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January 15, 2016

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

- RE: NORTHERN STATES POWER COMPANY
 2013 ELECTRIC RATE INCREASE APPLICATION
 CASE NO. PU-12-813
- NORTHERN STATES POWER COMPANY
 ADVANCED DETERMINATION OF PRUDENCE – COURTENAY
 WIND PROJECT APPLICATION
 CASE NO. PU-13-706
- NORTHERN STATES POWER COMPANY
 ADVANCED DETERMINATION OF PRUDENCE – ODELL
 WIND PROJECT APPLICATION
 CASE NO. PU-13-707
- NORTHERN STATES POWER COMPANY ADVANCED DETERMINATION OF
 PRUDENCE – PLEASANT VALLEY WIND PROJECT APPLICATION
 CASE NO. PU-13-708
- NORTHERN STATES POWER COMPANY ADVANCED DETERMINATION OF
 PRUDENCE – BORDER WINDS PROJECT APPLICATION
 CASE NO. PU-13-742
- NORTHERN STATES POWER COMPANY 150 MW BORDER WINDS PROJECT –
 ROLETTE COUNTY PUBLIC CONVENIENCE AND NECESSITY
 CASE NO. PU-13-743
- NORTHERN STATES POWER COMPANY ADVANCED DETERMINATION OF
 PRUDENCE – NG GENERATORS APPLICATION
 CASE NO. PU-13-194
- NORTHERN STATES POWER COMPANY RED RIVER VALLEY NG UNITS 1 & 2 –
 HANKINSON, ND PUBLIC CONVENIENCE AND NECESSITY
 CASE NO. PU-13-195

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 Counsel

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NORTHERN STATES POWER COMPANY ADVANCE DETERMINATION OF
PRUDENCE – 345 MANKATO ENERGY CENTER APPLICATION
CASE NO. PU-15-96

Dear Mr. Nitschke:

Enclosed for filing, please find the Brief of Northern States Power Company Supporting the Negotiated Agreement as requested at the December 15, 2015 hearing in the above referenced cases.

Please contact me at 612-215-4663 or alison.archer@xcelenergy.com if you have any questions or concerns.

Sincerely,

/s/

ALISON ARCHER
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cc: ALJ Mann
Jack Shuh
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Jerry Lein
Blaine Johnson

Before the North Dakota Public Service Commission
State of North Dakota

Northern States Power Company 2013 Electric Rate Increase Application	Case No. PU-12-813
Northern States Power Company Advanced Determination of Prudence – Courtenay Wind Project Application	Case No. PU-13-706
Northern States Power Company Advanced Determination of Prudence – Odell Wind Project Application	Case No. PU-13-707
Northern States Power Company Advanced Determination of Prudence – Pleasant Valley Wind Project Application	Case No. PU-13-708
Northern States Power Company Advanced Determination of Prudence – Border Winds Project Application	Case No. PU-13-742
Northern States Power Company 150 MW Border Winds Project – Rolette County Public Convenience and Necessity	Case No. PU-13-743
Northern States Power Company Advanced Determination of Prudence – NG Generators Application	Case No. PU-13-194
Northern States Power Company Red River Valley NG Units 1 & 2 – Hankinson, ND Public Convenience and Necessity	Case No. PU-13-195
Northern States Power Company Advance Determination of Prudence – 345 Mankato Energy Center Application	Case No. PU-15-96

**BRIEF OF NORTHERN STATES POWER COMPANY
SUPPORTING THE NEGOTIATED AGREEMENT**

Brief of Northern States Power Company Supporting the Negotiated Agreement

I. INTRODUCTION

In response to questions raised by Commission Advisory Staff at the December 15, 2015 hearing in the above referenced Cases, Northern States Power Company (NSP or Xcel Energy) submits this Brief in Support of the Negotiated Agreement to the North Dakota Public Service Commission (Commission). Specifically, at the hearing Advisory Staff raised questions related to the Commission's rate-making authority and the scope of the Commission's discretion to disallow certain costs of utility property used and useful for the provision of electric service.

While this specific question of law is important, Xcel Energy believes that the Negotiated Agreement – and the proposal for a “Resource Treatment Framework” (RTF) that is contained within it – should be viewed in the larger legal context of the Commission's rate-making powers and the impact of divergent state energy policies on NSP's North Dakota rates. Ultimately, NSP seeks to develop an RTF to manage the impact of divergent energy policies in a way that helps ensure its North Dakota rates can remain just and reasonable. A thoughtfully crafted RTF can provide the basis to do this in a way that is workable for our customers, our shareholders, and the Commission.

To that end, this Brief provides an analysis of the current state of the law pertinent to the issues raised by the Negotiated Agreement. Through this analysis, we provide our response to the questions posed by Advisory Staff and also provide additional context with respect to our understanding of current North Dakota law. We believe that this context will be helpful to Advisory Staff's, and the Commission's, evaluation of the Negotiated Agreement and the development of an RTF. The discussion in this Brief is, therefore, presented in a way to provide guidance for NSP, the Commission, and its Staff to the pertinent concepts and state of the law as we understand it. It is not intended to draw conclusions; we believe there is no doubt as to the Commission's authority to adopt the Negotiated Agreement and we intend to develop an RTF consistent with the Commission's broad authority.

