



85 7th Place East, Suite 500, St. Paul, MN 55101-2198

main: 651.296.4026

tty: 651.296.2860

fax: 651.297.7891

[www.energy.mn.gov](http://www.energy.mn.gov)

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November 7, 2012

Burl W. Haar  
Executive Secretary  
Minnesota Public Utilities Commission  
121 7th Place East, Suite 350  
St. Paul, Minnesota 55101-2147

**RE: Supplemental Response Comments of the Minnesota Department of Commerce,  
Division of Energy Resources**  
Docket No. G007,011/AI-10-783

Dear Dr. Haar:

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

Petition of Minnesota Energy Resources Corporation (MERC or the Company) for Approval of an Affiliated Interest Agreement (Agreement).

The Department's Supplemental Response Comments are provided in response to Additional Supplemental Reply Comments filed by MERC on October 1, 2012.

The Department recommends **conditional approval** of the Agreement.

The Department is available to answer any questions the Commission may have.

Sincerely,

/s/ MARLON GRIFFING  
Financial Analyst  
651-297-3900

MG/ja  
Attachment

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

SUPPLEMENTAL RESPONSE COMMENTS OF THE  
MINNESOTA DEPARTMENT OF COMMERCE  
DIVISION OF ENERGY RESOURCES

DOCKET No. G007,011/AI-10-783

**I. BACKGROUND**

Minnesota Energy Resources Corporation (MERC) filed a petition with the Minnesota Public Utilities Commission (Commission) on July 12, 2010, for approval of an affiliated interest agreement (Agreement). The proposed Agreement is between Integrys Energy Group, Inc. (Integrys) and all of the wholly owned regulated subsidiaries of Integrys, including MERC, all wholly owned non-regulated subsidiaries of Integrys, and one partially owned regulated subsidiary of Integrys.

In September 17, 2010 Reply Comments, MERC requested that the Commission defer scheduling consideration until any changes made to the Agreement by the Illinois Commerce Commission (ICC) and the Public Service Commission of Wisconsin (PSCW), which were also considering the Agreement, were known. The Department subsequently agreed with the request.

On February 9, 2011, MERC filed notice that the ICC approved the Agreement with modifications, notably to Sections 4.3 and 4.4, on December 15, 2010.

On April 25, 2012, MERC filed notice that the PSCW had approved the Agreement as modified by the ICC.

On August 8, 2012, the Department filed additional comments recommending approval with modifications pertaining to reporting requirements.

On August 20, 2012, MERC filed additional response comments agreeing with most of the Department's recommendations but requesting further discussion about the cost study.

On August 31, 2012, the Department filed supplemental response comments recommending that the Commission approve the Agreement as approved by the Illinois Commerce Commission (ICC) and the Wisconsin Public Service Commission (PSCW), including the Addendum, provided that the Commission require MERC to file in this docket:

- the annual internal audit report according to revised Section 4.3;
- the cost study covering the period ending December 31, 2011, within 30 days of the date of an Order approving the Agreement; and
- the annual updates to the cost study and subsequent cost studies according to revised Section 4.4.

On September 10, 2012, MERC filed additional comments agreeing with the intent of the Department's proposed modifications to the Agreement but requesting that the Agreement not be amended since that would require more processes in other states. Instead, MERC requested that the Commission require the reports through its Order rather than through amendments to the Agreement.

On September 18, 2012, the Department filed Additional Supplemental Response Comments agreeing with MERC's request that the Commission include the reporting requirements as points in an Order approving the Agreement rather than amending the Agreement. The Department listed six conditions regarding filing requirements for MERC. One of the requirements was that MERC file the cost study pertaining to the period ending December 31, 2011 required by Section 4.4 of the Agreement (non-IBS cost study) within 30 days of the date of an Order approving the Agreement.

On October 1, 2012, MERC filed Additional Supplemental Reply Comments stating that the non-IBS cost study was not completed since MERC had not received regulatory approval of the Agreement. Therefore, MERC could not file the non-IBS cost study within 30 days of a Commission Order. The Company said it planned to file a non-IBS cost study in May 2015 based on 2014 data.

