ISSUE DATE: February 18, 2000

DOCKET NO. E-015/M-99-416

ORDER DENYING RECONSIDERATION AND AFFIRMING ORDER DISALLOWING RECOVERY OF LOST MARGINS

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Gregory Scott	Chair
Edward A. Garvey	Commissioner
Joel Jacobs	Commissioner
Marshall Johnson	Commissioner
LeRoy Koppendrayer	Commissioner

In the Matter of Minnesota Power's Petition for Implementation of a CIP Adjustment Rate

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PROCEDURAL HISTORY

On July 27, 1999, the Commission denied Minnesota Power's request for recovery of $3,498,854 in 1998 **lost margins** related to Conservation Improvement Program (CIP) activities.[1] The Commission's Order in this matter indicated that: (1) MP was already earning above its authorized rate of return (2) lost margins were not successfully motivating the Company to increase its use of Demand Side Management (DSM), and (3) MP had not met its burden of proof in showing that the requested lost margin recovery is consistent with law and sound public policy.

On August 16, 1999, MP filed a request for reconsideration of the Commission's decision. MP argued, over the past five years, the Commission committed itself to allowing lost margin recovery through 1998 without regard to earnings. Also, the Company argued that the Commission's previous CIP orders establish a uniform policy that cannot be revoked or fundamentally altered retroactively. According to MP, these orders and the policy they established entitle MP to recover 1998 lost margins as a matter of law.

[1] MP's per unit **margin** on the sale of a unit of electricity is the difference between the Company's per unit revenue and per unit cost. As a result of a conservation program, a utility will sell fewer units of electricity than it otherwise would. Margins that the Company does not realize due to this reduction in sales are referred to as "lost" margins. The objective of allowing utilities' to collect these "lost margin" amounts is to eliminate a disincentive to invest in conservation, i.e. to make the utility financially indifferent as to energy sales reductions due to conservation efforts, thereby overcoming any resistance the utility might have to such an undertaking.

On September 1, 1999, Ag Processing et al.[2] filed a reply to MP's petition. It argued that the Commission should reject MP's request for reconsideration because the Company had not shown that the Commission's decision is either unlawful or unreasonable.

On August 31, 1999, the Office of the Attorney General (OAG) filed a reply to MP's petition. The OAG argued that lost margin recovery was simply a hedge against losses that cause a utility to underearn and that MP had no legitimate expectation that it would be allowed to recover lost margins if it had already earned its authorized rate of return.

On August 31, 1999, the Minnesota Department of Public Service, now the Department of Commerce (the Department), filed a reply to MP's petition. The Department stated that the Commission's decision to deny MP recovery of 1998 lost margins based on over-earnings was lawful and that any reliance by MP on a specific rate of recovery with respect to lost margins was unreasonable. However, the Department supported MP's request for reconsideration for the following policy considerations: (1) the Department believes that approval of financial incentives should be based on the Company's compliance with a Commission-approved financial incentive plan, not on earnings, and (2) the Department believes that a change in the Commission's treatment of financial incentives should be prospective to insure that financial incentives will work in the future.

The Commission met on October 28, 1999 and November 18, 1999 to consider this matter.

FINDINGS AND CONCLUSIONS

The Commission has an obligation to assure just and reasonable rates and to resolve any doubt as to the reasonableness of rates in favor of the consumers. Minn. Stat. § 216B.03. The Commission has reviewed the record and heard the arguments of all parties. Having examined the issues once again, however, the Commission continues to believe that its original decision was correct and should be affirmed. MP will not be allowed to include an additional $3.5 million (lost margins for 1998) in its CIP tracker account for subsequent rate recovery.

As noted in its initial Order at page 4, the Commission views the Company's request to book the 1998 lost margins to the CIP tracker as a proposal to increase rates, i.e., a proposal which requires the Commission to determine whether the resulting rates are just and reasonable.

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[2] Ag Processing is an ad hoc group of commercial and industrial electric customers that includes two members (Lakehead Pipe Line and North Star Steel) who purchase electricity from MP. They have been active participants in this Docket.

