Felhaber Larson
Fenlon & Vogt

A Professional Association – Attorneys at Law

MINNEAPOLIS
220 South Sixth Street | Suite 2200
Minneapolis, MN 55402-4504
612 339 6321 | Fax 612 338 0535

ST. PAUL
444 Cedar Street | Suite 2100
St. Paul, MN 55101-2136
651 222 6321 | Fax 651 222 8905

Richard J. Savelkoul
651-312-6042
Fax: 651-222-8905
E-mail: rsavelkoul@felhaber.com
Reply to St. Paul Office

January 4, 2011

Darrell Nitschke
Executive Secretary
North Dakota Public Service Commission
600 East Boulevard, Department 408
Bismarck, ND 58505-0480

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 Reply Brief

Dear Secretary Nitschke:

Enclosed please find Advocacy Staff's Reply Brief, along with a Certificate of Service in the above-referenced matter.

Very truly yours,

Richard J. Savelkoul

Enclosure

cc: Persons on attached Certificate of Service

State of North Dakota

Public Service Commission

MONTANA-DAKOTA UTILITIES CO.
ELECTRIC RATE INCREASE APPLICATION

ADVOCACY STAFF REPLY BRIEF

Case No. PU-10-124

Table of Contents

I. INTRODUCTION

In its initial post-hearing brief in this matter, MDU supports its position with three basic arguments: (1) Staff is applying the incorrect burden of proof; (2) Staff has not presented evidence that MDU's wind farm investments were imprudent or unreasonable; and (3) Staff has not shown that the Utility's incentive compensation and director fee expenses were unreasonable. In taking its position, MDU ignores pertinent facts in the record and misapplies relevant law. All of the Utility's arguments are refuted below.

II. BURDEN OF PROOF

The Utility attempts to divert the Commission's focus away from its failure to show the reasonableness of its rates by engaging in a confusing discussion of the appropriate "burden of proof" standard in rate cases. Consequently, a clarification of the standard and its correct application is warranted.

A. Standard in Rate Cases

The "burden of proof" is comprised of two distinct but related concepts: a "burden of production" and a "burden of persuasion."[1] The "burden of production" clarifies "which party must come forward with evidence to support a particular proposition."[2] Conversely, the "burden of persuasion" will "determine[] which party must produce sufficient evidence to convince a [factfinder] that a fact has been established."[3] Importantly, "[t]he burden of persuasion never leaves the party on whom it is originally cast."[4]

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[1] Am. Jur. 2d. on Evid. § 171.
[2] Id.
[3] Id.
[4] Id.

With specific regard to rate cases, "the burden of proof of the reasonableness of all costs incurred which enter into a rate increase request **rests with the utility**."[5] This requires the utility to prove "that each dollar of cost incurred was reasonably and prudently invested."[6] If the utility satisfies its initial burden of *production* by producing prima facie evidence of the reasonableness of its investment, the burden to produce evidence shifts to the contesting party "to demonstrate a tenable basis for raising the specter of imprudence."[7] However, if the utility fails to satisfy its affirmative duty by making a prima facie showing of reasonableness, the burden of production does not shift, and "no such expenses should be allowed."[8]

In the event the utility *does* make a prima facie showing of reasonableness, "the burden then shifts to . . . the rate protestant to produce evidence showing why the [investments or expenses] were not reasonable and should not be allowed."[9] If "**any** evidence is introduced that an investment or expense item has been unreasonably incurred, [then] the burden of production shifts again to the utility to introduce probative evidence of reasonableness."[10] Finally, it is important to remember that the burden of persuasion rests **at all times** with the

