BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Nancy Lange	Chair
Dan Lipschultz	Commissioner
Matthew Schuerger	Commissioner
Katie J. Sieben	Commissioner
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In the Matter of an Investigation into the Appropriateness of Continuing to Permit Electric Energy Cost Adjustments

ISSUE DATE: December 19, 2017

DOCKET NO. E-999/CI-03-802

ORDER APPROVING NEW ANNUAL FUEL CLAUSE ADJUSTMENT REQUIREMENTS AND SETTING FILING REQUIREMENTS

PROCEDURAL HISTORY

On June 2, 2016, the Commission issued an order in this docket asking the Department of Commerce, Division of Energy Resources (the Department) to prepare and file a proposal for the recovery of energy costs delivered to customers, including possible reform of the fuel clause adjustment (FCA) mechanism, under which utilities adjust their rates monthly and subsequently file monthly and annual reports that are reviewed for accuracy and prudence.

On March 8, 2017, the Department filed a proposal for reforming the FCA mechanism.

On April 28, 2017, the following parties filed comments on the proposal: Otter Tail Power Company (Otter Tail), Minnesota Power, Xcel Energy (Xcel), the Office of the Attorney General (OAG), the Minnesota Chamber of Commerce (the Chamber), and the Minnesota Large Industrial Group (the Large Industrial Group).[1]

On May 26, 2017, the Department, the OAG, and the Large Industrial Group filed reply comments.

On October 19, 2017, the Department's proposal came before the Commission.

[1] The Large Industrial Group is an ad hoc consortium of large industrial end-users of electricity in Minnesota: ArcelorMittal USA; Blandin Paper Company; Boise Paper; Enbridge Energy, Limited Partnership; Gerdau Ameristeel US Inc.; Hibbing Taconite Company; Mesabi Nugget Delaware, LLC; PolyMet Mining, Inc.; Sappi Cloquet, LLC; United States Steel Corporation; United Taconite, LLC; USG Interiors, LLC; and Verso Corporation.

FINDINGS AND CONCLUSIONS

I. Background

Minn. Stat. § 216B.16, subd. 7, authorizes the Commission to allow a public utility to automatically adjust charges for the cost of fuel. Under the existing fuel clause adjustment (FCA) mechanism, Minnesota's rate-regulated electric utilities adjust their rates monthly and subsequently file monthly and annual reports, which are reviewed for accuracy and prudence. The adjustments reflect, on a per kilowatt hour basis, deviations from the base cost of energy established in the utility's most recent general rate case.

In 2003, the Commission initiated an investigation to explore possible changes to the FCA, inviting stakeholders to comment on the purpose, structure, rationale, and relevance of the current FCA. In particular, the Commission asked participants to address whether the FCA continues to be an appropriate regulatory tool. Stakeholders did not reach consensus on possible changes, with utilities emphasizing the continuing need for the existing FCA framework and other stakeholders recommending changes to the FCA mechanism.

The Commission subsequently asked the Department to make a proposal for possible changes to the FCA mechanism, including identifying ongoing problems with the existing FCA and potential solutions that would better incentivize utilities to manage and control fuel costs. The Commission also asked that the Department identify the costs or cost categories that would be affected by possible changes.

II. The Department's Proposal

In response to the Commission's request, the Department filed a proposal that described ongoing issues with the existing FCA mechanism and offered a new approach aimed at addressing those issues and achieving the goal of better incentivizing utilities to manage and control fuel costs.

The Department stated that the current system under which utilities are automatically and immediately reimbursed for costs incurred unreasonably favors cost recovery and deters utilities from more effectively minimizing their fuel costs. The Department cited a 2009 report from the National Regulatory Research Institute that describes the importance of retrospective review of utility actions, which incentivizes utilities to better manage costs and avoid cost disallowance.

In assessing the existing monthly FCA mechanism, the Department identified five primary issues.

