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May 15, 2007

VIA eFiling

Dr. Burl W. Haar
Executive Secretary
Minnesota Public Utilities Commission
121 7th Place East, Suite 350
St. Paul, MN 55101-2147

Re: In the Matter of an Investigation into the Appropriateness of
Continuing to Permit Electric Energy Cost Adjustments
Docket No. E-999/CI-03-802

Dear Dr. Haar:

Pursuant to the Commission's Notice for Comments dated March 30, 2007, Minnesota Power submits its Reply Comments via eFiling in the above-referenced Docket. An Affidavit of Service is also enclosed.

Please call me at the number above should you have any questions regarding this filing.

Yours truly,

A handwritten signature in black ink, appearing to read 'C. D. Anderson', written over a horizontal line.

Christopher D. Anderson

kl
Enclosures
c: Service list

STATE OF MINNESOTA)
) ss
COUNTY OF ST. LOUIS)

AFFIDAVIT OF SERVICE VIA
EFILING AND
FIRST CLASS MAIL

Kristie Lindstrom of the City of Duluth, County of St. Louis, State of Minnesota, says that on the 15th day of May, 2007 she served Minnesota Power's Reply Comments in Docket No. E-999/CI-03-802 to Burl Haar and Sharon Ferguson via eFiling. The persons on the attached Service List were served via First Class Mail.

Kristie Lindstrom

Subscribed and sworn to before
me this 15th day of May, 2007.

Susan Romans
Notary Public



E999/CI-03-802

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**STATE OF MINNESOTA
BEFORE THE
MINNESOTA PUBLIC UTILITIES COMMISSION**

In the Matter of an Investigation into the
Appropriateness of Continuing to Permit
Electric Energy Cost Adjustments

Docket No. E-999/CI-03-802
REPLY COMMENTS

I. Introduction

Minnesota Power files these Reply Comments in response to April 30 Comments from the Department of Commerce (“Department”) and the Office of the Attorney General (“OAG”). Minnesota Power also finds the May 7 Comments of the Large Power Intervenor Group (“LPI”) in the AAA Report Docket (Docket No. E, G999/AA-06-1208) to be insightful for this proceeding and also makes reference to them herein.

II. Reply to Department Comments

The Department expresses a number of concerns about aspects of FCA management that it feels bear examination. However, the Department did not directly address whether this Docket is the appropriate venue for examining these issues. In its April 30 Comments, Minnesota Power asserted that while the instant Docket could be continued to examine FCA issues of concern, the Docket contains dated information, its action to date largely occurred prior to the significant MISO Day 2 proceeding and that at least some FCA matters remaining to be addressed may be better handled in issue or utility-specific proceedings. Given that the Department’s own comments build off of and incorporate previous comments filed in the AAA Report and Smart Metering (E-999/CI-06-159) Dockets, as well as the MISO Day 2 proceeding (Docket Nos.: E-002/M-04-1970, E-015/M-05-277, E-017/M-05-284 and E-001/M-05-406), Minnesota Power asserts that those specific Dockets could be utilized to address matters raised in this proceeding or other utility-specific or issue-specific proceedings could be initiated to address remaining FCA issues.

Regarding the Department's FCA policy positions, while Minnesota Power has filed comments that at a high level could support the Department's wish to continue the discussion about the FCA in this Docket or others to explore concerns, and while we may support some specific areas of examination the Department has discussed, Minnesota Power disagrees with the Department's starting point that suggests that the deregulation of the wholesale market has "weakened incentives" for FCA cost management.¹ Similarly, Minnesota Power disagrees with the Department's broad conclusion regarding how the current FCA "does not exert direct pressure on utilities to seek out and use cost discipline measures."² While the wholesale energy market has suffered increased volatility prior to and coincident with the introduction of the MISO market (particularly with the relatively recent presence of significant gas-fired peaking generation) and market prices are generally higher than energy costs from base loaded, older utility assets, there is no evidence that the simple presence of the market itself or the structure of the FCA itself has somehow made utilities less responsible in managing the FCA. Minnesota Power's FCA is under continual scrutiny by its Large Power customers (LPI) as well as the ongoing (monthly) analysis of the Department. Minnesota Power does not see the FCA as a license to be less diligent about fuel costs than it otherwise would be and it does not believe there is evidence in the record currently to come to this conclusion about Minnesota Power or any other utility.

