

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

LeRoy Koppendrayer
Marshall Johnson
Ken Nickolai
Thomas Pugh
Phyllis A. Reha

Chair
Commissioner
Commissioner
Commissioner
Commissioner

In the Matter of Otter Tail Power Company's
Report on a Call to its Ethics Hotline

ISSUE DATE: March 1, 2007

DOCKET NO. E-017/M-04-1751

ORDER ACCEPTING COMPLIANCE
FILING AS MODIFIED AND REQUIRING
FURTHER FILINGS

PROCEDURAL HISTORY

I. The Call to the Ethics Hotline

On May 27, 2004, Otter Tail Corporation d/b/a Otter Tail Power Company received an anonymous call to its Ethics Hotline from two of its employees. The Company characterized the call as "claiming that the Utility has been providing false and/or misleading financial information to the Minnesota Department of Commerce, the Minnesota Public Utilities Commission, and the North Dakota Public Service Commission."¹

The employees² expressed concern that the Company might be using questionable accounting practices to present financial data in ways that understated utility earnings. Such irregular financial reporting would prevent regulators from recognizing excessive earnings and from acting to protect ratepayers from the excessive rates required to sustain those earnings.

The callers raised the following specific concerns:

- (1) They questioned the Company's decision to change its accounting practices to move profits from "pass-through" electricity sales from the regulated to the unregulated side of the ledger. They also challenged the adequacy of the Company's disclosure of this accounting change.
- (2) They questioned the Company's decision to change its accounting practices to exclude short-term debt in calculating Allowance for Funds Used During Construction – driving up ratepayer costs – by using restrictive covenants in short-term debt instruments forbidding the use of short-term debt for utility construction.

¹ *Report on Hotline Call*, November 30, 2004, at 1-2.

² Both employees are now former employees of the Company.

- (3) They questioned whether the Company properly allocated costs between its regulated and unregulated operations, suspecting that reorganization and diversification had resulted in some costs more properly attributable to unregulated operations being allocated to the regulated utility.
- (4) They questioned the Company's decision to change its primary accounting system from the Uniform System of Accounts, required for use in filings with state and federal utility regulatory authorities, to an alternative system, Oracle, which they believed made it difficult to accurately determine and document the financial information required for utility regulatory purposes.
- (5) They questioned whether the accuracy of reported returns on equity had been compromised, particularly by changes in the accounting treatment of transmission revenues from the Mid-Continent Area Power Pool and by adjustments to the Company's capital structure.
- (6) They questioned the Company's compliance with statutory requirements to seek Commission approval of transactions with affiliated entities.
- (7) They questioned whether the Company's accounting treatment of unbilled revenues resulted in understating earnings.
- (8) They questioned the accuracy of Company reporting on its capital structure, suggesting that diversification and the resulting need to allocate costs could have affected the 50% equity level the Company has consistently been reporting.

In response to the Hotline call, the Company conducted an initial investigation, asked its outside counsel to conduct a more comprehensive investigation, met with staff from this Commission and the Minnesota Department of Commerce, and ultimately filed a report on the concerns raised in the call, based in large part on the investigation conducted by its outside counsel.

The Commission solicited comments from potentially interested persons on the Company's report and on initial comments filed by the Minnesota Department of Commerce.

II. The First Commission Order

The Commission issued its first Order in this case on March 10, 2006. The Order found that at that point it would be premature to reach final conclusions on the callers' concerns.

The Order did, however, require the Company to immediately take steps to improve its compliance with regulatory requirements, to clarify previous filings made with this Commission, and to resolve the disputed accounting treatment of short-term debt. Specifically, the Order required that Otter Tail

- Revise and update its Regulatory Compliance Plan, an in-house manual on Minnesota regulatory requirements, with special emphasis on preventing the recurrence of past failures to file contracts with affiliates for Commission review.

