

AC03-68-000

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July 18, 2003

Mr. John M. Delaware
Executive Director and Chief Accountant
Office of Finance, Accounting and Operations
Route FA-10, Room 42-41
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, DC 20426

Re: Upper Peninsula Power Company
Deferred Accounting Treatment for Costs Associated
With the Silver Lake Development (UPPCO Document # GB 0119)

ORIGINAL

FILED
OFFICE OF THE SECRETARY
03 JUL 18 PM 4:49
FEDERAL ENERGY
REGULATORY COMMISSION

Dear Mr. Delaware:

Upper Peninsula Power Company ("UPPCO" or the "Company"), a regulated public utility under Part II of the Federal Power Act, hereby tenders for filing a notice of its use of deferred accounting in connection with the incremental costs incurred as a result of the May 14, 2003 breach of the fuse plug spillway and earthen dike on UPPCO's Silver Lake Development, which is located on the Dead River in Marquette County in Michigan's Upper Peninsula. UPPCO also seeks such permission from this Commission as may be necessary to undertake deferred accounting for these costs.

UPPCO is subsidiary of WPS Resources Corporation. It furnishes electric generation and distribution services in Michigan's Upper Peninsula and experienced a 2002 peak load of 146 MW. UPPCO encloses as Exhibit U-1 its July 15, 2003 application to the Michigan Public Service Commission ("MPSC"), Case No. U-13831, for deferred accounting treatment for these costs in its retail rates. The MPSC regulates approximately 82% of UPPCO's requirements sales. This Commission has jurisdiction over the remainder.

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UPPCO is the owner of the Silver Lake Reservoir, which is one of three separate developments constituting the Dead River Hydroelectric Project No. 10855 ("the Project").¹ The Silver Lake Development itself has no generating facilities. Its function is to store and release water for electric generation and other purposes. The Project also consists of (i) the Hoist Development consisting of a dam and related facilities, including generating units, with a total installed capacity of 5.5 MW, and (ii) the McClure Development, which contains similar facilities with a total installed capacity of 10 MW. The Project's total capacity is 15.5 MW and it generates approximately 64,100 MWh annually.

The breach at the Silver Lake Reservoir occurred after heavy rainfall around May 9-12, 2003 which caused flooding in several areas in the Upper Peninsula. In addition to the Silver Lake dike, another dam downriver owned by the City of Marquette Board of Light and Power also breached. Still other dams held, but spilled water. The flooding caused evacuation and damage to property and infrastructure. The Governor of Michigan declared a state of emergency from May 15, 2003 through mid-June. Preliminary published estimates of the flood damage in the region total about \$100 million (Exhibit U-1 at 2).

The Company and FERC are investigating the root cause of the breach at the Silver Lake Reservoir. Replacement of the Silver Lake Reservoir dike will occur in 2004 at the earliest. Based on the results of the root cause analysis, UPPCO may elect or be required to make upgrades at the Silver Lake dike and other projects. See Exhibit U-1 at 2-3.

The Company's deferral request is exclusively for incremental Operation and Maintenance expenses ("O&M") incurred as a result of the flood. UPPCO does not request approval to defer capital costs associated with the UPPCO property damage.² UPPCO also does not request deferral of internal labor costs other than incremental costs incurred in direct response to the breach. Those incremental labor costs include overtime, meals, lodging and travel expenses.

¹ See *Upper Peninsula Power Co.*, Order Issuing Initial License, Project No. 10855-002, 101 FERC ¶ 62,013 (2002).

² The original fuse plug installed at Silver Lake is the biggest plant item that UPPCO believes must be written off. Since the fuse plug was only installed about a year ago as a condition of the FERC licensing, as of June 2003 most of the original cost is undepreciated. Since this plant no longer exists due to the flood, UPPCO needs to retire it and UPPCO proposes to follow normal utility accounting which will write off the undepreciated value of the plant, about \$710,000, to the depreciation reserve. The next time UPPCO files for depreciation rates, such rates should be adjusted to reflect this additional reserve including any offset the Company might receive through insurance proceeds. If other undepreciated plant must be written off as a result of the flood, UPPCO proposes to follow similar accounting.

