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April 30, 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:

In response to the Commission's Notice for Comments dated March 30, 2007, Minnesota Power submits its Comments 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,

Christopher D. Anderson

kl
Enclosures
c: Service list

STATE OF MINNESOTA	)	AFFIDAVIT OF SERVICE VIA
	) ss	EFILING AND
COUNTY OF ST. LOUIS	)	FIRST CLASS MAIL

Kristie Lindstrom of the City of Duluth, County of St. Louis, State of Minnesota, says that on the 30th day of April, 2007 she served Minnesota Power's 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 30th day of April, 2007.

Notary Public

JODI M. NASH
NOTARY PUBLIC - MINNESOTA
My Commission Expires Jan 31, 2010

E999/CI-03-802

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STATE OF MINNESOTA
BEFORE THE
MINNESOTA PUBLIC UTILITIES COMMISSION

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

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

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I. INTRODUCTION

On December 19, 2003, the Minnesota Public Utilities Commission ("Commission") issued a Notice of Comment Period ("Notice") further focusing the investigation into the continuing usefulness of the fuel clause adjustment ("FCA") as a regulatory tool (the "2003 FCA Docket"). The investigation was intended to determine the appropriateness of continuing to permit electric energy cost adjustments under Minnesota Statutes, Section 216B.16, subd. 7 and Minnesota Rules, Parts 7825.2390 through 7825.2920, which establish the requirements for implementing such adjustments. Initial Comments were filed on February 19, 2004, Reply Comments were filed on April 1, 2004, and supplemental Reply Comments were filed on June 11, 2004. Almost three years later, on March 30, 2007, the Commission requested comments on whether the investigation into the usefulness of the FCA should be continued and, if so, what issues should be pursued.

As explained further below, Minnesota Power believes the recently-completed MISO Day 2 Docket was, in final effect, a significant investigation of purchased power transactions, which are a major cost element of the FCA. The MISO Day 2 Docket also resulted in significant procedural and reporting changes to meet current FCA regulatory needs with regard to those transactions. Minnesota Power believes that, if a "general" FCA investigation continues in some form, the dated information in the instant Docket should be discarded and an investigation into the remaining key elements of the FCA beyond purchased power transactions should take its place. Those key elements would include fuel purchases, rail contracts and outage management.

With regard to the list of additional issues cited in the Commission's current request for comments, either utility-specific or issue-specific proceedings could be initiated, as appropriate, for the items that remain outstanding. The subjects on the list are generally narrower aspects of FCA application requiring focused analysis on single issues. If a broad FCA investigation still is deemed necessary, the Commission would benefit from completing its look at the core elements of the FCA in a general proceeding before turning its attention to these other subjects. Once a broader investigation was completed, it could inform any subsequent proceedings on more specific FCA matters. The Commission should avoid overextending the focus of a general FCA investigation docket and overwhelming such a proceeding by attempting to combine a significant study of core FCA elements with the detailed processes of making narrower policy determinations on single issues. Additionally, discarding the dated information in the instant Docket while pursuing a broader look at remaining core FCA elements also would facilitate the incorporation of the changes introduced to the FCA by the MISO market along with the benefits of additional stakeholder understanding and the significant reporting requirements related to the FCA that stemmed from 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).

II. THE FCA IS AN APPROPRIATE REGULATORY TOOL

The FCA was originally established by the Legislature in recognition of the variability in the fuel and purchased energy components of delivered energy cost. One objective of the FCA is to keep the utility neutral with regard to short-term changes in the cost of fuel and purchased energy through monthly adjustments to rates. Simultaneously, by adjusting rates to reflect incremental changes in the cost of energy delivered to customers above or below base rates in a relatively timely manner, the FCA just as importantly also helps to ensure that cost recovery is matched as closely as possible with corresponding customer usage. FCA recovery currency helps to allow fair assignment of costs to and among ratepayers.

