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December 27, 2010

PUBLIC SERVICE COMMISSION

Darrell Nitschke
Executive Secretary
North Dakota Public Service Commission
600 East Boulevard, Department 408
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VIA E-MAIL AND U.S. MAIL
ndpsc@nd.gov

**RE: Montana-Dakota Utilities Co. Application and Notice of Change in Electric Rates
NDPSC Case No.: PU-10-124
Advocacy Staff's Post-Hearing Brief and Proposed Findings of Fact, Conclusions
of Law and Order**

Dear Secretary Nitschke:

Enclosed please find Advocacy Staff's Post-Hearing Brief and Proposed Findings of Fact, Conclusions of Law and Order. Also enclosed is an Affidavit of Service.

Very truly yours,



Richard J. Savelkoul

Enclosures

cc: Persons on attached Certificate of Service

CERTIFICATE OF SERVICE

Montana-Dakota Utilities Co. Application and Notice of Change in Electric Rates	Case No. PU-10-124
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Kimberly J. Price certifies that on the 27th day of December, 2010, she served a true and correct copy of the attached **Advocacy Staff's Post-Hearing Brief and Proposed Findings of Fact, Conclusions of Law and Order** by e-mailing and placing it in the United States mail with postage prepaid, addressed to the following individuals:

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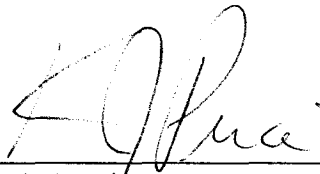
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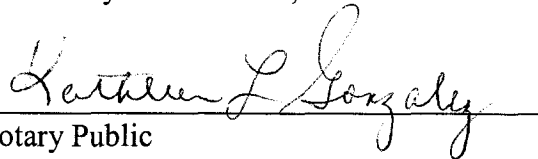
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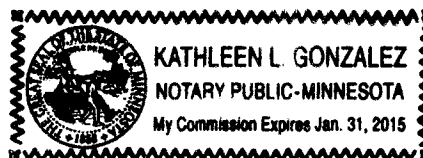


Kimberly J. Price

STATE OF MINNESOTA)
) ss.
COUNTY OF RAMSEY)

Subscribed and sworn to before me this 27th day of December, 2010.


Notary Public



State of North Dakota

Public Service Commission

**MONTANA-DAKOTA UTILITIES CO.
ELECTRIC RATE INCREASE APPLICATION**

ADVOCACY STAFF POST-HEARING BRIEF

Case No. PU-10-124

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I. STATEMENT OF THE CASE

Montana-Dakota Utilities Co. (“MDU” or “the Utility”), a division of MDU Resources Group, Inc., is an investor-owned public utility that provides natural gas and electric service to customers in a four-state area, including North Dakota. On April 19, 2010, MDU applied for a rate increase for electric service to its North Dakota customers. In total, the Utility sought to increase retail rates by \$15,396,303, or 14%.¹ The Public Service Commission (“Commission”) issued a Notice of Hearing regarding this proposed rate increase on June 16, 2010. A four-day hearing in this matter was held before the Commission, beginning on November 8, 2010. This post-hearing brief provides further legal authority and analysis in support of the North Dakota Public Service Commission Advocacy Staff’s (“Staff”) position at the hearing.

II. ARGUMENT

Prior to the hearing in this matter, MDU and Staff reached an agreement with respect to many of the disputed issues; however, two principle issues remain outstanding: (1) Whether MDU’s investments in the Diamond Willow and Cedar Hills wind farms were used and useful for the service and convenience of the public of North Dakota; and (2) Whether the Utility’s costs associated with incentive compensation paid to its employees and officers, as well as director compensation and other investor relations expenses, were used and useful for the service and convenience of the public of North Dakota.

A. The Commission Has Authority To Establish MDU’s Rate.

¹ This amount was amended to \$13,300,000 on July 6, 2010, and subsequently reduced to \$11,518,000 through an ROE negotiated settlement. See Pre-filed Responsive Testimony of George Mathai (hereinafter, “Mathai Pre-filed Testimony”), at CAS Ex. 17, p. 4, ll. 26-28.

Public utilities are regulated by Title 49 of the North Dakota Century Code. Title 49 provides the Commission with authority, after notice and hearing, “to originate, establish, modify, adjust, promulgate, and enforce” public utility rates.² Following a hearing to determine fairness of a proposed rate increase, the Commission is not limited to approval or denial of the proposal, but instead, “may order any schedule of rates which will yield the utility a just and reasonable return.”³

B. MDU Has The Burden To Show Its Proposed Rate Is Just And Reasonable.

When requesting a rate increase, “the public utility has the burden to establish that an increased rate or proposed change of rate is just and reasonable.”⁴ “In general, the governing principle for determining rates to be charged by a utility is the right of the public on the one hand to be served at a reasonable charge, and the right of the utility on the other to a fair return on the value of its property used in the service.”⁵ Importantly, “[e]very unjust and unreasonable rate or charge made, demanded, or received for . . . service is prohibited and unlawful.”⁶

In order to meet its burden of establishing that its proposed rate is just and reasonable, a public utility must show the Commission that the value of the property and/or services upon which that proposed rate is based is “used and useful for the service and convenience of the [North Dakota] public.”⁷ The Commission has authority to set a utility’s rates based on its

² N.D.C.C. § 49-02-03.

³ Application of Mont.-Dakota Utils. Co. of Minneapolis, Minn., 102 N.W.2d 329, 342 (N.D. 1960).

⁴ Mont-Dakota Utils. Co. v. Pub. Serv. Comm’n, 413 N.W.2d 308, 315 (N.D. 1987) (citing N.D.C.C. § 49-05-06).

⁵ Pub. Serv. Comm’n v. Mont.-Dakota Utils. Co., 100 N.W.2d 140, 144 (N.D. 1959).

⁶ N.D.C.C. § 49-04-01.

⁷ Id.

valuation of that utility's "used and useful" property under this standard.⁸ More specifically, "[t]he value of the property of a public utility, as determined by the commission for ratemaking purposes, is the money honestly and prudently invested therein by the utility"⁹

When a proposed rate increase involves changes in administrative and general expense allocation, the utility must establish the reasonableness of those changes with a breakdown and analysis of those expenses.¹⁰ The importance that the utility demonstrate the reasonableness of its requested increase is especially true where, as here, the proposed increase will likely result in its ratepayers paying more than the average amount charged by other utilities in the state.¹¹

C. MDU Failed To Meet Its Burden With Respect To Wind Farm Costs.

MDU has failed to meet its burden to show that its proposed rate is just and reasonable with respect to the portion thereof allocated to its investment costs in the Diamond Willow and Cedar Hills wind farms, because these investments have not been shown to be used and useful for North Dakota ratepayers, nor were they prudently made. The inability of MDU to meet its burden is evidenced by the Utility's failure to: (1) conduct an economic analysis of the wind farm investments as required under North Dakota law; (2) consider the cost-effectiveness of those investments; and (3) obtain an advanced determination of prudence from the Commission. Because MDU has failed to justify its investments in these wind projects, the Utility cannot demonstrate a revised rate including the wind projects is just and reasonable. Further, although it is the Staff's position that MDU has not met its burden, should the

⁸ See *id.*

⁹ N.D.C.C. § 49-06-02.

¹⁰ See *Mont.-Dakota Utils. Co.*, 413 N.W.2d at 314-15.

¹¹ See Tr. 55, ll. 13-25; Tr. 56, ll. 1-15 (Goodin Testimony).

Commission determine that MDU may recover any portion of the wind farm investments in its revised rate, Staff requests that a rider be implemented for the amount of recovery allowed.

1. MDU failed to conduct an economic analysis.

MDU is precluded from recovering the costs associated with its wind farm investments in its revised rate because it failed to engage in the requisite economic analysis regarding the cost-effectiveness of these projects on the customer charges. As set forth in N.D.C.C. § 49-02-32,

Before using new renewable and recycled energy . . . , the retail provider . . . shall make an economic evaluation to determine if the use of new renewable and recycled energy is cost-effective considering other electricity alternatives. After evaluating the renewable and recycled energy objective and economic evaluation, the retail provider or its generation supplier may use the electricity alternative that best meets its resource or customer needs.”

