FINDINGS OF FACT, CONCLUSIONS
OF LAW, AND ORDER

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BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Don Storm	Chair
Tom Burton	Commissioner
Marshall Johnson	Commissioner
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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.

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

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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 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 rates. 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

[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 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.

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 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

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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.

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 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.

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[5] See <u>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</u>, Docket No. E-002/GR-92-1185, ORDER AFTER RECONSIDERATION (January 14, 1994) and <u>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</u>, 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.

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.

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 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,

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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).

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.

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.

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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.

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.

d. The ALJ

The ALJ recommended excluding the organizational dues and allowing only 50 percent ($478,887) of the loan program expenditures. The ALJ found that the loan program was cost effective and should be allowed at 50 percent as a reasonable compromise, allowing the sharing of the cost equally between ratepayers and shareholders. On the other hand, organizational dues should be excluded altogether, according to the ALJ, because the record does not show that these dues have in any way benefitted the ratepayers.

e. Commission Action

Minn. Stat. § 216B.16, subd. 13 (1992) permits the Commission to allow a utility to recover from ratepayers the expenses incurred in economic and community development. In the Commission's view, demonstration of ratepayer benefit is a threshold consideration. Without such a showing, the Commission is not inclined to exercise its discretion to allow the Company to recover all or part of such expenses.

Applying that principle in this case means that MP's organization dues expense, for which no ratepayer benefit has been shown, will be excluded.

Regarding the loan program, MP argued that the Commission's decision in NSP's 1992 rate case indicated that if a program is shown to be cost effective it must be allowed at 100 percent. The Commission clarifies that this was not the intent of the Order. Cost-benefit analyses of economic development programs are useful in identifying ratepayer benefit but, once ratepayer benefit is identified, do not require that ratepayers should pay for such programs in full. From the beginning, the Commission's primary touchstone in this issue has been that if benefits from the economic development programs are shared by ratepayers and shareholders, the costs should also be shared. See the following discussion from the 1992 NSP rate case Order, the first Commission Order to apply the economic development statute:

> [NSP] has stated that its programs will help the economy of the community, and a healthy economy will eventually increase NSP's sales. The economic development costs will thus benefit NSP shareholders through increased profits and will benefit NSP's ratepayers through additional future sales and delayed rate increases. It is logical that economic
>
> development costs should be shared by the utility shareholders and ratepayers through a

50% recovery in rates.[12]

The logic of sharing costs in such a situation, cited by the Commission in its initial Order regarding the economic development, continues to persuade the Commission. In this case, therefore, since both ratepayers and shareholders will benefit from MP's loan program, ratepayers will be required to pay half (and no more than half) of these economic development costs. The Commission's adjustments increase net income $320,299.

8. SFAS 106

The Financial Accounting Standards Board (FASB) adopted Statement of Financial Accounting Standards 106 (SFAS 106) in 1990. This standard required the change, for financial reporting purposes, from the cash basis of accounting to the accrual basis of accounting for recording post-retirement benefits other than pensions (PBOPs). The costs affected primarily include health and life insurance.

SFAS 106 requires the recognition of costs at the time the benefit is earned by the employee instead of the time that the benefit is actually paid resulting in the recognition of potentially higher current costs. Additionally, there is a transition obligation incurred as a result of changing from the cash basis to accrual basis of accounting.

In the generic proceeding, Docket No. U-999/CI-92-96, the Commission generally determined that the new method was acceptable for rate purposes, subject to review in rate cases. However, the Commission excluded the increase in costs calculated under SFAS 106 over the old method from interim rates. Instead, the Commission authorized a deferral of the increased cost beginning January 1, 1993 until recognized in a general rate proceeding commenced within three years.

a. Minnesota Power's SFAS 106 Proposal

MP adopted SFAS 106 accounting on January 1, 1993. In its original filing, MP included $8,262,892 as test year expense for SFAS 106 costs. The Company reduced this amount by $37,372 as a result of an updated actuarial study.

The Company indicated that $5,850,403 of the increased test year cost results from higher annual service cost, the interest component of SFAS 106, and the 20-year amortization of the $45,223,440 transition obligation.

The $2,375,117 balance of the increased test year cost results from the Company's proposed five-year amortization of the $11,875,636 in costs deferred for the years 1993 and 1994.

The Company also proposed to continue to defer the increased costs resulting from

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[12] 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-91-001, FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER (November 27, 1991), page 39.

SFAS 106 from January 1, 1995 until final rates become effective in this proceeding. Recovery of the additional amount deferred would be sought in a future rate case.

MP proposed to externally fund the SFAS 106 obligation. The Company chose funding vehicles which would maximize the current tax deductibility of the contributions. All contributions to a Voluntary Employee Benefit Association (VEBA) established for the union employees will be tax deductible. The Company will contribute to another VEBA established for the non-union employees to the maximum tax deductible amount. The balance will be placed in a grantor trust which can only make distributions to the VEBA's or similar retirement plans.

The Company also recognized that because the increased SFAS 106 costs are deferred during the test year by the Commission's Order in U-999/CI-92-96, it will be necessary to adjust the Commission's finally determined revenue requirement for the test year to exclude the SFAS 106 effects for calculating any refund of interim rates.

b. The Department

The Department recommended MP's proposal for treatment of the SFAS 106 costs in its entirety, including the $37,372 reduction in originally filed test year expense.

c. Seniors

The Seniors originally recommended that the $11,875,636 amount deferred for the years 1993 and 1994 be deferred over 20 years instead of five years, but did not take exception to the ALJ's recommendation.

d. LPI

The LPI recommended that the amount deferred for the years 1993 and 1994 be amortized over 18 years instead of five years. The LPI argued that the longer amortization period would more effectively spread the burden to ratepayers, is permitted by accounting principles, and is reasonable because MP will not have a cash expense for these costs for many years.

e. The ALJ

The ALJ recommended the Company's proposal in its entirety, including the $37,372 adjustment, finding the benefit programs reasonable and prudent, the external funding mechanism reasonable and prudent, and the five-year amortization reasonable.

The ALJ found the five-year amortization reasonable because it is consistent with the Commission's decision in NSP's 1992 electric rate case (Docket No. E-002/GR-92-1185) where a three-year amortization was permitted. The costs relate to 1993 and 1994; a five-year amortization makes it more likely that customers receiving the benefit will be the customers paying for it. Further, the amounts at issue are considerably less than the transition obligation where the 20-year amortization is appropriate.

f. Commission Action

The Commission adopts the recommendation of the ALJ. No party raised objection to the level of affected benefits provided by the Company, the application and calculation of the amounts under SFAS 106, or the external funding.

The proposal to incorporate SFAS 106 costs in this rate proceeding are consistent with prior rate decisions regarding SFAS 106 costs. The proposal regarding the external funding assures maximum tax deductibility, while also preserving greater security of the funds when compared to alternative funding methods.

The Commission accepts the five-year amortization of the costs incurred for 1993 and 1994. The deferral mechanism was adopted by the Commission in the generic SFAS 106 proceeding, U-999/CI-92-96, for the purpose of reducing the need for utilities to file rate cases by January 1, 1993 to recover the increased costs resulting from SFAS 106. The deferral was not intended as a vehicle to postpone recovery of the costs.

The five-year amortization proposed by the Company will better relate the costs to those customers receiving service in 1993 and 1994, while substantially reducing the rate effect from what it would be with a shorter recovery period.

The Commission will allow MP to continue deferring the increased cost resulting from SFAS 106 until final rates are effective in this proceeding, for consideration in a future rate case. This will allow MP to potentially recover its costs while facilitating this proceeding. At the time this Order is prepared, it is not possible to estimate when final rates will be effective due to the potential for further legal process following the issuance of this Order.

The Commission will accept the adjustment to test year expense for the updated actuarial study. This reflects better information and reduces test year expense by $37,372.

9. SFAS 109

FASB issued Statement of Financial Accounting Standard 109 (SFAS 109) in early 1992. This statement addresses the presentation of deferred taxes in financial statements. For regulated utilities, the statement is generally revenue neutral for rate purposes.

a. Minnesota Power's Proposal

MP indicated that although SFAS 109 is generally neutral for rates, SFAS 109 does adjust the deferred tax balance for changes in tax rates. Because federal income tax rates changed from 34% to 35% in 1993, MP proposed to increase deferred taxes by $376,954 for the test year in its original filing. This represents a two-year amortization of the total amount of change in deferred tax resulting from the changed tax rates. The Company cited its most recent rate case (Docket No. E-015/GR-87-223) where certain excess deferred taxes resulting from a decrease in tax rates were returned in rates over a two-year period.

b. The Department

The Department indicated that the Company's proposal was reasonable and consistent with Commission precedent regarding the treatment of deferred taxes and changes brought about by changes in tax rates.

c. LPI

LPI did not object to the change to deferred taxes, but did recommend that the amount be amortized over 35 years instead of 2 years. LPI cited section 203(e) of the 1986 Tax Reform Act which protected the majority of deferred taxes, preventing excess deferred taxes from being returned to ratepayers more rapidly than over the remaining life of the underlying asset.

Therefore, LPI argued that precedent supported a longer amortization period.

d. The ALJ

The ALJ recommended that the Company's proposal be adopted, citing Commission precedent in the prior MP rate case.

e. Commission Action

The Commission accepts the recommendation of the ALJ and will make no adjustment to the original filing.

The two-year amortization is consistent with the treatment of a decrease in the deferred tax resulting from the Tax Reform Act of 1986 as approved by the Commission in MP's 1987 rate case. There the decrease in deferred tax was amortized as a reduction in revenue requirement over two years. A two-year amortization will more likely collect from customers that are on the system at the time of the tax change, preventing intergenerational transfer. Arguments citing the protected status of some deferred taxes under section 203(e) of the 1986 Tax Reform Act are irrelevant here. The record indicates that the deferred amounts at issue here are not covered by section 203(e).

10. SFAS 112

FASB adopted Statement of Financial Accounting Standard 112 (SFAS 112) in 1992. SFAS 112 requires a change, for financial accounting, from the cash basis to the accrual basis for costs such as long-term disability and worker's compensation. Basically, prior accounting recorded the costs related to such claims over the several years' duration of the claim. SFAS 112 accounting will require recording the estimated total cost of the claims in the year that the event leading to the claim occurred. As often occurs with a change from cash accounting to accrual accounting, there is a transition balance to address.

a. Minnesota Power's Proposal

MP adopted SFAS 112 accounting on January 1, 1994. There is a one-time transition amount of $1,504,282 for the Minnesota jurisdiction. MP initially included the full amount in the test year without amortization. Later, MP agreed to a three-year amortization.

b. The Department

The Department did not oppose the change in accounting, but did recommend that the transition amount be amortized over three-years.

c. Seniors

The Seniors did not oppose the change in accounting. The Seniors originally proposed that the entire transition amount be excluded from the test year with consideration for some form of surcharge mechanism. However, the Seniors did not except to the recommendations of the ALJ.

d. LPI

LPI did not oppose the change in accounting, but did recommend that the transition amount be amortized over 20-years. LPI argued that there was no reason to compress the transition period and unnecessarily increase rates. Accounting does not require including the full amount of the transition amount in one year.

e. The ALJ

The ALJ recommended the adoption of the Company's proposal, with the modification to a three-year amortization period as recommended by the Department and agreed to by MP.

The ALJ found that it is reasonable to include the transition amount using a three-year amortization. There is no reason to further delay this matter because all relevant facts are known at this time. Deferring this matter to a future rate case does not facilitate a timely transition to accrual accounting, which reflects more accurate matching of benefits with costs.

The ALJ rejected a 20-year amortization finding that the claims will be incurred within four or five years. A three-year amortization mitigates the rate impact.

f. Commission Action

The Commission adopts the findings and recommendation of the ALJ. This increases net income $588,178.

11. Rate Case Expense

a. Minnesota Power's Proposal

The Company estimated its rate case expenses at $1,170,853 for this rate case.

The Company proposed a three-year amortization resulting in a test year expense of $390,264. An unamortized balance of $398,588 was included in rate base. MP agreed to the recommendation of the Department to allocate $4,137 to non-utility activity.

b. The Department

The Department recommended that $4,137 of test year expense be allocated to non-utility activities. The Department made this recommendation based on the significant amount of time spent verifying that the rate case was based on costs pertaining only to the Minnesota jurisdiction. The Department did not otherwise object to the level or amortization of the proposed expense.

c. The ALJ

The ALJ recommended the adoption of MP's proposal, as adjusted by the recommendation of the Department to allocate a portion to non-utility activities. The ALJ found the proposal reasonable.

d. Commission Action

The Commission will accept the Company's proposal as modified by the Department's proposal. It is appropriate that rate case expenses be allocated to the non-utility activities when those activities require additional review to assure that the rate proposals are properly based on the costs of providing utility service. The Commission will reduce test year expense by $4,137.

The Commission continually seeks to keep rate case expenses as low as possible. Absent further challenge to MP's proposal, the Commission will accept the remainder of the costs and amortization proposal as reasonable for purposes of this proceeding.

12. Large Power Contract Payments

a. Minnesota Power's Proposal

In order to secure contract extensions from National, Hibbing Taconite, Inland, Eveleth Mines, and USX, MP made cash payments totalling $12.58 million to the companies in exchange for contract amendments. MP indicated those payments helped assure fixed cost recovery of over $173 million. These payments were largely made between 1988 and 1994, and generally followed approval of the contract amendments by the Commission. The Commission made no ratemaking commitment at the time the contracts were approved. MP is amortizing the payments over the lives of the contract extensions.

For the test year, MP included an unamortized balance of $1,795,387 in rate base, and a revenue offset of $574,359 for the test year amortization.

b. The Department

The Department reviewed this issue and recommended no adjustment.

c. LPI

LPI recommended that the entire amount be disallowed from rate recovery. Alternatively, LPI recommended that the amount be amortized equally over a seven-year period instead of over the lives of the associated contract amendments.

d. The ALJ

The ALJ recommended that the amortization be allowed as proposed by MP. The ALJ found that the contracts contributed to rate stability, benefitted ratepayers because lack of contracts would lead to increased risk, and that the Large Power customers receiving the cash payments did so understanding that MP could request recovery in rates. There is a benefit to the entire system.

e. Commission Action

The Commission accepts the Company's proposal as recommended by the Department and the ALJ. No adjustment is necessary.

The Commission finds that amortizing the payments over the lives of the related contract amendments more appropriately matches the costs with the benefits. Levelizing the amortization over seven years could lead to deferring costs to a future period for which there are few associated benefits. In the normal course, the test year concept suggests that a snapshot is taken of events occurring within a 12-month period. Following a formal rate process, rates are established which are anticipated to be in effect until they are no longer reasonable, at which time the Company can seek rate relief or an investigation can be initiated by the Commission. While some costs may decrease, there may also be other costs which will increase and variations in revenue streams.

The Commission did not resolve rate recovery at the time the contract amendments and payments were approved. Rate recovery was reserved for a rate proceeding. There was no indication that the Company was prevented from seeking rate recovery.

The Commission finds that the contract amendments prevented the Large Power customers from operating without contractual commitments. Without commitment, MP's risk and cost of capital would increase which would be borne by all ratepayers. Managing this risk is a benefit for the entire system.

13. EPRI Dues

In MP's most recent general rate case, MP 87-223, the Commission excluded that portion of dues paid by MP to the Electric Power Research Institute (EPRI) which supported nuclear power research. The Commission found that nuclear research provided little or no benefit to MP's ratepayers. The Commission found that MP had no nuclear generation and purchased little power from the MAPP system, where some nuclear power is produced.

a. Minnesota Power's Proposal

MP included the full amount of the EPRI dues as a test year expense, approximately $1.5 million. It was estimated that $269,301 represents that portion related to nuclear research.

b. LPI

LPI recommended that the nuclear portion of EPRI dues be excluded in this case as it was in MP's most recent rate case.

c. The ALJ

The ALJ recommended that the full amount of EPRI dues be allowed.

The ALJ found that ratepayers receive benefits from the research dues, including research. MP referenced studies showing cost benefit ratios of up to 13 to 1. The ALJ indicated that there is no challenge to MP's evidence.