MP has not challenged that enunciated decision-making framework. Instead, the Company raised several arguments attempting to circumscribe the Commission's legislative discretion to determine whether the proposed increase would result in rates that are just and reasonable. In sum, the Company argued that it is entitled, as a matter of law, to receive the lost margins for 1998. The Company's principal arguments are summarized and discussed as follows:

First, MP argued that the Commission may only determine whether MP's rates are just and reasonable in a rate case. The Commission agrees that base rates may only be changed in a rate case. However, the Commission has not sought to change the rate base in this proceeding. This case concerns the rate impact of NSP's requested recovery of lost margins. Minn. Stat. § 216B.03 gives the Commission the authority and responsibility to ensure that every rate demanded by a pubic utility is just and reasonable and does not restrict that obligation to the rate case setting. As noted previously, this matter was initiated by MP's request for Commission approval to book the 1998 lost margins to the CIP tracker. Since granting the request would impact rates, the Commission is required to apply the just and reasonable standard enunciated in Minn. Stat. § 216B.03 to that rate impact.

Second, MP argued that the Commission may not depart from a longstanding policy of the legislature and the Commission to allow DSM financial incentives regardless of utility earning. MP has incorrectly translated Commission Orders into a policy guaranteeing that utilities will be allowed lost margin recovery regardless of whether such recovery would result in the utility earning more than its authorized rate of return. See the Commission's analysis of its prior decisions involving MP's DSM incentive program and conclusion that the Commission had never established recovery of lost margins as a right. July 27, 1999 Order, pages 4-5.

- In MP's 1994 rate case Order issued November 22, 1994 Order in Docket No. E-015/GR-94-001, for example, the Commission required MP to file its lost margin requests annually but never committed in advance to granting those requests. It did not promise **recovery** of lost margins but simply approved a mechanism (formula) to **account** for those lost margins. Actual approval of such recovery was left to future proceedings (such as the current docket) from which the just and reasonable standard was not excluded.

- MP asserted that the Commission's October 26, 1995 Order in Docket No. E-015/M-95-898 "assured recovery" of lost margins through 1998. However, the cited Order made no mention of earnings in connection with lost margin recovery. Silence on this point does not translate into a guarantee of unconditional recovery and does not preclude the Commission from denying lost margin recovery due to over-earning. At the October 28, 1999 hearing on this matter, MP acknowledged that for the last five years it has not booked its lost margins in the year they are incurred because it does not know until the Commission approves them whether the Company is entitled to them.

- Likewise, the Commission's July 24, 1996 Order approving NSP's proposed CIP adjustment for 1995 (Docket No. E-002/M-996-340) provides no precedent binding the Commission in the current case. In that Order, the Commission addressed the recovery of **conservation costs** regardless of earnings and allowed such recovery. The Order did not involve requested recovery of **lost margins** regardless of earnings (the current issue) and, therefore, provides no precedent on that issue.

Third, MP argued that it would be unfair and arbitrary to deny lost margins to MP after giving them to Otter Tail Power Company and Minnegasco. In effect, MP argued that the precedent set in these two Orders is binding upon the Commission with respect to MP's lost margins. However, the facts in the Minnegasco and Otter Tail cases are so different that the decisions in those cases provide no precedent in this matter. With respect to the Minnegasco decision, the Commission believed it had committed to Minnegasco in a prior Order that approval for its DSM Financial Incentives Plan (which included a proposal to recover lost margins) would continue "without a sunset provision..." while no such commitment existed to NSP. See Footnote 4 of the Commission's July 27, 1999 NSP Order. More fundamentally, however, the actual 1998 earnings of Minnegasco and Otter Tail were **below** the authorized level. By contrast, MP over-earned on an actual basis in 1998 (the year the lost margins in question were incurred) and did so regardless of whether the Commission approves or denies lost margins for 1998.[3]

Fourth, MP argued that the Commission's prior decisions allowing utilities to recover lost margins irrespective of earnings levels is a Commission policy akin to a rule that the Commission may not change retroactively to deny MP's 1998 lost margins. No retroactive ratemaking (or rulemaking) is involved in this matter, however, as both the OAG and the Department noted. MP sought authority to recover from ratepayers in 1999 and 2000 those margins it claims were lost in 1998. Thus, the Company sought a future change in rates based on individual circumstances. Disapproval of a prospective rate based on facts specific to a single utility clearly cannot constitute retroactive ratemaking or rulemaking.

