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August 23, 2016

Daniel P. Wolf
Executive Secretary
Minnesota Public Utilities Commission
121 7th Place East, Suite 350
St. Paul, Minnesota 55101-2147

RE: **Comments of the Minnesota Department of Commerce, Division of Energy Resources**
Docket No. E015/AI-16-454

Dear Mr. Wolf:

Attached are the Comments of the Minnesota Department of Commerce, Division of Energy Resources (DOC or Department) in the following matter:

Minnesota Power's (MP's) Petition for Approval of Affiliate Interests Between ALLETE, Inc. and U.S. Water Services, Inc.

The petition was filed on May 25, 2016 by:

Christopher D. Anderson
Associate General Counsel
Minnesota Power
30 West Superior Street
Duluth, MN 55802

The Department recommends **denial and reporting requirements** and is available to answer any questions the Commission may have.

Sincerely,

/s/ SAMIR OUANES
Rates Analyst

SO/ja
Attachment

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

COMMENTS OF THE
MINNESOTA DEPARTMENT OF COMMERCE
DIVISION OF ENERGY RESOURCES

DOCKET No. E015/AI-16-454

I. SUMMARY OF MINNESOTA POWER'S PETITION

Pursuant to Minn. Stat. §216B.48, Minn. R. 7825.2200,¹ and the September 14, 1998 *Order Initiating Repeal of Rule, Granting Generic Variance, and Clarifying Internal Operating Procedures* in Docket No. E,G999/CI-98-651 (98 Order), Minnesota Power (MP or the Company) filed a request (Petition) on May 25, 2016 with the Minnesota Public Utilities Commission (Commission) for approval of “the Alliance Agreement, along with the current and future purchase orders entered into under the authority thereof” between U.S. Water Services, Inc. (USWS) and the Company.

MP stated that the Alliance Agreement was entered into on April 25, 2016 with an initial term through September 30, 2018.²

According to MP, this request would have no immediate effect on Minnesota Power's base rates.³ Should the affiliated agreements be approved, the work performed by USWS would comprise future operating and maintenance (O&M) expenses eligible for recovery in future rate cases.⁴ However, since MP intends to file a rate case before the end of 2016, the effects on ratepayers may occur in the near future.

II. BACKGROUND

According to MP, USWS is an affiliate of MP as a result of a transaction that closed on February 10, 2015.⁵ MP did not seek approval of the transaction that made USWS an affiliate of MP and claims in a footnote on page 3 of its Petition that it was not required to do so:

¹ Titled “Utilities with Affiliated Interests; Filing.”

² Source: Petition at 10-11.

³ Source: Id at 10.

⁴Source: Id.

⁵ Source: Petition at 1.

With respect to the requirements of Minnesota Statute Sections 216B.48, 216B.49 and 216B.50, because the USWS acquisition was compliant with the Company's capital structure requirements, because no new affiliate or administrative services requirements resulted from the transaction, and because the USWS operations in the state consisted of neither utility plant nor operating unit under Commission precedent or statute, or rules and regulations, the Alliance Agreement has become the first Commission-jurisdictional activity of USWS and Minnesota Power.

MP's proposed Alliance Agreement describes USWS as having:

...significant expertise in providing and is qualified to provide integrated total water and energy management solutions, including the custom design and installation of water treatment equipment, the creation and supply of specialty chemicals for water treatment, the supply of filters and other similar commodity items, and the provision of related engineering services...⁶

According to the proposed Alliance Agreement, the:

...Company from time to time has need of such integrated total solutions for water and energy treatment programs, materials and services to support its regulated utility businesses and desires to obtain water treatment materials and services from Supplier [USWS] due to the lack of availability of similar total integrated solutions in the marketplace.⁷

The Department notes that, while the Alliance Agreement was entered into on April 25, 2016 and filed for approval on May 25, 2016, MP proposes that the Alliance Agreement have an Effective Date of October 1, 2015, more than six months prior to when the Alliance Agreement was entered into.⁸ MP did not provide this material information in the body of the Petition; instead, the proposed effective date, which is important information, was located on page 6 of 86 of Exhibit D of the Petition. The Department discusses this issue further in Section III.B below.

The Petition includes a list of purchase orders MP entered into with USWS (between July 11, 2012 and December 11, 2014) before the acquisition of USWS.⁹ The amounts involved vary between \$1,294 (June 12, 2014) and \$584,193 (June 28, 2013).¹⁰

⁶ Source: page 5 of 86, trade secret version of Exhibit D of the Petition.