II. CONSIDERATIONS FOR RATE MAKING

A. Introduction - Just and Reasonable Rates

The Commission is a constitutionally established body¹ with its powers delegated to it by the legislature.² As such, the "Public Service Commission ...

¹ N.D. Const. art. V, § 2.

² N.D.C.C. ch. 49-01(2014) (providing the general rules concerning the Public Service Commission); *see generally* N.D.C.C. tit. 49 (providing the general rules concerning public utilities).

ha[s] only such powers and duties as are prescribed by law.”³ Consequently, the Commission’s actions concerning any subject matter within its jurisdiction, to be valid, must be in substantial conformity with the statutes governing its procedures and must be consonant with due process.⁴ Within these strictures, the Commission has broad authority.⁵

A key power delegated to the Commission by the legislature is the authority to ensure that the rates charged by a public utility are just and reasonable.⁶ “In general, the governing principle for determining rates to be charged by a utility is the right of the public on one hand to be served at a reasonable charge, and the right of the Utility on the other to a fair return on the value of its property used in the service.”⁷

The right of the utility to earn a fair return on the value of its property used to provide service to the public is founded in the Constitution of the

³ *Pub. Serv. Comm’n v. Montana-Dakota Utils. Co.*, 100 N.W.2d 140, 143 (N.D. 1959) [hereinafter *Montana-Dakota Utils. Co.*].

⁴ *State v. Chicago & N.W. Ry. Co.*, 179 N.W. 378, 381 (N.D. 1920); *see also* N.D.C.C. § 49-01-07 (2014) (“The commission in all cases may conduct its proceedings, when not otherwise particularly prescribed by law, in a manner most conducive to the proper dispatch of business and to the ends of justice”).

⁵ *Application of Montana-Dakota Utils. Co. of Minneapolis, Minn.*, 102 N.W.2d 329, 342 (N.D. 1960) (“In making its decision the commission is not limited to saying ‘aye’ or ‘nay’ to the utility’s proposal but it may order any schedule of rates which will yield the utility a just and reasonable return”).

⁶ N.D.C.C. § 49-02-03 (2014) (“The commission shall supervise the rates of all public utilities. . . . [T]he commission by order shall fix reasonable rates . . .”).

⁷ *Montana-Dakota Utils. Co.*, 100 N.W.2d at 144.

United States.⁸ Failure to set rates to provide a fair rate of return could result in the taking of utility property without due process of law and just compensation.⁹ The North Dakota Supreme Court has presented the principle as:

The Commission recognizes that the utility has a right to such rates as will permit it to earn a fair return on the fair value of the property which it employs for the convenience and service of the public which, should, at least, be equal to that generally made at the same time and in the same general part of the country on investments in other business undertakings which are attended by like risks and uncertainties....¹⁰

The right of a utility to rates that present it an opportunity to earn a reasonable rate of return is balanced against the right of the public to receive utility services at a reasonable cost as “excessive prices [are] something regulation seeks to prohibit.”¹¹ The North Dakota Supreme Court has

⁸ U.S. Const. amend. V; see *Stone v. Farmers’ Loan & Tr. Co.*, 116 U.S. 307 (1886) (review of rates by Court undertaking an eminent domain takings analysis).

⁹ *Covington & L. Tpk. Rd. Co. v. Sandford*, 164 U.S. 578, 597 (1896) (finding that the proper analysis is one which weighs “together with all other circumstances that are fairly to be considered in determining whether the legislature has, under the guise of regulating rates, exceeded its constitutional authority, and practically deprived the owner of property without due process of law”).

¹⁰ *N. States Power Co. v. Pub. Serv. Comm’n*, 13 N.W.2d 779, 783 (N.D. 1944) [hereinafter *N. States Power*]. As described further, *infra*, the “fair value” doctrine espoused in this case has been refined to the “honestly and prudently invested” standard provided for in N.D.C.C. § 49-06-02.

¹¹ *State ex. rel. Mo. Office of Pub. Counsel v. Pub. Serv. Comm’n of State*, 293 S.W.3d 63, 80 (2009) (internal citations omitted); *Munn v. Ill.*, 94 U.S. 113, 140 (Field, J.,

concurred that “the utility has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures....”¹²

Within these bounds, the Commission has very broad authority.¹³ “[I]t is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry ... is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.”¹⁴ That said, the Commission must still follow its legally prescribed requirements in reaching its ultimate rate decision.¹⁵

Importantly, establishing the lowest constitutionally-allowed rate, while being legally sufficient, may not be truly just and reasonable if those rates do

dissenting) (raising concerns over “tyrannical” rates if no protection of utilities is allowed by courts).

