FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D.C. 20426

In Reply Refer To:
Office of Enforcement
Docket No. FA20-2-000

December 4, 2020

ALLETE, Inc.
Attention: David R. Moeller
Senior Attorney and Director of Regulatory Compliance
30 West Superior Street
Duluth, MN 55802

Dear Mr. Moeller:

1. The Division of Audits and Accounting (DAA) within the Office of Enforcement (OE) of the Federal Energy Regulatory Commission (Commission) has completed an audit of ALLETE, Inc. (ALLETE). The audit covered the period January 1, 2016 through September 3, 2020.

2. The audit evaluated ALLETE's compliance with: (1) approved terms, rates, and conditions of its transmission formula rate mechanism as provided in Attachment O of the Midcontinent Independent System Operator, Inc.'s (MISO) Open Access Transmission, Energy and Operating Reserve Markets Tariff (MISO's FERC Electric Tariff); (2) conditions included in the Commission's orders granting ALLETE transmission incentives;[1] (3) accounting requirements of the Uniform System of Accounts Prescribed for Public Utilities and Licensees under 18 C.F.R. Part 101; (4) reporting requirements of the FERC Form No. 1, Annual Report of Major Electric Utilities, Licensees and Others, under 18 C.F.R. § 141.1; and (5) the requirements in Preservation of Records of Public Utilities and Licensees under 18 C.F.R. Part 125. The enclosed audit report contains seven findings and 36 recommendations that require ALLETE to take corrective action.

[1] The Commission granted ALLETE's requested transmission incentives, subject to certain prescribed accounting treatment and conditions, in Docket Nos. ER11-134-000 and ER16-118-000. *See Midwest Independent Transmission System Operator*, *Inc*., 133 FERC ¶ 61,270 (2010); *Midcontinental Independent System Operator*, *Inc*., 153 FERC ¶ 61,296 (2015).

3. On November 19, 2020, you notified DAA that ALLETE accepts the seven findings and 36 recommendations in the draft audit report and will submit within 30 days of the issuance of the final audit report a plan for implementing the audit recommendations. A verbatim copy of your response is included as Section V of the accompanying final audit report. I hereby approve the audit report.

4. ALLETE should submit its implementation plan to comply with the recommendations within 30 days of this letter order. ALLETE should make quarterly submissions to DAA describing the progress made to comply with the recommendations, including the completion date for each corrective action. As directed by the audit report, these submissions should be made no later than 30 days after the end of each calendar quarter, beginning with the first quarter after this audit report is issued, and continuing until all the corrective actions are completed.

5. The Commission delegated the authority to act on this matter to the Director of OE under 18 C.F.R. § 375.311. This letter order constitutes final agency action. ALLETE may file a request for rehearing with the Commission within 30 days of the date of this order under 18 C.F.R. § 385.713.

6. This letter order is without prejudice to the Commission's right to require hereafter any adjustments it may consider proper from additional information that may come to its attention. In addition, any instance of noncompliance not addressed herein or that may occur in the future may also be subject to investigation and appropriate remedies.

7. I appreciate the courtesies extended to the auditors. If you have any questions, please contact Kristen Fleet, Acting Director and Chief Accountant, Division of Audits and Accounting, at (202) 502-8063.

Sincerely,

Larry R. Parkinson

Larry R. Parkinson
Director
Office of Enforcement

Enclosure

Federal Energy Regulatory Commission
Office of Enforcement
Division of Audits and Accounting

Audit Report

Audit of ALLETE, Inc.'s Compliance with:

- Tariff requirements governing its FERC jurisdictional rates;
- Conditions included in the Commission's orders granting transmission incentives;
- Accounting requirements of the Uniform System of Accounts Prescribed for Public Utilities and Licensees;
- Reporting requirements of the FERC Form No. 1; and
- Requirements in Preservation of Records of Public Utilities and Licensees, 18 C.F.R. Part 125.

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I. Executive Summary

A. Overview

The Division of Audits and Accounting (DAA) within the Office of Enforcement of the Federal Energy Regulatory Commission (Commission or FERC) has completed an audit of ALLETE, Inc. (ALLETE or the Company). The audit evaluated ALLETE's compliance with: (1) approved terms, rates, and conditions of its transmission formula rate mechanism as provided in Attachment O of The Midcontinent Independent System Operator, Inc.'s (MISO) Open Access Transmission, Energy and Operating Reserve Markets Tariff (MISO's FERC Electric Tariff); (2) conditions included in the Commission's orders granting ALLETE transmission incentives; (3) accounting requirements of the Uniform System of Accounts Prescribed for Public Utilities and Licensees under 18 C.F.R. Part 101; (4) reporting requirements of the FERC Form No. 1, Annual Report of Major Electric Utilities, Licensees and Others, under 18 C.F.R. § 141.1; and (5) the requirements in Preservation of Records of Public Utilities and Licensees under 18 C.F.R. Part 125. The audit covered the period from January 1, 2016 through September 3, 2020.

B. ALLETE, Inc.

ALLETE is an energy services company headquartered in Duluth, Minnesota. Through its operating division, Minnesota Power, ALLETE generates, transmits, and distributes electricity in a 26,000-square-mile service territory in northern Minnesota. ALLETE's business operations include both regulated and non-regulated activities. The regulated operations include ALLETE's regulated utilities – Minnesota Power and Superior Water, Light and Power Company (SWL&P), and its investment in American Transmission Company, LLC (ATC), a Wisconsin-based regulated utility that owns and maintains electric transmission assets. ALLETE, doing business as Minnesota Power, provides regulated utility electric service in northeastern Minnesota to approximately 145,000 retail customers and electric generation and transmission service to 15 non-affiliated municipal customers as well as to SWL&P. Through Minnesota Power, ALLETE owns approximately 8,752 miles of electric transmission and distribution lines and 169 substations with a total capacity of 9,525 megavolt amperes. In 2019, ALLETE reported approximately $1.004 billion in total revenue from its electric operations. Of the $1.004 billion, $104.8 million was associated with its wholesale transmission operations.

C. Summary of Compliance Findings

Audit staff's compliance findings are summarized below. Details of these findings are in section IV. Audit staff found the following seven areas of noncompliance:

1. *Transmission Incentives* – ALLETE's method for computing Pre-funded Allowance for Funds Used During Construction (AFUDC) for its transmission incentive projects was contrary to the Commission's orders. As a result, ALLETE overstated the transmission plant balances used to compute its annual transmission revenue requirements, which led to overbillings to wholesale transmission customers.

2. *Accounting for Environmental Costs* – ALLETE improperly recorded environmental mitigation project costs of $4.2 million in Account 930.2, Miscellaneous General Expenses. As a result, ALLETE overstated its annual transmission revenue requirement and overbilled wholesale transmission customers.

3. *Transmission and Distribution Plant Accounting* – ALLETE improperly recorded distribution assets in transmission plant accounts and transmission assets in distribution plant accounts. As a result of the transmission and distribution asset misclassification, ALLETE overstated its annual transmission revenue requirement which led to overbillings to wholesale transmission customers.

4. *Accounting for Long-Term Debt and Interest Expense* – ALLETE improperly recorded proceeds from long-term debt instruments in Account 186, Miscellaneous Deferred Debits. In addition, ALLETE improperly recorded interest expense associated with the debt instruments in Account 920, Administrative and General Salaries. As a result, ALLETE overstated its annual transmission revenue requirement and overbilled wholesale transmission customers.

5. *Accounting Misclassifications* – ALLETE improperly recorded various administrative and general (A&G) expenses in a manner contrary to the Commission's accounting regulations. As a result of the improper accounting for certain A&G expenses, ALLETE overstated its annual transmission revenue requirement and overbilled wholesale transmission customers.

6. *Application of Nonapproved Depreciation Rates* – ALLETE applied state-approved depreciation rates to assets included in its wholesale transmission formula rate determination but had not previously filed these depreciation

rates with the Commission and obtained Commission approval. In addition, ALLETE improperly recorded depreciation expenses associated with plant held for future use in Account 403, Depreciation Expense, instead of Account 421, Miscellaneous Nonoperating Income. As a result of ALLETE's improper accounting for depreciation expenses associated with plant held for future use, ALLETE overstated its annual transmission revenue requirement which led to overbillings to wholesale transmission customers.

7. *FERC Form No. 1 Reporting* – ALLETE did not properly follow the FERC Form No. 1 instructions and, therefore, did not report all required information in its FERC Form No. 1 filings.

D. Recommendations

Audit staff's recommendations to remedy the audit findings are listed below. Section IV also contains these detailed recommendations for each finding. ALLETE will need to implement corrective actions to address these recommendations:

Transmission Incentives

1. Update and implement policies and procedures to ensure the accurate calculation of Pre-funded AFUDC recorded in Account 254 and included in the wholesale transmission formula rate.

