

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

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IN THE MATTER OF the Application of)	REGULATORY DIVISION
MONTANA-DAKOTA UTILITIES CO.,)	
A Division of MDU Resources Group,)	DOCKET NO. D2012.9.100
Inc., for Authority to Establish Increased)	
Rates for Natural Gas Service)	

MONTANA CONSUMER COUNSEL RESPONSE BRIEF

Montana Consumer Counsel (MCC) submits its Response Brief in this docket.

I. OVERVIEW

Applicant Montana Dakota Utilities (MDU or Company) submitted its application for a general rate increase on September 26, 2012, seeking an additional \$3,457,412 in annual revenues from MDU ratepayers.¹ The Company was authorized to collect an additional \$850,620 from its ratepayers, on an interim basis, by Commission Order 7254a, entered on April 11, 2013.

On February 25, 2013, MCC submitted the pre-filed direct testimony of its expert witnesses Dr. John Wilson; Jacob (Jack) Pous; George Donkin and Albert Clark.

MCC witness Dr. John W. Wilson recommended a 9% rate of return on equity. A unique feature of this case is that the Company's common equity capital amount for ratemaking purposes is not the per books amount as reported in MDU's Form 1 Report,

¹ This is a 17.9 percent increase in MDU's non-commodity costs.

but an amount that is estimated using a complex allocation scheme. As the evidence at hearing demonstrated, the Company's calculated common equity estimate is overstated, resulting in an excessive proposed common equity ratio for ratemaking. After considering the evidence in rebuttal and at the hearing, MCC witness Dr. John W. Wilson concluded that the correctly calculated common equity estimate for MDU using the Company's allocation methodology is \$322 million. Exhibit MCC-1, TR. p. 351-352, 353:2-10; Exhibit MCC-10A.

MCC witness Jack Pous recommended adjustments to the Company's proposed depreciation rates, as follows: a combined life and net salvage calculation on gas plant for a reduction of \$2,279,808 for gas plant as of December 31, 2008;² and a combined life and net salvage calculation on common plant for a total Company reduction of \$383,630 on common plant.³ Exhibit MCC – 3, p. 3-4; TR. p. 318.

George Donkin recommended continuation of existing customer class allocations and addressed MDU's proposed Distribution Delivery and Stabilization Mechanism (DDSM). Exhibit MCC 4; modification to reflect MDU updates and modifications set forth in Exhibit MCC 4A; TR. 428-429.

Albert Clark recommended numerous adjustments to MDU's revenue requirements. Combined with the proposals of Mr. Pous and Dr. Wilson, Mr. Clark

² For Gas Plant the combined recommendation consists of a 60R2.5 life-curve combination for Account 376, resulting in a \$1,043,790 reduction in total Company annual depreciation expense based on Gas Plant as of December 31, 2008, and net negative salvage values for the three largest gas plant accounts resulting in a \$1,496,989 reduction to total Company depreciation expenses for those accounts as of December 31, 2008

³ For common plant the combined recommendation consists of a recommendation to adopt a 55 year average service life resulting in a \$263,866 reduction to total Company depreciation expense based on plant as of December 31, 2008; and adoption of an initial step to a positive 20% net salvage in this docket resulting in a \$283,205 reduction in total Company depreciation expense based on plant as of December 31, 2008.

recommended a revenue increase of no more than \$421,966⁴ in this case. Exhibit MCC-2; TR. p. 413.

A hearing was held August 5-6, 2013 in Billings, Montana.

II. ARGUMENT

A. Rate of Return

The fundamental rate of return issues to be resolved by the Commission in this case are: (1) MDU's appropriate authorized return on equity capital ("ROE"); and (2) the Company's appropriate capital structure for ratemaking purposes in Montana.

1. *Return on Equity (ROE)*

Dr. Wilson recommended an ROE of 9.0 percent. The Company proposed a 10.5 percent ROE allowance. The Company then applies this to a common equity ratio of 53.387 percent, based upon its Statement F which was comprised of projected and allocated numbers, rather than actual values. These differences in calculating the overall rate of return to be allowed on rate base have a significant impact on ratepayers.⁵

The ROE differential of 1.5 percentage points between MCC's 9.0 percent ROE recommendation and MDU's 10.5 percent is almost entirely attributable to the Company's argument that it should be granted a large ROE increment because of alleged

⁴ The revenue increase Mr. Clark recommended was adjusted after review of the Company's rebuttal testimony and staff adjustments. See TR. p. 415-416.

⁵ Considering that the ROE bears a combined state/federal income tax expense of about 40% (39.58146% including the incremental impact of the MPSC/MCC taxes) the rate of return difference between the MCC and MDU positions is nearly two percentage points:

$$(9.0\% \times .50)/(1-0.4) = 7.5\%$$

versus

$$(10.5\% \times .53387)/(1-.04) = 9.343\%.$$

greater risks that it faces compared to other gas utilities.⁶ These greater risks, MDU claims, are due to the “small size of Montana-Dakota’s jurisdictional operations in Montana, and to the relatively undiversified nature of the economy in its eastern Montana service territory.” (MDU Brief p. 7.)

Beyond this “small size” argument, the Company has acknowledged that the Discounted Cash Flow (“DCF”) cost of equity analyses presented by its expert witness, Dr. Gaske, and MCC’s expert, Dr. Wilson, “generally produce similar results in terms of the range of returns indicated for the proxy companies.” (MDU Brief at 6-7; emphasis in original.) MDU acknowledges that the analytical results presented by both the MDU and MCC witnesses indicate a cost of common equity capital in the 8 percent to 9 percent range under current money market conditions. *Id.*, see TR. p. 139:4-10.

MDU is only able to get to its 10.5 percent ROE recommendation (as opposed to an ROE in the 8 to 9 percent range) by adding a very large and entirely inappropriate “small company” risk increment to the empirically derived results. The evidence before the Commission in this case establishes that a small size ROE risk adder for MDU is not appropriate. While MDU’s eastern Montana natural gas distribution operations, standing alone, are smaller than MDU’s total utility and also smaller than the total size of other comparable gas utility companies, that fact is not a meaningful cost of equity capital consideration. As Dr. Wilson testified, stockholders make capital available on the overall asset base of the total company. TR. p. 372:18-25. All of MDU’s common equity capital

⁶ A proposed adjustment for non-existent equity issuance costs is an additional factor increasing MDU’s requested ROE from the 8 to 9 percent range to 10.5 percent.

is raised on a consolidated basis by MDU Resources Group, Inc.,⁷ which is considerably larger than most comparable gas distribution utility companies. The rate of return authorized by this Commission for MDU in this docket must be “commensurate with the company’s cost of capital.” TR. p. 373:9-10. That cost of capital is determined at the parent company level. TR. p. 372:21 – 373:3. In fact, MDU Resources’ operating revenues are considerably greater than the operating revenues of all but one of MDU witness Dr. Gaske’s comparable companies. All of those companies, like MDU, are comprised of smaller geographical operations in various states which, again like MDU, obtain their equity capital on a consolidated basis. TR. p. 373:14 – 374:9; p. 157:8-158:4. It is incorrect to claim that the relatively small size of MDU’s eastern Montana gas utility operations in comparison to the total size of other comparable gas utility companies implies greater investment risk for MDU’s common equity investors. There is no evidentiary support for such a conclusion.

All of the comparable gas utilities, which were examined by the MDU and MCC witnesses, have numerous smaller subdivisions or subsidiaries that do business in various state jurisdictions. TR. p. 157:8 – 158:4. The individual jurisdictional utility operations of most of these companies are smaller components of the larger companies of which they are part. In response to a question from Commissioner Kavulla, Dr. Gaske agreed that any “risk” that exists has already been reflected in the earnings of the upstream

⁷ Since MDU Resources group raises all of MDU’s equity capital, MDU Resources (not a small imaginary enterprise in rural eastern Montana) is where investors evaluate the risks of investing in MDU, and that is where MDU’s market cost of capital is determined. MDU’s customers should be charged rates that reflect MDU’s actual cost of capital, not some fictional cost of capital that might apply to a very small imaginary stand-alone company that operates only in rural eastern Montana.

parent company, and the DCF model captures that effect automatically. TR. p. 158:8-15. All of MDU's Montana gas utility equity capital is obtained in financial markets by MDU Resources on a consolidated basis. MDU Resources is substantially larger than most comparable gas distribution utility companies and much larger than the individual jurisdictional utility operations of all of them. TR. p. 372:1-11.