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UPPCO has an excess liability insurance policy for third party demeges with e \$200,000 deductible. Expenses in excess of the \$200,000 deductible have already been incurred for independent consultants retained to investigate the cause of the breech and to assess environmental recovery needs end for legal fees incurred in connection with the investigation. UPPCO also hes a property insurence policy for damage to its own facilities with e \$1 million deductible and the exclusions customary to such policies for damagees to land (Exhibit U-1 at 4).

The deferred costs include but ere not limited to costs to respond to the breech end subsequent flooding; costs to determine the cause of the breach; costs of assessing and responding to third party damage claims; environmental recovery costs; non-capitalized costs to replce end/or repeer UPPCO facilities end property; and site safety costs. See Exhibit U-1 at 4-6. To the extent now known, the proposed deferred costs include:

- The eforesaid consultant and legel expenses up to the \$200,000 deductible under UPPCO's excess liability insurance policy for third party damagees.
- Anticipated non-capitalized expenses for repairs to be made to improve land up to the \$1 million property insurance deductible.
- Costs associated with the environmental recovery of Company owned land impacted by the breach that ere not covered under the Company's property insurance policy or reimbursed by other parties.
- Increased power supply costs as e result of a plant shut-down due to the flood, including costs incurred in restarting one of UPPCO's plents and installing temporary diesel generetors to supply replacement power, to the extent not recoverable under UPPCO's currently effective rates.
- Expenses incurred in UPPCO's immediate response to the breach, including retention of a security firm to monitor the area around the Silver Lake dam, advertisements to educate the public on dangers from flooding, retention of contractors to mitigate further damage to nearby dams, and incremental employee expenses es described above.
- Preliminary work expenditures to make the area safe and minimize future impacts.

The following considerations ere relevant to the proposed deferral:

- The expenditures in question are outside of UPPCO's control, and are being undertaken in response to a recognized state of emergency.

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- These expenditures do not constitute ordinary operation and maintenance expense; there is no previous record of expenditures of this kind at Silver Lake; and the expenditures are unanticipated, unusual and non-recurring in nature. As a consequence, these expenditures are not incorporated in UPPCO's current rates.

- The immediate recognition of these extraordinary expenditures would significantly distort the current year's income and result in the provision of misleading information to the financial markets.

At this early stage, UPPCO cannot predict the total of the incremental O&M expenses related to the breach that should be deferred. In the period since the breach and the flooding occurred six weeks ago, UPPCO has already incurred expenses of \$3 million, representing 6% of its total 2002 O&M expense (inclusive of fuel and purchase power), that are not recoverable under insurance and that would not have been incurred but for the breach. The unpredictability of the additional O&M expenses is due, but not limited, to the uncertainty of the environmental recovery requirements, the need to design, develop and implement an enhanced safety program and safety standards, the need to formulate a plan for restoration of the facilities, potential issues regarding the scope of insurance coverage, and the potential for third party claims. The additional O&M expenses to be incurred due to these and other factors could be material and substantial.

As indicated by the attached Exhibit U-1, UPPCO has a reasonable expectation of the recovery of these costs on a deferred basis from its Michigan retail customers. UPPCO will also seek appropriate cost recovery in its rates subject to this Commission's jurisdiction. The Company understands that the eventual recovery of these costs would be determined by the Commission in a subsequent rate case, at which time the Commission would determine whether the costs were actually and prudently incurred, the appropriate method of recovery, and whether the recovery is just and reasonable.

To accomplish the deferral before this Commission, UPPCO will debit Account 182 and credit the appropriate expense accounts.

UPPCO does not now anticipate exceeding the limits of either its property insurance or liability insurance coverage. However, should this change, UPPCO will file and request additional approval for deferral accounting. UPPCO would appreciate being advised of any specific requirements or if any additional information is needed in order to achieve its proposed accounting.

