MINNESOTA
DEPARTMENT OF
COMMERCE

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April 30, 2007

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

RE: In the Matter of the Commission's Investigation into the Appropriateness of Continuing to Permit Electric Cost Adjustments
Docket No. E999/CI-03-802

Dear Dr. Haar:

Attached are the comments of the Energy Division of the Minnesota Department of Commerce (Department) in the following manner:

> The March 30, 2007 Notice issued by the Minnesota Public Utilities Commission (Commission) requesting comments on the question of whether the investigation into the usefulness of the fuel clause adjustment (FCA) should be continued, and if so, what issues should be pursued.

The Department offers the following comments in this matter and is available to answer any questions the Commission may have.

Sincerely,

/s/ KATE O'CONNELL
Supervisor, Electric Planning and Advocacy

KO/ja
Attachment

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

COMMENTS OF THE MINNESOTA DEPARTMENT OF COMMERCE

DOCKET NO. E999/CI-03-802

I. INTRODUCTION

The Commission's Notice states the following:

> *On June 4, 2003, the Commission opened an investigation into whether the fuel clause adjustment (FCA) continues to be a useful regulatory tool. On December 19, 2003, the Commission solicited comments on the purpose, structure, and rationale of the current FCA. Parties filed comments during 2004 in response to the Commission's solicitation.*
>
> *Since comments were filed in 2004, several of the concerns initially raised in the comments have been addressed through various modifications or variances as follows.*
>
> - *In the December 20, 2006 ORDER ESTABLISHING ACCOUNTING TREATMENT FOR MISO DAY 2 COSTS*
> *Determined accounting and recovery of MISO charges through FCA*
> *Established reporting requirements*
> *Established FCA forecast and deviation reporting*
> *Directed investigation into best methods of assuring low-cost electricity*
> *Addressed treatment of wholesale revenues*
> - *Established FCA true-up for Otter Tail Power FCA*
> - *Cost of energy for Xcel separately shown on tariff/customer bills*
> - *Statutory changes address recovery of certain renewable costs*
>
> *To provide an opportunity for parties to update the record, the Commission is seeking comment on whether the investigation into the usefulness of the FCA should be continued, and if so, what issues should be pursued.*

Additional issues raised in comments to date include:

- *Incentives for controlling costs passed through the FCA*
- *Price signals*
- *Potential for fuel price manipulation*
- *Alternative FCA mechanisms such as the banding approach adopted in Wisconsin*
- *Data reporting including what is reported and how frequently*
- *Regulatory oversight of FCA data reporting*
- *Changes required in the FCA enabling statute; Minn. Stat. 216B.16, subd. 7*
- *Emission allowances and other environmental credits*
- *Other relevant issues*

The Department appreciates the opportunity to provide comments on the operation of the FCA, and offers the following comments which are consolidated from the comments and other information the Department has developed recently. These comments are intended to summarize and emphasize the high-level issues pertaining to fuel clause adjustments.

II. DEPARTMENT ANALYSIS

A. IMPORTANCE OF FCAS

The Department notes, first, that FCAs are important because the operation of the FCA directly affects the prices paid by Minnesota consumers for electricity. In other words, this discussion directly affects consumers' energy bills. Each month's fuel clause filing by each utility is, in effect, a mini-rate case pertaining to changes in fuel costs and any other costs allowed to pass through the FCA. It is important to ensure that these rates are reasonable.

In addition, with deregulation of the wholesale energy market, fuel and purchased power prices have become much more volatile. While utilities have raised this issue in support of the continuing usefulness of the FCA, the flip side of this argument is that weakened incentives for cost management of energy costs have become much more costly. In light of this development, it seems appropriate to reassess the tradeoff between positive and negative effects of the FCA. While the Department recognizes that utilities have certain incentives to keep FCA rates low, utilities also consider their fiduciary responsibilities to shareholders and may not have adequate incentives under a complete pass-through mechanism to dedicate sufficient resources to efforts to keep FCA rates low.

