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August 24, 2007

VIA FEDERAL EXPRESS & EMAIL

Illona Jeffcoat-Sacco
Executive Secretary
North Dakota Public Service Commission
State Capitol
Bismarck, ND 58505

Re: Montana Dakota Utilities Co., and Otter Tail Corporation; Advance Determination of Prudence, Big Stone II Generating Station
Case Nos. PU-06-481 and PU-06-482

Dear Ms. Jeffcoat-Sacco:

On August 15 and 22, Applicants had the opportunity to attend and also listen via the internet to the Commission's working sessions in the above matter. One issue over which there appears considerable uncertainty is the appropriate standard for the Commission to apply in this case. The Applicants respectfully request that the Commission consider the following comments with respect to this issue.

As both Applicants and Advocacy Staff have submitted, the appropriate standard is the "reasonable person" standard. This is the accepted prudence review standard followed by the Federal Energy Regulatory Commission as pointed out by Applicants, and by state public utility commissions as pointed out by Advocacy Staff.[1] While the Commission agrees this is the

[1] The standard is as follows: "managers of a utility have broad discretion in conducting their business affairs and in incurring costs necessary to provide services to their customers. In performing our duty to determine the prudence of specific costs, the appropriate test to be used is whether they are costs which a reasonable utility management (or that of another jurisdictional entity) would have made, in good faith, under the same circumstances, and at the relevant point in time. *New England Power Co.*, Opinion No. 231, 31 FERC ¶61,047, *reh. denied*, Opinion No. 231-A, 32 FERC ¶61,112 (1985), *aff'd sub nom. Violet v. FERC*, 800 F.2d 280 (1st Cir. 1986). In *New England Power*, the FERC conducted a thorough review of the case law concerning the criteria to be used in determining prudence, including several seminal U. S. Supreme Court decisions.

appropriate test where a utility is seeking rate recovery of plant expenditures *after the fact*, the Commission has questioned whether this is an appropriate standard in the instant case, where the Applicants seek an *advanced* determination of prudence. The Commission has suggested that in a case involving an advanced determination of prudence, risk is shifted from shareholders to ratepayers in a way not present in an *ex post* prudence review. As a result, Commissioners have indicated there might be two standards for reviewing prudence, and that the standard in an advanced determination case should be higher than in an *ex post* prudence review. Because risk to ratepayers does not shift one way or the other in a case depending on whether the review is *ex ante* or *ex post*, and because the Commission's decision in the instant case does not bind the Commission as to costs that are not prudently incurred, the appropriate standard in this case is the standard as articulated by both the Applicants and Advocacy Staff. There are not two separate standards for determining the prudence of a utility's investment decision.

The North Dakota Law And Similar Laws

North Dakota Century Code § 49-05-16 provides that a public utility proposing to construct a new power plant and transmission lines can apply to the Public Service Commission for an "advance" determination of prudence regarding the proposal. The Commission may issue an order approving the prudence of an electric resource addition if, among other things, the Commission determines the resource addition is "reasonable and prudent." The standard to apply in this case is set by the statute, and there are not two standards.

The purpose of the statute is also straightforward. It provides public utilities (whose rates are regulated by this Commission and who have a legal obligation to serve customers both reasonably and reliably) that find themselves needing to invest significant sums of capital in new energy infrastructure facilities an opportunity to obtain a decision from the Commission that the expenditures are reasonable, *in advance of that investment.* Upon such a finding, the public utility is provided some measure of certainty that it will be entitled to include in its future rates expenditures that are consistent with those presented in the advanced determination hearing. Considering the amount of money required to build large energy facilities, and the importance such facilities play to the quality and economic health of a state and region, the purpose of the law is eminently appropriate.

Obtaining assurance before a utility spends large sums of money is not a novel regulatory scheme. It is a method that most states, including North Dakota, already follow with respect to investment in large energy facilities. For instance, if the Big Stone Unit II was proposed to be located in North Dakota, project proponents would be required to obtain a certificate of public convenience and necessity from the Commission under N.D.C.C. Chapter 49-03. Under that law, utilities seeking to build power plants or transmission facilities to be located in the state must demonstrate, in advance, that there is a need for the facility and that alternatives to meeting the projected need have been examined. Even with a certificate of public convenience and necessity, public utilities nonetheless still retain the burden of proving that actual costs incurred in constructing the facility were reasonable.

In Minnesota, public utilities seeking to construct large energy facilities within the state are required to satisfy an elaborate maze of criteria to demonstrate, in essence, that there are no reasonable and prudent alternatives to the proposed facility. As with North Dakota, utilities in Minnesota have an obligation, once the facilities have been constructed, to later demonstrate that the costs *actually incurred* in constructing the facility (shown to be needed in the first place) were also *reasonably incurred* (and consistent with the information presented in the certificate of need hearing, and upon which the finding of reasonableness certainly depended). But as long as the costs incurred are materially consistent with the information upon which the certificate of need was issued, the utility should be entitled to recover those costs in its rates. If it were otherwise, there would be no reason for a separate certificate of need proceeding in the first place, because the issue of reasonableness would always be open for debate in the context of a utility's rate case.

