BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

LeRoy Koppendrayer	Chair
Marshall Johnson	Commissioner
Ken Nickolai	Commissioner
Phyllis A. Reha	Commissioner
Gregory Scott	Commissioner

In the Matter of the Petition of Northern States Power Company d/b/a Xcel Energy for Approval of an Extension of Rule Variances to Recover the Cost of Financial Instruments Through the Purchased Gas Adjustment Clause	ISSUE DATE: January 23, 2004 DOCKET NO. G-002/M-03-1627 ORDER EXTENDING VARIANCE WITH CONDITIONS

PROCEDURAL HISTORY

On January 23, 2002, the Commission granted the request of Northern States Power Company d/b/a Xcel (Xcel) for a two-year variance to Minnesota Rules parts 7825.2500.B. and 7825.2400, subpart 12.[1] These rules permit energy utilities to adjust their rates monthly to reflect changes in the cost of energy. The 2002 Order allows Xcel to adjust its rates for the additional purpose of recovering costs associated with using certain contracts ("financial instruments") to manage the volatility of natural gas prices.

On October 13, 2003, Xcel asked to extend and modify these variances for the purpose of continuing its management of natural gas prices.

On November 21, 2003, the Minnesota Department of Commerce (the Department) recommended partial approval of Xcel's proposal with conditions.

On December 4, 2003, Xcel replied to the Department's comments.

On January 6, 2004, the matter came before the Commission. At hearing Xcel did not contest the Department's recommendation.

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[1] *In the Matter of a Petition by Northern States Power Company d/b/a Xcel Energy for Approval of Variances to Allow Recovery of the Costs of Financial Instruments Through the Purchased Gas Adjustment*, Docket No. G-002/M-01-1336.

FINDINGS AND CONCLUSIONS

I. Background

Generally a public energy utility may not change the rates that it charges for service unless it undergoes a rate case wherein all of its costs and revenues are considered. But the Legislature has created exceptions to this general policy.[2] For example, the Commission may permit an energy utility to adjust its rates outside the context of a general rate case to reflect changes in the cost of energy.[3]

Consistent with this statute, the Commission has adopted rules for implementing a "purchased gas adjustment" (PGA). See Minn. Rules, part 7825.2390 *et seq*. In particular, these rules permit a gas utility to make monthly adjustments for "changes in the commodity-delivered gas cost and demand-delivered gas cost for purchased gas...." Minn. Rules, part 7825.2500.B. The rules define the "cost of purchased gas" with respect to certain federally-prescribed accounts, plus "the normal and ordinary cost of injection and withdrawal of gas from storage...." Minn. Rules, part 7825.2400, subp. 12. The utility files a monthly PGA report justifying any rate adjustment, as well as filing an Annual Automatic Adjustment of Charges (AAA) report reconciling the costs and revenues for gas purchases throughout the entire year.

Xcel argued that consumers benefit from stable commodity prices that can be achieved through certain "hedging" transactions. For example, if Xcel were to buy an option to buy gas at a specified price in the future, then its customers would be protected from the risk of prices rising above the option price. But the language of the Commission's rules do not provide for Xcel to recover the cost of the option, or similar transactions, through the PGA.

The 2002 Order varied some Commission rules to permit Xcel to recover certain hedging costs through the PGA, but also imposed certain conditions on Xcel's cost recovery.

II. Analysis

On October 13, 2003, Xcel asked to extend the 2002 Order's variance with modifications. The Department supports some aspects of Xcel's request and opposes others. Xcel now agrees not to contest the Department's recommendations.

The relevant issues are set forth below:

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[2] Minn. Stat. § 216B.16.

[3] *Id.*, subd. 7.

A. Variance Generally

As noted above, the 2002 Order varied Commission rules to permit Xcel to pursue prudent activities designed to mitigate the volatility of the natural gas prices paid by Xcel's consumers. Xcel and the Department now support granting the necessary variances to allow Xcel to continue this activity. They argue that the public interest is served if gas prices can be stabilized at reasonable cost. During the past two years Xcel has demonstrated that this is possible. Indeed, Xcel reports that in 2002 its hedging activities not only reduced volatility, they actually reduced Xcel's overall gas costs.

In contrast, enforcing Commission rules as written would deprive Xcel of the opportunity to recover hedging costs on the same basis as other gas costs, according to the Department and Xcel, creating a disincentive for Xcel to pursue such activities. Consequently the Department and Xcel agree on the general proposition that a variance is warranted, although they differed about a number of details.

B. Rules

In its 2002 Order the Commission agreed to vary Minnesota Rules part 7825.2400, subpart 12, and part 7815.2500.B.

On October 13, 2003, Xcel asked for the Commission to allow Xcel to continue its hedging activities by extending its variance of Minnesota Rules part 7825.2400, subpart 12 and part 7815.2500.B., as well as varying parts 7825.2700 (pertaining to the compilation of AAA reports) and 7825.2910, subpart 1 (pertaining to PGA reports).

The Department recommends that the Commission grant Xcel's request only with respect to Minnesota Rules parts 7825.2400, 7825.2500 and 7825.2700. In reply comments, Xcel agreed to the Department's recommendation.

