

STATE OF NORTH DAKOTA
PUBLIC SERVICE COMMISSION

Montana-Dakota Utilities Co. : Case No.
2000 Electric Operations : PU-399-01-186
Annual Report :

TRANSCRIPT OF
HEARING
VOLUME I

Taken At
State Capitol
Public Service Commission
Bismarck, North Dakota
February 25, 2002

BEFORE ALLEN C. HOBERG
-- PROCEDURAL HEARING OFFICER --

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A P P E A R A N C E S

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1 (The following proceedings were had and
2 made of record herein, commencing at 9:02 a.m.,
3 Monday, the 25th day of February, 2002:)

4 (Exhibits 1 through 10 were marked for
5 identification.)

6 MR. HOBERG: Okay. Let the record show
7 it's approximately nine a.m. on the 25th day of
8 February in the year 2002. This is the time and
9 place scheduled in the Public Service Commission
10 hearing room in the State Capitol in Bismarck,
11 North Dakota, for the hearing in the matter of the
12 North Dakota Public Service Commission staff
13 complaint regarding Montana-Dakota Utilities
14 Company in its year 2000 electric operations annual
15 report.

16 In November of last year the Office of
17 Administrative Hearings received a request from the
18 Public Service Commission to provide an
19 administrative law judge to preside in this matter.
20 My name is Allen Hoberg. I've been duly designated
21 by the Commission to serve as procedural hearing
22 officer today.

23 We'll start with the parties giving their
24 appearances for the record, beginning with the
25 complainant, PSC, and followed by the respondent.

1 Mr. Binek, please, if you'd tell us -- if you'd
2 make your appearance and tell us who you have with
3 you, please.

4 THE WITNESS: My name is William Binek.
5 I'm chief counsel for the Public Service
6 Commission, and I am appearing today as advocacy --
7 as counsel for the advocacy staff in this
8 proceeding. With me is Mike Diller, who is the
9 Commission's chief accountant or director of
10 accounting, and Mr. Charles King right in the table
11 behind me, who is the Commission's cost-of-capital
12 expert witness.

13 MR. HOBERG: Thank you. Will Mr. Fahn be
14 participating?

15 MR. BINEK: Oh, Jerry Lein is also on the
16 staff side. Mr. Fahn is a Commission advisor.

17 MR. HOBERG: Okay. Thank you, Mr. Binek.
18 Mr. Pearce, are you handling the matter this
19 morning?

20 MR. PEARCE: Yes, I am. William Pearce of
21 Pearce & Durick in Bismarck appearing on behalf of
22 Montana-Dakota Utilities Company. Also
23 appearing -- well, at the counsel table with me is
24 Mr. Donald Ball, MDU's director of regulatory
25 affairs. Mr. Douglas Schulz is also appearing with

1 me, MDU's legal staff, and with him is Rita Mulkern
2 of MDU, and also at the table with Mr. Ball and
3 myself is Mr. Terry Blinsky, one of our witnesses,
4 and we have four, five other of our witnesses who
5 are in the room. I believe all of our witnesses
6 are here.

7 MR. HOBERG: Okay. And you've indicated
8 that you have about nine witnesses?

9 MR. PEARCE: I think we have nine
10 altogether. That's right.

11 MR. HOBERG: Thank you, Mr. Pearce. I
12 don't believe there are any intervenors in this
13 matter today. Are you aware of any intervenors,
14 Mr. Binek?

15 MR. BINEK: No.

16 MR. HOBERG: Mr. Pearce?

17 MR. PEARCE: No.

18 MR. HOBERG: Is there anyone else who
19 wishes to participate in this hearing today in any
20 capacity? Anyone else present?

21 All right. And, of course, we have today
22 also members of the Public Service Commission, to
23 my left Commissioner Leo Reinbold, Commission
24 President Susan Wefald, and Commissioner Tony
25 Clark; and beginning with Commissioner Wefald, who

1 has the electric portfolio, I'll now ask the
2 commissioners for their opening comments.
3 Commissioner Wefald, please.

4 COMMISSIONER WEFALD: Good morning. I
5 know that this is a very important case to everyone
6 in this room. A lot of work has gone into it by
7 all of the parties as evidenced by the testimony
8 that has been presented to the Commission ahead of
9 time for us to read and to go over. I know that
10 this -- there's important issues involved in this
11 case, for example, the wholesale power sales that
12 are involved in it, and I'm looking forward to a
13 good hearing. Thank you.

14 MR. HOBERG: Thank you, Commissioner
15 Wefald. Commissioner Reinbold, please.

16 COMMISSIONER REINBOLD: Good to see
17 everyone here. It's a hearing and I'm here to hear
18 what you have to say. Not many people are
19 interested in what I have to say, so let's move on
20 and get started.

21 MR. HOBERG: Thank you, Commissioner.
22 Commissioner Clark, please.

23 COMMISSIONER CLARK: Certainly very
24 interesting and important case. Enjoyed reading
25 through the submitted written testimony and look

1 forward to a good hearing today. On a personal
2 note I would add it seems like all we've been doing
3 lately are telephone hearings, which is my
4 portfolio, which means I usually get to ask
5 questions first, but I get to ask questions last so
6 I get to depend on the other Commissioners now to
7 do all the heavy lifting for me, so that feels
8 good.

9 MR. HOBERG: Thank you, Commissioner
10 Clark. And our court reporter is Stephanie Smith
11 today.

12 Just a brief summary of the application
13 before we get going. On September 7th the North
14 Dakota Public Service Commission received a
15 complaint from its staff alleging that
16 Montana-Dakota Utilities is recovering more revenue
17 than necessary to earn a reasonable return on its
18 investment in North Dakota to provide electric
19 utility service.

20 On September 19th of 2001 the Commission
21 found that the staff complaint stated a prima facie
22 case and that the complaint should be served on
23 MDU. The staff complaint was served on MDU on
24 September 20th.

25 On October 9th MDU filed an answer

1 admitting some of the allegations of the complaint,
2 denying others, and asking that the complaint be
3 dismissed.

4 On November 21st the Commission served its
5 notice of hearing, notice of public input sessions
6 and notice of intervention deadline. Public input
7 sessions were scheduled for December 11th and held.
8 The public or formal hearing was scheduled for
9 today.

10 The issues for this matter as stated in
11 the notice of hearing are as follows: What is the
12 value of MDU's property, useful -- used and useful,
13 for the service and convenience of the public in
14 North Dakota?

15 What is MDU's rate of return on its
16 property, used and useful, for the service and
17 convenience in North Dakota?

18 What is a just and reasonable rate of
19 return on MDU's property, used and useful, for the
20 service and convenience of the public in North
21 Dakota?

22 What rates and charges are necessary to
23 provide a just and reasonable rate of return on
24 MDU's property, used and useful, for the service
25 and convenience of the public in North Dakota?

1 Are MDU's rate schedules designed in such
2 a manner that they result in a basis of charge to
3 its customers that is just and reasonable without
4 discrimination?

5 And, finally, any other relevant
6 information or proposals concerning the proceeding.

7 The burden of proof today is on the
8 complainant, the PSC staff, to show by the
9 preponderance or the greater weight of the evidence
10 that in the public interest MDU's electric service
11 rate should be changed to reduce annual revenue by
12 9.155 million, or to show that other administrative
13 action as a result of the staff complaint is
14 appropriate.

15 The parties have agreed to a procedural
16 schedule for this hearing and have prefiled direct,
17 rebuttal and surrebuttal testimony. Here is the
18 hearing procedure that'll be followed today in
19 light of that procedural schedule.

20 We'll start with the complainant, the PSC
21 staff, who indicates that they will present two
22 witnesses in this matter, Mr. Mike Diller and Mr.
23 Charles King. Both of them have already filed
24 direct and rebuttal testimony. So the staff will
25 call them to respond to MDU's -- primarily to

1 respond to MDU's prefiled surrebuttal testimony.

2 Following the questions by Mr. Binek of
3 each of those witnesses, they will be subject to
4 cross-examination by MDU, if it desires; and
5 thereafter the members of the Public Service
6 Commission may ask questions. Following Commission
7 questions I will allow such further questions of
8 the witnesses as are necessary.

9 Then following the complainant's
10 presentation of its two witnesses, I'll call on MDU
11 to present its case and further answer to the
12 complaint. MDU has already filed the direct
13 testimony of six witnesses, Mr. Fox, Mr. Gaske, Mr.
14 Blinsky, Mr. Gress, Mr. Ball and Ms. Mulkern. It
15 has also prefiled in response to Mr. Diller's
16 rebuttal testimony the surrebuttal testimony of
17 eight witnesses, Mr. Gaske, Mr. Mahowald, Mr.
18 Wilkinson, Mr. Schiffman, Mr. Blinsky, Mr.
19 Espeland, Mr. Ball and Ms. Mulkern.

20 Mr. Pearce has indicated that he will call
21 nine witnesses today to provide further testimony,
22 and it will be essentially the same procedure
23 there. Mr. Pearce will have some questions for
24 them on direct, Mr. Binek may have some questions
25 for them on cross-examination, then the Commission

1 may have some questions, then I'll allow such
2 further questions as are necessary of the
3 witnesses.

4 As I've indicated, there's been a lot of
5 prefiled testimony. If there's documentation
6 that's introduced today besides that that's already
7 marked and distributed, we'll need seven copies for
8 the record.

9 No decision is being reached on this
10 matter today. The proceedings are being
11 transcribed and tape-recorded and will be reviewed
12 by the Commission later. The Commission will then
13 issue its findings of fact, conclusions of law and
14 order in regard to the complaint, and anyone who
15 doesn't agree with the final -- I should say any
16 party who doesn't agree with the final decision of
17 the Commission may have appeal rights or other
18 rights under Chapter 28-32, the Administrative
19 Agencies Practices Act or under the practices and
20 procedural rules of the Commission, Article 69-02
21 of the North Dakota Administrative Code.

22 Expense of transcribing these proceedings,
23 if necessary, will be borne by the party appealing
24 the decision.

25 Are there any questions about the

1 procedures today? Mr. Binek?

2 MR. BINEK: No.

3 MR. HOBERG: Mr. Pearce?

4 MR. PEARCE: No.

5 MR. HOBERG: Commission members, any
6 questions?

7 COMMISSIONER WEFALD: No.

8 MR. HOBERG: Okay. Mr. Binek, did you
9 wish to begin with an opening statement?

10 MR. BINEK: I don't believe it would be
11 necessary to have an opening statement. The way we
12 intend to proceed is a little bit different in this
13 case because this case is a little bit different.

14 A great deal of the testimony -- the basis
15 for the cases are -- on both sides are laid out in
16 the rebuttal and from the MDU standpoint the
17 surrebuttal testimony that was just filed a few
18 days ago and was filed in accordance with the
19 procedure that was set up, but the staff witnesses
20 need to respond to that surrebuttal testimony.

21 So instead of just having the witnesses
22 present a summary, they will get into some depth in
23 their opening testimony and there will be question
24 and answer rather than just a summary, but I intend
25 to start out with Mr. Diller, who is going to have

1 a Power Point presentation, and I think that that
2 will lay a good overall -- or a good overview of
3 the case.

4 So I don't think that there's any need for
5 me to spend time with a preliminary statement. It
6 will be covered basically in Mr. Diller's opening
7 testimony.

8 MR. HOBERG: Thank you, Mr. Binek. I do
9 hope, though, that the parties -- even though it's
10 been docketed in the record, that all of the
11 exhibits that will be evidence in this matter, even
12 the direct and rebuttal and surrebuttal, will be
13 referred to so it's on the record of the hearing
14 today.

15 MR. BINEK: Yes.

16 MR. HOBERG: Okay. Okay. Please call
17 your first witness then, Mr. Binek.

18 MR. BINEK: I will call Mr. Mike Diller,
19 and I would ask that Mr. Diller be allowed to
20 testify back at the desk behind me where he has the
21 Power Point presentation set up, and there is a
22 microphone there.

23 MR. HOBERG: Okay. And that's good, but
24 we do need to swear him in, nevertheless, and I
25 need to tell you, Mr. Diller, and really all of the

1 witnesses here today, as I'm required to do by law,
2 that the maximum penalty for perjury in this state
3 is a Class C felony, punishable by a maximum 5
4 years imprisonment, \$5,000 fine or both.

5 (Witness sworn.)

6 MR. HOBERG: Thank you. Mr. Binek,
7 please.

8 MR. BINEK: Thank you.

9 MIKE DILLER,
10 having been first duly sworn, was examined and
11 testified as follows:

12 DIRECT EXAMINATION

13 BY MR. BINEK:

14 Q. Please state your name for the record.

15 A. Mike Diller.

16 Q. And what is your occupation?

17 A. I serve the Commission as its director of
18 accounting.

19 Q. And how long have you been employed by
20 the -- when you refer to the Commission, you're
21 talking about the Public Service Commission?

22 A. That's correct.

23 Q. How long have you been employed by the
24 Commission?

25 A. About 14 years.

1 Q. And where -- were you employed anywhere
2 prior to coming to work for the Commission?

3 A. I worked for the Oklahoma Corporation
4 Commission for about four years and a couple other
5 places before that.

6 Q. What is your educational background?

7 A. I have an accounting degree and I'm a
8 certified public accountant.

9 Q. Okay. And where did you get your degree?

10 A. Oklahoma Christian College.

11 Q. Have you testified previously in rate case
12 proceedings?

13 A. I have.

14 Q. Mr. Diller, I've handed you what have been
15 marked as Exhibits 1, 2 and 3, and can you identify
16 those exhibits, please?

17 A. Exhibit 1 is my direct testimony, Exhibit
18 2, rebuttal testimony, and Exhibit 3 is the Power
19 Point slides that I'll be presenting.

20 Q. Was the testimony in Exhibits 1 and 2
21 prepared by you or under your direction?

22 A. They were prepared by me.

23 Q. Are there any corrections that need to be
24 made to either Exhibits 1 or 2?

25 A. I don't believe so.

1 Q. If I asked you the questions today that
2 are contained in those exhibits, would your answers
3 be the same?

4 A. Yes.

5 Q. And do you adopt Exhibits 1 and 2 as your
6 sworn testimony in this case?

7 A. I do.

8 Q. And you said Exhibit 3 is -- are basically
9 the slides of the Power Point presentation that
10 you'll be making?

11 A. That is correct.

12 MR. BINEK: Okay. Thank you. And at this
13 time I would offer Exhibits 1, 2 and 3.

14 MR. PEARCE: No objection.

15 MR. HOBERG: Exhibits 1, 2 and 3 are
16 admitted.

17 MR. HOBERG: Commissioners, do you have
18 the exhibits?

19 COMMISSIONER WEFALD: Yes.

20 Q. (MR. BINEK CONTINUING) Mr. Diller, would
21 you please provide a brief summary of MDU's
22 reported earnings to the Commission?

23 A. Yes. As you can see here on this slide,
24 MDU's last electric rate case was filed in 1986 and
25 resulted in a 6.37 percent rate increase. Since

1 then earnings have fluctuated from year to year,
2 and that's basically what that chart on the right
3 shows.

4 The Commission has basically used a 12-
5 percent return on equity as kind of a benchmark in
6 settlements and even after full-blown rate cases
7 has ordered returns around 12 percent.

8 As you can see then, earnings have been
9 above 12 percent most of the time since the last
10 rate case, and in particular the last three or four
11 years earnings have been significantly higher than
12 12 percent. If -- and just to give you something
13 to think about, I guess, each return on equity is
14 worth about 1.1 million dollars. So if you wanted
15 to lower MDU's electric earnings by one percentage
16 point, you'd have to reduce rates by 1.1 million.

17 So just so you understand a little
18 further, I guess, so if we had perfect vision in
19 1998 and we knew exactly what the future would hold
20 in 1999, we would have lowered rates by around
21 four-and-a-half-million dollars, and even then 2000
22 and 2001 earnings would have been above that 12
23 percent again.

24 So we -- staff just believes that the
25 recent earnings are too high for a regulated

1 monopoly service provider and need to be adjusted.

2 Q. What test year are you using in this
3 proceeding?

4 A. Well, it's been kind of an evolutionary
5 process. We started out with a 2000 test year. We
6 filed a complaint against MDU alleging that MDU was
7 overearning by 9.155 million dollars, but then
8 in -- a few weeks ago 2001 results were received
9 and yielded basically the same return that the
10 year-end 2000 did.

11 So in staff's rebuttal testimony we give
12 consideration to the new 2001 test-year information
13 and MDU's testimony effectively moving the test
14 year to 2002 and beyond. Staff reduced its
15 original position to a finding of excess earnings
16 of 7.3 million instead of the 9.2 million.

17 Q. What should the Commission consider in
18 determining if rates are too high?

19 A. Well, the Commission's been employing
20 profit regulation for a long, long time, and we
21 should stick with that. Profit regulation is
22 comprised of three basic components, rate base or
23 investment in North Dakota electric plant; and then
24 rate of return, which is adjusted a weighted cost
25 of capital. It's a percentage that's based on the

1 cost of debt on term -- I'm sorry, cost of debt,
2 common equity and preferred stock. If you take
3 rate of return times rate base, you get return
4 required, and then you compare that to net
5 regulated income, and the difference is excess
6 earnings. You've got to apply a tax factor to
7 that, but essentially that's it.

8 Q. Would you describe what has happened to
9 the rate base level since the last test year?

10 A. Yes. We -- the Commission authorized
11 140 -- approximately 140-million dollars of rate
12 base in the last test year, and rate base did climb
13 the first two or three years after that and since
14 then has been kind of on a downward spiral. There
15 was a little bit of an increase there in the later
16 years, but overall the trend has been deteriorating
17 rate base, and basically what that means is that
18 accumulated depreciation and accumulated deferred
19 income taxes are outstripping plant and service
20 additions.

21 Q. What do you mean by rate base? What is
22 rate base?

23 A. What is rate base?

24 Q. Yeah.

25 A. Okay. I think that's -- well, rate --

1 Q. Just a general description.

2 A. Yeah. I think we're going to see it on
3 the next slide, that's why I'm hesitating, but rate
4 base is just an investment necessary and plant in
5 service, materials and supplies, those kinds of
6 things to provide electric service.

7 Q. Okay. Thank you. Is there any agreement
8 between staff and MDU as to the appropriate rate
9 base level for this proceeding?

10 A. Yes, basically there is. We don't have an
11 issue with rate base any longer. In rebuttal
12 testimony staff updated rate base for 2001
13 financial information which does reflect, like I
14 indicated, a lower rate base than originally filed
15 for the year-end 2000, but we also accepted MDU's
16 adjustments to rate base for what it termed as
17 extraordinary capital costs in its rebuttal
18 testimony. So in surrebuttal testimony MDU
19 accepted staff's rate base, and there really is no
20 issue with rate base.

21 Q. Please provide the Commission with a
22 detailed summary of rate base as agreed to by the
23 parties in this case.

24 A. This slide basically shows what I just
25 talked about, the different components of rate

1 base. The beginning -- though this slide does not
2 indicate, the beginning balance there is the
3 beginning balance as of 2002, and then the
4 adjustments reflect MDU's extraordinary capital
5 costs, and so we have a higher ending balance, and
6 just average the beginning and ending and that's
7 what we've agreed to as far as rate base, the
8 \$128,902,000.

9 Q. Okay. Moving on to the next component of
10 profit regulation, and that's the required return
11 on investment. Please summarize the reported cost
12 of capital since the last rate proceeding.

13 A. I presented this at the public information
14 session. It's included here just to refresh the
15 Commissioners' minds, but essentially we started --
16 when we -- when the Commission authorized the last
17 rate of return, it was set at 10.88 percent. That
18 just indicates what MDU has reported to us over the
19 years as far as its actual cost of capital,
20 weighted cost of capital, to give you some idea of
21 where it's been, and the components of cost of
22 capital are listed on the left side there.

23 Q. Has the North Dakota Public Service
24 Commission had any rate cases or earnings review
25 proceedings in the years 2000 and 2001?

1 A. Yes, it has.

2 Q. What are those cases and when were they
3 decided?

4 A. Well, we had a couple PBR cases with Otter
5 Tail and NSP, and in those cases we used a 12
6 percent return on equity as a benchmark. I'm --

7 MR. HOBERG: For the record, Mr. Diller,
8 PBR is what?

9 THE WITNESS: Performance based
10 regulation.

11 MR. HOBERG: Thank you.

12 THE WITNESS: The order date for NSP was
13 December 29th -- and Otter Tail was December 29th,
14 2000, and -- I hope I'm not getting ahead of you,
15 Bill, but --

16 Q. (MR. BINEK CONTINUING) Go ahead.

17 A. -- we also had a gas case with Northern
18 States Power Company where the Commission
19 authorized or ordered an 11.5 percent return on
20 equity.

21 Q. Okay.

22 A. And that one was decided October 9th --
23 I'm sorry. That's application date. It was
24 ordered June 27th, 2001.

25 Q. And the -- that NSP gas case, was that a

1 regular rate proceeding rate case?

2 A. Yes, it was.

3 Q. And what -- what did you say the return on
4 equity was set at in that case?

5 A. 11.5.

6 Q. Was there expert testimony on cost of
7 capital and return on equity in that case?

8 A. There was.

9 Q. Who was the staff's cost-of-capital
10 witness in that case?

11 A. Mr. King.

12 Q. Pardon me?

13 A. Mr. King.

14 Q. Okay. The same witness that is here --

15 A. Same witness.

16 Q. -- today. Would you please provide the
17 Commission with a comparison of MDU's cost of debt
18 with the other two investor-owned utilities
19 operating within the State of North Dakota?

20 A. Bill, could we go back one?

21 Q. Oh, I'm sorry. Did I move ahead of you
22 here? Okay. The cost of capital comparison?

23 A. Right.

24 Q. Would you please provide a cost of capital
25 comparison for the Commission to identify the

1 differences between the company's recommendation
2 and that of staff?

3 A. Yes. On this slide you can see that the
4 capital ratio is the same for both staff and MDU.
5 We are not taking issue with the capital ratio. We
6 are taking issue with the cost of long-term debt
7 and the cost of equity, and I've highlighted those
8 with original boxes there. That's -- those are the
9 issues with regard to cost of capital.

10 Q. Now would you please provide the
11 Commission with a comparison of MDU's cost of debt
12 with the other two investor-owned utilities
13 operating within North Dakota?

14 A. Yes. What we have here basically is a
15 chart of long-term debt cost reported to the
16 Commission since MDU's last test year. In the last
17 test year the Commission authorized a long-term
18 debt cost of just a little over ten percent.
19 That's signified by the solid red line there, and
20 then you have the comparison of MDU, Otter Tail and
21 NSP as far as the cost of debt. NSP is around
22 seven, Otter Tail's is around eight, and MDU's is
23 around nine.

24 Q. Who from the staff will be testifying to
25 the appropriate cost of long-term debt?

1 A. Mr. King.

2 Q. Moving on to the last component of profit
3 regulation, please summarize net regulated income
4 results reported since the last rate case.

5 A. Well, net regulated income is simply
6 revenues less expenses. Again, the red line
7 indicates what was authorized in the last rate case
8 back in 1986. You can see that net regulated
9 income has fluctuated some. It appears like
10 there's a number of years here that they've under-
11 earned, but that's not really the case. If you
12 recall the rate base summary, rate base has been
13 declining, and so when net income declined there in
14 that dip, it really wasn't a problem. MDU still
15 managed to return -- earn a reasonable return on
16 its investment, and you can see in the last few
17 years that net regulated income has gone up quite a
18 bit.

19 Q. Okay. I think you've already answered
20 this, but did MDU underearn every time its return
21 dipped below the red line?

22 A. No.

23 Q. Would you please break down revenues by
24 major categories for the Commission?

25 A. Well, I've broken them down into three

1 categories, retail sales, sales for resale, and
2 then anything else, other revenue.

3 Q. Did staff make any adjustments to the 2001
4 retail revenues?

5 A. We did not. MDU does not calculate the
6 impact of weather on retail sales. Both Otter Tail
7 and NSP provides us with weather normalized
8 information, but MDU does not have that capability,
9 and so in order for us to make an adjustment to
10 retail sales we would have had to develop our own
11 econometric model, and we just simply don't have
12 the resources to do that. I will make note here
13 that North Dakota net margins, if you take revenues
14 less production expense and include the off-system
15 sales, which has fluctuated in the last few years,
16 if you take those out, the net margins are down 1.1
17 million dollars in 2001 compared to 2000, but we've
18 not made an adjustment.

19 Q. If this case used a 2000 test year, would
20 North Dakota net margins be higher?

21 A. Yes. 1.1 million dollars higher.

22 Q. Why didn't staff develop its own
23 economic -- econometric model for forecasting sales
24 and make a weather normalized adjustment?

25 A. Well, like I said, we don't have the

1 internal resources necessary to develop something
2 like that. It has also to do with the way the
3 Commission is funded. We were provided dollars to
4 hire expert witnesses for rate increase
5 applications, but the legislature appropriates very
6 little money for cases like this. In fact, we had
7 to stretch this thing over two bienniums in order
8 to put the funds together to hire our one expert.

9 Q. Now moving on to sales for resale margins.
10 First, would you please explain what you mean by
11 the term "sales for resale"?

12 A. Explain the -- I'm sorry. What did you
13 say?

14 Q. What do you mean by the term "sales for
15 resale"?

16 A. Sales for resale is kind of what it sounds
17 like. It's sales that MDU makes to another company
18 for resale to the end customers.

19 Q. And how important is the resale issue in
20 this case?

21 A. Very important. It's most of the case.
22 You can see the numbers on the left-hand side
23 there. I mean, this is some serious -- serious
24 money here. Those are five-million-dollar
25 increments on a total company basis.

1 Q. Would you please summarize how margins
2 have changed in recent years?

3 A. Well, this slide shows that, and
4 basically -- is that first year '96? 1996 MDU
5 reported 1.9 million dollars of net margins on
6 sales for resale, in 1997 it reported 2.5 million
7 dollars, in 1998 it reported 4.8 million dollars of
8 margins, in 1999 MDU reported margins of 9.9
9 million, in the year 2000 MDU reported margins of
10 15.9 million dollars. In staff's case it's -- in
11 staff's case it has included total company margins
12 of 15.1 million, just slightly down from 2001, and
13 then MDU has -- is currently -- as far as I'm
14 aware, currently at 6.4 million dollars for net
15 margins in 2002.

16 Q. What has caused the growth in margins?

17 A. Well, the number of customers have grown,
18 volumes are up, and revenues per megawatt-hours
19 have increased, as well. If you take change in
20 volumes and change in price, that affects the net
21 margins.

22 Q. Why should the Commission place more
23 reliance on actual results than MDU projections
24 using the futures market as a proxy for test year
25 sales for resale margins?

1 A. I'm sorry, Bill. You're going to have to
2 read that again. I didn't hear it.

3 Q. Okay. Why should the Commission place
4 more reliance -- well, first of all, why don't you
5 explain this difference. What is the difference
6 between staff and MDU?

7 A. Well, this slide capsulizes the
8 difference, I guess. We are relying on actual
9 results, and MDU -- MDU's case relies on future
10 projections.

11 Q. And why should the Commission place more
12 reliance on actual results than MDU's projections,
13 which use future markets as a proxy for test-year
14 sales for resale margins?

15 A. Well, it sounds kind of coy, but actual
16 results have actually occurred, and there's some
17 confidence in that, I guess. It's not based on a
18 theoretical application. In MDU's case the future
19 projections are based on a lot of variables, and,
20 you know, it gets -- it gets down to what we've
21 testified in our -- each party's testified in its
22 case, and that's the general market condition is --
23 it's kind of hard to predict what's going to happen
24 in the near term and thereafter. I --

25 Q. Go ahead.

1 A. Okay. I guess predicting off-system sales
2 margins for any length of time to me is more of an
3 art than a science, and I just think that there's
4 room to consider both parties' presentations.

5 Q. After reading MDU's testimony, can you
6 identify factors it claims affect the future price
7 of electricity?

8 A. Well, what I did -- the time frame -- the
9 turnaround in rebuttal and surrebuttal was so close
10 that I can't address all the issues that MDU has
11 brought up. They've added quite a few new
12 witnesses and new information in the surrebuttal
13 round. So what I did is just tried to identify
14 factors that affect resale margins in their
15 testimony, and I thought they were pretty good.
16 Future contracts, natural gas prices, droughts,
17 national economy, manufacturing industry, new
18 generation capacity, natural gas supplies. These
19 things all affect future resale margins. Weather,
20 natural gas transportation rates, incremental
21 operating costs, transactional risks, fuel cost
22 differentials, transmission constraints, generation
23 mix, transmission access, market power of supplier,
24 institutional inefficiencies, regulation
25 uncertainties, stranded costs exposure, plant

1 outages, incomplete market information, and
2 finally, nuclear safety regulations, hedging
3 activities, spark-spreads, conservation programs,
4 gas exploration levels, gas in storage, and a
5 general market uncertainty.

6 Q. What do you recommend with regard to sales
7 for resale margins?

8 A. Well, I think the uncertainties of the
9 future warrants the consideration of actual results
10 as a proxy for future rates.

11 The resulting rates in this proceeding may
12 be in effect for 15 years. Using an average of
13 recent results will smooth out recent market
14 fluctuations and provide for a normalized level
15 going forward.

16 And I might be called the big easy, I
17 guess, for suggesting this, but I am going to
18 suggest an alternative here for the Commission's
19 consideration, and basically that is to use an
20 average of the sales margins for the past three
21 years for purposes of this proceeding.

22 Q. Please show the Commission how you have
23 calculated this proposal.

24 A. It's rather straightforward. The next
25 slide shows how it's calculated. Basically add '99

1 margins, 2000, and 2001 margins. You need to add
2 back demand penalties, which I'm not sure why they
3 were included in the first place in the margins,
4 but that's also in our testimony, that demand
5 penalties should not be included as a cost of
6 service. So you add that back in and you get total
7 margins then of 35 million over the last three
8 years. You get a three-year average, compare it to
9 2001 resale margins. The difference is 4.2 and you
10 jurisdictionalize that, and staff is willing to
11 step down once again and reduce net margins by 2.8
12 million dollars on North Dakota basis.

13 Q. Why are you recommending this proposal?

14 A. Well, I think that staff needs to remain
15 considerate of what the company's trying to do and
16 considerate of the testimony that it has provided.
17 We're not operating with blinders on. We see that
18 there has been a hiccup in the general economy,
19 market conditions, and so this is just a proposal,
20 I think, to keep our testimony relevant and in the
21 ballgame.

22 Q. Okay. Next moving on to expenses, please
23 summarize any remaining differences between MDU and
24 staff.

25 A. Okay. The remaining issues, demand

1 penalty and A&G costs. As far as the demand
2 penalty goes, staff argued that it should be
3 excluded. Company in its surrebuttal testimony
4 argued that, well, if you're going to exclude the
5 demand penalty, then you should at least give us
6 the cost of procuring additional capacity to avoid
7 the demand penalty, and that made sense to me, and
8 so the demand penalty is excluded. The additional
9 capacity costs that MDU suggests in its surrebuttal
10 testimony is now included in the staff's position.

11 As far as the A&G costs, I think it
12 requires a closer look.

13 Q. Please provide a summary of the
14 administrative and general expenses so the
15 Commission understands what is included in the
16 costs.

17 A. Okay. In the administrative and general
18 expense category we have, I don't know, ten or so
19 different accounts, salaries, office supplies,
20 outside services, property insurance, injuries and
21 damages, employee pension and benefit costs,
22 regulatory commission expenses, general
23 advertising, miscellaneous, rents and maintenance
24 of the general plant.

25 Q. In recent years A&G costs in total have

1 been decreasing. Please identify what caused A&G
2 expenses in 2001 to increase by 12.4 percent.

3 A. Well, it's pretty easy to identify what's
4 caused the increase, and I guess that's the purpose
5 of this slide. You can see in 2001 that A&G costs
6 in total went up about 12 percent, and then MDU's
7 position is another 12 percent above that for 2002
8 and beyond. As far as 2001 is concerned,
9 salaries -- A&G salaries are up a little more than
10 \$800,000, office supplies is up about 37 percent or
11 \$800,000. I guess the rest are pretty much the
12 same.

