Direct Testimony
John D. Armbruster

Before the Minnesota Public Utilities Commission

State of Minnesota

In the Matter of the Application of Minnesota Power
For Authority to Increase Rates for Electric Utility
Service in Minnesota

Docket No. E015/GR-21-335

Exhibit ________

TAX

November 1, 2021

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I. INTRODUCTION AND QUALIFICATIONS

Q. Please state your name and business address.

A. I am John Armbruster, and my business address is 30 West Superior Street, Duluth, Minnesota 55802.

Q. By whom are you employed and in what position?

A. I am employed by ALLETE, Inc., doing business as Minnesota Power ("Minnesota Power" or the "Company"). My position is Manager, Tax.

Q. Please summarize your qualifications and experience.

A. I have 30 years of experience in tax and finance. I have a bachelor's degree in accounting from the University of St. Thomas, and I have a Certified Public Accounting license that is currently inactive. I began my career in 1991 in Arthur Andersen's Tax Practice, and since 1993, I have worked in tax and treasury roles at various companies, including, since 1998, as head of the corporate tax function. I started in my current position in June of 2019.

Q. What are your present duties?

A. I am responsible for compliance, accounting, and planning for the income, property, and sales tax of ALLETE and its subsidiaries.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to address several tax issues relevant to this rate proceeding, including deferred taxes, tax credits, and property tax.

Q. Are you sponsoring any exhibits in this proceeding?

A. No.

II. ISSUES RELATING TO DEFERRED TAXES

A. <u>Accumulated Deferred Income Tax</u>

Q. What is Accumulated Deferred Income Tax?

A. For financial accounting and ratemaking purposes, public utilities depreciate assets using straight-line depreciation — reducing an asset's book value by an equal amount for each year of the asset's useful life. However, for federal tax purposes, most utilities depreciate assets using accelerated depreciation — reducing the asset's net book value more rapidly in the early years of its life — which generates greater deductions and lower income taxes for those years. The difference between the tax the utility pays under accelerated depreciation and the tax it would have paid under straight-line depreciation is known as accumulated deferred income tax ("ADIT").

Q. How does ADIT develop?

A. The ability to accelerate depreciation, resulting in ADIT, was created under various federal tax laws — generally as an incentive for businesses to make capital investments.

Q. How should ADIT be viewed in the context of a rate case?

A. For ratemaking purposes, ADIT can be considered as the prepayment of a utility's income taxes by its customers.

Q. Are there rules that govern the treatment of ADIT in a rate case?

A. Yes. The Internal Revenue Service ("IRS") has issued rules that mandate — as a general principle — that the tax benefits of ADIT must be spread over the same time period that the cost of investments are recovered by customers. This concept is referred to as "normalization." The objective of normalization is to ensure that current and future utility customers are treated equitably by allowing all customers to enjoy the tax benefits associated with utility assets.

B. Excess Deferred Income Taxes Resulting from the Tax Cuts and Jobs Act

Q. What is the purpose of this section of your testimony?

A. In late 2017, Public Law 115-97 (known as the Tax Cuts and Jobs Act or "TCJA") took effect — reducing the federal income tax rate for corporations from a maximum of 35 percent to a flat 21 percent — starting January 1, 2018. This resulted in excess accumulated deferred income taxes ("EDIT") for Minnesota Power.[1] The Minnesota Public Utilities Commission ("Commission") and Minnesota Power took steps thereafter to prepare for the return of the EDIT to Minnesota Power's customers, and Minnesota Power committed to incorporate the benefit of the EDIT in base rates in its next rate case. This section of my testimony provides an update on this topic and supports the incorporation of the EDIT into the base rates developed in this case.

Q. Please describe the steps taken by the Commission shortly after the passage of the TCJA.

A. At the time Congress passed the TCJA, the Company was working with the Commission to conclude its 2016 Rate Case (Docket No. E015/GR-16-664). Because of the timing, the effect of the TCJA on Minnesota Power was not fully incorporated in the final rates decided in the Company's 2016 Rate Case.[2] The Commission opened Docket No. E,G999/CI-17-895 to review the impact of the TCJA on utilities (the "Tax Reform Docket"). In the Tax Reform Docket, Minnesota Power proposed to return the EDIT to customers through a rate reduction rider that would be implemented at the same time as final rates with a separate one-time refund for the period from January 1, 2018 to the implementation of the rate reduction rider. On December 5, 2018, the Commission issued an Order agreeing with this proposal and directing Minnesota Power to amortize (using the Average Rate Assumption Method ("ARAM")) its protected EDIT as early as allowed under the IRS' rules, amortize its unprotected EDIT over ten years, and

[1] The IRS identifies two types of EDIT: protected EDIT refers to the tax expense associated with accelerated depreciation of utility plant assets, and unprotected EDIT includes other tax effects, such as miscellaneous differences between a utility's tax and book basis in utility assets other than plant assets.

