

# Memorandum

**To:** Illona Jeffcoat-Sacco, Executive Director  
**From:** Advocacy Staff  
**Date:** May 8, 2007  
**Re:** **Staff Support for Settlement Agreement  
Case No. PU-06-525**

## Brief History

In NSP's last gas rate increase application, Case No. PU-04-578, the commission ordered an interim rate increase of \$741,000, effective January 1, 2005. On June 1, 2005, the commission ordered an additional \$4,000 in rates for a final increase of \$745,000.

For the years ended 2005 and 2006, NSP reported earnings on equity invested in its North Dakota gas operations of 5.71% and 6.33%, respectively. It takes about one-third of a million dollars in additional revenue to increase earnings on equity by one percentage point.

On December 15, 2006, NSP filed to increase its revenue collections by \$2.8 million using a 2007 test year and an 11.3% return on equity.

On February 7, 2007, the commission ordered an interim rate increase of \$2,158,000.

On April 24, 2007, NSP filed a settlement agreement for a final rate increase of \$2,293,938.

On May 1, 2007, staff filed direct testimony arguing for a final rate increase of \$1,213,000 using a return on equity of 9.56%.

## Rationale for Entering into a Settlement Agreement

The settlement agreement entered into by advocacy staff and the company provides the commission with an alternative to conducting a full rate case proceeding. Similar to settlement agreements in the past, the agreement does not attempt to resolve or conclude the weightier matters that might otherwise be considered in a heavily contested hearing. Instead, it is crafted to provide an opportunity to achieve a similar outcome without the formality of a hearing.

The settlement agreement calls for a sharing of profits above 10.75%. For the narrow band of 10.75% to 11.25%, the company must share 50% of the profits with its ratepayers. For any earnings above 11.25%, the ratepayers will receive 75% of the profits. Staff agreed to this arrangement because it largely protects ratepayers from excess revenue collections.

Staff also entered into the agreement because it is unlikely that NSP's earnings on its equity invested in North Dakota will exceed 10.75%. Staff believes this for several reasons:

- 1) The higher rates are predicated on 2007 costs but will only be in effect for part of 2007 thereby minimizing the potential impact of rates on year one.
- 2) The new rates do not give consideration to the replacement of automated meter reading (AMR) modules scheduled to occur at the end of 2007 at a cost of \$2.4 million and an annual increase in revenue requirement of \$.5 million.
- 3) Residential rates will remain frozen through 2009 even though annual wage increases and operation and maintenance costs will continue to press upward.
- 4) Staff believes that although a rate freeze for commercial and industrial customers is not included in the settlement agreement, it is unlikely that NSP will file for a commercial or industrial rate increase before 2010 even if a rate increase is needed. Every class cost of service study filed by the company to date claims residential customers are subsidized by non-residential customers. Further, we believe the non-residential customers are able to represent their interests if such a case were filed.
- 5) Conservation appears to be occurring naturally without demand side management programs in place. Despite customer growth and recent rate increases, sales throughput and gross margins remain fairly flat.

Another reason for entering into an agreement with NSP is the term of the commitment. Given staff's outlook and general observations noted above, staff believes another rate case will be filed next year absent such an agreement. This agreement allows for an overall increase of 2.5% with no additional increases allowed until 2010.

Direct Testimony Filed by Staff

The recently filed testimony by staff argues for a rate increase of \$1.2 million instead of the \$2.3 million settlement amount. Did staff fall down and hit its head on a rock?

Staff believes it has filed good testimony in this case. However, most of the difference between what staff agreed to settle on and our direct testimony has to do with the cost of capital which is highly contentious and not necessarily a slam dunk.

If the company prevails on its requested 11.3% return on equity as compared to staff's 9.56%, then the staff's filed revenue requirement will increase by about \$.6 million.

If the company prevails on its traditional utility cost of capital structure as compared to staff's use of a total company capital structure, then staff's filed revenue requirement will increased by another \$.3 million.

Given the unknown and the reasons for settling as enumerated above, staff views the settlement agreement as reasonable and recommends that it be approved.

Parting Shot

A rather significant issue is raised in staff's direct testimony with respect to accounting for non-legal retirement obligations. While the issue has the potential for reducing future revenue requirements, staff's testimony did not include such an adjustment and was primarily focused on long-term asset ownership in a deregulated environment. For settlement purposes, this issue has been reserved for future consideration. The funds for these types of retirement obligations will continue to accumulate with or without this settlement agreement as long as the regulation of natural gas rates continues.