The ALJ also found that nuclear research has been applied to non-nuclear facilities. Further, MP cannot derive benefits unless it is a full member of EPRI. Even as a full member, MP cannot designate how its dues will be used.

d. Commission Action

The Commission will accept the Company's proposal to include the full amount of the EPRI dues as a test year expense. No adjustment will be made.

The Commission has a history of supporting research activities. The Commission further recognizes that research involving electric utility service can be extremely costly for a single utility. Combining the efforts of many utilities through the EPRI organization makes it possible to conduct research more efficiently.

The record contains evidence that the benefits of the EPRI research activities exceed the costs to MP by a ratio of up to 13 to 1. Further, the MP system receives benefits for the nuclear portions of dues even though MP does not have nuclear facilities. Nuclear research can be applied to non-nuclear facilities. As a member of MAPP, MP conducts exchanges and transactions with other MAPP members, some of which operate nuclear facilities.

14. Financial Communications
Printing Stock Certificates
Financial Communication/Meetings

In its FINDINGS OF FACT, CONCLUSIONS OF LAW , AND ORDER (March 1, 1988) in the Company's most recent rate case, MP 87-223, the Commission excluded similar costs. However, in its ORDER AFTER RECONSIDERATION (May 16,1988), the Commission found that these activities are also necessary for conducting utility business. The Commission allowed a portion of the costs after allocating based on a utility/non-utility allocation factor.

a. Minnesota Power's Proposal

MP included $6,991 for printing stock certificates, $31,255 for financial communication/meetings, and $31,306 for other financial meetings. These amounts were calculated using an allocation of 55.2% to the utility, the balance to non-utility.

b. LPI

LPI recommended that these amounts be disallowed as they were in the most recent MP rate case.

c. The ALJ

The ALJ recommended allowing these costs as was done on reconsideration in the most recent MP general rate case.

d. Commission Action

The Commission adopts the recommendation of the ALJ. No adjustment is necessary because the costs have been filed in a manner consistent with the prior action of the Commission. There is no evidence in this record to suggest the need for departure from that precedent.

15. Legislative Monitoring

In the Company's most recent rate case, MP 87-223, the Commission disallowed costs related to a special legislative project and legislative presentations as lobbying expenses not necessary in the provision of service.

a. Minnesota Power's Proposal

In this case, MP included $102,231 as test year expense for legislative monitoring.

b. LPI

LPI recommended that this cost be excluded based on precedent in the prior rate case.

c. The ALJ

The ALJ recommended that the cost be allowed. Monitoring is not lobbying. It is in the interest of ratepayers and necessary for the provision of service to analyze and develop positions on public policy issues related to electric operations. These costs are deductible for tax purposes, while lobbying costs are not.

d. Commission Action

The Commission adopts the recommendation of the ALJ. No adjustment will be made. The costs at issue differ in nature from those addressed in the prior rate case. It is necessary to monitor legislative activities, analyze, and prepare positions on public policy issues. These costs are identified separately from lobbying costs in the budget and are included as federal tax deductions. The record indicates that lobbying costs are not tax deductible.

16. Conservation Expense

The Commission approved a deferred debit accounting mechanism and conservation tracker account in MP's most recent rate case, MP 87-223. Conservation costs recovered in rates and conservation expenditures are entered to the tracker account. As of November 30, 1993, the expenditures exceeded recoveries by approximately $7.6 million.

The Commission approved a 2.64% conservation program adjustment (CPA) in docket E-015/M-93-996. The adjustment is included as a part of the "resource adjustment" shown on the bills. The objective of the CPA is to provide a mechanism for MP to recover the substantial CIP tracker balance. The CPA is being collected during the interim period.

a. Minnesota Power's Proposal

The Company proposed a test year CIP expense of $7,535,568 made up of approximately $4.8 million of test year expense and approximately $2.7 million amortization of the previous tracker balance. MP proposed that the CPA be set a zero at the time final rates determined in this proceeding take effect. The Company's proposal would essentially combine the test year CIP expense and the CPA amount in base rates.

The Company later agreed to the recommendations of the Department.

b. The Department

The Department recommended that the Company's test year CIP expense be set at $5,544,395 instead of the $4.8 million amount. The Department recommended that it is more appropriate for the current test year amount to reflect the costs of programs approved by the Department. The amount approved for the test year by the Department in Docket E-015/CIP-93-767 was $5,544,395.

The Department also recommended that the amortization of the previous tracker balance not be included in the test year. Further, the Department recommended that the CPA be reduced to zero at the time final rates determined in this proceeding are placed into effect. The CPA would remain at zero until such time as a new CPA is calculated in the upcoming CIP adjustment filing.

The effect of the Department's recommendation is that base rates determined in this proceeding would include the estimated current CIP expenses for the test year. Recovery of previous tracker balances would continue with the CPA to be determined in the next CIP adjustment filing. Additionally, approved lost margins and carrying charges would also be recovered through the CPA instead of base rates. The Department recommended that MP re-estimate its lost margin per kWh in its compliance filing.

The Department also recommended that the test year CIP expense be collected on a per kWh basis and that the CPA continue to be collected on a percentage of revenue basis.

The Department calculated a conservation cost recovery charge (CCRC) of $0.0007822 per kWh based on test year costs of $5,544,395 and sales of 7,088,234,000 kWh, before National restart.

c. Commission Action

The Commission accepts the recommendations of the Department which were accepted by the Company and the ALJ. Test year conservation expense will be decreased by $1,991,173, increasing test year net income by $1,167,425.

The Commission finds that removing the amortization of the prior tracker balance from base rates is appropriate. The base rates will be set to reflect an approved level of test year conservation expense, while the CPA will include the amortization of the prior tracker balance. Only the timing of the recovery of the past balance will be slightly modified; the recoverability will not be impaired as a result of this action. The Commission will direct that the CPA be set at zero at the time final rates determined in this proceeding become effective.

The Commission finds it appropriate that test year CIP costs be collected on a per kWh basis, while the CPA continue to be collected on a percentage of revenue basis. The CIP costs included in base rates are allocated to classes based on the rate design determinations made in the course of this rate proceeding. Collecting the CPA on a percentage of revenue basis will adequately preserve the basic rate design relationships.

The Commission finds it appropriate to consider recovery of lost margins and carrying charges through the CPA instead of base rates. Recovery of lost margins is permitted on a trial basis which may not be extended. Allowing recovery in the CPA will provide the Company the opportunity to recover approved costs, while preserving the opportunity to review those costs for reasonableness.

The Commission will direct that the Company include in its compliance filing in this docket its calculations of lost margin per kWh reflecting the rate changes resulting from this proceeding.

The Commission finds that the appropriate test year CIP expenditure to use for calculating the CCRC is $5,544,395 as proposed by the Department, MP, and accepted by the ALJ. The Commission also finds that the appropriate test year sales volume for calculating the CCRC is 7,088,234,000 kWh (before National Stipulation). As discussed in the National Stipulation section of this order, the restart of National increases test year kWh sales by 243,268,000. As a result, the Commission calculates a test year CCRC of $0.0007562.

The National Stipulation increases kWh sales by an additional 311,746,500 beginning January 1, 1995. As a result, the Commission calculates a CCRC of $0.0007254 beginning January 1, 1995.

17. Beginning O&M Budget UPA Equalization

a. The Department

In its review of the Company's test year budgets, the Department identified an error resulting during MP's conversion of its budgets from the responsibility centers to the cost of service. This resulted in an overstatement of O&M expense of $54,217 in the beginning O&M budget.

Also, the Department identified an error related to an allocation of carrying costs for the UPA equalization. This error resulted in allocating a carrying cost to a deferred account instead of an expense account. This understated test year expense by $98,915.

The Company and the ALJ incorporated these adjustments.

b. Commission Action

The Commission will incorporate these uncontested adjustments increasing test year expense by $44,698.

18. Property Taxes

a. The Department

At the time direct testimony was filed, the Department withheld judgment of MP's projected test year property taxes until actual 1993 taxes payable in 1994 could be reviewed.

During the evidentiary hearing, schedules reducing property taxes by $1,564,133 were introduced.

The Company agreed with the adjustment, and the ALJ incorporated the adjustment without comment.

b. Commission Action

The Commission accepts this uncontested adjustment and will reduce test year property taxes by $1,564,133.

19. Non-Utility O&M Allocation

a. The Department

The Department identified that the Company did not apply an A&G assessment to labor relating to expenses that were charged to non-utility but not billed to a subsidiary or non-regulated customer. The Department recommended that an allocation of A&G costs be applied to all non-utility O&M labor expenses that have not been assigned A&G costs. This adjustment reduces test year O&M expense by $154,699.

The Company agreed to the adjustment and the ALJ incorporated the adjustment.

b. Commission Action

The Commission accepts this uncontested adjustment and will reduce test year expense by $154,699.

C. Operating Income Summary

The Company proposed an operating income of $27,114,613 in the original filing. Incorporating the above findings, the Commission concludes that the operating income for the test year (including the effects of SFAS 106 and the 1994 effects of the National Stipulation) is $31,890,642 as follows:

Operating Revenues	
Sales of Electricity by Rate Class	$270,010,391
LP Interruptible, Dual Fuel	26,266,450
Other Electric Revenues	33,863,764
Other Revenues	1,988,766
Total Operating Revenues	332,129,371
Operating Expenses	
Operations and Maintenance	222,353,727
Depreciation	31,031,395
Amortization	1,092,799
Taxes Other Than Income	36,326,133
State Income Tax	3,509,025
Federal Income Tax	10,766,279
Provision for Deferred Tax (net)	-3,067,577
Investment Tax Credit	-1,350,982
Total Operating Expenses	300,660,799
Operating Income Before AFUDC	31,468,572
AFUDC	422,070
NET OPERATING INCOME	$ 31,890,642

XIV. RATE OF RETURN

B. Introduction

The overall rate of return represents the percentage the utility is authorized to earn on its Minnesota jurisdictional rate base. The overall rate of return is determined by the capital structure, which is the relative mix of debt and equity financing most of the rate base, and the costs of these sources of capital. The Commission will first address the capital structure, then the costs of debt and preferred stock and the cost of equity. Finally, the Commission will put these factors together to derive the authorized overall rate of return on rate base.

Six parties submitted rate of return testimony in this proceeding. Testifying for the Company were Arend J. Sandbulte, James K. Vizanko, David G. Gartzke, and Roger A. Morin. Eilon Amit testified for the Department. Matthew I. Kahal testified for the RUD-OAG. LPI provided testimony of Richard A. Baudino and Randall J. Falkenberg. Peter W. Ahn testified for LLPG, and Ronald L. Knecht submitted testimony on behalf of the Seniors.

C. Capital Structure

1. Summary of the Parties' Positions

The following table shows the capital structures proposed for use in this case:

Type of Capital	MP, Department, LLPG, Seniors	RUD-OAG	LPI
Long-term debt	45.84%	45.89%	47.00%
Preferred stock	5.55%	5.56%	8.00%
Common equity	48.61%	48.55%	45.00%

a. Minnesota Power

MP derived its proposed capital structure from that of MP-Consolidated. It subtracted from the common equity balance an average test-year investment in non-utility/non-regulated activities of $228,787,500. MP reversed certain accounting entries associated with its two leveraged Employee Stock Ownership Plans in order that neither plan will have any implications for the regulated capital structure or adversely affect the cost of service to ratepayers. Finally, MP increased the level of common equity by the unamortized balance of preferred stock call premiums and issuance expenses.

b. Department, Large Light and Power, and Seniors

MP's proposed capital structure was adopted for use by the Department, LLPG, and the Seniors.

c. RUD-OAG

The RUD-OAG proposed to reverse MP's adjustment adding the unamortized balance of preferred stock call premiums and issuance expenses to the common equity balance. The RUD-OAG proposal removes approximately $980,000 from the equity component of total capitalization for the test year.

The RUD-OAG argued that MP's adjustment seeks to add common equity to its capital structure which does not exist. The expenses were incurred to achieve a cost savings through the refinancing of preferred stock. Such cost savings, between rate cases, increase the profits for the Company and add to its common equity. It is not clear that the preferred stock call has a net effect of actually reducing common equity and requiring a corresponding adjustment.

d. Large Power

LPI's witness, Mr. Baudino, concluded that MP's requested equity ratio is too high. He based this conclusion on an analysis of his group of comparable companies, and recommended that the Commission impute the average capital structure of the group to MP. LPI suggested that this is more reasonable than MP's actual structure, which MP has chosen to fit its highly diversified operations. LPI said the diversified operations are riskier than MP's electric operations.

Mr. Baudino analyzed the group of 34 all electric utilities with a Value Line Safety Rank of 3, and found an average projected 1994 common equity ratio of 43.74%. Further, he found that the average projected 1994 common equity ratio for MP's group of A rated utilities, also screened for a Value Line Safety Rank of 3, was 44.73%. LPI said these analyses support the contention that MP's capital structure is too heavily weighted with common equity.

2. Recommendation of the ALJ

The ALJ recommended adoption of the capital structure proposed by the RUD-OAG. He rejected LPI's proposal to reduce the equity ratio to 45% because, except for the adjustment proposed by the RUD-OAG, he found the ratio to be reasonable in relationship to the comparison groups used by the Department, RUD-OAG, and the Company.

In reducing the equity ratio from MP's proposed 48.61% to 48.55%, he said that the cost savings resulting from the refinancing of the preferred stock, between rate cases, increase the profits for the Company and add to its common equity. The ALJ said that it is not clear that the preferred stock call has a net effect of actually reducing common equity and requiring a corresponding adjustment as claimed by Minnesota Power.

3. Commission Findings and Conclusions

The Commission agrees with the ALJ that MP's proposed capital structure is the proper starting point.

The Commission does not agree, however, with the adjustment to that proposal suggested by the RUD-OAG and approved by the ALJ.

MP's refinancing of preferred stock in 1992 resulted in cost savings as preferred stock with a lower dividend rate replaced preferred stock with a higher dividend rate. The refinancing itself was not without cost, however. The cost was approximately $1 million in call premiums and issuance costs.

These costs were charged against retained earnings, and had the effect of reducing the balance of common equity. Until this rate case, the cost savings went to the shareholders.

In this proceeding, however, we are recognizing the reduced cost of preferred stock resulting from the refinancing. Because ratepayers are receiving the benefits, they should also be responsible for the costs.

The Commission concludes that it was proper for MP to adjust the common equity balance by adding back these costs. The Commission adopts the capital structure proposed by MP, and recommended by the Department, LLPG, and the Seniors.

D. Costs of Long term Debt and Preferred Stock

MP proposed test-year costs of long term debt and preferred stock of 7.20% and 7.03%, respectively. These figures were not disputed by any of the six parties who submitted rate of return testimony. They were recommended for use by the ALJ.

The Commission finds that the test-year cost of long term debt is 7.20%, and that the test-year cost of preferred stock is 7.03%. The Commission concludes that these figures should be used to determine the overall rate of return authorized in this proceeding.

E. Rate of Return on Common Equity (ROE)

1. Legal guidelines for Commission Decision-Making

In reaching a decision on the appropriate cost of common equity, the Commission, as an administrative agency, must act both within the scope of its enabling legislation and the strictures of reviewing judicial bodies. Two United States Supreme Court cases provide these general guidelines for Commission rate of return decisions:

a. The allowed rate of return should be comparable to that generally being made on investments and other business undertakings which are attended by corresponding risks and uncertainties;

b. The return should be sufficient to enable the utility to maintain its financial integrity; and

c. The return should be sufficient to attract new capital on reasonable terms.

See Bluefield Water Works and Improvement Co. v. P.S.C., 262 U.S. 679 (1923), and FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944).

No particular method or approach for determining rate of return was mandated by those cases, but the necessity of a fair and reasonable rate of return was clearly stated:

> Rates which are not sufficient to yield a reasonable return on the value of the property used, at the time it is being used to render the service, are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment. Bluefield Water Works, 262 U.S. at 690.

The Minnesota Supreme Court has also provided some legal guidelines for Commission decision-making. In Minnesota Power & Light Company v. Minnesota Public Service Commission, 302 N.W. 2d 5 (1980), the Court said:

> ...The single term "ratemaking" has been used to describe what is really two separate functions: (1) the establishment of a rate of return, which is a quasi-judicial function; and (2) the allocation of rates among classes of utility customers, which is a quasi-legislative function.

