MINNESOTA PUBLIC UTILITIES COMMISSION

# Staff Briefing Papers

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| Meeting Date | August 27, 2020 | Agenda Item **7 |
| Company | Minnesota Power | |
| Docket No. | **E-015/S-20-279** | |
| | **In the Matter of Minnesota Power's Petition for Approval of its Capital Structure and Authorization to Issue Securities** | |
| Issues | Should the Commission approve MP's proposed 2020 capital structure and authorize MP to issue securities? | |


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| ✓ **Relevant Documents** | **Date** |
|---|---|
| Minnesota Power, Petition (TS) | February 13, 2020 |
| Department of Commerce, Comments | April 20, 2020 |
| Minnesota Power, Reply Comments | May 18, 2020 |
| Department of Commerce, Response to Reply Comments (TS) | June 5, 2020 |

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## I. Statement of the Issues

Should the Commission approve MP's proposed 2020 capital structure and authorize MP to issue securities?

## II. MP's Consolidated Capital Structure

The petitioner is Minnesota Power (MP), a division of ALLETE, Inc. (ALLETE). MP's instant capital structure filing addresses the consolidated capital structure of ALLETE. The instant petition is MP's request for approval of the Company's (ALLETE's) capital structure. MP is an operating division of ALLETE, Inc. rather than a wholly owned subsidiary corporation.

Capital expenditures discussed in this petition are the consolidated capital expenditures of ALLETE and its subsidiaries; however, specific references are made to MP's capital investments because the Company continues to operate its electric operations in Minnesota under the name of Minnesota Power.

MP advises that in this petition, the term "ALLETE" or the "Company" refers to the combined business units that make up ALLETE, and the term "Minnesota Power" refers to the regulated electric utility in Minnesota and that, throughout this petition, the Minnesota Power (MP) is the public utility as defined in Minn. Stat. § 216B.02, subd. 4.

The petitioner's name at the time of incorporation in 1906 was Duluth Edison Electric Company. The petitioner changed its name, first, to Minnesota Power & Light Company in 1923, and, later, to Minnesota Power, in 1998. The petitioner further changed its name to ALLETE in 2000. The official name change to ALLETE, Inc. was adopted by shareholders in 2001. However, as noted above, ALLETE's electric operations in Minnesota continue to be regulated under the name of Minnesota Power (MP).

## III. Details of MP's Capital Structure Petition

### A. Specific Provisions of the Petition

On February 13, 2002, MP filed its 2020 capital structure filing seeking approval of the following specific provisions:

i. Total capitalization of $6,145 million, including a contingency of $559 million, and flexibility to allow total consolidated capitalizations to exceed the cap for a period not exceeding 60 days;[1]

[1] When the Company expects total consolidated capitalization to exceed $6,145 million for a period exceeding 60 days, it will seek approval from the Commission for any such issuance.

ii. An equity ratio of 60.56% with a contingency range of +/- 15%, (resulting in an equity range of 51.48% to 69.64%),[2] and flexibility to allow its total equity ratio to exceed 69.64%, or fall below 51.48%, for a period not exceeding 60 days;[3]

iii. Request for a variance of Minn. Rules 7825.1000, subp. 6, to allow the Company to treat borrowings under multi-year credit agreements as short-term debt for approved capital structure purposes;[4]

iv. Approval for the ability to issue short-term debt[5] not to exceed 15% of total capitalization;

v. Continued flexibility to issue long-term debt, provided it remains within the limits approved for the short-term debt and equity ratios, as well as the total capitalization limit;

vi. Flexibility to issue securities provided that the Company remains within the approved capital structure ratios or does not exceed them for more than 60 days;

vii. Approval of the Company's consolidated capital structure for the period beginning with the date of issuance of an Order in this Docket through the date at which the Commission issues a subsequent order.

### B. Need for Financing

MP notes that the $6 billion in requested capital is driven by significant construction and infrastructure development expenditures. MP adds that the expenditures are expected to exceed internal cash generation for the 18-month period, January 2020 through June 2021, and that Company will need to issue long-term debt, common stock, tax equity financing, and/or short-term debt to support the planned investments.