As such, the Department concludes that it is important to verify that the FCA mechanisms provide proper incentives for utilities to minimize FCA rates. It is important to ensure that utilities have sufficient incentives to devote the resources necessary to minimize fuel costs and

continue to ensure reliable service. Thus, the Department welcomes the continuation of the discussion in this docket.

B. BACKGROUND FOR INSTITUTING FCAS

The Department provides the following background information about fuel clause adjustments. FCAs did not always exist, and were set up under very different circumstances than exist today. Likewise, fuel clauses may not exist or may be structurally different today in different states. As noted previously in this docket, the following are reasons for originally allowing FCAs:

1. the FCA was intended to allow utilities to address fuel price volatility without filing frequent, expensive rate cases;

2. the FCA addressed costs that were presumed to be beyond the utility's control;

3. the FCA was intended to reduce a utility's business risk and thereby improve the utility's credit ratings;

4. wholesale rates for purchased energy were federally regulated at the time the FCAs were first put into place which provided another level of oversight for such costs included in automatic adjustments; and

5. the FCA provided a way to pass savings to ratepayers if the actual cost of fuel dipped below the base cost included in rates.

Even though some circumstances have changed since FCAs were first permitted, FCAs are still in place. Thus, subsequent to a rate case, increases and decreases in those costs are reflected in automatic rate changes to energy customers.

Because these rate changes affect ratepayers immediately, it is important to assess whether the utilities' level of fuel costs are reasonable and whether the utilities are allocating fuel costs and revenues appropriately between retail customers and wholesale transactions.

C. SUBSEQUENT CHANGES IN FEDERAL REGULATION

Prior to actions by the Federal Energy Regulatory Commission (FERC) that deregulated the wholesale market, fluctuations in wholesale prices were fairly small on a month-to-month basis. However, these fluctuations are now much greater than before. Hence, it is even more important to assess the reasonableness of rates that are automatically changed on a month-to-month basis.

Overall, MISO's Day 2 energy market both did and did not change the way utilities provide service to customers. On one hand, as noted by the Commission in its December 20, 2006 Order *Establishing Accounting Treatment for MISO Day 2 Costs*, MISO's tariff (approved by FERC) recharacterized the way utilities provide electricity for the customers they are obligated to serve

(native load customers), including retail customers. Traditionally the utilities generated most of the electricity needed to serve their customers, and bought or sold any surplus or deficit from or to neighboring utilities. In contrast, MISO's tariff describes virtually all electric generation as a sale of electricity into a wholesale market, and describes the provision of electric service to entail a purchase of power back from the market.

On the other hand, the Commission required utilities to continue to use the lowest cost resources to serve customers, so this fundamental aspect of service did not change. Moreover, the Commission required a significant amount of oversight of the activity of utilities in the MISO Day 2 market. To date, the Department's efforts in this oversight includes investigations, reports and various efforts to ascertain whether the utilities are, in practice, acting in the best interests of their customers in the Day 2 market.

D. OPTIONS FOR REGULATION

Our April 2004 comments discussed various ways to redesign the FCA, including:

1. Leave the FCA as it is, with audits and rates subject to change after the fact if indicated by investigation. This is Minnesota's current process. Its advantages are flexibility to respond to changes in conditions over time, ability to reflect current cost, and ability to match, fairly closely, energy costs with ratepayers who use energy. Its chief disadvantages are that typically ratepayers do not know what rates they must pay until after they have already used the energy. Moreover, this approach does not exert direct pressure on utilities to seek out and use cost discipline measures so it is difficult to assess whether utilities are acting appropriately in ratepayer interests. In addition, this is an after-the-fact review so it may not completely match what certain ratepayers paid and any adjustments to reflect what they should have paid. Moreover, utilities often argue that the Commission's authority to adjust rates after-the-fact is limited.[1] Despite these limitations, the Department notes that, even under this approach it may be possible to assess significant drivers of costs and revenues and build in incentives to minimize costs (such as the outage benchmarking discussed below) or appropriately recognize revenues. In addition, it is important for utilities to acknowledge the Commission's ability to revise FCA rates.

