

## Staff Briefing Papers

Meeting Date August 8, 2019

Agenda Item 4\*\*

Company CenterPoint Energy Resources Corp., d/b/a CenterPoint Energy Minnesota Gas

Docket No. **G-008/AI-18-517**

**In the Matter of the Petition of CenterPoint Energy Resources Corp., d/b/a CenterPoint Energy Minnesota Gas, for Approval of an Affiliated Interest Agreement between CenterPoint Energy Minnesota Gas and Minnesota Limited**

- Issues
1. Should the Commission approve CenterPoint Energy's contract with Minnesota Limited as an Affiliated Interest Agreement?
  2. How should the Commission address recovery of costs incurred under this contract that are beyond the scope of work covered by the initial agreement between CenterPoint Energy and Minnesota Limited?

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### Relevant Documents

#### Date

CenterPoint Energy – Initial Filing (TS)	July 30, 2018
CenterPoint Energy – Stipulation	October 26, 2018
Minnesota Public Utilities Commission - Order	January 14, 2019
Department of Commerce – Comments (TS)	March 19, 2019
CenterPoint Energy – Reply Comments (TS)	April 3, 2019

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



## Relevant Documents

## Date

Department of Commerce – Response to Reply Comments – Revised  
(TS)

May 13, 2019

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## **I. Statement of the Issues**

Should the Commission approve CenterPoint Energy's contract with Minnesota Limited as an Affiliated Interest Agreement?

How should the Commission address recovery of costs incurred under this contract that are beyond the scope of work covered by the initial agreement between CenterPoint Energy and Minnesota Limited?

## **II. Introduction**

In its July 30, 2018 petition, CenterPoint Energy Minnesota Gas (CPEM, CenterPoint Energy or the Company) is asking for Commission approval of the Company's existing 2018 Metro Beltline (MBLSE) Replacement Project<sup>1</sup> construction services contract with Minnesota Limited, LLC ("Minnesota Limited"), a non-regulated subsidiary of Vectren Corporation (Vectren).

When this petition was filed on July 30, 2018, CenterPoint Energy, Inc. (CPEI) and Vectren Corporation had not yet merged and, arguably, Minnesota Limited was not yet an affiliate of CPEM. Regardless of the effective date of Minnesota Limited's status as an affiliate of CPEM, after the close of the merger agreement on February 1, 2019, the existing construction services contract between the Company and Minnesota Limited became subject to Minnesota's Affiliated Interest statutes and rules and required the Commission's approval.

In its May 13, 2019 revised response comments, the Minnesota Department of Commerce (Department, DOC) recommended that the Commission:

- Approve CPEM's Construction Contract with Minnesota Limited, and
- Determine that CPEM has not met its burden of proof to establish the reasonableness of costs incurred pursuant to the Construction Contract for projects that were not included in the initial scope of work included in the request for proposals and, that absent a showing in its next general rate case, the Company will not be permitted to recover those costs.

## **III. Background**

On April 23, 2018, CenterPoint Energy, Inc. (CPEI) and Vectren Corporation (Vectren) announced that they had entered into an agreement to merge via CPEI's acquisition of Vectren.

On July 30, 2018, CenterPoint Energy Minnesota Gas (CPEM, CenterPoint Energy or the Company) filed a petition (Petition) with the Minnesota Public Utilities Commission

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<sup>1</sup> The Metro Belt Line project is part of the Transmission Pipeline Replacement Project that was discussed in the most recent rate case (Docket No. G-008/GR-17-285). For additional information on the Transmission Pipeline Replacement Project, please see the testimony of Mr. Talmadge Centers starting at page 32 in docket no. G-008/GR-17-285.

(Commission) seeking approval of an affiliated interest agreement with Minnesota Limited, LLC (Minnesota Limited). CPEM is an operating division of CenterPoint Energy Resources Corp. (CERC), which is a CPEI subsidiary. At the time CPEM filed its Petition, Minnesota Limited was a non-regulated, subsidiary of Vectren, and the CPEI's acquisition of Vectren was still pending.

On October 26, 2018, CPEM filed a Stipulation committing the Company to a number of conditions and reporting requirements related to the proposed Vectren acquisition.

On January 14, 2019, the Minnesota Public Utilities Commission (Commission) issued an informal order in this docket approving the Stipulation and asking the Minnesota Department of Commerce (Department, DOC) to move forward with considering the Petition's merits.

On February 1, 2019, CPEI announced the merger's completion, at which point Vectren became a wholly owned CPEI subsidiary.

On March 19, 2019, the Department submitted its comments.

On April 3, 2019, CPEM submitted its reply comments.

On May 13, 2019, the Department submitted its revised response to CPEM's reply comments.

## **IV. Related Matters**

On April 29, 2019, CPEM submitted its request for approval of its 2019 MBLSE Replacement Project contract between the Company and Minnesota Limited, in Docket No. G-008/AI-19-292. This matter is pending.

