ISSUE DATE: February 29, 1996

DOCKET NO. G-001/GR-95-406

FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER

INTERSTATE POWER COMPANY ISSUE DATE: February 29, 1996
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FINDINGS OF FACT, CONCLUSIONS
OF LAW, AND ORDER

TABLE OF CONTENTS

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Joel Jacobs	Chair
Tom Burton	Commissioner
Marshall Johnson	Commissioner
Dee Knaak	Commissioner
Don Storm	Commissioner

In the Matter of the Request of Interstate Power Company for Authority to Change Its Rates for Gas Service in Minnesota

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FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER

PROCEDURAL HISTORY

I. INITIAL PROCEEDINGS

On May 1, 1995, Interstate Power Company (Interstate or the Company) filed a general rate case for its gas utility. In its filing Interstate requested a rate increase of $2,365,280, or approximately 29.8 per cent over existing rates. Interstate proposed a historical test year ending December 31, 1994.

On June 20, 1995, the Commission issued an Order accepting the filing and requiring certain further filings.

On June 23, 1995, the Commission issued Orders suspending the proposed rates and setting the matter for contested case hearings. The Office of Administrative Hearings assigned Administrative Law Judge (ALJ) Richard C. Luis to the case.

On June 23, 1995, the Commission issued an ORDER SETTING INTERIM RATES, in which the Commission authorized an interim rate increase of $1,502,316, for service rendered on or after June 30, 1995.

The ALJ held a prehearing conference on June 26, 1995. Thereafter, the case was reassigned to ALJ Steve M. Mihalchick, who issued a Prehearing Order on August 16, 1995.

II. PARTIES AND REPRESENTATIVES

A. Intervenors

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

The Department of Public Service (the Department), Dennis D. Ahlers, Brent Vanderlinden, and Ellen Gavin, Assistant Attorneys General, 1200 NCL Tower, 445 Minnesota Street, St. Paul, Minnesota 55101.

The Residential Utilities Division of the Office of the Attorney General (RUD-OAG), Sara J. DeSanto and Joan Peterson, Assistant Attorneys General, 1200 NCL Tower, 445 Minnesota Street, St. Paul, Minnesota 55101.

ConAgra Energy Services Company and its Freeborn Foods Division (ConAgra), Karen Swett, Nine ConAgra Drive, P.O. Box 3200, Dept. CIG 155, Omaha, NE 68103-0200.

B. The Company

The Company was represented by Kent M. Ragsdale and Christopher B. Clark, Staff Counsel, Interstate Power Company, P.O. Box 769, 1000 Main Street, Dubuque, Iowa 52004-0769.

III. PUBLIC HEARINGS AND PUBLIC TESTIMONY

The ALJ held public hearings to receive comments and questions from non-intervening ratepayers. Public hearings were held in Albert Lea on October 4, 1995, and in Stewartville on October 5, 1995. There were five public witnesses in Albert Lea and none in Stewartville.

IV. EVIDENTIARY HEARINGS

Evidentiary hearings were held in St. Paul, Minnesota, on October 16 and 17, 1995.

V. PROCEEDINGS BEFORE THE COMMISSION

On January 16, 1996, the ALJ filed his final report and recommendations.

On January 30, 1996, the Commission heard oral arguments from the parties and on February 1, 1996, the Commission met to deliberate.

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

VI. JURISDICTION

The Commission has general jurisdiction over the Company under Minn. Stat. §§ 216B.01 and 216B.02 (1994). The Commission has specific jurisdiction over rate changes under Minn. Stat. § 216B.16 (1994).

The case was properly referred to the Office of Administrative Hearings under Minn. Stat. §§ 14.48-14.62 (1994) and Minn. Rules, part 1400.0200 et seq. (1995).

VII. FURTHER ADMINISTRATIVE REVIEW

Under Minn. Rules, part 7829.3000, 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 the 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 (1994), no Order of the Commission shall become effective while a petition for rehearing is pending or until either of the following: ten days after the petition for rehearing is denied or ten days after the Commission has announced its final determination on rehearing, unless the Commission otherwise orders.

Chapter 224, Section 77 of the 1995 Minnesota Session Laws provides that any petition for rehearing not granted within 60 days of filing is deemed denied.

VIII. THE COMPANY

Interstate Power Company is an investor-owned combination electric and gas utility engaged principally in the generation, transmission, and distribution of electric energy and the transmission and distribution of natural gas in a 10,000 square mile service area in northeast and north central Iowa, southern Minnesota, and northwestern Illinois.
Interstate serves over 48,000 retail gas customers, 9,800 of whom are located in Minnesota. The largest community served by Interstate in Minnesota is Albert Lea, with a population of approximately 19,000.

For the year ending December 31, 1994, Interstate derived approximately 19.7 percent of its total gas revenue from sales in the Minnesota jurisdiction.

IX. BURDEN OF PROOF

Minn. Stat. § 216B.16, subd. 4 (1994) states: "The burden of proof to show that the rate change is just and reasonable shall be upon the public utility seeking the change." Under Minn. Stat. § 216B.03 (1994), every rate made, demanded or received by any public utility "...shall be just and reasonable...Any doubt as to the reasonableness should be resolved in favor of the consumer."

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 service 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 case 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. THE TEST YEAR

Interstate used the 12-month period beginning on January 1, 1994, and ending on December 31, 1994, for its test year. The test year is based on the historical 1994, adjusted for known and measurable changes.

No party objected to the Company's proposed historical test year. The ALJ found the Company's test year to be reasonable.

The Commission finds that the Company's use of a 12-month historical test year ending December 31, 1994 was appropriate in this proceeding.

XI. CONSERVATION COST RECOVERY

A. Existing Tracker Balance

1. The Company Proposal

In Interstate's last gas general rate case, the Commission allowed annual recovery in base rates of $73,000 of conservation costs. In this rate case filing, Interstate estimated that it had a balance of $501,618 in its tracker account as of June 30, 1995. On August 1, 1995, the Company updated that figure to $645,307. The updated balance reflected a modification Order by the Commission on May 5, 1995, in Docket No. G-001/M-94-1034.

2. Positions of the Parties; the ALJ

a. The Department

The Department generally supported the recovery of Interstate's CIP tracker balance because the balance includes either actual expenditures on approved CIP projects or lost margins or carrying charges approved by the Commission. However, Interstate exceeded its approved CIP expenditures, even above the initial flexibility allowed by the Department, during the first nine months of the CIP year by $48,908. The Department initially recommended that Interstate be allowed to recover a CIP tracker balance amount of $596,389 ($645,307-$48,908=$596,399; $596,399-$10 of carrying charges=$596,389).

However, Interstate had requested authority to increase its 1994-95 CIP budget by $239,450 and on January 18, 1996 the Commissioner of the Department approved an increase in the Company's CIP budget of $242,116. As a result, the Department recommended that the Company be allowed to recover its actual tracker balance as reported in its August 1, 1995 update.

b. The ALJ

The ALJ found that the CIP tracker amount finally approved by the Department should be included in rates.

3. Commission Finding

The Commission agrees with the ALJ that the CIP tracker amount finally approved by the Department should be included in final rates. The Commission finds that the amount proposed by the Company in its August 1, 1995 update of $645,307, which falls within the amount approved by the Commissioner of the Department, as modified in her Order of January 18, 1996, is appropriate and should be included in rates.

B. Method of Recovery of the Existing CIP Tracker Balance

1. The Company Proposal

The CIP tracker balance is usually recovered by subtracting it from the interim rate refund, allowing for a speedy recovery and immediate true-up of the tracker. Although Interstate did not disagree with the Commission's usual method of recovery, the Company believed that the interim rate refund would be insufficient to recover the full tracker balance. The Company proposed to expense the balance over three years and place half of the balance in rate base. In rebuttal testimony, the Company indicated that it did not object to the Department's proposed five year recovery period.

2. Positions of the Parties; the ALJ

a. The Department

If the interim refund is sufficient to recover the tracker balance, then the tracker should be handled in the Commission's usual manner. If the interim refund amount is insufficient, however, the Department proposed that the Company expense the remaining balance for five years as opposed to the three years proposed by Interstate. The Department argued that five years reflects the typical time period between Interstate's rate case filings. In addition, the Department recommended that the Company's proposal to include fifty percent of the tracker balance in rate base be denied. Instead, the Department recommended that Interstate be required to track its unrecovered balance and be allowed to accrue carrying charges, as is done with the current CIP tracker.

The Department suggested that revenues to be recovered should be determined by dividing one-fifth of the unrecovered tracker balance by the total normalized test year sales, then multiplying that amount by actual sales volumes, as is done with its current tracker.

Under the Department's proposal, the unrecovered balance would be tracked based on actual revenues and the balance could be examined in the Company's next rate case. At that time, the Commission could either zero out the tracker from the interim rate refund amount, or if that is insufficient, the Company could recalculate the per-therm charge.

b. The ALJ

In rebuttal testimony, Interstate indicated that it did not object to the Department's proposed recovery mechanism. Therefore, the ALJ found that the Department's method for recovery of the CIP tracker balance should be adopted. As a result, the Company's proposed rate base should be reduced by $250, 809.

3. Commission Finding

If the interim rate refund is insufficient to recover the Company's existing tracker balance, the Commission believes that the appropriate method to recover the remaining balance is the method proposed by the Department and supported by the ALJ. This method includes expensing the remaining balance over five years, with the Company tracking any unrecovered balance, including carrying charges, based on actual revenues. The balance will be reviewed in the Company's next rate case.

The Commission finds Interstate's proposal to place fifty percent of tracker balance in rate base to be inappropriate. The Company's proposed rate base should be reduced by $250,809.

C. Test Year CIP Expenses

1. The Company, Department, and ALJ

Interstate proposed to expense $254,125 for test year CIP costs. This is the CIP amount approved for the second year of the 1994-96 biennial program.

The Department supported the Company's proposal because it represents Interstate's approved CIP expenditures for the 1995-96 CIP year.

The ALJ found that the Company's proposal to expense $254,125 is reasonable. This amount should be included in test year expenses.

2. Commission Finding

The Commission agrees with the parties and the ALJ and finds that it is appropriate to include $254,125 in test year CIP expenses.

D. Allocating CIP Costs to Transportation Customers

1. The Company Proposal

In its initial filing, Interstate proposed allocating CIP costs to its transportation customers. After discussions with its transportation customer, the Company proposed instead not to allocate CIP expenses to this class of customers.

2. Positions of the Parties; the ALJ

a. ConAgra

ConAgra initially opposed the allocation of CIP expenses to the Transportation Service Class, arguing that it is discriminatory to allocate CIP expense to a rate class which is not eligible to receive benefits. ConAgra asked that it be considered eligible for conservation grants or that none of the CIP expenses be allocated to the Transportation Class, now or in the future.

b. The Department

The Department assured ConAgra that all customers are eligible to participate in CIP if the projects meet the qualifying criteria. The Department stated that while there is not a one-to-one relationship between CIP benefits and CIP expenses, transportation customers are not being treated any differently than other customers. The Department argued that utilities incur cost-effective CIP expenses to provide for system benefits and lower rates for all ratepayers. Also, as with other common costs, these cost allocations do not exactly match benefits received.

c. The ALJ

The ALJ found that CIP expenses are incurred to provide system benefits and lower rates for all ratepayers and that it is therefore appropriate that all ratepayers bear the costs of CIP, regardless of their participation in the program. The Department's policy is that all customers are eligible to participate in CIP, if projects meet qualifying criteria. For these reasons, the ALJ found that the costs of CIP should be allocated to all customer classes.

3. Commission Finding

The Commission finds that CIP expenditures are incurred to provide system benefits and, in the long run, lower bills for all ratepayers. Therefore, all ratepayers should bear the costs of conservation projects. While there is not a one-to-one relationship between CIP expenses and CIP benefits, it is important to treat ratepayers and rate classes consistently, and in a non-discriminatory manner. All ratepayers should bear the costs of conservation.

The Department of Public Service, not the Public Utilities Commission, determines eligibility for CIP projects. The Department has determined that transportation customers are eligible to participate in CIP projects as are other customers of the utility. The Commission finds that transportation customers, like all other customers, should bear some of the costs associated with conservation. Interstate should allocate CIP costs to its Transportation Class customers.

E. Calculation of the Conservation Cost Recovery Charge (CCRC)

1. The Company Proposal

Interstate calculated and proposed a CCRC per therm by dividing the proposed test year CIP expense by the adjusted total normalized test year sales.

2. Positions of the Parties; the ALJ

a. The Department

The Department took issue with the Company's calculation and proposed instead that the CCRC be calculated by dividing the test year CIP expenses by the approved total test year volumes, including transportation volumes. The Department's proposed CCRC is based on the Company's proposed test year volumes including interdepartmental sales of 9,750. Since the Company recovers the same margin from its transportation volumes as it does through similar sales rates, total throughput, rather than normalized sales volumes, should be used.

b. The ALJ

The ALJ found that the Department correctly used total volumes, including transportation. As noted by the Department, the Company recovers the same margin on its transportation volumes as it does through equivalent sales rates. Any calculation of the CCRC should be implemented by dividing the approved test year CIP expenses by the approved total test year volumes, including transportation volumes.

3. Commission Finding

The Commission finds that the Department correctly used total volumes, including transportation. Because the Company recovers the same margin on its transportation volumes as it does through equivalent sales rates, total volumes, rather than normalized sales, should be used. The Commission agrees with the ALJ and finds that any determination of the CCRC should be calculated by dividing the approved test year CIP expenses by the approved total test year volumes, including transportation volumes.

XII. RATE BASE

A. Plant in Service

1. The Company Proposal

The Company's proposed plant in service is a thirteen-month average based on the historical test year, which uses 13 months ending December 31, 1994. The Company analyzed the Department's proposed adjustments to plant, sales and cost of gas. Interstate argued that while the revenue requirement change is only $627, the Department's proposal would be a significant policy change and should be rejected.

The Company argued that the Department's recommendations represented a policy change because the Commission has previously required the use of a 13-month average for rate base and only allowed revenue and expense adjustments based on the matching principle. The move to year end rate base and forecasted revenue matched with historic expenses is not appropriate in the Company's view because it would confuse the issue of the appropriate precedent to follow in future rate cases.

2. Positions of the Parties; the ALJ

a. The Department

The Department's sales forecast was based on the number of customers on December 31, 1994. To be consistent with that forecast, the Department proposed to use the December 31, 1994 plant balances rather than the Company's proposed thirteen month average test year plant. This would increase gross plant $285,999 and increase accumulated depreciation and amortization $86,261. The net increase to plant would be $199,738.

b. The Stipulation and ALJ

The parties reached a stipulation that stated that the results of either the Company's or the Department's proposed sales forecast could be used. The plant adjustment is part of the Department's proposal and is reflected in the resulting change in the revenue requirement. The ALJ recommended using the Department's forecast to calculate revenues and, thus recommended that this adjustment should also be made.

3. Commission Finding

As discussed in the Sales Forecast section, the Commission finds that the Department's forecast should be used. See Section XIII (A) of this Order. Therefore, the Commission finds that the plant in service as of December 31, 1994 is the appropriate plant for the test year rate base.

B. Unamortized Rate Case Expenses

1. The Company Proposal

The Company proposed to include in rate base $134,132, a thirteen-month average of the unamortized rate case expenses. Interstate stated that it was allowed to include unamortized rate case expenses in rate base in its last electric rate case, Docket No. E-001/GR-91-605. The reason an unamortized balance needs to be included in rate base is to recognize the time value of money. The bulk of the expenses are assessments from the Commission, Department and the RUD-OAG. This expense is spread over several years rather than being recovered as incurred.

2. Positions of the Parties; the ALJ

a. The Department

The Department argued that the "unamortized rate case expense balance" should not be included in rate base because it does not believe that there is or should be an unamortized balance. The

Department's position is that recognition of rate case expenses as a cost of service should be accomplished through the simple inclusion of a reasonable, average, annual level in test year operating expenses.

A test year should be representative of the average annual operations of the utility over the time period that the resulting rates will be in effect, beginning with interim rates. Thus, even though Interstate did not incur or pay any rate case expenses in 1994, its test year, the Commission should allow recognition of rate case expenses through inclusion of an estimated average annual amount of rate case expenses in test year operating expenses. Allowing a Company to include in its test year an average annual level of a sporadically occurring expense should not lead to the creation of an estimated "hypothetical" deferred asset to be "amortized."

b. The ALJ

The ALJ found that in this case, the Company's unadjusted actual test year, 1994, did not include any rate case expenses. However, because a test year should be representative of the average annual operations of the utility for a normal year, the Commission should allow inclusion of an average annual amount of rate case expenses in the test year.

