BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF SOUTH DAKOTA

IN THE MATTER OF THE PETITION OF NORTHERN STATES POWER COMPANY D/B/A XCEL ENERGY REGARDING THE 2011 ENVIRONMENTAL COST RECOVERY RIDER AND 2010 ECR TRACKER REPORT

STAFF MEMORANDUM SUPPORTING SETTLEMENT STIPULATION

DOCKET EL10-012

Commission Staff (Staff) submits this Memorandum in support of the Settlement Stipulation of June 21, 2011, between Staff and Xcel Energy (Xcel or Company) in the above-captioned matter.

BACKGROUND

On September 3, 2010, the Commission received a petition from Xcel for approval of a revised Environmental Cost Recovery (ECR) rider adjustment factor for 2011 and approval of the tracker report for approved environmental expenditures and revenues received since the implementation of the first adjustment factor that became effective on February 1, 2009.

South Dakota Codified Laws Chapter 49-34A, Sections 97 through 100 authorize the Commission to approve the automatic annual adjustment of an electric utility's charges to recover costs incurred for environmental improvements to electric generation facilities. Eligible costs are those incurred for environmental improvements required under the Clean Air Act, the Clean Water Act, or any other federal law or rule or any state law or rule implementing a federal law or rule, or voluntary environmental measures designed to protect the environment.

In Docket EL07-026, the Commission approved the establishment of the ECR rider to recover the costs associated with pollution control measures at the Allen S. King (King) generating facility. These costs were subsequently incorporated into base rates during Xcel's last rate case, Docket EL09-009. In January 2010, the ECR rider adjustment factor was decreased to collect the remaining balance in the tracker account but no costs related to King pollution control measures.

For 2011, Xcel requests to recover approximately $325,000 for mercury control systems installed on the King and Sherburne County (Sherco) generation facilities. In addition, the Company proposes to return to customers an estimated $30,000 in over-collection of the remaining balance in 2010. The proposed annual revenue requirement of approximately $295,000 results in a rate of $0.000146 per kWh applied to all kWhs billed to each customer class beginning on January 1, 2011. This is a slight reduction to the current ECR rate of $0.000154 per kWh.

STAFF'S ANALYSIS AND SETTLEMENT RESOLUTIONS

Staff based its determination on its analysis of Xcel's filing, the information obtained during discovery, and the statutes permitting this filing. Staff reviewed the tracker report and the forecasted 2011 annual revenue requirement associated with new environmental improvements. The ratemaking elements included in the annual revenue requirements were consistent with the elements approved in Docket EL07-026.

Staff and Xcel (jointly the Parties) positions were discussed thoroughly at settlement conferences. As a result, some party positions were modified and others were accepted where consensus was found. Ultimately, the Parties agreed on a comprehensive resolution of all issues.

The Parties agree that the over-collection of the remaining balance as of December 31, 2010 is $117,221. The ECR rate rider is based on estimated costs of eligible environmental measures incurred with revenue requirements beginning January 1, 2011, subject to later "true-up" to their actual costs and actual recoveries. Exhibit A attached to the Settlement Stipulation is designed to implement the ECR rate rider upon approval by the Commission. The revised ECR adjustment factor would be $0.000043 effective July 1, 2011.

Tracker Report

The filed 2010 ECR tracker report contained actual tracker activity from July 2008 through December 2009 and projected activity for 2010. In April 2011, the Company provided Staff with an updated report of actual costs and revenues through December 2010. The schedules attached to the Settlement Stipulation support the revenue requirement determination.

Exhibit 2, Attachment 1, illustrates the revenue requirement calculation by month. Exhibit 2, Attachment 2, summarizes the revenue requirements by year. The costs associated with pollution control measures at the King generation facility were included in the ECR rider from July 2008 through January 17, 2010. Effective January 18, 2010, the King environmental improvement costs were reflected in base rates as part of Xcel's general rate filing.

Exhibit 2, Attachment 4, reports the revenue collection by month. The ECR rider was initially implemented at a rate of $0.001255 per kWh for all customers effective February 1, 2009. When the King environmental improvements were removed from the ECR rider as part of the rate case, the rate was adjusted accordingly to $0.000154 to collect the remaining balance in the tracker account. The monthly tracker activity is detailed on Exhibit 2, Attachment 5.

Staff reviewed the capital costs and operating expenses to determine if the costs were prudent and at the lowest reasonable cost to ratepayers. Unless otherwise noted, all of the changes discussed below are changes from the Company's originally filed position.

Capital Structure – The Company proposed to use its actual capital structure at the end of the calendar year for which the revenue requirement is determined. For example, net investments in 2008 would be multiplied by a rate of return based on Xcel's actual capital structure as of December 31, 2008 to determine the required operating income. The settlement reflects the use of the actual capital structure from the preceding calendar year as described in the Settlement Stipulation in EL07-026. Using the above example, 2008 investments would be multiplied by a rate of return based on Xcel's actual capital structure as of December 31, 2007 to determine the required operating income.

