COMMERCE DEPARTMENT

May 29, 2020

Will Seuffert
Executive Secretary
Minnesota Public Utilities Commission
121 7th Place East, Suite 350
Saint Paul, Minnesota 55101-2147

RE: **Comments of the Minnesota Department of Commerce, Division of Energy Resources**
Docket No. E017/S-20-454

Dear Mr. Seuffert:

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

Petition of Otter Tail Power Company for Approval of Its 2020 Capital Structure.

The Petition was filed on May 1, 2020 by:

Andrew Miller
Vice President, Financial Planning and Treasurer
Otter Tail Corporation
215 S. Cascade St.
P. O. Box 496
Fergus Falls, MN 56538-0496
(701) 451-3572.

The Department recommends that the Minnesota Public Utilities Commission (Commission) **approve the petition**. The Department is available to answer any questions that the Commission may have in this matter.

Sincerely,

/s/ STEPHEN COLLINS
Rates Analyst
SC/ja
Attachment

Before the Minnesota Public Utilities Commission

Comments of the Minnesota Department of Commerce
Division of Energy Resources

Docket No. E017/S-20-454

I. INTRODUCTION

On May 1, 2020, Otter Tail Power Company (OTP or the Company) filed a petition requesting that the Minnesota Public Utilities Commission (Commission) approve OTP's 2020 consolidated capital structure. Specifically, OTP requested approval of:

- An equity ratio of 47.5% to 58.1% -- derived from an midpoint of 52.8% plus or minus a contingency band of 10 percent of the midpoint (+ or – 5.28%);
- A maximum capitalization of up to $1.705 billion – derived from an base capitalization of $1.550 billion plus a 10% contingency amount of $0.155 billion;
- Continuation of the 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; and
- Authorization to issue securities, provided that OTP does not exceed the limits of the approved equity ratio, maximum short-term debt ratio, or maximum capitalization for more than 60 days.

In effect, these requests would allow OTP to reach up to $0.895 billion ([1 – 47.5%] * $1.705 billion) of debt outstanding or exceed this amount for no more than 60 days without Commission approval through a new petition.

The Minnesota Department of Commerce, Division of Energy Resources (Department) reviews these requests below.

II. DEPARTMENT ANALYSIS

The Commission approved the most recent OTP capital structure in an Order issued July 19, 2019 in Docket No. E015/S-19-299 (the 2019 Capital Structure Order). That Order approved:

- An equity ratio of 46.0% to 56.2% -- derived from a midpoint of 51.1% plus or minus a contingency band of 10 percent of this midpoint (+ or – 5.11%);
- A maximum capitalization of $1.331 billion, consisting of a base capitalization of $1.210 billion plus a contingency amount of $0.121 billion, or 10% of the base;
- Continuation of a variance to Minn. Rules 7825.1000, subp. 6 to allow OTP to treat borrowings under multi-year credit agreements as short-term debt;
- Allowance for OTP to issue short-term debt up to 15% of total capitalization;

- Authorization to issue securities provided that OTP does not exceed the preceding capital structure parameters for more than 60 days.

The maximum debt allowed by the 2019 Capital Structure was $0.719 billion ([1 – 46.0%] * $1.331 billion).

As such, OTP's this year is the same except for:

a) The requested equity ratio range is based on a slightly higher midpoint – 52.8% instead of last year's 51.1% -- resulting in a slightly higher and wider requested range of 47.5% to 58.1% versus 46.0% to 56.2% last year; and
b) The requested maximum capitalization is 28% higher – from $1.331 billion last year to $1.705 billion this year – though it is based on the same 10% contingency method.

Therefore, in effect OTP is requesting that the Commission increase its maximum allowed debt from $0.719 billion to $0.895 billion, or by 24.5%.

The Department concludes that it is reasonable to maintain the long-standing policies regarding issuing short-term debt up to 15% of total capitalization, the requested variance of 7825.1000, subp. 6, and the 60-day window. The reasons for the variance to 7825.1000, subp. 6 are provided in section IV of the Comments attached to the 2019 Capital Structure Order:

> OTP requests that the Commission continue to vary Minnesota Rues 7825.1000, subpart 6, to allow OTP to treat borrowing under its multi-year credit agreement as short-term debt for approved capital structure purposes. Because Minn. Rules part 7825.1000, subpart 6, defines short-term securities as those with a date of maturity of no more than one year, to classify multi-year credit agreements as short-term debt, OTP needs the Commission to make the requested variance.
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> To vary its rules, the Commission must determine, per Minn. Rules 7829.3200, subp. 1, that the variance satisfies three requirements:
>
> A. Enforcement of the rule would impose an excessive burden upon the applicant or others affected by the rule,
> B. Granting the variance would not adversely affect the public interest, and
> C. Granting the variance would not conflict with standards imposed by law.
>
> The Department agrees with OTP that the Company's requested variance satisfy the three requirements (Petition at pages 10 and 11). OTP's current multi-year credit agreement resembles traditional short-term debt

> instruments and classifying multi-year credit agreements as long-term debt could cause credit-rating agencies to react unfavorably, thus imposing an excessive burden on OTP and potentially hurting ratepayers. In addition, classifying multi-year credit agreements as short-term debt would not conflict with any standards imposed by law.
>
> Therefore, the Department recommends that the commission continue to vary Minn. Rules 7825.1000, subp. 6, an allow OTP to treat borrowing under multi-year credit agreements as short-term debt for approved capital structure purposes.