The ALJ stated that recording an unamortized balance for rate case expenses violates accounting principles because a capital asset is necessary to produce an unamortized balance and the process of estimating average expenses does not create a capital asset. Minn. Stat. § 216B.16, subd. 6, which delineates items to be included in rate base on which the utility is to be allowed to earn a return, limits such a return to "expenses of a capital nature." Since no capital asset or unamortized balance of rate case expense exists, it should not be reflected in Interstate's rate base.

The ALJ found that Interstate has not met its burden of proof to show that it will lose any time value of money or that for any other reason this rate base addition is appropriate. Therefore, The ALJ recommended that Interstate's proposed test year rate base should be reduced by $134,132 to remove any hypothetical "unamortized balance" of rate case expenses from rate base.

3. Commission Finding

The Commission agrees with the Department and the ALJ that the no unamortized rate case expenses should be allowed in rate base because the Company has failed to show that any capital asset or unamortized balance of rate case expense exists.

C. New Town System Extensions

The Commission's June 23, 1995 Notice and Order for Hearing in this rate case instructed parties to address the two issues of whether the Company's expansion to new towns was 1) economically justified and 2) in compliance with Interstate's service extension policy.

1. The Company Proposal

Interstate stated that there did not appear to be any other gas utilities actively seeking to provide service in the new towns added by the Company. Once the new towns were piped, the Company followed all of its service extension policies in adding new customers in these towns. The

Company's analysis compared the non-gas revenue with the total cost of the expansion to determine if the cost was recovered in five years. The Company stated it added seven new areas and it rejected expansion into two communities.

2. Positions of the Parties; the ALJ

a. The Department

The Department stated that it used an "economic feasibility" model similar to that recently approved by the Commission for NSP. The Department confirmed that the Company's costs of the extension projects are covered by the expected revenue from the additional customers and concluded that the extensions were appropriately cost and load justified.

Since the towns were not previously served by any other regulated natural gas utility, and because the extensions were found to be load justified, the Department did not challenge the additions to rate base that are the result of the expansion to the new towns since the last rate case.

According to a Department Information Request response, the plant additions related to the new towns was $1,489,486.

b. The ALJ

The ALJ stated that neither the Department nor the RUD-OAG advocated any adjustment to Interstate's rate increase request related to the Company's expansion to serve new towns. The ALJ found that Interstate is applying its extension policy tariffs correctly and consistently, and that the extensions to the six towns are appropriately cost and load justified and should be allowed into rate base.

3. Commission Finding

The Commission agrees with the parties and the ALJ and finds that the new town system extensions were cost and load justified and should be included in rate base.

XIII. INCOME STATEMENT

A. Test Year Sales Forecast

1. Stipulation by the Company and the Department

In Stipulation Exhibit No. 44, the Company and the Department agreed that either party's forecasting methodology will result in a revenue requirement that is, all other things being equal, very similar. The parties therefore, while not agreeing to the methodology of the other party, agreed that the resulting revenue requirement of either method would be appropriate. The parties asked that no ruling be made on the methodology.

2. The ALJ

The ALJ stated that the Department and Interstate each forecasted test year sales and that the two forecasts, considering the correction in the base cost of gas included in Exhibit 44, differ by only a few hundred dollars. Thus, while the methodology of the two parties differed, the ALJ noted that the results were substantially the same and that the parties stipulated that the numbers were reasonable without agreeing to the methodology.

The ALJ found that the Department's calculation of revenues included in Exhibit 44, Schedule C-1, pp. 1-2 should be used for calculating rates in this proceeding.

3. Commission Finding

The Commission agrees with the ALJ and will use the results of the Department's forecast in this case.

B. Rate Case Expenses

1. The Company Proposal

The Company estimated rate case expenses for this case would be $160,958. Interstate proposed to amortize this cost over three years with a test year cost of $53,653.

Interstate stated it was proposing a three-year amortization even though it has consistently filed cases on a five-year interval because it files cases when it needs to file and not on any scheduled basis. Past history of filings in no way means that future filings will follow the same timing sequence. Interstate noted that it will be experiencing increased expenses for MGP cleanup and for CIP, both of which could cause the Company to file rate cases more often in the foreseeable future.

Interstate disagreed with the level of expenses proposed by the Department. The Company stated that it is difficult to know what the expense will be in this case because of all the additional witnesses involved in this case for issues not anticipated by the Company. Because this case is more complex than the last case and likely will be litigated, the Company's original estimate should be used.

2. Positions of the Parties; the ALJ

a. The Department

The Department recommended that the test year rate case expenses be normalized, that is making the test period representative of the average operations of the utility.

The Department stated that companies who do not file frequent rate cases tend to have highly variable annual levels of rate case expenses, often ranging from zero in some years to quite high levels in other years. Interstate has historically filed a gas rate case approximately every five years, resulting in annual rate case expense levels that vary greatly. To normalize the test year, an average annual amount of rate case expenses should be included in test year operating expenses.

The Department considered many factors and performed a number of calculations in determining the normalized annual amount of rate case expenses it recommended for Interstate. For example, the Department calculated the average expense from the last case, then doubled it to account for inflation and the additional complexity of this case. The result was $32,084. The Department also took the Company's estimated cost and averaged it over five years. That result was $32,192.

The Department stated that it has not proposed any amortization period at all, explaining that there is no existing balance to amortize. Instead, it simply proposed that test year operating expenses include what it believes to be a reasonable average annual amount of rate case expenses. The Department recommended that the test year rate case expense should be $32,100.

b. The RUD-OAG

The RUD-OAG disagreed with the Company's proposed three year amortization rate. The RUD-OAG stated that any expenses that are amortized should be collected from ratepayers over the period of time when the rates are in effect or between Interstate's rate case filings. The RUD-OAG noted that if the amortization period is shorter than the period rates are in effect, the utility will over-collect these amortized expenses. If, on the other hand, the amortization period is longer than the period rates are in effect, the amortized expenses will not be collected between rate cases.

The RUD-OAG stated that Interstate has historically filed a gas rate case every five years: in 1975, 1980, 1985, 1990, and 1995. Consistent with that record, the RUD-OAG recommended that the rate case expenses be amortized over five years so the annual expense would be $32,192.

c. The ALJ

The ALJ stated that under Interstate's proposal, if the estimate of five years between rate cases turns out to be correct, Interstate would collect $265,000 (5 x $53,000) plus a return on $134,132 over the next five years for its rate case expense of $160,000. This is a potential over-recovery in excess of $100,000. Over the last four years, the Company had the opportunity to recover approximately $115,000 in rate case expense associated with its last rate case while it incurred only $66,980 in rate case expense for that time period.

The ALJ found that Intestate's past history in filing frequency is an appropriate basis for determining the appropriate amortization period, particularly given the potential for over-recovery. Interstate has shown no reason to believe that rate case expenses will likely increase because of manufactured gas plant cleanup expense increases or CIP expense increases. Based upon history and using Interstate's estimate of total rate case expenses, Interstate's proposed rate case expenses should be reduced by $21,553 to $32,100.

3. Commission Finding

The Commission agrees with the analysis presented by Department and the ALJ. The Commission finds that the rate case expenses should be normalized and that the appropriate test year expenses should be $32,100.

C. Allocations between Regulated and Nonregulated Operations

1. The Company Proposal

Although Interstate engages in nonregulated activity in parts of its three-state gas jurisdiction, it has chosen not to do so in Minnesota. Interstate recorded neither revenue nor expense in the nonregulated account in this rate case.

Interstate argued that it should not be required to apportion any cost to its non-Minnesota nonregulated operations. The Company stated that no revenue is being generated by Interstate's nonregulated activities in Minnesota gas operations; it would therefore be unable to recover any expenses allocated.

2. Positions of the Parties; the ALJ

a. The Department

The Department noted that Interstate has nonregulated merchandising, jobbing, and contract operations and a wholly owned nonregulated subsidiary, IPC Development Company, in the non-Minnesota portion of its three-state gas utility operation. The Department agreed with the Company that the extent of its nonregulated operations does not require strict adherence to the four-tier accounting principles favored by the Commission in its generic accounting docket.[1] In this case, however, the Company has failed to assign in *any* way the common regulated/nonregulated corporate Administrative and General (A&G) expenses to nonregulated operations. Because of this omission, the costs of some of its common corporate A&G services used by its nonregulated operations are being allocated to Minnesota gas utility operations.

The Department stated that Interstate allocates 100 percent of its common corporate expenses among its regulated activities in three states; a portion of these expenses is then allocated to the Minnesota gas utility. This is incorrect accounting because a nonregulated cost center or business division which uses corporate resources, and thus generates A&G expense, should absorb its share of the costs.

The Department recommended that the relatively small portion of A&G expenses attributable to the Company's nonregulated activities should be allocated to the nonregulated operation by means of a general allocator. The Department thus calculated a reduction of $1,397 to test year A&G expenses.

b. The ALJ

The ALJ agreed with the Department's position. According to the ALJ, if an A&G expense generated by a nonregulated activity is not properly allocated to nonregulated operations prior to those costs being allocated to Minnesota, Minnesota ratepayers will end up paying for some of the nonregulated operations in rates.

3. Commission Finding

A major reason that utilities often choose to engage in nonregulated as well as regulated activities is the resulting economies of scale and scope between the operations. Although Interstate does not engage in nonregulated operations in Minnesota, the Company's nonregulated activities

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[1] In the Matter of an Investigation into the Competitive Impact of Appliance Sales and Service Practices of Minnesota Gas and Electric Utilities, Docket No. G,E-999/CI-90-1008, ORDER SETTING FILING REQUIREMENTS (September 28, 1994).

benefit from cost efficiencies by sharing A&G costs with the Minnesota gas utility. A benefit to the nonregulated operation should be linked with the cost that supports it; in this case, the Company has failed to make the accounting link.

Faced with this accounting inequity, the Department responded by allocating a modest percentage of Interstate's A&G costs to the nonregulated operation. This use of a general allocator at the corporate level allows the benefit to the nonregulated activity from shared operations to be linked with a portion of the ensuing costs. It ensures equity in accounting and thus results in just and reasonable rates. Finally, the use of a general allocator allows proper accounting without requiring the Company to adhere to strict hierarchical cost allocation principles at the jurisdictional level, a practice which would not prove cost-effective in this case.

The Commission will adopt the position of the Department and the ALJ. Test year A&G expenses will be reduced by $1,397.

D. Property Taxes

1. The Company Proposal

Interstate proposed to use its 1994 property tax accrual as its test year property tax expense. Interstate stated that the accrued property taxes are more representative of what this expense will be in the future because of increased millage rates, inflation, increased company income that will increase the portion based on income, and increased plant investment. The Company argued that if actual property tax payments are accepted in this case, then the Commission should also be aware that the Company has under-accrued property taxes in the past and would likely propose an adjustment to increase this expense in future cases when the accrual was less than actual payments for the property tax year.

2. Positions of the Parties; the ALJ

a. The Department

The Department stated that the Company's test year property taxes are based on estimates that are adjusted after year end. Interstate booked its 1993 "true up" adjustment in 1994 and its 1994 "true up" adjustment in 1995. Using an accrual amount is not reasonable since the true up to actual amount itself may increase or decrease no matter what the trend in property tax. Using the accrued property tax amount is the same as using an estimated amount, whereas, the Company chose to file a historical test year adjusted for known and measurable adjustments. The Department recommended that the test year property taxes be the actual 1994 property taxes. This would reduce property tax expense by $8,797.

b. The ALJ

The ALJ found that the Department's proposal that the 1994 ***actual*** property tax amount be used is consistent with the Company's choice of a 1994 test year, is the known and correct amount, and should be adopted. The Department's proposed adjustment decreases property tax expense by $8,797.

3. Commission Finding

The Commission agrees with the Department's and the ALJ's analysis of this issue and finds that the actual 1994 property taxes is the appropriate test year property tax expense.

E. Manufactured Gas Cleanup Costs

1. Introduction

Manufactured gas plants operated throughout the United States from the early 1800's until manufactured gas technology was supplanted by natural gas pipeline distribution in the 1930's. While the manufactured gas plants were operative, they were used to produce synthetic combustible gas from coal. Waste materials from the manufacturing process, primarily coal tar, were usually disposed of on-site in lagoons or underground wells or pits.

In the 1980's, the hazards of the manufactured gas plant waste products became apparent. The federal Environmental Protection Agency and state agencies such as the Minnesota Pollution Control Agency (MPCA) began investigating former manufactured gas plant (MGP) sites and requiring remediation by present and former owners of the sites.

2. The Rochester and Albert Lea MGP Sites

a. Albert Lea

Manufactured gas was provided by Interstate and its predecessors in Albert Lea from 1903 until manufactured gas service was displaced by natural gas service in Albert Lea in 1933. One piece of the former MGP site was used by Interstate as a garage and warehouse for a number of years, until it was eventually sold. The other Albert Lea MGP site property is still owned by Interstate and is currently vacant. The property is crossed by underground electric and gas facilities. Interstate continues to serve gas utility customers in the Albert Lea area.

Prior to Interstate's July 11, 1994, request to defer MGP cleanup expenses, Interstate had paid $378,332 in investigation costs for the Albert Lea site. From July 11, 1994, through March 31, 1995, Interstate has spent $116,403 for investigation of the Albert Lea site. Remediation of that site has not begun.

b. Rochester

Interstate and its predecessors provided manufactured gas service in Rochester from 1888 through 1932. In 1932, the year that natural gas service displaced manufactured gas service in Rochester, Interstate lost the gas utility franchise. Interstate leased the property to Minnesota Northern Natural Gas for use in the provision of natural gas service from 1932 until 1948. In 1948, the plant and property were sold to Peoples Natural Gas Company (Peoples).

In 1990, the MPCA informed interested parties that the Rochester MGP site was contaminated and required environmental cleanup. In 1991, the three parties currently considered potentially liable for MGP cleanup in Rochester--Interstate, Peoples, and the City of Rochester--signed a cost-sharing agreement. The three parties have conducted remediation of the site under the agreement, while simultaneously pursuing third-party and insurance recovery for the costs.

Prior to Interstate's July 11, 1994, request to defer MGP cleanup costs, the Company had spent $598,593 in investigation and remediation costs for the Rochester MGP site. From July 11, 1994, through March 31, 1995, the Company has spent $4,823,770 for investigation and environmental cleanup of the Rochester site. Remediation of the Rochester site is nearly complete.

3. The Interstate MGP Cleanup Cost Deferral Docket

On July 11, 1994, Interstate filed a request for authority to defer costs of investigation and cleanup of five MGP sites, including Albert Lea and Rochester.

On April 13, 1995, the Commission issued its ORDER APPROVING REQUEST FOR AUTHORITY TO DEFER COSTS AND REQUIRING FILINGS in Docket No. G-001/M-94-633 (the deferral docket).[2] In that Order the Commission approved Interstate's request for deferral of the costs of investigation and cleanup of the Albert Lea and Rochester sites.[3] The Commission gave several reasons for granting an exception to the standard accounting methods to allow deferral. At p. 4 of the April 13, 1995, Order, the Commission stated:

> The Company has shown that the expenses for the Rochester and Albert Lea sites are substantial, extraordinary, and unforeseen. The costs are related to gas utility operations. Prompt attention to the MGP site remediation will likely benefit gas ratepayers by minimizing environmental litigation or fines. The Company is attempting to mitigate its liability by negotiating shared responsibilities and pursuing insurance recovery.

The Commission rejected the RUD-OAG's argument that deferral should not be allowed because the Company had previously expensed MGP costs in its financial statements. The Commission stated that "[p]rior financial reporting of estimated MGP liabilities for SEC shareholder informational purposes does not constitute rate treatment of the costs." Order at p. 4. The Commission stated further:

> The Commission will allow deferral, a special accounting treatment, so that the Company's extraordinary costs can be considered in the context of a general rate case. In the rate case venue all aspects of the costs can be developed by the parties: prudence and reasonableness of the expenses; proper accounting for regulatory purposes, including cash versus accrual methods; and such issues as possible gains from sales offsetting costs of cleanup. Order at p. 5.

The Commission accepted the Company's proposal to defer cash expenditures from July 11, 1994, the date the Company first asked for deferral authority, for consideration in the Company's next rate case. Under the proposal, Interstate would be precluded from recovering the approximately $880,000 in cash expenditures incurred for investigation and cleanup prior to July 11, 1994.

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[2] In the Matter of a Request by Interstate Power Company for Deferral of Expenses Associated with Former Manufactured Gas Plants

[3] The Commission determined that costs for the other three sites remained too speculative to warrant deferral at the time of the request.

Finally, in the April 13 Order, the Commission rejected the Company's request to allow allocation of MGP costs between the Company's gas and electric ratepayers. The Commission stated that "MGP costs are associated with the provision of gas service. There is no nexus between costs of remediation of MGP sites and provision of electric service." Order at p. 5.

4. The Company Proposal

Interstate proposed full rate recovery of its deferred investigation and cleanup costs for the Rochester and Albert Lea MGP sites.

