


Staff Briefing Papers

Meeting Date	September 19, 2019	Agenda Item 4 **	
Company	Minnesota Power		
Docket No.	E-015/S-19-170		
	In the Matter of the Petition of Minnesota Power for Approval of 2019 Capital Structure and Permission to Issue Securities		
Issue	Should the Commission approve Minnesota Power’s 2019 capital structure and grant permission to issue securities?		
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 Relevant Documents	Date
Minnesota Power 2019 Capital Structure and Permission to Issue Securities Petition (TS)	February 19, 2019
Department of Commerce – Comments (TS)	March 19, 2019
Minnesota Power – Reply Comments	March 27, 2019
Minnesota Power – Letter	June 24, 2019
Department of Commerce – Response to Reply Comments (TS)	July 31, 2019
Minnesota Power – Reply Comments	August 9, 2019

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Statement of the Issues

Should the Commission approve Minnesota Power’s 2019 capital structure and grant permission to issue securities?

Background

Minnesota Statute § 216B.49 states that issuance of securities by a public utility incorporated in Minnesota requires Commission approval through a formal order. Minnesota Rules, parts 7825.1000 through 7825.1500 establish the process by which the Commission monitors and approves the capital structure and securities issuances by public utilities organized under Minnesota law. Customarily, Minnesota Power (MP) files annually for approval of its capital structure on or before March 1 of each year.

In 2018, MP’s capital structure was approved in Docket No. E-015/S-18-155 in a Commission order dated September 5, 2018. The filings have been similar in structure and content for the last several years, containing similar Common Equity Ratios and ranges, steadily increasing total capitalization, and a rule variance request to allow the use of multi-year credit agreements (facilities) as short term debt.

Table 1: Recent Minnesota Power Capital Structure Petitions

Docket No.	Minimum Equity Ratio	Approved Equity Ratio	Maximum Equity Ratio
18-155	51.36%	57.07%	62.78%
17-142	51.05%	56.72%	62.39%
16-165	49.76%	55.29%	60.82%

Minnesota Power Petition

On February 19, 2019, Minnesota Power filed its 2019 Consolidated Capital Structure Petition (Petition), which covers all of Allete, of which MP is a division. The consolidated capital structure covers all of Allete’s regulated and unregulated businesses. This original 2019 Petition is similar to MP’s 2018 petition. In the Petition, MP sought approval of a Common Equity Ratio (CER) of 56.40% with a contingency window of +/- 10%, or 50.76% to 62.04%.

MP is also seeking approval of a total capitalization of \$5.235 billion, including a \$480 million contingency reserve, and the ability to issue short-term debt not to exceed 15% of total capitalization. This is a significant increase over current capitalization (see Table 2), and reflects construction and infrastructure development already underway, including investments to meet safety, environmental, regulatory, and system reliability objectives. MP also requests authorization to make one or more issues of securities, with the proviso that the range of debt and equity ratios requested will not be exceeded for more than 60 days without Commission approval from the date of the order in this docket through the later of May 1, 2020 or the next Commission order on MP’s capital structure.

On June 24, 2019, MP filed a letter requesting that the maximum CER cap be removed, essentially modifying the instant petition to request a CER of 56.40% with a minimum threshold of 50.76% and a maximum of 100%.

On August 9, 2019, in response to Department comments, MP filed additional comments suggesting a compromise where the maximum CER would be limited to 75%.

The following table compares MP’s recent, year-end actual capital structures to its projected, June 30, 2020 capital structure.

Table 2: Actual and Projected Capital Structure, 2016-2020 (in \$ Millions)¹

Capital Structures	Actual 12/31/2016		Actual 12/31/2017		Actual 12/31/2018		Projected 6/30/2020	
Long Term Debt	\$1,558	45.15%	\$1,503	42.09%	\$1,486	40.80%	\$2,073	43.60%
Short Term Debt	\$0		\$0		\$0		\$0	
Total Equity	\$1,893	54.85%	\$2,068	57.91%	\$2,156	59.20%	\$2,682	56.40%
Total Capital	\$3,451		\$3,571		\$3,642		\$4,755	

Table 3: Change in Financing from 12/31/2018 to 6/30/2020 (Projected)²

Financing Type	Estimated Net Amounts To be Issued 2019-2020
Long-Term Debt	\$587 million
Short-Term Debt	as needed
Common Equity	\$270 million