In addition, MP notes that ALLETE continues to evaluate acquisition and other investment opportunities to diversify its revenue base in order to reduce its dependence on revenues from a concentrated industrial base of taconite and paper customers in northeastern Minnesota.

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[2] If the Commission approves MP's proposal, any securities issuance that results in a total equity ratio within the window, that is, at or above 51.48%, but below 69.64%, is approved.

[3] When MP contemplates a securities issuance would cause the total equity ratio to fall outside the window (i.e., exceed 69.64% or fall below 51.48%) for a period exceeding 60 days, MP will seek approval from the Commission for any such issuance.

[4] The Commission has approved this variance in MP's capital structure petitions from 2011 through 2019 in dockets 11-174; 12-184; 13-126; 14-145; 15-168; 16-165; 17-142; 18-155; and 19-170.

[5] Commercial paper, borrowings that mature in one year or less, and direct borrowings under a 364-day credit agreement are the traditional instruments of short-term debt. If approved by the Commission, MP will count direct borrowings under a multi-year credit facility as short-term debt.

Table 1 below shows the Company's actual consolidated capital structure for the calendar years-ending 2017, 2018, 2019, and projected as of June 30, 2021:

**Table 1: Actual and Projected Consolidated Capital Structures ($ Millions)**

| Capital Structures | 12/31/2017 | | 12/31/2018 | | 12/31/2019 | | Projected June 30, 2021 | |
|---|---|---|---|---|---|---|---|---|
| Long-Term Debt[3] | $ 1,503 | 42.09% | $ 1,486 | 40.80% | $ 1,614 | 40.89% | $ 2,203 | 39.44% |
| Short-Term Debt | $ 0 | 0.00% | $ 0 | 0.00% | $ 0 | 0.00% | $ 0 | 0.00% |
| Total Equity | $ 2,068 | 57.91% | $ 2,156 | 59.20% | $ 2,333 | 59.11% | $ 3,383 | 60.56% |
| Total Capitalization | $ 3,571 | 100.00% | $ 3,642 | 100.00% | $ 3,946 | 100.00% | $ 5,586 | 100.00% |

[3] Contains long-term debt net of unamortized issuance costs.

MP anticipates increasing its long-term debt by $589 million, from $1,614 million at the end of 2019 to $2,203 by the end of June 2021.

MP's projected consolidated capital structure for 2021 is presented below in greater detail:

**Table 2: Projected Consolidated Capital Structure**
**June 30, 2021**
($ Millions)

| | Amount | Percentage |
|---|---|---|
| Long - Term Debt | $2,203 | 39.44% |
| Short - Term Debt | $ 0 | 0.00% |
| Total Equity | $3,383 | 60.56% |
| Projected Capitalization | $5,586 | 100.00% |
| Contingency | $ 559 | |
| Total Request | $6,145 | |

### C. Error in the E015/M-19-170 Order

MP indicated that it discovered during the development of this Petition that the approved upper cap of the authorized plus/minus 10 percent contingency equity ratio window, 62.04%, was inadvertently transposed to 60.24% in the September 11, 2019 briefing papers, including in Decision Option 1.a. on page 8. MP also noted that the Commission adopted Decision Option 1.a. verbatim from the briefing papers; therefore, the transposed number, 60.24%, is in the November 7, 2019 Order rather than the correct upper cap to the 10 percent contingency equity ratio window of 62.04%.

However, MP did not point to any time in the past year when the equity ratio exceeded the 60.24% upper limit for more than 60 days, and, as of the year-end 2019, the actual equity ratio was 59.11%.

<u>Staff Comment:</u> The transposition of 62.04% to 60.24% in ordering paragraph 1 of the Commission's order was discovered only while MP was preparing this filing. The error did not conflict with MP's equity ratio in 2019, with MP's actual equity ratio, as of December 1, 2019, being 59.11%. Staff has also ascertained from MP that the error dd not cause any problems to

MP's ability to finance its operations. If the Commission believes this error in the 2019 order should be corrected, Staff will take steps to issue an Erratum to correct the record.