> ...we now hold that the establishment of a rate of return involves a factual determination which the court will review under the substantial evidence standard.
>
> 302 N.W. 2d at 9.

In conducting its evaluation of the Commission's decision, the Court explained:

> ...A reviewing court cannot intelligently pass judgment on the PSC's determination unless it knows the factual basis underlying the PSC's determination. Judicial deference to the agency's expertise is not a substitute for an analysis which enables the court to understand the PSC's ruling. Henceforth, we deem it necessary that the PSC set forth factual support for its conclusion. The PSC must state the facts it relies on with a reasonable degree of specificity to provide an adequate basis for judicial review. We do not require great detail but too little will not suffice.
>
> 302 N.W. 2d at 12.

In order to provide the factual basis for its decision required by the Court, the Commission will review the testimony of each of the parties on rate of return on common equity. The Commission will also review the recommendations of the ALJ. Finally, the Commission will draw its conclusions from the parties' testimony and determine the proper rate of return.

2. Summary of the Parties' Positions

Return on equity recommendations ranged from 9.0% to 12.50%, as shown below:

MP	Department	RUD-OAG	LPI	LLPG	Seniors
12.50%	11.10%	10.85%	10.50%	9.0%	11.10%

Unlike the cost of debt or preferred stock, the cost of common equity cannot be directly observed, but must be inferred. The reason is that investors in common equity partake in the residual, the remainder of revenues after expenses have been paid. Investors purchase shares of common stock expecting to receive a stream of future payments consisting of dividends and (or) share price appreciation. Those expectations may prove to be wrong, but that is a matter of little consequence to anyone trying to evaluate the cost of equity at any particular time. Of more concern is the fact that the expectations cannot be observed. Although one may observe the prices at which transactions occur, and the dividend rates prevailing at the time of the transactions, the expectations may only be estimated.

All parties to this case employed (at least) a discounted cash flow (DCF) analysis. This analysis attempts to discern the rate of return required by investors through review of market data and information available to investors. The DCF formula includes two terms: the dividend yield (annual dividends divided by the price of the stock) and the expected growth rate.

All parties noted that Minnesota Power is a diversified company, and said it would be improper to simply determine the cost of equity for the consolidated organization and apply that to MP's electric operations, as the risk of MP-electric would differ from that of MP-consolidated. Instead, all agreed that it was necessary to estimate the cost of equity for MP's electric operations as if they were performed by a stand-alone company. It is, therefore, necessary to take particular care in selecting a group or groups of comparable or comparison companies.

a. Minnesota Power

MP selected its group of comparison companies from electric and combination electric and gas companies with a current Standard & Poor's (S&P) bond rating of A+, A, or A-. It dropped from this set companies whose stock prices were not published, whose electric operating revenue was less than 70% of total operating revenue, or whose total 1992 operating revenues exceeded $1 billion. Finally, MP eliminated 3 companies, including MP, for unusual circumstances not evident from the other screenings.

MP examined 3 spot dividend yields and the *Value Line* average dividend yields for 1991 and 1992. To account for growth during the year, MP multiplied the published yield figures by one plus the expected growth rate. Based primarily on a study by Merrill Lynch, MP determined that a conservative estimate of common stock flotation costs would be 3%. MP adjusted the yield figures for flotation costs by dividing the yield figures by one minus 3%. MP obtained an adjusted yield range for its group of companies of 6.8% to 7.7%, and used a yield of 7%. (At the time of its rebuttal testimony, MP looked again at yields, and said they had risen to a range of 7.6% to 8% for its group.)

MP reviewed historical and projected growth rates from published sources, excluded any that were zero or negative, and determined that investors expected growth at an annual rate of 4% for its comparison group of companies. The sum of a 7% dividend yield and a 4% growth rate resulted in a cost of equity for the comparison group of 11.0%.

MP said that the cost of equity for its comparison group should not be applied directly to MP-electric, because MP's electric operations entailed greater risk for investors than the companies in the comparison group. MP said its comparison group had a higher average S&P bond rating than the A- rating carried by MP. MP also said its electric operations were riskier than those of its comparison group due to two unique risk factors:

- Square Butte Power Purchase Agreement. This is a long-term "take or pay" contract, in which MP is obligated for payments even if it buys no electricity. Had MP conventionally financed Square Butte, it would have additional debt, equity, and preferred stock in its capital structure. Rating agencies view MP's obligations under the contract as "debt-equivalent." An adjustment to the return on equity is necessary to counteract the lower equity ratio which would result if the debt-equivalent obligation were reported as debt.

- Below average business risk profile [i.e., greater than average business risk]. S&P has characterized MP as having a below average business position due to its customer mix, industrial load make-up, and customer growth prospects. Industrial sales accounted for 68% of electric sales and 64% of electric revenues in 1992. MP's industrial sales are concentrated in sales to large customers in two major industries, both vulnerable to competitive business pressures.

MP said the risk of the Square Butte contract alone was worth 100-200 basis points on the return on equity. MP witness Dr. Morin estimated a risk adjustment for Square Butte of 120 basis points, and 50 basis points for business risk. MP said a conservative risk adjustment for both unique risk factors would be 150 basis points.

MP also said its history of controlling costs and maintaining low rates should be rewarded with a higher rate of return. It said the Commission could do this by choosing a return at the high end of the range of reasonableness. MP recommended that it be allowed a return on common equity of 12.50%.

The primary criticism of MP's analysis, leveled by all intervenors, was the adjustment for risk.

b. The Department

The Department performed a DCF analysis on two groups of comparison companies, and also on MP-Company.

For its Electric Comparison Group (ECG), the Department started with companies in the Compustat database with SIC Code = 4911 (electric), and with stocks publicly traded on one of the stock exchanges. The Department then applied the following screens to the group:

- S&P bond rating between AA- and BBB+
- Beta within one standard deviation of the group average beta
- Standard deviation of price change within one standard deviation of the group average

The Department ended with a group of 9 electric utilities.

For its Combination Comparison Group (CCG), the Department followed the same steps as for the ECG, only it started with SIC Code = 4931 (combination electric and gas). It removed one company, IES Industries, because it was created in a merger in 1991. Thirteen companies were in the Department's CCG.

The Department reviewed dividend yields for its group and MP-Company based upon the most recent available four weeks data (April 25, 1994 through May 27, 1994). Yields were adjusted for dividend growth during the year and for stock issuance costs equal to 5% of total proceeds. The resulting dividend yields were as follows:

ECC	7.57%
CCG	7.79%
MP-Company	7.80%

The Department reviewed 5- and 10-year historical growth rates in Earnings per Share (EPS), Dividends per Share (DPS), and Book Value per Share (BPS), as well as 5- and 10-year internal growth rates (the internal growth rate is the retention ratio times the realized rate of return). The Department also reviewed projected 5-year growth rates for BPS, DPS, and EPS as forecasted by Value Line, and EPS as forecasted by Zacks. The Department averaged the historical and projected growth rates, and said that it believed investors were expecting the following growth rates:

ECC	3.55%
CCG	3.15%
MP-Company	3.45%

Summing the dividend yields and the growth rates, the Department found required rates of return on equity ranging from 10.94% to 11.25% as follows:

ECC	11.12%
CCG	10.94%
MP-Company	11.25%

The Department said that MP-Electric was certainly not riskier than MP-Company. The Department recommended that the Commission allow MP a rate of return on common equity at the midpoint of its range, i.e. 11.10%.

c. The RUD-OAG

The RUD-OAG began its analysis with the group of single A bond-rated utilities identified by MP. From this group, it eliminated any company not having a Value Line safety rating of 3 (MP's Value Line safety rating). Fifteen companies remained. The RUD-OAG reviewed the equity ratio of this group, and found it had a lower equity ratio than MP. This indicated, all other things equal, greater financial risk for the group than for MP. The RUD-OAG also reviewed its group for the beta statistic, and found that the average beta equalled that of MP. The RUD-OAG concluded that its group closely matched MP's overall investment risk and provides a sound basis for estimating the Company's required return on equity.

The RUD-OAG calculated an average stock price for each company in its group. The monthly price used in the calculation was the average of the high and low prices for the stock in the month, and the RUD-OAG used a 6-month period ending in May, 1994. The annualized dividend was then calculated, and divided by the average stock price. The resulting dividend yield was then adjusted for one-half the year's expected growth in dividends. The adjusted dividend yield was 7.0%.

The RUD-OAG examined the growth in retained earnings for its comparison group. This growth is made up of both internal growth (the retention ratio times the realized rate of return) and external growth (growth through issuance of shares). Internal growth rates ranged from 2.2% to 4%, and the RUD-OAG concluded that 3.0% was reasonable. Although an external growth analysis showed a growth rate of 0.3%, the RUD-OAG used 0.5% to account for uncertainty over future stock issuances. Therefore, the expected growth rate was 3.5%. The RUD-OAG said that MP's growth rate estimate of 4% should form an upper bound to investor-expected growth, so it used a growth rate range of 3.5% to 4%.

The "barebones" DCF result of the RUD-OAG was, therefore, 10.5% to 11.0%. The RUD-OAG recommended that 0.1% be added to these rates to account for flotation costs of stock issuances. The DCF range after this adjustment was 10.6% to 11.1%, and the RUD-OAG recommended using the midpoint of the range, 10.85% as the cost of equity for MP.

The RUD-OAG recommended against making a risk adjustment. It said that the DCF analysis fully reflects any Square Butte risk, and neither MP's business risk nor its good performance justify an upward adjustment to the DCF-determined fair rate of return.

d. Large Power

LPI started its analysis with the group selected by MP. It eliminated the screen for companies with less than $1 billion in total revenues, and added a screen for Value Line safety rank of 3. It also changed the screen for percentage of electric to total revenues from 70% to 80%. There were nine companies selected after this process, and LPI eliminated two of them, Puget Sound Power and Light and Sierra Pacific Resources, because of recent or anticipated dividend cuts.

LPI reviewed dividend yields for the seven comparison companies over 6- 3- and 1-month periods ending March, 1994, and concluded that because yield requirements had risen over the period, the 1-month result, 7.02%, should be used. This yield value was adjusted upward to account for expected dividend growth in the first year.

LPI reviewed analysts' forecasts from Value Line and Institutional Brokers' Estimate Service (IBES), as well as a Sustainable Growth (internal growth rate) calculation to determine the rate of growth expected by investors. LPI determined that an average of the Value Line and IBES earnings per share forecast properly represented growth expectations of investors.

LPI recommended against a flotation cost adjustment and a risk adjustment. LPI recommended that MP receive a rate of return on equity of 10.50%.

e. Large Light and Power

LLPG's comparison group included all companies in the Value Line Electric Utility Industry, except those with stock traded on neither the New York Stock Exchange or the American Stock Exchange, or those that had decreased or omitted a common stock dividend in the current or prior four quarters. There were 85 companies in this group. LLPG also applied its methodology to three subsets of this group:

- Companies with a Value Line safety rating of "3" - 31 companies.
- Companies with an S&P stock rating of "A-" - 25 companies.
- Companies with an S&P bond rating of "A-" - 13 companies.

LLPG computed the dividend yield by averaging the high and low stock prices over the period January through March, 1994, and dividing the result into the most recent quarterly dividend, annualized, and adjusted for expected growth during the year.

LLPG used three growth measures:

- Value Line dividend growth projection
- 1993 Sustainable Growth Calculation
- Sustainable Growth based on Value Line projections on retention and return on equity

LLPG's DCF results ranged from 8.1% to 9.6%. LLPG recommended using a return of 9.0%.

LLPG recommended against using either a flotation cost adjustment or a risk adjustment.

f. Seniors

The Seniors began with the 95 electric utilities in Value Line. The Seniors first eliminated those with less than 96% of total revenues coming from electric utility operations. Next, firms were eliminated for which meaningful current dividends and growth rate combinations are not available. Finally, the Seniors added in MP and the six companies not otherwise in the Seniors' group, but used in MP's analysis.

The Seniors used the most recent quarterly dividend as reported by Value Line and the March 15, 1994 stock price quote. The dividends were adjusted for growth in both a quarterly and an annual DCF model.

The Seniors used Value Line dividend growth projections and IBES projected earnings growth rates.

The Seniors recommended against using only a DCF method to determine the cost of equity. The Seniors also used a Risk Positioning (or Risk Premium) method and the Capital Asset Pricing Model (CAPM) to estimate the cost of equity. The Seniors applied a flotation cost adjustment, but recommended that there be no risk adjustment.

The Seniors suggested that the cost of equity should be determined by adding twice the DCF result, the Risk Positioning result, and the CAPM result, and dividing by four. The Seniors recommended that MP be allowed 11.10% as the cost of equity.

3. ALJ Recommendation

The ALJ recommended that MP be allowed a return on equity of 10.70%. In making this recommendation, the ALJ adopted the Department analysis, except that he did not make an adjustment for issuance costs.

4. Commission Findings and Conclusions

The Commission observes that, with one exception, all the analyses of the cost of equity for comparison groups lie within 60 basis points of each other. Only the LLPG analysis, at 9.0%, lies outside of the range of 10.50% to 11.10%.

The Commission finds the LLPG analysis is flawed and should not be used here. The large number of companies used covers far too wide a range of risk to allow a meaningful comparison to the cost of equity for the electric operations of MP. Among the companies chosen to compare to MP, the LLPG has included some with required returns, under its analysis, as low as 0.7% and as high as 21.4%. Although the outliers are averaged, a simple arithmetic manipulation is not a sufficient replacement for an informed and careful estimate of investor expectations.

Within the remaining set of recommendations, there is good reason to look at the higher end of the range. Two parties - the Department and the Seniors - each recommended 11.10%. The RUD-OAG recommendation of 10.85% is a midpoint, with the high end of the reasonable range equal to 11.10%. MP's finding for its comparison group was 11.0%.
(During rebuttal, MP updated its yield figures for its comparable group. Using the updated yields and the original growth rates gives a range of returns between 11.60% and 12.0%.) And LP's 10.50% recommendation was based upon a yield incorporating a six-month period ending in March, 1994. Using the same growth rates with a six-month dividend yield ending in May, 1994 causes the result to rise to 11.06%.

The Commission agrees with the ALJ that the Department's analysis is well reasoned and the most comprehensive assessment and investigation of the cost of equity for a comparison group of companies. Unlike the ALJ, the Commission finds that an issuance cost adjustment advocated by the Department (and three of the other five parties) is appropriate.

Issuance or flotation costs are not simply for use in years when the company is issuing common stock. They represent the difference between what the investors paid and the company received during public offerings, and, because there is no fixed life, as there is with a bond, they must be recovered through a return adjustment.

The Commission concludes that the issuance cost adjustment proposed by the Department is appropriate, and that the cost of equity for a group of comparison companies should be found equal to 11.10%.

The Commission finds that none of the comparison groups adequately represents the risk that would be presented to an investor in MP as a stand alone electric company.

Although the intervenors have argued that the DCF method captures the overall investment risk of MP-electric, their risk screens consider primarily the risk of MP-consolidated. Bond rating, Value Line safety rank, beta and standard deviation of price change, for example, reflect the overall investment risk in MP-consolidated, and are not available for MP-electric.

Further, MP-consolidated, although it has relatively small investments in risky industries such as paper making, is marked by diversification, which tends to reduce overall risk, and by a very large holding of liquid investments.

The Commission finds that MP-electric is subject to very substantial additional risk due to its business position. In particular, the following characteristics increase its risk relative to any company in any of the comparison groups:

- Concentration of industrial sales. Sixty-four percent of MP's electric revenues in 1992 came from industrial sales. This is at least ten percentage points above the nearest U.S. utility, and is approximately twenty percentage points above Interstate Power. Interstate is the only utility common to comparison groups chosen by all intervenors.

- Concentration of industrial customers in just two industries, paper making and taconite operations. Both industries are subject to world-wide competition.
- Concentration of industrial sales to a few extremely large customers. One need only review the record of this case to see the effect of either the loss of one of these customers (ultimately precipitating the filing of this rate request) or of the return to business of that customer (bringing about the National Settlement).

In turn, these characteristics make MP particularly vulnerable to loss of customers in the event that retail wheeling of electricity becomes a reality. It is clear from the record of this case that retail wheeling is increasingly a topic of discussion and even action both at the federal and state levels.

