
Interim Rates

Testimony

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Basic Interim Rate Premise

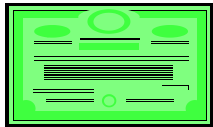
- Utilities must obtain and spend very large amounts of capital to build projects/maintain systems to serve customers
- This money is spent prior to and sometimes years in advance of recovering these costs from ratepayers
- Rate cases take 10-12 months to process
- Interim rates provide compensation to utilities for investments made prior to final rate case approval; they encourage investment

How the Regulatory Model Works



Electric Facilities
(Rate Base Regulated)

Debt Holders



(Capital Structure Regulated)

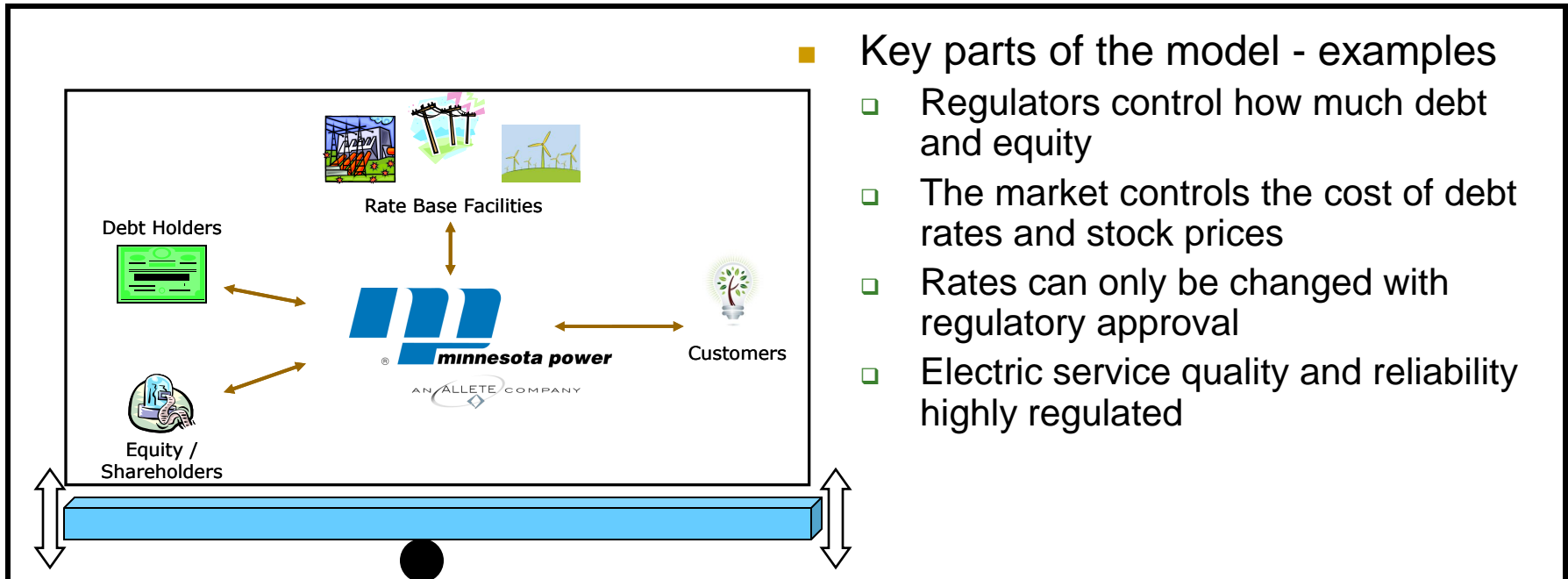


Equity /
Shareholders



Customers
(Rates Regulated)

Regulatory Model – Balance is important



- The regulatory model needs to remain in balance for all parties
- When the model gets out of balance:
 1. investment is unattractive
 2. there is no incentive to continue to invest or
 3. rates can become noncompetitive

Causes of Recent MP Rate Base Investment Leading to Rate Increases

- Federal Regional Haze Rule for NOx/SO2 (1999)
- MN Mercury Reduction Act (2005)
- Renewable Energy Standard (2007)
- Ongoing Maintenance
 - Generation, transmission, distribution system replacements/upgrades and related annual operating costs
 - Service reliability/quality maintenance

Utility Capital Project Recovery

- Utility projects typically cost millions and have long lead times:
 - Mandates
 - System requirements
- Utilities raise capital from investors to fund projects
- Utilities must build projects and have them “in service” before they can be put into rate base for cost recovery
 - “Rate riders” available for selected projects to temporarily allow earlier recovery, but final rate case approval still required
- Utilities are at risk for recovering costs of these capital investments from customers, after the money is spent
- Uncertain cost recovery = greater risk to investors = higher cost of capital = higher rates for customers