2. Reset FCAs on a periodic (quarterly, annual) basis with or without a true-up (rather than allowing the rate changes to flow through each month without the Commission expressly seeing these changes in rates). There are various ways of implementing this option. In the Department's April 2004 comments, the Department recommended that any such option should have rates set preferably at seasonally differentiated levels. One advantage of this approach is that, because ratepayers would know rates before they use energy, it would send known price signals, which

[1] See recent comments filed by Otter Tail Power in E017/AA-05-1228.

would allow customers to plan their energy use more effectively in advance. It would also give utilities more incentive to minimize net FCA costs since the utility's shareholders would benefit from reductions in net costs and be at risk for cost overruns. The main disadvantage is that it may be difficult to set the level of annual FCA rates due to volatility.

3. Allow utilities to recover changes in net fuel costs within a pre-determined range of rates set by the Commission. Like the option above, this approach could be established with seasonally differentiated levels. This approach would require changes in FCA rates only when warranted by changes in net costs outside of a set range. Since such changes may occur more or less frequently than once a year, this approach may require more or fewer changes in FCA rates than the second option outlined above. This approach would give utilities more incentive to minimize net FCA costs since the utility's shareholders would benefit from any reductions in net costs within the range and be at risk for any cost overruns in the range. However, it may be difficult to set the range, and the range may need to be updated frequently.

These options and others are still available to the Commission. To evaluate these options, it helps to have an overall framework, which recognizes that FCAs have advantages and disadvantages. If disadvantages of an option outweigh advantages, then that option should be abandoned or modified. If advantages of an approach are better than disadvantages, however, this option should be compared to other options that have net benefits to assess the best approach(es) to use.

In general, whatever option is used it should recognize the effects of FCAs and FCA structural changes on utility incentives and utility financial positions and provide for the appropriate adjustments in planning, ratemaking and other factors accordingly.

At this time, as discussed further below, the Department believes there may be advantages to continuing the FCA, at least for some utilities. The Department discusses serious concerns raised in the Department's recently filed Annual Automatic Adjustment (AAA) Report, Docket No. E,G999/AA-06-1208. Depending on whether and how those concerns are addressed in the AAA docket, it may be necessary to make adjustments to the operations of some utilities' FCAs.

The following discusses benefits and costs of FCAs.

1. Overall Benefits of Fuel Clause Adjustments

The main benefit of FCAs is administrative efficiency in avoiding the need for frequent rate changes as changes in net fuel costs occur over time. FCAs decrease rates charged to ratepayers if the net cost of energy declines. FCAs may also signal to credit rating agencies such as Standard and Poors that Minnesota has a favorable regulatory environment for utilities which may increase credit ratings for utilities and reduce overall costs of capital.

2. Overall Costs of Fuel Clause Adjustments

While FCAs were seen to provide the benefits noted above, there have been concerns from the beginning that allowing a pass-through in rates of changes in fuel costs could distort a utility's decision-making process, or at least lessen utilities' financial motivation to take whatever actions they could to ensure the lowest costs of energy.[2] Unfortunately, there appear to be examples of such distorted decision-making recently in Minnesota. The following discusses three such distortions that appear to be present in utility decision-making: not adequately planning for outages, not informing customers when fuel costs are high and not properly allocating costs between retail customers and shareholders. The Department notes below some ways that may address these distortions.

