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

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

Montana-Dakota, a Division of MDU Resources Group, Inc. (Montana-Dakota) filed its Opening Brief in this docket on September 13, 2013. The Montana Consumer Counsel (MCC) filed its Response Brief on September 27, 2013. Montana-Dakota now files its Reply Brief. It addresses the arguments of the MCC in the same subject order as its Opening Brief, except that it does not separately depreciation, cost allocation, or rate design. The differences between the parties on those three subjects are adequately laid out in the previous briefs.

I. COST OF EQUITY CAPITAL

A. <u>The integrity of the rate setting process in Montana is at stake in this docket</u>.

Montana-Dakota and NorthWestern Energy filed general rate cases for their respective Montana gas operations within three days of each other. The cost of capital witness for NorthWestern in its case presented cost of capital studies supporting a 10.5% cost of equity capital for the NWE gas operations. The cost of capital witness for Montana-Dakota in this case, Mr. Gaske, presented cost of capital studies supporting a 10.5% cost of capital for Montana-Dakota's gas operations in Montana.

The MCC hired the same cost of capital witness, Dr. John Wilson, as its cost of capital witness in both cases. His pre-filed testimony in the two cases was filed only two weeks apart. He testified, under oath, that the cost of equity capital for the two companies was the same - 9% - even though his cost of capital studies actually showed a slightly higher cost of capital for Montana-Dakota.

The MCC entered into a settlement agreement with NWE in which it represented to the Commission that the cost of equity capital for NWE's Montana gas operations - the cost of equity capital which would produce just and reasonable rates - was really 9.8%. The Commission found that the settlement, including a cost of equity capital of 9.8%, produced just and reasonable rates.

Despite the MCC's representations to the Commission that the correct cost of equity capital for NWE was 9.8%, it proposes that the Commission adopt the MCC's original advocacy, and limit Montana-Dakota's allowed return on equity capital to 9%. It inexplicably argues that any examination of the gross inconsistency of its own advocacy is "misplaced." MCC Response Brief at p. 6. It is only misplaced if one removes integrity from the rate setting process in Montana.

The Commission is required by law to render its decisions in contested cases based upon the record evidence before it. Section 2-4-704(2)(a)(v), MCA. It is also required to render its decisions in a reasoned and non-arbitrary manner. Section 2-4-704(2)(a)(vi), MCA. In both the Montana-Dakota and the NWE cases, the record evidence consists of utility studies which support a cost of equity capital of 10.5%, and MCC studies which support a cost of equity capital of 9%. Unless rate making before the Commission is simply a game of political influence, the same record evidence cannot produce two widely disparate results.

The MCC advocacy continues its assault on reason by asserting: "... for many years, MDU has thrived with ROE allowances below those of NorthWestern." MCC Response Brief at p. 7. The MCC's bizarre assertion belies the fact that its own cost of capital expert testified, under oath, that the cost of capital for both Montana-Dakota's and NWE's Montana gas operations was the same. Its argument is also a figment of its imagination - it is made up - it is untrue. The Commission established a 10.00% cost of capital for NWE's gas operations in its 2009 rate case. Ordering paragraph 1, Order 7046h, PSC Docket D2009.9.129. It did not set a cost of equity capital in NWE's 2007 gas rate case, but the Commission's Interim Order in that docket indicates that the Commission had previously established a 10.75% return on equity for NWE's operations:

> If the Final Order in this docket has a revenue requirement which is lower than the revenue requirement contained in the Interim Order, <u>the difference will be rebated to customers with interest at 10.75 percent, NWE's last approved return on equity</u>.

Ordering Paragraph 6, Interim Order 6852b, PSC Docket D2007.7.82.

The last Commission authorized cost of equity capital for Montana-Dakota's Montana gas operations was 12%, established in 1995. Finding of Fact 27, Order 5856b, PSC Docket 95.7.90. It was not until the entry of the Commission's Interim Order in this case that Montana-Dakota's authorized cost of equity capital was reduced to 10.5%:

> 15. MDU is presently authorized to receive a return on equity (ROE) of 12 percent, the last return authorized by the Commission. However, MDU has filed this general case requesting a reduced ROE of 10.50 percent. Furthermore, in MDU's interim request the utility has asked for a reduced ROE of 10.50 percent. ARM 38.5.506(2)(b) provides that the Commission will use a utility's last authorized ROE for interim purposes, but also provides that the Commission may modify that approach if it deems it appropriate. It is appropriate to use MDU's requested ROE of 10.50 percent for interim purposes. Granting the lower ROE for the interim request should in no way set precedent for future Commission interim decisions and should be viewed as an exception to the rule and an attempt to match the interim amount to MDU's lower requested ROE in this case.