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Any questions regarding the deferral should be addressed to:

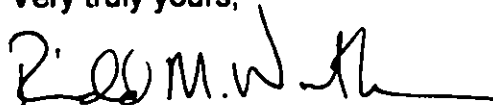
Mr. Dennis M. Derricks
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Wisconsin Public Service Corporation
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E-mail: clgentile@brudergentile.com

We appreciate your consideration of this matter. Please do not hesitate to contact us if you have any questions.

Very truly yours,



Richard M. Wartchow
Counsel for Upper Peninsula Power Company

CLG:RMW/psf

cc: Mr. Dennis M. Derricks
Ms. Diane L. Ford
Michigan Public Service Commission

Attachment

EXHIBIT U-1

July 15, 2003

**MICHIGAN PUBLIC SERVICE COMMISSION APPLICATION FOR
DEFERRAL WITH RESPECT TO UPPCO's
MICHIGAN RETAIL RATES**

Loomis, Ewert, Parsley, Davis & Gotting
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TELEPHONE: (517) 482-2400 FACSIMILE: (517) 482-7227

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KELLY K. REED
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DANIEL L. PULTER
EDDONNA M. RUDDOCK
KEVIN J. RORAGEN
THERESA A. SHEETS
LISA A. HANSON
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SARA L. LAFLEUR
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HOWARD J. SOIFER
(1948-2003)
GEORGE W. LOOMIS
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OF COUNSEL

July 15, 2003

Mr. Robert W. Kehres
Acting Executive Secretary
Michigan Public Service Commission
6545 Mercantile Way
P.O. Box 30221
Lansing, MI 48909-7721

Re: Upper Peninsula Power Company
MPSC Case No. U-13831 [e-file]

Dear Mr. Kehres:

Enclosed for filing in the above referenced matter are an original and four (4) copies of the Application. This document is also being electronically filed.

Very truly yours,

LOOMIS, EWERT, PARSLEY,
DAVIS & GOTTING, P.C.



Sherri A. Wellman

SAW/kb
Enclosures
Cc: without encl. Dennis Derricks

STATE OF MICHIGAN
BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter of the application of)
UPPER PENINSULA POWER COMPANY)
for deferral accounting approval of costs associated)
with the breach of the Silver Lake Earthen Dike.)
_____)

Case No. U-13831

APPLICATION

UPPER PENINSULA POWER COMPANY ("UPPCO" or the "Company") requests that the Michigan Public Service Commission ("Commission") authorize UPPCO to defer for accounting purposes all incremental costs incurred as a result of the breach of the fuse plug spillway end earthen dike on the Silver Lake Reservoir. In support of this application, UPPCO states the following:

1. UPPCO is a Michigan corporation, which is wholly owned by WPS Resources Corporation, a Wisconsin Corporation. UPPCO's principal offices are located at Houghton, Michigan. UPPCO is a public utility engaged in the generation, purchase, distribution and sale of electric energy in the Upper Peninsula of Michigan.

2. UPPCO serves certain cities, villages, and townships located in the counties of Alger, Baraga, Delta, Houghton, Iron, Keweenaw, Marquette, Menominee, Ontonagon and Schoolcraft. UPPCO's primary service area is known as its Integrated System and services are provided directly or indirectly to various communities and localities in each of the above-named counties except Iron County. In Iron County,

UPPCO serves in and about the City of Iron River, such service area being known as its Iron River System.

3. Michigan's Upper Peninsula received heavy rainfall in the May 9-12, 2003 timeframe causing flooding in several areas. In particular, on May 14, 2003, an UPPCO owned dike on the Silver Lake Reservoir in Marquette County breached and released a significant amount of water from the basin. The released water created a new river bed with a distance of approximately .75 miles before merging with the existing Dead River riverbed. The Hoist and McClure dams located below the Silver Lake Reservoir that are also owned and operated by UPPCO, held but spilled the excess water. The Tourist Park Dam, owned by the City of Marquette, located further downstream of the UPPCO facilities and near Lake Superior, was also breached. As a result, portions of the City of Marquette were flooded causing approximately 1752 people to be evacuated for 28 hours and causing damage to several roads and bridges. The Presque Isle Power Plant, owned by Wisconsin Electric Power Company, and located in Marquette, was shut down due to the flood.

