve have actually accrued.

If rates go into effect before the end of the test period, and the rate base reduction is not prorated, the utility commission is denying a current return for accelerated depreciation benefits the utility is only projected to have. This procedure is a form of flow-through, for current rates are reduced to reflect the capital cost savings of accelerated depreciation deductions not yet claimed or accrued by the utility. Yet projected data is often necessary in determining rates, since historical data by itself is rarely an accurate indication of future utility operating results. Thus, the regulations provide that as long as the portion of the deferred tax reserve based on projected (future estimated) data is prorated according to the formula in section 1.167(l)-1(h)(6)(ii), a regulator may deduct this reserve from rate base in determining a utility's allowable return. In other words, a utility regulator using projected data in computing ratemaking tax expense and rate base exclusion must account for the passage of time if it is to avoid flow-through.

But if rates go into effect after the end of the test period, the opportunity to flow through the benefits of future accelerated depreciation to current ratepayers is gone, and so too is the need to apply the proration formula. In this situation, the only question that is important for the purpose of rate base exclusion is the amount in the deferred tax reserve, whether actual or estimated. Once the future period, the period over which accruals to the reserve were projected, is no longer future, the question of when the

*amounts in the reserve accrued is no longer relevant (at the time the new rate order takes effect, the projected increases have accrued, and the amounts to be excluded from rate base are no longer projected but historical, even though based on estimates). (Emphasis added).*¹⁹

Xcel Position

Xcel stated it disagrees with the Department's alternative solution to use historical test years for riders, and noted that the use of a historical test year may solve this one issue, but there are better, less drastic options to solve the ADIT proration issue at hand and a historical test year creates a whole host of new issues as well.

Xcel stated that in an environment where capital investments are high, rates based on historical test years do not provide balanced recovery. The rates are effectively out of date as soon as the new rates go into effect. As a result, due to this regulatory lag, the use of historical test years essentially prevents utilities from earning its allowed rate of return, which increases risk and the cost of capital which could eventually be reflected in higher rates. In sum, the use of forward-looking test years better represents actual costs in rates and as a result produces better results for utilities and the customers.

Xcel noted that there are customer benefits associated with the use of accelerated tax methods in the forecast period that would disappear with the use of a historical test year. The Company stated that if the Commission wishes to explore the use of historical test years for riders, it believes there should be additional record development, including input from interested parties.

Other Minnesota Utilities Approaches

Xcel stated that other Minnesota utilities, like Otter Tail Power (OTP), agree with the Company's interpretation of IRS guidelines regarding ADIT proration. In its recent rate case, OTP stated its "goal is to comply in good faith with a well-documented IRS normalization requirement." Failure to use ADIT proration is non-compliance with the IRS normalization requirements which could result in losing the ability to take accelerated depreciation.

Regarding the ADIT true-up, some Minnesota utilities are approaching treatment of the true-up differently than Xcel Energy, though the Company stated it does not know what information the companies have based their decisions on. The Company stated it has reason to believe the approach to the ADIT true-up is outdated due to the earlier timing of their filings that addressed the issue. The Company stated its decision to maintain ADIT proration at true-up is based on the most recent IRS rulings, FERC guidance, and numerous consultations with accounting firms, tax advisors, in-house counsel, outside counsel, and internal experts; these consultations confirm that the Company's approach to maintaining ADIT proration in the true-up is consistent with the most recent guidance available. The Company stated it does not believe it has a choice of not maintaining ADIT proration in a true-up calculation if it is to remain in compliance with the Tax Normalization Rules.

¹⁹ <https://www.irs.gov/pub/irs-wd/201541010.pdf> pages 6-8.

Summary of Party Positions

Xcel Recommendations

The Company provided three Commission options, listed in order of Xcel Energy's preference, as well as the outcome associated with each option:

Option 1:

Approve the Company's TCR Rider rate factor for 2016, confirm ADIT proration is required, and defer proration of ADIT at true-up decision to a later proceeding.

The Company stated the TCR factors proposed in this TCR proceeding do not include a true-up of the ADIT balance, and the 2016 revenue requirements can be approved as proposed even if the Commission defers a decision on the treatment of the true-up balance. If additional guidance from the IRS, the FERC, or other proceedings shows our ADIT proration treatment to be unsupported, the Company stated it would credit to customers any difference through the TCR tracker.