## IV. Department of Commerce Comments

On April 20, 2020, the Department filed its comments.

The Department found MP's petition to be complete and in compliance with Minnesota administrative rules and prior Commission Orders. However, the Department noted that it had requested additional information[6] from MP and would provide its final recommendations after reviewing MP's reply comments.

The Department indicated that MP's proposed 51.48 percent lower limit on the equity range would allow MP to expand its debt component of total capitalization to a maximum of $2,982 million by June 2021. The Department's overall concern is that, because MP is an operating division of ALLETE, ALLETE's pursuit of non-regulated business activities and operations could eventually increase the cost of capital for MP if too much debt is used to finance those non-regulated activities. The Department questioned whether this level of debt was reasonable and needed by MP.

The Department expressed its concern that this level of debt would allow ALLETE to increase its net-debt/EBITDA (earnings before interest, taxes, and depreciation) to around 7.6, or even higher, if this year's macroeconomic issues cause ALLETE's EBITDA to decline. The Department noted that, at last year's approved maximum debt level of $2.578 billion, ALLETE could increase its net-debt/EBITDA ratio to a maximum of 6.6; the Department noted that while this ratio was high, it was nevertheless tolerable because of the potential need for financial flexibility. This concern forced the Department to seek more information about why granting ALLETE the option to increase its leverage by increasing the maximum amount of debt outstanding to $2.982 billion, would be reasonable and needed.

The Department noted that it has requested MP to provide more information about why granting ALLETE the option to increase its relative leverage, and to increase the maximum debt outstanding to $2,982 million, would be reasonable and needed.

In particular, the Department asked MP to address the following issues in its Reply Comments:[7]

1) provide supplemental information about why granting ALLETE the option to increase its relative leverage would be reasonable and needed;

[6] In particular, the Department solicited from MP more information about ALLETE's non-regulated capital expenditures, the prudent level of debt needed to finance these expenditures, and what measures ALLETE is taking to insulate it and its ratepayers from the debt incurred to pursue non-regulated lines of business.

[7] MP reply Comments, pp. 1-2.

2) identify measures ALLETE is taking to insulate MP and its ratepayers from the debt incurred to pursue non-regulated lines of business;
3) reconcile the information provided in Exhibits J and L (of MP's initial filing) to the statement made in ALLETE's February 13, 2020 earnings call related to its approximately $2 billion of projects scheduled in its CapEx plan for the next five years;

4) reconcile the clarifications requested and expected to be provided by MP in MP's reply comments regarding the level of debt to be used for non-regulated operations with the statement made on the February 13, 2020 earnings call on ALLETE's differentiated growth strategy being well supported by ALLETE's solid fundamentals and a longer runway of credit headroom enabling further non-regulated growth;

5) provide more detailed information about the specific projects that would warrant an increase in the debt ratio contingency range from 10% (in the 2019 capital structure filing) to 15% (in the present filing) and why specifically this increased flexibility is needed and reasonable at this time; and

6) confirm that the Company's capital structure for ratemaking purposes will not be affected by any changes regarding ALLETE's approved capital structure.

Overall, the Department maintains that MP has not shown why the high level of debt is necessary, nor has it shown how ALLETE could reach this level of debt while also protecting ratepayers without raising its cost of capital.

The Department believes the Commission should continue to enforce, on an on-going basis, Order Points 4, 5, and 6 in the Commission's November 7, 2019 Capital Structure Order, in Docket No. E-015/S-19-170.[8] This additional information would enable a better understanding of whether ALLETE is appropriately protecting ratepayers from risk in its other lines of business, and to what extent ALLETE is taking on risk in those businesses.

In the meantime, the Department recommended the Commission require MP to indicate in future capital structure filings, how much of any securities issuances and other financing activities are for Minnesota Power, how much is for other regulated entities; how much is for ALLETE Clean Energy; and how much is for other nonregulated entities.

