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ORIGINAL

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Executive Secretary
North Dakota Public Service Commission
State Capitol Building
Bismarck, ND 58505

PUBLIC SERVICE COMMISSION

Re: Case No. PU-10-124

Montana-Dakota Utilities Co. (Montana-Dakota), a Division of MDU Resources Group, Inc. herewith submits its Reply Brief in the above referenced case.

The original and seven (7) copies have been provided to the Commission and one copy has been provided to the parties noted below.

Please acknowledge receipt by stamping or initialing the duplicate copy of this letter attached hereto and returning the same in the enclosed self-addressed stamped envelope.

Sincerely,

Rita A. Mulkern
Regulatory Analysis Manager

Attachment

cc: Mr. Richard Savelkoul
Mr. Jim Roache
Mr. Scott Skokos (on behalf of the Missouri Valley Resource Council)

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Reply Brief

STATE OF NORTH DAKOTA
PUBLIC SERVICE COMMISSION

**Montana-Dakota Utilities Co., a
Division of MDU Resources Group, Inc.
Electric Rate Increase Application**

**Case No. PU-10-124
Reply Brief of
Montana-Dakota Utilities Co.**

INTRODUCTION

Montana-Dakota Utilities Co. (“MDU” or the “Company”) submits the following brief in reply to Staff’s Post-Hearing Brief. Many of the arguments in Staff’s brief are addressed in MDU’s Post-Hearing Brief. MDU will not repeat its position on those issues in detail here, but rather will summarize previously stated positions and address any new issues raised by Staff regarding its recommendations for disallowance of the Company’s investment in wind generation and partial disallowance of employee incentive compensation and director’s fees and expenses.

In its zeal to support its recommendations, Staff’s brief frequently mischaracterizes both the evidence and the law cited in support of its position. The first example of this appears on page 3 of its brief where the Staff states “[t]he 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.” Not only is this statement an inaccurate statement of the law as the Company’s burden of proof remains the same whether its rates are above or below those of other utilities, but also Staff cites pages 55 and 56 of the transcript of Mr. Goodin’s testimony as supporting Staff’s statement. In actuality, Mr. Goodin’s testimony on this issue from page 56 of the transcript is as follows:

Q. Are you familiar with how MDU performs within North Dakota compared to other utilities?

A. I would say we're pre-rate case, pre-rate filing, we're in the lower half, and with the percent increase that we requested, I think puts us probably right at about the median or maybe slightly above the median. I want to reserve my answer, though, that the exact details be produced. Again, that would be my recollection.

While the distinction between the language used by Staff's brief and Mr. Goodin's actual testimony is subtle, Staff's statement is deliberately misleading. Because of the frequency with which this occurs in Staff's brief, MDU will not identify each occurrence but will note only the more blatant examples of this misguided advocacy.¹ The Commission and its advisors, however, are urged to carefully review the evidentiary record and legal authority cited by the parties to assure the authorities and record citations actually support the positions for which they are cited.

A. The Staff Failed to Show that MDU's Investment in Wind Generation was Imprudent

Although the Staff on page 3 of its brief states that MDU's wind generation projects "have not been shown to be used and useful for North Dakota ratepayers," the Staff makes no attempt to support this conclusion and completely ignores the undisputed evidence that the projects are operational and expected to provide seven percent of the electric energy for customers of MDU's integrated electric system.

¹ Staff's advocacy suggests it misconstrues its role in this proceeding. Although the Commission's consultants and attorney in this case are labeled "Advocacy Staff," they are retained under N.D.C.C. § 49-02-02(6) to help and assist the Commission in its responsibility to determine rates which on one hand provide reasonable charges to customers while on the other provide a fair return to the utility on the value of its property used to serve the public. Public Service Commission v. Montana-Dakota Utilities Co., 100 N.W.2d 140 (ND 1959). The Staff has no independent power other than to assist the Commission in its role as a decision-maker. While the Staff is certainly expected to investigate, question, and challenge the Company, and when appropriate recommend alternatives to the Company's proposals, it has no power or responsibility to act as an adversary to the Company rather than as an assistant to a fair and impartial Commission.

Exhibit 6, p. 11; Tr. 961. Diamond Willow I for example has been providing electricity for North Dakota customers for nearly three years. Prior to interim rates in this proceeding, its only rate impact to customers was an effective reduction in the Company's fuel clause adjustment. Tr. 69, 176, 449, 455, 575, 661, 630, 961.

Because MDU's investment in wind generation is used and useful in providing electric service for its customers, MDU is entitled to a return on the value of its original investment in those projects less any amount shown to be impudent. Staff, however, does not advocate that just some incremental cost of the projects should be excluded as imprudent. Instead, despite the substantial evidence presented by MDU showing the prudence of its decision to invest in the wind generation, Staff argues the entire investment should be disallowed as imprudent; not because some of the investment was unreasonable or there were more cost effective resources available, but rather because Staff contends MDU failed to: "(1) conduct an economic analysis of the wind farm investments as required under North Dakota law; (2) consider the cost effectiveness of these investments; and (3) obtain an advance determination of prudence from the Commission." As was noted in MDU's Post-Hearing Brief, these are simply arguments by Staff rather than factual evidence to support a determination that the projects are imprudent. Moreover, they are incorrect arguments. There is no legal requirement that MDU conduct a particular economic analysis or obtain an advanced determination of prudence. In addition, Staff's position ignores the substantial evidence that MDU's investment in the wind projects was prudent for the reasons testified at the hearing and discussed in MDU's Post-Hearing Brief including its consideration of the cost effectiveness of the investments.