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[5] Hamm v. S.C. Pub. Serv. Comm'n., 422 S.E.2d 110, 112 (S.C. 1992) (emphasis added).
[6] Entergy Gulf States, Inc. v. Pub. Util. Comm'n. of Tex., 112 S.W.2d 208, 214 (Tex. App. 2003).
[7] Hamm, 422 S.E.2d at 112.
[8] See Turpen v. Okla. Corp. Comm'n, 769 P.2d 1309, 1323 (Okla. 1989).
[9] Id.
[10] City of Amarillo v. Railroad Comm'n of Tex., 894 S.W.2d 491, 498 (Tex. App. 1995) (emphasis added); see also Anaheim, Riverside v. FERC, 669 F.2d 799, 809 (D.C.Cir. 1981) ("where some other participant in the proceeding creates a serious doubt as to the prudence of an expenditure, then the applicant has the burden of dispelling these doubts and proving the questioned expenditure to have been prudent").

utility, meaning that it "bears the ultimate burden of proving the reasonableness of its expenditures."[11]

B. Application of the Standard to this Case

MDU has failed to meet its burden of proof in these proceedings. As an initial matter, the utility has not made a prima facie showing of the reasonableness of either its wind farm investments or its incentive compensation and director fee expenses. Moreover, even if the Commission generously provides MDU with the benefit of the doubt that it has made a prima facie showing, Staff has rebutted that showing by producing evidence that these investments and expenses were unreasonable and imprudent, as discussed in more detail in Sections II and III, *infra*. The burden of production then shifted back to the Utility to present evidence proving the reasonableness of its expenses, which it has failed to do. And ultimately, MDU has wholly failed to meet its burden of persuasion regarding the reasonableness of either its wind farm investments or its incentive and director expenses.

The Commission should also note that MDU misrepresents the record with its bald assertion that Staff has "offered no factual evidence that any of the costs incurred by MDU for the wind generation projects were excessive, unreasonable or otherwise imprudent."[12] Notably, MDU officials also made similar assertions in hearing testimony, which they subsequently admitted were not consistent with the record.[13] To the contrary, in its pre-filed direct testimony, throughout the hearing, and in its Initial Brief, Staff has repeatedly shown that the Utility's wind investments were excessive, unreasonable, *and* imprudent. This evidence has included, but is not limited to, the following: (1) the Utility's failure to conduct an economic

[11] City of Amarillo, 894 S.W.2d at 498.
[12] MDU Post-Hearing Brief, p. 18.
[13] See, e.g., Tr. 301, ll. 23-25; Tr. 302, ll. 1-6 (Stomberg Testimony).

evaluation of its investments as required under North Dakota law;[14] (2) the admission of MDU executives that environmental externalities played a role in the Utility's decision to build wind farms, also in contravention of North Dakota law;[15] (3) the fact that the Utility's investment decisions were driven by a need to satisfy a Montana renewable mandate;[16] (4) the inadequacies of the MDU's Request for Proposal for its Diamond Willow project;[17] (5) the failure of the Utility to compare the cost of building wind as compared to other resources;[18] (6) the failure of the Utility to quantify just how much more wind would cost ratepayers over the least-cost resource alternative;[19] (7) the failure of the Utility's IRPs to ever select wind as the best resource choice;[20] (8) the Utility's previous position in the Big Stone II proceedings that wind is too expensive; [21] (9) the 14% premium the Utility paid to build Diamond Willow in Montana in order to satisfy the Montana mandate;[22] and (10) MDU's untenable position regarding its failure to obtain an advanced determination of prudence for either farm.[23]

III. MDU WIND GENERATION PROJECTS

Typically in cases such as this involving projects that were imprudently built based on comparable costs to alternative projects, commissions will make adjustments to a utility's rate base to account for any premiums paid, cost of overbuild, comparable costs to other projects, inability to use the assets due to transmission congestion, etc. In doing so, commissions are, in

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[14] Staff's Post-Hearing Brief, pp. 4-6.
[15] Id., pp. 5-6, 11-12.
[16] Id., p. 10-12.
[17] Id., p. 12-13.
[18] Id., p. 8.
[19] Id., p. 9.
[20] Id., pp. 7-8.
[21] Id., p. 9-10.
[22] Id., p. 11-12.
[23] Id., pp. 13-17.

