

## Staff Briefing Papers

Meeting Date July 9, 2020 Agenda Item 5\*

Company Otter Tail Power Company

Docket No. **E-017/S-20-454**

**In the Matter of the Petition of Otter Tail Power Company for Approval of 2020 Capital Structure and Permission to Issue Securities**

Issues Should the Commission approve Otter Tail Power’s 2020 Capital Structure and grant permission to issue securities?

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 **Relevant Documents**

**Date**

Otter Tail Power Company - Petition	May 1, 2020
Department of Commerce, Division of Energy Regulation - Comments	May 29, 2020

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The attached materials are work papers of the Commission Staff. They are intended for use by the Public Utilities Commission and are based upon information already in the record unless noted otherwise.

## I. Statement of the Issues

Should the Commission approve Otter Tail Power Company's (OTP's, Otter Tail's) 2020 capital structure and grant permission to issue securities?

## II. Background and Initial Filing

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.

In 2019, Otter Tail's capital structure was approved in Docket No. E-017/S-19-299. On May 1, 2020, Otter Tail Power Company filed its petition for approval of its 2020 consolidated capital structure. Otter Tail requested:

- An equity ratio of 52.8% plus or minus 10%, for a target range for the equity ratio to remain between 47.5% and 58.1%.
- A base capitalization of \$1.55 billion, with a 10% contingency allowing for a maximum capitalization of \$1.705 billion.
- Continuation of a variance of Minn. Rules 7825.1000, subp. 6 to allow OTP to treat borrowing under multi-year credit agreements as short-term debt for approved capital structure purposes.
- Approval to issue short-term debt up to 15% of total capitalization.
- Authorization to issue securities, provided Otter Tail does not exceed the limits of the approved equity ratio, maximum short-term debt ratio, or maximum capitalization for more than 60 days.

Otter Tail states that this capital structure will allow it to maintain a strong credit rating, attract capital on favorable terms, and maintain a reasonable equity ratio.

Otter Tail submits that the multi-year credit agreement allows Otter Tail and its customers to reduce refinancing risk inherent in short-term credit facilities. It also represents liquidity viewed favorably by credit rating agencies, which could result in lower borrowing costs. Otter Tail generally uses these agreements in a manner consistent with the typical usage of short-term credit.

## III. Department Comments

On May 29, 2020, the Department of Commerce, Division of Energy Regulation (Department) filed its comments on Otter Tail's petition, recommending approval.

The Department notes that the only changes from last year's approved request are the equity ratio range and the maximum capitalization. The equity range approved last year

was 46% to 56.2% (with a midpoint of 51.1%), so the equity share requested has increased slightly. The maximum capitalization approved last year was \$1.331 billion compared to \$1.705 billion this year, which is a 28% increase. Combined, these two changes increase maximum allowed debt from \$719 million to \$895 million, an increase of 24.5%.

The Department concludes that the variance to Minn. Rules 7825.1000, subp. 6 to allow Otter Tail to treat its multi-year credit agreement as short-term debt and the request to allow short-term debt of up to 15% of total capitalization to continue to be reasonable, as they have been in years' past. The Department cites its comments attached to the 2019 informal letter order<sup>1</sup> noting that the variance satisfies three requirements – that enforcement of the rule would impose an excessive burden on the applicant or others affected by the rule, that granting the variance would not adversely affect the public interest, and granting the variance would not conflict with standards imposed by law. The Department agrees with Otter Tail that the multi-year credit agreement resembles short-term debt instruments and that it would be potentially harmful to treat this agreement as long-term debt.

The Department also concludes that allowing a 60 day grace period to correct or request approval of variances from the approved ranges or debt levels allows sufficient flexibility for Otter Tail to manage short-term aberrations while not allowing deviations for an undue amount of time.

The Department reviewed the capitalization request and the equity ratio proposal in terms of the ratio of net debt (debt minus cash and cash equivalents) to earnings before income tax and depreciation (EBITDA), which is a change from prior years' approach. This metric is intended to estimate the minimum number of years which would be required to pay back current debt principal assuming constant earnings. Over the past dozen years, Otter Tail's net-debt to EBITDA ratio has ranged from 2.9 to 3.8, which is considered reasonable according to the Department. A ratio of over 4 or 5 would be considered high.