1. MDU properly evaluated its generation alternatives.

Contrary to Staff's assertion, there is no requirement that a utility conduct a specific type of economic analysis of renewable energy, or any other type of generation project, as a pre-condition to rate recovery for the project. Staff's reliance upon North Dakota's renewable energy policy at N.D.C.C. § 49-02-32 is misplaced. As discussed in MDU's Post-Hearing Brief, the statute provides an exception to North Dakota's renewable energy policy such that a utility is not required, although also not prohibited, from meeting the renewable energy objective if its economic evaluation shows renewable energy is not cost effective considering other alternatives that might better meet its resource and customer needs. Tr. 329. The evidence shows that MDU evaluated the economics of wind generation in relation to other generation alternatives and market prices. Tr. 284, 366-367, 385-386, 487, 526-532. MDU conducted considerable evaluation and modeling of generation alternatives following the expiration of the AVS contract and the Company's investigation of replacement generation. Tr. 42-45, 167-168, 284, 366-367, 543-546. Modeling results were presented in the expert testimony and relied upon by the Commission in the advanced determination of prudence proceeding for the Big Stone II project. See the Commission's order in Case No. PU-06-482. The results of that modeling were considered by MDU in its decision to pursue the wind generation projects as cost effective generation in relation to other generation alternatives, as well as by the Commission in its directive that MDU should include wind generation in its generation portfolio even if it is not the least cost generation alternative. These modeling results showed coal generation was the least cost baseload generation alternative from a strict economic standpoint but that wind

generation in combination with natural gas generation was only marginally more expensive and a suitable complement or alternative to coal generation. Tr. 463. Case No. PU-06-482. If this analysis was sufficient for the Commission to determine in Case No. PU-06-482 that MDU should include wind generation in its future generation additions, it was certainly sufficient for MDU to also conclude that wind generation was a cost effective generation alternative for its customers.

Particularly confusing is Staff's statement that MDU offered no concrete numbers and provided no exhibits evidencing any economic evaluation. Mr. Neigum testified regarding specific cost values of generation alternatives available to MDU. Transcript 487, 527-530, 563-565. Although Staff criticizes the adjustments made by MDU to the revenue requirement calculation associated with the wind projects submitted at the hearing and explained by Ms. Mulkern, none of those adjustments related to the comparative cost information available to and considered by MDU in its decision to develop the wind generation projects. While MDU did not conduct the project specific revenue requirement analysis desired by Mr. Mathai, it provided considerable cost information related to the wind generation projects. Exhibit MDU 27 (DR-051, DR-052, DR-054, DR-058, DR-061, DR-073, DR-075, DR-079, DR-080, DR-081, DR-082, DR-091), Exhibit MDU 6R, p. 3, 7, 10. Specifically, Exhibit MDU 27, (DR-052), which was introduced into evidence and provided to Staff during discovery, provides a yearly cost per KWh from beginning to end of plant life for each project. In addition, Exhibit MDU 27 (DR-082) provided a revenue requirement calculation for the wind projects installed in 2010.

Staff also criticizes MDU's consideration of "societal and regulatory" factors in development of the wind generation projects. First, Staff mischaracterizes the evidence when it asserts that environmental laws and regulations were the considerations upon which MDU based its decision to develop wind energy. In support of its statement, Staff quotes four lines from Ms. Stomberg's testimony. A complete quotation of Ms. Stomberg's testimony on this issue reveals that environmental regulations, both existing and potential, as well as a number of other factors, were all considered by MDU in its decision making:

Well, certainly I think we're being responsive right now. I would back up and say that I'm not always sure that least cost is the best cost. If we looked at strictly least-cost modeling results, we would have a string of combustion turbines out on the prairie right now that when gas was running up to 8, 10, \$12 would have been frighteningly expensive for our customers. That might have been a least-cost resource per our models, but it didn't make business sense based on what we're paid to do, what we're expected to do, which is to understand the regulatory fuel, all the energy things that are going on in this country. To the extent we can understand them and synthesize them and select the best resources for our customers, that is what our job is. It's not always least cost.

So when we select something like wind, which is not necessarily a least-cost resource, we are looking at the energy attributes of the wind, which is low cost, zero fuel cost energy, you don't get that any other way, the environmental attributes, that wind is not subject to having a scrubber put on it, for instance, for a large amount of money, it is not going to be subject to carbon credits or carbon cap and trade, which we believe is on the horizon. Certainly the environmental pollution control rules are coming steady at us and are driving our costs.

We're looking at the public policy, the clear requirements, requests of our legislators or our elected body that support that type of fuel. We're looking at price mitigation to keep our customers from being – riding the gas price waves and also the MISO costs. We were seeing very high costs in MISO at the time we made these decisions. Gas price forward curve, as has been mentioned today, was going up, up, up.

And, further, this is a diversification of 10 percent of our installed capacity as a nonfossil resource. And in the world we're looking at and

were looking at, that's a smart decision. It may not be least cost. We believe it's best cost. We hope to bring the best-cost power to our customers like you. Tr. 306, line 22, through 308, line 16.

Second, Staff's argument regarding North Dakota's "externality law" is incorrect. The law does not prohibit consideration of future environmental laws and regulations in the Company's planning activities. The statute only prohibits the use of "environmental externality values" in the planning and selection of generation resources. "Environmental externality values" are defined at N.D.C.C. § 49-02-23 as "numerical costs or quantified values that are assigned to represent either:

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

This issue was addressed in the Case No. PU-06-482 in which it was determined the statute did not prohibit consideration of potential future environmental laws and regulations, but only prohibits the assigning of numerical costs or quantified values to such potential laws and regulations. The Commission stated in Finding of Fact 88:

In accordance with North Dakota Century Code Section § 49-02-23, Applicants have not utilized prohibited environmental externality values for carbon dioxide regulation in this proceeding. However, they have considered the possibility of future carbon dioxide regulation. While the Commission is prohibited from considering quantitative environmental externality values, the Commission can consider the possibility of carbon regulation in a qualitative manner.

The testimony in this proceeding indicates MDU did exactly what the Commission determined was permissible under N.D.C.C. § 49-02-23. Tr. 285-286.