Finding of Fact 15, Interim Order 7254a, PSC Docket D2012.9.100.

The MCC advocacy regarding the cost of equity capital for Montana-Dakota is inexplicable. It jeopardizes the integrity of the rate making process in Montana, by suggesting that the Commission's cost of equity determinations are nothing more than political theater.

B. Capital structure and the cost of equity capital.

Consistent with the overall tenor of its advocacy on this issue, the MCC asserts that the Commission can distinguish its decision in this case from its decision in the NWE case on the basis that the two companies have different capital structures: "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." MCC Response Brief at pp. 6-7. There is a glaring hole in the MCC's logic. Its expert witness, Dr. Wilson, knew the differences between the two companies' capital structures when he testified, under oath, that they had the same cost of equity capital. The impact of capital structure was necessarily subsumed within his determination that Montana-Dakota and NWE had the same cost of equity capital. Moreover, Montana-Dakota's presentation in this case of a 53.4% equity ratio had nothing to do with Dr. Wilson's opinion that the cost of equity capital for both Montana-Dakota and NWE was 9%. He rejected Montana-Dakota's presentation of its capital structure, and proposed a hypothetical 50/50 equity to debt ratio. The MCC appears to be arguing that the Commission should determine Montana-Dakota's cost of equity capital as if it was utilizing a 53.4% equity ratio while simultaneously rejecting that equity ratio.

C. The relative risk of Montana-Dakota's Montana gas operations.

As indicated in Montana-Dakota's Opening Brief at pp. 6-7, the primary difference between the Dr. Wilson and Mr. Gaske was how they dealt with the risk of Montana-Dakota's Montana gas operations relative to the risk of the sample companies used in their DCF analyses. Dr. Wilson made no differentiation, while Mr. Gaske differentiated on the basis of the jurisdictional gas operations and the nature of the service territory. The MCC argues vociferously that there should be no size differentiation because MDU Resources Group, Inc., a highly diversified set of companies and operations, is of similar size to the gas utilities used as sample companies in both Dr. Wilson's and Mr. Gaske's DCF analyses.

Again, there are multiple problems with the MCC assertions. The first is the fact that this Commission has already rejected that argument, as explained in Montana-Dakota's Opening Brief at pp. 7-8. That inconvenient fact is simply ignored by the MCC. It doesn't even mention, let alone discuss, the Commission's previous decision in Order 5856b entered in PSC Docket D95.7.90. The second is the fact that there was good reason for the Commission to have already rejected the MCC argument. The issue in this case is not the cost of equity capital for MDU Resources Group, Inc., a highly diversified company. The issue in this case is the cost of equity capital for Montana-Dakota's Montana gas operations. That is the very reason that both Dr. Wilson and Mr. Gaske use gas utilities as their proxy companies in their DCF analysis.

D. Montana-Dakota has not proposed a "small company adder".

The MCC argues that Montana-Dakota witness Gaske proposed a "small company adder" to arrive at his 10.5% recommended return on equity. That is a gross mischaracterization of not only Dr. Gaske's testimony, but DCF analysis in general. Dr. Gaske did not propose a small company adder - he differentiated between the average equity returns generated by his DCF analysis using a sample of gas utilities to reflect the risk characteristics of Montana-Dakota. That is precisely what is supposed to be done in a DCF analysis in a rate case, as the Commission is charged with responsibility for determining the cost of equity capital for the filing utility, not the industry average.

In a strange way, the MCC agrees with Montana-Dakota on this point, and denigrates its own misguided arguments. In a effort to rationalize how it can now support dramatically different costs of equity capital for Montana-Dakota and NWE, given Dr. Wilson's DCF analyses which shows that Montana-Dakota has a slightly higher cost of equity capital than NWE, the

MCC argues that Dr. Wilson's DCF analysis only establishes the industry average cost of equity capital, and not the company specific cost which the Commission must use in its decision:

> 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 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.

In one breath, the MCC argues that its own DCF analyses only produces industry averages, so Montana-Dakota can not use them to establish the gross inconsistency in the MCC's advocacy on the cost of equity capital for Montana-Dakota and NWE. In the next breath, the MCC argues that Mr. Gaske should not have developed a risk specific cost of equity for Montana-Dakota in his DCF analysis. Yet, that is precisely what the Commission does in its rate decisions - develop a risk specific cost of equity capital for the utility that filed the rate case.

The MCC's strange arguments raise another important point. If Dr. Wilson's DCF analyses really doesn't establish the cost of equity capital for Montana-Dakota and NWE on a company specific basis, his ultimate recommendation has no empirical backing, and is entitled to no weight in the Commission's deliberations.

