

Chesapeake Regulatory Consultants, Inc.

1698 Saefern Way
Annapolis, MD 21401-6529

Phone: 410.849.3210 Fax: 410.849.3220
eMail: rgtsbs@comcast.net

Robert G. Towers
Basil L. Copeland, Jr.
David E. Peterson

February 12, 2008

via eMail and US Mail

Dave Jacobson, Utility Analyst
South Dakota Public Utilities Commission
500 E. Capitol Avenue
Pierre, South Dakota 57501

RECEIVED

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SOUTH DAKOTA PUBLIC
UTILITIES COMMISSION

**RE: Consulting Services Proposal
Xcel Energy, Inc. - Proposed Environmental Cost Recovery Rider
SDPUC Docket No. EL07-026**

Dear Dave:

Thank you for providing me with the link to Xcel's September, 2007 Environmental Cost Recovery (ECR) Rider filing. I understand that this filing is the first such filing under legislation enacted in 2007 giving the Commission authority to approve a tariff mechanism that will trigger automatic annual rate adjustments designed to recover the costs of "environmental improvements" to existing electric generation facilities.

You asked me to review this material and to let you know if we would be available to assist the Commission Staff with its analysis of the filing and, if so, to provide you with an estimate of the cost of our services. We are available to assist the Staff and we are interested in doing so. I propose a budget of \$17,000 for our services.

Comparison of ECR and Transmission Cost Recovery (TCR) Riders

As you know, I am presently assisting Bob Knadle and Keith Senger with their analysis of Xcel's earlier TCR filing. Before reviewing the ECR filing and the enabling legislation I assumed that there would be many similarities but, in fact, there are some interesting and consequential differences:

While the purpose of the TCR Rider is to recover costs incurred to construct significant new transmission facilities, the ECR Rider would recover the cost of environmental improvements to existing generating facilities;

Whereas, consistent with the enabling legislation, the TCR filing made by Xcel provides for the immediate recovery from ratepayers of the carrying charges on capital projects as soon as they are undertaken (in lieu of capitalizing the construction period costs as AFUDC), the ECR filing made by Xcel provides for cost recovery only when project is completed and would qualify for inclusion in rate base as Plant in service.

Furthermore, although the enabling legislation states that the ECR Rider should allow the utility to recover costs “consistent with its allowed return on equity” while the TCR-enabling legislation requires “a return on investment at the level approved in the public utility’s last general rate case”, Xcel has used in both the ECR and TCR filings the overall rate of return on rate base derived from the Settlement of its 1992 rate case;

While Xcel’s TCR filing focuses on the entire investment in identifiable facilities its ECR filing deals with “the estimated percentage [of generation project costs] related to environmental improvements”.

While the TCR filing derives separate rates for each of several classes of South Dakota customers, the ECR provides a single rate for all classes.

Potential Issues With the ECR Filing

Broadly speaking, there appear to be two categories of issues related **directly** to the ECR filing:

- (1) Do the capital projects which are the subject of this filing qualify as environmental improvements made at the lowest reasonable cost?
- (2) Is the claimed projected revenue requirement reasonable and will the mechanism proposed to true-up revenues collected on the basis of these projections insure that the Company will recover no more than its actual costs?

Indirectly, the filing raises the question of whether the Company’s existing rates

are sufficient to allow it to recover the incremental revenue requirement associated with the environmental enhancements without any increase in its rates. While this same issue is raised by Xcel's TCR filing, the ECR's enabling legislation grants the Commission wide authority to consider "rate stability", "just and reasonable rates" and a "fair rate of return". SDCL 49-34A-100 states, in part:

".....To the extent that the environmental improvement may affect the following, the commission may also consider whether the environmental improvement is likely to enhance adequate utility service, rate stability, the financial stability of the public utility, reasonable capital costs, just and reasonable rates, a fair rate of return and other considerations that benefit the public interest."

Discussion

With respect to the issues raised **directly** by the ECR, the question of whether the subject facilities qualify for the tracker concerns the inclusion of costs that are only partially associated with an environmental enhancement (here the pollution control measures undertaken as part of a capacity upgrade and other improvements to Xcel's King Plant generating station in Minnesota). The filing's Exhibit 3, Attachment 1 shows that, of the \$235.8 million of capital expenditures associated with the King plant rehabilitation project, the Company proposes to include \$185.7 million in the ECR. However, of the \$185.7 million only \$76.9 million represents investments related exclusively to pollution control. The remainder represents portions of the rehabilitation project that have been allocated in part to the pollution control facilities with no detailed explanation.

Xcel acknowledges that the pollution control measures are "independent" of the capacity upgrade at the King plant. This suggests that any facilities that are ostensibly shared but would have been constructed if only the capacity upgrade were being implemented should be assigned to the capacity upgrade. ECR recovery should be limited to the costs that are exclusively environmental enhancements. This limitation would affect numerous elements of the claimed revenue requirement including return on investment, depreciation expense and, potentially, property taxes and labor costs. Other operating expenses, such as chemicals used exclusively for pollution control, should be easily identifiable.

As mentioned earlier, the enabling legislation (specifically, SDCL 49-34A-100) states that an ECR rate should provide for cost recovery "consistent with its [the utility's] allowed return on equity" and provides that the Commission may consider,

among others, “rate stability”, “reasonable capital costs”, “just and reasonable rates”, and “a fair rate of return”. Yet in computing its revenue requirement, Xcel relies on the preliminary instruction in SDCL 49-34A-98 (2) specifying a rate of return at the level approved in the utility’s last general rate case but ignores the qualification “unless a different return is found to be consistent with the public interest”.