¹² *N. States Power*, 13 N.W.2d at 783.

¹³ 73B C.J.S. *Public Utilities* § 33 (“Within the constitutional or statutory constraints on its scope of authority, the jurisdiction conferred on a public utility regulatory commission to regulate rates is broad and exclusive”).

¹⁴ *Fed. Power Comm’n v. Hope Nat. Gas Co.*, 320 U.S. 591, 602 (1944); *see also Montana-Dakota Utils. Co., a Div. of MDU Res. Grp., Inc. v. Pub. Serv. Comm’n*, 431 N.W.2d 276, 279 (N.D. 1988) (“In determining what is just and reasonable, the PSC is not restricted to any single formula, if the method followed and the order entered ‘when applied to the facts and viewed as a whole do not produce an unjust or arbitrary result’”).

¹⁵ *See, e.g., N. States Power Co. v. Board of R.R. Comm’rs.*, 298 N.W. 423 (N.D. 1941) [hereinafter Board of R.R. Comm’rs.] (applying legal doctrine to Commission’s rate decision).

not “enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed...”¹⁶ The Commission has recognized that when setting rates “the price so fixed must be sufficient to maintain the financial health of the utility, lest its construction program and ability to compete in the financial markets be impaired to the detriment of future consumers.”¹⁷ Ultimately, allowing “the company to earn sufficient revenues for it to enjoy ... financial health and integrity ... are requisite to the successful and efficient operation of a public utility.”¹⁸ It is the Commission’s responsibility to find the appropriate balance, taking into account the many factors that can impact rates.¹⁹

As the Commission is aware, rates are generally set in a rate case where the Commission may investigate and evaluate the myriad factors that must be considered in setting just and reasonable rates. At a high level, there are four factors used to determine the just and reasonable rate: (1) the utility’s rate base, (2) the utility’s assumed income, (3) the utility’s reasonable operating expenses,

¹⁶ *Hope Nat. Gas Co.*, 320 U.S. at 605 (finding that even if returns are meager, that these considerations should be taken into account when reviewing adequacy of rates).

¹⁷ *In re Otter Tail Power Co.*, 87 P.U.R.3d 204, 204 (N.D. P.S.C. Nov. 10, 1970).

¹⁸ *In re Montana-Dakota Utils. Co.*, 1 P.U.R.3d 97 (Mont. P.S.C. Nov. 12, 1953).

¹⁹ See generally N.D.C.C. § 49-02-03.

and (4) the appropriate rate of return.²⁰ Most relevant to the issues underlying an RTF are the determination of a utility's rate base and a determination of reasonable operating expenses. Additionally, because many matters before the Commission are often settled among the parties, the impact of settlement and acquiescence are also important factors when evaluating the legal issues surrounding an RTF.

B. Rate Base

To determine the appropriate rate base upon which to fix a rate of return, the “commission, for the purpose of ascertaining just and reasonable rates and charges of public utilities ... shall investigate and determine the value of the property of every public utility ... used and useful for the service and convenience of the public....”²¹ “The value of the property of a public utility, as determined by the commission for ratemaking purposes, is the money honestly and prudently invested therein by the utility....”²² “When valuing ... property the commission is to determine whether [an advanced or fictitious cost price, or] a price in excess of the fair market value of any commodity,

²⁰ *Montana-Dakota Utils. Co.*, 100 N.W.2d at 144 (“After the value or rate base of the property used and useful in the public utility business is ascertained, next to be ascertained is the amount of the operating expenses as compared with the gross income, after which a conclusion can be drawn as to the rates necessary for a fair return on the property”).

²¹ N.D.C.C. § 49-06-01.

²² N.D.C.C. § 49-06-02.

equipment, material, or service has been or is being paid by [the utility]. If so, the commission must allow only the reasonable price of such items and eliminate excessive prices or values.”²³

Under this statutory structure, the Commission first determines what utility property is used and useful for the provision of utility service. It then determines the value of the property, which is the money honestly and prudently invested therein. Last, if the Commission determines that the costs of used and useful property are fictitious or otherwise in excess of fair market value, it may then value the used and useful property at the fair market value.

With respect to these requirements, the Commission has asserted that:

Clearly, the commission has extraordinary powers with regard to rate base determination. However, these powers are essential if the commission is to have a meaningful role in the regulation of a utility monopoly. After all, the commission’s primary role in utility rate making is to fill the void of what should ideally be competitive forces.²⁴

Although the Commission does have broad authority under this statutory scheme, such authority is not unbounded.

²³ *In re Otter Tail Power Co.*, 44 P.U.R.4th 219, 225 (N.D. P.S.C. July 20, 1981) (citation omitted) (summarizing the Commission’s authority under N.D.C.C. § 49-06-04).

²⁴ *Id.* at 225-26.