Example: \$240 Million Boswell 3 Emission Reduction Project

- Mandated by Regional Haze Rule and MN Mercury Bill
- Ten year lead time:
 - 1999-2003 conceptual plans/consider alternatives
 - 2004-2006 detailed plans/major equipment orders
 - 2007-2009 construction
- Completed late 2009; delivering promised emission reductions and enhanced reliability; retrofit also employed 600 regional contractors on average for three years, 1.2 million hours per year

Interim Rate Decision in MP Rate Case

- MP filed a rate request 11/1/09:
 - ~70% was for capital investment, including Boswell 3 and other projects
 - Anticipated MPUC approval of temporary interim rate increases, based on statutory guidelines and typical practice
 - Full rate case review to occur over 10-12 months of scrutiny/testimony/debate, looking at all aspects of company assets, finances, operations and sales
- On 12/15/09 the MPUC allowed ~66% of MP's interim rate request versus typical practice, citing the economy, rate increase impacts
- Concerns about rate increases in current economy are understandable...yet regulatory model presumes utilities will spend in advance of being paid and will have financial stability

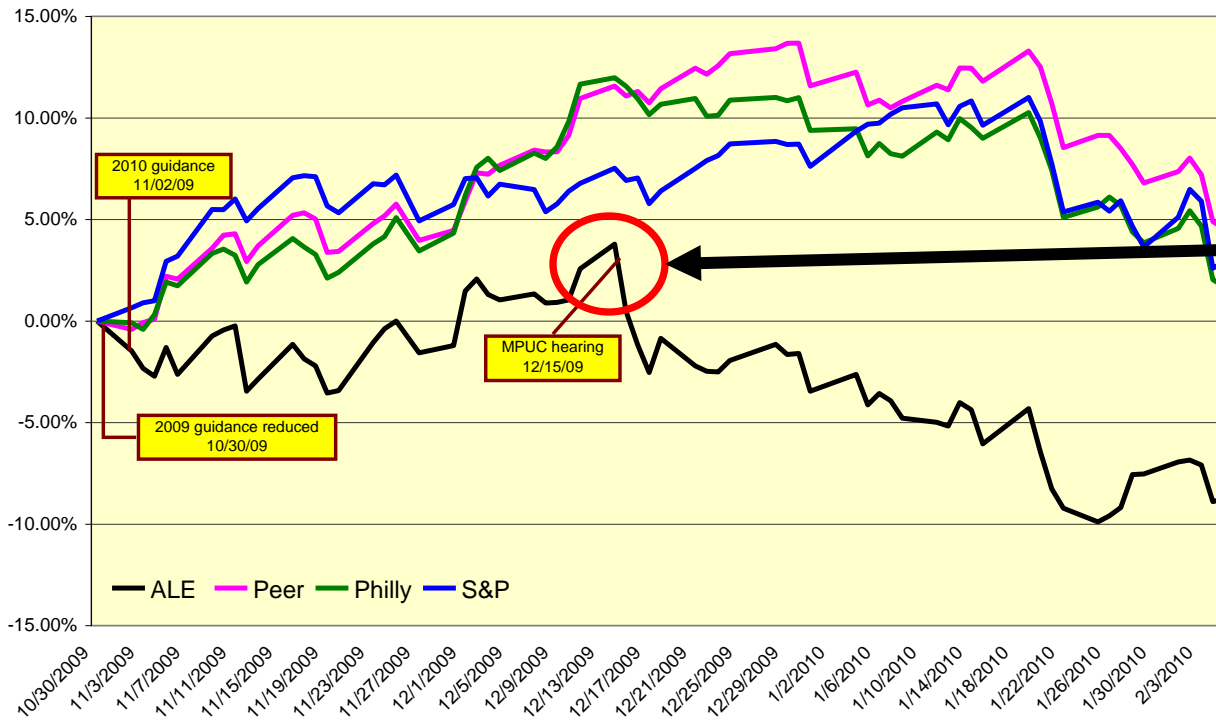
Interim Rate Decision in MP Rate Case

- Negative impact of sudden interim rate denial hit ALLETE stock immediately, raising cost of capital to invest—which will ultimately raise rates
- Unpredictable/unbalanced regulatory environment sends negative message to investors about Minnesota's utilities as investments—negatively affects ratepayers
- MPUC decision has ramifications for ongoing investment in renewables, emission reduction, transmission, etc., undercutting state energy policies
- A significant, unilateral change to the state's regulatory equation can throw it out of balance, eventually negatively affecting all parties

Regulatory Environment Affects Investors – Ultimately Affecting Ratepayers

A reduced stock price results in the need to issue additional shares to fund our construction needs. The result is in a permanent increase in the cost of capital adding to our customers' electric rates.

ALLETE vs S&P 500, Philadelphia Index and Peer Group
October 30, 2009 - February 5, 2010



Negative
12/15/09 interim
rate decision
resulted in a
reduction in
stock price
compared to
peer group and
broader indices