

No. A07-653

**STATE OF MINNESOTA
IN COURT OF APPEALS**

In the Matter of the Review of the 2005 Annual Automatic
Adjustment of Charges For All Electric and Gas Utilities

**BRIEF OF RELATOR
CENTERPOINT ENERGY MINNESOTA GAS**

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STATEMENT OF LEGAL ISSUES

1. Were the Minnesota Public Utilities Commission's ("Commission") decisions refusing to allow CenterPoint Energy to recover its prudently incurred gas costs, which failed to follow the Legislature's directive and its own rules, in excess of its authority, arbitrary and capricious, or otherwise affected by an error of law, given the Commission's deviation from its long-standing and only precedent on the subject?

The Commission's December 6, 2006 Order Denying Variance And Ordering Independent Audit, and its February 22, 2007 Order Clarifying Order Denying Variance And Ordering Independent Audit ("Orders") rejected CenterPoint Energy's requests that it be allowed to recover its prudently incurred gas costs, despite a greater financial impact on CenterPoint Energy than on prior companies allowed recovery of such costs.

Apposite Authority:

Minn. Stat. §§ 216B.01, subd. 1 and 216B.16, subd. 7

Minn. R. 7825.2700. subp. 7 and 7829.3200

Trout Unlimited, Inc. v. Minn. Dep't of Agric., 528 N.W.2d 903, 907 (Minn. Ct. App. 1995), *rev. denied* (Minn. Apr. 27, 1995)

2. Whether the Commission's Orders are unsupported by substantial evidence, or arbitrary and capricious, given the Commission's failure to allow witness testimony and the cross-examination of witnesses, and where its "findings of fact" relied exclusively on unsworn comment and rhetoric of counsel, as well as its deviation from well-established precedent on the same subject?

The Commission denied CenterPoint Energy's recovery of over \$21 million in prudently incurred gas costs, finding such a denial would not excessively burden the company, without ever conducting an evidentiary hearing on the subject.

Apposite Authority:

Minn. Stat. § 216B.16, subd. 7

Minn. R. 7825.2700. subp. 7 and 7829.3200

Trout Unlimited, Inc. v. Minn. Dep't of Agric., 528 N.W.2d 903, 907 (Minn. Ct. App. 1995), *rev. denied* (Minn. Apr. 27, 1995)

3. Did the Commission's Orders directing CenterPoint Energy to write off \$21 million, which equates to 25 per cent of its 2006 operating income, and lowering its return on equity by over 400 basis points, constitute a regulatory taking in violation of the Minnesota and United States Constitutions?

The Commission did not address this issue in its Orders.

Apposite Authority:

U. S. Const., amends. V and XIV

Minn. Const., art. I, §§ 7 and 13

Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989)

4. Were the Orders made upon unlawful procedure, or did the Commission exceed its authority, where it failed to refer the matter for a contested case hearing despite the fact that such a right is expressly and impliedly provided for in the applicable statutory and rule framework, and guaranteed by the due process clauses of the Minnesota and United States Constitutions?

The Commission's December 22, 2007 Order refused CenterPoint Energy's petition to refer the matter for a contested case hearing despite the existence of numerous disputed issues of material fact.

Apposite Authority:

MPIRG v. Minn. Envtl. Quality Council, 237 N.W.2d 375 (Minn. 1975)

Fosselman v. Comm'r of Human Servs., 612 N.W.2d 456 (Minn. Ct. App. 2000)

In the Matter of Hibbing Taconite Co., 431 N.W.2d 885 (Minn. Ct. App. 1988)

STATEMENT OF THE CASE AND PROCEDURAL HISTORY

This case involves the Minnesota Public Utilities Commission's ("Commission") denial of CenterPoint Energy Minnesota Gas' ("CenterPoint Energy") ability to recover approximately \$21 million in gas costs that it prudently incurred in order to serve its Minnesota customers.

Under Minnesota's purchased gas adjustment ("PGA") statute, Minnesota Statutes section 216B.16, subd. 7 (2006) ("PGA Statute"), public utilities like CenterPoint Energy are allowed to recover the actual natural gas supply costs that they incur to serve customers – no more and no less. Utilities do not "mark-up" or make any profit on the amount they pay for natural gas.

The PGA Statute does not impose any time limitation on how quickly a utility must seek recovery of its actual natural gas costs. Rather, the Legislature purposefully crafted the PGA Statute in general terms and delegated rulemaking authority to the Commission to determine how the adjustments necessary to allow for full natural gas cost recovery should be calculated and applied.

Consistent with this legislative grant of rulemaking authority, the Commission promulgated the PGA Rules, Minnesota Rules 7825.2400 to 7825.2920 (2005), to further detail the PGA process. The PGA Rules provide that a utility's PGA adjustment or true-up filing be done through an annual report that describes, *inter alia*, the utility's gas costs and gas revenues. Minn. R. 7825.2810, subp. 1 and 7825.2910, subp. 4 (2005). The plain language of Minnesota Rules 7825.2700, subp. 7 (2005) ("True-up Rule"), makes it clear that a utility is entitled to recover (or required to refund) in its true-up adjustment

the difference between the cost of gas incurred and the cost of gas collected, no more and no less.

Pursuant to this annual filing requirement, CenterPoint Energy filed its 2005 Annual Automatic Adjustment of Charges ("2005 AAA Filing") on September 1, 2005. On January 13, 2006, prior to any Commission action on that filing, CenterPoint Energy advised the Commission that the company had discovered that it had overstated its system sales volumes in its AAA filings going back to calendar year 2000, each of which required correction. CenterPoint Energy's January 13, 2006 filing further requested that the Commission hold open CenterPoint Energy's 2005 AAA Filing until CenterPoint Energy and its internal auditors completed a review of this matter.

On April 5, 2006, CenterPoint Energy filed its Additional Comments and Request for Variance. CenterPoint Energy's April 5, 2006 filing, as amended by its October 31, 2006 filing, included a detailed discussion of the specific impact of the sales overstatement on the current AAA Filing, as well as on prior years. Specifically, the filing explained that the overstatement of system sales led to an overstatement of revenues during those years, and a corresponding failure to actually recover the full cost of gas incurred by CenterPoint Energy during this time period. In order to allow recovery of the actual gas costs incurred in the years prior to the year at issue in the 2005 AAA Filing, CenterPoint Energy requested a variance to the Commission's PGA Rules, the process that the Commission used to approve other natural gas utilities' requests to recover gas costs going back more than one year due to similar accounting errors in their AAA filings.

The Minnesota Department of Commerce (“Department”) and Office of the Attorney General (“OAG”) filed comments in response to CenterPoint Energy’s April 5, 2006 filing on May 12, 2006 and May 11, 2006, respectively. CenterPoint Energy filed Reply Comments to the Department and OAG on May 22, 2006 and filed further detail on the unrecovered gas costs on June 16, 2006.

The Commission met and considered this matter on June 29, 2006, deciding at that time to request further argument from the parties, focusing primarily on the Commission’s legal authority to allow recovery of the gas costs at issue. CenterPoint Energy, the Department and OAG all filed comments and reply comments on these issues under the schedule set by the Commission.

The Commission met again on November 9, 2006, and on December 6, 2006, issued its Order Denying Variance And Ordering Independent Audit (“Order”), *Relator’s Appendix at APP1-APP10*, memorializing the decisions made at the November 9 meeting. In that Order, rather than effectuating the Legislature’s intent of allowing CenterPoint Energy to recover its prudently incurred gas costs, the Commission denied CenterPoint Energy any ability to recover approximately \$21 million in gas costs prudently incurred to serve Minnesota customers. In denying all recovery of these costs, the Order was contrary to well-established Commission precedent. Moreover, the Order relied exclusively on the unsworn comment and rhetoric of counsel and the parties, which contained misstatements of fact. Lastly, material facts remained in dispute. Despite well established Commission procedures and its own Staff’s recommendation that the matter

be referred to the Office of Administrative Hearings for a contested case proceeding to develop a full administrative record, the Commission refused to do so.

Pursuant to Minnesota Statutes section 216B.27 (2006) and Minnesota Rules 7829.3000 (2005), CenterPoint Energy filed its Petition For Rehearing and Reconsideration ("Petition") of the Commission's decision on December 26, 2006. *APP11-APP27*. In its Petition, CenterPoint Energy addressed the erroneous statements of fact and errors of law contained in the Order.

The Commission met to consider CenterPoint Energy's Petition on February 8, 2007. At that meeting, two separate motions to reconsider the Order deadlocked on two-to-two votes. *APP42-APP44*. A motion to deny reconsideration similarly failed on a two-to-two vote. *APP46*. These deadlocked votes left the Commission's original decision in place, with a majority of Commissioners able to agree only on clarifying one of the factual mistakes in the Commission's Order. *APP45*.