Interstate stated that the three Minnesota gas utilities which have requested recovery of MGP remediation costs have been granted authority for the recovery. Interstate cited the following previous Commission decisions: Northern States Power Company, Docket No. G-002/GR-85-108 (December 30, 1985); Minnegasco, Docket No. G-008/GR-92-400 (May 3, 1993), and Docket No. G-008/GR-93-1090 (October 24, 1994); and Peoples Natural Gas Company, Docket No. G-011/GR-92-132 (June 11, 1993).

Interstate noted that the Commission allowed recovery for Peoples, when the utility did not own the site at the time of pollution, and for the NSP Faribault site, when the utility no longer owns the property. In the case of the Minnegasco sites, the company recovered its MGP costs although a portion of the property had been sold, and a portion had never been owned by the company.

From these MGP decisions, Interstate derived three tests which the Commission applies to determine recoverability of MGP remediation costs. According to Interstate, the Commission has allowed recovery based on the following factors: 1) the expenses are mandated by the MPCA; 2) the expenses are reasonable and prudent; and 3) the land was used and useful for the normal provision of utility service at the time of pollution, or was later used and useful for other utility purposes.

Interstate argued that the MGP costs incurred in cleanup of the Rochester and Albert Lea sites conform to the three Commission tests for cost recovery. The investigation and remediation were ordered by the MPCA. No party has claimed that the costs were not reasonable or prudently incurred. The property was used and useful for the normal provision of utility service because manufactured gas was the normal gas service at the time and Interstate was the service provider. In the case of the Albert Lea site, the property was used by Interstate for a vehicle maintenance facility and warehouse after natural gas superseded manufactured gas.

The Company stated that there is no basis for distinguishing a particular type of gas service provided. Either manufactured gas or natural gas is simply gas service.

Interstate argued that its accounting treatment of MGP costs for SEC purposes does not constitute a reason for disallowance of costs. Ratepayers will pay only the legitimate utility expenses for which ratemaking principles allow recovery--no more or less.

The Company asserted that MGP cleanup has brought benefits to ratepayers through avoidance of litigation and fines. Environmental cleanup is a societal good.

Recognizing the significant amount of the MGP costs, Interstate proposed an amortization of the MGP costs over 15 years to mitigate rate shock for its gas ratepayers. The Company proposed a carrying charge of 8.5% on the unamortized balance. If the Commission did not allow a carrying charge, the amortization period should be shortened to five years.

Interstate opposed the ALJ's 50% sharing recommendation, calling it completely unsupported by the record.

5. Positions of the Parties; the ALJ

a. The Department

The Department agreed that the MGP costs were prudent and reasonable, but asserted that Interstate had failed to prove that the sites were used and useful in the provision of *natural* gas service to *natural* gas ratepayers. Because the sites did not bring a benefit to natural gas customers, the costs should not be recovered in rates paid by those ratepayers.

The Department argued that there is a total distinction between natural gas customers and manufactured gas customers. As a basis for this distinction, the Department cited the deferral docket, in which the Commission rejected Interstate's request to recover MGP costs from electric as well as gas customers. According to the Department, this decision showed that the Commission would be unwilling to consider manufactured gas customers with natural gas customers when determining cost recovery. The Department also mentioned Minn. Stat. 216B.02, subd. 2, in which the legislature lists both manufactured and natural gas under the definition of "service," as an indication that the two forms of gas are not to be treated as one.

According to the Department, the Rochester and Albert Lea sites are factually dissimilar and must be analyzed separately. The Department argued that there is little direct evidence that the Albert Lea site was ever a benefit to natural gas ratepayers through the utility's use of the site as a warehouse and maintenance facility. The Department argued that there is *no* evidence that Rochester was ever used and useful to natural gas ratepayers, since the Company lost its utility franchise at the time the area converted from manufactured gas to natural gas, and Interstate does not presently serve the Rochester area.

The Department distinguished NSP's Faribault site, for which NSP won recovery of MGP costs, because the utility owned the property until 1978, after the conversion to natural gas, and because the site is located within NSP's current service territory.

b. The RUD-OAG

The RUD-OAG stated that Interstate's MGP costs should be denied because the Company had failed to prove that the sites were used and useful to natural gas ratepayers, and because of the Company's financial accounting treatment of the costs.

The RUD-OAG agreed with the Department that a complete distinction must be made between the provision of manufactured gas and the provision of natural gas. According to the RUD-OAG, the Commission's past MGP decisions were based upon the fact that the sites had been at some time used and useful to natural gas customers. In the Peoples case, the property had not been owned by the utility at the time of pollution but was currently in the utility's service area; in Minnegasco, the utility had never owned part of the polluted property, but the site was in the utility's current service area; in the NSP case, the property had been owned by the utility at the time of pollution, was since sold, but the area remained in the utility's service area. In contrast, the RUD-OAG argued, the Rochester site had never been owned by Interstate at the time the utility was providing *natural* gas service in the area.

The RUD-OAG argued that Interstate should not be allowed recovery of MGP costs because the costs have already been expensed by the Company under the accrual method of accounting. Because the expenses have been reflected in Interstate's income statements, they have already been factored into shareholders' consideration of the Company's investment risk. The RUD-OAG argued that recovery of these previously expensed items from ratepayers at this point would provide a windfall to Interstate's shareholders.

The RUD-OAG also argued that any benefit from MGP cleanup has fallen to shareholders from eliminating liabilities that might deter investment and from possible capital gains consequences.

c. The ALJ

The ALJ found that Interstate has shown that the Albert Lea and Rochester MGP costs are recoverable in rates. The facts in these cases fall within the Commission's policy previously stated in its Orders. The expenses are mandated by the MPCA; they are reasonable and prudent; and the sites were used and useful in the normal provision of utility service.

The ALJ disagreed with the Department's and RUD-OAG's position that manufactured gas customers must be distinguished from natural gas customers. At p. 20 of his report, the ALJ stated:

> This argument must be rejected because it is contrary to Commission precedent and the common sense upon which the Commission precedent is based. As quoted above, the Commission has twice ruled that Interstate's MGP cleanup costs are related to the provision of gas utility services, not electric utility services. And common sense tells us that manufactured gas and natural gas are much alike; they are both combustible, gaseous substances distributed to customers through piping and used by the customers for heat and light. The fact that one was created locally and the other brought in by pipeline is just a matter of science and economics. We would not call electricity generated locally a different utility from electricity purchased from a remote provider, and there appears to be no logical reason to do so with the two types of gas. The DPS and OAG have cited no authority that agrees with their argument.

The ALJ noted that the Commission's past MGP decisions did not consider the generation source of the gas in concluding that there was a sufficient nexus between past costs incurred and present ratepayers to justify recovery. The Commission must have been aware that it was manufactured gas that was being provided at the time of pollution.

The ALJ stated that "[t]he use of the site as a manufactured gas plant is the specific factor satisfying the 'used and usefulness' requirement for both NSP at Faribault, and Interstate at Rochester and Albert Lea, because this is the 'use' 'at the time of pollution' to which the Commission refers." ALJ Report at p. 21.

The ALJ rejected the RUD-OAG's argument that Interstate's costs at the Rochester site must be distinguished from the circumstances of NSP's Faribault site, based on the fact that Interstate does not currently serve the Rochester area. The ALJ noted that utilities may be responsible for environmental cleanup outside their service territories; this does not preclude the utilities from recovering expenses. Further, the Commission assigned costs of cleanup at NSP's Faribault site to all gas utility customers, not just those in Faribault. The Commission therefore implicitly rejected the RUD-OAG's argument that a sufficient nexus only exists if a site is located in the utility's current service territory.

The ALJ also disagreed with the RUD-OAG's argument that MGP cost recovery must be disallowed because of the Company's past financial accounting. At p. 24 of his Report, the ALJ stated:

> Interstate's treatment of these expenses for financial statement purposes does not drive the regulatory decision regarding these expenses. Ratepayers will pay no more or no less than they would if Interstate had accounted for the expenses in a different manner on its financial statements.

Having found that the Company's MGP costs passed the Commission's criteria for recovery in rates, the ALJ then turned to the amount of recovery. The ALJ determined that an equal sharing of liability between shareholders and ratepayers should occur. The ALJ recommended amortizing 50 percent of the costs, or $2,470,087, over 15 years at eight percent interest. This would result in annual installments of $288,579.

6. Commission Finding

a. Introduction

Interstate has requested rate recovery for two former MGP sites, Albert Lea and Rochester. Interstate owned the Albert Lea site at the time of manufactured gas contamination, presently provides natural gas service to the Albert Lea area, and has made some use of the Albert Lea site since the transition from manufactured to natural gas service.

Interstate owned the Rochester site at the time of manufactured gas contamination, but lost the gas utility franchise in the year that the transition from manufactured gas service to natural gas service took place.

No party disputes that Interstate's costs for investigation and remediation of the MGP sites are prudent and reasonable. There is also no disagreement that the expenses have been mandated by the MPCA. The sole question is if the sites were used and useful to the provision of utility service, or if there is a sufficient nexus between the past costs incurred and utility ratepayers asked to pay the costs.

The Commission finds that the facts in these two cases conform to the criteria of the used and useful analysis. For the reasons the Commission will discuss, the Commission finds that these costs should be recovered in rates. The Commission therefore agrees with and adopts the ALJ's Findings Nos. 93-135.

b. The Used and Useful Standard

The Commission finds that the standard for determining if MGP costs are used and useful can be clearly found throughout its Orders. At p. 12 of its June 11, 1993 reconsideration Order in the Peoples case, the Commission clarified its standard, already established in the NSP Faribault decision: "The operative phrase for recovery in rates is 'used and useful' in the provision of utility service."

At p. 6 of the same Order, the Commission stated:

> The NSP case therefore stands for the finding that utilities are entitled to recover statutorily imposed cleanup costs which are assessed against utility property which has been found used and useful in the provision of utility service. The NSP property had been sold by the Company prior to the rate case and could therefore not be found used and useful to current ratepayers. The Commission, however, found sufficient support for recovery in the fact that the property had been used and useful at the time of pollution. This finding in no way precludes recovery in the Peoples case, where the property is found currently used and useful in utility service to the ratepayers who will pay the costs of cleanup.

The standard for used and useful analysis has consistently been that the property must be used and useful in the provision of utility service. In a case by case analysis, the Commission has found the standard met when the property was owned and used by the utility at the time of pollution (as in the NSP Faribault decision) and when the property was owned and used by the utility at the time of rate recovery (as in the Peoples decision).

In these cases (and in each of the other cases in which utilities have sought and received MGP cost recovery), the property was used and useful in the provision of utility service. The Commission has therefore determined that a sufficient nexus existed between the circumstances creating the liability and the ratepayers responsible for paying the costs of the liability. Under normal ratemaking policy, a utility is entitled to recovery of prudent and reasonable expenses incurred in the business of providing utility service.

c. Application of the Used and Useful Standard to These Facts

Applying the Commission's used and useful analysis to Interstate's two MGP cleanup sites, the Commission finds that the costs of their cleanup are recoverable in rates.

In the case of Albert Lea, the property was used and useful in the normal provision of utility service at the time of pollution, when the property was used to produce and distribute manufactured gas, and was used and useful to the utility as a warehouse and vehicle maintenance facility after the evolution of gas utility service from manufactured gas technology to natural gas distribution. The fact that the utility seeking rate recovery is no longer using the property or portions of the property for utility service has not prevented rate recovery in previous cases, such as the NSP Faribault or Minnegasco decisions, and does not prevent recovery in this instance. The Commission agrees with the ALJ that Interstate's Albert Lea cleanup costs are recoverable in rates.

In the case of the Rochester site, the Commission agrees with the ALJ that the Rochester site was used and useful in the normal provision of utility service at the time of pollution, when the property was used to produce and distribute manufactured gas, and thus fulfills the cost recovery criteria. The fact that Interstate did not make the transition from manufactured gas to natural gas in Rochester, or does not currently serve the territory, does not preclude recovery. As the ALJ stated at p. 23 of his Report:

> Recovery of expenses in Rochester is appropriate. The lack of current Interstate customers in Rochester is not a basis for denial. The lack of customers is not inconsistent with previous decisions or general ratemaking principles. Recovery is consistent with the Commission's policy to allow recovery for prudent, reasonable, MPCA mandated environmental remediation expenses.

d. The Department's and RUD-OAG's Two Main Arguments in the Used and Useful Analysis

The Commission does not accept the limitations to the used and useful standard--either by the timing of the service or by the gas product used to serve ratepayers--argued by the Department and the RUD-OAG.

i. Arguments Based on the Timing of the Service

The RUD-OAG and the Department argue that "use of the MGP site to produce manufactured gas is not proof of any benefit to Interstate's natural gas ratepayers"[4] and that some use in the post-MGP era must be found. By this reasoning, NSP's Faribault cleanup costs are recoverable because the utility owned the property in the post-MGP era (although it no longer owns the property) but Interstate's Rochester cleanup costs, although the result of pollution which occurred while the utility still owned the property, are not. This line of reasoning produces inequitable and illogical results. Presumably, if a utility used its property in the provision of utility service for one day after the transition from manufactured gas to natural gas technology took place, costs of MGP cleanup would be recoverable, but without the one day of use the cleanup costs would be disallowed. As the Commission previously clarified in the Peoples decision, the correct used and useful analysis allows recoverability if property was used and useful for the provision of utility service at the time of pollution (or for current ratepayers).

The RUD-OAG's related "service territory" argument could also lead to arbitrary findings. Under this reasoning, Minnegasco is eligible for cost recovery for the Parks and Recreation Board site, a site it never owned, because the property is within the utility's current service territory and is therefore used and useful to the utility's present ratepayers. At the same time, Interstate should not be allowed to recover its costs for the Rochester site cleanup, a property which the utility did own at the time of pollution, because the area is no longer within the Company's franchise.

The "service territory" line of reasoning is inconsistent with the realities of MGP environmental laws. The pollution laws don't distinguish if a property is within a utility's current service territory or not--a present or former landowner will be found liable. As the ALJ pointed out, there has never been a finding that utilities cannot recover cleanup costs for liabilities incurred outside their current service territory.

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[4] RUD-OAG's Reply Brief at p. 7.

Neither is the "service territory" argument consistent with the Commission's policy on assigning costs. If a utility can prove that its cost was a normal, reasonable and prudent expense of conducting utility business, it can recover the cost from the general base of utility ratepayers, no matter where the cost arose. Costs of nuclear decommissioning, for example, are not exacted against the nearby ratepayers, but are rather assigned to all utility ratepayers. The Commission has not stated that costs must bring a benefit to the current, surrounding class of ratepayers in order to be recoverable.

ii. Arguments Based on the Product Used to Serve

The Department's and RUD-OAG's arguments based on the timing of the utility service can only be logically maintained if one accepts a complete distinction between manufactured gas customers and natural gas customers. The arguments must start with the idea that there was *no* benefit to natural gas utility ratepayers from MGP production and distribution--without this premise, there is no need to find a use in the post-MGP era or a use to ratepayers from location in the current service territory. Both the Department and the RUD-OAG argue that there is a complete distinction between manufactured gas service and natural gas service and that no benefit to natural gas ratepayers ensued from MGP production or distribution. The Commission agrees with the ALJ that "[t]his argument must be rejected because it is contrary to Commission precedent and the common sense upon which the Commission precedent is based." ALJ Report at p. 20.

The agencies base their argument that an absolute demarcation exists between manufactured gas and natural gas service on the Commission's decision in the deferral docket. In addition, the Department mentions certain statutes listing manufactured and natural gas offerings.

The Department and RUD-OAG argue that natural gas ratepayers must not be responsible for costs arising from manufactured gas cleanup because the Commission refused to allocate costs of MGP cleanup to Interstate's electric ratepayers in the deferral docket. From this decision, the agencies infer that the Commission must distinguish between manufactured gas and natural gas ratepayers when assigning costs. The Commission disagrees. There was a strong policy reason for rejecting Interstate's proposal to allocate its MGP costs to its electric ratepayers. Gas utility ratepayers are an entirely different class from electric ratepayers. The two utilities are governed by different statutes and rules. Most utilities do not have both a gas and an electric operating division, choosing instead to provide one utility service or another. Although Interstate has both types of utility operation, which share certain administrative costs, the production, distribution, and sales of the two utility operations are completely unrelated. It would be against the basic principles of cost allocation to assign costs of one utility to the other utility's ratepayers.

In contrast, manufactured gas and natural gas are simply two products provided by a gas utility. As technology changed, gas utilities such as Interstate phased out one product (manufactured gas) and substituted another (natural gas). There is simply no basis for cutting off recovery because of a circumstance of technology. As the ALJ states, the use of one type of gas service or the other is simply "a matter of science and economics." ALJ Report at p. 20. It is no more logical to base recovery of expenses on the choice of manufactured gas or natural gas than it would be to base recovery on the choice of nuclear or coal-fired electric generation. Both manufactured gas and natural gas are simply gas utility service.

