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April 16, 2004

PUBLIC DOCUMENT

Burl W. Haar
Executive Secretary
Minnesota Public Utilities Commission
121 7th Place East, Suite 350
St. Paul, Minnesota 55101

RE: **PUBLIC Addendum and Revised Pages to Reply Comments of the Minnesota Department of Commerce**
Docket No. E999/CI-03-802

Dear Dr. Haar:

On April 5, 2004, the Energy Division of the Minnesota Department of Commerce (Department) submitted to the Minnesota Public Utilities Commission (Commission) the above referenced Reply Comments in the following matter:

Investigation into the Appropriateness of Continuing to Permit Electric Energy Cost Adjustments.

Since submitting these comments, two errors have come to the Department's attention. First, in the last bullet point on page 3 and in the first bullet point on page 4 of the Department's Reply Comments, findings of a study by David P. Baron and Raymond R. de Bondt were incorrectly attributed to Roger Clarke. Second, in the trade secret data on page 9, the high value was overstated by 1 percent. Please find enclosed the revised versions of these pages.

Finally, the Department is submitting, as an addendum to the original filing, the following documents:

- Appendix B1
- Appendix B2
- Attachment 1 to Appendix C

These documents were not submitted with the original filing.

The Department regrets these errors and is available to answer any questions the Commission may have.

Sincerely,

A handwritten signature in cursive script that reads 'Anna Jones'.

ANNA JONES
Rates Analyst

AJ/ja
Enclosure

Market Assurance: 1.800.657.3602
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disadvantages. For this reason, the Department offers the following analysis of the initially apparent negative effects of the FCA.²

At the outset, an important disadvantage of the FCA appeared to be its potential to distort incentives by treating fuel costs differently than other costs. Distortion of incentives could occur in the following ways:

- By easing the recovery of fuel costs, the FCA could encourage utilities to use fuel more intensively. In other words, the FCA could skew input selection in favor of fuel and against other inputs.
- By allowing utilities to pass fuel cost increases to utilities, the FCA could weaken utilities' incentives to aggressively manage fuel costs. Specifically, the FCA could reduce utilities' incentives to:
 - (i) select less volatile fuel sources over more volatile fuel sources when installing new plants;
 - (ii) switch existing plants to less volatile fuel sources; and
 - (iii) invest time and resources in negotiating lower prices for fuels currently in use.³

Despite these negative impacts, advocates of the FCA contended that its advantages would outweigh its disadvantages. In particular, the positive effect of risk reduction (see argument 3) was expected to counteract the negative effect of incentive distortion.

In the first few years after the FCA was implemented, empirical studies tended to confirm expectations of both risk and incentive effects. For example:

- In a 1980 study, Roger Clarke tested the effect of the FCA on systematic risk (a measure of the uncertainty of utilities' profitability) for a sample of 50 U.S. electric utilities over the period 1965-1974. Clarke concluded that an FCA tended to decrease systematic risk by approximately 10%, although the effect was stronger for utilities using oil and gas than for utilities using coal.⁴
- A 1979 study by David P. Baron and Raymond R. de Bondt addressed the theory that the FCA could skew input selection in favor of fuel and against other inputs. Baron and de Bondt stated that these effects could impact the selection of new

2 The Department notes that the analysis is based on research of similar FCA mechanisms implemented by the majority of U.S. states in the 1970s. However, in the Department's view, the conclusions of the analysis apply to the Minnesota case as well.

³ Source: Kaserman, David L., and Richard C. Tepel, "The Impact of the Automatic Adjustment Clause on Fuel Purchase and Utilization Practices in the U.S. Electric Utility Industry." *Southern Economic Journal*, Vol. 48, No. 3 (Jan. 1982): 686-700.

