

BEFORE THE NORTH DAKOTA PUBLIC SERVICE COMMISSION

MONTANA DAKOTA UTILITIES)
CO., A DIVISION OF MDU) CASE NO. PU-17-295
RESOURCES GROUP, INC. 2017)
NATURAL GAS RATE INCREASE)
APPLICATION)
_____)

STATEMENT IN SUPPORT OF
THE SETTLEMENT AGREEMENT

The Federal Executive Agencies (FEA) supports the settlement agreement reached by the MDU Resources Group, Inc. and the North Dakota Public Service Commission Advocacy Staff. FEA agrees this Settlement Agreement, if approved by the Public Service Commission (“Commission”), would resolve all outstanding expense, revenue, rate base, return, and rate design issues in this case between the Settling Parties.

However, should the Should the North Dakota Public Service Commission not approve the Settlement Agreement, FEA provides its arguments in the case in the final brief attached.



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**Post-Hearing Response Brief
of
Federal Executive Agencies**

July 19, 2018

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I. GENERAL OVERVIEW

MDU is requesting to increase revenues by approximately \$5,868,389. Virtually all parties in this case took issue with the Company’s estimated revenue deficiency. Indeed, FEA believes that the Company’s claimed revenue deficiency is overstated by at least \$1.1 million.¹ This conclusion was reached based on an adjustment to MDU’s claimed cost of service and revenue requirement. This adjustment reduces MDU’s revenue deficiency down to \$4.77 million. However, other parties may also propose adjustments to the Company’s claimed revenue deficiency that the Hearing Examiner and the Commission will find to be appropriate.

FEA requests the Commission thoroughly scrutinize the Company’s proposed revenue requirement, and resulting rates to retail customers. Without thorough and detailed review of a company’s justification and proposed changes to its tariff rates, the Commission needs to fulfill its customer protection obligation and ensure that the rates charged to retail customers are no higher than a just and reasonable level. For these reasons, FEA has made a thorough evaluation of the Company’s filing, proposed adjustments to the claimed revenue deficiency, cost of service measurement, spread of revenue deficiency across rate classes, and ultimately the design of retail tariff rates. These issues are important to the federal

¹Direct Testimony of Michael P. Gorman at 3.

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government institutions represented by FEA, and are also important to all other customers of MDU.

II. REVENUE REQUIREMENT ISSUES

II.A. Return on Equity

The Company outlines its requested return on equity in its Brief at pages 19-24. There, the Company outlines parties’ requested returns on equity in this proceeding to include Staff witness Griffing at a proposed return on equity of 9.5%, FEA witness Gorman a return on equity of 9.1%, and the Company’s witness Dr. Gaske a return on equity of 10%. FEA does not take exception with the Company’s disclosure of the *Federal Power Commission v. Hope* and *Bluefield* decisions on the standards for establishing a fair return on equity. As the Company notes, a return on equity should be adequate to maintain financial integrity and credit standing, but should do so while charging no more than reasonable rates to customers. However, in establishing those just and reasonable rate standards, the Company does not accurately assess the issues in the case. The deficiencies are several and are described here.

First, the Company does not accurately describe the return on equity model results produced by each of the witnesses, which are summarized in Table 1 below.

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TABLE 1

Return on Equity Summary¹

	<u>Mr. Gaske (MDU)</u>	<u>Dr. Griffing (Staff)</u>	<u>Mr. Gorman (FEA)</u>
Constant Growth DCF		8.91%-9.19%	8.47%-9.08%
Multi-Stage DCF		8.10%	7.10%
Projected DCF	N/A	N/A	N/A
CAPM	11.26%	7.17%	9.30%
Risk Premium	9.9% - 18.2%	N/A	9.20%
Returns in Other Jurisdictions	N/A	N/A	N/A
Flotation Cost	0.30%	0.20%	N/A
Recommended	10.0%	8.91%	9.10%

Sources: Gaske Direct Testimony at pages 19, 24, 28 and 30; Griffing Direct Testimony at pages 23 and 31 and Exhibit MFG-8, Schedules 1, 3 and 4; and FEA Gorman Direct Testimony at pages 43 and 56, Exhibit MPG-2, Schedules 6, 9 and 11.