As the ALJ stated, "[a]t the time 'manufactured gas' was provided, it was the only gas available." Id. It was the *only* means by which gas utility service was provided. The Commission has never qualified its criterion that the property be "used and useful in the provision of utility service" by stating that the property must be used and useful to *natural* gas utility ratepayers, and will not establish such a policy now.

The Commission is also unpersuaded by the Department's allusion to Minn. Stat. § 216B.02, subd. 6, as an indication that manufactured gas service must be treated differently from natural gas service. This subsection provides a general definition of the word "service":

> "Service" means natural, manufactured or mixed gas and electricity; the installation, removal, or repair of equipment or facilities for delivering or measuring such gas and electricity.

The Commission finds that this subsection conveys a meaning different from that advanced by the Department: the subsection simply lists the possible products to be found within the general heading of "gas." Moreover, the subsection is part of the general definitional section of the jurisdictional introduction to the public utilities statutes.

The Commission also notes that the term "manufactured gas" has another meaning, one that is relevant to modern gas utility service. The term can refer to liquefied petroleum gas or to liquefied natural gas, both of which are injected by modern gas utilities into their distribution systems when necessary to meet customer demands in excess of flowing natural gas inputs. Arguably, without this statutory reference, natural gas utilities would not be able to recover the costs of this "manufactured gas service." In fact, natural gas utilities do recover this manufactured gas costs.

The Commission finds that this subsection, and other cites listing manufactured gas and natural gas under the heading of "gas," do not require that any distinction be made between manufactured gas and natural gas ratepayers for the purpose of ratemaking.

e. The Policy behind the Commission's Used and Useful Analysis

Along with the logic and precedent which guide the Commission's decision, there are strong policy reasons for finding that Interstate's MGP costs are recoverable in this case.

Remediation of MGP environmental contamination is a generally accepted societal good. It would be poor public policy to discourage environmental cleanup by disallowing these prudent and reasonable costs of the process.

Remediation of former MGP sites is an issue which impacts the entire gas utility industry. It is a unique issue, with finite parameters, which must be addressed consistently, on an industry-wide basis. The Commission has been applying its standards for recovery consistently, and will continue to do so: the expenses must be prudent and reasonable, required by the MPCA, and the property must be used and useful in the provision of utility service. The Commission's used and useful standard allows the Commission to examine the utility's ongoing provision of utility service to determine if the property was used and useful at the time of pollution or is used and useful in the current provision of service. The consistent application of this standard is entirely compatible with the Commission's general policy of allowing prudent and reasonable costs of the provision of utility service.

Disallowing Interstate's prudent and reasonable MGP cleanup costs would be inconsistent with the Commission's ratemaking standard and could improperly risk the financial integrity of the utility. The Commission has a duty to prudent and well-managed utilities as well as to their ratepayers. Disallowing these significant costs in an attempt to reduce rates would be unjustified, in light of the fact that the utility has fulfilled the Commission's criteria for cost recovery.

Although the Department and RUD-OAG argue that allowing the costs will remove a necessary incentive for the Company to pursue third-party responsibility, the agencies have produced no evidence of this effect on this company or any other utility. If Interstate at any time fails to vigorously pursue its insurance and third-party recovery actions, the Department and the RUD-OAG have every right and opportunity to bring the matter to the Commission's attention. The Commission will also be requiring in this rate case that the Company file an annual recounting of any insurance and third-party recoveries. This will allow the Commission to monitor the effects of the Company's pursuit of liability claims.

Finally, the Commission rejects the Department's and RUD-OAG's assertions that allowing recovery of these MGP costs is tantamount to a policy of automatic MGP cost recovery. The Commission has carefully scrutinized these claims, as it has done in each instance that MGP cost recovery issues have been brought before it. Each site will bring a different set of facts which the Commission will examine. The prudence and reasonableness of the costs will be scrutinized. Recovery of these costs will be no more automatic than any other expense of ongoing utility operations for which a utility bears the burden of proof in a rate case.

f. The Company's Financial Reporting

The Commission agrees with the RUD-OAG that the Order in the deferral docket left the question of the effects of financial accounting open for further scrutiny in the rate case. The Commission finds, however, that the RUD-OAG has not shown any more basis for nonrecovery in the rate case filings and arguments than was previously rejected in the deferral docket.

The RUD-OAG seems to have shifted its wording away from retroactive ratemaking, a concept which the Commission specifically rejected in the deferral docket, and rephrased the same concept under other terms. In its reply brief, the RUD-OAG now refers to "expenses factored into the Company's 'bottom line' for financial reporting purposes," "expenses...covered by existing rates," Interstate seeking "to eliminate these consequences by resurrecting and recovering past expenses in future rates," and the shareholders receiving "a $5 million windfall" from "rate recovery of these past expenses."

The Commission disagrees with the RUD-OAG's argument, however worded. The MGP cleanup costs have not previously been considered in rates. As the Commission stated in its April 13, 1995, Order in the deferral docket, "prior financial reporting of estimated MGP liabilities for SEC shareholder informational purposes does not constitute rate treatment of the costs." Order at p. 4. Shareholders will not receive a windfall because ratepayers will pay no more nor less than the utility's prudently incurred costs.

The Commission also rejects three somewhat related arguments advanced by the RUD-OAG: recovery of costs is precluded by 1) the timing of the deferral request; 2) the annual reporting to shareholders; or 3) the lack of benefit from cleanup to ratepayers.

While timing of a deferral request is always significant, and the Commission requires prompt and timely requests, there has been no showing of ratepayer harm by the timing of the deferral request in this case.

Interstate's reporting of the risks of possible nonrecovery to its shareholders is of no relevance to the Commission's analysis of MGP cost recovery. This was a matter of normal business between the shareholders and Company management--no harm to ratepayers can be shown from the reporting.

The Commission disagrees with the RUD-OAG's assertion that MGP costs will benefit shareholders, not ratepayers. The Commission has repeatedly stated that environmental cleanup and avoidance of unnecessary litigation and fines are in the bests interests of ratepayers and the general public. The avoidance of litigation and fines would only benefit shareholders rather than ratepayers if one assumed that shareholders would be responsible for these costs because they were imprudently incurred.

g. The ALJ's Sharing Recommendation; Carrying Charges and Amortization Period

While the Commission agrees with the ALJ's reasoning and recommendations on the recoverability of MGP costs, the Commission does not agree with the ALJ's analysis and findings regarding sharing of the costs and the application of carrying charges.

After concluding at p. 25 of his Report that "[t]he Company has shown that the expenses for the Albert Lea and Rochester sites are recoverable," the ALJ discusses sharing and carrying charges at Findings No. 136 and 137:

> 136. The ALJ finds that Interstate should be allowed to recover 50 percent of the deferred expense of $4,940,173. The facts of this case and the arguments of the parties demonstrate that both shareholders and ratepayers should contribute equally to the cleanup. The expenses incurred before Interstate's petition for deferral are not an issue in this case and cannot be considered.
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> 137. The ALJ also finds that simply denying carrying costs is too loose an approximation and that it would be more appropriate to divide the expense by two and amortize it over an appropriate period with a carrying cost. While the company has proposed a carrying charge of eight and one-half percent, the reduction of interest rates since the filing of this case suggests that eight percent is now more appropriate. Amortizing $2,470,087 over 15 years at eight percent requires annual installments of $288,579 and over 10 years at eight percent requires installments of $368,116. The ALJ finds that the size of the rate increase in this case justifies the 15 year period.

It is difficult to discern from this discussion the basis for the ALJ's recommendation of an equal sharing between shareholders and ratepayers, or in other words, a 50% disallowance of the costs. The ALJ found that the MGP costs were reasonably and prudently incurred and the sites were used and useful in the normal provision of utility service. Normally, such expenses would not be disallowed but would be recovered in rates. The ALJ made no finding of mismanagement or inappropriate behavior on the part of the Company. The ALJ makes no reference to the record when he states that "the facts of this case and the arguments of the parties demonstrate" the need for equal sharing. The Commission is not aware of any support in the record for a sharing based on fault, mismanagement, or improper delay on the part of the Company.

The Commission finds that the ALJ's recommendation of an equal sharing of the expenses, in the absence of record support for imprudence, and in the context of full findings of recoverability of the costs, is inappropriate. The Commission will not require that shareholders share 50% of the costs of these ongoing, prudently incurred utility expenses.

The Commission will not, however, allow carrying charges on the unamortized balance of MGP costs. Unlike the partial disallowance, or cost-sharing concept, which under general ratemaking principles is usually linked with a finding of imprudence or fault on the part of the Company, carrying charges are an attempt to allow the Company the time-value of its money. Commission decisions in a number of areas have differed regarding the application of carrying charges. The Commission has consistently found that it has the discretion to decide on a case by case basis if carrying charges should be allowed, and if they should, at what rate and over what period of time.

The Commission finds that it is particularly difficult to set appropriate carrying charges for MGP costs. By their nature, the roots of MGP costs are ancient--some sixty years have elapsed since the gas utility industry converted from manufactured gas technology to natural gas distribution. More significantly, the Commission does not feel compelled to do so in this case. Allowing the Company full recovery of the MGP costs, properly amortized, is sufficient in this fact situation to allow the Company a just and reasonable cost recovery in rates.

Interstate acknowledges Commission precedent in the <u>NSP</u> Faribault case, and other MGP decisions, for disallowing carrying charges, and the appropriateness of using the carrying charge to adjust the recovery result as the Commission determines necessary. Interstate Exceptions at pp. 3,9.

In this case the Commission finds that disallowing carrying charges is appropriate. In order to ensure that the Company is not harmed by the lack of carrying charges, the Commission will set the amortization period at ten years rather than the 15 years proposed by the Company. This amortization period should balance the Company's interest in recovering its MGP expenses with the interest of ratepayers in avoiding rate shock. The Commission also notes that the carrying charge and amortization decisions together allow the Company a test year MGP cost recovery roughly equivalent to its original proposal.

h. Conclusion

The Commission finds that Interstate's Rochester and Albert Lea MGP cleanup costs meet the criteria for recoverability in rates. The Commission will allow full rate recovery, without carrying charges, and with an amortization period of ten years.

Because future insurance and third party recoveries will offset MGP rate recoveries, the Commission will establish a system for regular monitoring of future recoveries. The Commission will require Interstate to file on an annual basis the amount of its MGP expenditures for the year and its cumulative expenditures to date for MGP costs. The annual reporting of these costs shall explain and show the types of costs that were incurred and what monies were recovered from insurance companies and other parties. This information shall be filed by March 1 of each year.

F. Post Retirement Benefits other than Pensions (PBOPs)

1. The Company Proposal

Interstate requested $60,610 in PBOP expenses to reflect the adoption of FAS 106 accrual accounting for the current year and also requested amortization of deferred PBOP costs over three years, resulting in a test year expense of $73,258. The total cost in the test year for the excess of FAS 106 PBOP over the actual pay-as-you-go is $133,868. Interstate proposed to externally fund its PBOP obligation through a Voluntary Employee Benefit Association (VEBA) for union employees so that all contributions will be fully tax deductible in a 401(h) account.

2. Positions of the Parties; the ALJ

a. The Department

The Department evaluated the reasonableness of Interstate's proposed test year compensation costs, including PBOP expenses, and agreed they were reasonable. The Department agreed that using a VEBA and a 401(h) account to fund union and non-union employees' PBOPs is reasonable and appropriate. The Department did not contest the recovery of these costs nor the Company's proposed three year amortization.

b. The RUD-OAG

As discussed under the rate case expense amortization section, the RUD-OAG stated that Interstate files its rate cases every five years so the deferred FAS 106 costs ($219,774) should be amortized over five years rather than the three years proposed by the Company. This would reduce the test year cost by $29,303. The OAG did not contest the recovery of these costs.

c. The ALJ

The ALJ found that Interstate's funding mechanisms are reasonable, providing tax benefits and assurance 1) that Interstate will have the necessary funds to pay employees' non-pension post retirement benefits and 2) that funds collected to pay non-pension post retirement benefits will be used for this purpose. No party opposed the recovery of these costs. The ALJ did not make a recommendation on the amortization period for the deferred costs.

3. Commission Finding

Interstate historically has filed a gas rate case every five years. The Company has provided no evidence in this case to demonstrate that it will file more frequently in the future. Consistent with that historical pattern, the Commission finds that the appropriate amortization period for deferred PBOP costs is five years. This will reduce the test year cost by $29,303 to $43,955.

G. Economic Development

1. The Company Proposal

Interstate included $8,830 in economic development expenses for five programs in which it participated. Two of the programs were implemented by nonprofit marketing organizations.

Another two of the programs provided education and training workshops on economic development. The fifth program was a contribution to leverage the financial resources of businesses within its service territory.

Interstate asserted in general that the business climate in Minnesota requires that the Company offer more economic development incentives to attract new load, yet the regulatory environment in Minnesota makes it increasingly difficult for Interstate to compete with neighboring rural electric cooperatives or to justify its economic development efforts in the state.

In response to the Department's request for data showing the cost-effectiveness of its economic development expenses, the Company responded that it would be an inappropriate use of resources to develop a cost/benefit model in order to recover this relatively small amount, $8,830. Secondly, the Company argued that the small to medium sized projects, like the ones in this rate filing, typically generate more revenue indirectly through sales to employees and suppliers of the industry assisted. Finally, the Company observed that oftentimes the effects of these kinds of programs are not immediately known.

2. Positions of the Parties; the ALJ

a. The Department

The Department did not dispute whether the Company's economic development activities were "worthy" expenses. The Department nevertheless recommended that Interstate's economic development costs be denied because the Company did not provide any data that these expenses were cost-effective and beneficial to ratepayers.

The Department further argued that if the Company subsequently provided evidence that its economic development activities are cost-effective, Interstate should be allowed to recover fifty percent of the costs from ratepayers. The Department explained that costs for these programs may provide future benefits to Interstate's shareholders as well as to ratepayers and that the costs, therefore, should be shared by both groups.

b. The ALJ

The ALJ found that the Company's economic development costs should be allowed at the rate of 50 percent. Thus, $4,415 should be disallowed from the Company's proposed expenses. The ALJ found that the economic development expenses were incurred by the Company and that at this low level of expenditure, it would make little sense for Interstate to invest in the installation of expensive metering equipment to measure the impact. The ALJ suggested that it can be fairly assumed that there was some beneficial impact from the activities in Minnesota. However, Interstate should be required in its next rate case to provide a more detailed specification of its Minnesota economic development activities and results so that the benefits can more easily be determined.

The Department filed an exception to the ALJ's recommendation, arguing that the ALJ erred in excluding only 50 percent ($4,415) of Interstate's economic development costs.

c. The Commission Finding

The Commission must examine any proposal for economic development recovery in light of Minn. Stat. § 216B.16, subd. 13 (1994), which states:

> ECONOMIC AND COMMUNITY DEVELOPMENT. The commission may allow a public utility to recover from ratepayers the expenses incurred for economic and community development.

This statute gives the Commission discretion in whether to grant or deny expenses incurred for economic development and the Commission finds no hard and fast requirement in the statute that such costs can be justified only by means of a cost-benefit analysis, as urged by the Department.

From its earliest application of the economic development statute, the Commission has noted that the economic development statute indicates a legislative intent to facilitate economic development programs. The Commission has always recognized the difficulty of translating the indirect impact of such costs into hard data analysis.[5]

Upon review of the facts in this case, the Commission agrees with the ALJ that the Company's economic development costs should be allowed at the rate of 50 percent. In light of the relatively small amount of economic development costs at issue, it would be inconsistent with the sense of the statute to require the Company either 1) to incur the inordinate expense of developing and conducting a cost-benefit study of its economic development expenditures or 2) to forego recovery of those expenses altogether, the Hobson's choice urged by the Department. Such a prescription would surely serve to discourage the Company's economic development efforts rather than to encourage them, as is the clear purpose of the statute. The Commission has long recognized the value of a strong economy to all the public, including ratepayers, and reaffirms that allowing utilities and ratepayers to assume part of the responsibility of promoting a healthy economy is sound public policy. [6]

This is not to say, however, that the Company can be reckless in its economic development expenditures and still count on recovery. Unreasonable expenditures will not warrant any recovery. However, in this case, the Department has not challenged the reasonableness and good faith of the expenditures. Nor does the Commission determine in this case that a cost-benefit analysis will never be appropriate to meet the utility's burden of proof. Note that in this case, the cost-benefit analysis is not required of Interstate based on the comparative size of the economic development costs and the cost of preparing a cost-benefit study.

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[5] 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-91-1, FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER (November 27, 1991), page 10.

[6] 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-91-1, FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER (November 27, 1991), page 11.