1. *Used and Useful*

The concept of used and useful has been used to determine what portion of utility property is serving the public, and therefore, to what property a rate of return should be applied.²⁵ This doctrine derives from the time when valuation of utility property was the main focus of rate cases and, as the U.S. Supreme Court had found, “the basis of all calculations as to the reasonableness of rates to be charged by a [utility] under legislative sanction must be the fair value of the property being used by it for the convenience of the public.”²⁶ Although the fair value doctrine has since been superseded, the concept of used and useful remains.

Utility property is used and useful “[i]f . . . the addition has been completed and is in use”²⁷ and found to be serving the public.²⁸ By applying the used and useful standard, the Commission may ensure the utility’s investments for the public benefit are appropriately accounted for in setting rates.

²⁵ See generally 73B C.J.S. *Public Utilities* § 51 (describing the “used and useful” rule).

²⁶ *Smyth v. Ames*, 169 U.S. 466 (1898), *overruled by Fed. Power Comm’n v. Nat. Gas. Pipeline Co. of Am.*, 315 U.S. 575 (1942).

²⁷ *Board of R.R. Comm’rs*, 298 N.W. at 431.

²⁸ See *Montana-Dakota Utils. Co.*, 100 N.W.2d at 150 (“[T]he excess size of the pipe line . . . is not necessary to serve the communities proposed and not at the present actually to be used nor be made useful for the purpose of rendering its public service . . .”).

In general, an “asset is ‘used and useful’ for purposes of including it in utility’s base rate if it is acquired in good faith and held for use in the reasonably near future in order to enable the utility to supply and furnish adequate and uninterrupted service.”²⁹ Historically, if a regulated entity sought to include property in its rate base that was determined to be used to perform services not covered by rates, as opposed to property in service for the regulated purpose of the entity, then a decision-maker would properly exclude that property as not used and useful.³⁰ The decision-maker’s analysis would involve a determination of whether the property in question was utilized in the performance of regulated services and a comparison between the use of the property in question and other property that enables a regulated entity to execute its regulated function.³¹ In essence, the inquiry as to used and useful is one of dedication of property to the public good and if that property is actually used to provide the regulated service.

In North Dakota, the used and useful inquiry has historically been used to determine if utility property is being used to serve the public. It appears as if

²⁹ 73B C.J.S. *Public Utilities* § 51.

³⁰ See *Denver Union Stock Yard Co. v. U.S.*, 304 U.S. 470, 476 (1938) (holding that evidence was “not sufficient to prove that the property excluded is used and useful for the performance of services covered by rates being regulated by the Secretary” because “[n]one of [the] services [were] performed on or by the use of any of that property”).

³¹ See *id.*

the Commission has only exercised its authority with respect to making a used and useful determination when a utility has made investments in a plant that is intended to serve future customers but not necessarily used and useful for the current customer base.³² In these instances, the Commission has used its broad ratemaking authority to ensure that the interests of the utility and rate payers are equitably balanced and the financial health of the utility is maintained.³³

The statutory mandate with respect to utility property is clear;³⁴ it is not in question that if utility property is found to be used and useful, then it must be valued for the purpose of setting rates. This was apparent to the North Dakota Supreme Court: “[i]f ... the addition has been completed and is in use, its value will be allowed by the Commission as a matter of course.”³⁵ And, the Commission has determined that “in order for the commission to establish just and reasonable rates, it must determine the value of [the utility’s] property used and useful for the service and convenience of the public.”³⁶

³² See *Montana-Dakota Utils. Co.*, 100 N.W.2d at 150; *In re Montana-Dakota Utils. Co.*, 44 P.U.R.4th 219 (N.D. P.S.C. Aug 10, 1981); *In re Otter Tail Power Co.*, 44 P.U.R.4th 219, 225 (N.D. P.S.C. July 20, 1981).

³³ See, e.g., *In re Montana-Dakota Utils. Co.*, 44 P.U.R.4th 219 (N.D. P.S.C. Aug 10, 1981) (allowing a debt return on investment in Coyote plant that turned out to be unneeded excess capacity due to misforecasted load projections).

³⁴ N.D.C.C. § 49-06-01.

³⁵ *Board of R.R. Comm’rs*, 298 N.W. at 431-32.

³⁶ *In re Montana-Dakota Utils. Co.*, 44 P.U.R.4th 219, 225 (N.D. P.S.C. Aug 10, 1981) (emphasis added).

Consequently, if the utility property is found to be used and useful, it will be included in rate base. The Commission then moves to the next step of the process: determining its value.

2. *Valuing Rate Base*

After determining what utility property is used and useful for the provision of service to the public, the Commission must then value that property for the purpose of establishing the rate base. North Dakota statute sets that value as “the money honestly and prudently invested therein by the utility.”³⁷ This standard has been called the “honestly and prudently invested standard” or the “prudent investment rule.”³⁸

The prudent investment rule was a reaction to the difficulties in setting the value of rate base at a time when the general standard was to ascribe a “fair value” to utility property used and useful for the provision of utility service.³⁹ The difficulty in establishing fair value⁴⁰ led to the eventual adoption of the prudent investment rule in many states, including North Dakota.⁴¹

³⁷ N.D.C.C. § 49-06-02.

