IN THE MATTER OF THE PETITION OF NORTHERN STATES POWER COMPANY D/B/A XCEL ENERGY TO ESTABLISH A TRANSMISSION COST RECOVERY TARIFF AND FOR APPROVAL OF THE 2007 PLANNED TRANSMISSION INVESTMENTS TO BE INCLUDED IN RATES

STAFF MEMORANDUM SUPPORTING SETTLEMENT STIPULATION

DOCKET EL07-007

Commission Staff (Staff) submits this memorandum in support of the Settlement Stipulation filed December 17, 2008, by Staff and Xcel Energy (Xcel or Company) in the above captioned matter.

BACKGROUND

On February 28, 2007, Xcel filed a Petition for Transmission Cost Recovery (TCR) pursuant to legislation enacted during the 2006 Session of the South Dakota Legislature authorizing the Public Utilities Commission to approve a tariff mechanism for the automatic annual adjustment of an electric utility's charges to recover the South Dakota jurisdictional portion of the revenue requirements related to eligible new transmission resources. Eligible transmission lines must have a design capacity of at least 34.5kV and be more than five miles in length. Eligible facilities include both transmission lines and associated facilities, such as substations and transformers. (SDCL 49-34A-25.1 and 25.2).

The legislation requires that transmission improvements proposed for inclusion in a TCR be prudently incurred and achieved at the lowest reasonable cost to ratepayers and directs the utility to describe its efforts to minimize its costs (SDCL 49-34A-25.4 and 25.3 (4)).

Xcel proposed to recover its qualifying transmission costs by adding a Transmission Cost Recovery Rider to its tariff. The Rider provided for an annual determination of a TCR Adjustment Factor for each of four customer classes to be applied to all kWh billings. The TCR rate per kWh (the TCR Adjustment Factor) would be determined by dividing the forecasted revenue requirements associated with the eligible transmission facilities, determined using a standard model, by forecasted kWh sales for the same period. Once implemented, actual monthly revenue requirements would be determined and compared to the revenues actually billed and any over- or under-recovery would be posted to a Tracker Account. In subsequent TCR rate determinations the Company's revenues would be "trued-up" to actual costs by adding or subtracting the balance in the Tracker Account from the annual revenue requirement forecasted for the prospective period to determine the future TCR rate.

The Company's Petition identified six related transmission projects for inclusion in the TCR rate calculation, all of which it said were undertaken to increase transmission capacity between wind generation resources on the Buffalo Ridge in South Dakota and Minnesota and the Company's retail load centers, including Sioux Falls. Construction of the Main project (345kV and 115kV transmission lines, easement acquisitions, substations, and other related items) was scheduled to begin in August 2006 and to be completed in 2008 at a cost of approximately $188 million. The remaining five projects consist of four Wind Collector substations and one series capacitor station with a projected total cost of $30 million, scheduled to be completed by the end of 2007.

Xcel proposed to implement the TCR Adjustment Factor in the second calendar month following Commission approval.

STAFF'S ANALYSIS

Staff examined all elements of the Company's Petition in light of the enabling legislation including (1) whether or not the projects proposed for inclusion in the TCR are eligible facilities; (2) whether the Company's expenditures for the facilities resulted in the lowest reasonable costs to ratepayers; (3) whether the revenue requirements model and mechanics of the operation of the TCR proposed by the Company were reasonable; and (4) whether the implementation of a TCR at this time would result in excessive earnings by Xcel from its South Dakota ratepayers. Our examination of these issues produced the following conclusions or questions to be answered:

Eligibility of Facilities – The facilities proposed for inclusion in the TCR satisfy the eligibility requirements of the enabling legislation.

Lowest Cost to Ratepayers – Observing that the planning for and construction of the facilities had been subject to formal reviews by the Minnesota PUC and proceeded after receiving that Commission's regulatory approvals, Staff concluded that, with two possible exceptions, the cost standard had been satisfied. The exceptions concerned (a) the cost of relocating structures during the construction of the South Dakota portion of the 345kV line and (2) the additional costs incurred to upgrade, from the originally planned specification, the towers constructed to support the Minnesota portion of the 345kV line. A portion of the Minnesota tower costs is allocated to the South Dakota jurisdiction.