The Commission will not adopt the ALJ's further recommendation, however, that the Company be required to provide a more detailed specification of its Minnesota economic development activities and results so that benefits can more easily be determined. While not discounting out of hand the potential value of a more detailed specification of its Minnesota economic development activities and results, the Commission is not inclined to advise the Company on how to make its case for recovery of economic development costs in its next rate case. It is always the Company's responsibility to determine how it will bear its burden of proof on any issue, without special guidance from the Commission. This is particularly appropriate in the economic development cost recovery area, where no particular formula fits all cases and the circumstances (size of the company, amount and type of expenditures, etc.) can vary greatly from case to case.

H. Advertising Expenses

1. The Company, Department and ALJ

The Company proposed to recover $4,902 in advertising expenses.

The Department supported the Company's proposed advertising expenses because they provided information on safety or on the Cold Weather Rule.

The ALJ made no finding on the appropriateness of the advertising expenses.

2. Commission Finding

The Commission agrees with the Department and finds the Company's proposal to recover $4,902 for advertising expenses is reasonable and appropriate.

XIV. RATE OF RETURN

A. 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.

B. Capital Structure and Cost of Non-Common Equity Capital

1. Positions of the Parties; the ALJ

All parties and the ALJ agreed it was appropriate to use the following capital structure, which represents Interstate's financial position at the end of 1994. They also agreed to the cost rates shown for Long-term debt, Short-term debt, and Preferred and Preference Stock. These costs are readily ascertained from a review of the Company's books.

Type of Capital	Amount (Thousands)	Percent	Cost	Weighted Cost
Long-term debt	$206,175	43.972%	7.752%	3.409%
Short-term debt	35,600	7.593%	6.070%	0.461%
Preferred & Preference Stock	34,597	7.379%	7.225%	0.533%
Common Equity	192,505	41.057%		
TOTAL	**$468,877**	**100.000%**		

2. Commission Finding

The Commission agrees with the ALJ that "Interstate's proposed capital structure is reasonable and balances the competing interests of investors and consumers. Interstate's capital structure falls within the range of comparable companies in 1994." ALJ's Report at p. 3. The Commission concludes that Interstate's proposed capital structure, cost of debt and cost of preferred and preference stock should be adopted for this case.

C. Cost of Common Equity

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. Positions of the Parties; the ALJ

a. Interstate

Interstate presented the testimony of Mr. Robert S. Jackson, a retired Senior Vice President of Stone & Webster Management Consultants, Inc. Mr. Jackson's recommendation, 11.75%, was derived by averaging the results of five different studies.

The first study looked at the earned and projected rates of return for Interstate and a group of comparison gas companies during the periods 1990 to 1994 and 1998 to 2000. For the group, the average was 11.47%; for Interstate, it was 10.85%.

The second study, which was updated during rebuttal, was an average of discounted cash flow (DCF) quarterly market value and book value results. Mr. Jackson used historic and estimated future growth rates in per-share dividends and earnings. The yield component of the DCF formula resulted from the average of the high and low market prices during a three-month period, applied to the next four quarters of expected dividends. For the group of companies studied, the updated result was a return on equity of 10.73%. For Interstate, the result was 11.50%. Mr. Jackson argued that these results do not represent the fair rate of return on Interstate's book value in this case, because the market price of the stocks for the comparison group and Interstate has been considerably above the book value for several years. Mr. Jackson therefore made a separate study, in which he adjusted the market value DCF result for the market-to-book ratio. This study showed an average required rate of return on equity of 16.44% for the group, and 12.67% for Interstate. Mr. Jackson averaged the results together for his DCF study, coming up with an average of 13.47% for the group and 12.57% for Interstate.

The third study, also updated, was a payout ratio test. Here, the group average was 11.45%; the result for Interstate was 13.67%.

Mr. Jackson's fourth study, updated in rebuttal, was a capital asset pricing model (CAPM) risk premium analysis. This study resulted in a cost of equity of 10.78%.

The fifth study, which was updated, was a study of returns allowed for gas utilities, yielding a required return of 12.00%.

b. The Department

The Department presented the testimony of Dr. Luther Thompson, a rate analyst. Dr. Thompson performed a DCF study on Interstate and also on a comparable group of gas distribution utilities.

For his Interstate study, Dr. Thompson reviewed dividend yields over four different recent periods: a 20-day yield (8.738%), a quarterly yield (8.620%), a one-year yield (8.886%) and a two-year annual yield (8.296%). The average of these yields was 8.635%. Dr. Thompson used a range of 8.65% to 8.75% as a reasonable estimate of the dividend yield for the current regulatory period, and chose 8.70% as the single best estimate of the current dividend yield.

Dr. Thompson looked at various growth rates which investors might be expecting, placing more emphasis on the more stable growth rates, such as those in book value and dividends. He examined particularly 5-and 10-year growth rates in book value, dividends, and earnings per share, as well as log linear growth rates. Based on these figures, he determined that investors would expect growth for Interstate in the range of 2%. Dr. Thompson reviewed the internal growth rate for 5- and 10-year periods, and Interstate's dividend payout ratio and earnings on common equity for the past ten years. He concluded that 2% was a reasonable growth expectation. The sum of the 8.70% dividend yield and the 2.0% growth rate led to an estimate of the cost of common equity for Interstate of 10.7%.

Dr. Thompson also performed a DCF analysis on a comparable group of gas distribution utilities. He determined that the average of the group's dividend yields ranged from 5.45% to 5.65%, and that the expected growth rate was 5.25%. Using 5.55% for the current dividend yield, he determined a cost of equity of 10.8% for the group.

Dr. Thompson recommended 10.80% for this case since the return for the comparable group of gas companies is the best estimate for Interstate's gas operations.

c. The RUD-OAG

The RUD-OAG presented the testimony of Mr. Garth M. Morrisette, an economist. Mr. Morrisette performed a DCF analysis of a group of gas distribution utilities followed by Value Line, which had operating histories of ten years or more, and which derived at least 90% of their revenues from utility operations.

Mr. Morrisette calculated the dividend yield by averaging the monthly high and low stock prices for the six-month period ending in July 1995, and applying annualized dividend data. He found a current dividend yield of 6.10% for the most recent six months. He checked this result with the most recent 3-month and 12-month periods, both of which were 6.08%. Mr. Morrisette adjusted the yield estimate upwards by one-half-year's growth in dividends so that the final dividend yield reflects the dividend an investor expects to receive during the first year after purchase. The adjusted yield for his group was 6.25%.

Mr. Morrisette evaluated growth in retained earnings, analysts' growth estimates, and extrapolations from past trends in earnings per share, dividends per share, and book value per share. He relied most heavily on earnings retention, which he said was consistent with the theoretical basis of the DCF method. His earnings retention analysis produced a growth rate of 4.25%, made up of internal growth of 3.50% and external growth of 0.75%. He found that historical values and investor analysis support a 4.25% growth rate, with historical growth in dividends and earnings ranging from 2.49% to 3.60%, and long-term Value Line and IBES projections averaging 4.70%. After considering all relevant information, Mr. Morrisette concluded that a range of growth of 4.25% to 4.70% was appropriate, and that the midpoint of this range, 4.50%, was the best point value estimate.

Mr. Morrisette concluded that the combination of the 4.25% dividend yield with the 4.50% growth rate produced an ROE for the comparable group of 10.75%, and he recommended that this be adopted by the Commission.

d. Mr. Ericsson

At the Albert Lea public hearing, Mr. Lester Ericsson, on behalf of the Minnesota Utility Investors (MUI), provided information on an average of recent rate decisions around the United States which he said supported a return on equity of 11.99%. Mr. Ericsson testified as a member of the public, and his testimony was not subject to cross-examination by any party.

e. The ALJ

The ALJ found that the DCF method is appropriate for calculating a fair return on equity. He said it produces consistent, reliable results, and has been consistently used by the Commission.

The ALJ rejected the individual methods employed by the Company's witness, Mr. Jackson, and he rejected the result of combining the methods. The ALJ rejected Mr. Jackson's risk premium (CAPM) analysis, noting that the updated study changed the required rate of return by a full percentage point, moving from 11.78% to 10.78%. He stated that the Commission has consistently rejected this method because of the volatility of the results, which he found illustrated here.

The ALJ found Mr. Jackson's payout ratio study to be unreliable. He said that it has not been shown that the 1990-1994 mean historical payout ratios, excluding those greater than 1.00, represent the expected payout ratios for the group. Further, because all ratios greater than 1.00 were excluded, the historical rates were not based on actual numbers, and therefore may not represent a current market rate of return.

The ALJ found Mr Jackson's regression model to be overly simplistic, resulting in biased estimates. He criticized Mr. Jackson's method for failing to account for a number of variables that might affect the allowed return on equity awarded by state commissions. The ALJ stated that if regression models omit important explanatory variables, the results of the analysis will be biased and inconclusive. Therefore, the ALJ rejected Mr. Jackson's regression analysis.

The ALJ also rejected Mr. Jackson's DCF analyses. He said the adjustment of his DCF result to account for a market-to-book ratio greater than one is inappropriate. While Mr. Jackson maintained that if regulators set the allowed return on equity based on the DCF method, the stock price will be driven down until the market-to-book ratio equals 1.0, the ALJ noted that the stock price is set by the market, not by regulators. He found the approach to be at odds with basic economic theory because it assumes that shareholders will invest in utilities with market-to-book ratios greater than 1.0 with the expectation that the price will be driven down to book value, and their investment would lose money.

The ALJ also stated that Mr. Jackson's method is flawed because it ignores the actual market for the stock of the comparison companies. The yield portion of the DCF method is calculated to be D/P where D is the current dividend and P is the market price. If D/P is multiplied by the market-to-book ratio, P/B, as Mr. Jackson recommended, the result is D/B, and the market price falls out of the equation and is ignored. But the market price is of paramount importance in inferring what investors require in the market place.

The ALJ also noted that the Commission has already rejected this methodology:

> "By eliminating the market factor from its DCF-2 [DCFQB] analysis, Mr. Jackson produces a book yield and ROE which is not market-based and does not reflect current market conditions." Interstate Power Company, Docket No. E-001/GR-91-605, Findings of Fact, Conclusions of Law, and Order, p. 36, n. 16 (June 12, 1992) (parenthetical added).

Finally, the ALJ stated that Mr. Jackson's method produced unrealistic results. He said the approach produces ROE estimates ranging from 13.73% to 19.45%. This is well outside the realm of reasonableness, does not represent sustainable long-term growth, and is well beyond the most optimistic industry analyst projections.

The ALJ said that Mr.Ericsson's proposed return on equity of 11.99% is not based on a method that has been shown to be analytically sound or has been accepted by the Commission. He considered it to provide some support to Mr. Jackson's regression analysis, which he also found to be overly simplistic. Therefore, after consideration, the ALJ rejected this proposal.

The ALJ found no flaws in either Mr. Morrisette's or Dr. Thompson's analyses, and found them to be mutually corroborative.

The ALJ adopted the analysis of Mr. Morrisette. Combining the 6.25% dividend yield and the 4.50% expected growth rate produced a return on equity of 10.75%. This return, he said, permits Interstate to attract capital and maintain financial integrity. It is consistent with investor expectations, and fairly balances the interests of consumers and investors.

3. Commission Finding

The Commission adopts the ALJ's recommendation. For the reasons noted by the ALJ, the Commission has previously rejected Mr. Jackson's analysis. That analysis has not changed substantially since Interstate's 1991 electric rate case, Docket No. E-001/GR-91-605, and the Commission continues to find it inappropriate for determining the required rate of return.

As it has in the past, the Commission finds the DCF analysis to produce reasonable, consistent, and fair estimates of the cost of equity. Here, the Commission finds that Mr. Morrisette's analysis was the most reasonable implementation of that method. The Commission notes that Dr. Thompson's analysis, while different, resulted in a recommendation only 5 basis points apart from that of Mr. Morrisette. The Commission also observes that Mr. Jackson's updated DCF study of a comparable group, before his market-to-book adjustment (which has been found to be improper), found a cost of equity of 10.73%; a figure only two basis points below Mr. Morrisette's.

The Commission concludes that the cost of common equity for the Company is 10.75%.

D. Overall Cost of Capital

The Commission finds the overall cost of capital is 8.817%, calculated as follows:

Type of Capital	Amount (Thousands)	Percent	Cost	Weighted Cost
Long-term debt	$206,175	43.972%	7.752%	3.409%
Short-term debt	35,600	7.593%	6.070%	0.461%
Preferred & Preference Stock	34,597	7.379%	7.225%	0.533%
Common Equity	192,505	41.057%	10.750%	0.414%
TOTAL	**$468,877**	**100.000%**		**8.817%**

XV. RATE DESIGN

A. Class Cost of Service Study (CCOSS) in this Proceeding

1. The Company Proposal

The class cost of service study submitted by the Company in this proceeding is similar to the one it filed in its last rate case. The Company included two new costs in its current CCOSS:

conservation improvement and manufactured gas plant. The Company also used a different allocator for the costs of security deposits than the one approved in the Company's last rate case.

2. Positions of the Parties; the ALJ

a. The Department

The Department provided its own cost study in this proceeding. Its cost study used a similar cost-allocation methodology to the Company. However, the Department and Company cost studies differed with respect to their treatment of transportation customers. The Department's cost study provided separate estimates of the costs of serving transportation customers. The Company's cost study grouped transportation customers together with its interruptible customers.

The Department argued that it is important to separate and identify the cost differences in serving transportation and interruptible customers. The Department suggested that since its cost study provides separate estimates of the costs of serving transportation customers, its CCOSS should be adopted.

b. The ALJ

The ALJ found that separately allocating costs to transportation customers provides a more accurate picture of cost causation. The ALJ adopted the Department's CCOSS, which provides this allocation.

3. Commission Finding

The class cost of service study is an important tool to identify cost causation. A CCOSS should identify as accurately as possible which customer class is responsible for each cost incurred by the utility in providing service. No factors other than cost causation should influence a CCOSS.

The Commission uses the CCOSS as a starting point for its decisions in the area of rate design. However, other non-cost factors, such as sending proper price signals, reducing the potential for rate shock, and acknowledging the historical continuity of rates and rate increases, are considered by the Commission in its deliberations on rate design issues.

The Commission agrees with the ALJ that separately allocating costs to transportation customers provides for a more accurate picture of cost causation. The Commission finds that the Department's cost study, which provides separate estimates of the costs associated with serving transportation customers, should be adopted.

B. Recommendations for CCOSS in the Next Rate Case

The Department made three recommendations to modify the Company's CCOSS for the next rate case. These modifications are addressed in the following order:

1) Require the Company to conduct a minimum distribution study;
2) Require the Company to separate the costs of serving residential, commercial, and industrial firm customers within the current General Sales class; and

3) Require the Company to separate the costs of serving each type of interruptible sales and transportation customers based on consumption and on curtailment priorities.

1. Minimum Distribution Study

a. The Department Proposal

The Department recommended that Interstate be required to perform a minimum distribution study and submit the results of the study in its next rate case. The Department argued that such a study is an important part of a CCOSS. A minimum distribution study will identify the distribution system costs required to provide service to customers, whether they actually take any gas or not. The Department indicated that once these costs are identified, they represent the minimum costs required to hook up and stand ready to serve a customer. This level of cost would be classified as customer costs. The Department further argued that distribution costs above minimum distribution costs are generally classified as capacity costs and may ultimately impact the allocation of costs in the CCOSS.

The Department asserted that it cannot recommend how to classify costs before actual data is available. The Department offered to assist Interstate in designing an appropriate minimum distribution study, if the Company is uncertain how to proceed. Because the study would improve Interstate's cost allocation methodology, the Department recommended that the Company be required to conduct one as part of its next rate case.

The Department noted that the minimum distribution study may allocate more or less cost to the customer component. This uncertainty is not sufficient reason to avoid the study. A CCOSS is intended to accurately determine cost causation.

b. Position of the Company

Interstate argued against the Department's proposal and suggested that its own method of classifying costs related to distribution service regulators and meters as customer-related provides an appropriate basis upon which to establish customer charges.

The Company further argued that virtually all of its plant and facilities are used to provide gas service, regardless of whether gas is used, and that it would be necessary to analyze each distribution plant account to determine the customer component. The Company considers approximately 45 percent of distribution plant to be customer-related and expressed its concern that the Department did not specify how the customer-related component was to be determined. Whether to consider mains, or a portion thereof, as customer-related can make a significant difference in the calculation of customer costs. Also, the size and type of material used for mains has changed over the years and selecting the minimum main and its "historical" cost affects the amount of plant classified as customer-related.

