Direct Testimony
Rena E. Verdoljak

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-23-155

Exhibit ________

TAX

November 1, 2023

TABLE OF CONTENTS

Page

I. INTRODUCTION AND QUALIFICATIONS

Q. Please state your name and business address.

A. I am Rena E. Verdoljak, 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 23 years of experience in tax and accounting. I have a bachelor's degree in accounting from the University of Wisconsin-Superior. I began my career in 2000 with McGladrey & Pullen, LLP in Duluth, MN and worked in roles of increasing responsibility in tax and accounting, including my final role as tax manager. I have been employed by ALLETE since 2014. My previous positions with ALLETE include Supervisor – Tax, and Supervisor – Accounting. In May of 2022 I became Manager – Tax.

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 Direct Testimony?

A. The purpose of my Direct Testimony is to address several tax issues relevant to this rate proceeding, including property tax and proposed property tax true-up, excess deferred income taxes, and federal tax credits.

Q. Are you sponsoring any exhibits in this proceeding?

A. No.

II. PROPERTY TAX EXPENSE

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

A. In this rate case, Minnesota Power is requesting recovery of forecasted property tax expense for the 2024 test year (payable in 2025). Payment of property taxes is a necessary expense in providing electric service to our customers. I explain how Minnesota Power's property taxes are assessed and why Minnesota Power's methodology for forecasting property tax expense is reasonable. In addition, the Company renews its request for a property tax true-up mechanism.

Q. What amount of property tax expense is included in Minnesota Power's 2024 test year budget?

A. Minnesota Power's 2024 test year property tax expense is forecasted to be $53,729,280 Total Company ($46,776,711 MN Jurisdictional).

Q. What kinds of property taxes are included in that total amount for the 2024 test year?

A. Minnesota Power is subject to property taxes in both Minnesota and North Dakota. In Minnesota, the Company's taxes are primarily state-assessed, meaning the Minnesota Department of Revenue ("DOR") develops a value for the entire utility, and that value is allocated among all parcels in the counties where Minnesota Power has real or personal property. In North Dakota, taxes are assessed based on generation, capacity, and transmission line miles at the state level. Because Minnesota property taxes represent most of the property taxes the Company incurs, as indicated above, the discussion in my Direct Testimony focuses on Minnesota and the DOR's valuation process.

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

A. The DOR has adopted administrative rules (codified in Minnesota Rules Chapter 8100) that it uses to estimate the value of all of Minnesota Power's operating property, considered as a unitary system.[1] In short, the DOR typically uses two primary approaches to estimate utility property valuation: 1) the cost approach; and 2) the income approach).[2] The DOR 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 then deductions are made (for example, to remove property that is exempt from taxation). The result is the "Apportionable Market Value." The Apportionable Market Value is used by local jurisdictions to calculate 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 and no. On the one hand, the Company has a detailed understanding of the factors that affect the amount of Minnesota property taxes that will be paid, and has developed a forecast methodology that is reasonable and allows for consistent forecasts from year to year. On the other hand, several of the factors are outside the Company's control, and often there is some unpredictable change in them that causes the actual tax expense to vary from the forecast. One of these factors is the Capitalization Rate ("Cap Rate"). The DOR issues a capitalization rate study each spring, in which it determines the Cap Rate that it uses to determine all electric utilities' value under the income approach. The DOR's capitalization rate methodology evolves from year to year, making the DOR's Cap Rate difficult to predict.

Q. Can the Company challenge the DOR's initial assessment prior to final property tax bills being issued?

A. Yes. 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. Starting in 2018, this process was modified so that it allows the DOR and the utility to enter into a binding

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

[2] Under Minn. R. 8100.0300, the DOR may also utilize other approaches to value utility property, but it rarely does.

settlement concerning the utility's value. The appeal process has historically resulted in reductions in value as compared to the formulaic approach set forth in Chapter 8100. While the settlements that result from the appeal process each year have been favorable, the Company cannot precisely predict the amount by which the DOR is willing to compromise on the value each year or if the settlements will be favorable in the future.

Q. Are there any other factors that cause variability in the amount of Minnesota property taxes the Company has to pay each year?

A. Yes. Local property tax rates, including the statewide commercial-industrial general levy rate, are not in the Company's control, and vary somewhat from year to year. Thus, they can cause significant fluctuations in the Company's tax liability.

