BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Don Storm	Chair
Tom Burton	Commissioner
Marshall Johnson	Commissioner
Cynthia A. Kitlinski	Commissioner
Dee Knaak	Commissioner

In the Matter of the Application of Minnesota Power for Authority to Change Its Schedule of Rates for Retail Electric Service in the State of Minnesota

ISSUE DATE: November 22, 1994

DOCKET NO. E-015/GR-94-001

FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER

PROCEDURAL HISTORY

I. INITIAL PROCEEDINGS

On January 3, 1994, Minnesota Power & Light Company (MP or the Company) filed a petition pursuant to Minn. Stat. § 216B.16, subd. 1 (1992) seeking a general rate increase of $34,348,800 or 11.78 percent, effective March 4, 1994.

On February 7, 1994, the Commission issued an ORDER ACCEPTING FILING AND SUSPENDING RATES. In its Order the Commission accepted MP's filing for a general rate increase and suspended the proposed rates. On the same date, the Commission issued its NOTICE AND ORDER FOR HEARING which set the matter for contested case hearing. The Office of Administrative Hearings assigned Administrative Law Judge (ALJ) Allen E. Giles to the case.

On February 18, 1994, the ALJ held a prehearing conference.

On February 25, 1994, the Commission issued its ORDER SETTING INTERIM RATES. The Order authorized MP to collect as interim rates $20,133,135 in additional revenues or 7.09 percent of revenues over current rates for service rendered after March 1, 1994.

On March 9, 1994, the ALJ issued a Prehearing Order establishing the hearing schedule and procedural guidelines governing the conduct of the contested case proceeding.

On March 30, 1994, the ALJ issued a Supplemental Prehearing Order and Protective Order.

On April 22, 1994, MP filed its pre-filed direct testimony and a letter addressing several administrative matters pertaining to its pre-filed direct testimony and the public and evidentiary hearings on this matter.

On April 26, 1994, the Northwest Paper Division of Potlatch Corporation (Potlatch) filed direct testimony.

On April 26, 1994, MP filed a revenue and expense update as required by the ALJ's March 9, 1994 Prehearing Order.

On April 27, 1994, the Residential Utilities Division of the Office of the Attorney General (RUD-OAG), the Department of Public Service (the Department), and the Large Light and Power Group (LLPG) filed direct testimony and exhibits.

On April 28, 1994, direct testimony and exhibits were filed by the Large Power Intervenors (LPI). Eveleth Expansion Co., and the Minnesota Senior Federation (Senior Federation or Seniors). In addition, MP filed additional direct testimony.

On April 29, 1994, MP filed a supplement to its April 26 revenue and expense update.

Between May 2 and May 20, 1994, the ALJ conducted seven informal public hearings at locations in MP's service territory.

On May 2, 1994, the Seniors filed additional direct testimony.

On May 5, 1994, the Seniors filed a Notice of Appearance, Request for Compensation, Exhibits and a Statement of Participation.

On May 12, 1994, LPI corrected a portion of its direct testimony.

On May 18, 1994, the Department filed Errata to Direct Testimony of Eilon Amit and Direct Testimony & Exhibits of John P. Kundert.

On May 26, 1994, MP filed a response to the Seniors' request for compensation.

On May 26, 1994, Potlatch filed Rebuttal Testimony.

On May 27, 1994, Rebuttal Testimony was filed by the Department, MP, and LPI.

On May 31, 1994, the ALJ held the Final Prehearing Conference.

On June 6, 1994, LPI filed a Reply to Objections of MP to testimony of its (LPI's) witnesses.

On June 6, 1994, MP and the Department filed their Lists of Witnesses and Order of Appearance.

On June 7, 1994, Eveleth filed their List of Witnesses and dates of Appearance.

On June 8, 1994, the RUD-AG filed its List of Witnesses and Order of Appearance, the Seniors filed Surrebuttal Testimony, LPI filed Rebuttal Testimony, the RUD-OAG filed Surrebuttal Testimony and an Objection to the Rebuttal Testimony of MP Witness David G. Gartzke, and the Department filed Surrebuttal Testimony and Exhibits.

On June 9, 1994, LPI and LLPG filed Surrebuttal Testimony and the Seniors filed a List of Witnesses and Order of Appearance.

On June 10, 1994, MP filed a Witness Schedule and Reply to Objections of RUD-OAG.

On June 14 and 16, 1994, the Seniors filed additional Surrebuttal Testimony.

On June 17, 1994, MP filed an objection to the Surrebuttal Testimony filed by the Seniors on June 16, 1994 and the Seniors responded to that objection.

On June 23, 1994, the Seniors filed Corrections to Direct and Surrebuttal Testimony and Exhibits of Witness Knecht.

On June 24, 1994, the Commission issued its ORDER GRANTING PRELIMINARY DETERMINATION OF ELIGIBILITY FOR INTERVENOR COMPENSATION.

II. PARTIES AND REPRESENTATIVES

A. The Company

MP is an investor-owned company having a diversity of business operations. MP owns and operates electric, gas, water and waste water utilities. MP provides electrical service in Northern Minnesota and northwestern Wisconsin. In addition, MP's major operations include coal mining, paper recycling and manufacturing, and investment and financial services.

MP is authorized by the Commission to sell electricity at retail within a 26,000 square mile exclusive service area in northern and central Minnesota. The Company supplies retail electric service to approximately 110,000 customers residing in cities, towns, and rural areas within its assigned service area. The largest city served is Duluth with a population of approximately 85,000.

MP delivers electrical service according to a schedule of rates for the following customer rate classes:

Residential
General Service (includes some small business)
Large Light and Power
Large Power
Large Power Interruptible
Municipal Pumping
Lighting
Dual Fuel

The Company's Large Power class consists of approximately ten customers engaged in taconite mining or paper pulp production. This class accounts for approximately 54 percent of the Company's current revenues. The Company's Large Power and Light class accounts for approximately 16 percent of the Company's revenues. Together, therefore, the Large Power and the Large Power and Light classes account for approximately 70 percent of MP's current revenues.

Appearing on behalf of MP were: Samuel L. Hanson, Attorney at Law, 2400 IDS Center, Minneapolis, Minnesota 55402 and Johannes W. Williams and David J. McMillan, Attorneys at Law, Minnesota Power, 30 West Superior Street, Duluth, Minnesota 55802.

B. Intervenors

Petitions to intervene in this proceeding were filed pursuant to Minn. Rules, Part 1400.6200. The following were made parties to this proceeding: the Minnesota Department of Public Service, Eveleth Expansion Company, Potlatch Corporation, the Large Light and Power Group, the Large Power Intervenors, the Office of the Attorney General, the Minnesota Senior Federation Northeast Coalition, Boise Cascade Company, and the Energy CENTS Coalition. The Energy CENTS Coalition later withdrew from the proceeding as a separate intervenor and submitted testimony supporting the Senior Federation.

The intervenors and their representatives in this matter are as follows:

The Minnesota Department of Public Service (the Department) has an affirmative obligation to participate, representing the general public interest, in proceedings before the Commission. The Department has an obligation to investigate and enforce, on behalf of the public interest, the standards and requirements imposed on a public utility by the Minnesota Public Utility Act. The Department intervenes as a matter of right in proceedings before the Commission pursuant to authority contained in Minn. Stat. § 216A.07 (1992). The Department was represented by Brent Vanderlinden, Assistant Attorney General, Suite 1200 NCL Tower, 445 Minnesota Street, St. Paul, Minnesota 55101-2130.

Attorney General Hubert H. Humphrey, III, is statutorily charged with representing and furthering the interests of residential and small business utility customers in matters before the Commission involving utility rates and adequacy of utility services to residential and small business utility consumers. Minn. Stat. § 8.33, subd. 2 (1992). The Attorney General is entitled to intervene as of right and to participate as an interested party in matters pending before the Commission which affect the distribution of public utility services to residential and small business utility consumers. The Attorney General exercises this statutory right and responsibility through the Residential Utilities Division of his Office (RUD-OAG). Eric F. Swanson, Assistant Attorney General in the RUD-OAG, Suite 1200 NCL Tower, 445 Minnesota Street, St. Paul, Minnesota appeared for and on behalf of the Attorney General's Office.