Interstate argued that the National Association of Regulatory Commissioners (NARUC) recognizes its approach to classification. This approach uses the basic system theory under which mains are considered demand-related because they are installed to serve the demands of customers. Only facilities and equipment such as meters, regulators and service taps are considered to be customer-related.

c. Position of the ALJ

The ALJ found that the performance of a minimum distribution study is consistent with the Commission's Order in Peoples Natural Gas, Docket No. G-011 /GR-86-144 (January 16, 1987). But there are several ways to approach the task of estimating the costs of a minimum distribution system and several judgments to be made in making such a study. The Department offered to assist the Company in designing an appropriate minimum distribution study if Interstate is unsure of how to proceed. The Department is unable or unwilling, however, to specify ahead of time the definitions and standards it would require Interstate to follow in conducting such a study.

Furthermore, the ALJ stated that the Department presented no evidence that a minimum distribution study of the type it suggests would improve the cost allocation methodology used by the Company or have any practical benefit. Interstate suggested that its methodology is acceptable because NARUC references the "basic system theory" whereby mains are considered completely demand-related and only facilities such as meters, regulators and service taps are considered to be customer-related. Therefore, the ALJ found that Interstate should not be ordered to conduct a minimum distribution study as part of its next rate case.

d. Commission Finding

The Commission agrees with the parties and the ALJ that there are several ways to identify the minimum system requirements of providing service to customers, whether they actually take any gas or not. However, the Commission finds that complexity in the design of a study is not, in and of itself, sufficient reason for not performing such a study. If the Company is uncertain how to proceed with the study, the Department has agreed to work with it to develop the definitions and standards it would require.

The Commission finds that a minimum distribution study can identify the distribution system costs required to provide service to customers, whether they take any gas or not. For this reason, the Commission required Peoples to conduct a similar study in its Order in Docket No. G-011/GR-86-144 dated January 16, 1987. The Commission finds that it is appropriate to require Interstate to also conduct a minimum distribution study and provide the results in its next rate case.

2. Separate Firm Customers within the General Sales Class

a. The Department Proposal

The Department recommended that the Company be required to establish separate firm customer classes broken into Residential, Commercial, and Industrial. The Company should also propose rates which reflect the cost differences in written testimony in their next rate case.

b. Position of the Company

The Company generally accepted this recommendation, but proposed that the firm customers be broken into two categories: Residential and Commercial & Industrial, instead of the three categories recommended by the Department. Interstate also indicated that these proposals will be based on reasonable class estimates.

The Department accepted these modifications as a reasonable first step.

c. Position of the ALJ

The ALJ adopted the Department's proposal, as modified by the Company, because the information will provide a more accurate picture of which customers are responsible for which costs in Interstate's next rate case.

d. Commission Finding

The Commission agrees with the ALJ and finds that the Company should be required to break out the costs of serving firm customers within the General Sales class in order to establish two separate firm customer classes: Residential and Commercial & Industrial. The Company will also be required to propose rates which reflect the cost differences in written testimony in its next rate case.

3. Separate Costs of Interruptible and Transportation Customers Based on Consumption and Curtailment Priorities

a. The Department Proposal

The Department asserted that the main distinction between Interstate's Small Volume Interruptible Sales and Transportation Services and Large Volume Interruptible Sales and Transportation Services customers is the Company's curtailment priority. For example, Large Volume customers are classified as such, not necessarily because they use a large volume of gas, but because they accept the highest risk of service interruption. The higher the risk of interruption, the lower the rate paid by the customer.

Other Minnesota rate-regulated gas utilities have different interruptible sales and transportation customer classes based on the amount of monthly and/or annual consumption. The Department argued that the cost of service varies by consumption levels rather than curtailment priority and recommended that the Company be required to provide further information which distinguishes Small Volume and Large Volume Interruptible Sales and Transportation customer classes.

In order to develop this information, the Company would need to develop a CCOSS which separates the costs to serve each type of interruptible sales and transportation customer based on consumption levels. The Company should then provide a break out of the costs to serve these customer classes based upon curtailment priorities. The Department recommended that this information be provided in Interstate's next general rate case.

b. Position of the Company

The Company accepted this recommendation and indicated it would provide the information in its next rate case.

c. Position of the ALJ

The ALJ adopted the Department's recommendation because it will provide a more accurate picture of which customers are responsible

d. Commission Finding

The Commission agrees with the Department and the ALJ and concludes that Interstate should be required to develop the separate costs to serve Small and Large Volume Interruptible, and Small and Large Volume Transportation customers based upon consumption and curtailment priorities. The Company will provide this information in its next gas general rate case.

C. Revenue Apportionment

1. The Company Proposal

Interstate apportioned its proposed revenue requirement according to the results of its class cost of service study. The rate for each class is set so that the revenue derived from each class very closely approximates the results of the Company's cost of service study. The Company's allocation method resulted in a decrease in customer bills for interruptible customers.

Interstate argued that the Department's proposal (discussed below) to allocate more of the increase to interruptible customers is inappropriate. First, while the Department's proposal only moves the price of interruptible service closer to the price of alternate fuel, it establishes a point-in-time relationship that may result in potential harm to Interstate and may overcharge ratepayers, at least until the next rate case. Interstate's non-gas rates are fixed until the next rate case, while alternate fuel prices may fluctuate according to supply and demand.

Allocating costs to interruptible customers, as recommended by the Department, with the expectation that sales can be saved by flexing rates down can only increase the risk to Interstate's shareholders and reduce its ability to recover the revenues it is entitled to. If rates are flexed down, then Interstate may not only fail to recover the firm class costs, but may not recover the cost of service for the interruptible class itself.

2. Positions of the Parties; the ALJ

a. The Department

The Department argued that Interstate's proposed revenue apportionment is inappropriate and results in lower bills for interruptible customers. A bill reduction for these customers is not needed for the Company to remain competitive with available alternative fuels. Instead, the Department recommended that the revenue increase, which is significant for Interstate's firm customers, be spread among all customer classes.

Using its own CCOSS, which provides specific cost information on transportation customer classes not provided in the Company's testimony, the Department identified the cost-based revenue requirements of each class. After evaluating the effects of different revenue apportionments on customer bills, the Department then developed its proposed revenue apportionment taking into account its rate design goals of cost recovery, resource efficiency, historical continuity, customer understanding and administrative efficiency.

The Department's primary objective in revenue apportionment is the promotion of the efficient use of resources. In addition to cost of service, the Department considered the value of service or the price of competitive fuels for customers which have the potential to switch to alternative fuels. In this case, it is Interstate's interruptible customer classes which maintain this option.

b. The ALJ

The ALJ suggested that while the Department's proposed revenue apportionment for interruptible customers is larger than that proposed by Interstate, there are several reasons why it is unlikely that interruptible customers will leave Interstate's system based on this higher revenue apportionment. The Department's proposed rates, while higher than Interstate's, are still substantially lower than alternative fuel prices. Examining the price difference over a longer period demonstrates the same relative price differences.

The Department's recommended rates do not harm the Company and do not "overcharge" interruptible customers. They do result in more competitive natural gas rates for Interstate's interruptible customers than the rates proposed by Interstate and they are lower than the alternative fuel prices. In contrast, the Company's proposed revenue apportionment for interruptible customers does not reflect the economic value of the commodity to the customer because it does not reflect the cost of alternative fuels.

Since the Department's proposed rates are competitive with alternative fuels, it is unlikely that Interstate will need to use its flexible-rate tariffs with its interruptible customers. However, in the unlikely event Interstate is faced with the loss of customers because of price competition from alternative fuels or bypass as a result of a rate increase from the instant rate case, the Company can retain its customers using flexible-rate tariff provisions.

The ALJ found that a substantial variance between revenue and costs is appropriate in this case. The Department's recommendation regarding revenue apportionment results in an increase in customer bills for all customers, while keeping Small and Large Volume Interruptible customers' rates competitive with the costs of alternative fuels. By apportioning more revenue responsibility to the interruptible classes, the Department's recommendation moderates and more fairly distributes responsibility for the large rate increase proposed by Interstate. The ALJ adopted the Department's recommended revenue apportionment in this proceeding.

3. Commission Finding

The Commission agrees with the Department's and the ALJ's reasoning that the Company's proposed revenue apportionment is inappropriate. Interstate proposed rates which result in lower customer bills for interruptible customers, and significant increases to other customer classes. These rates are based on the results of the Company's CCOSS. The Commission considers both cost and non-cost factors when determining the appropriate design of rates. The Commission believes that the Department's proposed revenue apportionment, which results in an increase in rates for interruptible customers, and a more moderate increase for other customer classes, is more appropriate than the rates proposed by the Company.

The Commission also agrees with the ALJ that a substantial variance between revenue and costs is appropriate in this case. By apportioning more revenue responsibility to the interruptible classes, the Department's recommendation moderates and more fairly distributes responsibility for the large rate increase proposed by the Company.

D. Customer Service Charge

1. Interstate's Proposal

Interstate proposed the following customer service charges: Firm Sales - $7.00; Small Volume Interruptible - $25.00; Small Volume Interruptible Transport - $150.00; Large Volume Interruptible - $275.00; and Large Volume Interruptible Transport - $150.00.

The Company argued that its proposed charges should be accepted because they move rates closer to cost than the Department's proposals which, the Company complained, were not completely cost-based.

2. The Department's Comments

The Department proposed the following customer service charges: Firm Sales - $6.00; Small Volume Interruptible - $25.00; Small Volume Interruptible Transport - $150.00; Large Volume Interruptible - $170.00; and Large Volume Interruptible Transport - $295.00.[7] The Department stated that it based its proposals on the average cost imposed by each of Interstate's customer classes under the Department-sponsored CCOSS and then comparing those costs with the Commission-approved customer charges for other regulated Minnesota gas utilities.

The Department argued that its proposed customer charges for interruptible customers moved closer to cost than the Company's proposed charges. The Department noted that its proposed customer charge for Large Volume Interruptible Sales comes within $2.15 of cost while Interstate's exceeds it by over $100 and actually moves much further ***above*** cost than the current customer charge for that class. Additionally, the Department noted that Interstate's proposed customer charge for Large Volume Interruptible Transportation is substantially below cost, much further below cost than the Department's proposal for that class.

3. The ALJ

The ALJ found that under both the Department's and Interstate's customer charge proposals, customers who use little gas and currently do not pay for the customer costs allocated to them would pay higher bills than with current customer charges, while those customers who use more gas would pay lower monthly bills. Under both proposals, General Sales Service customers who use about 144 Ccf per month would see little or no change in their bills due only to the change in customer charges.

[7] Note that in order to defray the additional cost of serving gas transportation, the Department calculated its proposed monthly charges for the transportation classes by adding an "administrative & delivery fee" of $125 to the customer charge for the equivalent **sales** class.

Overall, the ALJ noted that the Department's proposed customer charges moved closer to cost than the Company's, while avoiding large changes to prevent extreme rate impacts on customers. For these reasons, the ALJ adopted the Department's recommended customer charges.

4. Commission Finding

Both Interstate and the Department appear to overemphasize the role of cost in the setting of rates.[8] As the ALJ noted, exact correspondence of revenue to cost is not required. In fact, the Commission has repeatedly stated that rate setting involves consideration of both cost and non-cost factors.[9] This is appropriate because the legislature has made it clear that the Commission is to set rates that are to be "just and reasonable." Minn. Stat. § 216B.16, subd. 6 (1994). In applying that standard, the Commission is acting in its legislative capacity[10] and it would be improper to reduce its judgment in that regard to a mathematical calculation.[11]

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[8] The Commission has stated: "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." 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, Docket No. E-015/GR-94-001, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (November 22, 1994) at page 73.

[9] "Unless the commission can be shown to have relied upon certain factors to the extent that clear injustice has resulted, or that its legislative authority has been clearly exceeded, we hold that *the courts may not restrict the scope of matters which the commission may consider in allocating electric costs among classes* of consumers." St. Paul Area Chamber of Commerce v. Minnesota Public Service Commission, 312. Minn. 250, 256-57, 251 N.W.2d 350, 358 (1977). Emphasis added.

[10] "When the PSC [predecessor to the Commission] allocates rates among classes of customers, it acts in a legislative capacity and the courts will uphold the PSC's decision unless it exceeds the PSC's legislative authority or results in unjust, unreasonable, or discriminatory rates by clear and convincing evidence." Hibbing Taconite Co. v. Minnesota Public Service Commission, 302 N.W.2d 5, 9 (Minn. 1981). Bracketed material added.

[11] In St. Paul Area Chamber of Commerce, supra at 57, the Minnesota Supreme Court stated: "We therefore agree with the reasoning expressed by the United States Supreme Court in the Permian Basin Area Rate Cases, 390 U.S. 747, 815, 88 S.Ct. 1344, 1385 (1968):

> ...Although the [Federal Power] Commission's exposition of these questions might have been more carefully drawn, it has quite appropriately incorporated in its calculations factors other than producers' costs....The Commission's responsibilities necessarily oblige it to give continuing attention to values that may be reflected only imperfectly by producers' costs; a regulatory method that excluded as immaterial all but current and projected costs could not properly serve the consumer interests placed under the Commission's protection. Bracketed material added by the Court.

In this case, the Commission has taken full consideration of the Company's costs and notes that even the proposals by the Company and the Department are not really cost-bound proposals. Neither proposal moves to cost for any class but instead moves ***toward*** cost at various rates of speed. At the same time, the Commission will take into consideration certain non-cost factors: rate stability, customer acceptance (rate shock), the prospect of competition, incentive to conserve and customer ability to pay.

Rate Stability: The Commission has always considered rate stability desirable. In the Commission's view the rate proposals of both the Company and the Department fail to achieve an appropriate level of rate stability with respect to customer charges. The substantial changes proposed by the Company and the Department are illustrated as follows:

Customer Class	Present Customer Charge **($)**	IPW Proposed Customer Charge **($)**	**Percent Increase over Present**	Department Proposed Customer Charge **($)**	**Percent Increase over Present**
Firm Sales	4.75	7.00	**47.37**	6.00	**26.32**
S.V. Interr.	14.00	25.00	**78.57**	25.00	**78.57**
S.V. Interr. Transport	100.00	150.00	**50.00**	150.00	**50.00**
L.V. Interr.	185.00	275.00	**48.65**	170.00	**-8.11**
L.V. Interr. Transport	100.00	150.00	**50.00**	295.00	**195.00**

The Commission would prefer to provide greater rate stability with respect to customer charges and finds that it can do so while still accommodating the other considerations relevant to rate design.

Rate Shock: The Commission notes that General Sales Service customers who use 10 Ccf per month would experience an increase of $2.09 per month (approximately 21 percent) under Interstate's proposed $7.00 customer charge and a $1.16 per month increase (approximately 12 percent) under the Department's proposed $6.00 customer charge. These increases are substantial.

Impending Competition: The Commission notes that if competition arrives in all customer classes, it is quite possible that the service charge (a charge paid regardless of usage) would place the Company at a competitive disadvantage. Accordingly, it may serve the Company well to begin to wean itself from the security that customer charges in a largely non-competitive environment represent.

Incentive to Conserve: Charges unrelated to usage conflict with conservation incentives and the Commission is unwilling to send the anti-conservation signals represented by substantial increases in customer charges. Keeping customer charges low with correspondingly higher usage charges will reward those able and willing to conserve.

Customer Ability to Pay: The Commission notes that it has always had the authority to consider this factor in determining the justice of rate allocations.[12] However, in recently enacted Minn. Stat. § 216B.16, subd. 15(a) (1994) the legislature has recently underlined that consideration, stating:

> The Commission may consider ability to pay as a factor in setting utility rates....

In this case, the record includes information relevant to this consideration. Interstate serves a significant percentage of low-income customers as well as elderly customers on fixed incomes who also may have special medical needs. Interstate has proposed a substantial rate increase that would raise residential rates as much as 30 percent. Such a large increase in rates would have a substantial impact on the ability of low-income customers to pay their utility bills. A substantial number of Interstate consumers have attested to the financial hardship that the rate increase would impose.

In addition, the Commission has taken into consideration the factors enumerated in Minn. Stat. § 216B.16, subd. 6 (1994):

- the public need for adequate, efficient, and reasonable service and
- the need of the public utility for revenue sufficient to enable it to meet the cost of furnishing the service.

Taking all these factors into consideration, then, the Commission finds that the following customer service charges are appropriate:

Customer Class	Present Customer Charge **($)**	Commission Approved Customer Charge **($)**
Firm Sales	4.75	5.00
Small Volume Interruptible	14.00	14.00
Small Volume Interruptible Transportation	100.00	100.00
Large Volume Interruptible	185.00	170.00
Large Volume Interruptible Transportation	100.00	100.00

[12] See, e.g. St. Paul Area Chamber of Commerce, supra at 256, where the Minnesota Supreme Court stated: "It is not a leap of logic to then say that for the most part commercial users of electricity are more 'able to pay' a rate increase than residential users. While such assumptive reasoning would not ordinarily be employed by a court, which must in most cases confine itself to the evidence, it may be legitimately employed by a legislative agency attempting to serve the public interest at large in a way that courts cannot."