C. Timing

The 2002 Order granted a variance for two years from the date of issuance. Specifically, the variance governs contracts entered into by Xcel by January 23, 2004, whether or not those contracts are completed by that date.

In order to continue its hedging operations, Xcel now asks the Commission to vary its rules until June 30, 2008. Xcel argues that it should be given this longer variance, noting that it has demonstrated the value of its hedging strategies in the past and that the Commission has previously granted a similar four-year variance.[4] Also, Xcel asks the Commission to extend the

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[4] See *In the Matter of the Petition of Aquila, Inc. for Variances to Minnesota Rules 7825.2400, 7825.2500 and 7825.2700 to Allow Recover of the Cost of Using Financial Instruments Through the Purchased Gas Adjustment*, Docket No. G-007, 011/M-03-821 ORDER GRANTING VARIANCES (October 13, 2003).

variance through the end of a heating season rather than let the variance expire in January. Xcel argues that this timing would permit the full benefits of its hedging strategies to be realized and would coordinate the end of the variance with the end of Xcel's PGA true-up period.

The Department supports Xcel's request to vary the Commission's rules regarding prudent contracts that Xcel enters into by June 30, 2008. The Department notes that granting this request would not deprive the Commission of the power to disallow recovery of imprudently-incurred costs or to revoke the variance prospectively, should the need arise.

D. Hedge Cap

The 2002 Order limited the amount of hedging costs that Xcel could recover through the PGA to 5% of its firm gas purchases or $15 million. Xcel asks the Commission to modify this cap in two ways.

First, Xcel asks that a new cap be set at $20 million. Xcel argues that Xcel's two years of experience with hedging should justify the Commission's confidence in raising the cap. Xcel notes that $20 million represents roughly 5% of its forecasted gas purchases, assuming a price of $5 per dekatherm (Dkt). Also, Xcel argues that a fixed cap is easier to administer than a 5% cap, which constantly fluctuates.

Second, Xcel proposes that the Commission allow Xcel to assume a "floor price" of $3.50/Dkt for purposes of implementing the $20 million cap. This assumption is intended to address the fact that Xcel cannot know the gain or loss of a futures contract at the time Xcel enters into the contract.

For example, assume that by March Xcel had already incurred $19,500,000 in hedging costs, and that Xcel has the opportunity to contract to receive 10,000 Dths of gas for each day in April for $4.50 per Dth. By buying this contract, Xcel could reduce the risk that Xcel would be required to buy more expensive gas on the spot market later. But the gain or loss of this contract depends upon the difference between the market price for gas in April and the contract price of $4.50. Because Xcel cannot know in March what the market price of gas will be in April, Xcel cannot know whether the costs of this contract would exceed the $20 million cap.

- If ultimately April gas costs $2.50/Dkt, then Xcel would have lost $2.00/Dkt on the contract ($4.50 contract price - $2.50 market price), and the contract would have cost roughly $600,000 (10,000 Dkt/day x 30 days in April x $2/Dkt). A $600,000 contract, added to the $19,500,000 in hedging costs already incurred, would result in a total of $20,100,000 in hedging costs, exceeding the $20 million cap.

- If, alternatively, April gas costs $3.50/Dkt, then Xcel would have lost only $1.00/Dkt on the contract ($4.50 contract price - $3.50 market price), and the contract would have cost roughly $300,000 (10,000 Dkt/day x 30 days in April x $1/Dkt). A $300,000 contract, added to the $19,500,000 in hedging costs already incurred, would result in a total of $19,800,000 in hedging costs, well within the $20 million cap.

To enable Xcel to determine beforehand whether the cost of a contract would cause Xcel to exceed the $20 million cap, Xcel asks to be allowed to assume that the eventual market price for gas will not be less than $3.50/Dkt. Xcel argues that $3.50/Dkt is a reasonable benchmark, reflecting the low estimates of the cost of liquid natural gas imports and well below the three-year average price for gas on the Northern Natural Gas Company system.

The Department does not oppose extending the cap to $20 million, noting that the Commission granted another utility the discretion to incur hedging costs up to 20% of its total firm commodity gas costs.[5] Similarly, the Department does not object to Xcel's proposed floor price and concludes that $3.50/Dkt is a reasonable benchmark for this purpose.

The Department emphasizes that this floor price should be approved only for the purpose of determining compliance with the $20 million cap, and should not create any presumption about the prudence of any specific transaction. The Department recommends that Xcel be directed to provide the final (settled) cost of hedging transactions in required reports and to use the actual settled cost to determine the gain or loss on hedging transactions. Xcel agrees to this recommendation.

E. Carrying Costs

In addition to seeking to recover the cost of hedging transactions through the PGA, Xcel also asked to be allowed to recover through the PGA the cost of financing these transactions. In the spring, for example, Xcel may buy an option for gas to be consumed in the winter. Xcel would need to incur the cost of the option immediately, but would not be able to recover the option's cost until the underlying gas was consumed in the winter. Xcel argued that, in the absences of the ability to recover the cost of the capital used during this period, Xcel would have a disincentive to purchase the option.