The Minnesota Senior Federation-Northeast Coalition (Senior Federation or Seniors) described itself as a grass roots membership based citizen organization, consisting primarily of people over the age of 55, but also including some younger people, in the Duluth area, Lake and Cook counties, southern St. Louis County, and northeast Carlton County. The Senior Federation directly represents over 5,500 individual dues-paying members who have fixed low and moderate incomes, and over 50 affiliated senior citizens clubs. The Senior Federation was represented by Susan Ginsburg, Attorney at Law, P.O. Box 425, Duluth, Minnesota 55802.

The Large Power Intervenors (LPI) are taconite mining companies and paper manufacturers that use large amounts of electricity in their industrial processes and are members of MP's Large Power Class. The Large Power Intervenors include: Eveleth Taconite Company, Hibbing Taconite Joint Venture, Inland Steel Mining, Blandin Paper Company, and USX Corporation. The LP class accounts for 54 percent of MP's revenues and consumes 64 percent of MP's jurisdictional output. To illustrate comparative sizes: in 1993, USX Corporation consumed more electricity and paid for more service than all MP residential customers combined. LPI was represented in this matter by Robert S. Lee, Attorney at Law, 1600 TCF Tower, 121 South Eighth Street, Minneapolis, MN 55402.

Members of the Large Light and Power intervenor group (LLPG) are large industrial and commercial businesses that are part of MP's Large Light and Power (LLP) class of customers. The LLP class purchased approximately 16 percent of MP's retail electric sales in 1993. LLPG members are: Diamond Brands, Inc. in Cloquet; Georgia Pacific Corp. in Duluth; Lamb Weston/RDD in Park Rapids; Midwest Timber, Inc. in Two Harbors; North Star Steel in Duluth; St. Gabriel's hospital in Little Falls; Upper Lakes Food, Inc. in Cloquet; USG in Cloquet; ME International in Duluth; and Land O' Lakes in Browerville. LLPG was represented by James D. Larson, Attorney at Law, 1100 One Financial Plaza, 120 South Sixth Street, Minneapolis, MN 55402.

Potlatch Corporation (Potlatch) is a publicly owned, diversified forest products company with manufacturing facilities which convert wood fiber into various wood products such as pulp and paper products. Potlatch has manufacturing facilities located in Cloquet, Brainerd, Bemidji, Cook and Grand Rapids. Potlatch is a MP customer taking service in both the Large Light and Power class and the Large Power class. In 1993, Potlatch paid approximately $8 million for electrical service from MP. Potlatch was represented in this matter by Laurence R. Waldoch, Attorney at Law, 4200 IDS Center, 80 South Eighth Street, Minneapolis, MN 55402.

Eveleth Expansion Company (Eveleth), together with Eveleth Taconite Company, owns and operates taconite-producing mines (Thunderbird North and Thunderbird South) known as Eveleth Mines and a concentrating and pelletizing facility known as the Fairlane Plant. Eveleth is a member of MP's LP customer class. In 1993, Eveleth spent $16,589,000 for power and produced 3.139 million tons of taconite pellets. David F. Boehm, Attorney at Law, 2110 CBLD Center East Seventh Street, Cincinnati, Ohio 45202 appeared on behalf of Eveleth in this matter.

III. PUBLIC HEARINGS AND PUBLIC TESTIMONY

The ALJ held public hearings to receive comments and questions from non-intervening ratepayers. Public hearings were as follows:

Little Falls (May 2, 1994)
Park Rapids (May 3, 1994)
Grand Rapids (May 4, 1994)
Eveleth (1 p.m. and 8:00 p.m. on May 5, 1994)
Duluth (1:30 p.m. and 7:00 p.m. on May 20, 1994)

In total, the meetings were attended by 314 persons. Twenty-five (25) persons spoke.

In addition to the comments at hearing, the Commission received approximately 271 written comments and phone calls regarding the proposed rate increase. Most of the comments were in opposition to the rate increase. There was also strong opposition to MP's proposal to increase the rates more for residential customers than for companies and other large users.

IV. EVIDENTIARY HEARINGS

Evidentiary hearings were held from June 13, 1994 to July 1, 1994 commencing at the Federal Courthouse in Duluth, Minnesota and concluding at the Commission's Large Hearing Room in St. Paul, Minnesota. Forty-two witnesses prefiled testimony and/or testified during the evidentiary hearings.

The post-hearing briefing schedule required Initial and Reply Briefs filed on July 25 and August 3, 1994, respectively.

V. REOPENING THE RECORD FOR ADDITIONAL EVIDENCE

On August 15, 1994, MP filed with the ALJ a Motion to Reopen the Record for purposes of filing additional evidence relating to the reopening of National Steel Pellet Company, a taconite mining facility located in Keewatin, Minnesota.

On August 26, 1994, the ALJ held a hearing on MP's Motion. The ALJ granted the Motion and issued an Order Reopening Record and Extending Period of Suspension of Rates on August 30, 1994. As part of the Order granting the Motion, the ALJ extended the ten-month statutory period for deciding on MP's rate increase request by two weeks, from November 3, 1994 to November 17, 1994 pursuant to Minn. Stat. § 216B.16, subd. 1a (a) (Supp. 1993).

On September 9, 1994, the parties filed with the ALJ a document entitled Stipulation for Order Reopening the Record. The ALJ incorporated the entire Stipulation into the record.

On September 16, 1994, the Company also filed work papers showing the underlying basis for the numerical financial impact of the Stipulation. Upon receipt of these documents, the ALJ closed the record.

VI. PROCEEDINGS BEFORE THE COMMISSION

On September 20, 1994, the ALJ filed his final report and recommendations with the Commission.

On October 5, 1994 and pursuant to its authority under Minn. Stat. § 216B.16, subd. 2 (b) (1992), the Commission issued an Order extending the time period for issuing its final Order in this matter 20 working days from the date of the final determination in the Minnegasco rate case, Docket No. G-008/GR-93-1090.[1]

On October 20, 1994, the Commission met to hear oral arguments from the parties.

On October 26, 1994, the Commission met to deliberate this matter.

Upon review of the entire record of this proceeding, the Commission makes the following Findings of Fact, Conclusions of Law, and Order.

FINDINGS AND CONCLUSIONS

VII. JURISDICTION

The Commission has general jurisdiction over the Company under Minn. Stat. §§ 216B.01 and 216B.02 (1992). The Commission has specific jurisdiction over rate changes under Minn. Stat. § 216B.16 (1992).

The case was properly referred to the Office of Administrative Hearings under Minn. Stat. §§ 14.48-14.62 (1992) and Minn. Rules, Part 1400.0200 et seq.

VIII. FURTHER ADMINISTRATIVE REVIEW

Under Minn. Rules, Part 7830.4100, any petition for rehearing, reconsideration, or other post-decision relief must be filed within 20 days of the date of the Order. Such petitions must be filed with the Executive Secretary of the Commission, must specifically set forth the grounds relied upon and errors claimed, and must be served on all parties. The filing should include an original, 15 copies, and proof of service on all parties.

Adverse parties have ten days from the date of service of the petition to file answers. Answers must be filed with the Executive Secretary of the Commission and must include an original, 15 copies, and proof of service on all parties. Replies are not permitted.

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[1] The Commission issued the final Order in the Minnegasco rate case on October 24, 1994. Pursuant to the Commission's October 5, 1994 Order in this matter then, the deadline for issuing the final Order in this case is November 22, 1994.

The Commission, in its discretion, may grant oral argument on the petition or decide the petition without oral argument.