Option 2:

Defer the entire ADIT proration decision as well as approving the Company's TCR Rider rate factors for 2016.

If the Commission takes this action, the Company would continue to collect at the current TCR rate factors without adjustment.

Option 3:

Order the Company to not prorate ADIT in general or at true-up as the Department has suggested.

If the Commission takes either of these actions, the Company would be required to notify the IRS of the Commission's Order that results in the Company being in violation of Tax Normalization Rules.

Department Summary & Recommendations

The Department provided the following reasons for the Commission to consider while making a decision on the issue of proration its ADIT credits:

- First, Private Letter Rulings (PLRs) are not the same as Internal Revenue Service (IRS) Regulations and every PLR states that they are only allowed to be used by the entity requesting the PLR and may not be used or cited as precedent.
- Second, providing ratepayers with an ADIT credit for rate base equal to the deferred tax expense that ratepayers are prepaying is a long-standing ratemaking policy.

- Third, under Xcel's proposal, debits and credits would no longer be equal which violates a fundamental accounting rule. The debit is to deferred tax income tax expense, which the Company still plans to fully charge customers, yet the ADIT credit would be reduced because of the proration.
- Fourth, Xcel is not incurring any additional costs to warrant such a change in this long-standing ratemaking policy; in fact, utilities are paying less income tax than ever due to bonus tax legislation. Thus, increasing costs to ratepayers is unsupported. (Note providing an ADIT credit equal to the deferred tax expense is no different than ratepayers paying depreciation expense and then getting the same amount as a reduction to rate base through accumulated depreciation.)
- Fifth, all components of forecasted rate base are calculated using an average of non-prorated beginning and end-of-year balances (average rate base). Thus, allowing the ADIT credit to be calculated on a prorated basis would result in an inconsistent treatment of rate base calculations and therefore would not be reasonable without adequate support for such a difference in accounting and ratemaking.

The Department provided three Commission options for the Commission to consider, listed in order of the Department's preference:

Option 1:

The Department recommended the Commission deny the Company's request for the proration of ADIT.

Option 2:

For purposes of resolving this issue and not using limited state resources, the Department's alternative recommendation is to:

- 1) allow the prorated ADIT only for recovery of forecasted costs (costs that are not historical, actual costs at the time the rates go into effect) and,
- 2) require a true-up in the following year (once all amounts are historical/actual) by using actual non-prorated ADIT amounts.

Option 3:

Finally, if Xcel continues to pursue this issue to the detriment of ratepayers, the Department recommends that the Commission consider either denying rider recovery or limiting rider recovery to historical costs, as both of these approaches would eliminate the need to prorate ADIT balances.

Staff Analysis

The Department's position is that ADIT issue in the TCR rider is a timing issue. In the rider, the issue is resolved by truing up to actual costs once the cost become known, not prorated costs. The Department's main concern is how the issue would be handled in a rate case because in the

rate case, there is no true-up of prorated ADIT and this results in a permanent rather than temporary difference between prorated ADIT and the offsetting ADIT credit to rate base.

In previous rate cases, the Company has included non-prorated ADIT balances in its forecasted test-year rate base. In its current rate case, the Company is proposing proration of the ADIT balances in its forecasted test-year rate base. The Company does not agree an ADIT true-up in the following year is required when the amounts become actual.

Straight Line Depreciation

Straight line depreciation allows the utility to recover the cost of an asset in equal amounts each year over the assets productive life. In setting rates for Minnesota ratepayers the Commission allows the Company to charge ratepayers for a tax expense based on the assumption of straight line depreciation. Because straight line depreciation expense is lower than an accelerated amount of depreciation when a Company is investing in its business, tax expense using the straight line method will be higher than it would be using one of the accelerated methods allowed for tax reporting purposes. The depreciation parameters and resulting rates are reviewed periodically and set by the Commission.