4. Governor Granholm declared the area a "State of Emergency" that was in effect from May 15th through mid June. Preliminary published estimates of the damages to the region as result of the flood were estimated to be approximately 100 million. Emergency procedures were put in place for the region.

5. The dike that was breached on the Silver Lake Reservoir included a "Fuse Plug" that was installed in the Fall of 2002 pursuant to dam safety modifications approved by the Federal Energy Regulatory Commission ("FERC") as part of the relicensing efforts. In simple terms, the fuse plug is compacted soil on the top of the dike that contains V-shaped notches that are intended to relieve excess water from the reservoir in a controlled manner to protect the rest of the dike. The fuse plug was

designed by Montgomery, Watson, Harza, a large engineering firm headquartered in Broomfield, Colorado that has significant experience in hydro related projects, including dam safety modifications. The fuse plug was installed by Moyle Construction, a construction firm headquartered in Houghton, Michigan that has performed construction for UPPCO on previous hydro related projects. The fuse plug was inspected and approved by FERC in October, 2002. On the night of the incident (May 14), the fuse plug failed.

6. On June 2, 2003, UPPCO filed with the FERC an incident report. Representatives from the FERC have visited the site and will attempt to determine the root cause of the fuse plug failure.

7. FERC approved the fuse plug installations at Silver Lake and UPPCO was scheduled to install two more fuse plugs at other dams. These future fuse plugs are on hold until further notice from the FERC. Replacement of the dike at the Silver Lake Reservoir is also on hold pending further analysis and may be replaced in 2004 at the earliest.

8. At this time, the Company cannot accurately quantify the total cost associated with the breach of the Silver Lake Reservoir dike. It will be some time before the root cause of the fuse plug failure is determined and responsible parties, if any, are identified. It will also take time to determine the total damages and costs as a result of the flooding. As addressed in paragraphs 10 through 15, these costs include, but are not limited to, costs to respond to the breach and subsequent flooding, costs to determine the cause of the dike failure, costs of determining and dealing with third party damage claims, and safety and environmental recovery costs.

9. Representatives from the Federal Emergency Management Agency ("FEMA") visited the site to make an evaluation for potential federal aid. The Michigan Governor

formally requested federal disaster aid, which was denied by President Bush. The state of Michigan is currently reviewing options to appeal this decision.

10. UPPCO has retained counsel who has hired independent experts to conduct an investigation of and provide a root cause analysis of the breach. In addition, UPPCO hired environmental consultants to provide an assessment of environmental recovery needs. UPPCO has an excess liability insurance policy for third party damages with a \$200,000 deductible. Expenses in excess of the \$200,000 deductible have been incurred by these consultants as well as legal fees incurred which includes fees of these consultants as part of the investigation.

11. UPPCO has a property insurance policy for UPPCO facilities. This policy has a \$1,000,000 deductible and also contains customary exclusions for damages to land. This means that making repairs to un-improved land may not be covered by the policy.

12. Also increased power supply costs incurred by UPPCO to serve its customers are not covered under the UPPCO insurance policies. As a result of the loss of the Presque Isle Power Plant, UPPCO, among other things, restarted the 19 Mw gas fired Warden Plant and leased and installed 20 Mw of temporary diesel generators. The Company will be requesting recovery of the fuel expenses to restart and operate the Warden Plant and fuel and lease expenses associated with the generators through the Power Supply Cost Recovery ("PSCR") mechanism. However, in this application UPPCO is requesting deferred accounting approval of the incremental Operation & Maintenance ("O&M") costs associated with restarting the Warden plant and the costs associated to electrically connect the 20 Mw of temporary diesel generation.