13 Q. Please identify the A&G expenses that
14 remain unresolved in this case.

15 A. Office supplies, insurance expense, and
16 pensions and benefits, and under pensions and
17 benefits we have pension expense, FAS 106, or post-
18 retirement benefits, and SISP, which stands for
19 supplemental income security plan.

20 Q. In the last chart it showed that office
21 supply -- office supplies expense increased from
22 2.122 million to 2.906 million when comparing 2001
23 to 2000, or 37 percent in office supplies. Please
24 explain what would cause this.

25 A. Well, within the office supplies expense

1 account we have a number of items that are included
2 in there, automobile service, bank charges, books
3 and subscriptions, building service,
4 communications, office equipment, computer
5 infrastructure, membership fees, office supplies,
6 legal department expenses, postage and printing,
7 meals, travel, incidental expenses, and corporate
8 aircraft. The ones in red there are the particular
9 items addressed by Mr. Ball in his testimony as to
10 the reason that office supplies expense is up 37
11 percent and will stay there.

12 Q. What do you recommend the Commission
13 should approve of a reasonable and ongoing expense
14 level?

15 A. Well, staff's position is that -- is that
16 we -- office supplies expense is somewhat
17 controllable. The Commission has an office
18 supplies expense account, just like I suppose any
19 other business, and there are years when we spend a
20 lot of money on software upgrades or equipment
21 upgrades, and then there's years that we don't
22 spend hardly anything.

23 It -- if you go back and look at those
24 items that I've provided you a list of, there's
25 some controllable costs in there, and I guess

1 staff's approach has been kind of like the
2 legislature's approach to us when we request
3 appropriations, and that is we're going to give you
4 so much money and that's -- and that's what you're
5 going to -- that's how you're going to conduct your
6 business, and so we've added five percent on top of
7 2000 and suggested that that's the level we should
8 use in this proceeding. And then I guess -- can I
9 go ahead, Bill?

10 Q. Sure. Go ahead.

11 A. I guess to finish up the slide here, MDU's
12 surrebuttal testimony does not provide an
13 analytical approach to quantifying future estimated
14 costs. In Don's -- Mr. Ball's testimony there are
15 some words that explain why costs are going up, but
16 it's not -- it's not adequately quantified in my
17 mind to convince staff to change its position, and
18 I might also say, for instance -- I guess if I'm
19 going to say it's not adequate, I should give you
20 at least one example of why I think that, and as
21 far as I know, there hasn't been any effort to
22 quantify the amount of savings on corporate
23 airfares that MDU expects because of owning this
24 corporate aircraft now and -- or at least having it
25 at their disposal beginning in 2001.

1 So I just think a lot more work needs to
2 be done before I can suggest a 37 percent increase
3 in office supplies expenses is reasonable.

4 Q. Moving to insurance expense, what accounts
5 within the A&G expenses are used to record
6 insurance expense?

7 A. I think it's account 924 and 925. I think
8 those are the FERC account numbers, but in any
9 event, property insurance is the cost of insurance
10 or reserve accrual to protect against losses to
11 property; and injury and damages account is the
12 cost of insurance or reserve accruals to protect
13 against damage claims of employees or others not
14 covered by insurance, and those are basically FERC
15 descriptions of those accounts. The Federal
16 Energy -- FERC stands for the Federal Energy
17 Regulatory Commission.

18 Q. Have you reviewed Mr. Ball's surrebuttal
19 schedule DRB-2, calculating MDU's increased
20 insurance expense?

21 A. I have. I have the same concerns with
22 their analysis of insurance expense. As I
23 recall -- I don't remember -- did you reference his
24 schedule, Bill?

25 Q. DRB-2.

1 A. I don't have it in front of me, but
2 it's -- I can recall it well enough. In that
3 schedule Mr. Ball lists premiums by all the
4 different insurance carriers, comes up with a total
5 company amount, and then jurisdictionalizes it and
6 compares that to what MDU or Mr. Ball calls, I
7 think, North Dakota expense of 420,000, is what I
8 recall, and the difference is an adjustment. I
9 don't know what that \$420,000 represents.

10 If I look at both -- if you go back -- if
11 you go back here and you add up property insurance
12 and injuries and damages for 2001, the 344 and 474,
13 you'll have over \$800,000 worth of insurance costs.
14 Now there might be other insurance costs in other
15 accounts somewhere, but when you -- when you
16 consider that there's \$800,000 worth of expenses
17 here and their list comes up with \$800,000 worth of
18 expenses, I don't know if that's an increase or
19 not. I just can't tell from that schedule.

20 MR. HOBERG: I'm sorry. Mr. Diller, you
21 said "when you said you go back here." The record
22 won't reflect where you went back to unless you
23 tell us.

24 THE WITNESS: To DRB-2.

25 MR. HOBERG: Thank you.

1 THE WITNESS: Okay. So our position
2 remains unchanged.

3 Q. (MR. BINEK CONTINUING) Okay. And that
4 includes insurance expense?

5 A. Right, right.

6 Q. Okay. Moving to pension and post-
7 retirement expense, what have you concluded after
8 reading Mr. Ball's testimony?

9 A. I sound like a broken record, but I guess
10 I have the same -- same concerns with it, and I did
11 provide Mr. Ball with a courtesy call, I think it
12 was Saturday or Sunday, this weekend, left a
13 message on his machine, and I understand that he's
14 going to have some more information, but, you know,
15 MDU chooses to update some costs for pension costs
16 and post-retirement benefits.

17 There's a lot more money in that 926 than
18 pensions costs and post-retirement benefits. I
19 don't know what else is in there, but it's -- it
20 would be kind of like me -- it would be kind of
21 like me going -- Susan's -- Commissioner Wefald is
22 looking at me. It would be kind of like going into
23 Commissioner Wefald's bank account and looking to
24 see that a particular item changed from one year to
25 the next and concluding that she needs more money

1 to live her life without considering all the costs
2 associated with a particular category or
3 classification of expenses.

4 Some of it may be just I don't -- I'm not
5 seeing it. So we'll give Mr. Ball an opportunity
6 later to clear this all up, but for -- I guess so
7 the company knows exactly where I'm coming from, if
8 you take 2001 pension expense, which is a negative
9 1.7 million dollars because fund assets are taking
10 care of current costs, and then you add to that
11 post-retirement benefits in 2001 of 1 million
12 dollars, that means you've included an analysis of
13 a negative \$600,000 worth of pension and benefit
14 costs, and if you go way back there again and -- I
15 never can go the right direction -- you can look
16 down there and see that the employee pension
17 benefit costs for 2001 is 2.4 million dollars
18 positive.

19 MR. HOBERG: And again, Mr. Diller, where
20 are we looking right now for the verbal record,
21 please?

22 THE WITNESS: In the administrative and
23 general expenses slide.

24 MR. HOBERG: Thank you.

25 THE WITNESS: And so, again, Mr. Ball may

1 very well have some answers for these things, but
2 at this point staff is unable to concede to
3 anything.

4 Q. (MR. BINEK CONTINUING) And now we come to
5 the last expense issue, which is supplemental
6 income security plan. In your rebuttal testimony
7 you speak about a number of other benefits MDU
8 employees receive and that only 27 employees are
9 considered key employees and that there is a lack
10 of symmetry in the plan. Can you give the
11 Commission any other reasons why it should not
12 allow SISP as a ratemaking expense?

13 A. Well, I know this is a hot issue and very
14 important to the people in this room, but I have a
15 lot of concerns with it. Basically, just so we're
16 clear, SISP represents a double pension for key
17 employees. That's essentially what it is.

18 It was a few weeks ago, but I had trouble
19 sleeping one night so I was up from two to four
20 o'clock in the morning, and, of course, nothing's
21 going except reruns of Congressional hearings and
22 things like that, and so I was watching the
23 Congressional hearings on Enron, and, I mean, I
24 don't know -- it was weird, but they were talking
25 about key employees, and the ex-CEO was being

1 questioned about the 100 million dollars that Enron
2 paid to its key employees to keep them on board --
3 on board as far as the sinking ship was concerned,
4 and it was 100 million dollars. In this case MDU's
5 only asking for 100 million dollars for --

6 Q. 100 million dollar or 1 million?

7 A. I mean 1 million. Yeah, I wish -- they
8 wish, they wish. 1 million dollars for 2001, but
9 it's still a significant amount of money, and one
10 of my employees when I'm -- when I'm struggling
11 with an issue trying to decide what the right thing
12 to do is, he said, Mike, if you can justify it on
13 the front page of the paper, then you can do it,
14 and that's -- I guess that's a principle that I'm
15 living by here when I talk about supplemental
16 income security plan.

17 I can't justify spending on average
18 \$40,000 per employee. If you take the million
19 dollars, divide it by 27 employees, have \$40,000
20 per employee for 2001 and forevermore -- or until
21 rates change again, I just can't justify that, and
22 I'm uncomfortable with it.

23 I think that people in -- Enron has been
24 an interesting case, and I think it has a warning
25 to all of us, especially managers of companies.

1 And then the next one is beneficiaries.
2 Who is SISP benefiting? Again going back to Enron,
3 I remember the -- I remember one of the Congressmen
4 asking the question, well -- or not even asking,
5 basically stating that, you know, it looks to me
6 like -- it looks to me like that what you've done
7 is management's taken care of itself. That's what
8 it looks like to me.

9 And so who are the beneficiaries? Are the
10 ratepayers the beneficiaries of this or are the
11 stockholders the beneficiaries? You decide, I
12 guess.

13 And then mergers and acquisitions I think
14 are also in the mix here. Every time NSP merges or
15 thinks about merging, the people I work with, the
16 people I talk to, they're scared to death. We
17 don't know if we're going to have a job when this
18 thing's over, and they're key employees, and when
19 we get down to the five bell operating electric
20 companies as this continues to -- it's just a
21 manner of speaking -- continues to play out,
22 there's going to be a lot of employees looking for
23 work, and there already are some. So we remain
24 unchanged in this position.

25 Q. Please summarize staff's adjustments to

1 net regulated income.

2 A. This is just a schedule of everything that
3 we've talked about. Some of these numbers come
4 from direct testimony, rebuttal testimony,
5 surrebuttal testimony, but it capsulizes staff's
6 adjustments to 2001. We reduce sales for resale
7 margins by 2.8 million dollars, and these are North
8 Dakota numbers, by the way. We amortize the AVS
9 maintenance over three years, eliminate demand
10 penalties, add additional capacities for purposes
11 of not incurring any more penalties, eliminate
12 Schedule F revenues, include -- and we include
13 Energy Share and Lignite Council dues in ratemaking
14 expense, normalize office supplies expense. We add
15 depreciation for the plant additions that we made
16 in agreement with MDU, and in the last number
17 there, income tax expense is just -- it's adjusted
18 to reflect all the other adjustments above that.

19 Q. Would you please provide a summary of net
20 regulated income?

21 A. Next slide does that. It shows 1999,
22 2000, 2001 reported earnings and then our
23 adjustments are in there, and you have a test-year
24 net regulated income of 15.7766 million dollars.

25 Q. After giving consideration to MDU's

1 surrebuttal testimonies, please show the Commission
2 how you've calculated what you believe to be MDU's
3 excess earnings position.

4 A. All the way over on the right side, the
5 rate base that we've essentially agreed to is the
6 first item, 128 million dollars. The rate of
7 return required -- it does reflect staff's
8 position, using 11.7 percent ROE and its cost of
9 date. So the rate of return is 9.92 percent.
10 Multiply the first two, get the third line, compare
11 that to the return earned that I just summarized in
12 the previous slide, get a return excess of 3
13 million dollars, you apply the tax factor to that,
14 and we are arguing at this point that MDU should
15 use its revenues by 5 million dollars or
16 thereabouts.

17 Q. Now you've -- staff has reduced it
18 position from basically 9 million dollars to 5
19 million dollars; is that correct?

20 A. Yeah, I know. Staff's calling me the big
21 easy, but I'm just trying to be as responsible and
22 forthright and fair as I can.

23 Q. Has MDU changed its position in any way
24 that you're aware of?

25 A. No. Not that I'm aware of.

1 Q. Do you have anything else that you would
2 like to present to the Commission prior to
3 cross-examination?

4 A. Well, I -- I thought it would be helpful
5 to the Commission, depending on what it decides --
6 it may or may not need these last couple of slides,
7 but I'm just providing the Commission with a
8 worksheet. There's really only four issues in this
9 case, and once you've decided those four issues,
10 you plug in the numbers, and whatever the revenue
11 excess calculates on the bottom, that's what you
12 should order.

13 Cost of capital -- you've got to decide
14 what the long-term debt cost should be and you need
15 to decide what the common equity return should be,
16 percentage return. You plug that in and you apply
17 it to the average rate base to get a return
18 required, and then all you need -- all you need is
19 net regulated income, what you think that'll be in
20 the near future or thereafter, and you need to make
21 an adjustment for administrative and general
22 expenses and sales for resale. Plug those in and
23 have your staff run through the income tax
24 calculation on the bottom and you'll have your
25 answer. So it's just provided mostly for your

1 staff, I guess, to use if they so choose.

2 MR. BINEK: At this time I tender the
3 witness for cross-examination.

4 MR. HOBERG: Thank you, Mr. Binek.

5 THE WITNESS: Should I -- should I go up
6 there now?

7 MR. HOBERG: Mr. Pearce --

8 MR. PEARCE: That would be more --

9 MR. HOBERG: -- would it be preferable to
10 have him up there.

11 MR. PEARCE: That would be more convenient
12 for me rather than having to turn around --

13 MR. HOBERG: Okay. Please, Mr. Diller.

14 MR. PEARCE: -- if that's possible.

15 MR. HOBERG: Mr. Pearce, please. Yeah.
16 It might work best if you could put the mike on
17 that side.

18 MR. PEARCE: Over here perhaps.

19 MR. HOBERG: Yeah, right there. Thank
20 you.

21 CROSS-EXAMINATION

22 BY MR. PEARCE:

23 Q. Okay. I have a few questions. Mike --
24 may I call you Mike? We've known each other for
25 years.

1 A. Please.

2 Q. Mike, you indicate in your testimony, and
3 it appears in your Exhibit 3, the Power Point
4 presentation printout here, that you effectively
5 moved the test year to 2000 and beyond; is that
6 right?

7 A. 2002.

8 Q. 2002, I mean.

9 A. That's correct.

10 Q. 2002 and beyond.

11 A. That's correct.

12 Q. Does that reflect your opinion that for
13 rates that are going to be forward going to the
14 future it's most appropriate to use the most recent
15 information available?

16 A. Yes.

17 Q. Now in your discussion of sales for resale
18 margin you indicated that there are lots of
19 variables and many factors. In fact, I believe you
20 listed a series of four pages of factors here that
21 you think are pretty good ones, if I may quote you;
22 is that correct?

23 A. I agree with the company that those
24 factors do in fact affect the price of electricity.

25 Q. And you're recommending now, as I

1 understand your testimony, a three-year average of
2 sales for resale margins as the appropriate
3 benchmark?

4 A. That's true.

5 Q. What was the purpose for three? I mean,
6 why not five to get a longer range analysis?

7 A. I guess you could -- you could go back ten
8 years when there wasn't any resale margins, I
9 guess, ten years ago, or none to speak of. To
10 answer your question directly, it's just arbitrary.
11 I don't think it would have made any difference to
12 add another year because -- let's see, 1998 resale
13 margins were still quite high, but if you went back
14 five years, it would change it a little bit.

15 Q. And again, if I may quote you, I think you
16 referred to 2001 as a hiccup in effect in the
17 national economy, recognizing that the year 2001 is
18 going to have some very unusual features about it.

19 A. Is that the word I used, hiccup?

20 Q. You did use hiccup, I think.

21 A. Okay. Yes, I guess I did.

22 Q. I'm not sure how to spell it, so I have it
23 in my notes here probably misspelled. And you
24 testified that trying to estimate prices in the
25 future is based on a lot of variables and it's more

1 of an art than a science, but you would agree,
2 however, would you not, that insofar as there are
3 reasonable techniques to try to project these
4 prices, it would be appropriate to use them?

5 A. Yes.

6 Q. I don't think I understood in your
7 testimony on the office supplies and expenses
8 account why you chose five percent as an allowance.
9 Was that a --

10 A. That was just an arbitrary number. Could
11 be ten. I thought five was reasonable.

12 Q. But you wouldn't think ten was
13 unreasonable?

14 A. I wouldn't argue strenuously against ten.

15 Q. And just to set the record straight, I
16 assume -- I hope you're not suggesting that
17 Montana-Dakota Utilities is run in some fashion
18 similar to the way Enron was run.

19 A. I have no reason to believe that.

20 Q. Your -- let me find the right page. The
21 page of your exhibit showing the resale margins --
22 here it is. I guess the pages aren't numbered, but
23 somewhere about a third of the way through the
24 sheet labeled resale margins it reflects a very
25 substantial decrease, does it not, from 2001 to

1 2002 in the net margins?

2 A. I think you're referring to MDU's
3 projections, the decrease from 2001 to 2002. That
4 represents MDU's projections.

5 Q. Right. Down to the figure you show for
6 MDU 2002, right at the far right, that's the
7 projections?

8 A. Right.

9 COMMISSIONER WEFALD: Excuse me. Where is
10 he referring to?

11 MR. HOBERG: He's referring to the resale
12 margin, I believe, the chart. This one.

13 MR. PEARCE: About a third of the way --
14 or half the way into his --

15 THE WITNESS: I couldn't figure out how to
16 number those slides. I'm sure there's a way, but I
17 was in a hurry.

18 Q. (MR. BINEK CONTINUING) Given that you are
19 in effect, as you say, moving the test year forward
20 to 2002 and I believe your agreement that the most
21 recent actual results provide the best benchmark,
22 if the evidence to date shows a continuing decline
23 in sales for resale margins, would it not be most
24 reasonable to give the most weight to the most
25 current figures? In other words, we're looking at

1 the -- we're always trying to base ongoing rates
2 with the future on conditions that will exist in
3 the future, are we not?

4 A. There was a lot in that question.

5 Q. I'm sorry. Let me --

6 A. I can -- I can ramble a little bit, but if
7 you want to narrow that down --

8 Q. Yes. Let me redo that. I realized
9 halfway through it was getting rather convoluted.
10 The point of the question was: In your opinion, is
11 it most -- would it be most reasonable, if we're
12 looking at rates that are going to be going forward
13 into the future, to base our projections on the
14 most recent available information and trends?

15 A. That is true. I feel like I have to say
16 something else here. That's true, but we have to
17 keep in mind that we're not necessarily setting
18 rates just for the next six months. It's our hope
19 that we can develop rates that'll be in effect for
20 the next 15 years, and we may not achieve that and
21 that may not be achievable, but this is -- you
22 know, ratemaking is theoretical, and we need to --
23 in the end we need to come up with rates that are
24 going to make sense over a period of time, and I
25 would not -- I would not conclude that this is just

1 for 2002.

2 Q. Do you have any basis for believing that
3 the hiccup, as we've characterized it, in 2001 will
4 return in 2003 or 2004 or 2005?

5 A. That's the whole quandary in this -- I
6 mean, that's the problem with this whole case, is
7 nobody's sure what's going to occur. The general
8 market is unsure where it's headed. You know, you
9 listen -- I listen to the news like everyone else.
10 One guy says we've had a recession, another guy
11 says we haven't had one yet. I don't know. I
12 don't have a crystal ball.

13 Q. I assume you have seen -- looked at Mr.
14 Ball's surrebuttal testimony, which hasn't gone
15 into the record orally yet, but to the effect that
16 at least the first month-and-a-half of 2002 are
17 continuing to show a fairly dramatic decrease in
18 resale margins?

19 A. I believe that's what his testimony shows.

20 MR. HOBERG: I think, Mr. Pearce, we've
21 marked your surrebuttal as Exhibit 7; is that
22 right?

23 MR. PEARCE: That's right. That's right.

24 Q. (MR. PEARCE CONTINUING) And turning back
25 to your -- I believe this is your prefiled direct

1 testimony, which would be Exhibit 1, on page 8,
2 line 21, you say it's difficult to determine to
3 what degree --

4 A. You're on my direct?

5 Q. Yes, yes.

6 A. The direct?

7 Q. I think my reference is to your direct, I
8 think, page 8, line 21.

9 MR. HOBERG: Exhibit 1.

10 MR. PEARCE: It would be Exhibit 1.

11 COMMISSIONER CLARK: Line 21?

12 MR. HOBERG: I think you said page 8, line
13 21; is that right?

14 MR. PEARCE: Yes.

15 THE WITNESS: "In this case staff has
16 determined not to pursue"; is that where we're at?

17 MR. PEARCE: I think I'm on the wrong --
18 I'm on the wrong -- I may be wanting to refer to
19 the Exhibit 2. Yes. I'm sorry. Exhibit 2, your
20 rebuttal testimony. It's at the bottom of page 8,
21 and you're saying --

22 THE WITNESS: Just a second. Exhibit --
23 okay. Rebuttal testimony.

24 Q. (MR. PEARCE CONTINUING) Exhibit 2, I'm
25 sorry. It's your rebuttal testimony.

1 A. Okay. I'll be right with you. Okay.

2 Q. And I'm not saying it's inconsistent --
3 it's consistent with what you've testified to this
4 morning, but you're saying a fair bit of judgment
5 by the Commission will be required to decide the
6 issue of how these economic factors will affect
7 prices. You're not saying, though, are you, that
8 the Commission should not exercise its best
9 judgment but simply rely on past data, but --

10 A. I think it's a difficult issue and it's a
11 difficult case, and they should exercise due
12 diligence in their determination.

13 Q. Relying on the evidence in the case, of
14 course?

15 A. Sure.

16 Q. Then on page ten of that rebuttal
17 testimony, toward the top, actually lines four and
18 five and six, you're agreeing that it appears that
19 this is in relation to one of these factors that
20 will affect the future resale margins?

21 A. You're talking about MAPP now?

22 Q. Right. You appear to be agreeing that
23 planned additions to generation will outstrip the
24 projected growth and demand, and then you indicate
25 that some believe that the recent effects

1 surrounding Enron has changed the energy markets in
2 general. Are you saying that you have some
3 evidence that these -- this new generation will not
4 come into place because of the Enron situation? I
5 didn't understand what you were getting at.

6 A. Well, you know, it's -- it's always
7 difficult to determine where resources will go, and
8 we don't have unlimited resources. Some of the
9 resources may go to war efforts or technologies or
10 Dot-Coms or generation. I don't know, but any time
11 you have some market changes like we're
12 experiencing, the market's going to respond to that
13 and resources are going to go in different places,
14 but -- so I guess that's what I was thinking when I
15 wrote that. We know that Enron has affected a lot
16 of companies. If you watch the news like I do -- I
17 guess I have a couple -- couple of news reports, if
18 that's what you want, that would state a similar
19 kind of thing. If you're interested in that, I can
20 provide that.

21 Q. I just was -- the question really was, I
22 guess, more directed at your -- your assessment of
23 the situation, and I realize none of us are -- or I
24 guess actually I'm not an expert on the Enron
25 situation, but do you have any strong reason for

1 believing that the Enron situation will
2 dramatically affect the growth of future generation
3 capacity, I guess is what I'm asking?

4 A. Well, I'm not an economist and I've not
5 fully researched this. When I make this statement,
6 it's based on news shows that I've watched and
7 articles that I've read at my desk while working
8 for the Commission indicating that resources are
9 harder to come by now that Enron has caused this
10 flap, and it's understandable. People are a little
11 worried as to, well, what do the books and records
12 really mean, and that reflects on the energy
13 industry and the independent power producers, and
14 they have to have a lot of capital to build a
15 generation facility, and that's all I'm trying to
16 say.

17 MR. PEARCE: That's all the questions I
18 have.

19 MR. HOBERG: Thank you, Mr. Pearce.
20 Perhaps we should take a ten-minute recess here
21 before we start with Commission questions.

22 (Recess taken.)

23 MR. HOBERG: We're back on the record
24 after a short recess, and we're about to begin
25 questions by the Commission. Mr. Fahn, as

1 commission advisor do you have any questions of Mr.
2 Diller at this time?

3 MR. FAHN: No, I don't. Thank you.

4 MR. HOBERG: Thank you, Mr. Fahn.

5 Commissioner Wefald, did you have any questions of
6 Mr. Diller, please?

7 COMMISSIONER WEFALD: I have a few.

8 EXAMINATION

9 BY COMMISSIONER WEFALD:

10 Q. Mr. Diller, I was -- went on to the web
11 site of NERC this morning, and I found a report,
12 and it was the reliability assessment of 2001-2010.
13 It's called The Reliability of Bulk Electric
14 Systems in North America, and it's dated October
15 16th, 2001, and it's put out by the North American
16 Electric Reliability Council.

17 MR. HOBERG: Are you familiar with that,
18 Mr. Diller?

19 THE WITNESS: Not really.

20 COMMISSIONER WEFALD: Should I pass him a
21 copy?

22 Q. (COMMISSIONER WEFALD CONTINUING) Are you
23 familiar with this report?

24 THE WITNESS: I'm not familiar with it.

25 COMMISSIONER WEFALD: May I pass this

1 report to him?

2 MR. HOBERG: Sure.

3 Q. (COMMISSIONER WEFALD CONTINUING) I've
4 underlined several sentences under Resource
5 Assessments for MAPP under -- on page 43.

6 A. Okay.

7 Q. Would you read those sentences?

8 A. Just the bottom?

9 Q. Mm-hmm. The things that are underlined on
10 that page.

11 A. Oh, okay. All right. First part of the
12 paragraph that's underlined, "The MAPP-U.S. region
13 is judged to be inadequate over the 2001-2010
14 period."

15 Q. The MAPP what?

16 A. The MAPP-U.S. region. I'm sorry. "The
17 MAPP-U.S. region is judged to be inadequate over
18 the 2001-2010 period."

19 Q. And that refers to -- "inadequate" refers
20 to what? What is the topic of that section?

21 A. Capacity.

22 Q. Capacity.

23 A. Okay. "The summer reserve margin is
24 expected to be below the 2000 forecast and to
25 decline from a high of 20 percent in 2001 to 15

1 percent in 2005 and 1 percent in 2010 when
2 committed and proposed generation is considered.
3 In addition, when a 3 percent demand forecast
4 uncertainty is taken into account, the MAPP-U.S.
5 area may be capacity" -- "In addition, when a 3
6 percent demand forecast uncertainty is taken into
7 account, the MAPP-U.S. area may be" -- oh, there
8 must be more -- I'm sorry. -- "may be capacity
9 deficient by 2004 summer and nearly 5,442 megawatts
10 by 2010.

11 "Because of the potential generating
12 system inadequacy, MAPP must plan for additional
13 resources and carefully watch construction lead
14 times to ensure that enough resources will be
15 available to maintain regional adequacy. The
16 ability to import power may be severely limited in
17 the near term because of the lack of external
18 resource availability."

19 MR. HOBERG: I think we better mark that
20 since he's been reading from the exhibit. We
21 better mark it and place it into the record as an
22 exhibit.

23 COMMISSIONER WEFALD: That would be fine.

24 MR. HOBERG: Would you hand it to the
25 court reporter, please, so she can mark that?

1 COMMISSIONER WEFALD: Sure.

2 MR. HOBERG: It would be Exhibit 11, I
3 think.

4 (Exhibit 11 was marked for
5 identification.)

6 MR. HOBERG: And I think we better give
7 Mr. Pearce an opportunity to look at that, too.

8 Q. (COMMISSIONER WEFALD CONTINUING) My
9 question is -- a question on that is that in your
10 recommendations you're recommending that we use the
11 last three years of wholesale revenues and average
12 those to determine an average amount that we could
13 expect to see in wholesale revenues in coming
14 years.

15 A. That is my assertion. Yes.

16 Q. This MAPP report indicates that -- taking
17 all those factors into consideration -- I'm
18 assuming they took all those factors into
19 consideration because these are experts who write
20 these reports -- that they're anticipating
21 shortages not only in 2002 and 2003 and 2004 but
22 extending into 2010. Given that information, are
23 you inclined to change your recommendation that we
24 average the last three years and just go with the
25 last year?

1 A. Well, I guess besides the reasons I've
2 already given, you know, the reason that I did that
3 is I do see some very near term problems with sales
4 for resale margins, but that's so -- to me some of
5 what's driving this is the absence of winter. I
6 mean, of course they're not selling any electricity
7 at this in December and January and February. I've
8 never seen a winter like this. I'm thinking longer
9 term than MDU, and that's really the difference.

10 Q. Well, on the -- on this -- even for this
11 year when they're projecting six million of
12 wholesale revenue -- and I'll have a chance to talk
13 to their person later on, but are -- those are
14 based on current costs, futures costs; is that what
15 they're --

16 A. The futures market, right, and I'm not an
17 investor in futures and I don't have a lot of
18 experience there, but my understanding is that the
19 further out you get, the less accurate futures are
20 going to be as far as what actual prices may end up
21 being. I would say it's pretty accurate a few
22 months out.

23 Q. So let's say that in May there's a
24 projection for a really hot summer and they -- with
25 the weather forecasters. Could those futures

1 change at that point? Could -- or should I be
2 asking someone else?

3 A. Well, it's just getting a little outside
4 of my expertise. I would guess that the futures
5 market is based on normal weather. I don't think
6 that futures are based on the Farmers Almanac or
7 anything like that, at least I hope not.

8 Q. But they change from month to month?

9 A. Sure, they do. They change every day.

10 Q. Okay. And on -- MDU may have the
11 potential to have increased wholesale sales
12 contracts in the future?

13 A. Yes. That opportunity always -- always
14 exists.

15 Q. And I have another question, and this is
16 on the AVS major maintenance in your testimony on
17 page 13.

18 MR. HOBERG: Direct testimony or --

19 COMMISSIONER WEFALD: This is on his
20 rebuttal testimony.

21 MR. HOBERG: Okay. Exhibit 2.

22 THE WITNESS: On page 13?

23 Q. (COMMISSIONER WEFALD CONTINUING) Mm-hmm.
24 You talk about -- under that, "Mr. Ball argues for
25 the inclusion of one-third of the major

1 maintenance cost of the Antelope Valley
2 generating station Unit II (AVS) incurred
3 in 2001 totaling 460,000 system-wide.
4 Originally, Mr. Ball's argument added
5 these additional expenses to staff's 2000
6 test year because the cost of the
7 maintenance was not incurred until 2001.
8 However, since staff is now advancing the
9 use of 2001 operating results, Mr. Ball's
10 testimony argues for a reduction in 2001
11 reported results by two-thirds of the
12 maintenance costs. Staff therefore
13 reduces maintenance expense in 2001 by
14 two-thirds of the total cost testified to
15 by Mr. Ball to properly reflect a
16 three-year amortization. An adjustment
17 to reduce 2001 operating expenses by
18 920,000 is therefore necessary."

19 Can you please explain to me why for one
20 test year you have a -- why it's two-thirds of the
21 maintenance cost and not one-third of the
22 maintenance cost?

23 A. I can see why that would be a little
24 confusing if you weren't familiar with the details.
25 It's not an issue that we're disputing with the

1 company. Both sides are in agreement with what
2 I've done, but having said that, in 2001 MDU
3 incurred a total cost of that 460 times three,
4 whatever that number is. That was recorded on the
5 books for 2001. MDU argued when I was using a 2000
6 test year that one-third of those costs should be
7 included in 2000. Okay. It should be included in
8 the test year. Well, when we updated the 2001 test
9 year, all of the AVS maintenance costs were
10 included in operating expenses. So all I'm doing
11 is turning --

12 Q. For a total of how much?

13 A. Well, the 460 times 3. What is that,
14 1280? No. It's more than that.

15 Q. 460 times 3?

16 A. 460 times 3. And so all I've done is
17 turned Mr. Ball's argument around on him and said,
18 okay, if you want one-third of the amortization in
19 2000 when it -- when it was expensed in 2001, it's
20 only appropriate that we exclude two-thirds of the
21 costs in the updated 2001 expense of it, because
22 all the costs are in there. Does that help or
23 should I keep talking?

24 Q. Why are -- was this expensed over three
25 years or was it expensed over just two years?

1 A. Well, it was booked as an expense in 2001.
2 All of the costs were booked as a maintenance cost
3 in 2001.

4 Q. All right.

5 A. And since we're using 2001 as a proxy for
6 developing rates in 2002 and beyond, we only want
7 one-third of those costs in there.