## **V. Relevant Statutes and Rules**

### **A. Minnesota Statute § 216B.48. Relations with Affiliated Interest.**

Minn. Stat. §216B.48, subd. 1(6) defines "affiliated interests" to include:

every corporation or person which the commission may determine as a matter of fact after investigation and hearing is actually exercising any substantial influence over the policies and actions of the public utility even though the influence is not based upon stockholding, stockholders, directors or officers to the extent specified in this section;

Minn. Stat. §216B.48, subd. 3 states (in part):

No contract or arrangement, . . .providing for the furnishing of management, supervisory, construction, engineering, accounting, legal, financial, or similar services . . . is valid or effective unless and until the contract or arrangement has received the written approval of the commission. . . . The commission shall approve the contract or arrangement made or entered into after that date<sup>2</sup> only if it clearly appears and is established upon investigation that it is reasonable and consistent with the public interest. . . . The burden of proof to establish the reasonableness of the contract or arrangement is on the public utility.

Minn. Stat. §216B.48, subd. 6 states (in part):

The commission shall have continuing supervisory control over the terms and conditions of the contracts and arrangements as are herein described so far as necessary to protect and promote the public interest. . . The fact that the commission shall have approved entry into such contracts or arrangements as described herein shall not preclude disallowance or disapproval of payments made pursuant thereto, if upon actual experience under such contract or arrangement it appears that the payments provided for or made were or are unreasonable.

## **B. Minnesota Rules 7825.1900-7825.2300**

These rules set the definitions, regulation procedure, filing requirements and record standards for Commission review and approval of affiliated interest agreements.

## **VI.CenterPoint Energy Minnesota Gas’ Petition**

### **A. Description of Contract**

According to CenterPoint Energy, the scope of the work covered by this contract included:

[A]ll supervision, labor and equipment to install approximately 16,180 feet of 24-inch diameter high pressure steel pipe and three below grade vaults and associated piping and regulator work at three locations within the project scope in the City of Golden Valley.<sup>3</sup>

The work included two railroad crossings and one pedestrian tunnel crossing with 24-inch diameter steel pipe installed via augur bore. Also included was the removal and disposal of some existing abandoned pipeline and existing below grade vaults. Additionally, regulations require that the new high-pressure steel piping be pressure tested with nitrogen to establish a 215 pounds per square inch gauge (psig) maximum allowable operating pressure (MAOP).

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<sup>2</sup> January 1, 1975 for “every subsidiary of a public utility” or August 1, 1993 for “every part of a corporation in which an operating division is a public utility”.

<sup>3</sup> CPEM Petition, July 30, 2018, page 4.

## **B. Reasons Why the Contract is in the Public Interest**

According to CenterPoint Energy, the contract was necessary in fulfilling the Company's obligation to comply with United States Department of Transportation, Pipeline and Hazardous Materials Safety Administration's ("PHMSA") rules and requirements for repair or replacement of large transmission line segments identified through CPEM's Transmission Integrity Management Plan. The Company asserted that, due to the critical nature of the work, it needs to use skilled workers to replace transmission pipe that was originally installed in the 1950s.

Minnesota Limited has prior experience<sup>4</sup> working on CPEM's distribution system and is one of the largest transmission pipeline contractors in this region. The Company stated that it is in the public interest to have qualified and able resources to reliably complete its pipeline replacement projects. The Company stated that Minnesota Limited also provides maintenance services for pipeline systems, which has included valve maintenance, re-coating, sleeving, line lowering, pipeline markers, anomaly investigation and right-of-way clearing.

Finally, CPEM used a competitive bid process to select Minnesota Limited.

## **C. Contract Compensation and the Competitive Bidding Process**

The Company stated that, at the time of the petition, the total cost was not known, but that the target cost was estimated to be no more than \$13 million. CPEM pointed out that the work performed will be capitalized and subject to review in a future rate case.

CPEM stated that its Purchasing and Construction/Contract Services departments initiated a request for proposals on February 14, 2018 and five vendors serving the Midwest were invited to bid. Project design specifications were listed in the bid document, along with line item quantities and lump sum price requirements. The Company asserted that it compared costs and available capacity to determine the best value relative to cost, service, and expertise.

The Company noted that the work involved in the contract is utility work in Minnesota with no inclusion of work for CPEM's non-regulated business lines and does not include any corporate costs allocated from CenterPoint Energy Service Company, LLC. Thus, CPEM states that it was not necessary to change CPEM's cost allocation manual (CAM) as a result of this filing.

The Company concluded by requesting Commission approval of the construction contract between the anticipated affiliates CenterPoint Energy Minnesota Gas and Minnesota Limited.

## **VII. Department of Commerce Comments**

On March 19, 2019, the Department submitted its comments.

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<sup>4</sup> 2014 MBLSE Replacement Project with \$21.5 million target value, 2015 MBLSE Replacement Project Construction at \$27.0 million, 2016 MBLNW Replacement Project Construction at \$29.0 million, and 2017 Belt Line Replacement Projects Construction at \$26.0 million. Source: CPEM Petition, page 5, footnote 4.