Although witnesses for the Utility made blanket assertions that economic analyses were conducted for the Diamond Willow and Cedar Hills wind farms, they offered no concrete numbers and provided no exhibits evidencing any such analysis.¹² Furthermore, what little documentation MDU *did* provide was riddled with errors, delayed, constantly changing (even up to the day of the hearing itself), and ultimately, unreliable.¹³

¹² See, e.g., Tr. 284, ll. 1-19 (insisting the economic analysis was performed internally) (Stomberg Testimony).

¹³ See, e.g., Mathai Pre-filed Testimony, CAS Ex. 17, at p. 8, ll. 1-21 (inadequate information and cross-referencing), p. 12, ll. 11-12 (oversight in application); Tr. 633-36 (material changes filed on first morning of hearing; failure to update financial calculations) (Mulkern Testimony); Tr. 647, ll. 22-25, Tr. 648, ll. 1-11) (failure to respond to information request) (Mulkern Testimony); Tr. 658, ll. 2-17 (lack of clarity regarding historical margin sales); Tr. 668, ll. 1-12 (overstating wind farm production) (Mulkern Testimony); Tr. 678, ll. 8-12 (mistake in filing) (Mulkern Testimony); Tr. 683, ll. 6-10 (failure to provide updated calculations) (Mulkern Testimony).

The Utility justifies its failure to complete the requisite economic analysis by arguing that business judgment supported its wind farm investment decisions.¹⁴ While it is not clear what exactly “business judgment” means, any assertion that it includes immeasurable “societal and regulatory considerations,”¹⁵ as it was described by MDU witnesses, runs contrary to North Dakota law, which expressly prohibits utilities from using “environmental externality values in the planning, selection, or acquisition of electric resources or the setting of rates for providing electric service.”¹⁶

Environmental externality values include, “[e]nvironmental costs that are not internalized in the cost of production or the market price of electricity from a particular electric resource,” as well as the “alleged costs of complying with future environmental laws or regulations that have not yet been enacted.”¹⁷ Future environmental laws and regulations are exactly the type of “societal and regulatory” considerations that MDU based its decision to choose wind, an energy resource that was not least cost, as illustrated by the testimony of Ms. Stomberg:

So when we select something like wind, which is not necessarily a least-cost resource, we [consider that] it is not going to be subject to carbon credits or carbon cap and trade, which **we believe is on the horizon.**¹⁸

¹⁴ “[I]f the economics don’t necessarily support [the Utility’s decision] or even if they do, you have other business judgment to be made around whether you . . . build these renewables or not.” Tr. 329, ll. 22-25; Tr. 330, 1-2 (Stomberg Testimony).

¹⁵ See Tr. 285, ll. 9-17 (Stomberg Testimony).

¹⁶ N.D.C.C. § 49-02-23.

¹⁷ *Id.*

¹⁸ Tr. 307, ll. 14-23 (Stomberg Testimony) (emphasis added).

Ultimately, MDU's justification for its failure to complete the economic analysis, based on its consideration of prohibited environmental externalities, should not withstand the Commission's scrutiny.

In addition, the Utility further argues that even if completed, an economic analysis can be entirely disregarded, allowing MDU to choose a particular resource "without regard to [its] cost-effectiveness."¹⁹ This position is unfounded and unreasonable. MDU cannot justify its failure to engage in the requisite economic analysis by arguing its right to make business judgment decisions regardless of cost. Had MDU engaged in the requisite economic analysis, it would have ultimately determined that the wind farms were not an appropriate energy alternative because their higher cost does not meet customer needs, as required under N.D.C.C. § 49-02-32. At the very least, had the analysis been completed, ratepayers and the Commission would be afforded an opportunity to consider just how expensive wind is compared to other resources. Although the Commission is aware that wind is not least-cost, it does not know just how much more expensive it actually is due to the Utility's failure to complete any sort of economic analysis. Furthermore, the Utility management's argument reflects a position of minimizing and/or disregarding the norm of jurisdictional oversight on used and useful utility investments and their cost effectiveness.

MDU's inability to quantify the increased costs associated with these wind farms above least-cost constitutes direct evidence of its failure to meet its burden that the proposed rate increase is just and reasonable. Thus, the Commission must reject recovery for this reason alone.

¹⁹ Tr. 372, ll. 14-17 (Q: "So is it your view that you can make that best decision without regard to the cost effectiveness[?]" A: "I think that's exactly what this says.") (Stomberg Testimony).

2. MDU's wind farms are not cost-effective.

Furthermore, MDU should not recover the costs associated with its wind farm investments from North Dakota ratepayers because of its failure to consider the cost-effectiveness of these projects. While Staff acknowledges the importance of implementing renewable energy alternatives, the Commission cannot ignore the requirement that such investments be made in the best interest of ratepayers. In this instance, the Utility's failure to act in ratepayers' best interest with regard to the cost-effectiveness of its wind investments is evidenced through: (a) MDU's Integrated Resource Plan models; (b) MDU's previous position on wind in the hearings for Big Stone II; (c) the fact that a Montana renewable resource mandate drove MDU's decision to build its wind farms; and (d) the inadequacy of the Utility's Request for Proposal process.

a. The IRPs show wind is not least-cost.

Like all utilities, MDU relies on integrated resource plans ("IRPs") when making new resource acquisitions and investments.²⁰ The Utility uses these plans as a guide to determine what the best resource investment is on a cost basis.²¹ After MDU inputs market and cost information relating to various resource options, the IRP models will "output" the least-cost plan for new resource investments.²² MDU uses these models to consider all of its energy

²⁰ Tr. 457, ll. 19-25 (Neigum Testimony).

²¹ Tr. 458, ll. 1-11 (Neigum Testimony).

²² Tr. 460, ll. 9-23 (Neigum Testimony).

options, and it perceives all of the IRPs it has filed with the Commission to be reasonable.²³ Yet notably, not one of its reasonable IRPs has ever selected generic wind as the best choice for new investments.²⁴ Indeed, wind is an expensive must-run resource that has to be forced into the IRP models.²⁵

MDU argues that it was still appropriate to invest in the Diamond Willow and Cedar Hills wind projects despite the fact that its IRPs never selected wind as the best investment option because wind is a resource that has societal and regulatory attributes which justify its investment.²⁶ Conveniently, these intangible attributes are not quantifiable.²⁷ Thus, the Utility is essentially asking the Commission to conclude that its investments in these wind farms were just and reasonable based entirely on the company's immeasurable business judgment that wind is "good for society." A regulated utility should not be allowed to impose such arbitrary "judgments" on its customers when they result in rates that are not fair, just, and reasonable.

Not only is this position questionable on its face, it is further weakened by the Utility's failure to present any IRP models comparing wind to other resources.²⁸ In addition, the selection of a renewable resource that was not least-cost runs contrary to the North Dakota

²³ Tr. 167, ll. 17-19 (Goodin Testimony); Tr. 300, ll. 3-6 (Stomberg Testimony).

²⁴ See 2005 IRP, PU-05-531; 2007 IRP, PU-07-394; 2009 IRP, PU-09-547 (all officially noticed, Tr. 469, ll. 19-25, Tr. 470, ll. 1-19; Tr. 473, ll. 9-14, Tr. 475, ll. 6-11); see also Tr. 287, ll. 13-17 (Stomberg Testimony); Tr. 300, ll. 7-10 (Stomberg Testimony); Tr. 463, ll. 4-7 (Neigum Testimony).

²⁵ Tr. 297, ll. 8-25; Tr. 298, ll. 1-12 (Stomberg Testimony); see also 2009 IRP, PU-09-547, at p. 34 ("legislative requirements are driving the need for increased wind generation which is a factor to be considered regardless of the economics of installing renewable generation") (emphasis added).

²⁶ Tr. 285, ll. 9-17 (Stomberg Testimony).