These customer service charges, together with the usage charges calculated to allow the Company to recover the Company's approved revenue requirement, are just and reasonable.

With this Order, the Commission continues to move Interstate toward cost based rates while seeking to buffer the rate impact upon the Company's smaller consumers and prepare the Company for the rigorous atmosphere of a competitive market. In so doing, the Commission does not allow cost and non-cost factors to race one against the other but harnesses them side by side in the public interest, in the manner approved by the U.S. Supreme Court (Permian Area Rates Cases, supra footnote 11, at 815) and the Minnesota Supreme Court in St. Paul Chamber of Commerce, supra footnote 9, at page 257.[13]

E. Pricing Structures for Sales and Transportation Rates

1. The Company Proposal

Transportation rates have been increased to reflect the new non-gas commodity charges of the proposed sales service rates. Interstate's proposed class rates make the Company indifferent to whether a customer is a sales or a transportation customer.

The Company argued that unless completely separate rates are developed for transportation and sales customers within a class, the Department's proposal of an additional $125.00 administrative fee would be inappropriate and confusing to customers. Currently, customers see that the difference between being a sales customer and a transportation customer is the difference in the cost of gas only.

2. Positions of the Parties; the ALJ

a. The Department

The Department recommended that transportation demand and commodity rates be set to produce the same margins as recovered from the standard sales customers. The Department also recommended that transportation service customer charges be set at the same rate as the equivalent sales class (Small Volume Interruptible =$25 and Large Volume Interruptible =$150) plus an "administrative and delivery fee" of $125 to cover the higher administrative costs involved in

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[13] The Commission notes that its decision regarding customer service charges in this Order is consistent with its analysis and treatment of customer service charges in two recent general rate cases: 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, Docket No. E-015/GR-94-001, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (November 22, 1994), pages 74-76 and In the Matter of the Application of Minnegasco, a Division of Arkla, Inc., for Authority to Increase Its Rates for Natural Gas Service in Minnesota, Docket No. G-008/GR-93-1090 (October 24, 1994), pages 46-48.

serving these customers. The Department's goal in recommending that rates be determined in this manner is to keep the Company indifferent to whether its gas sales are purchased through transportation or sales services.

The Department recommended that if the Commission approves a lower revenue requirement than Interstate requested, that the lower revenue requirement be proportionately apportioned to customer classes based on its proposed apportionment and that the Department's recommended level of customer charges for transportation customers be adopted.

b. The ALJ

The ALJ found that since his Report includes a lower revenue requirement than Interstate requested, the revenue requirement should be apportioned to the customer classes proportionately, consistent with the Department's recommendation. The ALJ adopted the customer charges as recommended by the Department and recommended determination of the corresponding commodity rates as performed by the Department.

3. Commission Finding

The Commission had initially determined that the Department's proposed pricing structure for sales and transportation rates were appropriate and that the addition of a $125.00 administrative and delivery fee, to cover the higher administrative costs associated with serving these customers, was cost-based and appropriate. However, when the Commission deliberated on the customer charges for all customer classes and considered additional non-cost factors in setting the appropriate levels of these charges, it chose instead to leave the customer charges for transportation customers at their existing levels.

F. Reconnection Charge

1. The Company; the Parties; the ALJ

Interstate proposed increasing the customer reconnection charge from "not less than $5.00" to a flat charge of $35.00.

The Department supported Interstate's proposed increase in the reconnection charge. The Department indicated that using one average rate is more efficient and that the proposed reconnection charge is based on the current actual cost of reinstating service.

The ALJ stated that Interstate proposed to raise the customer reconnection charge from the present cost of not less than $5.00 to a standard average fee of $35.00. The proposed reconnection charge is based on the current, actual cost involved in reinstating service. Using one average rate is more administratively efficient than using a non-uniform rate. The ALJ adopted the Department's recommendation to accept the Company's proposal.

2. Commission Finding

The Commission finds that the Company's proposed increase to the reconnection charge is appropriate.

G. Flexible Rate Provision

1. The Parties' Positions; the ALJ

The Department recommended that the Commission require Interstate to include a flexible rate provision in all of its current sales and transportation tariffs in its compliance filing at the end of this rate case. Such a provision is a necessary tool to allow the Company to remain competitive and to maintain its customer base.

Interstate did not object to the Department's proposal to include a flexible rate provision in all of the Company's sales and transportation tariffs at the conclusion of this rate case.

The ALJ adopted the Department's proposal.

2. Commission Finding

The Commission finds that it is appropriate for Interstate to develop a flexible rate provision for all of its current sales and transportation tariffs. The Company should provide this provision as a part of its compliance filing in this rate case.

H. Low-Income Rate Program

1. Development of the Issue

At the end of the evidentiary hearings for this rate case, the Administrative Law Judge indicated that he had received several letters from people who were not investors, but mostly low-income people. These persons have difficulty paying their bills and are generally opposed to any increase because they cannot afford it. The ALJ asked parties how they thought he should deal with this issue in this rate case.

All of the parties outlined the recent history of the Commission's efforts to examine and address the issue of low-income customers and gas and electric utility bills. The comments below are the specific comments each party provided on this subject.

2. Positions of the Parties

a. The Company

Interstate argued that it would be inappropriate to order a separate low-income rate in this proceeding. The Company suggested that the pilot program currently being conducted by Minnegasco should be completed and evaluated before a separate low-income rate is established for it. Interstate also noted that this issue is currently being addressed in its electric rate case.

b. The Department

The Department indicated that the present rate case is the first such filing to take place under the new legislation which allows the Commission to consider ability to pay as a factor in setting utility rates. At this point, the Commission has not clearly determined whether or not it will consider ability to pay as a factor in setting rates. No party to this proceeding had advocated that the Commission establish a separate rate for low-income customers. The Department argued that the Commission should keep rates as low as possible for all customers, within the dictates of the law, and that this goal can best be achieved by adopting its proposals in this rate case.

c. The RUD-OAG

The RUD-OAG indicated that it had been contacted by several Interstate customers who stated that they cannot afford a rate increase. The RUD-OAG suggested that while the Commission has not yet had the opportunity to consider the ability to pay in a rate case, this case presents a situation in which it would be an appropriate factor to consider. Interstate serves a community with a significant percentage of low-income customers, as well as elderly persons on fixed incomes or with special medical needs.

The RUD-OAG recommended that the ALJ and the Commission consider the effect of the rate increase on customer's ability to pay in determining final rates in this case.

3. Position of the ALJ

The ALJ found that the size of the rate increase in this case means that there will be an enormous impact upon low-income ratepayers. For example, a retired minister in Albert Lea estimated that his monthly budget rate payment of $106 would go to $132 under Interstate's original proposal--clearly a hardship on a minister's pension. The ALJ indicated his disappointment that the Department and RUD-OAG did not suggest using the new statute. But application of the statute requires data and argument that is not available in this record. Thus, the ALJ concurred that the only solution, at this point, would be to keep rates as low as possible for all customers within the dictates of the law.

4. Commission Finding

The Commission agrees with the ALJ that no party to this proceeding has proposed a specific low-income discount rate, and that there is insufficient evidence in this record from which to develop one. The Commission will therefore not specifically address the low-income rate program issue in this rate case.

XV. OVERALL FINANCIAL SUMMARIES

A. Rate Base Summary

The Commission's findings and conclusions relating to the Company's rate base result in a Minnesota jurisdictional average rate base of $7,324,549 for the test year as shown below:

Utility Plant in Service	$10,351,657
Less: Accumulated Depreciation	3,098,522
Net Utility Plant in Service	7,253,135
Retirement Work in progress	609
Accumulated Deferred Income Taxes	(677,068)
Working Capital:	
Cash Working Capital	23,511
Gas & Material Inventory	166,340
Prepayments	600,439
Customer Security Deposits	(57,282)
Cash/Minimum Bank Balances	14,865
Total Working Capital	747,873
Total Average Rate Base	$7,324,549

B. Operating Income Statement Summary

Based on the Commission's findings above in the Section entitled INCOME STATEMENT, the Commission concludes that the appropriate Minnesota jurisdictional operating income for the test year under present rates is $(581,352). As shown below:

Operating Revenues	
Sales of Gas	$8,150,528
Other Operating Revenue	122,771
Total Operating Revenues	8,273,299
Operating Expenses	
Production and Gas Supply	6,384,413
Distribution	743,604
Customer Accounts	218,541
Customer Services	94,465
Administrative and General	1,362,083
Depreciation and Amortization	348,357
Taxes Other than Income	320,076
Federal and State Income Taxes	(616,888)
Total Operating Expenses	8,854,651
Net Operating Income	$(581,352)

C. Gross Revenue Deficiency

The above Commission findings and conclusions result in Minnesota jurisdictional gross revenue deficiency for the test year of $2,093,039 as shown below:

Average Rate Base	$7,324,549
Rate of Return	.08817
Required Operating Income	645,805
Test Year Operating Income	(581,352)
Operating Income Deficiency	1,227,157
Revenue Conversion Factor	1.7056
Gross Revenue Deficiency	$2,093,039

In the test year income statement, the Commission found that the Minnesota Total Operating Revenues at present rates is $8,273,299. Adding the gross revenue deficiency of $2,093,039 to this amount results in total authorized revenue from Minnesota customers of **$10,366,338.**

ORDER

1. Interstate Power Company is entitled to increase gross annual revenues from Minnesota sales of natural gas by $2,093,039 in order to produce gross annual jurisdictional Total Operating Revenues of $10,366,338.

2. Within 30 days of the date of this Order, the Company shall file with the Commission for its review and approval, and serve on all parties in 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.

3. Within 30 days of the date of this Order, the Company shall file with the Commission and the Department, and serve on the other parties, a revised base cost of gas and supporting schedules incorporating the changes made herein. The Company shall also file its automatic adjustment establishing the proper 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 filing.

4. The Company shall conduct a minimum distribution study and provide the results in its next gas general rate case. If the Company is uncertain how to proceed with the study, it should consult with the Department to develop the definitions and standards required.

5. The Company shall separate the costs of serving firm customers within the General Sales class in order to establish two separate firm classes, Residential and Commercial & Industrial. In its next gas general rate case, the Company shall propose rates which reflect the cost differences in written testimony.

6. The Company shall develop a class cost of service study which separates the costs to serve each type of interruptible sales and transportation customer based on consumption levels. The Company shall then provide a break out of the costs to serve these customer classes based upon curtailment priorities. The Company shall provide this information in its next gas general rate case.

7. The Company shall file on an annual basis the amount of its MGP expenditures for the year and its cumulative expenditures to date for MGP costs. The annual reporting of these costs shall explain and show the types of costs that were incurred and what monies were recovered from insurance companies and other parties. The report shall be filed by March 1 of each year.

8. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

(S E A L)

DISSENTING OPINION

Commissioner Johnson, dissenting

Following an appropriate application of the "used and useful" standard in Interstate's manufactured gas plant clean-up costs deferral docket[14], the majority of the Commission, in a surprising and unprecedented move, proceeds in this matter to eviscerate that standard as it applies to recovery of such costs. I cannot join such a move. Specifically, I dissent from the decision allowing Interstate to recover in rates all of its cleanup expenses associated with its former manufactured gas plants (MGPs) located in Rochester and Albert Lea.[15]

To-date, Congress and the Minnesota legislature have resolved the question of who shall pay for the environmental clean-up of former MGP sites by indicating that the owners of the contaminated land shall be liable. Perhaps Congress or the legislators should develop a broader-based approach to address this societal problem. However, it is clear that neither Congress nor the Minnesota legislature has yet decreed that the ratepayers of a utility that is liable for clean-up costs due to its ownership (at some point) of contaminated sites should share that burden with the utility in all cases. Based on the particular facts of this case, I believe the Commission has overstepped the bounds of its regulatory authority in allowing Interstate to "share" the cost of its clean-up responsibility with its ratepayers.

Somehow lost in the deliberation of the MGP costs at Albert Lea and Rochester was the Commission's bottom line statutory responsibility: to ensure the justice and reasonableness of the rates it allows Interstate to impose on its customers. Minn. Stat. § 216B.16, subd. 4 (1994). In a nutshell, I cannot find it just and reasonable to allow Interstate to collect money from its current customers (natural gas customers) to pay the cleanup expenses due to activity taking place decades ago on sites that do not now and have never benefitted those customers. It is precisely to prevent this kind of anomalous result that the legislature adopted the used and useful standard and the Commission has developed its companion concept, matching the beneficiaries of costs with

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[14] In the Matter of a Request by Interstate Power Company for Deferral of Expenses Associated With Former Manufactured Gas Plants, Docket No. G-001/M-94-633, ORDER APPROVING REQUEST FOR AUTHORITY TO DEFER COSTS AND REQUIRING FILINGS (April 13, 1995). In this Order, the Commission rejected Interstate's request to allocate its MGP clean-up costs between its electric and natural gas operations for recovery from both sets of ratepayers.

[15] With respect to Rochester, I find that there is no connection whatsoever between Interstate's current ratepayers (natural gas customers) and the Rochester site. Interstate has not manufactured gas there since 1932, has not owned it since 1978, does not use it to serve (and never did use it to serve) any natural gas customers in Rochester. Regarding the Albert Lea site, I find the threads of connection (Interstate's maintenance of the site as a vacant lot crossed by underground gas and electric lines) too insubstantial to constitute any legitimate nexus between Interstate's current rate payers and that site. By contrast, see the current uses of the contaminated site relied on to establish the requisite "nexus" in Peoples Natural Gas Company Rate Case, Docket No. G-011/GR-92-132, ORDER DENYING RECONSIDERATION AND CLARIFYING ORDER (June 11, 1993).

the payers of those costs.

Despite this key legislative mandate, it has been successfully argued to the majority of the Commissioners that Commission precedent requires just such a result. Gone is any requirement that the cleanup site have even a modicum of usefulness to current customers. Under the majority decision, a totally phantom and cerebral "nexus" has fully replaced any semblance of matching as the indicator of used and useful. "Used and useful" has been defined in such a way to make a finding of "used and useful" virtually automatic.[16]

The Company, the ALJ, and the majority argue that Commission precedents mandate recovery for the Company in this case. What kind of precedents are these that would 1) take precedence over the Commission's legislative responsibility with respect to rates, 2) lead the majority to ignore common sense, fairness, and attention to the big picture ("just and reasonable"), and 3) reduce the Commission's legislative function to the Procrustean application of a cut and dried formula: used and useful for the provision of utility service **at the time of pollution**.[17] With the majority's decision in this matter, the evaporation of the used and useful standard is complete for all practical purposes.

In this dissent, I will 1) review all the MGP cases the Commission has handled, 2) note the partial dilution of the "used and useful" standard in the 1994 Peoples rate case when it adopted "nexus" in lieu of matching[18], and 3) object to the total obliteration of that standard in the current case.

Based on that analysis, it is clear that the Commission needs to take serious stock of the road it has headed down on this subject. But more important for the case at hand, I will argue that the Commission's MGP decisions to date do **not**, as Interstate, the ALJ and the majority argue, support, let alone compel, the decision made by the majority in this case.

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[16] By definition, MGP cleanup costs are related to the production of manufactured gas, a commodity provided as a utility service. In this Order, the majority finds that, for ratemaking purposes, this is the same as if the property had been used to distribute natural gas to Interstate's current customers. If it does not matter whether the claiming utility owned the site at the time of the pollution, and it does not matter whether the claiming utility ever used the site to benefit its customers after the site ceased to be used for MGP purposes, and it does not matter whether none of the claiming utility's current customers (natural gas customers) ever benefitted from operation of the site, and it does not matter that the site is not located in an area served by the claiming utility, a fair question is: what does matter any more? Not much, apparently.

[17] As shown below, the Commission has properly vacated and repudiated the Order in which that language originated (the Commission's December 30, 1985 Order in Docket No. G-002/GR-85-108) and has never applied that language prior to the majority's decision in this case.

[18] In the Matter of the Application of Peoples Natural Gas Company, a Division of UtiliCorp United, Inc. for Authority to Increase Its Rates for Natural Gas Service in the State of Minnesota, Docket No. G-011/GR-92-132, ORDER DENYING RECONSIDERATION AND CLARIFYING ORDER (June 11, 1993).

Background for the Review of Precedents

There has been too much loose use of the term "precedent" in the argumentation of this case. Since the majority's position claims to be precedent-driven, it is important to clarify just what a precedent is and is not.

The determinations that an adjudicating body must make in order to decide the case or issue before it have precedential value in deciding a subsequent case, but only when the subsequent case presents the same or materially similar facts. It is basic that the precedent set by any decision-making body in any case is limited to the facts of that case. In addition, precedent does not include the discussion or dicta that surrounds that decision. Once established, the precedent serves as a guide for the Commission when confronted with the same material facts.