## **A. Statutory and Filing Requirements for Affiliated Interest Agreements**

The Department noted that, pending completion of the merger, CPEI's and Vectren's April 21, 2018 Agreement and Plan of Merger placed restrictions on Vectren's dividend payments to its shareholders pending the completion of the merger,<sup>5</sup> and therefore, any excess profits would have accrued to CPEI. The Department stated that this gives a financial incentive for CPEI to inflate earnings at Minnesota Limited (Vectren's subsidiary) by paying above market prices for its construction services contract. At the very least it would lessen incentives for CPEI to control those costs. The Department believes that Minnesota Limited had substantial influence over CPEM's business decisions when the merger agreement was executed and, thus, CPEM and Minnesota Limited became affiliates at that time.

The Department asserted that, for regulatory purposes, the contract between the affiliated parties will only be effective if the Commission approves it and that should occur only if the contract's terms, conditions, and prices are reasonable and in the public interest.

The Department concluded that the petition meets the filing standards of Minn. Rule 7825.2200, B and the Commission's September 14, 1998 Order in Docket No. E,G-999/CI-98-651.

Additionally, the Department concluded that the Company reasonably addressed cost savings, ratepayer benefits, and changes to the cost allocation manual, as required in the Commission's July 11, 1996 Order in Docket No. G-008/AI-96-37.

## **B. Department Analysis of the Affiliated Interest Agreement**

### **1. Initial Scope of the Construction Contract**

In response to Department Information Request (IR) No. 12, the Company stated that it sought an outside contractor for the MBLSE Replacement Project because CenterPoint Energy lacks the necessary staffing level and certain necessary equipment to complete the job itself.

In its Petition, CPEM briefly described its process for selecting a vendor and that, initially, five vendors were issued a Request for Proposals (RFP). In its response to DOC IR No. 11, the Company stated that its Operations and Procurement staff identified the five vendors based on the contractors meeting insurance and credit requirements; possessing necessary licenses, certifications, and technical qualifications; prior experience with similar work in the industry; and having a presence in Minnesota.

In its DOC IR No. 13 response, the Company stated that three vendors submitted bids, which were then compared on cost and other factors, specifically, the available capacity to complete the work within designated parameters.

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<sup>5</sup> See CenterPoint Energy Minnesota Gas', Initial Comments, Attachment 2, Agreement and Plan of Merger, August 29, 2018.

The Department reviewed the three bids, the bid evaluation spreadsheet, and the bid recommendation and concluded that, pertaining to the initial scope of work, CPEM's process was reasonable, as was its selection of Minnesota Limited.

The Department noted that, in order to protect ratepayers against cost overruns, the MBLSE project was divided into a number of subparts with bidders providing costs estimates on a subpart basis. Also, CPEM protected ratepayers by requiring a change order process to prevent the contractor from performing unauthorized work. The Company also developed a target value for the work which served as a benchmark to evaluate actual costs.

The Department observed that the initial scope of work included in the RFP had a target value of \$13.0 million and requested that CPEM provide the actual costs incurred in its reply comments.

## 2. Additional Construction Services Provided Under the Contract

The Company explained, in its response to DOC IR No. 27, that it added several projects to the initial scope of work, resulting in a total target value increase from \$13.0 million to \$22.5 million.

The table below shows the target values and total spend for each line item, which are explained in more detail below the table:

**Table 1: Target Value Versus Actual Spend (in \$ millions)<sup>6</sup>**

Project	Target Value	Actual Spend
Belt Line Project at Golden Valley Road	13.0	
Additional Belt Line Segment	6.0	
Distribution Pipeline Construction	1.6	
Pipeline Integrity Digs	1.2	
Funding for Anticipated Cost Adjustments	0.7	
Total	22.5	20.7

<sup>6</sup> Department Comments, March 19, 2019, p. 7.

### Belt Line Project at Golden Valley Road

The scope of the original work, described above on pages 4-5, section VI. A.

### Additional Belt Line Segment

A 3,200-foot segment of 24-inch steel belt line in Minneapolis. This was added to the contract via a change order signed in September, 2018.

### Distribution Pipeline Construction

Three additional projects added via change orders.

### Pipeline Integrity Digs

Authorized by CPEM, but not until after the contract approval process, but billed by contractor at unit rate specified in the contract. Department noted that there did not appear to be a change order for these digs.

### Funding for Anticipated Cost Adjustments

This was the only description provided by the Company in its response to the IR.

Finally, DOC noted that there was an additional change order related to the final grading, but CPEM did not request additional funding for this change order.

The Department expressed concerns related to the additional work assigned in this contract. First, the additional target value of \$9.5 million represents almost 75% of the target value of the original scope (42% of the final total target value), yet the work was not competitively bid. Second, the information CPEM supplied in its response to the No. 27 IR was not enough to determine how the target values were derived. DOC requested that the Company provide, in its reply comments, an explanation of why it was reasonable to assign this large volume of work to a single contractor, particularly an affiliate, without using an additional bidding process. Also, the Department requested additional information on how the target values were set for the additional belt line work and the change orders associated with the distribution pipeline construction.