³⁸ See 73B C.J.S. *Public Utilities* § 49.

³⁹ See *State of Mo. ex. rel. Sw. Bell Tel. Co. v. Pub. Serv. Comm’n of Mo.*, 262 U.S. 276, 292 (Brandeis, J., dissenting); see generally Section 4609c37 of the Supplement to Compiled Laws of 1913 (N.D.).

⁴⁰ *Smyth*, 169 U.S. at 425.

⁴¹ N.D.C.C. § 49-06-02; see generally *Board of R.R. Comm’rs*, 295 N.W.2d at 436-49 (Christianson, J., dissenting). The provisions of Section 4609c37 of the

Under the prudent investment rule, rates reflect the fact that “[t]he thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise.”⁴² Consequently, under the prudent investment rule “a utility is compensated for all prudent investments at their cost when made regardless of whether they are necessary or beneficial in hindsight”⁴³ and not through some other type of valuation method (such as “fair value” or “replacement cost depreciated”). At base, “[t]he term ‘historical cost’ is synonymous with ‘prudent investment’....”⁴⁴

“The principle reason for qualifying and limiting the investment to one honestly and prudently made was to exclude from the rate base what might be found to be dishonest or obviously wasteful or imprudent expenditure.”⁴⁵ In providing the “honestly and prudently invested” language in statute, the legislature “sought to protect the public against rates based on padded values, such as hidden bonuses in security issues, the public payment for use of

Supplement to Compiled Laws of 1913 on which the majority based its decision provided six factors upon which the Commission must determine the valuation of property. These factors have since been repealed and only the “honestly and prudently invested” standard remains in statute.

⁴² *Sw. Bell Tel. Co.*, 262 U.S. at 292 (Brandeis, J, dissenting).

⁴³ 73B C.J.S. *Public Utilities* § 49.

⁴⁴ *Board of R.R. Comm’rs*, 298 N.W. at 443 (Christianson, J., dissenting).

⁴⁵ *Id.* at 442.

property which in reality did not exist, and payment for services which the utility had not rendered.”⁴⁶

While the honestly and prudently invested standard requires the Commission to accept the reasonable choices of a utility, the Commission is “not required to accept, without question any exorbitant price which a utility has seen fit to pay for the items of property included in the rate base.”⁴⁷ To that end, North Dakota statutes provide the authority to the Commission to fix reasonable prices if it determines that a cost paid by the utility for “any commodity, machinery, equipment, material, or service” is “advanced or fictitious ... or a price in excess of the fair market value.”⁴⁸ This authority is not unbounded⁴⁹ and, generally, has been used to ensure that transactions

⁴⁶ *Id.*; see also *Sw. Bell Tel. Co.*, 262 U.S. at 289 n.1 (Brandeis, J., dissenting) (“The term ‘prudent investment’ is not used in a critical sense. There should not be excluded, from the finding of the base, investments which, under ordinary circumstances, would be deemed reasonable. The term is applied for the purpose of excluding what might be found to be dishonest or obviously wasteful or imprudent expenditures”).

⁴⁷ 73B C.J.S. *Public Utilities* § 50.

⁴⁸ N.D.C.C. § 49-06-04.

⁴⁹ *Montana-Dakota Utils. Co.*, 100 N.W.2d at 146-47 (declining to countenance Commission’s repricing of gas contract on theory that non-affiliated, third-party gas sellers were receiving large profits under nearly identical predecessor statute to N.D.C.C. § 49-06-04).

amongst affiliates have been reasonable⁵⁰ and to ensure utility procurement policies result in reasonable costs.⁵¹

Since its inception, the “honestly and prudently invested” standard or the “prudent investment rule” has become the keystone to assessing utility investments in rate base. It is in essence a standard that measures the reasonableness of the utility’s actions based on the considerations it had to take into account at the time it undertook those actions. The New York courts have provided one of the best summaries of the modern application of the standard:

In determining whether a utility may recover certain costs, [the commission’s] rate-setting powers necessarily include assessment of the prudence of a utility’s actions as those actions impact upon the ratepayers. . . . *Prudence . . . is determined by judging whether the utility acted reasonably, under the circumstances at the time, considering that the company had to solve its problems prospectively rather than in reliance on hindsight.*⁵²

⁵⁰ *Montana-Dakota Utils. Co., a Div. of MDU Res. Grp., Inc. v. Pub. Serv. Comm’n*, 431 N.W.2d 276, 279-80 (N.D. 1988) (finding that the Commission acted within its authority when determining if utility affiliated subsidiary made unreasonable profits); *see generally* N.D.C.C. § 49-02-02.

⁵¹ *In re Otter Tail Power Co.*, 44 P.U.R.4th 219 (N.D. P.S.C. July 20, 1981).