3. Outages

The Department recently filed comments[3] concerning an outage of a large baseload facility that was planned at the beginning of February(during a peak winter load month), at a time when weather tends to be cold in Minnesota and outages are costly. The Department noted in its comments:

> To ensure that rates charged to customers are reasonable, the Commission should remind IPL of its burden of proving that the rates IPL charges to its ratepayers – in its fuel clause adjustment or base rates – are reasonable. The Department also notes that, per Minnesota Rule 7825.2920, approval of automatic adjustment filings is subject to the provision that the Commission "on complaint or on its own motion, and after appropriate investigation, notice and hearing, may issue an order to fix at current levels, discontinue, or modify an automatic adjustment provision for an individual utility."

The Department has not seen adequate concern by the utility regarding the rates its customers paid during a time when locational marginal prices (LMPs) were significantly high to replace power from a baseload plant.[4] More generally, it has not always been clear that utilities have planned adequately for power outages. The Department's April 16, 2007 Report regarding the Annual Automatic Adjustments (AAA)[5] discussed the issue of outages and suggested some ways to give the proper incentive to utilities to address outages. The following is an excerpt from that report:

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[2] Please see the Department's April 5, 2004 comments in this docket for further discussion of the distortion of incentives.
[3] Please see the Department's February 22, 2007 comments in E001/PA-05-1272. The Company's subsequent response did not allay the Department's concerns.
[4] The Department intends to file additional comments on this specific issue in Docket No. E001/PA-05-1272, but raises it here for illustrative purposes.
[5] Docket No. E,G999/AA-06-1208.

It has become evident that generation outages can have a significant effect on LMPs in the Day 2 market. For example, if a large baseload plant goes out or stays out of service unexpectedly, other generators – typically at higher costs – must be dispatched to make up for the lost energy. MISO indicates that it does not have any decision rights regarding the IOUs' timing of planned outages. Thus, it is important to ensure that utilities have reasonable outage policies and reasonable contingencies in place for unplanned outages.

As indicated above, the Department has identified outages as a significant cause of increases in fuel costs. The Department has noticed in our monitoring of MISO Day 2 costs some concerns regarding the timing of planned plant outages. As a result, the Department notes that planned plant outages that occur during peak months will be scrutinized.

Overall, given the higher costs of outages, especially of baseload facilities, utilities should be prepared to explain the utilities' efforts to avoid outages and why it is prudent for ratepayers to pay for the replacement power costs.

Alternatively, given the myriad of issues to monitor regarding outages, there may be a more efficient way to address the effects of outages. As noted above, the procedures described by IOUs may be reasonable; however, it is clear that outages are still a significant factor causing higher energy costs. One way to ensure that Minnesota ratepayers are paying reasonable energy costs would be with a system that gives the right incentives to IOUs to be proactive in minimizing costs. For example, benchmarking outages costs (planned and unplanned) would give utilities a framework within which to minimize outage costs. The following are possible options for benchmarking:

- limit recovery of unplanned or extended outages to 90% of replacement purchase power costs,

- limit recovery of planned and unplanned outages to specified percentages of average LMPs for the outage period;

- calculate averages of plant outages in recent years (3 years or 5 years) for each plant and disallow costs of replacement energy for outages above 90% of the average, or

- calculate the expected level of outages for similar plants and disallow recovery of replacement energy for any outage lasting longer than these periods.

4. Price Transparency

The Department notes that utilities do not yet seem to have embraced the role of informing their customers about times when the cost of fuel is high. The conflict for utilities may be that utilities generally make the greatest profit, by selling the most energy, at the time when energy is most in demand and fuel costs tend to be the highest.

The Department raised this issue in a few places, including our recent AAA Report. We will review the utilities' responses to our request in that docket that utilities provide the following information:

1. How do utilities coordinate their use (dispatch) of interruptible demand with Midwest ISO's dispatch of generation units?

2. How do utilities decide to stop using interruptible demand programs? That is, what decision criteria are used to evaluate when interruptible demand is no longer a least-cost resource?

3. How can the wealth of information readily available regarding the cost of electricity be used to make better use of DSM resources?