Further, the Department requested information on the pipeline integrity digs, why the work was not identified before contract approval, and whether the Company required a change order to amend the original contract. The DOC also requested an explanation for the line item "Funding for Anticipated Cost Adjustments" and how the \$0.7 million cost estimate was set.

Lastly, the Department asked that the Company provide, in reply comments, the actual spend per line item, so that it can be compared to the target values by line item.

## **C. Department Conclusion**

While the Department determined that the original contract scope and the CPEM contractor selection process appeared to be reasonable, it requested that the Company, in its reply comments, provide the following additional information:

1. A justification of why it is reasonable to assign such a large volume of additional work to one vendor, especially an affiliate.

2. An explanation of why the pipeline integrity digs were not identified before the original contract was approved and why no change orders were issued.
3. A description of how target values were set for Additional Belt Line Segment work and Distribution Pipeline Construction change orders.
4. Lastly, the actual costs per line item for a more granular comparison to target values.

The Department stated that it would provide a final recommendation to the Commission as soon as practicable after it reviewed the information provided by CPEM in reply comments.

## **VIII. CenterPoint Energy Minnesota Reply Comments**

On April 3, 2019, CenterPoint Energy submitted reply comments.

### **A. The Company and Minnesota Limited Are Affiliated Interests**

The Company stated that it originally submitted the instant petition as a proactive measure because it believed that it was possible that Minnesota Limited would become an affiliate of CPEM during the course of the construction contract. Further, the Company acknowledged that the parties became affiliated on the date of the merger transaction, coinciding with termination of the construction contract.

However, the Company disputed the Department's contention that "Minnesota Limited had substantial influence over business decisions made by [the Company once the Merger Agreement was executed] and, as a result, became an affiliated interest at that time."<sup>7</sup> CPEM further disputed the DOC contention that Minnesota Limited had "substantial influence" over the Company's business decisions simply because Minnesota Limited and the Company would eventually become affiliates. The Company said:

The Department suggests that Section 5.01(a) of the Transaction Agreement, a standard provision designed to ensure that a company that may be acquired does not dissipate its assets prior to close, allowed Minnesota Limited to exercise substantial influence over the Company, thereby meeting the definition of an affiliated interest under Minn. Stat. 216B.16, subd. 1(6). However, Section 5.01(a) merely ensured that pending the closing of the Transaction, Vectren would not issue dividends over and above what it normally issued in the regular course of business.<sup>8</sup>

Below are the Company's responses to the Department's specific questions from its March 19, 2019 comments.

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<sup>7</sup> Department Comments, March 19, 2019 at p. 2.

<sup>8</sup> CPEM Reply Comments, April 3, 2019, page 2, footnote 1.

## **B. The 2018 Construction Contract Is Reasonable and Consistent with the Public Interest and should be Approved<sup>9</sup>**

### **1. The Selection of Minnesota Limited and the Initial Scope of the Construction Contract Was Reasonable**

The Company stated that the Department noted the following ratepayer protections in its comments:

- Incorporation of pricing by subparts in order to protect CPEM and ratepayers from cost overruns.
- Clear descriptions of work to be completed, which allowed for bidders to develop comprehensive price estimates.
- A change order process to prevent the contractor from performing work not authorized by the Company and protection against paying for defective work.
- Target values, using per unit pricing and estimated units of work per the Company's engineering judgement, to serve as a benchmark to evaluate actual costs at the end of the project.

The Company agreed with the Department that the RFP process and the contract contained appropriate, reasonable ratepayer protections. CPEM stated that Minnesota Limited's execution of the initial scope was also reasonable and pointed out that the work was completed early and under-budget. Total costs for the initial scope were approximately \$12.7 million compared to a target value of \$13 million. The Company asserted that, based on Minnesota Limited's performance on the initial scope, it was prudent to add to the scope of activities under the construction contract.

### **2. The Additional Services Provided Under the Contract Were Reasonable and In the Public Interest.**

The Company acknowledged that several additional projects were added to the construction contract, raising the target value from \$13.0 million to \$22.5 million. Per the Department's request,<sup>10</sup> CPEM supplied the following table with actual costs at a line item level:

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<sup>9</sup> CPEM Reply Comments, April 3, 2019, pages 2-7.

<sup>10</sup> Department Comments, March 19, 2019 p. 7.