This year's total capitalization and equity ratios could result in a maximum debt of \$895 million, with maximum capitalization and minimum equity ratio. This corresponds to a net-debt to EBITDA ratio of 5.4. By comparison, last year's approved capitalization and equity ratios would result in a net-debt to EBITDA ratio of 4.8. This increase is driven by the abnormally large increase in capitalization, which resulted from \$179.5 million in expenditures at Merricourt Wind Farm, \$88.7 million for Astoria Gas Plant, and \$100.7 million in other planned capital expenditures for regulated activities. Because the increase is for approved capital expenditures and the maintenance of at least a 50% equity ratio, the Department does not object to the 28% increase in capitalization. The Department expects Otter Tail's capitalization needs to moderate in future years and the net-debt to EBITDA ratio to return to its historical range over the next several years as debt is paid off.

The Department recommends that the Commission **approve** OTP's petition.

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<sup>1</sup> Docket No. E-017/S-19-299, *In the Matter of the Petition of Otter Tail Power for Approval of 2019 Capital Structure and Permission to Issue Securities*, Attachment to Order of July 19, 2019.

#### IV. Staff Analysis

The Department recommendation does not include several requirements which it has requested in recent years, which the Commission has customarily approved. The Department did not provide any reason in its filing for excluding these recommendations. Most of them are requirements to file specific information about securities issuances or expand on the filing requirements for the following year's Petition. These recommendations are included as decision options number 6 through 10, 11 (a) through 11(d) and 12 through 14 below. Staff is unaware of any specific reason to remove these requirements from this year's Commission order, and believes continuing these requirements would serve the public interest by providing the Commission and the Department with information valuable to evaluation of Otter Tail's future 2021 Petition to approve capital structure and issue securities.

Staff believes the analysis of the ratio of net-debt to EBITDA is a reasonable rough approach to evaluating potential overall debt level, though Staff does note that a complete metric of time to pay off debt would take into account interest rates on existing debt in addition to principle balance. Staff agrees with the Department that Otter Tail's debt levels are currently reasonable.

#### V. Decision Alternatives

1. Approve OTP's 2020 proposed capital structure. This approval will remain effective until the latter of May 1, 2021 or the date at which the Commission issues a new capital structure order. **(OTP, Department)**
2. Approve OTP's equity ratio contingency of plus/minus 10% around its 2020 proposed equity ratio of 52.8%, equating to a range from 47.52% to 58.08%. Equity ratios outside this range may not exceed a period of 60 days without Commission approval. **(OTP, Department)**
3. Approve OTP's total maximum capitalization of \$1,704,607,144, or 10% above its base capitalization of \$1,549,642,858. Capitalization outside this range may not exceed a period of 60 days without Commission approval. **(OTP, Department)**
4. Allow OTP to issue any securities in 2020 that would not result in an equity ratio outside the proposed range or a total capitalization exceeding its proposed cap for more than 60 days. **(OTP, Department)**
5. Require OTP to obtain prior approval for the issuance of any securities in 2020 that would result in an equity ratio outside the approved range or a total capitalization exceeding its approved cap for more than 60 days. **(OTP, Department)**

6. Require OTP to provide, within 20 days after each non-recurring issuance of securities, the following information: **(Department historical)**
  - a) The specific purposes for the individual issuances;
  - b) The type of issuances;
  - c) The timing of issuances;
  - d) The amount of issuances;
  - e) Issuance costs (for common equity issuances, include price per share), and
  - f) Interest rates.
  
7. Require OTP to provide, in its next capital structure filing, 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. **(Department historical)**
  
8. Require OTP to provide, in its next annual capital structure filing, a report of actual issuances and uses of funds from the prior year. The report will be for information purposes only and need not cover short-term security issuances. **(Department historical)**
  
9. Require OTP to provide in its next annual capital structure filing a schedule comparing its actual capital investments in the past year with the capital investments projected by OTP in its previous capital structure filing. **(Department historical)**
  
10. Require OTP to provide in its next annual capital structure filing the Company's investment plan not only for the next year, but for at least the next five years. **(Department historical)**
  
11. Approve OTP's request for a variance to Minn. Rules 7825.1000 subp. to allow it to treat any loan under its multi-year credit facility as a short-term debt **(OTP, Department)** and require OTP to report on its use of such facilities including:
  - a) How often they are used;
  - b) The amount involved;
  - c) Rates and financing costs; and
  - d) The intended uses of the financing. **(Department Historical)**
  
12. Require OTP to file its request for approval of its 2021 securities issuances no later than May 1, 2021. **(Department historical)**

13. Require OTP, in its next securities issuance filing to show the competitiveness of its debt issuances, using analysis similar to its analysis in attachment 12 of its instant Petition. (**Department historical**)
  
14. Clarify that approval of securities issuance and the resulting capital structure, within this proceeding, is not a determination of the appropriate capital structure for ratemaking purposes. (**Department historical**)