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920199-WS

AFFILIATED INTEREST SERVICE AGREEMENTS
COST SEPARATION PROCESS

MARCH 1987

DOCKET 920199-WS
CASE # 93-03324
CASE # 93-04089
VOLUME # 81
(order 92-1289)
Declassified
DOCUMENT NUMBER-DATE
10225 SEP -4 1992
FPSC-RECORDS/REPORTING

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We have completed our audit of the charging of non-utility costs to subsidiary operations. Our audit procedures and overall assessment are summarized in this report.

Background

Over the past several years, the Company has been diversifying into non-electric businesses to broaden its business base and position itself for future growth. These diversification activities have been managed through subsidiary operations of the Company. As a result, the number of inter-company transactions has increased and more administrative services are being provided by Minnesota Power on behalf of the subsidiaries. These diversification activities require proper separation of the Company's electric utility costs, which are charged to the ratepayer, from the non-utility costs associated with the subsidiary operations.

Guidelines for the separation of these costs were established in "Administrative Service Agreements" (Agreements) executed by Minnesota Power and its direct subsidiaries; Superior Water, Light and Power, Topeka Group, Inc., Minnesota Paper, and Fibercore. (As of November 1, 1986, Fibercore became a subsidiary of Topeka.) The Agreements govern the rendering of and charging for services provided by Minnesota Power; the overall intent is that Minnesota Power recover from the subsidiaries any costs incurred on their behalf. No formal Agreements have been established between Minnesota Power and its other direct subsidiaries Energy Land, Inc., and Rendfield Land Company, Inc., because of the minor amount of activity occurring. The Agreements apply only to services which are not included in any other specific agreement(s) between the Company and its subsidiaries (for example, the allocation of Federal and State income taxes is provided for in separate tax allocation agreements).

Audit Objectives

We performed the audit to determine that:

1. Policies and procedures exist for charging costs to subsidiary operations.

2. Cost separation procedures provide for reasonable allocation of costs to subsidiary operations.

3. Costs are being properly charged to subsidiaries in accordance with these procedures.

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Audit Procedures

Our audit included:

1. Reviewing the Administrative Service Agreements between Minnesota Power and its subsidiaries.

2. Discussing with management personnel, where appropriate, the Company's philosophy or other procedures for charging costs to subsidiaries.

3. Reviewing and judgmentally testing 1986 Company billings to the subsidiaries.

Audit Scope and Limitations

Our audit was limited to a review of significant costs with emphasis on executive time, Company labor, overheads, vehicle and equipment usage, office space, computer resources, and administrative support.

Overall Assessment

Based on the results of the audit, and except for the following recommendations, it is our opinion that procedures are in place for charging costs to subsidiary operations; these procedures provide for reasonable allocation of costs to the subsidiaries; and costs are being charged to subsidiaries in accordance with these procedures.

Recommendations

1. The "Administrative Service Agreements" should be updated to reflect present circumstances.

   Although the overall intent of the Agreements remains the same, several changes have occurred since the initial establishment of the Agreements. For example: the methods of charging costs to the subsidiaries have been improved; at Topeka, changes have occurred in payroll processing and in organizational structure (Fibercore is now a subsidiary of Topeka); and, the revision of the administrative fee for Topeka and Minnesota Paper has affected the method of charging executive time. The Agreements should be reviewed by the Law Department and updated or supplemented to assure proper charging of costs to subsidiaries.

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2. <u>Master files should be established for each subsidiary containing the Administrative Service Agreement and all subsequent letters, agreements, and modifications.</u>

   During our review we noted that complete documentation of specific billing procedures was not always filed with the Agreement. Files for each subsidiary containing all information related to the Agreements and billing procedures should be maintained by Accounting to assure proper charging of costs to the subsidiaries.

3. <u>A routine process should be established for the review and update of cost allocation methods used in the billing process.</u>

   During our review we noted that documentation for the methods of calculation used in charging certain costs to subsidiaries was several years old. To assure that billings reflect current costs and circumstances, procedures for regular updating of costs should be defined, implemented, and coordinated by Accounting.