Under Minn. Stat. § 216B.27, subd. 3 (1992), no Order of the Commission shall become effective while a petition for rehearing is pending or until either of the following: ten days after the petition for rehearing is denied or ten days after the Commission has announced its final determination on rehearing, unless the Commission otherwise orders.

Any petition for rehearing not granted within 20 days of filing is deemed denied. Minn. Stat. § 216B.27, subd. 4 (1992).

IX. BURDEN OF PROOF

Minn. Stat. § 216B.16, subd. 4 (1992) states: "The burden of proof to show that the rate change is just and reasonable shall be upon the public utility seeking the change."

The Minnesota Supreme Court has articulated standards for the burden of proof in rate cases. In the Matter of the Petition of Northern States Power Company for Authority to Change Its Schedule of Rates for Electric Service in Minnesota, 416 N.W. 2d 719 (Minn. 1987). In the Northern States Power case, the Court divided the ratemaking function of the Commission into quasi-judicial and legislative aspects. The Commission acts in a quasi-judicial mode when it determines the validity of facts presented. Just as in a civil case, the burden of proof is on the utility to prove the facts by a fair preponderance of the evidence. Such items as claimed costs or other financial data are facts which the utility must prove by a fair preponderance of the evidence.

The Commission acts in a legislative mode when it weighs the facts presented and determines if proposed rates are just and reasonable. Acting legislatively, the Commission draws inferences and conclusions from proven facts to determine if the conclusion sought by the utility is justified. The Commission weighs the facts in light of its statutory responsibility to enforce the state's public policy that retail consumers of utility services shall be furnished such services at reasonable rates. In its legislative capacity, the Commission forms determinations such as the usefulness of a claimed item, the prudence of company decisions, and the overall reasonableness of proposed rates.

The utility therefore faces a two part burden of proof in a rate case. When presenting its case in the rate change proceeding, the utility has the burden to prove its facts by a fair preponderance of the evidence. The utility also has the burden to prove, by means of a process in which the Commission uses its judgment to draw inferences and conclusions from proven facts, that the proposed rates are just and reasonable.

X. TEST YEAR

MP proposed a fully projected 1994 test year ending December 31, 1994 as the test period to be used as the basis for determining its revenue requirements for providing retail electric service.

Minn. Rules, Part 7825.3100, subp. 17 states that any representative 12-month period selected by the utility can be used as the test period. The ALJ found that the Company's proposed test year was appropriate and no party objected to it. The Commission finds that the Company's test year is acceptable and will use it for evaluating representative levels of rate base, operating income and capital structure.

XI. NATIONAL CONTRACT AMENDMENT

A. Background

National Steel idled its Keewatin mine and pellet operation in October of 1993. When MP prepared its rate case using the test year 1994, there was little indication that National would restart its facilities. MP included revenues for National in the test year based on contractual agreements, January 1994 through July 1994 at the 20 MW level and 5 MW thereafter. National was also included as a Large Light and Power customer.

B. National Steel Reopens/the Record Reopens

After the close of the record at the end of June, National announced its intention to restart its facilities, which ultimately led to the signing of an Amendment to the Electric Service Agreement between MP and National on July 29, 1994. The Amendment extended the 20 MW level from July 1994 to November 1994. Service in excess of the 20 MW level for September and October is subject to the curtailable provision. For service beginning November 1994, the contract provides for 85 MW.

Recognizing the substantial change in conditions for the test year and beyond, MP filed a motion to reopen the record in this rate proceeding on August 15, 1994 and the ALJ granted the Company's motion.

C. Stipulation on the Amendment's Financial Impact

On September 9, 1994, parties to the rate case filed a stipulation addressing the financial effects of the reopening of the National facilities. The stipulation was signed by MP, LLPG, Potlatch, Seniors, Eveleth, LPI, the Department, and the RUD-OAG.

The Stipulation did not resolve rate design issues, other than to basically preserve the parties' respective arguments prior to the Stipulation.

The Stipulation on the financial effects of National's restart provides:

- If the Commission approves the National Amendment in Docket No. G-015/M-94-713, the 1994 test year sales should be adjusted to reflect sales to National that will occur during the test year. This adjustment increases test year rate base by $1.7 million, increases test year net income $1.5 million, and reduces the test year revenue deficiency by $2.3 million when applying the Company's proposed rate of return.

- The test year kWh sales should be adjusted upward by 243,268,000 for purposes of calculating the conservation cost recovery charge (CCRC) for the test year.

- If the Commission does not approve, or materially modifies, the National Amendment or the additional 100 MW interruptible offering in a separate docket, the parties reserve the right to withdraw or modify the Stipulation. LPI and Eveleth oppose portions of the National Amendment. LPI continues to argue that the shortfall in bulk power sales revenues compared to the interruptible discounts should be borne entirely by the Company.

- Because the National Amendment will produce additional impacts during and after 1995, the parties calculated an annualized impact to become effective on January 1, 1995. On January 1, 1995, rates determined on the 1994 test year should be adjusted to reflect a reduction in revenue requirement of $3.9 million.

- The CCRC beginning January 1, 1995 should be modified to reflect an additional 311,746,500 in kWh sales.

D. ALJ's Recommendation

The ALJ found the Stipulation reasonable and appropriate and recommended that the Commission accept it.

E. Commission Action

1. The Stipulation

In an Order issued October 28, 1994, the Commission approved the National Amendment in Docket No. E-015/M-94-713. As a result, National's consumption will, in fact, increase from 20 to 85 MW through at least October 2004 on a take or pay basis. Such a change in Company revenues should be taken into account in determining the Company's revenue deficiency in this case.

The Commission has reviewed the parties' Stipulation regarding the financial impact on MP of National's resurgence and has examined the work papers submitted by the Company in support of that Stipulation. The Commission finds that the Stipulation reasonably calculates the financial impact on MP's revenue requirement/deficiency in this case and will accept it.

2. Apportionment of the Reduction

The parties did not agree on the manner in which the various classes would benefit from the revenue requirement reduction attributable to National's amended contract. Accordingly, the Stipulation did not present an agreement as to the proper apportionment among rate classes of MP's revised revenue requirements. Instead, the Stipulation simply presented the parties' positions:

The Company proposed to share the decrease in the 1994 revenue requirement due to the National Amendment only with the LP and LLP classes. As to the further reduction in revenue requirement beginning in 1995, the Company proposed that the class or classes exceeding the authorized rate of return by the largest margin should receive the benefit of that further reduction, i.e. lower retes. Potlatch supported the Company's proposal.

The Department proposed that the additional revenue provided by the reopening of National Street should be apportioned on a pro rata basis to all of MP's non-interruptible classes.

The RUD-OAG proposed that the reduction in MP's revenue requirement for both 1994 and 1995 should be apportioned in equal percentages among the Residential, General Service, LLP, and LP classes.

LPI proposed that the Commission 1) require MP to run a new cost of service study, 2) set the initial residential revenue requirement at a level that would result in this class paying its full cost of service after a seven year phase-in and 3) set the revenue requirements for all of the other classes at levels that would result in equal rates of return for all other classes and produce the overall approved revenue requirement.

LLPG also would have the Company rerun its class cost of service study based on the Company's final 1994 revenue requirement and set the rates at the Company's cost of service. If this proposal were not accepted, LLPG argued that any additional 1995 revenues from National Steel should first be used to move General Service (GS) and LLP customers' 1995 rate to MP's cost of service.

Eveleth proposed that the reduction due to the National Amendment be shared only by the LP and LLP classes.

The Senior Federation proposed that the Residential class receive no greater rate increase than the average overall increase finally ordered. The Seniors argued that the Residential class should share in a substantial portion of the revenue produced from the National Amendment and that this portion should be applied to maintain the customer charge and lifeline rate at current levels, leaving the increase in Residential rates to be paid by the high use residential customers who are better able to pay it.

The Commission has considered the parties arguments on this topic and has determined to distribute the non-test year National revenue stipulated by the parties to all non-interruptible classes on a *proportional* basis, as recommended by the Department.