Regarding the short-term debt windows of up to 15% and 60-days, the Department notes that these long-standing policies allow OTP sufficient flexibility to manage any short-term aberrations while not allowing deviations from approved ratios for an undue amount of time.

The Department reviews the remaining requests below.

The ratio of net debt (debt minus cash and cash equivalents) to earnings before interest taxes and depreciation (EBITDA) indicates the minimum years needed for a business to pay back its current level of debt principal assuming constant EBITDA. In 2019, 2018, and 2017, OTP generated EBITDA of $152, $137, and $140 million, respectively, showing modest growth that roughly corresponds to the compound average growth rate of 5.8% shown since 2008.[1] The net-debt to EBITDA ratios for 2019, 2018, and 2017 were 3.9, 3.7, and 2.9, respectively.[2] Going back to 2008, the previous high for this ratio was 3.8, and lowest level was 2.9 (achieved in both 2017 and 2010). A ratio over 4.0 or 5.0 is generally considered high, but may be an appropriate level depending on whether EBITDA is expected to increase and the certainty regarding future EBITDA.

Assuming that normalized (that is, ignoring for the purposes of this analysis any temporary macroeconomic effects) EBITDA continues to grow at its 5.8% average rate and that OTP maintains the same cash levels as last year, at OTP's requested maximum debt level of $0.895 billion, OTP would be allowed to reach a normalized net-debt/EBITDA ratio as high as 5.4. In comparison, at last year's approved maximum debt level of $0.719 billion, OTP was allowed to increase its net-debt/EBITDA ratio to a maximum of 4.8.

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[1] The Department defines EBITDA as operating income with depreciation and amortization added back. An alternative way to define EBITDA is net income with interest, taxes, depreciation, and amortization added back; however, due to the ability of unusual gains/sales of assets to affect net income, the Department's methodology more accurately represents normalized ability to pay back debt.

[2] As the net-debt/EBITDA ratio is an amount of dollars divided by another amount of dollars, the result is a unitless number. Nonetheless, the ratio indicates the minimum number of years needed to pay back the current level of debt principal assuming constant EBITDA.

Given the following:

(a) the unusual power plant capital expenditures in the form of $179.5 million in capital expenditures required for the Merricourt wind farm and $88.7 for the Astoria gas plant this year,
(b) the remaining $100.7 of OTP's planned 2020 capital expenditures are for regulated activities,[3] and
(c) the Company plans to maintain its overall capital structure at around the same 50-50 debt/equity levels as used over the past decade,

the Department does not object to the 28% increase in capitalization and slightly higher and wider equity range for this particular year.

The Department expects OTP's capitalization needs to moderate significantly in coming years, as OTP forecasts capital expenditures on average in years 2021-2024 to be around one-third of 2020's capital expenditures, as shown in Attachment 10B to the petition. While the large unusual increase in capital expenditures this year will likely result in OTP's net-debt/EBITDA for 2020 exceeding the historical 2.9-3.9 range,[4] the Department expects OTP's relative debt as measured by its net-debt/EBITDA to return to this range in future years as capital needs return to normal levels and debt is paid off.

III. RECOMMENDATION

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

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[3] OTP's planned capital expenditures for 2020 total $368.8 million. For context, OTP's capital expenditures from 2008-2018 ranged from $44.0 million to $175.8 million and averaged $119.3 million. In 2019, capital expenditures were $219.8 million. Therefore OTP's actual capital expenditures in 2019 and expected capital expenditures for 2020 are, respectively, about 2x and 3x more than average. As in 2020, 2019's above-average expenditures were driven by the Merricourt wind farm and the Astoria Station.

[4] Attachment 1 to the petition shows that OTP expects gross debt to equal $0.731 billion by year end 2020. Assuming that EBITDA grows at its historical 5.8% rate, the expected net-debt/EBITDA ratio for 2020 is 4.4.

CERTIFICATE OF SERVICE

I, Sharon Ferguson, hereby certify that I have this day, served copies of the following document on the attached list of persons by electronic filing, certified mail, 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 No. E017/S-20-454

Dated this **29th** day of **May 2020**

/s/Sharon Ferguson

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