- File documentation clarifying how the categories and operations of the Oracle accounting system, discontinued after the Hotline call, relate to the more widely used Uniform System of Accounts, to which the Company has reverted.
- File a petition with the Federal Energy Regulatory Commission for a ruling on the permissibility of its practice, challenged by the Hotline Callers, of excluding short-term debt in calculating Allowance for Funds Used During Construction (AFUDC), by means of inserting restrictive covenants in its short-term debt instruments.
- File an updated corporate cost allocations manual, detailing how costs are apportioned between utility operations and non-utility operations, and explaining how the Company's cost allocation procedures square with the Commission Orders on allocating costs between regulated and non-regulated activities.³

The Order also required the Company to make filings as required to keep the Commission and the Department of Commerce apprised of developments relating to an operational audit of the Company being conducted by the Federal Energy Regulatory Commission and to file that agency's final report when issued.

To ensure maximum transparency in future financial reporting, the Order required the Company to highlight, by separate letter, any future changes in the manner in which it derived or reported the financial information covered in its Minnesota Electric Jurisdictional Annual Report.

And finally, the Order required the Company to file a general rate case by October 2007, to permit the Commission to conduct a comprehensive review of the Company's current financial situation – revenues, costs, investment levels, rate levels, and rate design – and to set fair and reasonable rates based on that review.

III. The Compliance Filing and Parties' Comments

A. The Company's Filing

The Company duly filed the materials required under the March 10 Order:

- An updated Regulatory Compliance Plan.
- Extensive materials mapping the Oracle accounting system to the Uniform System of Accounts.
- An updated corporate allocations manual, with accompanying explanations.
- A ruling from the Federal Energy Regulatory Commission rejecting the Company's practice of excluding short-term debt in calculating AFUDC.

³ *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, Orders of September 28, 1994 and March 7, 1995.

The Company also reported that the operational audit by the Federal Energy Regulatory Commission was still underway and that it would file the final report when it became available.

B. The Comments of the Department of Commerce

The Department of Commerce reviewed the compliance filing in detail, served additional discovery on the Company, and held clarifying discussions with Company personnel. During this process the Company made several revisions to both its Regulatory Compliance Plan and corporate allocations manual to meet Department concerns.

At the end of this process there were no immediately contested issues between the Company and the Department, and both parties were preparing to shift their primary focus to the upcoming general rate case. The Department emphasized that it believed that only a rate case could provide the context and informational depth required to comprehensively address the web of issues surrounding those raised by the Ethics Hotline Callers.

C. The Comments of the Residential and Small Business Utilities Division of the Office of the Attorney General

The Residential and Small Business Utilities Division of the Office of the Attorney General (RUD-OAG) did not file comments on the compliance filing, but did appear at the hearing at which the Commission addressed the filing. The RUD-OAG renewed its request that the Commission appoint an independent investigator, perhaps with forensic accounting skills, to examine all the issues raised by the Hotline Callers, as well as related issues unearthed in the course of this inquiry.

D. The Comments of the Hotline Callers

The two former Otter Tail employees, who had called the Ethics Hotline while employed by the Company, filed comments through counsel. Among other things, they urged the Commission to appoint an independent investigator and to examine the possibility of ordering rate refunds on the theory that inaccurate earnings information in the Company's Minnesota Jurisdictional Annual Reports had rendered the Company's rates invalid.

FINDINGS AND CONCLUSIONS

The compliance filing made under the March 10, 2006 Order came before the Commission on January 25, 2007. Having reviewed the entire record and having heard the arguments of the parties, the Commission makes the following findings, conclusions, and order.

I. Action on the Compliance Filing

The Commission concurs with the Department of Commerce that the Company's compliance filing should be accepted, with the modifications and revisions made or agreed upon in response to the concerns raised by the Department.

A. Regulatory Compliance Plan

The Company's new Regulatory Compliance Plan appears to be well designed and likely to meet its purpose of ensuring that employees recognize the dates and events that trigger regulatory filing requirements or other regulatory responsibilities. The Plan specifically addresses Company obligations under the affiliated interest statute and rules; this is critical because the Company's post-Hotline-call investigation revealed that it had failed to file several tax-sharing agreements with affiliates.

The refinements suggested by the Department further strengthen and clarify the Plan, and the Commission will approve it, with those modifications.

B. Cost Allocations Manual

In 1994, the Commission adopted cost-allocation principles to govern the accounting treatment of costs, especially joint, common, or shared costs, in situations involving both regulated and nonregulated operations.⁴

These allocation principles, modeled after the cost separations procedures of the Federal Communications Commission, were developed and adopted after a lengthy, industry-wide proceeding to determine how to protect ratepayers from the potentially adverse consequences of utility diversification into unregulated enterprises. These principles have proven clear and effective and have become an essential regulatory tool.

