STAFF MEMORANDUM SUPPORTING SETTLEMENT STIPULATION

TO: COMMISSIONERS AND ADVISORS

FROM: BRITTANY MEHLHAFF, PATRICK STEFFENSEN, KRISTEN EDWARDS, AND AMANDA REISS

RE: DOCKET GE17-003 – IN THE MATTER OF STAFF'S REQUEST TO INVESTIGATE THE EFFECTS OF THE TAX CUTS AND JOBS ACT ON SOUTH DAKOTA UTILITIES

DATE: October 5, 2018

Commission Staff (Staff) submits this Memorandum in support of the September 28, 2018 Settlement Stipulation (Stipulation), between Staff and Montana-Dakota Utilities Co., a Division of MDU Resources Group, Inc. (MDU or the Company) in the above-captioned matter.

BACKGROUND

On December 20, 2017, the United States Congress passed the Tax Cuts and Jobs Act (TCJA), which was ultimately signed into law by the President on December 22, 2017. The TCJA impacts each tax paying utility's cost of service and all ratepayers. The TCJA contains provisions including, but not limited to, lowering the corporate tax rate from 35% to 21% effective January 1, 2018. The significant decrease in the tax rate and its resulting impact on utility costs and rates requires an investigation to ensure rates remain just and reasonable going forward after the enactment of the TCJA.

On December 21, 2017, Staff filed a "Motion Requesting Order Requiring Comments and Securing Tax Effects for Customers as of January 1, 2018" (Motion). In the Motion, Staff requested the Commission investigate the effect the TCJA has on South Dakota utilities and requested the Commission issue an order requiring utilities to submit comments on the effect the TCJA has on each utility. Additionally, Staff requested the Commission issue an order requiring that any adjustment to rates from the TCJA will be made effective January 1, 2018.

On December 29, 2017, the Commission issued its "Order Requiring Comments; Order Requiring Rates in Effect January 1, 2018, are Subject to Refund; Order Granting Intervention." On January 29, 2018, NorthWestern Energy submitted initial comments and on February 1, 2018, Black Hills Energy, Montana-Dakota Utilities Co., MidAmerican Energy, Xcel Energy, and Otter Tail Power Co. filed initial comments pursuant to the Commission's instructions. On September 28, 2018, Staff and MDU (Parties) filed a "Joint Motion for Approval of Settlement Stipulation" and a "Settlement Stipulation" (Stipulation). A review of the terms of the Stipulation is provided below.

REVIEW OF THE STIPULATION

Staff worked with the Company to design a settlement that refunds the 2018 impacts of the TCJA, consistent with the Commission's order requiring any adjustment to rates be effective January 1, 2018 and reduces rates effective January 1, 2019 for ongoing TCJA tax expense reductions.

2018 TCJA Refund

The Parties agree that the effects of the TCJA should be refunded to customers effective January 1, 2018 as required in the Commission's December 29, 2017 order. The Parties agree that MDU should refund its natural gas customers approximately $1,327,000 and its electric customers approximately $591,000 for 2018. The refund reflects a fair balancing of the Company's obligation to customers for 2018 regarding the TCJA impact, including the difference between the 35% corporate tax rate and the 21% corporate tax rate, and accumulated deferred tax balances.

The calculation of the 2018 refund involves three components, the first of which is determining the refund associated with the difference between the 35% tax rate and the 21% tax rate. The Parties agreed to base this calculation on a 2017 test year, adjusted for the impact of the change in tax rate as well as normalizing adjustments consisting of a conservative portion of the adjustments approved by the Commission in the Company's most recent rate cases.

The adjusted 2017 test year also includes the impact of the amortization of the property related excess ADIT balances. Due to the use of accelerated and bonus depreciation and tax normalization for rate purposes, the amount of taxes actually paid to the Internal Revenue Service (IRS) by MDU associated with protected plant[1] has been much less than the taxes recovered from ratepayers. Prior to January 1, 2018, MDU's ADIT balance was accumulating at the 35 % tax rate. Because the tax rate has now been reduced to 21%, MDU now has an excess in its deferred tax reserve associated with protected plant that must be returned to ratepayers. The Parties agree that all excess protected plant-related ADIT will be amortized over the remaining book life of MDU's plant using the Average Rate Assumption Method (ARAM), as required by the IRS. MDU also has non-protected[2] plant related excess ADIT, the benefit of which should also be returned to ratepayers. The Company claims its tax system handles all plant the same and therefore the non-protected plant related excess ADIT must be amortized using ARAM as well, as the cost of modifying the system would be significant. Since the majority of the plant related excess ADIT is protected plant, Staff agreed to the ARAM treatment for all property related excess ADIT for settlement purposes.