[2] *See In the Matter of the Application of Minnesota Power for Authority to Increase Rates for Electric Service in Minnesota*, Docket No. E015/GR-16-664, ORDER GRANTING RECONSIDERATION IN PART, REVISING MARCH 12, 2018 ORDER, AND OTHERWISE DENYING RECONSIDERATION PETITIONS (May 29, 2018).

return these sums to customers through a rate rider.[3] This Order also required Minnesota Power to submit annual compliance filings about the rate reduction rider. As to TCJA savings that had already accrued, this Order required Minnesota Power to either return a one-time refund to customers or incorporate the sum into the interim rate refund calculation resulting from its 2016 Rate Case.

Q. Did Minnesota Power implement the rate reduction rider and address the TCJA savings that had already accrued?

A. Yes. Minnesota Power implemented the rate reduction rider, effective January 1, 2019, and completed the one-time refund for EDIT for 2018.

Q. Did Minnesota Power propose in 2019 to incorporate the benefit of the EDIT into base rates instead of through the rate reduction rider?

A. Yes. Minnesota Power filed a letter with the Commission, dated February 14, 2019, confirming that it intended to incorporate the benefit of the EDIT balances in its next rate case. When Minnesota Power filed its general rate case in Docket No. E015/GR-19-442 ("2019 Rate Case"), it reaffirmed this intent and explained how it intended to include the EDIT in base rates.

Q. Was Minnesota Power able to include the EDIT in base rates as it proposed?

A. No. The COVID-19 pandemic disrupted Minnesota Power's 2019 Rate Case. In filings dated April 23 and 30, 2020, Minnesota Power proposed to resolve and withdraw the 2019 Rate Case.[4] In Orders dated June 30, 2020, August 7, 2020, and December 11, 2020, the Commission accepted Minnesota Power's proposals and imposed some additional conditions, and the 2019 Rate Case was then withdrawn. The net result was that the development of rates reflecting the inclusion of the EDIT did not happen in the Company's 2019 Rate Case.

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[3] *See In the Matter of a Commission Investigation into the Effects on Electric and Natural Gas Utility Rates and Services of the 2017 Federal Tax Act*, Docket No. E,G999/CI-17-895, ORDER RESPONDING TO CHANGES IN FEDERAL TAX LAW (Dec. 5, 2018).
[4] The April 30, 2020 filing was made in Docket No. E015/M-20-429.

Q. What does Minnesota Power propose at this time?

A. Minnesota Power proposes to incorporate the benefit of the EDIT balances in the rates developed in this case. This also means that the rate reduction rider will be discontinued with interim rates.

Q. How does Minnesota Power's proposal compare to the Commission's Orders relating to the EDIT?

A. Under the TCJA and the IRS' normalization requirements, the return of protected EDIT to customers must be done over the remaining life of the underlying plant assets using ARAM. Minnesota Power will amortize its protected EDIT using the ARAM method. Minnesota Power proposes to amortize its unprotected EDIT to customers over a ten-year period. This approach — ARAM for protected EDIT and ten years for unprotected EDIT — is consistent with the way the Commission, in its December 5, 2018 Order, authorized both Minnesota Power and Northern States Power Company d/b/a Xcel ("Xcel") to amortize EDIT into base rates.

Q. What are the 2022 test year amortization amounts resulting from the inclusion of the EDIT in base rates?

A. The total 2022 test year amortization amount for EDIT is $9,634,298. This consists of $8,939,005 for protected EDIT and $695,293 for unprotected EDIT. The Minnesota jurisdictional amount is $8,445,397 (this is the total of both protected and unprotected).

Q. How long will this amortization amount continue?

A. Minnesota Power proposes to include the above amount of EDIT in base rates until such time that the Company files a subsequent rate case. At that time, the amount of EDIT incorporated in current period annual deferred tax expense will be updated.