We also discussed this issue in our comments on November 1 and December 1, 2006 in the Commission's *Solicitation of Comment on the Smart Metering Standard* (Smart Metering Docket) Docket No. E999/CI-06-159. The following is intended to boil down (and update where needed) our comments into general notes and a list of examples of actions that could be taken to help customers know when the best times are to conserve energy, based on those general comments.

Overall, the Department noted in its comments on the Smart Metering Docket that the "Day 2" market of the Midwest Independent System Operator (MISO) now provides an opportunity that did not previously exist:

> In addition, a major development occurred in recent years that affects the feasibility and effectiveness of time-of-day rates. Specifically, there is real-time data on wholesale energy prices that is now publicly available through the website of the Midwest Independent System Operator (MISO) in its MISO Day 2 energy market. This information was previously considered difficult to communicate to customers on a real-time basis. Availability of this information on a real-time basis by consumers who have internet access could help address this difficulty, if this data is communicated in an effective manner to consumers. These prices could give consumers better information about current energy

> prices and allow more informed choices about the best times to reduce energy use.

However, the Department has seen little evidence that utilities have begun to use information from the MISO Day 2 market to help their customers use energy wisely on behalf of all customers. The following highlights the action items from the Department's comments in the Smart Metering Docket are as follows:

- **Give customers clear, advanced information about times when fuel costs will be high**. For most customers, it will be necessary for them to know far in advance when energy prices are highest so they can take steps to reduce their energy use. Most customers need not know the precise time and the precise amount by which current energy costs are changing, but it would be helpful for all customers to have a general idea about the times at which prices are likely to increase. The Department notes that Minnesota is effectively moving toward time-of-use rates through the operation of the FCA, but there is no educational component to accompany this change.

- **Use information from MISO Day 2 Market**: At a minimum, the information that is being gained from the MISO Day 2 market can be used to help provide advance information to consumers. For example, utilities can use the pattern of energy prices developed to date to show that weather and plant outages will affect energy prices, to a larger degree than in the past. Customers need to be advised that their bills are likely to be higher during peak periods. Customers also need to be advised, in advance of the time when peaks occur, to take whatever measures are feasible for the customer to be able to either conserve energy overall or be able to respond to high energy prices on a short-term basis.

- **Promote conservation tools**: When peak periods occur, customers should again be encouraged to use energy conservation measures and peak reduction tools, when it matters most. For example, having peak energy alerts issued during peak days would be a helpful way to advise all customers to think about their energy use and take measures that might be available to them, such as running appliances at night instead of during peak periods.

- **Make more tools available to customers**: The more tools customers have available to respond to higher electricity prices, the more likely they will be to use at least one of these tools. For example, certain cooperative utilities use devices installed at customer locations that limit the amount of energy that can flow through to the customer's home or place of business. This option may be useful to offer to other utilities' customers on a voluntary basis. This tool would be particularly beneficial if consumers could see the amount by which they are reducing their bills by avoiding higher costs during peak periods.

- **Clearly tell customers what tools they have to reduce energy use:** The best way to encourage customers to respond to expected increases in energy prices is to make it as simple as possible for customers to respond. Utility and other websites should make it simple for customers to get information about programs their utility offers. For example, Dakota Electric Association has a website that shows energy conservation as a link on its homepage, with a list of programs offered.

- **Tell customers clearly how to use the tools**. To make the information tool as effective as possible, customers need to know what steps they can take to reduce energy use, with step-by-step guidance, and resources where customers can get the tools they need to lower their energy use.

- **Tell customers early and often how they can control energy use.** Generally, the more time (months, years) that customers have to respond to consistent price signals, the more opportunities they have to respond to the information. For example, they can choose to purchase more energy efficient appliances when it comes time to replace old appliances. Thus, even if customers aren't able to respond immediately to price signals, they will be better able to do so over time.