The Department suggests that utilities have no incentive to lower purchased power costs flowing through the FCA. At the same time, in a separate docket, the Department has proposed a "benchmarking" system that appears to only penalize utilities for passing market energy costs through the fuel clause during generator outages. Minnesota Power hopes that a broad or specific fuel clause related investigation would begin with an adequate understanding of fuel clause dynamics and management and then find ways, based on complete information, to improve upon the steps utilities take to lower fuel clause costs. An adequate understanding of utility FCA management does not currently exist for making recommendations to change that management.

¹ See Department Comments, page 2

² See Department Comments, page 4

Minnesota Power can agree, as evidenced by its Comments, that major aspects of the FCA that were not a part of the MISO Day 2 proceeding could be analyzed subsequently in this Docket (or others) to provide an entire picture of major FCA elements and FCA cost management. With that foundation, sensible policy FCA modifications that may be necessary could be proposed and debated based on an informed discussion with final recommendations made to the Commission. The Department's own Comments suggest that the record needs to be developed before parties jump to any conclusions about what is appropriate or fair regarding possible FCA policy changes. On page 5 of its Comments, for example, the Department discusses the difficulties inherent in attempting to set annual FCA rates or establish FCA ranges, which are alternatives the Department suggests as possibilities to the current FCA that could be explored. The Department also notes further in this same section of its Comments the necessity to weigh advantages and disadvantages of potential FCA options in order to arrive at conclusions. Minnesota Power agrees with this measured, reasoned approach. Certainly more examination of FCA design elements, dynamics, advantages and disadvantages needs to occur, along with adequate dialogue among all stakeholders, before any broad conclusions are reached concerning utility FCA management or possible FCA changes.

The Department cites three potential "distortions" in utility FCA decision making about which it is concerned. These include not adequately planning for outages, not encouraging price transparency by informing customers about high fuel costs and not properly allocating costs between retail customers and shareholders.³ Minnesota Power takes issue with the Department's broad-brush portrayal that these "distortions appear to be present in utility decision making" or that they may "lessen utility financial motivation to take whatever actions they could to ensure the lowest cost of energy", based on the lack of information in the record. We discuss these items as examples in the succeeding paragraphs, both with regard to specifics of our own performance and to help illustrate the larger concern of parties drawing conclusions about utility FCA performance overall based on an inadequate record.

³ See Department Comments, page 6

1. Outage Management. Minnesota Power takes tremendous care to minimize costs related to generation outages, and has been frequently communicating with its largest customers for many years about outage practices and management, without any regulatory prompting. Minnesota Power would be quite willing to share its efforts on outage management in more detail in detail in this proceeding.
2. Price Transparency.
 - A. The Department “notes that utilities do not yet seem to have embraced the role of informing their customers about the times when the cost of fuel is high”. Minnesota Power assumes the Department intended to reference those times when market energy prices are high. Minnesota Power, in fact, has had an ongoing real time market pricing notification system for approximately ten years which it employs for about 60% of its load (large industrials) for interruptible energy purchases. This system gives large customers daily information about market prices for the purposes of making operating decisions. While this may not be an entire answer to concerns about the need for price signals, it is evidence that Minnesota Power does care about sharing market pricing information and does so regularly with a majority of its load with most likely the greatest opportunity to reduce usage.
 - B. Price notification and price transparency are best addressed in connection with utility-specific proceedings via the development of real-time pricing.
 - C. The Department’s price notification proposal also needs to recognize that the utility needs to be purchasing a somewhat significant amount of energy in the real-time market in order for the price notification process to work. High market prices have no effect on Minnesota Power customers if Minnesota Power is not purchasing significant MWh on an hourly basis. This is yet another reason why further information is necessary for proposals like this to take shape.
 - D. Additionally, Minnesota Power wishes to underscore that its profits do not increase with higher fuel costs as is mistakenly suggested by the Department in its remark: “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.” (See Department Comments, page 6.) In discussing any purported benefits to utilities from high energy market prices, it is extremely important for parties to understand the fundamental difference between revenues and