Third, the Staff is incorrect in its suggestion, without evidentiary support, that if MDU had engaged in what Staff perceives to be the requisite economic analysis, the

Company would have ultimately determined that wind generation is not an appropriate energy alternative and consequently the Commission is unaware of how much more expensive wind generation is compared to alternative resources. As noted in MDU's Post-Hearing Brief, the Commission discussed the cost comparison between wind generation and other generation alternatives as a result of the modeling introduced in Case No. PU-06-482 and reached the conclusion, contrary to Staff's assertion, that wind energy was an appropriate generation alternative for MDU notwithstanding that it was not the least cost generation resource. That conclusion is supported by the renewable energy policy at N.D.C.C. § 49-02-32. The statute does not contemplate generation resource selection based solely upon the results of an economic evaluation. Rather, the utility, after evaluating the renewable energy objective and the economic evaluation, "may use the electricity alternative that best meets its resource or customer needs."

MDU was already pursuing development of a major coal generation project as a least cost alternative to meet a large portion of its generation needs when it undertook development of the wind project. The successful completion of that project was in question, however, because of a number of challenges and even if successful would not be operational for five years. Moreover, MDU would have needed additional energy even if Big Stone II was completed. Tr. 363. For additional resources, MDU's alternatives were limited to natural gas, wind and market purchases. Because of the volatility of gas prices and market prices and MDU's existing reliance on those resources, additional natural gas generation or market purchases did not best meet MDU's resource or customer needs while wind generation provided a hedge against the

price volatility of those other resources. Accordingly, the Company properly evaluated its resource options and concluded wind generation was a cost effective generation resource to meet its needs at the time.

2. MDU's wind generation is cost effective.

As discussed in greater detail in its Post-Hearing Brief, MDU's wind generation projects are cost effective and provide a benefit to its customers. Staff's arguments do not support its position that the wind projects are not cost effective.

a. MDU's IRPs support the inclusion of wind generation in a diversified generation portfolio.

MDU's Integrated Resource Plans ("IRP") support its position that wind generation is a cost effective resource in a diversified generation portfolio. The modeling used in the creation of the 2007 and 2009 IRPs did not select wind as a least cost generation alternative but rather selected the Big Stone II project as the least cost generation alternative. Tr. 463. The same modeling, however, showed that although wind in combination with gas generation was not the least cost baseload resource, it was a suitable complement or alternative to coal generation. Tr. 463. In selecting the Company's resource investments, the Company is not a slave to the modeling results reflected in its IRPs, but rather selects the best resource solution for its customers' needs based upon the economic conditions and the resource alternatives available at the time of its decision-making. Tr. 286, 306-308, 331,468-469, 531-532. Mr. Neigum described the role of the IRPs in that decision-making process:

Q. Describe for me what is the role of the company's IRP in the decision – in the company's decision-making process for adding generation resources?

A. The IRP is a plan or a guideline of looking out at what we're seeing, at least on the horizon, for our customer load available options to use in the potential ways that we might be able to meet those future obligations of our customer. But it is only a snapshot or a point in time based upon, you know, certain assumptions that were made at the time that that document is produced.

Q. It isn't necessarily saying that that's exactly what you're going to do?

A. No, it does not. Tr. 536-537.

MDU's 2007 IRPs specifically addressed the likely role of wind generation in the Company's future generation portfolio. In addition to including 20 megawatts of wind generation as part of its preferred generation plan, the IRP at page 32 included the following discussion of the potential role of wind generation in its generation portfolio:

Montana-Dakota's service territory and its surrounding area have been called the "Saudi Arabia of Wind." Wind development and proposed wind development, driven by environmental concerns primarily, cannot be ignored when considering new resources. Even though wind technology and costs have made wind more competitive, total costs for wind turbines, including capacity recovery, are still dependent on governmental incentives, which are not based on economic evaluations. In addition, 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 sources.

The Company's 2007 IRP was filed with and available to the Commission when it made its determination in Case No. PU-06-482 that even though wind and gas generation were not the least cost resources, the resource planning activities of MDU indicated that wind generation should be a part of the future addition of generation resources for the Company. MDU agreed with and responded to this directive by pursuing development of the Diamond Willow II and Cedar Hills projects and the Commission issued a certificate of public convenience and necessity ("CPC&N") for the Cedar Hills project. Case No. PU-08-94.

The Company's 2009 IRP reflected the inclusion of all three projects in the Company's generation portfolio. In addition, the 2009 IRP showed that a wind and gas combination could be comparable with a baseload coal-fired generating unit on a least cost basis. Exhibit MDU 6R, p. 10.

Although the Company's IRPs did not show wind generation as a "least cost" generation resource, the IRPs support the inclusion of wind generation as part of the Company's generation portfolio in meeting the needs of its customers.

b. MDU's position is consistent with its position in the Big Stone II proceeding.

MDU witnesses testified in Case No. PU-06-482, as they have in this proceeding, that wind generation, at least in the 2006-2008 timeframe, was generally not viewed as the least cost generation resource. Ms. Stomberg, however, testified in the Big Stone II proceeding, as she did in this proceeding (Tr. 306-308), that the least cost resource is not necessarily the best cost resource.

If you pick gas turbines to really fill the niche that you need in the planning for your resource as presented in the model, it would pick that – pick that resource, that gas turbine, and that's very expensive energy. The capital costs are low, but the energy is very expensive and subject to the fluctuation of the gas pricing as well as the availability of that resource. That is not going to be an attractive energy type to supply to a large industrial that wants to come in and says, I need low-cost energy for a long period of time. You can't do that with gas turbines. So it's a least-cost resource, but it may not be the best-cost resource to meet the needs that you hope you'll see within your service territory.

Additionally, 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, certainly going to exclude solar, going to exclude a lot of these other technologies that some people have interest in our developing – in us developing if you have to be tied to strictly least-cost energy selections. Exhibit CAS 9 at p. 535.

At the time of the two Big Stone hearings (June 2007 and April 2008), MDU was planning and operating the Diamond Willow I project. It never advocated against future additions of wind generation to its portfolio and indeed Ms. Stomberg testified the Company intended to consider additional wind generation to meet the North Dakota renewable energy policy. Exhibit CAS 9 at p. 547.

c. The wind generation was a prudent investment regardless of the Montana renewable energy policy.