The intervenors argued that any company in a comparison group can be found to have some unique risk characteristic which makes it different from the group, but that is no reason to adjust the equity return found reasonable for the group.

In most situations, the Commission concurs with that assessment. Here, however, the Commission is persuaded that not only is the business position risk facing MP is unique, but also it is significant enough that a risk adjustment to the return on equity is necessary. MP's business position risk is of a different magnitude than the risks the intervenors suggested might be faced by comparison companies: regulatory climate, plant construction, even nuclear operations.

The Commission concludes that a risk adjustment to the rate of return on equity is appropriate. MP witness Dr. Morin estimated that 50 basis points would be a conservative indication of the risk differential between the comparison groups and MP-electric due to MP-electric's business position. The Commission concurs. The Commission concludes that MP ought to be allowed a return on equity of 11.60%.

F. Overall Rate of Return

Based upon the Commission's findings and conclusions on return on equity, cost of debt and preferred stock, and capital structure herein, the Commission finds the overall rate of return for MP in the test year to be 9.33%, calculated as follows:

Capital Employed	Percent	Cost	Weighted Cost
Long term debt	45.84%	7.20%	3.30%
Preferred stock	5.55%	7.03%	0.39%
Common Equity	48.61%	11.60%	5.64%
Total	**100.00%**		**9.33%**

XV. RATE DESIGN

A. Class Cost of Service Study

The issue before the Commission is which class cost of service study (CCOSS) provides the best cost information for guidance in determining appropriate class revenue allocation.

The Company's embedded class cost of service study is a variant of the average and excess demand method, using a capital substitution, or CAPSUB, model to classify power supply production costs as capacity-related and energy-related. Another component of the Company's study is the average and excess demand/probability of deficiency, or A&E/POD, model for determining how capacity-related and energy-related fixed costs, transmission-related costs, and energy costs are allocated to costing periods and subsequently to classes.

The Department's embedded class cost of service study method is similar to that of the Company's in many respects. The most significant difference between the two studies is the Department's use of the stratification method for classifying power supply production costs as demand- and energy-related. The two studies also differ with respect to the separation of competitive-rate customers and Large Power interruptible customers into separate classes, as well as the appropriate allocation of conservation costs.

The Department recommended that the Company modify its cost study in its next rate case in the following two ways: (1) by providing a description of how the Company performs its minimum distribution study, including discussions of how the minimum system is determined and of whether the demand allocation factors should be adjusted to recognize the minimum load-carrying capacity of the minimum-size system; and, (2) by using Company-specific numbers in estimating its probability of deficiency. The Company subsequently agreed to these two changes.

The RUD-OAG and the Seniors argued that cost studies require subjective judgments which result in arbitrary allocations. Because of the inherent weaknesses of cost studies, the RUD-OAG and the Seniors recommended that the Commission not base its rate design decisions solely on the results of the cost studies.

The LPI recommended that the Commission adopt the Company's cost study because it has been approved in previous rate cases. The LPI indicated that its prime concern is that both cost study methodologies show a substantial subsidy to the residential class. The LPI argued that until the Commission approves a rate design which moves the residential class closer to the cost of service, there is little benefit to be achieved in fine-tuning either of the cost of service methodologies.

The ALJ found that the Company's A&E/POD methodology provides the best information for allocating capacity- and energy-related fixed costs, transmission-related costs and variable (energy) costs. The ALJ found it appropriate for the Commission to adopt the Company's cost study methodology as was done in the MP's last general rate case.

The ALJ adopted the Department's recommendations to separate competitive rate and Large Power Interruptible customers as separate classes in the cost study, and to allocate conservation costs based on capacity and energy savings.

The Commission finds the Department's modifications, as agreed to by the Company, reasonable and appropriate. The Commission will require the Company to modify its cost study (to be filed in the its next rate case) to include information on a minimum distribution system and the use of Company specific numbers in estimating the probability of deficiency.

The Commission finds it unnecessary to adopt either the Company's or the Department's proposed cost studies. The cost studies presented in this case are very similar. The major difference between the cost studies is their method of classifying power supply production costs as demand- or energy-related. The results of the cost studies are very similar in that both studies identify a significant subsidy to the residential class. The similarity in the results of these two studies increases the Commission's confidence that either study can be used as a starting point to determine reasonable and appropriate class revenue responsibility.

The Commission acknowledges the general thrust of the arguments put forth by the RUD-OAG and the Seniors that cost studies are subjective and should be used with caution when determining class revenue responsibility and rates. A class cost of service study is merely a starting point for determining reasonable class revenue responsibility levels. As the Commission stated in Minnesota Power, E-015/GR-81-250 and reiterated in Minnesota Power, E-015/GR-87-223:

> The Commission believes that class cost of service studies provide an important starting point for determining class revenue responsibilities. However, such studies have limitations and cannot claim to be precise measures of cost. The Commission continues to find that other cost and non-cost factors may properly be taken into account when setting class revenue requirements....

The Commission continues to find these statements appropriate. Other cost and non-cost factors may, and should, be taken into consideration when determining class revenue responsibility. In the particular circumstances of this proceeding, the Commission agrees with the LPI that the choice of a cost study methodology, or a decision to make minor modifications to either individual methodology, is less important than acknowledging the existence of the subsidy to residential customers and determining a design of rates which more appropriately addresses cost causation.

The Commission does not wish to imply that cost studies are nonessential. On the contrary, the Commission believes cost studies are an important starting point for allocating revenue responsibility and for designing just and reasonable rates. The Commission decision in this proceeding simply indicates that, at this time, either cost study is adequate. The Commission is well acquainted with both CCOSS methodologies and has adopted a CCOSS using each of the proposed methodologies in other rate case proceedings.

B. Class Revenue Allocation

1. Positions of the Parties; the ALJ

a. Minnesota Power

The Company based its recommendations for class revenue allocation on its own cost of service study. It argued that the study supports a lower than average increase for the LP customer class, since this class provides the highest rate of return under present rates. The Company also argued that its study indicates that there is a substantial underrecovery of costs for the Residential class relative to other classes.

According to the Company, a lower than average increase for the LP customer class is also supported by the fact that the rate base devoted to serving the LP class has declined since 1987. Yet, LP revenues have changed only slightly.

The Company argued an above average increase is warranted for the Residential class because the Company's investment in rate base to serve residential customers, essentially distribution plant, has grown since 1987. Moreover, the Company argued it has experienced residential sales growth, which causes additional costs to be allocated to this class.

MP argued that the disparity in rates of return between classes creates problems because:

- a negative return from residential customers does not provide fair compensation for investors

- artificially low rates are, in the long run, unfair to the residential customers who make energy use decisions in response to a flawed pricing signal

- the increased costs to the LP class jeopardizes financial viability of customers in this class. The failure of any of the LP customers would place residential and other customers at risk for even higher electric rates

The Company did not recommend that residential rates should be immediately increased to provide the system average rate of return. It noted that such a large increase would have a disruptive impact on residential customers. Instead, MP proposed a phased-in rate increase in order to make some immediate movement toward cost and to assure a continuation of this movement over the next three years.

The Company proposed that residential rates be increased by 25% over a four year period (even after the distribution of the National revenues) as follows:

- a 7% annual increase through interim rates effective on March 1, 1994

- an additional 11% increase with general rates effective on January 1, 1995

- an additional 3.5% increase on January 1, 1996

- a final 3.5% increase on January 1, 1997

The Company proposed that the 1996 and 1997 residential rate increases of 3.5% be distributed back to the LP and the LLP classes as a credit.

The Company proposed that the initial increase for the LLP class be set so that this class would be providing a rate of return equal to the LP rate of return. The Company argued that this would distribute the residential subsidy more fairly between these two classes.

MP argued that since the LLP and LP classes would then be paying the highest returns of any classes, they should share the credit from the residential increase equally. MP noted that the phased-in revenues would have no effect on the Company since these revenues would be credited to the LP and LLP classes.

The Company proposed an increase of 18% (prior to the distribution of the non-test year National revenues) for the General Service class, to equal the initial percentage increase for the Residential class.

The Company proposed an increase of 14.93% (prior to the distribution of non-test year National revenues) for the Municipal Pumping class, to provide the same return as the General Service class.

The Company proposed a zero increase for the Lighting class. The Company argued that subsequent to the filing its cost study, it noted that the customer allocation factors for the Lighting class were inappropriate. For this reason, the Company proposed to maintain the Lighting class revenue at the present level until the next rate case. The Company proposed to develop an appropriate Lighting customer cost allocation method to be included in its next rate case filing.

To more closely reflect current cost of service and market conditions, the Company proposed an increase of 20.13% for the Dual Fuel Residential class. It proposed an increase of 45.63% for the Dual Fuel Commercial class for the same reason.

The Company proposed that the test year National revenues be distributed to the LP and LLP classes. The Company also suggested that once the cost study is rerun based on the decisions in the case, that the non-test year National revenues be distributed back to those classes that exceed the authorized rate of return level by the largest margin.

b. The Department

In making recommendations on revenue apportionment, the Department relied on its own cost study. It argued that its cost study indicated that neither the Residential nor the Lighting class are providing sufficient revenue to offset the cost each class imposes on MP's system. According to the Department, Residential class rates would have to increase by about 100% to bring them to cost. The Lighting class would require a 36% increase.

For this reason, the Department initially proposed a 25% rate increase, phased in over four years, for both of these classes. It proposed that the revenue responsibility for all other non-interruptible classes be reduced accordingly over the same four year period.

The Department revised its proposal for class revenue allocations to include the effects of the National revenues. Its proposal revised to incorporate National revenues included a 13% increase for both the Residential and the Lighting class, with annual increases of 3.25% for each of these two classes in 1996, 1997, and 1998. This results in a cumulative increase to each of these classes of 22.75% beginning in January 1998.

The Department recommended a series of gradual increases over four years in order to move these two classes toward cost-based rates, while minimizing the rate impact on these classes. The Department argued, in this case, movement toward cost-based rates for residential customers is critical because it would reduce the risk of large future increases to the Residential class.

The Department initially proposed that the Company file an embedded cost study 120 days before the date of each proposed phase-in. The cost study would include each classes' current revenue-to-cost ratio, MP's overall return on equity, and the Company's proposed rates. The Department witness modified this proposal at the hearing and agreed to accept a cost study in the second year of a phase in.

The Department noted that its cost study indicates that all of MP's retail classes except Residential and Lighting have revenue-to-cost ratios that exceed 1.0 to 1.0. The Department argued that no class that is contributing more than its cost of service should receive a greater-than-average increase by the end of the phase-in period.

The Department proposed initial rate increases to the General Service, LLP, and Municipal Pumping classes of 5.87%. These increases would fall to 3.21% at the end of the phase-in period, January 1998. The Department proposed a 3.25% increase for the LP class. This increase would fall to 1.89% in January 1998.
All of these increases are based on the Department's proposed revenue requirement and the Department's proposed treatment of the National revenues.

The Department noted that the Company admitted to using an inappropriate customer allocation factor for the Lighting class in its cost study. However, it maintained that the Company provided no record evidence to support this. Thus, the Department argued the 0% increase, proposed by the Company, should not be granted.

The Department supported the Company's proposal for an increase of 20.13% to the Dual Fuel Residential class and an increase of 45.63% to the Dual Fuel Commercial class.

The Department recommended that the additional revenues from the National stipulation be apportioned on a pro rata basis to all non-interruptible classes.

c. RUD-OAG

The RUD-OAG maintained that the Commission should consider cost and non-cost factors, such as equity, in designing rates. To promote efficient use of resources, the OAG argued that rates should be set at marginal cost. Since there is no marginal cost study in this case, the OAG maintained that the Commission should consider the economic impacts of its rate design decisions on each customer class.

The RUD-OAG argued that residential customers face severe economic hardships. It recommended that the Commission consider economic hardship in setting rates. For this reason, the RUD-OAG proposed an even across the board rate increase of about 10.5% for the Residential, General Service, LLP, and LP class.

In addition, the RUD-OAG argued that the residential rate phase-in proposal is unnecessary, unfair and should be rejected. It argued that continuing residential rate increases (in some cases stretching as far as the year 2001) and corresponding decreases for other classes would be speculative.

According to the RUD-OAG, the Commission should not rely on the cost studies contained in the record of the case. It claimed that MP, the Department, and MP's large industrial customers all recommended increases in residential rates in order to move residential rates closer to cost. However, the RUD-OAG believes there are inherent weaknesses in embedded cost studies and specific problems with the cost studies submitted in this case.

The RUD-OAG argued that strict reliance on cost would overturn both court and Commission precedent, violate the Commission's responsibility to consider non-cost factors in setting rates, and amount to an abandonment of the Commission's quasi-legislative powers.

The RUD-OAG maintained that the Commission should consider the economic conditions facing small businesses as well as the conditions facing LP customers. It argued that an 18% increase for General Service, as proposed by the Company, would cause economic harm for small businesses, their vendors, and their employees. According to the OAG, these businesses operate in a competitive environment and have no ability to pass on higher costs to their customers. In such a situation, an increase in electricity prices may mean a reduction in income, in wages, and in employment.

The RUD-OAG maintained that the record in the case shows some improvement in the economic conditions faced by LP customers. Given these positive indicators, the OAG argued that a disproportionately low increase for the LP customers may not be as necessary.

The RUD-OAG argued that MP has many ways to address the needs of the LP customers outside of a rate proceeding, such as cash payments, discounted interruptible service, an industrial conservation pilot (ICP) project, EPRI research, and fuel cost reductions.

The RUD-OAG proposed that the Commission use the same apportionment methodology described above to distribute the National revenues. It specifically stated that the additional revenue from National in both 1994 and 1995 should be apportioned so as to result in the same net proportional increases in revenue responsibility among the Residential, General Service, LLP, and LP classes.

d. Seniors

The Seniors argued that ability to pay should be an important consideration in the design of rates. Under the Seniors' proposal for revenue allocation and rate design, the smaller billing impacts would fall on those residential customers who use the least energy and can least afford an increase. The greatest impact would fall on those customers using the most energy and that can most afford an increase.

Specifically, the Seniors proposed that the rate increase for the residential class be no greater than the overall increase authorized by the Commission. They argued that assigning the average overall increase to the residential class is reasonable, considering their ability to pay. According to the Seniors, Minn. Stat. § 216B.16, subd. 14, allows the Commission to consider ability to pay as a factor in setting utility rates.

The Seniors testified that, since MP's last rate case, the economic conditions for low income customers in northeastern Minnesota have deteriorated. Specifically, they argued that elderly residential ratepayers on fixed incomes have lost ground. They noted that amounts spent by elderly ratepayers on Medicare Part B have increased, and medical bills and prescription costs have risen faster than the rate of inflation.

The Seniors testified that 35% of MP's residential customers are eligible for low income benefits programs due to their lack of adequate income. According to the Seniors, any increase in rates would have a significant impact on these households, forcing many to cut back on other basic necessities. The Seniors maintained that spreading a substantial increase over a period of years does not ameliorate the impact of the increase.

The Seniors argued that cost of service studies have limitations and are not precise measures of costs. Thus, these studies should be used only as a starting point in setting rates.

The Seniors argued that MP has not considered historic use as a basis to determine class cost of service. They argued that much of MP's production system was built to serve the increased need of the taconite industry. The Seniors also maintained that not all classes of customers should pay equal rates of return, since the risk each class poses to MP is different.
According to the Seniors, the LP class has already received large cost savings and will continue to do so in the future. Moreover, the Seniors maintained that the steel industry is recovering and is expected to show substantial earnings improvement in the future.

The Seniors proposed that the Commission use the same apportionment methodology, as proposed by the Seniors and described above, to distribute the National revenues, regardless of the dollar level of revenue requirement.

e. LPI

The LPI argued that based on the Company's proposed revenue deficiency of $34 million, it would be necessary to increase residential rates by about 97% to bring them up to cost. The LPI testified that this type of increase would be unrealistic. For this reason, it proposed a seven year phased-in increase for the residential class to bring residential class revenues up to cost of service.

