October 4, 2019

Daniel P. Wolf
Executive Secretary
Minnesota Public Utilities Commission
121 7th Place East, Suite 350
Saint Paul, Minnesota 55101-2147

RE: **Comments of the Minnesota Department of Commerce, Division of Energy Resources**
Docket No. G011/D-19-377

Dear Mr. Wolf:

Attached are the *Response Comments* of the Minnesota Department of Commerce, Division of Energy Resources (Department), in the following matter:

The Petition of Minnesota Energy Resources Corporation for its Annual Review of Depreciation Rates for 2019.

The Department recommends that the Minnesota Public Utilities Commission (Commission) **approve** the Petition, **with modifications**. The Department is available to answer any questions that the Commission may have in this matter.

Sincerely,

/s/ CRAIG ADDONIZIO
Financial Analyst

ca/[Word Processing initials]
Attachment

Before the Minnesota Public Utilities Commission

Comments of the Minnesota Department of Commerce
Division of Energy Resources

Docket No. G011/D-19-377

I. INTRODUCTION

On May 31, 2019, Minnesota Energy Resources Corporation (MERC or the Company) filed a petition (Petition) with the Minnesota Public Utilities Commission (Commission) requesting approval of its proposed depreciation rates, effective January 1, 2019. In its Petition, MERC included a proposal to depreciate two of the buildings in Account 390, Structures and Improvements, separately from the other 20 buildings in the same account. The Company also proposed a test to determine whether to depreciate any new buildings it adds in the future individually or using group depreciation.

On August 9, 2019, the Minnesota Department of Commerce, Division of Energy Resources (Department) and the Office of the Attorney General-Residential Utilities and Antitrust Division (OAG) filed Comments on MERC's Petition. The Department concluded that MERC's proposed depreciation parameters and rates for all accounts other than account 390 are reasonable, but recommended that the Commission approve a modified version of MERC's proposal for Account 390. The Department recommended that MERC be required to depreciate four buildings in Account 390 individually, and depreciate the remaining 18 buildings using group depreciation. The Department also requested additional information regarding the remaining life of MERC's Cloquet Service Center, one of the additional two buildings the Department recommended be depreciated individually. Finally, the Department concluded that MERC's proposed test to determine which depreciation method to use for new buildings was unnecessary.

The OAG disagreed with the life assumptions MERC proposed to apply to the Rochester and Rosemount Service Centers and with MERC's proposed test to determine which depreciation method to use for new buildings. The OAG recommended instead that the Commission require MERC, in future depreciation filings, to identify any new buildings with a gross plant value of at least $1 million (or existing buildings whose gross plant value exceeds that threshold as a result of additions) so that a review and determination of depreciation method can be made. The OAG also recommended that the Commission require MERC to assess whether any large transmission or distribution assets are more appropriately depreciated individually rather than with group depreciation.

On August 28, 2019, MERC filed Reply Comments responding the Department's and OAG's Comments.

II. DEPARTMENT ANALYSIS

A. TEST TO DETERMINE DEPRECIATION METHOD FOR NEW BUILDINGS

As described in the Department's Comments, in MERC's most recent rate case, the Commission ordered the Company to review whether group depreciation is appropriate for its larger assets and either propose changes to depreciation practices or explain why changes are not necessary.[1] As a result of this review, MERC proposed a test to use on a going forward basis to determine whether to depreciate new buildings individually or using group depreciation. Specifically, the Company proposed to depreciate individually any new building it adds to its system that has a gross plant value greater than or equal to one percent of the Company's total net depreciable plant at the time it is acquired or constructed. MERC refers to these buildings as "Major" buildings. Any new building with a gross plant value below this threshold at the time it is acquired or constructed (i.e. "Minor" buildings) will be depreciated using group depreciation as part of the Minor buildings group. MERC also applied this test to the buildings it currently owns, and as a result proposed to continue to depreciate its Rochester Service Center individually, begin to depreciate its new Rosemount Service Center individually, and depreciate its remaining 20 buildings in the Minor buildings group.

The Department concluded that MERC's proposed test is unnecessary because the relative infrequency with which new buildings are added to the Company's system means that reviewing new buildings on a case-by-case basis will not be overly burdensome. Additionally, the Department concluded that MERC's proposed test was unreasonable because it would result in the Cloquet and Albert Lea Service Centers being depreciated as part of the Minor buildings group despite the fact that the Cloquet Service Center's gross plant balance is nearly identical to the Rochester Service Center ($3.1 million and $3.2 million, respectively), and the Albert Lea Service Center's gross plant balance is close to the old Rosemount Office Building's gross plant balance ($1.3 million and $1.7 million, respectively), whose problematic retirement prompted this review of the Company's depreciation practices. Lastly, the Department noted that it is possible that using MERC's proposed test, the Company could add buildings which qualify as Minor buildings in the future that have life characteristics are which are different enough from MERC's other Minor buildings that including them in the Minor buildings group would be unreasonable.