MDU's claim for an ROE risk adder due to the relatively undiversified nature of the economy in its eastern Montana service territory is a similar red herring. No doubt the Company's eastern Montana service territory has a less diversified economy than the area served by the total company and the broader regions served by most other total utilities. As in the case of the Company's "small size" argument, this is irrelevant because it is not uncommon for all major gas utilities to serve various undiversified local communities, and all of these companies, including MDU, raise capital on a consolidated total company basis.

The only arguably palpable appeal that MDU has made for an ROE allowance above the 8 percent to 9 percent range defined by its own witness' DCF calculations (and underscored by Dr. Wilson's more comprehensive analyses) is that the recent NorthWestern gas utility rate settlement provided for a 9.8 percent ROE. That, of course, does not warrant a 9.8 percent ROE for MDU. MDU and NorthWestern are significantly different companies. There is no evidence in this case that the two companies' financial risks and capital costs are equivalent.

NorthWestern's ROE relates to a common equity ratio that is well under the 50 percent ratio that MCC advocates for MDU in this case and far below the 53.4 percent

common equity ratio that MDU advocates. And, for many years, MDU has thrived with ROE allowances below those of NorthWestern. Taking MDU's argument to its logical conclusion would eviscerate the need for individual rate cases.

Additionally, and very importantly, NorthWestern's 9.8 percent was part of a comprehensive settlement that resolved many disputed rate case issues. It was not the result of the Commission's stand-alone cost of equity capital determination. It would be highly unreasonable to allow a utility to pick and choose one element that it likes from a settlement to which it is a stranger, without being subject to all other provisions and considerations that resulted in the overall settlement. It is no surprise that the terms of this particular settlement, approved by the Commission, explicitly prohibit such unreasonable application.

Both at the hearing and in its opening brief, MDU attempts to make an issue of the fact that MCC witness Dr. Wilson recommended ROE allowances of 9.0 percent for both MDU and NWE, while his DCF models produced slightly lower results for NWE.⁸ MDU argues that since the DCF results were slightly lower for NWE and Dr. Wilson recommended a 9.0 percent ROE allowance for NWE, his ROE recommendation for MDU should have been higher than 9.0 percent.

This argument displays a complete misunderstanding of the conclusions that can be reasonably drawn from the DCF analyses presented by either rate of return witness in this case. The DCF analyses do not produce measures of MDU's (or NWE's) common equity cost, but estimates of the range of common equity costs for the selected

⁸ Of note is the fact that in both the NWE and MDU cases the DCF results were below 9.0 percent.

comparable gas utility groups used in each case. Indeed, the groups for which the DCF analyses were done did not even contain MDU or NWE. The slight differences in Dr. Wilson's DCF results between the NWE and MDU cases reflect slight differences in the comparable utility groups and the timing of the comparable company market data used in the DCF analyses for the comparable companies; they do not reflect differences in common equity costs between MDU and NWE. Based partially on these DCF analyses of comparable gas utility companies, cost of capital witnesses then consider additional factors and make an ROE recommendation for the company in question. MDU's witness Dr. Gaske adds very substantially to his DCF results in recommending a 10.5 percent ROE for MDU based on the mistaken contention that his large addition is justified by the allegedly small size of MDU's eastern Montana operations.

In contrast, Dr. Wilson pointed out that: (1) investor evaluation of MDU's gas utility risks focuses not on eastern Montana alone but on all of the Company's gas utility operations in multiple states; (2) all of MDU's equity capital is issued on a consolidated basis by its parent, MDU Resources, which is larger and less risky than the comparable gas utilities, and even much larger than NWE; and (3) all of the comparable gas utility companies, like MDU, are comprised of many much smaller local operations in multiple states, some of which are smaller than MDU's eastern Montana service area.

Dr. Wilson also considered capital asset pricing model ("CAPM") results and comprehensive measurements of risk for gas utilities in arriving at his ROE recommendation for MDU (and for NWE). Dr. Wilson's 9.0 percent ROE

recommendation, like Dr. Gaske's, was also higher than the comparable company DCF results, albeit not as much higher as Dr. Gaske's recommendation.

There is no evidence that MDU's cost of capital or that the Company's standing in capital markets is less favorable than other comparable gas utility companies or that investment in MDU's eastern Montana utility operations is perceived as more risky by the investment community. Exhibit MCC – 1, p. 32. MDU's arguments for a small size risk adder and for an issuance cost adder are unsubstantiated and unwarranted, and should be rejected.

2. Capital Structure: Common Equity Ratio

In light of the actual capital structure allocation values agreed to by MDU at the hearing, nothing greater than the Company's target of a common equity ratio of 50 percent should be adopted.⁹

MDU's argument to use a 53.4 percent common equity ratio in calculating its rate of return on rate base is in direct contradiction of the record evidence. Dr. Wilson recommended that the Commission hold MDU "to the 50, not merely because it's the target, but because it's an accurate reflection of what their capital structure is." TR. p. 374:17-19. MDU's target capital structure is premised on a 50 percent common equity ratio. TR. p. 90:19-23; MDU Brief at 10. The appropriate capital cost allowance in this case is obviously the costs associated with the Company's 50 percent target equity ratio.

At hearing, MDU witness Senger explained that MDU's calculated 53.4 percent common equity ratio, as shown on page 1 of Rule 38.5.146, Statement F, was predicated

⁹ See TR. pp. 68-79; Exhibits MCC 5 – 10A.

on incomplete information at the time of the Company's filing; and also included calculation errors. Mr. Senger acknowledged that MDU failed to update its originally filed Statement F to actual values as of December 31, 2012, relying instead on estimates that were made by the Company in mid-2012.

MDU's capital structure should be based upon actual numbers. In calculating its claimed 53.4% common equity ratio for ratemaking purposes, because the actual year-end values were not known at the time of the Company's rate filing, MDU assumed a 2012 year-end corporate common equity amount of \$2,813,576,698.¹⁰ See Statement F, Exhibit MCC 5; TR. p. 96:1-7. In contrast to this assumed amount, MDU's actual year-end corporate common equity was really \$2,633,248,256: almost \$200 million less than had been assumed in calculating the 53.4% common equity ratio for ratemaking purposes. TR. p. 76 – 79:3-7; Exhibits MCC 5, 6, and 7. Truing up this amount to the actual 2012 year end amount reduces the calculated equity ratio to less than 50 percent. TR. p. 375:3-7.¹¹

Likewise, at the time of its rate filing, MDU did not know its actual short term debt amounts for 2012. TR. p. 96:1-7. MDU assumed a short term debt amount of \$33.5 million for 2012 in its filing.¹² In reality, MDU's actual short term debt balance climbed to \$76 million by year end 2012, more than double the amount assumed by MDU in calculating Statement F. TR. p. 86:1-2; Exhibit MCC 7, 10. The Company's failure to

¹⁰ The rate case was filed in September of 2012, and Mr. Senger testified that the last month of actual data that he possessed regarding equity investment in MDU would have been before September, "or not even July." TR. p. 96:1-7.

¹¹ Dr. Wilson testified "If you simply make the correction for the overstatement of common equity at the end of the year, make the proper deductions for nonutility investments from that amount, you get to a figure that is less than 50 percent." TR. p. 375:3-7.

¹² Statement F; Exhibit MCC 5.

update short term debt to reflect actual 2012 amounts contributed further to its overstatement of the appropriate common equity ratio for ratemaking purposes. Dr. Wilson noted that “if you add in short-term debt at year end, of course, you get to a figure that’s 46 percent.” TR. p. 375:7-9; Exhibit MCC 10A.