Revenue Requirements Model and TCR Mechanics – With three exceptions, Staff found the revenue requirement model and the mechanics of the TCR's operation to be appropriate and consistent with the Commission's ratemaking principles and practices.

Staff believed that the rate of return which Xcel proposed to apply to transmission investments – based on the resolution of its 1992 rate case – was excessive, exceeding Staff's assessment of the Company's current costs of capital. Second, Staff found that the Company's proposal to reflect wholesale revenues as billed under FERC-approved tariffs did not "allocate project costs appropriately between wholesale and retail customers", as required by SDCL 49-34A-25.2(4) and, finally, Staff observed that Xcel's proposal to omit a carrying charge on balances in the Tracker Account was inconsistent with the Commission's required treatment of similar balances arising from fuel adjustment transactions of all utilities.

Rate Design – Staff questioned the validity of Xcel's support for establishing different TCR rates for four classes of customers with the highest rate imposed on Residential users.

Reasonableness of Xcel's Overall Earnings from Regulated Rates – Recognizing Staff's responsibility to assist the Commission in its efforts to maintain tariffs with rates that result in just and reasonable charges to ratepayers and provide the utility with an opportunity to earn a reasonable return on its investments, Staff questioned whether additional revenues from ratepayers at this time, through a TCR or by any other means, would result in excessive customer bills and contribute to higher-than-required earnings by Xcel.

SETTLEMENT RESOLUTIONS

The issues raised in Staff's analysis have been resolved in the Settlement Stipulation, as follows:

Lowest Cost to Ratepayers – As explained above under this heading, two issues were raised by Staff concerning (a) the cost of moving facilities involved in the construction of the 345kV line in South Dakota and (b) the additional costs incurred by changing the design of the 345kV towers located in Minnesota. With respect to (a), the Settlement Stipulation provides that none of the moving costs will be recovered by Xcel through the TCR, neither in the initial rate nor in any subsequent "true-up".

With respect to (b), the additional cost of the towers in Minnesota, the Settlement Stipulation allows for their recovery in the TCR.

Although Staff believed that Xcel should have pursued its original plan to use the less expensive tower design in Minnesota, as it did in South Dakota, the Company argued that its decision to change the design of the towers to avoid litigation of an undeterminable length by accommodating a ruling by the Minnesota DOT, allowed it to continue with construction of the project and, thereby, to avoid other delay-related costs (additional fuel and purchased power costs) that would have been incurred and immediately passed on to ratepayers. Staff's acquiescence on this issue reflects its evaluation of the Company's contentions and Xcel's agreement that the Settlement Stipulation does not preclude Staff or the Commission from addressing any purchase power contract issues that might arise in Xcel's fuel adjustment clause filings.

Revenue Requirements Model and TCR Mechanics – As explained under this heading above, Staff raised three issues.

First, Xcel, relying on the statutory directive in SDCL 49-34A-25.2(2) to allow "a return on investment at the level approved in the public utility's last general rate case" proposed to use a rate of return derived from the sixteen year-old, 1992 settlement of its "last" general rate case, including an 11.25% return on equity (ROE). Staff, invoking the additional statutory provision that the return allowed in the utility's last rate case should be used "unless a different return is found to be consistent with the public interest", believed that the allowable return should be limited to Xcel's current cost of capital, reflecting its current capital structure, debt costs and, based on Staff's preliminary analysis, an ROE not in excess of 9.50%. The Settlement Stipulation adopts this approach but allows Xcel to adjust the ROE used in the TCR calculations, if it should file a new general rate case using a 2008 test year and a cost of equity is determined that differs from 9.50%. Any adjustment to ratepayer billings would be prospective from the time of the redetermination. This adjustment provision does not apply if a new ROE is determined in a rate filing based on a test year later than 2008.

Second, Xcel's proposed TCR accounting for costs of eligible transmission plant effectively assigned a portion of these costs to wholesale customers by reflecting the revenues received from FERC-jurisdictional customers as provided for in FERC-approved rates. Staff objected to this "allocation" of costs because the FERC rates result in delayed cost recovery by Xcel. Staff proposed that the delay in recovery be eliminated by an adjustment to wholesale customer revenues and the Settlement Stipulation adopts this position.