In its Reply Comments, MERC stated that its proposed test is objective and therefore is preferable to the Department's proposal, which MERC deemed too subjective.

While the Department understands MERC's concern, the Department maintains its position that a strict test would be unnecessarily limiting and that building additions are rare enough that reviewing them on a case-by-case basis will not be overly burdensome.

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[1] Department Comments, page 6.

MERC also stated in its Reply Comments that its proposal is preferable to the OAG's proposal to depreciate all buildings with gross plant value of $1 million or more individually because MERC's proposal to use its net depreciable balance would allow the Major/Minor threshold to adjust naturally over time to reflect system growth and inflation. However, the Department's understanding is that the OAG's proposal is not, as MERC suggested, to apply a strict test based only on gross plant value. Rather, the OAG recommended only that all buildings with gross plant value of at least $1 million be reviewed on a case-by-case basis to determine whether individual or group depreciation is appropriate. The OAG's recommendation is thus similar to the Department's recommendation to review new buildings on a case-by-case basis.

B. MERC'S RESPONSE TO THE DEPARTMENT'S PROPOSAL TO DEPRECIATE THE CLOQUET AND ALBERT LEA SERVICE CENTERS INDIVIDUALLY

While MERC maintained its position that only its Rochester and Rosemount Service Centers should be depreciated separately based on its proposed test, the Company stated in its Reply Comments that if the Commission requires it to also depreciate separately its Cloquet and Albert Lea Service Centers, then reasonable parameters that appropriately reflect these changes should be set for each of the four Major buildings as well as the Minor buildings group.

As the Department noted in its Comments, and MERC reiterated in its Reply Comments, in order to depreciate the Rosemount, Rochester, Cloquet, and Albert Lea Service Centers individually, lives, salvage rates, and beginning depreciation reserves must be determined for all four buildings. In its Petition, MERC proposed to determine the beginning depreciation reserves for the Major buildings and the Minor buildings group based on their theoretical depreciation reserves. Thus, the beginning depreciation reserves would largely be a function of the initial life assumptions of each depreciable unit.

In its response to OAG Information Request (IR) 11, MERC provided the analysis necessary to begin depreciating the Rosemount, Rochester, Cloquet, and Albert Lea Service Centers individually, but noted that the probable retirement year used to determine the depreciation expense for the Cloquet Service Center did not appropriately reflect significant, life-extending improvements made at Cloquet in 1992.[2] The Department asked MERC to explain why it could not propose a retirement year that reflects these investments.

In its Reply Comments, the Company stated that it does not believe it can reasonably predict with certainty an alternate probable retirement date for this facility. However, the Company also stated that if the Commission requires the Company to depreciate the Cloquet Service Center separately, then the probable retirement year of 2035 reflected in its response to OAG IR 11 would be reasonable, and that the depreciable life the building could be adjusted as necessary in future filings.[3]

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[2] Department Comments, page 10.
[3] MERC Reply Comments at 5.

As the Department noted above, the initial life assumptions for each of the Major buildings and the Minor buildings group impact the initial allocation of Account 390's depreciation reserve, which in turn impacts the depreciation expense for each depreciable unit. For this reason, it is important to develop the best possible life assumptions using the most current information available. In its response to OAG IR 11, MERC indicated some uncertainty surrounding the expected life of the Cloquet Service Center, and the Company was unable to resolve that uncertainty in its Reply Comments.

While preferring to use the most current and up-to-date life assumptions possible, the Department concludes that using a probable retirement year of 2035 for the Cloquet Service Center would be reasonable, and that the likely impact of any future adjustments should be small enough that they would not have significant negative impacts on either the Company or its ratepayers. For this reason, the Department recommends that the Commission approve the depreciation parameters and rates determined in MERC's Response to OAG IR 11, as summarized in the table below.[4]

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

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

C. IMPACT ON DEPRECIATION EXPENSE AND DEFERRED ACCOUNTING

MERC noted in its Reply Comments that its initial proposal to depreciate the Rochester and Rosemount Service Centers individually would result in an increase in annual depreciation expense of $32,000 relative to its current practice. MERC also noted that the Department's proposal to also depreciate the Cloquet and Albert Lea Service Centers individually would result in an additional increase of $32,000, or $64,000 annually relative to current practice. The Company requested authorization for deferred accounting treatment of the increase in expense associated with the changes to its depreciation practices for Account 390.