Q. What is Minnesota Power requesting with respect to future EDIT-related compliance filings?

A. If EDIT is incorporated into the base rates developed in this case as the Company proposes, the compliance filings are no longer necessary. Accordingly, for clarity, Minnesota Power requests discontinuation of the compliance filing requirement in Docket No. E,G-999/CI-17-895.

Q. Will Minnesota Power's proposals relating to EDIT change if the corporate tax rate is changed by Congress?

A. Minnesota Power is aware that Congress is considering infrastructure initiatives that include various clean energy initiatives that may result in the corporate tax rate increasing from the flat 21 percent established in the TCJA. The Company cannot predict when Congress will act or what it will do; however, Minnesota Power has been evaluating the various proposals and has also quantified the effect of a potential corporate tax rate increase. An increase in the corporate tax rate to 26.5 percent effective 2022 would create an estimated $93 million of deferred expense (over $4 million per year under a 21-year amortization life) and an estimated $6 million current tax expense. In other words, a change in the corporate tax rate could have a very material impact on Minnesota Power.

Accordingly, the Company proactively recommends that if a new corporate tax rate — or some other similarly important tax measure — is enacted during the pendency of this rate case, there should be a path that allows the Commission to consider the new law's impact on Minnesota Power and other affected utilities in a manner that is consistent with the tax rate reduction measures taken after the TCJA. Minnesota Power respectfully recommends that the Commission should develop a rate rider through which the effect of the new law's impact is recovered in Minnesota Power's rates.

C. <u>Proration of ADIT</u>

Q. Please describe the proration of ADIT.

A. When a utility is utilizing a forecasted test year for determining revenue requirements, the IRS has a normalization requirement that governs the calculation of the averaged ADIT balance used to reduce rate base. The application of this normalization requirement — or proration — was clarified in the context of the Minnesota retail ratemaking process with the issuance of a Private Letter Ruling ("PLR") to Otter Tail

Power Company ("Otter Tail") in 2017. In Minnesota Power's 2016 Rate Case, the Company agreed that although Otter Tail's PLR is expressly applicable only to Otter Tail, Minnesota Power is subject to the same requirements in its Minnesota retail rate proceedings; therefore, Minnesota Power would follow the guidance in Otter Tail's PLR.

Q. How did Minnesota Power propose, in its 2019 Rate Case, to handle the proration requirement for the forecast test year?

A. Minnesota Power proposed to use the same proration calculation method, based on Otter Tail's PLR, that the Company agreed to use in the 2016 Rate Case. However, because the 2019 Rate Case was ultimately withdrawn, this issue was never presented for the Commission's consideration.

Q. How does Minnesota Power propose, in this rate case, to handle the proration requirement for the forecast test year?

A. Minnesota Power proposes to again use the same proration calculation method — based on Otter Tail's PLR — that the Company agreed to use in the 2016 Rate Case. Specifically, the Company is using proration in the calculation of the ADIT balance used for interim rates. The effects of proration on interim rates will not be reversed or offset in a subsequent phase or with any interim rate refund for the period of the test year. Proration is not being used in the calculation of the ADIT balance used for rate base for the final test year revenue requirement.

Q. Why does Minnesota Power propose this approach?

A. First, the Company must follow the IRS' normalization requirements. If the Company did not follow IRS normalization requirements, a normalization violation would occur, and the IRS would disallow all accelerated depreciation, thereby increasing the Company's tax liability by the amount not normalized, which would increase rates for customers. Second, one of the IRS' normalization requirements is that once a utility begins a proration schedule, that same schedule must continue to be used thereafter. *See* IRS Regulation 1.167(l)-1(h). Third, this approach is consistent with the approach used in the Company's previous rate cases. Finally, the approach based on the Otter Tail PLR means that the benefits of ADIT are timely and fully made available to customers.

III. FEDERAL TAX CREDITS

A. <u>Federal Production Tax Credits</u>

Q. What are Production Tax Credits?

A. Production Tax Credits ("PTCs") are federal tax credits that are earned from the generation of electricity using renewable resources. They are intended to act as a financial incentive to support the development of renewable energy facilities and are provided for the first ten years of a renewable energy facility's operation.