⁷ Source: Id.

⁸ Source: Id. at 6.

⁹ Source: Exhibit B of the Petition.

¹⁰ Source: Id.

The Petition also includes a list of twelve purchase orders MP entered into with USWS (between March 31, 2015 and April 25, 2016) after the acquisition of USWS.¹¹ The amounts involved vary between \$127 (September 17, 2015) and \$24,000 (March 17, 2016).¹²

According to MP, Exhibit F of the Petition includes the “current purchase orders and project proposals.”¹³

The Department notes that the “current” purchase orders include the twelve purchase orders MP entered into with USWS between March 31, 2015 and April 25, 2016.¹⁴ Exhibit F appears to diverge in part on the status of the purchase orders since it shows that the March 17, 2016 purchase order was canceled when Exhibit E shows that this same purchase order was “approved and accepted.”

For clarity of the record in this matter, the Department requests that MP address in reply comments this apparent inconsistency.

The “current” project proposals include eleven project proposals dated between January 10, 2014 and May 11, 2016.¹⁵

The Department notes that Exhibit G of the Petition reproduces a “current” project proposal dated November 9, 2015.¹⁶

Finally, Exhibit H of the Petition confirms that the filing was verified.

III. DEPARTMENT ANALYSIS

A. STATUTORY REQUIREMENTS FOR AFFILIATED-INTEREST AGREEMENTS

Minnesota Statutes dictate the requirements necessary to be met for affiliated service agreements at Minnesota Statute section 216B.48, subd. 3 as follows:

No contract or arrangement, including any general or continuing arrangement, providing for the furnishing of management, supervisory, construction, engineering, accounting, legal, financial, or similar services, and no contract or arrangement for the purchase, sale, lease, or exchange of any property, right, or thing, or for the furnishing of any service, property, right, or thing, other than those above enumerated,

¹¹ Source: Exhibit E of the Petition.

¹² Source: Id.

¹³ Source: Petition at 13.

¹⁴ Source: pp. 2-64 of 183, trade secret version of Exhibit F of the Petition.

¹⁵ Source: pp. 65-183 of 183, trade secret version of Exhibit F of the Petition.

¹⁶ Source: pp. 88-94 of 183, trade secret version of Exhibit F of the Petition.

made or entered into after January 1, 1975 between a public utility and any affiliated interested as defined in subdivision 1, clauses (1) to (8), or any arrangement between a public utility and an affiliated interest as defined in subdivision 1, clause (9), made or entered into after August 1, 1993, *is valid or effective unless and until the contract or arrangement has received the written approval of the commission.* (Emphasis added)

Minnesota Statute section 216B.48, subd. 3 additionally provides two tests to be applied by the Commission in cases of affiliated-interest contracts; the burden of proof for satisfying these tests rests with the Company:

The commission shall approve the contract or arrangement made or entered into after that date only if it clearly appears and is established upon investigation that it is reasonable and consistent with the public interest. No contract or arrangement may receive the Commission's approval unless satisfactory proof is submitted to the commission of the cost to the affiliated interest of rendering the services or of furnishing the property or service to each public utility. Proof is satisfactory only if it includes the original or verified copies of the relevant cost records and other relevant accounts of the affiliated interest, or an abstract or summary as the commission may deem adequate, properly identified and duly authenticated, provided, however, that the commission may, where reasonable, approve or disapprove the contracts or arrangements without the submission of cost records or accounts. *The burden of proof to establish the reasonableness of the contract or arrangement is on the public utility.* (Emphasis added)

Specifically, the burden of proof is on the Company to show that the Alliance Agreement is both reasonable and consistent with the public interest; if the Commission determines that MP has met its burden of proof, the Commission shall approve the agreement.

Finally, Minnesota Statute section 216B.48, subd. 6 is clear that the Commission has continuing authority over the affiliated-interest agreement if actual experience under the agreement results in rates that are unreasonable:

Subd. 6. Commission retains continuing authority over contract. The commission shall have continuing supervisory control over the terms and conditions of the contracts and arrangements as are herein described so far as necessary to protect and promote the public interest. The commission shall have the same jurisdiction over the modifications or amendment of contracts or arrangements as are herein described as it has

over such original contracts or arrangements. The fact that the commission shall have approved entry into such contracts or arrangements as described herein shall not preclude disallowance or disapproval of payments made pursuant thereto, if upon actual experience under such contract or arrangement it appears that the payments provided for or made were or are unreasonable.