[4] See also the Department's Comments, Attachment 3.

MERC stated in its Reply Comments that the incremental depreciation expense for which it requests deferred accounting would meet the four criteria for deferred accounting treatment, which require that the costs be:

1. related to utility operations;
2. significant in amount;
3. unforeseeable, unusual or extraordinary items; and
4. subject to review for reasonableness and prudence.

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

> Traditionally, deferred accounting has been reserved for costs that are unusual, unforeseeable, and *large enough to have a significant impact on the utility's financial condition*. [emphasis added.][5]

MERC's annual depreciation accruals in 2017 and 2018 were $11.9 million and $10.1 million, respectively, and will likely be well over $12.0 million in 2019. An increase of $64,000 amounts to an increase of only a half of a percent of overall depreciation expense and an even smaller amount compared to total expenses.[6] Further, in its most recent Jurisdictional Annual Report, MERC reported net utility operating income of $28.1 million for 2018. A decrease of $64,000 would be a decrease of less than a quarter of a percent, and would not have a significant impact on MERC's financial condition.[7]

Additionally, while the Department agrees that the specific circumstance of the Commission requiring a utility to change a depreciation methods outside of a rate case is not common, changes to depreciation expense outside of rate cases are common, and are often much larger than $64,000. For example, in MERC's last depreciation docket (Docket No. G011/D-17-442), the Company requested, and the Commission approved, depreciation rates that were expected to decrease depreciation expense by $1.2 million annually, beginning January 1, 2017. That reduction was not reflected in MERC's rates until January 1, 2018, when MERC implemented interim rates in its most recent rate case (Docket No. G011/GR-17-563), and MERC did not request deferred accounting for that change in expense.[8]

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[5] See, for example, Docket Nos. E002/M-03-1463, E,G001/M-08-728, E002/M-11-1263, and E015/M-11-1264.
[6] Petition, Statement 1C.
[7] The impact on MERC's net utility operating income would be less than $64,000 as a result of tax effects.
[8] *In the Matter of the Application of Minnesota Energy Resources Corporation for Authority to Increase Rates for Natural Gas Service in Minnesota*, Docket No. G011/GR-17-563, Order Setting Interim Rates at 4, December 5, 2017.

Based on this information, the Department concludes that the increase in depreciation expense that would result from the Department's proposal for Account 390 is not significant, and therefore recommends that the Commission deny MERC's request for deferred accounting.

D. EVALUATION OF ASSETS OTHER THAN BUILDINGS

In its Comments, the OAG recommended that the Commission require MERC to review other existing large transmission or distribution assets, as well as any future large or unique assets to determine if they should be depreciated individually or using group depreciation.[9]

MERC stated in its Reply Comments that no additional review is necessary because the Company reviews its assets as part of its annual depreciation update process and has already concluded that group depreciation continues to be the most appropriate method for depreciating transmission and distribution assets. MERC also stated that its distribution and transmission property includes many dispersed but interrelated assets for which additions and retirements occur continually and are not conducive to individual depreciation.

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

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

[9] OAG Comments at 8.

III. CONCLUSION AND RECOMMENDATIONS

After review, the Department recommends that the Commission:

1. approve the depreciation parameters and rates proposed in MERC's Petition for all plant accounts other than Account 390 Structure and Improvements;
2. require MERC to depreciate its Rochester, Rosemount, Cloquet, and Albert Lea Service Centers individually, and to depreciate the remaining 18 buildings in Account 390 using group depreciation, using the following depreciation parameters and rates as presented in the Company's response to OAG IR 11:

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

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

3. deny MERC's request for deferred accounting;
4. require MERC to include in its next depreciation filing a summary of the largest individual assets booked to each of its plant accounts and an explanation of why group accounting is or is not appropriate for those assets.
5. require MERC to file its next annual depreciation study by June 1, 2020; and
6. require MERC to file its next five-year study by June 1, 2022.

/ar

CERTIFICATE OF SERVICE

I, Sharon Ferguson, hereby certify that I have this day, served copies of the following document on the attached list of persons by electronic filing, certified mail, e-mail, or by depositing a true and correct copy thereof properly enveloped with postage paid in the United States Mail at St. Paul, Minnesota.

Minnesota Department of Commerce
Comments

Docket No. G011/D-19-377

Dated this **4th** day of **October 2019**

/s/Sharon Ferguson

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