8 Q. Yes.

9 A. So to do that you have to take two-thirds
10 out.

11 Q. Okay. And so at the present time you're
12 only including \$460,000 --

13 A. That's right.

14 Q. -- in 2001?

15 A. That's right.

16 Q. All right. But now you're using a 2002
17 test year. So can you just show me how then you
18 updated that number?

19 A. Just carried it forward. I mean, if you
20 incurred it in 2001 and you agree to a three-year
21 amortization, then the 460,000 should still be in
22 2002 and 2003.

23 Q. Okay. All right. Thank you.

24 A. On a theoretical basis. I mean, MDU has
25 expensed it already in 2001, but for ratemaking

1 purposes we've agreed to a three-year amortization
2 on AVS maintenance.

3 Q. All right. Thank you. On page 14 on the
4 MISO RTO of your rebuttal testimony, that
5 paragraph, Mr. Ball argues that revenue streams
6 related to MAPP Service Schedule F for
7 power transmitted on or across its system
8 will disappear as a result of MDU joining
9 the Midwest Independent System Operator,
10 Inc., regional transmission organization.
11 MDU further asserts through its responses
12 to staff's inquiries that no savings or
13 additional off-system sales will occur
14 because of MDU's decision to join MISO
15 staff has no proof to the contrary that
16 these revenues will -- should it be "not
17 be lost"?

18 A. That these revenues -- these revenues will
19 be lost and therefore -- well, I'm just saying that
20 we have no proof to argue against MDU's assertion
21 that these revenues will no longer occur. I don't
22 know much about MAPP or Schedule F.

23 Q. Anyway, so we're accepting those?

24 A. I've trusted MDU's judgment in this
25 matter.

1 Q. All right. On contributions on page 17,
2 "Staff agrees to include North Dakota's share of
3 contributions made to Energy Share of North Dakota
4 and the Lignite Energy Council as testified to by
5 Don Ball totaling \$33,000."

6 What donations are given to the Lignite
7 Energy Council and why should ratepayers pay for
8 those?

9 A. That's -- that's what -- that's what Mr.
10 Lein asked me, too. He's been assigned to staff in
11 this case, and I guess I just didn't want to argue
12 about it. I didn't think it was a material amount
13 of money. I didn't give it a lot of thought, and
14 there certainly is arguments that contributions
15 like these should be recorded below the line and
16 the company should be willing to pay for that out
17 of stockholder dollars. I'm not -- I'm not hung up
18 on it either way.

19 Q. Does that include the Energy Share
20 dollars, as well?

21 A. Yes. I mean -- and that one's probably
22 easier than Lignite. At least Lignite -- well, let
23 me start over. That one seems to be easier to
24 exclude. I mean, who is getting the benefit of
25 being the contributor? Is it the ratepayers or is

1 it MDU? I mean, if you're getting the glory, then
2 maybe you should pay for the cost of it.

3 COMMISSIONER WEFALD: I have no further
4 questions at this time.

5 MR. HOBERG: Thank you, Commissioner
6 Wefald. Before we move on to Commissioner
7 Reinbold, we better deal with Exhibit 11 which
8 we've marked. Have you had a chance to look at
9 that, Mr. Binek?

10 MR. BINEK: No, I haven't.

11 MR. HOBERG: Okay. Maybe you should take
12 a look at it, too. What is it actually titled, Mr.
13 Binek?

14 MR. BINEK: Reliability Assessment, 2001
15 through 2010.

16 MR. HOBERG: Thank you.

17 MR. BINEK: And it's put out by North
18 American Electric Reliability Council. I have no
19 objection to it.

20 MR. HOBERG: Mr. Pearce, any objection to
21 it?

22 MR. PEARCE: I have no objection as to
23 foundation. I guess I wouldn't stipulate to its
24 relevance or reliability, but no objection to
25 having it received for what it is.

1 A. That's my testimony, yes.

2 Q. Okay. You indicated also that off-system
3 sales, that type of income, is heavy and very
4 significant in the case?

5 A. Almost -- well, without that we probably
6 wouldn't have brought a case to the Commission.

7 Q. Okay. Then let me ask you the next
8 question. Off-system sales, is it a guessing game?

9 A. Sure, it is. That's why I made the
10 comment that it's more of an art than a science.
11 It's a difficult issue. I mean, if the economy was
12 going along like it was and there was no indication
13 that it would falter, then this case would be easy.

14 Q. So you're --

15 A. We'd just reduce rates nine million
16 dollars and be happy, but --

17 Q. Are you agreeing that it might be a
18 guessing game by the company?

19 A. It -- we're both trying to provide the
20 Commission with an analysis, an approach to
21 projecting what we see as reasonable margins on
22 sales for resale, and that's it, I guess.

23 COMMISSIONER REINBOLD: Okay. That
24 satisfies that question. And that takes care of
25 all of them. Thank you.

1 MR. HOBERG: Thank you, Commissioner
2 Reinbold. Commissioner Clark, please.

3 COMMISSIONER CLARK: I do have just a
4 couple questions.

5 EXAMINATION
6 BY COMMISSIONER CLARK:

7 Q. I don't believe that it's a point of
8 contention at all, but I didn't see it discussed
9 much in the prefiled testimony. The tax factor,
10 just for my own edification, could you talk a
11 little bit about how that's arrived at? Is it kind
12 of a generally accepted accounting number? I think
13 it's 1.65 or something like that.

14 A. Right. There's -- there is no argument
15 between the parties in this case. That's a factor
16 that's, I guess, been used ever since I came here.
17 Well, no. We had a little, slight tax change a
18 while back, but it's -- it's simply a factor that
19 adjusts the results for the effect of income taxes.
20 So if I come up -- let me -- maybe I can refer
21 to -- if I can find one. For instance, towards the
22 end of my Power Point presentation, just three
23 pages back, it's labeled staff revenue excess
24 calculation.

25 Q. Mm-hmm.

1 A. When we're all done, we have a return
2 excess of 3 million dollars, and that's -- that's
3 how much we want to see net regulated income
4 adjusted downward, and in order to get that kind of
5 a reduction you've got to actually reduce revenues
6 by 5 million dollars because you're going to have
7 tax savings resulting from those revenues, and so
8 that's the principle. As far as how it's exactly
9 calculated I could provide that later. I don't
10 have it in front of me.

11 Q. But there's no disagreement on that?

12 A. There's no disagreement that I'm aware of.

13 Q. The -- this is more of just kind of a
14 high-level regulatory philosophy question, and
15 it -- it came to my mind because of your response
16 to the letter from Commissioner Wefald from a few
17 months ago where she was exploring ways of dealing
18 with volatile types of income like off-system
19 sales. You talked about the philosophy of
20 regulatory lag, and that -- that that's one basis
21 for using historic net income as a basis for rate
22 setting. Is that still the staff position?

23 A. That is a high-level theoretical question,
24 and, again, Mr. Lein, assigned to staff, has
25 questioned me on that, Are you sure you don't want

1 to accept Commissioner Wefald's suggestions through
2 her letter that we maybe want to include this in
3 the fuel cost adjustment? I'm still the same free-
4 enterprise guy that I've always been, and I prefer
5 to see a level established in rates and let the
6 company try to beat it than just capturing it
7 through a fuel clause adjustment. Then it seems to
8 me like it takes all the incentive out of the game,
9 and that's steeped in my own personal philosophy
10 more than anything.

11 Q. But the theory of regulatory lag itself
12 would kind of say that -- correct or not -- that in
13 the good years where MDU can outperform, they maybe
14 make a little more, then the staff comes forward
15 with a rate case and you reset rates a little, and
16 maybe they -- and they may hit a few bad years and
17 then they don't do quite as well so they come in
18 for cases, kind of the idea that over time these
19 peaks and valleys -- you get the right rate and
20 kind of an equitable treatment for ratepayers over
21 time. Is that the general theory on that?

22 A. That's the general theory. I would say
23 that the staff is somewhat handicapped because of
24 the funding, and so the regulatory lag is likely
25 much greater for us than it is for the company.

1 When they file, we have eight months to deal with
2 the case. When we file, we might have to wait a
3 few years until budget dollars are there to present
4 our case.

5 COMMISSIONER CLARK: Okay. Thank you.
6 That's all I have.

7 MR. HOBERG: Thank you, Commissioner
8 Clark.

9 COMMISSIONER WEFALD: I have a follow-up
10 question.

11 MR. HOBERG: Commissioner Wefald, please.

12 FURTHER EXAMINATION

13 BY COMMISSIONER WEFALD:

14 Q. So if in future years MDU actually, let's
15 say in the next five years, makes at least 15
16 million dollars on wholesale power sales every
17 year, then you would be off by -- then you should
18 have reduced rates perhaps in this case by --

19 A. An additional 4 million dollars.

20 Q. -- an additional 4 million dollars.

21 A. That's true.

22 Q. And so then ratepayers are hurt by the
23 calculations that were made today on this matter.

24 A. That's true.

25 Q. If MDU only makes -- it makes less, then

1 MDU is hurt by this calculation.

2 A. Correct.

3 Q. But in your mind then MDU has the
4 incentive to make further -- take further cuts,
5 make further efficiencies, try harder to do off-
6 system sales in order to make up that difference;
7 is that correct?

8 A. That would be my assumption. Yes.

9 Q. And so that's why you weren't willing to
10 go with the proposal that it be a set percentage of
11 whatever type on that?

12 A. Well, I mean, quite frankly, you could --
13 I guess you could -- every month if we wanted to
14 true-up rates to reflect all the costs that MDU
15 incurs to provide electricity, I suppose we could
16 do that, but we would be in a lot of trouble, I
17 think, if we got into that kind of mode because
18 then there's no incentive to manage costs, no
19 incentive to increase revenues because the PSC's
20 going to flow through everything that we do. This
21 is just a smaller piece of the pie but that same
22 principle applies, and so that's why staff to this
23 point has been unwilling to agree to some of the
24 suggestions that are in this letter, but we even
25 have some disagreements within our own group. As

1 I've already indicated, Mr. Lein asked me if I was
2 sure, and so what I'm testifying to is my
3 philosophy and my opinion and that's it.

4 COMMISSIONER WEFALD: Thank you.

5 MR. HOBERG: Thank you, Commissioner
6 Wefald. Any further questions? Commissioner
7 Clark.

8 COMMISSIONER CLARK: I do have one.

9 FURTHER EXAMINATION

10 BY COMMISSIONER CLARK:

11 Q. Are you aware of any other ways of dealing
12 with this issue of volatile off-system sales that
13 other commissions around the country have gone
14 about besides just the fuel clause adjustment-type
15 mechanism? Are refunds ever awarded? I'm just
16 kind of trying to think outside the box.

17 A. Well, I have very limited knowledge about
18 what other states are doing. You know, I did -- as
19 I've already testified, I did come from the
20 Oklahoma Corporation Commission, and in that state,
21 at least while I was there -- I don't know if
22 they're still practicing this -- they require --
23 they required that the company keep ten percent of
24 off-system sales profits for themselves as an
25 incentive to make off-system sales, and the other

1 90 percent would be flowed back to ratepayers
2 through those -- through the ratemaking process.
3 So it wasn't an automatic flow-through, but -- so
4 there's -- I'm sure there's lots of things like
5 that out there. I'm just not aware. I think we
6 can be as creative as we want.

7 COMMISSIONER CLARK: Thank you. That's
8 all I have.

9 MR. HOBERG: Thank you, Commissioner
10 Clark. Any further questions? Anything on
11 redirect, Mr. Binek?

12 MR. BINEK: Yes. I think just a couple of
13 questions.

14 REDIRECT EXAMINATION

15 BY MR. BINEK:

16 Q. In response to a question from Mr. Pearce
17 concerning expenses, I think you made the comment
18 that you wouldn't argue strenuously against a ten
19 percent increase for expenses. Your recommendation
20 is that five percent is what should be the
21 allowance?

22 A. That's my recommendation.

23 Q. And that remains your recommendation?

24 A. Yes, it does.

25 Q. Okay. Mr. Pearce also referred to Mr.

1 Blinsky's testimony that showed a decline -- I
2 think a sharp decline in resale sales for the first
3 two months of 2002, and I think you've already
4 addressed this in another comment, but doesn't the
5 mild weather that we've experienced here and
6 basically across the country so far in 2002 and all
7 winter long cause sales for resale to decrease from
8 previous year levels?

9 A. Well, I know that one of their big
10 customers is Otter Tail Power Company, at least it
11 has been in the past, and it's a winter-peaking
12 utility company. If you don't have any winter,
13 that customer's sales is probably not going to
14 happen. So I just extrapolated that little bit of
15 knowledge when I'm stating that, of course, sales
16 are down these first few months.

17 Q. And that would be true for basically all
18 companies selling into the resale market.

19 A. I would think so.

20 MR. BINEK: I have no further questions.

21 MR. HOBERG: Thank you, Mr. Binek. Mr.
22 Fahn, did you have a question?

23 MR. FAHN: Yes.

24

25

1 EXAMINATION

2 BY MR. FAHN:

3 Q. I wanted to make sure I understand the
4 staff position. Staff started out at 9.155 million
5 dollars -- suggesting a 9.155-million-dollar rate
6 reduction, revenue reduction.

7 A. That's correct.

8 Q. And then changed to 7.327 and --

9 A. In -- or in -- I guess it's called
10 rebuttal, that's true.

11 Q. Right. And we've been continuing down
12 here -- we're now at 4.941-million-dollar revenue
13 reduction and I guess I'm -- the Commission has to
14 rely on the facts in the case, and so I want to
15 make sure I understand that would you characterize
16 your position as telling the Commission that they
17 should not reduce revenue -- I mean, the maximum
18 they should reduce revenue is 4.941 million, or
19 could they reduce revenue by some other number
20 that -- somewhere between where you started and
21 where you are today or something less than where
22 you are today?

23 A. I think there's enough information in this
24 case the Commission could use a 2000 test year, a
25 2001 test year, a 2002 and beyond. My

1 recommendation of 5 million dollars is just based
2 on what I feel is appropriate. After the
3 Commission's finished hearing the rest of the
4 witnesses in this proceeding, maybe they'll go with
5 something lower or higher. No, I'm not suggesting
6 that we limit it to 4.9 million dollars.

7 MR. FAHN: Thanks.

8 MR. HOBERG: Thank you, Mr. Fahn. Mr.
9 Pearce, did you have some questions of Mr. Diller?

10 MR. PEARCE: Yes, just two, I think.
11 Actually two related questions, I guess.

12 RE-CROSS-EXAMINATION

13 BY MR. PEARCE:

14 Q. Mike, in response to a question that Mr.
15 Binek just asked you about weather being a factor,
16 you aren't saying weather is the sole factor. As I
17 recall, you gave 28 factors in your four pages.

18 A. No. I'm not arguing that weather's the
19 only thing affecting off-system sales.

20 Q. One of many factors?

21 A. One of many factors.

22 Q. And I believe the evidence shows -- or
23 will show it in MDU's testimony that there actually
24 were more megawatts sold for resale in January of
25 2002 than in January of 2001; is that your

1 understanding?

2 A. I could probably get that understanding.
3 I'll agree to that, subject to check.

4 Q. All right. What we're talking about is a
5 matter of net margins, and that's based on price
6 rather than -- I mean, it isn't simply a matter of
7 the power sold, is it? It's a matter of power and
8 the price?

9 A. Right. It's the product of the two.
10 Yeah.

11 Q. As far as the impact of weather, that
12 would simply impact the amount of power sold, not
13 the price?

14 A. That's true. Weather would have -- well,
15 I don't know the answer to that one.

16 MR. PEARCE: That's all I have.

17 MR. HOBERG: Thank you, Mr. Pearce. Any
18 further questions of Mr. Diller then? Commissioner
19 Clark.

20 COMMISSIONER CLARK: I do have one on the
21 expense side.

22 FURTHER EXAMINATION

23 BY COMMISSIONER CLARK:

24 Q. And following what Mr. Fahn said, building
25 a record for the Commission to decide things on, on

1 the office supply expense you recommend --

2 COMMISSIONER WEFALD: What page are you
3 on, Commissioner Clark?

4 COMMISSIONER CLARK: Well, this would be
5 in Mr. Diller's rebuttal, 18 and 19.

6 Q. (COMMISSIONER CLARK CONTINUING) It talks
7 about office supply expense and making a --
8 specifically on 19 -- making an upward five percent
9 inflationary adjustment. Where is that five
10 percent derived from, or should we have something
11 on the record that verifies that is an appropriate
12 inflationary increase?

13 A. Well, as far as where the percentage comes
14 from, I think I've testified that that's arbitrary,
15 but as far as how it's calculated, if you take the
16 2000 expense level, the more normal level, if you
17 will, of \$2,122,000 and you take that times 1.05,
18 you will come up with the \$2,228,000, and so you
19 just compare that with the 2001 number of
20 \$2,906,000 and you get an adjustment required of
21 \$678,000. That would be on a total company basis.

22 Q. But the five percent isn't tied to the CPI
23 or any specific --

24 A. Not tied to anything.

25 Q. Okay. For the insurance expense -- I'm

1 not sure exactly where that is pagewise in the
2 testimony, but I remember it more from your slide
3 presentation. I heard you saying that's a little
4 bit tougher to tell and you just don't think we
5 have the information yet to verify if the
6 insurances expense is a legit increase?

7 A. Right. I'm just -- I'm not sure. It
8 doesn't appear that they've analyzed all of the
9 pension and benefit costs, but I could be wrong. I
10 guess I'm waiting for Mr. Ball's testimony to --

11 COMMISSIONER CLARK: Thank you. That's
12 all I have.

13 MR. HOBERG: Thank you, Commissioner
14 Clark. Any further questions then of Mr. Diller?
15 Mr. Binek?

16 REDIRECT EXAMINATION

17 BY MR. BINEK:

18 Q. I hate to get back into this weather
19 situation, but Mr. -- Mr. Pearce asked you
20 basically about the correlation between demand and
21 price. If we have -- if we have warm weather like
22 we're experiencing and experiencing it throughout
23 the country basically, even if MDU's sales --
24 resale sales are high, you know, comparably high,
25 the fact that we have warm weather does result in

1 overall decreased demand and decreased price for
2 the product, doesn't it? It does have an effect
3 also on price?

4 A. That's why I changed my answer and said I
5 don't know. I would think that it would, but -- it
6 seems to me like it would be, yes.

7 MR. BINEK: Nothing further.

8 MR. HOBERG: Anything further of Mr.
9 Diller? No further questions of Mr. Diller? Thank
10 you, Mr. Diller.

11 THE WITNESS: Thank you.

12 MR. BINEK: At this time I'll call Charles
13 King.

14 COMMISSIONER WEFALD: Could everyone have
15 a copy of that exhibit then?

16 MR. HOBERG: Yes, yes.

17 COMMISSIONER WEFALD: Thank you.

18 MR. HOBERG: Good point. Mr. Pearce -- I
19 think at a break or something we'll make copies of
20 Exhibit 11. Please be seated, Mr. King. I think
21 you were present earlier when I gave the admonition
22 in regard to percentage; is that correct?

23 THE WITNESS: Yes.

24 (Witness sworn.)

25 MR. HOBERG: Thank you. Mr. Binek,

1 please.

2 MR. BINEK: Thank you.

3 CHARLES W. KING,

4 having been first duly sworn, was examined and

5 testified as follows:

6 DIRECT EXAMINATION

7 BY MR. BINEK:

8 Q. Please state your name and business

9 address for the record.

10 A. My name is Charles W. King. My business

11 address is 1220 L Street Northwest, Washington,

12 D.C.

13 Q. And what is your occupation?

14 A. I am an economic consultant.

15 Q. And by whom are you employed?

16 A. I am the president of the economic

17 consulting firm of Snavelly King Majoros O'Connor &

18 Lee, Incorporated.

19 Q. And how long have you been in this

20 position?

21 A. I have been either president or vice

22 president of this company since it was founded in

23 1970, which makes it what, 32 years now.

24 Q. And could you just briefly state your

25 educational background?

1 A. I am a -- received a Master -- a Bachelor
2 of Arts in economics from Washington and Lee
3 University and a Master of Arts in public economic
4 policy from the George Washington University.

5 Q. And did you prepare prefiled testimony in
6 this case, both direct and rebuttal testimony?

7 A. Yes, I did.

8 Q. I show you what have been marked as
9 Exhibits 4 and 5 and ask if you can identify those
10 exhibits.

11 A. Those are the testimonies that I prepared.
12 Yes.

13 Q. And if I asked you the same questions
14 today that are contained in these exhibits, would
15 your answers be the same?

16 A. Yes, they would.

17 Q. And do you adopt your prefiled testimony
18 as your sworn testimony in this case today?

19 A. Yes. I should note that the rebuttal
20 testimony to some extent supersedes some of the
21 information that was in the initial testimony.

22 Q. Yes. Do you have any corrections that
23 need to be made to your testimony?

24 A. A couple minor typos that one could
25 correct. In the initial testimony, page 4, line

1 29, the word -- the fourth word in that line is
2 "if." It should be "it," so that it reads, Nothing
3 prevents it from inflating the company's -- from
4 inflating the equity percentage. And then page 11
5 of that same initial testimony, at line 22 is
6 missing a word. It should read "that it must be a
7 large corporation." Those are the only corrections
8 I have.

9 Q. Okay. And with those corrections do you
10 adopt this as your sworn testimony?

11 A. Yes, I do.

12 MR. HOBERG: Are you offering these, Mr.
13 Binek?

14 MR. BINEK: Yes, I will offer them.

15 MR. HOBERG: Okay. Exhibits 4 and 5,
16 which are Docket Nos. 14 and 53, have been offered.
17 Mr. Pearce, any objection?

18 MR. PEARCE: No objection.

19 MR. HOBERG: No objection. Exhibits 4 and
20 5 are admitted.

21 Q. (MR. BINEK CONTINUING) Thank you. What
22 rate of return are you recommending -- I guess I
23 should -- what rate of return are you recommending
24 be allowed to MDU's electric operations in North
25 Dakota?

1 A. I am recommending an overall rate of
2 return of 9.22 percent, which incorporates a
3 returned equity of 11.7 percent. This is a
4 revision upward from the testimony that I submitted
5 last August in which I had recommended a returned
6 equity of 11.2 percent.

7 Q. Have you read the rebuttal and surrebuttal
8 testimony of MDU witness Stephen Gaske in this
9 proceeding?

10 A. Yes, I have.

11 Q. What rate of return does Dr. Gaske
12 recommend for MDU's electric operations in North
13 Dakota?

14 A. Dr. Gaske recommends a return of 10.7
15 percent with an equity return incorporated into
16 that of 12.75 percent.

17 Q. Can you identify the specific reasons for
18 the difference between your recommendation and that
19 of Dr. Gaske?

20 A. Yes. There are four reasons for the
21 difference between our recommended rate of return.
22 The first is the cost of the debt that should be
23 included in overall rate of return.

24 The second -- well, the next three go to
25 the cost of equity, but they are respectively the

1 selection of companies that are comparable to MDU
2 for purposes of determining the appropriate rate of
3 equity return; the addition of an increment to the
4 equity return in the amount of -- for stock
5 flotation costs; and, finally, a tiny difference in
6 the procedure for calculating the value of next
7 year's dividends in the process of computing a DCF,
8 discounted cash flow, rate of return.

9 Q. Are there other areas -- any other areas
10 of disagreement with Dr. Gaske?

11 A. Yes. We disagree as to the appropriate
12 checks for our respective discounted rate --
13 discounted cash flow rates of return.

14 Q. Okay. What is the issue with respect to
15 the cost of debt?

16 A. The issue relates to how to treat the cost
17 of refunding the old debt that was repurchased back
18 in 1992 when the company acquired or sold much of
19 the long-term debt that it now has outstanding.
20 These costs were considerable. They were 13
21 million dollars out of a total of 136 million
22 dollars in debt, or about 10 percent of the
23 principal. Now both Dr. Gaske and I agree that
24 these costs should be recovered. The question goes
25 to where they should be recovered and how.

1 Dr. Gaske advocates what's called the
2 yield to maturity approach. If you think of the
3 cost of debt as a fraction, the numerator of the
4 fraction is the annual cost of debt, the
5 denominator is the total principal amount. Under
6 the yield to maturity approach the cost of -- these
7 flotation costs -- I'm sorry, not flotation -- they
8 were costs of issuance, mostly of the cost of
9 repurchasing the old preexisting debt, the 13
10 million. That is backed out of the denominator.
11 That is, it's backed out of the amount of money to
12 be recovered.

13 There is the alternative approach, which I
14 have employed, which we will call the accounting
15 approach, in which the amount is -- the cost of
16 issuance of a debt is added to the numerator, that
17 is, the annual amount that is recovered in the rate
18 of return. These yield very different costs of
19 debt.

20 The yield to maturity approach in this
21 particular case yields 9.22 percent, and the
22 accounting approach, which I recommend, yields 8.62
23 percent.

24 Now I've adopted the accounting approach
25 because MDU's 9.22 percent debt cost is way out of

1 line with that of other utilities. NSP, which
2 is -- now calls itself I believe Xcel Energy -- has
3 an embedded debt cost of 6.99 percent. That is
4 about -- well, let's see, 223 bases points -- a
5 basis point being a hundredth of a percentage --
6 below what MDU is requesting. Otter Tail's
7 embedded debt cost is 7.68 percent. You saw
8 those -- these comparisons in one of Mr. Diller's
9 slides. This rate of 9.22 percent is also way
10 above any current cost of corporate debt, the
11 yields to corporate funds in the public markets.

12 What I am proposing is a significant --
13 significant reduction over the -- over the yield to
14 maturity approach, but it reflects certain known
15 facts. The first is that no competitive company
16 would be able to maintain debt costs of 9.22
17 percent, 2 percent -- 2, 3 percent above what
18 current yields are, without some hurt to its
19 stockholders.

20 We are not asking for a hurt to the
21 stockholders of MDU. We're just asking that debt
22 issuance costs be recognized exactly as they appear
23 on the financial books. This isn't such a shocking
24 idea because NSP proposed exactly this approach in
25 its rate case here last year.

1 Q. The NSP approach, do you have an exhibit
2 that shows NSP's approach?

3 A. I'm sorry. I do not have -- it's set
4 forth in Dr. Gaske's testimony.

5 Q. Okay. So your -- at this point your
6 position is the accounting approach should be used?

7 A. Yes. As I indicate, this is easier on
8 ratepayers, it reflects the fact that the company's
9 debt costs are excessive. You will probably
10 hear -- you will hear this afternoon of elegant
11 reasons why the company could not reduce its debt
12 costs.

13 The fact remains that all the rest of
14 the -- the other two utilities in North Dakota and
15 all other utilities I am aware of are able to
16 maintain debt costs well below eight percent. I do
17 not understand why it would be impossible for this
18 company to reduce its debt costs. To use the
19 financing approach, which is fair to ratepayers and
20 fair to shareholders, gives the company some
21 incentive to reduce its debt costs whenever
22 possible.

23 Q. Mr. King, on -- in your direct testimony
24 on page six you make reference to a 40-million-
25 dollar term loan from the Bank of America, and you

1 state that the 40 million dollars was borrowed on
2 December 29, 2000, and matured on January 2, 2001.
3 Is that correct?

4 A. That's correct. The -- the -- go ahead.

5 Q. Okay. Was that -- was the full 40 million
6 dollars being carried on MDU's books as debt for
7 the year 2000?

8 A. What brought it to my attention is when we
9 initially began this proceeding, we had received a
10 statement from the company as to its cost of
11 capital, and the full 40 million dollars was shown
12 as outstanding on December 31st of 2000.

13 Q. And this loan only covered a period of
14 three days in the year 2000; is that correct?

15 A. Apparently the company had taken out the
16 loan -- I can't remember the exact dates --
17 December 29th and it repaid it on something like
18 January 2nd.

19 Q. Do you know what the interest rate was for
20 that loan?

21 A. It was 9.575 percent.

22 Q. Did you make an adjustment in your
23 testimony?

24 A. Yes, I did. I inquired of the company as
25 to what the average outstanding amount against this

1 line of credit was during the year 2000. The
2 company responded that it was 1.3 million. So I
3 reduced the amount in the capital structure and in
4 the debt structure to 1.3 million, and that is
5 reflected in the debt allowance that I've got, and
6 I believe the company has accepted that adjustment,
7 at least Dr. Gaske has not objected to it.

8 Q. Okay. Does that complete the issues with
9 regard to the cost of debt?

10 A. Yes, it does.

11 Q. What is the issue with respect to
12 selection of comparable companies for the purposes
13 of DCF calculation?

14 A. Well, you have to understand you can't
15 measure MDU's equity return directly, and the
16 reason is that it has too many nonregulated
17 businesses. MDU's parent, of course, is the only
18 company that sells stock. MDU -- M-D Utilities,
19 which I think is the official name of the affiliate
20 or the subsidiary that we're dealing with, does not
21 sell stock in the open market.

22 The parent company really has only about a
23 quarter of its earnings generated by regulated
24 activities. Three-quarters of its earnings come
25 from nonregulated activities, a lot of it in the

1 pipeline and energy exploration business, and
2 that's in my initial testimony. The result is that
3 it's necessary to use surrogate companies that are
4 heavily regulated that reflect the kind of business
5 that MDU is engaged in.

6 I set up a series of criteria for
7 selecting these companies. First, that they had to
8 be -- 85 percent of their revenue had to be
9 regulated, that is from rate base return type
10 regulations such as we're talking about here. The
11 companies had to have investment grade beyond
12 ratings; and, finally, the companies had to have
13 sufficient size to be reasonably comparable to MDU,
14 and I established a threshold of annual revenues of
15 100 million dollars.

16 I made two selections, one electric-only
17 company and the other a combination gas and
18 electric company, and the listing of these
19 companies is set forth in an exhibit to my initial
20 testimony.

21 I found only five electric-only companies
22 that fit this standard, and I believe ten -- yeah,
23 it was ten combination companies, and those are the
24 companies that I studied for purposes of
25 determining their return to equity to MDU.

1 Having studied those, I found that the
2 electric-only companies generally had higher rates
3 of return, that is discounted cash flow indicating
4 rates of return than did the combination companies,
5 and I concluded that the combination companies
6 should be used as the comparable utilities to MDU.
7 Why? Because MDU is a combination company.

8 Now this might not matter if there were no
9 difference between the risk of a combination
10 company -- by combination I'm talking about gas and
11 electric -- if combination companies had the same
12 risk as electric-only companies.

13 The two objective reasons for believing
14 that a combination company is less risky: In the
15 first place for some uses of energy the two were
16 competitive. That certainly is true of cooking and
17 hot water heating, and in much of the company it's
18 true of heating, as well. Maybe less so in North
19 Dakota where electric heating is relatively rare.
20 Elsewhere in the company electric heating is quite
21 competitive with gas heating.

22 The other reason has to do with the
23 weather. Most gas companies -- well, all gas
24 companies peak in the wintertime because the
25 principal use of gas is space heating. Most

1 electric companies in this country, not all, but
2 most, peak in the summer because the principal use
3 for electricity is air conditioning. If you have
4 both services, electricity and gas, you have -- you
5 spread the risk of unusual weather. So that if you
6 have a warm winter, like we're having now, that's
7 going to hurt your gas operation, but that could be
8 offset by a warm summer, which will pick up on the
9 electricity side.

10 So as a consequence combination companies
11 are less risky. MDU, being a combination company,
12 I selected the returns from the combination
13 companies. Dr. Gaske strongly objects to this. He
14 thinks that electric-only companies are the
15 appropriate surrogate, and obviously we disagree,
16 and it's, I guess, for you to decide which of us is
17 right. So that's the principal disagreement there.

18 Q. Why do you object to Dr. Gaske's selection
19 of electric-only companies?

20 A. Well, Dr. Gaske used a different threshold
21 of regulated revenue than I did. I set the
22 threshold quite high at 85 percent. Even at 85
23 percent there's still a fairly significant
24 influence in investors' minds of unregulated
25 activities because often those are the fastest

1 growing and the potentially most profitable but in
2 the near term often the least profitable activities
3 the company engages in.