B. FILING REQUIREMENTS

The 98 Order requires that within 30 days of executing a contract or arrangement with an affiliate, the utility must make a filing that includes the following information:

1. A heading that identifies the type of transaction.
2. The identity of the affiliated parties in the first sentence.
3. A general description of the nature and terms of the agreement, including the effective date of the contract or arrangement and the length of the contract or arrangement.
4. A list and the past history of all current contracts or agreements between the utility and the affiliate, the consideration received by the affiliate for such contracts or agreements, and a summary of the relevant cost records related to these ongoing transactions.
5. A descriptive summary of the pertinent facts and reasons why such contract or agreement is in the public interest.
6. The amount of compensation and, if applicable, a brief description of the cost allocation methodology or market information used to determine cost or price.
7. If the service or good acquired from an affiliate is competitively available, an explanation must be included stating whether competitive bidding was used and, if it was used, a copy of the proposal or a summary must be included. If it is not competitively bid, an explanation must be included stating why bidding was not used.
8. If the arrangement is in writing, a copy of that document must be attached.
9. Whether, as a result of the affiliate transaction, the affiliate would have access to customer information, such as customer name, address, usage or demographic information.
10. The filing must be verified.

The Department reviewed the Petition and notes the following. On pages 10 to 14 of the Petition, MP provided the affiliated-interest requirements pursuant to the 98 Order, with the information for each requirement in one location, along with a brief explanation on how the Company believes it has satisfied each requirement. The Department concludes that MP has substantially complied with the filing requirements under the 98 Order, with the exception noted above regarding the effective date of the contract or arrangement.

As explained in section II above, while the Alliance Agreement was entered into on April 25, 2016 and filed for approval on May 25, 2016, MP proposes that the Alliance Agreement have an Effective Date of October 1, 2015, more than six months prior to when the Alliance Agreement was entered into.¹⁷ As indicated by its prominence as item 3 in the list of the “Filing Requirements” identified above, the proposed effective date is important information, particularly in this case, given that MP: 1) proposes to file a general rate case before the end of 2016 and 2) implicitly requests a retroactive approval (going back to October 1, 2015) of “the Alliance Agreement, along with the current and future purchase orders entered into under the authority thereof.”

C. ANALYSIS OF PROPOSAL

The Department notes that, when the transaction does not involve an affiliate, the public utility often has the right incentives to keep its O&M costs as low as possible since its recovery of these costs is already included and fixed in base rates until its next rate case.

However, the fact that MP waited until USWS became an affiliate to execute such an arrangement and then executed the arrangement, without a competitive bidding, raises in the Department’s opinion serious concerns as identified below by Commission Staff:¹⁸

In staff’s opinion, transactions between a public utility and its affiliates lend to the possibility for mischief, should be viewed with a suspicious eye, and should be subjected to extra controls. The earnings of the regulated utility are subject to the limits of the reasonable rates established in rate proceedings. However, if excess costs can be shifted to the utility by an affiliate, or revenues shifted to the affiliate from the utility, it may be possible for the overall corporation to maximize earnings at the expense of the captive ratepayers. Minn. Stat. 216B.48 exists for the purpose of protecting ratepayers from such potentially unreasonable transactions. It should be kept in mind that there may be benefits to the utility by entering into reasonable transactions with affiliates.

These concerns articulate the basis for the Department’s support for a competitive bidding process as the preferred standard to ensure a reasonable fair market value and arms-length transaction. This preference is reflected in the Commission’s Rule 7825.2200.

¹⁷ Source: page 6 of 86, trade secret version of Exhibit D of the Petition.

¹⁸ Source: July 31, 2008 Staff Briefing Papers at 8 in Docket No. E017/M-08-119.

The Company offered the following justification for executing the arrangement without competitive bidding:¹⁹

The purchase orders entered into with USWS under the Alliance Agreement have not been subject to competitive bidding, and future work made pursuant to project proposals will also not be subject to competitive bid. The primary reason is that the work represented by the purchase orders and proposals have been the result of comprehensive analysis performed by USWS to address specific process improvements that have commodity pricing quotes or standardized general operations and maintenance work, the solutions brought forward by USWS are specialized and unique. Minnesota Power would not bid such work out if provided by any other entity due to its comprehensive and proprietary nature unique to that specific vendor. Despite the absence of competitive bidding, as noted in Section III above, the Alliance Agreement has been negotiated to obtain favorable pricing (including the “favored nations” clause) and other general contract terms and conditions in order to account for the fact that services and products provided by USWS will not be subject to competitive bid. In addition, Minnesota Power is not required or contractually committed in any way to use USWS for any project; nor is Minnesota Power required to pursue a project to completion even if it is scoped and analyzed by USWS. Further, because cost recovery of any purchase order completed under the Alliance is subject to review either via the compliance process or through a general rate case, both parties are incentivized to seek cost effective solutions or Minnesota Power faces the potential that recovery of costs in rates will not be granted. As a result, while competitive bidding will not be used in this case, the protections and incentives of the competitive bid process have been captured by the terms of the Alliance Agreement and the annual compliance process.