As developed in Table 1 above, each of the witnesses produced return on equity estimates based on Discounted Cash Flow (“DCF”) studies, Capital Asset Pricing Model (“CAPM”) studies, and risk premium studies. Importantly, Staff witness Griffing’s testimony studies indicate that the highest reasonable return on equity for MDU in this proceeding would be 9.19%. Similarly, FEA witness Gorman’s market-based models show that the highest reasonable return on equity for MDU in this proceeding should be 9.3%. For these reasons, the Company’s suggestion that Dr. Griffing’s testimony supports a return on equity of 9.5% simply is without merit and should be rejected. Indeed, even including the 20 basis point

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flotation cost adder recommended by Staff witness Griffing, the highest return on equity his analysis would support would be 9.39%.

The Commission should carefully scrutinize whether or not a flotation cost adjustment should be added to MDU’s cost of common equity. FEA witness Gorman stated that a flotation cost adjustment would be appropriate for setting rates, if the flotation costs are shown to be reasonable, can be verified as actually incurred, and are properly reflected in cost of service. Flotation costs are not obscure costs that cannot be properly accounted for and shown to be prudent and reasonable. MDU did not disclose it actually has incurred flotation costs, and whether or not those flotation costs are properly assigned to its MDU gas operations. For these reasons, the Company simply has not proven that it has known and measurable flotation cost estimates that should be included in its return on equity. Because the Company has the burden of proof, and the Company failed to meet its burden in this proceeding, no flotation cost adjustment should be included in MDU’s return on equity in this proceeding.

The Company also made arguments in its Brief concerning MDU’s credit rating, relative to the credit rating of the proxy group used by Staff witness Griffing and FEA witness Gorman. The Company argues that MDU’s bond rating is BBB+ where the bond ratings of the companies in the proxy group average around A- (MDU Brief at 21). However, the Company ignores the clear evidence from Staff and FEA witnesses that indicates that MDU’s bond rating is negatively impacted

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by its non-regulated affiliate companies. MDU’s gas utility investment risk is much lower than the consolidated risk of MDU Resources, which is the bond rating referred to by MDU in its Brief. If gas operations are lower risk than MDU Resources, it would not be appropriate for North Dakota retail customers to pay higher rates to support investment risks that are unrelated to the provision of regulated utility service in North Dakota. Rather, MDU Resources’ non-regulated companies must contribute adequate cash flow to support its bond rating and investment risk, without causing unjust rate pressure to retail customers in North Dakota. Investment risk subsidies across operating divisions of MDU Resources are simply not just and reasonable, and the Commission should not allow the Company’s request to increase rates to subsidize non-regulated operations in this proceeding.

The Company also went into detail about authorized returns on equity for other electric utility companies around the country. However, the Company has not established whether or not those other utilities have similar investment risk as MDU Resources’ North Dakota gas utility operations, nor has it established whether or not there are extenuating circumstances in those rate proceedings which supported the commissions’ decisions to award those utilities a return on equity that is above the cost of equity that is estimated by the experts in this proceeding. Absent complete details of the factual circumstances that supported the regulatory commissions’ authorized returns on equity in other jurisdictions, those findings

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simply cannot be used to circumvent the clear un rebutted market evidence by Staff and FEA that MDU’s market cost of equity in this proceeding is in the range of 9.0% to 9.3%. Indeed, relying on other commissions’ authorized returns, rather than the current market cost of equity for MDU, would be inconsistent with the *Hope* and *Bluefield* standards that state an authorized return on equity should reflect fair compensation, which reasonably compares to the compensation available to investors in other enterprises of comparable risk, but without imposing unjust and unreasonable rate burdens on customers. The Company has failed to establish that the Commission should ignore the market-based models widely accepted as reliably able to measure a fair return on equity for MDU in this proceeding, and would instead impose an unjust and unreasonable rate burden on North Dakota’s retail gas customers.

For all these reasons, MDU’s requested return on equity should be rejected, and the Commission should award a return on equity for MDU of 9.1% as recommended by FEA witness Gorman, but in no event should it award a return on equity higher than the 9.2% range recommended by Staff witness Griffing.

III. PROPOSED REVENUE SPREAD ACROSS RATE CLASSES

The Company’s proposed spread of the revenue increase across customer classes is detailed in Statement N. Mr. Jordan Hatzenbuhler explains that the Company uses the results of its embedded cost of service study (“ECOSS”) as a

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guide in allocating its revenue requirement to its rate classes. Table 2 below shows a comparison of the percent revenue increase required under the Company’s ECOSS in order for each class to reach equal rates of return, alongside the Company’s proposed total revenue increase.