profits. Higher fuel costs increase revenues but Minnesota Power, in fact, does not make any more money on energy that is purchased at a higher price per MWh.

3. MISO Day 2 Cost and Benefit Allocation. As discussed on page 11 of its Comments, the Department expresses concerns about how some utilities have applied judgments the Department sees as detrimental to retail ratepayers in apportioning MISO market costs and benefits between wholesale and retail sales. Minnesota Power has been allocating MISO related costs and benefits on a straightforward MWh basis for both retail and wholesale transactions, without any regulatory prompting. Minnesota Power was even positively recognized by both the Department in its AAA Report analysis and the LPI in its Comments in that Docket for employing such a methodology versus attempting to make subjective decisions about market cost allocation which could unfairly affect customers.

Minnesota Power believes it is important in this proceeding to fully examine the issues discussed above, or any others that may be posed as possible concerns, before arriving at conclusions about specific utilities or utilities as a whole regarding FCA performance. Minnesota Power feels a disservice would be done to all stakeholders to conclude there is a blanket and/or ongoing problem with any or all utilities on every issue that may be raised based on inadequate information. Like the MISO Day 2 Docket, the more regulatory agencies understand about the market elements and operating decisions utilities deal with day-to-day, as well as understand to a greater extent the steps utilities take to manage and control purchased power costs, the better future decisions regarding FCA policy will be.

In summary, after reviewing the Department's Comments, Minnesota Power reiterates its contention earlier in this section of its Reply Comments that this proceeding or any other that addresses FCA issues would benefit from a thorough analysis of the kinds of concerns the Department raises and an avoidance of reaching conclusions about the efficacy of utility cost management on the FCA or arriving at FCA "solutions" for FCA "problems" until adequate information is in the record. Minnesota Power feels it would be most effective to discuss and explore more of these items and their details once the direction of a continuation of this proceeding is established.

III. Reply to OAG Comments

On Page 4 of its Comments, the OAG cites a concern about “extra-statutory” FCA recovery on such things as wind curtailment payments, MISO Day 2 charges and hedging. The OAG claims items like these are neither fuel costs nor costs for wholesale energy purchases. Minnesota Power maintains that all three of these items, as examples, are and should be recovered through the FCA. Wind curtailment payments are part and parcel of wind energy purchase contracts. It is fallacious to suggest wind curtailment payments are not part of energy costs. MISO Day 2 charges which are related to purchasing energy for native load are recoverable through the FCA and gained that designation after an extensive Commission proceeding designed to address their FCA recoverability. Energy market hedging strategies are designed to help remove some of the cost risk for end use customers and thus legitimately are costs of procuring purchased power. The OAG’s attempts to narrowly define recoverable FCA costs by naming the preceding items as “extra statutory” are an unrealistic interpretation of items that are inextricably linked to securing energy supplies. Also, the OAG fails to recognize that it is the Legislature, not the Commission, that decides what statutory changes, if any, should be made to Minn. Stat. §216B.16, subd. 7. If the Legislature felt that the Commission had taken an “extra statutory” approach to FCA approvals, the Legislature is on notice of the Commission’s actions and could have responded accordingly.