**Table 2: 2018 Construction Contract Estimated and Actual Costs<sup>11</sup>**

Initial Construction Contract			
Initial Scope of Work	Engineering Est.	Target Value	Actual Costs
14,500-foot Beltline Segment	[TRADE SECRET DATA HAS BEEN EXCISED]	\$13.0 Million	[TRADE SECRET DATA HAS BEEN EXCISED]
Additional Scope Added to Construction Contract			
Additional Projects Added to Scope	Engineering Est.	Target Value	Actual Costs
1) 3,300-foot Beltline Segment (24-inch Steel)	[TRADE SECRET DATA HAS BEEN EXCISED]	\$6.0 Million	[TRADE SECRET DATA HAS BEEN EXCISED]
2) Large-Diameter Distribution Work		\$1.6 Million	
3) 27 Pipeline Integrity Digs		\$1.2 Million	
4) Funding for Anticipated Cost Adjustments		\$0.7 Million	
<b>Total</b>		<b>\$22.5 Million</b>	<b>\$20.64 Million</b>

#### a. Competitive Bidding for Additional Scope

The Department had requested the Company explain why it was reasonable to assign a large volume of construction work to a single contractor, particularly an affiliate, without using a bidding process to ensure that the costs were reasonable.

The Company responded by, first, disputing that Minnesota Limited became an affiliate before the close of the merger transaction. Then, CPEM stated that assignment of additional work was reasonable due to four factors.

1. CPEM had a longstanding relationship with Minnesota Limited and that, if time allows, it was standard practice to use the beltline contractor for similar-scope projects within the annual construction season. The Company “has been satisfied with the quality, cost and timing of Minnesota Limited’s work, and nothing about the Transaction altered the ongoing relationship between the two companies”.<sup>12</sup> CPEM stated that it was standard practice to utilize its beltline contractor for similar-scope projects that can be completed within the annual construction season, if time allowed. The Company stated that this practice benefits CPEM and its customers by incenting the contractor to complete its work on-time or ahead of schedule and allows CPEM to maximize Minnesota’s short construction season.
2. There was no need for bidding the additional scope since the work was priced at the terms of the competitively bid construction contract<sup>13</sup>. Further, the Company asserted that it was able to secure 2019-scheduled work in 2018, and at 2018 prices.

<sup>11</sup> CPEM Reply Comments, April 3, 2019, p. 3.

<sup>12</sup> CPEM Reply Comments, page 4.

<sup>13</sup> CPEM Reply Comments, page 4 footnote 2. “After the Construction Contract was executed, four minor changes were made to incorporate additional per unit pricing: the contract was amended in June

3. The Company asserted that Minnesota Limited “is one of very few qualified large-diameter pipeline installers that operates within the state of Minnesota”.<sup>14</sup> CPEM pointed out that only three vendors responded to its 2018 RFP and one of them was still engaged on work the Company had already assigned it for the 2018 season. Minnesota Limited had the equipment and the expertise to install larger diameter pipe segments. Further, CPEM said that is unclear whether any other vendors would have bid on this late-season work.
4. It was necessary to add the pipeline integrity digs because that work was federally required to be done within certain time periods, some as short as within five days of discovery.<sup>15</sup>

#### **b. Target Values for Additional Scope**

The Department had requested that CPEM provide an explanation of how it derived the \$6.0 million target value associated with the additional beltline work and also, the \$1.6 million target value for the three smaller change orders. The Company stated that the target values were based on an internal estimate of the cost of each piece of work, plus necessary contingencies, using the prices established by the contract and project information that was available at the time.

For the additional beltline segment, the engineering cost estimate totaled \$3.9 million, based on the Company’s best engineering judgment at the time the work was designed. The Company internally requested \$6.0 million as a budget for this project. The \$6.0 million was only used internally for budgeting and approval purposes, and that number was not given to Minnesota Limited.<sup>16</sup>

For the three distribution projects, the Company’s engineering estimate was \$1.5 million. Minnesota Limited completed the work at the Construction Contract rates, but CPEM had requested cost estimates based on contract rates from Minnesota Limited to facilitate a comparison with internal engineering estimates before the work actually began.

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2018 to include pricing for final grading of the project areas; and in September 2018, the contract was amended to adjust for the per foot cost of trenched 24-inch diameter steel due to a change in the construction environment (suburban to urban); add a cost per four-way offset; and to add a cost for directional boring per lineal foot of useable pipe.”

<sup>14</sup> CPEM Reply Comments, page 5.

<sup>15</sup> See 49 C.F.R. 192.933 (listing actions required to address integrity issues).

<sup>16</sup> CPEM noted that it had inadvertently used the terms “Target Value” and “Authorized Funding” interchangeably in its Response to DOC IR 27. These terms can be, but are not necessarily, interchangeable. “Target Value” is a value used internally at the Company to best estimate the project cost, based on the engineering estimate and use of contingency funds. The term “Funding Request” or “Authorized Funding” is also a value used internally at the Company to refer to the formally approved project budget. CPEM Reply Comments, page 6, footnote 4.