On October 3, 2012, MERC filed as an informational item the cost study for Integrys Business Support (IBS), the centralized service company within the Integrys holding company system. The cost study was prepared for Docket No. G007,011/AI-07-779.

## II. DEPARTMENT ANALYSIS

### A. INTRODUCTION

The proposed Agreement, if approved, would govern the provision of inter-company services provided by and among affiliates within the Integrys holding company system<sup>1</sup> other than services provided by IBS. The IBS Affiliated Interest Agreement approved by the Commission in Docket No. G007,011/AI-07-779 governs IBS's provision of shared services to MERC and the other regulated entities within the Integrys holding company system.

The Agreement is proposed to supersede the Affiliated Interest Agreement approved by the Commission in Docket No. G007,011/AI-06-1052, which currently governs the provision of goods, services, and property between Integrys and its regulated public utility subsidiaries, including MERC.

MERC and the Department agree that the Commission should include the following items as Order points in this docket:

- Each year by May 1 MERC shall file with the Commission billing reports showing its charges, as a Providing Party, to any Receiving Party to which it provided Services under the Agreement during the preceding calendar year and billing reports showing its payments, as a Receiving Party, for Services received from Providing Parties under the Agreement during the preceding calendar year;
- MERC shall file the annual internal audit report in this docket with the Commission no later than July 1 of each audit year;
- MERC shall file the annual updates to the cost study in this docket with the Commission by May 1 of each applicable year;
- MERC shall file subsequent cost studies in this docket with the Commission by May 1 of each applicable year; and
- MERC shall file a study with the Commission three years from the effective date of the Agreement providing information sufficient to enable the Commission to determine whether the Agreement should continue, be modified, or be discontinued.

As noted above, the Department also recommended that the Commission require MERC to file the non-IBS cost study pertaining to the period ending December 31, 2011 in this docket with the Commission within 30 days of the date of an Order approving the Agreement. However, in its

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<sup>1</sup> The Agreement is entered into by and among Integrys Energy Group, Inc., a public utility holding company, all of the wholly-owned regulated subsidiaries of Integrys (Michigan Gas Utilities Corporation, Minnesota Energy Resources Corporation, North Shore Gas Company, The Peoples Gas Light and Coke Company, Upper Peninsula Power Company, and Wisconsin Public Service Corporation), one partially-owned regulated subsidiary of Integrys (Wisconsin Valley Improvement Company), and all of the wholly-owned non-regulated subsidiaries of Integrys.

October 1, 2012, Additional Supplemental Reply Comments, MERC stated that the non-IBS cost study is not completed. Thus, to coordinate the cost studies on IBS and non-IBS services:

Integrys plans to complete the non-IBS cost study in May 2015 based on 2014 data. That timeframe will allow Integrys to coordinate the non-IBS cost study with the IBS cost study required by the IBS Affiliated Interest Agreement approved in Docket No. G007,011/AI-07-779 (IBS AIA docket). Integrys completed the IBS cost study in May 2012.

Therefore, the Department's comments below focus on the issue of the uncompleted non-IBS cost study, specifically the:

- role that the cost study plays in setting the prices for MERC and other Integrys affiliates covered by the Agreement as they provision goods and services for one another;
- requirements that the Agreement places on MERC to submit the non-IBS cost study; and
- authority that the Commission has to continue monitoring the Agreement.

*B. ARTICLE 2 OF THE AGREEMENT: DETERMINING CHARGES FOR SERVICES PROVIDED*

*1. Price-Setting Rules under the Agreement*

Article II of the Agreement establishes the prices that the Integrys affiliates, including MERC, shall charge as they provide and receive goods and services to and from one another. Section 2.1 of the article covers Cost of Services:

- Services provided by a Regulated Party to another Regulated Party will be priced at cost;
- Services provided by a Regulated Party to a Non-Regulated Party will be priced at the greater of cost or fair market value;
- Services provided by a Non-Regulated Party to a Regulated Party will be priced at the lesser of cost or fair market value; and
- Services provided by any Party to IBS will be priced at cost.