The Commission has consistently applied these principles over the past twelve years, not just to keep utilities from subsidizing unregulated affiliates, but to fairly allocate the joint and common costs of multi-jurisdictional utilities. They are applied on a frequent and recurring basis.

The Hotline Callers challenged Otter Tail's cost allocations procedures, claiming that the Company's Minnesota Jurisdictional Annual Reports had consistently over-allocated costs to regulated operations and under-allocated costs to nonregulated operations. And in fact, over the course of the Company's post-Hotline Call investigation and subsequent discussions with the Department of Commerce, the Company reduced the percentage of generally allocated costs allocated to regulated operations from some 70% to 39%.

The Company continued to argue, however, that strict compliance with the allocations method set forth in the Commission's 1994 and 1995 Orders would produce less reliable and less equitable results than an alternative, Company-specific method it had developed.

The Department recommended that the Company be permitted to use its alternative method, pending full examination of both methods in the upcoming rate case. The Department also recommended requiring the Company to clearly delineate the workings and results of each method in its general rate case filing.

⁴ *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); Order Clarifying Order Dated September 28, 1994 (March 7, 1995).

The Commission concurs. The rate case filing will be made in less than eight months; there is little if any practical benefit to be derived from insisting upon a thoroughgoing comparison of both cost allocation methods in advance of that proceeding. The Department's recommendation that the Company use the rate case filing to demonstrate the workings and results of both the Commission-approved cost-allocation method and the cost-allocation method the Company prefers is entirely consistent with the Commission's cost-allocation Orders.

Those Orders recognize the importance of methodological flexibility, while placing the burden of proof on any utility seeking to use an alternative cost allocation system:

The Commission understands that utilities differ in many essential respects, including their participation in affiliated operations. The Commission believes that the hierarchical principles offer sufficient flexibility for each utility to develop appropriate allocation methodologies based on the principles.

Should a utility wish to base its cost separations on different principles, the burden of proof would be on that utility to prove that its cost allocation principles arrive at fully allocated costs, free of any cross-subsidization. The utility would have to show that the goals of fully allocated costing, as expressed in this and other Orders, are fully realized. The utility would have the burden of demonstrating that it has considered all of its costs and that they are allocated to share burdens and benefits equitably between the regulated and nonregulated operations.

Order Setting Filing Requirements, at page 6.

The Commission is confident that the general rate case will be an appropriate vehicle for careful examination of the Company's cost-allocation system.

C. AFUDC Calculations

As noted above, the Hotline Callers challenged the Company's exclusion of short-term debt from its AFUDC calculations, and the March 10, 2006 Order required the Company to seek clarification from the Federal Energy Regulatory Commission (FERC) on the permissibility of this practice.

FERC has ruled that the practice is impermissible, and the Company will be required to promptly recalculate AFUDC and to file those recalculations and related journal entries. The Company stated that it reserves its right to appeal the FERC decision, and the Commission will of course address any subsequent, conflicting FERC determination as necessary.

II. Further Filings Required

As discussed above, there are further filings, set forth below, to be made in this docket:

- **AFUDC Recalculations and Journal Entries** – The Company will file its new AFUDC calculations and journal entries within 60 days.
- **FERC Operational Audit** – The Company will continue to keep the Commission and the Department apprised of the progress of its FERC operational audit and will file the final report when it becomes available.

- **Changes to Future Jurisdictional Reports** – The Company will file a letter with the Commission and the Department highlighting and clearly explaining all future changes in the manner in which it reports or derives the data reported in its Minnesota Electric Jurisdictional Annual Report.
- **New Hotline Complaint** – The Company reported that it had received another complaint to its Ethics Hotline, this one apparently challenging its conduct and the accuracy of the information it has submitted in the course of this proceeding. The Commission will require the Company to file a copy of the complaint (or an account of its allegations, if the complaint was made orally) and its response to the complaint.

III. No Expansion of Current Inquiry

Both the RUD-OAG and the Hotline Callers urged the Commission to continue this proceeding and to expand its scope until all potential accounting irregularities in which the Company may have been engaged have been identified and analyzed.