Bonus Tax Depreciation

Bonus tax depreciation is a depreciation method used for income tax purposes that reflects more depreciation in the early years of an asset's useful life compared to straight-line depreciation and most other forms of accelerated depreciation. Straight-line depreciation is used for financial accounting and regulatory purposes and is the method on which gas and electric utility rates are set. Bonus depreciation is used for federal tax accounting purposes and defers income taxes by reducing taxable income in the early years of an asset's life and increasing taxable income in the latter years. The difference between straight-line depreciation (constant through an asset's life) and bonus depreciation is a matter of timing, which in turn generates a deferred tax liability. Below are two hypothetical examples. The first example compares straight line depreciation to bonus depreciation. The second example illustrates the effect that using straight line depreciation vs. bonus depreciation has on the calculation of operating income in Year 1.

Straight Line vs. Bonus Depreciation

Year	Straight Line (MN)	Bonus Depreciation (Tax)
1	\$100,000	\$200,000
2	\$100,000	\$320,000
3	\$100,000	\$192,000
4	\$100,000	\$115,200
5	\$100,000	\$115,200
6	\$100,000	\$57,600
7	\$100,000	\$0
8	\$100,000	\$0
9	\$100,000	\$0
10	\$100,000	\$0
Total	\$1,000,000	\$1,000,000

Operating Income Year 1

	Regulatory Basis (MN)	Tax Basis
Revenue	\$1,000,000	\$1,000,000
Expenses	(700,000)	(700,000)
Depreciation	(100,000)	(200,000)
Taxable Income	200,000	100,000
Income Tax Expense @ 35%	(70,000)	(35,000)
Operating Income	130,000	65,000

Accumulated Deferred Income Taxes

The ADIT deferral is a significant tax incentive that Congress adopted with the specific intent of encouraging businesses to make capital investments. In public utility rate cases, many regulatory agencies, including this Commission, consider the related accumulated deferred income tax liabilities to be cost-free capital available to the utility and, consequently, require that they be credited to rate base for ratemaking purposes.

The revenue requirement is impacted by bonus depreciation as a decrease to rate base when the bonus depreciation is factored into the ADIT calculation. The revenue requirement is impacted because this reduces the value of the assets on which the Company is authorized to earn a rate of return. Depreciation expense, on the other hand, is included in the revenue requirement calculations, as part of the Company's expenses that are included in the cost of service. Under normalized accounting for income taxes, ADIT signifies amounts paid by customers for current taxes that the utility will not have to pay the government until a later period.

Normalization

Deferred taxes are a result of an accounting process called "normalization", which is the timing difference between book and tax accounting. The difference is then multiplied at the current tax rate to determine the current deferred tax. This amount in turn is added to the Accumulated Deferred Income Tax (ADIT) balance. Deferred taxes derive from tax depreciation being greater than book depreciation (in the early years of an assets life.) The Company's ADIT balance has been growing in large part due to bonus tax depreciation as well as increased spending on capital projects. The Company strives to maximize the tax benefits by using accelerated methods to depreciate its assets, which are often taken in the early years of an asset's life. Deferred taxes, from a rate making perspective, allow the Company to share some of the early tax benefits with customers over the asset's straight line book life. An illustration of the computation of deferred taxes is provided below.

(The alternative to the "normalization" method is the "flow-through" method. "When a utility is required...to flow through the tax savings which the utility enjoys with the use of accelerated depreciation, the financial statements of the utility reflect straight-line depreciation and actual

taxes paid. The result is an increase in net income after taxes. In a rate making situation this will mean a higher rate of return. The flow-through concept not only advocates flowing through the actual tax savings and subsequently, higher income on the income statement, but also anticipates a flowing onward to the rate payer in the form of lower rates since the rate of return has now increased and the savings, in fact, belong to the rate payer.”²⁰

Accumulated Deferred Income Taxes

Year	Book Depreciation	Tax Depreciation	Timing Difference	Deferred Tax @ 35%	ADIT
1	\$100,000	\$200,000	(\$100,000)	(\$35,000)	(\$35,000)
2	\$100,000	\$320,000	(\$220,000)	(\$77,000)	(\$112,000)
3	\$100,000	\$192,000	(\$92,000)	(\$32,200)	(\$144,200)
4	\$100,000	\$115,200	(\$15,200)	(\$5,320)	(\$149,520)
5	\$100,000	\$115,200	(\$15,200)	(\$5,320)	(\$154,840)
6	\$100,000	\$57,600	\$42,400	\$14,840	(\$140,000)
7	\$100,000	\$0	\$100,000	\$35,000	(\$105,000)
8	\$100,000	\$0	\$100,000	\$35,000	(\$70,000)
9	\$100,000	\$0	\$100,000	\$35,000	(\$35,000)
10	\$100,000	\$0	\$100,000	\$35,000	\$0
Total	\$1,000,000	\$1,000,000			