The Commission issued its Order Clarifying Order Denying Variance And Ordering Independent Audit on February 22, 2007, constituting the Commission's final decision on this matter. *APP57-APP59*.

STATEMENT OF FACTS

The cost of gas represents the single largest cost component included in the bills of Minnesota natural gas customers. Approximately 80% of every dollar paid to CenterPoint Energy by its customers simply reimburses the company for its direct cost of natural gas. *CenterPoint Energy's Supplemental Comments, August 18, 2006, p. 8*.

Given the significance of gas costs to utilities, Minnesota law allows utilities such as CenterPoint Energy dollar-for-dollar recovery of these costs. Minn. Stat. § 216B.16, subd. 7 (2006); Minn. R. 7825.2700, subp. 7 (2005). To effectuate this recovery, utilities submit their “annual automatic adjustment” (“AAA”) filings to the Commission, demonstrating the amount of gas costs incurred and the amount of gas costs recovered. These filings allow a “true up” to occur, which allows the utility to recover any previously unrecovered costs or to refund any over-recovered costs. Thus, Minnesota law provides for a direct pass through of natural gas supply costs from utilities to their customers, with utilities neither making nor losing money on these supply costs, so long as the costs are prudently incurred. No party has alleged any imprudence on the part of CenterPoint Energy in this matter. In fact, Commissioner Reha specifically stated that “the company made the purchase of gas in a prudent manner.” February 8 transcript, pp. 21, ll. 16-17.

CenterPoint Energy filed its 2005 AAA Filing on September 1, 2005. *App. at 1*. However, in late 2005, CenterPoint Energy learned that it had inadvertently overstated the system sales volumes in both its 2005 AAA Filing and in its filings dating back to calendar year 2000. *CenterPoint Energy’s Supplemental Comments, August 18, 2006, p. 3*. CenterPoint Energy informed the Commission of the errors in these filings on January 13, 2006, prior to any Commission action on the 2005 AAA Filing. *APP1*.

On April 5, 2006, June 16, 2006 and October 31, 2006, CenterPoint Energy submitted detailed filings to the Commission (collectively referred to as the “Gas Cost Recovery Filings”) regarding these prior overstatements of sales volumes. The Gas Cost

Recovery Filings: (1) explained that by overstating sales volumes (and the corresponding revenues); CenterPoint Energy had understated the amount of gas costs it still needed to recover from customers; (2) set forth the reasons for this overstatement of sales and under-recovery of gas costs; and (3) provided the amount of under-recovery both on a year-by-year and total cost basis.

As the Gas Cost Recovery Filings demonstrated, in approximately November 2000, CenterPoint Energy began inadvertently overstating its sales volumes used as the basis for CenterPoint Energy's financial statements. The overstatements occurred due to errors made in the accounting for lost and unaccounted for gas and in the accounting of unbilled revenues (sales made in the time period at issue but not yet billed to customers). Throughout this time period, CenterPoint Energy accurately stated the actual gas costs it incurred. By accurately stating its gas costs, but overstating customer sales, the Gas Cost Recovery Filings explained and demonstrated that CenterPoint Energy has under-recovered its gas costs.

The Gas Cost Recovery filings further explained that, on either a monthly or annual basis, these flawed entries of sales volumes were not sufficiently large to stand out and call for further analysis. The overstatement of sales volumes ultimately became apparent when CenterPoint Energy identified that the total volume of unbilled sales not only continued to grow over time but became unreasonably large.

As demonstrated in its October 31, 2006 filing, CenterPoint Energy has failed to recover over \$28.3 million in gas costs prudently incurred to serve its Minnesota customers. Of that amount, approximately \$7.3 million relates to the 2005 "gas year"

directly before the Commission in the 2005 AAA Filing. The remaining approximately \$21 million relates to the years included in the Company's four prior AAA filings and for which CenterPoint Energy requested a variance from the one year true-up called for in the Commission's PGA Rules, so that it could recover those prudently incurred costs.

Given the direct pass through nature of these costs, any denial of recovery decreases, on a dollar-for-dollar basis, the annual operating income, or profit, of CenterPoint Energy. As Commission Chair Koppendraye correctly stated: "gas cost is separate . . . and you don't make anything on this gas cost and you're writing off something you never had an opportunity to make any money on anyway." *APP32 (Transcript of February 8, 2007 Commission Hearing ("Tr. "), p. 18, ll. 11-14.*

As CenterPoint Energy explained in its Petition, the \$21 million at issue equates to over 25% of CenterPoint Energy's 2006 annual operating income. *APP12, APP17.* In fact, the denial would reduce CenterPoint Energy's return on equity for 2006 to just 5.35%, compared to the 9.71% return authorized by the Commission for the company in its most recent rate case. *Id.* This reduction of over 400 basis points represents roughly 45% of the total return authorized by the Commission for CenterPoint Energy in that rate case. *Id.* The impact of a denial of such a huge percentage of CenterPoint Energy's return to its shareholders caused CenterPoint Energy's parent company, CenterPoint Energy Resources Corporation, to issue a Form 8-K to investors to inform them of the Commission's refusal to allow recovery. *APP24-APP26.*

Importantly, at no point in the proceedings before the Commission did any party challenge the appropriateness of the gas costs incurred by CenterPoint Energy on behalf

of its Minnesota customers. In fact, Commissioner Reha specifically stated that “the company made the purchase of gas in a prudent manner.” *APP33 (Tr. p. 21, ll. 16-17)*.

Moreover, no party disputed CenterPoint Energy’s evidence that it inadvertently overstated its sales volumes for the reasons set forth in the Gas Cost Recovery Filings, nor did any party suggest that CenterPoint Energy incorrectly calculated the amount of under-recovered gas costs. Nonetheless, Respondent OAG now takes the position that CenterPoint Energy “has never established that *any* amounts remain unrecovered.” *See Respondent OAG Statement of the Case, p. 4*. To the contrary, the record before the Commission demonstrates that approximately \$21 million in gas costs, prudently incurred to serve Minnesota customers, remains unrecovered by CenterPoint Energy, as reported to the Securities and Exchange Commission and CenterPoint Energy’s investors in its November 15, 2006 Form 8-K filing. As Commissioner Reha summarized: “you actually purchase[d] that gas, I don’t think there was a question as to the prudence of that purchase, and . . . you did not receive payment for that purchased gas, and so there’s a significant hit” to CenterPoint Energy. *APP29 (Tr. p. 5, ll. 21-25)*. Nonetheless, the Commission denied CenterPoint Energy recovery of approximately \$21 million in gas costs, prudently incurred to serve Minnesota customers.

SUMMARY OF ARGUMENT

The Commission erred in denying CenterPoint Energy any ability to recover over \$21 million in gas costs, prudently incurred to serve Minnesota customers. First, the Commission exceeded in its authority and acted arbitrarily and capriciously when it deviated from its precedent and violated the “regulatory compact” between the State of Minnesota and its public utilities by denying recovery of these gas costs. Contrary to clear legislative direction – direction followed by the Commission in its prior cases – the Commission’s denial prevents CenterPoint Energy from recovering the costs prudently incurred to obtain essential natural gas supplies for CenterPoint Energy’s Minnesota customers. Instead of following this legislative direction and its precedent, the Commission created a new standard, never before articulated in statute, rule or prior Commission decisions.

Second, the Commission Order denying recovery of these gas costs is not supported by substantial evidence in the record. The record of this proceeding demonstrates that denial of recovery imposes a \$21 million loss on CenterPoint Energy, an amount greater than 25% of the company’s annual operating income and equal to roughly 45% of the return on equity allowed in CenterPoint Energy’s most recent rate case. Moreover, the loss imposed on CenterPoint Energy far outweighs the potential losses examined by the Commission in prior cases. While the Commission found those smaller amounts to represent an “excessive burden” on the companies involved in the prior cases, the Commission characterized the losses imposed on CenterPoint Energy as

“minor.” The record does not and cannot support that characterization and the radical departure it represents from Commission precedent.

Third, the Commission’s denial of recovery, forcing a write-off of over 25% of CenterPoint Energy’s annual operating income for 2006, constitutes a regulatory taking. Under Minnesota law, regulated natural gas utilities are entitled to recover the actual costs of gas supplies prudently acquired to serve Minnesota customers – no more and no less. The Commission’s refusal to allow such recovery, due to inadvertent accounting errors, severely punishes CenterPoint Energy to the point of denying the company the ability to earn a reasonable return on its assets.