Prepared by:

Auditor-In-Charge

Reviewed by:

Director of Internal Audit

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COST SEPARATION PROCESS

JANUARY 1989

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We have completed our audit of the process of charging costs to non-utility operations. Our audit procedures and an overall assessment are summarized in this report.

Background

While Minnesota Power's core business is the production and sale of electric power, this is no longer the Corporation's only activity. In recent years, Minnesota Power has been faced with a capital base which has been expanding in excess of rate base expansion (See Analysis of Corporate Capital at Exhibit I). In order to provide a fair rate of return to shareholders, the Company has been diversifying into non-electric activities.

Non-utility costs are costs which do not relate to producing and supplying electric power to Minnesota Power's electric customers. As a result of recent diversification efforts, it has become increasingly important that costs related to these expanding non-utility activities are properly separated from electric utility costs, which are charged to the ratepayers.

Examples of the non-utility activities in which Minnesota Power is currently involved are investments, merchandising (the Electric Outlets), Lake Superior Paper Industries, the Duluth Steam District #2, and various water/wastewater and telephone utilities acquired through Topeka Group, a wholly-owned subsidiary of Minnesota Power. In addition, the Company recently acquired Baukol-Noonan, Inc., which is in the business of surface mining and sale of lignite coal.

Costs which are incurred by Minnesota Power in support of non-utility activities are charged to non-utility accounts or are billed to outside parties. These costs include a range of goods and services the Company provides to subsidiary operations which have been established for the purpose of expansion into non-electric utility businesses.

Costs relating to work Minnesota Power does for outside parties which are then billed out to those parties are typically accumulated through jobbing orders. Costs relating to projects conducted within Minnesota Power and costs and revenues relating to enhancements are accumulated through maintenance/operation requisitions (M/ORs).

These non-utility costs are either identified directly as incurred or, in instances where specific identification is either not possible or is not cost effective, on-going allocations are made based upon cost studies. Various departments identify costs to be charged and Property Accounting and General Records personnel share responsibility for preparation of billings or necessary accounting entries on a

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monthly basis. Administrative Service Agreements with affiliated companies or contracts with outside companies provide the basis for the billings.

Audit Objectives

We performed the audit to determine that:

1. Procedures surrounding the separation of non-utility costs are adequate to ensure that all non-utility costs are properly charged.
2. Agreements covering the charging of costs to subsidiaries and others are current and properly reflect the original intent underlying these agreements.
3. Costs being billed to subsidiaries and others are in accordance with the appropriate agreement.
4. Costs are being allocated to non-utility activities within the Company consistent with information provided to the Commission in the recent rate filing.
5. Information provided to responsibility center management is adequate for monitoring and decision-making purposes.

Audit procedures

Our audit included:

1. Soliciting input concerning the adequacy and clarity of existing cost separation procedures from all responsibility centers within the Company.
2. Discussing with Company personnel the procedures used to separate non-utility costs.
3. Reviewing administrative service and other agreements covering charging costs to subsidiaries and others.
4. Reviewing a sample of 1988 charges to subsidiaries and others and following through to the billings.
5. Reviewing a sample of non-utility costs within the Company charged to non-utility expense accounts.
6. Comparing actual non-utility cost allocations to allocations reviewed in the recent rate filing.
7. Reviewing reports provided to management of actual non-utility costs charged.

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Audit Scope and Limitations

Our audit scope was limited to a review of significant non-utility costs with an emphasis on reviewing the process of identifying and separating these costs.

We limited our review to costs charged to jobbing orders and maintenance/operation requisitions and did not include a review of capital expenditures. Our review did not include the Merchandising/Marketing area or a detailed review of the Other Accounts Receivable system. These areas will be reviewed in conjunction with future audits.

