

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

LeRoy Koppendraye  
Marshall Johnson  
Ken Nickolai  
Phyllis A. Reha

Chair  
Commissioner  
Commissioner  
Commissioner

In the Matter of a Petition by Interstate Power  
and Light Company for Authority to Increase  
Electric Rates in Minnesota

ISSUE DATE: July 1, 2004

DOCKET NO. E-001/GR-03-767

ORDER AFTER RECONSIDERATION AND  
AMENDING MODIFICATION TO  
SETTLEMENT

**PROCEDURAL HISTORY**

**I. The Original Rate Case Order**

On April 5, 2004, the Commission issued its Findings of Fact, Conclusions of Law and Order; Order Modifying Settlement in this general rate case. Among other things, that Order found that Interstate Power and Light Company (IPL or the Company) was incurring an annual revenue deficiency of \$214,073, set new rates to permit recovery of this revenue deficiency, and required the Company to refund the difference between amounts collected in interim rates and amounts collectible in final rates.

There were only two active parties to this case, the Company and the Minnesota Department of Commerce. These parties settled three issues – the cost of capital, the treatment of rate case expenses, and the weather normalization of sales volumes and revenues. They also independently reached identical positions on many issues, and on these issues they submitted joint proposed findings, conclusions, and recommendations. They litigated eight issues before the Administrative Law Judge, but only six of these were still contested when the case came before the Commission.

The April 5 Order accepted the parties' settlement on all issues except the cost of equity, which it reduced from 12.22% to 11%. It accepted the parties' resolution of all issues on which they had independently reached the same conclusions and submitted joint recommendations. It also resolved the six contested issues on the basis of the evidentiary record developed by the Administrative Law Judge.

The most significant contested issue was the ratemaking treatment of costs paid for transmission services to the Midwest Independent System Operator (MISO). On this issue the Commission concurred with the Department that rate recovery should be denied for lack of evidence that the costs benefitted ratepayers.

## **II. The Notice Rejecting Settlement Modification and Petition for Reconsideration**

On April 15, 2004, the Company filed a notice of rejection of the Commission's modification to the settlement under Minn. Stat. § 216B.16, subd. 1a (b). The Company also filed a petition for reconsideration under Minn. Stat. § 216B.27, seeking reconsideration of both the decision to modify the settlement and the decisions on four of the six contested issues.

The Company's filing stated that it would reexamine its decision to reject the settlement modification after the decision on reconsideration; it also stated that the Company would accept a return on equity of 11.3% to 11.49%. The filing also included an alternative proposal on the ratemaking treatment of MISO costs, proposing that the Commission permit immediate rate recovery of 80% of those costs and defer the remaining 20% for consideration in the next rate case.

On April 26, 2004, the Department of Commerce (the Department) filed its response to the petition for reconsideration. The Department took no position on the Commission's modification to the settlement agreement. The Department opposed reconsideration of the Order's resolution of the contested issues and opposed the Company's new proposal on the recovery of MISO costs.

On June 10, 2004, the petition for reconsideration came before the Commission.

On June 14, 2004, the Commission issued an Order granting reconsideration to toll the 60-day statutory deadline after which petitions for reconsideration not granted are deemed denied.<sup>1</sup> The Order explained that the issues raised on reconsideration were complex and could not be adequately addressed within the statutory time frame.

## **FINDINGS AND CONCLUSIONS**

### **I. Summary of Commission Action**

Having reexamined the record and having heard the arguments of the parties, the Commission concludes that on two issues – the rate of return on equity and the ratemaking treatment of MISO costs – the April 5 Order should be changed.

---

<sup>1</sup> Minn. Stat. § 216B.27, subd. 4.

On reconsideration, the Commission will set the Company's rate of return on equity at 11.25% and will permit immediate recovery of 80% of MISO costs, granting deferred accounting treatment to the remaining 20%. On all other issues the Order will be affirmed.

These decisions will be explained in turn.