essence, adjusting cost to a prudent level for what is needed and used. Unfortunately, however, in this case, neither the Commission nor Staff has any idea how much the Utility's wind projects cost in excess of a prudent resource due to MDU's failure to provide the statutorily-required economic analysis. This is not just an issue of excessive cost of the wind from the farms; rather, it is also an issue of whether all of the wind projects are effective within MDU's system. Consequently, the costs associated with these expenses must be outright denied.[24]

In addition to its failure to make a prima facie showing of reasonableness, MDU has failed to rebut the evidence Staff has presented showing that its wind farm investments were unreasonable and imprudent. The Utility urges the Commission to pass the costs of these farms onto North Dakota ratepayers simply because it demonstrated a need for additional resources and because these farms do in fact produce electricity. This analysis is incomplete. In addition, Staff has shown the imprudent nature of these investments based on evidence that they were made with complete disregard to established North Dakota policies. Further, MDU's assertion that the Commission's findings of prudency for other wind investments requires the same outcome here is unfounded. Finally, the Commission must deny recovery for these projects due to the Utility's failure to complete the statutorily-required analysis, completion of which would have demonstrated prudency of lack of prudency.

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[24] See, e.g., Pub. Serv. Comm'n of State of N.D. v. Mont.-Dakota Utils. Co., 100 N.W.2d 140, 150 (N.D. 1959) (affirming Commission's disallowance of all excess pipeline cost built not to benefit current ratepayers, but rather to benefit future constituents); Columbus Gas & Fuel Co. v. Pub. Utils. Comm'n of Ohio, 292 U.S. 398 (1934) (holding no need to include any value of investments not used for benefit of ratepayers in rate base); State ex rel. City of St. Louis v. Pub. Serv. Comm'n, 110 S.W.2d 749, 757 (Mo. 1937) ("a utility cannot maintain equipment of comparatively small or no useful value on premises unnecessarily large and valuable and demand a return upon the whole").

A. Used and Useful

The Utility argues that it has proven that the Diamond Willow and Cedar Hills wind farms are used and useful for the benefit of North Dakota ratepayers because they are fully operational and generating electricity for the Utility's integrated system.[25] It is important the Commission remember that its analysis does not simply end there; rather, the Commission must also determine whether these investments were reasonable and prudent.[26] This Commission has historically protected ratepayers by refusing to require them to pay for costs associated with used and useful programs of another state if those programs are not cost-effective.[27] And, as MDU aptly points out, "[t]he Commission, in making rates, **is not bound to give effect to an imprudent or unreasonable management decision** to incur an expense, or operate its system in a particular fashion."[28]

Indeed, a closer examination of just how "used and useful" the Diamond Willow and Cedar Hills wind farms have proven to be demonstrates the unreasonable and imprudent nature of MDU's investments. As discussed in Staff's Initial Brief, these wind farms make up approximately one-fourth of the Utility's entire rate base.[29] Despite composing such a large percentage of MDU's rate base, the wind farms are producing only one percent of ratepayers'

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[25] See MDU Post-Hearing Brief, p. 8.
[26] See, e.g., Gulf States Utils. Co. v. La. Pub. Serv. Comm'n, 689 So.2d 1337, 1346 (La. 1997) ("Under the prudent investment standard, "the utility must demonstrate that it went through a reasonable decision making process to arrive at a course of action and, given the facts as they were or should have been known at the time, responded in a reasonable manner.") (internal quotations omitted).
[27] See Tr. 1054-57 (Diller Closing); see also PU-400-02-646 (request withdrawn after Staff's comments); PU-07-776 (recovery removed by Commission-approved settlement agreement).
[28] MDU Post-Hearing Brief, p. 10 (citing Mont. Power Co. v. Mont. Dept. of Pub. Serv. Reg., 68 PUR 4th 521 (Mont. 1984).
[29] See Staff's Post-Hearing Brief, p. 15.