²⁷ Tr. 285, ll. 19-22 (Stomberg Testimony).

²⁸ See generally 2005 IRP, PU-05-531; 2007 IRP, PU-07-394; 2009 IRP, PU-09-547; Tr. 286, ll. 16-25 (Stomberg Testimony).

environmental externality statute, as discussed *supra*.²⁹ Ultimately, the Commission cannot determine how much more expensive the wind investments were over the other alternative resource options because MDU has not produced any documentation evidencing the additional cost that would be required before an IRP would select generic wind as the best resource option.³⁰ Nor, for that matter, has MDU shown how the costs of building the Diamond Willow and Cedar Hill facilities compared to the estimated costs of building alternative facilities.³¹

b. *MDU argued in the Big Stone II proceeding that wind is too expensive.*

In previous proceedings before this Commission, MDU has taken the position that wind is not a least-cost resource, and because of that, wind projects are only implemented to satisfy state renewable resource objectives. More specifically, in the Advanced Determination of Prudence Hearing on Big Stone II, MDU Executive Andrea Stomberg explained, “renewable energy is not usually a least-cost resource. So if you have to go with strictly least-cost resource planning, you’re likely to exclude wind.”³² Indeed, MDU executives insisted that wind was too expensive, as illustrated by the testimony of MDU Executive Duane Stone:

I guess I respectfully disagree that wind is coming in cheaper. We've seen the same price increases in wind because of the copper and the steel that we have seen in other generation resources, so wind is getting -- **wind is expensive.**³³

²⁹ See N.D.C.C. § 49-02-23.

³⁰ See 2005 IRP, PU-05-531; 2007 IRP, PU-07-394; 2009 IRP, PU-09-547; Tr. 370, ll. 7-24 (Stomberg Testimony).

³¹ Tr. 369, ll. 12-25 (Stomberg Testimony).

³² CAS Ex. 9, Tr. 291, ll. 14-21 (Stomberg Testimony).

³³ CAS Ex. 4, Tr. 301, ll. 2-9 (emphasis added).

Despite its position in Big Stone II, MDU is suddenly arguing that wind can, at times, be the best investment option for its ratepayers. Consequently, it is asking the Commission to pass the costs of these investments onto its North Dakota ratepayers because “unquantifiable societal and regulatory considerations” justify the construction of these facilities (discussed *supra*). As noted by Commissioner Clark, MDU failed to engage in the same sort of “systematic analysis” with respect to its available resource options for Diamond Willow and Cedar Hills that it engaged in for Big Stone II.³⁴ Perhaps the Utility’s failure in this respect is an immediate consequence of MDU executives’ knowledge that wind was not the best investment option for ratepayers due to its expense.

c. *A Montana mandate drove construction of the wind farms.*

“Well, the decision to build wind was driven by a rule in the State of Montana, which I understand is an issue because it’s a Montana rule driving costs for North Dakota customers.”³⁵

- Andrea Stomberg, MDU Vice President of Electric Supply

MDU executives have previously taken the position that North Dakota is the best location for harnessing wind energy.³⁶ Yet, despite this knowledge, the Utility is now asking its North Dakota ratepayers to assume the cost of wind facilities MDU constructed in Montana to satisfy a renewable resource mandate imposed by that state. MDU officials repeatedly admitted that the Diamond Willow projects were constructed to satisfy the Montana mandate. For example, when pressed why the Utility did not thoroughly explore its alternative resource options with respect to these projects, Stomberg explained, “we knew we needed some wind. We knew we needed wind in Montana and we understand a desire for wind in the State of

³⁴ Tr. 341, ll. 16-25; Tr. 342, ll. 1-19 (Stomberg Testimony).

³⁵ Tr. 343, ll. 19-22 (Stomberg Testimony).

³⁶ Tr. 291, ll.22-25; Tr. 292, ll. 1-8 (Stomberg Testimony).

North Dakota.”³⁷ Staff notes that while MDU was required to acquire wind for Montana’s *mandate*, North Dakota only has a renewable *objective*—an objective which, importantly, requires an economic analysis before investment.³⁸

In addition, it is worth noting that MDU had alternative options available for complying with the Montana mandate that would not result in costs being imposed on its North Dakota ratepayers. For example, the Utility could have purchased renewable energy credits from certified sources in order to meet the mandate.³⁹ Consequently, based on all of the foregoing considerations the Commission should not—indeed it cannot—allow the costs associated with the wind farm investments MDU made to comply with the Montana mandate to be passed on to North Dakota ratepayers through the Utility’s revised rate.

Given MDU’s admission that the Diamond Willow wind farms were built to comply with the Montana mandate, it is not surprising that evidence has shown that the Utility paid a premium to build these wind farms *in Montana* in order to satisfy the mandate.⁴⁰ In addition, it is worth noting that a review of projects by another North Dakota regulated utility, completed in the same time frames as the ones in this proceeding, demonstrates that a premium was paid by MDU.⁴¹

Importantly, the Commission is statutorily prohibited from passing the costs associated with the premium MDU paid to build its wind farms in Montana onto North Dakota ratepayers. N.D.C.C. § 49-06-24 provides,

³⁷ Tr. 342, ll. 21-23 (Stomberg Testimony) (emphasis added).

³⁸ See N.D.C.C. §§ 49-02-23, 49-02-32.

³⁹ Tr. 335, ll. 7-12; Tr. 362, ll. 2-11 (Stomberg Testimony).

⁴⁰ Mathai Pre-filed Testimony, CAS Ex. 17, p. 14, ll. 10-24; p. 15, ll. 1-8.

⁴¹ See Tr. 640, ll. 13-16; Tr. 643, ll. 5-6 (taking official notice of PU-10-18).

The commission may not increase electric rates as a result of actions taken by other states requiring higher cost resources to be built, purchased, or otherwise acquired as a result of the application of quantified environmental externality values . . . as part of any resource selection process.

As a result, at the very minimum, the Commission should deny the allocation of the proposed rate increase resulting from the premium MDU paid to build Diamond Willow in Montana in order to comply with the Montana renewable resource mandate.

d. MDU's Request for Proposal process was inadequate.

MDU has attempted to show the just and reasonableness of its Diamond Willow investment through evidence of its Request for Proposal (“RFP”) process for this project—a process the Utility did not bother completing for Cedar Hills. If anything, MDU’s RFP process for Diamond Willow evidences the inadequacies of its investment decision. Ultimately, the project RFP was far too limiting to ensure that MDU was making the best investment decision for its North Dakota ratepayers. For example, the Diamond Willow Request for Proposal considered renewable resources only.⁴² This limitation reflects the fact that the project was being built to comply with the Montana renewable resource mandate.⁴³ Indeed, the first goal MDU stated on its RFP was that it desired to “[s]upport the economy in areas of Montana that are served by MDU,” essentially requiring that the project be built in that state.⁴⁴

In addition to this expressly stated goal, MDU’s RFP was unnecessarily limiting in geographical scope, requiring that the proposed facility be located within MDU’s service territory even though a facility built anywhere in the MISO footprint would have been able to

⁴² Tr. 284, ll. 16-23 (Stomberg Testimony).

⁴³ Tr. 957, ll. 23-25; Tr. 958, ll. 1-16 (Neigum Testimony).

⁴⁴ MDU Ex. 23 at 10 (emphasis added); Tr. 956, ll. 13-25; Tr. 957, 1-2 (Neigum Testimony).

serve the energy needs of MDU customers.⁴⁵ MDU admitted that this geographical restriction—which was imposed to satisfy the Montana renewable resource mandate—significantly limited potential RFP responses.⁴⁶ Further, MDU included utility ownership as one of the RFP’s favorable criteria, discouraging proposals involving power purchase agreements.⁴⁷ Not surprisingly, because its RFP was so limiting, MDU received only six responses despite there being dozens of wind providers competing in the MISO system.⁴⁸ Of those six responses, only “two to three” were viable and could actually be considered.⁴⁹

Ultimately, Staff has shown that MDU’s Diamond Willow and Cedar Hills wind farm investments were not cost-effective. Therefore, because MDU has failed to meet its burden of showing that the portion of its proposed rate based on its wind farm investments is just and reasonable, the Utility should be entirely precluded from passing the costs of these investments onto North Dakota ratepayers.