2. Provide training to staff on the updated Pre-funded AFUDC accounting and wholesale transmission formula rate procedures. Also, develop a training program that supports the provision of periodic training in this area, as needed.

3. Submit proposed accounting entries and supporting documentation to DAA that reflect the correction of the Pre-funded AFUDC amounts in Account 254, and other accounts impacted by the under-accrual of Pre-funded AFUDC within 60 days of issuance of the audit report.

4. Submit a refund analysis, within 60 days of issuance of this audit report, to DAA for review that explains and details the following: (1) calculation of refunds to ALLETE's wholesale transmission customers since January 1, 2016, plus interest, relating to the adjustments made in response to the preceding recommendation; (2) determinative components of the refund; (3) refund method; (4) customers to receive refunds; and (5) period(s) for which refunds will be made.

5. File a refund report with the Commission after receiving DAA's assessment of the refund analysis.

6. Refund the amounts disclosed in the refund report to wholesale transmission customers, with interest calculated in accordance with section 35.19a of Commission regulations.

Accounting for Environmental Costs

7. Revise policies and procedures to ensure that ALLETE properly accounts for donations in accordance with Commission accounting regulations.

8. Provide training to its staff on the revised procedures for recording donations. Also, develop a training program that supports the provision of periodic training in this area, as needed.

9. Submit a refund analysis, within 60 days of issuance of this audit report, to DAA for review that explains and details the following: (1) calculation of refunds to ALLETE's wholesale transmission customers since January 1, 2016, plus interest, relating to the improper accounting for donation costs in Account 930.2; (2) determinative components of the refund; (3) refund method; (4) customers to receive refunds; and (5) period(s) for which refunds will be made.

10. File a refund report with the Commission after receiving DAA's assessment of the refund analysis.

11. Refund the amounts disclosed in the refund report to wholesale transmission customers, with interest calculated in accordance with section 35.19a of the Commission's regulations.

Transmission and Distribution Plant Accounting

12. Revise and implement policies and procedures to ensure assets are recorded in the proper accounts under the Commission's accounting regulations.

13. Provide training to staff on the revised asset accounting procedures. Also, develop a training program that supports the provision of periodic training in this area, as needed.

14. Submit a refund analysis, within 60 days of issuance of this audit report, to DAA for review that explains and details the following: (1) calculation of refunds to ALLETE's wholesale transmission customers since January 1, 2016, plus interest, relating to the adjustments made in response to the preceding two recommendations; (2) determinative components of the refund; (3) refund method; (4) customers to receive refunds; and (5) period(s) for which refunds will be made.

15. File a refund report with the Commission after receiving DAA's assessment of the refund analysis.

16. Refund the amounts disclosed in the refund report to wholesale customers, with interest calculated in accordance with section 35.19a of the Commission's regulations.

Accounting for Long-Term Debt and Interest Expense

17. Revise and implement policies and procedures to ensure that long-term debt and interest expense are recorded in the proper accounts under the Commission's accounting regulations.

18. Provide training to staff on the revised accounting procedures. Also, develop a training program that supports the provision of periodic training in this area, as needed.

19. Submit proposed accounting entries and supporting documentation to DAA that reflect the correction of the long-term debt amounts in Account 186 within 60 days of issuance of the audit report.

20. Submit a refund analysis, within 60 days of issuance of this audit report, to DAA for review that explains and details the following: (1) calculation of refunds to ALLETE's wholesale transmission customers since January 1, 2016, plus interest, relating to the adjustments made in response to the preceding recommendation; (2) determinative components of the refund; (3) refund method; (4) customers to receive refunds; and (5) period(s) for which refunds will be made.

21. File a refund report with the Commission after receiving DAA's assessment of the refund analysis.

22. Refund the amounts disclosed in the refund report to wholesale customers, with interest calculated in accordance with section 35.19a of the Commission's regulations.

Accounting Misclassifications

23. Revise policies and procedures to ensure that ALLETE properly accounts for expenditures in its books and records.

24. Provide training to its staff on the revised procedures for properly accounting for expenditures in ALLETE's books and records. Also, develop a training program that supports the provision of periodic training in this area, as needed.

25. Perform an analysis of A&G accounts to identify additional expenses that were inappropriately recovered through ALLETE's transmission formula rates, such as lobbying costs, during the audit period. Provide the results of the analysis to audit staff within 60 days of the date of issuance of this audit report.

26. Submit a refund analysis, within 60 days of issuance of this audit report, to DAA for review that explains and details the following: (1) calculation of refunds to ALLETE's wholesale transmission customers since January 1, 2016, plus interest, relating to the adjustments made in response to the preceding recommendation; (2) determinative components of the refund; (3) refund method; (4) customers to receive refunds; and (5) period(s) for which refunds will be made.

27. File a refund report with the Commission after receiving DAA's assessment of the refund analysis.

28. Refund the amounts disclosed in the refund report to wholesale transmission customers with interest calculated in accordance with section 35.19a of the Commission's regulations.

Application of Nonapproved Depreciation Rates

29. Develop and implement processes and procedures to ensure that depreciation rates and related studies are filed with the Commission for consideration and decision before being used for ratemaking purposes.

30. File current depreciation studies in dockets relating to ALLETE's Wholesale Transmission Formula Rates within 60 days.

31. Provide training to its staff on the revised procedures. Also, develop a training program that supports the provision of periodic training in this area, as needed.

32. Submit a refund analysis, within 60 days of issuance of this audit report, to DAA for review that explains and details the following: (1) calculation of refunds to ALLETE's wholesale transmission customers since January 1, 2016, plus interest, relating to the improper accounting for depreciation associated with electric plant held for future use in Account 403; (2) determinative components of the refund; (3) refund method; (4) customers to receive refunds; and (5) period(s) for which refunds will be made.

33. File a refund report with the Commission after receiving DAA's assessment of the refund analysis.

34. Refund the amounts disclosed in the refund report to wholesale transmission customers, with interest calculated in accordance with section 35.19a of the Commission's regulations.

FERC Form No. 1 Reporting

35. Revise and strengthen documented policies, procedures, and practices to ensure that information reported in the FERC Form No. 1 is correct, accurate, complete, and consistent with the instructions of the form.

36. Provide training to staff on the revised FERC Form No. 1 policies, procedures, and practices. Also, develop a training program that supports the provision of periodic training in this area, as needed.

E. Compliance and Implementation of Recommendations

Audit staff further recommends that ALLETE submit the following:

- A plan for implementing the audit recommendations within 30 days after the audit report is issued;

- Quarterly reports describing progress in completing each corrective action recommended in the audit report. Quarterly nonpublic submissions should be made no later than 30 days after the end of each calendar quarter, beginning with the first quarter after the audit report is issued, and continuing until all recommended corrective actions are completed; and

- Copies of written policies and procedures developed in response to recommendations. These documents should be submitted in the first quarterly filing after the development of written policies and procedures.

II. Background

A. ALLETE's Corporate Structure

As noted above in section I, ALLETE's business operations include both regulated and non-regulated activities. The regulated operations include those of ALLETE's regulated utilities, Minnesota Power and SWL&P, and its investment in ATC. SWL&P provides regulated utility service to approximately 15,000 electric customers, 13,000 natural gas customers, and 10,000 water customers in the city of Superior, Wisconsin and surrounding areas in northwestern Wisconsin. SWL&P is regulated by the Public Service Commission of Wisconsin. ALLETE, acting through its Minnesota Power division, provides services regulated by the Minnesota Public Utilities Commission and also is a regulated utility under the Commission's jurisdiction. ATC is a regulated utility under the Commission's jurisdiction which owns and maintains solely wholesale electric transmission assets.

Minnesota Power Operations

ALLETE, doing business as Minnesota Power, is a regulated electric utility under the jurisdiction of the Minnesota Public Utilities Commission with respect to the retail electric services it provides in Minnesota. The Commission regulates ALLETE with respect to its sale and transmission of electricity in interstate commerce. ALLETE, through its operating division, generates, transmits, and distributes electricity to 145,000 retail and 15 non-affiliated municipal customers as well as to SWL&P. ALLETE owns approximately 8,752 miles of electric transmission and distribution lines and 169 substations with a total capacity of 9,525 megavolt amperes.

American Transmission Company, LLC

ALLETE owns approximately 8% of ATC, a Wisconsin-based utility that owns and maintains electric transmission assets in portions of Wisconsin, Michigan, Minnesota, and Illinois. As of December 31, 2019, ALLETE's equity investment in ATC was approximately $141.6 million.