### **c. Funding for Anticipated Cost Adjustments**

The Department requested that the Company explain the line item “Funding for Anticipated Cost Adjustments” and how it derived the \$0.7 million estimate that appeared in CPEM’s discovery response. The Company stated that this additional \$700,000 was added to the Fund Request submitted for the \$1.6 million for distribution work to provide an overall contingency amount if, due to unforeseen circumstances, the amount invoiced exceeded the amount previously funded for all of Minnesota Limited’s work. The amount was chosen based on an assessment of the invoices that CenterPoint Energy had received as of the date the Fund Request was submitted compared to a prediction of the amount that was yet to be billed. Minnesota Limited was not aware that this money was available if needed.

### **d. Pipeline Integrity Digs**

The Department requested an explanation of the pipeline integrity digs, the \$1.2 million cost estimate, why those digs were not identified until after the contract process was complete, and if the digs required a change order. The Company explained that the estimate for these digs was based on an estimate by CPEM engineers using an average cost per dig. Due to increased number and complexity of digs, the actual spend for this project was \$2.34 million. The Company further noted that most of the pipeline integrity digs were required within five days of receipt of inspection results and all of them needed to be done before the heating season to safely operate system pressures during the colder months. A change order was not required because the Company and the vendor agreed on the scope of the work to be performed and the pricing. Change orders are done to ensure agreement on scope and pricing.

## **C. Conclusion**

CPEM concluded that its selection of Minnesota Limited for continued beltline construction in 2018 and the terms of the contract were prudent and reasonable, as was CPEM’s decision to assign additional work under the contract’s competitively-bid terms. The Company further stated that all work performed was necessary and all costs incurred were reasonable. Therefore, CPEM requests Commission approval for its affiliated interest contract with Minnesota Limited.

## **IX. Department of Commerce Response Comments**

On May 2, 2019, the Department submitted response comments.

### **A. Analysis of Actual Cost of Initial Scope of Work Included in the RFP**

According to the Department, in Table 1 of its Reply Comments, the Company indicated that the actual costs to complete the initial scope of work included in the RFP was less than the \$13.0 million target value (including the contingency amount) estimated prior to beginning construction. Based on this information, and on the Department’s analysis, the Department concluded that the actual costs of the initial scope of work included in the RFP were reasonable.



## **B. Additional Work Assigned to Minnesota Limited after the Initial Scope of Work was Completed**

### **1. Assignment of Additional Work without a Bidding Process**

After the initial scope of work, the Company added an estimated \$9.5 million of additional construction work, increasing the amount by 73 percent and bringing total estimated costs to \$22.5 million.

The Department stated that it understood that the Company has a long successful history of construction contracts with Minnesota Limited and is satisfied with the quality, cost, and timing of its work. The DOC also recognized that there are a limited number of qualified construction contractors to meet CPEM's needs. However, when CPEM's parent acquired Minnesota Limited's parent it changed the financial incentives in a significant way, requiring greater scrutiny and oversight from the Commission to protect ratepayers from possibly excessive costs. The Department claimed that CPEM has not provided enough information to determine that the costs of the additional construction work assigned to Minnesota Limited were reasonable.

### **2. Analysis of Estimated and Actual Costs of Work Added to the Scope of the Construction Contract**

The Department noted that it was able to conclude that the initial scope of work included in the RFP was reasonable and that the actual costs incurred were also reasonable because these conclusions were:

based on the thorough evaluation process the Company used to develop detailed cost estimates based on bids provided by the construction companies, which allowed for meaningful comparisons to be made between bidders. In other words, the RFP process developed an informed cost estimate for the initial scope of work, which provided a sound basis for the Department to evaluate the reasonableness of the actual cost to the work.<sup>17</sup>

The Department observed that it was hoping to apply similar techniques when it asked the Company to provide in reply comments "all information necessary to demonstrate how it derived" the target values (i.e. the initial cost estimates including contingencies) for the additional construction projects assigned to Minnesota Limited. If the Department could evaluate whether those target values were reasonable, then it could use them as benchmarks to evaluate reasonability of the costs of the additional projects.

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<sup>17</sup> Department Response Comments, May 13, 2019, page 3.

The Department found that CPEM's reply comments only contained a very general description of the process used<sup>18</sup>, which was not enough information to show how it established its initial cost estimates. Further, in its trade-secreted Exhibit 1 to CPEM's reply comments, the Company only provided high-level cost estimates that did not allow for any type of comparison to per-unit prices established under the Construction Contract. This is particularly problematic since one of CPEM's main justifications for not seeking bids on the additional work was that it was priced at the rates tested under a bidding process in the Construction Contract. These factors prevented DOC from assessing the reasonableness of those estimates.

Also, the Company's Reply Comments clearly stated that the largest project added to the scope of the Construction Contract (the 3,300-Foot Beltline Segment) involved work where unit prices had not been established in the Construction Contract.<sup>19</sup> Instead, CPEM established unit prices for three types of work via a change order: 1) a price per foot of 24-inch trenched steel main in an urban environment, 2) a price per four-way offset, and 3) a price per lineal foot of directional boring.<sup>20</sup>

The Department pointed out that, if these newly established prices accounted for a significant percentage of the initial cost estimate, then it was not reasonable to rely on a competitive bidding process to establish reasonableness, since a potentially significant portion of the costs were not subject to competition.