3. MDU should have obtained an advanced determination of prudence.

Although North Dakota has an elective renewable and recycled energy objective,⁵⁰ public utilities are encouraged by statute to seek an advanced determination of prudence (“ADP” or “advanced determination”) from the Commission before investing in such renewable resources.⁵¹ N.D.C.C. § 49-05-16 provides:

A public utility proposing to construct, lease or make improvements to an energy conversion facility, renewable energy facility, transmission facility, or proposed energy purchase

⁴⁵ Tr. 940, 20-25; Tr. 941, ll. 1-11 (Neigum Testimony).

⁴⁶ Tr. 941, ll. 14-25; Tr. 942, ll. 1-13 (Neigum Testimony).

⁴⁷ Tr. 949, ll. 3-25; Tr. 950, ll. 1-19 (Neigum Testimony).

⁴⁸ See MDU Ex. 23.; Tr. 483, ll. 14-24 (Neigum Testimony).

⁴⁹ Tr. 521, ll. 6-25; Tr. 522, 1-3 (Neigum Testimony).

⁵⁰ See N.D.C.C. § 49-02-28.

⁵¹ See N.D.C.C. § 49-05-16.

contract from another entity or person for the purpose of ensuring reliable electric service to its customers may file an application with the commission for an advance determination of prudence regarding the proposal.

MDU elected to forego this opportunity and did not obtain an advanced determination.

With respect to prudence, MDU asserts that because this is not an ADP proceeding, it can avoid a prudence analysis on an asset-by-asset basis.⁵² This assertion is contrary to the purpose of determining just and reasonable rates, contrary to precedence in prior cases, and would result in absurd outcomes. More specifically, the Utility's position is refuted by the following: (a) MDU's belief that the purpose of the ADP process is so that the company can obtain financing is unfounded; (b) the Certificate of Public Need and Convenience that the Utility obtained for Cedar Hills does not replace an advanced prudence finding; and (c) Staff has rebutted any presumption of prudence that MDU argues it may enjoy.⁵³

a. *The ADP process is not made available for financing purposes.*

It is MDU Executive Goodin's position that the advanced determination provision contained in the North Dakota Century Code was enacted primarily for the benefit of the *utility*. More specifically, Good reasons that the advanced determination proceedings are made available so that a utility may have more success obtaining financing for its proposed projects. As Goodin explains, "[t]he purpose of the advanced determination of prudence . . . is an ability particularly on large projects, where a large capital requirement would be needed, [to] provide some sort of clarity . . . to those lenders that would lend moneys to that project."⁵⁴ Thus, under Goodin's rationale, MDU was therefore justified in its decision *not* to seek an

⁵² See Tr. 1101, ll. 8-15 (Kuntz Closing Argument)

⁵³ See Tr. 1110, ll. 16-25 (Kuntz Closing Argument).

⁵⁴ Tr. 66, ll. 14-20 (Goodin Testimony).

advanced prudence determination because it already had its financing for the wind projects in place.⁵⁵ Indeed, Goodin admits that in the future, he will consider obtaining an ADP on a proposed wind project only if the Utility cannot obtain the necessary financing without it.⁵⁶

In reality, the Commission may issue an advanced determination if it “determines that the resource addition is reasonable and prudent.”⁵⁷ This standard parallels the “honestly and prudently invested” standard the Commission uses in ratemaking cases such as this.⁵⁸ Consequently, an advanced determination of prudence was appropriate not, as Executive Goodin understands it, to assist the utility in obtaining financing, but because it would have ensured that the investment was reasonable and in the best interest of North Dakota ratepayers *before* the burden fell on them to pay for the investment. An advanced determination was especially warranted where, as here, the wind investments make up a substantial portion of the Utility’s rate base. In this instance, the Diamond Willow and Cedar Hills wind farms compose approximately one-fourth of the Utility’s entire rate base.⁵⁹ This percentage is particularly troubling considering that these wind farms only produce approximately one percent of the ratepayers’ peak demand as accredited by MISO.⁶⁰ This percentage is unreasonable considering MDU is in need of capacity.⁶¹

b. A Certificate of Public Convenience and Necessity is insufficient.

With specific regard to the Cedar Hills project, MDU argues that it was unnecessary for the Utility to obtain an advanced determination of prudence because it obtained a

⁵⁵ Tr. 67, ll. 14-17 (Goodin Testimony).

⁵⁶ Tr. 78, ll. 6-23 (Goodin Testimony).

⁵⁷ N.D.C.C. § 49-05-16(1)(d).

⁵⁸ See N.D.C.C. § 49-06-02.

⁵⁹ Tr. 71, ll. 12-18 (Goodin Testimony).

⁶⁰ Tr. 476, ll. 18-24 (Neigum Testimony).

⁶¹ See Tr. 501, ll. 3-25; Tr. 502, ll. 1-12 (Neigum Testimony).

Certificate of Public Convenience and Necessity (“CPCN”) from the Commission. However, this CPCN, which MDU was legally obligated to obtain before constructing Cedar Hills because the project was located within North Dakota,⁶² is not the equivalent of an advanced determination of prudence.⁶³ If it was, the advanced determination process would be superfluous. In fact, the CPCN process involves no sort of prudency finding whatsoever.⁶⁴ In addition, it is telling that MDU did not bother obtaining a CPCN for the Diamond Willow projects since it had no obligation to do so because the projects were built outside North Dakota.⁶⁵

c. *MDU no longer enjoys a presumption of prudence.*

Staff acknowledges that the Utility’s failure to obtain an ADP for its wind farm investments does not make those projects *de facto* imprudent. Rather, it is Staff’s position that the Utility’s failure to obtain an ADP means that it does not enjoy a presumption of prudence. It must also be noted that any presumption that would have been available to MDU by obtaining an ADP would only have extended to Cedar Hills, because that particular project was built within North Dakota’s borders.⁶⁶ Moreover, even if MDU *had* enjoyed a presumption of prudence with respect to Cedar Hills, Staff successfully rebutted that presumption by showing that: (1) the project was not least-cost; and (2) the Utility did not perform a sufficient economic analysis (both discussed *supra*). Because Staff has rebutted any presumption of prudence—if it indeed had been enjoyed—the burden shifted back to MDU to show that its Cedar Hills investment was actually prudent. As discussed herein, MDU has been wholly unable to

⁶² See N.D.C.C. § 49-03.1-01.

⁶³ Tr. 68, ll. 16-21 (Goodin Testimony).

⁶⁴ *Id.*

⁶⁵ Tr. 68, ll. 22-25; Tr. 69, ll. 1-5; Tr. 165, ll. 11-13 (Goodin Testimony).

⁶⁶ See N.D.C.C. § 49-05-16(6).

establish the reasonableness of its rates.⁶⁷ Thus, for all of the foregoing reasons, MDU's failure to obtain an advance determination of prudence for any of its wind projects is indicative of its failure to meet its burden to show that its investments in these projects were just and reasonable. Ultimately, the Utility's failure to provide the Commission with any sort of evidence or documentation justifying the reasonableness or cost-effectiveness of its wind farm investments warrants a Commission finding that the costs associated with these investments should be entirely excluded from the Utility's revised rate.

D. The Commission Should Require A Rider If Any Costs Are Allowed.

If recovery for MDU's wind farm investments is allowed at all, rider recovery is appropriate. In the event the Commission determines that MDU has met its burden sufficient to allow it to recover any portion of its wind farm investments from North Dakota ratepayers, the unique nature of wind farm investments warrants that MDU be required to re-file under a renewable rider so that the appropriate amortization, recovery, and allocation of costs can be determined. Not only is rider recovery supported by North Dakota precedent, it has already been effectively utilized for renewable resource projects constructed by another state utility.⁶⁸ In fact, even MDU has indicated its willingness to recover the costs of its wind farm investments under a rider.⁶⁹

Rider recovery is warranted due to the unique nature of renewable energy investments. With respect to a revenue requirement, the value of these particular assets drops significantly in the first several years that they are in service, as compared to traditional assets added to rate

⁶⁷ See N.D.C.C. § 49-02-32.