While the Montana renewable energy policy prompted the development of the Diamond Willow I project, just as the North Dakota and South Dakota energy policies as well as the Commission's directive in Case No. PU-06-482 promoted the development of Diamond Willow II and Cedar Hills, MDU's response to the Montana policy does not prove the investment was imprudent just as NSP's and OTP's responses to Minnesota's renewable energy policy did not make their investments in wind generation imprudent. MDU did not develop wind generation solely to respond to the Montana policy. Staff recognizes that MDU could have met the Montana renewable portfolio standard without investing in new generation and MDU would not have invested in new generation if it did not have a need for the generation or if it had determined the generation was a cost resource. Tr. 450-452, 496-497. The Company had previously signed contracts to acquire wind energy from two other projects that were not completed. Tr. 948, 963-964; Exhibit CAS 4, 629-630. Therefore, the underlying premise of Staff's position that MDU would not have pursued wind generation but for the Montana mandate fails. A fundamental flaw in Staff's position is that the Montana policy is bad policy and even a small percentage of renewable energy within a generation portfolio is imprudent unless its shown to be a least cost resource. MDU disagrees and believes there is a role for

wind generation in a diversified portfolio. Tr. 935. The North Dakota and South Dakota Legislatures and this Commission have reached the same conclusion. MDU pursued wind generation, just as it pursues all of its generation projects, first and foremost to meet the energy needs of its customers. Tr. 496; Exhibit MDU 27 (DR-050). It then selects development projects from the limited alternatives available to it at the time. Tr. 307, 468-469. The testimony in this case, as summarized in MDU's Post-Hearing Brief, discussed the number of considerations that went into MDU's decision to pursue the wind generation projects. As acknowledged by Mr. Mathai, the fact that those considerations included compliance with renewable energy policies in states where MDU operates its integrated electric system does not mean there was not a need for the projects or the projects were imprudent. Tr. 765. Mr. Goodin testified that in his opinion MDU would have invested in the wind generation regardless of the renewable energy policies because "we thought it was a nice complement for the diversified energy portfolio." Tr. 161, 167. He also stated "if I had to do it all over again, given what we know today, we would still do it." Tr. 168.

Staff's argument that MDU paid a premium for its Diamond Willow wind projects is incorrect and inappropriate. First, as discussed in MDU's Post-Hearing Brief, the Diamond Willow II project actually had a slightly lower cost than the Cedar Hills project. The Company's analysis provided in discovery and introduced as evidence showed the cost of the projects on a levelized basis were comparable. Tr. 936-937; Exhibit MDU 2 (DR-052). Mr. Mathai's comparison, as cited in support of Staff's position, was not only an incorrect calculation, but was also based upon the treatment of the North Dakota investment tax credit which effectively reduces the cost of the project to North Dakota

customers but does not result in a premium paid for the Diamond Willow project. Tr. 931-932.

Staff's reliance upon Case No. PU-10-18 for its assertion that MDU paid a premium for its projects in comparison to projects completed by OTP is inappropriate. While official notice was taken of Case No. PU-10-18, the financial information in that case is trade secret and not available to MDU nor made a part of the record in this proceeding. Staff's attempt in its post-hearing brief to create an argument of a premium based upon costs not in the record nor available to MDU is inappropriate as MDU has no ability to examine and explain cost differences, if any, between different projects built at different times by different utilities.

Finally, the actual costs incurred by MDU for the construction of its projects are not "environmental externality values" under N.D.C.C. § 49-06-24 as argued by Staff.

d. MDU's request for proposal process was adequate.

Staff argues that MDU's 2006 request for proposal ("RFP") for renewable energy was too limiting because it expressed preferences that the proposed facility be located within MDU's service territory and for facility ownership over power purchase agreements. The 2006 RFP referenced by Staff was limited to renewable resources because MDU was specifically seeking renewable resource opportunities by the RFP. MDU had previously issued RFP's in 2004 and 2006 for baseload generation resources, and reviewed other generation opportunities, and therefore, had a full array of generation resource information available to it for consideration in making its investment decision. Exhibit CAS 4, p. 624-628. MDU explained the reason for its preference for that project to be located within MDU's service territory to assure deliverability and

reduce the possibility of additional transmission costs either now or in the future. Tr. 944-947, 962-963. Similarly, MDU testified why it preferred an ownership option over a power purchase agreement based upon its prior experience of projects for power purchase agreements that were not developed and that ownership is generally a better option for customers over the life of the project. Tr. 183-184, 948-950.

MDU strongly disagrees with Staff's assertion that Staff has somehow shown the wind generation investments were not cost effective, and therefore, MDU should be entirely precluded from recovering the cost of those investments in its North Dakota rates. Despite months of investigation, pre-filed testimony, four days of hearing, and a post-hearing brief, Staff has only offered criticism of what MDU did or didn't do in its selection of its wind generation resources but has never offered, let alone attempted to prove, what it contends would have been better or more cost effective resources. The reasons are obvious. First, Staff's criticisms are much easier to make when not presenting an alternative resource. MDU would have welcomed a comparative examination of the merits of its decision to pursue wind generation versus any alternative supply resource offered by Staff. Other than the Big Stone II project, which was the least cost generation resource available to MDU at that time and which has certainly been subject to its own criticisms, wind generation was a cost effective resource endorsed by the Commission's determinations in Case No. PU-06-482 and the CPC&N for the Cedar Hills project in Case No. PU-08-942. In addition, offering an alternative resource would have defeated Staff's pre-determined recommendation against rate recovery for a generation resource obviously being used to provide service to customers. Any generation resource alternative, even if considered strictly on a least

cost scenario, would have at best only been marginally less expensive than MDU's wind generation projects even without considering the other factors favoring MDU's selection of wind generation. Such a hypothetical alternative, if it could have been shown to exist, could have only supported an argument for incremental exclusion of the marginal difference between the cost of the wind projects and the hypothetically less expensive alternative; and consequently, would not have supported Staff's position to entirely deny recovery of the wind generation resources based on the Montana renewable energy portfolio standard. Staff's criticisms of MDU's RFP or economic evaluations do not support a determination that the projects were imprudent investments and certainly do not support exclusion of those investments for rate recovery.