The methods of determining “cost” and “fair market value” are outlined in Sections 2.2 through 2.4 of Article II. The two concepts are not interchangeable. The purpose of defining both cost and market-value for the purpose of pricing is to ensure that ratepayers do not subsidize a utility's unregulated enterprises. The above rules are reasonable since they prevent regulated

affiliates within the Integrys holding company system from being charged prices that shift costs to them or from charging prices that reduce their revenues.

## 2. *Commission Precedent*

In Docket No. G,E999/CI-90-1008, *In the Matter of the Investigation into the Competitive Impact of Appliance Sales and Service Practices of Minnesota Gas and Electric Utilities* (CI-90-1008 Docket), the Commission determined the allocation principles which must be applied in allocating costs between utilities and non-regulated affiliates. The overall goal of this allocation method is to protect ratepayers from subsidizing a utility's unregulated affiliates. Specifically, the Commission found that the following four basic hierarchical cost allocation principles, extracted from the comprehensive Federal Communications Commission (FCC) cost methodology, are the best means of ensuring proper cost separation between regulated and non-regulated activities:

1. Tariffed rates shall be used to value tariffed services provided to the non-regulated activity.
2. Costs shall be directly assigned to either regulated or non-regulated activities whenever possible.
3. Costs which cannot be directly assigned are common costs which shall be grouped into homogeneous cost categories. Each cost category shall be allocated based on direct analysis of the origin of the costs whenever possible. If direct analysis is not possible, common costs shall be allocated based upon an indirect cost-causative linkage to another cost category or group of cost categories for which direct assignment or allocation is available.
4. When neither direct nor indirect measures of cost causation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and non-regulated activities, excluding the cost of fuel, gas, purchased power, and the purchased cost of goods sold.  
(September 28, 1994 Order)

## 3. *Implications for the Current Docket*

As noted, the proposed rules for setting prices regulated affiliates and nonregulated affiliates of Integrys shall charge one another under Section 2.1 of the Agreement are intended to prevent ratepayers from subsidizing a utility's unregulated enterprises. None of the services under the proposed agreement are tariffed; however, the proposed rules would use the higher of cost or market value when the regulated utility provides service to a non-regulated affiliate, and the

lower of cost or market value when the regulated utility receives service from the non-regulated affiliate. Because ratepayers would not pay more than cost for services received from affiliates and would be compensated for at least the cost for services provided to affiliates, the Department concludes that MERC, as it provides or receives goods and services under the terms of the Agreement, would be in compliance with Commission findings in the CI-90-1008 Docket.

However, the results of both a cost study and a fair-market value study are necessary if the Agreement is to function fully as intended. If both studies are not available, ratepayers may not receive all of the intended benefits under the proposed Agreement.

*C. ARTICLE IV OF THE AGREEMENT: ACCOUNTING; RECORDS; REPORTS*

Section 4.4 from Article IV of the Agreement is presented below. Both versions of the Agreement that MERC has submitted in this docket, the initial proposal submitted on July 12, 2010 and the amended edition approved by the ICC and PSCW on April 25, 2012, contained the underlined sentence that concludes the section:

4.4 Every third year, on or before May 1, the Parties shall conduct a new study of the *cost of services* provided hereunder for the purpose of testing compliance with the provisions of this Agreement requiring charges at the fair market value and to analyze the market price of services provided. The study shall include Services provided between a Regulated Party and a Non-Regulated Party *at cost [emphases added]*. The study shall be updated at least annually. The Parties shall notify the person or department designated by the Commissions or the Commissions' staffs of the availability of the study and annual update and, if requested, make such available for review at the Commission's offices. The first such new study shall pertain to the period ending December 31, 2011, and shall be due on or before May 1, 2012.

