

E-017/S-93-1091 ORDER APPROVING CAPITAL STRUCTURE

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

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

In the Matter of the Petition of Otter Tail Power Company for Approval of its 1994 Estimated Capital Structure Prior to the Issuance of Securities for Calendar-Year 1994	ISSUE DATE: January 26, 1994 DOCKET NO. E-017/S-93-1091 ORDER APPROVING CAPITAL STRUCTURE
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PROCEDURAL HISTORY

On October 29, 1993, Otter Tail Power Company (OTP or the Company) filed its annual request for approval of its capital structure and permission to issue securities for calendar year 1994.

On November 16, 1993, the Minnesota Department of Public Service (the Department) filed its Report of Investigation and Recommendation in this matter. The Department recommended that the Commission approve the Company's petition.

On January 6, 1994, the Commission met to consider this matter.

FINDINGS AND CONCLUSIONS

Overview

In the course of reviewing the 1992 annual capital structure filings, the Commission has developed a growing concern regarding its statutory responsibility to provide regulatory oversight of utilities' capital structures. In this Order, the Commission will accept the Department's recommendation to approve OTP's proposed capital structure, but will adopt procedural measures which will improve the Commission's ability to execute its statutory oversight responsibilities in this area. Specifically, the Commission will narrow the range that the Company may vary from its best estimate capital structure before being required to seek additional Commission authorization.

Background

Minnesota law requires public utilities that are incorporated in the State of Minnesota or that encumber property in the state to obtain Commission approval of their capital structures prior to issuing securities. Minn. Stat. § 216B.49 (1992). The statute gives the Commission a great deal of discretion on how it approaches capital structure reviews. It sets out a number of elements the Commission must consider and approve, but does not specify a particular procedure for doing so.

Review of a utility's securities issuances and resulting capital structure is important for several reasons. The cost of capital is related to the utility's capital structure; as the proportion of debt increases, added financial risk can result in higher costs for both debt and equity capital. If the proportion of debt is high, fixed charges will be high, which can create financial stress in times of low earnings. Excessive indebtedness can lead to inability to meet obligations and eventual bankruptcy. In theory, if a company is over-capitalized and needs additional revenue to meet its fixed obligations, a commission may be placed in the position of allowing the company to raise rates to meet its fixed obligations, or face financial stress. The financial stress could make it difficult for the utility to attract capital in the future. For these reasons over-capitalization does affect the rates and services of public utilities. Finally, there has been increased concern recently over utility diversification in non-utility ventures. Diversification has the potential to increase risk and cost of capital for utilities and could be reflected in rates. The capital structure review may provide an opportunity to study these kinds of utility activities and their potential impacts.

Commission Analysis

In this case, OTP has proposed a "contingency" or "maximum" capital structure that exceeds its "best estimate" capital structure by \$86,442,000 or 23 percent. This comparison excludes the \$50 million of short-term debt the Company has included in its request. The short-term debt provides an additional \$50 million, or 13 percent, in financing. In total, the Company has requested authorization to issue an amount which is approximately 14 times greater than the \$9,101,000 estimated increase in total capitalization.

The Commission recognizes the practicality of authorizing some contingency amounts. Different capital structures will exist during the course of the year, depending on which securities have been issued at that point. In addition, it is impossible to be certain exactly what level of issuances will be needed during the year, due to uncertainties over interest rates, stock market conditions, construction plans, and other financing needs. Also, utility earnings cannot be predicted with accuracy.

The utility's need for flexibility, however, must be balanced with the need for regulatory oversight by the Commission. The process of capital structure approval becomes essentially meaningless if too broad a range of contingencies for different classes of securities and/or total capitalization is allowed. In this case, the Commission finds that the Company's request fails to meet that balance.

Commission Action

Having considered the needs of the Company for flexibility and the need to establish more realistic Commission oversight, the Commission will approve the following contingency ranges:

Equity ratio contingency range: the Commission will establish a contingency window (+ or - 10 percent) around the Company's approved "best estimate" equity ratio of 45.28 percent. Equity ratios within that window (i.e. at or below 40.75 percent or at or above 49.81 percent) are approved. In addition, equity ratios that do not exceed 49.81 percent or fall below 40.75 percent for a period exceeding 60 days are also authorized. Those that fall outside the window for a period in excess of 60 days are not authorized by this Order. As soon as it becomes clear that a contemplated financial transaction would cause the Company's equity ratio to fall outside the window (i.e. exceed 49.81 percent or fall below 40.75 percent) for a period exceeding 60 days, the Company must seek Commission approval for this variation.

Total capitalization contingency range: rather than approve "maximum" issuance amounts for each capital component as requested by the Company, the Commission will adopt a contingency cap on total capitalization: 10 percent above \$384,136,000 (the approved total capitalization) or \$422,549,000. Any securities issuance that results in total capitalization below the cap (i.e. below \$422,549,000) is authorized. In addition, total capitalizations that exceed the cap for fewer than 60 days are also approved. As soon as it becomes clear, however, that a contemplated financial transaction would cause the Company's total capitalization to exceed \$422,549,000 for a period in excess of 60 days, the Company will be required to seek approval from the Commission for that variation.

With the adoption of these reasonable parameters, the Commission has established both an appropriate range for Company discretion and clear triggers for further authorization proceedings before the Commission if that range would be exceeded.

In addition to these modifications to the Company's proposal, the Commission will clarify that the authorization granted in this Order shall run for a period of one year from the date of this Order.

ORDER

1. The estimated capital structure submitted by Otter Tail Power Company (OTP or the Company) is approved. The contingency ranges for equity ratio and total capitalization are approved as set forth in the body of this Order at page 3.
2. For a period of one year from the date of this Order, OTP is authorized to make one or more issuances of securities, provided that the impact of the issuance or issuances on the Company's capital structure is not to exceed, for a period in excess of 60 days, the contingency ranges for equity ratio and total capitalization established in this Order .
3. As soon as the Company has reason to know that a contemplated securities issuance would cause the equity ratio or the total capitalization to exceed the authorized limits for a period of more than 60 days, it shall seek approval from the Commission for any such issuance.
4. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

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