First, the monthly FCA diminishes the effectiveness of price signals by changing the price of fuel after a customer uses the energy, reducing a customer's ability to make decisions about usage based on cost. Second, a utility is not incentivized to minimize fuel costs in the same way a utility is incentivized to manage costs between rate cases. Eliminating the monthly adjustment would motivate the utility to more carefully manage fuel costs. Third, risk management currently resides with ratepayers, not shareholders, and is inconsistent with how a utility manages its other costs. Fourth, the FCA incorporates too many adjustments, which hinders Commission review of

the reasonableness of the cost relationship across rates. Fifth, the lack of effective price signals preempts customers from making the most efficient choices about energy usage.

The Department noted several circumstances illustrating the issues identified above. For example, planned outages are not scheduled with the goal of minimizing expected costs for replacement power during outages; unplanned outages occur more frequently due to lower spending on generation maintenance than the amount included in base rates. And, there are issues with contractor performance, such as quality and financial accountability, as well as inadequate oversight of contractor work resulting in unexpected but preventable outages. Further, the Department stated that utilities do not sufficiently share information on outages to help prevent similar outages and do not develop plans for minimizing replacement power costs during extensive outages.

In proposing modifications to the existing FCA mechanism, the Department identified several goals: giving customers clear and timely information about energy costs; allowing customers to take action to respond to expected increases in energy costs; giving utilities the opportunity to recover reasonable costs; holding utilities accountable for the energy costs they charge; eliminating a utility's incentive to minimize maintenance costs built into base rates and increase replacement energy costs; providing, where feasible and reasonable, more certainty about energy prices; and making better use of limited resources to assess FCAs.

To achieve these goals, the Department developed a framework that would include the following:

- The Commission would, in a rate case or separate proceeding, set the cost of a utility's fuel, power purchase agreements, and any other fuel-related rates, considering a utility's forecast of per kWh costs. The rate would be set for each month at a $/MWh amount.

- The utility would be required to notify customers in advance of implementation of the rate.

- There would be no monthly adjustment to the fuel clause after the Commission sets the approved rate, but the Commission could, on an annual or biennial basis, reset the fuel clause rate if known and measurable changes warrant a reset.

- Under varying scenarios, the utility may be allowed to track changes in its $/MWh fuel costs that occur throughout the year (or biennium) with or without a carrying charge.

In addition to the framework described above, the Department proposed four scenarios addressing whether a utility should be allowed to request a true-up if actual fuel-related costs are higher or lower than the fuel rate set by the Commission. Under two scenarios the Department offered for consideration, the utility could request to true-up any over or under-recoveries, either annually or biennially. In a third scenario, the utility could request a true-up only in a subsequent rate case. And in a fourth scenario, there would be no true-up.

Under the options where utilities could track changes in monthly fuel costs and request a true-up,

a utility may recover under-recoveries if revenues are lower than actual fuel-related costs and the utility demonstrates that it acted prudently in incurring the additional costs. In addition, the Department's proposal considered the use of a sharing incentive mechanism, to further incentivize better cost management, that would limit the percentage of under or over-recoveries subject to true-up. In other words, a utility would be allowed to retain a percentage (one or two percent) of over-recoveries or would be required to forgo a percentage of under-recoveries, and then only be allowed a true up of the remaining percentage of over- or under-recoveries.

Under all scenarios proposed, each utility would file a "lessons learned" document after three to five years to assess how effectively the mechanism is working.

The Department ultimately recommended that the Commission adopt the framework set forth above, with the option to reset the fuel cost rate annually, if necessary, and to authorize utilities to track changes in fuel costs without a carrying charge and to annually request a true-up of over- or under-recoveries (without a sharing mechanism). Under this scenario, the fuel rate would be set in advance for each month; monthly rates may differ, depending on fuel costs during, for example, summer months.