Finally, the Commission erred in denying CenterPoint Energy’s request to recover these gas supply costs without affording CenterPoint Energy a contested case hearing. In so doing, the Commission ignored the recommendation of its own staff, who recommended a contested case hearing given the apparent presence of material factual disputes. By refusing to refer this matter to contested case hearing prior to its decision on the merits, the Commission effectively granted summary judgment against CenterPoint Energy. The record cannot support such a finding and the Commission’s refusal to afford CenterPoint Energy the ability to fully contest certain issues further evidences the Commission’s exercise of its will and not its judgment. For all of these reasons, the decision of the Commission must be reversed.

ARGUMENT

I. STANDARD OF REVIEW.

This Court may reverse or modify the Commission's decision if it is:

- (a) In violation of constitutional provisions; or
- (b) In excess of the statutory authority or jurisdiction of the agency; or
- (c) Made upon unlawful procedure; or
- (d) Affected by other area of law; or
- (e) Unsupported by substantial evidence in view of the entire record as submitted; or
- (f) Arbitrary and capricious.

Minn. Stat. § 14.69 (2006). Also, “[t]his court is not bound by an administrative agency’s determination on a question of law” and need not give deference to the agency’s determination on such matters. *Cent. Tel. Co. v. Minn. P.U.C.*, 356 N.W.2d 696, 699 (Minn. Ct. App. 1984); *see also No Power Line, Inc. v. Minn. Env’tl. Quality Council*, 262 N.W.2d 312, 320 (Minn. 1977) (“Because this conclusion is based on legal rather than factual considerations, the reviewing court is not bound by the decision of the agency and need not defer to agency expertise”). This lack of deference in such circumstances is consistent with the overarching principle that questions of law receive *de novo* review. *Minnegasco v. Minn. Pub. Utils. Comm’n*, 549 N.W.2d 904, 910 (Minn. 1996) (noting that Commission determination was contrary to express statutory language and therefore overturned). Agency determinations are reversed when they reflect an error of law. *Id.*; *see also Central Telephone Co.*, 356 N.W.2d at 702.

On questions of fact, this Court reviews an agency decision to determine whether the decision is “unreasonable, arbitrary or capricious, with review focused on the legal sufficiency of and factual basis for the reasons given.” *Iron Rangers For Responsible*

Ridge Action v. Iron Range Res., 531 N.W.2d 874, 880 (Minn. Ct. App. 1995), *rev. denied* (Minn. July 28, 1995). “An agency’s decision is arbitrary and capricious if it represents the agency’s will and not its judgment.” *Trout Unlimited, Inc. v. Minn. Dep’t of Agric.*, 528 N.W.2d 903, 907 (Minn. Ct. App. 1995), *rev. denied* (Minn. Apr. 27, 1995) (internal quotes omitted). Further,

An agency’s decision is arbitrary or capricious if the agency...entirely failed to consider an important aspect of the problem, if it offered an explanation for the decision that runs counter to the evidence, or if the decision is so implausible that it could not be ascribed to a difference in view or the result of agency expertise.

Pope County Mothers v. MPCA, 594 N.W.2d 233, 236 (Minn. Ct. App. 1999). The reviewing court will intervene “where there is a combination of danger signals that suggest the agency has not taken a hard look at the salient problems and has not genuinely engaged in reasoned decision-making.” *Id.* (internal citations omitted).

The court also reviews the administrative record to determine whether there is substantial evidence supporting the agency finding. *Cable Commc’ns Bd. v. Nor-West Cable Commc’ns P’ship*, 356 N.W.2d 658, 668-669 (Minn. 1984). The substantial evidence test requires the reviewing court to evaluate the evidence relied upon by the agency in view of the entire record as submitted. *Id.* Similar to the arbitrary and capricious standard, the reviewing court will intervene when the agency has not “taken a hard look at the salient problems.” *Id.*

II. STATUTORY AND REGULATORY BACKGROUND.

Minnesota Statutes Chapter 216B sets forth the regulatory scheme for natural gas utilities in Minnesota. There, the Legislature declares that:

It is hereby declared to be in the public interest that public utilities be regulated as hereinafter provided in order to provide the retail consumers of natural gas and electric service in this state with adequate and reliable services at reasonable rates, *consistent with the financial and economic requirements of public utilities and their need to construct facilities to provide such services or to otherwise obtain energy supplies.*

Minn. Stat. § 216B.01 (2006) (emphasis added).

Consistent with this overarching goal of providing adequate and reliable service at reasonable rates, while recognizing the need for utilities to recover their costs of obtaining energy supplies, the Legislature also adopted the PGA Statute. The PGA Statute provides as follows:

Energy Cost Adjustment. Notwithstanding any other provision of this chapter, the commission may permit a public utility to file rate schedules containing provisions for the automatic adjustment of charges for public utility service in direct relation to changes in: (1) federally regulated wholesale rates for energy delivered through interstate facilities; (2) *direct costs for natural gas delivered*; or (3) costs for fuel used in generation of electricity or manufacture of gas.

Minn. Stat. § 216B.16, subd. 7 (2006) (emphasis added).

In accordance with the PGA Statute's plain language, it is the Legislature's intent to allow a utility to recover the actual energy supply costs that it incurs -- no more and no less.

To implement this legislative directive, the Commission adopted a series of rules, known as the PGA Rules. Minn. R. 7825.2400-7825.2920 (2005). In accordance with the PGA Rules, utilities such as CenterPoint Energy make their annual automatic adjustment ("AAA") or "true-up" filings each year, detailing their gas costs and gas

revenues. Minn. R. 7825.2910, subp. 4 (2005). The PGA Rules describe the true-up adjustment for natural gas utilities as:

The difference between the commodity and demand gas revenues by class collected by the utility and the actual commodity-delivered gas cost and demand-delivered gas cost by class incurred by the utility during the year.

Minn. R. 7825.2700, subp. 7 (2005) (“True-up Rule”).

While the True-up Rule and other PGA Rules describe the “true-up” as an annual process, looking at each year’s costs and recoveries, the plain language of the True-up Rule makes clear that a utility is entitled to recover (or refund) in its true-up adjustment the difference between the cost of gas incurred and the cost of gas collected by class of customer. *Id.*¹

When enacting the PGA Statute and promulgating the PGA Rules, including the True-up Rule, the Legislature and Commission recognized that utilities must have confidence in the recoverability of their natural gas supply costs. Indeed, this is the essence of the “regulatory compact” between the state and the utility whereby the utility is provided the right to recover its costs, in exchange for accepting the obligation to serve consumers. *See, e.g., Transmission Access Policy Study Group v. Fed. Energy Regulatory Comm’n*, 225 F.3d 667, 700 (D.C. Cir. 2000). In the case of CenterPoint Energy, the company has purchased approximately \$4.2 billion of gas during the time

¹ While this rule describes the true-up process as an annual event, in fact, the true-up is a perpetual ongoing determination. Since the true-up is determined based upon estimated sales for the subsequent 12 month period, and since actual sales will not match the estimated sales, there is always a mismatch of gas costs incurred and revenues recovered from customers at the end of that next year. Thus, utilities actually “true-up the true-up” ever year, meaning out of period costs and recoveries are always a component of the PGA process.

period at issue in this case. Moreover, the cost of gas represents approximately 82% of every dollar that a Minnesota customer pays. Uncertainty related to the recovery of these costs would add substantial risks to utilities, ultimately increasing costs to customers.

In the instant case, in late 2005, CenterPoint Energy discovered unrecovered gas costs dating back to calendar year 2000. Due to the one-year time frame of the PGA Rules, CenterPoint Energy filed for a variance to the True-up Rule, so that it could recover these previously unrecovered gas costs. CenterPoint Energy filed its petition pursuant to Minnesota Rules 7829.3200, subpart 1 (2005), which provides:

The commission *shall grant* a variance to its rules when it determines that the following requirements are met:

- A. enforcement of the rule *would impose an excessive burden upon the applicant* or others affected by the rule;
- B. granting the variance would not adversely affect the public interest;
and
- C. granting the variance would not conflict with standards imposed by law.

(Emphasis added.)

On the two prior occasions where utilities made similar mistakes resulting in under-recovery of prior incurred gas costs, the Commission granted the utilities a variance to the one year time period of the True-up Rule, in order to allow full gas cost recovery. *APP60-APP71. (In the Matter of the Review of the 1997 Annual Automatic Adjustment for All Gas and Elec. Utils., MPUC Docket No. G,E-999/AA-97-1212 (“1997 AAA Docket”)), Order Reviewing 1997 Annual Automatic Adjustment Reports and True-Up Filings, May 28, 1998 (“Order Granting Interstate Variance”), and APP72-APP88*

In the Matter of the Review of the 1994 Annual Automatic Adjustment of Charges for All Gas and Elec. Utils., MPUC Docket No. E,G-999/AA-94-762 (“1994 AAA Docket”), *Order Accepting Annual Automatic Adjustment Reports*, July 13, 1995 (“*Order Granting NSP Variance*”). In those cases, the Commission recognized that failing to allow full recovery would impose an excessive burden on those utilities (even though substantially fewer dollars were at stake) and that granting a variance would not “burden” ratepayers, since ratepayers would have paid those full gas costs in the prior years but for the utilities’ accounting errors. *Id.* The Commission also found that allowing recovery would not adversely impact the public interest and would not conflict with other standards imposed by law. *Id.*

In the current case, the Commission deviated from this precedent and from the directives of the PGA Statute and PGA Rules by denying CenterPoint Energy the ability to recovery any of its previously unrecovered gas costs, and imposing a significant financial penalty on the company.