⁶⁸ Tr. 592, ll. 21-25, Tr. 593, ll. 1.

⁶⁹ See Tr. 178, ll. 1-4 (Goodin Testimony); Tr. 647, ll. 11-13 (Mulkern Testimony); Tr. 694, ll. 25, Tr. 695, ll. 1 (Mulkern Testimony); Tr. 987, ll. 3-4 (Mulkern Testimony).

base. This is acknowledged by MDU.⁷⁰ Traditional assets are more appropriate for base rates because they are assumed to depreciate approximately at the same rate that a utility invests in new assets and has other costs increase. Conversely, the same type of matching of depreciation and new additions does not occur when significant wind investments are added to base rates. The reason these assets drop so significantly is the more favorable tax depreciation and significant tax credits that reduce rate base dramatically on the front end of these investments.

MDU has not provided sufficient information to set just and reasonable rates in a rider. Consequently, additional information is needed to be reviewed before rider recovery is appropriate. This information includes: (1) correct depreciation period for useful life of the wind farms; (2) appropriate amortization of tax credits for ratemaking purposes; and (3) an analysis of the election of PTC as opposed to Federal Grant.

1. Appropriate Depreciable Life.

MDU has chosen to amortize these wind farms over a 20-year period.⁷¹ This is shorter than the useful lives used by other North Dakota utilities and shorter than the industry average.⁷² Other North Dakota regulated utilities have used a 25-year depreciable life for their wind farms.⁷³ Further review is necessary to determine whether MDU's amortization practice is appropriate before any rider recovery should be allowed.

2. Amortization of Tax Credits.

⁷⁰ Tr. 692, ll. 1-11; Tr. 694, ll. 13-20 (Mulkern Testimony).

⁷¹ Tr. 684, ll. 9-20 (Mulkern Testimony).

⁷² See Tr. 640, ll. 13-16; Tr. 643, ll. 5-6 (taking official notice of PU-10-18).

⁷³ Tr. 684, ll. 22-24 (Mulkern Testimony).

MDU has incorrectly proposed recovery of the North Dakota Investment Tax Credit over the life of the project, as opposed to passing it directly through. MDU argues that it is required to recover over the life of the project because of a tax election.⁷⁴ Importantly, however, tax elections do not control or influence how the Commission sets rates. Indeed, Financial Accounting Standards Board Statement No. 71 allows the Commission to make policy decisions that differ from those followed by the utility for financial accounting purposes.⁷⁵ In this instance, it is not just and reasonable to allow MDU to use these tax benefits/refunds without immediately returning them to ratepayers. Furthermore, as discussed above, the cost to ratepayers of these wind farms is much more front-ended than other utility assets, so early ratepayers pay for far more than those at the end of the resource's useful life. This amounts to an intergenerational transfer which can be alleviated slightly by passing on the North Dakota Investment Tax Credit as received. Staff is not advocating that MDU deviate from its financial reporting or tax treatment; rather, Staff is simply pointing out that regulatory accounting can be different from financial accounting, and in fact should differ in this particular case for the benefit of the ratepayers.

3. PTC or Grant.

Analysis must be performed on MDU's selection of PTC as opposed to the available Federal Grant. MDU relies on financial analysis that did not pass through the benefit of the Grant when received—again, claiming a tax election required them to amortize the benefit.⁷⁶ This results in a significant time value difference in the modeling. As discussed above, the Commission is not bound by how tax laws are applied by utilities for financial accounting

⁷⁴ Tr. 686, ll. 12-25, Tr. 687, ll. 1 (Mulkern Testimony).

⁷⁵ See also Tr. 691, ll. 10-25 (Mulkern Testimony).

⁷⁶ Tr. 978, ll. 13-25, Tr. 979, ll. 1-13 (Neigum Testimony).

purposes. This is also directly opposite to the conclusion of the only other North Dakota utility to add a farm with an opportunity to elect use of the Grant.⁷⁷ While PTC may have been the best decision for MDU, further analysis should be done in the rider filing proceeding to determine if MDU made the correct decision on behalf of ratepayers. Ultimately, MDU should be limited to recovery under the method most favorable to ratepayers.

E. MDU Failed To Meet Its Burden Relating To Incentive And Director Pay.

The Commission should not include all of the costs associated with incentive compensation paid to MDU employees and officers because the Utility has not met its burden of showing that the costs associated with this compensation are just and reasonable. Likewise, the allowance for director and investment relations expenses should also be reduced for the same reason. In particular, the Utility's failure to meet its burden with respect to incentive and director and investment relations expenses is evidenced by MDU's inability to (1) provide a breakdown establishing reasonableness of incentive and director and investment relations expenses; (2) show a correlation between incentive pay and employee turnover; (3) reconcile the fact that incentive and director compensation primarily benefits shareholders; and (4) cooperate in the regulatory process.

1. MDU failed to establish the reasonableness of incentive and director compensation.

As previously discussed, when a proposed rate increase involves changes in administrative and general expense allocation, the Utility must establish the reasonableness of

⁷⁷ See Tr. 640, ll. 13-16; Tr. 643, ll. 5-6 (taking official notice of PU-10-18).

those changes with a breakdown and analyses of those expenses.⁷⁸ This is especially true when the increased costs are associated with performance—that is, the Utility must show how its performance on behalf of ratepayers justifies providing additional pay rewards to employees and officers with discretionary incentive pay. In addition, the Utility must show how its compensation of directors benefits its ratepayers, as opposed to its shareholders.

MDU has attempted to support the reasonableness of its incentive compensation by relying on industry surveys.⁷⁹ These surveys are only conducted every three to four years.⁸⁰ And, although the Utility acknowledges that such surveys would be helpful to ratepayers and intervenors in rate cases such as this one,⁸¹ it failed to retain the last survey it conducted approximately two years ago.⁸² The Utility provided no recent study support to justify its annual incentive pay awards. Additionally, the limited performance matrix information provided to the Staff during the review process showed a heavy weighing on financial performance, which primarily benefits investors. The Utility's witnesses could not explain this fact, instead wrongly asserting during their oral testimonies that safety and customer relations were the major performance criteria used to determine incentive compensation. In reality, financial performance was the major emphasis in every category of employees. Therefore, Staff's proposal to exclude 60% of the Utility's proposed rate increase allocated to such costs should be accepted.

⁷⁸ See Mont.-Dakota Utils. Co., 413 N.W.2d at 314-15.

⁷⁹ See Tr. 405, ll. 12-17 (Del Vecchio Testimony).

⁸⁰ Tr. 405, ll. 14-15 (Del Vecchio Testimony).

⁸¹ Tr. 405, ll. 21-25; Tr. 406, ll. 1 (Del Vecchio Testimony).

⁸² Tr. 405, ll. 16-17 (Del Vecchio Testimony).

In addition, a significant portion of the proposed rate associated with MDU director and investment relations expenses should also be excluded. While Staff acknowledges that ratepayers may receive an attenuated benefit from the directors' administration of their fiduciary duties, it is actually shareholders who receive the primary benefit from the work performed by the Utility's directors. Therefore, the shareholders should incur the primary expense associated with those directors' compensation. Consequently, the portion of the Utility's revised rate associated with these expenses must be reduced.

2. MDU has not shown a correlation between incentive compensation and reduced turnover.

The Utility argues that a competitive incentive compensation package is necessary to avoid employee turnover, which "can impede the safe and reliable delivery of low-cost service."⁸³ Unfortunately, MDU did not conduct any survey in recent years to support this position.⁸⁴ Moreover, the last study the Utility did conduct on turnover, which occurred "years ago" did not show that employees were leaving as a result of inadequate incentive pay.⁸⁵ This is not surprising, considering that the Utility's regular pay and incentive compensation is above the market average.⁸⁶ Thus, MDU has failed to show that its current incentive compensation structure benefits ratepayers by preventing employee turnover.