Fifth, MP argued that the Commission is estopped from denying MP its 1998 lost margins because the Commission made representations assuring the recovery of lost margins, MP reasonably relied on those representations, and (as a consequence) the Company will be harmed if the Commission is not bound by those representations. However, MP has shown none of the elements of estoppel identified in *Brown v. Department of Public Welfare*, 368 N.W.2d 906, 910 (Minn. 1985).

Most basically, as noted previously, the Commission has at no point represented to anyone that future claims for recovery of lost margins would be granted irrespective of the utility's earnings.

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[3] The Commission's DSM 1999 decisions are fully consistent in this regard. Where the utility (MP and NSP) over-earned on an actual basis in 1998, the year the lost margins in question were incurred, and did so regardless of whether the lost margins for 1998 were recovered, the Commission **denied** recovery of lost margins. By the same token, where the utility (Otter Tail and Minnegasco) did **not** over-earn on an actual basis in 1998, the year the lost margins in question were incurred, and would not do so even if the Commission approved lost margins for 1998, the Commission **approved** recovery of lost margins.

None of the other elements of estoppel listed in *Brown* exist either. For example, as the Department and the OAG noted, MP has not shown detrimental reliance, i.e., that the Company changed its position due to any Commission Order and that harm resulted. MP's earnings show that any lost margins resulting from its CIP projects were made up by increased revenues elsewhere. Since recovery of lost margins in excess of its authorized rate is not an entitlement, not being granted such recovery does not constitute "harm." Recovery of lost margins in excess of its authorized rate also is inappropriate since the objective of lost margin recovery is to make the utility financially indifferent as to energy sales reductions due to conservation efforts. Finally, MP's interest in receiving lost margins when it is already over-earning certainly does not outweigh the public interest in just and reasonable rates.

In addition to its legal arguments, MP (joined by the Department) sought to persuade the Commission that the decision to deny recovery of the lost margins for 1999 was unwise or imprudent as a matter of public policy. The Commission has carefully reviewed MP's and the Department's policy considerations, including the valuable contribution of conservation expenditures and concerns about the impact of denial on the effectiveness of financial incentives in the future. On balance, the Commission finds that these concerns do not outweigh the Commission's determination that in the circumstances of this case allowing recovery of the lost margins would result in unjust and unreasonable rates.

The contribution of conservation expenditures is not questioned by the Commission's decision in this matter. Nor has the Commission's decision to disallow lost margins in this case failed to appropriately compensate the Company for these expenditures. The Commission has allowed the Company to recover the entire dollar amount of such expenditures, dollar for dollar, so that the Company is not a penny out of pocket. In addition, under the rationale adopted by the Commission in this case (and in all its 1999 DSM Orders reviewing 1998 lost margins) the Commission would have allowed the Company to recover lost margins if it had not overearned. These are not inconsiderable means of acknowledging the value of conservation expenditures.

As to ensuring utilities' confidence in financial incentives, the Commission can not be held hostage to unrealistic expectations regarding guarantees that the Commission has not given.

The Commission remains convinced that since MP was already overearning (charging higher than what is necessary to recover its authorized rate of return) during the period in question (1998), the Commission should not allow the Company to charge its ratepayers even more, i.e., to allow the Company to recover additional amounts (incentive amounts) from the ratepayers. In this case, the guaranteed recovery of conservation costs together with the statutory mandate to make a certain level of conservation-related expenditures provided adequate incentive for MP to meet that statutory mandate.

In sum, the Commission's obligation to assure just and reasonable rates and to resolve any doubt as to the reasonableness of rates in favor of the consumer requires it to affirm the July 27, 1999 Order in this matter as it stands.