The Commission finds that such a sharing arrangement is the most equitable. All classes should benefit from the unique circumstances of MP's increased revenue from National to soften the impact of the rate increases found necessary in this case. The Commission believes that it would be inappropriate to deny benefit from the National revenues to any customer class, as proposed by MP, Potlatch, Eveleth, LPI and LLPG.

XII. RATE BASE

MP originally proposed a rate base of $483,657,724, a reduction from the $543,202,866 total rate base approved for the Company in its 1987 rate case.

In its Brief, MP increased the amount of its proposed rate base to $484,231,331. The Department calculated a rate base of $484,254,999 in its brief (figures before National Stipulation) and the ALJ recommended that amount.

The Commission determined a test year rate base of $485,896,166 as detailed in the Overall Financial Summaries section of this Order.

As indicated, the amount of rate base was not a major contested issue in this case. Nevertheless, several issues merit discussion.

A. Capital Budgeting

MP projected both the beginning and ending 1994 rate base beginning with the actual December, 1992 balances. The 1992 yearend balances were then adjusted to reflect the expected changes based on the budgets. September 30, 1993 was the last date of actual data that was available at the time of the filing.

The Department reviewed MP's budgeting practices and concluded that the levels of capital expenditures proposed for the test year are reasonable. A Department witness, Dale Lusti, presented a table showing the test year construction budget of $37.9 million compares favorably to MP's six year average actual construction expenditures of $37.1 million. Mr. Lusti also reviewed the allocation of plant to nonutility ventures and recommended MP's practices as appropriate for rate setting purposes. No party challenged the budgeting methods as affecting rate base.

The Commission finds that MP's capital budgeting is dependable for rate setting purposes.

B. Prepayments

MP erroneously included in rate base prepayments related to nonutility activities in the amount of $774,464. The Department recommended, and MP agreed to its removal from the test year rate base. The ALJ incorporated this adjustment, as will the Commission,

C. Cash Working Capital

MP calculated the cash working capital component of its rate base using the lead/lag method. The amount included in the original filing was a negative amount of $29,940,602, and represents a reduction to rate base. Although there are many components, the negative cash working capital results primarily from property taxes. The property tax expense included in the test year and collected as a component of rates need not be remitted to the taxing authority until the following year.

The Department had a minor disagreement with the lead/lag study because it calculated cash working capital on a total company basis and then allocated it to jurisdictions. The Department believed it would be more accurate to calculate the cash working capital effect related to income taxes at the Minnesota jurisdiction. MP agreed with the Department.

In addition, the Company and the Department agree that cash working capital should be further adjusted to properly reflect the final income statement adjustments approved by the Commission. The ALJ used the Department's cash working capital calculations.

The Commission will accept the Company's proposed method of calculating cash working capital as modified by the Department. Incorporating the modification and the cash working capital effects of the Commission's adjustments to the income statement results in a test year cash working capital of a negative $28,815,840.

D. April 26, 1994 Update

MP filed an update on April 26 as provided for in the ALJ's prehearing order. MP included the effects to the rate base resulting from the update in its rebuttal testimony. No party raised specific objection to the updates. The adjustments may be summarized as follows:

• ***Revenue Adjustments:*** The Company incorporated nine revenue adjustments which will be identified more fully in the Income Statement section of this Order. The effect of the change in test year revenues leads to a slight modification of the allocation factors used in allocating plant to the Minnesota jurisdiction. The combined effect of the revenue adjustments is to increase Minnesota jurisdictional rate base (pre-National Stipulation) by $269,096.

• ***Depreciation:*** The Company originally filed its case with depreciation expenses based on depreciation rates approved in prior years, but requested that the rate case ultimately reflect the depreciation rates in its pending study. In April of 1994, the Company filed updated general plant and production plant depreciation studies in Docket No. E-015/D-94-346 and E-015/D-94-376. The Commission approved those studies in Orders issued following the Commission's September 1, 1994 agenda meeting at which these matters were considered.[2] See also the discussion of the Decommissioning Steam Plant issue in the Income Statement section of this Order, infra at page 49.

The expense adjustments will be discussed in the Income Statement section of this Order. As a result of the increase in annual depreciation expense, test year rate base decreases by $172,878 to reflect the forecasted larger accumulated depreciation.

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[2] Pursuant to Minn. Stat. § 14.60, subd. 4 (1992), the Commission has taken administrative notice of the factual findings in its Orders in these two dockets.

• ***Other:*** The Company adjusted cash working capital resulting from its update adjustments to the income statement. This reduced rate base by approximately $28,000. Additional adjustments to cash working capital will be discussed below.

XIII. INCOME STATEMENT

MP originally proposed test year income of $27,114,613, based on revenues of $327,535,315. This was adjusted to $30,030,440 based on revenues of $328,811,721 ($291,689,059 from rates subject to change in this proceeding) in MP's brief.

The Department calculated a test year income of $30,403,203 in its brief, based on the same revenues as used by MP, and the ALJ calculated test year income of $30,319,000 (before the National Stipulation).

Based on all the adjustments to income listed in the following section, the Commission finds that MP's test year income (including the National adjustment) is $31,890,642.

The following revenue and expense issues merit discussion:

A. REVENUE ISSUES

1. Sales Forecast

MP forecasted test year sales for residential and small commercial accounts through the use of its econometric modeling program called Forecast Pro. This is a multiple regression mathematical model which projects sales based on independent variables which best correlate with historical patterns.

MP forecasted test year sales for large customers through the use of judgement. Customer service representatives work directly with large customers to develop sales projections. Discussions with the customer and knowledge of economic conditions are employed.

No party proposed modifications to MP's sales forecast. The Department recommended adoption of the forecasts. The Department did suggest some procedural modifications to be employed by MP in future rate cases, but did not recommend that those suggestions be required by the Commission's Order in this docket. The Department's recommendations were:

- If MP develops forecasts based on regression models that contain several independent explanatory variables, the Company should either use models similar in form to those used in long-range forecasts for resource planning or else explain carefully why different regression models are preferable for short-term forecasting.

- The Company should include theoretical and analytical explanations of its reasons for preferring the particular models selected.

- If MP uses measures of economic activity as independent or explanatory variables in its models, the Company should either use data that measure economic activity in its service area or else explain why it believes that the use of national economic data is preferable.

- If MP chooses to use measures of "normal" weather differing from figures published by the National Oceanic and Atmospheric Administration, the Company should explain why its figures are preferable.

- The Company should explicitly model the impact of demand side management (DSM) programs on sales as part of its forecasting process, and not make ad hoc adjustments for the DSM programs.

The Commission finds that the Company's estimates provide a reasonable forecast of 1994 test-year sales. Accordingly, the Commission will accept the sales forecast and resulting billing units proposed by MP, subject to modification for updates and further adjustment due to acceptance of the National Stipulation.

Regarding future sales forecasting, the Commission will not order that the recommendations be implemented. However, the Company should carefully consider the Department's recommendations as a guideline in future rate cases.

2. April 26, 1994 Update

As discussed in the rate base section above, MP filed an update to the original filing on April 26, 1994. The financial effects of the update were incorporated in MP's rebuttal testimony. The adjustments made to the original filing to reflect the update are as follows.

- Inland Amendment: Test year net income was increased $67,799 to reflect demand revenue increased as a result of the February 1994 contract amendment with Inland Steel.

- USX Amendment: Test year net income was decreased by $810,466 to reflect a firm contract demand reduction from March through December of 1994, with an offset for an increase in excess demand. The assignment of National's excess demand is also considered.

- LTV Amendment: Test year net income was increased by $305,274 to reflect the provision of up to 60 MW of standby capacity from May 1994 through April 1995.

- Eveleth Amendment: Test year net income was increased $615,755 to reflect a 17 MW increase in Eveleth's incremental service requirements for May through October of the test year.

- **Lakehead:** Test year net income was increased by $237,282 to reflect an adjustment to correct the test year forecasted Lakehead sales. (The adjustment is based on a $404,712 revenue correction.). The error resulted from a metering error in 1993. (LLPG, LPI, and the ALJ expressed approval of this adjustment.)

- Non-Firm Energy Sales Revenue Reclassification: Test year net income was decreased by $50,932 to reflect the correction of an error in the original filing. All of the revenues were classified as energy, when some should have been classified as demand related.

- **Depreciation:** MP filed current depreciation studies in April for production plant (Docket No. E-015/D-94-346) and general plant (Docket No. E-015/D-94-376). If the new studies are accepted, MP requested that the new rates be incorporated into the test year. This adjustment reduces test year net income by $202,716. The Commission approved the new studies at the September 1, 1994 agenda meeting. As discussed in the Decommissioning Steam Plant section of this Order, the Commission has taken official notice of the depreciation rates approved in those dockets.

- **Purchased Power Cost Reclassification:** Test year net income was decreased by $121,081 to reflect the correction of an error in the original filing where purchased power costs were incorrectly allocated between demand and energy related costs.

- **Allocation:** Test year net income was decreased by $56,730 to reflect the changes to the allocation factors resulting from the change in Large Power loads as identified in the amendments above.

No party raised specific objection to the update. The Commission has reviewed these adjustments and finds them appropriate. The Commission accordingly will accept them.

3. Bulk Power Sales

On June 17, 1993, the Commission approved a Large Power Interruptible tariff which allows MP to offer 100 MW of interruptible power to large power customers and includes a $5.00 per MW discount off the demand charge. Docket No. E-015/M-93-153. In an effort to recover the cost of the interruptible discount, MP markets the firm capacity made available (freed-up) when large power customers switch to interruptible service under this tariff.

In its post-hearing brief, LPI recommended imputing bulk sales revenues (received from the marketing of the firm power made available due to adoption of the interruptible tariff) in the amount of $6,000,000 regardless of what amount of sales revenues are actually obtained. LPI argued that in the long term MP could make up any shortfall by charging higher prices for the freed-up firm power after the test year.

LPI also argued that its proposal was consistent with the Commission's June 17, 1993 Order in the interruptible docket. In that Order, the Commission rejected MP's proposed incentive proposal related to the sale of the freed-up firm power. In that docket, MP had proposed that any over- or under-recovery arising from the interruptible rate proposal would be shared on a 50/50 basis between shareholders and ratepayers. The Commission rejected the incentive proposal, reasoning that because MP is in the position to make the decisions regarding its capacity needs and power sales, the Company should bear the corresponding risks of under-recovery. In the Matter of the Petition of Minnesota Power for Approval of an Interruptible Rate for the Large Power Class, Docket No. E-015/M-93-153, ORDER PARTIALLY APPROVING AND PARTIALLY DENYING RATE PROPOSAL (June 17, 1993).

Based on the June 17, 1993 Order, LPI argued that imputing the $6,000,000 revenues to offset anticipated discounted revenues would be an appropriate way in which to assure that MP would continue to bear the risk associated with this matter.

MP objected that LPI did not raise the issue in prefiled testimony and mischaracterizes the Commission's June 17, 1993 Order approving the interruptible rate. Moreover, MP asserted that although in the long-term MP will recover the $5 discount in the bulk market, the near-term bulk market is weak and does not support full recovery of the discount.

MP further argued that the interruptible rate was proposed to meet the needs of the LP customers and provide benefits to the entire system. Even with a near-term shortfall in recovering the discount, the system benefitted because LP customers amended power contracts to incur more revenue responsibility.

Finally, MP noted that the amounts included for the test year are the actual expected. The Company argued that there is no basis to require the imputation of hypothetical revenue after the interruptible rate was approved and the incentive proposal was rejected.

The ALJ rejected LPI's proposed adjustment and recommended that the Commission do the same. The ALJ analyzed LPI's proposal as a challenge to the reasonableness of the Company's proposed income statement. The only way to properly mount such a challenge, the ALJ noted, would have been for LPI to sponsor a witness to affirmatively justify and explain the basis for its proposal. Having failed to do so, LPI had failed to prepare an adequate record to allow proper consideration of the issue.

Further, the ALJ found that while the record did not support LPI's proposal, the record did support the value of the LP interruptible rate offering as proposed by MP and specifically approved by the Commission in the June 17, 1993 Order. Based on evidence in the record, the ALJ found that the interruptible rate provides a service requested by the Large Power customers and at the same time benefits all other ratepayers through 1) the longer term commitments made by the Large power customers and 2) providing a net benefit to ratepayers (when all capacity sales and capacity purchases are netted) of $5,360,050.

LPI responded that the ALJ's decision was not consistent with the Commission's June 17, 1993 Order and that since the issue it was raising was legal, not factual, no witness was necessary and raising it after the close of the record was appropriate.

The Commission disagrees. The unreasonableness asserted by LPI is not a question of law, as LPI claimed in its exceptions to the ALJ's report. The Commission's June 17, 1993 Order does not go as far as LPI intimated. Consistency with the Order does not require the imputation of $6,000,000 bulk sales revenues as proposed by LPI.[3]

On the other hand, the record does support the reasonableness of MP's income statement regarding MP's figures for bulk power sales revenues. Accordingly, the Commission will approve those figures.

B. Expense Issues

1. Interest Synchronization

In the original filing, MP calculated the amount of interest expense deduction for tax purposes of $15,960,705. After incorporating the Commission's adjustments to rate base for the various rate base issues, the cash working capital effects of the various income statement adjustments, and the cash working capital effects related to the increase granted, the Commission calculates a final interest expense deduction of $16,034,573. No party objected to this calculation. The final decision incorporates the related deduction in income taxes from the original filing of $30,560.

2. Operating and Maintenance (O&M) Budgeting

MP included approximately $250,722,911 as total company operating and maintenance (O&M) expense in its original filing. Excluding fuel and purchased power results in an amount called other O&M. For purposes of this record, the amount of O&M is reduced to $95,400,000.

MP accumulated its O&M budget by responsibility center and by account number or project number. Some amounts are direct; these are charged directly to FERC O&M accounts. Other amounts are allocated from Maintenance/Operations Requisitions (MOR). The MORs accumulate all amounts budgeted to an activity by the responsibility centers. These are then allocated to either utility or nonutility, or both.

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[3] The Commission agrees with the ALJ that the proper way to prepare the record with respect to any requested adjustment is to do so by affirmative testimony so that the utility may cross-examine and submit testimony of one of its witnesses.

MP's 1994 budget guideline was originally established at the 1993 budgeted level of expenses plus 2.3 percent. Later, the 2.3 percent escalator was eliminated, setting 1994 O&M budget guidelines at the 1993 budgeted level, $84,762,000 (actual 1993 other O&M is now known to be about $82.2 million). Two items, CIP recovery and SFAS 112 were considered exempt from the guideline and increased the 1994 budget guideline by $9,883,000 to $94,645,000.

The budget for the 1994 test year (total company) came in at $95,379,457. When reduced by the $9,883,000 amount for CIP and SFAS 112, and reduced by $811,000 to reflect an item that should have been recorded as fuel and an item which should have been recorded as a revenue, the amount budgeted for 1994 equates to $84,685,000, slightly less than the guideline.

Only two parties commented on MP's O&M budgets: the Department and the LLPG. The Department recommended the O&M budgets as reliable for rate purposes. The LLPG argued that the budgets were unreliable and recommended 1) reducing the test year expense by $2.9 million and 2) requiring that all future budgets be based upon FERC USOA accounts.

a. Recommended Reduction of Test Year Expense by $2.9 Million

The Commission will reject LLPG's recommendation to reduce MP's proposed test year costs by $2.9 million.

As presented in direct testimony, this recommendation was based on a miscalculation. In direct testimony LLPG had 1) understated MP's budget guidelines by using **actual** 1993 "other" O&M costs rather than the July 1993 budgeted costs and 2) overstated the O&M budget by using the amount included in the test year cost of service after adjustment, rather than the budget amount.

In its rebuttal testimony, LLPG presented other arguments in its rebuttal testimony in support of a $2.9 million adjustment. LLPG stated its claim in rebuttal as follows:

1. $0.8 million: MP's reduction of its test year O&M costs
2. $1.2 million: MP witness Berguson's admission that 1994 is over guidelines
3. $1.3 million: Results Sharing is not an exception to guidelines
4. $0.1 million: Unexplained increase in 1993 actual costs
5. $0.5 million: Correction of MP witness Berguson's error

The Commission has reviewed these arguments and agrees with the analyses of the ALJ, MP and the Department witnesses who found no merit in them. See Tr. Vol. 3, pp.143-144, 158 and Vol. 5, p. 112. LLPG's arguments on rebuttal are as unpersuasive on this point as its arguments in direct testimony.

b. Recommended Required Future Use of FERC Accounts

LLPG argued that its witness had difficulty tracking costs through the budget and had difficulty determining from the reports what was in the test year and what was not. LLPG stated that because MP budgets by responsibility center but does not present its rate case by responsibility center, the budget is not comparable to the rate case. Further, due to many changes, the budgets cannot be compared to historical costs. LLPG noted that even the MP witness required several pages to explain the process of tracking a single expense item through MP's budget process.

MP responded that the difficulty experienced by the LLPG witness was not a flaw of the budget, but rather stemmed from a lack of study of the process. MP tracked amounts in question through the budget process in rebuttal and at the hearing. The Company also noted that the Department's testimony demonstrated its ability to understand the budgets and compare them to FERC accounts.

According to MP, what is important is this ability to compare MP's budgets to cost of service and prior years, by project, responsibility center, coordinating responsibility center, on both a pre- and post-allocated basis. MP explained that it budgets by responsibility center, but then translates the budget into FERC accounts for cost of service purposes. These are then fully comparable to FERC and other regulatory reports. MP noted that the Department's testimony also demonstrates that MP's current budgeting provides that comparability.

The Commission agrees that MP's current budgeting method is reasonable for regulatory purposes and will not require that it be altered to present its budgets by FERC accounts, as requested by LLPG. The Company's budget is a management tool to accumulate, monitor, and control costs. The underlying activities drive the cost. The budget assists in managing those activities. FERC accounts are only a place to record the costs *after* they have been incurred and are not a basis for pro-active cost control.

c. General Reliability of MP's O&M Budget

The Department recommended MP's O&M budgets as a reliable base to be used for rate setting purposes.[4] A Department witness reviewed each 1994 Maintenance/Operations Requisition (MOR), compared the 1994 budget against actual and budgeted expenses for each of the preceding three years for each of the 126 responsibility centers, and reconciled 1994 O&M expenses with comparable 1993 expenses. In its testimony, the Department

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[4] The Department did identify specific issues for which it recommended adjustments. Those items, which were accepted by the Company, do not go to the dependability of the budget process and are discussed as individual issues separate from this discussion on O&M budget.

witness discussed the components of the budget, the ability to review the budget, the regulated/nonregulated separation of costs, the budget accuracy, and the test year applicability of the budget. The Department concluded that the test year budget is below the guideline.

In support of its contention that MP's budget was not reliable, LLPG cited three allegedly incorrect MORs that the Department's review had failed to uncover. The three cited MORs were: 1) a $58,300 expense for funding the Minnesota Utility Investors; 2) $16,600 charged for the proposed acquisition of the Northern Electric Co-op; and 3) $28,900 in costs for providing engineering service to a wholesale customer, the City of Proctor.

MP had a sound response to each of the alleged inappropriate MORs:

1. The MOR dealing with the Minnesota Utility Investors was 55.2% allocated to the electric utility. However, no amount is included in the rate case because it was excluded from the rate filing.

2. The MOR dealing with Northern Electric Co-op costs is properly recoverable in rates. The Co-op's board asked MP to develop a proposal for the purchase of the Co-op. It is clearly in the interest of ratepayers for MP to examine such opportunities.

3. The MOR dealing with the City of Proctor engineering services results from the long-term contract with Proctor that includes an amount of engineering services.

The Commission notes that MP's budget system is the same system that was used and approved in MP's 1987 rate case and 1991 rate investigation with certain modifications that enhance cost separation and reflect changes in the Company's organizational structure. Contrary to LLPG's assertions of unreliability, all amounts could be tracked and tied out with final cost of service. One can compare the budget to the cost of service and to prior year Responsibility Budgets and actual charges, by project, by Responsibility Center, by Coordinating Responsibility Center, both on a pre- and post-allocated basis. The review of MORs demonstrates that MP's budget process is accessible, that its budget documentation is detailed and that the budgeted costs are carefully reviewed before inclusion in the test year cost of service for ratemaking purposes.

d. Commission Action

Accordingly, the Commission concludes that MP's budgeting process used for this proceeding and test year O&M budget developed from that process are reasonable and appropriate for this proceeding.

3. Employee Compensation

MP included $54,316,983 base pay, $2,045,737 results sharing, and $305,511 annual incentive in the rate case. Another program, long-term incentive, was not included in the test year expenses.

a. Base Pay

MP indicated its goal was to compensate employees competitively with the external marketplace and to provide internal equity among positions. The Company stated that it determined base pay using external market data, collective bargaining, and individual performance. MP requested that the Commission focus on total compensation levels and allow MP's management the prerogative of designing the components of compensation.

MP supplied several schedules of salary comparisons with witness Shippar's direct testimony. The stated goal is to match total compensation to the average or mean level of the market. Variations do occur. Comparisons to market data are considered compatible with the goal if pay is within 95 - 105% of market. MP stated that unless employees at least meet the threshold levels of performance under the results sharing or incentive compensation programs, it is likely that wages will be below market.

b. Results Sharing

MP stated that all employees would participate in the results sharing incentive program. This program provides for annual awards of up to 15% of base compensation, depending on the level of achievement. Achievement is judged by meeting financial thresholds, and meeting various Key Result Area goals. Those goals include customer satisfaction, safety, environmental preservation, and market expansion. It is necessary to meet the minimum financial performance ($2.50 earnings per share for the test year plus a minimum operating income goal for the business unit) before any awards are paid.

According to testimony, employees "bought into the program" by accepting a merit pay increase of 1% less than agreed upon in 1992, again in 1993, and .5% less in 1994. Thus the Company argues that because employees have foregone 2.5% of pay increases, a results sharing award of 2.5% is really akin to base pay.

At the minimum financial and Key Results Area measurements, the program is said to be at target level. The target level award would be 5% of base pay.

The approximately $2 million included in this rate case for results sharing represents results sharing at 80% of the 5% award at target level, or 4% of base pay. Awards above that level are not included in this rate case.

The 80% level results from meeting the target financial performance and achieving 80% of the Key Results Areas. 80% is the level met in recent years.

c. Incentive Compensation

Additional incentive compensation would be available to officers and selected management. This program measures MP performance to a peer group of utilities and compares to the Standard and Poor's 500. Return on equity, total shareholder return, low O&M growth rates, and lower electric rates are some of the measures considered.

As with the results sharing program, participating employees partially fund the program through reductions in base pay increases. Threshold level payments plus base pay are designed not to exceed market.

The maximum awards range from 15% of base compensation to 60% of base compensation. However, the threshold level ranges from 6% to 24% of base compensation.

The amount of expense included (approximately $305,500) for the test year is calculated at the threshold level for the executive incentive compensation program. The intent is to recover in rates only that portion that primarily benefits ratepayers, with shareholders absorbing any additional amounts.