peak demand, as accredited by MISO.[30] Although the Utility is quick to remind the Commission of its need for capacity,[31] it fails to reconcile the high cost of renewable resources that produce such a small amount of accretited capacity. While MDU is correct when it advocates that the Commission's determination regarding the reasonableness and prudency of its investment may not be based on hindsight or the Commission's substitution of its own judgment for that of the Utility's management,[32] the knowledge that MDU had **at the time these farms were built** that wind is an expensive must-run resource, as testified to in the Big Stone II advanced determination hearings, in addition to its failure to conduct **any** sort of economic analysis of the cost-effectiveness of these farms, cannot be ignored.[33]

While MDU claims that conditions at the time supported its investment (e.g., MISO costs, fuel costs, and volatility), it fails to reconcile the fact that these factors had already been weighed in its biennial IRP process, which *never* chose wind resources as least cost.[34] MDU claims that business judgment was used in considering these factors, which resulted in the decision to invest in the wind farms despite multiple resource planning results to the contrary. But, MDU acknowledged that the place to use business judgment on those factors was actually in the integrated resource planning.[35]

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[30] Id.
[31] See MDU Post-Hearing Brief, p. 11-12.
[32] See id., p. 9.
[33] See Staff's Post-Hearing Brief, pp. 9-10; see also Assoc. of Businesses Advocating Tariff Equity v. Pub. Serv. Comm'n, 527 N.W.2d 533, 542 (Mich. App. 1994) (holding commission's finding that utility acted imprudently was not improperly based on hindsight or substituted judgment, but rather supported by substantial evidence of the utility's knowledge at the time its decision was made).
[34] See generally 2005 IRP, PU-05-531; 2007 IRP, PU-07-394; 2009 IRP, PU-09-547; CAS Ex. 9 at p. 535, ll. 22-25; CAS Ex. 4, at p. 634.
[35] Tr. 460-61 (Neigum Testimony).

B. Prudent Investments

MDU also claims that North Dakota renewable resource policy motivated MDU to make this investment. Notably, however, MDU fails to address other policies that are important for North Dakota utilities. As fully discussed in Staff's Initial Brief, these policies include making wise and economic investments (as contained in the Renewable Objective Statute itself).[36] In addition, these policies do not allow North Dakota ratepayers to pay for improvements incurred at a higher cost due to a need to satisfy other states' objectives and mandates.[37] Moreover, North Dakota policies prohibit the artificial inflation of resource costs for environmental externalities.[38]

Staff has presented affirmative evidence that MDU imprudently invested in its wind farms in contravention of all of these policies. First, Staff demonstrated that the Utility failed to provide any tangible evidence of economic analysis **mandated** under North Dakota law before making its renewable investments.[39] Furthermore, Staff presented evidence that not only was MDU aware that these wind farms were not cost-effective when built, the Utility believes it is justified in passing their unreasonable costs onto ratepayers due to "unquantifiable societal and regulatory considerations."[40] In addition, even if it was appropriate to include wind in MDU's system, Staff showed that MDU paid a premium to build the Diamond Willow farms in Montana in order to satisfy the Montana renewable resource mandate.[41] Finally, Staff articulated specific examples of testimony from the Utility's witnesses conceding that

[36] See N.D.C.C. § 49-02-32
[37] See N.D.C.C. § 49-06-24.
[38] See N.D.C.C. § 49-02-23, MDU Initial Brief, p. 25 (asserting that environmental impacts hedge against future costs was a factor weighed).
[39] Staff's Initial Brief, pp. 4-6.
[40] Id., pp. 7-13.
[41] Id., p. 11.

environmental externalities including proposed cap and trade and carbon credit regulations played an economic role in MDU's decision to make these wind investments.[42]