3. MDU was not required to obtain an advanced determination of prudence.

Although Staff acknowledges that North Dakota's advance determination or prudence ("ADP") statute at N.D.C.C. § 49-05-16 is elective, it interprets the statute to encourage utilities to seek an advance determination of prudence. The statute provides no support for that position as the decision to pursue an ADP is entirely discretionary with the utility. MDU does not contend that its election to forego an ADP relieves it of the burden to show the prudence of its wind generation investment. It is not required, however, in the context of a general rate proceeding to provide an asset by asset revenue requirement determination in the format that might otherwise be presented in an ADP proceeding. The enactment of N.D.C.C. § 49-05-16 did not create a new standard or filing requirement in a general rate proceeding as a pre-requisite for rate recovery of the Company's used and useful assets. Indeed, even N.D.C.C. § 49-05-16 does not require the type of presentation that Mr. Mathai advocated in this

proceeding. The only economic information specifically required by the statute is a projection of costs of the resource to the date of anticipated commercial operation. Such development costs for MDU's wind generation projects, which are already completed, have been presented in this proceeding. MDU's election not to pursue an ADP for its wind generation projects is indicative of nothing other than its confidence that its investment in those projects was prudent.

a. The ADP process is intended to assist companies in the financing of projects.

Despite Staff's arguments, a review of the legislative history of the ADP statute shows it was intended to reduce the financial risk to the utility in investing in certain utility projects and therefore possibly assist in obtaining financing at reasonable rates.² The statute does not change the standard under which an investment is determined prudent; it simply changes the time when that review is conducted or may be conducted. The decision of whether to obtain or not obtain an ADP should not increase costs to customers since rates should theoretically include recovery of prudently incurred costs and preclude recovery of costs to the extent imprudently incurred, recovery regardless of when the prudence determination is made.

ADP protects the utility, its investors and lenders from the risk that an investment will be determined imprudent after the investment is made. MDU assumed that risk by its construction of the wind generation projects. The assumption of that risk, however,

² See Legislature History of S.L. 2005, Ch. 396, § 1 (H.B. 1324) including letter from Illona Jeffcoat-Sacco to Honorable Duane Mutch, Chairman of Senate Industry, Business and Labor Committee ("The type of process envisioned in the bill is an incentive for shareholders to develop generation, and a protection for shareholders against some of the risk associated with doing so.") and testimony of Daniel Kuntz to the House, Industry and Labor Committee on April 12, 2005 (The bill will "have the commission involved in that decision making that will give the utility some comfort level, that what they are doing, they will not be second guessed, it may even help with their financing").

does not make the investment imprudent.³ Instead, the Company has offered overwhelming evidence that its investment in the wind generation projects was prudent. While these generation resources currently provide approximately one percent of the Company's accredited capacity, which is expected to be increased, they provide approximately seven percent of the Company's energy generation and displace what would otherwise be the most expensive energy either purchased or produced by the Company in the absence of the wind generation resources. Tr. 450,455, 537, 961.

b. The CPC&N for Cedar Hills supports the prudence of the wind generation resources.

Although a CPC&N for a facility is not identical to an ADP for the same facility since an ADP does not allow construction of the facilities, the proceedings serve similar functions with respect to the prudence of the facilities. The threshold determination in a CPC&N proceeding is whether there is a public need for the construction and operation of the facility to prevent unnecessary investment in utility property. See N.D.C.C. § 49-03-01 and 49-03.1-01. A Commission determination that there is a public need for a utility to construct, own, and operate a specific facility, in this case a 19.5 megawatt wind energy facility in Bowman County is a clear indication, if not a presumption, that the construction of the facility by the utility is prudent investment in the absence of intervening events or unreasonable expenditures.⁴

³ The ADP process does not always lend itself to investment decisions for smaller projects because decisions can be influenced by short term opportunities such as tax credits, equipment availability, etc. By MDU's review only one wind project in North Dakota (NSP's proposed Merricourt project) has been developed after an ADP.

⁴ In Public Service Commission v. Montana-Dakota Utilities Co., 100 N.W.2d 149, (ND 1959) the Commission approved a CPC&N for a natural gas transmission line from Tioga to Minot. Although the decision is somewhat unclear, it appears the certificate did not specify the size of the transmission line and the Company built a line that the Commission deemed larger than necessary to meet the Company's immediate needs. The Court held that although the cost of the overdesign was a prudent investment for possible future growth, the overdesign was not used to serve the public and therefore its value could be

As the Commission may recall, Mr. Mathai recommended the Cedar Hills investment be excluded as imprudent because he, being unaware of the issuance of the CPC&N, believed MDU had not shown a need for the facility:

We are excluding Cedar Hills because MDU has not met its burden of proof as to its need or usefulness. Exhibit CAS 17, p. 15.

Certainly, to the extent a prudence determination is based upon whether or not there was a need for the facility, a CPC&N is conclusive evidence of prudence in the absence of intervening circumstances that change the underlying assumptions upon which the CPC&N was issued. No such intervening circumstances exist with regard to Cedar Hills.

The requirement for a CPC&N for construction of utility facility within the state does not make ADP process superfluous. While a determination that there is a public need for a facility implicitly involves a determination that a utility is acting prudently in constructing the facility to meet the public need, a CPC&N determination is only applicable to physical facilities constructed within the state. The ADP statute applies to a broader set of investments including leases, improvements, and purchase contracts, whether within or outside the State, but carries no authority for construction. Under either process, however, there is a determination by the Commission of the need for the facility to provide service to customers and correspondingly a determination, whether made explicitly in the ADP process or implicitly in the CPC&N process, of the prudence of the utility in fulfilling that need.

excluded from ratemaking consideration. In this case the CPC&N issued for Cedar Hills specifies the size of the wind generation facility and MDU constructed and operates the facility as specified.

c. The Cedar Hills project is entitled to a rebuttable presumption of prudence.