Xcel has made no effort to demonstrate that the rate of return established in a 1992 rate settlement is a “fair rate of return” in 2007 when its filing was made. And, in fact, we know that a fair rate of return in 2006, 2007 or 2008 would not be determined on the basis of debt costs that existed in 1992 or the taxable cost of preferred stock capital which is no longer a component of the Company’s capital structure. Neither has Xcel explained why consistency with the public interest might not require a different rate of return. Indeed, its own calculations, provided in response to a Staff data request in the TCR filing, shows that, if the 1992-based 11.25% ROE were to be applied to its 2006 capital structure, the overall cost of capital in 2006 would be either 9.09% (including the cost of short term debt as in Xcel’s data response) or 9.13% (excluding the cost of short term debt consistent with South Dakota practice both now and in 1992).¹ Moreover, if Xcel’s required ROE were determined to be substantially less than 11.25%, its required return on rate base would be substantially less than even 9.09%. For example, if its cost of equity capital were determined to be within a 9.0% to 10.0% range², its “fair rate of return” on rate base would lay between 8.0 and 8.5%. By any measure, it appears that the Company has greatly overstated the fair rate of return that should apply to its incremental investment in environmental enhancements.

In addition, information gathered to date suggests that the ECR filing raises *indirectly* the question of whether or not the Company’s existing earnings are not more than sufficient to recover both a fair return on all of its existing investments in South Dakota-related facilities and the incremental costs of new environmental measures. Indeed, the earnings information provided by Xcel suggests its earnings from South Dakota ratepayers might be excessive even after absorbing the incremental environmental costs.

The Company calculated that in 2006 it earned (weather normalized) a 9.96% rate of return on its South Dakota average rate base.¹ Adjusting that calculation by adding the *claimed* incremental effects of the King Plant environmental

¹ Staff has requested that the data response be updated to reflect Xcel’s operating results in 2007.

² Staff’s rate of return witness in the recent NWEnergy rate case recommended a 9.0% ROE for that company based on a study of combination gas/electric utilities.

enhancements on rate base and operating income suggests that it would still earn a 9.33% return on rate base. This is measurably greater than an 8% to 8.5% "fair rate of return".

Proposal

As you know, we have considerable experience with general rate increase requests by electric and gas utilities including experience with the types of potential issues that I have identified here. In addition to our participation with South Dakota Staff in more than thirty formal rate proceedings since 1976 and Xcel's pending TCR filing, we are presently or have recently been engaged by the Colorado Consumer Counsel, the New Jersey Rate Counsel, the Staff of the Delaware Public Service Commission and the West Virginia Consumer Advocate as consultants in gas, electric and water rate cases before the regulatory commissions in those states.

In this proceeding, we propose to assist the Staff in analyzing the issues outlined above. I would be primarily responsible for our activities, obtaining input from Basil Copeland on cost of capital issues and assistance from David Peterson as required on accounting issues. We are proposing however that, while we would participate actively in all of the required analyses, discovery and the formulation of recommendations, we would serve primarily as advisors to Commission Staff thus allowing Staff members to participate fully in negotiations with Xcel and in providing testimony if the case goes to hearing.

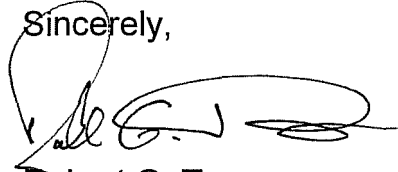
This project is unlike a general rate case where the process tends to be routine. Consequently, for the purpose of preparing a cost estimate, I have not tried to estimate our time by specific task. Likewise, I have not made any specific allowance for trips to South Dakota or Minneapolis. Also, I should add that my cost estimate does not encompass a comprehensive assessment of Xcel's revenue requirements as would be required if its existing base rates were to be challenged. My estimate of \$17,000 was developed as follows:

Robert G. Towers	80 hrs. @ \$140	\$ 11,200.00
Basil L. Copeland, Jr.	35 hrs. @ \$140	4,900.00
David E. Peterson	6 hrs. @ \$140	<u>840.00</u>
Total fees		\$ 16,940.00
Misc. out of pocket expenses (FedEx, etc.)		<u>60.00</u>
TOTAL		<u>\$ 17,000.00</u>

Of course, our actual charges would be based on actual time spent on the project and actual out of pocket costs. The cost estimate would not be exceeded without additional further authorization.

Please let me know if you have any questions about my discussion of the issues, division of the workload between Staff and our firm or any other aspect of this proposal. We look forward to working with you again.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert G. Towers", written over a horizontal line.

Robert G. Towers
President

Attachment: Fee Schedule (January 2007)

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1698 Saefern Way
Annapolis, MD 21401-6529

Phone: 410.849.3210 Fax: 410.849.3220
Email: rgtsbs@comcast.net

Robert G. Towers
Basil L. Copeland, Jr.
501.851.8619
David E. Peterson
410.286.0503

FEE SCHEDULE

Hourly Rate

Robert G. Towers Annapolis, MD	Senior Consultant	\$ 140.00
Basil L. Copeland, Jr. Maumelle, AR	Senior Economist	\$ 140.00
David E. Peterson Dunkirk, MD	Senior Consultant	\$ 140.00

January 1, 2007