The timing of the regulatory processes in Illinois and Wisconsin meant that MERC filed the amended version of the Agreement with the Commission on April 25, 2012, only days before the stated deadline for submission of the non-IBS cost study by MERC. It is understandable that MERC could not have filed the cost study by the May 1 deadline, but it would have been helpful to know earlier in the process that MERC does not intend to conduct the cost study on non-IBS services until 2015.

As noted above, MERC would like to delay filing the non-IBS cost study to coordinate work on that cost study with the work on the IBS cost study. While it is understandable that MERC would like to coordinate the studies, it is also necessary to ensure that ratepayers are adequately protected against subsidizing MERC's affiliates.

Minnesota Statute §216B.48, subd. 3 provides that the Commission shall approve a contract or agreement with an affiliated interest “only if it clearly appears and is established upon investigation that it is reasonable and consistent with the public interest.”

Further, the Commission has ongoing authority over contracts such as the Agreement is stated in Minnesota Statute §216B.48, subd. 6:

Subd. 6. Commission retains continuing authority over contract. 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 commission shall have the same jurisdiction over the modifications or amendment of contracts or arrangements as are herein described as it has over such original contracts or arrangements. 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.

Therefore, the Commission has continuing authority over the Agreement beyond the date of an Order in the docket, including, but not limited to, the power to disallow costs in a general rate case.

The results of both a cost study and a fair-market value study are necessary if the Agreement is to function fully as intended. If both studies are not available, ratepayers may not receive all of the intended benefits under the proposed Agreement. Further, it is necessary to have the results of the non-IBS cost study to allocate costs of those goods and services.

However, because the services indicated in Appendix C pertain to non-gas costs, there will not be any rate impacts on ratepayers of the proposed affiliated interest agreement until MERC’s subsequent rate case. Thus, to ensure that ratepayers are adequately protected according to the allocation rules identified above, the Department concludes that it is appropriate for the Commission to condition its approval of MERC’s petition with the requirement that MERC obtain approval of the non-IBS cost study prior to MERC’s next rate case. MERC proposes to file its non-IBS study by May 2015. Thus, MERC would either need to wait to file its next rate case until it receives approval of the non-IBS study filed in 2015 or, if MERC intends to file its next rate case sooner, the Company would need to file its non-IBS study sooner.

### **III. DEPARTMENT'S CONCLUSIONS AND RECOMMENDATIONS**

The Department concludes that MERC's proposal would appropriately prevent ratepayers from subsidizing MERC's unregulated enterprises. The proposed rules would use the higher of cost or market value when the regulated utility provides service to a non-regulated affiliate, and the lower of cost or market value when the regulated utility receives service from the non-regulated affiliate. Because ratepayers would not pay more than cost for services received from affiliates and would be compensated for at least the cost for services provided to affiliates, the Department concludes that MERC's proposal is in compliance with Commission findings in the CI-90-1008 Docket.

However, the results of both a cost study and a fair-market value study are necessary if the Agreement is to function fully as intended. If both studies are not available, ratepayers may not receive all of the intended benefits under the proposed Agreement. Further, it is necessary to have the results of the non-IBS cost study to allocate costs of those goods and services.

Because the services indicated in Appendix C pertain to non-gas costs, there will not be any rate impacts on ratepayers of the proposed affiliated interest agreement until MERC's subsequent rate case. Thus, to ensure that ratepayers are adequately protected according to the allocation rules identified above, the Department concludes that it is appropriate for the Commission to condition its approval of MERC's petition with the requirement that MERC obtain approval of the non-IBS cost study prior to MERC's next rate case. MERC proposes to file its non-IBS study by May 2015. Thus, MERC would either need to wait to file its next rate case until it receives approval of the non-IBS study or, if MERC intends to file its next rate case sooner, it would need to file its non-IBS study sooner.