Additionally, the Department stated that, even if most of the added work was priced using the Construction Contract, since the initial scope bids were evaluated at a total project level instead of the sub-project level, the per-unit prices by the three bidders could not be compared "head-to-head". Minnesota Limited's per-unit prices were lower than other bidders on some types of work, but higher on others. So, depending on the mix of work performed, a different contractor may have been able to perform the totality of work more cost-effectively. Finally, the Department said that CPEM did not provide enough information to fully evaluate price differences of the 3,300 Foot Beltline Segment project that was added through change order, or any other projects added to the scope of the Construction Contract.

For the reasons discussed above, the Department concluded that CPEM had not met its burden to show that costs associated with the additional work added to the scope of the Construction Contract was reasonable.

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<sup>18</sup> "The development of the target value for each piece of additional work was similar to the development of the target value for the work identified in the initial scope of the Construction Contract. The target value was based on an internal estimate of the cost of each piece of work, plus necessary contingencies, using information about the project available at the time and the prices established under the Construction Contract.", CPEM Reply Comments, April 3, 2019, Page 5.

<sup>19</sup> CPEM Reply Comments, April 3, 2019, Page 4, footnote 2.

<sup>20</sup> Ibid.

## **C. Other Information Requested**

### **1. Funding for Anticipated Cost Adjustments**

The Department asked the Company to explain the line item “Funding for Anticipated Cost Adjustments” and how it derived the \$0.7 million estimate. CPEM replied<sup>21</sup> that this amount was an additional contingency for all the work to be performed by Minnesota Limited and was based on invoices already received from Minnesota Limited compared to CPEM’s prediction of amounts yet to be billed.

The Department expressed some concern about how CPEM estimated these contingency amounts and observed that there was significant variation on the size of the estimated contingencies. DOC noted that the only project with a significant cost overrun was the Pipeline Integrity digs where actual costs nearly doubled estimated costs and that CPEM’s actual \$20.6 million costs for all of the work performed under the Construction Contract were higher than the initial total cost estimate excluding contingencies.

The Department was unable to conclude that the initial estimate was reasonable and was also unable to conclude that final, actual costs were reasonable.

### **2. Pipeline Integrity Digs**

The Department requested an explanation of how CPEM developed its cost estimate for the pipeline integrity digs, why the digs were not identified until after the contract process was complete, and whether the addition of these digs required a change order. In response, the Company stated that its estimate of total costs was derived from a per-dig estimate, but did not explain how the per-dig estimate was established. CPEM also stated that the digs were done pursuant to integrity inspections that were not available until August, 2018 and some of the anomalies detected by the digs had to be completed within specific time periods, some as little as five days.<sup>22</sup> The Department concluded that this explanation was reasonable.

Regarding a change order, the Company explained that it was not necessary because the parties had agreed on the scope of work and it was priced according to the terms of the Construction Contract. It was not clear to DOC how the contract could have included that associated work, given the fact that the need for the digs was not known until after the contract was signed. In any case, CPEM did not provide enough information to demonstrate how the initial cost estimate was derived and how it related to any of the unit-prices within the Construction Contract. So, the Department was unable to conclude that these costs were reasonable.

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<sup>21</sup> CPEM Reply Comments, April 4, 2019, Page 6.

<sup>22</sup> CPEM Reply Comments, April 4, 2019, Pages 5 and 7.

## D. Conclusions and Recommendations

The Department stated that Minn. Stat. §216B.48, subd. 5 and 6 make clear that approval of an affiliated interest agreement is separate and distinct from approval of the recovery of costs incurred pursuant to that agreement. If the Commission approves the Construction Contract, the Company would still bear the burden of showing that the costs incurred were reasonable in any type of rate-setting where the Company sought to recover those costs from ratepayers.

Based on its analysis detailed above, the Department would have likely recommended that the Commission approve the Construction Contract because CPEM showed that the RFP was reasonable and appeared to contain sufficient and reasonable ratepayer protections.

The Department noted that its analysis of the Construction Contract was initially delayed by the investigation into the potential impact of the Company's merger with Vectren Corporation. Without that delay the Department would likely have made its recommendation prior to the end of the 2018 construction season. The Department also would likely have recommended reporting requirements related to initial scope of work and additional work assigned under the Construction Contract.

In conclusion the Department recommended that the Commission:

- approve CPEM's Construction Contract with Minnesota Limited, and
- determine that CPEM did not meet its burden of proof to establish the reasonableness of costs incurred pursuant to the Construction Contract for projects that were not included in the initial scope of work included in the request for proposals, and that absent a showing in its next general rate case, the Company will not be permitted to recover those costs.

## X. Staff Analysis

Staff concurs with the Department's statement that approval of the affiliated interest agreement is separate and distinct from approval of cost recovery. Further, statute<sup>23</sup> provides that the Company has the burden of proof to show that any and all contracted work is reasonable; preferably as a result of a competitive bidding process or through another demonstration that the pricing and cost is fair and absent any unregulated utility cross-subsidies charged to ratepayers.