The Department also recommended in the Smart Metering Docket that the Commission work with other states to encourage these states to continue to work on implementing conservation and other demand-response tools, to help reduce the wholesale prices in the region. The Department notes that we are now participating in MISO's Demand Response Workgroup; however, we continue to encourage Commissioners to work with their fellow Commissioners in other states to pursue energy conservation and demand response. The upcoming MARC Conference the Commission is developing for June 2007 appears to provide an excellent opportunity for this discussion.

Finally, the Department noted in our Smart Metering comments that the utilities provided information about the programs already in place, but generally did not suggest a long-term plan for improving those programs. Recognizing that fuel costs have been increasing over the years, the Department recommended that the Commission request that each utility provide further information on the following:

- the utility's long-term plan for improving its ability to reduce energy costs,
- the utility's long-term plan to inform customers about increases in energy costs so they can respond in a timely manner,
- the utility's plan to replace its metering system (when planned, which types of systems are being considered, and why), and
- any other information the Commission considers to be important.

The Department notes that only IPL and OTP have responded to date to this information request.

5. Reasonable Rates

At the time the Department wrote its April 5, 2004 comments in this docket, the FCA did not allow ratepayers to recover increases in utilities' wholesale revenues from the amount that was computed in the utility's most recent rate case. This issue has changed for some utilities in the meantime, but not for all.

In our most recent AAA Report, the Department noted that:

> … there have been improvements in the MISO Day 2 market in 2006 compared to 2005. However, we have some concerns about some utilities' current efforts to minimize overall costs for retail customers and about most utilities' allocations of costs and revenues to retail customers and the wholesale sector. We continue to analyze whether utilities are capturing sufficient benefits of the MISO Day 2 market for Minnesota ratepayers under current procedures.

In the AAA Report, the Department also identified a series of concerns about the way utilities allocate costs and revenues between retail and wholesale customers. There appears to be a disturbing trend of allocating generally more costs to retail customers while allocating more revenues to wholesale transactions (which often benefit shareholders). To address this issue, the Department recommended, overall, that all costs and revenues related to the MISO Day 2 market should be allocated between retail customers and wholesale transactions on a MWh basis, whether the sale was ultimately to a retail customer or as a wholesale transaction. In other words, all costs and revenues should be allocated to all sales, whether the sale occurred in a retail or wholesale transaction. The MWh allocation basis appears to provide an equitable and transparent result.

III. DEPARTMENT CONCLUSIONS

As noted above, the Department appreciates the opportunity to continue this discussion. The Department also incorporates by reference our comments in the AAA Report (06-1208) and Smart Metering (06-159), along with the earlier comments in this docket.

The Department notes that there may be merit in continuing the FCA for most utilities at this time, with heightened oversight, including:

(1) outage benchmarking,

(2) revisions in the allocations of costs and revenues between retail and wholesale customers, and

(3) better use of MISO data to inform customers in advance about the times during the year when prices tend to be highest, and about times when prices are spiking, so that customers have more timely information about price increases.

The Department also notes that, depending on the circumstances and actions of utilities, the Commission may chose to make adjustments to the operation of a utility's FCA to address concerns that arise in practice. The Department has noted some concerns, for example, in its AAA Report. The Department looks forward to reviewing the responses by the utilities to the Department's AAA Report, along with the comments filed in this proceeding.

/ja

STATE OF MINNESOTA)
) ss
COUNTY OF RAMSEY)

AFFIDAVIT OF SERVICE

I, **Sharon Ferguson**, being first duly sworn, deposes and says: that on the **30th** day of **April, 2007** served **Minnesota Department of Commerce Comments**

DOCKET NO. E999/CI-03-802

XX by depositing in the United States Mail at the City of St. Paul, a true and correct copy thereof, properly enveloped with postage prepaid

XX by electronic filing

to all persons on the attached list:

see attached list

/s/Sharon Ferguson

E999/CI-03-802

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