A further distortion of the Company’s claimed common equity ratio for ratemaking purposes resulted from its failure to deduct equity investments in non-utility property from the common equity capital balance attributable to the regulated utility business. TR. p. 79 – 83. MDU’s Form 1 Report for 2011(Exhibit MCC 7, page 110, line 18) shows \$4,168,474 of non-utility property (Account 121) that Mr. Senger failed to deduct in computing MDU’s proposed common equity ratio for utility ratemaking purposes. TR. p. 80 – 81. There is no valid basis for calculating the equity ratio used in determining rates with the inclusion of non-utility property. Mr. Senger agreed that the reason MDU backs out MDU’s investments in subsidiaries in its Statement F is “because it wouldn’t be reasonable to ask Montana ratepayers to pay rates that include an equity return to MDU for investments in other subs.” TR. p. 79:22 – 80:1. But, MDU left substantial investments in nonutility assets in its proposed capital structure, which, if uncorrected by the Commission, will require ratepayers in Montana to pay a monthly bill that gives MDU an equity return on property that has nothing to do with running the utility.¹³ MDU did not make the deduction; the Commission must do so in order to set just and reasonable rates. Making the corrections to MDU’s filed Statement F to reflect accurate numbers and excluding MDU’s nonutility investments, results in the Company’s

¹³ See TR. p. 82:8-25; 83:1-17.

actual common equity ratio being 45.6 percent rather than 53.4 percent. Exhibit MCC – 10A; TR. p. 375:3-8.¹⁴ As Dr. Wilson testified, the “50 percent is [...] the most that the Commission should allow for common equity because it’s a very costly proposition for ratepayers. [...] [Y]ou’re not only going to a 9 percent allowed return as opposed to a 5 or 6 percent debt cost, but you’re also building in income taxes because equity returns are taxable. So you’re really looking at a 16 or 17 percent cost of money for equity, as opposed to a 5 or 6 percent for debt.” TR. p. 375:9-17.

MDU’s allowed rate of return on rate base in this case should be calculated using a common equity ratio that is no more than the Company’s own 50 percent common equity target and an ROE of no more than 9.0 percent.

B. Adjustments to revenue requirements

MCC recommended a number of adjustments to MDU’s proposed revenue requirements, some of which are no longer at issue. Of Mr. Clark’s initial recommended adjustments, the following major issues remain for the Commission to decide: the Customer Care and Billing System portion of the post-test year plant additions; the Billings Landfill investment and expenses; depreciation rates; and capital structure and

¹⁴ In responding to a follow-up question on this matter by Commissioner Gallagher, Mr. Senger argued that any deduction for non-utility investments should be made from both debt and equity capital. (TR. 104) Mr. Senger’s argument is wrong. These investments by MDU are ownership investments that provide income that flows to the Company’s owners. They provide no income or benefit to utility ratepayers; they are not in the utility’s rate base; and any income derived from them flows to Company stockholders rather than offsetting ratepayer costs. Moreover, there is not a shred of evidence that these investments are used as collateral for the Company’s public utility first mortgage bonds. The argument that the company’s non-utility investments are funded by both its debt and equity flies in the face of the principles of public utility debt financing; ignores the fact that any income from these investments flows to stockholders outside of the regulatory process; and, if accepted by the Commission, would require public utility ratepayers to fund equity capital that is unrelated to utility rate base and provides no benefit to utility ratepayers. Indeed, this is the reason that MDU subtracted some nonutility investments in the first instance, as shown on its filed Statement F. The Commission must remove all of MDU’s nonutility investments from MDU’s proposed equity capital in this docket.

cost of capital.¹⁵ Other, smaller issues remaining for decision include: the amortization period for the gains and losses on property disposals; the exclusion of the amortization of the incentive pay from the labor expense calculation; the level of postage expense; and whether interest synchronization should include non-rate base Construction Work in Progress.

1. Customer Care and Billing System (“CCBS”)

¹⁵ All but the Customer Care and Billing System and items under smaller issues for decision are addressed in other sections of this Brief. MCC’s initial recommendation and MDU’s response were:

1. Late payment revenues: MDU did not rebut or brief the issue.
2. Penalty revenues: MDU did not rebut or brief the issue.
3. Gain/loss on property disposal: In rebuttal, MDU objected to Mr. Clark’s proposed amortization period.
4. Labor expense: in rebuttal, MDU proffered a correction to Mr. Clark’s adjustment in the amount of \$10,369 that reduces the adjustment to \$59,551. Mr. Clark agreed with this correction. MDU also objected to Mr. Clark’s removal of the average incentive compensation from the calculation
5. Fringe benefits: MDU did not rebut or brief the issue, but the increase to labor expense has an extremely small impact of \$98.
6. Labor taxes: MDU did not rebut or brief the issue, the increase to labor expense has a small impact of \$780.
7. Advertising expense: MDU did not rebut or brief the issue.
8. MPSC/MCC taxes: MDU did not rebut or brief the issue.
9. Postage expense: MDU proffered a correction to Mr. Clark’s adjustment to reduce it from \$(7,919) to approximately \$(2,380). Mr. Clark agreed with this correction. In rebuttal, MDU also objects to using gas utility only as opposed to combined gas and electric operations for the purposes of this adjustment.
10. Vehicles and work equipment: MDU did not rebut or brief the issue.
11. BOD meetings: MDU did rebut the issue and Mr. Clark agreed that the adjustment should be removed.
12. Prepaid insurance: MDU did not rebut or brief the issue. The calculation of the adjustment, however, was corrected in the Interim Order in this case. The correction increases rate base adjustment from \$1,893 to \$3,737. Mr. Clark agreed to this correction.
13. Prepaid demand/commodity charge: see number 11. The correction increased the rate base adjustment from \$31,184 to \$145,755. Mr. Clark agreed with the correction.
14. Materials and supplies: see number 11. The correction increases the rate base adjustment from \$82,877 to \$86,850. Mr. Clark agreed with this correction.
15. Post-test year plant additions (excluding the Customer Care Billing System). In rebuttal, MDU updated Mr. Clark’s adjustment through December 31, 2012. The impact of this update, along with the correction of the calculation of the plant balance at 12/21/2012, increases average test year plant in service by \$1,055,248. The associated adjustment to accumulated provision for depreciation decreases rate base by \$37,808. The associated adjustment for the accumulated deferred income taxes raises average rate base by \$223,140. Mr. Clark agrees with these updates and correction.
16. Billings Landfill: In rebuttal, MDU corrected its allocation of ADIT associated with the land fill and corrected the income taxes associated with the landfill included in Mr. Clark’s Exhibit No.__(AEC-4) Mr. Clark agrees with both corrections, subject to the initial and overarching recommendation that Billings Landfill not be included in rate base in any event. MDU opposes Mr. Clark’s treatment of the project, but the amount of the adjustment is settled.
17. Depreciation rates: The adjustment to certain depreciation rates are at issue.
18. Interest synchronization: The issue is whether non-rate base CWIP should be reflected in the calculation of the interest expense.
19. Cost of capital/capital structure: contested issues.

MCC's witness Mr. Clark treated the CCBS as any other component of the post-test year plant additions originally proposed by MDU. At the time MCC submitted its initial testimony, MCC had information through October 31, 2012.¹⁶ At the time MDU filed its Rebuttal testimony, it updated the post-test year plant additions to include all plant in service by December 31, 2012 at the actual cost of each project. Significantly, the CCBS was not reflected in Ms. Mulkern's update. TR. p. 484:11-14. Ms. Mulkern testified that plant in service as of December 31, 2012 "excluded the customer billing system." TR. p. 484:15-18. If MDU could support an argument that the customer billing service was providing used and useful utility service to the ratepayers by December 31, 2012, then it would have included this asset in the update. It chose not to do so, and that fact must be treated as an admission by MDU that the asset should not be considered as part of rate base in this proceeding.

MDU's witness Mr. Gardner testified that the CCBS would not be in service by December 31, 2012. (Exh. MDU 11, page 6, lines 18-21). Mr. Gardner testified that the system was activated in February of 2013. TR. p. 175:20-23. While MDU blamed its failure to implement the billing system in 2012 on issues related to compliance with Sarbannes-Oxley, this is disingenuous and irrelevant. Sarbannes-Oxley is not new; it was passed in 2002. MDU could reasonably have begun the installation process in time to allow for the required Sarbannes-Oxley compliance. MDU characterized the MCC's proposal as "simply an attempt to kick the can down the road..." TR. p. 27:5-6). If this can has been kicked at all it was by MDU, not the MCC.