Staff reminds the Commission that, in 2006, when Otter Tail Power (OTP) petitioned for approval of the Administrative Services Agreement with its affiliate Midwest Construction Services (MCS)<sup>24</sup>, the Commission required:

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<sup>23</sup> Minn. Stat. § 216B.48, Subd 5. *Applicability to determining rates and costs*, and Subd. 6. *Commission retains continuing authority over contract*.

<sup>24</sup> Docket E-017/AI-06-925, September 29, 2006.

- That OTP demonstrate in future rate cases that the agreement had not resulted in cross-subsidization by ratepayers.
- That OTP use competitive bidding whenever it receives goods or services from MCS or its subsidiaries.
- That whenever OTP does not use competitive bidding, it must provide and maintain documentation (for future ratemaking recovery) demonstrating why it was in the public interest not to have used competitive bidding.

Staff also notes that, in the case of Otter Tail Power’s petition for an affiliated interest agreement with Nalco Water in 2017, the Commission stated that an on-going affiliated interest arrangement requires ongoing oversight and, to that end, the Commission required annual reporting. Specifically, the Commission directed Otter Tail Power to annually provide:

- A description of any changes in the affiliated interest relationship with their affiliated vendor;
- A spreadsheet of ongoing individual component products and services purchased from Nalco Water in the prior calendar year;
- A complete explanation of any increase in the overall payment amounts from the prior calendar year of more than three percent; and
- Copies and summaries of all proposals to provide water treatment or other services when Nalco Water is the bidder.<sup>25</sup>

Based on the record in this proceeding, it appears that CenterPoint’s handling of additional work was consistent with the process the Company followed in prior years. The Department has indicated that, as a result of the Vectren transaction, costs now require greater scrutiny and Commission oversight. Since the Vectren transaction closed after the 2018 construction season, CPEM has argued that 2018 costs were incurred prior to the companies becoming affiliates; therefore, the Commission’s decision regarding cost recovery may be based on whether the Commission believes that the additional scrutiny should be applied pre-merger.

Since CPEM has hired Minnesota Limited to perform work during the 2019 construction season<sup>26</sup>, it appears the CPEM/Minnesota Limited relationship will be ongoing; therefore, in light of the affiliation, the Commission may want to require that, by October 1, CPEM annually provide the following information:

- A report disclosing any changes in CPEM’s relationship with its Minnesota Limited.
- A report showing contract work performed as a result of competitive bidding, including details of the bidding process.

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<sup>25</sup> Docket E-017/AI-17-682, *Order Approving Affiliated Interest Arrangement and Requiring Reporting*, April 24, 2018, page 3.

<sup>26</sup> See Docket Number G-008/AI-19-292.

- A report showing any contract work performed outside of competitive bid pricing (e.g. scope addition via change orders, etc.) and documentation that such work is reasonable.

Additionally, to provide better granularity regarding the scope of the work to be performed, the Commission may want to instruct CPEM to incorporate any emerging work resulting from the current construction season into the *initial* scope of future construction seasons' RFPs.

## XI. Decision Alternatives

### 2018 Affiliated Interest Agreement

1. Approve the Company's existing 2018 Metro Beltline (MBLSE) Replacement Project construction services contract with Minnesota Limited, LLC ("Minnesota Limited") a non-regulated subsidiary of Vectren Corporation. (CPEM, DOC) **OR**
2. Do not approve the contract as an affiliated interest agreement.

### Cost Recovery

3. Determine that all CPEM 2018 MBLSE Project construction costs were reasonably incurred and allow the Company to seek recovery in its next rate case. (CPEM) **OR**
4. Determine that CPEM has not met its burden of proof to establish the reasonableness of costs incurred pursuant to the Construction Contract for projects not included in the initial scope of work in CPEM's initial request for proposals. Absent a showing in its next general rate case, the Company will not be permitted to recover costs for projects that were outside the initial scope of work. (DOC) **OR**
5. Take no action on cost recovery at this time and require that, if CenterPoint Energy requests cost recovery for work performed under this contract in its next rate case, the Company provide further evidence that the portions of the work performed outside of the competitively bid contract are fair and reasonable and merit cost recovery. (Staff) **OR**
6. Take no position on cost recovery.

### **Compliance Reporting**

Require CPEM to annually file on October 1<sup>st</sup> of each year:

7. A report disclosing any changes in CPEM's relationship with Minnesota Limited, its affiliated vendor. (*Staff*) **AND**
8. A report showing contract work performed as a result of competitive bidding, including details of the bidding process. (*Staff*) **AND**
9. A report showing any contract work performed outside of competitive bid pricing (e.g. scope addition via change orders, etc.) and documentation that such work is reasonable. (*Staff*)

### **Future Contracts**

10. Instruct CPEM to incorporate any emerging work resulting from the current 2019 construction season into the initial scope of future construction seasons' RFPs.