> These statements are in the nature of conclusions and are of little weight unless supported by evidence showing factual data.

Freight Rate Association v. Railroad Commission, 128 Mont. 127, 134, 271 P.2d 1024 (1954). Moreover, the MCC appears to be arguing that a valid DCF estimate of the cost of equity capital for Montana-Dakota or NWE must include Montana-Dakota or NWE in the sample companies used for the analysis. That assertion is contrary to the presentation of its own witness, and violates basic precepts on avoiding circular reasoning.

II. CAPITAL STRUCTURE

Montana-Dakota proposed a 53.4% equity ratio for its capital structure based upon its projected equity and debt at year end 2012, given bonus depreciation. The MCC, through the testimony of Dr. Wilson, proposed a hypothetical 50/50 debt equity split.

The Company accedes to the hypothetical capital structure proposed by Dr. Wilson. It does so for two reasons. First, as testified by Montana-Dakota witness Senger, Montana-Dakota targets a 50/50 capital structure in its management of the utility. Second, Montana-Dakota now projects that as of the end of this year, 2013, its equity ratio will have declined to 51%, not markedly different than either its target capital structure or the Wilson recommendation.

III. BILLINGS LANDFILL

Montana-Dakota wanted to treat the Billings Landfill as a utility asset, and include it in rate base. The MCC, through the testimony of MCC witness Clark, opposed treating the Billings Landfill as a utility asset and including it in rate base. He proposed that any landfill gas used by Montana-Dakota for its gas utility customers be treated the same as a third party purchase, and reflected in rates in Montana-Dakota's gas cost tracking adjustment at the CIG index price.

The Company largely accedes to the position of the MCC on this issue, and abandon's any notion of treating the Billings Landfill as a utility asset. It will treat the gas from the Billings Landfill as a third party purchase, and include the cost of the gas in its gas cost tracking adjustment filings.

IV. CUSTOMER CARE AND BILLING SYSTEM.

The MCC opposes including the Customer Care and Billing system in rates despite the fact that it has been rendering bills and providing customer information for the last nine months. That unusual circumstance arises from the fact this case did not even come before the

Commission for hearing until eleven months after Montana-Dakota filed its application for a general rate increase in this docket. The originally scheduled hearing, set in April, was vacated to accommodate the Montana Consumer Counsel. By the time the Commission renders a final decision in this case, the 2011 test year upon which this case is based will be outdated by two years. The unusual procedural circumstances of this case should be considered by the Commission when it decides how to apply its administrative rules to this proceeding.

The MCC argues at pages 15-16 of its Response Brief that no post test year investments should be reflected in rate base if their revenue effect cannot be included. While Montana-Dakota agrees conceptually with the MCC, it is misapplying the concept in this case.

An example of a correct application of the MCC's stated principle would be a post test year main extension. It would be reasonable to assume that a new main extension would mean new customers and new revenues. Replacing a billing system does not provide new customers or generate new revenues. There are no new customers associated with replacing an older and dated customer information system with a new one. Happy customers - yes. New customers, and increased revenues - no.

The MCC argues that any investment which makes a utility more efficient increases revenues. Under that standard, post test year investments would never be allowed in rates since every utility investment is intended in some way to improve the efficiency of the overall system. If it didn't, there would be no reason to make the investment. Yet, the Commission has no hesitation in reflecting post test year investment in rates when it is good public policy.

The Commission's Minimum Rate Case Filing Standards do not dictate rate case outcomes. All they do is specify the minimum amount of information which must be included in an initial rate filing. Once the filing requirement is satisfied, the Commission is not obligated to limit its deliberations to the minimum amount of information which must be provided. The Commission should strive for a reasoned application of its general policies.

CONCLUSION

The Commission should not be persuaded by the misguided advocacy of the MCC in this case. Its final decision in this docket should be rendered in a reasoned and non-arbitrary manner.

DATED this 28th day of October 2013.

HUGHES, KELLNER, SULLIVAN & ALKE, PLLP

By John Alke

John Alke
40 W. Lawrence, Suite A
P.O. Box 1166
Helena, MT 59624-1166

Attorneys for Montana-Dakota Utilities

CERTIFICATE OF SERVICE BY MAIL

I HEREBY CERTIFY that a copy of the foregoing REPLY BRIEF was served upon the following by mailing a true and correct copy thereof on this 28th day of October 2013, addressed as follows:

MONTANA CONSUMER COUNSEL
PO BOX 201703
HELENA MT 59620-1703

John Alke

John Alke