(1) Parties' Comments

The Department recommended allowing the costs, but recommended that MP return any unpaid incentive to ratepayers. The Department found that MP's overall compensation package is reasonable, that MP has made a reasonable attempt to demonstrate a relationship between compensation and labor productivity, that its employees are likely to respond to incentive payments, that rate recovery for incentive compensation is justified by projected effects on labor productivity, and that MP's proposed test-year level of incentive payments is just and reasonable. The Department also argued, however, that allowing the Company to retain any collected but unpaid incentive would be inconsistent with the Commission's decision in Northern States Power Company's (NSP's) recent rate case, Docket No. E-002/GR-92-1185. According to the Department, any unpaid incentive should be returned to the ratepayers to prevent an unwarranted transfer of risk from shareholders to ratepayers. The ALJ adopted the Department's position.

LPI argued for excluding all of the test year incentive costs, or allowing only that portion of results sharing which is above the employee's "buy-in" level.

LLPG argued for reducing the test year cost by $600,000: $300,000 related to the executive incentive compensation plan and $300,000 related to the portion of results sharing attributable to MP executives.

(2) Commission Action

The Commission finds that MP's compensation plan is appropriate, with minor modifications, and will approve it.

Regarding incentive compensation, the Commission has found in previous rate cases that incentive compensation plans can be effective management tools when properly designed and administered.[5] In this case, the Commission finds that the two incentive compensation

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[5] See In the Matter of the Application of Northern States Power Company for Authority to Increase its Rates for Electric Service in the State of Minnesota, Docket No. E-002/GR-92-

programs proposed by MP (Results Sharing and Incentive Compensation for Officers and Management) have been appropriately designed.

The Commission will approve them with one modification. Perception of favoritism or inequity in the administration of the incentive program could have negative repercussions for employee morale and consequently negatively affect their productivity. Such a wide range of award (up to 60 percent of base pay) substantially increases the possibility of such perceptions. In addition, as the Commission has previously found, offering key decisionmakers large financial rewards for producing short-term shareholder benefits does not promote regulatory efficiency or the long-term fortunes of the Company.[6] The Commission, therefore, will limit annual incentive payments to 15 percent of an individual's base pay, the same maximum level available to all other employees.[7]

Regarding the Department's recommendation that MP be required to return any unpaid incentive in its next rate case, the Commission does not agree that this would be appropriate. Contrary to the Department's contention, the Commission's decision regarding unpaid compensation in the NSP case does not control or even largely inform the Commission's decision in this case. In the NSP case, NSP had reserved the right not to make incentive payments earned under the plan. It was this retention of right to withhold payment, notwithstanding the fact that the incentive had been earned, that the Commission viewed as inappropriately transferring risk to the ratepayers.

1185, ORDER AFTER RECONSIDERATION (January 14, 1994) and In the Matter of the Application of Minnegasco, a Division of Arkla, Inc., for Authority to Increase Its Rates for Natural Gas Service in Minnesota, Docket No. G-008/GR-93-1090, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (October 24, 1994).

[6] A 15 percent limit on executive incentive compensation is consistent with the Commission's decision in previous rate cases. See, e.g. the Commission's ORDER AFTER RECONSIDERATION in NSP's 1992 electric rate case (cited previously in footnote 5). In that Order, the Commission stated:

> The Commission continues to believe, for the reasons set forth in the original Order, that the officers' and executives' plans allow too high a proportion of these employees' total wages to come from incentive compensation. (These plans provide for incentive payments of up to 40 percent of base pay.) The Commission will limit recoverable incentive payments to 15 percent of an individual's base salary. Order at page 7.

[7] The Commission notes that the record indicates that incentive payments to a few MP employees exceed the 15 percent level. The amount at issue appears minimal, but cannot be determined with certainty from the record. Rather than estimate the amount of incentive payment that is disallowed under the 15 percent limitation, The Commission will direct MP to calculate the amount and incorporate it into the compliance filing.

For retaining such a right, the Commission required NSP to record all "earned but unpaid" incentive compensation recoverable in rates for future return to the ratepayers.[8]

The Department acknowledged that MP has not reserved the same right to withhold payment as NSP. Nevertheless, the Department raised the concern that the inappropriate shift of risk is present in both MP's proposal and NSP's proposal. The Commission disagrees. MP has stated to the Commission without reservation that it intends to pay the incentive compensation that is earned. In addition, absent the right to withhold once the compensation is earned, MP will be contractually bound to its employees (unlike NSP) to pay the incentive compensation amounts.

In such circumstances, the Commission does not find the risk-shifting that was present under the NSP proposal. Finally, any window for such shifting is nailed shut as follows. If, despite its representations to the Commission and its contractual agreement with its employees to pay earned incentive compensation, MP does not in fact make the agreed upon payments, the Company will be required to return the amount of such incentive (earned but not paid) to the ratepayers.

4. Early Retirement Program

a. Minnesota Power's Proposal

MP offered an Early Retirement Program to 37 supervisory and management employees attaining the age of 55 by 12/31/94. The employees would receive normal retirement pay, two weeks base pay per year of accredited service, and $700 per month to age 62. Those participating were to leave the Company by 7/30/94. The cost of the program was estimated at $3 million. The Company estimated a Minnesota jurisdictional savings of $1.7 million over the 36-month period.

The two issues raised in connection with this program are: how much program expense should be included in the test year and over what period should the balance be amortized.

b. Test Year Expense

The Company proposed to include five months of costs and five months of benefits in the test year, thereby reducing test year expense by $241,852.

The Department recommended an adjustment which the Company accepted related to the Minnesota jurisdiction, thereby reducing test year expense by $283,155.[9] In other respects, the Department supported the Company's proposed test year treatment of the Early Retirement Program.

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[8] ORDER AFTER RECONSIDERATION, Docket No. E-002/GR-92-1185, page 7.

[9] The Department proposed to allocate 10.59 percent of program costs to non-utility expense.

The LLPG recommended that the test year impacts of the program be annualized. Even though the Early Retirement Program was effective for only five months of the 1994 test year, the LLPG would calculate the cost and savings from the program as if it had full 12-month impact upon the test year. In addition, the LLPG argued that the fact that the returning employees will not be replaced shows that they were not necessary for the provision of service and that payments to such "surplus" employees should not be recovered in rates.

The ALJ rejected the LLPG's recommendation to exclude payments to the early retiring employees. The ALJ found that there was nothing in the record to indicate that the retiring employees were not necessary or useful to MP for the period in 1994 prior to their retirement. In addition, the ALJ recommended that only the five months of costs and savings that were actually expected to occur in 1994 should be included in the test year.

c. Amortization Period

MP proposed to amortize the cost of the program over 36 months. The Company noted that 36 months is consistent with the time chosen to amortize rate case expenses and argued that the common rationale is that MP will file a case in 36 months and these costs would be fully amortized.

The Department initially proposed a 48 month amortization period, consistent with a retirement age of 62. The Department argued that it would be inappropriate to base the amortization on age 60 because the program is designed to induce retirement before age 62.

The ALJ recommended a 36 month amortization period, based on MP's rebuttal testimony that the average age at which MP employees retire is actually 60, not 62.

d. Commission Action

The Commission will adopt the ALJ's recommendation regarding the test year expenses. Since the costs and savings from the Program will actually occur for only five months in 1994, it would be inappropriate to develop the test year cost of service by pretending there were actually 12 months of costs and savings. Regarding the usefulness of expenditures directed to MP's retired employees, the testimony is that the opportunity to reduce costs evolved over a period of time and presented itself in the middle of the year. The opportunity was identified when planning and budgeting for 1995. Identifying future savings does not support a conclusion that the past expenditures were unnecessary.

Regarding the amortization period issue, the Commission believes that this cost should be fully collected before the filing of MP's next rate case and not be perpetuated in rates beyond that filing. Since it is likely that MP will begin another rate case within 36 months, the Commission finds that a 36 month amortization period is more appropriate than the 48 month period. In addition, the longer amortization period would result in a greater mismatch of payers/beneficiaries. Finally, as the ALJ noted, the record supports a finding that the average age of retirement for MP employees in 60 rather than 62. For these reasons, a 36 month amortization period will be approved.