For the reasons set forth in MDU's Post-Hearing Brief, the Cedar Hills project is entitled to a rebuttable presumption of prudence upon N.D.C.C. § 49-05-16 as interpreted and applied by the Commission in prior proceedings. That presumption, in conjunction with the CPC&N issued for Cedar Hills, the Commission's determination in Case No. PU-06-482 that MDU's future generation should include wind, the Company's testimony of its considerations to develop the Cedar Hills project, and the Commission's precedent of rate recovery for wind generation facilities by other public utilities, conclusively establish the prudence of MDU's investment in the Cedar Hills facility. In contrast, Staff provided nothing to rebut the presumption other than arguments that the Company should have provided further studies.

d. MDU does not object to rate recovery through a compliance filing rider.

MDU has stated its willingness to include a renewable energy rate rider for recovery of its wind generation costs as part of a compliance filing in this proceeding. To be sure, MDU has not agreed to the exclusion of its wind energy costs in this proceeding, or to a re-filing for rate recovery of those costs in some new proceeding that might support an argument for a refund of its interim rates or to continued challenges to the prudence of its investment and expenses. MDU has shown its wind generation investments are used, useful and prudent and it is entitled to rates that recover the cost of those investments, whether as a part of an increase in general rates or in a rate rider implemented through a compliance filing. MDU's agreement to a compliance filing does not include agreement to a new proceeding on issues that were or could have been

raised in this proceeding. The time and opportunity for review of issues such as depreciation rates, tax treatment, and cost allocation that are routinely reviewed in rate application proceedings, and for which Staff had more than ample opportunity to review in this proceeding, are over. The purpose of the compliance filing should be limited to review and confirmation of the amount of MDU's investment and expenses associated with the wind generation assets; it should not be an opportunity for Staff to have another bite of the apple on issues that were open for consideration in this proceeding. Staff failed to provide any evidence or recommendations contrary to that presented by the Company on the issues which Staff suggests further review is needed. The record on those issues is closed.

1. Depreciation Life.

MDU is depreciating its wind generation assets over 20 years, which is consistent with depreciation lives used in the industry. Tr. 684. Staff's witnesses provided no testimony or recommendation that a shorter depreciation life was justified. The indication that another utility in another proceeding may have chosen a longer depreciation life for its wind generation is not sufficient to support a determination that the depreciation life used by MDU is unreasonable.

2. Amortization of tax credits.

Staff, in its post-hearing brief, and without any support by its witnesses or evidence in the record, argues that MDU has incorrectly proposed recovery of the North Dakota investment tax credit. Ms. Mulkern sponsored an exhibit (Exhibit MDU 8R (RAM-3, pages 2 and 8) and provided testimony that the North Dakota investment tax credit will be applied to immediately reduce rate base as the credit is realized.

Accordingly, contrary to Staff's apparent misunderstanding reflected in its post-hearing brief, North Dakota customers will receive the benefit of the credit as it is received by the Company.

3. Selection of the PTC.

Staff's discussion of the distinction between the Company's selection of the federal production tax credit ("PTC") versus what Staff terms the "federal grant" appears to represent either Staff's misunderstanding of an issue or its failure to adequately investigate the issue. Following Staff's investigation which presumably included review of the Company's selection of the PTC rather than the Federal Energy Tax Credit, since information regarding the selection was requested and provided in discovery and Mr. Mathai did not raise an issue regarding the selection in his pre-filed testimony (Exhibits MDU 27 (DR-058), CAS 17), Staff's counsel spent considerable time in this proceeding attempting to cross examine MDU witnesses as to why the Company didn't select a "federal grant" rather than the PTC for its wind projects. Mr. Senger testified regarding the Company's analysis that showed the use of the PTC, rather than the 30 percent upfront federal energy tax credit, provided a net present value savings to customers of approximately \$6.4 million over 20 years ($\$43.2M - \$36.8M = \$6.4M$). Exhibit MDU 27 (DR-058), MDU 10, Tr. 976. Counsel's confusion apparently stems from an election by OTP for its Luverne wind project to utilize the cash grant under Section 1603 of the American Recovery and Reinvestment Act of 2009 ("Act"). The Act provided for a 30 percent cash grant in lieu of the 30 percent Federal Energy Tax credit for those projects otherwise eligible for the PTC. OTP's application indicates it selected the cash grant because the cash assisted in the financing of OTP's project during a period when

commercial financing was difficult and the cash grant mitigated the risk associated with production tax credits. Because OTP has significantly more wind development than MDU and it is receiving PTC's from its earlier wind projects, use of the federal cash grant for the Luverne project assured OTP the ability to utilize the full amount of the credit which it might otherwise not have been able to utilize through acquisition of additional PTCs depending upon its tax situation. OTP's situation is not applicable to MDU and does not change MDU's analysis that the PTC is advantageous to its customers. Note that OTP had apparently concluded, like MDU, that the PTC was more advantageous to its customers than the Federal Energy Credit for OTP's earlier projects.

E. MDU met its burden regarding employee incentive compensation and director's fees and expenses.

MDU's testimony in this case establishes that its test year includes a representative cost for employee incentive compensation and director's fees and expenses as provided by N.D.C.C. § 49-05-04.1(2). There has been no showing that either expense is unreasonable or that management has otherwise abused its discretion and judgment with respect to these expenses. Accordingly, under the precedent discussed in MDU's Post-Hearing Brief, MDU is entitled to recover the cost of those expenses in its rates.

1. MDU's incentive compensation and director's fees and expenses are reasonable.

MDU is not proposing a change in its administrative and general expense allocation as suggested by Staff. Nor is it proposing "additional pay rewards to employees and officers" from the amounts traditionally included as employee incentive

compensation. As testified by Mr. Goodin, MDU changed the weighting of the factors for the calculation of employee incentive compensation effective January 1, 2010, however, the total targeted dollar amounts to be paid under the revised weighting is the same as the total dollar amounts historically paid under the Company's prior incentive plans and included in the test year. Tr. 579, 581, 583, 989-992.