The OAG also makes a seemingly positive reference to the previous “relatively rigid approach” to price regulation in the wholesale market as compared to today’s increasing reliance on market forces. In this discussion, the OAG appears to presume that the presence of market forces alone should call into question the purpose and justification of the FCA.⁴ While the markets now are more volatile, there is no evidence in the record that competitive wholesale energy supplies are always or absolutely bad for consumers or that the market itself may not be naturally modified over time by the economic forces of additional supplies or increased transmission access that may ameliorate volatility concerns. There is also no evidence that the more “rigid” markets of the past were or would still be a better value for FCA purchases than the markets of today, even though

⁴ See OAG Comments, page 5

they may have been less volatile.⁵ Finally, the OAG seems to communicate a sense that utilities should be held responsible for wholesale market activity that is deemed less favorable to ratepayers which would be an illogical and patently unfair conclusion.

In its discussion of price signals, the OAG suggests that because the MISO market was implemented, “ratepayers are no longer protected through (federal) oversight.”⁶ In fact, FERC still regulates the MISO market and has instituted functions such as the MISO Independent Market Monitor with an explicit charge to track market activity and investigate reports of potential manipulation. The OAG goes on to discuss how the FCA, “*as applied today*,” (emphasis added) represents a rolling average of costs rather than a real time price. This wording seems to suggest that FCA cost averaging methodology is somehow a new application. The FCA has been a rolling average since its inception. This averaging methodology is not a new institution. It also is important to understand that the FCA was not originally conceived as a real time pricing mechanism intended to alter consumer behavior and the utilities have not represented it to be one. Real time pricing mechanisms such as Minnesota Power’s interruptible tariff or Xcel’s time of use programs were consciously established to send current price signals to affect consumer usage; the FCA was not established with that goal in mind. If it is determined through this proceeding or others that additional utility time of use price signal programs are in order, they can be established to provide that function. The FCA was and is intended to be an ongoing true-up for the fluctuation in basic purchased power and fuel costs, not a time of use mechanism.

The OAG concludes its comments with an unfounded presumption that “the FCA...suffers from numerous problems and unfairly subjects Minnesota ratepayers to undue risks solely to the benefit of the utility suppliers.”⁷ This type of broad-brush conclusion about “problems” in the FCA stemming from the market, in fact, has not been demonstrated in the record. Nor has there been any dialogue in the record of how to solve

⁵ The MISO Day 2 Stakeholder Report and process leading up to the report, in fact showed how Minnesota utilities benefited from a broader regional market for energy purchases, rather than being limited to only a few local counterparties.

⁶ See OAG Comments, page 8

⁷ See OAG Comments, page 10

any problems whose existence may eventually be established with adequate information. The OAG overreaches in its conclusions about the state of the FCA and its suggestions of action regarding it. The record does not support the sweeping conclusions the OAG attempts to draw about FCA policy.

The OAG fails to recognize that the elimination of the FCA as a cost recovery mechanism does not eliminate the issues identified by the OAG as problems; the cost recovery mechanism for purchased power costs will simply shift from being the focus of monthly and annual fuel clause filings to frequent utility rate cases where the cost of fuel and purchased power will be established for cost recovery. By seeing first hand how fuel clause issues are addressed by the Minnesota and Wisconsin jurisdictions, Minnesota Power feels quite strongly that ratepayers and utilities are better served by the monthly and annual fuel clause proceedings present in the Minnesota regulatory environment.

Finally, when considering the OAG's unsubstantiated premise that the introduction of deregulated markets has caused FCA problems, it must be acknowledged that changes in federal energy policy can be expected to happen from time to time with or without full engagement and concurrence by the states. Investor-owned utilities under state and federal regulation must work with other stakeholders to navigate the requirements of both "masters" while ensuring customers are treated properly and the utility, as a business with shareholder responsibilities, does not suffer unfounded harm. The MISO Day 2 proceeding amply illustrated that state regulators are fully capable of identifying federal policy changes that require their attention and investigation and that they are fully capable of making modifications in regulatory requirements they deem necessary in light of such changes with adequate stakeholder input.