The Department opposes this request. The PGA was not intended to recover capital costs, the Department argues. The Department questions why Xcel should be permitted to recover carrying costs related to buying a futures contract for gas, but not when Xcel actually purchases gas for its own storage. Xcel's rates were designed to provide Xcel with sufficient revenues to finance ongoing operations, according to the Department; permitting Xcel to recover carrying costs though the PGA would allow Xcel to recover such costs twice.

While Xcel disputes the Department's conclusions, at hearing Xcel agreed not to pursue this matter.

F. Reporting Requirements

The 2002 Order directs Xcel to report a variety of data about its hedging operations. Xcel proposed to continue making these reports if the Commission will extend its rule variances.

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[5] *Id.*

But the Department makes a different recommendation. In the interest of standardizing the reports that the Commission and the Department are receiving regarding such variance requests, and to ensure that information is provided on a timely basis with respect to various periodic filings, the Department recommends that Xcel make the following filings instead:

1. In its monthly PGA report,[6] Xcel should identify the amount of anticipated hedging transaction costs and/or benefits included in the calculation of the PGA rate.

2. In its request to approve changes in demand entitlements,[7] Xcel should include –

    - a list of all hedging contracts entered into for the coming heating season,
    - the cost premium associated with each contract,
    - the size of each contract,
    - the contract date,
    - the contract price, and
    - an explanation of the anticipated benefits of these contracts to Xcel's ratepayers.

3. In its AAA report,[8] Xcel should include data on the relative benefits of price hedging contracts, including the average cost per decatherm for natural gas purchased under a hedging contract compared to the comparable monthly and daily spot index prices, as well as –

    - a list of each hedging contract entered into,
    - the total volumes contracted for, for each contract, and
    - the net gain or loss, including all transaction costs for each contract in comparison to the appropriate monthly and daily spot prices.

Xcel expresses concern that these filing requirements may focus unduly on the extent to which hedging reduces Xcel's total gas prices rather than the extent to which hedging reducing price volatility. Nevertheless, Xcel is willing to make these filings.

III. Commission Action

Under Minnesota Rules part 7829.3200 the Commission may vary any of its rules upon findings that –

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[6] Minn. Rules part 7825.2910, subp. 1.

[7] Minn. Rules part 7825.2910, subp. 2.

[8] Minn. Rules part 7825.2810.

- enforcement of the rule would impose an excessive burden upon the applicant or others affected by the rule,

- granting the variance would not adversely affect the public interest, and

- granting the variance would not conflict with standards imposed by law.

Minnesota Rules part 7825.2390 *et seq*. are well-crafted to ensure that the PGA represents a narrow exception to the general policy that rates should be set through rate cases, after consideration of all costs and revenues. The rules' rigor prevents utilities from recovering costs through the PGA that are already being recovered through base rates. But the rules did not anticipate how hedging transactions could reduce the volatility of prices passed through to ratepayers or how price stability would serve the public interest.

The Commission finds that price stability does serve the public interest. To the extent that the Commission's rules create an disincentive for Xcel to engage in prudent policies to promote price stability, they impose an excessive burden on Xcel and its customers. Varying such rules to encourage Xcel's hedging activities will not harm the public interest, but rather will promote it. Finally, the Commission finds no legal standard prohibiting the variance of these rules.

Having reviewed the record of this case and heard the arguments of the parties – especially Xcel's acquiescence in the Department's recommendations – the Commission finds the Department's recommendations reasonable. The Commission will grant a variance to its rules with conditions as recommended by the Department.

ORDER

1. The Commission hereby varies Minnesota Rules part 7825.2400, subpart 12, part 7815.2500.B. and part 7825.2700 to permit Xcel to use the purchased gas adjustment to recover the costs of financial instruments used for hedging purposes in securing natural gas supplies. These variances apply to the costs and benefits of prudent hedging transactions that Xcel enters into through June 30, 2008.

2. Xcel may not recover through the PGA more than $20 million worth of hedging costs per fiscal year, calculated based on a presumed minimum price of $3.50/Dkt.

3. Xcel shall provide the final (settled) cost of financial instruments in required reports and shall use the actual settled cost to determine the gain or loss on financial instruments.

4. Xcel shall not recover imputed capital costs or "carrying costs" on its hedging transactions through the PGA.

5. In its monthly PGA report, Xcel shall identify the amount of anticipated financial instrument costs and/or benefits included in the calculation of the PGA rate.

6. In its request to approve changes in demand entitlements, Xcel shall include –

- a list of all financial instrument arrangements entered into for the coming heating season,
- the cost premium associated with each contract,
- the size of each contract,
- the contract date,
- the contract price, and
- an explanation of the anticipated benefits of these contracts to Xcel's ratepayers.

7. In its Annual Automatic Adjustment of Charges (AAA) report, Xcel shall include data on the relative benefits of price hedging contracts, including the average cost per decatherm for natural gas purchased under financial instruments compared to the comparable monthly and daily spot index prices, as well as –

- a list of each hedging instrument entered into,
- the total volumes contracted for, for each instrument, and
- the net gain or loss, including all transaction costs for each instrument in comparison to the appropriate monthly and daily spot prices.

8. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

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