In addition, it was noted at the hearing that MDU obtained an employee from a cooperative within North Dakota because MDU's pay and incentives were more favorable.⁸⁷

The Commission should not allow a regulated utility to recover for compensation that is

⁸³ Tr. 401, ll. 16-21 (Del Vecchio Testimony).

⁸⁴ Tr. 401, ll. 22-24 (Del Vecchio Testimony).

⁸⁵ Tr. 401, ll. 24, Tr. 402, ll. 22-25 (Del Vecchio Testimony); Tr. 999, ll. 11-17 (Goodin Testimony).

⁸⁶ Tr. 405, ll. 17-21 (Del Vecchio Testimony).

⁸⁷ Tr. 439, ll. 12-16 (Del Vecchio Testimony).

significantly better than other utilities within the state such that other ratepayers are losing their utility employees. In essence, MDU ratepayers are paying too much and other utility ratepayers are also losing through increased turnovers while being forced to increase their own labor costs in order to complete.

3. Incentive and director compensation is primarily for shareholder benefit.

This Commission and those in other jurisdictions have consistently found that a public Utility's incentive pay is a cost that should be primarily borne by shareholders, rather than ratepayers, because such costs are incurred largely for shareholder benefit. The same is true for director and investment relations expenses. While Staff does not dispute that MDU's employment compensation package "is a matter left largely to the deference and judgment of [MDU],"⁸⁸ the Utility must still meet its burden showing that the compensation is reasonable and constitutes an expense incurred for the benefit of its North Dakota ratepayers. This Commission has previously held that incentive compensation should be primarily designated a shareholder expense.⁸⁹ The Commission's precedent is in line with the rationale that "[i]ncentive programs generally benefit shareholders rather than ratepayers; and utility employees should perform at an optimum level to service customers without any additional compensation."⁹⁰

⁸⁸ See Mont.-Dakota Utils. Co., 413 N.W.2d at 315-16. While MDU may argue that this case supports its position that its compensation package is just and reasonable, it is important to note that the case spoke primarily to the *form* of compensation, rather than the level, and the court still held that a utility must support its rate request with documentation establishing the reasonableness of its compensation. See *id.* at 314-16.

⁸⁹ See, e.g., In re N.States Power Co., 139 P.U.R.4th 348, 365, 1992 WL 421306 (N.D.P.S.C. Dec. 15, 1992) (disallowing costs attributable to incentive compensation from rate increase).

⁹⁰ In re GASCO, Inc., 132 P.U.R.4th 352, 368, 1992 WL 121735 (Haw.Pub.Util.Comm'n 1992) (noting that incentive programs will generally not be recognized for ratemaking purposes)

Moreover, incentive pay systems have a tendency to create an inherent conflict of interest between a public utility's financial performance for the benefit of its shareholders, and the increased costs required to deliver satisfactory customer service to its ratepayers in an industry essentially devoid of competition. The Washington Supreme Court has summarized this conflict succinctly:

There is a potential tension between service quality and earnings. A firm can concentrate on financial elements so heavily that it can lose sight of the importance of providing customer service. In a public utility service, where many customers have no reasonably suitable alternatives, the Commission must substitute for the competitive market in assuring that customer service remains a priority in the business.^{91 92}

Incentive pay constitutes a reward for satisfying financial performance goals on behalf of investors.⁹³ Consequently, the costs associated with such pay should be borne primarily by those investors rather than MDU's ratepayers.

This is especially true where, as here, the focus of the incentive pay is on profitability and financial performance. MDU Chief Executive David Goodin testified at the hearing that profitability was only one of a number of *evenly-weighted* factors considered as part of MDU's

and holding utility had not met its burden of showing that its employee-directed incentive compensation program benefited ratepayers).

⁹¹ US W. Comms., Inc. v. Wash. Utils. & Transp. Comm'n, 949 P.2d 1337, 1363 (Wash. 1997) (holding Commission acted within its discretion in disallowing recovery of bonus incentive payments carrier made to its employees which did not benefit ratepayers and which tended to lower service quality).

⁹² For additional decisions refusing to factor incentive compensation into a utility's rate increase, see, e.g., US W. Comms., Inc. v. Pub. Serv. Comm'n of Utah, 901 P.2d 270, 277 (Utah 1995); In re Illinois Power Co., 131 P.U.R.4th 1, 62-63, 1992 WL 486361 (Ill.Commerce Comm'n 1992) (concluding incentive program cost should not be borne by ratepayers).

⁹³ MDU concedes that financial performance is for shareholder benefit. Tr. 414, ll. 4-7 (Del Vecchio Testimony).

incentive compensation package for 2007-2009.⁹⁴ Goodin's statement was outright wrong. For example, in 2007, two-thirds of MDU's incentive compensation package was based in the Utility's financial performance.⁹⁵

The Utility argues that regardless of what its practice was in the past, its compensation package for 2010 weights financial performance evenly along with operation costs and customer service.⁹⁶ This alone, however, is insufficient to support a Commission finding that the portion of MDU's proposed rate increase resulting from incentive compensation is just and reasonable. As a preliminary matter, MDU's expert on compensation could not tell the Commission whether the Utility's proposed increase was based on past or future compensation packages.⁹⁷ In actuality, the Utility's proposed rates are based on its 2009 incentive compensation levels, which did in fact include compensation that was much more heavily weighed on MDU's profitability.⁹⁸

Moreover, while only one-third of MDU's compensation package for low-level employees may be tied to financial performance going forward, that percentage for mid-managers and officers is much larger. Indeed, 50% of mid-managers incentives are based on financial performance, and 100% of incentive compensation for officers is based on the same.⁹⁹ Ultimately, while Staff is willing to give MDU the benefit of the doubt that a *portion* of its incentive compensation and director and investment relations expenses is for the benefit of ratepayers, those ratepayers should not bear the *entire* costs associated with such

⁹⁴ Tr. 61, ll. 24-25 (Goodin Testimony).

⁹⁵ Tr. 411, ll. 19-25; Tr. 412, ll. 1-4 (Del Vecchio Testimony).

⁹⁶ Tr. 163, ll. 1-9 (Goodin Testimony).

⁹⁷ Tr. 414, ll. 14-25; Tr. 415, ll. 1-4 (Del Vecchio Testimony).

⁹⁸ See Tr. 753, ll. 18-25, Tr. 754, ll. 1-18 (Mathai Testimony).

⁹⁹ Tr. 413, ll. 8-15, 21-25; Tr. 414, ll. 1-3 (Del Vecchio Testimony).

compensation, because it is primarily for shareholder benefit. Accordingly, the amount of incentive and director compensation expenses included in the Utility's revised rate should be reduced.¹⁰⁰

4. MDU has failed to cooperate in the regulatory process.

MDU's failure to be adequately prepared for and participate in these proceedings argues for further adjustment to incentive compensation. While the Utility has demonstrated that it enjoys the many benefits of the monopoly it holds, it advocates against regulation, and in fact will fight such regulation to the greatest extent permitted. The Commission should not allow this unproductive conduct and should ensure that ratepayers are provided protection in this (necessarily) regulated industry. In these proceedings, MDU had made numerous material mistakes,¹⁰¹ refused to provide adequate responses necessary to allow the regulatory agencies to perform an adequate analysis of the Utility's requests,¹⁰² and provided delayed material adjustments, resulting in inadequate regulatory review of filings.¹⁰³ While MDU would like to blame these problems on Staff's consultant as new to the MDU company operation, the multitude of mistakes, problems, and inconsistencies in the Utility's own submissions defeat

¹⁰⁰ See Pre-filed Mathai Pre-filed Testimony, CAS Ex. 17, p. 23, ll. 8-20; Tr. 753, ll. 2-11 (Mathai Testimony)

¹⁰¹ See, e.g., Tr. 12, ll. 11-12 (oversight in application) (Goodin Testimony); Tr. 408, ll. 6-13, Tr. 411, ll. 19-25, Tr. 412, ll. 1-4 (claiming only 15-20% of incentive pay based on financial performance when it actually composed as high as 66%) (Del Vecchio Testimony); Tr. 668, ll. 1-12 (overstating wind farm production) (Mulkern Testimony); Tr. 678, ll. 8-12 (mistake in filing) (Mulkern Testimony).