III. THE COMMISSION EXCEEDED ITS AUTHORITY AND ACTED ARBITRARILY AND CAPRICIOUSLY IN DENYING CENTERPOINT ENERGY RECOVERY OF ITS PRUDENTLY INCURRED GAS COSTS.

At the Commission’s hearing on reconsideration, in discussing whether it was appropriate to continue denying CenterPoint Energy’s request for recovery of its past incurred gas costs, Commissioner Reha stated:

[T]his issue is one of a procedure, and it’s one of trying to be evenhanded in how we deal with procedure here. And I think you have to look at what’s required. We have to determine, number one, whether there was an excessive burden, . . . and I think we said in the NSP order that failure to recover one million in gas costs would undoubtedly place a burden upon

NSP Gas. Well, *certainly here the numbers are even more significant* and I think it's an excessive burden to the company.

. . . *[T]he company made the purchase of gas in a prudent manner, there's no indication that they did not, and that that gas cost would have been paid by customers had there not been this mistake, this error. And so to me I don't think the . . . trueup would harm ratepayers since the recovery should have and could have occurred in the prior period.*

. . . *[P]unishing the company for a clerical error in the tune of \$21 million, . . . if we're going to hand out a variance in one case, we can't be arbitrary and not hand a variance in another case when the same standards and criteria apply to both companies. And in the NSP case we looked at those standards and said, yes, it had a significant impact, excessive burden, and it would not be against the public interest to allow this and we gave them a variance. Now here with another company in the same circumstances, and even more seriously so, we're saying we shouldn't give them a variance. . . . [I]t seems awful arbitrary to me to hand it out in one and not in another.*

APP32-APP33 (Tr. p 20, l. 25- p. 23, l. 3) (emphasis added).

The record of this proceeding graphically demonstrates each of the errors discussed by Commissioner Reha. The Commission's denial of any recovery of these past incurred gas costs: (1) runs contrary to legislative direction, to the "regulatory compact" between the state and utilities, and to the intent of the PGA Statute and PGA Rules; (2) failed to follow established Commission precedent; and (3) incorrectly found that a \$21 million loss would not constitute a burden to CenterPoint Energy.

A. The Commission's Denial Of Recovery Violates The Regulatory Compact And Runs Contrary To Legislative Direction And To The Intent Of The PGA Statute And PGA Rules.

In its "Legislative Findings," explaining the purpose of state regulation of utility companies, the Legislature states:

It is hereby declared to be in the public interest that public utilities be regulated as hereinafter provided in order to provide the retail consumers of natural gas and electric service in this state with adequate and reliable services at reasonable rates, *consistent with the financial and economic requirements of public utilities and their need to construct facilities to provide such services or to otherwise obtain energy supplies.*

Minn. Stat. § 216B.01 (2006) (emphasis added).

This statute embodies the essence of the “regulatory compact” between the state and the utility, whereby the utility is provided the right to recover its costs, in exchange for accepting the obligation to provide adequate, reliable service to Minnesota customers. *Transmission Access Policy Study Group*, 225 F.3d at 700; *PacifiCorp v. Pub. Serv. Comm’n of Wyo.*, 103 P.3d 862, 871 (Wyo. 2004); *U.S. Gypsum, Inc. v. Ind. Gas Co., Inc.*, 735 N.E.2d 790, 797 (Ind. 2000). Moreover, the statute specifically calls out the financial and economic requirements of obtaining energy supplies as a critical issue to be addressed. Further recognizing the critical nature of gas supply costs, the Legislature also adopted the PGA Statute, providing the Commission the authority to approve rate schedules for the “automatic adjustment of charges for public utility service in direct relation to changes in . . . direct costs for natural gas delivered.” Minn. Stat. § 216B.16, subd. 7 (2006). This particular attention to energy supply costs is vital to natural gas utilities such as CenterPoint Energy, since natural gas supply costs represent over 80% of the overall cost structure of the utility.

The Commission, in furtherance of these legislative directives, adopted the PGA Rules to provide for precise dollar-for-dollar recovery of prudently incurred gas costs. In other words, because natural gas utilities make no profit on the natural gas supplies they

purchase for their customers, they are assured of full recovery of those costs provided they were prudently incurred.

In denying CenterPoint Energy recovery of its prudently incurred gas costs, the Commission has violated the regulatory compact between the State and its public utilities at the most fundamental level – it has denied CenterPoint Energy the ability to recover the costs of serving its Minnesota customers, instead requiring the Company to “write off” \$21 million in prudently incurred gas costs. This is contrary to the most fundamental principle of utility regulation. *Transmission Access Policy Study Group v. Fed. Energy Regulatory Comm’n*, 225 F.3d 667, 700 (D.C. Cir. 2000) (stating that “utilities invest[] money, buil[d] facilities, and enter into long-term fuel or power contracts, relying on the ‘regulatory compact’ under which utility shareholders accepted lower rates of return on their investment in exchange for the certainty of regulated rates and ability to recover prudently incurred costs.”) (emphasis added); *PacifiCorp v. Pub. Serv. Comm’n of Wyo.*, 103 P.3d 862, 871 (Wyo. 2004) (emphasizing that “[t]he ‘regulatory compact’ provides the fundamental basis for utility regulation. In general, the compact is a theoretical agreement between the utilities and the state in which, as a quid pro quo for being granted monopoly in a geographical area for the provision of a particular good or service, the utility is subject by regulation by the state to ensure that it is prudently investing its revenues in order to provide the best and most efficient service possible to the consumer.”); *U.S. Gypsum, Inc. v. Ind. Gas Co., Inc.*, 735 N.E.2d 790, 797 (Ind. 2000) (noting that “[t]he bedrock principle behind utility regulation is the so-called ‘regulatory compact,’ which arises out of a ‘bargain’ struck between utilities and the state.”)

B. The Commission's Denial Of Recovery Runs Counter To Clear Commission Precedent.

The Commission's decision will be reversed as "arbitrary and capricious if it represents the agency's will rather than an exercise of its judgment." *In re Good Faith Efforts In Meeting Renewable Energy Objectives Under Minn. Stat. 216B.1691*, 700 N.W.2d 533, 539 (Minn. Ct. App. 2005) (citing *In re Excess Surplus Status of Blue Cross Blue Shield of Minn.*, 624 N.W.2d 264, 278-83 (Minn. 2001)); *In the Matter of the Rate Appeal of Sleepy Eye Care Ctr.*, 572 N.W.2d 766, 770 (Minn. Ct. App. 1998) (stating that "[i]f agency departs from past practice, it must justify that departure in the record of evidence."); *In the Matter of Whitehead*, 399 N.W.2d 226, 229 (Minn. Ct. App. 1987) (noting absence of Commission explanation of reasons for decision prompted Court to conclude that the decision was arbitrary and capricious). Although administrative agencies are not bound to "rigid adherence to precedent. This does not mean, however, that an agency may abandon its own precedent without reason or explanation." *Peoples Natural Gas Co. v. Minn. P.U.C.*, 342 N.W.2d 348, 352 (Minn. Ct. App. 1983), *rev. denied* (Minn. Apr. 24, 1984). "An agency must either conform to its prior norms and decisions or explain the reason for its departure from such precedent." *In the Matter of N.S.P. Gas Util. For Auth. to Change Its Schedule of Gas Rates*, 519 N.W.2d 921, 925 (Minn. Ct. App. 1994) (citing *Peoples Natural Gas Co.*, 342 N.W.2d at 353)); *Lewis v. City of Medina*, 535 P.2d 150, 152 (Wash Ct. App., Div. I 1975), *reh'g denied* (Sept. 29, 1975) (noting prior holding that "Board's disregard of its own statutory requirements justifies the conclusion that a denial of a variance is arbitrary and capricious.")

(emphasis added). Here, the Commission's decision to deviate from its long-standing precedent and the Legislature's directive of allowing the recovery of all gas costs, without explaining the factual and legal bases for its decision, demonstrates that the Commission sought to exercise its will, not its judgment, and must be reversed.