<u>Rate Class</u>	<u>Increase / (Decrease) to Reach Cost of Service</u>	<u>MDU Proposed Increase / (Decrease)</u>
Residential	9.7%	5.9%
Firm General	2.3%	5.5%
Air Force Delivery	-1.1%	0.0%
Small Interruptible	-11.6%	0.0%
Large Interruptible	-25.6%	0.0%
Overall	5.4%	5.4%

Source: Statement N, page 2 of 17.

Because the Air Force Delivery, Small Interruptible, and Large Interruptible classes are producing above system average rates of return in the ECOSS, the Company proposes to hold these classes at current rate levels. The Company proposes increases to the North Dakota retail Residential and Firm General classes of 5.9% and 5.5%, respectively, as compared to the proposed system average increase of 5.4%.

The increase proposed is less than that which is necessary to move the Residential and Firm General Service classes to cost of service. Nevertheless, it

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represents a reasonable movement toward cost of service, with each class getting less than 1.1x the system average increase.

Even though certain classes are deserving of a rate decrease as indicated by the Company’s ECOSS, holding those classes at current rate levels is reasonable. By doing so, this provides the Company the opportunity to provide rate mitigation to the Residential class. Mitigation of the Residential class increase recognizes the principle of gradualism and prevents the Residential class from experiencing rate shock in the form of a rate increase nearly double the system average increase of 5.4%.

The Company’s proposed revenue spread based on its claimed revenue deficiency was supported by FEA witness Gorman as well as AARP witness Rubin.

IV. COST OF SERVICE STUDY

The Company’s proposed ECOSS is described by Mr. Jordan Hatzenbuehler and can be found in Statement M.

For gas distribution utilities, the largest contributor to the overall cost of service is the cost associated with distribution mains, including the return on, and return of, the utility’s capital investment in distribution mains. Within the ECOSS, the Company’s method of allocating distribution mains costs is reasonable and aligned with cost incurrence.

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The Company classified 75% of its investment in distribution mains as demand related, while 25% of its investment in distribution mains has been classified as customer related. The amount of cost classified as demand related was allocated to each rate class based on the design day demand attributed to each rate class. The amount of cost classified as customer related was allocated to each rate class based on the average number of customers in each rate class.

FEA witness Gorman testified that a gas distribution utility designs and constructs its system of distribution mains to meet the design day demand of its system. This ensures that all firm customers on the utility’s system will be able to receive delivery of gas on the day of greatest expected system gas demand. The costs of the distribution mains system related to the capacity size of the mains are properly classified as demand related and allocated to customers based on their contribution to system design day demand.

Mr. Gorman also testified that the utility designs and constructs its system to ensure that all customers are connected to the system of distribution mains in order to provide customers the opportunity to take delivery of gas. The costs of the distribution main system not related to the capacity of the system but rather to the length of mains necessary to connect customers to the system are properly classified as customer related and allocated to customers based on the number of customers on the system.

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MDU used the minimum size method to determine the customer component of distribution mains. AARP witness Scott J. Rubin disagreed with this approach because it can be controversial, according to the NARUC Gas Manual.

The fact that this component of an ECOSS can be controversial does not mean it is not accurate and reliable. Importantly, Mr. Rubin confirms a minimum-size system analysis is a recognized method for classifying a portion of distribution costs as being customer related. And it is reasonable and appropriate for MDU to employ this method of allocating distribution main costs across rate classes in its jurisdiction.

Advocacy Staff did not appear to disagree with the Company’s determination of the customer component of distribution mains. As described in the testimony of Advocacy Staff witness Ms. Sara Cardwell, with respect to the minimum size system approach, she appears to favor the facilities charge approach as described in her direct testimony for determining the customer component of distribution mains costs. However, she indicates in her testimony that the minimum size system approach is an attempt to come to similar conclusions as with the facilities charge approach without having to expend the level of effort that is necessary to develop facilities charges.

Classifying distribution main costs partially as demand related and allocating those costs on a design day demand basis, while classifying distribution main costs partially as customer related and allocating those costs on a customer

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basis reflects how the utility incurs the costs of designing and constructing its system of distribution mains and as a result, best reflects class cost causation on the utility’s system.

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing has been furnished by electronically and/or by U.S. mail on this 19th day of July, 2018 to the following:

/s/ Ebony M. Payton

Ebony M. Payton

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