

**STATE OF NORTH DAKOTA**  
**BEFORE THE PUBLIC SERVICE COMMISSION**

**Montana-Dakota Utilities Co., a**  
**Division of MDU Resources Group, Inc.**  
**Electric Rates Investigation**

**Case No. PU-399-**  
**01-186**

**BRIEF OF MONTANA-DAKOTA UTILITIES CO.**

**Introduction**

This proceeding was initiated by the filing of a complaint by the North Dakota Public Service Commission Staff [hereinafter the AStaff@], seeking to have the Commission order a reduction in Montana-Dakota=s North Dakota electric rates. As the moving party in this proceeding, the Staff therefore has the burden of proof, as well as the burden of going forward with the evidence, as the Administrative Law Judge pointed out:

The burden of proof today is on the complainant, the PSC staff, to show by the preponderance or the greater weight of the evidence that in the public interest MDU=s electric service rate should be changed to reduce annual revenues by 9.155 million, or to show that other administrative action as a result of the staff complaint is appropriate.@ [Tr. p. 12]

The complainant=s burden of proof is the same in an administrative proceeding as in a judicial proceeding. Morrell v. North Dakota Department of Transportation, 598 N.W.2d 111 (ND 1999), Kobilansky v. Liffrig, 358 N.W.2d 781 (ND 1984).

Since the Staff bears the burden of proof, the Commission may adopt the Staff position only

if it has presented substantial evidence in support of the position, and that evidence must have been a preponderance of the entire evidence in the record. Prairieview Nursing Home v. North Dakota Department of Human Services, 598 N.W.2d 116 (ND 1999); Wahl v. Morton County Social Services, 574 N.W.2d 859 (ND 1998). The Commission's decision must be such that a reasoning mind could reasonably have determined the factual conclusions reached were proved by the weight of the evidence in the record. Application of Skjonsby Truck Line, Inc., 357 N.W.2d 227 (ND 1984); Ganske v. North Dakota Workmen's Compensation Bureau, 355 N.W.2d 800 (ND 1984). This is a higher standard than the "clearly erroneous" test, which has no application to review of administrative agency findings of fact. O'Brien v. North Dakota Workmen's Compensation Bureau, 222 N.W.2d 379 (ND 1974). The Commission's conclusions of law and order must then be sustained by findings of fact that have been proved by the weight of the evidence. Bank of Hamilton v. State Banking Board, 236 N.W.2d 921 (ND 1975).

The written testimony initially filed in this matter by the Staff raised a number of issues pertaining to adjustments to rate base, allowable operating expenses, revenues from wholesale electric sales and resulting margins, and the cost of capital (permitted rate of return on rate base). As a result of the submission of Montana-Dakota's written direct testimony, followed by the submission of the Staff's written rebuttal testimony and Montana-Dakota's written surrebuttal testimony, certain of these issues were eliminated. In particular, there are no remaining issues with regard to the amount of the test year rate base. [Tr. p. 23]. Accordingly, this brief addresses only the remaining issues that are disputed between the parties.

## I. Wholesale Electric Sales Margins

The issue of Montana-Dakota's margins on wholesale sales of electric power constitutes, as Staff witness Mike Diller pointed out, most of the case. [Tr. p. 30]. Montana-Dakota introduced clear expert evidence showing that the margins earned through wholesale electric power sales (sometimes referred to as sales for resale margins) during the 2001 test year, as well as during the original proposed 2000 test year, arose from anomalies in the wholesale electric market that would not recur in 2002 or in any foreseeable succeeding year. The record is completely devoid of any evidence, however, in support of the Staff's use of the 2001 level of sales for resale margins, or the average of the sales for resale margins for the last three years (as proposed by Mr. Diller in testimony during the hearing; Tr. p. 34-35), as a proxy for determining the amount of such margins likely to be generated by wholesale sales in 2002. Not only is there no substantial evidence to support the Staff's position; there is none. Mr. Diller admitted that Montana-Dakota had presented a substantial amount of evidence in support of all of the factors that determine future resale margins and that he thought they were pretty good [Tr. p. 33]. He dismissed all of this evidence, however, with the unsupported observation that I think the uncertainties of the future warrant the consideration of actual results as a proxy for future rates. [Tr. p. 34]. The fundamental fallacy of this reasoning is that the actual results Mr. Diller relied upon are the 2001 wholesale electric margins which Montana-Dakota's unrefuted evidence showed arose from highly unusual market conditions that would not recur in succeeding years.

Mr. Diller conceded that the market factors testified to by Montana-Dakota all affect the price of electricity, and therefore the resale margins, but then concluded that it is difficult to determine to what degree such things will have on future off-system sales or the price of those sales. A fair bit of

judgment will be required by the commission to decide this issue@ [Ex. 4, p. 8]. The Commission must always exercise its informed judgment in weighing the evidence in the record in reaching its conclusion, of course, but here the Staff offered no evidence whatsoever on which the Commission can reach a conclusion. There must be evidence on which the Commission can base its decision, as an agency decision without a rational basis in the record is arbitrary and capricious. Tri-County Electric Coop., Inc. v. Elkin, 224 N.W.2d 785 (N.D. 1974).

The undisputed testimony of Montana-Dakota=s witness Terry Blinsky showed that the reason for the abnormally high resale margins achieved in 2001 was that high electric prices had been locked in under the terms of a contract signed in March 2001, based on future prices then in effect for the summer peak season, even though prices actually in effect later in 2001 were declining:

AVery simply, the reason that sales for resale margins remained up in 2001 was that Montana-Dakota was successful in entering into a contract with a buyer in March 2001 that covered the summer season of 2001. At the time the contract was executed, prices of gas and electricity were still relatively high and the buyer agreed to pay essentially the future price that existed at the time the contract was executed. Thus even though electric prices fell during 2001, as did the gas price, the revenues received by Montana-Dakota were dictated by the contract and the buyer was obligated to pay the contract price rather than the current price at the time of delivery. Absent this contractual arrangement, Montana-Dakota would not have been able to retain the margins it did in 2001.@ [Tr. p. 348-49]

All of the evidence in the record shows that this condition will not be repeated in the foreseeable future. Montana-Dakota=s witness Roger Schiffman testified in discussing the 2001

contract, that under current market conditions contracting opportunities such as that enjoyed by Montana-Dakota are no longer available because the premium between contract and spot market prices is substantially smaller. ... The price spikes we experienced recently in the winter of 2000-2001 were clearly an anomaly. @ [Tr. p. 286]. Those market conditions are influenced by weather, fuel prices, economic growth, generation mix, and the supply-demand balance [which] all play important roles in defining trends in the broader wholesale power markets. @ [Tr. p. 279] AThe Staff offered no evidence to refute Mr. Schiffman's conclusion that a variety of unusual market factors had resulted in abnormally high profit margins for coal-fired generators throughout the first months of 2001" when this contract was entered into. [Tr. p. 288]. The outlook for 2002 and the foreseeable future is for a much less profitable scenario for off-system sales:

This combination of factors points to lower and more stable wholesale electricity prices in the MAPP region for 2002 compared to the price and volatility levels seen over the last four years and particularly during the first half of 2001. ... With lower and more stable natural gas and electricity prices, profit margins on off-system sales will be correspondingly lower. ... Montana-Dakota will face greater competition for off-system sales.

...

In summary, market conditions toward the end of 2001 are significantly more representative of what can be expected in 2002 and for the foreseeable future. @ [Tr. p. 290-292]

Not only will the profit margins decrease, but also the volumes of wholesale electric power that can be marketed will most likely be less in the future than in 2000 and 2001. As Mr. Schiffman further pointed out:

AWith lagging electricity sales due to the current economic downturn, that competition will only be greater and Montana-Dakota might face reduced volumes of off-system sales, in addition to lower profit margins on those sales. @ [Tr. p. 291-92]

For this reason the margins from wholesale sales projected by Mr. Blinksy are in fact probably higher than can actually be achieved, since those projections are based on the same future wholesale sale volumes being achieved as were actually achieved in the last twelve months prior to this hearing. [Ex. 10]. Montana-Dakota has no contracts for off-system sales in place now or for the upcoming peak summer season, in stark contrast with the situation a year ago in March 2001 when the very favorable contract was in place. [Tr. p. 350].

None of the evidence was refuted and there is therefore simply no basis for ignoring all of the changes in the wholesale electric sales markets. Nor is there any evidence that the anomalous scenario that was in place during 2000 and 2001 is a realistic model for what will happen from this point on. Montana-Dakota presented testimony through both Mr. Schiffman and Mr. Blinsky as to what the most probable level of current prices is likely to be, based on the best indicators available. These are the nationally recognized futures markets referred to as the NYMEX and the Intercontinental Exchange. Futures markets provide a reasonable method for projecting the wholesale price of electricity at any given time into the future. For example, the March 2001 NYMEX futures prices formed the basis for the 2001 summer peak prices built into the contract which Montana-Dakota entered into in March 2001. In March 2001, those projected prices were the best indicator of what wholesale electric prices would be during the future period in which the contract would be in effect. [Tr. p. 348-49]. Projecting energy prices into the future, as Mr. Schiffman stated, is not a simple matter, but the established futures markets provide a basis for doing this:

“Forecasting energy market prices is always a difficult exercise, and using the prices of currently traded future contracts is a reasonable way to assess current market expectations of spot market prices that will prevail during the relevant months of

2002.@ [Tr. p. 292]

As Mr. Blinsky pointed out, the use of futures prices are appropriate because they represent the prices of actual transactions between willing sellers and willing buyers and therefore are used as a guide by market participants when buying or selling energy.@ [Tr. p. 354]. As a check on the NYMEX futures prices which Mr. Blinsky used in projecting future wholesales margins, he made a comparison with the margins that would be predicted by using the Intercontinental Exchange Prices, which had been testified to by Mr. Schiffman [Ex. 9]. The result was a projected 2002 margin of \$6,080,199, which is strikingly close to the \$6,428,778 margin projected using the NYMEX futures. The close correspondence between the two methods underscores the inherent reliability of this approach to projecting future wholesale prices. No other evidence was introduced in support of future wholesale electric price levels and this is clearly the evidence of what kinds of margins Montana-Dakota can be expected to achieve in the future. Experience has now borne this out, as Montana-Dakota=s actual wholesale sales margins for the first quarter of 2002 were \$1.6 million. Annualizing this level gives a twelve-month total of \$6.4 million, which is essentially the 2002 projected level testified to by Mr. Blinsky. [Tr. p. 353].

## **II. Cost of Capital**

The testimony of Montana-Dakota=s expert witness J. Stephen Gaske showed that the weighted cost of capital, that is the allowed rate of return on the rate base which should be approved in this proceeding, is 10.70%. The weighted cost of capital includes the usual elements of equity capital, long-term debt and preferred stock. There is no dispute in this matter as to the 4.63% cost of Montana-Dakota=s preferred stock, which accounts for 5.23% of the capital structure.

## Long-Term Debt

Dr. Gaske, however, testified that the true cost of Montana-Dakota's long-term debt is 9.22%, as opposed to the 8.62% cost of long-term debt testified to by the Staff's expert witness Charles King. The 9.22% level was derived by the use of the yield-to-maturity method, which this Commission has approved as the proper methodology and which is required to be used by FERC in rate proceedings under its jurisdiction. Mr. King utilized the accounting approach to derive his 8.62% for the sole reason that he deemed that Montana-Dakota's cost of long-term debt is way out of line with that of other utilities.<sup>6</sup> [Tr. p. 94-5]. Mr. King's conclusion is based solely on his comparisons with embedded debt costs of the two other public utilities that serve electric customers in North Dakota (Xcel Energy, Inc. - 6.99%, and Otter Tail Power Company - 7.68%). No evidence was offered, however, as to why the debt costs of these two utilities are at these particular levels and no meaningful comparison can be made among utility cost of debt capital levels without examining the makeup and timing of the specific debt capital structures. Montana-Dakota, on the contrary, presented undisputed evidence as to why its debt cost is at the level it is, resulting primarily from debt originally issued in connection with the construction of the Coyote electric generating facility late in the 1970's, at a time when debt costs were high. There has been no suggestion that the Coyote Plant investment was not a prudent one or that it has not provided good service, but it was constructed at a time of high cost financing, as Dr. Gaske pointed out:

AThey [Montana-Dakota] were building an electric plant, and anyone who remembers that time period remembers that very suddenly interest rates went to extremely high levels and stayed there through the early Eighties.... So the company had a very large need for financing at the same time that interest rates were very high. It issued a very high cost debt at that time ... The plant is still in service. It provides, as I understand, very economical service to the ratepayers, but the fact of the matter is that plant was built at a high cost in terms of what they had pay for interest at the

time.@ [Tr. p. 158-59]

Montana-Dakota=s witness Douglass Mahowald demonstrated how the Company has continued to act prudently and in the public interest to reduce its embedded debt cost by refinancing if, and whenever, any savings in cost can be achieved. If the market conditions at any time are such that debt costs can be saved by refinancing, the Company does so. Thus, for example, in 1992 Montana-Dakota refinanced its long-term debt because it was able to achieve an annual savings of \$231,500. [Tr. p. 371-72]. Conversely, if the market conditions are such that the total cost of debt after a refinancing, including the necessary cost of reacquiring the old debt, would be higher than the existing cost, it would clearly not be prudent to refinance the debt simply to obtain a lower coupon rate, because the actual total cost would be higher. In that case refinancing would be not be in the public interest and therefore the Company would not do it. [Tr. p. 373-74]. As Dr. Gaske pointed out:

AThe real issue with regard to the debt cost has to do with reacquisition costs ... The company refinanced in 1986 to get the cost down, and B but they still had high cost debt that in 1992 they again refinanced. So what you really see on the books of Montana-Dakota today is B are debt costs that are right in line with everybody else except for the fact that they have some high reacquisition costs that have been carried over quite a number of years and really from a time period that they needed to build a new plant and raise a lot of money at high interest rates.

....

When you look at the overall circumstances and delve into them a little bit .. you find that their debt costs are perfectly reasonable considering the circumstances under which they were incurred.@ [Tr. p. 158-59]

Mr. King stated that he did A not understand why it would be impossible for this company [Montana-Dakota] to reduce its debt costs.@ [Tr. p. 96]. The evidence presented by the Company demonstrated why that is impossible and that Montana-Dakota continuously attempts to keep its debt costs as low as possible. In fact, all of the Montana-Dakota debt issues that have occurred since the

1992 refinancing of the original high cost debt from the 1970's have an average cost of 7.31%, comparable to the debt costs for Xcel Energy and Otter Tail Power which were the basis for Mr. King's comparisons. [Tr. p. 157]. Once the reacquisition costs of the early high-cost debt are fully accounted for, as Dr. Gaske pointed out, Montana-Dakota's debt costs will be similar to those of the other utilities serving North Dakota:

AAAt some point in the future as the reacquisition costs are paid down and the current debt that those reacquisition costs are associated with, as that disappears off their books, they will B their costs will drop down to a level that=s probably commensurate with everybody else.@ [Tr. p. 160]

### Equity Capital

#### Comparable Companies

Dr. Gaske also testified that the appropriate cost of equity capital is 12.75%, whereas Mr. King's testimony was that the appropriate rate is 11.7%. The primary points of difference between these two figures arise from the use of a flotation cost adjustment by Dr. Gaske and his use of both combination utilities (gas and electric) and electric-only utilities in his comparable company analysis, as long as the companies derive at least 75% of their revenue from electric operations [Tr. p. 164], whereas Mr. King eliminated electric-only utilities. The basis for Mr. King's approach is that he believes that the risk for combination companies like Montana-Dakota is less than the risk for electric-only companies, thereby justifying a lower rate of return for the less risky company. It is submitted that Dr. Gaske's analysis is the more reasonable: That the typical investor will assess the risks of the electric operations if he is investing in the hope of making a given return on electric operations and similarly will assess the risks of the gas operations if he is investing in the hope of making a given return on gas operations, and that these risks will be analyzed separately:

Now one of the points he [Mr. King] makes is that, well gas and electric compete with each other, and therefore if the same company owns both, it really is indifferent as to what happens and that somehow reduces the risk of investing in one or the other. That=s not true for several reasons.

First, and by far the most important one, is the fact that when you sit down and you try to B to decide whether to invest in, say, a new generating plant or a transmission line, you look at the risks that that faces. You look at the electric market, you look at competitive alternatives, and you make the investment.

If the investment later goes bad and you lose your money, you know, that=s part of the risk, but it=s the risk of the electric operation that you=re considering when you make your electric investment. It=s not the risk of the combination company, because when you=re investing in the gas business, you sit down separately and say, what=s the risk of investing in the gas business, and you make investments there, and they may or may not pan out.@ [Tr. p. 167-68]

Accordingly, Dr. Gaske=s use of both combination companies and electric-only companies provides an appropriate group of comparable companies, and his requirement that his comparable companies derive at least 75% of their revenues from electric operations assures that his group of companies is appropriate as a basis of comparison with Montana-Dakota. The 75% requirement assures that the comparison companies will be tend to be in the same market situation as Montana-Dakota:

AThe issue in this case B I mean, the really big issue is this case is the sales for resale by Montana-Dakota, and if you=re looking for companies that are comparable to Montana-Dakota, I can=t think of a company that would be more comparable than one that is making sales for resale, in addition to having a high percentage of their revenues in the electric business.@ [Tr. p. 170]

#### Flotation Cost

The basis for allowing a rate of return on equity capital, often referred to as the cost of equity capital, is that a utility company should be in a position to be able to raise equity capital by issuing common stock at any time. The generally accepted method for determining the proper cost of equity capital is the DCF (discounted cash flow) analysis employed by the expert witnesses for both Montana-Dakota and the Staff. That method is based on the premise that the stock price must be

sufficiently above book value that stock can be issued without diluting the value of existing shareholders' investments, and this requires the inclusion of an allowance for the flotation cost, that is the cost associated with issuing stock (underwriting commissions, filing fees, etc.) that reduce the net proceeds of issuance below the total amount actually received. As Dr. Gaske points out, this means that if the proceeds on a issue are 91 percent of market price, the agency should maintain market price at about 110 percent of book value [*i.e.* 1/91%]. (quoting from Gordon, The Cost of Capital to a Public Utility, p. 165-66 (1974)) [Ex. 7, JSG 3, p. 8].

This goal can only be achieved if the flotation cost adjustment is applied to the entire rate of return, and the appropriate adjustment, as testified by Dr. Gaske, is approximately 4.75 percent:

The experience of other electric companies suggests that a flotation cost adjustment of 4.75 percent is required to ensure that the allowed rate of return is sufficient to attract capital on reasonable terms. [Ex. 7, JSG 3, p. 7-8]

A rate of return which does not include the flotation cost adjustment, amounting to approximately \$363,000 in this case, is necessarily inadequate. [Tr. p. 172, 176].

### **III. Operating Expenses**

#### Supplemental Income Security Program

Montana-Dakota introduced evidence showing that the portion of the annual cost of its Supplemental Income Security Program (SISP) allocable to North Dakota electric operations is \$683,000. The SISP program is a supplemental pension benefit designed to attract and retain key employees. These kinds of programs, which have in the last few years become commonplace in the utility industry due to changes in federal regulations pertaining to retirement benefits and Social Security benefits, are essential in order to

attract, retain and provide equitable benefits for key employees.© [Tr. p. 410]. The costs associated with providing the SISP program are therefore just and reasonable expenses incurred in providing high quality utility service to Montana-Dakota=s customers and should be allowed as operating expenses. As the Company=s witness Richard Espeland summarized:

AThe SISP is a common type of benefit provided in today=s business environment. The combined replacement income from all retirement plans when taken together is equitable, reasonable and justifiable. The SISP recognizes the contributions of key employees whose abilities and vision have enabled Montana-Dakota to streamline operations, reduce costs and employee numbers, implement new technologies and, more importantly to the ratepayer, to keep Montana-Dakota=s electric rates at 1987 levels at a time when the Consumer Price Index rose 59 percent during the same period of time.© [Tr. p. 414-15].

#### Office Supplies Expense

The evidence offered by the Staff noted what it deemed to be an abnormally high level of office supplies expense in 2001, and accordingly Staff proposed using a figure representing a 5 percent increase over the 2000 level, rather than the actual 2001 level, resulting in a proposed disallowance of \$678,000 in 2001 expenses. The undisputed evidence presented by Montana-Dakota, however, shows that the 2001 increase resulted from costs associated with a corporate aircraft, increased costs for computer infrastructure and telephone expense, as well as some reclassification of fees from other accounts, all of which will be continuing costs on a year-to-year basis, rather than one-time increases experienced only in 2001. There was no evidence offered to suggest that these costs were unreasonably or imprudently incurred and therefore they should be allowed as increased operating expenses.

**CONCLUSION**

The great preponderance of the evidence in the record demonstrates that there is no basis for a reduction in revenues for Montana-Dakota=s electric operations in North Dakota and therefore the complaint should be dismissed.

Dated April 2, 2002.

**Montana-Dakota Utilities Co.**

By

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