There is no evidence that the dollar amounts included in the test year for employee compensation and director's fees and expenses are unreasonable. Indeed, the only issue raised by Staff in its pre-filed testimony regarding employee incentive compensation and director's fees and expenses was a recommendation that a portion of the costs should be borne by shareholders and not included within the Company's rate recovery. In response to Staff's position, MDU presented evidence establishing that incentive compensation is a part of total employee compensation similar to base salary and benefits. Exhibits MDU 4R, MDU 7; Tr. 45-48, 397, 993-995. It also provided testimony that it regularly reviews the overall level of its employee compensation packages with other employers to determine that its packages are competitive. Exhibit MDU 4R, p. 5; Tr. 397-398, 994-995. These surveys have indicated that the Company's employment packages are near the median of other utilities in this region. Tr. 397, 994-995.

A copy for the Company's 2010 pay grade structure which was based upon salary market surveys was provided to Staff in response to a document request and introduced as an exhibit in this proceeding. Exhibit MDU 24 (Attachments A and B). Staff provided no evidence that either MDU's incentive compensation or that its total compensation packages are unreasonable except for an unsupported statement in Mr.

Mathai's testimony summary that MDU's compensation might be competitive without employee incentive compensation. Exhibit CAS 18. That testimony was addressed in MDU's Post-Hearing Brief. Instead, Staff's testimony and cross examination were focused on attempts to show that payments under the Company's prior incentive compensation plans were weighted heavily on financial performance, and therefore, benefit shareholders. Apparently recognizing that its recommendation that some portion of incentive compensation be disallowed as beneficial to shareholders is not supported by North Dakota precedent, Staff has now shifted to a new argument, first raised in its post-hearing brief, that employee incentive compensation and director's fees should be disallowed contending MDU didn't show the reasonableness of its incentive compensation and director's fees because it didn't produce survey results on the issue.

MDU established a *prima facie* case for the inclusion of incentive compensation based upon historical and forecasted amounts paid to employees and directors. N.D.C.C. § 49-05-04.1(2). It also provided testimony of how its employment compensation packages are reviewed to assure the reasonableness of such compensation. Exhibit MDU 4R, p. 5, MDU 7; Tr. 397-398, 994-995. There was no reason for the Company to conduct additional surveys, or introduce the results of surveys previously conducted, around the reasonableness of its compensation plans when the reasonableness of the compensation was not raised as an issue by Staff. Likewise, simply because MDU Resources did not retain a copy of its most recent review of its incentive compensation plan is not a basis for disallowance of these expenditures.

2. Incentive Compensation and Employee Turnover

Staff makes a puzzling argument, supported by a mischaracterization of the evidence, that the Company failed to show a correlation between employee turnover and incentive compensation. The argument is puzzling because it is the Company's position that competitive compensation assists in avoiding employee turnover and the Company's review of employee turnover statistics indicates a relatively low level of employee turnover suggesting that its employee compensation packages, of which incentive compensation is a component, have been successful in preventing employee turnover.

Disturbing is Staff mischaracterization of the evidence cited in support of its argument. For example, Staff states that MDU argued "that a competitive incentive compensation package is necessary to avoid employee turnover. . ." Staff brief, p. 22. In support of this statement it cites the testimony of Mr. Del Vecchio on page 401 of the transcript. Mr. Del Vecchio's testimony, however, was that the "Company's ability to maintain a competitive total remuneration package helps avoid employee turnover." Exhibit MDU 7, page 2. Mr. Del Vecchio did not testify that incentive compensation in itself is necessary to prevent employee turnover, but rather the self evident fact that a competitive total remuneration package, which typically includes incentive compensation, is necessary to prevent employee turnover. Generally, if one component of a total remuneration package is reduced or eliminated, the other components of the package must be correspondingly increased to remain competitive.

Similarly, Staff also states "the Utility's regular pay and incentive compensation is above the market average." Staff's brief, page 22. The testimony cited in support of the

statement was Mr. Del Vecchio's testimony regarding comparisons conducted by MDU Resources and MDU of their respective incentive compensation packages to market surveys. Contrary to Staff's statement, Mr. Del Vecchio testified that "the comparisons have shown that "MDU Resources' target incentives were slightly above the market survey incentives while Montana-Dakota's were roughly aligned with the market survey." Exhibit MDU 7, p. 6. In another example, Staff cites Mr. Del Vecchio's testimony in support of a statement in its brief that MDU obtained an employee from a cooperative "because MDU's pay and incentives were more favorable." Staff brief, p. 22. The record cited in support of the statement was a response by Mr. Del Vecchio to a question posed by Mr. Roaché on page 439 of the transcript:

Q. Getting along with Mr. Kuntz, I don't know if you were aware that MDU stole Randy, our lineman, from a co-op because the pay and benefits were better with MDU.

A. I wasn't aware of it.

Mr. Del Vecchio's testimony that he could not confirm the statement posed in Mr. Roaché's question does not make the question evidence of a fact.

In its Post-Hearing Brief, MDU described North Dakota Supreme Court precedent that the level of legitimate business expenses, including employee compensation, is left largely to the discretion of management in the absence of a showing that management abused its discretion and judgment. Staff attempts to distinguish the most recent of those cases, Montana-Dakota Utilities Co. v. Public Service Commission, 413 NW2d 308, 315-316 (1987), by arguing the case spoke primarily as to the form of compensation rather than the level of compensation. In that regard, Staff is correct because there was no suggestion in that case that the Company's total remuneration

package, including employee utility discounts, was unreasonable. Instead, the Commission sought to exclude consideration of employee utility discounts for ratemaking purposes, not because it had been shown the discounts in combination with other components of remuneration were unreasonable, but rather because the discounts resulted in the provision of gas service to employees at a cost below MDU's wholesale cost of gas. That is effectively the same position taken by Staff in this case as there has been no showing that MDU's total remuneration package is unreasonable, but rather Staff seeks to exclude a portion of the remuneration that is in the form of incentive compensation. In the absence of any showing by Staff that MDU's overall level of compensation is unreasonable, Staff's position must be rejected consistent with Montana-Dakota Utilities Co. v. Public Service Commission, supra.