The LPI argued that all of MP's classes are earning at or near a reasonable rate of return, with the exception of the residential class, which is earning a negative 6.3% rate of return. The LPI noted that under present rates the LP class is earning a 12.68% rate of return on rate base. According to the LPI, under present rates, the LP class is subsidizing the residential class by $23 million.

The LPI argued, under MP's proposal for a 25% phased-in increase to the residential class, this class would still earn a negative rate of return at the end of the phase-in period.

The LPI proposed that the phased-in rate increase to the residential class be implemented in equal dollar steps through the seven years 1995 to 2001. However, the LPI proposed a larger initial increase in 1995 to offset the fuel adjustment reduction. Under the Company's proposed revenue requirement, the increases to the residential class would be as follows: a 15.76% increase in 1995; an 11.74% increase in 1996; a 10.50% increase in 1997; a 9.51% increase in 1998; an 8.68% increase in 1999; a 7.99% increase in 2000; and, a 7.40% increase in 2001.

In addition, the LPI proposed, during the phase-in period, that the revenue responsibility for the General Service, LL&P, and LP classes be set at the same rate of return level. Thus, the LPI proposed a 21.88% increase for the General Service class, a 13.97% increase for the LL&P class, a 5.72% increase for the LP class, a 0.87% increase for the Municipal Pumping class, and, a 32.16% increase for the Lighting class.

LPI witness Falkenberg testified that MP's total rate base has actually declined somewhat, due to a decline in the power supply investment. However, the Company's investment in distribution and customer accounting investment assigned to the residential class has increased by 80% in the past seven years.

The LPI argued that residential rates that are far below cost create a burden on the LP customers. This burden has an adverse effect on LP customers in the competitive market in which they compete. The LPI testified that if a bold movement toward cost based rates is not made now, MP will lose industrial load. This would increase rates to other industrial and residential customers. The LPI also maintained that moving the residential and industrial classes toward cost based rates, would provide MP with a more stable and less risky revenue situation.

In addition, the LPI argued that the current prices charged to residential customers are sending false price signals to customers and are directly contrary to the goal of encouraging conservation.

To distribute the National revenues, the LPI proposed that the Commission use the same apportionment methodology described above, regardless of the dollar level of the authorized revenue requirement. The LPI recommended the Commission: (1) rerun the CCOSS including the National revenues; (2) set initial Residential class revenue requirement at cost after a seven year phase in; (3) set revenue requirements for all other classes at an equal rate of return; and (4) distribute the phased-in revenues back to other classes.

f. LLPG

The LLPG argued that rates should be set, and revenues apportioned based on cost of service. However, it noted that raising all classes to the cost of service immediately would result in significant rate impacts for the Residential and Lighting classes.

For this reason, the LLPG proposed that the Residential class and the Lighting class each be assigned an 18% initial increase. In addition, the LLPG proposed that all classes be moved to their cost of service over a sixty month period through the use of a monthly adjustment mechanism that provides credits to the LP class and surcharges to the Residential and Lighting classes. It proposed that during the phase-in period that any deficiency in revenue requirements that result from limiting the Residential class increase to 18% be assigned to the LP class.

The LLPG argued that MP's proposed rates would underrecover from the Residential and Lighting classes, and would overrecover from the General Service, LL&P, LP, and Municipal Pumping classes.

The LLPG argued that the LP class should support a larger portion of the residential subsidy than other classes for the following reasons: in past cases, the Commission has decided that the LP class should provide the subsidy; MP has provided $12,580,000 in direct cash payments to the LP class since the 1987 rate case; MP has provided $6,000,000 in annual rate reductions to the LP class since the 1987 rate case in the form of interruptible demand credits; the LP class increases MP's business risk; and, MP's CCOSS understates the LP cost of service.

The LLPG proposed that the Commission use the apportionment methodology described above to distribute the National revenues. The LLPG recommended the Company rerun its CCOSS based on the authorized revenue requirement, including the test year National revenues. The LLPG proposed that if the Commission does not adopt the LLPG proposal to move rates to cost, the non-test year National revenues should be used to move General Service and LL&P class rates towards cost.

g. Potlatch

Potlatch argued that the Commission should adopt a revenue allocation procedure that would result in all classes paying rates based on the cost to provide service to each. Potlatch proposed an initial increase of 18% for the Residential class, followed by a 3.5% increase in 1996 and 1997, as proposed by the Company.

In addition, Potlatch proposed, in each of the five years following January 1997, that the Commission further increase Residential rates. These increases should be implemented so as to result in equal rates of return for all classes at the end of the eight year phase-in period. Potlatch proposed that the phased-in revenues be credited to the LP class.

Potlatch argued that the subsidy to the residential class is an important factor forcing Potlatch in the direction of energy self-sufficiency. In the past fifteen years, Potlatch has increased its degree of energy self-sufficiency from about 40% to 70%.

Potlatch argued that residential customers would be subsidized by $33.8 million per year even after MP's proposed 18% increase. Even after the proposed 18% increase, Potlatch would pay $1,524,380 per year to subsidize the Residential class. For this reason, Potlatch argued that increases to the Residential class beyond the phased-in 25% recommended by MP are necessary and appropriate.

Potlatch proposed that the Commission use the same apportionment methodology described above to distribute the National revenues. In the Stipulation, Potlatch argued that the additional revenues from National should be apportioned to the LP and LL&P classes, as proposed by the Company.

h. Eveleth

Eveleth argued that the apportionment of revenue among classes should be based on the costs to serve each class. Eveleth recommended that revenue should be allocated among customer classes so that the subsidy provided by the LP customers to residential customers would be reduced faster, and to a greater extent than under the proposals made by MP or the Department.

Eveleth proposed an initial increase of 25% for the Residential class, with phased-in compounded increases of 10% in 1996 and 1997. Eveleth witness Cecil testified that under this proposal the cumulative residential rate increase by January 1997 would be 51.25%. Eveleth proposed that the additional revenue from the phased-in Residential increase should be credited to the LL&P and the LP class.

Eveleth argued that MP's cost study shows the Residential class providing a negative 6.34% return. Eveleth argued that MP's cost study is biased and penalizes high load factor customers. However, Eveleth argued even with this bias, the study shows a large subsidy flowing to the Residential class.

Eveleth noted that even after MP's phased-in increase of 25% to the Residential class, this class would be paying a negative 2.01% return. The LP class would be paying a 15.61% rate of return, almost 6 percent points more than the system rate of return proposed by the Company.

Eveleth proposed that the Commission use the same apportionment methodology described above--apportion additional revenues from National to the LP and LL&P classes.

i. The ALJ

The ALJ adopted the OAG proposal for an even across the board application of the average overall increase to the Residential, General Service, LL&P, LP, Municipal Pumping, and Lighting classes. He concluded that none of the proposals for large increases to the Residential class were reasonable, moderate, or consistent with prior Commission decisions. Moreover, he decided that concern for the economic situation of the LP customers should not overshadow the same concern for the Residential, General Service, and LL&P classes.

According to the ALJ, at no time in the past has the Commission ordered revenue responsibility for the Residential class based solely on cost. He found that the underrecovery of revenue from the Residential class is a product of prior Commission decisions. In past decisions, the Commission allocated revenue responsibility to the LP class consistent with the higher risks of serving that class.

The ALJ also concluded that the 18% increase proposed by MP for the General Service class would have a negative impact on the small business customers in MP's service area. He found that the small business customers represent a very important sector of the economy in northeastern Minnesota.

The ALJ found that the record of the case indicates a more positive economic situation for LP customers in the near future. In addition, the ALJ noted that the Commission has ways to address the needs of the LP customers outside of a rate case.

The ALJ recommended that the additional revenues from National be distributed using the same apportionment methodology described above, an even across the board application to all classes.

C. Commission Action on Residential Class Revenue Allocation

1. Summary of Commission Action

The Commission finds that the facts of this case support and require shifting responsibility for more of the Company's revenue requirement to the residential class. The Commission will authorize a 21% residential rate increase, phased-in over three years to mitigate its impact. The first year increase will be 13.5% over pre-rate case rates.[13] The second and third year increases will be 3.75% over pre-rate case rates. The first and largest increase will apply only to usage amounts exceeding the "lifeline" usage level of 350 kWh.
This increase is lower than the proposals submitted by the Company, the Department, and the large volume customers and higher than the proposals submitted by the RUD-OAG and the Senior Federation. The Commission believes this increase represents the most equitable and workable balance of the cost and non-cost factors that govern rate design.

This action does not reflect a fundamental rethinking of the role of cost and non-cost factors in rate design, a retreat from the Commission's longstanding commitment to affordable residential rates, or any other major policy reversal. It reflects the careful application of traditional rate design principles, the Commission's expertise, and its best judgment, to the facts of this case.

This decision is explained more fully below.

2. The Costs of Serving the Residential Class Have Increased and Are Asymmetrical with Residential Rates

Cost studies are imprecise tools, and the actual costs of serving any customer class can be debated interminably. In this case, however, no one disputes the point that residential rates do not recover the costs of serving residential customers. The disputes center around the amount of the shortfall and how the Commission should treat the shortfall in designing rates.

The Company's cost studies show that an 82.5% increase would be required to bring residential rates to cost; the Department's cost studies show that a 100% increase would be required.[14] Current residential rates average 5.388 cents per kWh; a reasonable approximation of the average cost of that kilowatt hour is 9.377 cents.

The gap between the residential class's contribution to the revenue requirement and the contributions of other classes has grown since the Company's last rate case, because the costs of serving residential customers have increased. Since 1988 the Company has increased its

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[13] The first year increase can be larger because the potential for rate shock has been reduced by customers' paying higher rates during the interim rate period.

[14] The difference is due mainly to differences in projected revenue requirement, not cost allocation between customer classes.

investment in its residential distribution system by some 60%, or $13.5 million. Rate base has otherwise generally declined. Similarly, the Company has upgraded its customer accounting processes, increasing expenses in that area by 80%.

In short, the cost increases driving this rate case are largely attributable to serving residential customers. This fact, while not determinative, is an important consideration in allocating revenue responsibility among the customer classes.

3. Large Customers Cannot Pick up the Slack

It is axiomatic that non-cost factors play an important and often decisive role in rate design. Ability to pay, ability to pass on and diffuse costs, ability to deduct costs from taxes, rate stability, efficient use of resources, and impact on conservation are typical non-cost factors the Commission considers in designing rates.

The RUD-OAG and the Senior Federation argue that non-cost factors justify or require assigning the residential class responsibility for no more than a pro rata share of the revenue increase awarded in this case. They believe large volume customers, especially Large Power customers, can absorb cost increases more readily than residential customers and that their contribution to the costs of providing residential service should increase to the extent necessary to hold residential rate increases to a pro rata share of the total rate increase. The Commission disagrees.

There are limits to the ability of large volume customers, especially Large Power customers, to absorb rate increases. The Commission believes pro rata increases would stretch if not exceed those limits.

The taconite producers, who with the wood and paper products industry account for 54% of Minnesota Power's revenues, have introduced persuasive evidence that intense global competition has severely reduced their ability to pass on and diffuse utility cost increases. Although there is widespread optimism that the industry's low point is behind it, capacity remains 35% below levels prevailing 15 years ago. Furthermore, taconite production is such an energy-intensive process (electricity constitutes 16% of production costs) that increased energy costs can jeopardize individual producers' survival.

Potlatch, a large wood and paper products producer, introduced persuasive evidence that tight profit margins in that industry force continual rethinking of all components of production costs. This rethinking has already led Potlatch to produce 70% of its own energy.

In short, this Commission's ability to place more responsibility for total system costs on large ratepayers is at or near its limits.[15] Self-generation is clearly a realistic alternative to purchasing power for price-sensitive customers heavily dependent on electricity. Self-generation harms the system and all remaining customers by shifting to remaining customers the portion of fixed costs formerly borne by the self-generator.

Even worse than self-generation, however, is plant closure. Energy costs can significantly affect profits in energy intensive industries such as taconite production and can contribute to business failure. This is worse than self-generation because not just the utility system, but the community

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[15] By this the Commission does not imply it would impose those costs on large customers if it could. If the ability to shift costs were there, the Commission would have to carefully consider fairness, efficient use of resources, conservation effects, and all other cost and non-cost factors before reaching a decision.

itself is deeply and adversely affected.

The Commission concludes that under current conditions it would be imprudent and counterproductive to increase rates for large customers to the extent necessary to limit the residential rate increase to a pro rata share of the overall increase.

4. The Authorized Increase is Just and Reasonable

The Commission is keenly aware of the economic distress many of the Company's residential customers face and knows that that distress is more prevalent and intractable in northeastern Minnesota than in many other parts of the state. Because high energy bills can impose hardships on low income people, the Commission never views residential rate increases lightly. At the same time, the Commission's main responsibility and competence lie in setting just and reasonable utility rates, and it is clear to the Commission that the residential rate increase authorized here is just and reasonable.

Unfortunately, the nature of utility regulation tends to make rate increases appear higher than they are, averaged over time. Utilities cannot raise their rates in imperceptible increments, like unregulated retailers -- they have to file a rate case. Since that process is cumbersome and expensive, it is not used to recover trivial shortfalls. Therefore, while utility rates may remain level for long periods of time, when they go up, they tend to go up in significant increments.

In this case, for example, residential ratepayers have had only one 1% rate increase since 1981. Their pre-rate case rates were 20.6% below the national average. It would require a 31% increase to bring them up to the average for Minnesota investor-owned utilities.[16]

Even the 25% increase sought by the Company, averaged over the 13 increase-free years, would have come to 2.18% per year. This is significantly below the 3.77% average annual increase in the Consumer Price Index and below the 5% average annual cost of living increase in Social Security benefits.

None of this, of course, diminishes the hardship some customers may face as a result of this increase. For this reason, the Commission has limited the application of the largest portion of the increase to amounts above the "lifeline" usage level and has rejected the Company's proposal to raise the customer charge, which applies to that usage level, beyond a nominal increase. The Commission will also require the Company to meet with the RUD-OAG and the Department to explore the possibility of creating, expanding, or increasing access to energy assistance programs for low income consumers.

5. The Large, Long-term Increases Sought by the Large Commercials and Industrials are Inappropriate

The large commercial and industrial customers introduced various plans to bring residential rates up to the cost of service within various time periods stretching up to seven years. The Commission rejects these proposals for failing to properly balance cost and non-cost factors, for crediting cost studies with more precision than they can actually deliver, and for unduly limiting future Commission rate design decisions.

6. The Authorized Increase Does Not Indicate a Major Policy Reversal

The Administrative Law Judge found that any rate increase to the residential class should not

[16] These figures are based on usage at the 1000 kWh usage level.

exceed that class's pro rata share of the total rate increase. He believed that all parties' proposals for higher increases represented major departures from Commission precedent and major policy reversals. He would perhaps place the increase approved here in that category as well.

While the Commission appreciates this close attention to earlier Orders and articulated policy, the Commission does not read previous Minnesota Power Orders as the Administrative Law Judge does. The two 1988 Orders, for instance, were clearly grounded in the unique facts of that case -- the Company had come in for a rate increase and had received a decrease instead. The Commission expressed concern about the apparent imbalance between the costs of providing residential service and residential rates in the first Order, but concluded as follows:

> The Residential class appears to be the customer group most below cost based solely on the results of the cost of service studies. However, the Commission has already found that the class cost of service study overstates the Residential, and other non-LP class, revenue responsibilities due to changes in LP usage patterns. The Commission finds the unreliability of the cost study results discussed previously, coupled with non-cost factors such as the economic situation of Residential customers in MP's service area, make it reasonable to maintain the Residential class revenues at the level existing before the rate case filing.
>
> <u>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</u>, Docket No. E--15/GR-87-223, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (March 1, 1988) at 91.

Significantly, however, that Order rejected requests to lower residential rates and granted requests to lower Large Power and Lighting rates. Then, on reconsideration the Commission increased residential rates by 1% overall, when faced with the need to make up an additional $2,636,529 revenue deficiency.[17]

These Orders by no means established a conscious policy to go to extraordinary lengths, then or in the future, to shield residential customers in this economically distressed area from rate increases. In fact, residential ratemaking issues were not treated in detail in either Order.