Overall Assessment

Based on the results of the audit work we performed, and except for the following recommendations, it is our opinion that procedures are in place for separating the costs of non-utility operations, the procedures provide for reasonable allocation of costs to these operations, costs are being charged to non-utility operations in accordance with the procedures, and adequate information is being provided to responsibility center management for monitoring and decision-making purposes.

Recommendations

1. A "quick reference" guide should be developed for non-utility activities.

   Based on issues which arose during our review and on the results of the survey we conducted of all responsibility centers within the Company, we believe that there is need for a central source of information relating to non-utility activities. Guidelines and procedures for charging costs to non-utility operations are currently contained in various letters, budgeting instructions, and accounting documentation. We realize that it is not practical, or desirable, to write instructions which would prescribe specific procedures for all non-utility activities. However, Accounting should develop and maintain a "quick reference" guide which would provide a definition of non-utility activities with examples, general guidelines for identifying costs related to these activities, instructions for charging these costs, and most importantly, where to call if questions arise. This "quick reference" is necessary to ensure that people throughout the Company can recognize non-utility costs and know how to consistently account for such costs.

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2. <u>Existing monthly budget reports of non-utility costs charged to M/ORs should be distributed to all coordinating responsibility centers</u>.

   During our review, we noted that not all responsibility centers responsible for coordinating an M/OR were receiving information in sufficient detail to allow them to adequately monitor the amount of the M/OR which was being allocated to non-utility. We believe that it is the responsibility of the coordinating responsibility center to review the charges to an M/OR not only for the appropriateness of costs charged, but also for proper allocation between utility and non-utility. Budgeting should distribute monthly reports showing the allocation between utility and non-utility by M/OR to all coordinating responsibility centers.

3. <u>Detail reports of jobbing order charges should be reviewed and the preparation of these reports should be centralized</u>.

   We noted during our review that there is no standard report of detail charges to jobbing orders distributed to the responsibility centers charging to these jobbing orders. Those individuals who are reviewing detail jobbing order charges are using reports which they have created. We believe that an important control exists when charges to jobbing orders are reviewed by the originating responsibility centers, but reports used for this review should be generated from a central source to ensure that consistent, quality information is being supplied. Property Accounting has taken the first steps by working on the development of a reporting format for charges billed to subsidiaries. We suggest that Accounting work with the Budgeting department to develop a report within the budgeting system which shows jobbing order charge detail. This report should then be available to a coordinating responsibility center, similar to the procedures currently used for M/OR's.

4. <u>The "Administrative Service Agreements" should be updated to reflect current circumstances</u>.

   Although the overall intent of the Agreements remains the same, several changes have occurred since they were initially established. For example, at Topeka, changes have occurred in payroll processing and in organizational structure; and the revision of the administrative fee for Topeka and Minnesota Paper has affected the method of charging executive time. The Agreements should be reviewed by the Law Department and updated or supplemented to assure that costs are properly charged to subsidiaries.

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At the time of this report, the Law Department has issued revised drafts of the Administrative Services Agreements.

5. Master files should be established for each subsidiary containing the Administrative Service Agreement and all subsequent letters, agreements, and modifications.

   During our review, we noted that complete documentation of specific billing procedures was not located in a central source. In order to assure proper charging of costs to the subsidiaries, Accounting should establish and maintain files for each subsidiary containing all information related to the Agreements and billing procedures.

6. A routine process should be established for the review and update of cost allocation methods used in the billing process.

   During our review we noted that some documentation for the methods of calculation used in charging certain costs to subsidiaries was several years old. Some calculations which had been recently updated had not been reviewed for several years prior to this update. To assure that billings reflect current costs and circumstances, procedures for regular updating of costs should be defined, implemented, and coordinated by Accounting.

This report has been discussed with Accounting, Budgeting and Rate department personnel.