4 Dr. Gaske set his threshold lower. He set
5 it at 75 percent and in the process picked up three
6 companies. IDACORP, which is Idaho -- what is it,
7 Idaho Gas, Idaho Utilities Energy -- but anyway,
8 that's its new name, IDACORP -- AEP, which stands
9 for American Electric Power, and Cleco, these are
10 all electric utilities that have between 75 and 85
11 percent of regulated revenue. They also have very
12 high DC -- discounted cash flow rates of return as
13 computed by Dr. Gaske. They range from 12.5
14 percent to 15.4 percent.

15 I have included in my rebuttal testimony
16 an exhibit which has the -- the Value Line writeups
17 for these three companies. If you look at those
18 writeups, you will see that what excites Value Line
19 at least is the nonregulated activities of each of
20 these three companies. That's what's driving
21 investor expectations, particularly as to future
22 growth.

23 Now, it results in a much higher rate of
24 return? Why? Because these are riskier
25 activities, being unregulated. These -- these

1 companies can't go to regulators if profits go
2 south on these -- on these unregulated ventures.
3 As a consequence I believe these companies are
4 inappropriate to compare with MDU's regulated
5 electric activity.

6 If you take these three companies out and
7 if you ignored Dr. Gaske's flotation cost adder,
8 which I will talk about in a minute, you find that
9 the remaining I believe seven companies have rates
10 of return virtually in the range that I'm talking
11 about, that I recommend, 11.7 to 11.9 is his range
12 for the remaining companies. That probably is one
13 of the bigger areas of disagreement between us.

14 Q. What is the issue with respect to
15 flotation costs?

16 A. Well, flotation costs are the costs of
17 selling stock, and they involve underwriters'
18 commissions and discounts and a whole host of
19 things. Dr. Gaske has increased the discounted
20 cash flow equity return by 4.75 percent to capture
21 what he claims is a necessary component for
22 flotation costs, and this number's based on a
23 survey that he conducted of the cost of floating
24 new stock by a number of utility companies.

25 Now I reject this adder for a number of

1 reasons. First of all, it's too large for MDU. If
2 you take MDU's total flotation costs for the last
3 five years and compare it to the amount of stock
4 that it sold or issued, it comes to only about .94
5 percent, but that's not the real objection. The
6 real objection is that Dr. Gaske would take this
7 flotation cost, which pertains to selling new
8 issues of stock, and apply it to the entire value
9 of all the equity that had ever been sold by this
10 company, including equity that's been sold through
11 dividend reinvestment plans which have virtually no
12 flotation costs, and stock that is not necessarily
13 issued in public offerings.

14 The result is that when you apply Dr.
15 Gaske's 4.75 percent, you come with a figure of
16 about 6 million dollars every year that is
17 recaptured for flotation costs. Well, 6 million
18 dollars exceeds the entire cost of flotation
19 companies incurred for all stock issues over the
20 last five years. It's a gross overrecovery.

21 Now, I don't think that flotation costs
22 should be excluded from the recovery of capital
23 costs, but if you take the actual flotation costs
24 of MDU for the last five years and you annualize
25 them, it comes to about a million dollars a year.

1 You compare that to the total value of -- book
2 value of MDU's equity and it comes to about .1
3 percent. The number is so small that it gets lost
4 in the rounding, and I think it is not unfair to
5 simply ignore it because it is a minuscule item.

6 The company's stock is selling well above
7 book value. It does not -- oh, and we'll get into
8 that. That's the other reason for Dr. Gaske's
9 proposal, to include flotation costs. He argues
10 that if you don't include flotation costs, the
11 company's stock will sell below book value. Why?
12 Because DCF is a calculation of the investor-
13 required return. If you apply it to book values as
14 Dr. Gaske has, the stock will sell at book value,
15 and as a consequence when shares are sold, the
16 subtraction from proceeds for flotation costs means
17 that the company receives in terms of real money
18 less than its book value, less than the -- and
19 there is a dilution of the value of -- book value
20 of these shares of the company.

21 I have an exhibit which I presented to you
22 about a -- was it last year when I was here for the
23 NSP case, which demonstrates that that flatly isn't
24 so, and if we could hand that out, I could show why
25 this is the case.

1 MR. BINEK: Why don't we mark this.

2 MR. HOBERG: This hasn't been marked yet,
3 Mr. --

4 MR. BINEK: No, it hasn't.

5 THE WITNESS: In the NSP --

6 MR. HOBERG: Just a minute, please.

7 (Exhibit 12 was marked for
8 identification.)

9 MR. HOBERG: Do you want to look at the
10 exhibit first?

11 MR. BINEK: Yes. I would like to have him
12 identify what this exhibit is.

13 MR. HOBERG: Okay.

14 THE WITNESS: This exhibit was distributed
15 in the NSP case -- and I can't remember exactly the
16 date I was here, but it was last year -- where I
17 was rebutting the NSP -- NSP of course is Northern
18 States Power and is now called Xcel Energy, but I
19 think we all know it as NSP, but in any case, their
20 rate-of-return witness argued that investors looked
21 to a return on market value rather than book value
22 and that we should be applying the DCF return to
23 market value, and I was trying to show --
24 because -- unless you do that you will depress the
25 stock down to its book value and you will not be

1 able to maintain ratios of market value to book
2 value that are higher than one.

3 The purpose of this exhibit was to
4 demonstrate that it flatly isn't true that when you
5 give a discounted cash flow based rate of return to
6 the book value of a regulated utility, that the
7 consequence is a market value that equals book
8 value.

9 Now if you look at the -- and what this
10 has is the market per share -- market value per
11 share, book value per share, the market-to-book
12 ratio, and then column D is earnings per share, and
13 then we get the return on first the market price
14 and then on the book price, and --

15 MR. HOBERG: Before we testify on this,
16 though, we better offer it.

17 MR. BINEK: Yes. I will offer this as an
18 exhibit.

19 MR. HOBERG: Okay. Exhibit 12, Mr. King's
20 chart from last year's NSP case, Mr. Pearce, any
21 objection to Exhibit 12?

22 MR. PEARCE: No objection to foundation.

23 MR. HOBERG: Okay. Exhibit 12 is
24 admitted. Mr. Binek, please.

25 Q. (MR. BINEK CONTINUING) Yes. Would you

1 proceed, please, with your explanation?

2 A. Yes. Look at the far right column. This
3 is the percent earnings on book value. Now these
4 are all gas companies, and in the NSP case I had
5 recommended a rate of return of 11.2 percent on --
6 for NSP, and I believe in the settlement that
7 subsequently was made it was agreed that the
8 allowed rate of return would be 11.5 percent.

9 So if 11.2 to 5 -- let's say 11.5 is the
10 appropriate rate of return on book value, then we
11 can observe several instances where companies are
12 earning less than 11.5 percent on book value. AGL
13 Resources, that stands for Atlanta Gas & Light, is
14 only earning 10.8 percent; Leclde Gas is only
15 earning 9.1 percent; Northwest Natural Gas earning
16 only 10.2 percent; Wisconsin Energy, 9.1 percent.
17 These companies are clearly not earning an adequate
18 return on their book value.

19 But look then at the market-to-book
20 ratios. In every case they are still well above
21 one. Why is that? And the reason is that the
22 companies -- that investors are not looking at the
23 current return on book value as the basis on what
24 they'll buy that share for. They'll buy the shares
25 for both the current return and the forecast future

1 earnings. All the -- investors in all of these
2 companies are anticipating that earnings will
3 increase; and, therefore, they are willing to
4 accept very low returns on market price, and that's
5 column E here, which, as you see, not one even
6 approaches ten percent. Not one -- well, there's
7 only one that does, that's Energy East, but all the
8 rest are in the 6, 7 and 8 percent return. That's
9 the current return that investors are making on the
10 market value of their shares, and that's because
11 they are betting that these utilities will be able
12 to generate increased earnings in the future.

13 So I -- the basis of all this is that if
14 you offer a book return -- a return on book value
15 that matches the discounted cash flow return, which
16 I believe to be 11.7 percent, the result will be a
17 market price which exceeds the book value and
18 easily recaptures the flotation costs that Dr.
19 Gaske contends will be lost otherwise. So that's
20 my rebuttal to that piece of Dr. Gaske's
21 supplemental testimony.

22 Q. And what is the issue with respect to
23 forecasting of dividends during the coming year?

24 A. Well, this is a mechanical thing. The
25 theory of DCF is that the -- the dividend yield

1 piece, which is the immediate return of the
2 discounted cash flow formula, should be next year's
3 dividend over recent price. That's the dividend
4 yield.

5 Now the question is we have -- we know
6 what this year's dividend is. What's next year's
7 dividend going to be? It probably will be
8 increased over this year's dividend.

9 Conventionally -- a rather mechanical way it's
10 done -- is that you take the growth factor, which
11 you've already identified as part of the DCF, and
12 you divide it in half. Why in half? Because the
13 probability of the dividend increase is randomly
14 distributed through the coming year, and half of
15 the coming year is six months from now and that's
16 half of the annual increase in earnings that you
17 predict for the company.

18 And so I used an adder of .5 of the growth
19 factor to increase the dividend in my dividend
20 yield calculation. Dr. Gaske says that's wrong, it
21 should be .625, and Dr. Gaske will have to tell you
22 why he's right and I'm wrong, but the result is
23 negligible difference in our rates of return. It
24 really is a nit on the whole calculation, but it is
25 an area of disagreement.

1 Q. What is the -- what is the issue with
2 respect to various checks on DCF rate of return?

3 A. Well, as you know, the DCF is the standard
4 classical way you calculate rate of return, if
5 you've sat in enough of these proceedings, but
6 there usually is a need to have some kind of sanity
7 check on what you get from the discounted cash flow
8 procedure.

9 The sanity check I used was to look at the
10 trend in interest rates since earlier rate-of-
11 return decisions, and if you look at Schedule 4 of
12 my initial testimony, you'll see a chart which
13 traces both corporate and, I believe, government
14 interest rates since the 1980s, and what you will
15 see there is a gradual downward trend. It ziggles,
16 but currently it's lower than it's been in 15
17 years. That's partly because of the Federal
18 Reserve, it's partly because of the decline in
19 inflation, but whatever the reasons, interest rates
20 now are considerably lower than they were when
21 rates of return were last set for this company, and
22 the chart has on it the rates of return that were
23 established not only by this Commission but by
24 the -- I believe the Wyoming, South Dakota and
25 Montana commissions to the extent that they made

1 decisions during the last 15 years.

2 COMMISSIONER WEFALD: Which page is that
3 on?

4 THE WITNESS: That's exhibit -- Schedule 4
5 of the initial testimony.

6 COMMISSIONER WEFALD: Thank you.

7 MR. HOBERG: That's Exhibit 4.

8 THE WITNESS: It's just before the little
9 resume, and I assume it's paginated the same way.
10 It looks like this.

11 COMMISSIONER WEFALD: Thank you.

12 THE WITNESS: And at the far right of this
13 I show the rate of return that I had picked last
14 August, but that should have a new little star,
15 which is a little higher for the rate of return
16 which I'm now recommending of 11.7 percent instead
17 of 11.2 percent.

18 Dr. Gaske has used two very different
19 checks. Oh, I should say that the interest rates
20 are not directly correlated with returns to equity.
21 They vary because of different concerns about the
22 assurance of equity return, the stock market
23 variations, and inflation has a lot to do with it
24 because an -- stocks are perceived as a hedge
25 against inflation, and bonds -- if you lock in a

1 low interest rate and inflation goes through the
2 roof, why, you're really losing because you're
3 simply not -- I mean, you've got a fixed interest
4 rate, and if you're earning five percent and the
5 inflation rate goes to seven, you're behind two
6 percent every year.

7 So these variations from year to year
8 affect the risk premium of stocks over bonds,
9 and -- but in general there is a -- is a
10 correlation between stock returns and bonds, and
11 that is -- that's called the risk premium check,
12 and that's what I've attempted to do here.

13 Dr. Gaske has used the infamous Ibbotson
14 Singfield approach, which I find rather bizarre.
15 It goes all the way back to 1926 and says, let's
16 trace what the difference between the returns to
17 equity and the returns to debt have been over 50 --
18 now, what, 60, 70 -- I don't know how long that
19 is -- almost 70 years, and that difference will
20 wash out because it's many, many, many years --
21 will wash out the year-to-year fluctuations that
22 might come about because of depressions and
23 recessions and booms and busts and that's a good
24 measure of risk premium, which I think is
25 ridiculous.

1 First of all, if short-term expectations
2 don't pay off, in other words, if you buy stocks
3 this year thinking that you'll do better than bonds
4 and as we saw in the last year the DOW goes from --
5 what is it now, 10,000 now, but it was close to
6 15 -- I mean, close to 12,000 a year or so ago,
7 Nasdaq has gone -- is tanked, then you didn't
8 realize your expectations, and that happened in the
9 short run, and the idea that if you add all the
10 short-run failures with some of -- and they'll
11 offset the short-run successes that would have
12 happened if you bought stocks back in the mid
13 Nineties and kept them and sold them right at that
14 magic moment in March 2000, well, that's
15 ridiculous, that these would wash out and result in
16 some real believable measure of risk premium.

17 The other objection -- or two other
18 objections to this approach. The other one is that
19 there's some sort of fixed, unchangeable risk
20 premium over bond -- bond yields that applies for
21 decades at a time. That's not true. Bonds and
22 stock vary in their relative risk and benefit as I
23 discussed a minute ago.

24 And the final objection is a purely
25 mathematical one. If you look at the variations

1 in -- annual variations -- actually these are
2 monthly measures, but if you look at the variations
3 from year to year and the yields in the risk
4 premiums over bond yields, they -- those variations
5 exceed the average, exceed the mean, which means
6 that the mean has no statistical significance
7 whatever as a predictive instrument. And so I
8 would dismiss this procedure for measuring risk
9 premium completely.

10 Q. (MR. BINEK CONTINUING) What is your
11 assessment of Dr. Gaske's alternative equity
12 investment analysis?

13 A. Well, that's Dr. Gaske's other check on
14 his equity return. He comes up with an equity
15 return of 12.75 percent, and this is pumped up by
16 the use of companies that are heavily engaged in
17 nonregulated activities and by his 4.75 percent
18 kicker for flotation costs.

19 Then he says, ah-hah, let's see what the
20 return-to-book equity for industrial companies will
21 be, and so he takes several hundred industrial
22 companies and says that over 5 years they have
23 earned 29.4 percent on their book equity value, and
24 this means that a return of 12.75 percent to MDU is
25 really quite modest and quite low.

1 Well, what this ignores is the very
2 different relation -- different importance of
3 return to book equity for an industrial company as
4 compared to a utility company. If you want to buy
5 a share of an industrial company, you have to pay
6 the market price. There's no way you can get the
7 book value. The book value is a historical number
8 which measures how much money was put into the
9 capitalization of the company over the past, but
10 it's not a number that is meaningful to you as an
11 investor. The only number that's meaningful is
12 what is your return on the market value.

13 Overwhelmingly, market values exceed book
14 value all across the economy, and so what appears
15 to be a very high 29.4 percent on book value when
16 you look at the market value is a much, much, much
17 lower number.

18 Now why is that different from MDU or
19 other utilities? It differs from MDU and utilities
20 because MDU is regulated based on its book value.
21 Book value has importance for utilities that is
22 nowhere found in industrial companies because
23 regulators, such as yourselves, decide what rate of
24 return should be allowed on a rate base, and that
25 rate base is not tied to the market value of the

1 company but to its book value, and that's why book
2 value returns are important in utilities. They are
3 not important or relevant in industrial companies.

4 Q. Do you have any final comments you'd like
5 to make to the Commission?

6 A. Yes. I think there really are only two or
7 three decisions you have to make. With respect to
8 debt costs you have to make a simple decision of
9 whether you would go with one calculation or
10 another, and I've given you reasons for using the
11 financial return, which I mentioned is used by NSP.
12 So it's not an unthinkable thing.

13 The financial calculation of the cost of
14 debt. We need to have some incentive to this
15 company to get that debt cost down, which is
16 excessive. That's one decision.

17 The other decision I don't think is all
18 that great, that is the return to equity, because
19 when you -- when you peel off Dr. Gaske's -- the
20 two areas where Dr. Gaske has pumped up his equity
21 return, which is including three highly -- well,
22 three companies where nonregulated activities are
23 clearly demonstrated -- are inflating the expected
24 return and if you get rid of this flotation cost
25 kicker, you find that his returned equity on his

1 selection of companies, which I don't even agree
2 with, is about the same as mine. It's 11.7 to
3 11.9. I recommend 11.7 because it's based on
4 combination gas/electric utility, and MDU is a
5 combination electric gas and electric utility, and
6 that's I think really -- I tried to reduce to a
7 nutshell the decisions you have to make.

8 MR. BINEK: Thank you. At this time I'd
9 tender the witness for cross-examination.

10 MR. HOBERG: Thank you, Mr. Binek.
11 Perhaps this is a good time to take luncheon
12 recess.

13 MR. BINEK: I would like to comment, Your
14 Honor, that Mr. King does have to leave this
15 afternoon. I think he probably needs to go to the
16 airport, what, about 3:30?

17 THE WITNESS: Well, the plane's 4:40, so
18 3:30 is --

19 MR. BINEK: And I think MDU also has a
20 witness in that same situation.

21 MR. HOBERG: Is that correct, Mr. Pearce?

22 MR. PEARCE: Yes. And I don't have a very
23 extensive cross-examination for Mr. King, so that
24 would certainly be no problem having him finished,
25 I would think, within a half-hour after we get back

1 from lunch.

2 MR. HOBERG: Okay. So you don't have any
3 problem with taking a luncheon break?

4 MR. PEARCE: No. That's fine.

5 MR. HOBERG: Till one o'clock?

6 COMMISSIONER WEFALD: Right at one?

7 MR. HOBERG: One o'clock. Okay. We'll be
8 back after lunch at one o'clock.

9 (Noon recess taken.)

10 MR. HOBERG: We're back from luncheon
11 recess, and we're about to begin the
12 cross-examination of Mr. King. Mr. Pearce, please.

13 MR. PEARCE: Thank you.

14 CROSS-EXAMINATION

15 BY MR. PEARCE:

16 Q. Mr. King, I may have misheard, but at the
17 very beginning of your testimony it seems to me
18 that you said that your overall cost of debt was
19 9.22. I think you meant 9.92. Maybe I misheard
20 it.

21 A. Let me make sure. That's a pretty
22 important number.

23 MR. HOBERG: He said 9.22.

24 Q. (MR. PEARCE CONTINUING) Right. And I
25 believe your number is 9.92.

1 A. 9.92, right.

2 Q. Okay.

3 A. Overall capital cost.

4 Q. Right. That's what I thought I heard.

5 Now you testified on the -- as to your basis for
6 reducing MDU's cost of debt from 9.22 to 8.62
7 percent. If I understood your testimony, your
8 opinion is based solely on the -- your perception
9 that that 9.22 is unreasonably high; is that right?

10 A. That's correct.

11 Q. And I think you also testified that the
12 debt level of NSP that you talked about was based
13 on your accounting based approach, not a yield to
14 maturity?

15 A. The debt return is based on the accounting
16 approach which amortizes the acquisition costs, the
17 reacquisition costs over the life of the debt
18 issued, which is the standard accounting treatment
19 for these costs.

20 Q. Now I believe that -- doesn't FERC
21 practice and also the prior practice of this
22 Commission is to use a yield-to-maturity approach
23 for the cost of debt?

24 A. That has been the case, yes, as I say so
25 in my reply testimony.

1 Q. And that typically will yield a higher
2 cost of debt than the accounting approach you
3 testified to?

4 A. Yes.

5 Q. I believe you stated in a data response
6 that you didn't know how the Otter Tail debt-
7 comparison figure was computed; is that right?

8 A. No, I do not. I don't have background on
9 that.

10 Q. Now when you say that the MDU cost of debt
11 is unreasonably high, that -- again, that's simply
12 your opinion based on comparing it to two other
13 utilities, Otter Tail and Xcel?

14 A. Not just them. You get the Federal
15 Reserve report on what current interest rates or
16 bond yields are. You'll find numbers dramatically
17 lower than 9.22 percent.

18 Q. Yes. And those are current rates, not
19 embedded --

20 A. Current rates, right.

21 Q. Have you done any investigation into the
22 MDU debt as to the purpose for the occurring of the
23 debt or the timing of the debt issues that make up
24 its --

25 A. I've looked at the report on the 1992

1 refunding. I've looked at it fairly carefully, but
2 if that's investigation, the answer is yes.

3 Q. Is that the extent of the investigation
4 that you've done?

5 A. I think so, yes.

6 Q. Now -- but in order to actually come to a
7 reasoned judgment, expert opinion about the cost of
8 debt, wouldn't you have to look at all of the
9 history by which MDU acquired and refinanced and
10 incurred the current embedded cost of debt?

11 A. I guess I don't understand your question.

12 Q. Well, let me -- perhaps I phrased it in a
13 convoluted way again, but in order to make an
14 informed judgment, let's say, about whether a debt
15 cost is unreasonable or not, wouldn't you have to
16 look at all the circumstances under which each
17 issue of debt was incurred and the refinancings
18 that occurred subsequently?

19 A. You know, I'm not even sure that would do
20 the trick. Everything had to do with timing, and
21 it would appear that MDU picked a very poor time or
22 did poor timing, for whatever reason, in its
23 refunding, and the refunded -- the effective costs
24 of much of the refunded long-term debt was no lower
25 than the cost of the debt that was refunded. Those

1 would show up in the MDU data.

2 I'll give you a specific example. Here's
3 a retired issue -- a retired issue of -- looks like
4 74 million dollars with a cost of money of 10.498
5 percent. The new issue is effective cost of money
6 of 11.024 percent.

7 MR. HOBERG: Mr. King, what were you
8 referring to there?

9 THE WITNESS: I'm sorry. The document I'm
10 referring to is not in evidence, and maybe it will
11 be, though. Maybe this is provided by one of your
12 witnesses, but what it is is the -- I had asked for
13 a cost benefit study for the refunding of the debt
14 that was responsible for these very high long-term
15 embedded costs, and I was given two sheets of
16 paper. One shows the long-term debt capital as of
17 December 31, 1991, and the other one shows the cost
18 of capital as of -- or cost of debt, rather, as of
19 December 31, 1992, and presumably the difference
20 between the two is the effect of the refunding.

21 So I was -- you know, I can't explain why
22 it appears that those particular issues having been
23 refunded wound up resulting in a higher cost than
24 the previous issue. That's something your folks
25 will have to explain. I couldn't rationalize it.

1 Q. (MR. PEARCE CONTINUING) You didn't look
2 into or inquire as to the specific reason for the
3 refinancing that was done?

4 A. No. I didn't get into why the
5 refinancing.

6 Q. Now turning for a moment to your
7 comparison companies, your proxy companies, I'm
8 looking at your Exhibit CWK-3R, I believe it is,
9 listing both -- showing both your list of electric-
10 only utilities and your list of combination gas/
11 electric utilities.

12 MR. HOBERG: Is this in the direct or
13 rebuttal?

14 MR. PEARCE: I think that CWK-R is in your
15 rebuttal. I think it's the last page, I believe,
16 in exhibits to your rebuttal.

17 THE WITNESS: I have it.

18 Q. (MR. PEARCE CONTINUING) I note that under
19 the electric utilities -- or electric-only you
20 have -- just taking a couple, for example, Pinnacle
21 West and Great Plains Power, which I believe is the
22 successor to Kansas City Power and Light; is that
23 right?

24 A. That's correct.

25 Q. Both have a DCF return of 12.9 percent.

1 A. Yes.

2 Q. And now those are companies, which I
3 believe if we look at -- and the same evidence may
4 be in your testimony, but I took this particular
5 page from Mr. Gaske's schedule which shows the
6 percent of revenues from electric operations of all
7 the companies that derived 75 percent or more. I
8 believe it's in his initial testimony in response
9 to your direct. It's his JSG-2, Schedule 3, page 1
10 of 2?

11 A. JSG-2, Schedule 3.

12 Q. It's entitled "Mr. King's Electric
13 Companies That Derive 75 Percent of Revenue From
14 Regulated Electric Service."

15 A. Yeah, I have it.

16 Q. Now I notice that those two companies I
17 mentioned, electrics-only, Kansas City Power &
18 Light, which is the same as Great Plains, and
19 Pinnacle West derived 95 percent of the revenue
20 from electric operations. So we're looking at
21 companies that are -- as you say, they're electric-
22 only. They derive the vast bulk of their revenues
23 from electric operations.

24 A. Yes, sir.

25 Q. It would seem that these would be logical

1 ones to compare to Montana-Dakota rather than, for
2 example, looking down in your list of combination
3 companies of Con Ed and Energy East, which I think
4 respectively derived 73.6 and 68.4 percent of their
5 revenue from electric operations and have
6 significantly lower DCF figures then of about 9.6
7 and 10.9 percent. I know you've testified as to
8 your theory about the combination companies and the
9 risk, but doesn't it just as a matter of common
10 sense make more sense to be comparing
11 Montana-Dakota Utilities' electric operations to
12 companies that are deriving essentially -- or a
13 large bulk of their revenue from electric
14 operations?

15 A. No. And the reason is that the fact that
16 Montana-Dakota Utilities also has regulated gas
17 services means that the appropriate comparison is
18 with entities that provide both electric and gas
19 service under regulation and very little else, that
20 is very little in the way of nonregulated
21 activities, and the reason is that the electric --
22 the risk of the electric activity is not a stand-
23 alone risk as Dr. Gaske seems to think. It is
24 affected by the presence of the regulated gas
25 activity for the reasons that I've discussed. So

1 the comparable company is the one that is the
2 combination company.

3 Q. Well, suppose for a moment as an example
4 that for whatever reason there was a very bad year
5 for electric sales for Montana-Dakota and a very
6 good year -- well, suppose a lot of customers
7 switched over, as you've suggested they might, to
8 gas. Then Montana-Dakota would have to invest
9 significant additional funds into its gas
10 operations, I assume, doesn't that make sense, to
11 serve them?

12 A. It might. But the virtue is that it's
13 better off than if it had no gas operations.
14 That's the advantage that a combination company has
15 that an electric-only company doesn't have.

16 Q. And if that happened, the Commission would
17 then, of course, need to allow Montana-Dakota to
18 recover those additional expenditures on the gas
19 side; right?

20 A. Conceivably, but we're talking about rate
21 of return and investors' perception of business
22 risk, and investors' perception is that the
23 presence of gas -- regulated gas operations in the
24 same service territory is a protection, not a --
25 not an obstacle to the company's business success.

1 Q. But would those investors -- how would
2 they factor into account? In my example if the
3 electric -- substantial electric costs were now
4 stranded because the customers have switched over
5 to gas, is the Commission going to allow MDU to
6 recover on the electric side of those stranded
7 costs in plant?

8 A. Well, there's very little -- virtually no
9 example that I could think of where shifts between
10 fuel sources has created stranded facilities of any
11 kind, and the reason is that in most of the country
12 total fuel consumption, because of total
13 population, if nothing else, and also economic
14 activity is expanding, so that when you have a
15 shift from, say, electricity to gas, it is at the
16 increment. It isn't that the electricity contracts
17 and you have stranded electric facilities which you
18 wind up as having a slower rate of growth for the
19 electric side and a higher rate of growth for the
20 gas side and the reverse if there is a shift in the
21 other direction.

22 Q. But aren't we now in a recession, and for
23 Commissioner Reinbold I will say my opinion is that
24 we are in a recession, so won't that affect your
25 increasing economic, aren't we going in reverse?

1 on page three. You state that Mr. Gaske calculates
2 the average flotation cost of new common stock
3 issues at 4.75 percent, and then you discuss about
4 how he applied these -- how if you divide --
5 flotation costs are a little hard for me, so you'll
6 have to excuse me. I need a little time to ask my
7 question. You talk about how the -- and let me
8 make sure I understand flotation cost first.
9 Flotation cost is how much it costs to put out this
10 new stock offering to the public or to whoever
11 wants to take it; is that correct?

12 A. That's right. It's things like
13 underwriters' commissions.

14 Q. Okay. So I think I've got the basic
15 concept. All right. Now, when -- when Mr.
16 Gaske -- Dr. Gaske figures this, you're saying that
17 he multiplies it by the whole 1.77 million book
18 equity value of the company and that comes to 6.3
19 million dollars annually, which is more than all
20 the flotation costs the company has incurred in the
21 past five years, and so therefore -- then you talk
22 about what their actual flotation costs have been
23 in the last five years, and that's 1.1 million.

24 A. That's correct.

25 Q. That's all on page four.

1 A. Right.

2 Q. But in their rebuttal testimony to yours,
3 the final thing that we received last week, they
4 talk about how some of these were mergers and so
5 then the mergers didn't really have much. They
6 were acquiring stock or something, there was hardly
7 any cost.

8 A. I don't know the detail, but my impression
9 is it may have been exchanging stock or something
10 like that.

11 Q. Exchanging of stock or something. So his
12 comments about the exchange of stock, does that
13 make any difference on your testimony on this
14 issue?

15 A. It goes to my .94 percent, which Dr. Gaske
16 says is understated, because I used in that the
17 denominator of all -- the value of all the shares
18 issued, including the acquisition shares. I don't
19 know for certain how this acquisition worked and
20 whether there was in fact an increment in the
21 capital of the combined companies, but taking Dr.
22 Gaske at his word, then the 9.4 percent isn't a
23 good expression of the cost of getting new equity
24 capital, new as opposed to exchanged equity
25 capital, and he comes up with a figure of

1 three-and-a-half percent or something like that.

2 That doesn't change, though, the figure
3 that I talk about on line 17, page -- I mean, line
4 16, page 4, the 1.1 million. That is in fact the
5 average annual real flotation cost incurred by the
6 company each -- on average each year in the last
7 five years. So that number is unaffected by this
8 whole business of acquisition equity.

9 Q. In --

10 A. So his recovery of six million is still
11 six times what it ought to be.

12 Q. All right. And does he actually use that
13 figure for calculating the -- for adding -- for
14 adding this flotation adder?

15 A. Well, it's the effect of his flotation
16 adder. If you take this -- this adder of
17 4-and-a-half percent and apply that to the total
18 equity of the value of the company, it comes up to
19 6.3 million annually.

20 Q. Are you -- even if -- but he points out in
21 his testimony that there is a -- that the 4.5 is
22 closely associated with the cost of issuing new
23 stock that would be comparable to MDU Utility
24 stock, and is it your position that there just
25 should not be an adder, period?

1 A. If you wanted to put an adder in, you
2 should take some expression of the average
3 flotation cost annually and use that as the basis
4 for the adder. What I contend -- you'll see that
5 on page four -- is that this would be an allowance
6 of .1 percent.

7 Q. And do you even think an adder should be
8 used, because you said if a flotation cost adder is
9 used.

10 A. Yeah.

11 Q. You say "if." Are there situations
12 when -- in rate cases where people do not allow a
13 flotation cost adder?

14 A. Oh, rarely is -- I've been in a number --
15 I fight this battle all the time, and generally
16 commissions do not allow flotation adders. Now
17 there are probably some that have, but it's not --
18 it's not one that sells well with commissions
19 because it results in such an astronomical increase
20 in the cost of equity relative to the true cost of
21 flotation.

22 This 1.1 million versus 6.3 million
23 comparison is repeated anytime that a company does
24 what Dr. Gaske's proposing, which is to take the
25 cost of floating incremental, that is to say new

1 equity, and apply that as an adder to the entire
2 volume of equity of the whole company. It's just
3 an apples-and-oranges application and results in an
4 inflated recovery of what is really not a very big
5 cost.

6 Q. And then the other issue that you said was
7 very small and that has to do with the one where
8 you're using a number of .5 and they're using shall
9 and MDU's using a number of point --

10 A. .625. That's even --

11 Q. -- 625. And you said that's very small
12 as far as dollar factor. You said, "The effect of
13 this disagreement on the final result, however, is
14 minimal," page nine.