Finally, it is important to remember that no rate case issues are more intimately bound to particular facts, more legislative in nature, and less amenable to resolution by precedent, than rate design decisions. The 1988 rate design decisions were tied to the facts of that rate case, just as the rate design decisions made here are tied to the facts of this rate case. There, as here, no long term policy on residential rates was considered practical or desirable.

The factors bearing on rate design are dynamic and unpredictable over time. The Commission must preserve its ability to deal fairly and effectively with the situation each rate case presents.

D. Commission Action on Non-Residential Class Revenue Allocation

The Commission finds that the facts of this case support the application of the overall increase[18], to the General Service, Municipal Pumping and Lighting classes. These classes, except for the Lighting class, are currently paying rates of return above the system average rate of return. For

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[17] ORDER AFTER RECONSIDERATION AND REHEARING (May 16, 1988).

[18] The overall increase granted by the Commission in this case is about 6.4%.

this reason, the Commission will authorize a 6.5% rate increase, which includes the distribution of the National revenues, to these three classes.

Since the LL&P and LP classes are paying class rates of return well above the system average, the Commission finds it appropriate to authorize a lower increase for these two classes. In addition, the Commission finds it appropriate to distribute revenues resulting from the phased-in increase to the Residential class back to the LP and LL&P classes as a credit.

Although there are discrepancies in the record regarding the actual class rate of return for the Lighting class, the Commission recognizes that both cost studies indicate that this class is paying below the system average rate of return. For this reason, the Commission finds it appropriate to authorize the overall increase for this class. The Commission encourages the Company to develop an appropriate Lighting customer cost allocation method to be included in its next rate case.

The Company proposed an increase of 20.13% for the Dual Fuel Residential class and an increase of 45.63% for the Dual Fuel Commercial class. LLPG objected that there was insufficient cost information in the record to support the proposed changes. The Commission finds that these increases are intended to reflect current costs and market conditions and that contrary to LLPG's assertion, there is sufficient cost information in the record to support the proposed increases. There was no other objection to the Company's proposals. Therefore, the Commission finds these increases to be appropriate.

E. Allocation of National Revenues

The Commission finds it appropriate that all classes share fairly in the revenues derived from the National reopening. For this reason, the Commission authorizes that the non-test year National revenues be apportioned to all non-interruptible classes on a proportional basis as recommended by the Department.

F. Residential Class Rate Design

1. Consolidation of Residential Rate Areas

a. Minnesota Power's Proposal

MP proposed to consolidate Residential Rate Areas I, II, and III into a single residential rate area. MP testified that the current rate levels vary slightly by rate area. It also testified that the elimination of the three distinct rate areas would simplify the residential rate and reduce administrative costs of applying the rate.

b. The Department

The Department recommended that the Company's proposed consolidation of the three residential rate areas be rejected. Department witness John Kundert testified that the Company had not performed a cost study that indicates whether the costs of serving the different rate areas are the same, or that consolidation would reduce costs.

c. The ALJ

The ALJ supported the Department's recommendation. He concluded that MP had not provided evidence indicating that the cost of serving the three rate areas is the same, or that the proposed consolidation would reduce costs.

d. Commission Action

The Commission adopts the Company's proposal to consolidate the three residential rate areas. The Commission expects that the consolidation will promote efficiency and reduce costs. It notes that the record does not demonstrate quantifiable cost savings from the consolidation. However, the Commission finds that it is reasonable to assume that some cost savings and certainly increased efficiencies will occur as a result of the consolidation.

To the extent that the existing classification into three rate areas is arbitrary and does not reflect cost, the Commission finds the existing separation to be unfair. The Commission notes that the situation in which two customers live next to each other but pay different rates often causes confusion. The consolidation will eliminate any such confusion.

2. Residential Customer Charge

a. Minnesota Power's Proposal

The Company proposed to increase the existing residential customer charge from $4.12 in Rate Area I, $4.17 in Rate Area II, and $4.22 in Rate Area III, to $5.00 for the consolidated residential rate area. The customer charge would continue to include the first 50 kWh of usage. Because the Company's CCOSS shows that the current customer charges underrecover customer-related costs, the Company proposed an increase in the customer charge that is larger than the increase to other energy blocks.

The Company also proposed that the entire amount of any phased-in increase be applied to the customer charge. Under the Company's proposal, the residential customer charge would go up by $1.34 in 1996 and by the same amount in 1997. This implies a customer charge of $5.00 in 1995, $6.34 in 1996, and $7.68 in 1997.

b. The Department

Initially, the Department recommended that more of the proposed rate increase be applied to the customer charge (than proposed by the Company), since the Department's CCOSS indicates a residential customer cost of $34.32. However, in its Initial Brief, the Department recommended adoption of the Company's proposal.

c. Seniors

The Seniors proposed that MP's minimum bill, which included the customer charge, be maintained at a low level and that any revenue to be recovered be recovered through the energy charges. The Seniors proposed that the customer charge not be increased to more than $5.00 even after a phased-in increase.

d. The ALJ

The ALJ found that the Company's proposed rate structure for residential rates should be revised. He recommended that it be revised so as to lessen the impact on low income ratepayers and to more reasonably share the increase with those residential ratepayers who are more able to pay.

He concluded that MP's proposal for residential rate design places most of the increase on the front end charge, the customer charge and lifeline block. This structure affects low income ratepayers more adversely than other residential ratepayers.

The ALJ found, as part of any future rate case filing containing large increases for residential customers, that the Company should file a plan for reducing the impact of the increase on low income residential customers.

e. Commission Action

The Commission will adopt the Company's proposal to increase the customer charge to $5.00 as part of the initial increase to residential rates. However, the Commission will not adopt the Company's proposal to apply the phased-in increase to the customer charge. Instead, the Commission will apply the phased-in increases in 1996 and 1997 to the energy rate blocks and not to the customer charge.

There are several reasons for this. First is the confusion and annoyance expressed by residential ratepayers at the prospect of a higher customer charge. The Commission finds that residential rates should be understandable and credible to those who pay them.

Second, the record of this case clearly demonstrates that increases to the customer charge create significant billing impacts on low use customers. The record also demonstrates that low income customers are least able to absorb a large rate increase. In addition, increases to the customer charge, as proposed by the Company and the Department, would have a significant billing impact on all customers taking service at the lifeline rate level.

Third, charges unrelated to usage conflict with conservation incentives, and the Commission is unwilling to send this anti-conservation signal to the residential class.

None of the reasons for increasing the customer charge, better resource allocation through more accurate price signals, greater revenue stability, fairer distribution of fixed costs, reach a level of importance that justifies the adoption of a confusing rate structure or one that will create rate shock for low use customers.

In sum, the Commission believes a $5.00 customer charge compares well across the country, and recognizes the economic situation of MP's residential ratepayers.

3. Residential Energy Charge

a. Minnesota Power's Proposal

The Company proposed to maintain a lifeline rate feature in its residential rate. MP's lifeline rate applies to all residential customers and it ensures that an essential level of usage is provided at an affordable level. MP's residential rate design also contains a declining tail block.

MP proposed an increase of 12% to the lifeline energy block, an increase of about 20% to the energy block for usage between 350 and 700 kWh (i.e. the mid block), and, an increase of about 15% for the tail block.

b. The Department

The Department testified that it has consistently recommended elimination of block rate structures because these rate structures have no cost basis. However, it noted that flattening the Company's block structure while imposing a large overall increase could have extreme billing impacts on low-use customers. Consequently, the Department proposed maintaining the Company's block rate structure. However, it recommended that MP move toward reducing and ultimately eliminating its block rate design in future rate cases.

c. Seniors

The Seniors proposed that the Company's customer charge remain at a low level and that any revenue to be recovered be recovered through the energy charges, first to the tail block and then to the mid block. This proposal results in flattening the rate for usage above 350 kWh.

The Seniors maintained that this rate design would help those most in need of help, and lets those who can most afford it to pay. According to the Seniors, this rate design proposal: (1) avoids disproportionately harsh billing impacts to low use customers; (2) promotes the conservation of energy; (3) promotes economic efficiency; and (4) promotes continuity in rates.

The Seniors noted, by January 1997, under MP's proposal for residential rates, the lifeline rate would increase by 33%. The customer charge would increase by 88%. The Seniors argued that the Commission look closely at how customers are effected at the various usage levels and not just to look at an "average" ratepayer.

The Seniors introduced Exhibit 104 into the record of the case. This Exhibit shows that low-use customers generally have less income and have small households. It maintained that kWh usage is not only related to income, but to household size as well. For this reason, the Seniors argued the greatest impact of MP's proposal is on small, low-income households.

d. Commission Action

The Commission supports the Company's proposal to maintain the lifeline rate feature of the residential rate. It also finds that, given the record in this case, increases as large as 33% are too dramatic for customers at this usage level (i.e. below 350 kWh). For these reasons, the Commission will adopt the proposal by the Seniors to apply the initial increase, first to the tail block, and next to usage above 350 kWh. The phased-in increase will be applied in equal percentage increases to all three rate blocks.

The Commission's intent is to apply the initial and phased-in increases to the three rate blocks in a way that will preserve the lifeline rate structure. The Commission is concerned that customers at the lifeline usage level (i.e. 350 kWh and below) be protected from dramatic rate increases.

The Commission notes, however, that it does not have information on billing impacts of this decision (given the revenue deficiency level authorized in this case). To the extent that billing impacts are too dramatic at any usage level, the Commission may modify the way in which the initial and phased-in increases are applied to the three rate blocks.

4. Customer Assistance Program for Low Income Customers

a. Seniors' Proposal

The Seniors witness Pam Marshall proposed a comprehensive customer assistance program to assist low income residential customers. She argued that Minn. Stat. 216B.16, subd. 14, passed in the 1994 legislative session, provides that the Commission may establish programs for low income residential ratepayers in order to ensure affordable reliable and continuous service to low income utility customers.

The Seniors' proposal for a customer assistance program included six components: affordability; arrearage forgiveness; shut-off protection; targeted conservation; coordination with Energy Assistance Program providers; and, the use of fuel funds for customers in a utility-related emergency.

The Seniors argued that customer assistance programs have been proven to reduce collection and write-off costs as well as other costs. They proposed that the Commission order MP to study all of the potential saving such a program has to offer and to design a program using those savings.

b. Minnesota Power

In response to the Seniors' proposal for a customer assistance program, Company witness Allen Harmon argued that MP's residential service was already priced at less than its full cost of service.

For this reason, the Company opposed further discounts to residential service. However, witness Harmon testified that the Company was willing to work with Commission and Department staff, and other interested parties to develop an assistance program, the cost of which could be offset by reduced credit and collection costs. He also testified that conservation program development, under the provisions of the CIP legislation targeting low income customers, should be done in separate CIP proceedings.

c. The Department

Department witness John Kundert testified that the Company's proposed rate increases and rate design may have a unbalanced effect on low use, low income customers. For this reason, he proposed that the Company be required to review its existing low income programs to see if these programs could be used to reduce rate impacts for low income customers.

Witness Kundert specifically noted that the Department is opposed to low income rates for residential customers. He argued that the redistribution of income is a function best left to the social welfare system. He also noted that the Department believes that arrearage forgiveness send an inappropriate signal to low income ratepayers and that the Commission's cold weather rule already provides shut-off protection during cold weather season. He also suggested that targeted conservation be discussed as part of the Company's CIP program.

Department witness Kundert suggested that a fuel fund based on voluntary contributions might be a reasonable addition to the Company's customer assistance program.

d. Commission Action

The Commission finds that a fuller review of all the potential components of a customer assistance program, as discussed in the record of the case, would be of benefit to MP and to all its customers. For this reason, the Commission will require the Company to work with the Commission, Department and RUD-OAG staff, and interested parties to discuss and/or develop a customer assistance program for low income residential customers.
This work group, among other things, should review: the six components of a customer assistance program as proposed by the Seniors, the existing and potential CIP programs for low income customers, and, the potential for a voluntary fuel fund as proposed by the Department.

The Commission notes that the Seniors testified that customer assistance programs in other states have reduced collection and write-off costs as well as other costs. Moreover, the Seniors have introduced evidence into the record showing that arrearage forgiveness programs have the potential to reduce rather than to create additional costs for the Company. The Commission would like the work group to explore these types of potential cost savings.

In addition, the Commission would like the work group to review all the programs under CIP that target low income customers. The Commission is concerned about the comparatively small portion of CIP funds that are directed to low-income customers given their numbers. The Commission is also concerned by the low participation rates that the Company has achieved in its low-income residential CIP programs as demonstrated by RUD-OAG Exhibit 31.

The Commission will expect a report from the work group within a reasonable period of time but no later than June 30, 1995.

4. Residential Duel Fuel Interruptible Service

The Company proposed to increase the rate for this service by 20% and to revise the interrupt provision to allow testing for Mid-Continent Area Power Pool (MAPP) certification.

The Senior Federation argued that the dual fuel rate was actually a promotional rate and should therefore be increased by more than the 20% proposed by MP.

The Department did not oppose the Company's proposal.

The Commission finds that the Company's proposals to increase the rate for Residential Dual Fuel Interruptible service by approximately 20% and to change the interrupt provision to allow for MAPP certification are reasonable and appropriate.

G. General Service Rate Design

1. Consolidation of General Service Rate Areas

a. Minnesota Power's Proposal

MP proposed to consolidate General Service Rate Areas I, II, and III into a single General Service Rate Area. The Company proposed the consolidation for the same reasons it proposed consolidation of the residential rate areas: current rate levels vary slightly by rate area; consolidation will simplify the general service rate; and, consolidation will reduce the administrative cost of applying the rate.

b. The Department

The Department recommended that the Company's proposal to consolidate the three general service rate areas be rejected for the same reason it recommended rejection of the proposal to consolidate the residential rate areas. According to the Department, there is no specific cost information to support the proposed change.

c. The ALJ

The ALJ rejected the Company's proposal to consolidate the three rate areas for General Service for the same reasons he rejected the proposal for the Residential Service.

d. Commission Action

The Commission adopts the Company's proposal to consolidate the three General Service Rate Areas. As in the case of the residential rate areas, the Commission expects that the consolidation will promote efficiency and reduce costs. It notes that the record does not demonstrate quantifiable cost savings from the consolidation. However, the Commission finds it reasonable to assume that some cost savings and certainly increased efficiencies will occur as a result of the consolidation.

To the extent that the existing classification into three rate areas is arbitrary and does not reflect cost, the Commission finds the existing separation to be unfair. The Commission notes that the situation in which two customers operate businesses next to each other but pay different rates often creates confusion. The consolidation of general service rate areas will eliminate this type of confusion.

2. General Service and Large Light and Power Interruptible Rider

The Company proposed a new Interruptible Rider as an alternative to its Commercial Dual Fuel Interruptible service for customers with loads over 200 kW. The Company proposed to set the discount at 20% percent of a customer's monthly bill.

The Department testified the Rider was appropriate but argued that a 20% discount or approximately a $3.50 per kW was not cost-effective. It asserted that an 11% discount or approximately $2.50 per kW was more appropriate.

The ALJ found the Rider, as proposed by the Company, to be reasonable and appropriate.

The Commission supports the Company's efforts to offer service options to its customers. However, the Commission agrees with the Department that the discount for taking service under this Rider should be cost-based. Therefore, the Commission finds it appropriate to authorize the Company to offer the General Service and Large Light and Power Interruptible Rider with an 11% discount.

H. Commercial and Industrial Service Rate Design

1. Commercial Dual Fuel Interruptible Service

a. Minnesota Power's Proposal

The Company proposed to increase the rate for this service by approximately 45%, to change the interrupt provision for this service to allow for MAPP certification, to close the service to new customers, and to eliminate the service to customers with loads over 200 kW as of December 31, 1999. The Company testified that it is concerned with the potential for revenue erosion if customers with loads over 200 kW take service under this rate and invest in self generation.

b. The Department

The Department supported the Company's proposed increase and change to the interrupt provision. However, the Department opposed the Company's recommendation to close the service to new customers and to eliminate the service for loads over 200 kW as of December 31, 1999. The Department argued that the Company's concerns about revenue erosion could be addressed by changing the rate for this service rather than eliminating it. It argued that this service is still meeting the needs of customers.

c. LLPG

The LLPG opposed the Company's proposal, arguing that the record lacked sufficient cost information to support the proposed increase of 45%. The LLPG asserted that eliminating this rate for customers with loads over 200 kW is unduly discriminatory and is also preferential to customers under 200 kW. The LLPG supported the Department's argument that the service should not be closed because it is still meeting the needs of customers.

d. The ALJ

The ALJ found the Company's proposals for Dual Fuel Interruptible service to be reasonable and appropriate. The ALJ agreed with the LLPG that the Company had not provided sufficient cost information to support the proposed changes. However, the ALJ adopted the Company's argument concerning revenue erosion and recommended that the Commission adopt MP's proposals.

e. Commission Action

The Commission finds there is sufficient cost information in the record to support the Company's proposed rate increase for Commercial Dual Fuel Interruptible service. The Company testified that an increase well in excess of 45% would be required to make this rate cost-based.