MP also requested a variance to Minn. Rules, part 7825.1000, subpart 6, which defines a “Short-term security” as “any unsecured security with a date of maturity of no more than one year from the date of issuance; and containing no provisions for automatic renewal or “roll over” at the option of either the obligee or obligor”. Allete has a \$400 million credit finance agreement (CFA), recently renewed through January 2024, which it would use for short-term funding. This CFA is used to provide liquidity in support of MP’s planned capital outlays. MP requests that it be allowed to treat borrowing under this agreement as short-term debt for the purposes of its capital structure petitions. Such a variance has been granted for the past several years.³

Parties’ Positions

Department - Comments

On March 19, 2019, the Department filed its initial comments. The Department noted that MP had provided all required information per Minn. Rules, parts 7825.1000 through 7825.1500, but requested additional information regarding the reasons for significant differences between actual and projected expenditures for both regulated and non-regulated operations, and Allete’s plans for its credit facility agreement past November 2019.

¹ MP Petition, p. 3

² Department Comments, March 19, 2019, p.2

³ See Docket Nos. E-015/S-11-174, E-015/S-12-184, E-015/S-13-126, E-015/S-14-145, E-015/S-15-168, E-015/S-16-165, E-015/S-17-142 and E-015/S-18-155.

Notwithstanding the request for additional information, the Department recommended approval of MP's 2019 capital structure as initially proposed by MP. However, the Department noted the 259 basis point increase in CER since the 2016 rate case, and recommended that the Commission state in its Order in this docket that approval of MP's capital structure does not predetermine a Commission decision on CER in a future rate case.

The Department recommended that the Commission require MP to provide the following within 20 days after each issuance of securities:

- a. The specific purposes for the individual issuances;
- b. The type of issuances;
- c. The timing of issuances;
- d. The amounts of issuances;
- e. Issuance costs (for common equity issuances, include price per share), and
- f. Interest rates.

In addition, the Department recommended the following items in future capital structure filings:

- a. an exhibit showing a general projection of capital needs, projected expenditures, anticipated sources, and anticipated timing, with the understanding that such exhibit is not intended to require dollar-for-dollar information on the uses identified in the exhibit or to limit the issuances to project specific financing. The exhibit need not list short-term security issuances.
- b. a report of actual issuances and uses of the funds from the prior year. The report will be for information purposes only and need not cover short-term security issuances.
- c. a schedule comparing its actual capital investments in the past year with the capital investments projected by MP in its previous capital structure filing.
- d. the Company's investment plan not only for the next year, but for at least the next five years.

Finally, the Department recommended that MP file its next capital structure request by March 1, 2020, and that the Commission clarify that approval of securities issuance and the resulting capital structure, in this proceeding, is not a determination of the appropriate capital structure for ratemaking purposes.

Minnesota Power - Reply Comments

In its first reply comments on March 27th, 2019, MP satisfactorily explained why its actual capital expenditures were less than projected expenditures for 2018. MP noted that certain generation projects, including maintenance at Boswell Energy Center, were deferred, and that some other projects were cancelled or modified in scope. Cold weather in winter also reduced the cost of transmission construction and other savings were identified and implemented, and installation of a meter data management system for use with future AMI (advanced metering infrastructure) was deferred to 2019. On the non-regulated side, several initiatives, including

acquisitions, were deferred, which also accounted for actual expenditures being less than projected.

MP also stated that its credit facility agreement had been extended to January 2024.

MP - Letter to the Commission

On June 24th, 2019, MP filed a letter with the Commission requesting to remove the cap on its CER, effectively changing its initial requested equity window from 50.76% - 62.04%, to 50.76% - 100%. MP cited its effectiveness at delivering renewable resources to its customers, the need for Allete's non-regulated businesses to carry a higher equity share, and the need for flexibility for all Allete subsidiaries for investment in energy projects. MP also stated that it is evaluating conversion to a holding company structure which could alleviate future concerns regarding the CER maximum, and so would support returning to the 10% +/- band at that time.

Department - Second Reply Comments

On July 31, 2019, the Department filed their second set of response comments. In these comments, the Department provided its final recommendations and MP's responses to its discovery requests. The Department noted that MP's additional responses included credit reports which do generally support the idea that MP's non-regulated businesses require higher than typical equity than would be ideal for the Company's regulated operations.

