

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 )  
MONTANA-DAKOTA UTILITIES CO., a ) REGULATORY DIVISION  
Division of MDU Resources Group, Inc., for )  
Authority to Establish Increased Rates for Electric ) DOCKET NO. D2015.6.51  
Service in the State of Montana )

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**MONTANA LARGE CUSTOMER GROUP'S RESPONSES  
TO THE MONTANA PUBLIC SERVICE COMMISSION'S  
DATA REQUESTS PSC-079 THRU PSC-083**

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Montana Large Customer Group ("LCG") provides the attached responses to the Montana Public Service Commission's Data Requests PSC-079 thru PSC-083.

Respectfully submitted this 21st day of December, 2015.

**MONTANA LARGE CUSTOMER GROUP**

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## **DATA REQUESTS**

**PSC-079:** RE: Capital Structure, Exhibit MPG-1, DCF Inputs  
Witness: Gorman

- a. Please explain why the Common Equity 12/31/2014 shown on Exhibit MPG-1 was reduced by \$639,554 from the same amount shown on MDU Rule 38.5.146, Statement F Page 2.
- b. The Exhibit MPG-1 -\$77,048,201 adjustment to common equity proposed by the witness is the total of the 12/31/14 balances for Nonutility Property, Accumulated Depreciation and Other Investments from MDU Rule 38.5.121, Statement A, Page 1. These 12/31/2014 ending balances were used to adjust the MDU 12/31/15 Common Equity balance and the MDU Average 2015 Common Equity balance. Is this not a timing mismatch using end of year 2014 balances to adjust end of year 2015 balances? Please explain.
- c. Please explain why the witness approves of the use of the MDU proxy group.
- d. Please explain why the witness believes the 13 week average stock price is preferable to the 6 month average stock price utilized by MDU witness Gaske. MPG Testimony Page 18.
- e. Please explain why the witness chose to use SNL Financial and Reuters as the source for expected dividend growth rather than Yahoo Finance (used by MDU witness Gaske). MPG Testimony Page 19.

### **Response to PSC-079:**

- a. As shown on Mr. Gorman's Excel exhibit and workpapers, he used the common equity balance shown on Rule 38.5.121, Statement A. Based on the Company's response to LCG-058, "[t]he schedule showing common equity and investment in subsidiary amounts shown on Statement F was prepared prior to the 2014 final closing entries were completed."
- b. Mr. Gorman did not have the Company's actual balances for the referenced accounts. However, Mr. Gorman agrees once those actual numbers become available his adjustment should be updated to reflect the actual end of year balances for 2015.
- c. Please refer to pages 16-17 of Mr. Gorman's direct testimony where Mr. Gorman concludes that the proxy group has a comparable investment risk to MDU.
- d. Please refer to page 18 of Mr. Gorman's direct testimony.
- e. Mr. Gorman has a long practice of using the consensus analysts' growth rates from the sources described on pages 18-20 of his direct testimony. He has

consistently used these sources over many years and he does not see a need to change his methodology in response to Dr. Gaske's use of growth rates provided by Yahoo! Finance. In Mr. Gorman's decades of completing cost of service studies, he has reviewed several consensus analysts' growth rate estimates. Based on that experience, Mr. Gorman believes that the consensus analysts' growth rates he relied on are equally as reliable as those published by Yahoo! Finance.

**PSC-080:** RE: DCF Models  
Witness: Gorman

- a. In analyzing the DCF analysis on Exhibit MPG-5, the average and the median DCF results are shown in column 5. Which result is the preferable result to use in choosing a ROE for MDU?
- b. Please explain how Column 6 – Growth on Exhibit MPG-7, Page 2 is calculated.
- c. Using the formula shown on Exhibit MPG -7, Page 2 for Column 8 – V Factor, staff cannot replicate the numbers shown in Column 8. Please explain how these numbers are calculated.
- d. Please explain the Adjustment Factor Column 6 on Exhibit MPG-7, Page 1.
- e. Please explain the logic of MPG-7 Column 10 being the product of Columns 7 times 9.