The Department stated that a utility's filing must include: documentation supporting proposed fuel rates; disclosure of all power purchase agreements; cost estimates of each fuel type and the proportion of each fuel type; a description of any models used to develop the proposed $/MWh fuel rates, including a description and justification of inputs and formulas used for all fuel types; and documentation of sales forecasts. Additionally, the Department recommended that if a utility demonstrates that actual costs differ significantly over time, or the Commission determines that the FCA rates are no longer reasonable, the Commission reset a utility's FCA rates.[2]

A. Comments Supporting the Proposal

The Chamber of Commerce, the Large Industrial Group, and the OAG supported the Department's recommended proposal.

1. The Chamber of Commerce

The Chamber concurred with the Department's observation that utilities have little incentive to minimize fuel costs. For example, while utilities are expected to minimize between rate cases their fixed operations and maintenance costs (which are included in base rates that do not fluctuate based on actual costs), the resulting savings accrue to the benefit of shareholders or conversely incentivize utilities to spend elsewhere, including on replacement power costs. The Chamber stated that automatic recovery under the FCA then hinders a thorough review of the prudence of those costs, particularly in the context of how a utility manages its other costs.

The Chamber supported the Department's recommended proposal, with the option to annually review a utility's fuel clause rate. The Chamber also recommended implementing a one or two percent cost-sharing mechanism that would allow ratepayers to retain one or two percent of

[2] In reply comments, the Department stated that if the recommended changes to the FCA are made, the Commission should grant a variance to the FCA rules, particularly Minn. R. 7825.2600, subp. 3, which governs when electric utilities calculate and apply their monthly automatic adjustments.

under-recoveries and would allow the utility to retain one or two percent of over-recoveries. A true-up would be used to reallocate any remaining over- or under-recoveries.[3]

2. The Large Industrial Group

The Large Industrial Group supported the Department's recommended proposal, stating that the existing FCA mechanism in effect shifts the burden of proof to ratepayers. The Large Industrial Group acknowledged that a utility bears the burden to demonstrate that its costs are prudent and reasonable, with any doubt resolved in favor of ratepayers. But the Group stated that stakeholders representing ratepayers wind up shouldering the burden to obtain, through extensive discovery, evidence related to whether amounts already collected were imprudently incurred and whether refunds to ratepayers are warranted.

The Large Industrial Group emphasized that disputing prudence after costs have been recovered dilutes the burden on utilities by lowering the level of scrutiny a utility faces in demonstrating prudence, transposing the role of the ratepayer and the utility. Further challenging cost recovery is the difficulty of accessing, months or years later, data and other relevant evidence germane to a prudence determination. The Large Industrial Group asserted that the Department's proposal is the best approach to correcting this misalignment by ensuring that utilities bear the burden to promptly file detailed relevant data addressing questions of prudence.

3. The OAG

The OAG recommended that the Commission adopt the Department's recommended proposal to modify the FCA, stating that the existing mechanism does not sufficiently incentivize utilities to manage their fuel costs.

Specifically, the OAG stated that utilities are not encouraged to competitively pursue the most cost-effective fuel contracts because fuel costs are directly passed on to customers. The OAG claimed that the Department's proposal to set the fuel clause rate in advance will incent utilities to better manage their monthly fuel costs to avoid cost overruns that would be subject to a subsequent true-up, thereby placing the financial risk with utilities, not ratepayers. Under the current system, the OAG stated that regulatory agencies bear the responsibility to persuade the Commission to authorize a return of cost overruns to ratepayers after utilities have already collected those amounts through the FCA.

Further, the OAG concurred with the Department's assertions that under the Department's proposal price signals will be more effective because customers will better understand their bills.

The OAG opposed a cost-sharing mechanism, stating that cost savings is not likely to occur within the one-year timeframe of the Department's proposal and that the Commission should instead revisit the issue after at least one year of experience with the new FCA process. The

[3] Independent of the Commission's decision on the FCA mechanism, the Chamber also recommended a rate design change that would require the costs of wind and solar to be recovered through the FCA using a composite allocator that would assign the capacity value of solar at 50 percent and the capacity value of wind at 15 percent.