The Department argued, however, that MP has provided no indication that anything pertaining to regulated operations had changed between the original filing and the June letter, and MP had provided no evidence that the originally filed capital structure request was inadequate. The Department noted that equity capital is more costly in a rate case than debt capital, and so a high CER could potentially impose excess costs on ratepayers, and MP can file a new capital structure request at any time if the CER limits or equity cap are at risk of being exceeded. The Department thus believes that MP's request for an unlimited equity share of capital is not reasonable. The Department did, however, accept the reasonableness of MP's explanations of the difference between its projected and actual capital investments for 2018, and its request to extend the CFA to 2024.

The Department also explored the pros and cons of restructuring MP as a holding company. Corporate reorganization is not a trivial exercise and may have high transaction costs and unanticipated effects. However, it would allow Allete to better separate its relatively low-risk regulated businesses from its higher risk, non-regulated operations which require higher equity capital. The Department believes this could benefit ratepayers in the long run, and would in any event simplify cost of capital determinations for ratemaking. The Department will participate if MP wishes to initiate a corporate restructuring process or study, but recommended no Commission action on the issue at this time.

The Department reiterated its original recommendations from its March 19th comments, adding recommendations that the Commission require MP to keep the Commission informed of any corporate restructuring or rating agency action.

MP - Reply Comments

On August 9, 2019, MP provided reply comments to the Department recommendation to deny the 100% CER cap. MP rebutted the Department's recommendation by stating that MP has taken a conservative approach to financing using additional equity rather than leveraging risk with debt, which has historically concerned the Commission. Changing the cap doesn't immediately change the actual equity share or pre-commit the equity structure ordered in a rate case, and issuing equity improves Allete's credit rating, which is beneficial to MP and its customers. MP suggested a compromise 75% cap on CER would be adequate for their needs and might address Department concerns.

Staff Analysis

Requested Equity Band

The standard +/-10% range has been approved in prior cases as properly balancing financial flexibility for MP with sufficient regulatory oversight. In the original capital structure filings from 2011, the Department did suggest that a larger band would be reasonable in the right circumstances. They suggested +/- 15% at the time.⁴ The Department has not had the opportunity to provide feedback on the 75% cap.

In response to Department discovery requests, MP provided Allete's credit reports with Moody's and S&P, which the Department filed with its July 31, 2019 reply comments. These copyrighted (non-public) documents are identified by MP as being trade secret. The credit reports suggested that the rating bureaus might consider favorable action on Allete's bond (credit) rating if Allete lowered overall debt levels, which would improve its operating revenue to debt ratio, among other metrics. Both agencies noted other factors, both positive and negative, which could affect Allete's ratings more strongly. The credit reports, however, do not address the amount or share of equity in Allete's capitalization directly; the reports speak of overall debt levels and operating revenues as a percentage of overall debt level.

A 75% equity limit would allow for all-equity financing of non-regulated activities while still allowing MP's regulated business to maintain approximately the current CER once non-regulated activities are backed out. The higher equity percentages that MP proposes would allow MP to finance future regulated and non-regulated projects and acquisitions entirely with equity up to the \$5.235 billion cap, including contingency, and still be able to retire \$100 million in bonds before bumping up against the 75% cap. It would also potentially allow MP to significantly alter the capitalization of its regulated business in a way that could increase its requested revenue requirement in its next rate case. A six percentage point change in the approved equity share of capital – from 54% to 60%, for example – could result in approximately a 1% increase in rates during a rate case.

Decision alternatives 1a, 1b, or 1c reflect approval of an equity band with a maximum of 60.24%, 100%, or 75% respectively.

⁴ PUC Docket E-015/S-11-174, DOC OES Comments, April 11, 2011, p. 5.

Minnesota Rule 7825.1300 allows the regulated utility to issue short-term debt up to an amount specified by the Commission, and gives the utility 60 days to file for a change to capital structure from the date a security issue places the CER outside the band set by the Commission. Staff believes decision alternative 2, allowing up to 15% of capitalization in short-term debt, gives Allete the financial flexibility it needs to cost-effectively run MP to the benefit of both ratepayers and shareholders, and is identical to previous orders for MP capital structure.