As discussed in Section II, *supra*, in the only two prior instances where a utility's accounting mistakes led to unrecovered past gas costs, the Commission granted variances to the one-year time frame of the True-up Rule. In the 1994 AAA Docket, discussed by Commissioner Reha, NSP sought to recover a past under-recovery due to an "accounting error." APP76. NSP had "discovered that, *due to an internal accounting change*, certain commodity gas costs were inadvertently deducted twice in its true-up report" submitted in the prior period. *Id.* (emphasis added). As a result of this accounting error, NSP had under-recovered approximately \$1.05 million. *Id.* In granting NSP a variance, the Commission found that "[f]ailure to recover over \$1 million in gas costs would undoubtedly place a burden on NSP Gas...[as] the loss would represent almost 10% of the return on equity allowed in the Company's most recent rate case." APP78. The Commission further found that the \$1 million "could have and should have been collected as a normal cost during the [prior] period. The net effect [on ratepayers] is \$0." APP78-APP79. Although the Commission recognized that "the adjustment will take place with a ratepayer list which differs somewhat from the list of ratepayers when the under collection occurred[,] [t]he Commission agree[d] . . . that this circumstance does not outweigh the benefit of allowing the Company *full gas cost recovery as contemplated under the PGA rules.*" APP79 (emphasis added).

In the *1997 AAA Docket*, Interstate requested a variance to recover prior period gas costs still unrecovered due to Interstate's inadvertent omission of its synthetic storage gas charges for the two prior filing periods, 1994-1995 and 1995-1996. *APP63*. Again, the Commission agreed that a variance should be granted, noting that a "\$164,781 adjustment is significant and could adversely affect the Company if it is not allowed to recover the expense,...and there would be no net impact on ratepayers." *Id.* The Commission further agreed that the requirements for granting a variance had been met in light of the fact that the utility's error was inadvertent and the net impact on ratepayers was zero. *Id.*

The current case presents the Commission with the same legal issue faced in the *1994 AAA Docket* and the *1997 AAA Docket*, with substantially similarly situated parties and similar underlying fact issues. However, the Commission now reaches an opposite result, construing the law differently in the current case -- a clear indication of an agency acting arbitrarily and capriciously. See Ron Beal, *Administrative Law 2004 Update and Analysis*, 57 *Baylor L. Rev.* 359, 367-371 (2004).

In the instant case, CenterPoint Energy sought relief from the one-year recovery period due to the accounting or reporting errors it made exactly as Interstate and NSP did. Interstate inadvertently omitted synthetic storage gas charges for the two prior filing periods, 1994-1995 and 1995-1996. *APP63*. In the current case, CenterPoint Energy inadvertently failed to consider certain lost and unaccounted for gas. Similarly, NSP "discovered that, due to an internal accounting change, certain commodity gas costs were inadvertently deducted twice in its true-up report" submitted in the prior period. *APP76*. In the current matter, CenterPoint Energy under-collected due to an internal accounting

change that impacted its accounting for unbilled revenues. In neither the Commission's December 22, 2006, *Order Denying Variance and Ordering Independent Audit*, nor the Commission's February 22, 2007, *Order Clarifying Order Denying Variance and Ordering Independent Audit*, did the Commission ever address any *substantive difference* between the accounting or reporting errors made by Interstate and NSP, with those made by CenterPoint Energy.² Accordingly, the Commission's failure to differentiate the factual circumstances presented by CenterPoint Energy, and those presented by *NSP* and *Interstate* cases demonstrates the Commission's willingness to abandon its own (and only) precedent without reason or explanation. See *Peoples Natural Gas Co.*, 342 N.W.2d at 352-53.

In addition, the Commission's refusal to grant the relief sought by CenterPoint Energy prevents it from recovering an amount equal to over 25% of its annual operating income, or *\$21 million*, in prudently incurred gas costs. In the *Interstate* case, the Commission found, that a "*\$164,781* adjustment is significant and could adversely affect the Company if it is not allowed to recover the expense,...and there would be no net impact on ratepayers." *APP63* (emphasis added). In the NSP case, the Commission found that "[f]ailure to recover over *\$1 million* in gas costs would undoubtedly place a

² The Commission's *only* attempt to distinguish CenterPoint Energy's accounting and reporting error with those of Interstate and NSP was the time it took to detect the error, as well as the statement that it is due to "Company-initiated changes to its accounting practices." *APP59*. Although this was a purported basis upon which the Commission sought to distinguish the Commission's case, it was the reason relied upon by the Commission to *grant* NSP's relief. NSP had "discovered that, due to an internal accounting change, certain commodity gas costs were inadvertently deducted twice in its true-up report" submitted in the prior period. *NSP Order at 5*.

burden on NSP Gas...[as] the loss would represent almost 10% of the return on equity allowed in the Company's most recent rate case." *APP78* (emphasis added). In the instant case, the Commission found that \$21 million was not excessively burdensome amount for a utility to absorb, yet in its only two prior cases analyzing the issue, the Commission found \$164,781 and \$1 million to be excessively burdensome. Again, the Commission abandoned its precedent without making any factual findings distinguishing the instant case from the factual circumstances underlying its precedent. In doing so, the Commission has acted arbitrarily and capriciously, and its decision must be reversed.³

Lastly, the Commission denied the relief sought by CenterPoint Energy based upon its erroneous factual presumption that the Company sought to hold "ratepayers accountable" and use ratepayers as a "failsafe or back-up source of cash for the Company." *APP58-APP59*. On this point the Commission's finding again completely contradicts its precedent and finds no substantive factual support in the record. *As with all gas costs that are prudently incurred, utilities are entitled to recover them (dollar for dollar) from ratepayers.* Minn. State. § 216B.16, subd. 7 (2006). In the *NSP* case, the Commission found that the \$1 million "could have and should have been collected as a normal cost during the [prior] period," and that the net impact on ratepayers is \$0 because all amounts "could have and should have been collected as a normal cost during the [prior] period[s.]" *APP79* (emphasis added). In the *Interstate* case, the Commission

³ At a minimum, CenterPoint Energy should be allowed to present the disputed issues of fact to an Administrative Law Judge as part of a contested case hearing, as discussed further in Section VI, *infra*. Indeed, many of the statements relied upon by the Commission are nothing more than rhetoric of opposing counsel, which cannot provide the requisite evidentiary or factual support for Commission findings or conclusions.

found that “\$164,781 adjustment is significant” and “there would be no net impact on ratepayers.” *APP63*.

Commissioner Reha noted that the same fact holds true in the current case – that recovery from ratepayers “should have and could have occurred in the prior period.” *APP33 (Tr. p. 21, ll. 22-24)*. Indeed, CenterPoint Energy simply seeks the same recovery of costs incurred to serve customers sought and received by NSP and Interstate in similar situations. Again, close scrutiny of the record reveals that the Commission sought to exercise its will, rather than its judgment, and abandoned its only precedent without reason or explanation. Like the two precedential cases referenced herein, the Company admittedly seeks recovery from a somewhat different set of ratepayers than those on whose behalf the underlying costs were incurred. Yet, the Commission has already faced this situation. For example, in NSP, the Commission stated: “the adjustment will take place with a ratepayer list which differs somewhat from the list of ratepayers when the under collection occurred[,] [t]he Commission agrees . . . that this circumstance does not outweigh the benefit of allowing the Company *full gas cost recovery as contemplated under the PGA rules*.” *APP79* (emphasis added). Moreover, in a case involving refunds to customers, the Commission approved issuing refunds to a customer list some *eighteen (18) years* different than the list of customers originally charged. *APP89 In the Matter of the Request to Vary Supplier Rules Regarding A Kansas Ad Valorem Production Tax Refund Made By Mobil Corp.*, Docket No. G-999/AA-98-332, *Order Directing Refund*, August 8, 2001. Accordingly, its decision cannot stand.

C. The Commission's Finding That A \$21 Million Loss Is "Minor" Is Unsupported By Any Evidence, Let Alone Substantial Evidence.

The Commission strays furthest from its precedent when it finds that a \$21 million loss, equal to over 25% of CenterPoint Energy's annual operating income, is "minor." The Commission makes this astonishing finding by creating a new and entirely inapposite test. In creating this new test, the Commission errs as a matter of law and errs in a manner requiring correction by this Court to prevent future and potentially even more draconian results.