IV. LPI AAA Report Comments

Minnesota Power appreciates the thoughtful Comments about FCA management offered by the LPI in the AAA proceeding and finds them relevant to discuss in this Docket. As Minnesota Power has readily acknowledged to members of the LPI directly on many occasions and through its comments made in this proceeding, the LPI has a

significant interest in FCA management. Minnesota Power has made it a practice to formally and informally brief LPI members on details of FCA performance and Minnesota Power's efforts to keep FCA costs down.

The LPI has put forward some initial thoughts on potential ways to change the structure of the FCA with the intention of eventually arriving at a new design that would encourage optimal utility performance. Whether the FCA mechanism is changed or not to reflect these or other ideas in the AAA proceeding or elsewhere, Minnesota Power appreciates the mention of a balance needing to be struck between minimizing outages and managing maintenance expenses. The LPI, perhaps more than any other non-utility party in an FCA proceeding because of its industrial composition, understands that reasoned decisions about maintenance investments using predictive and preventative tools along with the insights of experienced plant personnel and equipment vendors are arrived at following the considerations of multiple operating issues. Any notion that there is some sort of simple "cookbook" to follow for decisions about all maintenance matters or that spending an unbridled amount of money on maintenance to avoid any and all outages is appropriate is incorrect.

Minnesota Power agrees with the LPI that the Department's four suggestions in the AAA Report for reducing the impact of outages on FCA costs are all punitive. Minnesota Power also believes, as it has discussed previously in these Comments, that these suggested possibilities are presumptive because they are made before a full record has been established and evaluated on the issues these suggestions are intended to address. Minnesota Power has said that it believes utility FCA performance should be examined in detail to arrive at an educated understanding about it before suggestions are made or conclusions are drawn about any actions that might be taken. This recommendation would apply to this Docket, the AAA Docket or any other FCA-related docket and such an examination would be similar to the stakeholder process that was followed in the successful MISO Day 2 proceeding.

Many of the LPI's Comments had to do with setting up a strategy to "share the risk and reward" on the FCA, yet the LPI also acknowledged that "this is easy to say, but difficult to come up with".⁸ Minnesota Power suggests that the challenge of arriving at the right conclusions about the FCA and any possible actions to be taken concerning the FCA rests "in the details" and the details have not yet received a full and fair presentation or examination in this proceeding. Thus, while Minnesota Power respects the suggestion of possible ideas for FCA changes made by the LPI (as well as other parties), it also respectfully asks all stakeholders to allow an examination of FCA performance concerning the issues to be addressed before attempting to apply possible remedies in this proceeding, the AAA Docket or other proceedings.

The LPI also offers the suggestion of exploring how Minnesota Power might provide incentives to large customers to schedule their maintenance outages to coincide with Minnesota Power's planned unit outages, given the unique opportunity such an arrangement might have on reducing Minnesota Power's outage energy purchasing requirements. Minnesota Power thinks this idea is worthy of study and would look forward to discussing it further with the LPI and other parties.

IV. Conclusion

Minnesota Power believes that any potential changes to the FCA or decisions about its components or management must be considered and made with the benefit of a full record, either in this proceeding or other issue or utility specific proceedings that deal with the FCA. Drawing conclusions that changes must be made to FCA management or asserting what particular changes should be made to the FCA without adequately gathering and analyzing complete information about whatever aspect of FCA performance is under consideration would not be responsible and the outcomes of such a process are likely to be either ineffectual or detrimental. The MISO Day 2 proceeding is an excellent example of how FCA policy changes were navigated by stakeholders based

⁸ See LPI Comments, page 3

on full information to arrive at an effective, actionable outcome. A similar process could be engaged in this Docket, the AAA Docket or other proceeding for the FCA.

Dated: May 15, 2007

Respectfully submitted,

/S/

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