Credit Facility Arrangement

Allete's \$400 million credit facility arrangement has been extended through January 2024. It is used by the Company as a short-term debt instrument, though it is, by the letter of the rule, long-term debt when the CFA is used. The Commission has found that the requested rule variance is appropriate in the past, and there have been no events which would likely change that evaluation. Decision alternative 3 implements the requested rule variance.

Filing Requirements

The filing requirements recommended by the Department are the same ones that have been ordered in the last several capital structure petitions from MP, and are acceptable to all parties. These are included in decision alternatives 4 and 5.

Ratemaking Implications

It is worth noting that this proceeding addresses the capital structure of Allete as a whole. The capital structure, and associated cost components, used for establishing revenue requirements in a rate case will be representative of a regulated utility, which excludes all non-regulated businesses. One approach to this would be to take the actual capital structure of Allete, back out the non-regulated businesses by assigning equity and debt to them and subtracting that out of the overall totals, leaving just the regulated business. Another, possibly complementary approach, would be to base the capital structure on comparable stand-alone utilities. The appropriate capital structure for the regulated business is usually a matter of debate during any rate case. The clarification on the ratemaking implications of this docket requested by the Department is consistent with prior MP capital structure petition orders and is included as decision alternative 6.

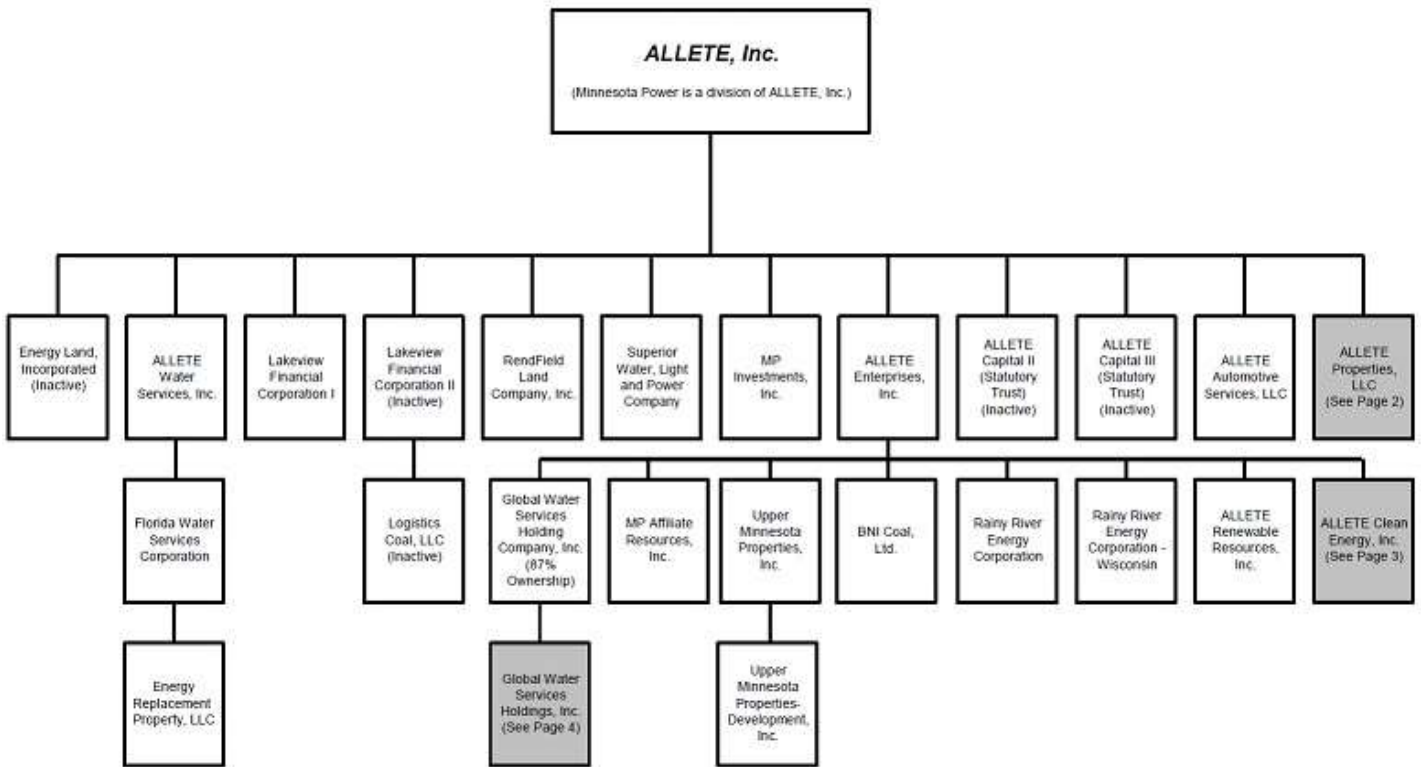
Variation between projected and actual capital expenses.