In addition, the Department requested that MP confirm that MP's capital structure for ratemaking purposes will not be affected by any changes regarding ALLETE's approved capital structure.

[8] Staff Comment: These requirements generally relate to projection of capital needs, projected expenditures, purposes of the individual issuances, and notice of any significant change in ALLETE's or MP's credit ratings and outlook. Staff has not included these requirements in the decision alternatives because these are standing requirements previously established and remain in effect until revoked by the Commission.

## V. MP's Response to the Department's Comments

On May 18, 2020, MP responded to the Department's concerns regarding the level of debt in MP's 2020 capital structure petition.

MP stated that the proposed debt was needed to finance wind projects. According to MP, "due to the nature and unique timing of tax equity financing, ALLETE needs the flexibility to finance the tax equity projects with debt through the construction phase, and then subsequently replace the debt with a tax equity investment once the project is placed in service."

MP also stated that recently, until June 2019, MP had requested approval of a +/- 10 percent equity ratio contingency rate. However, prior to 2009, MP had been approved for +/- 15 % equity ratio contingency rate and that the Department had recommended, in Docket No. E-015/M-09-1233, that "[i]n future capital structure[s] a 15 percent range may be appropriate given an appropriate explanation by MP."

MP indicated that the rapidly evolving energy industry and continually changing financial environment, especially over the past approximately 12 months, increases the need for ALLETE to have flexibility to execute business transactions.

The request to increase the contingency range from 10% to 15% allows for increases to both the equity and debt ratios. This allows for greater flexibility to coincide with the nature of tax equity financing.

MP also indicated that it, in a rate case, it has an imputed capital structure that is set by the Commission through the regulatory process. All non-regulated operations are carved out of MP's capital structure for ratemaking purposes.

MP agreed to identify in future capital structure petitions and compliance filings, "a historical account of what is allocated to Minnesota Power, ACE [ALLETE Clean Energy] and other nonregulated entities."

## VI. Department's Reply and Recommendation

On June 5, 2020, the Department replied to MP's response.

The Department recommended that the Commission approve MP's petition with a modification to the amount of debt in the capital structure.

The Department recommended that ALLETE be required to limit its maximum debt to last year's maximum of $2,578 million, as opposed to MP's requested $2,982 million for the year 2020. The Department noted that ALLETE had $1,623 million of debt at the end of 2019, which increased to $1,731 as of March 31, 2020 due to the debt issuances thus far in 2020. At a maximum debt limit of $2,578 million, ALLETE would still have the flexibility to increase debt by another 49%, or $847 million.[9] According to the Department, this level of debt would leave ALLETE with more than enough flexibility and put a more reasonable limit on ALLETE's overall level of debt than the Company's requested $2,982 million. With this modification, the Department indicated that it will not object to MP's requested total capitalization and equity ratio range, as the modification would place a reasonable limit on debt.

In sum, the Department's recommendation involves the following:

1) limiting MP's maximum possible debt to the amount authorized in its 2019 capital structure filing (Decision Alternative **A. iii** below); and

2) requiring, in future filings, separation, in general, of securities issuances between regulated and non-regulated business activities, operations and entities (Decision Alternative **A. x.** below).

## VII. MP's Reply

MP indicated via email that it accepted the Department's recommendation to limit its maximum debt to last year's maximum of $2,578 million.

## VIII. Staff Comment

Staff recommends that the Commission adopt the two modifications suggested by the Department to MP's 2020 capital structure filing.

Staff notes that an upper limit of 15 percent on the equity ratio of 60.56 percent would amount to $4,279 million (.6964 times $6,145 million) of equity capital leaving a debt of $1,866 million, which is consistent with the maximum allowable amount of debt capital of $2,578 million.

However, the lower limit (51.48 percent) of the allowable range (i.e. -15%) on the equity ratio would put it at $3,163 million, which would allow the debt to increase to $2,982 million. This amount would be well above the maximum limit of $2,578 million.