The original purpose and need for the FCA to make adjustments for changes in cost from base rates has not gone away. And while energy policy and other factors may modify major or minor elements of the FCA and require adjustments in regulatory oversight, recent regulatory history, such as with the MISO Day 2 Docket, illustrates that the FCA and its oversight can be appropriately adapted to encompass these changes.

A. The MISO Day 2 Docket Illustrated Successful FCA Investigation and Policy Adaptation for Purchased Power Costs

The MISO Day 2 market is a recent and extensive example of an energy policy change that prompted modifications in FCA management as well as its regulatory supervision. The MISO Day 2 proceeding was essentially an investigation into purchased power costs which are a major cost element of the FCA. While perhaps not seen as part of its original purpose, the MISO Day 2 regulatory proceeding in fact significantly helped to increase the understanding and transparency of the FCA as a cost recovery mechanism for all stakeholders.

The regulatory proceedings that ensued with the MISO market's introduction, via utility cost recovery petitions, caused an investigation both into the market and related FCA applications for many months, deeply involving all stakeholders in an examination of market dynamics and components. The MISO Day 2 proceeding provided a foundation for renewing and expanding regulatory supervision of purchased power portion of the FCA. The ongoing need for regulatory supervision of the FCA in general has been updated and bolstered by the process of the MISO Day 2 Docket. The MISO Day 2 Docket in fact illustrates that the Commission, the Department and other stakeholders have the ability to establish new means and tools to effectively manage the FCA as energy policies change.

The MISO Day 2 Docket and related stakeholder proceedings resulted in considerable changes to FCA reporting and analysis. These include changes in procedures and expanded monthly reporting requirements by the utilities that are making reporting across the utilities uniform, thereby enhancing the price transparency already existing through MISO. Among other things, in these reports, utilities are required to document their projected fuel clause performance on an annual basis, with monthly updates and detailed explanations required when projections differ materially from forecast. The MISO Day 2 Docket also resulted in the implementation of quarterly reports by the Department in which they analyze fuel clause trends and issues affecting each utility in detail. This enhanced reporting scheme affords greater regulatory understanding of issues driving overall FCA costs in Minnesota.

B. <u>Other Major FCA Cost Elements Could Be Investigated Similar to Purchased Power Costs</u>

If the Commission deems it necessary to continue a broad look at the current role and purpose of the FCA, it should vacate the dated information in this Docket and build on what was accomplished in the MISO Day 2 Docket with regard to the FCA by starting afresh with a look at remaining key FCA elements. The MISO Day 2 Docket provided a thorough analysis of purchased power transactions, the most dynamic component of FCA costs. The Commission could extend what it started in the MISO Day 2 Docket and complete an examination of the FCA in general by studying the remaining major FCA cost elements, along with any potential for modification of their regulatory oversight. This would include an investigation of fuel purchases, transportation costs and outage management.

Minnesota Power believes that narrower FCA issues, such as those discussed in Section IV of these Comments, that may need to be addressed should be covered in dockets specifically set up to focus on them. Many of these issues are utility-specific or narrowly-focused subjects that would detract from an examination of overall FCA cost components and/or not receive the attention they deserve due to the excessive breadth of a docket addressing large and small FCA matters simultaneously. The information and understanding derived from the analysis of major FCA components could inform the dockets on narrower issues and provide a beneficial context for considering them.

C. <u>Regulatory Oversight of FCA Is Ongoing and Was Recently Enhanced</u>

While the Commission may wish to consider an investigation into the remaining major components of the FCA as described in the preceding section, parties should remain mindful that there already are substantial processes in place for regulating FCA cost recovery of all FCA components. In addition to the newly-instituted monthly reporting requirements of utilities and the quarterly reporting by the Department described in section II.-A. which stemmed from the MISO Day 2 proceeding, FCA compliance for all utilities is scrutinized in the Department's review of the utilities' individual Annual Automatic Adjustment Report filings ("AAA Filings"). This comprehensive review includes an analysis of procurement policies, dispatching procedures, cost-minimizing efforts, adjustment computations, auditors' reports and fuel cost projections based on information supplied in the utilities' filings.