Allete's projected capital expenses for 2018 far exceeded their actual expenses. The difference reflected deferred and canceled projects and acquisitions, and it is reasonable both that MP reported them in the 2018 petition and that they didn't actually do them. It is better that they reported projects they were likely to do, and not do them, than to have not reported them and have to come in early for another capital structure proceeding when they near exceeding their approved capitalization.

Restructuring

Allete is currently structured such that Minnesota Power, which represents the majority of their revenues and profits, is a division of Allete. Restructuring as a holding company would separate MP out as a wholly owned subsidiary of Allete. That would allow Allete and MP several options, most notably for Commission proceedings, MP’s capital structure petitions would only affect MP, and Allete might be able to finance its non-regulated and non-Minnesota businesses however it chooses without Commission approval. As the Department noted, a holding company model might also make separating MP costs and revenues from the rest of Allete cleaner during a rate case. However, there would be costs to this process, with respect to e.g. gaining regulatory approval at all levels, handling shared corporate services, existing debt, etc. Allete has been considering formation of a holding company structure for several years, and no action is required from the Commission on this issue no matter what decision the Commission makes on the equity band.

Table 4: Allete (Minnesota Power) Current Corporate Structure 2016⁵



⁵ https://www.oasis.oati.com/woa/docs/MP/MPdocs/legal_organizational_chart_11112016.pdf

Decision Alternatives

- 1a. Approve MP's filing with a \$5.235 billion total capitalization, \$480 million capital contingency, a Common Equity Ratio of 56.4%, and an allowed equity band of +/- 10% of the approved CER, from 50.76% to 60.24%. (Department) OR
- 1b. Approve MP's filing with a \$5.235 billion total capitalization, \$480 million capital contingency, a Common Equity Ratio of 56.4%, and an allowed equity band from 50.76% to 100%. (MP) OR
- 1c. Approve MP's filing with a \$5.235 billion total capitalization, \$480 million capital contingency, a Common Equity Ratio of 56.4%, and an allowed equity band from 50.76% to 75%. (MP compromise proposal)
2. Approve issuance of short-term debt up to 15% of total capitalization, and flexibility to issue securities provided that Allete remains within the CER band and the approved capitalization including contingency, or does not exceed them for more than 60 days. Require MP to obtain prior approval for issuance of any securities that would result in a CER outside the approved range or a total capitalization exceeding its approved cap for more than 60 days. (MP, Department)
3. Approve continuation of variance to Minnesota Rule, part 7825.1000, subp. 6 to allow Allete to continue to treat borrowing under multi-year credit agreements as short-term debt. (MP, Department)
4. Require that MP provide all of the following in future capital structure filings:
 - a. An exhibit showing a general projection of capital needs, projected expenditures, anticipated sources, and anticipated timing, with the understanding that such exhibit is not intended to require dollar-for-dollar information on the uses identified in the exhibit or to limit the issuances to project specific financing.
 - b. a report of actual issuances and uses of the funds from the prior year.
 - c. a schedule comparing its actual capital investments with the capital investments projected by MP in its previous capital filing.
 - d. the Company's investment plan for at least the next five years.
(Department, MP does not object)
5. Require MP to file details on the specific purposes for the individual issuances, the type, timing, amounts, cost of issuance (including price per share for common equity issuances), and interest rates, within 20 days after any security issuance. Require MP to file an informational update within 20 days if it becomes aware of any significant change in Allete's or MP's credit ratings and outlook, or if it undertakes any corporate restructuring. (Department, MP does not object)



6. Require MP to file its request for approval for its 2020 securities issuance no later than February 28, 2020. Clarify that approval of a capital structure under this proceeding does not determine appropriate capital structure for ratemaking purposes. (Department, MP does not object)