**Response to PSC-080:**

- a. Please note the average and median results in this case are relatively close to one another. Please refer to Table 4 on page 31 of Mr. Gorman's direct testimony, which shows the average DCF results for the three DCF models developed by Mr. Gorman, which he used to derive the DCF return for MDU. When the average and median proxy group results are similar to one another, this is an indication that the central tendency of the proxy group is reasonably measured using the average and/or the median growth rate outlook. In instances where there is a significant deviation between the average and the median, Mr. Gorman generally relies on the median result. In this instance, there typically are observations within the proxy group which skew the average and render the median more reflective of the central tendencies of the proxy group results.
- b. Column 6 on page 2 of Exhibit MPG-7 is calculated based on the annual average growth of shares outstanding reflecting the three- to five-year projection shown in Column 5 and the actual numbers in 2014. The projection is assumed to occur five years after the actual number in Column 4. The calculation is computed as  $(\text{Column 5} \div \text{Column 4}) + (1 \div 5) - 1$ .
- c. The V Factor reflects the accretion in book value caused by selling stock above book value. It is calculated by taking:  $1 - (1 \div \text{market-to-book ratio shown in Column 3})$ .
- d. The adjustment factor is used to adjust the end of year book value equity as reported by *Value Line* to average year book value equity.
- e. Please refer to pages 21 and 22 of Mr. Gorman's direct testimony. The internal growth rate calculated in column 10 as a product of the forecasted retention ratio and return on equity is tied to the percentage of earnings reinvested in the

company. The reinvested earnings, not being paid out as dividends increase the rate base when utility plant funded by these earnings is put into service.

**PSC-081:** RE: DCF Models  
Witness: Gorman

- a. Please explain the logic behind columns 7, 8, and 9 on MPG-7 Page 2 and why Column 9 is added to Column 10 on Page 1 to calculate the sustained growth rate in Column 11.
- b. How are the Adjusted Yield shown in Column 4 of Exhibit MPG-8 and Column 4 of Exhibit MPG-5 calculated and why are they different?
- c. Please explain the differences between the LCG Sustainable Growth Rate DCF model versus the MDU Retention Rate DCF model versus the MCC Fundamental Growth Rate DCF model, since they all appear to be based on retention rates. However, the LCG model has more inputs than either the MDU or MCC models.
- d. Please explain how the Multi-Source Growth Rate DCF estimates in Column 10 of Exhibit MPG-10 were calculated and provide the actual calculations for those estimates.

**Response to PSC-081:**

- a. As shown on that exhibit and discussed on pages 21-22 of Mr. Gorman's testimony, Column 9 is the product of the expected growth in the number of shares to finance investments and the expected profitability of the equity investment.
- b. The adjusted yield in Exhibit MPG-8 is based on the sustainable growth rate shown on that exhibit. The adjusted yield in Exhibit MPG-5 is based on the consensus analysts' growth rate shown on that exhibit.
- c. The models are very similar, however, the LCG Sustainable Growth Rate DCF model reflects accretion growth created by selling new shares to the public. Dr. Gaske's Retention Growth model reflects only an internal growth rate produced by retaining earnings in a company and reinvesting them. Stated more simply, the LCG Sustainable Growth Rate DCF model used by Mr. Gorman reflects internal growth *and* external growth created by book value accretion from selling stock to the public. In comparison, Dr. Gaske's retention growth rate reflects only internal growth.
- d. Mr. Gorman's multi-stage model starts with the first stage growth that is based on analysts' three- to five-year growth rate projections for the proxy group companies. His third-stage growth is based on long-term GDP growth forecasts. The second-stage growth reflects a linear transition from the first-stage growth to the third-stage growth. It adjusts the short-term growth rate up or down to the long-term growth rate in five equal linear adjustments. Please see Mr. Gorman's workpapers for the actual calculations.

**PSC-082:** RE: Risk Premium  
Witness: Gorman

- a. Please discuss the use of the Ibbotson Associates risk premium of 5.7% utilized by MDU witness Gaske. That is, are there advantages or disadvantages to using this risk premium versus the average risk premium of 4.03 percent as calculated by this LCG witness.
- b. It would appear from the testimony on Page 35 that the average “A” rated utility bond spread for the last 36 years of 1.52% exceeds the current utility bond spread of 1.24%. Please explain the statement that “[t]he current ‘A’ and ‘Baa’ rated utility bond spreads over Treasury bonds are higher than the 36-year average spreads.”
- c. Is it true that in the DCF results offered by the LCG that the assumption is that the dividend is paid once annually rather than quarterly, as was assumed by both the MCC and MDU?
- d. If the answer to c above is yes, please explain your preference for the annual dividend assumption over the quarterly assumption. If the answer to c above is no, please explain how the quarterly dividend assumption is reflected in your DCF models.
- e. What is the Beta Coefficient ( $\beta$ ) for MDU Resources Group, Inc.? Is this Beta Coefficient of any value in analyzing the risk associated with MDU’s Montana electric operations?