Q. What Minnesota Power facilities have generated PTCs?

A. Minnesota Power currently generates PTCs for its Bison Wind Energy Center and for its Taconite Ridge Wind Energy Center.

Q. How were PTCs addressed in the 2016 Rate Case?

A. Prior to the 2016 Rate Case, as PTCs were generated, they were included in the Company's Renewable Resource Rider ("RRR") and used to reduce revenue requirements in the RRR. In the 2016 Rate Case, the annual benefit of the tax credits was moved from the RRR and incorporated in base rates. Along with the incorporation of the PTC benefit in base rates, Minnesota Power proposed to continue to use the RRR for an annual true-up of PTCs. The Company proposed an annual true-up of the PTCs because of the difficulty of predicting annual wind generation, because of expected future increases in the tax benefit from the PTCs for IRS-determined inflation, and to account for the loss of PTCs at the end of the ten-year credit period. The Commission agreed with this proposal and, since then, the RRR has been utilized to true up the difference between PTCs in base rates and actual PTCs generated since the 2016 Rate Case.

Q. How does Minnesota Power propose to handle PTCs at this time?

A. Minnesota Power proposes to continue with the same methodology — the annual benefit of tax credits will be incorporated into base rates with an annual true-up for the difference between the PTCs in base rates and the actual PTCs generated.

Q. What is the amount of PTCs that Minnesota Power proposes to include in base rates for the 2022 test year?

A. Minnesota Power's estimated PTC tax benefit for the 2022 test year is $32,001,832.

B. <u>Federal Investment Tax Credits</u>

Q. What are Investment Tax Credits?

A. Investment Tax Credits ("ITCs") are federal tax credits available for qualified renewable energy projects (such as solar, wind, hydro, and geothermal projects). They provide a tax credit in the amount of 30 percent (26 percent for solar) of the qualified expenditures for the project. An ITC is generated at the time the qualifying facility is placed in service. Federal ITCs are intended to act as a financial incentive to support the development of renewable energy facilities.

Q. What federal ITCs does Minnesota Power have at this time?

A. In 2015, Minnesota Power placed in service the substantial rebuild of the Thomson Hydro Dam, which was destroyed by a flood in 2012. The rebuild of the dam qualified for $24 million of federal ITCs under Internal Revenue Notice 2008-60, Electricity Produced From Certain Renewable Resources.

In addition, in 2020, the Company began work on pursuing approximately 21 MW of utility-scale solar projects in Northern Minnesota, which is described in more detail in Commission Docket E015/M-20-828. As described in the Company's February 4, 2021 filing in that docket, the current plan is to structure these projects with an affiliate so as to take advantage of the resulting tax credits and pass them along to customers.

Q. What effect do the federal ITCs have on Minnesota Power's rates in this rate case?

A, Federal ITCs are handled through the RRR and have no effect on the rates proposed in this rate case.

IV. PROPERTY TAX EXPENSE

Q. What is the purpose of your testimony related to property tax expense?

A. In this rate case, Minnesota Power is requesting recovery of forecasted property tax expense for the 2022 test year. I briefly explain how Minnesota Power's property taxes are assessed and why Minnesota Power's methodology for forecasting property expense is reasonable.

Q. What amount of property tax expense is included in Minnesota Power's 2022 test year budget?

A. Minnesota Power's 2022 test year total company property tax expense is projected to be $55,237,907 Total Company and, of that total, $53,100,831 is assessed by the state of Minnesota. The Minnesota adjusted amount is $36,121,983, and the Minnesota jurisdictional amount is $32,214,885.

Q. What are the property taxes that Minnesota Power pays?

A. Minnesota Power pays property tax in two states — Minnesota and North Dakota. The vast majority of the Company's property tax burden is from the state of Minnesota. Most of the Minnesota property tax results from an assessment by the Minnesota Department of Revenue ("DOR"), and the remainder is assessed by Minnesota local assessors. The North Dakota property tax is assessed under North Dakota's laws and rules relating to wind and transmission property tax.