The Iowa Utilities Board utilizes a belt and suspenders approach. Under Iowa law, a utility may seek advance determinations from the Iowa Utilities Board with respect to large energy facilities. Under a separate provision of the law, Iowa requires that utilities also file for a certificate of public convenience, use and necessity. Section 476.53 of the Iowa Code provides that rate regulated public utilities contemplating new generation facilities may seek to obtain from the Board, *in advance of construction of the facility*, the "ratemaking principles" which will guide the Board when the utility subsequently seeks to recover the costs of the facility in its rates. *See, e.g., Re Interstate Power and Light*, Iowa Utilities Board, Docket No. RPU-02-6 (September 17, 2002). Importantly, in determining the applicable ratemaking principles, the Board is required to find, among other things, that the public utility has "demonstrated . . . that the public utility has considered other sources for long-term electric supply and that the facility . . . is *reasonable* when compared to other feasible alternative sources of supply." Iowa Code § 476.53(4)(b)(2). The statute specifically requires that the Board's decision "shall be issued prior to commencement of construction" of the facility. Iowa Code § 476.53(4). Following the Board's determination, the utility may either withdraw any application it has submitted for a certificate of public convenience, use and necessity (pursuant to Iowa Code Chapter 476A), or proceed with construction of the facility. Iowa Code § 476.53(4)(f). And like the North Dakota and Minnesota laws, the purpose of the Iowa statute is clear and justified: to avoid the prospect of public utilities making large investments of finite capital in critical energy infrastructure needs if there is concern on the part of the Board as to the reasonableness of the chosen resource addition. But the Iowa Utilities Board does not apply a different standard in its advanced ratemaking principles determination and its subsequent rate case determination. Instead, the standard is the same in both instances: whether the expenditures are reasonable under the circumstances.

Indeed, the entire concept of integrated resource planning is in large measure meant to act as an advanced hedge against the prospect of public utilities making large, improvident expenditures of capital. In an integrated resource plan, utilities undertake significant (and very transparent) efforts to identify resources that they believe are least cost, reliable, and prudent. Facilities identified in a utility integrated resource plan as least cost – like the Big Stone Unit II was shown to be in the plans of both Montana-Dakota and Otter Tail – are reviewed in advance

by state public utility commissions. An advanced determination of prudence is simply another step in the resource planning process.

Thus, there is nothing novel in the North Dakota advance determination of prudence statute. While decisions concerning large utility investments may have been traditionally subject only to *ex post* reviews, the trend among almost all states, and certainly the process for utility investment decisions (that now regularly run in the hundreds of millions of dollars) here in the Midwest, is that some level of assurance as to reasonableness, and therefore cost recovery, is *always* obtained, indeed required, before that investment decision is made. The stakes are simply too large for both the utility and its customers for it to be otherwise.[2]

The Commission Is Making an Advanced Determination as to Reasonable and Prudent Costs, Not All Costs

At the August 22 working session, the Commission referred generally to the Iowa cases interpreting its advance determination law, and expressed concern about another similarity between the North Dakota and Iowa statutes: the concept that the Commission's decision in the advanced determination proceeding is "binding" with respect to subsequent rate cases. That the Commission's decision here is binding on future rate recovery determinations should not cause the Commission undue concern.

In the Iowa cases, the Board has suggested that because its decision in an advanced rate principles proceeding is binding with respect to future ratemaking, its decision "has more long-term impact on perhaps any other type of decision the Board makes." *See, e.g., Re MidAmerican Energy*, Iowa Utilities Board, Docket No. RPU-01-09 (May 29, 2002). In other words, if the decision is not a reasonable one, the Board has expressed concern that its decision "cannot be undone in a subsequent rate case." *Id.*

Section 49-05-16 of the North Dakota Century Code includes a similar provision intended to provide a public utility proposing a resource addition with some level of future rate certainty. It provides that the "commission's order determining prudence of the resource

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[2] A further comment is appropriate here. The Applicants submit that it is in ratepayers' interest that utilities such as Montana-Dakota and Otter Tail, with an obligation to serve, engage in this very complicated planning effort as a way of selecting resources that are reasonable and prudent. The Applicants, along with their co-owners, have been in the permitting process for Big Stone Unit II since the end of 2005. The Applicants' decisions have been questioned every step of the way by the DRC and other similarly situated groups. In today's environment, that is perhaps inevitable and in any event is the result of a democratic process. But there should be no question that it could have been far easier, as Terry Deason pointed out, for the Applicants to have proposed, for instance, a natural gas plant. It would have been presumably much easier to proceed through the permitting process. Instead, the Applicants have engaged in an exhaustive and almost endless process of justifying their decision to proceed with this project, a project which their studies have continually demonstrated is in the best interests of their customers, without regard to their shareholders' interests. Unless state utility commissions want the public utilities over whose rates they regulate to seek only the path of least resistance in building additional critical energy resources or purchasing power from the market to meet their customers' future energy needs, they should encourage, not discourage, utilities from seeking at least some hedge against future cost recovery. This is consistent with what ex-Commissioner Deason meant when he referred to the project as "commendable," and possibly "contrary to natural inclinations." TR. Vol. III, p. 724, lines 22 – p. 25, lines 1-15.