⁴ Source: Clarke, Roger G., "The Effect of Fuel Adjustment Clauses on the Systematic Risk and Market Values of Electric Utilities." *Journal of Finance* Vol. 35, No. 2 (May 1980): 347-358.

generating plants, but noted that utilities had few options to substitute fuel for other inputs once generating plants were in place.⁵

- Baron and de Bondt's study suggested that the FCA was unlikely to reduce utilities' incentives to seek least-cost fuel sources. However, a 1982 study by David Kaserman and Richard Tepel drew the opposite conclusion after testing the effect of the FCA on fuel expenses for a sample of 121 Class A and B electric utilities in 1977 and 1978. Kaserman and Tepel concluded that utilities with FCAs tended to pay higher prices for fuel than those without, even after controlling for regional differences.⁶

In general, these empirical results did not lead industry analysts to question the original rationale for the FCA. In a 1990 study, Joseph Golec commented that:

“Regardless of how clear it is that weakened incentives are costly, much uncertainty remains concerning the risk effects of FAC removal. Many PUCs feel that, without FACs, financial risk will increase and, with it, the cost of capital for electric utilities. This increased cost could offset fuel cost savings due to improved incentives and force electricity rates higher.”⁷

The Department believes that the above quote accurately represents the prevailing arguments at that time for keeping the FCA, at least under previous regulatory conditions. In the next section, the Department describes the operation of the FCA under current conditions.

2. *Utilities' Comments on the Current Operation of the FCA*

In comments on the current operation of the FCA, utilities have provided detailed information regarding the application of the FCA to Minnesota utility operations in general and to their own operations in particular. This information is summarized below.

- DEA's Resource and Tax Adjustment (RTA) allows the utility to recover changes in purchased power costs, conservation spending, and changes in net property taxes. DEA observes that its recovery of conservation expenses through the RTA has effectively removed financial disincentives to promote conservation. Also, as DEA's property taxes and purchased power costs have decreased in recent years, the RTA has allowed DEA to pass these cost reductions on to its consumers. However, DEA

⁵ Source: Baron, David P., and Raymond R. de Bondt. "Fuel Adjustment Mechanisms and Economic Efficiency." *Journal of Industrial Economics*, Vol. 27, No. 3 (March 1979): 243-261.

⁶ Source: See footnote 2 above.

⁷ Source: Golec, Joseph, *The Financial Effects of Fuel Adjustment Clauses on Electric Utilities*. *Journal of Business*, Vol. 63, No. 2 (1990), p. 166. The Department notes that Golec concludes that removing the FCA does not significantly increase a utility's financial risk. However, because Golec examined risk effects mainly during periods of decreasing fuel costs, the Department does not believe this result necessarily applies to the current market environment.

If fuel costs are passed through the FCA during period of fraudulent activity, then this policy raises questions about the potential for overcharges due to market fraud.

Although this example pertains to natural gas costs, this discussion applies to all fuel costs passed through the FCA. It will be important, at a minimum, to track changes in costs of specific fuels passed through the FCA. For example, the Department compiled data from information requests on natural gas volumes, prices, and suppliers for the period December 2003 – January 2004. This information is included in Appendix B. As shown in the table, the natural gas share of fuel and purchased power costs ranges from [TRADE SECRET DATA HAS BEEN EXCISED] This information indicates that undue inflation of natural gas prices would affect customers of different utilities differently as these effects are passed to ratepayers through the FCA.

At a minimum, to allow for better tracking of changes in specific fuel costs, the Department recommends that the Commission require utilities to begin reporting additional information regarding specific fuel supply and procurement strategies. For example, the Commission could require utilities to provide the following information by fuel source for coal, natural gas, and nuclear fuel:

- the total volume of fuel used in electric operations,
- the total MWh of electricity generated using the fuel,
- the total cost of fuel used in electric operations,
- a list of suppliers of fuel,
- the volume of fuel used, by supplier and/or by plant,
- the price paid per unit of fuel, by supplier and/or by plant, and
- the transport cost of fuel, by transporter and/or by plant.

The Department understands our recommendation regarding data reporting would not eliminate the problem of market fraud. However, assuming that the Commission decides to allow the FCA mechanism to continue to operate, gathering more data would allow the Commission and the Department to recognize the potential size of any such problems and provide better information that would be necessary to deal with any such problems in the future if fraudulent costs are passed through an FCA mechanism.