15 A. Yes. And that really is a nit. I suspect
16 Dr. Gaske would agree with me on that.

17 Q. Okay. So how many dollars would you think
18 that's worth?

19 A. I haven't figured it out, but I could do
20 it.

21 COMMISSIONER WEFALD: All right. That's
22 all the questions I have right now. Thank you.

23 MR. HOBERG: Thank you, Commissioner
24 Wefald. Commissioner Reinbold, please.

25 COMMISSIONER REINBOLD: Thank you. Just a

1 couple to clarify my notes here so that I can read
2 it myself.

3 EXAMINATION

4 BY COMMISSIONER REINBOLD:

5 Q. Mr. King -- Dr. King, excuse me, do you
6 agree with Diller, basically there are about four
7 issues here in this case?

8 A. That's about it.

9 Q. Okay. So you wouldn't -- from a previous
10 time you had stated that you were in favor of 11.7
11 percent on equity and you dropped it to 11.5.

12 A. It's the other way around. I started out
13 at -- I ran these numbers back in August and it was
14 11.2 percent on equity, and between August and
15 February we had such things as the California
16 energy crisis and we had a little problem with a
17 company called Enron, and I think the public -- the
18 investing public took a somewhat dimmer view of
19 utilities as investment vehicles, and I think
20 that's bumped up the cost of equity for utility
21 companies, and that's evidenced in my revision to
22 11.7 percent.

23 Q. Okay. Then my last question is the one
24 we're all trying to get an answer to, and that is:
25 Have we had a recession?

1 bonds back will decline. One of the most expensive
2 issues is due up, I believe, in 2007.

3 So within the next few years it'll pay
4 this company to refinance. Whether they can do it
5 right now beneficially, I don't know.

6 One additional reason for setting the debt
7 rate a little lower than the company would like is
8 the very fact that if we lock in this very high
9 9.22 percent debt return and, as Mr. Diller
10 suggested, that we don't have a rate case for a
11 number of years, the company can enjoy a nice
12 windfall when it does refinance because it will
13 have a revenue award that reflects very high debt
14 costs and yet it's refinanced its debt down 300
15 basis points, which is quite possible.

16 So that's yet another reason that I think
17 we should go with the lower financial or accounting
18 calculation of debt cost.

19 Q. When Mr. Diller had his slide show
20 earlier, do you recall that he indicated that MDU's
21 long-term debt has always been quite high compared
22 to Otter Tail and NSP for the past 15 years, and so
23 wouldn't you expect that over time MDU's cost of
24 debt would become -- begin to come in line with
25 those other companies?

1 MR. HOBERG: Okay. Mr. Pearce, are you
2 ready to present MDU's case.

3 MR. PEARCE: Yes. May I have just a
4 moment to arrange my papers here?

5 MR. HOBERG: Sure. We're off the record.

6 (Off the record.)

7 MR. HOBERG: Mr. Pearce, your first
8 witness is whom?

9 MR. PEARCE: Wayne Fox.

10 MR. HOBERG: Mr. Fox, please. I think you
11 heard the admonition I gave earlier in regard to
12 perjury, Mr. Fox?

13 THE WITNESS: I did.

14 (Witness sworn.)

15 MR. HOBERG: Thank you. Mr. Pearce,
16 please.

17 MR. PEARCE: Thank you. I just have a
18 very few comments by way of opening statement, and
19 then I will ask Mr. Fox to testify.

20 The basis for the proceeding is already in
21 the record. The evidence that the company will
22 present will demonstrate that Montana-Dakota
23 Utilities will immediately begin to incur revenue
24 deficiency if new rates based on the Commission
25 staff's position go into effect in 2002 and

1 continue in effect.

2 And, of course, as the case has already
3 shown, the primary driving force behind this
4 conclusion -- behind the case in general is the
5 sharply declining level of margins on wholesale
6 electric sales, also called off-system sales, that
7 the company believes it's now able to make and will
8 be able to make in the future as compared to the
9 unusually high margins that were in effect for
10 sales in the years 2000 and especially 2001.

11 The company's evidence will demonstrate
12 clearly that the wholesale market for electric
13 sales is declining dramatically and for a variety
14 of reasons will continue to do so, including the
15 reasons that have already been mentioned, the
16 precipitous decline in the price of natural gas,
17 the advent of new generation facilities that can
18 compete economically with the company's coal-fired
19 generation in the wholesale market, the present
20 economic recession in the United States, and a
21 resulting falling off of demand and many other
22 factors.

23 The company's witnesses will address these
24 factors in detail in their testimony; and, finally,
25 the company, of course, also takes issue with the

1 position?

2 A. August of 2000.

3 Q. And how long have you been employed by the
4 company?

5 A. Since June 1980.

6 Q. And I believe you have a summary of
7 testimony that you would like to make, and I would
8 ask you to just go ahead and read that into the
9 record.

10 A. I do. Should I proceed?

11 Q. Yes.

12 A. In my direct testimony I explain the
13 company's position regarding the North Dakota
14 Public Service Commission staff's recommendation
15 for electric rate decrease and introduce the other
16 witnesses who sponsored testimony on behalf of
17 Montana-Dakota in this proceeding.

18 It is our position that there is no basis
19 to reduce Montana-Dakota's electric rates at this
20 time. The staff case does not take into account a
21 number of necessary adjustments in making an
22 appropriate determination regarding the
23 reasonableness of the existing electric rates.

24 Our direct testimony filed on January
25 11th, 2002, indicated that there is a revenue

1 deficiency of \$710,000. Our surrebuttal testimony
2 filed on February 19th, 2002, reflecting an update
3 to 2001 actual information consistent with the
4 staff position, indicates a revenue deficiency of
5 \$1,727,000.

6 The testimony of the other witnesses
7 addresses the necessary adjustments to the staff
8 position. Montana-Dakota's electric rates were
9 last changed in February 1987. From 1987 to 2001
10 the Consumer Price Index has risen 59 percent.

11 In spite of this significant increase, we
12 have been able to hold our electric rates flat for
13 this entire period by finding ways of operating our
14 businesses more efficiently and taking advantage of
15 new technology where it makes sense to do so, and
16 that's maintaining a consistent focus on providing
17 reliable and safe electric service to our over
18 70,000 electric customers in North Dakota at
19 reasonable and at competitive prices.

20 My direct testimony contains examples of
21 what we did to take advantage of technology and
22 operate more efficiently. We also continue to look
23 for other opportunities to operate our businesses
24 more efficiently and to reduce cost.

25 In the years -- excuse me. In the years

1 since 1987 our earnings have sometimes fell below
2 the authorized level set by the Commission and
3 sometimes above that level. A regulated utility on
4 average and over time should be able to earn at or
5 near its authorized return. A regulated public
6 utility is only afforded the opportunity to earn a
7 reasonable return on its investment and facilities
8 dedicated to the public utility service. There is
9 no guarantee.

10 The earned return levels for the last few
11 years that gave rise to this proceeding were caused
12 primarily by a single element, the selling of power
13 in the wholesale market as the opportunities arose.
14 It was a market anomaly that afforded us and other
15 utilities across the country the ability to
16 temporarily obtain significantly increased revenues
17 and margins from sales of electric energy into the
18 wholesale market in the last few years.

19 Those opportunities, we believe, peaked in
20 2001 and will be significantly reduced in the year
21 2002 and beyond. The reasons for the loss of
22 opportunities are described in the testimony of Mr.
23 Blinsky, Mr. Gaske, Mr. Wilkinson and Mr.
24 Schiffman.

25 In short, the last few years were an

1 unusual period of time in the energy markets where
2 high gas prices, high demand and a strong economy
3 converged to create high demand and high prices for
4 wholesale power. These conditions have now changed
5 and are not likely to be present in the near
6 future, and those reasons are explained in the four
7 witnesses I just mentioned.

8 What this means for Montana-Dakota is that
9 we will no longer be able to sell power in the
10 wholesale market at the higher prices that we have
11 seen in the last few years. This translates to a
12 significant downturn in our earnings and our
13 returns. The effect of this on our earnings is
14 quantified by other witnesses.

15 In addition to the wholesale sales levels,
16 there are other changes in cost levels from the
17 year 2000 basis and now the year 2001 basis which
18 staff has adopted that the Commission needs to take
19 into consideration in determining the
20 reasonableness of our electric rates. These
21 changes are discussed in detail by other witnesses.

22 So in view of the above, in my opinion
23 there is no basis to reduce our electric rates at
24 this time. That represents a summary of my
25 testimony.

1 first slide on his exhibit, you'll see that the
2 company failed to earn its authorized return for
3 about a four- or five-year spread there, and when I
4 say bite the bullet, what we did in those
5 particular cases, we froze our labor rates, which
6 is a significant portion of our cost. We looked
7 for efficiencies of operation, and that's outlined
8 in my testimony, a list thereof.

9 So we're going to continue to look for
10 ways of operating our business more efficiently and
11 take advantage of new technology. So I'm not ready
12 at this point to give up on it, but there clearly
13 is, from my testimony and the testimony of Mr. Ball
14 and other witnesses in this case, that there exists
15 a likely revenue deficiency for 2002 -- or based
16 upon the test year -- I'm sorry, based on the test
17 year 2001 as adjusted.

18 Q. Do you have anything in mind for the
19 efficiencies that you were talking about, to save
20 money in the future?

21 A. Well, one we haven't implemented yet, but
22 I think it's already recorded in the case, is the
23 Itron hand-held meter reading. We found that Itron
24 is now going to support the method that we have
25 adopted here several years ago. It's more

1 efficient, and so we think that we'll probably go
2 to the hand-held technology that's now available to
3 us. We'd like to go to even a higher technology,
4 but we can't see the economics of doing so, but
5 that's just one example.

6 Joint meter reading with municipalities --
7 again, we reflected some of that in the case. We
8 started doing that for the towns here in
9 Richardton -- and there's one other town that I
10 forgot the name of it already -- that we're
11 enjoying joint meter reading right now, but we're
12 looking for other opportunities to do that.

13 Joint trenching is allowing us to provide
14 service to other customers that we couldn't
15 otherwise do, especially with the telecommunication
16 companies. That's helped us get service into areas
17 that we couldn't, but the list actually just goes
18 on, but some of them are not real material but you
19 kind of add them up over time, but that's how we've
20 stayed away from this Commission as far as asking
21 for a rate increase since 1987, is trying to do
22 those type of things.

23 Q. Will any of those things be implemented in
24 the test year, the 2002?

25 A. Like I said, they're already reflected I

1 think in this 2000 case because we're looking ahead
2 on the 2001 cost adjustments.

3 MR. FAHN: Okay. Thanks.

4 MR. HOBERG: Thank you, Mr. Fahn.

5 Commissioner Wefald, did you have any questions of
6 Mr. Fox?

7 COMMISSIONER WEFALD: I have no questions
8 for this witness.

9 MR. HOBERG: Commissioner Reinbold.

10 EXAMINATION

11 BY COMMISSIONER REINBOLD:

12 Q. Mr. Fox, it sounds as though you subscribe
13 to the idea that the wholesale market is kind of a
14 guessing game, you don't know what it's going to be
15 now or in the future?

16 A. Well, I tell you, I think it's an unknown,
17 and we struggle with that ourselves in the sense of
18 what is going to happen. Terry Blinsky, who is our
19 operator and trying to take advantage of sales as
20 they come along, he's really reacting, if you will,
21 to opportunities that are out there. He doesn't
22 really know what's going to come down the pike, but
23 when it does, he's going to try to make the best
24 deal that he can.

25 I've talked with experts, American Gas

1 Association, we've talked with other people,
2 including the Edison Electric Institute. As Mr.
3 Diller's done, we watch the news and take advantage
4 of that, as well, but the reason I brought in three
5 experts today is so that you and I can get a better
6 handle on what might be a reasonable determination
7 of wholesale levels in the future, and these folks
8 are here to help us understand that.

9 COMMISSIONER REINBOLD: That's all I have.

10 MR. HOBERG: Thank you, Commissioner
11 Reinbold. Commissioner Clark, please.

12 COMMISSIONER CLARK: I have no questions.
13 Thank you.

14 MR. HOBERG: Thank you, Commissioner
15 Clark. Any further questions then, Mr. Pearce?

16 MR. PEARCE: No.

17 MR. HOBERG: No further questions? Thank
18 you, Mr. Fox.

19 THE WITNESS: You're welcome. Thank you.

20 MR. HOBERG: Your next witness, Mr.
21 Pearce, please.

22 MR. PEARCE: I'll call Dr. J. Stephen
23 Gaske.

24 COMMISSIONER REINBOLD: Who?

25 MR. HOBERG: Dr. Gaske.

1 MR. BINEK: Dr. Gaske.

2 MR. HOBERG: Please be seated. Is it
3 Gaske or Gaske.

4 THE WITNESS: Gaske.

5 MR. HOBERG: Dr. Gaske, I think you heard
6 the admonition I gave earlier in regard to perjury;
7 is that correct.

8 THE WITNESS: Yes, I have.

9 (Witness sworn.)

10 MR. HOBERG: Thank you. Mr. Pearce,
11 please.

12 J. STEPHEN GASKE,
13 having been first duly sworn, was examined and
14 testified as follows:

15 DIRECT EXAMINATION

16 BY MR. PEARCE:

17 Q. Dr. Gaske, I'm going to show you a bound
18 book that's labeled Exhibit 6 and Exhibit 7 and
19 just ask you to identify that your previously-filed
20 testimony appears in those two books.

21 A. Yes. Yes, it does, with --

22 Q. Go ahead.

23 A. Okay. There was one schedule omitted from
24 the surrebuttal testimony.

25 Q. And I believe that's been marked as

1 Exhibit 8 -- of the Commission exhibits. It's your
2 JSG-4, Schedule 1, I believe. I think I must -- I
3 have it here.

4 MR. HOBERG: You marked something as a
5 separate exhibit?

6 MR. PEARCE: I think we marked that as a
7 separate exhibit. I think it was inadvertently
8 omitted from the --

9 MR. HOBERG: Oh, yes. Exhibit 8. Part of
10 the surrebuttal?

11 MR. PEARCE: That's right.

12 Q. (MR. PEARCE CONTINUING) I'm showing you
13 also what's been marked as Exhibit 8. Is that the
14 schedule that was inadvertently omitted from your
15 rebuttal testimony?

16 A. Yes. This was a data request -- or a
17 response to a data request that I provided to Mr.
18 King.

19 Q. Do Exhibits 6, 7 and 8 appear to contain
20 your original rebuttal testimony and surrebuttal
21 testimony as filed in this case?

22 A. Yes, they do.

23 MR. HOBERG: Just for the Commission's
24 information, 6 and 7 contain all of the direct and
25 all of the surrebuttal of MDU.

1 COMMISSIONER WEFALD: Yes.

2 MR. PEARCE: And with the Commission
3 counsel's agreement and the hearing officer's
4 agreement, I think what I would suggest doing is
5 I'll offer Exhibits 6, 7 and 8, offering 6 and 7
6 with the proviso that as each witness testifies, I
7 will ask him if that is his testimony as filed.

8 MR. HOBERG: I think that would be
9 acceptable. Mr. Binek, is that all right?

10 MR. BINEK: Yes.

11 MR. HOBERG: Okay. So you're offering in
12 total then Exhibits 6, 7 and 8.

13 MR. PEARCE: 6, 7 and 8, yes.

14 MR. HOBERG: Any objection, Mr. Binek?

15 MR. BINEK: I was just taking a look at 8
16 here. No, I have no objection.

17 MR. HOBERG: Okay. 6, 7 and 8 are
18 admitted, and just for the record, Dr. Gaske's
19 direct and surrebuttal are Dockets 49 and 63. Mr.
20 Pearce, please.

21 Q. (MR. PEARCE CONTINUING) Dr. Gaske, first
22 I would ask you to -- and you may simply read this
23 from the first couple of pages of Exhibit 7, if you
24 wish -- to summarize your background and
25 experience.

1 A. My educational background is that I hold a
2 Bachelor's degree from the University of Virginia.
3 I hold a Master's of business administration degree
4 from George Washington University, and I hold a
5 Ph.D. from Indiana University where my major fields
6 of concentration were public utilities, financing
7 and microeconomics.

8 My professional experience is that
9 subsequent to receiving my MBA I worked at the
10 consulting firm of H. Zinder & Associates for
11 several years as a research associate and director
12 of -- later as director of research.

13 I left there and worked for a year with
14 Olson and Company and then went back to school to
15 get a Ph.D. During that time I continued to do
16 independent consulting. I also taught a number of
17 different courses, including public utilities and
18 transportation. I also during that time was the
19 coordinate to the Edison Electric Institute rate
20 course.

21 In 1986 I went to work for Trinity
22 University as a professor of finance and left there
23 in 1988 to come back to H. Zinder & Associates
24 where I've been since then as a consultant.

25 Q. And have you previously testified in rate

1 proceedings?

2 A. Yes. I've testified or submitted
3 testimony in, I believe, more than 40 proceedings.

4 COMMISSIONER REINBOLD: Could you speak up
5 a little bit, please?

6 MR. HOBERG: Could speak up a little bit
7 please, Dr. Gaske?

8 THE WITNESS: Yes.

9 Q. (MR. PEARCE CONTINUING) Drawing your
10 attention, Dr. Gaske, just for a moment to Exhibit
11 7, I believe there was a number correction that
12 needed to be made there on line 17 of page 20 of
13 your surrebuttal. That would be Exhibit 7.

14 A. Yes. That refers to the Montana-Dakota
15 estimate of the margins that will be available.
16 The number shown shows 7.2 million. The corrected
17 number that's in the surrebuttal testimony of Mr.
18 Blinsky is 6,429,778.

19 Q. With that correction does your -- your
20 testimony as contained in Exhibits 6 and 7, is that
21 true and accurate and complete as you --

22 A. Yes.

23 Q. Now you heard the testimony of Mr. King
24 here in this proceeding this morning, I think, have
25 you not?

1 A. Yes.

2 Q. Would you respond to the issues and the
3 comments that Mr. King has made?

4 A. Yes. I guess I'll take them one at a
5 time, in the same order that Mr. King addressed
6 them, and I guess I should say at the outset that
7 most of what I'm going to say is in my surrebuttal
8 testimony.

9 During Mr. King's response he mostly
10 repeated what was in his rebuttal testimony and
11 appeared to not address almost anything that was in
12 my surrebuttal testimony. So much of what I'm
13 going to say actually is in written form in the
14 surrebuttal testimony and will respond to what Mr.
15 King said while he was on the stand.

16 The first issue as to the debt cost is
17 that the accounting based approach that he
18 advocates is equivalent to disallowing a portion of
19 the company's debt cost, and the reason it is is
20 that the accounting based approach does not reflect
21 the effective cost of the debt, what it really
22 economically costs and what the company needs to
23 recover to recover its costs.

24 In particular, if you focus on the
25 reacquisition cost issue, by having Montana-Dakota

1 recover reacquisition costs, you know, as they're
2 being amortized for accounting purposes, you're
3 essentially assuming that the reacquisition costs
4 are going to be incurred this year and next year
5 and the following year, when in fact the company
6 actually wrote the check for the reacquisition
7 costs many years ago.

8 The company spent the money, the cash is
9 outstanding, and when you use the accounting
10 approach, you're making an entry, a simple book
11 entry each year, to spread that cost over a number
12 of years, but that does not reflect the fact that
13 the money was already spent many years ago, and
14 essentially they lose the carrying value of the
15 dollars that they spent. It's equivalent to no
16 allowed rate of return on the reacquisition costs.
17 So when you use his approach, you are going to
18 effectively disallow a portion of the true cost of
19 the debt.

20 As to the reasonableness of the debt cost,
21 in my surrebuttal testimony I have a calculation
22 where I show that the debt issuances that occurred
23 since April of 1992 have an average cost of about
24 7.31 percent. That's right in the same ballpark
25 with the costs of Otter Tail and Northern States

1 Power. In fact, it could even be lower than theirs
2 in that the 7.31 reflects the yield to maturity
3 approach for calculating cost, and we're not
4 entirely sure how, for example, the Otter Tail
5 costs were calculated. I asked for a calculation
6 of those costs from Mr. King. He said he did not
7 know how they were calculated, either.

8 So the debt that has been issued since
9 1992 has basically the same cost or possibly even a
10 lower cost than the other utilities in the state.

11 The real issue with regard to the debt
12 cost has to do with reacquisition costs and the
13 high cost of debt that was issued really initially
14 in the late Seventies and early 1980s. At that
15 time Montana-Dakota had several things going on,
16 but the biggest thing was that they were building
17 an electric plant, and anyone who remembers that
18 time period remembers that very suddenly interest
19 rates went to extremely high levels and stayed
20 there throughout the early Eighties.

21 So the company had a very large need for
22 financing at the same time that interest rates were
23 very high. It issued a very high cost debt at that
24 time, and I think Mr. Mahowald will talk about this
25 in more detail, but it had to refinance those

1 high -- or it found it advantageous to refinance
2 those costs in 1986, but the fact of the matter is
3 that once you have very high cost debt out there,
4 in order to get it back from investors and get them
5 to, you know, give up the high interest rates that
6 they were getting on that debt, you have to pay a
7 fair amount to get the debt back, and there was a
8 lot of money involved.

9 They -- the company refinanced in 1986 to
10 get the cost down, and -- but they still had high
11 cost debt that in 1992 they again refinanced. So
12 what you really see on the books of Montana-Dakota
13 today is -- are debt costs that are right in line
14 with everybody else except for the fact that they
15 have some high reacquisition costs that have been
16 carried over quite a number of years and date
17 really from a time period that they needed to build
18 a new plant and raise a lot of money at high
19 interest rates.

20 The plant is still in service. It
21 provides, as I understand it, very economical
22 service to the ratepayers, but the fact of the
23 matter is is that plant was built at a high cost in
24 terms of what they had to pay for interest at the
25 time.

1 So I -- when you look at the overall
2 circumstances and delve into them a little bit --
3 and Mr. Mahowald will be able to go into more
4 detail, I think, than I can, you find that their
5 debt costs are perfectly reasonable considering the
6 circumstances under which they were incurred.

7 They're higher than other utilities, and
8 at some point in the future as the reacquisition
9 costs are paid down and the current debt that those
10 reacquisition costs are associated with, as that
11 disappears off their books, they will -- their
12 costs will drop down to a level that's probably
13 commensurate with everybody else. If they were to
14 refinance today, they would still have those
15 reacquisition costs hanging over them in one form
16 or another.

17 So the second -- and really it was a whole
18 set of issues that are related to the return on
19 equity. One of the major differences between the
20 two of us is the use of proxy companies and what we
21 consider to be comparable companies for measuring
22 the cost of -- the cost of equity for investing in
23 electric utility operations. That -- that's really
24 the issue in this case.

25 We're not talking about combination

1 companies or highly diversified companies, but
2 we're trying to come up with cost of common equity
3 for investing in electric utility operations, and
4 the issue between us is probably best understood if
5 you were to turn to my Exhibit JSG-2, Schedule 3.

6 MR. HOBERG: Is that in --

7 MR. PEARCE: That's in 6, Exhibit 6.

8 MR. HOBERG: Thank you.

9 COMMISSIONER WEFALD: That's in your
10 direct testimony?

11 MR. PEARCE: Direct testimony.

12 THE WITNESS: In the direct testimony,
13 yes, ma'am.

14 COMMISSIONER REINBOLD: What page?

15 MR. HOBERG: What page was it again?

16 THE WITNESS: This is Schedule 3, page
17 one, and it's towards the back of the direct
18 testimony. The -- for the most part the data shown
19 here are taken from Mr. King's exhibits. He
20 provided -- with one exception. He provided all of
21 the basic numbers that went into these. I just
22 combined two of his exhibits in one place and then
23 sorted the numbers. I calculated the percentage of
24 revenue from electric operations and then just
25 sorted them from highest to lowest.

1 In the left column underneath where it
2 says "King company," I've designated where it's an
3 electric company in his group with an E or whether
4 it's a combination company with a C. The companies
5 in bold are companies that I've used in my
6 analysis.

7 The thing to point out is that Mr. King
8 has decided not to use electric companies. So, for
9 example, where you see Southern Company and Kansas
10 City Power & Light with 98 and 95 percent of their
11 revenue from electric operations, he has concluded
12 that these are not appropriate companies for
13 setting -- or making a comparison to the risk of
14 electric operations and setting rates for electric
15 operations. So he has calculated a cost of capital
16 for those companies, but he's thrown those results
17 out, they're not relevant.

18 If you look about halfway down, you'll see
19 the last three -- or actually the last three that
20 have Cs next to them -- and actually Madison Gas &
21 Electric, which he would -- he indicates that he
22 would have used except he couldn't get an analyst
23 forecast or growth for them. These are companies
24 that he would use in setting the electric rates
25 because they're combination companies. He would

1 use them for setting electric rates for
2 Montana-Dakota.

3 These companies have approximately 73, 68,
4 68 percent, and actually Madison Gas & Electric has
5 62 percent of its revenues associated with electric
6 operations. So I basically objected to and
7 disagree with the idea that when you're in an
8 electric rate case, you would throw out a company
9 like, say, Kansas City Power & Light that's getting
10 95 percent of its revenues from electric operations
11 and replace it with a company like, say, Alliant or
12 Consolidated Edison where you're getting 73 or 68
13 percent from electric -- or electric operation.

14 This has a very real impact on the results
15 in a couple of ways, and I guess probably the best
16 way to look at the results would be to turn to Mr.
17 King's direct testimony, and in particular page 18
18 of his direct testimony. Actually, let me take
19 that back. Since he updated his rate of return,
20 his rebuttal testimony has the newer numbers, and
21 those appear on Exhibit CWK-3R, which is at the
22 back of his rebuttal testimony.

23 MR. HOBERG: That's Exhibit 5, rebuttal
24 testimony.

25 THE WITNESS: Looking at the companies

1 that I just referred to, you have, for example,
2 Pinnacle West, which has about 95 percent of its
3 revenues from electric operations. He doesn't
4 consider that to be relevant, but the DCF return is
5 12.9 percent, and it's virtually an all-electric
6 company. He threw that out and replaced it with,
7 say, a company like Consolidated Edison with a rate
8 of return of 9.6 percent, which only gets 72
9 percent of its revenues from electric operations.

10 Similarly, he threw out up above where you
11 have Great Plains Power, which used to be Kansas
12 City Power & Light. They get 95 percent of their
13 revenue from electric operations, and they have a
14 required return of 12.9 percent. He considers that
15 to not be reasonable -- to not be relevant to this
16 proceeding and instead replaces it with a company
17 like, say, Energy East with a required return of
18 10.9 percent.

19 I maintain that the best way to approach
20 this problem is to include all of the companies
21 that get at least 75 percent of their revenue from
22 electric operations. You can see that back on the
23 Schedule 3 of Exhibit 6 that we were talking about
24 a few minutes ago. I believe it's appropriate to
25 include those companies and include companies that

1 get 98 percent of their revenue from electric
2 operations even if they don't have a gas operation.

3 Now, one of the big differences in us is
4 Mr. King believes that the required rate of return
5 for an electric company somehow is affected by
6 whether or not it's owned by a combination company.
7 You have the ability to more or less offset good
8 years in the gas business with bad years in the
9 electric business, and he's right. That's true for
10 every company.

11 If Montana-Dakota were to merge with
12 Qwest, their electric operations, maybe they have a
13 bad year there but their telephone operations have
14 a good year and the two things offset each other.
15 The question you have to ask yourself is: Does
16 that mean that it's more attractive to invest in
17 new utility plant to serve people in North Dakota
18 if the company merges with Qwest?

19 Or the alternative way of looking at this
20 is if Montana-Dakota were to spin off its gas
21 operations, would it suddenly be less attractive to
22 build a new utility plant, new electric generating
23 plant to serve people in North Dakota, and my
24 answer to that is, no, that the risk really doesn't
25 change between the two.

1 Now another component of his testimony
2 goes to this question of, well, if you're an
3 electric-only company, investors require a higher
4 rate of return because you don't happen to also own
5 a gas distribution company or have that rolled in
6 there to work out or offset some of the risks.

7 Well, if you look at a company like
8 Southern Company that gets 98 percent of its
9 revenues from electric operations, if I'm an
10 investor and I really believe that the cost of
11 capital is lower if -- if in fact you have some gas
12 operations, I'll go out and I'll buy stock in
13 Atlanta Gas & Light and Alabama Power Company,
14 which are in the same -- I'm sorry, Alagasco, which
15 are gas distribution companies that are in the same
16 territory. So now I as an individual investor own
17 stock in both the gas distribution companies in
18 that area and the electric company in that area.

19 Does this mean that my cost of capital for
20 the electric utility has suddenly gone down? Well,
21 I probably have a diversified portfolio now, but I
22 think that I still perceive the risk in the
23 electric company the same way. If I was concerned
24 about the risk and thought that having gas
25 distribution stocks would eliminate the risk, then

1 I could buy some gas distribution stocks and put
2 them in my portfolio.

3 Investors are smart enough to figure this
4 out. So if there is a benefit to having stock in
5 both companies, that's already reflected in the
6 required rate of return for Southern Company or for
7 Kansas City Power & Light. They can accomplish
8 this diversification on their own.

9 So what you're left with is a rate of
10 return that investors require for investing in
11 electric operations with the full knowledge and
12 ability to also buy natural gas stocks in their
13 portfolio to eliminate whatever risk natural gas
14 distribution companies do eliminate for the
15 companies, and so in almost every respect you get a
16 true rate of return for an electric company that
17 also considers the possibility of owning gas stocks
18 to eliminate the risk.

19 Now, one of the points that he makes is
20 that, well, gas and electric compete with each
21 other, and therefore if the same company owns both,
22 it really is indifferent as to what happens and
23 that somehow reduces the risk of investing in one
24 or the other. That's not true for several reasons.

25 First, and by far the most important one,

1 is the fact that when you sit down and you try
2 to -- to decide whether to invest in, say, a new
3 generating plant or a transmission line, you look
4 at the risks that that faces. You look at the
5 electric market, you look at competitive
6 alternatives, and you make the investment.

7 If the investment later goes bad and you
8 lose your money, you know, that's part of the risk,
9 but it's the risk of the electric operation that
10 you're considering when you make your electric
11 investment. It's not the risk of the combination
12 company, because when you're investing in the gas
13 business, you sit down separately and say, what's
14 the risk of investing in the gas business, and you
15 make investments there, and they may or may not pan
16 out.

17 On both sides of the coin there are
18 significant examples. In the early 1980s utilities
19 all over the country ended up having to write off
20 massive investments in generating plants that they
21 started and had to cancel, and, you know, whether
22 they were a combination company or not a
23 combination company, they had to do that, and those
24 were really big risks that they still face today
25 that somehow they'll start a plant and the market

1 will change on them or -- and in some respects they
2 may face even greater risks today because of the
3 possibility of deregulation in the future, that you
4 build a plant and four, five years from now the
5 market is opened up for competition and they lose
6 their shirt on the plants that they've built. So
7 they face that, and it's an electric-related risk.

8 In the gas business quite a few
9 companies -- this applied more to gas pipelines
10 than gas distribution companies, but in the past
11 they've lost an awful lot of money by signing
12 contracts to buy gas and -- and then finding that
13 the markets changed on them and industrial
14 customers in particular won't buy their gas.

15 So each type of investment basically needs
16 to be evaluated differently. Mr. King said that I
17 strenuously object to the use of combination
18 companies. However, if you look at Schedule 3, I
19 don't really object to the use of combination
20 companies. I include combination companies, but
21 what my criterion is is that you have 75 percent of
22 your investment from electric operations, and he
23 objects to that, but he was very happy to include a
24 number of companies that have a smaller percentage
25 of their revenues from electric operations.

1 I think I've picked a reasonable and
2 indicative group. There are three in particular
3 that he objects to, IDACORP, American Electric
4 Power and Cleco, and in my surrebuttal testimony I
5 quote from the Value Line page for IDACORP where it
6 talks -- talks about the fact that IDACORP makes
7 sales for resale and has made some fairly decent
8 amount of money in recent years on their sales for
9 resale, but in 2001 those sales were down
10 significantly, and Value Line and investors expect
11 those sales for resale to go down quite a bit more
12 next year in 2002 because the prices in the market
13 for power have more or less crashed.