The Commission agrees with the Department that concerns about revenue erosion should be addressed by changing the rate and not by eliminating the service. The Commission finds this service is meeting the needs of customers and should remain open.

No party opposed the Company's proposed change to the interrupt provision to allow for MAPP certification. Therefore, the Commission finds the proposed change to the interrupt provision to be reasonable and approves it.

I. Large Power Service Rate Design

1. Large Power Energy Rate

The Company originally proposed an LP energy rate of 1.02 cents/kWh. The Department objected to the rate, arguing that the Company should set the energy charge based on its average incremental energy cost. During the case, the Company updated its class cost of service study and determined an energy unit cost of 1.33 cents/kWh. The Department indicated that the updated energy charge addressed its concerns.

The LPI supported the Company's updated energy charge.

The Commission adopts the updated LP energy charge of 1.33 cents/kWh as reasonable and appropriate.

2. Large Power Service Non-Contract Rate

The issue before the Commission is whether to allow the Company to reinstate its Non-Contract rate and the companion Rider for Revenue Credit.

a. Minnesota Power's Proposal

The Company proposed to reinstate the Large Power Non-Contract Rate Service schedule 58/78 that was approved in 1987 and expired in April 1991. This schedule would be made available to customers with load requirements of 10 MW or more, who are unable to enter into long-term contractual commitments for service under the standard Large Power Service Schedule 54/74.

The rates proposed for Non-Contract service, as proposed, are based upon the rates approved by the Commission for standard Large Power Service. The Demand Charge and the Service Voltage Adjustment for Non-Contract service is set at 120% of the charges approved for standard Large Power Service. The Company suggested that the 20% adder is included as a risk premium for providing this type of service.

The Company also proposed to reinstate the Rider for Revenue Credit to provide a mechanism to flow the revenues resulting from the 20% adder back to all retail customers (except Non-Contract) on the Company's system.

b. The Department

The Department supported the Company's proposal arguing that a 20% premium is appropriate for LP customers unwilling to make long-term contract commitments.

c. Potlatch and Eveleth

Potlatch and Eveleth argued that the 20% adder was not cost justified and, as proposed, exacts too high a penalty to customers unwilling or unable to enter into long-term take-or-pay commitments. Eveleth argued further that equity was being sacrificed in order to reduce the risk to MP.

d. The ALJ

The ALJ found the Company's proposal to be reasonable and appropriate and recommended adoption by the Commission.

e. Commission Action

The Commission agrees with the Department and the ALJ and finds that the Company's proposal to reinstate the Non-Contract rate and the Rider for Revenue Credit reasonable and appropriate and will authorize the Company to reinstate the Rate and Rider.

The Commission believes the Non-Contract rate is an appropriate alternative rate for LP customers who decline to commit to the standard long-term contracts. The Commission finds that there are costs to MP's other ratepayers associated with the absence of long-term commitments from large customers, such as perceived risk by investors and the additional uncertainty to long-term planning. The Commission concludes that MP's proposed Non-Contract rate, including the 20% demand charge premium, and the companion Rider for Revenue Credit should be approved.

3. Large Power Excess Demand Discount

The issue before the Commission is whether to eliminate the excess demand charge discount for demand in excess of contract demand.

a. The Department

The Department recommended the elimination of the excess demand discount. The discount is currently a standard feature of the LP rate which gives a reduced demand charge (a $5.00 per kW discount) for demand taken in excess of a customer's contract demand.

The Department argued the initial justification for the excess demand discount, namely that the Company no longer has excess capacity and no longer needs to market capacity, is no longer valid. The demand discount prices short-term power cheaper than long-term power, thereby encouraging LP customers to postpone long-term power commitments. The Department suggested that eliminating the discount would also eliminate an inappropriate price signal.

Finally, the Department recommended that the Company be allowed to continue to offer excess demand but without the discount, and use the revenues generated to lower the demand charge for long-term contract demand.

b. Minnesota Power

MP opposed the Department's recommendation, arguing that the discount is a necessary tool for meeting customers' needs, for encouraging sales to utilize existing capacity, and for providing flexibility to customers' production requirements. The Company also argued that the elimination of the discount would significantly reduce excess power sales.

c. LPI and Potlatch

The LPI and Potlatch also opposed the elimination of the excess demand discount. These parties indicated that no Large Power customers supported the Department's proposal and that the revenue impact was restricted to the Large Power class. These parties also argued that the excess demand discount prevents customers from taking advantage of marginal production decisions.

Furthermore, LPI and Potlatch indicated that customers have relied upon the discount in planning their operations and establishing long-term contract levels of demand. MP has used the discount to help it obtain LP contract extensions and renewals and should be allowed to continue to do so.

Finally, the LPI and Potlatch agreed with the Company and argued that the excess demand discount is critical to meeting industrial customers future competitive requirements and should remain available to encourage sales to utilize existing capacity, encourage incremental taconite and wood products production in Minnesota, and provide flexibility to customers to adjust to changed production requirements.

d. The ALJ

The ALJ found that it was reasonable and appropriate to continue the Excess Demand Discount. He indicated that the discount continues to be necessary for the following purposes: to encourage sales to utilize existing generating capacity, to encourage incremental taconite and wood products production in Minnesota, and to provide flexibility to customers to adjust to changed production requirements.

e. Commission Action

The Commission approved the offering of the excess demand discount in the Company's 1987 rate case, finding that the discount and its residual benefits made sound economic sense.

The Department argued that the excess demand charge discount encourages customers to delay or avoid long-term commitments. The LPI and Potlatch, on the other hand, argued that the discount is appropriately used by MP to obtain contract extensions and renewals. The Commission agrees with both of these arguments and finds that the additional benefits of offering the discount, as identified by the Company, the LPI, and Potlatch, provide good reasons for maintaining the status quo.

The excess demand discount encourages customers to increase production if opportunities to sell their product are available without penalizing the user with a permanent upward ratchet in contract demand. The change in MP's capacity situation suggests that the excess demand discount makes less economic sense now than when it was first approved by the Commission in 1987. However, if the excess demand discount remains available, LP customers maintain production flexibility, MP is still afforded the opportunity to obtain revenues from utility plant that may otherwise remain idle, and additional variable and fixed costs are recovered that would otherwise be borne by MP or its other ratepayers.

Similar to the Department, the Commission has a long standing policy of encouraging Large Power customers to make long-term commitments with MP. However, the Commission finds nothing in the record of this case which seriously negates the economic benefits the Company and its ratepayers receive from offering the excess demand discount. Therefore, the Commission adopts the Company and the ALJ's position here and rejects the Department's recommendation to eliminate the excess demand discount.

4. Real Time Energy Pricing for Large Power Customers

The issue before the Commission is whether to require the Company to study real-time energy pricing and provide a report to the Commission one year from the date of the Order in this case.

The Department recommended that MP be required to study the use of real-time energy pricing to be implemented as quickly as practicable. The Department originally proposed that a report be submitted to the Commission within six months of the Order in this proceeding, but later agreed that a one year time frame was appropriate.

Potlatch supported the Department's recommendation to study real-time energy pricing and the submission of a report to the Commission within one year. Potlatch also requested that the Commission require the Company to allow for meaningful participation by interested customers.

The Company agreed that the Department's proposal for a study of real-time energy pricing was appropriate under a one year time line for submission of the report to the Commission.

The Commission finds the Department's recommendation to have the Company study real-time energy pricing and file a report on its findings with the Commission within one year of the date of the Order in this case to be reasonable and appropriate.

It is the Commission's impression that the Company already works closely with its LP customers in designing and implementing services for that class. Nevertheless, the Commission will require the Company to facilitate meaningful customer participation in the process of the real-time energy study as requested by Potlatch.

5. Large Power Unused Demand Charge

The issue before the Commission is whether to modify the billing demand ratchet for contract demand in excess of measured billing demand to provide a $4.50 per kW month reduction from the standard LP demand charge.

a. LPI's Proposal

The LPI proposed to retain the billing demand ratchet provision in the LP tariff, and recommended that the charge for demand that is not actually used but for which the customer must make payment under the 100% demand ratchet. The LPI suggested that the contract demand in excess of measured demand be billed at $4.50 per kW month less than the standard LP demand charge. The $4.50 per kW month discount is based upon the LPI's calculation of the amount that LP customers are paying to subsidize current below-cost residential rates.

The LPI argued that the Company should bear the risk associated with the subsidy to residential customers. It noted that this proposal has no impact on any other rate class.

b. Minnesota Power

The Company opposed the LPI proposal, arguing that it would result in considerable risk of revenue instability and unrecovered fixed costs for the Company. MP further contended that the LPI's proposal does not recognize the billing and operational flexibility the Company has already incorporated into LP contracts. The Company noted that the 100% billing demand ratchet was designed so that MP's fixed costs remain the same whether customers are operating or not.

c. The Department

The Department also opposed the LPI proposal arguing that the demand ratchet is an important revenue-stabilizing tool and is an integral part of MP's strategy to insulate itself and its ratepayers from the business fluctuations of its LP customers. MP should not be expected to transfer the business risks of some of its customers to other ratepayers.

d. The ALJ

The ALJ found that the LPI proposal would introduce considerable risk of revenue instability and unrecovered fixed costs for MP and, therefore, should be rejected.

e. Commission Action

The Commission adopts the finding of the ALJ on the issue of "unused demand." The LPI proposal would introduce substantial risk to MP due to revenue instability and unrecovered fixed costs. The demand charge billing ratchet was designed to recognize the fact that MP's fixed costs are the same regardless of whether customers are operating or not.

The Commission finds that nothing has changed to warrant any reduction in the recovery of fixed costs to the Company. The Commission also finds that the Company has made significant efforts to provide customers with billing and operational flexibility and believes it is inappropriate to transfer the business risk of some of its customers to the other ratepayers.

6. Measurement of Large Power Demand

The issue for the Commission is whether the current method of measuring LP demand should be modified. Under the Company's current LP rate, measured demand is established based upon the highest 15 minute demand at any time during the month.

a. LPI's Proposal

The LPI proposed that a LP customer's demand be measured during the 15 minute period of the customer's greatest use during the peak period of the month. The LPI suggested that this type of measurement would recognize the fact that it costs the Company almost nothing when individual customer peak demands occur during off-peak periods.

b. Minnesota Power

The Company opposed the LPI's recommendation, arguing that the LPI proposal would result in reduced billing demand for LP customers since the highest off-peak loads would not be considered for billing purposes. The Company further argued that the LPI recommendation would present further risk to the Company that customers would shift substantial amounts of load to off-peak periods which would further reduce billing demand and result in reduced revenues.

The Department also opposed the LPI proposal to modify the way in which LP demand is measured. The Department argued that the proposal would promote revenue instability and would allow LP customers to avoid contributing to the recovery of MP's fixed costs by shifting their consumption to off-peak periods. The Department urged the Commission not to allow risk to be inappropriately shifted to MP and its ratepayers.

c. The ALJ

The ALJ recommended that the LPI proposal to modify the way measured demand is determined be rejected. He concluded that the proposal would result in reduced billing demand for LP customers and would present further risk that customer operations would shift on-peak to off-peak periods, further reducing billing demands and revenues.

d. Commission Action

The Commission agrees with the Company, the Department, and the ALJ and finds the LPI proposal to modify the way measured demand is determined to be inappropriate. The LPI proposal, while it would reduce LP customer bills, would likely increase risk to the Company and its other ratepayers by promoting revenue instability, providing an inappropriate incentive to shift load off-peak, resulting in reduced revenues. For these reasons, the Commission rejects the LPI proposal.

7. Large Power Contract Terms and Extensions

The issue for the Commission is whether to reduce the initial term of the LP tariff from 10 years to five years and to reduce the notice of cancellation period from four years to one year.

a. LPI's Proposal

The LPI proposed to revise the LP tariff to require a five year initial term and a one year cancellation period. In support of its proposal the LPI argued that the reasons for previously requiring lengthy contract terms are no longer valid. The LPI noted that in the 1970's MP built substantial generating capacity to serve the LP class. These facilities are now used to serve a wide array of customer loads and, therefore, there is no justification for requiring long-term commitments.

b. Eveleth's Proposal

Eveleth proposed to reduce the cancellation notice to one year and to make LP interruptible power available to customers without requiring contract extensions. Eveleth argued that the cost to taconite customers of a 10 year commitment is prohibitive.

Eveleth further argued that MP's requirement of lengthy contract extensions to qualify for interruptible load has a negative effect on the taconite customers that are most vulnerable to the market forces of the taconite industry.

c. Minnesota Power

The Company opposed the proposals by the LPI and Eveleth to change the contract terms for LP service. It argued the four year notice of cancellation provision is critical to the Company's forecasting, bulk marketing, and resource planning efforts. In addition, the provision serves as a guide by which financial markets assess the Company's future revenues and financial stability. Any reduction of the contract terms would increase the Company's risk and would result in higher return on equity requirements, with corresponding higher rates.

The Company noted that flexibility exists under current rates to provide for shorter term initial contracts for new LP customers who do not require significant capital investment in facilities.

d. The Department

The Department recommended that the contract terms for LP service not be changed. The Department asserted that economic conditions have not changed such that long-term take-or-pay commitments are now unnecessary. The Company continues to incur significant fixed costs. A reduction in the contract terms for LP service would only serve to inappropriately shift risk from LP customers to MP and its ratepayers.

e. The ALJ

The ALJ recommended that the proposals to reduce LP contract terms be rejected. He adopted the arguments put forth by the Company.

f. Commission Action

The Commission finds that the proposals to reduce the contract terms for Large Power service are inappropriate and should be rejected. The Commission agrees with the Department that economic conditions have not changed sufficiently to justify altering the terms of service. Reducing the contract terms would inappropriately shift risk from the LP class to the Company and its other ratepayers. This shift in risk would result in higher return on equity requirements, with correspondingly higher rates.

The Commission also finds that the four year cancellation provision is important to the Company's ability to conduct load forecasting, to sell power in the bulk power market, and to plan for its future resource needs.

Eveleth proposed that the Company be required to provide LP customers interruptible power without requiring lengthy contract extensions. The Commission finds this recommendation to be inappropriate.

The Commission notes that the interruptible service the Company provides its LP customers is unique among Minnesota utilities and requires even longer term commitments from participating customers. The Company offers interruptible service with a $5.00 per kW month discount and attempts to offset the cost of the discount by selling the power made available in the bulk power market.

Absent long-term commitments from participating customers, all of the costs and risk associated with interruptible service would be shifted to MP and its ratepayers and could not justify the present level of the discount. The requirement of long-term commitments offsets what is, in the short run, a discount level that is not cost-based. For this reason, the Commission rejects Eveleth's proposal.

J. Uncontested Rate Design Issues

1. Residential Service Issues

The Company proposed a Residential Controlled Access Service tariff for controlled-storage space-heating and/or water heating loads served during the time period 11 p.m. to 7 a.m. and supplied through one meter. The tariff consists of a monthly service charge and an energy charges.

The Department recommended the Commission approve the proposed tariff. No party opposed the Company's proposal. The Commission finds it reasonable to authorize the Company to offer this service.

2. General Service Issues

a. General Service Rate Design

The General Service tariff is available to non-residential customers whose total electric requirements are supplied through one meter and whose total power requirements are less than 10,000 kWh. Customers whose quarterly use exceeds 2,500 kWh, or whose connected loads exceed 10 kW, are required to have a demand meter. For customers without a meter, the General Service tariff includes a customer charge and an energy charge. For customers with a demand meter, the tariff includes customer, demand and energy charges.