B. Accounting and Financial Reporting

ALLETE uses an accounting system that interfaces with other financial and operational systems within the Company. These other systems house data relating to project and work order creation, fixed asset management, depreciation, taxes, overheads, and customer billings. A chart of accounts, using numbering similar to the FERC Uniform System of Accounts, was set up in ALLETE's main accounting system to code

and record transactions; however, some manual reclassification of costs is necessary during ALLETE's preparation of its annual FERC Form No. 1 filings.

Costs incurred by ALLETE are recorded according to their Uniform System of Accounts chart of accounts using specific codes to identify the nature and type of cost. The chart of accounts uses separate fields to easily track costs, including company segment, department, FERC account, cost type, and location. The cost type field has unique codes to make expenditures easily identifiable for users of the system and to help to ensure transactions are recorded in the appropriate accounts.

C. Transmission Incentives

On December 29, 2010, in Docket No. ER11-134-000, the Commission granted ALLETE's transmission incentive rate treatment requests for two jointly sponsored transmission projects associated with its participation in the CapX2020 Transmission Capacity Expansion Initiative (CapX2020 Projects), subject to various accounting conditions.[1] As part of the approval, the Commission granted ALLETE's request for inclusion of 100% of prudently incurred Construction Work in Progress (CWIP) in rate base and 100% recovery of prudently incurred costs of transmission facilities that are cancelled or abandoned for reasons beyond the control of ALLETE. The first project, the Fargo Project, was the construction of a 250-mile, 345 kilovolt (kV) transmission line between Fargo, North Dakota, and Monticello, Minnesota. The second project, the Bemidji Project, was the construction of a 68-mile, 230 kV transmission line between Grand Rapids and Bemidji in northern Minnesota. Construction of these CapX2020 Projects was completed in 2015.

On December 17, 2015, in Docket No. ER16-118-000, the Commission granted, subject to conditions, ALLETE's transmission incentive rate treatment request relating to construction of the Great Northern Transmission Line (Great Northern Project).[2] As part of the approval, the Commission granted ALLETE's request for 100% CWIP recovery and abandoned plant recovery for the project. The Great Northern Transmission Line is a 500 kV transmission line that extends approximately 220 miles from a point on the Minnesota/Manitoba (Canada) border northwest of Roseau, Minnesota to ALLETE's existing Blackberry Substation near Grand Rapids, Minnesota.

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[1] *Midwest Independent Transmission System Operator*, *Inc*., 133 FERC ¶ 61,270 (2010).

[2] *Midcontinent Independent System Operator, Inc.,* 153 FERC ¶ 61,296 (2015).

Construction of the Great Northern Project began in January 2017 and was completed in June 2020. The Great Northern Project is a contractual arrangement between 6690271 Manitoba Ltd., a Manitoba Hydro[3] subsdiary, and ALLETE. ALLETE owns 100% of the Great Northern Project and per the agreements between ALLETE and 6690271 Manitoba Ltd, ALLETE is responsible for 46% of the project costs, while 6690271 Manitoba Ltd. is responsible for the remaining 54%. ALLETE tracks all costs related to the Great Northern Project in specific projects and work orders. As of December 31, 2019, ALLETE had recorded approximately $300 million on its books associated with ALLETE's portion of costs incurred for the Great Northern Project.

As part of its request for Commission approval of its participation in the CapX2020 Projects and the Great Northern Project, ALLETE proposed to calculate AFUDC and book an offsetting regulatory liability equaling 100% of each project's AFUDC (i.e., Pre-funded AFUDC) and include that regulatory liability as a reduction to rate base in ALLETE's Attachment O transmission formula rate. The Commission accepted ALLETE's proposal since it met the Commission's requirement that an applicant must propose accounting procedures to ensure that customers are not charged for both capitalized AFUDC and amounts associated with CWIP in rate base.[4]

D. Affiliate Transactions

As previously noted, ALLETE is an energy services company with several wholly owned utility and non-utility subsidiaries and divisions. To some of these, ALLETE provides support services. The support services include, but are not limited to, management, accounting and financial reporting, tax, and legal services. In 2019, ALLETE reported approximately $15 million in support services provided to SWL&P, ALLETE Enterprises, Inc., and ALLETE Properties, Inc. In the same year, ALLETE reported approximately $1.4 million for services received from affiliates which were related to wind facility maintenance and operation.

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[3] Manitoba Hydro is the electric power and natural gas utility in the province of Manitoba, Canada. Founded in 1961, it is a provincial Crown Corporation governed by the Manitoba Hydro-Electric Board and the Manitoba Hydro Act. The company operates 15 interconnected generating stations and has approximately 527,000 electric power customers and more than 263,000 natural gas customers.

[4] *See* 18 C.F.R. § 35.25 (2019) (recovery of CWIP in rate base).

E. Wholesale Transmission Formula Rate

Doing business as Minnesota Power, ALLETE owns and operates numerous electric transmission lines, distribution lines, and substations, with functional control of its alternating-current transmission facilities transferred to MISO pursuant to MISO's FERC Electric Tariff.[5] ALLETE recovers the costs of owning, operating, and maintaining its transmission system using its forward-looking transmission formula rate approved by the Commission,[6] which is included in Attachment O of MISO's FERC Electric Tariff.

The transmission formula rate was designed to provide a reasonable opportunity to recover (1) the costs and expenses associated with providing transmission service, and (2) a reasonable return on transmission investments. The development of ALLETE's transmission revenue requirement through the transmission formula rate for wholesale billings relies on the accuracy of the financial statements presented in ALLETE's FERC Form No. 1 filings, which in turn rely on the accurate accounting of costs and transmission investments in its books of record.

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[5] *See Minn. Power*, *Inc*., 96 FERC ¶ 61,153 (2001) (authorizing the transfer of operational control of Commission-jurisdictional transmission facilities now owned by ALLETE to MISO's predecessor, the Midwest Independent Transmission System Operator, Inc.).

[6] ALLETE's wholesale transmission formula rate was approved by the Commission in Docket No. ER10-190-000 on December 4, 2009. *See ALLETE, Inc.,* Docket No. ER10-190-000 (Dec. 4, 2009) (delegated order).

III. Introduction

A. Objectives

The audit evaluated ALLETE's compliance with: (1) approved terms, rates, and conditions of its transmission formula rate mechanism as provided in Attachment O of MISO's FERC Electric Tariff; (2) conditions included in the Commission orders granting ALLETE transmission incentives; (3) accounting requirements of the Uniform System of Accounts Prescribed for Public Utilities and Licensees under 18 C.F.R. Part 101; (4) reporting requirements of the FERC Form No. 1, Annual Report of Major Electric Utilities, Licensees and Others, under 18 C.F.R. § 141.1; and (5) the requirements in Preservation of Records of Public Utilities and Licensees under 18 C.F.R. Part 125. The audit covered the period from January 1, 2016 through September 3, 2020.

B. Scope and Methodology

Audit staff performed the following to facilitate the testing and evaluation of ALLETE's compliance with Commission requirements relevant to the audit objectives:

<u>Audit Planning, Processes, and Administration</u>

- *Reviewed Public Information* – Conducted an extensive review of public information before commencing the audit. This review entailed detailed examination of ALLETE's corporate structure, the services it provides, major events affecting operations and finances, significant contracts, prior audit issues, and other key regulatory and business activities. Examples of materials reviewed included ALLETE's annual reports and SEC Form 10-Ks, FERC Form No. 1 filings, prior FERC audit reports, corporate web sites, and other relevant regulatory and media sources.

- *Identified Standards and Audit Criteria* – Identified the regulatory requirements and criteria for evaluating ALLETE's compliance with each audit objective. These include Attachment O of MISO's FERC Electric Tariff, Commission accounting and reporting requirements, and other Commission orders relevant to the audit.

- *Issued Data Requests* – Issued data requests to collect information not commonly available to the public. This information included internal policies, procedures and controls, business practices, risk management, corporate structure, contractual agreements, financial accounting and reporting activity, corporate compliance, regulatory filings, and other pertinent information. These data were used to test

and evaluate ALLETE's compliance with Commission requirements relevant to the audit's objectives.

- *Conducted Teleconferences Interviews* – Conducted multiple teleconferences with ALLETE employees to discuss audit objectives, processes, procedures and operations, testing, data request responses, technical and administrative matters, and compliance concerns.

- *External Auditor Working Papers Review* – Reviewed ALLETE's external auditor's working papers prepared as part of ALLETE's annual audits for 2016 through 2019.

- *Conferred with Subject-Matter Experts* – Conferred with Commission staff in other offices to ensure audit report findings were consistent with Commission precedent and policy.