OAG also recommended that the Commission consider opening a rulemaking proceeding to amend its existing FCA rules.

B. Comments Opposing the Proposal

Xcel Energy, Minnesota Power, and Otter Tail Power each opposed the Department's proposal.

1. Xcel Energy

Xcel opposed the Department's proposal, disagreeing with the Department's assertions that the existing FCA mechanism is fundamentally flawed and stating that costs recovered through the FCA are primarily outside the Company's control.

Xcel stated that the FCA effectively serves a critical function by reducing volatility of operating margins and therefore risk, as perceived by financial markets, resulting in a lower cost of debt that benefits ratepayers. Financing investments and operations at a reasonable cost is fundamental to the Company's financial health, and Xcel stated that the FCA is an important part of its stable financial structure. Xcel also stated that the unique characteristics of fuel costs – they are considerably large, market-driven, and potentially volatile – warrant recovery between rate cases. Changing the cost recovery mechanism is likely to increase hedging to offset volatility, increasing costs to ratepayers.

Xcel pointed to historical FCA data in support of its contention that ratepayers benefit from a timely pass-through of cost savings. According to the Company's data, the per-kWh cost of electricity has decreased since 2009; ratepayers have benefitted from the decreases as well as monthly recovery of those savings through the FCA. Xcel also noted that the Department's proposal to conduct annual true-ups, which would not be implemented for at least one year, could lead to delayed recovery, causing some customers who did not consume more energy to pay disproportionally higher rates.

Xcel stated that the existing FCA mechanism eliminates the need for frequent rate cases, which are costly to ratepayers, and has facilitated implementation of the Renewable Energy Standards. Xcel also countered the Department's claim that a non-adjustable fuel clause rate would send more accurate price signals to customers; because actual costs fluctuate monthly, a more immediate true-up sends a more accurate price signal than a subsequent true-up that occurs one or more years later.

Xcel stated that a proposal that focuses on cost categories such as replacement power costs related to utility performance is a better approach to modifying the FCA and stated that eliminating the monthly fuel clause is both an overly broad approach and an unnecessary change in light of the benefits of the FCA.

Further, Xcel stated that to implement a new FCA mechanism, the existing FCA rules would need to be amended.

2. Minnesota Power

Minnesota Power opposed the Department's proposal, stating that the problems described in the proposal are vague and lack sufficient detail to justify the recommended changes.

In disputing the Department's claim that utilities are not incentivized to minimize fuel costs in the same way that they are incentivized to minimize costs between rate cases, Minnesota Power pointed to its large industrial customers, who place particular emphasis on keeping fuel costs as low as possible. They make up 60 percent of Minnesota Power's revenue, and the FCA is approximately 40 percent of their monthly bills. Because these customers are globally competitive companies whose energy costs bear on their financial viability, they actively and effectively advocate for lower fuel costs.

The Company also claimed that it takes reasonable steps to reduce the cost of replacement power by considering numerous market factors in deciding when to take a generating unit offline. These include weather, load, generation outages, transmission outages and constraints, wind forecasts, and MISO imports and exports. In addition to market factors, the Company considers personnel safety, environmental compliance, resource availability, and potential risk to equipment if the outage is delayed. After calculating outcomes under various scenarios, the Company determines the most prudent outage schedule.

The Company also disputed the claimed correlation between lower spending on operations and maintenance costs and increased spending on replacement power. The Company filed data showing that in no year has the Company spent less on maintenance than the maintenance expense approved in the Company's 2010 rate case.

Minnesota Power also claimed that the Department does not specify how various cost categories would be treated and stated that changing the FCA in a manner that delays cost recovery could adversely affect the Company's credit rating by increasing imputed debt and therefore the cost of capital, which would likely increase ratepayer costs.