Accordingly, the Commission will reduce originally filed expenses by $283,155 to incorporate the early retirement proposal as adjusted for the Department's allocation recommendation.

5. Decommissioning Steam Plant

a. Minnesota Power's Proposal

MP proposed to include costs incurred to decommission its Hibbard Units 1,2,3,4, Laskin Station, and Boswell Station. MP specifically proposed that the decommissioning costs be allowed beginning with the implementation of final rates and not be included in the calculation of any refund for the interim period.

Regarding the Hibbard station, MP proposed including the cost of decommissioning the entire Hibbard station, estimated at $1,409,968, amortized over five years. The Company did not seek an unamortized balance in rate base. The amount amortized as test year expense in the original filing is approximately $228,000.

As to Laskin and Boswell, in its original filing, MP proposed to increase annual expense by $1,207,147 (approximately $1 million jurisdictional) to recover the expected costs ($28 million at Boswell, $5 million at Laskin) of decommissioning Boswell and Laskin over the remaining lives of the plants (Boswell 24 years, Laskin 12 years).

b. The Department

The Department recommended that the Commission accept MP's proposal regarding depreciation costs as filed. The Department considered the costs to be reasonable. The Department did recommend that future depreciation filings continue to monitor the appropriateness of the decommissioning costs, and that MP prepare a contingency plan in the event that Hibbard units 3 & 4 are brought back into operation. The contingency plan should include a comprehensive evaluation of the appropriate remaining life for the units.

c. LPI

LPI recommended that no decommissioning recovery be allowed for the Hibbard facility. LPI noted that in the 1987 rate case the Commission determined that Hibbard was not used and useful. Having failed to price for dismantlement when the plant was used and useful, MP should not now be allowed to collect dismantlement costs from current ratepayers who are getting no benefit from the facility.

As for Laskin and Boswell, LPI argued that the remaining lives for these plants should be increased to 54 years and the decommissioning probability reduced from 80 percent to 50 percent. These changes would reduce test year expense by approximately $427,000.

d. The ALJ

The ALJ recommended MP's proposal for the Hibbard decommissioning as reasonable, largely citing the conclusions of the Department.

e. Commission Action

The Commission finds that MP is acting prudently in retiring Hibbard at this time and was not negligent in not recovering earlier. Hibbard was an integral part of MP's system for many years. The failure to recover full costs during its useful life is simply the result of the imprecision of depreciation rates. In addition, the Company sought recovery in the 1981 rate case and was denied. Accordingly, the Commission will allow recovery for the Hibbard plant as requested by the Company.

Regarding Laskin and Boswell, the Commission finds no basis for LPI's proposal to extend the lives and reduce the probability of decommissioning the Laskin and Boswell facilities. It is appropriate to amortize the decommissioning costs over the same period as used for depreciation purposes. Life extensions are usually associated with major overhauls or additions. MP's proposal is consistent with treatment allowed for Ottertail Power Company in Docket No. E-017/D-83-2.

Further, in MP's depreciation dockets (E-015/D-94-346 and E-015/D-94-376), the Commission made findings of fact consistent with what MP has proposed in this matter regarding test year depreciation costs for Hibbard, Laskin, and Boswell.[10] Those Orders have become final. The Commission will reaffirm those findings at this time. The proper decommissioning expense for these facilities, then, is $1,252,290 for Boswell and Laskin as found in Docket No. E-015/D-94-346 and $228,000 for the Hibbard facility. This expense will begin to be recovered with the implementation of final rates, with adjustment for interim rates. The Commission will, of course, continue to monitor MP's decommissioning costs in the Company's annual depreciation filings.

6. Hibbard Retirement Loss

a. Minnesota Power's Proposal

Hibbard units 1 & 2 were first placed into service in 1931 and 1943. They will be retired at December 31, 1994. They last generated in 1981 and have been in a cold standby status since. In the resource plan accepted by the Commission in 1993, the units were no longer

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[10] In the course of deliberating this matter, the Commission took official notice of the factual findings in its Orders in these two dockets, pursuant to Minn. Stat. § 14.60, subd. 4 (1991).

considered viable generating options. At retirement, there will be an undepreciated balance of $541,230 (Minnesota jurisdiction). MP proposed to amortize this balance to rates over five years ($108,246 for the test year). The Company did not request that the unamortized balance be included in rate base.

b. LPI

LPI recommended the disallowance of the entire amount included in the test year for the recovery on the loss on retirement related to the Hibbard units 1 & 2.

LPI noted that the units were excluded in MP's most recent rate case in 1987 as excess capacity and that the units were not used since 1980. LPI argued that it would not be fair to burden current ratepayers with the unrecovered cost of this plant. This should have been recovered from the ratepayers that received service from it.

c. The ALJ

The ALJ recommended MP's proposal as reasonable and appropriate. Units 1 and 2 were an integral part of MP's power supply until 1981. The ALJ noted that the option to restart the units was a viable option until MP filed its 1993-2007 resource plan which was accepted by the Commission in June 1993.

d. Commission Action

The Commission does not accept LPI's argument that the Commission's decision in the Company's 1987 rate case to exclude Hibbard from the Company's rate base means the Company should be forever barred from recovering the cost of this asset. In the 1987 rate case, the Commission concluded that

> ...the appropriate ratemaking remedy to MP's excess capacity problem is removal from rate base of that part of the Hibbard facility not removed in conjunction with the boiler transfer to the City of Duluth, and removal of associated expenses from operating expenses.[11]

Inclusion of an asset in the rate base rests on a used and useful analysis quite different from the consideration here, i.e. a utility's reasonable recovery of asset investments. Likewise, the Hibbard-related expenses at issue in the 1987 case were proposed test year operating expenses and did not involve recovery of the undepreciated balance of an asset that has been used and useful.

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[11] In the Matter of the Petition of Minnesota Power & Light Company, d/b/a/ Minnesota Power, for Authority to Change Its Schedule of Rates for Retail Electric Service in the State of Minnesota, Docket No. E-015/GR-87-223, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (March 1, 1988), at page 19.

The Commission finds that the units in question were an integral part of MP's power supply system until 1981 and remained a generation option while held in Plant Held for Future Use until the Commission accepted MP's 1993-2007 resource plan in June 1993. The Commission finds that MP used prudent depreciation rates over the life of the facility and notes that depreciation is inherently inexact. In addition, the Commission finds that the Company has used reasonable judgement in retiring the units.
In these circumstances, the Commission will not penalize the Company for not fully collecting the cost over the estimated useful life of the asset. The Commission will allow the Company to amortize the loss which it will experience on the units when they are retired. The Company's proposed amortization period, five years, is also reasonable and will be approved.

7. Economic Development

a. Minnesota Power's Proposal

MP proposed to include as test year expenses 100 percent of the corporate and individual dues it projected it would pay during that year, $69,130. In the alternative, the Company stated that it would accept 50 percent of this amount. In addition, MP requested inclusion of 100 percent of its loan program costs as test year jurisdictional economic development costs, $957,764.

b. The Department

The Department recommended disallowing all the community development organization dues and half of the $957,764 amount for the loan program. The Department's adjustment would decrease test year expense by $548,012.

The Department noted that the statute does not require recovery and that Commission precedent limits recovery to 50 percent of programs because both shareholders and ratepayers benefit, as in NSP's 1993 rate case, Docket No. E-002/GR-92-1185.

The Department argued that ratepayers should bear part of the cost only if they receive benefit. Since it could not determine a benefit for the organization dues ($69,130), that amount must be totally excluded. The loan program is cost effective and should be allowed at the precedented level, 50 percent.

c. LPI

LPI recommended that the Commission totally disallow these expenditures (for both the organization dues and the loan program) because they are not necessary or essential to the provision of electric service. Also supporting exclusion of all or at least 50 percent of these expenditures, according to LPI, is the fact that the Company makes these expenditures, at least in major part, for the long-range benefit of its shareholders.