- *Conducted Site Visit* – Conducted a site visit to ALLETE's corporate headquarters to discuss, observe, and evaluate ALLETE's procedures, practices, and controls for ensuring compliance with Commission regulations. The site visit enabled audit staff to:

    - Discuss ALLETE's corporate structure, departmental functions, and employee responsibilities with key company officials;

    - Learn about ALLETE's transmission system and operations, in particular the assets, departments, activities, functions, systems, and processes used;

    - Interview executives, managers, and staff responsible for accounting, financial reporting, transmission operations, and corporate compliance;

    - Review Board of Directors and Audit Committee meeting minutes and internal and external audit reports;

    - Discuss and observe internal accounting and reporting procedures, processes, and controls relevant to audit scope; and

    - Discuss ALLETE's preservation of records policies, procedures, and practices.

Audit staff evaluated ALLETE's compliance with all relevant requirements of the audit objectives through the following

Compliance with Wholesale Transmission Formula Rate

Audit staff performed these actions to evaluate ALLETE's compliance with the requirements of its wholesale transmission formula rate:

- *Formula Rate Schedules* – Reviewed Commission approved wholesale transmission formula rate and schedules in effect for ALLETE as reported on page 106 of ALLETE's FERC Form No. 1.

- *Commission Orders* – Reviewed the Commission orders accepting ALLETE's wholesale transmission formula rate, including those approving related settlements. Reviewed Commission orders for background information about specific cost treatments and unique inputs, and other matters disclosed as part of approving the derivation of ALLETE's wholesale transmission formula rate.

- *Formula Rate Input Reconciliation* – Reconciled the wholesale transmission formula rate inputs to figures reported in ALLETE's FERC Form No. 1 filings for 2017 and 2018. Evaluated the adequacy of disclosures provided by ALLETE for formula rate inputs not derived from its FERC Form No. 1 filings.

- *Interviewed Employees* – Interviewed ALLETE employees responsible for providing data inputs into the transmission formula rate and calculating the annual transmission revenue requirement. Assessed the level of oversight and controls employed by ALLETE to ensure complete and accurate wholesale transmission formula rate inputs.

- *Mathematical Accuracy* – Evaluated the mathematical accuracy of computations performed by ALLETE in applying its wholesale transmission formula rate to test whether inputs and computations were accurate. For example, audit staff reviewed supporting documentation for the depreciation rate used to test whether amounts were correctly populated into the wholesale transmission formula rate template.

- *Formula and Input Analysis* – Reconciled the components of the approved formula rate to the corresponding calculations in the annual transmission revenue requirement filings. Analyzed and assessed ALLETE's compliance with the Commission's required accounting treatment of select formula rate inputs. Reviewed ALLETE's calculation and application of the allocation factors used in the wholesale transmission formula rate to test whether the correct amounts were used in these calculations.

Compliance with Commission Transmission Incentive Rate Orders

Audit staff performed these actions to evaluate ALLETE's compliance with the Commission's transmission incentive rate orders:

- *Commission Orders* – Reviewed the Commission orders accepting ALLETE's inclusion of CWIP in rate base for the Fargo, Bemidji, and Great Northern Transmission Line projects. Audit staff reviewed the orders for background information and conditions included in the orders.

- *Accounting Processes and Procedures* – Evaluated ALLETE's accounting procedures for compliance with the Commission orders allowing ALLETE to include CWIP in rate base. Held discussions with and interviewed ALLETE employees responsible for calculating AFUDC and Pre-funded AFUDC, and discussed ALLETE's internal controls intended to achieve compliance with the Commission's incentive rate orders.

Compliance with Commission Accounting Regulations

Audit staff performed these actions to evaluate ALLETE's compliance with the Commission's accounting regulations under 18 C.F.R. Part 101:

- *Accounting Processes and Procedures* – Evaluated ALLETE's financial accounting processes, procedures, and internal controls for consistency with Commission financial accounting regulations under 18 C.F.R. Part 101. Audit staff interviewed ALLETE employees about accounting practices, reviewed system processes for account assignments, and observed controls for achieving compliance with the Commission's accounting regulations.

- *Accounting Applications and Classifications* – Evaluated ALLETE's chart of accounts used during the audit period to determine whether it was consistent with the Commission's accounting regulations. Reviewed descriptions of accounting practices and tested specific accounts in sample months to determine whether accounting classifications complied with the Commission's accounting regulations.

- *Accounting Systems* – Reviewed ALLETE's financial accounting systems used to manage company financial records, such as systems for recording and tracking ALLETE's costs, including the general ledger, work order, expense, billing, and accounts payable systems. Reviewed practices and procedures around the accounting cycle for charges and the mapping of these charges to FERC accounts.

- *Significant Accounting Matters* – Tested select accounts impacting or comprising inputs to the wholesale transmission formula rate to evaluate whether the nature of costs recorded in those accounts complied with the Commission's accounting regulations and ALLETE's wholesale transmission formula rate requirements. Audit staff performed select testing which included but was not limited to the following accounting matters:

    - *Transmission versus Distribution* – Reviewed certain transmission operating and maintenance accounts to test whether costs related to transmission or, alternatively, distribution were appropriately recorded in the correct functional expense accounts;

    - *Administrative and General Expenses* – Tested select administrative and general expense accounts to determine whether ALLETE recorded salaries, office supplies, outside services (e.g., consultant fees), pensions and employee benefits, etc., consistent with the accounts' instructions;

    - *Cost Allocations* – Examined the support for, and tested the application of, corporate and associated company allocation methodologies for allocating and recording shared service costs among affiliates, and billing and accounting for non-power goods and services provided among associated companies. For example, audit staff reviewed allocation ratios and tested selected costs to test whether ALLETE was allocated and had accounted for shared services correctly. Also reviewed affiliate billing procedures and select invoices to test whether ALLETE recorded the proper amounts in accordance with those procedures;

    - *Accumulated Deferred Income Taxes* – Reviewed a monthly summary of deferred taxes that flowed into the rate base component of the wholesale transmission formula rate. Analyzed supporting documentation to evaluate how ALLETE calculated the deferred tax component and underlying accounting entries made to FERC deferred tax accounts (i.e., Accounts 190, 282, and 283);

    - *Income Taxes and Tax Allocation Agreements* – Evaluated ALLETE's consolidated income tax allocation agreement and the tax payment structure between ALLETE and the consolidated group, including the methodology used to allocate the tax benefits/burden to members of the consolidated group. Reviewed supporting documentation to validate the calculation of tax accruals and deferred income taxes;

    - *Depreciation* – Reviewed ALLETE's monthly depreciation expense and supporting calculations to determine whether ALLETE used the proper

accounts and recorded the correct amounts. Reviewed ALLETE's depreciation expense calculation to test whether it derived monthly depreciation expenses using approved depreciation rates on file with the Commission;

- *Contingent Liabilities* – Reviewed the Notes to the Financial Statements in ALLETE's FERC Form No. 1 filings and identified information about accruals for potential future obligations. Analyzed information on commitments and environmental and legal contingencies, and assessed whether these amounts affected the wholesale transmission formula rate's resulting annual transmission revenue requirement and billing rates; and

- *AFUDC* – Reviewed ALLETE's AFUDC rate calculation for consistency with Electric Plant Instruction No. 3, Order No. 561,[7] and other Commission AFUDC guidance. Reviewed ALLETE's methodology for determining the annual AFUDC rate to ensure it was based on ALLETE's own debt and equity book balances and to ensure the short-term debt rate variance did not exceed 25 basis points. Reviewed work orders to test whether ALLETE ceased accruing AFUDC during the following instances: (1) when an asset was placed in-service, (2) during periods of suspension of construction, and (3) when plant was abandoned. Examined the components of ALLETE's construction base to determine whether ALLETE only included amounts related to construction activities and properly allocated overheads.

Compliance with FERC Form No. 1 Reporting Requirements

Audit staff performed these actions to evaluate ALLETE's compliance with Commission reporting requirements under 18 C.F.R. Part 141:

- *Reporting Process and Procedures* – Evaluated ALLETE's financial reporting processes, procedures, and quality controls used to prepare ALLETE's FERC Form No. 1 filings.

[7] Order No. 561, *Amendments To Uniform System of Accounts for Public Utilities and Licensees and for Natural Gas Companies (Classes A, B, C and D) to Provide for the Determination of Rate for Computing the Allowance for Funds Used During Construction and Revisions of Certain Schedule Pages of FPC Reports*, 57 FPC 608, at 610, *reh'g denied and clarification granted,* Order No. 561-A, 59 FPC 1340 (1977), *clarification granted*, 2 FERC ¶ 61,050 (1978).

- *Financial Reporting Instructions* – Evaluated ALLETE's financial reporting for 2018 to determine whether it complied with the account and page instructions of the FERC Form No. 1.

- *Financial Statement Account Balances* – Tied the account balances reported in ALLETE's FERC Form No. 1 filings to ALLETE's books and records (i.e. general ledger). To facilitate the review, audit staff reviewed select transactions to confirm the balances.

- *Account Variance Analysis* – Performed variance analyses for sample accounts reported in ALLETE's FERC Form No. 1 filings with large balances, unusual activity, and/or significant fluctuations.