¹⁶ Had MDU updated its responses, MCC would have had information through December 2012.

The correct legal criteria for the inclusion of post-test year plant is not only that it be non-revenue producing, but also that it be “non-income” producing, i.e., not raise revenues or reduce expenses. In Montana-Dakota Utilities, Co., Docket No. 83.8.48, Order No. 5020b, the Commission stated:

Inclusion of additional plant without reflecting associated revenue and expense adjustments renders useless the computation of rate of return earned before any allowed revenue increase. Allowing a return and depreciation expense recovery on a plant addition without also reflecting, for example, decreased operating expenses resulting in more efficient operation **results in a windfall to the Company and an excessive expense to the consumer.** (FOF53, emphasis added).

Mr. Gardner testified that “Once all Utility Group companies are utilizing the system, ongoing costs will be more efficient, including hardware, licensing and maintenance, as the costs will be shared by all Utility Group companies.” Exhibit MDU 11, p. 6, lines 1-4. Thus, MDU is asking for the full return on investment and return of investment for a project that did not provide used and useful utility service during the test year, or during the twelve months beyond the test year, without any consideration for the associated “ongoing” cost efficiencies expected to be associated with the investment.

ARM 38.5.106 allows for adjustments to book costs but provides:

[N]o adjustments shall be permitted unless based on changes in facilities, operations, or costs which are known with certainty and measurable with reasonable accuracy at the time of the filing. No adjustment will be entertained unless it will become effective within 12 months of the last month of the test period as used in this section.

The customer billing system was not effective within 12 months of December, 2011. The only reason MDU has given the Commission to include the expenses associated with this system in rate base, without a corresponding accounting for the cost

efficiencies associated with the investment, is that the Commission should waive its own rules for the Company's benefit. The ratepayers object. The Commission must follow its own rules. See *Whitehall Wind, LLC v. Mont. PSC*, 2010 MT 2 ¶ 24, 355 Mont. 15 ¶ 24, 223 P.3d 907 ¶ 24, citing *Montana Solid Waste Contractors v. Montana Department of Public Service Regulation*, 2007 MT 154 ¶ 18, 338 Mont. 1, 161 P.3d 837.

There is no set of circumstances under which the customer billing system can be included in the plant in service for purposes of this rate case. Including this system in the rate base would be a violation of the Commission's own rules. These rules were adopted for good reason, to avoid unreasonable rates that would result from a mismatch of revenues and expenses. The customer billing system must be excluded from rate base.

2. Billings Landfill

The Billings Landfill should not be included in the regulated rate base and expenses for MDU in this proceeding. As Robert Morman, MDU's witness on this subject aptly noted: "it's the stockholders in this company that are reimbursed for risk. And I think evening [sic] under the most recent study that the company has performed, they're still showing a long time before they're turned around [...]" TR. p. 424:20-25 (emphasis added).

Production from the Billings Landfill should be priced at the CIG index price and the entire facility should be treated as an unregulated system gas supply. TR. p. 420:15-18. That is how the stockholders are reimbursed for risk and the ratepayers are shielded from the consequences of terrible investments. The ratepayers in Montana cannot be compelled to pay inordinately high prices for gas from a bad investment. In the event

that circumstances change and the Landfill becomes a wise investment, the shareholders will benefit accordingly. MDU's "heads I win tails you lose" regulatory paradigm captures precisely what happens when a bad investment is allowed into ratebase: ratepayers pick up the tab while shareholders bear none of the consequences of a bad investment. This would be an unjust and unreasonable outcome, and legally unsustainable. If the Company is able to produce gas from the facility at a cost lower than the CIG index price, the investors of the Company reap the benefits. TR. p. 420:16-18. As MDU's witness Morman testified, it is risk that should be shouldered by the investors, who stand to gain when risk reaps reward, and not the Montana ratepayers.

MDU's arguments regarding the inception of the Billings Landfill (Brief p. 11-12) belie that fact that the project was, and is, a voluntary endeavor by both MDU and the City of Billings; one on which MDU agreed to make royalty payments to the City of Billings. TR. p.113:13-23. The Billings Landfill does not require methane capture. Exh. MDU 7, p. 2, lines 21-22. Significantly, it is a revenue producer for the City because MDU is paying a royalty based on the price of gas at the CIG index. TR. p. 113:6-16. MDU did not introduce any evidence as to whether these royalty payments are included in the already astronomical cost of the gas produced from the Landfill, and this is an issue that the Commission should clarify when considering the costs of this project.

MDU witness Robert Morman testified that the Landfill reduces "exposure to the volatile price swings" and serves as "a physical hedge as the price would remain relatively stable and known." Exh. MDU 7, p. 5. MDU acknowledged that production from the Landfill is "about one third of the projected volume." Brief p. 12; TR. p. 110:9-

15. In light of actual production, it is not credible to advance an argument that gas produced from the Landfill serves as any kind of hedge for MDU's ratepayers. The facility is currently producing 0.5% of system supply and, at best production estimates, is expected at maximum output to produce only 1.5% to 2.0% of supply. That supply is currently at an out of market cost by a factor of five. MDU projections show that the gas from the Landfill is not expected to be at or below market price for the next 17 years. TR. p. 458. Morman argued that Clark ignored replacement gas transportation costs. Exh. MDU 8 p.9. However, Morman acknowledged that the gas produced from the Billings Landfill could be replaced easily. TR. p. 451:14-18.

Morman testified that any comparison of the costs related to the Billings Landfill "has to use a life cycle analysis." TR. p. 454:3-9, Exh. MDU 8, p. 5 lines 2-5, lines 18-21. Further, Morman testified such analysis would require "fairly heroic assumptions." *Id.*, TR. p. 454:10-21. MDU made no present value calculations were made on the project. TR. p. 459:3-7. A life cycle analysis without a present value calculation is flawed on its face and simply unreliable. Without a present value calculation, the analysis fails completely. It does not in any way indicate which of the options under consideration (in this case build the facility versus buy gas on the market) is financially viable, in the best interests of the ratepayers and the investors, and is less expensive over the life of the project. It is impossible to conclude that MDU undertook any reasonable cost calculations absent a present value calculation; the fact that this is an expensive investment must inure only to the detriment of the shareholders, not to the ratepayers. MDU's arguments about where the problems lie are not relevant. MDU simply didn't do

it's homework on this project, and the ratepayers cannot, in any defensible decision, pick up the slack for MDU's failure to properly plan and analyze this project prior to undertaking it.

MDU has provided updated calculations of future landfill costs and future traditional gas supply prices. See MDU response to Data Request MCC-227, Attachment A. However, in performing that study, MDU did not perform net present value calculations (NPV) of future Billings Landfill costs or savings. TR. p. 459:3-7. NPV calculations over the full life cycle of the facility must be made to determine whether or not ratepayers would realize a *real* economic benefit over the life of the facility, taking into account estimated future production levels, estimated future production costs, estimated future prices of traditional gas supplies, and the fundamental economic reality that dollar values for future outcomes are worth less in real 2013 dollars. Stated another way, the dollar value of Billings Landfill above-market costs in year 2013 is far greater in real dollars than a comparable dollar amount in year 2033 of estimated Billings Landfill below-market costs. Accordingly, the life cycle analysis without a present value calculation is flawed on its face, simply unreliable and not useful.

The calculations presented by MDU in response to Data Request MCC-227, Attachment A are, however, informative of the likely result that would have obtained had the Company performed a NPV analysis of estimated future costs and benefits of Billings Landfill methane production. The MDU response shows that the crossover point when estimated future landfill costs fall below projected future traditional gas supply prices does not take place until the year 2030. TR. p. 458:13-18. This means that MDU's

ratepayers are expected to bear the burden of above-market costs for Billings Landfill methane supplies for, *at minimum*, another seventeen years. This estimated outcome represents very strong support for concluding that the NPV of future costs and benefits from MDU's Billings Landfill project is a significant negative dollar amount.