The Department notes the following in response to MP’s statements. First, MP did not claim in response to item 7 of the 98 Order that “the service or good acquired from an affiliate is [not] competitively available.” In fact, a simple Google research showed that there was at least one other company that may be able and willing to provide similar services and goods, Fremont Water Solutions, based on the information provided in its website.²⁰ Other companies are likely available as well. At the end of the day, only a competitive bidding process would identify the companies that may be able and willing to provide the needed services and goods.

¹⁹ Source: Petition at 12-13.

²⁰ Source: pp. 1-5 of <http://fremontind.com/industries/powerutilities/>

Second, the Company's justification for not using competitive bidding is that "the work represented by the purchase orders and proposals have been the result of comprehensive analysis performed by USWS to address specific process improvements that have been identified and brought forward to Minnesota Power." As a result, MP cannot bid such work out "due to its comprehensive and proprietary nature unique to that specific vendor."

In essence, MP appears to be saying that it cannot use competitive bidding because it already worked with USWS and, as a result, USWS identified process improvements that would be at the basis of current and future purchase orders and proposals that are of a "comprehensive and proprietary nature unique to that specific vendor."

While it is not clear to the Department why the Company cannot still pursue competitive bidding on the basis of "the specific process improvements identified and brought forward to Minnesota Power," edited to protect the "proprietary nature unique" to USWS, the Department notes that the Company chose to commit to and work with USWS while knowing in advance that "competitive bidding is the [Commission's] preferred standard by which to determine reasonableness."²¹

Finally, the Department disagrees with MP's representation that "the protections and incentives of the competitive bid process have been captured by the terms of the Alliance Agreement and the annual compliance process." In particular, nothing in the record shows that the proposed pricing terms would achieve a reasonable fair market value and be consistent with an arms-length transaction for any of the services or goods to be acquired from USWS.²² This includes but is not limited to a level of profit margin,²³ pricing of services²⁴ and price adjustments²⁵ that may or may not reflect market prices faced or to be faced by MP.

The Department concludes that MP did not meet its burden of proof to show that the Alliance Agreement is both reasonable and consistent with the public interest. Therefore, the Department does not recommend approval of the Petition.

The Company's next rate case filing is expected before the end of 2016. Since some of the costs related to the Alliance Agreement (including "current" and/or future purchase orders) may be part of the rate case, depending on the test year chosen by MP, the Department recommends that the Commission require the Company to identify any such costs and fully support the reasonableness of these costs in its initial rate case filing.

²¹ Source: July 23, 2012 Order at 4-5 in Docket No. E015/AI-11-868.

²² The proposed pricing terms are described in the trade secret version of Exhibit D of the Petition at 9-10 of 86 and 77-79 of 86 of the Petition.

²³ Id. at 77 of 86.

²⁴ Id. at 77 of 86.

²⁵ Id. at 9-10 of 86.

IV. CONCLUSION AND RECOMMENDATIONS

The Department concludes that MP did not meet its burden of proof to show that the Alliance Agreement is both reasonable and consistent with the public interest. Therefore, the Department does not recommend approval of the Petition.

Since some of the costs related to the Alliance Agreement (including but not limited to “current” and/or future purchase orders) may be part of MP’s next rate case, depending on the test year chosen by MP, the Department recommends that the Commission require the Company to identify any such costs and support the reasonableness of these costs in its next initial rate case filing.

/ja

CERTIFICATE OF SERVICE

I, Linda Chavez, hereby certify that I have this day served copies of the following document on the attached list of persons by electronic filing, e-mail, or by depositing a true and correct copy thereof properly enveloped with postage paid in the United States Mail at St. Paul, Minnesota.

MINNESOTA DEPARTMENT OF COMMERCE – COMMENTS

Docket Nos. **E015/AI-16-454**

Dated this **23rd** day of **August, 2016**.

/s/Linda Chavez

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