[addition] is binding for ratemaking purposes." N.D.C.C. § 49-05-16(4). But this provision must be considered within the overall statutory authority of the Commission to assure that rates charged by public utilities are just and reasonable.

The Applicants do not read the statute, nor should the Commission, that a finding of advanced prudence under N.D.C.C. § 49-05-16 gives the public utility essentially *carte blanche* with respect to future, actual expenditures associated with the facility. After an extraordinary amount of due diligence and study, the Applicants have put forth specific evidence in this case with respect to the expected costs, including escalation, with respect to the Big Stone Unit II facility (including delivered fuel costs) and related transmission interconnection facilities. The Applicants have provided both an expected capital cost on a per megawatt basis, and an operating cost on per megawatt-hour basis. Under both scenarios, the Big Stone Unit II project, under reasonable assumptions and testing for contingencies, is both a more economic and reliable option than is its next best baseload alternative. To the extent that the Commission finds the resource addition as "reasonable and prudent" under the statute, it can only do so in the context of the evidence in the record. Thus, the Applicants are under no illusion that once they receive an advanced determination of prudence they are somehow receiving a blank check in managing the construction of Big Stone II and handling fuel delivery issues.

The Applicants fully understand that the Commission is not without recourse in future rate cases concerning the costs of the project. More specifically, the statute's "binding for ratemaking purposes" language does not automatically entitle the Applicants to include in future rates every single expenditure associated with the project, regardless of whether the utilities exercised prudence in managing the construction process. A finding of prudence simply means that should the Applicants continue to act prudently and consistent with the Commission's finding in this case, they are entitled to recover in future rates those costs that the Commission has found the utilities to have estimated in good faith, based on the circumstances known to them at the time that decisions needed to be made, in the exercise of their obligation as prudent utility managers, and that such costs cannot be denied recovery based on an *ex post facto* determination that construction of the plant was imprudent and the Applicants should have pursued some alternative supply source to meet their customers' energy needs.

Thus, in the case of an advanced determination of prudence, as with post expenditure recovery requests, the Commission retains *at all times* the right to allow in rates only those costs that it determines are reasonable and prudent.[3] Accordingly, there is no undue shift in risk to ratepayers in a case involving an advanced determination of prudence versus one involving an after the fact determination. In either case, utilities are only allowed to recover and customers are only required to pay for costs incurred for investments that were reasonable and prudent based on the facts as they existed at the time the investment decision was made. And because there is no shifting of risk from shareholders to ratepayers, or any other shifting of risk, there is no regulatory (or other) justification for a different standard in one case versus the other. The standard in both *ex ante* and *ex post* reviews is the same: whether the costs as proposed by utility management, acting in good faith and based on circumstances known to them at this time, are

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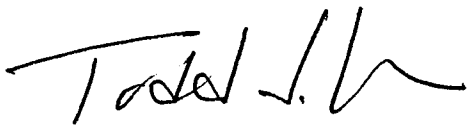
3 *See, e.g.*, N.D.C.C. § 49-02-03 (power of the PSC to establish rates).

reasonable. This is the standard. And judged by this standard, the Applicants respectfully submit that the Big Stone II resource addition is both reasonable and prudent.

Thank you for your consideration.

Very truly yours,



Todd J. Guerrero, On Behalf of Applicants
Montana-Dakota Utilities Co., and
Otter Tail Corporation

TJG/kas
c: Attached Service List (via email and regular mail)

STATE OF NORTH DAKOTA

PUBLIC SERVICE COMMISSION

Otter Tail Corporation, Advance Determination of Prudence Application

AFFIDAVIT OF SERVICE

Montana-Dakota Utilities Co., a Division of MDU Resources Group, Inc., Advance Determination of Prudence Application

Case Nos. PU-06-481, PU 06-482

Kristen Swenson, of Minneapolis MN, being sworn, says that on August 24, 2007, a copy of the following documents:

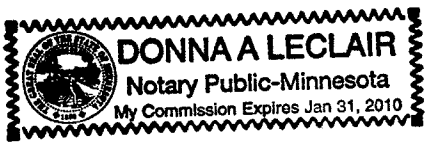
3. Applicants' Letter to North Dakota Public Service Commission; and
4. Affidavit of Service

have been served upon the North Dakota Public Service Commission and the attached service list via United Stated Mail and email.

Kristen Swenson

Subscribed and sworn to before me
this 24th day of August, 2007.

Notary Public



STATE OF NORTH DAKOTA

PUBLIC SERVICE COMMISSION

Otter Tail Corporation, Advance Determination of Prudence Application

SERVICE LIST

Montana-Dakota Utilities Co., a Division of MDU Resources Group, Inc., Advance Determination of Prudence Application

Case Nos. PU-06-481, PU 06-482

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