⁵² *Nat’l Fuel Gas Distrib. Corp. v. Pub. Serv. Comm’n of State*, 71 A.D.3d 62, 66, 893 N.Y.S.2d 652, 655 (2009), *aff’d* 16 N.Y. 3d 360, 947 N.E.2d 115 (2011)(emphasis added) (citations omitted).

This is the same general test used to determine prudence as explained by Justice Brandeis in 1941.⁵³

Under this standard, “the prudence rule looks to the time of investment, whereas the ‘used and useful’ rule looks toward a later time.”⁵⁴ Because of its temporal nature, the “prudent investment rule” requires regulatory commissions to view the reasonableness of the utility’s choices at the time, and with the information that was available, when it made its choices.⁵⁵ It is perhaps because of this that some state legislatures, including North Dakota, have authorized commissions to make advanced determinations of prudence⁵⁶ at the same time that the utility makes its initial investment decision. Because

⁵³ See *Sw. Bell Tel.*, 262 U.S. at 289 (Brandeis, J., dissenting).

⁵⁴ 73B C.J.S. *Public Utilities* § 51.

⁵⁵ See, e.g., *Montana Dakota Utils. Co. Elec. Rate Increase Application*, Case No. PU-10-124, ORDER ON SETTLEMENT (N.D. P.S.C. June 8, 2011) (adopting settlement where analysis of the reasonableness and prudence of a two wind resources was performed based on information known at the time the decision to invest in the wind resources was made and not some other future time even though resources were used and useful when rate case was filed); *New England Power Co.*, Opinion No. 231, 31 FERC ¶ 61,047, *reh. denied*, Opinion No. 231-A, 32 FERC ¶ 61,112 (1985), *aff’d sub nom. Violet v. FERC*, 800 F.2d 280 (1st Cir. 1986); *In re Mountain Water Co.*, Case No. D2010.4.41, 2011 WL 2714078 (Mont. P.S.C. Mar. 22, 2011) (“The Commission finds that the refinancing was prudent based on the best information available at the time [of refinancing]”); *In re UNITIL Serv. Corp.*, 72 N.H. P.U.C. 467, 472 (N.H. P.U.C. 1987) (“In determining whether a judgment was prudently made, only those facts available at the time of the judgment was exercised can be considered. Hindsight review is impermissible” (citation and quotation omitted)).

⁵⁶ N.D.C.C. § 49-05-16; see, e.g., Iowa Code § 476.53(3)(a)(Iowa’s advance ratemaking principles law); Minn. Stat. § 216B.1695.

the prudent investment standard requires a review of a utility's decisions at the time they were made, making an advanced determination of prudence provides a commission the ability to determine prudence with the same information available to the utility at the time it makes its decision thereby providing certainty to the utility about the prudence of its investment.

By applying the “honestly and prudently invested” standard, the Commission may complete its requirement to value the utility's rate base. The Commission can then evaluate the utility's expenses.

C. Reasonable Expenses

Unlike many other states,⁵⁷ North Dakota statutes do not directly address the Commission's evaluation of utility expenses. However, North Dakota courts have found that establishing operating expenses of the utility is part of the ratemaking process:

Implicit in rates which are “just and reasonable,” is the right of the utility and its investors to a reasonable return as well as the consumers' right to pay a rate which reflects the cost of service rendered plus a reasonable profit. These considerations require a determination of the operating expenses of the utility and, in order for an allowance for a return

⁵⁷ See, e.g., 220 I.C.S. 5/9-225(3) (2014) (providing a list of categories of advertising that can be considered allowable operating expenses for utilities); Minn. Stat. § 216B.16 (2014) (providing numerous examples of expenses that the commission may or may not allow as operating expenses); Tex. Utils. Code §§ 36.051, 104.055(d) (“The regulatory authority may adopt reasonable rules complying with this section with respect to including and excluding certain expenses in computing the rates to be established”).

on the investments, the retail rate must be over and above the expenses.⁵⁸

Further, North Dakota courts have also recognized the Commission's authority to review a utility's expenses for reasonableness (and prudence).⁵⁹

When evaluating the reasonableness of utility expenses for ratemaking, “[i]t was the duty of the Commission to allow an amount which in its judgment was sufficient for the purpose.”⁶⁰ That judgment must be based on the evidence on the case record and the Commission may not impose its judgment

⁵⁸ *N. States Power Co. v. Hagen*, 314 N.W.2d 32, 37 (N.D. 1981).