## **II. Rate of Return on Equity**

### **The Original Order**

The April 5 Order rejected the parties' proposed 12.22% return on equity for three main reasons:

- The flotation adjustment applied by the Department was not requested by the Company, was inconsistent with Commission precedent, had no support in the record, and could not be justified as a just and reasonable rate component.
- The substantial upward adjustments the parties applied to the base cost of equity to reflect the Company's relatively small size were not supported by the record, which not only lacked empirical data demonstrating the Company's susceptibility to size-related risk but also failed to examine and account for other business and investment risks that might offset or even outweigh the risks associated with the Company's size.
- It would have been anomalous to set the Company's return on equity at its highest point in the past 13 years, at a time when the cost of money was at its lowest point in some 40 years.

The Order went on to set the rate of return on equity at 11%, based on the three fully developed, factually-supported DCF (Discounted Cash Flow) studies placed in the record by the parties, and on a smaller upward adjustment to reflect the Company's comparatively small size.

### **Positions of the Parties**

The Company argued that the 11% return on equity set by the Commission was unsupported in the record, pointing out that both parties' expert witnesses had testified that a higher rate of return was appropriate. The Company also argued that the Commission's reduction of the size adjustments applied by the parties was inconsistent with the record, especially the 2002 Ibbotson Associates

study showing that historically, firms with smaller capitalizations have had higher returns than firms with larger capitalizations.<sup>2</sup>

The Company stated that the record did support returns on equity between 11.3% and 11.49% and that it would accept a return in that range as reasonable.

The Department took no position on the Commission's modification to the settlement's return on equity, except to note that the alternative range of returns proposed by the Company was within the range of returns – 9.90% to 12.22% – presented as reasonable in the Department's testimony.

### **Commission Action**

As the April 5 Order explained, setting the rate of return on equity is not like solving an equation – there is no right answer. Instead, there is a range of reasonable options that the Commission must analyze based on its professional judgment, institutional expertise, and historical experience.

The Commission has reexamined both the record and the analytical process by which it calculated the 11% rate of return on equity adopted in the April 5 Order. The Commission finds the analytical framework of the Order sound and continues to rely on it as it reexamines the cost of equity. On the basis of the arguments made on reconsideration, however, and with the benefit of further reflection, the Commission finds that a 45-point adjustment for company size more accurately reflects IPL's size-related risk than the 20-point adjustment made in the April 5 Order.

The 20-point upward adjustment reflected the Commission's best judgment, informed by the record and its own deliberations, of IPL's size-related risk; it was not, however, a mathematical representation of that risk. Upon reconsideration the Commission concludes that the 45-point adjustment the Company sponsored in its testimony more closely approximates that risk and will adopt it in recalculating the cost of equity.

The 45-point adjustment was proffered by the Company's rate-of-return expert as his calculation of IPL's risk premium when compared with the three gas and electric companies in his combination-utility proxy group. These companies were, on average, 3.5 times the size of IPL, which translated into 45 basis points when entered into his empirical model with other factors affecting business or financial risk.

While empirical models are decision-making tools whose usefulness does not extend to dictating outcomes, in this case the Commission finds that the 45-point adjustment for company size is a more straightforward, objective, and accurate measure of the Company's size-related risk than the original 20-point adjustment. The Commission will adopt the 45-point adjustment, bringing the rate of return on equity to 11.25%.

---

<sup>2</sup> Direct Testimony of Frank J. Hanley, Exhibit, Schedule 1, pages 6 *et seq.*

With this adjustment, the overall rate of return for IPL is 9.172%, calculated as follows:

<b>Type of Capital</b>	<b>Ratio</b>	<b>Cost</b>	<b>Weighted Cost</b>
Long-Term Debt	45.155%	7.084%	3.199%
Preferred Stock	7.697%	8.688%	0.669%
Common Equity	47.148%	<b>11.250%</b>	5.304%
<b>Overall ROR</b>	100.000%		<b>9.172%</b>

### **III. Ratemaking Treatment of MISO Schedule 10 Costs**

#### **A. The Original Order**

The April 5 Order rejected rate recovery of some \$202,798 in MISO Schedule 10 administrative costs, concurring with the Administrative Law Judge that the Company had failed to prove by a preponderance of the evidence that these costs were reasonable in amount and had been prudently incurred.