14 Well, I look at something like that and I
15 say, what's the issue in this case? The issue in
16 this case is -- I mean, the really big issue in
17 this case is the sales for resale by
18 Montana-Dakota, and if you're looking for companies
19 that are comparable to Montana-Dakota, I can't
20 think of a company that would be more comparable
21 than one that is making sales for resale, in
22 addition to having a high percentage of their
23 revenues in the electric business.

24 So -- and the same thing is true with
25 American Electric Power and Cleco. They have some

1 unregulated operations, but as this table
2 indicates, all of them still are getting at least
3 75 percent of their revenue from regulated electric
4 operations, or at least that's according to Mr.
5 King.

6 So these are overwhelmingly primarily
7 regulated electric companies who also are making
8 some sales in the sale for resale market and some
9 unregulated electric sales which makes them even
10 more comparable to Montana-Dakota.

11 So for all of those reasons, I think that
12 I've got a reasonably representative proxy group
13 company for setting electric rates in Montana --
14 excuse me, for Montana-Dakota in North Dakota.

15 COMMISSIONER REINBOLD: Did you misspeak
16 and say Montana?

17 THE WITNESS: Pardon?

18 COMMISSIONER REINBOLD: Did you say
19 Montana?

20 THE WITNESS: Well, I started to say for
21 Montana-Dakota and I stopped at Montana.

22 COMMISSIONER REINBOLD: Pretty dangerous
23 in North Dakota to make any reference to Montana.

24 THE WITNESS: Where is it located? I
25 guess the next area that I'll address is the

1 flotation cost adjustment, and I addressed this in
2 my surrebuttal testimony, but initially I'll say
3 one thing about it is that Mr. King keeps using the
4 number 6 million dollars, and for purposes of this
5 case the impact is approximately \$365,000. So I
6 think that'll probably put that more in
7 perspective. 6 million sounds so large when you're
8 talking about electric operations that have only a
9 rate base of 128 million, but the fact is the
10 impact is 365,000.

11 More importantly is the reason that a
12 flotation cost adjustment is needed and necessary.
13 Both of us agree that if you apply the DCF
14 adjustment -- approach and you come up with a cost
15 of common equity, the value of the electric
16 operations should be equal to their book value, and
17 he testified to that earlier.

18 So if I'm Montana-Dakota and I go out and
19 I raise a dollar to invest in my electric
20 operations, I raise that dollar, I pay 5 cents of
21 it to brokers and investment bankers and other
22 people who have their hand out in the process, I've
23 got 95 cents left to invest, but I -- and I go and
24 I invest it in my electric operations and I've got
25 95 cents worth of electric plant, but I had to go

1 out and I had to raise 1 dollar to invest 95 cents
2 in my electric operations.

3 Your DCF result when you apply that rate
4 of return sets the book value of the plant that you
5 bought for 95 cents, sets the market value equal to
6 that also. So you have a value of 95 cents for
7 your plant, but you had to spend 1 dollar to get
8 that, and the flotation cost adjustment is designed
9 to recognize that fact.

10 Now, the other crucial point is that in
11 setting the cost of capital for common equity it's
12 a little bit different from almost any other
13 component in your cost of service. The other
14 components in your cost of service are really --
15 you can look up on the accounting books and you can
16 see what they are and you can make adjustments for
17 various things, and -- and they're right there, but
18 the return on common equity has to be a forward-
19 looking number.

20 The courts have had fundamental tests that
21 it must be sufficient to attract capital in
22 reasonable terms. Now, that doesn't say only --
23 only sufficient if you need to actually raise
24 capital. The point is that if it's reasonable,
25 it's reasonable to raise capital whether you need

1 to do so or not, and that's why the going back and
2 measuring what they've spent on flotation costs
3 over the last several years misses the main point
4 of the flotation cost adjustment.

5 It's just like having a good credit
6 rating. I'll worry about getting a good credit
7 rating when I need to borrow money, but if I don't
8 need to borrow money right now, I'll maintain a bad
9 credit rating. It just doesn't work that way. You
10 need to be in that position at all times that you
11 can raise capital on reasonable terms.

12 Now, it's not -- this is not a completely
13 ridiculous notion. In my surrebuttal testimony I
14 have quotes from several leading treatises on the
15 subject of setting public utility rates and the
16 cost of capital, and I point out that I'm not the
17 only one who advocates those.

18 The point that Mr. King made about
19 Montana-Dakota having a book value in -- or a
20 market value in excess of book value -- and that's
21 really for MDU Resources, their publicly traded
22 stock, but when they go out and they issue new
23 stock and perhaps they issue it at a price above
24 book value, they get that money and they have
25 several options.

1 If they invest it in electric operations
2 at -- that really have a value of 95 cents after
3 that I have raised the dollar and spent their money
4 on flotation costs, they've -- they've essentially
5 lost some value to their entire company, and that
6 value comes out of the pockets of the stockholders.

7 If on the other hand they take that dollar
8 and they pay the 5 cents to the brokers and they
9 have 95 cents to invest, they go out and they
10 invest it in industrial assets, they can create
11 value for their stockholders, and the average
12 market-to-book value for industrial companies is
13 about 6. So they could turn that 95 cents into
14 nearly 6 dollars if they invest it somewhere else.

15 So the other point about flotation costs
16 is that, sure, their market value is above book
17 value. They have other operations, and yet their
18 overall market-to-book ratio is pretty low compared
19 to other industrial companies, even though
20 Montana-Dakota has industrial operations.

21 If they invest the dollar -- or actually
22 the 95 cents in industrial operations, then Mr.
23 King is right. They can maintain the value of
24 their company with no dilution. If on the other
25 hand they invest it in the regulated electric

1 operations, they're going to dilute the market
2 value of the company.

3 Now, in his statement earlier he kept
4 referring to the book value, they can increase the
5 book value, but they're actually going to reduce
6 the market value; that the investors in the company
7 will be hurt if Montana-Dakota takes that money and
8 puts it in electric operations and reduce the value
9 of it. So there's a disincentive, and essentially
10 the rate of return would be inadequate if you don't
11 recognize the flotation cost.

12 The next area -- it's a fairly small area,
13 but I addressed this also in my surrebuttal, but it
14 probably is worth going into here -- is why I have
15 a .625 adjustment to the dividend yield in the DCF
16 model that I apply, and I guess probably the best
17 way to describe the difference between us, if you
18 don't mind, I'd like to write on the board behind
19 me.

20 MR. HOBERG: As long as you're explaining
21 as you go for the record so we --

22 THE WITNESS: Yes. I --

23 COMMISSIONER WEFALD: You can take the
24 microphone with you.

25 MR. HOBERG: Yeah. You probably should,

1 in fact, so we can all hear you.

2 THE WITNESS: Yeah. People keep telling
3 me I talk too softly. There are several concepts
4 that get rolled in together when you're looking at
5 this adjustment for the dividend yield, and the
6 math is fairly complicated. It would fill several
7 pages of algebra, but the intuition is really very
8 simple.

9 You've got one concept which is the idea
10 that you have a timing of your dividends, and if
11 you look on a time line that's measured in years,
12 you might get your dividend or your dividend
13 increase immediately, which would be at time zero,
14 or you might get it one year from now at time one.
15 Well, on average, you would look at this and the
16 average timing of your dividend would be at 0.5
17 years or half a year.

18 And Mr. King and I both agree on that.
19 We're in absolutely complete agreement, and my
20 number reflects that assumption and he says that
21 assumption is correct.

22 Where we differ is that he stops there.
23 He thinks that's all there is to the DCF model, but
24 when you work through the math of it, the crucial
25 insight in a DCF model is the fact that there's a

1 time value to money, that a dividend received today
2 is more valuable than a dividend received a year
3 from now.

4 So to see what the impact on the DCF model
5 is you need a second line, which would be your
6 present-value line, and if you received one dollar
7 right now, it's worth one dollar in present-value
8 terms, and that would be reflected in the stock
9 price if people expected to receive the dollar
10 right now.

11 If, on the other hand, you were to receive
12 that 1 dollar a year from now, the present value of
13 the 1 dollar would have to be discounted and you'd
14 have to take into account the time value of money,
15 and say your cost of capital is 11 percent. You
16 would divide that 1 dollar by 1.11 and you'd have a
17 value of 90 cents.

18 COMMISSIONER WEFALD: Is that because of
19 inflation that it's discounted or is there another
20 reason?

21 THE WITNESS: No. It's -- if you could
22 get your one dollar now, you could invest it and
23 earn 11 percent. So --

24 COMMISSIONER WEFALD: I could? How do you
25 come up with that 11 percent number?

1 THE WITNESS: I just made it up for --

2 COMMISSIONER WEFALD: Example?

3 THE WITNESS: -- for an example.

4 COMMISSIONER WEFALD: All right. Thank
5 you.

6 THE WITNESS: But, you know, in this case
7 your bond yields -- say, they're nine percent.

8 COMMISSIONER WEFALD: They're not right
9 now.

10 THE WITNESS: Yeah. But if you had
11 something that was nine percent -- well, actually
12 if you had bonds that yield an 11 percent, the way
13 they get that 11 percent is by discounting back to
14 the present to come up with a price that you would
15 pay today in order to get 1 dollar a year from now,
16 and as it turns out, if you were buying a stock
17 that was going to give you a dividend a year from
18 now of 1 dollar, you would pay 90 cents today, and
19 a year from now when you get -- actually get 1
20 dollar, you're -- the 90 cents you paid for today
21 when they give you 1 dollar, you've earned 11
22 percent.

23 COMMISSIONER WEFALD: But you're just
24 using 11 percent as an example. It could be any
25 number. It could be 3 percent.

1 THE WITNESS: Yes. It could be any number
2 at all.

3 COMMISSIONER WEFALD: All right.

4 THE WITNESS: As we both agree, on average
5 you end up in the middle -- or as to the timing of
6 when you get your dividend. So the average present
7 value over the course of that year would be 1
8 dollar plus 90 cents divided by 2. So one plus .9
9 over 2, which is equal to -- what am I at? Yeah --
10 and actually you've got to multiply it by your
11 probability, but on average you end up with
12 something like -- yeah --

13 COMMISSIONER WEFALD: .95.

14 THE WITNESS: Yeah, .95. So it -- you
15 don't end up with 1. You end up with .95 if it's
16 in the middle of the year.

17 COMMISSIONER WEFALD: If you guess that
18 it's going to be an 11 percent return.

19 THE WITNESS: Yes, yes.

20 COMMISSIONER WEFALD: Thank you.

21 THE WITNESS: As long as there's any kind
22 of cost of capital that pays interest or requires a
23 time value, that will be true.

24 Now, if you knew that you're getting your
25 dividend here, the -- your dividend adjustment

1 factor would be 0. If you knew that your dividend
2 was going to be here, it would be 1, and if on
3 average it's going to occur halfway through the
4 year at this point, it's not halfway between 0 and
5 1. Because of the time value of money the fact
6 that this is .95 and not 1 as the average, your
7 dividend adjustment factor is .625. The reason
8 it's not the .5 that you had for the timing halfway
9 through the year has to do with the time value of
10 money, and it's .625.

11 I hope I haven't thoroughly confused you
12 with this, but mathematically that's the way it
13 works out, and intuitively that's why it is not .5.

14 Now, Mr. King also commented on my risk
15 premium approach to more or less measuring or
16 setting a benchmark for the rate of return. The
17 numbers I used for any risk premium approach are
18 the -- come from the -- what I would refer to as
19 the famous Ibbotson & Singfield study. It was
20 referred to this morning as the infamous study.

21 However, it's quite famous. It's used by
22 investment analysts, it's used by mutual funds in
23 talking to people, it's used for a variety of
24 purposes to estimate the average premium that
25 stocks have earned over bonds over a long period of

1 time.

2 Now, it's hard to imagine a better stand-
3 alone independent estimate of what kind of a risk
4 premium you need at any given point in time to
5 invest in the average common stock than this long
6 historical period unless you use a DCF approach.

7 In my mind a DCF approach is really how
8 you estimate the cost of common equity, but this
9 number does provide a good benchmark for
10 determining whether or not -- you know, is this in
11 the kind of ballpark that anybody in their right
12 mind would think companies need to earn, and so I
13 use this approach as a benchmark to more or less
14 see whether I'm in the right ballpark. Well --

15 COMMISSIONER WEFALD: Can you tell me what
16 page that's on where you discuss that? It's in
17 your first direct testimony, I believe, of January
18 11th.

19 THE WITNESS: Sure. It's in my direct
20 testimony. The summary of all of the approaches is
21 in the -- is on page 46.

22 MR. KING: That's 33 through 34.

23 THE WITNESS: And on page 46 I've looked
24 at risk premium varies different ways, the historic
25 premium over treasury bonds that large company

1 stocks have earned, and that's 13.3 percent. Small
2 companies of the size of the Montana-Dakota
3 electric operations are 17.6 percent, and if you
4 compare it to corporate bonds and the premium that
5 common stocks have had over corporate bonds, the
6 number is 14.8 percent for large companies and the
7 companies the size of Montana-Dakota electric
8 operations, it's 19 percent.

9 So at least to my mind this is an
10 independent check on whether or not the rate of
11 return is reasonable. It's not definitive. It
12 doesn't absolutely answer the question, but it does
13 tell me that, you know, I don't have a number
14 that's wildly out of line with the kinds of
15 premiums that have been earned over a long period
16 of time in the past.

17 The second check that I have is my
18 alternative equity investment approach where I look
19 at the returns that companies have actually learned
20 in recent years, and those returns are 20.7 percent
21 on average for the S&P 500 and 20 --

22 COMMISSIONER WEFALD: What are those
23 years?

24 THE WITNESS: Those would be in this
25 testimony '96 through 2000. Now that time period

1 is exceptionally high. I mean, those were some of
2 the best years ever, and so, you know, you wouldn't
3 place too much weight on those.

4 COMMISSIONER WEFALD: If you use the most
5 recent three years, I wonder what your numbers
6 would be.

7 THE WITNESS: Oh, even higher. Well,
8 because these are returns actually earned on the
9 book value, you know, if you looked at the -- what
10 the company earned, not what stockholders earned.
11 Stockholders -- the price of their stock went down
12 for a lot of companies and they didn't make much
13 money, but the companies themselves have made very
14 substantial profits on their book values. I don't
15 expect this upcoming year or -- and it's quite
16 possible 2001 is going to come in much lower, but I
17 don't have those numbers yet.

18 But this gives you a general idea of the
19 kinds of returns that are available on average --
20 for an average company and have been in recent
21 years.

22 Mr. King's response to this is that
23 investors don't have access to book value returns,
24 and that's not really true. Investors in common
25 stocks of these companies don't have direct access

1 to this. They've bid up the price of the stock to
2 the point where what they really get on their stock
3 is something less than 29 percent, but numbers like
4 this are relevant if you're asking the question of
5 does Montana-Dakota have an alternative place to
6 put its capital rather than putting it in electric
7 operations? Could it go out and build, you know,
8 additional mining facilities and earn a 30 percent
9 return on those or can it put the dollars directly
10 into the electric operations and earn 12-and-three-
11 quarters, which is what I've recommended.

12 So it is relevant in terms of looking at
13 the kinds of returns and options that are available
14 to investors who actually go out and build plant,
15 actually build the facilities, and usually that's
16 within a company and the company has capital
17 budgeting processes that it goes through where each
18 year it will sit down and it will look at what
19 projects could we do and which ones will give us
20 the best return for the risk and whatnot, and then
21 they make those investments.

22 Within most corporations these -- these
23 are the kinds of returns that you can get on
24 nonregulated industrial-type investments, and they
25 consider that possibility that they could get that

1 kind of a return and compare it to what they could
2 get on their electric.

3 So it has some relevance. Again, it's not
4 definitive because, you know, the fact -- the fact
5 that they earn these returns is one reason they
6 have such high book values. These returns are
7 really higher than the cost of their capital, but,
8 you know, if I can make more than my cost of
9 capital, I'm happy to invest in something like
10 that, and that competes with whether or not I'm
11 going to build another electric generating plant
12 for the people of North Dakota.

13 So in that respect the allowed return that
14 you grant is -- needs to be competitive with these
15 other returns, but I don't place heavy emphasis on
16 these because particularly in the last several
17 years they've been so high.

18 I believe that completes my comments on
19 Mr. King's testimony.

20 MR. HOBERG: Mr. Pearce --

21 THE WITNESS: And most of this, I think,
22 you'll find in my surrebuttal testimony.

23 MR. HOBERG: Mr. Pearce, is this the
24 witness that needed to be at the airport.

25 MR. PEARCE: No, no. I do have one more

1 question for Dr. Gaske.

2 MR. HOBERG: Okay.

3 Q. (MR. PEARCE CONTINUING) Dr. Gaske, in
4 your surrebuttal testimony, I think it starts on
5 page 20, this is Exhibit 7, I believe, you discuss
6 some of the factors affecting sales for resale
7 margins. In that frame of work do you have any
8 comments on Mr. Diller's testimony from this
9 morning on that issue?

10 A. Yes, a few points. One is that if you
11 look at the general economy, several comments have
12 been made about whether we're in a recession or not
13 in a recession, but a few days ago data on
14 industrial production came out, and in January,
15 once again, the industrial production had gone
16 down. So that sector of the economy is shrinking
17 and continues to shrink and that's a major source
18 of demand.

19 The data on this are actually shown in a
20 graph that's on -- or data that supports this are
21 on a graph that's in Exhibit -- what is JSG-4
22 numbered?

23 Q. That would be 8, I believe.

24 A. 8. Schedule 2, page two, where it's a bar
25 graph showing manufacturing production.

1 Q. I'm sorry. That's actually in the book.
2 That is in the book. I'm sorry. That's not a
3 separate exhibit.

4 A. Oh, yeah, yeah. That is in the book.

5 MR. HOBERG: In his direct or rebuttal?

6 THE WITNESS: In the rebuttal.

7 MR. PEARCE: It's in the surrebuttal.

8 It's JSG-4, Schedule 2, page one of six.

9 THE WITNESS: Actually I'm addressing
10 right now page two.

11 MR. PEARCE: Page two.

12 MR. HOBERG: So Exhibit 7, the
13 surrebuttal?

14 MR. PEARCE: Yes.

15 THE WITNESS: Yes.

16 COMMISSIONER WEFALD: Is it -- did you say
17 it's JSG-4?

18 THE WITNESS: Schedule 2, page two, and
19 it -- it looks like this.

20 COMMISSIONER WEFALD: All right.

21 THE WITNESS: You may not have a colored
22 copy.

23 COMMISSIONER WEFALD: This one?

24 THE WITNESS: Yes.

25 COMMISSIONER WEFALD: Thank you.

1 THE WITNESS: Yes. If you see what was
2 happening with manufacturing production, it was
3 rising fairly rapidly and peaked in the third
4 quarter of the year 2000 and since then has
5 declined regularly and steadily, and the forecast
6 declined throughout 2001, and the forecast for
7 2002, as you can see, is quite a bit lower than,
8 say, the average for the 2000 and 2001 time period.
9 So that -- that's one factor.

10 COMMISSIONER WEFALD: Is this national?

11 THE WITNESS: This is national, yes, and
12 in -- just as an aside, in the last couple of
13 months almost every other week it seems you're
14 hearing another -- one of the car manufacturers
15 announcing massive layoffs, and that continues to
16 happen. So we have been in a recession for --
17 since the middle of last year. The level of
18 manufacturing production projected for next -- for
19 this upcoming year is quite a bit less than it's
20 been over that 2000, 2001 time period.

21 The second point that I would like to make
22 goes to some of the discussion that occurred this
23 morning, in particular regarding the use of futures
24 prices to forecast the margins for the upcoming
25 year. The one point I want to make most strongly

1 is that when you use a futures numbers, it's not
2 the same as a forecast. It's not a guess. It's
3 something that you could realize today.

4 In other words, the price that
5 Montana-Dakota will sell its electricity at next
6 October it could sell in -- it could sell it at the
7 futures price right now, today, and lock that in.

8 So we're not -- we're in part talking
9 about forecasting, but when you're using futures
10 prices, those are real prices that you could
11 actually sell next October's electricity at right
12 now, today, and in that way it's not the same thing
13 as sitting down and trying to come up with some
14 model to forecast. It's a real market price for
15 that power next October.

16 It's equivalent to, say, asking the
17 question what could I buy MDU Resources stock for
18 today? Well -- you know, or approximately what
19 could I buy it for today? I could take two
20 approaches. I could use an econometric model and
21 figure out what the valuation is and come up with a
22 price, or I could look it up in The Wall Street
23 Journal and see what it's trading for right now.

24 One approach is similar to forecasting,
25 and you use all these different techniques to kind

1 of make your best guess, and the other is, you
2 know, looking up and seeing exactly what people are
3 buying and selling next October's electricity for.

4 So in that sense the data that Mr. Blinsky
5 has put together on prices should be given a great
6 deal of weight and should not be confused with the
7 uncertainty and vagaries of forecasting. They're
8 real prices.

9 MR. HOBERG: Any further questions, Mr.
10 Pearce? Oh, are you done?

11 THE WITNESS: No. I was going to make
12 just a couple of other points. All of -- all of
13 the witnesses on this issue will address this, and
14 different ones of us will address different
15 portions of this fact, but anybody that's been
16 reading the newspaper over the last couple of years
17 is well aware that in 2000 and 2001 the energy
18 markets in the United States went haywire, and
19 those were extremely unusual conditions where a lot
20 of different factors came together simultaneously
21 to drive rates to very, very high levels.

22 Nobody truly expects the next couple of
23 years to be anything like they were in 2000 and
24 2001, and if you just take actual results during
25 that time period, you'll get a very poor, you know,

1 forecast going forward for setting your rates.

2 Now, Mr. Diller made the point that gas
3 prices and electric prices sometimes correlate, but
4 last year MDU's margins seemed to stay high even
5 after gas prices dropped in the latter half of the
6 year.

7 Mr. Blinsky will really talk about this in
8 more detail, but the fact is that early in the year
9 they had a power contract, they sold power for next
10 summer later in the year in January at essentially
11 the futures prices that were available early in the
12 year. So they locked in a high price. I think it
13 was a price of like -- well, it's in his testimony,
14 but something along the order of \$140 a megawatt-
15 hour.

16 So later in the year when the power
17 markets tanked and the price was \$40, they were
18 selling for \$140. That to a large extent explains
19 why you didn't see, at least in the MDU data, this
20 correlation between the gas prices dropping
21 dramatically and the electric margins dropping
22 dramatically.

23 If they hadn't just gotten lucky and
24 signed a longer term contract for the power that
25 year, you would have seen that correlation. You

1 would have seen the margins that they were getting
2 dropping just like the gas prices.

3 So -- and that continues to be true today.
4 The gas prices are down quite a bit below the
5 unusual prices they reached during that time period
6 and are forecasted to continue to do so.

7 I've got -- at the back of my surrebuttal
8 testimony there's a graph on gas prices. These
9 are -- once again, these are average nationwide
10 prices, but generally over the last decade gas
11 prices have been around the two dollars -- low two-
12 dollar level, and on average they spiked up to over
13 four dollars in 2000 and 2001.

14 COMMISSIONER CLARK: Excuse me. Is this
15 page one of six on Schedule 2?

16 THE WITNESS: Yes. I'm sorry. It's page
17 one of six. So you can see the -- the checkered --
18 or the triangle colored -- or pattern graph are the
19 gas prices, and you see them getting very, very
20 high. The slashed pattern bars all refer to coal
21 prices, and the coal prices stayed fairly flat
22 during that time period, and as a result if you had
23 coal power to sell, you got huge margins all of a
24 sudden, but those margins are projected, at least
25 in 2002, to go back down to a lower level and

1 possibly even be lower than they were in even '98
2 and '99.

3 So I think that concludes all of my
4 comments on Mr. Diller's testimony.

5 MR. HOBERG: Mr. Pearce, anything --

6 MR. PEARCE: Yeah. Just maybe one or two
7 questions, I guess.

8 Q. (MR. PEARCE CONTINUING) In your -- in
9 your surrebuttal testimony, Dr. Gaske, you did also
10 mention the coming on of large amounts of new
11 efficient electric generation in the near future.
12 Is that a part of your conclusion that margins will
13 go down?

14 A. That plays a role, but I think Mr.
15 Schiffman is the one who will really be addressing
16 those dynamics in the electric markets.

17 MR. PEARCE: I think I have nothing
18 further of Dr. Gaske.

19 MR. HOBERG: Thank you, Mr. Pearce. Let's
20 take a recess at this time of about 10 to 12
21 minutes.

22 COMMISSIONER WEFALD: Do you need -- one
23 of the people has to go to the airport, but do they
24 need to be a part of these questions?

25 MR. BINEK: Well, he will be here for a

1 while yet.

2 COMMISSIONER WEFALD: Okay.

3 MR. HOBERG: Let's go off the record.

4 (Recess taken.)

5 (Exhibit 13 was marked for
6 identification.)

7 MR. HOBERG: Okay. We're back from a
8 short recess, and we were about to begin the
9 cross-examination by Mr. Binek, but, Mr. Pearce,
10 you say you have at least one more question.

11 MR. PEARCE: Yes, Judge. Just one more
12 question really, if I may.

13 Q. (MR. PEARCE CONTINUING) Dr. Gaske, would
14 you just very briefly summarize your response then
15 to the question of resale sales margins?

16 A. Various factors that contributed to the
17 high margins in 2000 and 2001 are not likely and
18 not forecast to continue in the upcoming year. In
19 particular the ones that I was addressing had to do
20 with the manufacturing production, which has an
21 impact, the general overall economy, which is in
22 recession, and natural gas prices, which are down,
23 and in particular down relative to coal prices, and
24 in addition, I discussed the fact that futures
25 prices are real prices in the sense that you could

1 do a transaction right now at those prices to sell
2 your power over the course of the next year at
3 those prices.

4 So they're considerably more reliable than
5 just a forecast, and I think that that would sum up
6 my testimony. Other witnesses will be addressing
7 other aspects of those issues.

8 MR. PEARCE: Thank you. I have nothing
9 further.

10 MR. HOBERG: Thank you, Mr. Pearce. Mr.
11 Binek, did you have some questions of Dr. Gaske,
12 please?

13 MR. BINEK. Yes, I do.

14 CROSS-EXAMINATION

15 BY MR. BINEK:

16 Q. First of all, on the sales for resale,
17 have you done any in-depth study of this issue?

18 A. Not of the sales for resale market. I
19 look pretty closely at the gas price market.

20 Q. You testified concerning the manufacturing
21 production, a reference to your JSG-4, Schedule 2,
22 page two, and you talked about the manufacturing
23 production being down from 2001. According to the
24 chart you have here, in fact the projection is for
25 the manufacturing production to increase in 2002,

1 isn't it?

2 A. What I was talking about is that in 2002
3 if you look at the average level of it --

4 Q. I realize that --

5 A. -- it's projected to increase from where
6 it is right now.

7 Q. Right.

8 A. But over the course of this --

9 Q. That was my question?

10 A. Yeah. And over the course of this entire
11 year, though, it would be quite a bit lower.

12 Q. But it is increasing?

13 A. That's the projection.

14 Q. Okay.

15 A. We hope that in the next few months we
16 won't continue to have manufacturing production
17 declining as it did last month.

18 Q. When you talked about use of the futures
19 market, you said that's not a forecast, and I
20 understand the discussion that you had, but aren't
21 futures prices established using estimates in
22 forecasts? They don't just pick a figure out of
23 the air and say, this is what we're going to pay in
24 September 2002.

25 A. Implicitly in -- within the prices that

1 people are willing to pay is a forecast or their
2 guess, and so basically you have a buyer and a
3 seller who are both trying to pick what the price
4 will be and they come together and that's what it
5 is, but the -- so, yes, implicit in that is
6 probably a forecast of both the buyer and seller,
7 and when their forecasts agree, they do a
8 transaction, and to the extent there are people in
9 the market who dramatically disagree with the
10 forecast, they have opportunities to jump into the
11 market and either buy or sell, depending on whether
12 they think it's too high.

13 So overall it represents an unbiased
14 estimate by all the players in the market, even the
15 people who don't get into the market because they
16 might stay out because they think, yeah, that's a
17 fair price. If they thought it was traumatically
18 unfair, there would be opportunities for huge
19 profits for them.

20 Q. I'm going to kind of jump around here a
21 little bit, if it's all right with you.

22 A. All right.

23 Q. First of all, you talked about Mr. King's
24 6.3 million dollars being the wrong figure, and
25 your reference was to CWK-1R, I believe, from Mr.

1 King's testimony. Why is his 6.3 million figure
2 wrong?

3 A. The -- the rate base in this case is 128.9
4 million dollars. The -- in percentage terms or in
5 terms of what the cost of capital difference is for
6 common equity between having a flotation cost and
7 not having it, I've recommended 12.75 percent. If
8 you took out flotation cost adjustment, you'd have
9 12.17 percent. The difference is that -- so
10 essentially we're talking about 0.58 percent is the
11 value of the flotation cost adjustment.

12 Now, not all of the rate base is financed
13 by common equity. 48.87 percent of the rate base
14 is financed by common equity. So if you take
15 128 -- or 128.9 million dollars in rate base,
16 multiply it times .4887, the equity component of
17 that, and then multiply that times .0058, which is
18 the flotation cost adjustment to the equity return,
19 you have \$365,000 as the amount that would be
20 included in the cost of service.

21 Q. Would you please go to Exhibit 1R, CWK-1R?

22 COMMISSIONER WEFALD: And that's found in?

23 MR. BINEK: That is in --

24 MR. HOBERG: Exhibit 5.

25 MR. BINEK: -- Mr. King's rebuttal

1 testimony. Right.

2 COMMISSIONER WEFALD: Thank you. His
3 surrebuttal or his rebuttal?

4 MR. BINEK: His rebuttal.

5 COMMISSIONER WEFALD: Thank you.

6 MR. BINEK: Mr. King's.

7 COMMISSIONER WEFALD: Okay.

8 Q. (MR. BINEK CONTINUING) Is the -- looking
9 at line 23 -- are you at that exhibit?

10 A. Yes.

11 Q. Is the figure of 0.58 percent correct?

12 A. Yes, it is. That's what I just said
13 earlier, was the flotation adder, 0.58 percent.

14 Q. All right. And is the -- Mr. Gaske, is it
15 true that if .58 percent is applied to the total
16 company -- total book equity, that the figure that
17 Mr. King used is correct, the 6.3?

18 A. Mathematically it's correct, but it's not
19 what I've proposed in this proceeding and it's
20 not -- essentially when the company decides whether
21 or not to raise capital for, say, an unregulated
22 part of its operation, it looks at the cost of
23 capital for the unregulated part of the operation
24 and it would have to consider flotation costs for
25 that, but in terms of providing an allowed rate of

1 return of 68 million dollars to their unregulated
2 operations, those are not at issue in this
3 proceeding.

4 So the \$365,000 number that I mentioned
5 earlier, that does total out in dollars that are at
6 issue in this proceeding.

7 Q. Would you agree that the -- that the 6
8 million flotation charge is more than the total
9 flotation cost for the company for the last five
10 years?

11 A. Yes, I would.

12 Q. Okay. Thank you. And if you scale it
13 back to North Dakota, the same relationship would
14 exist?

15 A. Yes, in terms of what actually was
16 incurred during that period of time. As I said
17 before, what we're -- we're dealing with a forward-
18 looking approach of what rate of return do they
19 need to attract capital.

20 Q. Do your book value returns under
21 alternative investments measure the return
22 available to new investment?

23 A. No. They measure the return that's
24 available to all of the investment.

25 Q. To the embedded investment?

1 A. Yes, sir.

2 Q. I'd like to refer you to page 2 of -- this
3 is your surrebuttal testimony -- page 2, lines 11
4 and 13. I'd like -- where did Mr. King admit that
5 he had incorrectly calculated debt cost?

6 A. I have different line numbers in mine,
7 but --

8 Q. Well, it's just under debt cost, the first
9 question, and you started out with your answer that
10 in his rebuttal testimony Mr. King concedes that he
11 had incorrectly calculated the cost of debt for
12 Montana-Dakota in his direct testimony, and then in
13 13, "Nevertheless, he recommends that the PSC adopt
14 his admittedly incorrect debt cost," and my
15 question to you is: Where did Mr. King admit that
16 he had incorrectly calculated debt cost?