- *Notes to Financial Statements* – Reviewed the Notes to the Financial Statements of ALLETE's FERC Form No. 1 filings for significant accounting matters and followed up with ALLETE to understand financial statement and wholesale transmission formula rate implications.

IV. Findings and Recommendations

1. Transmission Incentives

ALLETE's method for computing Pre-funded AFUDC for its transmission incentive projects was contrary to the Commission's orders. As a result, ALLETE overstated the transmission plant balances used to compute its annual transmission revenue requirements, which led to overbillings to wholesale transmission customers.

Pertinent Guidance

- In Docket No. ER11-134-000, the Commission granted ALLETE's request for transmission rate incentives relating to the CapX2020 Projects, subject to ALLETE following certain prescribed accounting treatment. The Commission's order stated, in relevant part:

> While ALLETE explains its rate mechanism to avoid double recovery, the filing does not provide the specific FERC accounts that ALLETE will use to initially record the Pre-funded AFUDC Regulatory Liability or the accounts to be used to amortize the amount recorded in that account once the project is in service. Therefore, we direct ALLETE to record the Pre-funded AFUDC Regulatory Liability by debiting Account 407.3, Regulatory Debits, and crediting Account 254, Other Regulatory Liabilities, in accordance with the instructions of those accounts. In addition, ALLETE is directed to amortize the Pre-funded AFUDC Regulatory Liability as an offset to depreciation expense by debiting Account 254 and crediting Account 407.4, Regulatory Credits. ALLETE must also maintain all necessary controls to ensure the amount of the Pre-funded AFUDC Regulatory Liability recorded in Account 254 includes the total amount of AFUDC accrued on the ALLETE CapX2020 Projects. ALLETE's accounting for the Pre-funded AFUDC Regulatory Liability and Attachment O adjustments to appropriately include CWIP in rate base may be subject to scrutiny through Commission audit or rate review.[8]

[8] *Midwest Independent Transmission System Operator*, *Inc*., 133 FERC ¶ 61,270, at P 7.

- In Docket No. ER16-118-000, the Commission granted ALLETE's request for transmission rate incentives relating to the Great Northern Project, subject to certain prescribed accounting treatment. The Commission order stated, in relevant part:

> We note that ALLETE must also have sufficient accounting controls and procedures to ensure that unpaid accruals properly recorded in the Great Northern Project work orders are excluded from transmission rate base… ALLETE's accounting for the Pre-funded AFUDC Regulatory Liability and Attachment O adjustments to appropriately include CWIP in rate base may be subject to scrutiny through Commission audit or rate review.[9]

Background

The Commission granted ALLETE's requests for transmission incentive rate treatments in Docket No. ER11-134-000 and Docket No. ER16-118-000 on December 29, 2010 and December 17, 2015, respectively. The transmission incentive projects accepted by the Commission in Docket No. ER11-134-000 are related to two jointly sponsored transmission projects associated with ALLETE's participation in the CapX2020 Projects. These projects consisted of the Fargo Project, a 250-mile, 345 kV transmission line between Fargo, North Dakota, and Monticello, Minnesota, and the Bemidji Project, a 68-mile, 230 kV transmission line between Grand Rapids and Bemidji in northern Minnesota. The transmission incentive rate treatment approved by the Commission in Docket No. ER16-118-000 is related to the Great Northern Project. The Great Northern Project is a 500 kilovolt (kV) transmission line that extends approximately 220 miles from a point on the Minnesota/Manitoba (Canada) border northwest of Roseau, Minnesota to ALLETE's existing Blackberry substation near Grand Rapids, Minnesota.

The transmission incentive rate treatments granted by the Commission consisted of 100% of CWIP in rate base and recovery of prudently incurred costs if the projects were abandoned or cancelled due to factors beyond ALLETE's control. As part of seeking the Commission's approval of its participation in the CapX2020 and Great Northern Projects, ALLETE proposed to calculate AFUDC and record a regulatory liability equaling 100% of each project's AFUDC (i.e., Pre-funded AFUDC) and include the Pre-funded AFUDC as a reduction to rate base in ALLETE's wholesale transmission formula rate. The Commission accepted ALLETE's accounting and wholesale transmission formula rate proposal as consistent with the Commission's requirement that

[9] *Midcontinent Independent System Operator*, *Inc*., 153 FERC ¶ 61,296, at P 24.

an applicant propose accounting procedures to ensure that customers are not charged for both capitalized AFUDC and amounts associated with CWIP included in rate base.

Audit staff reviewed ALLETE's accounting controls implemented to prevent it from recovering the same costs twice – once as CWIP included in rate base and a second time as capitalized AFUDC – to determine whether ALLETE complied with the Commission's orders. Audit staff found that ALLETE calculated AFUDC on all projects, whether they were transmission incentive projects or regular construction projects. For the transmission incentive projects, ALLETE computed and recorded Pre-funded AFUDC in Account 254 as required by the Commission's transmission incentive rate orders. The Pre-funded AFUDC amounts in Account 254 were used as reductions to rate base in ALLETE's wholesale transmission formula rate for the computation of the annual transmission revenue requirement. However, audit staff found that ALLETE understated the amount of Pre-funded AFUDC it recorded in Account 254 and included in the computation of its annual transmission revenue requirement.

The amount of Pre-funded AFUDC calculated by ALLETE was less than 100% of the amount of AFUDC accrued on the transmission incentive projects. ALLETE's understatement of the Pre-funded AFUDC was contrary to the Commission's orders. In both orders, the Commission required ALLETE to maintain all necessary controls to ensure that the amount of Pre-funded AFUDC in Account 254 was equal to 100% of the amount of AFUDC accrued on the transmission incentive projects. ALLETE's understatement of the amount of Pre-funded AFUDC caused it to overstate the transmission plant balances used to compute its annual transmission revenue requirements, which led to overbillings to wholesale transmission customers since 2016.

Recommendations

DAA recommends that ALLETE:

1. Update and implement policies and procedures to ensure the accurate calculation of Pre-funded AFUDC recorded in Account 254 and included in the wholesale transmission formula rate.

2. Provide training to staff on the updated Pre-funded AFUDC accounting and wholesale transmission formula rate procedures. Also, develop a training program that supports the provision of periodic training in this area, as needed.

3. Submit proposed accounting entries and supporting documentation to DAA that reflect the correction of the Pre-funded AFUDC amounts in Account 254, and other accounts impacted by the under-accrual of Pre-funded AFUDC within 60 days of issuance of the audit report.

4. Submit a refund analysis, within 60 days of issuance of this audit report, to DAA for review that explains and details the following: (1) calculation of refunds to ALLETE's wholesale transmission customers since January 1, 2016, plus interest, relating to the adjustments made in response to the preceding recommendation; (2) determinative components of the refund; (3) refund method; (4) customers to receive refunds; and (5) period(s) for which refunds will be made.

5. File a refund report with the Commission after receiving DAA's assessment of the refund analysis.

6. Refund the amounts disclosed in the refund report to wholesale transmission customers, with interest calculated in accordance with section 35.19a of Commission regulations.

2. Accounting for Environmental Costs

ALLETE improperly recorded environmental mitigation project costs of $4.2 million in Account 930.2, Miscellaneous General Expenses. As a result, ALLETE overstated its annual transmission revenue requirement and overbilled wholesale transmission customers.

Pertinent Guidance

- 18 C.F.R. Part 101, Account 426.1, Donations, states:

> This account shall include all payments or donations for charitable, social or community welfare purposes.

Background

On July 16, 2014, ALLETE entered into a consent decree with the United States Environmental Protection Agency (EPA) and the Minnesota Pollution Control Agency (MPCA). The consent decree was the culmination of a process that began with a complaint against ALLETE for alleged violations of the federal Clean Air Act.[10] The complaint against ALLETE was based on its operation of certain modified coal-fired electricity generating units without permits authorizing the modifications and operation of these units, and without installing and employing acceptable technology to control emissions of sulfur dioxide (SO_2), nitrogen oxides (NOx), and/or particulate matter (PM), as required by the Clean Air Act and applicable implementing regulations. ALLETE's operation of the units following the modifications resulted in large amounts of SO_2, NOx, and PM pollution being released into the atmosphere.

In accordance with the terms of the consent decree, ALLETE was required to implement specific environmental mitigation projects that were transferred/donated to other parties after completion. The projects included but were not limited to the following: installation of a solar photovoltaic project on Fond du Lac Tribal Land, implementation of a project to replace distribution customers' wood-burning appliances, and a project to donate and restore ecologically significant land. ALLETE was required to incur approximately $4.2 million to implement the projects. ALLETE recorded the cost in Account 930.2. During audit staff's interviews of ALLETE's employees, the Company explained that the costs of the projects were recorded in Account 930.2 because the amounts paid did not represent a penalty and were associated with ALLETE's utility operations.