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 primarily uses the cost approach and the income approach, as previously indicated). Several of the inputs are based on Company financial data; for those, the Company uses the most recent budgeted data. Two of the remaining inputs—the Cap Rate and the weighting of each approach—are highly discretionary and subjective within the DOR, can change materially from year to year, and are often the subject of disagreement between the DOR and the Company. Minnesota Power assumes an even weighting between the cost approach and income approach. To estimate the Cap Rate, the Company considers historical data and market trends, but this input is very difficult to predict. As to the final input, the local tax rate, Minnesota Power calculates the average of the prior three years' overall effective tax rate and applies that rate to its estimate of the DOR's valuation that it created using the modeling and assumptions described above. That results in an estimated amount of tax expense for the year being forecast. This is the same practice the Company followed in Minnesota Power's 2021 Rate Case, Docket No. E015/GR-21-335 ("2021 Rate Case"), its most recent rate case.

Q. Could you explain how using the inputs you just discussed results in a reasonable forecast of property tax expense for the 2024 test year?

A. We believe our forecast is very reasonable, because it uses the most current Company financial data, and for the factors that are out of the Company's control, our assumptions are developed based on past years' experience and activity.

Q. Is Minnesota Power required to estimate its property tax expense for this rate case prior to knowing its actual property tax expense for the 2024 test year?

A. Yes. The tax expense for the 2024 test year is payable in 2025. The DOR's Cap Rate for taxes payable in 2025 will not be issued until March 2024, the DOR's valuation for taxes payable in 2025 will be finalized in approximately August 2024, and the property tax bills for that tax year will not be received by the Company until approximately March 2025. To be submitted with this rate case, the property tax estimate has to be developed many months before those events.

Q. In light of the lead time required to estimate property taxes for the 2024 test year, and the variables that make the property tax expense difficult to predict, is Minnesota Power proposing any mechanism that would help ensure that customers ultimately pay only actual property tax amounts?

A. Yes. In this case, the Company is proposing a property tax true-up that would ensure that customers only pay the actual amount of property taxes incurred by the Company.

Q. Did the Commission approve a property tax true-up mechanism in the Company's 2021 Rate Case?

A. No, it did not. The administrative law judge concluded that the Company's proposed property tax true-up proposal was reasonable because it was consistent with the true-up process used by Xcel Energy, some important variables in the property tax process are discretionary with the DOR, and the Company has strong incentives to prudently manage and mitigate its tax expense.[3] The Commission disagreed.[4] The Company, however, renews its request for a property tax true-up mechanism in this proceeding.

Q. How would Minnesota Power's proposed property tax true-up mechanism benefit customers?

A. The Company's proposed property tax true-up mechanism would be the most accurate, timely, and direct recovery mechanism supporting the true cost of service. It would ensure that there is neither under- nor over-recovery of property tax expense in any given year.

Q. How would the Company's proposed property tax true-up process work?

A. Consistent with the true-up that the Commission approved for Xcel Energy in Docket No. E002/GR-21-630,[5] 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 2024 test year would be submitted in the second quarter of 2025. This compliance filing would identify the amount by which the actual property tax obligations were over or under the forecasted amount for property taxes established in this rate case (the "baseline"). If the actual property tax obligations are lower than the baseline, the Company would refund the difference to customers, and if the actual property tax obligations are higher than the baseline, the Company would charge customers through a bill surcharge or similar mechanism.

Q. Will Minnesota Power continue to advocate for the lowest possible state-assessed valuation if the Commission approves a property tax true-up mechanism?

---

[3] *In re Application of Minnesota Power for Auth. to Increase Rates for Elec. Serv. in Minn.*, Docket No. E015/GR-21-335, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND RECOMMENDATIONS at 135–36 (Sept. 1, 2022).

[4] *In re Application of Minnesota Power for Auth. to Increase Rates for Elec. Serv. in Minn.*, Docket No. E015/GR-21-335, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 76 (Feb. 28, 2023).