The Commission also declined to accept the Administrative Law Judge's recommendation to grant deferred accounting treatment for these costs, finding that the costs of deferred accounting – administrative inefficiency, added expense, and inter-generational subsidies – outweighed any benefit that might result from preserving these costs for potential later recovery.

#### **B. Positions of the Parties**

In its reconsideration petition the Company reiterated its earlier arguments in support of immediate rate recovery of all Schedule 10 costs, but it also proposed an alternative treatment of these costs – immediate rate recovery of 80%, with the remainder deferred, without carrying charges, for consideration in the next rate case.

The Department continued to oppose rate recovery of any portion of these costs, but advocated limiting recovery to 50% of total costs with no deferral of the remainder if the Commission chose to grant any rate recovery.

#### **C. Commission Action**

As the April 5 Order makes clear, proper ratemaking treatment of MISO Schedule 10 administrative costs is a difficult issue.

On the one hand, hard evidence of tangible contributions by MISO to IPL's operations is conspicuously absent. IPL's justification for recovering MISO costs essentially consisted of listing the same goals it had cited in its petition for authority to join MISO, arguing that achieving these goals would benefit Minnesota ratepayers, and stating that MISO was making good progress toward meeting these goals.

Difficult as this issue is, with the benefit of further reflection the Commission finds that the Company's alternative proposal – to build 80% of MISO's administrative costs into current rates and to defer the remaining 20% for consideration in the next rate case – is the most reasonable approach and the one most consistent with the public interest. There are three reasons for this decision.

First, it is important that regional transmission organizations such as MISO be given every opportunity to succeed. They play a critical role in federal efforts to promote more efficient wholesale power markets, to eliminate discrimination in transmission access, to improve network security and reliability, and to simplify transmission charges and access procedures. Rejecting rate recovery of MISO costs at this stage of MISO's development is unlikely to help it achieve these goals and may impair its ability to do so. The Company's proposal offers a reasonable way for the Commission to avoid acting at cross purposes with these important policy goals without abdicating its responsibility to Minnesota ratepayers.

Second, it is not clear that individual MISO members' inability to translate MISO's achievements into positive monetary impact means that MISO costs were imprudently incurred or unreasonable in amount. MISO is in the start-up phase of a unique and complex endeavor. It is laying the groundwork for a new transmission paradigm. Positive monetary impact on ratepayers is perhaps less to be expected at this point than clear evidence of competent, timely, significant progress toward MISO's ultimate goals. These are not conventional rate case issues, however, and they were not developed in detail in the record.

Again, though, the Company's proposal offers a balanced approach to these unique and difficult issues. Permitting immediate rate recovery of a significant but limited portion of these costs, while deferring the remainder, accomplishes several important and potentially conflicting goals – it acknowledges the public policy importance of MISO, it recognizes the inevitable difficulty of quantifying the benefits of start-up costs, it avoids placing the entire weight of this difficulty on IPL, and it minimizes ratepayer exposure to potentially unproductive costs.

Furthermore, the Company's deferred accounting proposal allays many of the concerns about the three drawbacks of deferred accounting discussed in the April 5 Order – inefficiency, expense, and inter-generational inequity.

First, the deferral proposed by the Company will not result in administrative inefficiency, since the recoverability of MISO costs will be an issue in the next rate case whether these costs are deferred

or not. This is not a situation in which an issue that should have been litigated to its conclusion will be revived and re-litigated due to deferred accounting.

Second, the deferral proposed by the Company will not be as expensive for ratepayers as a typical deferral, since the Company waives any claim to carrying charges and since it plans to file another rate case in very short order. This deferral will therefore not create a large and growing ratepayer liability with no recovery date in sight.

Third, for the same reasons set forth above, this deferral will not pose significant issues of inter-generational equity. Since the next rate case is expected to be filed within the next few months, the Commission will still be able to closely match the set of ratepayers who benefit from the deferred costs with the set of ratepayers who will pay for them in rates.

The Commission concludes that, of all the MISO-related proposals put forward in this proceeding, the Company's most recent proposal strikes the fairest and most helpful balance between immediate ratepayer interests and the long term interests of ratepayers and the public. It avoids compounding the challenges facing MISO, offers the Company the opportunity for full recovery, and protects ratepayers from the potential burden of unjustified costs.