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[10] See the Clean Air Act, 69 Stat. 322, as amended (codified as amended at 42 U.S.C. §§ 7401-7671q (2018)).

In accordance with the Commission's regulations describing Account 930.2, that account is used to record the cost of labor and expenses incurred in connection with the general management of the utility not provided for elsewhere. The environmental mitigation projects were not part of the general management of ALLETE but, instead, were the result of an enforcement action against ALLETE due to its failure to maintain compliance with the Clean Air Act. Amounts incurred by ALLETE to construct the solar projects should have been recorded in the appropriate donation account since the projects were donated to other parties after completion. In addition, the costs incurred associated with donations of land and other assets to specific entities should have been recorded in Account 426.1, Donations. ALLETE's wholesale transmission formula rate includes Account 930.2 in the computation of its annual transmission revenue requirement. Audit staff found that portions of the environmental mitigation costs recorded in Account 930.2 were included in ALLETE's wholesale annual transmission revenue requirement and resulting billings to wholesale transmission customers. Consequently, environmental mitigation costs were improperly included in wholesale transmission rates.

Recommendations

DAA recommends that ALLETE:

7. Revise policies and procedures to ensure that ALLETE properly accounts for donations in accordance with Commission accounting regulations.

8. Provide training to its staff on the revised procedures for recording donations. Also, develop a training program that supports the provision of periodic training in this area, as needed.

9. Submit a refund analysis, within 60 days of issuance of this audit report, to DAA for review that explains and details the following: (1) calculation of refunds to ALLETE's wholesale transmission customers since January 1, 2014, plus interest, relating to the improper accounting for donation costs in Account 930.2; (2) determinative components of the refund; (3) refund method; (4) customers to receive refunds; and (5) period(s) for which refunds will be made.

10. File a refund report with the Commission after receiving DAA's assessment of the refund analysis.

11. Refund the amounts disclosed in the refund report to wholesale transmission customers, with interest calculated in accordance with section 35.19a of the Commission's regulations.

3. Transmission and Distribution Plant Accounting

ALLETE improperly recorded distribution assets in transmission plant accounts and transmission assets in distribution plant accounts. As a result of the transmission and distribution asset misclassification, ALLETE overstated its annual transmission revenue requirement which led to overbillings to wholesale transmission customers.

Pertinent Guidance

- 18 C.F.R. Part 101, Electric Plant Instruction 14, Transmission and Distribution Plant, states in relevant part that:

> A. *Transmission system* means:
> (1) All land, conversion structures, and equipment employed at a primary source of supply (i.e., generating station, or point of receipt in the case of purchased power) to change the voltage or frequency of electricity for the purpose of its more efficient or convenient transmission;
> (2) All land, structures, lines, switching and conversion stations, high tension apparatus, and their control and protective equipment between a generating or receiving point and the entrance to a distribution center or wholesale point; and
> (3) All lines and equipment whose primary purpose is to augment, integrate or tie together the sources of power supply.
>
> B. *Distribution system* means all land, structures, conversion equipment, lines, line transformers, and other facilities employed between the primary source of supply (i.e., generating station, or point of receipt in the case of purchased power) and of delivery to customers, which are not includible in transmission system, as defined in paragraph A, whether or not such land, structures, and facilities are operated as part of a transmission system or as part of a distribution system.

Background

Audit staff reviewed ALLETE's process and procedures for recording plant additions, retirements, and transfers to and from electric plant in service accounts to determine whether ALLETE complied with the Commission's accounting regulations regarding asset functionalization. Audit staff found that ALLETE performed a comprehensive review of its plant in service accounts during the audit period as part of a rate case proceeding with the Minnesota Public Utilities Commission. Based on ALLETE's review of the plant in service accounts, the Company identified various

distribution assets that were misclassified as transmission assets, and various transmission assets that were misclassified as distribution assets.

Based on the review of electric plant in service accounts, audit staff determined that ALLETE transferred approximately $497,264 of distribution assets from transmission accounts between 2016 and 2019. Also, ALLETE transferred approximately $278,330 of transmission assets from distribution accounts between 2016 and 2019. Although ALLETE identified and adjusted its improper accounting for these assets, it did not make adjustments to correct the rate impact of the errors. The amounts were improperly included in the computation of ALLETE's annual transmission revenue requirement and billings to wholesale customers. As a result of ALLETE's improper accounting for transmission and distribution assets, the Company overstated its annual transmission revenue requirement from 2016 through 2019 and overbilled wholesale transmission customers.

Recommendations

DAA recommends that ALLETE:

12. Revise and implement policies and procedures to ensure assets are recorded in the proper accounts under the Commission's accounting regulations.

13. Provide training to staff on the revised asset accounting procedures. Also, develop a training program that supports the provision of periodic training in this area, as needed.

14. Submit a refund analysis, within 60 days of issuance of this audit report, to DAA for review that explains and details the following: (1) calculation of refunds to ALLETE's wholesale transmission customers since January 1, 2016, plus interest, relating to the adjustments made in response to the preceding two recommendations; (2) determinative components of the refund; (3) refund method; (4) customers to receive refunds; and (5) period(s) for which refunds will be made.

15. File a refund report with the Commission after receiving DAA's assessment of the refund analysis.

16. Refund the amounts disclosed in the refund report to wholesale customers, with interest calculated in accordance with section 35.19a of the Commission's regulations.

4. Accounting for Long-Term Debt and Interest Expense

ALLETE improperly recorded proceeds from long-term debt instruments in Account 186, Miscellaneous Deferred Debits. In addition, ALLETE improperly recorded interest expense associated with the debt instruments in Account 920, Administrative and General Salaries. As a result, ALLETE overstated its annual transmission revenue requirement and overbilled wholesale transmission customers.

Pertinent Guidance

- 18 C.F.R. Part 101, Account 224, Other Long-Term Debt, states:

  > A. This account shall include, until maturity all long-term debt not otherwise provided for. This covers such items as receivers' certificates, real estate mortgages executed or assumed, assessments for public improvements, notes and unsecured certificates of indebtedness not owned by associated companies, receipts outstanding for long-term debt, and other obligations maturing more than one year from date of issue or assumption.
  >
  > B. Separate accounts shall be maintained for each class of obligation, and records shall be maintained to show for each class all details as to date of obligation, date of maturity, interest dates and rates, security for the obligation, etc.

- 18 C.F.R. Part 101, Account 427, Interest on Long-Term Debt, states:

  > A. This account shall include the amount of interest on outstanding long-term debt issued or assumed by the utility, the liability for which is included in account 221, Bonds, or account 224, Other Long-Term Debt.
  >
  > B. This account shall be so kept or supported as to show the interest accruals on each class and series of long-term debt.

Background

In 1986 and 1988, ALLETE established an Executive Investment Plan, which allowed company executives to defer pretax compensation into a non-qualified deferred compensation plan. In order to fund the Executive Investment Plan, ALLETE purchased life insurance policies on the life of company executives with ALLETE as the beneficiary of the proceeds from the insurance policies. Based on its ownership of the life insurance policies, ALLETE entered into multiple loan arrangements with three insurance

companies. ALLETE used its ownership of the life insurance policies as collateral for the loan amounts. Audit staff found that at the end of 2018, ALLETE had approximately $10 million in loans outstanding associated with the life insurance policies. The loans were considered non-recourse loans since they were secured by the life insurance policies. ALLETE was required to repay a loan to the insurance company when it surrendered the associated life insurance policy used as collateral or upon the death of the covered participant. As part of the loan arrangements, ALLETE was required to make interest payments on the outstanding loan amounts.

Audit staff reviewed ALLETE's processes and procedures for recording the loan amounts, interest costs on the outstanding loan amounts, and life insurance premium payments, in order to determine whether ALLETE complied with the Commission's accounting regulations. Audit staff found that ALLETE's accounting for the life insurance premium payments was consistent with Commission accounting regulations. However, ALLETE improperly recorded the proceeds from the loans and the interest expense in Accounts 186, Miscellaneous Deferred Debits, and 920, Administrative and General Salaries, respectively. The loans are expected to mature more than one year from the date of issuance, as such, the loan proceeds are long-term debt instruments. In accordance with Commission accounting regulations, the loan proceeds should be recorded in Account 224, Other Long-Term Debt, and the interest payments should be recorded in Account 427, Interest on Long-Term Debt.

ALLETE's wholesale transmission formula rate includes Account 920 in the computation of its annual transmission revenue requirement. Audit staff found that portions of the interest costs improperly recorded in Accounts 920 were included in ALLETE's annual transmission revenue requirement and in billings to ALLETE's wholesale transmission customers.