In the Order Granting NSP Variance and Order Granting Interstate Variance, the Commission looked to the total dollars at stake for the utilities – slightly over \$167,000 for Interstate and approximately \$1 million for NSP. The Commission found that requiring either company to absorb those otherwise recoverable costs would impose an "excessive burden" on the companies, thereby justifying a variance. In the case of NSP, the Commission specifically noted that the dollars "would represent almost 10% of the return on equity allowed in the Company's most recent rate case." *APP78*. In the current case, CenterPoint Energy explained that the dollars at issue, if disallowed, reduce CenterPoint Energy's return on equity to roughly 5.35%, from the recently allowed return of 9.7% – nearly 45% of the return on equity allowed in that case.

The Commission did not address this four-fold greater impact on CenterPoint Energy, when compared to NSP, instead calling the losses at issue for CenterPoint Energy "minor." The Commission did so by comparing these losses, not to CenterPoint Energy's income, as was done in the *1997 AAA Docket*, but by comparing the losses to

the total gas costs incurred by CenterPoint Energy over the past several years. *APP58*. Under the Commission's logic, since \$21 million represents only one-half of one percent of CenterPoint Energy's total gas costs through this period, failure to recover these dollars should be seen as trivial by CenterPoint Energy. *Id.*

If the Commission's new test stands, given the substantial dollars spent on energy supplies, comparing virtually *any* potential loss to total gas costs incurred over several years could lead to that loss being deemed "minor." Indeed, disallowance of even a small percentage of total gas costs could eradicate a company's entire earnings for a year. Moreover, the evidence in the record of this proceeding demonstrates that the losses at issue are severe enough to warrant filing notice to investors through CERC's 8-K filing to the Securities and Exchange Commission. Under no reasonable interpretation can such losses be called "minor" and the Commission's deviation from precedent on this point must be reversed.

IV. THE COMMISSION'S DETERMINATION TO DENY CENTERPOINT ENERGY RECOVERY OF \$21 MILLION, OR 45% OF ITS ALLOWED RETURN ON EQUITY, IS NOT SUPPORTED BY SUBSTANTIAL EVIDENCE.

CenterPoint Energy provided documentary evidence demonstrating that it has failed to recover approximately \$21 million in gas costs. As Commissioner Reha noted, no party has disputed that CenterPoint Energy prudently incurred those costs to serve Minnesota customers. *APP29 (Tr. p. 5, ll. 21-25)*. As Commission Chair Koppendrayner noted, since gas costs are a direct pass through to customers, any failure to recover these costs is a direct hit to CenterPoint Energy's bottom line. *APP32 (Tr. p. 18, ll. 11-14)*. In

this proceeding, CenterPoint Energy demonstrated that this write-off amounted to over 25% of its annual operating income in 2006, or approximately 45% of the allowed return on equity for the company. Given this substantial negative impact, CenterPoint Energy's parent company filed a Form 8-K with the Securities and Exchange Commission, informing investors of the Commission's denial. *APP24-APP27.*

In the face of this evidence, the only substantive evidence on the subject, the Commission nonetheless characterized CenterPoint Energy's losses as "minor." In so doing, the Commission first misstated the losses, saying they were only \$2.4 million. *APP6.* After CenterPoint Energy identified this error, the Commission corrected its finding, correctly increasing the losses incurred due to the Commission's denial by nearly nine times, to \$21 million. *APP58.* Nonetheless, because of a two-to-two deadlock vote of the Commissioners present, the Commission continues to insist that these losses are insignificant.

No evidence, let alone any credible evidence, supports the characterization of a \$21 million loss as "minor." Indeed, the only information cited by the Commission in an attempt to minimize this enormous loss is the comparison of the loss to the total gas costs incurred by CenterPoint Energy. However, as discussed above, this comparison to total gas costs ignores the fact that CenterPoint Energy earns no profit on the actual cost of gas, constitutes a complete reversal of Commission precedent which analyzed losses in the context of utility earnings, and would allow virtually *any* loss to be characterized as insignificant. As such, the Commission's finding that a \$21 million loss would not

constitute a burden to CenterPoint Energy is not supported by substantial evidence and must be reversed.

Minnesota courts have defined substantial evidence as:

1. *Such relevant evidence as a reasonable mind might accept as adequate to support a conclusion;*
2. More than a scintilla of evidence;
3. More than some evidence;
4. More than any evidence; and
5. *Evidence considered in its entirety.*

Cable Commc'ns Bd. v. Nor-West Cable Commc'ns P'ship, 356 N.W.2d 658, 668-669 (Minn. 1984) (emphasis supplied). This test requires the reviewing court to evaluate the evidence relied upon by the agency in view of the entire record as submitted. *Id.* Similar to the arbitrary and capricious standard, the reviewing court will intervene when the agency has not “taken a hard look at the salient problems” and the agency’s decision lacks “articulated standards and reflective findings.” *Id.* In the current matter, the evidence considered in its entirety unquestionably shows the impact of the Commission’s denial on CenterPoint Energy – an impact considerably more severe than the impacts examined, and found excessive, in the *1994 AAA Docket* and the *1997 AAA Docket*. Moreover, the record demonstrates that the Commission continued to characterize the losses here as “minor,” even after acknowledging that it originally erred by a factor of nearly nine in quantifying those losses. In short, the record demonstrates the Commission’s failure to take a “hard look” at the impact of its action and fails to support the conclusion that the impact of its denial does not impose a burden on CenterPoint Energy.

V. THE COMMISSION'S DENIAL OF CENTERPOINT ENERGY'S RECOVERY OF \$21 MILLION, OR 45% OF CENTERPOINT ENERGY'S ALLOWED RETURN ON EQUITY, CONSTITUTES AN UNCONSTITUTIONAL TAKING.

The Commission's order refusing to allow CenterPoint Energy to recover \$21 million in prudently incurred, actual gas costs punishes CenterPoint Energy and constitutes an unconstitutional taking of property without just consideration. *See* U.S. Const. amends. V, XIV; Minn. Const., art. I, §§ 7 and 13. The Commission's Order denying CenterPoint Energy any ability to recover over \$21 million in prudently incurred gas costs used to serve Minnesota customers forced CenterPoint Energy to write-off over 25% of its 2006 annual operating income and effectively reducing its return on equity to just 5.35% for 2006, 44.9% less than the 9.71% return authorized for CenterPoint Energy by the Commission in its most recent rate case. *APP12, APP17.*

The United States Supreme Court has long held that the Constitution protects public utilities like CenterPoint Energy "from being limited to a charge for their property serving the public which is so 'unjust' as to be confiscatory." *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307 (1989) (citing *Covington & Lexington Turnpike Road Co. v. Sandford*, 164 U.S. 578, 597 (1896); *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 585 (1942); *FPC v. Texaco, Inc.*, 417 U.S. 380, 391-392 (1974)). Similarly, the Minnesota Supreme Court has long held that "Courts must and do have the power to prevent the unlawful taking of property without due process of law by the establishment of rates which are confiscatory or noncompensatory." *N. States Power Co. v. City of St. Paul*, 99

N.W.2d 207, 211, 256 Minn. 489, 494 (1959); *see also Hibbing Taconite Co. v. Minn. Pub. Serv. Comm'n*, 302 N.W.2d 5 (1980).

Courts are to examine the impact of a regulatory commission's order on the public utility in analyzing whether the order is confiscatory and therefore violates the takings clause of the Fifth Amendment as applied to the states through the Fourteenth Amendment. *Duquesne Light Co.*, 488 U.S. at 310, 314. ("It is not theory but the impact of the rate order which counts.") (internal quotation omitted). "The Constitution protects the utility from the net effect of the rate order on its property." *Id.* at 314. Although there is "no formula for determining whether a rate is confiscatory" and therefore unconstitutional, *KN Energy, Inc. v. Cities of Broken Bow*, 505 N.W.2d 102, 107 (Neb. 1993), the United States Supreme Court has long held that utilities are entitled to a reasonable and fair return on their investments. *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 690 (1923); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *L.A. Gas & Elec. Corp. v. R.R. Comm'n*, 289 U.S. 287 (1933).

A "government-established rate for a utility is confiscatory when the rate fails to produce a return on investment equal to the return realized on investments which have risks corresponding to those of the utility." *KN Energy*, 505 N.W.2d at 107 (citing *Hope Natural Gas*, 320 U.S. 591; *L.A. Gas & Elec. Corp.*, 289 U.S. 287; *Bluefield*, 262 U.S. at 690-92). Accordingly, "a state cannot set rates which are unjust, unreasonable, and confiscatory and which, therefore, deprive the utility of property without due process of law guaranteed by" the Fourteenth Amendment. *KN Energy*, 505 N.W.2d at 107;

Duquesne Light Co., 488 U.S. at 314-15; *Bluefield*, 262 U.S. at 690-692; *Hope Natural Gas*, 320 U.S. at 603.