Northern States Power Co. v. Board of Railroad Commissioners, 298 NW 423, 434 (ND 1941) is particularly instructive as to Staff's recommendation to disallow some, but not all, of the Company's employee incentive compensation and director's fees and expenses. In the NSP case, the Commission sought to disallow some, but not all, of the Company's dues and donations without a determination that any of the donations were improper.

The inconsistency is patent. The finding is that donations for some unstated purposes are not improperly allowable as expenses and the allowance is for a reduced sum or all purposes including the unstated improper ones. If the Commission had concluded that some of the donations were improper, it should have pointed them out specifically and if it thought that some of the contributions were so large as to constitute an abuse of discretion on the part of the Company's officials, it should have said so. The action which the Commission did take is simply an attempt to control the discretion of the Company's management. This was in excess of the powers of the Commission.

This is precisely what Staff is advocating in this case; an attempt to control the discretion of the Company's management. Staff has not shown that any part of the Company's employee compensation, including its incentive compensation, is improper or unreasonable. Rather, it seeks to have the Commission disallow a portion of an otherwise proper expense based upon an argument that a portion of that expense is determined based upon financial performance which is beneficial to shareholders. As previously stated by the Company, compensation is provided to an employee for performance of the employee's duties. Performance of those duties in the provision of utility services is a benefit to customers who receive the service and the shareholders of the Company providing the service. The employee influences financial performance only through the efficient performance of his or her job responsibilities. Those efficiencies benefit of customers by reducing operating costs that are otherwise passed through rates. Exhibit MDU 4R, p. 4-5; Tr. 63. The fact that the performance of those duties and the associated remuneration, regardless of the form that remuneration, also benefit shareholders is not a basis to deny recovery of that remuneration in rates. Staff is simply seeking to control the form of employee remuneration which is not allowable under North Dakota law.

Staff's reliance upon the Commission's opinion in Case No. PU-400-92-399, Northern States Power Electric Rates (1992) is also misplaced. In that case, the Commission did not deny recovery of all incentive compensation. Rather, it adopted the recommendation of a Commission consultant to decrease the amount of "long term" incentive compensation for officers which was based entirely upon financial performance and which was 326 percent greater than the survey averages for the utility

group. There was also evidence that total compensation for NSP officials was above stated pay goals and market averages. None of those considerations are applicable to Staff's proposal in this case to disallow a portion of MDU's employee incentive compensation. Instead, Staff proposes an arbitrary 60 percent reduction of all employee incentive compensation without regard to overall compensation levels.

Staff's arguments regarding incentive compensation is another area in which Staff misstates the record testimony. Staff states that Mr. Goodin incorrectly testified that financial performance was one of a number of evenly weighted factors considered as part of MDU's incentive compensation plan for 2007-2009. Staff's brief, p. 24-25. A review of the transcript cited by Staff in support of this statement indicates that Mr. Goodin's testimony was directed to the 2010 incentive compensation plan, in which 15 percent of the target incentive compensation is directed towards a safety recognition program, (Exhibit MDU 24 (Attachment K)) and the balance of the targeted incentive compensation is equally weighted between financial goals, O&M expense goals, and customer satisfaction goals. Exhibit MDU 24 (Attachment E). As previously stated, the targeted dollar amounts for the 2010 incentive plan are based upon historic levels and correspond to the amount included in the test year for incentive compensation; however, the weighting factors for the achievement of the targeted levels are those reflected in the 2010 plan.

There is no support in the record for the arbitrary reduction of the Company's legitimate business expenses for employee compensation and director's fees and expenses.

Cooperation in the Regulatory Process

Staff's brief contains a number of unsupported and outrageous statements regarding MDU's cooperation in the regulatory process. MDU has not advocated for deregulation, now or in the past, nor has it fought such regulation to the greatest extent permitted, as stated by Staff. While MDU does not claim perfection in every aspect of its application in this proceeding, Staff likewise has no claim to perfection. While Staff has criticized adjustments of the revenue requirement calculation associated with the wind projects, such adjustments are specifically allowed under N.D.C.C. § 49-05-04.1(4) and each adjustment reduced the Company's rate request.

MDU's officers and employees have sought to cooperate fully with the Staff in its review of MDU's application. Tr. 710. Unfortunately, Staff entered its review with the predetermined position to exclude the Company's wind projects based upon the Montana renewable portfolio standard. Interestingly, Staff made similar recommendations in NSP's recent rate case in Case No. PU-07-776. Because MDU did not have the type of evidence that Staff believed would support its position, Staff attempts to claim the lack of support for its position is because MDU failed to cooperate. However, how did MDU fail to cooperate? By failing to produce studies that don't exist? By failing to apply for an ADP? By failing to anticipate Staff's positions? MDU responded to Staff's discovery requests, prepared and filed written pre-filed rebuttal testimony on short notice for the Staff and the Commission, and worked to resolve issues raised by Staff. Its witnesses, including the Company's president, answered every question posed to them over a four-day hearing. MDU's officers and employees respect the regulatory process and have repeatedly sought to resolve issues with Staff

in this proceeding. Unfortunately, on the issues remaining before the Commission, MDU was unsuccessful. As a result of its approach to recommend total denial of the wind investments, Staff failed to perform the type of routine review associated with such expense items as depreciation and tax treatment. Those failures cannot be based upon an alleged lack of cooperation by MDU, but rather reflect Staff's failure to conduct which should have otherwise been a routine review. The Commission should deny Staff's recommendations to exclude rate recovery for the wind generation projects and portions of the Company's employee incentive compensation and directors' fees and expenses. Instead, the Commission should accept the proposed settlement agreements and grant the Company the rate relief requested.

Respectfully submitted this 4th day of January, 2011.

Montana-Dakota Utilities Co., a Division of MDU
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