The Department recommends that the Commission approve MERC's proposal with the following conditions:

- Each year by May 1 MERC shall file with the Commission billing reports showing its charges, as a Providing Party, to any Receiving Party to which it provided Services under the Agreement during the preceding calendar year and billing reports showing its payments, as a Receiving Party, for Services received from Providing Parties under the Agreement during the preceding calendar year;
- MERC shall file the annual internal audit report in this docket with the Commission no later than July 1 of each audit year;
- MERC shall file the annual updates to the cost study in this docket with the Commission by May 1 of each applicable year;
- MERC shall file subsequent cost studies in this docket with the Commission by May 1 of each applicable year;
- MERC shall file a study with the Commission three years from the effective date of the Agreement providing information sufficient to enable the Commission to

determine whether the Agreement should continue, be modified, or be discontinued;  
and

- MERC shall obtain approval of the non-IBS cost study prior to MERC's next rate case; in any event, MERC must file its non-IBS study no later than May 1, 2015.

/ja

## **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  
Supplemental Response Comments**

**Docket No. G007,011/AI-10-783**

Dated this **8<sup>th</sup>** of **November, 2012**

**/s/Sharon Ferguson**

First Name	Last Name	Email	Company Name	Address	Delivery Method	View Trade Secret	Service List Name
Michael	Ahern	ahern.michael@dorsey.com	Dorsey & Whitney, LLP	50 S 6th St Ste 1500 Minneapolis, MN 554021498	Electronic Service	No	OFF_SL_10-783_AI-10-783
Julia	Anderson	Julia.Anderson@ag.state.mn.us	Office of the Attorney General-DOC	1800 BRM Tower 445 Minnesota St St. Paul, MN 551012134	Electronic Service	Yes	OFF_SL_10-783_AI-10-783
Michael	Bradley	bradley@moss-barnett.com	Moss & Barnett	4800 Wells Fargo Ctr 90 S 7th St Minneapolis, MN 55402-4129	Electronic Service	No	OFF_SL_10-783_AI-10-783
Sharon	Ferguson	sharon.ferguson@state.mn.us	Department of Commerce	85 7th Place E Ste 500  Saint Paul, MN 551012198	Electronic Service	Yes	OFF_SL_10-783_AI-10-783
Burl W.	Haar	burl.haar@state.mn.us	Public Utilities Commission	Suite 350 121 7th Place East St. Paul, MN 551012147	Electronic Service	Yes	OFF_SL_10-783_AI-10-783
Richard	Haubensak	RICHARD.HAUBENSAK@CONSTELLATION.COM	Constellation New Energy Gas	Suite 200 12120 Port Grace Boulevard La Vista, NE 68128	Paper Service	No	OFF_SL_10-783_AI-10-783
John	Lindell	agorud.ecf@ag.state.mn.us	Office of the Attorney General-RUD	1400 BRM Tower 445 Minnesota St St. Paul, MN 551012130	Electronic Service	Yes	OFF_SL_10-783_AI-10-783
Brian	Meloy	brian.meloy@leonard.com	Leonard, Street & Deinard	150 S 5th St Ste 2300  Minneapolis, MN 55402	Electronic Service	No	OFF_SL_10-783_AI-10-783
Andrew	Moratzka	apm@mcmlaw.com	Mackall, Crouse and Moore	1400 AT&T Tower 901 Marquette Ave Minneapolis, MN 55402	Paper Service	No	OFF_SL_10-783_AI-10-783
Ann	Seha	seha.ann@dorsey.com	Dorsey & Whitney	Suite 1500 50 South Sixth Street Minneapolis, MN 554021498	Paper Service	No	OFF_SL_10-783_AI-10-783

First Name	Last Name	Email	Company Name	Address	Delivery Method	View Trade Secret	Service List Name
Eric	Swanson	eswanson@winthrop.com	Winthrop Weinstine	225 S 6th St Ste 3500 Capella Tower Minneapolis, MN 554024629	Electronic Service	No	OFF_SL_10-783_AI-10-783
Gregory	Walters	gjwalters@minnesotaenergyresources.com	Minnesota Energy Resources Corporation	3460 Technology Dr. NW  Rochester, MN 55901	Paper Service	No	OFF_SL_10-783_AI-10-783