[5] *In re Application of N. States Power Co., d/b/a Xcel Energy, for Auth. to Increase Rates for Elec. Serv. in the State of Minn.*, Docket No. E002/GR-21-630, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 162, 164 (July 17, 2023); *In re Application of N. States Power Co., d/b/a Xcel Energy, for Auth. to Increase Rates for Elec. Serv. in the State of Minn.*, OAH Docket No. 22-2500-37994, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND RECOMMENDATIONS at 30–31 (Mar. 31, 2023).

A. Absolutely. Minnesota Power has a long-proven history of successfully advocating for adjustments to lower its system value and has every incentive to continue to do so. The Company dedicates significant time and resources each year to obtain the lowest reasonable value.

Q. Please summarize your recommendations regarding property taxes for the 2024 test year.

A. I recommend that the Commission approve the Company's forecasted level of property tax expense for the 2024 test year. The Company also renews its request for a property tax true-up mechanism.

III. EXCESS DEFERRED INCOME TAXES RESULTING FROM THE TAX CUTS AND JOBS ACT

Q. What is the purpose of this section of your Direct Testimony?

A. In late 2017, the federal Tax Cuts and Jobs Act ("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 <u>excess</u> accumulated deferred income taxes ("EDIT") for Minnesota Power. This section of my Direct Testimony provides an update on that topic.

Q. How was the EDIT addressed in the 2021 Rate Case?

A. The Company proposed to incorporate the benefit of the EDIT in the rates developed in that case. The Internal Revenue Service ("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. The Company proposed to amortize its protected EDIT using the Average Rate Assumption Method ("ARAM"), as required by the TCJA and IRS rules, and proposed to amortize its unprotected EDIT over a ten-year period. The Company identified the test year amortization amount for each type of EDIT that was to be incorporated into base rates in the 2021 Rate Case. This issue was not contested. The Company also committed that in its next rate case, it would update the amount of EDIT to be included in rates.

Q. What are the 2024 test year amortization amounts resulting from the inclusion of the EDIT in base rates in this rate case?

A. The total 2024 test year amortization amount for EDIT is $11,923,249 Total Company ($10,524,652 MN Jurisdictional). This consists of $11,009,143 Total Company ($9,717,771 MN Jurisdictional) for protected EDIT and $914,106 Total Company ($806,881 MN Jurisdictional) for unprotected EDIT.

IV. FEDERAL TAX CREDITS

Q. What is the purpose of this section of your Direct Testimony?

A. In this section, I introduce and discuss the amount of federal tax credits the Company includes in its 2024 test year forecast. I then discuss how recent changes to federal law have impacted these federal tax credits, primarily the transferability of these federal tax credits, and the impact on rates in this case.

A. Federal Production Tax Credits

Q. What are Production Tax Credits?

A. Production Tax Credits ("PTCs") are federal tax credits that are earned from the generation of energy 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 has generated PTCs through the operation of its Bison Wind Energy Center ("Bison") and its Taconite Ridge Wind Energy Center ("Taconite Ridge").

Q. How does Minnesota Power propose to handle PTCs for purposes of this rate case?

A. In Minnesota Power's 2016 Rate Case, Docket No. E015/GR-16-664 ("2016 Rate Case") and its 2021 Rate Case, the Company proposed that the annual benefit of PTCs would be incorporated into base rates, with an annual true-up for the difference between the PTCs in base rates and the actual PTCs generated. In this rate case, the Company proposes to continue with the same methodology.

Q. Why is an annual true-up appropriate for incorporating adjustments resulting from the actual amount of PTCs generated?

A. The amount of PTCs generated in a year depends on the amount of power produced by wind facilities during that year—although reasonable estimates can be made, it is not possible to accurately predict the amount of wind that will blow. In addition, in most years, the IRS adjusts the PTCs rate. The methodology that the Company proposes—incorporating the annual benefit of PTCs into base rates, with an annual true-up—has worked well since it was first proposed in our 2016 Rate Case.

Q. What is the amount of PTCs that Minnesota Power proposes to include in base rates for the 2024 test year?

A. Minnesota Power's estimated PTC benefit for the 2024 test year is $21,220,499[6] Total Company ($18,812,397 MN Jurisdictional).

B. Federal Investment Tax Credits

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 are intended to act as a financial incentive to support the development of renewable energy facilities. An ITC is generated at the time the qualifying facility is placed in service.

Q. What federal ITCs has Minnesota Power qualified for?

A. Minnesota Power qualified for approximately $24 million of ITCs in 2015 through the rebuild of the Thomson Hydro Dam, which was damaged by a flood in 2012.