⁵⁹ *See, e.g., Board of R.R. Comm'rs*, 298 N.W. at 423 (judicial review of Commission's adjustment to operating expenses and mentioning there is no lack of “prudence” on the part of management with respect to certain legal expenses); *Montana-Dakota Utils. Co.*, 100 N.W.2d at 140 (judicial review of Commission adjustment to purchased gas cost); *Hagen*, 314 N.W.2d at 37 (finding certain FERC approved expenses as preempting discretion of the Commission which must, therefore, be passed through in rates); *In re N. States Power Co.*, 139 P.U.R.4th 349 (N.D. P.S.C. 1992) (making adjustments for operating expenses); *see also Pike Cty. Light & Power Co. v. Penn. Pub. Util. Comm'n*, 465 A.2d 735 (Penn. Comm. Ct. 1983) (finding Commission empowered to determine prudence of utility choice of two FERC-approved wholesale power rates); *Ky. W. Va. Gas Co. v. Penn. Pub. Utility Comm'n*, 650 F. Supp. 659, 670 (M.D. Pa. 1986), *aff'd*, 837 F.2d 600 (3d Cir. 1988) (“We conclude that Act 74 and the PUC order issued pursuant to its authority do not violate the supremacy clause, and we note our agreement with the rationale of the Pennsylvania Commonwealth Court on this issue [provided in *Pike County*]”); *Gulf States Utils. Co. v. Pub. Utils. Comm'n of Tex.*, 841 S.W.2d 459, 469 (Tex. App. 1992), *writ denied* (Sept. 10, 1993) (“Under the circumstances of this case, federal preemption does not preclude the Commission's review of Gulf States' prudence in contracting to purchase this quantity of energy capacity from Southern in light of its projected needs and considering its alternative sources of power”).

⁶⁰ *Board of R.R. Comm'rs*, 298 N.W.2d at 434.

for what “the Company ought to be able to do.”⁶¹ The North Dakota Supreme Court cabined the Commission’s discretion in this way because:

The Commission is not the financial manager of the corporation, and it is not empowered to substitute its judgment for that of the directors of the corporation; nor can it ignore items charged by the utility as operating expenses, unless there is an abuse of discretion in that regard by the corporate officers.⁶²

Within this band of discretion, however, the Commission has broad authority. For example, in NSP’s 1992 rate case, the Commission made various adjustments to the Company’s operating expenses related to distribution expenses, property taxes, and certain organization dues, among other things.⁶³ Consistent with the North Dakota Supreme Court’s requirements,⁶⁴ the Commission made these adjustments based on the evidence in the record and articulated each of these adjustments separately and for reasons not substituting its judgment with that of the utility.⁶⁵

⁶¹ *Id.*

⁶² *Id.* (internal quotations and citations omitted) (finding failure to enumerate what charges were disallowed and instead making a determination on overall expenses substituted the Commission’s judgment for that of the utility’s when actual expenses were not rebutted on the record).

⁶³ *In re N. States Power Co.*, 139 P.U.R.4th 349 (N.D. P.S.C. 1992).

⁶⁴ *See Board of R.R. Comm’rs*, 298 N.W.2d at 434 (“If the Commission had concluded that some of the donations were improper, it should have pointed them out specifically . . .”).

⁶⁵ *In re N. States Power Co.*, 139 P.U.R.4th 349 (N.D. P.S.C. 1992).

That said, the Commission did appear to internalize the limits on its authority articulated by the North Dakota Supreme Court in refusing to make certain other adjustments. For example, when addressing certain employee compensation matters, the Commission did not alter the judgment of the Company because the record evidence did not support doing so:

We decline to make Miles' recommended adjustment. We are concerned with NSP's choice of companies for its market comparison and agree with Miles that this choice of companies is biased and skews the results. However, Miles did not independently define the appropriate market for comparisons, but rather recommended the median cut-off point because of the problems with NSP's defined market.⁶⁶

Additionally, the Commission also chose not to adjust certain labor expenses, recognizing that it may not adjust a known and definite expense without something more.⁶⁷

In addition, a substantial portion of the adjustment for this issue relates to negotiated, contractual labor costs. The amount of the original adjustment attributable to bargaining unit costs is \$784,000. We will not adjust NSP's revenue requirement for this labor amount, since it is a known and definite

⁶⁶ *Id.* at Finding 110.

⁶⁷ See *Board of R.R. Comm'rs*, 298 N.W.2d at 433-34 (“There is no question but that the Company, during that year spent for legal services the amount claimed should be allowed annually for legal expenses. . . . There is no testimony in the record which challenges the prudence or the good faith of the Company's management in the incurring of these charges, nor is there any evidence which indicates that the cost of legal services will be a less sum in the future”).

expense. However, we tend to agree with Miles that the amount is too high and strongly suggest that NSP continue its efforts to close the gap between what the industry as a whole pays for its labor and what NSP pays for its labor. In the future, NSP must prove the reasonableness of such costs through an appropriate compensation comparison and demonstrate to the Commission that it has made efforts to bring its salaries more in line with the industry in general.⁶⁸

In the end, the Commission has broad discretion to adjust operating expenses to ensure rates are just and reasonable. But, this discretion is not unbounded, as has been recognized by the Commission and the courts. Ultimately, the Commission may adjust operating expenses so as long as its decisions are reasonable, well-articulated, based on the record, and do not result in unjust and unreasonable rates.