MDU argues that the commodity cost of gas was above \$6/Dkt when the project was initially evaluated, and that while it was in the formative stage the price had spiked at \$13 during the summer of 2008 and was generally running in the \$7 to \$10 range. Exh. MDU 8, p. 7, Brief p. 11. However, and significantly, when MDU made the decision to move forward the commodity cost of gas was down to \$7/Dkt, while the estimated cost of gas from the landfill remained at \$6/Dkt. Exh. MDU 8, p. 9; Brief p. 12. This represents a significant narrowing of the cost versus price differential. As Morman admitted, in light of the actual economics, the cost of production is higher than what was projected when MDU made the decision to move forward. TR. p. 455:6-19. MDU's failure to conduct any present value analysis leaves a huge void of information as to the true life cycle costs of the project. MDU's willingness to move forward without any reliable information was a decision that has been enormously expensive, and that expense must be borne by the shareholders, not the ratepayers.

MDU did not seek any kind of pre-approval to rate base the project. TR. p. 451:19-21. MDU argues that the project was "prudent" and that MCC has not argued otherwise. As characterized by MDU, the decision before the Commission is narrowly framed as whether the Landfill can be excluded from rate base because the "unit cost of gas it produces is more than the market price of gas in the field." Brief, p. 14. This

characterization of the problem of the Billings Landfill is factually and legally wrong.

First, as a matter of fact, the unit cost produced by the Landfill is at least three times what it is “in the field.” MDU cannot seriously contend that foisting gas upon the ratepayers for the benefit of MDU and the City of Billings that is at a minimum three times the cost of gas purchased at market is prudent, reasonable, just, fair or useful. If the project had been wildly successful, MDU could have, and surely would have as testified to by Mr. Morman, opted not to rate base the investment. TR. p. 463:10-20. In the event that the Billings Landfill had had the opposite economic outcome, producing gas at low cost, the Commission can be sure its approval for putting it in rate base would not be sought. The facility went “on line” in December 2010, and this case was not filed until September 2012. Thus, the Company had nearly two years to evaluate its success or failure, with ratepayers the convenient back-stop to insulate investors from any cost of failure.

Second, as a matter of law, MDU may not duck the “used and useful” standard set forth in §69-3-109, MCA by morphing its attempt to bring the Landfill into rate base into a “prudence” argument. Under §69-3-109, MCA, the Commission may, in its discretion, investigate and ascertain the value of the property of each public utility “actually used and useful.” This Commission should follow its earlier path in *Montana Power Co. v. P.S.C.*, 214 Mont. 82, 692 P.2d 431 (1984) in which the Commission concluded that Colstrip Unit 3 was not used and useful and could not be included in rate base. The Supreme Court affirmed that decision. The Court noted that once a facility is constructed, the Commission has jurisdiction to determine whether the facility is actually

used and useful and whether the facility's output is required by the ratepayers. *Id.* The unequivocal testimony and evidence in this docket establishes that the output from Billings Landfill is not required by the ratepayers.

MDU argues that the problem with the Landfill project has been with the manner in which the wells were developed. MDU did test flows on three wells. TR. p. 124:12-18. Current production from Phase 1, where MDU states the problems lie, is 65 mcf per day with one-third of that output coming from the test well. Brief p. 12; Exh. MDU 8 p. 10. MDU states that it "switched from vertical wells to horizontal wells to increase gas flows and better match the operations of the Billings landfill." Brief p. 12. This sleight of hand belies the fact that horizontal wells were not initiated by MDU to maximize production; but rather, a response to the manner in which the City of Billings was delivering garbage. TR. p. 424:12-19. The original planning did not include any scenario where horizontal piping was to be used. But now, the horizontal piping, which was simply a happy coincidence that came up in the summer of 2012 after the City changed its filling method, is viewed as the future of the project. The facts establish the unavoidable conclusion that that this project was undertaken without forethought.

Even with the horizontal piping, Mr. Morman testified:

By continuing the installation piping as additional lifts of garbage are filled, projections indicate that over the next 28 years the average cost of the gas from the landfill will be approximately \$7.10 per dekatherm of gas. When looking at future estimates of natural gas pricing, the projected landfill prices, while HIGHER than the current projected price, are closer to the index prices over the LONG TERM and still in the range of the estimated price at the time the decision was made. Exh. MDU 8, p. 12:19 - 13:2, emphasis added.)

However, MDU knew, when it made the decision to proceed with the project, that the estimated cost of the supply from the Landfill was around \$6 (Exh. MDU 7 p. 5; TR. 122:3-5. So even with new production figures based on a hoped-for increase in production from horizontal piping (which, as Mr. Morman testified, would require additional investment, TR. p. 127:5-15) the estimated cost of supply from the facility has actually gone up. Additionally, the very latest projections (MDU response to MCC Data Request 227) indicate the landfill costs exceed the estimated cost of gas supply until 2030 in an analysis that runs through 2040. TR. 458:19-23. MDU did not undertake any present value calculations on this investment. TR. p. 459:3-7. Importantly MDU witness Morman acknowledged:

- 1) the crossover when Billings Landfill unit cost becomes less expensive than projected traditional gas supply unit cost does not occur until 2030; and
- 2) that MDU did not perform a net present value calculation on Billings Landfill unit cost as compared to the projected traditional gas supply unit cost. TR. pp. 456-459.

There is simply no credible evidence before the Commission that would justify forcing the ratepayers of Montana to bear the risk of the investments related to the Billings Landfill. As Mr. Morman testified, shareholders are reimbursed for risk. The Commission should not put the ratepayers at the losing end of the regulatory paradigm MDU created of “heads I win tails you lose.” Charges for adequate service must be reasonable and just. Charges for gas produced from Billings Landfill are neither.

3. Other adjustments to proposed revenue requirements

i. Gains/Losses on Property Disposed

MCC witness Mr. Clark proposed a three year amortization for gain and losses on property disposed. The basis for his proposal is to better match what the Company has proposed for the amortization of rate case expense and, thus, the expected interval between rate cases. Exhibit MCC 4, page 7, lines 8 - 20. MDU objects to the three year amortization period and proposed a five year period instead. Exhibit MDU 16, Mulkern Rebuttal, page 1, line 14 - page 2, line 6. MDU's witness Mulkern testified that a "three-year average for our amortization rate case expense has been used in the past. It has been accepted." TR. p. 282:15-17. The prior use of a five year amortization for the gains and losses on property disposed, without objection by interveners, does not foreclose a change in this case to a period that is a better match for MDU's anticipated timing between rate cases. The Commission should adopt the three year amortization period proposed by Mr. Clark in this case as supported by MDU's own testimony regarding an appropriate period between rate cases.

ii. Labor Expense

The sole remaining issue in the calculation of the test year labor expense is whether to include or exclude the amortization of the 2009 incentive pay. Mr. Clark proposes to remove the amortization from the calculation. Exh. MCC 4, page 8, lines 1-12.) The reason is simple; the three year amortization was completed in the years 2009, 2010 and 2011. MDU's witness Mulkern argues that at least two years of the three year amortization should be included. Exh. 16, page 2, lines 11-18. That argument is simply incorrect. The amortization should be included until it is exhausted.

The ratepayers fulfilled their obligation by providing for the amortization in rates through 2011 (and indeed for a fourth year in 2012 as rates have not yet been changed to remove it). MCC's proposal advanced by Mr. Clark to remove the amortization expense associated with the incentive pay should be adopted by the Commission in this case.

iii. Postage

MCC's witness Mr. Clark proposed an adjustment to postage expense. Exh. 4, page 10, lines 1 - 10. After correction for the allocation noted by MDU witness Mulkern (Exh. 16, page 3, lines 16-17), the adjustment is approximately \$2,380. However, it is correct to apply and the Commission should adopt this corrected adjustment.

iv. Interest Synchronization - non-rate base CWIP

The question before the Commission is whether to incorporate non-rate base Construction Work in Progress ("CWIP") in the interest synchronization calculation. Non-rate base CWIP has historically been included in this calculation. (See, for example, Montana-Dakota Utilities, Co., Docket No. 86.5.28 where the Company included non-rate base CWIP in its interest synchronization calculation for the electric utility in the amount of \$635,387 at Rule 38.5.169, Statement J, p. 8.) At some point utilities stopped including this component of the calculation. MCC raised the issue here to give the Commission an opportunity to decide whether it should be included.