Return on Equity – The Company's filing developed ECR revenue requirements for both the true-ups of all past requirements and collections (2008 thru 2010) and for the determination of a prospective (2011) ECR rate, reflecting the environmental projects introduced in this filing, by applying the ROE incorporated in the settlement of its most recent general base rate case in Docket EL09-009. The EL09-009 settlement was approved by the Commission on January 12, 2010 and the rates became effective on January 18, during the time that Xcel's first ECR rate was in effect. The ROE reflected in the first ECR rate (approved by the Commission's January 13, 2009 Order in Docket EL07-026 and made effective on February 1, 2009) was 9.5%; the ROE incorporated in the settlement of its base rate filing was **Begin Confidential End Confidential.**

Staff was concerned that the **Begin Confidential End Confidential** ROE might be excessive for application in this ECR filing for several reasons – first, because the passage of time since the base rate determination was made might have resulted in a significant change in the Company's cost of equity capital; second, because the settlement of the ROE issue in general base rate cases often reflects an element of judgment affected by the parties' resolution of other issues; and, third, because of the important practical difference between the nature of the rates established in a general base rate case and the rates established for a rate rider, such as Xcel's ECR. The base rate case determines a rate level that will provide the utility with *a reasonable opportunity to recover its future costs*, including a return on its utility investment. By contrast, the ECR mechanism provides for rate recovery of investments in specific environmental projects and/or expenses associated with specific environmental operations and provides for a later reconciliation, or "true-up", of the rider revenues collected from ratepayers with the actual costs of the environmental projects. That is, the ECR rate process virtually *guarantees recovery of specific costs* while the conventional base rate determination *provides only the opportunity to recover costs* that will be incurred while those rates are in effect.

Each of these concerns required an evaluation of Xcel's current cost of equity capital by Staff's cost of capital consultant, Basil L. Copeland. His preliminary analysis indicated that Xcel's current cost of equity capital lies within a range of **Begin Confidential**

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After incorporating the above changes into the revenue requirement calculation, the over-collection of the remaining balance as of December 31, 2010 is $117,221.

2011 ECR Adjustment Factor

The 2011 ECR Adjustment Factor is based on the over-collection in the tracker account and the estimated 2011 revenue requirements associated with the King and Sherco mercury control systems. These emission reduction projects were required to comply with the Minnesota Mercury Emissions Reduction Act (MMERA), Minnesota Statute 216B.68 through 216B.688. Under MMERA, utilities must employ the available technology for mercury removal that is most likely to result in the removal of at least 90 percent of the mercury emitted from the unit.

On March 16, 2011, the Environmental Protection Agency (EPA) proposed the National Emission Standards for Hazardous Air Pollutants (NESHAP) from Coal- and Oil-fired Electric Utility Steam Generating Units (EUSGUs), or EGU maximum achievable control technology (MACT). This proposed rule is developed under the Clean Air Act and establishes emission standards for mercury, acid gases (hydrochloric acid or HCl), and particulate matter. Under this rule, mercury emissions would be limited for units burning sub-bituminous coal to less than or equal to 1.0 pounds per trillion BTUs.

During discovery, the Company indicated that the controls installed under MMERA will satisfy the mercury requirement under EGU MACT. Staff believes these control systems qualify as eligible environmental improvements under SDCL 49-34A-97 as the controls fulfill requirements under state law, and achieve the mercury reduction as contemplated under the proposed update to the Clean Air Act.

The ECR legislation also requires consideration of whether the environmental improvements will achieve compliance at the lowest reasonable cost to ratepayers. Four different mercury control technologies were evaluated for cost effectiveness. At both generation facilities, B-PAC sorbent injection systems were projected to achieve similar emission control performance as the other technologies at about one-third of the cost per pound of mercury reduced. In addition, Xcel competitively bid the projects to ensure the lowest reasonable cost. Once Xcel determines the brand of mercury sorbent that provides the most cost effective removal rate it will seek bids for a long term contract.

The mercury control systems were completed and placed in-service during December 2009 and December 2010 at the Sherco and King plants, respectively. Although the capital costs are known and measurable at this time, the operating expenses are estimated and will be "trued-up" to actual costs in subsequent ECR rate filings. Staff identified the following issues that could be resolved:

Bonus Tax Depreciation – The Company's filing did not include bonus tax depreciation for the King project. The project expenditures eligibility for 50% or 100% bonus depreciation is still being determined under 2010 tax law, but the parties agree to reflect 50% bonus depreciation for the projects cost as an appropriate estimate. The model will need to be revised to incorporate 100% bonus depreciation in next year's ECR filing.

Return on Equity – See the return on equity section under the Tracker Report.

Effective Date – Xcel's filing proposed that the ECR adjustment factor be revised effective January 1, 2011. Staff and Xcel agree that the ECR should have been implemented effective January 1 in accordance with the tariff. Since this date has already passed and given the difficulties associated with retroactive billing to customers, the ECR is based on the revenue requirements associated with the mercury control systems beginning January 2011. The ECR rate is designed to be implemented effective July 1, 2011 using actual 2011 ECR revenues received through May 2011 and forecasted sales from June through December of 2011.

The net effect of these changes is an estimated 2011 revenue requirement of $318,749 associated with the mercury control systems. When the 2011 revenue requirement is combined with the $117,221 over-collection in 2010, the total revenue requirement is $201,528. This results in a rate of $0.000043 effective July 1, 2011.

Other Issues

Reasonableness of Overall Earnings from Regulated Rates – The Company has agreed to continue to file, by June 1 of each year, an annual report with the Commission detailing its South Dakota jurisdictional earning for the preceding calendar year. Staff believes the report is necessary to monitor the Company's earnings and the potential effect of adding the ECR rate to its South Dakota tariff.