The deferred tax liability is a different sort of liability because the tax is not really owed to the government. As far as the IRS is concerned, the only tax due is the current portion of the tax expense that is calculated on the current year’s tax return. However, it is an expense that the Company has included in income tax expense for ratemaking purposes.

The main issue being discussed in this case is whether the ADIT balances should be prorated or not prorated when the Company forecasts its test year for rate base. And, if the Commission agrees with Xcel that proration of the ADIT balances is required because of the federal tax code, must the true-up also be calculated using the proration method when adjusting for actual ADIT.

Xcel provided the following data in its TCR filing which illustrates the effect proration will have on ratepayers. A simple comparison of the Company’s January forecasted monthly deferred tax expense to the Company’s prorated deferred tax expense would produce the following results:

Month	Proration Factor	Forecasted Monthly Deferred Tax Expense	Prorated Deferred Tax Expense	Difference
Jan	0.917808	\$815,944	\$748,880	\$67,064

Under the Company’s proposal to use proration of the forecasted monthly deferred tax expense,

²⁰ Public Utility Accounting, Theory and Application, James Suelflow, pp. 116-117.

ratepayers would pay \$815,944 in tax expense and receive an ADIT offset of \$748,880. As can be seen from this example, if this data were turned into a journal entry for accounting purposes, the debits and credits would not be in balance. The remaining \$67,604 would be a permanent difference. The permanent differences could be a substantial burden on ratepayers especially in the context of the rate case.

It is Staff's opinion that the ADIT proration issue requires further development before the Commission makes a decision on this issue. As of the date of the Commission meeting there are several proceedings in progress that seek to address the ADIT issue and arrive at a definitive answer as to how proration of ADIT and proration of the ADIT true-up should be treated.

Otter Tail Power Rate Case

The issue of ADIT proration was also raised by interested parties in Otter Tail Power's (OTP) currently pending rate case.²¹ Due to timing this issue was not addressed in either parties comments. The issue in OTP's case is similar, if not identical to the issues raised in Xcel's rate case. To resolve the issue in OTP's rate case, the Department, OAG and Company agreed to submit a PLR request to the IRS to have a firm and definitive ruling on the issue.

The goal of interested parties is to develop the request for a PLR and submit it to the IRS by the end of December 2016. OTP stated that based on its experience and general IRS practice, a PLR should be issued by June of 2017. The procedure and timeline outlined by OTP provides that all stakeholders would have an opportunity to provide input for the PLR request prior to submission to the IRS.

It is anticipated that the parties would still present their arguments addressing the ADIT proration issues following the same timetable in the rate case, while recognizing that the process to obtain a PLR is in progress. The Company stated that the Commission would not be prevented from resolving all other issues presented in the OTP rate case, other than those included in the PLR. OTP stated that while this procedure is not typical, it believes that receiving guidance from the IRS merits the use of this process.

OTP additionally stated it would agree to an extension of the time period for resolving the rate case to accommodate the process. The Company also stated that an outside time limit, such as August 31, 2017 would be established for the receipt of the PLR. If the outside time limit passes without receipt of the PLR, the ADIT proration issue in the rate case would be decided based on the information available. Final rates would not be established and interim rates would remain in effect during any extension of time used to accommodate this process.

For additional information about the disputed ADIT prorate issue and the request for a PLR in the OTP rate case, in Docket No. E-017/GR-15-1033, please see the initial briefs submitted on November 8, 2016: (1) OTP initial brief, pp. 70-81, (2) DOC initial brief, pp. 26-39, and (3) OAG initial brief, pp. 29-31. (Reply briefs were filed on Dec. 1, 2016.)