C. Depreciation

1. *Overview*

The Company has the burden of proving its proposed depreciation parameters, which in effect are relied upon to develop depreciation rates, and that the charges for service predicated on such depreciation rates as reasonable and just. Section 69-3-201, MCA. The Company not only failed to meet its burden of proof through its depreciation testimony, depreciation study, and its response to discovery, but in many areas failed to come forward with any evidence whatsoever to support its rates.

In January of 2010 the Company began implementing new depreciation rates, without Commission approval, that resulted in an increase to annual depreciation expenses of at least \$525,793 from then-existing Commission approved rates. See 2008 Depreciation Study prepared by Earl Robinson as of December 31, 2008 (2008 Study); TR. p. 87:2-8. While MDU's unauthorized actions of unilaterally changing depreciation rates is completely unacceptable, MDU went even further. MDU abused the process to a greater extent by implementing only the part of the new depreciation rates proposed by Mr. Robinson that benefitted shareholders, without also implementing the cost of removal recommendations that would have benefitted customers in between rate cases. TR. p. 87:9-11. Unauthorized lowering of depreciation rates in between base rate cases results in artificially higher net plant and rate base in the next rate case (i.e., here).

Changes to a utility's depreciation rates may not be made without Commission approval. Section 69-3-302, MCA. The Commission applied this to a request from Montana Power Company ("MPC") seeking interim and permanent approval of increased depreciation rates, among other things. See Docket No. 90.3.17, Order No. 5465, FOF 1

and 4 (March 13, 1990). In its Second Interim Order, Order No. 5465a, on May 22, 1990, the Commission denied the depreciation portion of the filing, stating:

Concerning the depreciation portion of this filing, the Commission specifically denies MPC's proposal in this Interim Order. The Commission finds that this Interim Order will not reflect the effects of MPC's proposed new depreciation study. One reason for denying interim treatment for the depreciation study and its proposed results is that this matter will be a contested issue in this proceeding. Another reason is that the depreciation study has not yet been approved by the Commission in a final order.

Order No. 5465a, FOF 24. If a utility cannot get interim approval because the rates have not been approved in a final order, it stands to reason that the utility cannot unilaterally change its depreciation rates without Commission approval. At a minimum, the Commission should compel MDU to reverse recorded depreciation expense based on unauthorized changes in depreciation rates and record depreciation expense based on authorized depreciation rates. The resulting lower rate base should then be recognized for rate of return purposes in this case.

Further, MDU's expert on depreciation, Mr. Robinson, who prepared the 2008 study that was the basis of MDU's 2010 unauthorized changes to its depreciation rates, did not produce any life analysis outputs from his semi-actuarial analyses until rebuttal testimony in spite of MCC's request for such evidence and it being Mr. Robinson's "primary analysis" for his life proposals. TR. p. 207:19 – 208:1; 209:2-7.

Mr. Robinson's life analyses were not provided until his rebuttal testimony because he initially destroyed or did not retain such analyses. Only due to MCC's criticism of such unusual actions did Mr. Robinson decide it was necessary to rerun and finally produce them. MDU's failure to produce information and evidence in its filing or

in response to discovery that it relied upon to reach its proposals should not be condoned by this Commission.

The Commission should order MDU to provide all support and justification for its depreciation parameters at the time it files any depreciation study. The required support and justification must be specific in scope and documented so that all reviewing parties can clearly identify the specific basis for each parameter.

Finally, the MCC recommends the Commission adopt the following depreciation rates as testified to by MCC witness Jack Pous.

2. *Specific recommendations on depreciation*

i. *Gas Plant: average service lives*

The Company proposes a two-year increase in average service life for Account 376 – Mains, the largest plant account. Exh. MDU 13, p. 26-27. The Company relied on its interpretation of Simulated Plant Records (“SPR”) analyses as its primary driver for estimating an average service life. TR. p. 206:10-13. SPR analysis is a semi-actuarial approach that relies on un-aged data. The Company relied on SPR analyses, even though it admits that the actuarial method is the preferred method and that it had aged retirement data available. TR. p. 206:4-9; 15-20.

MCC has demonstrated that even if the SPR results ultimately re-run by the Company and presented in rebuttal are relied upon,¹⁷ they do not support an average service life as short as MDU’s proposed 47 years. Exh. MDU 13 p. 27; Attachment A to

¹⁷ The Company did not provide this information to MCC upon request, nor was it included in MDU’s expert’s study. TR. p. 209:15-24; TR. p. 210:6 – 211:6; 211:23-25.

Response to Data Request MCC 150; TR. p. 325 - 326. Indeed, the full-band analysis presented in Exhibit No.__(EMR-6) page 1 of 13 shows many average service lives in the upper-50- to mid-60-year range with excellent Retirement Experience Indices and higher Conformance Indices than the Company's 47-year proposal. TR. p. 325:22 – 326:1. The same is true for the most recent five-year rolling band presented by the Company (Exhibit No. __EMR-6 pages 2- 4 of 13). The Company's 47R4 life-curve selection is the ninth-poorest fit of simulated analyses out of 32 curves analyzed. TR. p. 216:6-18. From an SPR standpoint, the Company has in no way supported its proposal. Better fitting dispersion patterns with longer average service lives are indicated from the Company's own analyses. TR. p. 216 – 217; 326:10-15.

Unlike the Company, MCC relied on actuarial data for its presentation. Exh. MCC 3 p. 13-23. As demonstrated in Mr. Pous' testimony, a longer average service life is warranted, but in order to remain conservative he recommended a gradual increase to a 60-year average service life. Exh. MCC 3 p. 23; TR. p. 325:18-25. In addition, Mr. Pous demonstrated that industry values, including those proposed by Mr. Robinson for other utilities, are as long if not longer than Mr. Pous' recommended 60-year average service life. Exh. MCC 3 p. 23 – 28; TR. p. 326:10-14. MCC also demonstrated that there have been advancements in technology both for steel and plastic mains over the past several decades, as well as improvements in installation practices, all of which have resulted in longer life expectations than reflected in the historical data Exh. MCC 3 pages 25-26; TR. p. 326:22 – 327:6.

In summary, the Company has not presented any meaningful support or justification for its proposal. Indeed, its own SPR analyses demonstrate the poor-fitting relationship presented through its proposal. MCC has factually demonstrated that the preferred and more accurate method of life analysis results in a longer average service life than that being used or proposed by the Company. Changes in technology and installation practices also warrant a longer average service life.

MCC witness Mr. Pous also demonstrated that, from a confirmational standpoint, industry values also support a longer average service life. The evidence clearly demonstrates that a 60R2 life-curve as proposed by MCC is the most appropriate, and a fairly conservative, value and should be adopted.

ii. Gas Plant: net salvage

The Company's restraint regarding the basis of its net salvage proposals as compared to its life analysis is notable. Indeed, Section 4 of the Company's Depreciation Study (Exhibit EMR-1) remains totally silent on the basis and support for net salvage estimations. Only through discovery did the Company finally present any information at all to support its proposals. That evidence consisted of generalized factors, but still fails to provide meaningful specifics associated with the Company's proposals. Through discovery, the Company claims that it considered the overall experience band, recent activity, future expectations – inflation, and gradualism. TR. p. 221:2-13.

While the Company elected not to present the basis for its net salvage proposals in its application, it continued its position in response to discovery. TR. p. 222:8-15. Even when attempting to discuss specifics for an account, the Company failed to

demonstrate how any of its generalized terms and factors could combine to result in its proposed values. Indeed, for Account 376 the largest plant account, while the Company recognized the need to propose a less negative level of net salvage, its reduction is inadequate and unsubstantiated. The Company proposes a -50% net salvage. However, its own documents demonstrate that the overall net salvage analysis yields a result of -32%. TR. p. 222:21 – 223:17; also Exhibit EMR-1 page 7-13.

Next, the most recent data as depicted by the Company's own three-year rolling bands indicates not only a trend to less negative values, but values in the -25% to -35% range (Exhibit EMR-1 page 7-13). When asked whether there was any support in the Company's data that showed a number as negative as Mr. Robinson's negative 50% being proposed here, Mr. Robinson answered "I didn't say there was." TR. 225:5 – 226:3. Only the Company's reliance on future inflation can result in a value as negative as its' proposed -50% value. TR. p. 231:10-19. As Mr. Robinson agreed, either on an annual basis or on the most recent five three-year rolling bands in the Company's study, the recent experience shows a less negative value than that proposed by MDU. TR. p. 227:16-21.