Q. Please summarize the process the DOR uses to value Minnesota Power's property.

A. The State of Minnesota has adopted administrative rules that it uses to estimate the value of all of Minnesota Power's operating property considered as a unitary system.[5] Very

[5] *See* Minn. R. 8100.0100 *et seq.*

briefly summarized, the DOR uses two primary approaches (the cost approach and the income approach), considers other approaches, and then assigns "weightings" to the results of those approaches to reach a "System Unit Value." The System Unit Value is then adjusted to reflect the amount of Minnesota Power's operating property that is in Minnesota, and other adjustments are made — resulting in the "Apportionable Market Value." The Apportionable Market Value is used by local jurisdictions to arrive at the property tax liability for each jurisdiction.

Q. Is it difficult to predict the amount of Minnesota property taxes Minnesota Power will have to pay each year?

A. Yes. Valuation of utility property is a complex and subjective exercise, and the DOR has the ability to exercise discretion at each stage of the process.

Q. What does Minnesota Power do to mitigate the unpredictability of its Minnesota property taxes?

A. Minnesota Power takes advantage of a process, set forth in Minn. Stat. § 273.372, allowing for an "administrative appeal" of the DOR's initial valuation. Through this annual process, Minnesota Power vigorously advocates for adjustments to lower its System Unit Value and to make the DOR's valuation determination more consistent and predictable. Minnesota Power also submits advocacy to the DOR about property tax valuation each spring. Minnesota Power takes every available opportunity to advocate for its property tax burden arising from the DOR's valuation to be as low as reasonably possible.

Q. How does Minnesota Power forecast the amount of Minnesota property taxes for each year?

A. Minnesota Power estimates the valuation of its property using a model that reflects the relevant financial data inputs for each of the approaches used by the DOR (the DOR uses primarily the cost approach and the income approach and occasionally considers other approaches). Some elements of the approaches are based on past actual data, and others are based on estimated or budgeted future data. Certain key inputs to the valuation analysis — such as the capitalization rate and the weighting of each approach — are highly discretionary with the DOR, change materially from year to year, and are often the subject of disagreement between the DOR and the Company. The DOR may change these key inputs from one year to the next, and the Company tries to anticipate the DOR's approach and the long-term historical trend of the valuation process. Minnesota Power then calculates the previous year's overall effective tax rate and applies that rate to the valuation estimated using the modeling and assumptions described above. That results in an estimated amount of tax expense for the year being forecast.

It is important to recognize that the budget process necessitates the estimation of property tax expense approximately 18 months before the property tax bills are issued to Minnesota Power.

Q. How will Minnesota Power ensure that the amount set for property tax expense in this rate case is as accurate as possible?

A. Although Minnesota Power believes it has done the best it reasonably can do to forecast property tax expense, the actual amount can vary for the reasons discussed above. Minnesota Power proposes that if its 2022 tax expense is materially different from the projection, Minnesota Power will use the actual amount for final rates. Once the DOR's final 2022 Apportionable Market Value is determined, which is expected to be in August 2022, Minnesota Power will supplement my testimony so that the record in this rate case reflects whether the final property tax expense is significantly different from forecast.

Q. Is Minnesota Power requesting a method to true-up property tax expense?

A. Yes. An annual true-up would be consistent with the Commission's past approval of true-ups for property taxes in other cases. For example, in the rate case Xcel filed in 2015, it proposed a symmetrical true-up, which was approved as part of a multi-issue settlement in that case.[6] Such an approach would represent the most accurate, timely, and direct recovery mechanism supporting the true cost of service and would ensure there is neither under- nor over-recovery of property tax expense in any given year.

Q. How would the true-up process work?

A. The Company proposes to use the same process that it understands is currently used by Xcel, as follows. Each year, once the Company's actual property tax obligations for that year are known in sufficient detail, the Company would submit a compliance filing in the docket for this rate case. For example, the compliance filing for the 2022 test year would be submitted in the third quarter of 2023. This compliance filing would identify the amount by which the actual property tax obligations were over or under the amount for property taxes established in this rate case (the "baseline"). If the property tax obligations were lower than the baseline, the Company would refund the difference to customers (with interest at a rate established by the Commission equivalent to the Company's short-term borrowing rate), and if the property tax obligations were higher than the baseline, the Company would charge customers through a bill surcharge or similar mechanism.

V. CONCLUSION

Q. Does this complete your testimony?

A. Yes.

[6] *See, e.g., In the Matter of the Application of Northern States Power Company for Authority to Increase Rates for Electric Service in the State of Minnesota*, Docket E002/GR-15-826 FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 14, 36 (June 12, 2017) (describing property tax true-up).