A related consideration is the potential for utility affiliates to inflate fuel prices. The FCA seems to compound this issue by making the utilities less affected by fuel price increases.¹¹ The Department recommends that the Commission consider modifications to the FCA to help correct this incentive structure.

¹¹ The Department notes that although the Commission has provided safeguards regarding the treatment of utilities' fuel and power purchases from their affiliates (see, for example, the Commission's July 3, 2001 *Order Approving Affiliated Interest Agreement and Setting Reporting Requirements*, Docket No. G-002/AI-00-1278), these safeguards would not protect ratepayers from pass-through of inflated prices if affiliate behavior increased prices for the market as a whole.

[TRADE SECRET DATA HAS BEEN EXCISED]

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Attachment 1 to Appendix C: Wisconsin Fuel Adjustments¹

Fuel Rules Adjustments Completed through 2003				
Utility	Docket	Date Order	Change \$ Million	Percent of Ave Fuel
WEPCO	6630-ER-100	Jun-86	\$ (18.58)	-6.4 %
WEPCO	6630-UR-100	Aug-87	(15.74)	-6.0%
WEPCO	6630-UR-102	Aug-89	(4.64)	-1.6%
WEPCO	6630-UR-103	Nov-90	(16.53)	-5.3%
WEPCO	6630-UR-104	May-91	(18.93)	-5.5%
WEPCO	6630-UR-105	June-92	(30.54)	-9.3%
WEPCO	6630-UR-106	Nov-93	(10.58)	-3.7%
WEPCO	6630-UR-107	Aug-94	(20.37)	-6.7%
WEPCO	6630-UR-109	May-97	15.59	9.7%
WEPCO	6630-UR-109	Dec-97	11.85	3.8%
WEPCO	6630-UR110	Apr-99	(5.25)	-2.4%
WEPCO	6630-UR-111	May-2001	58.724	14.2%
WEPCO	6630-UR-111	Oct-2003	61.205	12.8%
WPL	6680-UR-100	Jan-86	\$ (15.85)	-4.9%
WPL	6680-UR-104	Apr-90	(9.27)	-6.4%
WPL	6680-UR-104	May-91	(3.17)	-2.4%
WPL	6680-UR106	Mar-92	(5.66)	-4.2%
WPL	6680-UR-110	Jul*98	14.72	13.2%
WPL	6680-UR-110	Mar-99	14.49	11.1%
WPL	6680-UR-110	June-2001	57.76	23.2%
WPL	6680-UR-110	May-2000	16.46	7.6%
MGE	3270-UR-12	1984	Decrease	
MGE	3270-UR-103	May-90	\$ (1.15)	-4.5%
MGE	3270-UR-104	May-91	(1.67)	-4.0%
MGE	3270-UR-106	Aug-94	(0.87)	-2.7%
MGE	3270-UR-109	Aug-99	2.04	13.6%
MGE	3270-UR-110	Oct-2002	(3.31)	-3.9%
MGE	3270-UR-110	May-2001	5.38	8.9%
NSP	4220-UR-100	Nov.-86	\$ (2.40)	-4.5%
NSP	4220-UI-100	Aug-87	2.77	7.4%
NSP	4220-UR-102	Jul-89	3.64	9.3%
NSP	4220-UR-103	Oct-90	(2.47)	-5.0%
NSP	4220-UR-109	Sept-97	2.80	3.3%
NSP	4220-UR-110	Oct-99	10.39	13.8%

¹ Source: Mike Ritsema, Public Utility Auditor, Electric Division, Wisconsin PSC.

NSPW	4220-UR-111	May-2000	9.58	11.25%
NSPW	4220-UR-112	Nov-2002	11.31	
NSPW	4220-UR-112	Jan-2003	5.07	
NSPW	4220-UR-111	Oct-2001	11.33	-
WPS	6690-UR-106	May-92	S (7.28)	-5.0%
WPS	6690-UR-107	Nov-93	(2.79)	-2.2%
WPS	6690-UR-108	May-94	(3.68)	-2.9%

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