**Response to PSC-082:**

- a. Dr. Gaske used the actual historical achieved return on stocks less corporate bonds which was 5.7% over the period 1926-2014. This risk premium reflects that of the overall stock market index relative to corporate bonds. In comparison, Mr. Gorman produced a risk premium for utility stocks versus utility bonds using data from 1986-2015. The Ibbotson Associates risk premium reflects the overall stock market, where Mr. Gorman’s risk premium reflects that of the lower-risk utility stock index only. Hence, the difference in risk premium reflects the difference in the stock index used.
- b. The statement should read “the current ‘Baa’ rated utility bond spread over Treasury bonds is higher than the 36-year average spread.”
- c. Yes.
- d. Including quarterly compounding in the DCF return estimate to replicate re-investment of quarterly dividends over a year can overstate a fair return on equity for setting rates. This occurs because the return available to investors from reinvesting dividends is not a cost to the utility. Therefore, it should not be reflected as a cost of capital in setting utility rates. By including the quarterly

compounding adjustment in the authorized returns used to set rates, investors are provided an opportunity to earn that quarterly compounding return twice. First, by setting rates to increase the allowed return on equity to include a dividend reinvestment return despite the absence of actual reinvestment of the dividend in the utility. Second, investors are able to earn the reinvestment dividend return again when investors receive dividends from the utilities and actually reinvest in alternative investments. As such, including the quarterly compounding return in the DCF return estimates overstates a fair return on equity for setting rates, because it overstates the utility's cost of capital.

- e. Mr. Gorman did not include MDU Resources in his comparable group. Hence, he did not obtain the *Value Line* beta at the time he completed his return on equity study. The parent company of MDU is exposed to higher risks associated with its unregulated operations.

**PSC-083:** RE: Financial Risk, Blended Rate DCF Model  
Witness: Gorman

- a. Please explain in more detail the statement on Page 44 of your testimony that MDU has a “Strong” business risk profile and a “Significant” financial risk profile. That is, what S&P benchmarks determine the business risk rating and the financial risk rating and what are those benchmarks for MDU?
- b. Please comment on the LCG’s position regarding the use of a blended rate DCF by MDU witness Gaske.

**Response to PSC-083:**

- a. These are Standard & Poor’s (“S&P”) business and financial risk rankings for the proxy group utility companies. S&P ranks a utility’s total credit risk based on the combination of its business risk and financial risk. Business risk rankings range from “Excellent” to “Vulnerable” in six categories (“Excellent,” “Strong,” “Satisfactory,” “Fair,” “Weak,” and “Vulnerable”) and financial risk rankings range from “Highly Leveraged” to “Minimal” in six categories (“Highly Leveraged,” “Aggressive,” “Significant,” “Intermediate,” “Modest,” and “Minimal”). Typically, electric utility companies have business risk profile scores of “Excellent,” and financial risk scores of “Strong” to “Aggressive,” which are the lowest business risk ranking and second and third highest financial risk rankings. Because of MDU’s affiliation with higher-risk non-regulated companies, its business risk is rated higher by S&P than an electric utility without the same level of affiliate risk. Please refer to MPG Confidential Workpaper 8, Standard & Poor’s RatingsDirect: “Criteria: Corporate Methodology,” November 19, 2013. This S&P report discusses the S&P methodology in assigning its business and financial risk profiles.
- b. Mr. Gorman believes that a blend of projected earnings growth rates and retention growth rates does not provide a consistent estimate of a DCF return based on a clearly defined input parameter. Using consensus analysts’ growth rates produces DCF estimates based on published independent analysts’ projections of future growth. In contrast, internal growth rates are based on the Company’s own financial data that indicates long-term sustainable growth. The analysis should attempt to use data that likely would have been available to investors to make informed investment decisions. To the extent investors use both of them, they would use these growth rates likely independently to draw a variation in the estimated DCF return or valuation estimate. It is unlikely that investors would mismatch growth rates within the proxy group as a means of making informed investment decisions. While Mr. Gorman does not agree with the use of the higher of or lower of growth rate methodologies reflecting this blended proposal, it is relevant to observe that Dr. Gaske’s blended growth rate DCF study produced an ROE for the group median of less than 9% (8.53%).

## CERTIFICATE OF SERVICE

I hereby certify that on this, the 21st day of December, 2015, the **MONTANA LARGE CUSTOMER GROUP'S RESPONSE TO THE MONTANA PUBLIC SERVICE COMMISSION'S DATA REQUESTS PSC-079 THRU PSC-083** was e-filed with the Commission and served via U.S. mail and e-mail, unless otherwise noted, to the following:

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*s/ Adele C. Lee* \_\_\_\_\_