D. Settlement and Acquiescence

In addition to the Commission's broad authority under North Dakota law, the Commission's adoption of settlements allows for broader outcomes than those that could be achieved merely through the Commission's prescriptive authority. This is because through settlement a utility can agree to waive those legal restrictions on the Commission's broad authority that accrue

⁶⁸ *In re N. States Power Co.*, 139 P.U.R.4th 349, at Finding 111 (N.D. P.S.C. 1992).

to its benefit.⁶⁹ In that manner, utilities can acquiesce to outcomes beyond which the Commission could nominally prescribe but that result in just and reasonable outcomes benefitting both the utility and its customers.

An example of this occurred in 1993 upon the Commission's investigation of Otter Tail Power Company's then-effective rates.⁷⁰ Through its investigation, the Commission determined that Otter Tail's earnings were too high under their rate structure.⁷¹ In that case, the Commission was faced with a choice to either call in Otter Tail for a new rate case to lower their rates – with the higher rates remaining in effect for the time the rate case was ongoing and the inability to order refunds of the overearnings that had already accrued – or adopt the settlement that Staff had entered into with Otter Tail, which would have, among other things, allowed for the disgorgement of some of Otter Tail's over-earnings during 1993.⁷² Recognizing that “[c]apturing excess earnings for the year ended 1993 cannot be achieved outside a

⁶⁹ N.D.C.C. § 01-02-28; *J.R. Watkins Co. v. Vangren*, 116 N.W.2d 641, 650 (N.D. 1962); *Wellens v. Beck*, 103 N.W.2d 281, 285 (N.D. 1960) (“The doctrine of waiver is applicable to all rights and privileges to which a person is legally entitled, whether secured by contract, conferred by statute, or guaranteed by the Constitution, provided such rights and privileges rest in the individual who has waived them and are intended for his benefit”).

⁷⁰ *In re Otter Tail Power Co.*, No. PU-401-93-520, 1993 WL 560361 (N.D. P.S.C. Sept. 22, 1993).

⁷¹ *Id.* at *1.

⁷² *Id.*

settlement process without constituting retroactive ratemaking[.]” the Commission opted to adopt the settlement so that Otter Tail’s excess earnings could be legally refunded to rate payers.⁷³

This example illustrates how, if conditions are right, the Commission can achieve even more just and reasonable outcomes through settlement than through merely exercising its authority. NSP submits that many of the outcomes of its last rate case⁷⁴ and the value exchanged under the Negotiated Agreement are similarly based on collaborative settlements and acquiescence, which, NSP believes, provides greater value to both NSP and our customers.

III. CONCLUSION

The legal structures governing the Commission were established in the early part of the 20th century and the significant jurisprudence defining the Commission’s powers was developed more than 60 years ago. Under these structures, the Commission’s legal authority with respect to setting just and reasonable rates is broad but not unbounded. These structures are, however, sufficiently expansive to support the ability for the Commission, in

⁷³ *Id.*; see also *Montana-Dakota Utils. Co. v. Pub. Serv. Comm’n*, 431 N.W.2d 276, 280 (N.D. 1988) (stating the rule against retroactive ratemaking and citing approvingly to N.D.C.C. § 49-02-03).

⁷⁴ See *2013 Electric Rate Increase Northern States Power Company*, Case No. PU-12-813, ORDER ADOPTING SETTLEMENT (Feb. 26, 2014).

collaboration with NSP, to adopt frameworks to mitigate the impact of divergent energy policies.⁷⁵

NSP believes that an RTF can significantly mitigate the impact that divergent energy policies will have on its customers, its shareholders, and the Commission and help to ensure that rates do not become unjust and unreasonable. Through an RTF, NSP hopes to develop the appropriate regulatory structure to allow it to manage the impact of divergent state energy policies within the NSP System in a way that is consonant with the Commission's legal authority and in a manner sufficiently robust to meet the challenges of the future. Importantly, the Negotiated Agreement leaves the current status quo in place unless and until the Commission adopts an RTF.⁷⁶

Therefore, NSP respectfully requests that the Commission adopt the Negotiated Agreement.

⁷⁵ The Commission has significant authority under the auspices of ensuring rates are just and reasonable to develop structures that would allow for such outcomes. *See, e.g., Cass Cty. Elec. Coop., Inc. v. N. States Power Co.*, 518 N.W.2d 216 (N.D. 1994) (deferring to the Commission's authority to implement flexible tariffs); *In re Otter Tail Power Co. for Approval of a Voluntary Renewable Energy Rider*, Case No. PU-01-095, ORDER (May 23, 2001) (establishing rider not explicitly authorized by legislature); *2013 Electric Rate Increase Northern States Power Company*, Case No. PU-12-813, ORDER ADOPTING SETTLEMENT (Feb. 26, 2014) (same and establishing gatekeeping function prior to allowance of recovery of PPAs in FCR); *2011 Electric Rate Increase Northern States Power*, Case No. PU-10-657, ORDER ON SETTLEMENT (Feb. 29, 2012) (establishing reliability performance plan through settlement with both rewards and penalties).

⁷⁶ Exhibit 1, at § III.C (Negotiated Agreement).

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Respectfully submitted,

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