As MCC has shown, and the Company failed to present any meaningful counter evidence, its future inflation estimate has been excessive since the 2008 period. More important is the fact that it cannot explain why current customers should be required to pay with their current dollars for future inflated costs. Such position is not only inequitable, but it is also illogical. MCC's recommendation for a -30% net salvage value should be adopted.

The Company's proposal for Account 380, the second-largest account, is not supported any better than its presentation for Account 376. Indeed, the Company's proposal for Account 380 is -200%, a value more negative than Mr. Robinson has proposed anywhere else and would represent one of the most negative values in the industry. As MCC points out, the Company's overall historical average is only a -88% (Exhibit EMR-1 page 7-28). It must be noted that the overall average is the first consideration noted by Mr. Robinson as the generalized basis of his proposals. Review of the Company's more recent data indicates unusual patterns not only in annual variations, but the ability to even record gross salvage or cost of removal for extended periods of time (Exhibit EMR-1 pages 7-24 to 7-25).

As identified by MCC, the more recent average beginning when the Company consistently recorded gross salvage and cost of removal (beginning in 1995) yields a -179% average, or approximately the existing -175% value. Again, it would appear that the Company relied heavily on future forecasts of inflation, resulting in a -210% value to support its proposed -200% value. As previously noted, reliance on future inflation is inappropriate and ill-conceived. The Commission should adopt MCC's conservative recommendation to retain the existing -175%.

The Company's support for Account 381 – Meters is no better. The overall average is a positive 7% (Exhibit EMR-1 page 7-33). The more recent data is a trend to a negative 9% (*Id.* at page 7-32). Again, it would appear that the Company relied heavily on future forecasts of inflation, resulting in a -19% value to support its proposed -15%

value. As previously noted, reliance on future inflation is inappropriate and ill-conceived. The Commission should adopt MCC's recommendation of a -5% value.

One additional matter demands comment. The Company in rebuttal for the first time raised the concept of data subsequent to its 2008 Depreciation Study as support for its proposals. It must be noted that the 2008 Depreciation Studies were submitted to the Company on January 28, 2010. TR. p. 224:13-18; Exh. MDU 14, Exhibits EMR-1 and 2 cover letters. Data for 2009 would not have been compiled by that time, and obviously data for 2010, 2011, and 2012 did not exist. TR. p. 224:17-18. Therefore, there could have been no reliance on such data by Mr. Robinson in his proposals reflected in his 2008 Depreciation Study. Moreover, claims of support for his position due to such data subsequent to the 2008 Depreciation Study is also misplaced, given that net salvage on its own cannot be analyzed for periods subsequent to the depreciation test year. Indeed, changes in retirement activity that would affect the life portion of the depreciation analysis have to be analyzed in conjunction with any changes in net salvage in order to present a balanced depreciation review. The Company acknowledges that it did not perform such analysis and therefore subsequent data cannot be viewed in a vacuum. TR. p. 224:15-18. Indeed, the Company had every opportunity to update its depreciation analysis prior to the filing, yet chose to ignore the data between 2009 and 2012 at that time.

Such data, even if inconclusive one way or the other, should not be considered in determining depreciation rates in this proceeding. Any impact that 2009 through 2012

data may have on depreciation matters can be properly addressed in a complete review during the next depreciation study.

iii. MDU Common Plant: Average Service Lives

The Company's proposed 35-year average service life for major steel and brick office buildings is neither fact-based nor rational. Buildings can and do last for 60 to 100 years if maintained properly. MCC demonstrated that the vast majority of the investment in this account is owned by the Company and that the investment consists of steel buildings with either brick or pre-cast concrete exteriors (Exhibit MCC-3 page 29). Not only is it reasonable and appropriate to expect that such types of structures can last for 60 years, 70 years, or even longer periods, but MCC pointed out that the Company's Bismarck general office building was installed in 1968 and is still in service with no identifiable plans for retirement. *Id.* In other words, the largest single investment in the account has already lasted for 45 years and the Company has no plans to retire that building. This by itself demonstrates the fallacy of MDU's position that a 35-year average service life for its investment in this account should be used.

iv. MDU Common Plant: net salvage

Turning to net salvage for the investment in Common plant Account 390 – Structures and Improvements, the Company's zero percent proposed level of net salvage is also unrealistic. The Company has retired 11 buildings in the last 20 years; in all instances, the Company experienced positive levels of net salvage. Exhibit MCC-3 page 43. In fact, the positive level of net salvage experienced during the past 20 years for the sale of the 11 office buildings was in excess of a positive 100%. Even if one takes into

account the retirement of assets that are not buildings, the Company's overall net salvage is a positive 21%. *Id.*

MCC has demonstrated that it is inappropriate to assume that steel and concrete office buildings will have zero value when they are retired, as demonstrated by actual Company experience. This reality cannot be ignored. The only evidence in this proceeding is that *some* level of positive net salvage is warranted. MDU's advocacy for zero is ludicrous; MCC has proposed a gradual first step to a positive 20%. Such amount should be adopted.

D. Cost Allocation

MDU argues that the majority of its costs are fixed costs, and that distribution mains should be classified as demand costs. Brief p. 25. MDU concludes with a statement that MCC "predictably" proposes allocations that allocate the cost of service away from small residential users and "burdens" the larger commercial users. Brief p. 26.

MDU ignores the reality that cost functionalization is just one of several steps to be taken when allocating costs of interstate pipelines; the others being cost classification and cost allocation. Cost functionalization separates a pipeline's total costs into several broad categories; based on the facilities associated with those costs. For example, production, gathering, storage costs and transmission are treated in separate broad categories of functionalized costs. Functionalizing costs does not involve separating those costs between fixed and variable costs. Nor did that process change as a matter of law when the Federal Energy Regulatory Commission ("FERC") adopted the Straight-

Fixed Variable (SFV) method of cost classification, cost allocation and rate design. The FERC's Orders 636 – A and 636 –B in Docket No. RM91-11-004 and Docket No. RM87-34-069, issued November 27, 1992 (collectively the FERC 636 Orders), do not require the use of SFV for cost allocation.

In fact, demand/energy allocators are still being used to allocate a portion of fixed capacity costs to some customers of interstate pipelines. Most small volume customers of interstate pipelines are allocated costs on the basis of demand/energy allocators. Rate design for most small volume customers of interstate pipelines result in one part commodity rates, not two-part demand commodity rates. One part commodity rates are calculated with imputed load factors that are greater than the actual load factors of small-volume customers.

MDU's cost allocation and rate design recommendations in this case were presented by MDU witness Ms. Aberle. Ms. Aberle's pre-filed direct testimony contains both an embedded cost of service study (ECOS) and a marginal cost study. MCC witness Donkin presented pre-filed direct testimony addressing in detail the Company's ECOS and rate design proposals. Both Mr. Donkin and Ms. Aberle recommend that ECOS analysis be used as a guide to apportion customer class cost and revenue responsibility on the MDU system.

Mr. Donkin did not present a marginal cost analysis or otherwise address the specifics of MDU's marginal cost study. Instead, he asked the Commission to ignore the marginal cost analysis that was presented in the pre-filed direct testimony of Ms. Aberle. MCC. Exhibit MCC 4, at pp. 10-11. Ms. Aberle stated in her Rebuttal Testimony that

she agrees with Mr. Donkin's marginal cost analysis recommendation. Exh. MDU Exhibit 18, at p.12. In its Brief the Company requests that the Commission no longer require that MDU file marginal cost studies in future general rate cases. The MCC concurs with that MDU request.

In her Rebuttal Testimony Ms. Aberle presented a revised ECOS study. Ms. Aberle's revised ECOS study contains revised allocation factors, different ECOS study results, with relatively small changes to her estimated customer class rates of return at present rates. See Exhibit ___(TAA-7). Because Mr. Donkin's ECOS study Ms. Aberle's ECOS model, input data, and allocation factors, Mr. Donkin revised his ECOS study to reflect Ms. Aberle's revisions. See MCC Exhibit 4A, Revised Exhibit___(GLD-1), and TR. p. 435:17 through TR. p. 436:8.

