

**IN THE MATTER OF THE PETITION OF NORTHERN STATES
POWER COMPANY D/B/A XCEL ENERGY TO ESTABLISH AN
ENVIRONMENTAL MEASURES COST RECOVERY TARIFF AND
FOR APPROVAL OF 2007 AND 2008 PLANNED
ENVIRONMENTAL MEASURES TO BE INCLUDED IN RATES**

**STAFF MEMORANDUM SUPPORTING SETTLEMENT
STIPULATION**

DOCKET EL07- 026

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 September 7, 2007, Xcel filed a Petition for Environmental Measures Cost Recovery (ECR) pursuant to legislation enacted during the 2007 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 environmental improvements to its existing generating 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. (SDCL 49-34A – 97 through 100).

The legislation requires that the utility must describe the context of the projects proposed for inclusion in the ECR, the schedule for their implementation, and its efforts to achieve the improvements at the lowest reasonable cost to ratepayers. (SDCL 49-34A-99).

Xcel proposed to recover the costs of its qualifying environmental improvements by adding an Environmental Cost Recovery Rider (ECRR)

to its tariff. The Rider provided for an annual determination of a single ECR Adjustment Factor to be applied to all kWh billings to all customers. The ECR rate per kWh (the ECR Adjustment Factor) would be determined by dividing (a) the forecasted revenue requirements associated with the eligible improvements, determined using a standard model, by (b) 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 ECR rate determinations the Company's revenues would be "trued-up" to actual costs by adding or subtracting the balance in the Tracker Account to/from the annual revenue requirement forecasted for the prospective period to determine the future ECR rate.

The Company's Petition identified seven components ("Measures") of environmental improvements undertaken at its base load Allen S. King coal-fired generating plant in Stillwater, Minnesota (see Petition, Exhibit 2, Attachments 1 and 2). The improvements were undertaken as part of an extensive renovation of the plant, resulting in an increase in its generating capacity and an extension of its useful life. The improvements were undertaken in response to Minnesota legislation encouraging emission reductions by permitting ECR-type cost recovery and were subject to the Minnesota PUC's "Cost Review Standards". The seven King Plant environmental "Measures" include:

1. An Air Quality Control System (AQCS) to remove sulfur from the combustion process;
2. A Selective Catalytic Reduction System (SCR) to remove nitrous oxides;
3. "Balance of Plant Equipment" which consists of systems supporting the AQCS and SCR systems, such as bulk material handling equipment and fire protection equipment;
4. "Substructures Construction" representing the civil and mechanical foundation and piping work required for the environmental enhancements;
5. All Electrical Equipment supporting the environmental improvements;
6. A Cooling Tower required to maintain proper discharge water temperatures; and

7. Pre-Engineered Buildings required to house the environmental enhancement equipment.

Where such measures accommodated both the environmental improvements and other improvements being made at the King Plant, their costs were allocated between the two activities so that only costs related to environmental measures would be recovered in the ECR (see Petition, Exhibit 3, Attachment 1).

The environmental improvements at the King Plant were completed in July 2007 although their final actual costs are still being determined. The final costs estimated in December 2006 and used in the Petition totaled \$236 million of which \$186 million was deemed to be associated with environmental enhancements.

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

STAFF'S ANALYSIS AND SETTLEMENT RESOLUTIONS

Xcel's ECR filing followed by approximately six months its Petition for approval of a Transmission Cost Recovery (TCR) tariff in Docket EL07-007. Although the statutes permitting the two filings focus on different system enhancements they are similar in all other significant respects. Moreover, the ratemaking elements of the Company's ECR filing, including the proposed standard model to be used to calculate annual revenue requirements, the proposed rate of return to be applied to eligible investments, the proposed implementation schedule and the proposed true-up mechanism are the same as those proposed for the TCR. Thus, having already analyzed the TCR filing in light of its understanding of the legislative requirements, Staff identified the following issues that could be resolved in the same manner as with the TCR:

Issues Resolved as in the TCR Settlement

Revenue Requirements Model and ECR Mechanics – As for the TCR, Xcel proposed to use a **rate of return** based on the resolution of its 1992 rate case; Staff's position was that this rate of return, including an 11.25% ROE, did not reflect the Company's current capital costs and that it would not be "consistent with the public interest" to apply such a return in a ratemaking determination at this time.