Prepared by:

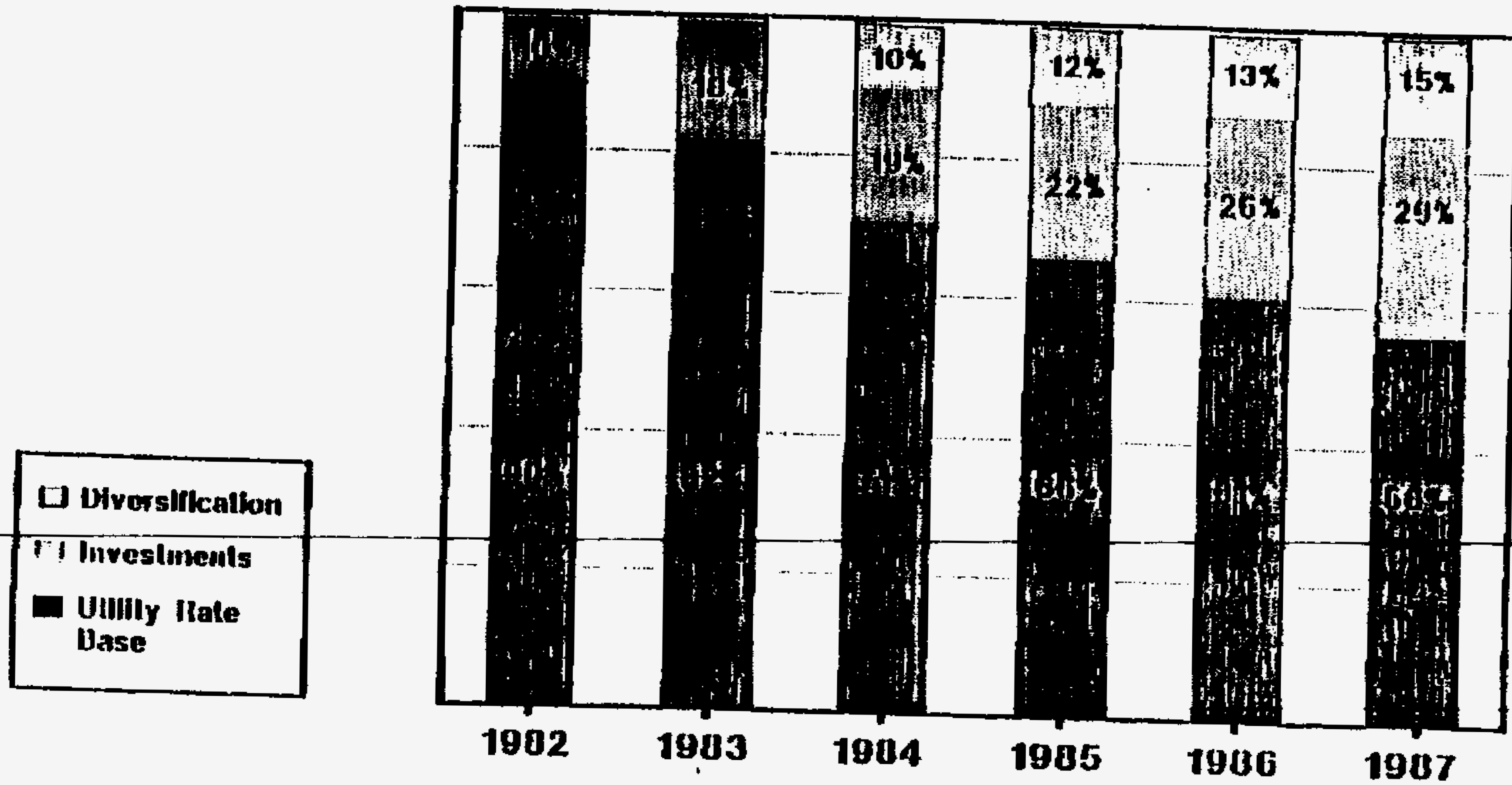
Jeffrey K. Harty
Auditor

Kathleen D. Sanders
Auditor-In-Charge

Reviewed by:

Director of Internal Audit

Corporate Capital



Statistics compiled by Corporate Reporting.

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EXHIBIT I

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COST SEPARATION

April 1992

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We have completed our audit of the process of charging costs to non-utility operations. Our audit procedures and an overall assessment of the cost separation process are provided in this report.