C. Reliance on Other Utility Investments and Commission Decisions

The Utility takes the untenable position that because the Commission has found wind investments made by other utilities to be reasonable and prudent, its own investments in the Diamond Willow and Cedar Hills farms are *ipso facto* reasonable and prudent, as well.[43] This is essentially the equivalent of an argument that "wind is always prudent." To the contrary, however, the ability of other utilities to establish the reasonableness and prudency of their individual wind investments does not weigh on MDU's ability to satisfy its own burden in this particular case. Indeed, the circumstances when the Commission has allowed recovery of wind investments of other utilities are too different to allow for a legitimate comparison.[44] The other utilities faced substantially different ratepayer needs, generation mixes, capacity needs, service territories, energy production and capacity factors for the projects built and installation costs. If anything, the Commission's findings with respect to the reasonableness and prudency of the wind investments for other utilities supports Staff's position that MDU should not be allowed to recover in this particular case.

MDU asserts that findings in the Big Stone II Order, Case PU-06-482, support its building of wind projects. At best, this proceeding simply does not foreclose investments in

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[42] Id. at p. 5-6.

[43] See MDU Post-Hearing Brief, pp. 15-17.

[44] For example, MDU references Case No. PU-07-776, in which Staff recommended a 25% reduction in recovery for wind projects NSP built in Minnesota to satisfy a Minnesota mandate. See MDU Post-Hearing Brief, p. 16. The Commission should note that in that particular case, adjustments were made to the utility's requests, such that Staff ultimately felt recovery was reasonable **for NSP's system**, and agreed to settle. Regardless, however, settlements have no precedential value before this Commission.

wind, and as a practical matter, the case merely supports Staff's position that additional analysis is necessary prior to making renewable investments. Notably, the Findings of Fact in PU-06-482 also (1) state that there are cost differences that are "utility specific and project specific"; (2) make specific reference to MDU PPA's that were canceled; and (3) note that MDU has not studied the amount of wind their system could handle, if any.[45] Staff notes that the only reference to MDU wind was to cancelled projects that presumably were not at a price sufficient to complete; certainly no findings were made with respect to higher-priced or larger projects.[46] Further, the PU-06-482 proceeding was not intended for the purpose of any prudency decision related to wind. Indeed, neither the Commission's Conclusions of Law nor its Order made any mention related to wind.[47]

D. Failure to Provide Economic Evaluation

MDU failed to perform the statutorily-required economic evaluation, but then claims that "business judgment" was the ultimate factor that resulted in its decision to build wind. The Utility cited to economic factors that entered into this judgment decision, but, without providing **any** documentation calculating the impact of such investments, MDU nonetheless suggests that these factors were weighed and contributed to its decision.[48] In fact, the business judgment it was referring to was weighed several times and, in every instance, wind was found not to be a least cost resource, based on those same factors.[49] Even MDU witness Neigum acknowledged that the place for business judgment in pricing volatility, MISO market prices

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[45] See Mont.-Dakota Utils. Co., PU-06-482, at Findings 101, 108 and 111.
[46] Tr. 948, ll.2-25; Tr 948, ll.1-2.
[47] Cf. PU-06-482, Commission's Findings of Fact, Conclusions of Law, and Order.
[48] See MDU Post-Hearing Brief, p. 8.
[49] See Staff's Post-Hearing Brief, pp. 7-10.

and similar quantifiable estimates is done in the integrated resource evaluation process—it is through this process that "business judgment" is used to determine appropriate prices used.[50]

While MDU claims that conditions at the time supported its investment, including MISO costs, fuel costs, volatility and other factors, it fails to reconcile the fact that these factors are weighed in the IRP process, which *never* chose wind resources as least cost. Indeed, no other tangible economic evaluation was done or submitted. Conclusory statements submitted by a party are insufficient evidence to satisfy a party's burden of proof.[51] This is all we have from MDU—a conclusory statement that economic analysis was done. Ultimately, the Commission may not allow the Utility to recover for its wind farm investments due to MDU's failure to complete the required economic evaluation in direct violation of North Dakota law.