Also, as for the TCR, no **carrying charge** on balances residing in the Tracker Account was proposed by Xcel for the ECR. Staff believed that a carrying charge was appropriate to compensate either ratepayers (if the balance represented amounts over-collected) or the Company (on under-collections) would be appropriate and that such a practice would be consistent with the Commission's treatment of analogous balances arising from the operation of fuel adjustment clauses.

The proposed ECR **Settlement Stipulation** would resolve these issues in the same manner that they are proposed to be resolved in the TCR Settlement Stipulation:

- The ECR Stipulation provides that the **rate of return** shall be determined using the Company's capital structure and senior capital costs as of the end of the preceding calendar year and a 9.50% ROE. And, as in the TCR Stipulation, the Company would be permitted to revise this ROE to reflect an ROE determination approved by the Commission in a future general rate case filing provided that such filing was based on a 2008 test year. Under the Commission's rules such a filing would have to be made no later than June 30, 2009. This condition accommodates Xcel's position that its cost of equity capital is higher than 9.50% but, at the same time, does not allow for a higher ROE to be determined at a time so distant in the future as to be inappropriate for rates to be charged in the 2008-2009 time period.
- The Stipulation provides that a **carrying charge**, at a rate based on the allowed rate of return adjusted for income tax, be applied to all Tracker Account balances.

Rate Design – Xcel proposed a single rate applicable to all energy sales to all customers. This was the basis for the TCR settlement and, thus, Staff agreed to the Company's proposal.

Effective Date -- Xcel's filing in 2007 proposed that the ECR be implemented two months after Commission approval. As in the TCR Settlement Stipulation, Staff and Company agreed that the ECR should be implemented on a date certain -- July 1, 2008, -- but, in light of the fact that this date had already passed, provided that there would be no retroactive billing to customers. This is the same date and procedure as is provided for in the TCR Stipulation.

Thus the initial rate established in the ECR is based on revenue requirements commencing on that date and projected through the year 2009 to be recovered from ratepayers in 2009.¹

Reasonableness of Overall Earnings from Regulated Rates -- Although the effective date described above might be perceived as an unnecessary concession to Xcel, Staff believes that it is reasonable in light of the Company's agreement to file, by June 1 of each year, an annual report with the Commission detailing its South Dakota jurisdictional earnings for the preceding calendar year. Staff believes that such reports will be highly useful in monitoring the Company's earnings. Indeed, during its analyses of both the TCR and the ECR filings, Staff requested and awaited such reports for the years 2006 and 2007 before it was persuaded that the potential for Xcel achieving excessive earnings by adding TCR and ECR rates to its South Dakota tariff should not be a concern at this time. Under the Settlement Stipulation, the first such regular report will be filed in 2009 reflecting the Company's earnings in 2008.

Issue Unique to ECR

The ECR legislation requires assurance that the subject enhancements will be achieved at **“the lowest reasonable costs to ratepayers”**. Staff accepted the fact that the King Plant renovations,

¹ Accordingly, the spreadsheets attached to the Settlement Stipulation develop an ECR rate to recover eighteen months (July 1, 2008, through December 31, 2009) of forecasted revenue requirements (associated exclusively with the eligible 2007- 2008 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.

including the environmental enhancements, have been subject to extensive reviews by the Minnesota PUC and the fact that competitive bidding was used to obtain the environmental technologies as *prima facie* evidence that this South Dakota standard has been met. However, Staff identified one aspect of Xcel's determination of the King Plant costs proposed to be recovered in the ECR as requiring additional proof.

Significant components of the King Plant renovation project are required for both the environmental enhancement of the facility and for other improvements, including an increase in generating capacity and life extension. Xcel's filing provided little detail or explanation for the allocations of its investments in these joint purpose facilities to **substantiate that the allocated costs were qualified for recovery in the ECR.** Of the \$235.8 million of estimated capital expenditures, some \$76.9 million were for environmental enhancements exclusively while \$158.9 million were joint purpose investments of which \$108.8 million, or 68.5% was allocated to environmental enhancements (derived from Petition, Exhibit 3, Attachment 1). Staff requested more supporting information and the Company recently completed and submitted detailed descriptions and data supporting its allocations of (updated) investments in the joint purpose facilities.

The proposed Settlement Stipulation requires the Company to submit such analyses for Commission review and approval at the time the actual costs are known and reflected in an ECR true-up determination.