Recommendations

DAA recommends that ALLETE:

17. Revise and implement policies and procedures to ensure that long-term debt and interest expense are recorded in the proper accounts under the Commission's accounting regulations.

18. Provide training to staff on the revised accounting procedures. Also, develop a training program that supports the provision of periodic training in this area, as needed.

19. Submit proposed accounting entries and supporting documentation to DAA that reflect the correction of the long-term debt amounts in Account 186 within 60 days of issuance of the audit report.

20. Submit a refund analysis, within 60 days of issuance of this audit report, to DAA for review that explains and details the following: (1) calculation of refunds to ALLETE's wholesale transmission customers since January 1, 2016, plus interest, relating to the adjustments made in response to the preceding recommendation; (2) determinative components of the refund; (3) refund method; (4) customers to receive refunds; and (5) period(s) for which refunds will be made.

21. File a refund report with the Commission after receiving DAA's assessment of the refund analysis.

22. Refund the amounts disclosed in the refund report to wholesale customers, with interest calculated in accordance with section 35.19a of the Commission's regulations.

5. Accounting Misclassifications

ALLETE improperly recorded various A&G expenses in a manner contrary to the Commission's accounting regulations. As a result of the improper accounting for certain A&G expenses, ALLETE overstated its annual transmission revenue requirement and overbilled wholesale transmission customers.

Pertinent Guidance

- 18 C.F.R. Part 101, Account 426.4, Expenditures for Certain Civic, Political and Related Activities, states:

  > This account shall include expenditures for the purpose of influencing public opinion with respect to the election or appointment of public officials, referenda, legislation, or ordinances (either with respect to the possible adoption of new referenda, legislation or ordinances or repeal or modification of existing referenda, legislation or ordinances) or approval, modification, or revocation of franchises; or for the purpose of influencing the decisions of public officials, but shall not include such expenditures which are directly related to appearances before regulatory or other governmental bodies in connection with the reporting utility's existing or proposed operations.

- 18 C.F.R. Part 101, Account 925, Injuries and Damages, states in part:

  > A. This account shall include the cost of insurance or reserve accruals to protect the utility against injuries and damages claims of employees or others, losses of such character not covered by insurance, and expenses incurred in settlement of injuries and damages claims. For Major utilities, it shall also include the cost of labor and related supplies and expenses incurred in injuries and damages activities.

- 18 C.F.R. Part 101, Account 921, Office Supplies and Expenses, states in part:

  > A. This account shall include office supplies and expenses incurred in connection with the general administration of the utility's operations which are assignable to specific administrative or general departments and are not specifically provided for in other accounts. This includes the expenses of the various administrative and general departments, the salaries and wages of which are includible in account 920.

Background

Audit staff tested a sample of charges recorded in A&G expense accounts to determine whether the charges were accounted for in accordance with Commission accounting requirements. As part of this review, audit staff examined ALLETE's invoicing and accounts payable processes, assessed supporting documentation, and interviewed employees who performed relevant accounting functions. Audit staff's analysis of the charges found that ALLETE misclassified costs associated with lobbying, injuries and damages claims, injuries and damages insurance premiums, and office supplies expenses.

Lobbying Expenses and Activities

In 2016 and 2017, ALLETE incurred lobbying costs of approximately $26,000 associated with professional lobbying activities and recorded these amounts in Account 921, Office Supplies and Expenses. In accordance with Commission accounting requirements, costs related to lobbying activities should be recorded in Account 426.4, Expenditures for Certain Civic, Political, and Related Activities, which is not an account included in ALLETE's wholesale transmission formula rate. ALLETE's wholesale transmission formula rate does include Account 921 in the computation of ALLETE's annual transmission revenue requirement. Audit staff found that portions of the lobbying costs in Account 921 were improperly included in the annual transmission revenue requirement and in ALLETE's billing rates to wholesale transmission customers.

Fuel Adjustment Cost

Audit staff reviewed a sample of transactions recorded in Account 930.2 in order to determine whether ALLETE complied with the Commission's accounting regulations. Audit staff discovered that ALLETE recorded $19 million of fuel adjustment clause amounts associated with its production activities in Account 930.2. In accordance with Commission accounting requirements, costs related to production activities should be recorded in a production related O&M account. Account 930.2 is used to record cost of labor and expenses incurred in connection with the general management of the utility not provided for elsewhere. ALLETE's practice of recording fuel adjustment clause amounts associated with its production activities is improper and contrary to the Commission's accounting regulations. Although ALLETE improperly recorded the fuel adjustment clause amounts in Account 930.2, it did not include those amounts in the computation of its annual transmission revenue requirement and billings to wholesale transmission customers.

Other A&G Costs

Audit staff reviewed a sample of transactions recorded in Accounts 921 through 925 to determine whether ALLETE complied with the Commission's accounting regulations. Audit staff discovered that ALLETE recorded injuries and damages claims expenses in Account 921, Office Supplies and Expenses, injuries and damages insurance premiums in Accounts 924, Property Insurance, and office supplies expenses in Account 923, Outside Services Employed. In accordance with the Commission's accounting requirements, the injuries and damages claims and insurance premiums should have been recorded in Account 925, Injuries and Damages, and the office supplies expenses should have been recorded in Account 921.

Summary

ALLETE's errors accounting for professional lobbying expenses inappropriately included the costs in the determination of its annual transmission revenue requirement and wholesale transmission customer billings. In addition, ALLETE's A&G expense misclassification errors resulted in A&G expense account balances reported in its FERC Form No. 1 reports being misrepresented.

Recommendations

DAA recommends that ALLETE:

23. Revise policies and procedures to ensure that ALLETE properly accounts for expenditures in its books and records.

24. Provide training to its staff on the revised procedures for properly accounting for expenditures in ALLETE's books and records. Also, develop a training program that supports the provision of periodic training in this area, as needed.

25. Perform an analysis of A&G accounts to identify additional expenses that were inappropriately recovered through ALLETE's transmission formula rates, such as lobbying costs, during the audit period. Provide the results of the analysis to audit staff within 60 days of the date of issuance of this audit report.

26. Submit a refund analysis, within 60 days of issuance of this audit report, to DAA for review that explains and details the following: (1) calculation of refunds to ALLETE's wholesale transmission customers since January 1, 2016, plus interest, relating to the adjustments made in response to the preceding recommendation; (2) determinative components of the refund; (3) refund method; (4) customers to receive refunds; and (5) period(s) for which refunds will be made.

27. File a refund report with the Commission after receiving DAA's assessment of the refund analysis.

28. Refund the amounts disclosed in the refund report to wholesale transmission customers with interest calculated in accordance with section 35.19a of the Commission's regulations.

6. Application of Nonapproved Depreciation Rates

ALLETE applied state-approved depreciation rates to assets included in its wholesale transmission formula rate determination but had not previously filed these depreciation rates with the Commission and obtained Commission approval. In addition, ALLETE improperly recorded depreciation expenses associated with plant held for future use in Account 403, Depreciation Expense, instead of Account 421, Miscellaneous Nonoperating Income. As a result of ALLETE's improper accounting for depreciation expenses associated with plant held for future use, ALLETE overstated its annual transmission revenue requirement which led to overbillings to wholesale transmission customers.

Pertinent Guidance

- Order No. 618, Depreciation Accounting, at footnote 25, states in relevant part:

> To change prices charged for power sales or transmission services (whether determined by stated rates or formula rates) to reflect a change in depreciation, a utility would first have to make a filing with us, pursuant to sections 205 or 206, 16 U.S.C. 824d, 824e, as appropriate, to that effect.[11]

- 18 C.F.R. § 35.1(e) states:

> No public utility shall, directly or indirectly, demand, charge, collect or receive any rate, charge or compensation for or in connection with electric service subject to the jurisdiction of the Commission, or impose any classification, practice, rule, regulation or contract with respect thereto, which is different from that provided in a rate schedule required to be on file with this Commission unless otherwise specifically provided by order of the Commission for good cause shown.

- 18 C.F.R. § 35.13(h)(10) states in part:

> *Statement AJ – Depreciation and amortization expenses*. Statement AJ consists of statements of depreciation and amortization expenses for Period I and Period II.

[11] *Depreciation Accounting,* Order No. 618, 92 FERC ¶ 61,078, FERC Stats. & Regs. ¶ 31,104, at 31,695 n. 25 (2000).

(iv) For Period I and Period II, the utility shall show the annual depreciation rate applicable to each function and subfunction for which depreciation expense is reported. The utility shall indicate the bases upon which the depreciation rates were established. If the depreciation rates used for Period I or Period II data differ from those employed to support the utility's prior approved jurisdictional electric rate, the utility shall include in or append to Statement AJ detailed studies in support of such changes. These detailed studies shall include:

(A) Copies of any reports or analyses prepared by any independent consultant or utility personnel to support the proposed depreciation rates; and

(B) A detailed capital recovery study showing by primary account the depreciation base, accumulated provision for depreciation, cost of removal, net salvage, estimated service life, attained age of survivors, accrual rate, and annual depreciation expense.