Between ongoing FCA reporting and analysis enhanced through the MISO Day 2 Docket, AAA Filings and the examination of FCA costs that occurs in utility-specific dockets, there is sustained regulatory monitoring, analysis and guidance of the FCA overall. If the Commission conducted an investigation into the remaining FCA elements beyond purchased power, it is possible that, similar to the MISO Day 2 Docket, information from these proceedings might cause FCA reporting requirements to undergo further change to meet current needs identified as a result of these subsequent proceedings.

III. THE INFORMATION TO DATE IN THIS DOCKET SHOULD BE SET ASIDE

Both in terms of information and in terms of regulatory processes for monitoring the FCA, the information in this Docket is quite dated and should be set aside if the Docket continues. The Docket began over three years ago as a general investigation into the FCA as it existed then. Since June 2004, the Docket has been dormant while the MISO Day 2 market has come into existence and created a new regime for purchased power transactions. A key feature of the FCA from a regulatory standpoint is its role as a supervised mechanism for recovering purchased power costs incurred through bi-lateral transactions or the MISO market. All the utilities that are parties to this Docket are MISO market participants and will be purchasing power through the MISO structure on an ongoing basis. All of these utilities also were parties to the MISO Day 2 Docket.

Considerable regulatory inquiry, analysis and deliberation occurred as a result of utility filings for MISO Day 2 transaction cost recovery. These efforts examined MISO charges and market mechanisms in detail and validated the MISO market system. The process also included a review of each utility's MISO Day 2 transactions and, by reference, the larger context of the FCA. Thus, by virtue of the MISO Day 2 proceedings, both the MISO market and the treatment of MISO costs in the FCA recently underwent extensive regulatory scrutiny. Moreover, the MISO Day 2 proceedings resulted in significant changes to strengthen FCA reporting requirements that were agreed upon and recommended to the Commission through a lengthy stakeholder process involving regulators, customers and utilities.

The initial proceedings in the instant Docket occurred prior to the significant changes caused by the MISO Day 2 market in wholesale market operation and regulatory scrutiny. Any future, broad-based analysis of the FCA, whether in a generic docket or in an individual utility proceeding, likely would need to be informed by and take into account the MISO market. Thus, any future consideration of FCA issues that may become necessary for energy policy changes or other reasons would likely involve MISO Day 2 market information that became known and established after this Docket was begun. It would be inefficient and ineffective to attempt to continue the instant Docket by attempting to “catch up” its content to serve an analysis of the FCA as it exists now with the MISO market and the additional regulatory oversight and FCA reporting changes the MISO Docket evoked. If the Docket continues, it should be on a fresh footing.

IV. ADDITIONAL FCA ISSUES

The Commission’s March 30 Notice listed a number of additional FCA issues raised in comments in this Docket. Minnesota Power offers comments below on each of those items. Minnesota Power notes that some of these issues already were addressed extensively in the MISO Day 2 Docket and need no further exploration at this time. It may be appropriate to initiate other proceedings to specifically address certain remaining items on the list in the March 30 Notice, should the Commission determine such proceedings to be of value.

Regarding the possible initiation of other proceedings, Minnesota Power is not suggesting that all or even most questions about FCA application are best answered in multi-utility proceedings. Minnesota Power has stated previously in this Docket that there are specific circumstances that appropriately differentiate each utility’s application and use of the FCA as a regulatory tool. To the extent that there are questions with respect to specific cost-recovery items, Minnesota Power believes these should be addressed on a utility-by-utility basis in the AAA reports. The Department also has made observations in the 2003 FCA Docket that there are specific circumstances that allow for differentiation of each utility’s treatment of costs under the FCA. At the same time, there will likely be certain instances when a general docket on FCA policy involving all utilities may be appropriate, such as was the case with the combined MISO Day 2 Docket.