A court reviewing a regulatory commission's order must assure itself both that "each of the order's essential elements is supported by substantial evidence" and that "the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interest, both existing and foreseeable." *Permian Basin Area Rate Cases*, 390 U.S. 747, 792 (1968). Therefore, a court cannot simply affirm an order because each of the component decisions of that order, taken in isolation, was permissible. *Id.*; *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1177 (D.C. Cir. 1987) (en banc). Instead, the court must examine the rate set to determine whether it "produce[s] arbitrary or unreasonable consequences." *Permian Basin*, 390 U.S. at 800; *Jersey Cent. Power & Light Co.*, 810 F.2d at 1177. Moreover, expenses which are "properly incurred ... must be allowed as part of the composition of the rates" set for a utility because "otherwise, the so-called allowance of a return upon the investment, being an amount over and above expenses, would be a farce." *Miss. River Fuel Corp. v. Fed. Power Comm'n*, 163 F.2d 433, 437 (D.C. Cir. 1947).

The application of these principles here establishes that the Commission's Order constitutes an unconstitutional taking of CenterPoint Energy's property without just compensation. Under Minnesota law, the general rate case process (where the Commission sets a utility's allowed rate of return) and the gas cost recovery process occur in separate and distinct proceedings. Indeed, the Legislature and Commission

purposefully crafted the AAA filing process as a distinct process so that utilities would recover their gas costs on a dollar-for-dollar basis whether or not a utility files a general rate case. However, as demonstrated by CenterPoint Energy in its filings to the Commission, denying a utility the ability to recover its prudently incurred gas costs can effectively eviscerate the utility's earnings allowed by the Commission in its most recent rate case, effectuating a taking under these clear principles. Indeed, despite the Commission's erroneous characterization of the \$21 million of prudently incurred gas costs as "minor," under no reasonable interpretation of the undisputed facts can the Commission's Order be viewed as anything other than a substantial taking of CenterPoint Energy's property.

The \$21 million at issue equates to over 25% of CenterPoint Energy's 2006 annual operating income. *APP12*. As noted above, if affirmed, the Commission's Order would result in a return on equity for CenterPoint Energy for 2006 of just 5.35%, compared to the 9.71% return authorized for the company in its most recent rate case. *Id.* This reduction of 436 basis points represents a 44.9% reduction of the total return authorized by the Commission for CenterPoint Energy in that rate case. In fact, the substantial impact of the denial of such an enormous percentage of CenterPoint Energy's return to its shareholders required CenterPoint Energy's parent company, CenterPoint Energy Resources Corporation, to file a Form 8-K with the Securities and Exchange Commission to inform investors of the Commission's Order. *APP24-APP27*.

Thus, despite the Commission determining that CenterPoint Energy was entitled to a reasonable rate of return on equity of 9.71%, the Commission's Order reduces this

return for 2006 by more than 40%, resulting in CenterPoint Energy earning a rate of return substantially less than the returns being made at the same time by other gas utilities. This constitutes an unconditional taking under United States Supreme Court precedent. *See Bluefield*, 262 U.S. at 690-692; *Duquesne*, 488 U. S. at 314-315. Other courts have held under similar circumstances that such a denial of a reasonable rate of return constitutes an unconstitutional taking of property without just compensation. *See, e.g., KN Energy, Inc. v. Cities of Broken Bow*, 505 N.W.2d 102, 106-109 (Neb. 1993); (rates set by municipalities were unconstitutional because the rates set resulted in a “return on [the utility’s] equity to a level below that which investors could earn from investments in other similar businesses”; rates reduced utility’s rate of return on equity by 3.7 to 4.99%); *KN Energy, Inc. v. City of Scottsbluff*, 447 N.W.2d 227 (Neb. 1989) (holding expenses prudently incurred by the utility must be included in rate determination, otherwise the rate would be unreasonably low and unconstitutionally confiscatory).

Similarly, the United States Court of Appeals for the District of Columbia has remanded a case back to federal regulators for further proceedings because the utility had presented evidence that the rate set by the commission was unconstitutionally confiscatory and the commission had refused to grant a hearing to consider the proof. *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1181-1182 (D.C. Cir. 1987) (en banc). Thus, at a minimum, this Court should remand the case to the Commission for further hearings on CenterPoint Energy’s taking claim, as discussed further in Section VI, *infra*.

VI. THE COMMISSION EXCEEDED ITS AUTHORITY, ACTED ARBITRARILY AND CAPRICIOUSLY, AND ISSUED ITS ORDERS BASED UPON UNLAWFUL PROCEDURE IN DENYING CENTERPOINT ENERGY A CONTESTED CASE HEARING.

The right to a contested case hearing can be based upon an express statement of such a right in an agency's statutes or rules, or it may be implied from an overall examination of the purpose of statutory scheme. George A. Beck, *Minnesota Administrative Procedure* 46 (1998); *Fosselman v. Comm'r of Human Servs.*, 612 N.W.2d 456, 459-460 (Minn. Ct. App. 2000); *MPIRG v. Minn. Env'tl. Quality Council*, 237 N.W.2d 375, 381-82 (Minn. 1975). Similarly, a party adversely affected by agency action may be entitled to a contested case hearing pursuant to the due process guarantees of the Minnesota and United States Constitutions. Beck, *Minnesota Administrative Procedure* at 47. In other words, if the failure to grant such a hearing did, in fact, deprive a party of due process, then the statutes and rules "must be construed to grant them such a hearing." *Fosselman*, 612 N.W.2d at 460. In the instant case, the Commission's denial of CenterPoint Energy's petition for a contested case hearing was arbitrary and capricious, made upon unlawful procedure, and was made in violation of the constitutional guarantees of due process.

A. CenterPoint Energy Is Entitled To A Contested Case Hearing Based Upon The Plain Language Of The Commission Statutes And Rules.

CenterPoint Energy should have been granted a contested case hearing based upon a plain reading of the applicable statutes and rules governing the Commission's consideration and disposition of such matters. The PGA Statute allows utilities like CenterPoint Energy to recover their actual gas costs incurred, no more and no less. Minn.

Stat. § 216B.16, subd. 7 (2006). In accordance with its enabling legislation, the Commission promulgated rules detailing the process by which utilities must make their PGA filing, as well as their recovery of its actual gas costs incurred. Minn. R. 7825.2700-7825.2910 (2005).⁴

Based upon the Commission-prescribed one-year rule regarding the recovery of gas costs, CenterPoint Energy petitioned the Commission for a variance in accordance with the Commission policies and procedures governing utility practice. Minn. R. 7820.3200, subp. 1 (2005). At the same time, CenterPoint Energy requested a contested case hearing, in accordance with Minn. R. 7829.1000 (2005), to resolve a number of disputed issues of material fact vital to the Commission's resolution of this matter, including the specific variance request.

Minn. R. 7820.1000 provides, in pertinent part, that:

If a proceeding involves contested material facts and there is a right to a hearing under a statute or rule, or if the commission finds that all significant issues have not been resolved to its satisfaction, the commission shall refer the matter to the Office of Administrative Hearings....

Id. (emphasis added). Although the Commission granted itself, as part of its rulemaking, the discretion to determine whether "all significant issues have been resolved to its satisfaction" and thereby deprive a party of a contested case hearing, this authority is not limitless. The Commission's authority is measured by the statute from which it derives its authority; it is not obtained by the agency's own acts, or by its assumption of that authority. *In the Matter of Hibbing Taconite Co.*, 431 N.W.2d 885, 890 (Minn. Ct. App.

⁴ Despite the fact that the controlling statute does not impose any such time limitation, the Commission's rules prescribe this one-year look back for the recovery of gas costs.

1988) (citations omitted). Here, the Commission relied exclusively on the rhetoric of counsel and the parties to support its decision, which included significant misstatements of fact, despite the fact that significant, contested material facts clearly remained in dispute.

One glaring example came in the form of the OAG's Statement of the Case to this Court, which parroted its argument to the Commission, wherein it stated that "[r]ecord evidence fully supports the Commission's finding that '[a]fter twice going through the extensive examination and analysis of a ratemaking proceeding, there has been no showing that Relator has not been fully compensated by ratepayers.'" *OAG-RUD Statement of the Case* at 5.⁵ Simply put, the argument of counsel, no matter how emphatic, will not suffice where evidence to support such statements has not been introduced into the record. Importantly, since these arguments came from opposing counsel, CenterPoint Energy had no opportunity to cross-examine any fact witness to expose the significant flaws in these arguments. Accordingly, based upon the plain language of the rule and the statute granting the Commission the authority to promulgate said rule, as applied to the factual circumstances of this case, at minimum, this matter should be remanded back to the Commission with a directive that a contested case hearing be ordered.

Furthermore, CenterPoint Energy's right to a contested case hearing and the authority to file this appeal is found in the express statutory language of Minn. Stat.