The Company proposed higher percentage increases for the customer and demand charges than the energy charge. The Department supported the Company's proposed allocation of the increase among the customer, demand, and energy charges. No other party addressed this issue.

The Commission will not adopt the Company's proposal to increase the customer and demand charges by a greater percentage than the energy charge for this service. Instead, the Commission finds it appropriate to require MP to increase the customer and demand charges by the same or no greater percentage than the energy charge.

In general, where appropriate, the Commission prefers to increase energy charges rather than fixed charges. By placing an increase in an energy charge rather than a fixed charge, customers are more likely to see differences in their bills based on variable energy consumption.

b. General Service Discount for High Voltage Service

The Company proposed to increase the discount for high voltage service, to more closely track a differential in costs that results from serving customers at higher voltage levels. The present rate has a discount of $0.50 per kW for customers receiving service above 13,000 volts. Under the Company's proposal, General Service customers receiving service between 13,000 and 115,000 volts will receive a $1.00 per kW discount, while those receiving service at or above 115,000 volts (transmission voltage) will receive the equivalent of a $2.00 per kW discount.

The Department testified that the voltage discount for General Service customers as proposed by the Company was cost justified. No party opposed the Company's proposal. The Commission finds it reasonable to authorize the Company to increase the discounts for high voltage service as described above.

c. General Service Power Factor Adjustment

The Company proposed placing a limit on the adjustment provision for General Service customers having a poor power factor. Under present rates, there is no limiting provision. The proposed adjustment provision restricts the adjustment factor applied to the customer's billing demand to slightly less than two. This would provide General Service customers with a more reasonable penalty for poor power factors.

The Department noted that a limit on the adjustment for poor power factors imposes a more reasonable penalty on customers and recommended approval of the provision. No party opposed the Company's proposal. The Commission finds it reasonable to authorize the Company to apply such an adjustment provision.

d. General Service Non-Metered Rider

The Company proposed a General Service non-metered rider applicable to any General Service customer whose operation is not practical to meter at the point of service. Under this proposal, customers would pay the standard General Service customer and energy charges. Monthly usage is estimated for five, different non-metered customers. Billing to non-metered customers are based on those usage characterizations.

The Department concluded the estimated charges for the service were reasonable and recommended adoption. No party opposed the Company's proposal. The Commission finds it reasonable to authorize the Company to offer this rider as described above.

e. General Service Controlled Access Electric Service

The Company proposed a General Service Controlled Access Electric Service tariff. It will be available for controlled-storage space-heating and/or water heating loads that are served daily between 11 p.m. and 7 a.m. and supplied through one meter. The proposed tariff consists of a customer charge and an energy charge.

The Department noted that the Company supplied adequate cost information to support the proposed service and recommended approval. No party opposed the Company's proposal. The Commission finds it reasonable to authorize the Company to offer this service as described above.

3. Large Light and Power Service Issues

a. Large Light and Power Service Rate Design

The Large Light and Power tariff is available to customers whose total electric requirements are supplied at one point and whose total power requirements are less than 10,000 kW. The tariff includes a minimum demand charge, incremental demand charges for additional billing demand over 100 kW, and energy charges.

The Company proposed greater percentage increases for the customer and demand charges than the energy charge for this service. Specifically, the Company proposed to increase the customer charge from $790.00 to $950.00 for Large Light and Power schedules 55 and 75.

The Department testified that its cost study indicated that the customer and demand charges for this service are currently priced below cost. The Department supported the Company's proposal to move these rates toward cost, and to increase the customer and demand charges by a higher percentage increase than the energy charge.

No party opposed the Company's proposal. The Commission finds it reasonable to authorize the Company to increase its customer, demand and energy charges for this service as proposed above.

b. Large Light and Power Discount for High Voltage Service

The Company proposed a discount for high voltage service for the Large Light and Power tariff that mirrors its proposal for the General Service tariff.

The Department testified that the high voltage discount proposed by the Company is cost justified and recommended approval. No party opposed the Company's proposal. The Commission finds it reasonable to authorize the Company to offer this discount.

c. Large Light and Power Factor Adjustment

The Company proposed a limit to adjust billing demand for poor power factors for LL&P customers that mirrors its proposal for the General Service tariff.

The Department testified that the Company's proposal for a limit to adjustments for poor power factors provides a more reasonable penalty for these customers. It recommended approval of the proposal. The Commission finds it reasonable to authorize the Company to adjust LL&P Service billing demand for poor power factors as proposed.

d. Rider for Schools Associated with Large Light and Power Schedules 55/75

The Rider for Schools applies to LL&P Service Schedules 55 and 75 for schools, which are part of the elementary and secondary school system. Under this Rider, the rate (and other provisions) of "other applicable schedules" apply. The Company proposed an increase to the first 100 kW block of Demand Charge under this Rider. It also proposed the same limit on the adjustment for power factors suggested for the General Service.

No party opposed the Company's proposal. The Commission finds it reasonable to authorize the Company to make these changes as proposed.

e. Large Light and Power Service Reduction in Demand Ratchet

In Rebuttal testimony, the Company proposed a reduction in the LL&P Rate Schedules 55/75 demand ratchet from 90% to 75%. The Company asserted that the 75% ratchet level would still maintain reasonable incentive for LL&P customers to operate at an efficient level. Yet, this level of ratchet still provides an opportunity for customers to increase production on a short-term basis in order to compete for spot-market or short-term sales.

No party opposed the Company's proposal. The Commission finds it reasonable to authorize the Company to reduce the demand ratchet for this service as proposed.

4. Municipal Pumping Service Issues

a. Municipal Pumping Service Rate Design

The Municipal Pumping Service is available to municipalities for the operation of water-pumping and sewage-disposal facilities whose electric requirements are supplied at one point. For customers without a demand meter, the tariff includes a customer charge and an energy charge. For customers with a demand meter, the tariff includes customer, demand and energy charges.

The Company proposed that the customer and demand charges be increased by a greater percentage than the energy charges. The Department noted that the Company's cost study indicated that the customer and demand charges are priced below cost. In an effort to move these rates toward cost, the Department recommended that these rates receive a larger increase than the energy rate.

The Commission will not adopt the Company's proposal to increase the customer and demand charges for this service by a greater percentage than the energy charge for this service. Instead, the Commission finds it appropriate to require the Company to increase the customer and demand charges by the same or no greater percentage than the energy charge.

In general, where appropriate, the Commission prefers to increase energy charges rather than fixed charges. By placing an increase in an energy charge rather than a fixed charge, customers are more likely to see differences in their bills based on variable energy consumption.

b. Municipal Pumping High Voltage Discount

The Company proposed a discount for high voltage service for Municipal Pumping Service that mirrors its proposal for the General Service and LL&P tariffs.

The Department recommended approval of the Company's proposal for a high voltage discount. It relied on the same reasoning given for its support of the discount for the General Service and LL&P tariffs. The Commission finds it reasonable to authorize the Company to offer the discount as proposed.

c. Municipal Pumping Billing Adjustment for Poor Power Factors

The Company proposed a limit to adjust billing demand for poor power factors for Municipal Pumping customers that mirrors its proposal for the General Service and LL&P tariffs.

The Department testified that the Company's proposal for a limit to adjustments for poor power factors provides a more reasonable penalty for these customers. It recommended approval of the proposal. The Commission finds it reasonable to authorize the Company to adjust Municipal Pumping Service billing demand for poor power factors as proposed.

5. Lighting Service

The Company's Lighting Service is available to customers for outdoor lighting purposes. The Lighting Service tariff includes a flat monthly charge for each lamp.

The Company proposed several intra-class rate changes to this service. In addition, the Company proposed a monthly estimated kWh usage amount to replace the current annual average usage amount. The Company also proposed to consolidate the current Area and Outdoor Lighting Services into one schedule, and the Street Lighting, Ornamental Lighting, Highway Lighting, and International Falls Street Lighting into a second schedule. Finally, the Company proposed to discontinue the Tower Light and Traffic Controller rate under Highway Lighting.

The Department recommended approval of all the Company's proposed changes to this service. The Department noted that the Company's replacement-cost study indicates that the monthly replacement-cost revenue requirement varies significantly by technology. The Department also testified that the intra-class changes are a justifiable effort to move these rates closer to cost. It testified that the introduction of monthly usage levels will better match usage levels and costs.

The Department also supported approval of the Company's proposed schedule consolidations and the discontinuance of the Tower Light and Traffic Controller rates under Highway Lighting. It testified that both these proposed changes promote administrative ease. It noted that the Tower Light and Traffic Controller services have not been used for a number of years.

The Commission finds it reasonable to authorize the Company to make the proposed changes to the Lighting Service. The Commission also finds it reasonable to authorize the Company to apply the revenue deficiency allocated to the Lighting class in a way that will better align rates with costs.

6. Large Power Service

The Company proposed changes to the Surcharge Provision of the LP schedule 54/74. No party opposed the Company's proposed change to this provision. The Commission finds it reasonable to authorize the Company to make the change.

The Company also proposed changes to the Rider for Implementing Company's "Best Efforts" Marketing Policy for the LP class. No party opposed the Company's changes to this Rider. The Commission finds it reasonable to authorize the Company to make the proposed changes to this Rider.

The Company currently offers a service voltage adjustment as part of its LP tariff. No party opposed the Company's proposed adjustment. The Commission finds this provision is reasonable and will authorize the Company to continue this adjustment.

7. Rider for Fuel Adjustment

The Rider for Fuel Adjustment applies to electric service under all the Company's retail rate schedules (except Competitive Rate Schedules, Seasonal Residential Service, and Traffic and

Police Signal Rate Code 65).

The Company proposed changes to the conditions in the Rider for Fuel Adjustment. It also proposed to include a new base cost of fuel of 1.018 cents per kWh. (This new base cost of fuel was approved in Docket No. E-015/MR-94-2.)

No party opposed these changes. The Commission finds it reasonable to authorize the Company to make these changes.

8. Technical Terms and Abbreviations

The Company proposed changes in its listing of Technical Terms and Abbreviations. No party opposed these changes. The Commission finds it reasonable to authorize the Company to make them.

XVII. OVERALL FINANCIAL SUMMARIES

A. Rate Base Summary

In its original filing, the Company proposed a rate base of $483,657,724. Incorporating the above findings, the Commission concludes that the rate base for the test year is $485,896,166 (including the effects of SFAS 106 and the 1994 effects of the National Stipulation) as shown below:

Utility Plant in Service	$1,023,868,262
Less: Accumulated Depreciation	-380,870,938
Net Utility Plant in Service	642,997,324
Construction Work in Progress	9,421,886
Working Capital:	
Cash	-28,815,840
Materials and Supplies	8,535,051
Fuel	6,630,885
Prepayments	7,682,243
Accumulated Deferred Income Tax	-151,641,557
Customer Advances and Deposits	-927,839
Unamortized Rate Case Expense	398,588
Unamortized Transmission Charge	-10,190,779
Unamortized LP Contract Payments	1,806,204
Total Average Rate Base	$ 485,896,166

B. Operating Income Statement Summary

The Company proposed an operating income of $27,114,613 in the original filing. Incorporating the above findings, the Commission concludes that the operating income for the test year (including the effects of SFAS 106 and the 1994 effects of the National Stipulation) is $31,890,642 as shown below:

Operating Revenues	
Sales of Electricity by Rate Class	$270,010,391
LP Interruptible, Dual Fuel	26,266,450
Other Electric Revenues	33,863,764
Other Revenues	1,988,766
Total Operating Revenues	332,129,371
Operating Expenses	
Operations and Maintenance	222,353,727
Depreciation	31,031,395
Amortization	1,092,799
Taxes Other Than Income	36,326,133
State Income Tax	3,509,025
Federal Income Tax	10,766,279
Provision for Deferred Tax (net)	-3,067,577
Investment Tax Credit	-1,350,982
Total Operating Expenses	300,660,799
Operating Income Before AFUDC	31,468,572
AFUDC	422,070
NET OPERATING INCOME	$ 31,890,642

C. Gross Revenue Deficiency

Based on the Commission findings and conclusions, the Minnesota jurisdictional gross revenue deficiency for final rates for the test year (including the effects of SFAS 106 and the 1994 effects of the National Stipulation) is $22,929,330 as shown below:

Rate Base	$485,896,166
Rate of Return	9.33%
Required Operating Income	45,334,112
Test Year Net Operating Income	31,890,642
Operating Income Deficiency	13,443,470
Revenue Conversion Factor	1.705611
Revenue Deficiency	$ 22,929,330

In the test year income statement, the Commission found revenues from sales of electricity by rate class and dual fuel/LP interruptible of $296,276,841. Increasing revenues by $22,929,330 results in total authorized Minnesota revenues in these categories of $319,206,171 for final rates for the test year.

As discussed in the National Stipulation section of this Order, the stipulation reduces MP's revenue deficiency by $3,944,854 to $18,984,476, based on stipulated revenues of $298,025,022. Rates effective January 1, 1995 should reflect the provisions of the National Stipulation.

ORDER

1. Minnesota Power is entitled to increase gross annual revenues from Minnesota sales of electricity by rate class and dual fuel/LP interruptible of $22,929,330 to produce authorized revenues from these categories of $319,206,171. For rates effective January 1, 1995, the increase is reduced by $3,944,854 resulting from the National Stipulation as discussed herein.

2. Within 30 days of the date of this Order, the Company shall file with the Commission and the Department and serve on the parties a revised base cost of fuel and supporting schedules incorporating the changes made herein. The Company shall also file a fuel clause adjustment to be in effect at the time final rates become effective. The Department shall review these filings in the same manner as any other automatic adjustment filings.

3. Within 30 days of the date of this Order, the Company shall calculate the amount of results sharing and incentive compensation included in test year expense which exceeds the 15 percent of base compensation limit per individual employee discussed herein. The Company shall include the adjustment in establishing its authorized rate level and interim rate refund. This information shall be filed with the Commission and served upon all parties to this proceeding.

4. Within 30 days of the date of this Order, the Company shall file with the Commission for its review and approval, and serve upon all parties to this proceeding, a proposal to make refunds, including interest calculated at the average prime rate, to affected customers. The proposal shall reflect the difference between the revenue collected during the interim rate period and the amount authorized herein, taking into account the refund adjustments discussed herein.

5. Within 60 days after all administrative review of this Order has been exhausted, the Company shall file with the Commission, and serve on all parties, a report of its actual rate case expenditures in this docket.

6. MP is authorized to commence decommissioning cost recovery effective with the date of implementation of final rates in this proceeding as discussed herein. MP shall prepare a contingency plan in the event that Hibbard units 3 and 4 are restarted, including a comprehensive evaluation of the appropriate remaining life for these units. MP shall address the contingency plan and decommissioning issues in future depreciation studies and filings.

7. Within 30 days of the date of this Order, MP shall file with the Commission, and serve on all parties, its calculations of lost margin per kWh reflecting the rate changes resulting from this proceeding.

8. MP shall set its conservation program adjustment (CPA) at zero effective with the date of implementation of final rates resulting from this proceeding. The CPA shall be collected on a percentage of revenue basis in the future.

9. On or before April 1, 1995, and annually thereafter, MP shall file with the Commission, and serve on all parties, its report of lost margins, CPA proposal, and evaluation of the CIP tracker balance.

10. The return on equity for MP is 11.60 percent, which combined with other factors results in an overall rate of return of 9.33 percent, calculated as shown in the body of this Order.

11. The Commission accepts and adopts the Stipulation for Order Reopening the Record as filed on September 9, 1994.

12. Within 30 days of the date of this Order, the Company shall file with the Commission for review and approval, and serve on all parties to this proceeding, revised schedules of rates and charges reflecting the revenue requirement and the rate design decisions contained herein, along with the proposed effective date.

13. Within 12 months of the date of this Order, the Company shall file with the Commission, and serve upon all the parties to this proceeding, a report on the study of real-time energy pricing.

14. Parties shall have 15 days to comment on the filings required in Ordering Paragraphs 12 and 13.

15. On or before June 30, 1995 the Company shall file with the Commission, and serve upon the Department, the RUD-OAG and the Senior Federation, a report summarizing the progress of the low income customer assistance work group.

16. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

(S E A L)