A. Incentives for Cost Control

Minnesota Power has ably managed its fuel clause costs through volatile energy periods as reflected in Minnesota Power’s yearly and monthly filings with the

Department. Due to its significant concentration of sales to large industrial customers who face intense international competition, Minnesota Power has a strong incentive to minimize its FCA costs, regardless of existing regulatory oversight. For a number of years, Minnesota Power annually has provided a formal, intensive analysis of its FCA to its large industrial customers, without any regulatory prompting, since those customers, in particular, realize the largest dollar impact of any upward fluctuations in FCA costs.

Minnesota Power has worked successfully to negotiate rail and coal contracts which have resulted in favorable average fuel costs. Minnesota Power has also made a concerted effort to reduce the frequency and length of outages while ensuring generation reliability. Elsewhere in these proceedings, Minnesota Power has discussed the diligence with which it conducts maintenance, plans for maintenance outages and contends with unplanned outages to minimize cost impact. This also includes Minnesota Power's utilization of a portfolio approach for replacement energy needs. Significant increases in market energy prices make the markedly higher cost of purchases compared to the cost of Minnesota Power-owned generation more evident. As newer and gas-fired generation units have entered the power market, the cost gap between purchases compared to supplies from older, coal-fired base load assets, such as Minnesota Power's, has widened. This likely will make any need to purchase replacement energy from the market noticeably more costly, regardless of other efforts to mitigate the impact.

One significant incentive for FCA cost control for Minnesota Power, beyond large industrial customer interest, is regulatory oversight and approval authority. The Department, the Commission and other stakeholders all have established avenues to examine, question and challenge FCA costs as described in Section II.C. Furthermore, regulatory involvement with the FCA was significantly deepened as a result of the MISO Day 2 proceedings. Dynamic purchased power costs comprise the majority of FCA changing expenses and are most subject to unpredictable variability. The MISO Day 2 proceedings were an extensive examination of the origins and treatment of this FCA cost component. The resulting additional scrutiny, utility reporting and accountability requirements from the final MISO Day 2 Order have increased the transparency of FCA purchased power transactions and put an ongoing process in place to closely monitor this activity.

Another important FCA cost control incentive is the perception of its benefit by utility credit rating agencies. Interstate Power and Light filed comments in this Docket that included a report from Standard and Poor's Rating Services which described the positive impact that the FCA, through matching of customer rates with expenses, has on utility credit ratings. Extreme weather, energy market price fluctuations, hydro and wind generation availability and forced outages are some of the unpredictable factors that affect FCA costs. While utilities work to manage and mitigate this unpredictability, they cannot control it and they cannot eliminate it. The FCA mechanism recognizes the natural existence of this unpredictability and provides a measure of stability to utility finances that positively affects utility credit ratings. Positive credit rating impacts afford benefits to a utility and its ratepayers by helping to lower the cost of capital. There is an ongoing incentive for all stakeholders to minimize the cost of utility capital and the presence of an FCA contributes to that outcome.

B. Price Signals

Minnesota Power believes the matter of establishing price signals for demand side management is a utility-specific undertaking because each utility's customer base is unique. Minnesota Power also believes price signals are most appropriately addressed in a utility rate case within the context of looking at a utility's specific load shape and forecast as well as all of its customer classes and rate structures. A generic proceeding on price signals involving all utilities would not derive valuable, actionable information for affecting consumer behavior.

C. Potential for Fuel Price Manipulation

Minnesota Power's base energy resources are defined by their stable coal supplies which are delivered under long term contracts. This is in contrast to other utilities and other parts of the country where a greater percentage of energy supplies are derived from natural gas. Natural gas is much more subject to price volatility and the potential for short terms gains from energy market trading.