¹⁰² See, e.g., Tr. 581, ll. 20-25, Tr. 582, ll. 1-20 (insufficient response to Staff's information request) (Mulkern Testimony); Tr. 647, ll. 22-25, Tr. 648, ll. 1-11 (failure to respond to information request) (Mulkern Testimony); Tr. 658, ll. 2-17 (lack of clarity regarding historical margin sales).

¹⁰³ See, e.g., Tr. 633-36 (material changes filed on first morning of hearing; failure to update financial calculations) (Mulkern Testimony); Tr. 683, ll. 6-10 (failure to provide updated calculations) (Mulkern Testimony).

this position. MDU's approach to this rate case and lack of respect for the regulatory process should result in further downward adjustment to incentive compensation.

F. The Commission Should Approve The Settlement Agreement

Prior to the hearing in this matter, MDU and Staff executed two settlement agreements regarding a number of issues arising from and relating to MDU's proposed rate increase. Staff recommends that the Commission accept the parties' settlement agreements in their entireties with respect to these issues.

III. CONCLUSION

For the reasons set forth herein, Staff asks the Commission to deny MDU's request that the costs associated with its wind farm investments be factored into its revised electric rate. In addition, Staff requests that the Commission modify MDU's request as proposed by Staff with respect to incentive compensation and director and investment relations expenses to reduce the amount allowed for these expenses. Lastly, Staff requests that the Commission accept the settlement agreements between MDU and Staff with respect to the remaining issues in this matter.

Respectfully submitted,



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STATE OF NORTH DAKOTA
PUBLIC SERVICE COMMISSION

Montana-Dakota Utilities Co.
Electric Rate Increase
Application

Case No. PU-10-124

ADVOCACY STAFF'S PROPOSED
FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER

Appearances

Commissioners Tony Clark, Kevin Cramer, and Brian Kalk.

Daniel S. Kuntz, Associate General Counsel, MDU Resources Group, Inc., 918 East Divide Avenue, P.O. Box 5650, Bismarck, North Dakota 58506, on behalf of Montana-Dakota Utilities Co.

Richard J. Savelkoul, Felhaber, Larson, Fenlon & Vogt, P.A., 444 Cedar Street, Suite 2100, Saint Paul, Minnesota 55101, on behalf of Advocacy Staff.

Scott Skokos, Missouri Valley Resource Council, 103-1/2 South Third Street, Suite 8, Bismarck, North Dakota 58504, on behalf of Missouri Valley Resource Council.

James D. Roaché, 707 First Street Southwest, Crosby, North Dakota 58730, appearing pro se.

PRELIMINARY STATEMENT

On April 19, 2010, Montana-Dakota Utilities Co. (MDU) filed its application and Direct Testimony seeking a revenue increase of \$15,396,303, or 14 percent of total revenues (Application) with the North Dakota Public Service Commission (Commission).

On May 12, 2010, the Commission suspended the tariff revisions filed in MDU's Application.

On June 15, 2010, MDU and the North Dakota Public Service Commission Advocacy Staff (Staff) executed a partial settlement agreement regarding Cost of Debt, Return on Equity, and overall Rate of Return in this matter. The partial settlement agreement was subject to Commission approval.

On June 16, 2010, the Commission issued an Order on Interim Rates, approving MDU's proposed interim increase of \$7,617,000 per year.

On June 16, 2010, the Commission issued a Notice of Hearing and Notice of Public Input Sessions, outlining the issues to be considered at the hearing, including:

1. What is the value of MDU's property, used and useful, for the service and convenience of the public in North Dakota?
2. What is MDU's rate of return on its property, used and useful, for the service and convenience of the public in North Dakota?
3. What is a just and reasonable rate of return on MDU's property, used and useful, for the service and convenience of the public in North Dakota?
4. What rates and charges are necessary to provide a just and reasonable rate of return on MDU's property, used and useful, for the service and convenience of the public in North Dakota?
5. Are MDU's proposed rate schedules designed in such a manner that they result in a basis of charge to its customers that is just and reasonable without discrimination?
6. Other relevant information or proposals concerning the proceeding.

On July 6, 2010, MDU amended its Application to revise its requested rate increase to \$13,312,000, or 12 percent of total revenues. With the negotiated ROE settlement, this amount was reduced further to \$11,518,000, or 10 percent.

On July 12 and July 13, 2010, public input sessions were held via interactive television to locations in Bismarck, Dickinson, and Williston, North Dakota.

On July 14, 2010, James Roaché, an MDU ratepayer, petitioned to intervene on behalf of himself and the retirement community in his area in the proceedings. This petition was granted by the Commission on August 24, 2010.

On October 15 and 19, 2010, Staff witnesses filed Direct Testimony.

On October 21, 2010, Missouri Valley Resource Council petitioned to intervene in the application proceedings. This petition was granted by appointed Temporary Administrative Law Judge Al Wahl on October 25, 2010.

On November 5, 2010, MDU witnesses filed Rebuttal Testimony.

On November 8, 2010, MDU and Staff executed a second partial settlement agreement. This second agreement modified the terms agreed to in the parties' June 15, 2010, agreement. In addition, this second agreement resolved many of MDU and Staff's disputed issues. This second agreement was subject to Commission approval.

On November 8 through November 12, 2010, the hearing was held in the Commission Hearing Room at the State Capitol in Bismarck, North Dakota.

Having allowed all interested persons an opportunity to be heard and having heard, and considered all testimony and evidence presented, the Commission makes the following:

FINDINGS OF FACT

1. Montana-Dakota Utilities Co. is a division of MDU Resources Group, Inc. currently registered with the North Dakota Secretary of State and authorized to do business in North Dakota as a foreign corporation. MDU is doing business in North Dakota as a public utility company.

2. MDU provides electric retail service in four states, including North Dakota, Montana, South Dakota, and Wyoming.

3. Staff and MDU do not dispute the following issues:

- Cost of Debt
- Return on Equity
- Overall Rate of Return
- Margin Sales and Sales for Resale
- Aircraft Ownership
- Customer Deposits
- Maintenance Costs for Big Stone and Coyote Generating Facilities
- Transmission - WAPA Costs
- Storm Damages
- Deferred Generation Costs
- Treatment of Costs Associated with Refinancing Certain Debt at Lower Interest Rates
- Labor Costs

4. Staff and MDU do dispute the following issues:

- Whether investments made by MDU in the Diamond Willow and Cedar Hills wind farms were used and useful for the service and convenience of the public in North Dakota;
- Whether costs associated with incentive compensation paid to MDU employees and officers, as well as director and investment relations

expenses, were used and useful for the service and convenience of the public in North Dakota.

Wind Farms

5. MDU's proposed rate initially included a Wind Energy Revenue Requirement totaling \$10,547,551 to recover MDU's costs associated with its investment and related expenses in three wind farm projects: Diamond Willow (1 and 2), located in Montana, and Cedar Hills, located in North Dakota.

6. MDU has requested that approximately 65% of its wind energy be allocated to North Dakota, resulting in \$72 million in investments and \$324,000 in expenses.

7. These wind farms, which make up approximately 25% of MDU's entire rate base, only provide for approximately 1% of ratepayers' peak demand, as accredited by MISO.

Economic Analyses

8. North Dakota has a renewable and recyclable energy objective set forth in N.D.C.C. § 49-02-28 that 10% of electricity sold at retail be obtained from renewable and recycled energy sources by 2015. This objective is voluntary.