Commission Decision #1: NSP's Faribault Site (Docket No. G-002/GR-85-108)

The first request for recovery of MGP clean-up costs was made by NSP regarding its Faribault site in its 1985 rate case, Docket No. G-002/GR-85-108. NSP proposed to include $215,900 in test year expenses and $143,000 in rate base. In an Order issued December 30, 1985, the Commission approved.

Since it was a case of the first impression, it is understandable that the Commission's thinking regarding MGP costs was not fully developed. In these circumstances, the Commission's normal approach would be to be cautious in placing too much weight on such a decision and look to subsequent decisions on the issue to provide more mature guidance. Unfortunately, the majority ignores this consideration and the Commission's subsequent developments regarding this issue and places tremendous weight upon this initial decision, weight which the Order simply cannot bear.

As a review of subsequent MGP Orders will show, the Commission's approach to MGP cost recovery has **never** followed the December 30, 1985 Order. Apart from the strikingly aberrant language in the December 30, 1995 Order, the Commission has consistently indicated that the "used and useful" standard requires a showing of **current** benefit and has applied that requirement first to rate base items and later to both rate base **and** expense items. These case developments, the factual dissimilarity between the circumstances of the Faribault site and the current case, and the circumstances surrounding the December 30, 1985 Order eliminate any usefulness of the Commission's decision in this first MPG case as precedent for the current case.

A brief review of the circumstances surrounding the Commission's first decision on the MGP issue (the December 30, 1985 Order) shows how unusually inappropriate it is to rely on this decision as Commission precedent. The Commission vote on the issue was 3-2. Commissioner Leo Adams made the motion and cast the deciding vote. Subsequent revelation that Commissioner Adams had been conducting employment discussions with NSP during the time period of the Commission's deliberations, vote and preparation of the December 30, 1985 Order led the Commission in an Order dated February 19, 1986 to vacate that Order and dismiss NSP's rate case.

On March 18, 1986, the Commission issued an ORDER DENYING RECONSIDERATION AND REHEARING AND GRANTING STAY OF FEBRUARY 19, 1986 ORDER. The Commission denied NSP's request for rehearing but stayed, pending appeal, two Ordering Paragraphs in the February 19, 1986 Order that required refunds and discontinued interim rates. Regarding the status of the December 30, 1985 Order, the Commission stated:

> The Commission has vacated its Order of December 30.....Thus the December 30 Order has no validity. Order at page 4.

When NSP appealed the Commission's action to the Minnesota Supreme Court, the Court found that there was substantial evidentiary support for the Commission's findings in the February 19, 1986 Order that Commissioner Adams had a substantial conflict of interest and that he should have but did not disqualify himself from active participation in the matter. The Court found that the proceedings were tainted as a result. Northern States Power Company, Relator v. Minnesota Public Utilities Commission, 414 N.W.2d 383, 386-387 (Minn.1987).

The Court did not question the Commission's authority to vacate its Order, but found that a less harsh result than dismissal of the entire rate case was appropriate where the record lent itself to an elimination of disputed elements of the petitioned increase where the vote of the disqualified member of the Commission was determinative. Supra at page 388. The Court, therefore, remanded the matter to the Commission with the direction that the Commission examine the issues for taint on an issue-by-issue basis and revise its order fixing rates accordingly. The Court did express the expectation, however, that the Commission would exclude at least the components on which Commissioner Adams' vote had been decisive. Supra at page 388. In short, while dismissal of the rate case was found beyond the Commission's authority, the Commission's vacation of the December 30 Order was not disturbed.

On remand, the Commission reviewed a Stipulation presented by all the parties. All parties, including NSP, agreed that the Commission's decisions regarding the Faribault coal gasification plant (and two other items in which Commissioner Adams' vote had been decisive) were tainted. In its ORDER AFTER REMAND, the Commission stated:

> The Commission agrees with the parties that all the items they have identified as tainted are tainted and should be disallowed. All these items passed on votes in which Commissioner Adams' vote was decisive.....These items were removed because of taint and because they are treated in the subsequent 86-160 rate case.[19]

With this action, the Commission properly and fully repudiated the treatment given the Faribault MGP cost recovery issue in the December 30, 1985 Order. The repudiation should stand. In light of these facts, no latter day resurrection of language on this issue from the discredited December 30, 1985 Order can be accepted.[20]

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[19] In the Matter of the Petition of Northern States Power Company for Authority to Change its Schedule of Gas Rates for Retail Customers Within the State of Minnesota, Docket No. G-002/GR-85-108, ORDER AFTER REMAND REVISING RATESETTING ORDER OF DECEMBER 30, 1985 (December 8, 1987), pages 2-3.

[20] This is not to suggest that the majority knowingly gave precedential value to a repudiated Order. The circumstances of the December 30, 1985 Order cited in this dissent with respect to the Faribault MGP issue were not brought to the Commission's attention by any

Commission Decision #2: NSP's Faribault Site (Docket No. G-002/GR-86-160)

The second time the MGP issue came before the Commission, the Commission (perhaps because it had already vacated the December 30, 1985 Order) did not even consider the previous NSP decision as precedent and in a major respect took a different approach on the MGP cost recovery issue.

As in the previous case, NSP requested amortization of operating expenses over a five year period and inclusion of the unamortized balance in the rate base. In its Order, the Commission noted no disagreement among the parties that the total cleanup cost ($856,248) should be amortized, but **disallowed** rate base treatment of the unamortized balance.[21]

Commission did not conduct a "used and useful analysis" of NSP's requested operating expenses, reflecting the view that a "used and useful" analysis is unnecessary with respect to the expensed items. In this regard, the Order reiterated the formula enunciated in the first Faribault MGP Order:

> In the absence of negligence or misconduct, the investor should be entitled to recovery of the expenses mandated by the MPCA. Order at page 11.

However, when it came to the **rate base** portion of NSP's request, the Commission did not follow the prior Order at all, but applied the traditional "used and useful" analysis (current benefit) to the rate base request. In rejecting NSP's rate base request, the Commission stated:

> However, ratepayers should not be required to pay a return on cleanup costs which are providing **no current benefit** to them. (Emphasis added.)

Subsequently, in NSP's 1991 electric rate case and subsequent Orders, the Commission has abandoned the distinction made in the 1987 NSP gas rate case Order between operating expense and rate base items in this regard. The Commission has clarified that the "used and useful" standard is applicable to operating expenses as well as to rate base items.[22]

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party prior to its vote on the issue. Had the circumstances of the Commission's first decision regarding the Faribault plant been known, it is likely that the vote on the MGP issue in this case would have been quite different.

[21] In the Matter of the Petition of Northern States Power Company for Authority to Change its Schedule of Gas Rates for Retail Customers Within the State of Minnesota, Docket No. G-002/GR-86-160, FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER (January 27, 1987) at page 11.

[22] See, e.g. 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-91-1, FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER (November 27, 1991) at page 28.

By the time the Commission considered its third MGP case, then, the status of the "used and useful" standard was that it was to be applied to rate base **and** expense items (NSP Order in Docket No. E-002/GR-91-1, November 27, 1991) and called for a showing of **current** benefit to rate payers.

Commission MGP Decision #3: Minnegasco's Docket No. G-008/GR-92-400

In Minnegasco's 1992 rate case, the Commission accepted the parties' Amended Offer of Partial Settlement which covered several issues, including Minnegasco's request to recover MGP costs at two sites. In accepting the parties' Settlement, the Commission specifically noted that its acceptance of the Settlement provided **no precedent** on how it would resolve the issues contained therein in future rate cases. Order at page 8.

Commission MGP Decision #4: Minnegasco's Docket No. G-008/GR-93-1090

In Minnegasco's 1993 rate case, the Commission modified the parties' Settlement Agreement regarding the clean-up cost recovery for two sites, reducing the figure agreed to in the Settlement by 50 percent. The Commission conducted no "used and useful" analysis or prudence analysis and made no findings in this regard.

In short, the Commission's Orders regarding Minnegasco's 1992 and 1993 rate cases do not modify the traditional "used and useful" standard that the Commission applied in the 1987 NSP gas rate case Order to NSP's rate base request (supra at footnote 8). That standard, as we saw above, required a showing that the property in question is "used and useful" to Minnegasco's **current** ratepayers.

Commission MGP Decision #5: Peoples' Docket No. G-011/GR-92-132

In the ORDER AFTER RECONSIDERATION in this matter, the Commission uses, for the first time, the term "nexus" to describe the required relationship between the site in question and the utility's current ratepayers. This represented a step away from the matching concept, but still required a substantial beneficial connection between the site in question and the utility's current ratepayers.

The relevant facts and points at issue in the Peoples case are so different from this case that the Commission's decision in the Peoples' case to allow recovery of MGP costs provides no precedent supporting Interstate's claim in this case. In the Peoples case, the site in question was "used and useful" to Peoples' current ratepayers. The Commission found that

> ...the record shows, that the land at issue has been used and useful for utility purposes since it went into [Peoples'] rate base in 1948. The land itself clearly meets the used and useful test, and it has for 40 years.[23]

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[23] In the Matter of the Application of Peoples Natural Gas Company, a Division of UtiliCorp United, Inc. for Authority to Increase Its Rates for Natural Gas Service in the State of Minnesota, Docket No. G-011/GR-92-132, FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER (February 22, 1993) at page 9.

In the Peoples case, unlike the present case, there was no dispute before the Commission whether the land had to be "used and useful" to Peoples current ratepayers in order to justify recoverability of the clean-up expenses. No party disputed that requirement and the Commission did not find that usefulness of the property to current ratepayers was unnecessary. Therefore, the Peoples case provides no precedent for deciding, as the majority has decided in this case, that usefulness of the property in question to current ratepayers is unnecessary. To the contrary, the Commission's decision in Peoples affirms the requirement that land for which remediation cost recovery is sought must be shown to be used and useful to the company's current ratepayers.

This is not to say, however, that the Peoples Order sheds no light on the present case. On the contrary: at page 9 of that Order, the Commission considered applying the "used and useful" test to the land at the time the need for remediation was created (as urged by Interstate in this case and adopted by the majority) and rejected that approach. Order at page 9. Strangely, that is exactly the approach that the majority takes in the current case.

Since Interstate and the majority cannot rely on the precedents actually set in the Peoples Order, they must focus on dicta regarding the Commission's December 30, 1985 Order in Docket No. G-002/GR-85-108, NSP's 1985 gas rate case. The dicta in question appears on page 4 of the Commission's June 11, 1993 ORDER DENYING RECONSIDERATION AND CLARIFYING ORDER. The language cited is dicta because it is not the basis for the Commission's decision to allow Peoples recovery of MGP costs. As noted above, the basis for that recovery (hence the precedent established in the Order) was that Peoples owned and operated the site in question for the benefit of its current rate payers.

Moreover, for the reasons cited above in the discussion of NSP's December 30, 1985 Order, the dicta in Peoples' ORDER DENYING RECONSIDERATION concerning that Order is inaccurate if it suggests that the Order is good precedent today. As we have seen, the Commission has not followed the MGP language in that Order as precedent in any subsequent case, but has instead properly repudiated it as fruit of a tainted tree. Accordingly, the December 30, 1985 Order can hardly control the current case.[24]

Summary of the Review of Precedents

In light of this case-by-case analysis of the Commission's MGP Orders, it is clear that Interstate was right when it informed its shareholders in its 1993 Annual Report:

> ...no Minnesota precedent has been established for the recovery in a similar situation.

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[24] There is additional dicta in the Peoples ORDER DENYING RECONSIDERATION which may have helped create an atmosphere conducive to eroding the substance of the used and useful (nexus) requirement. The Commission observed: "Although it would be ideal to match ratepayer use perfectly with clean-up costs, such symmetry is often impossible." In verbally suggesting that matching is similar to an aesthetic ideal ("symmetry") rather than a justice-based concept, this dicta inappropriately discounts the equitable imperative to match benefits with payers. In retrospect, this dicta is unfortunate, seeing how bold the attacks on the used and useful standard have become.

In allowing Interstate to recover MGP costs for the Rochester and Albert Lea sites, then, the Commission is not simply in the logical grip of its own precedents as suggested by the majority, but is breaking new ground and essentially vacating the used and useful standard. In my view, this is ground better left unbroken. Maintaining some substance to the used and useful standard (requiring some substantial beneficial connection or nexus between the site in question and current customers before requiring those customers to pay the clean-up costs for that site) is essential.

Whatever Became of Proper Allocation of Burden of Proof and Resolving Doubts in Favor of the Consumer?

In addition to the "just and reasonable" standard cited above, the Commission must apply the following statutory directive:

> Any doubt as to reasonableness should be resolved in favor of the consumer.
> Minn. Stat. § 216B.03 (1994).

The majority has lost this focus mandated by the legislature and instead substitutes its preference for the shareholders and what the majority views as the preferable public policy concern: encouraging the utility to fulfill its obligations under the clean-up laws.

To illustrate this loss of focus: the majority adopts the posture urged by the Company when dealing with the Company's assertion that customers receiving manufactured gas service and customers receiving natural gas service should be treated as one category for rate making purposes. Despite the statutory requirement that the utility bear the burden of proving every element of its case by the preponderance of the evidence, the majority assumes an element of the Company's case (that two commodities, manufactured gas and natural gas, are identical in all relevant respects) and places the burden on the Department and the RUD-OAG to demonstrate to the majority's satisfaction[25] that manufactured gas and natural gas are different utility services that warrant different regulatory treatment. This assumption of an element of Interstate's case, of course, reverses the proper burden of proof and is contrary to basic regulatory law, but the majority does it without batting an eye.

The majority's discussion at page 29 illustrates how completely it has reversed the burden of proof. The majority characterizes the point raised by the Department's and the RUD-OAG's as an effort to "cut off recovery" (as if recovery is a given unless someone can prove to the contrary!) and repulses the effort. In the absence of any facts in the record to bear Interstate's burden on the point, the majority simply rejects a series of arguments offered by the Department and the RUD-OAG, alludes to (without citing) "Commission precedent", claims that it has "common sense" on its side, and considers its work done.

However, although the Department and RUD-OAG do not bear the burden on the issue, they do succeed in making the very modest but important point that the Minnesota legislature as well as the Federal Energy Regulatory Commission (FERC) recognize that there is a difference between manufactured gas and natural gas.[26] The inference from that legislative recognition of difference

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[25] Given the majority's policy preferences, this was a tough sell, indeed.

[26] See Minn. Stat. § 216B.02, subd. 6 (1994) and 18 CFR Part 201 (21).

is that there is no legislative assumption or directive that customers of the two different products should be viewed as interchangeable, as the majority assumes they should be treated. A further inference is that it is reasonable, in appropriate circumstances, for the Commission to make distinctions between customers of those services. If the legislature wanted to preclude the Commission from ever making distinctions between the two items in its regulatory dealings, the legislature could have done so. Since the legislature left the question open, the burden is upon the utility (if it wishes the Commission to treat manufactured gas and natural gas as indistinguishable, for example, for MGP cost recovery purposes) to close the question.

Interstate has failed to do so. Its recourse to Commission precedent fails. The Commission Orders cited by the Company as establishing that the costs related to MGP site remediation are "related to gas utility operations" do not constitute Commission findings for purposes of this proceeding. Its recourse to the supposed dictates of "common sense" also fails. So-called common sense that leads to counterintuitive results (requiring ratepayers who have never benefitted from the sites in question to pay for the clean-up of those sites) is a contradiction in terms.

In these circumstances, Interstate's claim is murky at best and the majority has stood the statutory imperative upon its head and favored the Company.[27]

CONCLUSION

It is not too late. The Commission may still regain proper focus on the MGP cost issue. To do so, the Commission must retreat from the recently unearthed and totally illegitimate formula: used and useful for utility service at the time of the contamination. That formula binds ratepayers (no matter how far away in time, space, service category, benefit etc. from the scene of the contamination) in the strands of the majority's public policy preferences and delivers them as a source of funding for virtually any reasonably incurred MGP cleanup costs.

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[27] To clarify, this dissent does not view resolution of the natural gas v. manufactured gas issue to be critical to its opposition to the majority's decision to allow cost recovery in this case. The failure of nexus between Interstate's current customers and the Rochester and Albert Lea sites is evident, based on the traditional "used and useful" analysis, without this additional distancing factor. However, the fact that it is reasonable to view manufactured gas customers and natural gas customers as composing different categories of utility customers certainly adds another substantial distancing element between Interstate's current customers and the sites in question and lends additional strength to an already adequate analysis that Interstate's current customers have no reasonable responsibility for the clean-up at these sites.

As shown in this dissent, the majority's formula for Company recovery in this case is inconsistent with the Commission's actual precedents and statutory obligations and, therefore, should be repudiated.

Signed:

Marshall Johnson
Commissioner

Date: