

STATE OF NORTH DAKOTA
PUBLIC SERVICE COMMISSION

Montana-Dakota Utilities Co.
2000 Electric Operations
Annual Report

Case No. PU-399-01-186

STAFF RESPONSE TO BRIEF OF MONTANA-DAKOTA UTILITIES CO.

At the conclusion of the hearing in this proceeding, the Public Service Commission (Commission) requested that both Montana-Dakota Utilities Co. (MDU) and the Public Service Commission Advocacy Staff (Staff) submit proposed Findings of Fact, Conclusions of Law and Order for the Commission's consideration. No request was made for the filing of briefs.

On April 2, 2002, both the Staff and MDU filed proposed Findings of Fact, Conclusions of Law and Order, but in addition, MDU filed a brief in support of its position. Consequently, Staff is compelled to file a short response to MDU's brief.

Staff does not disagree with MDU's arguments concerning the law that is applicable in this case. Staff does disagree with MDU's assertions as to the evidence or lack of evidence presented by Staff.

Wholesale Electric Sales Margins

MDU asserts that Staff presented no evidence to support its position concerning wholesale electric sales margins. That assertion by MDU is erroneous. Staff proposed that the Commission use a three-year average of **actual** sales for resale to establish the level of resale margins. Staff's rebuttal Exhibit MRD-1 depicts sales margins that have

been growing for the past six years. MDU, on the other hand, basically argues that the Commission should rely on the futures market to **project** future resale margins.

Staff presented evidence of **actual** sales that have been made over the past several years to support its position. MDU used future estimates and projections to support its position. In addition, Staff identified 28 factors affecting future resale margins from the testimony of MDU's ten witnesses. One of the factors listed by Staff includes "new generation capacity." If price is determined by supply and demand principles discussed in this case, new electric supplies to meet new demand are critical to the long-term pricing of electricity. According to MDU's representation, the Mid-American Power Pool (MAPP) forecasts excess capacity in the future. However, Exhibit 11 entered in the record shows that the North American Electric Reliability Council suggests that the MAPP capacity is inadequate for the time period of 2001-2010. This evidence contradicts the evidence submitted by MDU concerning the opportunities for resale sales in the future.

Both Staff and MDU pointed out numerous factors that may affect the future price of electricity. One of the most important factors is the price of natural gas. A natural gas issue of considerable importance is the effect of decreased drilling activity on the supply and price of natural gas. One or more of MDU's expert witnesses acknowledged that there currently is a decline in drilling activity, that most new electric generating capacity that has come on line or is being constructed is fueled by natural gas, and that the increased demand for natural gas means an upward pressure on natural gas prices.

Staff agrees that futures prices is one of the tools that may be used to estimate the future cost of electricity, but it is only one of several tools that may and should be employed by the Commission in rendering an overall decision in this case.

Cost of Capital

Staff argued that the weighted cost of capital should be 9.92%, and that the return on common equity should be set at 11.7%. Staff also recommends that the overall cost of long-term debt should be 8.62%. MDU argued that the weighted cost of capital should be 10.7%, and that the return on common equity should be set at 12.75%. MDU's proposed overall cost of long-term debt is 9.22%.

MDU acknowledged that in Public Utilities Reports annual survey of returns on equity granted by state agencies over the most recent one year period reported, out of 45 companies listed, only three companies were granted returns on equity that were equal to or higher than MDU's proposed 12.75%, and only 11 out of the 45 companies were granted returns on equity that were higher than the Staff's proposed 11.7%.

Long Term Debt

Staff argued that MDU's reported cost of debt since 1988 remains significantly higher than the cost reported by the other two investor owned electric companies operating in North Dakota, and that little progress has been made by MDU to bring its costs down to a level competitive with the other investor owned electric companies operating in North Dakota. MDU argued that differences in the cost of debt are due to timing of financing needs and therefore are often explained by the vintage of the debt obligations.

Staff argued for an accounting-based cost of debt. Staff recommended that debt issuance and redemption costs be amortized over the life of the debt issues, which results in MDU recovering all of its costs. Staff noted that the Commission utilized an accounting-based cost of debt calculation in Northern States Power Company's last rate case application. Using an accounting-based cost, Staff argued that MDU's cost of debt is 8.62%.

MDU argued for a "yield-to-maturity" cost of debt calculation. MDU's position is that the yield to maturity calculation gives consideration to the time value of money. Accordingly, the yield to maturity calculation results in a higher cost of debt or 9.22%.

The time value of money was not considered with respect to other expenses included in the test year. Staff testified that cash working capital is a calculated level of cash needed to pay ongoing expenses and that because revenues are often collected in advance of expenses, it can be a source of cost free capital. Staff testified that the Commission's practice with MDU has been to disallow cash working capital absent a lead-lag study. Staff pointed out that past Commission decisions have resulted in reducing rate bases of Otter Tail Power Company and Northern States Power Company for cash working capital and that its inclusion typically has benefited North Dakota ratepayers in other cases. Staff's position is that absent a lead-lag study, it is unwarranted and unfair to include the time value of money for debt issuance and redemption costs.

MDU's cost of debt remains significantly higher than the other investor owned utilities operating in North Dakota despite Staff's reduction of the \$40 million four day loan that had been carried on MDU's books.

Comparable Companies

Staff used a DCF analysis to estimate the cost of common equity. Staff identified eight comparable combination (gas and electric) utility companies' dividends and growth estimates for estimating the return required on MDU's common equity. Staff used an "interest rate risk premium" check to test DCF conclusions for reasonableness.

Using a different set of criteria, MDU utilized twelve companies including both electric only and combination companies for its DCF analysis. The different criteria resulted in MDU discarding four combination companies identified by Staff and adding others. MDU used a risk premium approach known as the Ibbotson & Sinquefeld study and also the "alternative equity investment approach" to test its DCF conclusions for reasonableness.

Staff argued that the comparison companies should be comprised of combination gas and electric companies because MDU is a combination gas and electric utility company. Montana-Dakota Utilities Co. is a division of Montana-Dakota Resources Group, Inc. As such, any common stock issuance or dividend paid is done so by Montana-Dakota Resources Group, Inc., a combination gas and electric company.

Flotation Costs

Flotation costs are the costs associated with issuing new common equity capital. Staff argued that flotation costs should be excluded. MDU argued that the stock price must be sufficiently above book value so that stock can be issued without diluting the value of existing shareholders' investments.

Staff conducted a review of flotation costs actually incurred during the past five years. Staff found that the actual costs were immaterial and lost in the rounding when

applied to the return required on common equity. As a result, Staff did not include any flotation costs in its return on equity calculation.

MDU did not use actual expenditures in making its calculations. Instead, MDU argued for the inclusion of a theoretical cost of issuing common equity based on a sampling of electric companies during 1996-2000. MDU's theoretical flotation cost of 4.75% for new equity is then used to inflate the estimated return on equity. Staff believes that MDU's position includes enough flotation costs that MDU could reissue all of its common equity annually at the expense of ratepayers. MDU agreed that most regulatory commissions do not allow flotation costs.

Operating Expenses

MDU's brief discusses two issues under the Operating Expense category. Those issues relate to the Supplemental Income Security Program (SISP) and Office Supplies Expense. Staff includes in this brief a discussion of salaries.

Supplemental Income Security Program

MDU argued for the inclusion of expenses associated with SISP. MDU argued that the plan provides a supplemental pension benefit to key employees. MDU further argued that the benefit is necessary to attract and retain high quality Staff in a number of key positions within the company.

Staff argued strenuously against the inclusion of SISP in ratemaking expense. Staff argued that MDU's plan lacks symmetry and pointed out that the SISP benefits are heavily weighted in favor of the high-end salaried employees participating in the plan. Staff noted that only 27 employees of MDU's gas and electric employees are considered to be key employees. Staff characterized SISP as a double pension for

MDU's few key employees and referenced the Enron debacle regarding the payments it made to key employees. Staff observed that one of the Congressmen in the Enron hearings stated that the payments to key employees looked like management taking care of itself.

Staff opposed spending a million dollars a year (\$683,000 North Dakota share) for the benefit of a few employees. In addition to SISF, these key employees are paid a minimum of \$75,000 to \$80,000 per year according to MDU and participate in all the other benefits offered to regular employees such as health insurance, life insurance, 401k participation, profit sharing plans, incentive plans, defined benefit plans, social security and discounted gas and electric service for those living in MDU's service territory.

Staff stated and MDU agreed that while the plan has been in effect since 1982, the company has never sought rate recovery in any electric or gas rate case until now.

Office Supplies Expense

Staff's position is that the types of expenditures included in office supplies expense are controllable expenditures. Staff contended that with regard to these types of expenditures, MDU is not all that different from the Commission. Staff stated, for example, that there are some years when the Commission spends a lot of money on computer software and hardware upgrades, but there are also years when that is not the case because of budgetary constraints. Staff argued that it is unreasonable to assume that one extremely high cost year is representative of future expense levels. Staff's position is that controllable costs can be controlled and the Commission should order a reasonable and normal level of office supplies expense.

MDU's position is that the 2001 increase resulted from expenditures that will be continuing on a year-to-year basis rather than one-time increases. Staff supported a 5% increase from actual year 2000 expenses as being a reasonable office expense level. Staff pointed out that annual office supplies expense normally runs from \$1.8 million to \$2.1, but actual expenditures for 2001 were reported at \$2.9 million.

Salaries

Staff noted a significant increase in the salaries account of A&G expenses. Staff pointed out that no exception was taken to the expense level as Staff assumed that the difference was due to different levels of salary capitalization from one year to the next. Under cross-examination, MDU witness, Donald Ball, was not sure why A&G salaries increased so much but thought it had to do with the capitalization differences as well. MDU agreed to research the difference and file Late Filed Exhibit No. 19. Late Filed Exhibit No. 19 discloses that most of the difference resulted from the payment of higher bonuses and commissions (\$635,765 on a total electric company basis). Staff did not make an adjustment to salaries expense at the hearing, as this information was not known until after the hearing. However, the Late Filed Exhibit No. 19 is in the record as evidence in the case and should be considered by the Commission in making its decision. Staff believes that the bonus and commission increase from \$581,509 to \$1,217,274 is unwarranted and unreasonable.

Conclusion

One of the major issues in this case relates to wholesale electric sales margins. Staff presented evidence of actual sales that have occurred over the past several years to support its position that MDU's rates should be reduced. Staff recognized that

changes in the economy may impact future sales, and for that reason recommended that the Commission use a three-year average of actual sales to establish the level of resale margins. MDU proposes that the Commission rely the futures market to project future resale margins. Staff's evidence in the case is based on **actual** sales whereas MDU's evidence is based on **assumptions** and **projections**.

Another major issue is cost of capital. MDU's proposed return on common equity is 12.75%. MDU acknowledged that in Public Utilities Reports annual survey of returns on equity granted by state agencies over the most recent one year period reported, out of 45 companies listed, only three companies were granted returns on equity that were equal to or higher than MDU's proposed 12.75%, and only 11 out of the 45 companies were granted returns on equity that were higher than the Staff's proposed 11.7%. MDU's long-term debt is excessive when compared to other investor owned utilities operating in North Dakota. Flotation costs are unnecessary and should be disallowed.

The operating expenses should be reduced as recommended by Staff. The Supplemental Income Security Plan is a supplemental benefit available to only a few of MDU's highly paid employees. This is a costly plan (\$683,000 North Dakota share) that has been in place since 1982, and until now has been paid for by MDU's shareholders. If MDU wants to continue this plan, it should continue to be paid for by the shareholders. The burden of paying for SISP benefits should not be shifted to MDU's ratepayers. The salaries expense item should also be reduced as a result of the disclosure in MDU's Late Filed Exhibit No. 19 which shows that most of the increase in salaries expense was a result of total company bonus and commission increase from \$581,509 to \$1,217,274. This increase is unwarranted and unreasonable.

Staff's position is supported by evidence and reason. The Commission should reduce MDU's rates in accordance with Staff's recommendations.

Dated April 4, 2002.

Respectfully submitted,

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