3. Otter Tail Power

Otter Tail opposed the Department's proposal, challenging the Department's claims that utilities need better incentives to increase efficiency.

Otter Tail stated that the Company does not factor FCA recovery into its approach to operations and maintenance spending. The Company explained that fluctuations in spending vary and that risk management requires careful balancing of capital expenditures, operations and maintenance spending, and outage costs. Further, prudent and responsible management relies on a coordinated assessment of known risks, potential mitigation relative to the cost, and the probability and magnitude of potential harm. The Company conducts such analyses in managing its own operational risks and contends that the existing FCA mechanism is a balanced approach that benefits ratepayers and the Company.

Specifically, Otter Tail stated that in 2013 and 2014, several factors contributed to higher than

forecasted energy costs but that in 2016, energy costs were lower than forecasted, and ratepayers received the savings, without delay, through the FCA.

Otter Tail also stated that it is not clear how any true-up would occur, including how long it would take to implement recovery and over what period of time. In Otter Tail's case, the Company stated that the FCA's average monthly bill impact between 2012 and 2016 ranged from less than one to two dollars, an impact that does not warrant drastic changes in how the Company recovers its fuel costs.

C. Commission Action

The Commission concurs with the Department that a new approach to the FCA mechanism is warranted. Minn. Stat. § 216B.16, subd. 7, governs the automatic adjustment of charges as a result of changes in the cost of fuel or wholesale energy, giving the Commission the authority to decide whether to authorize automatic adjustments and the discretion to determine the framework for implementing such adjustments.

By design, the existing FCA mechanism is aimed at providing a quick reconciliation of fuel costs beyond a utility's control. But over time, and in the experience of non-utility stakeholders, identifying costs that are beyond a utility's control has become less clear, and the sorting of facts more complex as other items, including purchased power, are recovered under the FCA. The Department stated that in this context, understanding the relationship among costs, including those contained within the FCA and those recovered in base rates, has also become increasingly difficult.

In response, the Department proposed a method for more closely examining all costs included in the FCA *prior* to rate adjustments by setting a fuel rate in a separate proceeding prior to cost recovery. The Commission concurs that setting an annual fuel rate is likely to more equitably balance the interests of a utility and its ratepayers, particularly in light of the fact that an electric utility's expected fuel costs are generally predictable. Fuel contracts and anticipated seasonal variations in fuel costs limit the amount of unexpected changes in rates, and it is therefore reasonable to annually set a utility's monthly fuel rate.

Unanticipated costs are, however, less predictable. For example, replacement power costs as a result of an unexpected outage can cause costs to exceed forecasted rates. Under the existing FCA mechanism, such costs are automatically recovered by a utility with a subsequent prudence review conducted simultaneously with the review of all other FCA costs. But under the Department's proposal, a utility that incurs costs above the approved fuel rate may promptly petition the Commission for cost recovery, subject to a prudence review. Up-front scrutiny of such costs is likely to aid record development and informed decision-making by enabling stakeholders to more incisively analyze costs that deviate from a utility's annually approved fuel rate.

These changes will permit more effective prudence review of fuel costs, better protect consumers from potentially unreasonable rates, and increase clarity of anticipated fuel costs, enhancing a customer's ability to make meaningful choices about energy usage. And when necessary, an annual true-up mechanism will ensure that over- or under-recoveries are equitably addressed.