²¹ Docket No. E-017/GR-15-1033.

Joint Consumer Advocates Intervention at FERC

On November 23, 2016, the Joint Consumer Advocates (JCAs)²², which includes the Minnesota Department of Commerce, filed a motion to intervene at FERC. The JCAs represent the parties whom the entire industry and its regulators are supposed to serve, and are not just another representative of a particular party, trade association, or economic interest group. The JCAs represent customers of the MISO Transmission Owners, and accordingly, have interests through the rates that are affected by the outcome of the FERC proceeding. The JCAs assert that ADIT must be handled appropriately to avoid unnecessarily and unreasonably increasing rates for ratepayers by millions dollars, despite that fact that utilities are not paying any additional costs.

The JCAs recommend that FERC deny Ameren Services Company's and Xcel Energy Services Inc.'s request to modify their Attachment O formula rates, specifically their changes to the true up that would allow continued prorated instead of non-prorated actual ADIT amounts. Additionally, the JCAs recommend that FERC deny Ameren Services Company's and Xcel Energy Services Inc.'s inclusion of true-ups related to 2016 transmission rates, which is inconsistent with FERC's Orders and would be retroactive ratemaking.

The Joint Consumer Advocates also recommend that FERC not allow any ADIT proration, and would support a technical conference to further address this ADIT prorate issue and the related negative impact to ratepayers due to changes to long-standing ratemaking and accounting policies. However, since FERC has allowed ADIT proration for the forecasted amounts, it is critical that FERC require a true-up to non-prorated ADIT amounts once actual amounts are known (i.e. are historical figures, no longer forecasted), so that ADIT proration is only a timing issue and not a permanent overcharging of ratepayers. Staff is unsure about the timing of a decision by the FERC Commission.

(For more information, please see FERC Docket No. ER17-305-000)

Xcel Settlement in Rate Case

The Department and Xcel reached a settlement on all of the financial issues in the rate case and that is why the issue is being discussed in this proceeding. Because Staff is not privy to the terms of the black box settlement, some of the questions the Commission may want to ask Xcel at its December 8, 2016 agenda meeting in regards to the rate case settlement:

- Does the settlement change the way ADIT has been treated in the past?
- An explanation as to what would have been the financial effect if its proposal was approved in the rate case.
- What would be the effect of the Company prorating its forecasted ADIT balances while

²² The Joint Consumer Advocates include: Illinois Citizens Utility Board, Indiana Office of Utility Consumer Counselor, Iowa Office of Consumer Advocate, Michigan Citizens Against Rate Excess, Minnesota Department of Commerce, Minnesota Attorney General's Office, Missouri Office of the Public, and the Citizens Utility Board of Wisconsin.

maintaining proration in the true-up?

- How much would benefit Xcel and its shareholders vs. the benefit to its ratepayers?

The Commission may also want to ask Xcel to address these issues in its next TCR filing.

Xcel PLR

In an e-mail dated November 29, 2016 Xcel stated its intention to seek guidance from the IRS regarding the correct interpretation of their requirement to prorate the accumulation of current year ADIT in rate base when implementing a projected test year rate as well as a true-up of that rate. Xcel stated its goal is for the IRS response to clarify the interpretation and ensure that customers continue to benefit from the reduction in rate base provided by income tax normalization. It is anticipated the PLR request would be done in consultation with PUC staff and the Department, much like OTP's proposal. However, staff does not believe formal written authorization from the Commission in the form of an order is necessary for Xcel (or OTP) to submit its request for a PLR from the IRS. Staff believes it would be sufficient for the parties to the proceeding to stipulate to the request for the PLR and PUC staff may only need to be consulted.

Historical Costs

Staff would like to note that the Department's recommendation to allow rider recovery based on historical costs is appealing. It is staff's experience that Xcel's rider filings usually turn into a small rate case. As shown in this briefing paper regarding the ADIT issue, the issues Xcel tends to raise in its riders are complex and time consuming for both the Department and PUC staff to deal with. In Xcel's last TCR rider filing²³ the Company asked the Commission for "guidance" as to when to recover the revenue requirements associated with two TCR eligible projects located out of state, the Couderay to Osprey project located in Wisconsin and the Big Stone to Brookings project located in South Dakota. This guidance was requested after the Company had made a written commitment in its most recent rate case to not seek rider recovery for any new projects through the TCR rider during the duration of its Multi-Year Rate Plan (MYRP).²⁴

²³ Docket No. E-002/M-14-852.