IV. INCENTIVE PAY AND DIRECTOR COMPENSATION

The Utility has failed to meet its burden of showing that its expenses associated with incentive compensation and director fees are used and useful for the convenience of North Dakota ratepayers. MDU is quick to quote dicta language from the North Dakota Supreme Court's decision in Mont.-Dakota Utils. Co. v. Pub. Serv. Comm'n., 413 N.W.2d 308, 316 (N.D. 1987), that employment compensation "is a matter left largely to the deference and judgment of [a utility's] management." In Mont.-Dakota Utils. Co., the court held that the Commission's conclusion that an employee discount on monthly gas bills included as part of the employees' total compensation package was unreasonable due to the fact that the employees' purchase price was less than the wholesale cost was not supported by the

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[50] See Tr. 460-61 (Neigum Testimony).

[51] See, e.g., Lawrence v. Delkamp, 658 N.W.2d 758, 764, 766 (N.D. 2003) (holding party's conclusory averments, which were not supported by specific facts, were insufficient to meet burden of proof); Conlin v. City of St. Paul, 605 N.W.2d 396, 402-03 (Minn. 2000) (same).

Commission's findings of fact.[52] Notably, however, neither the Commission nor Staff in that case challenged whether ratepayers were receiving the entire benefit from of the utility's compensation expense, whereas in this case it is Staff's position that shareholders are receiving a significant benefit from the compensation. In addition, it should be noted that following the North Dakota Supreme Court's decision in Mont.-Dakota Utils. Co., the Commission has disallowed recovery of incentive compensation in subsequent cases for other utilities, and had its decisions affirmed.[53]

The Commission must also keep in mind that in that very same decision, the court held with respect to another expense issue that a utility must support the reasonableness of proposed adjustments to expenses with a "breakdown and underlying analysis" of those expenses.[54] The court ultimately affirmed the Commission's refusal to adjust the utility's administrative and general expenses for purposes of its revised gas rate because the utility did not meet its burden of proving the reasonableness of its requested changes.[55] More specifically, the utility failed to provide a breakdown and analysis of its expenses, which the Court noted might have included salaries of employees who were not performing work relating to gas distribution for the benefit of ratepayers.[56]

Here, MDU has similarly failed to provide a breakdown and analysis of which of its expenses benefit shareholders and which benefit ratepayers. This is especially true with

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[52] Mont.-Dakota Utils. Co., 413 N.W.2d at 316.

[53] 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); Order on Settlement, PU-08-742, PU-08-862 (approving a *partial* recovery of costs associated with incentive compensation from ratepayers).

[54] See id. at 314-15.

[55] Id. at 315.

[56] See id.

respect to *test year* expenses relating to its incentive compensation plan, which are based on the Utility's compensation packages from prior years and heavily weighted toward financial performance. The Utility has the burden of demonstrating a "sufficient nexus" between the financial performance portion of an incentive compensation plan and a benefit to ratepayers, [57] which it has wholly failed to do.

Furthermore, Staff presented affirmative evidence that it is unjust and unreasonable for all of the costs associated with such expenses to be passed onto ratepayers when they are incurred primarily for the benefit of the Utility's investors. Rather than taking a harsh position on this issue and advocating that these costs be entirely excluded from MDU's revised rate (which has invariably occurred in dozens of rate cases in other jurisdictions),[58] Staff has taken the reasonable middle ground, recognizing that because ratepayers do incur at least some attenuated benefits from such costs, they should also incur **some** (but not all) of the expense. In fact, MDU cannot deny that strong financial performance benefits shareholders. Consequently, given MDU's failure to show that all of its expenses associated with incentive compensation and director fees are used and useful for the convenience of North Dakota ratepayers, the Commission should adopt Staff's recommended reductions with respect to these expenses.

