

November 21, 2001

Jon Mielke, Executive Secretary  
Public Service Commission  
State Capitol  
Bismarck, ND 58505

RE: Response to Commissioner Wefald's Letter  
Case No. PU-399-01-186

Dear Mr. Mielke:

Staff appreciates the opportunity to discuss the issue of off-system sales. Commissioner Wefald has correctly identified the primary issue in staff's complaint case and we are happy to provide input on how the commission should handle the profit from off-system sales.

Staff does not believe the commission needs to change its policy but will address the issues raised.

When establishing MDU's electric rates, the commission allows the company an opportunity to earn a fair return on its investment in North Dakota. Included in that investment are the generation and transmission facilities necessary to provide retail service as well as to make off-system sales. Since the ratepayers are paying a return on these investments through rates, it is easy to understand why ratepayers should receive credit for most, if not all, of the profits from off-system sales.

It seems that the interest in including the profits from off-system sales in the fuel cost adjustment is predicated on the position that off-system sales are volatile and unpredictable. Since 1996, total company profits from off-system sales have increased every year from \$1.9 million in 1996 to \$9.9 million for the year ending 2000. Off-system sales profits have doubled during the first five months of 2001 compared to the same five months in 2000. The explosive growth in profits from these sales appears to remain.

With these things in mind, staff will address the questions of whether the commission should include off-system sales in the fuel cost adjustment and whether it should consider the use of incentives to encourage the continued marketing of off-system sales.

#### Fuel Clause Adjustment

The commission's administrative rules for fuel cost adjustments provides for increases or decreases in energy costs incurred by an electric utility less energy costs related to intersystem sales. Therefore, it appears that including off-system sales profits as a cost of energy offset would not comply with existing rules. However, the rules also allow for the commission to deviate from its rules when its use would result in an undue burden. In the end, the commission would need to change its rules or find that the existing framework is an undue burden before implementing a flow through of profits from off-system sales through the fuel cost adjustment.

#### Incentives

Staff is supportive of regulatory schemes to encourage higher levels of performance. Because of MDU's fiduciary responsibility to its stockholders, companies like MDU can be encouraged to act by designing the proper profit incentives. The difficulty lies in determining to what extent incentives are necessary for the achievement of optimal performance as well as the fair distribution of profits between stakeholders.

Under the commission's current policy, profits from off-system sales are used to offset the cost of providing service. Therefore, the profit margins included in base rates are only established during rate cases. In the case of MDU, rates were last established using a 1986 test year, which likely contained very little profits related to off-system sales in comparison to today's levels. Therefore, stockholders benefit to the extent MDU can outperform margins last included in the development of rates. This kind of built in incentive in rate of return regulation is often referred to as "regulatory lag." It is also worth noting that MDU's ratepayers have benefited from regulatory lag as the increased margins have offset inflationary pressures and the need to raise rates. Given the lengthy period of time since MDU's last rate case, it would be difficult to create a greater incentive to sell more electricity than already exists.

At the other end of the spectrum, requiring an immediate pass through of profits through a monthly billing adjustment would largely reduce the profit incentive to make sales. Under this approach, MDU would still work to

make off-system sales for the purposes of keeping prices down. Keeping prices down is important to economic development activities and the potential for increased sales. Keeping prices down is also important in the event that the electric industry is deregulated and effective competition develops. Still, while some incentives would exist in a pass through environment, the profit motive for increasing off-system sales would certainly be diminished.

#### Other Commissions' Decisions

The Washington Utilities and Transportation Commission approved Avista Utilities request for deferring certain increased costs related to power supply beginning July 1, 2000, and ending June 30, 2001. Avista positioned itself in a surplus power situation beginning in 2002 and will use the profits from those sales to erase the balance of deferred costs by February 28, 2003. In this special situation, the commission decided to offset the high cost of purchased power during one period of time with the expected profits from off-system sales of another period. *Re Avista Corporation dba Avista Utilities*, 210 PUR 4<sup>th</sup> 142-144 (WUTC 2001).

The Indiana Utility Regulatory Commission became concerned that PSI Energy, Inc. may be profiting from off-system sales by freeing up generation resources through native load purchases. The commission ordered that an after-the-fact calculation be made to determine the level of profits from off-system sales made from the freed up generation. The profit is distributed to retail customers in the form of a "mitigation credit" allowing PSI to recover its actual net purchased power expenses. *Re PSI Energy, Inc.*, 210 PUR 4<sup>th</sup> 299, 305, 309 (IURC 2001).

The Florida Public Service Commission removed profits from off-system sales from base rates and established a three-year moving average of profits as the threshold for the application of the shareholder incentive. Under this plan, any profits below the threshold are returned to ratepayers and any profits above the threshold are shared 80% / 20% between ratepayers and shareholders, respectively. *Re Wholesale Power Sales by Investor-owned Electric Utilities*, 204 PUR 4<sup>th</sup> 544 (FPSC 2000).

The South Dakota Public Utilities Commission approved a tariff revision that allows MidAmerican Energy Company to purchase energy from its South Dakota customers who voluntarily agree to interrupt their firm load for purposes of avoiding high cost purchases or as an opportunity to make off-system sales. The order requires that MidAmerican set up a tracking

account for purposes of accumulating the profits made in these transactions until the next rate case at which time the commission would decide proper treatment. *Re MidAmerican Energy Company*, 203 PUR 4<sup>th</sup> 538-540 (SDPUC 2000).

The Kansas State Corporation Commission included a normalized level of off-system sales profits in its rate reduction order pertaining to West Plains Energy Kansas. The normalized level reflects an upward trend but does not include the price spikes seen during the summer of 1998. The commission has not established a policy of sharing off-system sales profits but notes that the utility will be able to retain all of the profits above the normalized level. *Re UtiliCorp United, Inc. dba West Plains Energy Kansas*, 198 PUR 4<sup>th</sup> 397-398 (KSCC 2000).

The North Dakota Public Service Commission granted a natural gas rate increase to Montana-Dakota Utilities Co. in 1982. The increase granted was reduced by projected off-system sales profits. *Re Montana-Dakota Utilities Company*, 46 PUR 4<sup>th</sup> 195 (NDPSC 1982), Case No. 10,280.

#### Summary & Conclusion

Staff believes that the current policy of including profits from off-system sales in the establishment of rates is a fair and reasonable approach. The current policy provides a big incentive for MDU to make off-system sales, primarily because of regulatory lag. Because of regulatory lag, MDU has benefited greatly during the past few years as sales have climbed dramatically. However, profits from off-system sales will likely decline as new generation is built. When that occurs, ratepayers will similarly benefit from the other side of the curve.

Staff believes that flowing through profits automatically will eliminate most of the incentive for MDU to continue its high level of sales marketing.

Sincerely,

Mike Diller  
Director of Accounting