Background

Cost separation is the process of charging costs to utility or non-utility operations, based upon the nature of the related activity. Utility costs generally include costs incurred in the process of producing and supplying power to the Company's electric customers. Costs incurred which provide no benefit to electric customers are considered non-utility. Properly charging costs ensures that electric rates are based upon services and benefits received by electric ratepayers. Accordingly, cost separation is of special interest to the Minnesota Public Utilities Commission who periodically reviews our cost separation process.

Since the last Cost Separation audit performed in 1989, diversified operations have grown with the addition of Synertec, Rainy River, and Lehigh operations. Continued non-utility expansion requires additional Company resources to support the diverse operations. The costs of these additional resources must be correctly assigned to ensure no cross subsidization occurs. In 1991, operations were restructured into distinct Business Units in an attempt to position the Company for future growth. The new organizational structure will enhance the proper assignment of costs by highlighting specific activities and related costs of the Company's diverse operations.

Among the Company's affiliates and within the Business Units, there are many services provided to one another. "Administrative Service Agreements" have been established between the Company and affiliates to guide charging for services, with the intent that charges between them are properly assigned. Charges are accumulated and assigned to specific affiliates through Jobbing Orders (JOs). Properly charging costs to the Company's regulated affiliates ensures that their customers' rates are also based on fair and accurate costs.

There are also many services provided to the public which are non-utility in nature. Among them are merchandising activities and the installation and repair of electric equipment not owned by the Company. These costs must also be separated to ensure fair electric rates and are billed through direct account charges (merchandising) and JOs (electric equipment).

Operating and maintenance costs related to specific projects or activities within the Company are accumulated in Maintenance/Operation Requisitions (MORs). Each MOR is created with instructions for distributing costs to utility or non-utility

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accounts. The individual generating the MOR is responsible for determining the proper allocation of charges. MOR cost distributions are reviewed by Budgets, Revenue Requirements, and General Accounting.

Capital project costs are accumulated in the accounting process through the use of Expenditure Requisitions (ERs). ER project completion reports are reviewed by Property Accounting to determine utility and non-utility plant additions.

Costs not specifically related to JOs, MORs, or ERs are charged directly to the appropriate Federal Energy Regulatory Commission accounts.

The responsibility for properly charging costs belongs to all employees with oversight from all levels of management. Company-wide awareness of non-utility activities is critical to proper cost separation for both budgeted and actual charges.

Audit Scope and Limitations

Our audit focused on reviewing and testing procedures which determine the separation of non-utility costs. A review of actual billings to affiliates was not performed.

Audit Objectives

We performed the audit to determine that:

1. Procedures for the separation of non-utility costs ensure that all costs are properly charged.

2. Agreements covering the charging of costs to affiliates and others are current and properly reflect the original intent underlying these agreements.

3. Sufficient information on non-utility activity exists for cost monitoring, budgeting, and future allocation methodology.

Audit Procedures

We performed the following procedures:

1. Discussed and reviewed cost separation procedures with various personnel to determine philosophy behind charging costs to non-utility accounts.

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2. Reviewed MOR and Construction Budgets and tested a sample of items for appropriate non-utility consideration and compliance with past rate orders.

3. Examined methods for charging management time, administrative and general time, and miscellaneous operating expense to non-utility activities.

4. Reviewed Administrative Service Agreements for all affiliates and methods of charging related costs.

5. Reviewed methods of accumulating and charging costs to non-affiliated companies and customers.

Overall Assessment

The results of our audit indicate improvement and increased awareness of the Company's cost separation process since the last audit. Except as noted below, it is our opinion that cost separation procedures are effective, agreements covering the charging of costs to affiliates and others are current and properly reflect the original intent underlying these agreements; and sufficient information on non-utility activity exists for cost monitoring, budgeting, and future allocation methodology changes.