Staff suggested to both the Department and MP via email that a reworking of the equity range requested by MP may be necessary. Staff indicated that re-working the lower limit of the equity range subject to a debt ceiling of $2,578 million, gives the lower limit for the equity range of -4.14 percent.[10]

At, -4.14% of the contingency range, the equity ratio will be 58.05% of total capitalization (i.e., $3,567 million), leaving debt at $2,578 million.

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[9] $847/$1,731 = 49%

[10] $3,721 million * (1-X) = $3,567 million, where $3,721 million is 60.56 percent of total capitalization of $6,145 million; $3,567 million ($6,145 million minus $2,578 million) is the lowest amount of equity compatible with the maximum allowable debt of $2,578 million. X = -0.0414.

Thus, the re-worked equity range would be 58.05% (60.56% minus 4.14%) to 69.64% (60.56% plus 15%), compared to MP's proposed range of range of 51.48% to 69.64%.

MP gave a hypothetical example illustrating how the lower limit of the equity range would put MP out of compliance even when the debt amount is far below the maximum limit of $2,578 million. In the example below, MP's equity ratio falls below 58.1 percent even when the debt is well below the maximum limit of $2,578 million.

In the hypothetical, a significant change in debt/equity ratios occurs by the addition of a large, new project. As of December 31, 2019, ALLETE's debt and equity were, respectively, $1,614 million (40.89%) and $2,333 million (59.11%). If the Company were to start a $500 million project, that would require the Company to finance $500 million of debt during construction. In this example, adding $500 million of debt would bring the debt and equity ratios to 47.5% ($2,114 million) and 52.5% ($2,333 million), respectively, at the peak of construction. Once the project is placed into service, the debt is paid off and replaced with equity, the $500 million would swing the other way (-$500 million of debt, +$500 million of equity), resulting in debt and equity ratios of 36.3% ($1,614 million) and 63.7% ($2,833 million), respectively. As demonstrated in this example, the debt and equity financings do not happen simultaneously and had a cumulative change in the equity structure of approximately 18% from peak to trough, thus the need for flexibility.

Staff realizes that MP would like the flexibility entailed by the requested equity range. However, because of the potential conflict between the maximum allowable debt and the lower limit of the equity range of 51.48% to 69.64%, Staff suggests that the Commission consider imposing the following requirement (Decision Alternative A. iv. below):

> if there is a conflict between the authorized maximum debt and the authorized equity range, the debt limit would override the equity range.

MP has indicated its acceptance of this condition. The Department has not opposed this condition.

## IX. Decision Alternatives

A. Approve MP's 2020 capital structure petition and grant permission to issue securities subject to:

i. total capitalization of $6,145 million, including a contingency of $559 million, and flexibility to allow total consolidated capitalizations to exceed the cap for a period not exceeding 60 days;

ii. an equity ratio of 60.56% with a contingency range of +/- 15%, (resulting in an equity range of 51.48% to 69.64%);

**iii.** <u>the maximum debt is limited to $2,578 million (Department modification);</u>

**iv.** <u>if there is a conflict between the authorized maximum debt and the authorized equity range, the debt limit would override the equity range (Staff modification)</u>;

v. a variance of Minn. Rules 7825.1000, subp. 6, to allow the Company to treat borrowings under multi-year credit agreements as short-term debt for approved capital structure purposes;

vi. ability to issue short-term debt not to exceed 15% of total capitalization;

vii. continued flexibility to issue long-term debt, provided it remains within the limits approved for the short-term debt and equity ratios, as well as the total capitalization limit;

viii. flexibility to issue securities provided that the Company remains within the approved capital structure ratios or does not exceed them for more than 60 days;

ix. approval of the Company's consolidated capital structure for the period beginning with the date of issuance of an Order in this Docket through the date at which the Commission issues a subsequent order; and

**x.** <u>indicate in future capital structure petitions and compliance filings how much of any capital issuances and other activities cited are for Minnesota Power, how much is for other regulated entities, how much is for ALLETE Clean Energy, and how much is for other nonregulated entities (Department modification)</u>.

B. Other action by the Commission.