9. This renewable and recyclable energy objective has a mandatory component requiring a utility to conduct an economic analysis of the cost-effectiveness of a renewable resource project before making an investment in that resource. N.D.C.C. § 49-02-32 provides:

Use of renewable and recycled energy - Economic evaluation. Before using new renewable and recycled energy after August 1, 2007, to meet the objective, the retail provider or its generation supplier shall make an economic evaluation to determine if the use of new renewable and recycled energy is cost-effective considering other electricity alternatives. After evaluating the renewable and recycled energy objective and economic evaluation, the retail provider or its generation supplier may use the electricity alternative that best meets its resource or customer needs

10. The purpose of this economic analysis is to ensure that a renewable resource investment is in the best interest of North Dakota ratepayers.

11. Although it argues economic analyses were completed for the Diamond Willow and Cedar Hills projects, MDU has presented no evidence or documentation of such analyses.

12. MDU has not shown how the costs of building its wind farm facilities compare to the costs of building alternative resource facilities.

13. MDU has failed to quantify the increased costs associated with constructing the Diamond Willow and Cedar Hills wind farms above least-cost.

14. The Commission therefore finds that MDU did not engage in the requisite economic analyses of the cost-effectiveness of the Diamond Willow or Cedar Hills wind farms before their construction, in contravention of North Dakota law.

Advanced Determination of Prudence

15. Public utilities are encouraged to seek an advanced determination of prudence from the Commission before investing in renewable resources under N.D.C.C. § 49-05-16.

16. The purpose of obtaining an advanced determination of prudence is to ensure that a renewable resource investment is reasonable and in the best interest of North Dakota ratepayers.

17. MDU did not seek an advanced determination of prudence for either the Diamond Willow or the Cedar Hills wind farms.

18. Had MDU sought an advanced determination of prudence, it would have enjoyed a presumption of prudence for its Cedar Hills wind farm because that project is located in North Dakota. Since no advanced determination was sought, no presumption was enjoyed.

Environmental Externalities

19. North Dakota Century Code Section 49-02-23 prevents utilities from considering evidence of environmental externality values or costs of future environmental regulations. Section 49-02-23 states:

Consideration of environmental externality values prohibited. The commission may not use, require the use of, or allow electric utilities to use environmental externality values in the planning, selection, or acquisition of electric resources or the setting of rates for providing electric service. Environmental externality values are numerical costs of quantified values that are assigned to represent either:

1. Environmental costs that are not internalized in the cost production or the market price of electricity from a particular electric resource; or
2. The alleged costs of complying with future environmental law or regulations that have not yet been enacted.

20. MDU based its decisions to invest in the Diamond Willow and Cedar Hills wind farms, at least in part, on such environmental externalities, in contravention of N.D.C.C. § 49-02-23.

Cost-effectiveness

21. MDU argues that it may make investment decisions relating to renewable resources on behalf of North Dakota ratepayers without regard to the cost-effectiveness of those resources. It cannot.

22. None of MDU's integrated resource plans selected wind as the least-cost option for a new resource investment. Wind is a "must-run" resource that had to be forced into the integrated resource plan models because of its expense.

23. The Request for Proposal process that MDU implemented for its Diamond Willow wind farms was inadequate, unnecessarily limiting, and resulted in the utility paying a premium for those projects.

24. MDU did not complete a Request for Proposal for the Cedar Hills wind farm.

25. MDU failed to demonstrate that the Diamond Willow and Cedar Hills wind farms were the lowest cost alternative to meeting North Dakota's limited wind resource requirements.

26. MDU has previously argued before the Commission that wind is an expensive resource only utilized to comply with governmental renewable energy objectives and mandates.

Montana Renewable Mandate

27. North Dakota has better wind resources than Montana.

28. The State of Montana has a legislative mandate requiring utilities to meet 10% of their retail sales with wind energy by 2010 and 15% by 2015.

29. MDU's decision to invest in the Diamond Willow and Cedar Hills wind farms was driven largely by its need to comply with this Montana mandate.

30. Compliance with the Montana mandate could have been achieved by MDU through alternative means that would not have resulted in expenses being passed onto North Dakota ratepayers, *i.e.*, purchasing renewable energy credits from certified sources.

31. MDU did not model the cost of wind versus other resources.

32. MDU has failed to demonstrate that its investments in the Diamond Willow and Cedar Hills wind farms were in the best interest of North Dakota ratepayers.

33. We find that MDU has failed to meet its burden of showing that its proposed rate is just and reasonable when the Wind Energy Revenue Requirement is included, based on MDU's failure to show that its investments in the Diamond Willow and Cedar Hills wind farms were prudent, and have been used and useful for the benefit of North Dakota ratepayers. Therefore, we accept Staff's recommendation that the Wind Energy Revenue Requirement be entirely excluded from MDU's revised rate.

Incentive Pay, Director Compensation, and Investor Relations Expenses

34. MDU's proposed rate includes costs associated with incentive compensation for its employees and officers, as well as director compensation and other investor relations expenses.

35. MDU has failed to establish the reasonableness of its incentive and director compensation.

36. No correlation has been shown between reduced employee turnover and MDU's payment of incentive compensation.

37. The incentive compensation packages MDU provides to its employees, mid-managers, and officers are heavily based on financial performance and profitability.

38. Incentive compensation is primarily for shareholder benefit, though ratepayers do see some benefit, as well.

39. Director compensation and investor relations expenses are also primarily for shareholder benefit, with some attenuated benefits to ratepayers.

40. The Commission notes that obtaining complete cooperation from MDU in these rate proceedings has been difficult.

41. MDU submitted a number of late filings, made material changes shortly before the hearing, and refused to provide complete responses to a number of Staff's information requests.

42. We find that because incentive pay, director compensation, and investor relations expenses are primarily for the benefit of shareholders, their costs should be predominantly borne by shareholders. We therefore agree with Staff and accept its adjustment to exclude 60% of the costs associated with these expenses from revenue requirements.

Settlement Agreements

43. On June 16, 2010, Staff filed an executed partial settlement agreement between Staff and MDU resolving a number of the parties' disputed issues. On November 8, 2010, MDU filed a second executed partial settlement agreement, which amended the first agreement and resolved additional disputed issues between Staff and MDU.

44. Having considered these agreements, the Commission finds them to be reasonable and that both should be approved.

From the foregoing Findings of Fact, the Commission makes the following:

CONCLUSIONS OF LAW

1. The Commission has jurisdiction over this proceeding.
2. MDU has the burden to establish that an increased rate or proposed change of rate is just and reasonable and not in violation of any of the provisions of N.D.C.C. title 49.
3. An investor-owned utility is entitled to earnings sufficient to pay its expenses and provide a fair and reasonable return to its investors.
4. To establish the just and reasonable rate of a public utility, the Commission is required to determine the value of the property of a public utility used and useful for the service and convenience of the North Dakota public.
5. "Used and useful" requires North Dakota ratepayers to have received a tangible and quantifiable benefit.
6. N.D.C.C. § 49-02-32 requires a public utility to conduct an economic analysis to determine the cost-effectiveness of a proposed renewable resource investment before such an investment is made.
7. N.D.C.C. § 49-06-24 prohibits the Commission from increasing electric rates as a result of actions taken by other states requiring higher cost resources to be built due to the application of environmental externality values.
8. It is just and reasonable to require Montana ratepayers to pay costs imposed due to Montana policy and renewable energy mandates when those costs do not provide a quantifiable benefit to North Dakota ratepayers.
9. It is not just and reasonable for ratepayers to pay for expenses that primarily benefit an electric utility's shareholders.

From the foregoing Findings of Fact and Conclusions of Law, the Commission makes the following:

ORDER

The Commission orders:

1. The Settlement Agreement dated June 15, 2010, a copy of which is attached to this Order and made part of this Order, is APPROVED.
2. The Settlement Agreement dated November 8, 2010, a copy of which is attached to this Order and made part of this Order, is APPROVED.
3. MDU may implement a rate increase for service rendered on and after _____, 2011, sufficient to produce a total annual revenue increase of an amount to be determined after detailed compliance filings are made for removal of wind and incentive costs.
4. MDU shall file revised tariff sheets for the Commission approval consistent with the foregoing findings of fact and conclusions of law.

PUBLIC SERVICE COMMISSION

**Tony Clark
Commissioner**

**Kevin Cramer
Commissioner**

**Brian Kalk
Commissioner**