The Department, which conducted a comprehensive investigation into the issues raised by the Hotline Callers, disagreed. The Department argued that all issues raised by the Hotline Callers had either been adequately addressed in this case⁵ or could be addressed more effectively in the upcoming general rate case or a separate docket.⁶

The Commission concurs with the Department and will not expand the current inquiry, for at least three reasons. First, the concerns raised by the Hotline Callers have been thoroughly examined and have either been resolved on a prospective basis or will be so resolved in the near term.

Second, it is important not to divert time, attention, or resources – none of which are in limitless supply for any party – from the upcoming general rate case. The general rate case is the gold standard for purposes of determining a utility’s financial condition, its cost of providing service, and its optimal rate structure. It is critical that the full resources of the Department, other intervening parties, and the Commission be focused on this important – but complex and resource-intensive – endeavor.

Third, the wide-ranging inquiry urged by the Hotline Callers and the RUD-OAG appears very unlikely to yield public-interest benefits equal to its costs. The basic issues they seek to explore – (1) whether, if Otter Tail had used the accounting and disclosure practices required in this case, the Commission would have opened an earlier earnings investigation and (2) whether that earnings investigation would have resulted in lower rates – are contingent on a host of facts that would be very difficult, if not impossible, to ascertain.

⁵ For example, accounting for short-term debt in calculating AFUDC, strengthening regulatory compliance through a new Regulatory Compliance Plan, documenting the relationship between the old and new accounting systems.

⁶ For example, fine-tuning cost allocations, fly-specking un-billed revenue accounting, ensuring proper treatment of transmission and wholesale revenues in light of structural changes in the industry.

At this point it would be nearly impossible to reconstruct the factual conditions that would have determined rates at any given point in time – e.g., customer numbers and projected growth rates; general economic conditions and interest rates; cost of labor, supplies, equipment, taxes, and capital; total capital investment and near-term plans to increase that investment. And exploring these issues would consume huge amounts of time and resources. The Commission cannot conclude that further, open-ended investigation of the Company’s past regulatory compliance and historical financial condition would be an efficient use of regulatory resources.

Of course, none of this is to minimize the contributions of the Hotline Callers or to prejudge any issue that might be raised in the new Hotline complaint, which will be filed shortly. The Commission is simply not persuaded that trying to reconstruct past historical conditions and to determine their probable impact on a hypothetical ratemaking determination not undertaken at the time is likely to yield practical benefits.

For all these reasons, the Commission declines to expand the scope of this inquiry and instead trains its resources on the upcoming general rate case.

ORDER

1. The Commission accepts and approves the Company’s compliance filing under the March 10, 2006 Order, as amended and supplemented by the Company and with the revisions and conditions recommended by the Department of Commerce.
2. Within 60 days of the date of this Order the Company shall file its recalculations of AFUDC, beginning as of May 2003, and the resulting journal entries. These recalculations shall include short-term debt as required under the ruling obtained from the Federal Energy Regulatory Commission pursuant to this Commission’s Order of March 20, 2006.
3. The Company is hereby permitted to use its proposed cost allocation method, as modified in response to the comments of the Department of Commerce and subject to the conditions recommended by the Department of Commerce, pending the examination in the upcoming rate case of both the Company’s method and the Commission-approved method.
4. In its upcoming rate case the Company shall demonstrate the workings and results of both the Commission-approved cost-allocation method and the cost-allocation method the Company prefers.
5. The Company shall make filings as required to apprise the Commission and the Department of Commerce of developments relating to its operational audit by the Federal Energy Regulatory Commission and shall file the final report of that audit when it becomes available.
6. The Company shall file a letter with the Commission and the Department of Commerce each time it makes any change in how it reports or derives data reported in its Minnesota Electric Jurisdictional Annual Report.

7. The Company shall promptly file in this docket and serve on the Department of Commerce and the Residential and Small Business Utilities Division of the Office of the Attorney General a copy of the complaint recently submitted to its Ethics Hotline relating to its conduct in this proceeding, together with any response it wishes to make.
8. 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) 201-2202 (voice) or 1-800-627-3529 (MN relay service).