- 18 C.F.R. Part 101, Account 108, Accumulated Depreciation, states in part:

A. This account shall be credited with the following: …

(3) Amounts charged to account 421, Miscellaneous Nonoperating Income, for depreciation expense on property included in account 105, Electric Plant Held for Future Use. Include, also, the balance of accumulated provision for depreciation on property when transferred to account 105, Electric Plant Held for Future Use, from other property accounts. Normally account 108 will not be used for current depreciation provisions because, as provided herein, the service life during which depreciation is computed commences with the date property is includible in electric plant in service; however, if special circumstances indicate the propriety of current accruals for depreciation, such charges shall be made to account 421, Miscellaneous Nonoperating Income.

Background

Audit staff evaluated ALLETE's depreciation processes and procedures to determine whether ALLETE complied with the Commission's depreciation accounting and rate regulations. Audit staff found that ALLETE did not have the depreciation rates used in computing its annual transmission revenue requirement on file with the Commission. In addition, ALLETE improperly recorded depreciation expense associated

with plant held for future use in Account 403, Depreciation Expense, instead of Account 421, Miscellaneous Nonoperating Income.

Depreciation Rate Filing

Audit staff reviewed and analyzed how ALLETE determined the appropriate amounts of depreciation expense, and how those depreciation expense amounts were used to develop wholesale transmission billings. To accomplish this review, audit staff requested ALLETE's most recent depreciation rate on file with the Commission. ALLETE stated that it did not file depreciation rates with the Commission and that it used its state approved depreciation rates in the wholesale transmission formula rate computations. Audit staff reviewed the depreciation rates that ALLETE used to determine its annual transmission revenue requirement and confirmed that ALLETE used its state commission approved depreciation rates in calculating its depreciation expense for book and wholesale transmission formula rate purposes.

Although ALLETE filed its depreciation studies and depreciation reports with its state commission, it must also comply with Commission requirements and make a filing with the Commission for approval. Further, 18 C.F.R. § 35.13(h)(10) requires that depreciation studies be filed when depreciation rates are changed, and it also requires that these studies be filed in dockets related to the rates affected. Audit staff found that ALLETE changed its depreciation rates used for wholesale transmission revenue requirement computations without properly filing those rates with the Commission.

Depreciation of Plant Held for Future Use

Audit staff reviewed ALLETE's wholesale transmission formula rate and the FERC Form No. 1 references associated with amounts used in the computation of the annual transmission revenue requirement. Audit staff found that ALLETE computed depreciation expenses on assets recorded in Account 105, Electric Plant Held for Future Use, by recording the expenses in Account 403. However, in accordance with the instructions to Account 108, ALLETE is required to record depreciation amounts associated with plant held for future use in Account 421.

Based on the Commission's accounting requirements, ALLETE's accounting practices for depreciating assets in electric plant held for future use accounts were contrary to Commission regulations. ALLETE's wholesale transmission formula rate includes Account 403 but excludes Account 421 in the computation of its annual transmission revenue requirement. Audit staff found that portions of the depreciation expenses associated with electric plant held for future use in Account 403 were included in ALLETE's annual transmission revenue requirement and resulted in billings to wholesale transmission customers. Consequently, depreciation expenses associated with

electric plant held for future use were improperly included in wholesale transmission billing rates.

Recommendations

DAA recommends that ALLETE:

29. Develop and implement processes and procedures to ensure that depreciation rates and related studies are filed with the Commission for consideration and decision before being used for ratemaking purposes.

30. File current depreciation studies in dockets relating to ALLETE's Wholesale Transmission Formula Rates within 60 days.

31. Provide training to its staff on the revised procedures. Also, develop a training program that supports the provision of periodic training in this area, as needed.

32. Submit a refund analysis, within 60 days of issuance of this audit report, to DAA for review that explains and details the following: (1) calculation of refunds to ALLETE's wholesale transmission customers since January 1, 2016, plus interest, relating to the improper accounting for depreciation associated with electric plant held for future use in Account 403; (2) determinative components of the refund; (3) refund method; (4) customers to receive refunds; and (5) period(s) for which refunds will be made.

33. File a refund report with the Commission after receiving DAA's assessment of the refund analysis.

34. Refund the amounts disclosed in the refund report to wholesale transmission customers, with interest calculated in accordance with section 35.19a of the Commission's regulations.

7. FERC Form No. 1 Reporting

ALLETE did not properly follow the FERC Form No. 1 instructions and, therefore, did not report all required information in its FERC Form No. 1 filings.

Pertinent Guidance

- 18 C.F.R. § 141.1(b)(2)(iii), which discusses FERC Form No. 1, states:

> This report must be filed with the Federal Energy Regulatory Commission as prescribed in § 385.2011 of this chapter and as indicated in the General Instructions set out in this form and must be properly completed and verified. Filing on electronic media pursuant to § 385.2011 of this chapter is required.

Background

ALLETE is required to report financial and operational information on an annual basis in the FERC Form No. 1, Annual Report of Major Electric Utilities. During fieldwork, audit staff reviewed ALLETE's 2018 FERC Form No. 1 and evaluated whether the Company properly followed the requirements and instructions for populating and reporting information in the form. This review entailed a detailed analysis of each page.

Audit staff found several instances where ALLETE did not report information in its FERC Form No. 1 consistent with the form's instructions. The following table presents ALLETE's reporting errors and their locations in the 2018 FERC Form No. 1:

Schedule	Page(s)	Reporting Error
Directors	105	Business addresses of the directors listed are not complete. Only the city and state are listed.
Information on Formula Rates	106	Wholesale transmission formula rate filing not listed.
Capital Stocks (Accounts 201 and 204)	251	Preferred stock listed does not include whether dividends are cumulative or noncumulative, as required per instruction 4.
Long-Term Debt (Accounts 221, 222, 223 and 224)	256	Total expenses in column (c) do not indicate whether they are a premium or discount per instruction 8.
Substations	427	Basis of sharing expenses, or for accounting between parties for substations jointly owned was not included in the footnotes per instruction 6.

Transactions with Affiliates	429	Non-power goods and services provided by affiliates to ALLETE were not included.

Recommendations

DAA recommends that ALLETE:

35. Revise and strengthen documented policies, procedures, and practices to ensure that information reported in the FERC Form No. 1 is correct, accurate, complete, and consistent with the instructions of the form.

36. Provide training to staff on the revised FERC Form No. 1 policies, procedures, and practices. Also, develop a training program that supports the provision of periodic training in this area, as needed.

V. ALLETE's Response to the Draft Audit Report

30 West Superior Street
Duluth, MN 55802-2093
www.mnpower.com

November 19, 2020

Kristen Fleet
Acting Director and Chief Accountant
Division of Audits and Accounting
Office of Enforcement
Federal Energy Regulatory Commission
888 First Street NE, Room 51-59
Washington, DC 20426

Re: Docket No. FA20-2-000, Draft Audit Report

Dear Ms. Fleet:

On November 6, 2020, ALLETE, Inc. ("ALLETE") received the Draft Audit Report issued in the above-referenced docket. The Draft Audit Report contains seven findings and 36 recommendations. Pursuant to Section 41.1(b) of the Commission's regulations and consistent with your request, ALLETE is hereby responding to the Draft Audit Report as follows:

Findings:

1. Transmission Incentives

ALLETE accepts this finding and the related recommendations.

2. Accounting for Environmental Costs

It is ALLETE's position that this finding overlooks important policy considerations that should inform the proper accounting of related expenses. Nonetheless, ALLETE accepts this finding and the related recommendations.

3. Transmission and Distribution Plant Accounting

ALLETE accepts this finding and the related recommendations.

4. Accounting for Long-Term Debt and Interest Expense

ALLETE accepts this finding and the related recommendations.

5. Accounting Misclassifications

ALLETE accepts this finding and the related recommendations.

6. Application of Nonapproved Depreciation Rates

ALLETE accepts this finding and the related recommendations and will be submitting the required application to FERC under Section 205.

7. FERC Form No. 1 Reporting

ALLETE accepts this finding and the related recommendations.

As requested at page 7 of the Draft Audit Report, ALLETE will submit within 30 days of the issuance of the final audit report a plan for implementing the audit recommendations. ALLETE will also make quarterly reports of its progress in completing each corrective action, and ALLETE will provide copies of any written policies and procedures developed in response to the recommendations.

If you have any questions regarding this filing, please contact me at (218) 723-3963 or dmoeller@allete.com.

Yours truly,

David R. Moeller
Senior Attorney and
Director of Regulatory Compliance

DRM:th