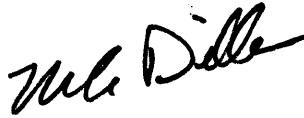


Memo

To: Darrell Nitschke, Executive Secretary
From: Mike Diller, Director of Economic Regulation
Date: February 12, 2013
Re: PU-10-124
Cost Allocation Study



On January 30, 2013 MDU filed its Cost Allocation Study prepared by Concentric Energy Advisors (Concentric) as agreed to by Settlement Agreement and approved by the commission. Staff agrees with the overall conclusion of the study. Additional details of that conclusion follow.

The purpose of this memo is to respond to Concentric's conclusion that MDU Resources Group, Inc.'s (Resources) current process of allocating corporate costs to Montana-Dakota Utilities Co. (MDU) is fair and reasonable. Ensuring the fair allocation of corporate costs to MDU is critical to the commission's regulatory mission to ensure fair and reasonable rates. A number of reasons exist to conduct such a review, including the diversity of holdings by Resources, the sizable costs associated with operating Resources, and expressed concerns by commissioners and customers of possible cross-subsidization by MDU to Resources' other business units.

Allocation processes all follow the same general three tiered approach. First, any costs incurred for the direct benefit of one particular business unit is assigned to that business unit. Second, costs that are incurred for the benefit of multiple business units are assigned to the various business units based on a usage factor of some kind such as number of checks processed or invoices handled. The final group, and the one under review here, are the costs which are not directly assignable or indirectly assignable by a usage factor. The last basket of costs often referred to as "common costs" are assigned using a general allocator.

In the case of MDU Resources, most of its costs are assigned to MDU through this common cost allocator. This occurs for a couple of reasons including administrative ease and because many of the functions and costs of Resources' corporate headquarters are general in nature.

Most utilities use some combination of asset values, payroll, revenue or number of employees to develop a general cost allocator. Prior to 2006, the general cost allocator was based on MDU's share of two equally weighted factors of Net Plant and full-time employees. MDU became concerned that this factor was not fair and resulted in it bearing a disproportionate percentage of corporate costs. As a result, a new factor was developed referred to as the Capitalization Factor based on each business units' total invested capital. As Concentric explains, total invested capital includes common and

preferred equity as well as long-term debt. Based on Chart 3 of the report, it does not appear that the change resulted in a significant change in percentage of costs assigned to Montana-Dakota Utilities Co.

Otter Tail Corporation allocates its unassigned administrative costs by using a weighted factor of assets, payroll and revenue. Xcel Energy Services allocates its costs by using a weighted factor of assets, revenue and employee counts. Both of these would be deemed a more normal approach than Resources' capitalization factor. The use of a weighted factor based on many different relationships reduces the risk of fluctuations in a factor and limits the risk of a factor becoming obsolete when conditions change. It is similar to the idea of why one does not invest in only one stock. For this reason, I tend to prefer the more weighted approach used by Otter Tail and Xcel Energy. That said, it appears that these other methods would result in a higher cost allocation to Montana-Dakota Utilities Co. than the capitalization factor currently in use.

In support of its conclusion, Concentric argues that the capitalization factor is appropriate because, for the most part, Resources' business units are capital intensive businesses. I agree with that assertion and agree with their conclusion that the capitalization factor results in a fair allocation of common costs.

Concentric also makes a good consultant's suggestion that the study be redone every three-to-five years or as circumstances dictate to ensure continued fairness and reasonableness of the current approach. I am inclined to support redoing the review when circumstances dictate such as the acquisition of a significant non-capital intensive business. If the capitalization factor is fair and reasonable today, then until the business unit mix changes or the focus of corporate changes, I see little reason to review the process again within a prescribed period of time.