Neither Ms. Aberle nor Mr. Donkin recommend setting customer class revenues equal to the estimated customer class costs in their respective ECOS studies. However, they do not agree on how MDU's costs should be classified and allocated to customer classes. The significant differences in the two approaches to ECOS analysis are as follows:

1. Ms. Aberle classifies and allocates the costs of MDU's Distribution Mains pipelines entirely on the basis of customer class peak pay demands. Mr. Donkin states that this ignores the fact that Distribution Mains pipelines never would have been built only to serve customer demands on a single peak day, and that the main purpose of gas pipelines is to meet customers' annual delivery requirements. Mr. Donkin correctly classified and allocated

- Distribution Mains costs on the basis of both peak day (50%) and annual (50%) volumes. Exhibit MCC 4A, p. 17.
2. Ms. Aberle classifies and allocates the costs of services, i.e., the pipelines used to deliver gas from Distribution Mains to customers' premises, and meters, as entirely customer-related costs. Mr. Donkin correctly recognized in his analysis that MDU's approach to allocating the costs of services and meters conflicts with the Commission's view of how services and meters costs should be allocated to customer classes in natural gas ECOS studies. See Docket No. D2010.9.90, Order No. 7132c, at p. 24, where the Commission stated as follows: "Nor is the Commission convinced that a 100% customer-related classification of services and meters is reasonable. Some portion of service and meter costs should be classified capacity-related." MCC Exhibit 4A, p. 18. Accordingly, Mr. Donkin correctly allocated MDU's services and meter costs on the basis of 50% peak day Dkt volumes and 50% number of customers. MCC Exhibit 4A, p. 22.
 3. Ms. Aberle allocates Administration & General (A&G) expenses on the basis of operation and maintenance expenses, excluding gas supply costs. Mr. Donkin observes that much of MDU's A&G expenses is overhead associated with running a regulated natural gas utility business, and much of that business involves activities to meet the Company's daily, monthly, seasonal, and annual gas supply and gas demand requirements. To reflect the main reason for MDU incurring these expenses, Mr. Donkin correctly allocates MDU's A&G

expenses on the basis of peak day Dkt demands (50%) and annual Dkt demands (50%). MCC Exhibit 4A, p.22, 1.12, through p. 24, 1. 2.

Both Ms. Aberle and Mr. Donkin presented revised ECOS studies. The estimated customer class rates of return resulting from their respective revised ECOS studies are as follows:

	<u>Revised Statement L</u>	<u>Revised Exhibit GLD-1</u>
Residential	0.231%	3.328%
Small Firm General	11.268%	9.958%
Large Firm General	7.365%	5.510%
Small Interruptible	43.166%	15.435%
Large Interruptible	17.617%	-14.216%
Total MDU Montana	3.718%	3.718%

Both Ms. Aberle and Mr. Donkin recommend that their ECOS studies be used by the Commission only as a guide in apportioning customer class revenue responsibility among the classes, and that customer class revenues should not be set equal to the estimated class costs in their respective ECOS studies.

Mr. Donkin's Revised Exhibit___(GLD-3) presents a comparison of MDU's and MCC's recommended apportionment to customer classes at the Company's proposed annual revenue increase of \$3,457,412. As shown there, MDU is proposing a total non-gas revenue increase of 17.2%. The percentage increase in non-gas revenues under the MDU and MCC proposals for individual customer classes at MDU's proposed 17.2% total increase are as follows:

	<u>MDU Proposed</u>	<u>MCC Proposed</u>
Residential	23.2%	17.3%
Small General Service	NA	16.5%
Large General Service	NA	17.0%

Total General Service	9.1%	16.8%
Small Interruptible	2.5%	17.0%
Large Interruptible	1.4%	20.75%
Total MDU Montana	17.2%	17.2%

Mr. Donkin’s Revised Exhibit__(GLD-3) also presents his proposed methodology for apportioning revenue responsibility to customer classes at alternative total Company non-gas revenue levels that may result from the Commission’s decision in this case. Mr. Donkin describes his proposed “scale-back” methodology for apportioning customer class revenues at alternative total Company non-gas revenue levels at pages 29-30 of Exhibit MCC 4A. MCC recommends that the customer class revenues that will result from this case should be developed as Mr. Donkin recommends in Exhibit MCC 4A, using the proposed scale-back methodology presented in Exhibit__(GLD-3).

E. Rate Design

The rate design issue in this case concerns the level of the Residential service charge. MDU proposes a **67.6%** increase – from \$6.35 per month to \$10.64 per month – in the fixed monthly service charge for Residential customers. Mr. Donkin discusses in his pre-filed direct testimony (Exhibit MCC 4A, pp. 31-32) and shows in Exhibit__(GLD-4) how the very large increase in the Residential service charge being proposed by MDU would produce significantly different impacts on the total delivery charges that would be paid by individual Residential customers on the Company’s Montana system.

To illustrate, Exhibit __ (GLD-4), shows that a Residential customer with annual gas usage of 35 Dkt would experience a 40.7% increase in annual non-gas delivery charges if MDU’s proposed service charge is approved, while a Residential customer with annual

usage of 175 Dkt would experience only a 10.7% increase in annual delivery charges at MDU's proposed Residential service charge. In this same connection, MDU's response to Data Request MCC-121, shows that 49.1% of MDU's Residential customers use less than 71 Dkt per year, 68.7% use less than 91 Dkt per year, and only 17.4% use over 110 Dkt per year. As Mr. Donkin discusses at MCC Exhibit 4A, p. 32, a much larger number of Residential customers would be adversely affected, in comparison to the customers who would benefit, if MDU's proposed increase in the Residential service charge is adopted.

Mr. Donkin recommends that the Residential service charge resulting from this case should be kept at the present level of \$6.35 per month. That would dampen the significantly different revenue impacts to individual Residential ratepayers that result from fixed monthly service charges. He also points out that keeping the fixed monthly customer charge at its present level is consistent with the level of customer-related O&M expenses that MDU incurs in providing Residential gas service. Exhibit MCC 4A, pp. 32-33, and Donkin Exhibit___(GLD-5), which presents a summary of MDU's annual customer-related O&M expenses, average number of customers, and average monthly customer-related O&M expenses in calendar years 2007 – 2011. As shown there, MDU's present Residential service charge of \$6.35 per month is significantly greater than the per customer average monthly customer-related O&M expenses the Company incurred each year during 2007 – 2011, i.e., a range of \$3.75 per month in 2008, down to \$3.14 per month in 2011.

MCC recommends that MDU's present monthly Residential service charge be kept at \$6.35 per month. In the alternative, if the Commission determines that some increase in the Residential service charge is appropriate, MCC recommends that the

increase be limited to the percentage increase in the Company's total annual revenue requirement that results from this case.

F. DDSM

MDU characterizes its Distribution Delivery Stabilization Mechanism ("DDSM") as simply a "weather normalization" proposal and not a decoupling proposal. Brief p. 28. Under either definition or interpretation the Company's DDSM represents a revenue adjustment mechanism that, if adopted by the Commission, would produce automatic revenue and rate adjustments for Residential and Firm General Service ratepayers. As discussed by Mr. Donkin in Exhibit MCC 4A:

- MDU's proposed DDSM is a single-issue ratemaking device that can produce periodic rate increases without taking into account other factors that would support no rate change, or even a rate reduction.
- If approved, MDU's proposed DDSM would distort price signals to the Company's Residential and General Service ratepayers. This is because increases or decreases in rates in subsequent time periods to reflect warmer or colder than normal temperatures in prior time periods would produce rates that exceed or fall short of actual costs.
- The proposed DDSM also would reduce MDU's business risk, relative to the business risk that likely was used by the Commission in arriving at the cost of capital associated with the Company's investments in gas utility operations.

MCC therefore recommends that the Commission reject MDU's proposal to implement automatic revenue and rate adjustments for Residential and Firm General Service customers with the proposed DDSM.

III. CONCLUSION

MCC requests the Commission adopt its recommendations as set forth above.

DATED this _____ day of September, 2013.

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By: _____

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