⁵ This statement is erroneous for a number of reasons, the most important of which is the fact that there is a gas utility's PGA and a ratemaking proceeding are separate processes with different purposes.

§§ 14.63 and 216B.52 (2006), as confirmed in the Statements of the Case filed with this Court by the Commission and the OAG. Indeed, Minn. Stat. § 14.63 provides that “[a]ny person aggrieved by a final decision in a *contested case* is entitled to judicial review of the decision under the provisions of sections 14.63 to 14.68....”⁶ As the Minnesota Supreme Court has expressly provided, “[i]n order to be subject to review under that statute, the [party seeking review] must be found to be ‘aggrieved by a final decision in a contested case.’” *MPIRG*, 237 N.W.2d at 381. In other words, based upon the Commission and OAG’s implicit acknowledgement that judicial review is proper under said section, this Court should conclude that CenterPoint should have been provided the right to a contested case hearing. *Id.*

B. CenterPoint Energy’s Right To A Contested Case Hearing Can Reasonably Be Implied From The Legislature’s Statutory Framework And The Rules Promulgated By The Commission.

The right to a contested case hearing may also be implied by the overall statutory and rule framework governing public utilities. Beck, *Minnesota Administrative Procedure* at 46; *MPIRG*, 237 N.W.2d at 379-381. As expressly detailed in the Legislative Findings for Chapter 216B, it is the Legislature’s goal to regulate comprehensively public utilities to ensure that they provide retail consumers of electric and natural gas services with adequate and reliable services at reasonable rates, *consistent with the financial and economic requirements of public utilities and their need to obtain adequate energy supplies*. Minn. Stat. § 216B.01 (2006) (emphasis added). Consistent

⁶ A “contested case” is defined as a proceeding before an agency in which the legal rights, duties, or privileges of specific parties are required by law or constitutional right to be determined after an agency hearing.” Minn. Stat. § 14.02, subd. 3 (2006).

with these findings, and realizing the significant costs that utilities incur in conjunction with their procurement of energy supplies, the Legislature also adopted the PGA Statute, governing utilities' ability to recover gas costs incurred, as part of the overall framework governing hearings pertaining to rate changes. Minn. Stat. § 216B.16 (2006). This statute broadly provides for contested case hearings as a natural and necessary part of the general ratemaking process where the utility and the parties to the proceeding are unable to resolve the disputed issues. *See* Minn. Stat. § 216B.16, subs. 1-7 (2006). Of course, as discussed above, gas costs comprise over 80% of the costs passed on to customers by national gas utilities, meaning costs at issue in general ratemaking proceedings represent just 20% of a utilities' overall costs. Given that CenterPoint Energy and other gas utilities are entitled to a contested case hearing to resolve disputed issues of material fact as part of the general ratemaking process, it must necessarily be implied from the overall regulatory framework governing the recovery of prudently incurred gas costs that a contested case is similarly required for these substantially bigger costs. By neglecting to refer the matter for a contested case hearing, the Commission prevented CenterPoint Energy from developing a factual record to support its statutory and common law right to recover all prudently incurred gas costs. In doing so, the Commission erroneously relied on rhetoric, rather than evidence, let alone substantial evidence, in contravention of well-established Minnesota law.

It is the unequivocal expressed intent of Chapter 216B to ensure that the Commission achieves the balance between guaranteeing natural gas customers reliable service at reasonable rates, while at the same time allowing for the utility's financial and

economic requirements to be met, including their ability to obtain, and pay for, adequate energy supplies. Minn. Stat. §§ 216B.01 and 216B.16, subds. 1-7 (2006). In the instant case, the Commission abandoned its legislatively mandated obligation to take into consideration the second part of this test so as to ensure that CenterPoint Energy is allowed to recover all prudently incurred gas costs. *Id.* In so doing, the Commission has affected the important legal rights and property interests of the company, and the Commission has not provided any rationale whatsoever for failing to grant a contested case hearing. Consistent with the Legislature's express intent of balanced, yet comprehensive regulation of utilities for the benefit of the public, as well as the statutory scheme governing the right to a hearing when disputed material facts exist, the Court should reverse the Commission's decision and allow a full development of the record necessary for a full and fair adjudication.

C. CenterPoint Energy Is Entitled To A Contested Case Hearing Pursuant To The Due Process Clauses Of The Minnesota And United States Constitutions.

Finally, CenterPoint Energy's right to a contested case hearing is mandated by the due process clauses of the Minnesota and United States Constitutions, as well as notions of fundamental fairness. Beck, *Minnesota Administrative Procedure* at 47. In order for a party to establish a claim of deprivation of procedural due process, they must establish that they have a life, liberty or property interest at stake. In the instant case, it cannot reasonably be disputed that the Commission's action has deprived CenterPoint Energy of significant property interest, in the amount of more than \$21 million paid for actual gas

costs incurred, yet not recoverable, which is guaranteed by both statute and case law. *Id.* at 48-49; *Fosselman*, 612 N.W.2d at 461-462.

Where there is an undisputed, protected interest like the Company's \$21 million property interest in the instant case, the Court examines: whether the interest will be affected by the official action; the risk of erroneous deprivation of such interest through the procedures used, if any, of additional or substitute procedural safeguards; and the additional burdens placed on the Commission if the additional procedures are ordered. *Fosselman*, 612 N.W.2d at 461-462.

First, it again cannot reasonably be disputed that the Company's \$21 million is a significant amount of money and has been affected by the Commission's erroneous, procedurally defective, decision. *Id.* at 462.

Second, the risk of the erroneous deprivation of the \$21 million is apparent and this factor also weighs heavily in favor of the Company. *Id.* Indeed, although the Company was afforded the opportunity to submit written and oral "comment," it was prevented from calling witnesses to elicit their testimony, prevented from introducing documents into evidence, and prevented from cross-examining adverse witnesses. *Id.*⁷ The failure to grant the Company the contested case hearing, which would ensure that

⁷No witness testimony was elicited as part of the "process" before the Commission. Instead, the Commission relied exclusively on the unsworn statements of counsel for purposes of supporting its findings. The ability to examine and cross-examine witnesses, and establish their credibility, and veracity, is a fundamental aspect of procedural due process. *Fosselman*, 612 N.W.2d at 462. The Commission's findings as part of its initial and clarifying Orders, and the argument of the OAG-RUD and the Department, implied that the Company was not being forthright about why it failed to discover these accounting errors, or the amount involved.

adequacy of the procedural safeguards allowed, is “fatal to the constitutional adequacy of the [Commission’s] procedures.” *Id.* (citations omitted).

Third, although there may be some incidental costs and minor burdens associated with providing the Company with the additional, constitutionally protected guarantees, they cannot be deemed as anything more than that where the Company is at risk of being erroneously deprived of \$21 million. *Id.* In such circumstances “[t]he hearing required by the Due Process Clause must be meaningful, and appropriate to the nature of the case.” *Id.* Indeed, although the Commission has an obligation to protect ratepayers, it cannot be done at the expense of the Company’s rights that are established by the regulatory framework governing utilities, the Minnesota and United States Constitutions, as well as state and federal common law. As a result, this Court should reverse and remand the Commission’s decisions where the associated costs and burdens with doing so are minor, when compared with the significant, additional procedural protections that will be afforded to the Company if the contested case hearing is granted.

CONCLUSION

Minnesota law provides natural gas utilities such as CenterPoint Energy full recovery of their prudently incurred costs of natural gas. Nonetheless, the Minnesota Public Utilities Commission denied CenterPoint Energy any ability to recover approximately \$21 million in gas costs, prudently incurred to serve Minnesota customers, and did so without affording CenterPoint Energy the full procedural protections of a contested case hearing. This denial of recovery of \$21 million eliminated approximately 25% of CenterPoint Energy’s annual operating income for 2006. In so deciding, the

Commission exceeded its authority, arbitrarily and capriciously deviated from its prior precedent, failed to rely on any record evidence to support its factual findings, and effected a taking of CenterPoint Energy property. For all of those reasons, the Commission's decision must be reversed. At minimum, this matter must be remanded to the Commission with direction to conduct a contested case hearing, so that CenterPoint Energy can present formal evidence and conduct cross-examination regarding any opposing evidence that may be offered. The regulatory compact between the state and its utilities, as well as the constitutional guarantees of due process and fundamental fairness demand no less.

Dated: 5/22/07

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CERTIFICATE OF COMPLIANCE

Pursuant to Minnesota Rule of Civil Appellate Procedure 132.01, subd. 3, the undersigned hereby certifies, as counsel for Appellants, that this brief complies with the type-volume limitation as there are 12,229 words of proportional space type in this brief. This brief was prepared using Microsoft Word 2003.

Dated: May 22, 2007

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