While Minnesota Power does not have a trading operation and, thus, has very minimal occasion to engage in purchased power transactions beyond those for securing least cost supply, it does have comments to make on the subject of power trading and fuel price manipulation. Previously in this Docket, Minnesota Power has described the steps it takes with internal and external auditing procedures to guard against fuel price manipulation. Those steps and procedures remain in place, even though Minnesota Power is largely and almost solely in the market to supply its native customer base. Additionally, several significant developments since the initiation of this Docket that were discussed earlier in these Comments also address concerns about fuel price manipulation. Certainly the many new purchased power reporting requirements resulting from the MISO Day 2 Docket increase the transparency of fuel pricing and provide opportunities to examine and question activity with any transactions that may affect the FCA. Additionally, the April 1, 2005 start-up of the MISO Day 2 market itself, which of course occurred after this Docket began, greatly reduces the likelihood of market power influencing transactions and, consequently, costs to customers. As a result of the MISO Day 2 proceedings, the instant Docket does not need to continue to address fuel price manipulation as the MISO proceedings have instituted safeguards to address those issues.

D. Alternative FCA Mechanisms Such as the Banding Approach Adopted in Wisconsin

The current application and regulatory oversight of the FCA in Minnesota is an optimal and appropriate mechanism for managing fuel costs. It has been suggested that Minnesota consider a fuel cost performance banding approach similar to that of Wisconsin. The banding approach utilized in Wisconsin does not address fuel price manipulation nor does it provide incentives for cost control. In fact, the Wisconsin method actually distorts cost allocation by delaying cost adjustments for fuel costs above or below the band until an annual filing occurs. In Wisconsin, a utility's fuel costs are either charged or credited with approved adjustments long past the time of customer energy use so these adjustments are well-removed from any connection to the consumers that occasioned them. This is not an efficient method of cost attribution. Finally, Wisconsin regulation mandates frequent rate cases, so every two years the band is reset. The utilities are therefore financially harmed by the delayed recovery of legitimate fuel costs, and the customer base is still assessed the fuel costs, albeit on a delayed basis as well.

E. Data Reporting/Regulatory Oversight of Data Reporting

As discussed previously in various places within these Comments, as a result of the extensive MISO Day 2 Docket, FCA data reporting and regulatory oversight of this reporting have increased and expanded significantly. There is no need to keep this Docket open simply to increase either reporting or oversight. As evidenced in the MISO Day 2 Docket, the Commission has the authority to increase reporting authority and oversight as it deems necessary as energy policy evolves and new FCA issues arise. It can be expected, as exemplified in the MISO Day 2 Docket, that additional or modified reporting and/or oversight will unfold in the natural course of FCA dockets as needed.

F. Minn. Stat. 216B.16, Subd. 7

Minnesota Power has no language changes to suggest at this time. However, as regulatory proceedings unfold or other sources of energy policy changes arise, Minnesota Power may find it appropriate to suggest and seek changes.

G. Emission Allowances and Other Environmental Credits

Cost recovery for emission allowances and credits is an open issue for utilities regulators and stakeholders. Emission credits costs are directly related to fuel consumption decisions and thus it is appropriate for the cost of these credits to be recovered in the FCA. Minnesota Power believes this is one area of the FCA that requires regulatory resolution though it is unclear whether this would be best handled utility-by-utility or in a generic proceeding.

V. CONCLUSION

Minnesota Power believes the FCA continues to be an appropriate regulatory tool for managing short term changes in fuel costs that balances the benefits to utility finances and cost of capital with assignment of energy costs to customers in a timely and fair manner. While energy policy and other factors may modify major or minor elements of the FCA and require adjustments in regulatory oversight, recent regulatory history, such as with the MISO Day 2 Docket, illustrates that the FCA and its oversight can be appropriately adapted to encompass these changes. If the Commission deems it necessary to continue the investigation begun in this Docket, Minnesota Power respectfully suggests that the stale information previously obtained in the Docket be set aside and that the Docket focus on remaining major FCA elements with narrower FCA issues handled in issue or utility-specific proceedings.

Dated: April 30, 2007

Respectfully submitted,

/S/

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