ORDER

1. MP's petition for reconsideration is denied.

2. The July 27, 1999 Order in this matter is affirmed.

3. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

(S E A L)

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DISSENTING OPINION
ON THE
LOST MARGIN DECISIONS
(Docket # E-002/M-99-419 & E-015/M-99-416)
BY
EDWARD A. GARVEY
MINNESOTA PUBLIC UTILITIES COMMISSION

The Minnesota Public Utilities Commission has awesome responsibilities with its decisions having wide ranging and long-term impacts. As a result, the people of Minnesota expect it to act wisely and honorably. Wisdom, of course, is in the eye of the beholder, but to me it means thoughtfully balancing quality, prices, profits and mandates. It also means not being penny-wise and pound-foolish or acting whimsically. Though amorphous, acting honorably to me means acting in a fair and deliberate way, with consistency, respecting precedent, giving affected parties unambiguous warning of the Commission's intentions, and applying Commission decisions prospectively. The Commission acted unwisely when it concluded that lost margins either do not exist or that their recovery is inappropriate if a utility meets or exceeds its authorized earnings level. The Commission acted less than honorably by applying this conclusion to NSP's and Minnesota Power's request for recovery of 1998 lost margin amounts.

Wisdom: Balancing Competing Public Interests.
The role of the Commission is to decide what is in the public interest. However, it is important to appreciate that the public interest is not an absolute law of nature, a tangible thing that we can touch, or a universal law of physics that utility regulators discover. Rather, the public interest is like the weather: it changes over time and affects each utility and its customers differently. Just as the weather is determined by the interaction of wind, rain, temperature, and sunshine, there are four fundamental elements that make up the public interest balance. The first element is service quality. I define service quality as keeping the lights on in a reliable and safe way throughout the service area.

Price is the second element. Price is how much utilities charge for the electricity services they provide consumers. Establishing the prices utilities can charge consumers is an important role of public utility commissions in a rate-regulated world. The desire for lower prices by some and greater pricing flexibility by others are driving forces behind restructuring efforts.

The third element is profits. Electricity, though a necessity, cannot be produced or delivered for free. Providers of electricity must be able to earn a return on their capital resources and investments. Even cooperatives and municipal providers must recover their costs.

The final element in the public interest balance is societal factors. These desires and mandates include environmental concerns, renewable energy requirements, universal service, protecting low income consumers and, of course, the replacement of monopoly rate regulation with market-oriented competition.
Just as weather forecasters balance competing meteorological elements to predict the weather,

utility commissions makers must balance quality, price, profits and mandates in a myriad of ways to determine the public interest. Let me list several common balancing issues. Under regulation's traditional "social contract," the balancing was between price, quality and profits, as governmental oversight of service quality and pricing was the trade-off for assured recovery of prudently-incurred costs and an opportunity to earn a set percentage of profit. Similarly, we routinely balance reasonable electricity prices with the costs of generating it. Recently, social desires and mandates in the form of renewable energy requirements have become an important part of this balancing act. Proposals to develop new transmission lines have tested the balancing between quality and mandates. And, the desire to restructure the industry is forcing a new balance point between all four public interest elements. There are many balances to be struck, because each element changes the equation, making the balancing a difficult, dynamic and interactive Commission decision-making process.

The lost margin issue poses one of the more difficult balancing issues, requiring the Commission to balance profits, prices and social desires against one another. However, it appears not to be difficult for the Commission because it chose not to do any balancing whatsoever. Instead of balancing competing interests, the Commission evidently concluded that under no circumstances should a utility earn more profits than its approved rate of return, regardless of what the countervailing interests may be. I conclude this since there is nothing in the record on what the consumer price impact would be if NSP and Minnesota Power were allowed to recover the lost margins. There was no discussion of consumer prices. The entire focus was on the amount recovered by the utility. Nor was the recovery balanced against the competing energy efficiency and conservation mandates that led to the lost margins issue in the first place.

Wisdom: Promoting Energy Conservation
A wise commission supports energy conservation and efficiency efforts because of their many environmental and rate-protection benefits. Efficiency and conservation is being penny-wise. First and most importantly, energy conservation and efficiency reduces the need for electricity generation. It is estimated that NSP's conservation and efficiency efforts have saved the equivalent of two medium-sized power plants. Such reductions mean less air pollution and greenhouse gas emissions. It also means avoiding the economic and societal costs associated with building new generation facilities. Conservation and efficiency also mean that consumers use less electricity, therefore spending less money on electricity. Thus, a wise commission supports energy conservation and efficiency because it saves consumers money and helps build a more sustainable environment.