²⁴ Docket No. E-002/GR-13-868.

Decision Alternatives

ADIT Proration

1. Confirm proration is required in the TCR rider and defer the decision of proration at true-up to a later proceeding. (Xcel preferred)
2. Defer the entire ADIT proration decision. (Xcel second preference)
3. Order the Company to not prorate ADIT in general or at true-up. (Xcel third preference, Department preferred)
4. Allow the Company to prorate ADIT only for recovery of forecasted costs (costs that are not historical, actual costs at the time the rates go into effect) and, require a true-up in the following year (once all amounts are historical/actual) by using actual non-prorated ADIT amounts. (Department second preference)
5. Either deny rider recovery or limit rider recovery to historical costs, as both of these approaches would eliminate the need to prorate ADIT balances. (Department third preference)

2016 Revenue Requirement

6. Approve the 2016 proposed revenue requirement of approximately \$78.4 million for recovery through the TCR rider. (The revenue requirement may fluctuate up or down when the Company updates its forecasted numbers with actual numbers.) A large change in the revenue requirement would be brought to the Commission's attention. (Xcel preferred, DOC)
7. Approve the 2016 proposed revenue requirement of approximately \$78.4 million for any decision the Commission make related to proration of ADIT (in alternatives 1 through 5) for recovery through the TCR rider. (The revenue requirement may fluctuate up or down when the Company updates its forecasted numbers with actual numbers.) A large change in the revenue requirement would be brought to the Commission's attention. (Xcel preferred, DOC)
8. Do not approve the Company's 2016 proposed revenue requirement of approximately \$78.4 million for recovery through the TCR rider and allow the Company to continue collecting at its current level of approximately \$64 million. (Xcel second preference)

9. Approve the Company's initially proposed revenue requirement of \$19.2 million. The reduction of the revenue requirement would account for projects that are proposed to be moved into base rates at the completion of the rate case. Under-collection would be accounted for in a true-up in the Company's next TCR rider filing (Staff alternative)

True-up and Tracker

10. Approve the 2015 TCR True-up and Tracker balance report and carryforward of the 2015 tracker balance. (The true-up may fluctuate up or down when the Company updates its forecasted numbers with actual numbers.) A large change in the revenue requirement would be brought to the Commission's attention. (Xcel, DOC)
11. Do not approve the 2015 TCR Tracker True-up and Tracker balance report and carryforward of the 2015 tracker balance.

2016 TCR Adjustment Factors

12. Approve the resulting TCR Adjustment Factors by class to be included in the Resource Adjustment on bills for Minnesota electric customers. (Xcel, DOC)
 - A. Authorize Xcel to recalculate, as needed, the TCR adjustment factors based on a twelve-month period. OR
 - B. Authorize Xcel to recalculate the TCR adjustment factors based on some other length of time.
13. Do not approve the resulting TCR Adjustment Factors by class to be included in the Resource Adjustment on bills for Minnesota electric customers for the 12 months beginning January 1, 2016 and allow the Company to continue collecting its revenue requirement at the rates currently in effect. (Xcel alternative, Department alternative)

Tariff Sheets & Customer Notices

14. Approve the Company's proposed revised tariff sheet and proposed customer notice. (The TCR adjustment factors in the tariff and proposed customer notice may fluctuate up or down based on the Commission's decisions.) (Xcel, DOC)
15. Do not approve the Company's proposed revised tariff sheet and proposed customer notice.

Compliance Filing

16. Require the Company to submit a compliance filing updated to reflect the Commission's decisions in the Order and updating the forecasted numbers with actual numbers within 10 days from the date the Commission's Order is issued. (Xcel, DOC)

17. Do not require the Company to submit a compliance filing updated to reflect the Commission's decisions in the Order and updating the forecasted numbers with actual numbers within 10 days from the date the Commission's Order is issued.

Recommendation

4, 9, 10, 12B, 14, 16