17 A. It comes in a -- that conclusion comes
18 from the combination of his direct testimony and
19 his rebuttal testimony. In his direct testimony he
20 indicates that he used the accounting based
21 approach, and he indicates that the reason he used
22 that was it matched the FERC accounting
23 regulations.

24 In my direct testimony in response to that
25 I pointed out to -- to him and to the record that

1 FERC's accounting regulations don't require a
2 calculation of the rate of return on the debt, that
3 you have to go to its regulation regarding rate
4 filings, and in the regulations regarding rate
5 filings they specify that in calculating the cost
6 of debt you use the yield-to-maturity approach.

7 So the reason in his direct testimony that
8 he provided for -- for the number that he came up
9 with was that this is the way the FERC regulations
10 say to do it.

11 When I pointed out that he had gotten the
12 wrong part of the regulations, he came back and he
13 said on -- on his -- in his testimony -- and this
14 would be his rebuttal testimony -- on page 2, lines
15 13 to 15, he says, "Dr. Gaske is correct that the
16 yield-to-maturity procedure is the conventional
17 method of calculating the cost of debt. Indeed, I
18 am informed that the North Dakota Commission staff
19 normally uses that procedure," and I take that to
20 be a concession that indeed I was right, that that
21 was the right way to calculate the cost of debt,
22 and in fact it is the right way to calculate the
23 cost of debt.

24 Q. Is the word "incorrect" ever mentioned in
25 Mr. King's testimony?

1 A. This may be quibbling quite a bit, but let
2 me -- let me again read directly what he says on
3 page 2, line 13 of the rebuttal testimony. "Dr.
4 Gaske is correct that the yield to maturity
5 procedure is the conventional method of calculating
6 the cost of debt."

7 So to answer your question, the answer is,
8 no, he does not say "incorrect" -- he did it
9 incorrectly. He says that when I pointed out that
10 he had done it incorrectly, I was correct, and it's
11 a very small --

12 Q. And he says --

13 A. I mean, I might not understand your
14 question because the word "incorrect" in one
15 context and the word "correct" in this context are
16 exactly the same thing.

17 Q. Well, let's stop splitting hairs here.
18 Didn't Mr. King state in his testimony that NSP
19 used the accounting method, so it -- while yield to
20 maturity may be the conventional method, he also
21 says on line 14, I am informed that North Dakota
22 Commission staff normally used that procedure, but
23 in fact NSP didn't use -- in the NSP case the
24 accounting method was used. So we aren't splitting
25 hairs here. There is a difference between what

1 you're saying and what Mr. King is saying.

2 A. Now, I don't believe -- I don't believe
3 that's true, but let's go to the NSP case that you
4 just brought up. If indeed they used the
5 accounting based method, and as Mr. King noted
6 earlier, that will come up with a lower number --
7 or lower cost than the yield-to-maturity approach,
8 the correct way of doing it is the yield-to-
9 maturity approach, and if you use the accounting
10 base approach, you will not recover your flow debt
11 costs. It's equivalent to a disallowance.

12 If NSP calculated their costs that way,
13 they inadvertently did it wrong and they should
14 probably come back in the next rate case with the
15 yield-to-maturity approach because they're not --
16 they don't have a component in their costs that
17 would fully recover the debt cost.

18 Q. Or maybe NSP intended to do that.

19 A. I don't know. I can't put myself in their
20 place.

21 Q. You're speculating.

22 A. Yes.

23 Q. Okay. If this commission provides MDU
24 with a yield-to-maturity debt cost return as you
25 proposed, what incentive will the company have to

1 examine the feasibility of refinancing its debt to
2 a lower cost?

3 A. Good management, and that's sort of a
4 loaded question, and I'll -- if you don't mind,
5 I'll answer the full load of the question. As
6 we've talked about earlier --

7 Q. Well, the question is: What incentive do
8 they have?

9 A. Right. And as we talked about earlier,
10 their opportunities to greatly reduce that debt
11 cost are limited or nonexistent, and that's because
12 a big part of the difference in the debt cost is
13 the hangover from the long-term debt that they had
14 to issue many years ago, and once that's gone, the
15 cost will go down.

16 In general regulatory theory a company
17 always has an incentive to keep its costs down in
18 between rate cases, but the fact of the matter is
19 that -- and I think Mr. Mahowald will address
20 this -- they don't have many opportunities to
21 reduce that cost of debt at this point in time.

22 Q. In terms of incentive wouldn't it be to
23 MDU's advantage to lock in its high debt cost in
24 this rate case and then refinance its debt to a
25 lower rate?

1 A. I don't believe so because what we're
2 really talking about is their share of the overall
3 MDU Resources capital structure and debt
4 obligations, and if you go to my Exhibit -- it's
5 one of the exhibits with my direct testimony, and
6 it's Exhibit JSG-2, which is in my direct, and
7 that's Exhibit No. -- is that 6?

8 MR. HOBERG: Oh, no. That's Exhibit --

9 MR. PEARCE: It's 6.

10 MR. HOBERG: Yeah, 6. That's right.

11 THE WITNESS: Okay. On Schedule 4, page
12 one, down towards the bottom, that schedule shows
13 assets and operating revenues and operating income
14 for my electric utility proxy companies, but down
15 towards the bottom it shows the -- on the very last
16 line it shows Montana-Dakota's electric utility
17 operations as a percent of the total MDU Resources
18 Group operations, and you can see that the assets
19 are about -- of the electric operations are about
20 13 percent of the whole.

21 If MDU Resources were to go out and
22 refinance that debt, the scenario you just
23 described would make money for them on 13 percent
24 of their operation and lose money on 87 percent of
25 their operation.

1 So, frankly, their biggest incentive is --
2 would have been to do that as soon as they possibly
3 could, possibly years ago if they could have done
4 it profitably, but I think as Mr. Mahowald will
5 tell you, because essentially they're carrying over
6 these high costs and high refinancing costs from
7 many years ago, there are not a lot of
8 opportunities to get rid of that carryover, and so
9 there are not a lot of opportunities to get a
10 better debt rate, but the incentive for them given
11 that only 13 percent of their assets -- and even
12 only 8.6 percent of their revenues are in the
13 electric utility part of MDU Resources, they have
14 huge incentives to do that as soon as they possibly
15 can, and there's not much to the -- not much to be
16 gained from the -- from postponing it for an
17 electric rate case and then losing out on those
18 savings for, you know, 87 percent of their
19 operations.

20 So, yeah, the question for MDU Resources,
21 I'd say, no, they don't have any incentive to do
22 that when you look at the total benefits to the
23 company.

24 Q. (MR. BINEK CONTINUING) Do you have any
25 empirical data that would demonstrate that failure

1 by a commission to provide for flotation costs in a
2 return to equity has resulted in an inability to
3 sell common stock at net proceeds less the book
4 value of that stock?

5 A. I'm not aware of any company that has
6 specifically said we didn't issue common stock this
7 year because we didn't have a flotation cost
8 adjustment.

9 I'm aware of utilities that have said
10 we're not issuing stock at this time because our
11 stock price is too low, which could be the result
12 of flotation costs -- the absence of the flotation
13 cost adjustment, and I'm aware of companies that
14 have issued stock at less than book value
15 essentially because they had an inadequate rate of
16 return, which may or may not be just flotation
17 costs. It could be flotation costs and other
18 factors, but they've gone ahead and issued it and
19 really taken a loss on the issuance and invested it
20 in public utility operations because they felt that
21 they had a -- or at least the things that I read at
22 the time when this was happening -- they felt they
23 had a public service obligation to continue to
24 provide reliable service, even when the Commission
25 did not grant them an adequate rate of return, and

1 that happened in the late 1970s in several
2 instances. A lot of companies needed to build
3 plants, or at least felt they needed to build
4 plants, and their stock prices were below book
5 value.

6 Q. Do you believe that most years regulatory
7 commissions do not allow flotation costs?

8 A. I haven't done a complete survey. I -- I
9 would agree that -- yes, I would agree with that.
10 Probably a majority. It's a split thing.

11 Q. Do you have any evidence that there are
12 any MDU investments in either electric or gas
13 operations that have become stranded by reason of
14 loss of market?

15 A. Not at this time.

16 Q. Isn't it true that the wholesale sales at
17 issue in this proceeding are those made from the
18 same generating facilities that provide the retail
19 power for which this Commission sets rates?

20 A. Yes.

21 Q. Wholesale sales from generating units that
22 might be owned by MDU that are altogether outside
23 of its retail service territory would be excluded
24 from this case, would they not?

25 A. Yes.

1 Q. I'd like to refer you to Mr. King's
2 rebuttal testimony, and in his -- Exhibit CWK-2R
3 talks about Value Line reports for IDACORP?

4 A. Yes.

5 Q. Do you have that in front of you?

6 A. Yes, I do.

7 MR. HOBERG: That's Exhibit 5.

8 MR. BINEK: Right.

9 Q. (MR. BINEK CONTINUING) First of all, do
10 you know where Mr. King got this Value Line
11 information?

12 A. I don't have his exact exhibit in front of
13 me. I have the November 16th Value Line, but I
14 presume that's what he has because it had the same
15 quote that he had.

16 Q. Okay. Yes, that is the same.

17 A. Yes.

18 Q. Would you read the lead paragraph in Value
19 Line's write-up about IDACORP?

20 A. "IDACORP's noncore enterprises are an
21 important source of income. The wholesale energy
22 subsidiary, which operates in 31 states, Canada,
23 and Mexico, will likely be a major profit driver
24 over the next three to five years."

25 Q. Why don't you read the whole paragraph?

1 A. Oh. "Too, IDA invests in affordable
2 housing, which generates profits through income tax
3 credits. It also has an interest in 12 unregulated
4 hydro plants that are steady contributors to net.
5 Other subsidiaries" -- do you want me to just keep
6 on reading?

7 Q. Yes. That whole paragraph?

8 A. Actually I'll read the whole thing, if
9 you'd like.

10 Q. That whole first paragraph.

11 A. Okay. "Other subsidiaries, still in
12 start-up stages and not expected to be profitable
13 for a few years, include a telecommunications unit
14 and a provider of energy-related products and
15 services. Finally, the company owns 70 percent of
16 a fuel cell business that has a patent on four
17 reformers that convert hydrogen fuels into
18 electricity. It already has contracts for 3.5
19 million for the sale of 110 units of the Bonneville
20 Power Administration, and it is pursuing orders in
21 Japan and France. Those varied activities will
22 likely produce 40 percent of company profits by
23 2004."

24 Q. Thank you. Now I'd like to reference you
25 to page 19 of your rebuttal -- or, yes, your

1 rebuttal -- your surrebuttal testimony. Is that
2 marked as 8 or 7?

3 MR. HOBERG: 7. It's 7.

4 Q. (MR. BINEK CONTINUING) Okay. And I would
5 ask you to look at lines 15 through 17, and please
6 read that sentence. It starts with "An allowed
7 rate of return."

8 A. I was looking at something else. Could
9 you give me the reference again?

10 Q. Okay. It's page 19.

11 A. Of my surrebuttal?

12 Q. Right.

13 A. Yes.

14 Q. And starting on line 15, would you please
15 read that sentence, and then tell the Commission
16 whether you have any empirical data that would
17 support this statement?

18 A. "An allowed rate of return established by
19 the DCF method should make the value of the
20 electric operations equal to the book value of
21 those operations in the absence of a flotation cost
22 adjustment."

23 The theoretical underpinning of the DCF
24 approach is that that in fact is true.

25 Q. Well, my question is whether you have any

1 empirical data that supports the statement. That's
2 the question.

3 A. No, I don't.

4 Q. Going back to the -- your earlier
5 testimony you talked about -- you were responding
6 to what Mr. King had said, and you talked about
7 debt cost, and in talking about the reasonableness
8 of the debt cost and the -- the -- you talked about
9 the situation that occurred in the -- I believe it
10 was the late Seventies, early Eighties when MDU was
11 having to borrow money at high rates, and it was in
12 the process of -- one of the main reasons was, as I
13 understood it, it was in the process of building a
14 power plant.

15 A. Yes. The Coyote plant.

16 Q. Okay. Otter Tail Power Company was a
17 partner with MDU in the building of the Coyote
18 power plant, weren't they?

19 A. I'm not aware of that. Mr. Mahowald can
20 probably address that.

21 Q. Okay. Thanks. When you were talking
22 about the use of proxy companies and you were --
23 you have disagreements with Mr. King about the --
24 his decision not to use electric companies and to
25 use combination companies. MDU is a combination

1 company, isn't it?

2 A. MDU Resources Group, yes, it is.

3 Q. Well, isn't -- okay. You said -- you made
4 a statement that in -- concerning -- you were
5 talking about investment portfolios, and you were
6 talking about electric companies, gas companies and
7 combination companies, and you said that
8 investors -- if they -- if they are concerned about
9 electric investments, they can invest in gas, you
10 know, vice versa, but if they -- if there's a
11 combination company, they can invest in that, and
12 don't they reduce their risks by making the
13 investment in a combination company?

14 A. And the answer to that is that the company
15 probably reduces its risks, but it doesn't reduce
16 the cost of capital to the electric operations.

17 Q. You also mentioned the possibility of
18 deregulation as a risk. Is there any move towards
19 deregulation in North Dakota?

20 A. It's my understanding that it's being
21 studied at this time.

22 Q. Do you know if there's any move toward
23 deregulation?

24 A. I don't know what the definition of "move"
25 is in the context of it's being studied, which

1 implies to me that somebody must think it's worth
2 thinking about.

3 Q. Well, who's studying it?

4 A. Let's see.

5 COMMISSIONER CLARK: Page 43 of your
6 original testimony is the spot you're looking for.

7 THE WITNESS: Apparently there -- the
8 legislature has an Electric Industry Competition
9 Committee.

10 Q. (MR. BINEK CONTINUING) Do you know if
11 they're doing anything at this point?

12 A. No, I don't know.

13 Q. I've got to find the right testimony here.
14 On pages 12 and 13 of your direct testimony you
15 discuss --

16 MR. HOBERG: Exhibit 6.

17 MR. BINEK: Pardon?

18 MR. HOBERG: Exhibit 6.

19 MR. BINEK: Yes.

20 Q. (MR. BINEK CONTINUING) You discuss
21 economic factors that affect the cost of capital,
22 and you state that in recent months the economy has
23 been shrinking and is in a recession. Isn't it
24 true that with a shrinking economy or a recession
25 that investors are looking more favorable at

1 investments in companies such as MDU where rates
2 are regulated and risks are limited?

3 A. I think Mr. King indicated this morning,
4 and I agree with him completely, that in recent
5 months people have been very concerned about
6 utility investments, and in fact that was part of
7 the reason for him revising his rate-of-return
8 study.

9 During -- during difficult times or
10 recessions or when there's more uncertainty in the
11 economy, they may move their money into utility
12 stocks, but unfortunately utility stocks aren't
13 what they were 20 or 30 years ago. They're now
14 considered to be relatively risky investments.

15 What more often happens and the thing that
16 really affects the capital markets is that they
17 start holding cash and cash equivalents, and
18 there's been an enormous increase in the holding of
19 cash and cash equivalents in the last year.

20 Q. But you would agree, wouldn't you, that an
21 investor during -- during times when there's an
22 economic downturn, utility stocks are a more
23 favorable investment, you know, granted that there
24 is more risk to utility stocks just as there is
25 more risk to every other kind of stock?

1 A. Yes. I would agree with that, and I think
2 given the fact that we have a down turn and what
3 you've just described, the DCF analysis that I've
4 performed reflects that because it reflects the
5 recent stock prices, and so 12.75 percent would
6 reflect exactly the phenomenon that you've just
7 described.

8 (Exhibit 14 was marked for
9 identification.)

10 MR. BINEK: That's Exhibit 15?

11 THE REPORTER: 14.

12 MR. HOBERG: 14.

13 MR. BINEK: 14.

14 Q. (MR. BINEK CONTINUING) You're familiar
15 with Public Utilities Reports?

16 A. Yes, I am.

17 Q. I show you Advance Sheets of the Public
18 Utilities Reports dated December 15, 2001, and I
19 also show you an Exhibit 14, and could you tell me
20 if you would agree that Exhibit 14 is a copy of the
21 preliminary statement and an annual summary -- or
22 annual survey of electric and gas utilities as
23 compiled by the Public Utilities Reports?

24 A. Yes, it looks like it's a correct copy.

25 Q. Have you reviewed the results of that

1 survey that's contained in the Public Utilities
2 Reports?

3 A. No. But I'll do so --

4 Q. Okay.

5 A. -- as quickly as I can for your benefit.

6 Q. Okay. I guess before doing that, would
7 you just read into the record the first paragraph
8 of the first page, the Roman numeral -- small I or
9 small 1?

10 A. "The following pages present the results
11 of our latest annual survey of authorized rates of
12 return or common equity for state-regulated energy
13 utilities. This year's survey covers orders issued
14 by state regulatory commissions during the period
15 October 1, 2000, through September 30, 2001."

16 Q. Would you -- yeah. I think that's
17 sufficient.

18 MR. HOBERG: Are you offering that, Mr.
19 Binek?

20 MR. BINEK: Yes, I will offer it at this
21 time.

22 MR. HOBERG: Okay. Exhibit 14, the Public
23 Utilities Report, Advance Sheets, December 15,
24 2001, do you have any objection to that, Mr.
25 Pearce?

1 MR. PEARCE: No, I wouldn't -- I wouldn't
2 agree that it's relevant, but I have no objection
3 to it being accepted for what it is.

4 MR. HOBERG: Okay. Exhibit 14 is
5 admitted.

6 Q. (MR. BINEK CONTINUING) The actual survey
7 begins on the third page; is that correct? For --
8 I won't ask you to count the number of companies,
9 but would you accept, subject to check, that there
10 are 46 companies listed here?

11 A. Yes.

12 MR. BINEK: I would like to point out that
13 I noticed that Public Utilities Report does have an
14 error on page seven of their survey. Under North
15 Dakota they show Otter Tail Power Company Electric
16 and below that they show Otter Tail Power Company
17 Gas. It's the same case number, same decision
18 date, and I think that everyone here can agree that
19 that is a mistake, that there is no Otter Tail
20 Power Company Gas and that it's just a duplication
21 of the prior Otter Tail Power Company Electric, and
22 I would ask that that -- Mr. Pearce if he would
23 stipulate to that.

24 MR. PEARCE: Yes. I'll agree that there's
25 no Otter Tail Power Company that provides gas.

1 Q. (MR. BINEK CONTINUING) Okay. So that
2 leaves 45 companies then in this list.

3 A. Yes. Or I'll accept that subject to
4 check.

5 Q. Okay.

6 A. I'll take your word for it.

7 Q. Now I've -- if you'll notice, I have
8 highlighted some companies in there hopefully to
9 help you with the questions I'm about to ask.
10 Okay. Out of these 45 companies can you tell me
11 how many of those companies have an authorized rate
12 of return on common equity greater than the 11.7
13 percent ROE recommended by staff in this case, and
14 for -- for your convenience and your help, those
15 are the companies that I've highlighted in yellow.

16 A. Thank you.

17 COMMISSIONER WEFALD: Higher than 11.75?

18 MR. BINEK: Pardon me?

19 COMMISSIONER WEFALD: Higher than what?

20 MR. BINEK: 11.7.

21 COMMISSIONER WEFALD: Higher than 11.7.

22 Thank you.

23 MR. BINEK: If I said 11.75, that was my
24 mistake.

25 COMMISSIONER WEFALD: No, no.

1 THE WITNESS: It appears 11 companies in
2 that time period.

3 Q. (MR. BINEK CONTINUING) Okay. Now,
4 looking at page five of that report, would you
5 agree that two of these companies are located in
6 Minnesota and that the ROE for those two companies
7 is 11.71 percent or one-one-hundredths of a percent
8 higher than the staff recommended ROE in this case?

9 A. For back in that time period, yes.

10 Q. I mean, that's what the survey says;
11 right?

12 A. Right. I'll kind of make that --

13 Q. That's all that I'm asking.

14 A. Yeah. I'll continue to make the
15 distinction about the time period, but yes.

16 Q. Okay. And two of the companies -- and
17 I'll refer you to page seven. Two of the companies
18 are NSP Electric and Otter Tail Electric in North
19 Dakota that are at 12 percent. Those are the
20 companies that Mr. Diller referred to earlier with
21 performance-based regulation?

22 A. Yes. I'll --

23 Q. I think if you'll look at the footnotes,
24 it does talk about the performance-based
25 regulation.

1 A. Yes.

2 Q. And the third -- there's also a Northern
3 States Power Company Gas, and that's the 11.5
4 percent ROE that Mr. Diller talked about earlier,
5 the rate case with Otter Tail.

6 A. Yes.

7 Q. Okay. That brings us down to the
8 remaining seven companies. Would you agree with me
9 that six of those remaining companies are all
10 located in Wisconsin, the last page, and that the
11 ROEs there range from 12.1 to 12.9?

12 A. Yes.

13 Q. The seventh company is -- on page five is
14 Cleco, or however you pronounce that, in Louisiana.
15 Cleco is one of the companies that you included as
16 a proxy and that Mr. King says shouldn't be
17 included as a proxy; is that correct?

18 A. Yes, that's correct.

19 Q. Okay. And their rate is at 12.25 percent?

20 A. Yes.

21 Q. Okay. Out of these 45 companies listed,
22 how many of those companies have a -- an authorized
23 rate of return on common equity equal to or in
24 excess of the ROE of 12.75 percent that is proposed
25 by you in this proceeding?

1 A. In that time period the Wisconsin
2 companies -- there were two at 12.9 and one at
3 12.75, the same number.

4 Q. Okay. So 3 out of 45 companies had ROE at
5 equal to or greater than your recommended ROE for
6 MDU?

7 A. In that time period, yes.

8 Q. So to summarize, would you agree that this
9 annual survey conducted by Public Utilities Reports
10 for the period of October 1, 2000, through
11 September 30th, 2001, shows 3 out of 45 companies
12 with ROEs equal to or greater than MDU's proposed
13 12.75 ROE and 34 out of 45 companies have ROEs less
14 than the 11.7 percent ROE proposed by staff; is
15 that true?

16 A. Yes, in that time period.

17 MR. BINEK: I have no further questions.

18 MR. HOBERG: Thank you, Mr. Binek. Mr.
19 Fahn, did you have any questions of Dr. Gaske?

20 MR. FAHN: No questions. Thank you.

21 MR. HOBERG: Thank you, Mr. Fahn.

22 Commissioner Wefald, did you have any questions of
23 Dr. Gaske?

24 COMMISSIONER WEFALD: I have just a
25 couple.

1 EXAMINATION

2 BY COMMISSIONER WEFALD:

3 Q. On futures it's my understanding that we
4 may know the futures price today for what the
5 futures price -- what someone will pay or sell for
6 today for that -- in that futures market but that
7 it's awfully hard to predict what that futures
8 price is going to be tomorrow or next week; would
9 you agree?

10 A. Yes.

11 Q. And so sometimes a company -- let's say
12 they purchase electricity. Their price of
13 electricity right now on the futures market may be
14 low, but do you know what it's going to be next
15 week for this summer? Do we know what -- we know
16 what the futures price today is if you were
17 purchasing electricity for July, but do you know
18 what the futures price for electricity is going to
19 be next week?

20 A. No.

21 Q. And do you know what it's going to be in
22 May --

23 A. No.

24 Q. -- for that same -- for that same June
25 period?

1 A. No. The futures price at any given point
2 in time reflects the best estimate of the market as
3 to what it will be in the future, and as you get
4 closer and closer to a time period or as -- in
5 people's perceptions of the market change, that can
6 change.

7 Q. For example last fall, didn't the -- there
8 was a time period when there was a prediction there
9 was going to be an exceptionally cold winter, I
10 believe it was the end of October, and the futures
11 price for natural gas went way up, and, I mean,
12 went up considerably in a blip, but then two months
13 later the futures price was down considerably
14 because it wasn't happening, that cold weather
15 wasn't developing. Do you agree that there are --
16 that there are changes in the futures market based
17 on predictions of the weather or other indications
18 of market supply and market demand and those other
19 factors?

20 A. Absolutely. The point of my comments
21 earlier --

22 Q. You said there was certainty about the
23 futures market, you said, about today's price.

24 A. Right. So you could lock in that price
25 right now today.

1 Q. Yes. But you don't know if that's the
2 correct price because tomorrow it may go down or it
3 may go up, and that's part of the guesswork of the
4 futures market.

5 A. Right. You can lock that price in if you
6 actually do the transaction.

7 Q. Oh, I know you can, but you have to guess
8 then -- or make your decision is that market going
9 to go up or is it going to go down?

10 A. Right.

11 Q. I know in the -- otherwise if everyone
12 knew what was going to happen in the futures
13 market, it really wouldn't be a futures market. It
14 would be -- it would -- there wouldn't be any
15 guesswork about it, do you agree, because when you
16 make a decision today, you're making a calculated
17 risk that you think you're getting the very best
18 deal today.

19 A. Right. People like MDU, if they don't
20 sell on a long-term basis in the sales for resale
21 market or if they don't sell a futures contract,
22 they take a risk that the price will either go up
23 or it will go down, and so --

24 Q. So if they waited -- even if they waited
25 till next week, they might get a higher price for

1 their electricity if they didn't sell it today at
2 the low price.

3 A. Right. For purposes of trying to figure
4 out how much money they're likely to make over the
5 next year, though, the current futures prices is
6 the best available evidence.

7 Q. Well, what if we were holding this case
8 next week and the price was way up?

9 A. Then --

10 Q. Then would that be the best price? If
11 that price was going to make them 20 million
12 dollars this year, would that be the price you were
13 arguing was the best price?

14 A. Yes.

15 Q. It would be? Even though -- but today
16 you're arguing that price is a lower price, and so
17 therefore you're saying that that's the best price
18 today and it's, you're saying, 6 million dollars or
19 whatever would be made this year?

20 A. Right. I'm not arguing for a specific
21 price, but I am saying that if you as a regulator
22 have to make a decision as to what the most likely
23 price is to be over the next year, there's nothing
24 that can beat those futures prices as the best
25 estimate at this point in time, and if you had to

1 make your decision right now at this point in time
2 or based on the record available at this point in
3 time, there is nothing that would be a better -- in
4 my mind, a better predictor or estimator for what
5 price and margin they'll be able to achieve.

6 Q. I appreciate your opinion on that.

7 A. Okay.

8 Q. Okay. And then on page -- the
9 manufacturing production, that's that schedule you
10 referred to, Schedule 2, of page two of six.

11 A. Yes.

12 MR. HOBERG: Which exhibit?

13 COMMISSIONER WEFALD: It's Schedule 2,
14 page two of six.

15 MR. HOBERG: In his direct.

16 COMMISSIONER WEFALD: It's in surrebuttal
17 testimony.

18 MR. HOBERG: Okay. Exhibit 7. Thank you.

19 Q. (COMMISSIONER WEFALD CONTINUING) That
20 shows national manufacturing production. How does
21 this relate to our MAPP region?

22 A. Well, I think other witnesses will
23 probably address that even more than I will, but
24 MAPP and the adjacent regions are all tied together
25 in a large transmission network, and a huge portion

1 of the manufacturing production is occurring in the
2 Upper Midwest, in Illinois and Wisconsin and
3 Detroit -- or in the Michigan area and in Indiana,
4 and so those are relatively nearby areas.

5 To the extent utilities between here and
6 there can't sell electricity to those areas, they
7 would compete directly with MAPP in selling
8 electricity and they wouldn't -- there wouldn't be
9 demand for their electricity.

10 So that would, you know -- in a very
11 general way the electricity that's being sold in
12 MAPP that perhaps moves east has to compete with
13 electricity that -- and prices in those adjacent
14 regions, and I think Mr. Schiffman talks about the
15 link between the adjacent regions and MAPP and how
16 that plays into the prices in MAPP.

17 Q. Who has MDU traditionally sold its
18 electricity to up in the Upper Midwest in these
19 contracts?

20 A. I don't know exactly. Mr. Blinsky is the
21 witness on that.

22 Q. Okay. Thank you. And then on the -- on
23 the previous page, Schedule 2, page one of six,
24 that's the average annual U.S. energy prices, but
25 again this is nationally -- the national chart;

1 right?

2 A. Right.

3 Q. And then in the Upper Midwest in the MAPP
4 region, did we have -- this is for U.S. energy
5 prices. This shows natural gas, right, and then it
6 shows coal prices, but in the Midwest did we have
7 those same high natural gas prices in -- does this
8 reflect the whole year or what does this reflect?

9 A. This reflects an average over the year.
10 You had periods in, oh, November, December of 2000,
11 January, February of 2001 where the price was nine,
12 ten dollars.

13 Q. Okay. And so that's the average of the
14 whole year for that period then?

15 A. Right.

16 Q. Well, in 1999, though, on the chart that
17 Mr. Diller gave us, it shows that --

18 MR. HOBERG: Which one is that?

19 COMMISSIONER WEFALD: This is on the back
20 of his --

21 MR. HOBERG: His presentation?

22 COMMISSIONER WEFALD: -- rebuttal
23 testimony.

24 MR. HOBERG: Okay. Exhibit 2.

25 Q. (COMMISSIONER WEFALD CONTINUING) Your

1 point is that high gas prices can translate into
2 higher revenues for off-system sales?

3 A. Yes, that's correct. Or that's one of the
4 factors that --

5 Q. One of the factors, but in 1999 Mr.
6 Diller's chart shows that Montana-Dakota Utilities
7 made \$8,772,000 on off-system sales, and that's a
8 year when gas prices were at \$2.50 average. The
9 next year, in the year 2000, when gas prices were
10 up to, let's say, 4-and-a-quarter, they made
11 \$9,900,018. So there wasn't -- there was a million
12 dollars -- not quite -- a little more than a
13 million dollars difference that they made on
14 those -- between those two years.

15 Would you agree that there's -- they made
16 considerably more in 1999 than they did in 1998 on
17 off-system sales even though gas prices were pretty
18 much the same as they were in 1998 as they were in
19 1999?

20 A. Yes. And that was not driven by gas
21 prices. I think Mr. Schiffman will address this in
22 his testimony --

23 Q. All right.

24 A. -- that it had to do with nuclear plants
25 shutting down.

1 Q. Thank you. And then I think I have just
2 one more question.

3 A. Okay.

4 Q. You mentioned -- this was on your page one
5 of nine, Schedule 4. This is in the direct
6 testimony filed January 11th, 2002, under your
7 name, and it's Schedule 4, page one of nine, and
8 you mentioned that if Montana-Dakota Utilities
9 Group chose to refinance right now, that 13.2
10 percent of its assets would be in electricity,
11 around 97 percent would be in their other portions
12 of their company. So is it possible for MDU
13 Resources Group, Inc., to only refinance its
14 electricity debt?

15 A. No. This is overall debt of the company
16 that's, as I understand it, been allocated to the
17 electric operations.

18 Q. But my question is: Is it possible for
19 only the electric portion to refinance its
20 electricity debt?

21 A. I don't believe so, no.

22 Q. Why not? Why couldn't you just take those
23 bonds or whatever and --

24 A. Because those are actually bonds of MDU
25 Resources Group, at least that's my understanding.

1 Q. But you said they had to do with building
2 electric plants back in the early Eighties.

3 A. Exactly. That was the time period when
4 the company issued it, when they needed a whole lot
5 of additional capital.

6 Q. So --

7 A. And MDU Resources, I don't think, was
8 nearly as diversified as it is today. So the
9 reason that the debt was issued was to raise a lot
10 of capital at that time when they were -- when they
11 needed to build plants for the utility operations,
12 but overall, MDU Resources, as I understand it,
13 this is their debt, it's the parent company debt.
14 Mr. Ball can probably talk to this more directly.

15 COMMISSIONER WEFALD: Thank you. That's
16 all I have right now. Thanks.

17 MR. HOBERG: Thank you, Commissioner
18 Wefald. Commissioner Clark, did you have any
19 questions for Dr. Gaske?

20 COMMISSIONER CLARK: I do, just a couple.

21 EXAMINATION

22 BY COMMISSIONER CLARK:

23 Q. One is a followup on some things that
24 Commissioner Wefald was asking, and that is about
25 the futures market and any potential predictive

1 value that they have, and you had commented that
2 nothing is a better estimator of what could be
3 happening down the line here a little bit, and I'm
4 wondering if you're aware of any studies that
5 contract statistically the predictive value of the
6 futures market and how often they're wrong or
7 right. Or in the absence of that maybe just
8 anecdotally. Looking at the run up to 2001 where
9 we had on the gas side such high prices in January,
10 did the futures market a year before that or
11 however many months before that predict that that
12 was going to happen?