Over the last decade, this Commission, working with the Department of Commerce, has acted wisely by promoting energy conservation and efficiency. It has done this by implementing the state-mandated gross review spending requirement by adopting conservation improvement programs and resource plans and by allowing lost margin recovery. Loss margin recovery supports energy conservation and efficiency. Minnesota Power and NSP earn most of their money by selling electricity. They do not make, and may in fact lose, money when they do not sell electricity. Thus, since energy conservation and efficiency efforts reduce electricity sales, these utilities have little incentive to pursue them with the vigor such programs need and deserve.

Requiring utilities to pursue programs that are contrary to their corporate best interests is like asking banks to promote loan reduction programs, or credit card companies to promote consumer spending reduction programs, or car companies to promote light rail transportation systems. These things are not required, nor should they be, and obviously, if they were, the entities involved would be doing things against their corporate self-interests, resulting in less than ideal implementation. Thus, in many respects if we have a problem with loss margins, the solution is not eliminating the incentive that makes the programs work, but finding ways to eliminate the conflict of interest we have built in by having utilities implement the energy conservation and efficiency programs. Nonetheless, utilities are the entities this state has asked to implement energy conservation programs. This mandate was imposed knowing that it was against the utilities' corporate interests. To overcome this commonsensical disincentive, the legislature permitted, and the Commission wisely allowed, lost margin recovery. The benefits in reduced electricity demand and its associated environmental and societal benefits speak for the success of the programs.

Instead, the Commission unwisely accepted the linguistic tautology that lost margins do not exist if the utility meets or exceeds its authorized rate of return. "But for" energy conservation and efficiency efforts, NSP and Minnesota Power would have sold more electricity. These sales would have earned them money, both in terms of cost recovery and profits. Of course, they would have earned more than they do now and that may have been above their authorized rates of return requiring a rate case. But they did not earn that money due the energy efficiency and conservation efforts. Thus, lost margins have nothing to do with earnings. Linking lost margins to a utility's earnings is not based in fact or accounting.

To summarize, energy conservation and efficiency offers important environmental and rate-protection benefits and is in the public's interest. A wise commission, therefore, promotes such efforts, with lost margin recovery being one of the useful promotion tools. This state and this Commission have acted wisely. It has promoted energy conservation and efficiency, using loss margins recovery as a one of its tools to promote such efforts.

Act Honorably When Changing Regulatory Policies

Unlike the first source of disagreement, which is founded in one's perspective of wisdom and the public interest balancing, the second source of disagreement stems from a fundamental belief on how the Commission ought to pursue its awesome regulatory powers. Some view such a methodology in narrow legal terms of due process or of statutory authority. I take a less legalistic view, believing that the Commission ought to act honorably when reaching its decisions, and does so in most cases. Unfortunately, as it relates to lost margins recovery, it did not.

Although I disagree with the Commission's desire to eliminate lost margin recovery as a tool to promote energy conservation, it is certainly appropriate for the Commission to change its mind on how to, and which tools to use, to promote conservation or to achieve any public interest goal. But, when making such changes it should act honorably. To act honorably, a commission provides certainty and consistency. To do otherwise leads to uncertainty and inconsistency, which increases costs and risks to both the utility and the public that we serve. The Commission must remember that it regulates businesses that must develop and implement important and complicated operations. Inconsistent, whimsical or unprincipled regulation undermines those plans and threatens reliability, safety and the low costs that we strive to achieve.

In order to provide certainty and consistency, the Commission should respect precedent. In this case, that means recognizing that loss margins recovery was a long-standing and effective policy tool used to promote conservation. It is also Commission precedent to not condition lost margin recovery on a utility's earnings. The Commission has specifically rejected such a condition. If the Commission wishes to reverse a clear precedent, it should do it in an honorable way.

This means not knee-jerking in the face of unpleasant news. In these dockets there are some high aggregate lost margin recovery amounts which seem to shock and perhaps offend some people. But, an honorable commission does not knee-jerk to such news and rush to pull the plug. Instead, it ought to thoughtfully and deliberately think about why such high recoveries are possible and explore potential solutions against the underlying policy of promoting conservation and its benefits. Having done that, an honorable commission acts in a principled and fair manner, giving unambiguous advance warning and then applying its decision prospectively.