Recommendations & Management Response

1. Methods for charging administrative and general expenses to non-utility accounts should be evaluated and implemented.

   Components of administrative and general expense from some responsibility areas are not currently being charged to non-utility accounts. Expenses such as staff meeting time, materials and supplies, training time, and the administrative duties necessary in daily operations for both utility and non-utility functions alike are currently being charged to utility accounts. The expenses primarily include labor and some miscellaneous items. The non-utility portion of these costs was not significant in prior years, and as a result, minimal effort was made to allocate a percentage to non-utility accounts.

   As diversification activities continue to expand, the materiality of these items will increase. Accordingly, we recommend that charging practices be reviewed to determine what methods need to be developed for allocating administrative and general expenses to non-utility accounts.

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Management Response

Several alternatives have been reviewed to ensure that indirect administration expenses are charged to non-utility accounts when appropriate. In a variety of cases, M/ORs are being used to allocate a portion of such expenses to non-utility accounts. In addition, labor charged to jobbing orders that are billed to affiliates are assessed an administrative and general expense overhead with corresponding credit to utility O&M expense. In all other cases employees will be instructed to charge an appropriate portion of their administrative time, training materials, and supplies directly to non-utility accounts.

Budget instructions addressing these items will be distributed with the 1993 budget solicitation. In addition, the Budget Manual and the non-utility pamphlet will be revised during 1992.

2. Management time reporting procedures should be reviewed and, as appropriate, revised to improve the accuracy of non-utility labor distribution and the efficiency of processing semimonthly payroll.

Based on the audit work performed, we noted instances where non-utility activities are not being properly charged to non-utility accounts for some employees on the semimonthly payroll.

Currently, semimonthly payroll employees are not required to submit actual time on a monthly basis. In addition, many original non-utility labor distribution estimates are not accurate. The result is an incorrect labor distribution to non-utility accounts.

In addition, the current semimonthly payroll process does not allow actual hours to be entered until after the labor distribution is actually run. The result is numerous manual adjustments and additional system time to update labor distribution.

Based on these concerns, we recommend that all employees on the semimonthly payroll system be required to submit actual time on a monthly basis to ensure proper labor distribution to non-utility activities. In addition, the possibility of revising or eliminating the semimonthly payroll system to enhance the efficiency and accuracy of the related labor distribution should be explored.

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Management Response

The current semimonthly labor distribution processing is being reviewed. Management will be required to submit at least once a month prior to labor distribution processing, an accounting of how their time was allocated for the pay period(s). This will help eliminate manual corrections or adjustments. Emphasis will be made on the importance of carefully reviewing how their time was spent, especially for non-utility activities. A new semimonthly labor distribution system will be implemented as soon as it is feasible.

A management study has already been initiated to review the possibility of combining the semimonthly payroll with the biweekly process.

3. Account distribution guidelines for ERs with a non-utility component should be determined and consistently followed.

We noted that the Company does not have a consistent account distribution method for ERs which have a non-utility component. Two different methods are currently being used. First, an ER may be capitalized as a utility asset, with the related non-utility entity being charged rent as utility income. Second, the asset may be split into utility and non-utility components. Either method will result in proper matching of assets with costs, but inconsistent account distribution for ERs with a non-utility component may lead to inefficient record keeping and extra analysis required to prepare cost of service studies.

We recommend that ER account distribution guidelines be developed and consistently followed.

Management Response:

The following ER account distribution guidelines have been developed and will be followed in the future:

1) MP distinguishes 100% non-utility property units from utility property units; e.g., Lake Superior Plaza Parking Ramp.

2) Property units that serve utility and non-utility functions will be classified as utility property. This guideline is necessary because units of property cannot be efficiently split and managed. Non-utility activities will be charged rent which will be included in other electric revenues.

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3) The rental rate for non-utility activities will be determined annually. The rental rate will reflect a rate of return on rate base, depreciation, and property taxes. The rental rate may also include general operation and maintenance expenses that are not directly assigned.

This report has been discussed with Company management.

Auditor

Director of Internal Audit

Auditor

Auditor-In-Charge