For these reasons, the Commission will adopt the Department's proposal, as follows:

a. The Commission will set recovery of the electric utility's fuel, power purchase agreements, and other related costs (fuel rates) in a rate case or an annual fuel clause adjustment filing unless a utility can show a significant unforeseen impact.

b. Each electric utility will publish its monthly fuel rates in advance of each year to give customers notice of the next year's monthly electric fuel rates.

c. The monthly fuel clause adjustment will not operate – each electric utility will charge an approved monthly rate.

d. Each electric utility will be allowed to track any changes in $/MWh fuel costs that occur over the year and there will be no carrying charge on the tracker.

e. Annually, each electric utility will report actual $/MWh fuel costs in each month by fuel type (including identification of costs from specific power purchase agreements) and compare the annual revenue based on the fuel rates set by the Commission with annual revenues based on actual costs for the year. The emphasis is on the overall average actual $/MWh even if actual monthly costs vary from expected monthly costs.

f. Each electric utility will refund any over-collections and show the prudence of costs before recovering under-collections. If annual revenues collected are higher than total actual costs, the utility must refund the over-collection through a true-up mechanism. If annual revenues collected are lower than total actual costs, the utility must show why it is reasonable to charge the higher costs (under-collections) to ratepayers through a true-up mechanism.

Initially, each utility must file proposed fuel rates outside a general rate case. If the proposed fuel rates are different from the rates set in a utility's most recent miscellaneous rate docket that coincides with a rate case, the utility must fully explain the basis for any difference. These filings should include complete documentation supporting the proposed fuel rates, including each PPA, estimates of costs for each type of fuel, and the proportion of each type of fuel, along with a complete description of any model used to develop the proposed fuel rates, including but not limited to the identification and justification of the inputs and formulas used for all fuel types, and fully documented sales forecasts.

The Commission will also require Xcel, Minnesota Power, and Otter Tail to file, within 60 days of the date of this order, a compliance filing addressing implementation of the Commission's decision. These filings will facilitate further discussion among the parties to develop a more complete framework for implementing the Department's proposal.

The implementation date of the new process is July 1, 2019. Each utility must file, after three years (to ensure three years' worth of data), a lessons-learned report assessing the new process.

ORDER

1. The Commission hereby approves the Department's proposal, as follows:

   a. the Commission will set recovery of the utility's fuel, power purchase agreements, and other related costs (fuel rates) in a rate case or an annual fuel clause adjustment filing unless a utility can show a significant unforeseen impact.

   b. each electric utility will publish the monthly fuel rates in advance of each year to give customers notice of the next year's monthly electric fuel rates.

   c. the monthly fuel clause adjustment will not operate – each electric utility will charge an approved monthly rate.

   d. utilities will be allowed to track any changes in $/MWh fuel costs that occur over the year and there will be no carrying charge on the tracker.

   e. annually, each electric utility will report actual $/MWh fuel costs in each month by fuel type (including identification of costs from specific power purchase agreements) and compare the annual revenue based on the fuel rates set by the Commission with annual revenues based on actual costs for the year.

   f. Each electric utility will refund any over-collections and show prudence of costs before allowing recovery of under-collections. If annual revenues collected ($/MWh) are higher than total actual costs, the utility must refund the over-collection through a true-up mechanism. If annual revenues collected are lower than total actual costs), the utility must show why it is reasonable to charge the higher costs (under-collections) to ratepayers through a true-up mechanism.

2. Each utility must file proposed fuel rates outside of a general rate case. If the proposed fuel rates are different from the rates set in a utility's most recent miscellaneous rate docket that coincides with a rate case, the utility must fully explain the basis for any difference. These filings should include complete documentation supporting the proposed fuel rates, including each PPA, estimates of costs for each type of fuel, and the proportion of each type of fuel, along with a complete description of any model used to develop the proposed $/MWh fuel rates, including but not limited to the identification and justification of the inputs and formulas used for all fuel types, and fully documented sales forecasts.

3. Each utility must file a lessons-learned report at the end of three years to assess the new process.

4. Within 60 days of the date of this order, Xcel, Minnesota Power, and Otter Tail must file a compliance filing addressing implementation of the Commission's decision.

5. The implementation date of the new process is July 1, 2019.

6. This order shall become effective immediately.

BY ORDER OF THE COMMISSION

Daniel P. Wolf
Executive Secretary

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