Acting honorably also means adopting fair polices that can be applied to all that it regulates in similar situations. The use of earnings as a condition of lost margin recovery sets up an unfair standard. A utility's earnings are dependent on many things, i.e. weather, management decisions, acts of God, etc. They rarely turn on the efficacy of its conservation efforts. Thus, using earnings to determine whether loss margins are allowed unfairly benefits the unlucky or poorly-run utility, while punishing the lucky or well run utility. To make matters worse, the Commission appears to have based its decision for Minnesota Power and NSP on normalized earnings, but used actual or annual earnings for other utilities; Reliant-Minnegasco comes to mind, and there may be others.

As I said, it is all right for this Commission to decide that the lost margins tool is no longer appropriate, but to act honorably means making such a change, such an important and long-standing change, with clear and unambiguous advance notice to those affected. No such advance warning was given here. It was not until last November, November 1998, that the topic came up and the Commission's action led the Department of Commerce and utilities to think that 1998 loss margins would be recovered but 1999's would likely be disallowed. Some have argued to the Commission that NSP and Minnesota Power should have been on notice that they may not be allowed to recover 1998 lost margins because the Department of Commerce urged the Commission to take such a position as long ago as 1997.
Such an argument is wrong for several reasons. First, having a party or a number of parties raise an issue is not nor should not be deemed "notice" to affected parties. The positions of parties do not reflect the Commission's decision or intentions. Only the Commission, through its decisions and orders, reflects the Commission's intentions. Second, the record indicates that the OAG had been arguing for the elimination of lost margins for many years, and as late as 1997 the Department of Commerce had in fact supported lost margins recovery for 1996. Thus, parties change their positions, which is very appropriate given the rapidly changing world in which we live in. But that also makes clear that the Commission should expect parties to be on notice of potential Commission action based upon those positions. To do so is to build policy on an ever-shifting and arbitrary foundation. In this case, it is clear to me that the Commission did not give the affected utilities advance notice.

Even to the extent that the Commission believes that it gave such notice in November 1998, such notice was ambiguous, not the clear and unambiguous notice the Commission should give. I conclude this by pointing out that the Department and the utilities did not interpret the Commission's decision last November as such notice. In fact, they concluded just the opposite. That is why the Department comes before us asking this Commission to approve 1998 lost margins recovery even though they led the charge against such recovery. Similarly, NSP's failure to notify its shareholders last November of the potential that 1998 lost margins recovery would be disallowed is evidence that NSP shared the Department of Commerce's interpretation of the Commission's November 1998 decision.

Finally, given all this, unless there is a compelling reason to act otherwise, a commission that wishes to act honorably does not change a long-standing policy and apply it retroactively. Acting honorably means acting prospectively. It is wrong for a lawyer to raise her hourly billing rate and then back bill her clients for the increased rates, or for the government to change the tax code mid-year or after the tax year has ended, or, for a parent to punish a child for actions that the child did not know was wrong or were not wrong at the time the action was taken. Similarly it is just as wrong for this Commission to deny 1998 loss margins almost a year after that year has ended. That is retroactive, and lacking a compelling reason to do so, it is not how a wise and honorable commission governs.

There is no compelling reason here that justifies such retroactive application. There is only the concern of the magnitude of the loss margins recovery and a desire to connect recovery to a utility's earnings. While both may be legitimate concerns, they are not compelling enough to overcome the traditional way a wise and honorable commission governs.

I strongly disagree with the Commission's decisions on lost margins. Lost margins have proven to be a very effective tool to promote energy conservation and efficiency. Through such promotion, Minnesota has saved itself the environmental, societal and economic costs of having to build new generation facilities. Ratepayers have benefitted by not paying for higher cost electricity from such new generation facilities and by using less electricity in the first place. These benefits far outweigh the costs of lost margins recovery. In sum, a wise commission promotes energy conservation and efficiency, with lost margin recovery being one useful tool for doing so.

But, a commission can and should always assess the regulatory tools it wishes to use to promote the public interest. It may therefore be entirely appropriate to no longer permit lost margin recovery in the future, and to that end it is my understanding that for 1999 the utilities, the Department of Commerce and the Office of Attorney General will present to the Commission a new way of promoting energy conservation and efficiency. Making such changes in a prospective way is the honorable way to act. Unfortunately, the Commission chose not to act prospectively. It chose to act retroactively and deny lost margin recovery for 1998.

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Edward A. Garvey, Commissioner