13. UPPCO has also incurred incremental expenses associated with security as a result of the breach of the Silver Lake earthen dike. A security firm was hired to

monitor the area around the Silver Lake Reservoir and Dead River to keep the public away for safety reasons and UPPCO has taken out advertisements educating the public on safety concerns created by the flooding. Contractors were hired the night of the incident (May 14) to move soil material to shore up the Hoist and McClure dams to mitigate further damages. There are also some incremental employee expenses that are being incurred as a result of this incident that UPPCO is requesting deferral of. This includes incremental overtime, meals, lodging, and travel expenses. These costs would not include normal wages of either UPPCO or other WPS Resources Corporation employees.

14. Some preliminary work has been done at and near the Silver Lake Reservoir to make the area safe and minimize future impacts. This work includes seeding of some of the Silver Lake Basin and stabilizing newly created riverbanks. Some of this work is being funded 75% from the United States Department of Agriculture.

15. In summary, UPPCO is requesting approval to defer incremental O&M expenses incurred as a result of the breach of the fuse plug spillway and earthen dike on the Silver Lake Reservoir. UPPCO is not requesting approval to defer capital costs associated with the UPPCO property damage or UPPCO or other WPS Resources Corporation internal labor costs other than stated above in Paragraph 13.

16. To the degree that UPPCO obtains payments from parties associated with this incident, including insurance settlements, governmental aid, and recovery from responsible third parties, these payments shall be credited against the incremental costs deferred by UPPCO.

17. UPPCO is not anticipating exceeding the limits of either its property insurance or liability insurance coverage. However, should this change, UPPCO will file requesting additional approval for deferral accounting.

18. UPPCO offers the following information as to why costs associated with the breach of the Silver Lake Reservoir dike that are incremental to costs reflected in UPPCO's current Integrated System retail electric rates should be deferred:

- a. The costs are unusual and constitute an extraordinary event;
- b. The immediate recognition of the expenditures would cause UPPCO serious financial harm or significantly distort the current year's income, and;
- c. The Silver Lake fuse plug design and construction were inspected and approved by FERC.

19. UPPCO is requesting the Commission to provide a deferral, beginning May 14, 2003, for the costs incremental to costs already contained in UPPCO's current Integrated System retail electric rates, resulting from the May 2003 breach of the fuse plug spillway and earthen dike at the Silver Lake Reservoir.

20. UPPCO also requests that these deferral expenses be subject to recovery in future rates, following a subsequent rate case or rate surcharge proceeding to be initiated by UPPCO.

21. The original fuse plug installed at Silver Lake was capitalized on UPPCO's books. As of June 2003, most of the original cost is undepreciated since the fuse plug was only installed about a year ago as a condition of the FERC relicensing. Since this plant no longer exists due to the flood, UPPCO needs to retire it and UPPCO proposes to follow normal utility accounting which will write off the undepreciated value of the plant, about \$710,000, to the depreciation reserve. The next time UPPCO files for

depreciation rates, such rates should be adjusted to reflect this additional reserve including any offset the Company might receive from the insurance company. Currently, this is the biggest plant item that UPPCo believes must be written off. However, if other undepreciated plant must be written off as a result of the flood, UPPCO proposes to follow similar accounting.

22. This application seeks approval of deferred accounting treatment only.

23. Jurisdiction in this matter is pursuant to 1909 PA 300 as amended, MCL 462.2 et seq.; and the Commission's Rules of Practice and Procedure, R 460.17101 et seq.

24. Since UPPCO's request made herein will not result in a rate increase to its customers, the request may be granted without the expense and time consuming process of notice and hearing.

WHEREFORE, Upper Peninsula Power Company requests that the Commission issue an ex parte order:

- A. Authorizing UPPCO to defer, for accounting purposes, incremental O&M costs associated with the breach of the fuse plug spillway and earthen dike on the Silver Lake Reservoir; and
- B. Granting such other and further relief as may be necessary and lawful.

UPPER PENINSULA POWER COMPANY

Dated: July 15, 2003

By *Sherri A. Wellman*
One of its Attorneys
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