Finally, the Commission reiterates the importance of quantifying the ratepayer benefits of MISO administrative costs before these costs become permanent parts of IPL's rate structure. The Commission concurs with the Department that IPL must, in its next rate case and in subsequent rate cases as appropriate, provide substantive, quantified cost-benefit analysis demonstrating the benefits of these costs.

#### **D. Remainder of Order Affirmed**

The Commission affirms all other decisions in the April 5 Order as those most consistent with the facts, the law, and the public interest. The Commission reserves judgment on the scope of the issues to be addressed if this case is referred to the Office of Administrative Hearings for further evidentiary proceedings.

#### **E. Financial Schedules**

##### **Gross Revenue Deficiency**

The above Commission findings and conclusions result in a Minnesota jurisdictional gross revenue deficiency of \$593,382 as shown below:

Rate Base	\$107,730,307
Rate of Return	<u>9.172%</u>
Required Operating Income	\$ 9,881,024
Test Year Net Operating Income	<u>\$ 9,533,124</u>
Operating Income Deficiency	\$ 347,900
Revenue Conversion Factor	<u>1.705611</u>
Gross Revenue Deficiency	<u><u>\$ 593,382</u></u>

### Rate Base Summary

Based on the above findings, the Commission concludes that the appropriate rate base for the test year is \$107,730,307 as shown below:

Utility Plant in Service	\$234,195,681
Less: Accumulated Depreciation	<u>120,466,446</u>
Net Utility Plant in Service	\$113,729,235
Customer Advances for	(2,973)
Construction Work in Progress	4,435,731
Accumulated Deferred Income	(11,061,129)
Customer Deposits	(164,919)
Working Capital	
Materials and Supplies	1,347,772
Fuel Inventories	1,723,938
Prepayments	214,704
Cash Working Capital	<u>(2,492,052)</u>
Total Rate Base	<u><u>\$107,730,307</u></u>

### Operating Income Summary

Based on the above findings, the Commission concludes that the appropriate Minnesota jurisdictional operating income for the test year under present rates is \$9,533,124 as shown below:

Operating Revenue	
Sales of Electricity	\$61,490,181
Other Operating Revenue	<u>2,234,761</u>
Total Operating Revenue	\$63,724,942
Operating Expenses	
Production	\$22,611,358
Transmission	1,601,430
Distribution	3,092,216
Customer Accounts	1,910,423
Customer Service and Sales	3,855,292
Administrative and General	4,759,029
Depreciation and Amortization	9,408,571
Income Tax	3,692,558
Taxes Other Than Income	<u>3,495,455</u>
Total Operating Expenses	<u>\$54,426,332</u>
Operating Income Before AFUDC	\$ 9,298,610
AFUDC	<u>234,514</u>
Operating Income With AFUDC	<u><u>\$ 9,533,124</u></u>

### **ORDER**

1. The Commission finds that the record demonstrates that Interstate Power and Light Company is entitled to increase its gross Minnesota jurisdictional revenues by \$593,382, in order to produce total gross annual jurisdictional operating revenues of \$64,318,324.
2. The Commission amends its original modification to the settlement submitted by the parties to set the Company's return on equity at 11.25%. In all other respects, the Commission continues to accept and adopt the settlement.
3. The Commission grants Interstate Power and Light Company's request to include in test year expense 80% of the \$202,798 in MISO Schedule 10 administrative costs disallowed in the April 5 Order and to place the remaining 20% in a deferred account for consideration in

the Company's next rate case. This authorization for deferred accounting treatment takes effect on the effective date of interim rates in this proceeding and ends with the conclusion of the Company's next rate case. The Company shall not collect carrying charges on amounts deferred under this paragraph.

4. In its next rate case and in subsequent rate cases as appropriate, Interstate Power and Light Company shall provide substantive, quantified cost-benefit analysis demonstrating the benefits of any MISO administrative costs for which it seeks rate recovery.
5. All portions of the April 5 order not explicitly modified herein remain in full force and effect.
6. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar  
Executive Secretary

(S E A L)

This document can be made available in alternative formats (i.e., large print or audio tape) by calling (651) 297-4596 (voice), or 1-800-627-3529 (MN relay service).