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[1] Excess ADIT associated with protected plant refers to excess ADIT that the TCJA requires be normalized using the Average Rate Assumption Method (ARAM). Under ARAM, the utility cannot return to customers the excess in the deferred tax reserve that is protected until the year in which the book depreciation expense is more than the tax depreciation on the underlying assets. Utilities must follow ARAM for these protected assets in order to avoid a normalization violation. Therefore, ARAM must be used for ratemaking purposes.

[2] Generally, the Commission has discretion on the amortization of non-protected excess ADIT for rate making purposes. This can include both plant related and non-plant related non-protected excess ADIT.

The impact of the change in tax rate, including the ARAM amortization of all property related excess ADIT balances, is $382,678 for MDU's South Dakota electric customers and $659,882 for South Dakota's natural gas customers.

MDU also has non-property related excess ADIT. The Parties agreed to refund the entire balance to customers as part of the 2018 refund. This adds an additional $208,746 to the electric refund and $667,033 to the natural gas refund, for total 2018 refunds of $591,424 for electric customers and $1,326,915 for natural gas customers.

While the method of determining the impact of the change in tax rate differs from settlements approved by the Commission for other utilities, Staff agreed to this calculation since the difference between Staff's preferred method and the settlement method was so small it did not warrant the additional expense and time it would take to litigate the issue or the cost of a potential rate case. Furthermore, Staff views MDU's agreement to eliminate the entire non-property related excess ADIT balance in one year as a significant benefit to customers.

The 2018 refund amounts will be posted in a single payment to customers' accounts no later than February 15, 2019 and will be shown as a separate line item on customer bills. The refund will be allocated to customer classes based on each class' share of the revenue allocation approved in EL15-024 and NG15-005. Customer refunds will be calculated based on each customer's actual 2018 volumes. In the event customers have left MDU's system, checks will be issued if the refund is $5.00 or greater. Any remaining refund amount associated with inactive customers whose refund is less than $5.00 which in total is less than or equal to $5,000 will require no regulatory action.

When using historical volume information, MDU preferred to use calendar year 2018 volumes rather than a different historical 12-month period. The Company also indicated that regardless of which historical 12-month period was used, the earliest refunds could be issued is February 2019, in order to allow sufficient time for calculating and verifying the individual refund amounts and testing its billing system. Therefore, Staff agreed to the above refund methodology as Staff believes a historical 12-month period more appropriately allocates the 2018 refund among customers.

However, although Staff recommends the method discussed above, the Parties also agreed to an alternative method in the event the Commission desires customers to receive a refund earlier than February 2019. Under this alternative method, the Company would divide the class allocated 2018 refund amounts by the projected November 2018 class volumes and apply the resulting per unit rate to the actual billing units billed to each customer in November 2018. Again, under this method, any balance which is less than or equal to $5,000 will require no further regulatory action. This alternative method allows the refund to go back to customers quicker, however, may result in inequitable inter-class allocations since only one month of volumes is used to calculate the refund and has the higher potential of an over/under balance given projected sales are used.

Base Rate Reduction

The Parties agree that the effects of the TCJA beyond January 1, 2019 should be given back to customers in the form of a permanent reduction in base rates. The calculation of this permanent base rate reduction will begin with the adjusted 2017 test year used for the 2018 refund. However, the Parties agree MDU will also include known and measurable plant additions in-service as of October 31, 2018[3]. The Company shall provide the calculation of the revenue reduction and resulting rates by December 1, 2018. The revenue reductions will be allocated to customer classes based on each class' share of the revenue allocations determined in the Company's most recent rate cases. The Company estimates the base rate reduction will be approximately $250,000 for MDU's South Dakota electric system and $300,000 for MDU's South Dakota natural gas system. However, these amounts are subject to change based on actual plant additions placed in service and Staff's review of such plant additions.

RECOMMENDATION

Staff recommends the Commission grant the Joint Motion for Approval of Settlement Stipulation and adopt the Settlement Stipulation without modification.

[3] The settlement specifies two projects that will not be included in the calculation supporting base rates effective January 1, 2019. Instead the Company will request these projects be included in the Transmission Cost Recovery Rider and Infrastructure Rider, subject to Commission prudency review.