Finally, Xcel did not propose that a carrying charge be applied to the accumulated monthly balances of TCR over- or under-recoveries on the theory that differences between forecast and actual revenues and costs should be small. Staff did not disagree that the process objective would be to minimize such differences but, nonetheless, such differences (positive or negative) are certain to occur and, moreover, that there is no reason in principle to ignore carrying charges on the actual balances. Indeed the application of a carrying charge to TCR balances would be consistent with the Commission's practice in tracking Fuel Cost Adjustment charges. The Settlement Agreement requires a carrying charge.

Spreadsheets attached to the Settlement Stipulation illustrate the application of the modified revenue requirements model and develop the initial TCR rate.

Rate Design – Xcel proposed a schedule of four tariff rates in the TCR rider applicable to Residential, Commercial – Non-Demand billed, Commerical – Demand billed, and Street Lighting customers, contending that varying load characteristics justified the inter-class rate differences. Staff does not disagree that load characteristics differ among different groups of customers but it objected to the Company's "refinement" of its rate design based on class load characteristics used to develop class cost allocations in its sixteen year-old, 1992 rate case. No current load studies were presented by Xcel and the Settlement Stipulation reflects Staff's recommendation that a single rate applicable to all classes be incorporated in the TCR.

Reasonableness of Xcel's Overall Earnings from Regulated Rates – From the time Staff's analysis of the TCR filing began Staff was concerned that the combination of Xcel's existing rates for electric service and an additional TCR rate to recover eligible transmission costs might result in charges to ratepayers that are unjust and unreasonable and provide greater revenues to the Company than are required for it to recover its costs, including a reasonable, cost of capital-based return on its investments in utility plant. To assess these concerns, Staff requested and Xcel provided in the Spring of 2008 a report of its 2007 South Dakota jurisdictional earnings, both actual and weather-normalized, reflecting South Dakota ratemaking principles. Based on the results of this study Staff was persuaded that the potential for excess earnings during the rate-effective period of the TCR established in this case should not be a concern. However, Staff also was convinced that the type of earnings analysis provided by Xcel would be a useful new tool for monitoring the utility's earnings and, to that end, proposed that Xcel agree to provide such analyses on an annual basis. The Settlement Stipulation reflects Xcel's commitment to make such filings beginning with a filing by June 1, 2009, analyzing its earnings in 2008.

Effective Date of Initial Rate – Xcel filed its Petition with the Commission in February 2007, based on transmission investments included in its 2007 construction program. It proposed to implement the TCR rate two months after Commission approval.

Xcel's TCR filing is the first such filing made pursuant to the enabling legislation enacted in 2006. As a consequence of the need to evaluate the intent and requirements of the statutes, the qualifying attributes of eligible investments, the appropriate elements of a TCR formula, and the specific components of Xcel's proposed rate, the time required to fully assess Xcel's filing was greater than the time that should be required either for subsequent TCR filings or for a traditional rate filing. Thus, Xcel's initial proposal to recover 2007 costs related to 2007 construction projects has been unavoidably delayed well beyond that year and it seems unlikely, even with prompt Commission approval, that the TCR rate that would be established by the Settlement Stipulation could be applied to customer bills much before January 1, 2009.

To ameliorate the effect of this delay, Xcel proposed that the rate be made effective as of January 1, 2008, with any revenue requirement predating the actual implementation date be billed prospectively by accruing these requirements into the Tracker Account for prospective billing. Alternatively, Staff proposed that the starting date for accruing TCR revenue requirements be set at July 1, 2008. This is the starting date adopted in the Settlement Stipulation.

Accordingly, the spreadsheets attached to the Settlement Stipulation develop a TCR rate to recover eighteen months (July 1, 2008 through December 31, 2009) of forecast revenue requirements (associated exclusively with the eligible 2007 plant identified in this filing) over the twelve months of 2009. The revenue requirements associated with the period July 1 through December 31, 2008, are treated in the calculation as a recoverable balance in the Tracker Account as of January 1, 2009.