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[57] Commonwealth Edison Co. v. Ill. Commerce Comm'n, 924 N.E.2d 1065, 1077 (Ill. App. 2009).

[58] See, e.g., cases discussed on pp. 24-25 of Staff's Post-Hearing Brief and the many more cases cited within those decisions

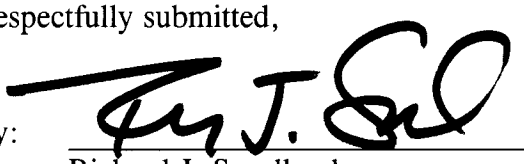
V. CONCLUSION

MDU should be prohibited from recovering the costs of its Diamond Willow and Cedar Hills wind farm investments from North Dakota ratepayers. It has failed to meet its burden of proving that these investments were prudent and reasonable. Staff has shown that the Utility disregarded the excessive expense of these facilities in order to satisfy a Montana renewable resource mandate and to comply with anticipated future environmental regulations, both in direct violation of North Dakota law. MDU did not engage in the requisite economic analysis of these investments before they were made because its executives were well aware that wind was expensive and not cost-effective. The Commission cannot allow the costs of these imprudent investments to be passed onto ratepayers simply because MDU exercised its "business judgment" based on unquantifiable "societal and regulatory" considerations. Rather, the Commission must follow the standard established under North Dakota Century Code, Title 49, as well as its own precedent, and exclude the costs associated with these wind farms from the Utility's revised rate.

Likewise, MDU has not met its burden with respect to incentive compensation and director fee expenses. Staff has shown that these expenses are borne primarily for the benefit of shareholders. Consequently, their costs should be predominantly borne by shareholders, as well. Staff has asked for a reasonable reduction to the percentage of these expenses allocated to ratepayers. This request is in line with previous decisions by this Commission and with the precedent established by countless other public service commissions throughout the United States.

Given MDU's failure to ensure that all of these costs have been incurred for the convenience and benefit of North Dakota ratepayers, the Commission should adopt Staff's recommendations.

Respectfully submitted,

By: 

Richard J. Savelkoul
North Dakota Attorney Reg. No. 06793
444 Cedar Street, Suite 2100
St. Paul, MN 5 5101
(651) 222-6321

ATTORNEYS FOR ADVOCACY STAFF

CERTIFICATE OF SERVICE

Montana-Dakota Utilities Co. Application and Notice of Change in Electric Rates	Case No. PU-10-124

Deborah S. Murphy certifies that on the 4th day of January, 2011, she served a true and correct copy of the attached **Advocacy Staff's Reply Brief** by e-mailing and placing it in the United States mail with postage prepaid, addressed to the following individuals:

Jim Roache
707 1st St. S.W.
Crosby, ND 58703

Scott Skocos
103½ S. Third St., Suite 8
Bismarck, ND 58504
Email: scott@drcinfo.com

Illona. Jeffcoat-Sacco
ND Public Service Commission
600 East Boulevard, Dept. 408
Bismarck, ND 58505-0480
Email: ijs@nd.gov

Daniel S. Kuntz
Rita Mulkern
Montana-Dakota Utilities Co.
400 North Fourth Street
Bismarck, ND 58501
Email: dan.kuntz@mduresources.com
rita.mulkern@mduresources.com

Darrell Nitschke (7 copies U.S. Mail)
ND Public Service Commission
600 East Boulevard, Dept. 408
Bismarck, ND 58505-0480
Email: psccomm@nd.gov

Legal Group
Email: psclegal@nd.gov

Utilities Group
Email: pscpud@nd.gov

Deborah S. Murphy

STATE OF MINNESOTA)
) ss.
COUNTY OF RAMSEY)

Subscribed and sworn to before me this 4th day of January, 2011.

Notary Public

TRICIA L. CINKER
NOTARY PUBLIC-MINNESOTA
My Commission Expires Jan. 31, 2015

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