---

[6] 731,741,353 kWh x $0.0290 per kWh = $21,220,499.

Q. What is the status of the Company's use of those ITCs?

A. Under the IRS' normalization rules, Minnesota Power cannot begin to amortize those ITCs until the consolidated group (i.e., ALLETE and all of its subsidiaries that join in its consolidated federal tax return) realizes a reduction of federal taxes payable. That is expected in 2024. Thus, the amortization will begin in 2024. The amortization will continue throughout the remaining useful life of the rebuilt Thomson Hydro Dam facility, which is expected to be through 2064.

C. Impact of the Inflation Reduction Act on Federal Tax Credits

Q. What is the Inflation Reduction Act?

A. The Inflation Reduction Act of 2022 ("IRA") is a set of federal laws passed in August 2022. Among other things, the IRA extended and expanded PTC and ITC benefits for various clean/renewable energy resources. The IRA also provided holders of federal PTCs—but only those generated in 2023 or afterward—the ability to transfer the PTCs to eligible taxpayers ("Transferees") in exchange for cash payments.

Q. What is the effect, if any, of the IRA on Minnesota Power for this rate case?

A. First, Minnesota Power is evaluating renewable energy projects, including wind and solar, that will take advantage of the extensions and expansions of PTCs and ITCs to reduce the Company's federal income tax expense. But any such projects will take place after this rate case is filed, and so these potential opportunities will not have a direct impact on rates in this rate case.

In addition, Minnesota Power intends to transfer PTCs under the transferability provisions of the IRA. The impact of such transfers will be addressed in the next iteration of Minnesota Power's Renewable Resource Rider ("RRR"), and thus will not have a direct impact on rates in this rate case.

Q. Why would the Company seek to transfer PTCs?

A. Transferring PTCs will accelerate the utilization of the Company's Accumulated Deferred Income Tax Asset ("ADITA") for PTCs, which is currently included in rate base. As a result, transferring tax credits should benefit customers.

Q. Please explain in more detail.

A. As noted above, the construction of Minnesota Power's four Bison Wind projects, as well as the construction and repowering of Taconite Ridge, generated significant PTCs. The PTCs reduced the Company's revenue requirement in the years in which they were generated, but because the Company had Net Operating Losses ("NOL") for those years, the PTCs could not be applied to reduce the Company's federal tax liability for those years and were instead carried forward as an ADITA. The ADITA was incorporated into base rates in the 2016 Rate Case. In 2020, the Company fully utilized its federal NOL and began utilizing the ADITA to offset its federal tax liability. As a reference point to indicate the size of the ADITA, its balance was $319,655,744 Total Company ($281,287,465 MN Jurisdictional) as of December 31, 2022.

Q. What impact will the transfer of PTCs to be generated in 2023 or afterwards have on the Company's existing ADITA for PTCs?

A. The IRA only allows PTCs generated after 2023 to be transferred. Therefore, any potential transfer of PTCs will not immediately reduce the existing ADITA. But, the transfer of PTCs generated in 2023 and afterward will cause the ADITA to reduce faster than it would have if the credits had been retained by Minnesota Power.

Q. As Minnesota Power transfers PTCs generated in 2023 or afterwards, will they be transferred at full value or at a discount?

A. We expect that PTCs would have to be transferred at a discount—this is necessary to incentivize eligible transferee taxpayers to purchase the credits. Minnesota Power will return the net benefit of the credits to our customers through the RRR, which will reduce rates in the long term.

Q. What effect will transferability have on rates in this rate case?

A. Minnesota Power has not included any impacts of transferability in this rate case and expects to incorporate the impact into the next RRR.

V. CONCLUSION

Q. Please summarize your recommendations.

A. I recommend that the Commission approve the Company's forecasted property tax expense for the 2024 test year, which represents a reasonable level of property tax expense and baseline for the Company's proposed property tax true-up. In addition, I recommend that the Commission approve the proposed property tax true-up mechanism. I recommend that the Commission accept the estimated PTC tax benefit for the 2024 test year of $21,220,499 Total Company ($18,812,397 MN Jurisdictional) as a baseline that will be trued-up.

Q. Does this complete your Direct Testimony?

A. Yes.