13 A. I think the futures market is virtually
14 never correct in terms of how things actually turn
15 out, but if you want the best unbiased estimate of
16 what is most likely to happen, it's the futures
17 market, and if you actually do a transaction in the
18 futures market, if you actually sell your power in
19 the futures market, then it's absolutely guaranteed
20 that that's what you will make.

21 So right now today you could absolutely
22 guarantee it, but I think, as with virtually any
23 prediction, it -- it would be almost uncanny if it
24 were actually ever right, but people make decisions
25 based on that. Yeah. I was suggesting that this

1 is the best basis for a regulatory decision.

2 Q. Okay. On page 41 of your direct
3 testimony -- you may not --

4 MR. HOBERG: Exhibit 6.

5 Q. (COMMISSIONER CLARK CONTINUING) Exhibit
6 6. If this is a question that's better given to
7 another witness, just let me know, but since you
8 brought it up in your testimony, the Territorial
9 Integrity Act or TIA, I think you used that as an
10 example of kind of potential risk factors that --
11 that impact Montana-Dakota, but it got me
12 wondering, and just out of curiosity have you or
13 MDU, that you're aware of, ever calculated the
14 effects of TIA, being that you had brought it up in
15 your testimony, and what that is on net income and
16 what then translating that through the potential
17 impact could be on other ratepayers?

18 A. No, no. That really would be a
19 long-term -- or its effect is sort of on the
20 long-term dynamic of the market of -- for their
21 product, but I'm not aware of any study that's
22 quantified it.

23 COMMISSIONER CLARK: Okay. Thanks.
24 That's all I have.

25 MR. HOBERG: Thank you, Commissioner

1 Clark. Mr. Pearce, did you have any further
2 questions?

3 MR. PEARCE: Just very few, as lawyers
4 say, but actually I mean it, just a very few.

5 REDIRECT EXAMINATION

6 BY MR. PEARCE:

7 Q. Looking at Exhibit 14, the PUR report, Dr.
8 Gaske, I don't imagine it would surprise you, would
9 it, that in a report like this ranging over the
10 whole country there would be ranges in return on
11 equity from 9.98 to 12.9?

12 A. No.

13 Q. And given the fact --

14 A. I'm surprised that there are any as low as
15 9.8, but it wouldn't surprise me that there's a
16 range.

17 Q. And that's taking into account the fact
18 that there are test years ranging from '98 to 2001
19 here, I think, as well.

20 A. Yes.

21 Q. And it wouldn't be your advice to a
22 commission, would it, to pick a return on equity
23 looking at other returns around the country at
24 diverse and different companies?

25 A. No. And the reason I continually stated

1 "in that time period" was that Mr. King and I agree
2 on this, and he talked about it this morning, that
3 since September 11th and since Enron, the investors
4 have looked at utilities very differently, and we
5 both believe that the cost of capital is now higher
6 than it was for utilities prior to that time
7 period, and the -- these specifically -- the
8 results in Exhibit 14 specifically end in decisions
9 that were issued September 30th. So I have to
10 think that the record in those decisions closed
11 before September 11th.

12 Q. Now turning just briefly back again to the
13 DCF method, you were asked whether you had any
14 empirical evidence to support your conclusion that
15 allowed rate of return established by DCF should
16 make the value of the electric operation equal to
17 the book value. Isn't that simply an underlying
18 assumption of the DCF methodology, so you wouldn't
19 expect empirical data needed to support that?

20 A. Yes. And there's a little more to it than
21 that, and that is that what you would have to be
22 able to do is set a -- set an allowed rate of
23 return, come back and see how companies are doing
24 and be able to do that in a clean, pure environment
25 where nothing has changed and it was a clean

1 company and didn't have other operations, the cost
2 of capital hadn't changed in the meantime, maybe
3 interest rates hadn't changed, and ultimately,
4 yeah, it would be very difficult to do an empirical
5 study that would prove or disprove the theory.
6 Virtually everyone agrees with the theory. Mr.
7 King and I agree on that. I think he said very
8 specifically this morning that the DCF approach
9 would produce a market value equal to book value.

10 MR. PEARCE: That's all I have.

11 MR. HOBERG: Thank you, Mr. Pearce. Mr.
12 Binek, anything further?

13 MR. BINEK: Yes, just a couple.

14 RE-CROSS-EXAMINATION

15 BY MR. BINEK:

16 Q. Has MDU entered into any futures contracts
17 for 2002?

18 A. I'm not aware of any. I'm not the right
19 witness to answer that question.

20 Q. Who would be the right witness?

21 A. Mr. Blinsky.

22 Q. I forgot to ask you one question. It's
23 not all that important, but this dividend yield --
24 I glanced up and saw that up on the board yet, and
25 you spent a considerable time -- amount of time on

1 that. My recollection is that Mr. King said it
2 really doesn't make much -- any difference. Do you
3 agree with that; it really doesn't make any
4 difference?

5 A. It's a small difference. I just -- it
6 makes some, but it's a small difference, and I
7 didn't want to leave, you know, that unrebutted
8 since mathematically it's just simply not true.

9 MR. BINEK: Okay. Nothing further.

10 MR. HOBERG: Thank you, Mr. Binek. Mr.
11 Fahn, anything further?

12 MR. FAHN: No questions.

13 MR. HOBERG: Commissioners? Commissioner
14 Reinbold, you didn't get a chance to ask questions.

15 COMMISSIONER REINBOLD: No questions.

16 MR. HOBERG: Okay. Any further question?

17 Okay. Thank you, Dr. Gaske. In view of the fact
18 that we'll be back tomorrow, might this be an
19 appropriate time to -- I don't know if your next
20 witness is a long one, Mr. Pearce. What's your
21 thought?

22 MR. PEARCE: Well, it always depends, of
23 course, on the cross-examination. We were
24 proposing to put on Mr. Wilkinson as a short --
25 he's got about ten pages --

1 COMMISSIONER REINBOLD: Who?

2 MR. PEARCE: Paul Wilkinson. -- today,
3 which we could finish 15 minutes on direct. I'm
4 not sure what he might have on cross.

5 COMMISSIONER WEFALD: I think we should
6 move ahead until five o'clock.

7 MR. HOBERG: Okay. We'll try and get Mr.
8 Wilkinson today then.

9 MR. PEARCE: I'll call Paul Wilkinson.

10 MR. HOBERG: Okay. Mr. Wilkinson, were
11 you here earlier when I gave the admonition
12 regarding perjury?

13 THE WITNESS: Yes, I was.

14 (Witness sworn.)

15 MR. HOBERG: Thank you. Mr. Pearce,
16 please.

17 PAUL L. WILKINSON,
18 having been first duly sworn, was examined and
19 testified as follows:

20 DIRECT EXAMINATION

21 BY MR. PEARCE:

22 Q. Mr. Wilkinson, I'll show you Exhibit 7,
23 which I'm opening to what appears to be an opening
24 page of your surrebuttal testimony. I would ask
25 you to look at that testimony and -- ten pages, I

1 think, and is that -- does that appear to be your
2 surrebuttal testimony as previously filed?

3 A. Yes, it does.

4 MR. HOBERG: Just for the record, that's
5 Docket No. 60.

6 Q. (MR. PEARCE CONTINUING) Would you please
7 state your name, please?

8 A. My name is Paul L. Wilkinson.

9 Q. And by whom are you employed and in what
10 capacity?

11 A. I'm employed as vice president of policy
12 analysis at the American Gas Association. I've
13 been an AGA vice president since January of 1995,
14 and I've been employed by AGA since June of 1980.
15 I'm responsible for all analytical activities at
16 AGA. These activities include energy markets in
17 general, natural gas markets in particular,
18 including issues related to energy supply, energy
19 demand, energy prices, energy data and information
20 collection and dissemination. I've also been
21 heavily involved in environmental issues that
22 affect energy markets. In all of these areas I
23 conducted research and prepared and published
24 analyses either directly or by supervisor of AGA
25 employees or contractors.

1 Q. Would you please briefly describe your
2 educational background and professional experience?

3 A. I hold a Bachelor's degree in economics
4 from the University of Maryland and also a Master's
5 degree in economics from Catholic University of
6 America. I've also completed numerous
7 graduate-level courses in economics, energy and the
8 environment at Georgetown University and George
9 Washington University between 1974 and 1977.

10 Q. On whose behalf are you testifying in this
11 cause?

12 A. I'm testifying on behalf of Montana-Dakota
13 Utilities, a division of MDU Resources Group, Inc.

14 Q. And what is the purpose of your testimony?

15 A. I will be addressing natural gas market
16 conditions in the 1990s and during the 2000-2001
17 winter season, as well as future market conditions.

18 Q. Can you describe the natural gas market
19 conditions during the winter of 2000-2001?

20 A. The natural gas market was extremely tight
21 during the winter of 2000-2001. Demand had
22 increased significantly in 2000, and gas production
23 capability had trouble keeping up with the demand
24 increase. As a result of this pressure on gas
25 supplies, prices increased substantially. In fact,

1 as reflected on Exhibit PLW-1 attached to my
2 testimony, the gas price hit ten dollars per MMBtu,
3 by far the highest level in a decade. All classes
4 of consumers, residential, commercial, industrial
5 and electric utilities, paid more for gas than in
6 recent years. This was true in all parts of the
7 country.

8 Q. How did these conditions compare with
9 previous winter periods during the 1990s?

10 A. Most of the 1990s can be characterized by
11 the term surplus deliverability. That is, the
12 decade of the Nineties was in general one in which
13 the ability to produce and deliver gas exceeded the
14 demand for that gas, and as a result wellhead gas
15 prices remained in a fairly narrow range with an
16 equilibrium price of roughly two dollars MMBtu for
17 most of the 1990s.

18 In fact, when adjusted for inflation, gas
19 prices in the 1990s were about one-third less than
20 in the mid 1980s. The early portion of the winters
21 in the 1990s tended to show some upward price
22 movement. However, this upward movement was, in
23 general, rather modest and it tended to fall back
24 quickly in the later winter periods.

25 Q. Were there any price spikes during the

1 1990s comparable to the one we saw during the
2 winter of 2000-2001?

3 A. No. The NYMEX price of gas at the Henry
4 Hub hit 10 dollars per million in December of 2000,
5 and this was twice as high as any spike in the
6 prior 10 years. There were relatively modest
7 spikes in December of 1996 and October of 1997 when
8 the price of gas hit 4.57 per MMBtu and 3.80 per
9 MMBtu. However, in both cases the prices retreated
10 back to about 2 dollars per MMBtu fairly quickly.
11 In general, the price of gas fluctuated in a
12 relatively narrow price band around 2 dollars per
13 million for the decade of the 1990s.

14 Q. How could a more normal weather pattern
15 have affected prices during the 2000-2001 winter?

16 A. Prices were in the mid-4-dollar to mid-5-
17 dollar range for most of the 2000 summer. They had
18 a temporary peak of \$5.54 on October 13th but then
19 fell back to 4.48 by October 30th. I believe that
20 if we had seen normal or warmer than normal weather
21 in November and December instead of extreme cold,
22 the price would have shot downward from the 4.48
23 level instead of rocketing upwards.

24 Q. To what do you attribute the market
25 conditions during the winter of 2000-2001?

1 A. The marketing conditions during the winter
2 of 2000-2001 were attributable to supply factors,
3 demand factors, and what I call market factors.
4 These individual factors combined in an unusual
5 pattern to put extreme upward pressure on gas
6 prices.

7 On the supply side the critical factor was
8 a serious decline in drilling for gas. We like to
9 see the number of gas rigs operating nationally at
10 600 to 800 rigs or more. For most of 1998 we were
11 at the lower end of this range. However, in the
12 spring and the summer of 1999 there was a severe
13 reduction in the number of gas rigs operating as a
14 result of low wellhead gas prices. The number of
15 operating rigs fell off to the 300 to 400 range,
16 and the impact of this drilling decline was masked
17 in 1999 due to extremely mild weather that
18 moderated gas demand. However, when demand surged
19 in 2000, it was clear that production capability
20 had fallen to a critical level.

21 A second factor on the supply side was the
22 amount of gas held in storage. Gas withdrawn from
23 underground storage satisfies about 18 percent of
24 gas demand during the heating season. The volume
25 of gas in storage was at a relatively normal level

1 in the spring of 2000. However, gas prices began
2 to rise in the summer of 2000, and some storage
3 operators reduced their storage injections in an
4 expectation that prices would fall off.

5 Also, the demand for gas for electricity
6 generation was increasing in response to a hot
7 summer, reducing the volume of gas available for
8 storage. As a result, storage volumes in the late
9 summer and the early fall were running 8 to 10
10 percent behind normal based on the 5-year average,
11 and this deficit approached 30 percent by the end
12 of the year due to extremely heavy early winter
13 storage withdrawals.

14 The key variable on the demand side was
15 the weather. The summer of 2000 was significantly
16 warmer than normal, increasing the demand for air
17 conditioning and thus the demand for electricity.
18 Gas is being used increasingly for electricity
19 generation due to both economic and environmental
20 factors. The hot summer was followed by a very
21 cold, early winter. Energy demand switched from
22 air conditioning to heating as we moved into the
23 coldest November and December period on record.

24 An often overlooked demand factor is
25 economic activity. The economy was very strong for

1 most of 2000 with an annual GDP rate of 4.8 percent
2 in the first quarter and 5.6 percent in the second
3 quarter. This strong economic activity translated
4 into strong gas demand to fuel factories and
5 commercial establishments throughout the country.

6 Normally, the relatively high gas prices
7 that were experienced in mid 2000 would have
8 resulted in fuel switching from gas to oil and
9 large industrial establishments with dual fuel
10 capability. These large facilities switched back
11 and forth between gas and oil depending on the
12 relative fuel prices, thereby offering a price
13 relief valve when prices increase. However, oil
14 prices had roughly tripled from their level from 18
15 months earlier, and this relief valve was
16 effectively eliminated.

17 Finally, in addition to the supply and
18 demand fundamentals, there was a market factor that
19 further exacerbated the high prices of 2000 and
20 2001. The gas market is a real-time market traded
21 on the NYMEX in a very robust fashion.

22 There is very limited real-time
23 information regarding gas supply or demand on a
24 real-time basis. Thus, it tends to move on the
25 basis of incomplete information and speculation.

1 That real-time information that is available tends
2 to be overemphasized, gas storage information,
3 weather information, storm activity in the Gulf of
4 Mexico.

5 As indicated above, the gas market in 2000
6 became very tight and supply was struggling to keep
7 pace with demand. Speculation and overreaction to
8 incomplete market information at a time when the
9 market was very tight resulted in significant price
10 volatility.

11 Q. To what extent was weather a contributing
12 factor to the market conditions during the winter
13 of 2000-2001?

14 A. Weather was a critical factor. In fact,
15 it was the most important factor on the demand side
16 of the gas market equation. It was important both
17 in the summer of 2000 and the winter of 2000-2001.
18 The summer was warmer than normal, which increased
19 the demand for air conditioning, which in turn
20 increased the demand for natural gas to generate
21 electricity.

22 The winter was colder than normal,
23 particularly the early winter, driving up the
24 demand for gas as a heating source. These
25 increases in demand at a time when markets were

1 already tight and prices were relatively high
2 forced prices even higher.

3 Q. How warm was the summer of 2000?

4 A. On a national average basis it was about 7
5 percent warmer than normal. However, parts of the
6 south and west were 15 to 20 percent warmer than
7 normal. This is key because most of the
8 electricity generation that uses gas is located in
9 the South and the West. In addition to pushing up
10 the overall demand for gas, using gas for
11 electricity generation in the summer also diverts
12 gas that otherwise would be injected into storage.
13 When storage levels are lower than normal, as was
14 the case in the summer of 2000, market uncertainty
15 increases and prices tend to move higher.

16 Q. How cold was the winter of 2000-2001?

17 A. The winter of 2000-2001 was extreme by any
18 measure. In particular the early winter, November
19 and December, was the coldest on record on a
20 national basis. Not only was it cold, but it was
21 extremely cold, it was cold early and it was cold
22 everywhere. Oklahoma, Arkansas, Missouri all had
23 the coldest November and December on record.

24 Across the country the last two weeks of
25 November were 36 percent and 33 percent colder than

1 normal, respectively. Further, it was colder than
2 normal in all ten geographic regions during these
3 two weeks. Such uniform cold is very unusual.
4 Although temperatures moderated in January and
5 February, the damage with respect to gas prices was
6 already done.

7 Q. Were these general market conditions
8 isolated in specific geographic areas?

9 A. No. The natural gas market is in essence
10 a national market. The tight market and the high
11 prices were experienced in all parts of the
12 country. Consumers buying gas are essentially
13 paying for two things, the cost of the gas
14 commodity and the cost of delivering that gas to
15 them. The cost of the gas commodity went up
16 dramatically in 2000-2001 irrespective of where
17 that gas was consumed. The cost of gas delivery is
18 a function of distance and various operational
19 factors and thus it does vary by location.
20 However, delivery charges are regulated and they
21 did not fluctuate in 2000-2001 as did the commodity
22 charges.

23 Q. Have you or other employers of the
24 American Gas Association addressed the market
25 conditions of the 2000-2001 winter in the service

1 territories of other local gas utilities?

2 A. Yes. This is a national issue, and we
3 have addressed it in various forums all over the
4 country. We have spoken to legislators,
5 regulators, media and customer groups from
6 Louisiana to New York to Washington and California.
7 The problem was universal and it was extreme.

8 Q. What is your outlook for the near-term
9 natural gas market?

10 A. First, let me say that AGA does not
11 perform short-term price projections for antitrust
12 reasons. However, I can comment on some of the
13 factors that do affect gas prices.

14 The retreat in gas prices following the
15 2000-2001 winter was as dramatic as their rise.
16 Prices have been in the low two-dollar range for
17 several months now. We have moved from a situation
18 of high demand and low supply to one of low demand
19 and high supply. This situation is expected to
20 continue throughout 2002.

21 On the demand side, the economy remains
22 sluggish and expectations are that this will
23 continue for most of the year. In addition,
24 weather has been very mild, and the long-term
25 forecast of the National Oceanic and Atmospheric

1 Administration suggests that heating and cooling
2 demand in 2002 will be normal or less than normal.

3 The volume of gas in storage, one
4 barometer of the supply situation, remains at a
5 very high level. As of February 8, 2002, there was
6 43 percent more gas in storage than the prior five-
7 year average.

8 Given the economy and the weather
9 conditions, this surplus is expected to carry into
10 the 2002-2003 winter season, thus continuing
11 downward pressure on gas prices.

12 Q. Do you believe others share your view on
13 near-term market conditions?

14 A. Yes, I do. The short-term energy outlook
15 of the U.S. Energy Information Administration, EIA,
16 projects that wellhead gas prices will be less than
17 \$2 per thousand cubic feet for the second, third
18 and fourth quarters of 2002, and that they will
19 range from \$2.24 to \$2.76 for 2003. Similarly,
20 future gas prices on the NYMEX are in the high \$2
21 to low \$3 range for all of 2002 and 2003. These
22 prices are in short contrast to the \$10 peak we saw
23 last winter.

24 Q. How about natural gas prices in the longer
25 term?

1 A. Going out to 2010 I expect prices to
2 remain generally below four dollars. Between 2004
3 and 2010 I expect prices to move within a band of
4 two dollars to four dollars, although temporary
5 movements outside this band are certainly possible.

6 Q. And do other experts share this view, as
7 well?

8 A. I would say that in general, yes. While
9 there's certainly no unanimity in long-term energy
10 price projections, the long-term outlook of the EIA
11 projects wellhead gas prices of \$3.65 per thousand
12 cubic feet in 2010. We can also look at the NYMEX
13 prices and see that they do not exceed \$3.75 going
14 out to December of 2007. Prices are not available
15 beyond this point in time.

16 Q. Does this mean that natural gas market
17 conditions in the future can't repeat the 2000-2001
18 experience?

19 A. The prices we saw in the winter of
20 2000-2001 were extreme and attributable to a number
21 of factors that all came together at once as I
22 previously mentioned. Some refer to last winter as
23 a perfect storm scenario. A recurrence is
24 certainly not impossible but it is unlikely, and I
25 would certainly not use last winter as a baseline,

1 nor would I suggest that last winter was in any way
2 normal or representative of future likely market
3 conditions.

4 Q. One additional question. You referred
5 several times to the NYMEX price or NYMEX price at
6 the Henry Hub.

7 A. Yes.

8 Q. Could you just very briefly explain what
9 that means?

10 A. Well, if you look at the Exhibit PLW-1,
11 that shows the NYMEX Henry Hub futures. That's at
12 the specific dates that are indicated on the lower
13 axis, how much you could contract for gas 30 months
14 in advance and that there are buyers and sellers
15 willing to make a deal at that price at that point
16 in time.

17 Q. Does this complete your testimony?

18 A. Yes, it does.

19 MR. PEARCE: I have no further questions.

20 MR. HOBERG: Thank you, Mr. Pearce. Mr.
21 Binek, do you have any questions of Mr. Wilkinson?

22 MR. BINEK: Yes.

23 CROSS-EXAMINATION

24 BY MR. BINEK:

25 Q. Mr. Wilkinson, what is AGA?

1 A. AGA is American Gas Association. We
2 represent local gas utilities across the country.
3 We represent 187 local gas utilities that deliver
4 gas to 50 million -- 52 million residences and
5 commercial establishments throughout the country.

6 Q. What do you mean by you represent?

7 A. What do I -- we provide services to these
8 member companies based on their advocacy needs and
9 also their informational needs or other operational
10 needs.

11 Q. How are the operations of AGA financed?

12 A. They are financed based on the dues of
13 these member companies.

14 Q. Is MDU a member company?

15 A. Yes, it is.

16 Q. On page four of your surrebuttal
17 testimony, beginning on line three, you talk about
18 market conditions and market factors during the
19 winter of 2000-2001. One of the critical supply
20 side factors that you talked about was the serious
21 decline in drilling for gas. With the current
22 decline in natural gas prices has there also been a
23 decline in drilling activity?

24 A. There has been a decline. We are
25 currently a little under 800 rigs, so certainly

1 nowhere near the decline that we saw, the 300 to
2 400 range, back in '98, '99.

3 Q. And doesn't decreased drilling activity
4 generally occur with falling gas prices or low gas
5 prices?

6 A. Yes. There is a correlation between gas
7 prices and drilling activity.

8 Q. So if the low prices continue, would you
9 anticipate there will be a further decline in
10 drilling?

11 A. Well, low price is a relative term. There
12 was a period in 1999 where we had, I believe, nine
13 months in a row of gas prices between roughly \$1.50
14 and \$2, and right now we're at about \$2.30. So
15 prices are certainly low today relative to what
16 they were a year ago. They are certainly not low
17 relative to what we saw two years ago.

18 Q. Do you agree that most new electric-
19 generation facilities that have come on line or
20 that are being constructed are fueled with natural
21 gas?

22 A. Natural gas has been the fuel of choice in
23 recent years for new generating capacity.

24 Q. Won't that drive up the demand and price
25 for natural gas again?

1 A. Price is a function of supply and demand.
2 As demand increases to meet that load, if there was
3 not a -- an increase in supply of an equal amount,
4 prices would move upward. Certainly, increased
5 demand does mean upward price pressure to some
6 extent.

7 Q. Aren't many experts saying that economic
8 recovery has begun or will begin in the near
9 future?

10 A. I think that in general most economists
11 are saying that the economy is sluggish at best
12 through the end of this year.

13 Q. If the economy does rebound and we had the
14 projections from the last witness concerning
15 manufacturing projections and that showed that the
16 projections were increasing for 2001, won't that
17 drive up the demand and the price for natural gas?

18 A. Economic activity is one factor that
19 affects industrial gas demand. As industrial gas
20 demand goes up, there would be upward price
21 pressure until supply response.

22 Q. On page five of your surrebuttal -- or
23 your rebuttal testimony -- I guess it is
24 surrebuttal, beginning on line -- line eight of
25 your surrebuttal testimony, you state that the key

1 variable to the market conditions or market factors
2 during the 2000 -- during 2000-2001 was the
3 weather. Isn't it true that the unusually warm and
4 mild winter we're experiencing throughout most of
5 the United States at the present time has
6 contributed significantly to the current reduced
7 demand and lower prices of natural gas?

8 A. Yes, that's true.

9 Q. On page 6, line 18 of your surrebuttal
10 testimony you state weather was a critical factor.
11 In fact, it was the most important factor on the
12 demand side of the gas market equation. That
13 statement applies today just as it did in
14 2000-2001, doesn't it?

15 A. Weather is the critical variable,
16 particularly with respect to residential and
17 commercial markets.

18 MR. BINEK: Thank you. I have no further
19 questions.

20 MR. HOBERG: Thank you, Mr. Binek. Mr.
21 Fahn, any questions?

22 MR. FAHN: Yes.

23 EXAMINATION

24 BY MR. FAHN:

25 Q. On page six of the testimony -- of your

1 testimony you talk about market factor and you talk
2 about limited real-time information regarding gas
3 supply or demand, and I'm wondering if people that
4 are in the futures market -- that's what they're
5 seeing, right, limited real-time information?
6 They're making their decisions based on real-time
7 information?

8 A. Yes, I would agree with that.

9 Q. And I'm wondering if you could tell us
10 more about why you describe it as limited.

11 A. You cannot find information in the
12 marketplace today that tells you how much gas was
13 consumed last week or how much gas was produced
14 last week. You can -- you can find information on
15 how much gas was injected into storage last week.
16 So in terms -- because there is no supply demand
17 data available, other than on a monthly basis with
18 significant time lags, I think that there is an
19 overemphasis on that information which is
20 available. For example, you'll hear that there's a
21 storm coming into the Gulf and you'll see the NYMEX
22 shoot up as a reaction to that, when in fact most
23 of those rigs rarely stop operating, even in severe
24 storm conditions.

25 Q. I don't think you'll know the answer to my

1 next question, but I'll ask it anyway. Would you
2 think the same -- we have the same problem in the
3 electric business? The people that are buying
4 futures in the electric business, would they have
5 limited real-time information?

6 A. I'm really not an expert on that, so I
7 won't comment on it.

8 MR. FAHN: Thank you.

9 MR. HOBERG: Thank you, Mr. Fahn.

10 Commissioner Wefald, did you have any questions for
11 this witness?

12 COMMISSIONER WEFALD: Yes, I do, a couple
13 here.

14 EXAMINATION

15 BY COMMISSIONER WEFALD:

16 Q. Mr. Diller this morning in Exhibit 3 laid
17 out a whole group of factors that could affect
18 future resale margins.

19 A. Electricity.

20 Q. Do you have a copy of those?

21 A. No, I don't.

22 Q. Can you get a copy of those?

23 MR. HOBERG: Mr. Pearce, can you provide
24 him a copy of -- or somebody over there?

25 Q. (COMMISSIONER WEFALD CONTINUING) You

1 mentioned with natural gas that the key variable on
2 the demand side was weather. Do you think that's
3 the key variable in this list, as well, affecting
4 through to resale markets?

5 A. I don't want to portray myself on as an
6 expert on electricity markets, and so I really
7 would not speculate on that.

8 Q. All right. Why do you think you were
9 brought in today to be an expert? Because it's --
10 natural gas prices is only one of all of these
11 factors that's listed out of the 20-some factors.
12 Why do you think you were brought in today?

13 A. Well, I think that the assumption is, and
14 I think it's a correct assumption, that the amount
15 of electricity that can be sold into the market is
16 heavily dependent on the price of natural gas. If
17 you are a coal-based electric utility, then
18 certainly the price of natural gas going into your
19 competitors' boiler units is a critical factor. I
20 don't know whether it is the most critical factor
21 out of this list. This is a long list, but it's
22 certainly a very important factor.

23 Q. Is it more important than how much
24 generation capacity is available in the region?

25 A. I would say that they are both very

1 important factors.

2 Q. Is it more important than the role of
3 weather when you have -- let's say you have, you
4 know, a period of really high peak demand in the
5 middle of the summer and there's -- and you have a
6 real need for electricity. Is it more important
7 than weather?

8 A. Well, it -- it may be, but then the --
9 it's also reacting to weather.

10 Q. How about is it more important than plant
11 outages that occur? Let's say a whole bunch of
12 plants go down and there's a need for electricity
13 to avoid a brownout.

14 A. Probably not.

15 Q. So there's a bunch of different factors,
16 and you're here to just represent one of those --

17 A. That's correct.

18 Q. -- that could be important.

19 A. That's correct.

20 COMMISSIONER WEFALD: Thank you. That's
21 all.

22 MR. HOBERG: Thank you, Commissioner
23 Wefald. Commissioner Reinbold, please.

24 COMMISSIONER REINBOLD: I have a question.

25

1 EXAMINATION

2 BY COMMISSIONER REINBOLD:

3 Q. Do you know Eric Weiss?

4 A. Yes, I do.

5 COMMISSIONER REINBOLD: Well, that's a
6 point for you, and when you see him, you tell him I
7 got him into the transcript of a very big case.
8 That's my only question.

9 MR. HOBERG: Thank you, Commissioner.

10 COMMISSIONER REINBOLD: Oh, I have one
11 more question.

12 Q. (COMMISSIONER REINBOLD CONTINUING) Are
13 you on the stand tomorrow morning, too?

14 A. No, I don't think so.

15 Q. Are you done today?

16 A. I hope so.

17 COMMISSIONER WEFALD: Unless you've got a
18 bunch of questions.

19 COMMISSIONER REINBOLD: Oh, no, no, no.

20 COMMISSIONER CLARK: I haven't gone yet,
21 Commissioner Reinbold.

22 COMMISSIONER WEFALD: Commissioner Clark
23 may have a whole bunch of questions.

24 COMMISSIONER REINBOLD: Okay. We'll leave
25 it up to Commissioner Clark.

1 MR. HOBERG: Thank you, Commissioner
2 Reinbold. Commissioner Clark, please.

3 COMMISSIONER CLARK: I have no questions.
4 End of the suspense.

5 MR. HOBERG: Okay. Anything further of
6 Mr. Wilkinson, Mr. Pearce?

7 MR. PEARCE: No, I have none.

8 MR. HOBERG: Mr. Binek?

9 MR. BINEK: No.

10 MR. HOBERG: Mr. Fahn, anything further?

11 MR. FAHN: No.

12 MR. HOBERG: Okay. Thank you, Mr.
13 Wilkinson.

14 COMMISSIONER REINBOLD: Excuse me. I've
15 got one more question to ask you.

16 Q. (COMMISSIONER REINBOLD CONTINUING) Is
17 this your first trip to North Dakota?

18 A. Yes, it is.

19 Q. How do you like it? We put on a little
20 blizzard for you.

21 A. I appreciate that.

22 COMMISSIONER REINBOLD: Good to have you
23 here.

24 THE WITNESS: Thank you.

25 MR. HOBERG: Okay. Thank you, Mr.

1 Wilkinson --

2 COMMISSIONER WEFALD: And we also ordered
3 up some cold weather for him.

4 COMMISSIONER REINBOLD: That's right.

5 MR. HOBERG: Okay. Does it look like
6 quitting time until tomorrow? Approximately what?

7 COMMISSIONER WEFALD: Should we say 8:30?

8 MR. HOBERG: 8:30, is that fine?

9 MR. PEARCE: That's find with us.

10 COMMISSIONER WEFALD: Would that be okay,
11 Commissioner Reinbold?

12 COMMISSIONER REINBOLD: 8:30 tomorrow,
13 fine.

14 MR. HOBERG: Okay. We'll stand in recess
15 then until 8:30 tomorrow when we'll continue with
16 MDU's case, and that will be your third witness
17 then.

18 MR. PEARCE: Right.

19 MR. HOBERG: Okay. We'll stand in recess.

20 (Recessed at 5:02 p.m., Monday, the 25th
21 day of February, 2002.)

22

23

24

25

