

Service Date: March 25, 2016

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

IN THE MATTER OF THE Application of) REGULATORY DIVISION
Montana-Dakota Utilities Co. for Authority to)
Establish Increased Rates for Electric Service in) DOCKET NO. D2015.6.51
the State of Montana) ORDER NO. 7433f

FINAL ORDER

APPEARANCES

FOR THE APPLICANT:

Montana-Dakota Utilities

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FOR THE INTERVENORS:

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FOR THE COMMISSION:

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BEFORE:

Travis Kavulla, Vice Chairman and Presiding Officer
Roger Koopman, Commissioner
Bob Lake, Commissioner
Kirk Bushman, Commission

PROCEDURAL HISTORY

1. On June 25, 2015, Montana-Dakota Utilities Co. (“MDU”), a Division of Montana-Dakota Resources Group, Inc., filed an *Application for Authority to Establish Increased Rates for Electric Service in the State of Montana* with the Montana Public Service Commission (“Commission”). MDU’s proposed rates would provide an additional \$11,755,752 of annual revenue, a 21.1 percent increase overall. MDU also sought an interim increase of \$10,977,511 in annual revenue.

2. On July 8, 2015, the Commission issued a *Notice of Application and Intervention Deadline*. On August 6, 2015, the Commission granted intervention to the Montana Consumer Counsel (“MCC”), The Alliance for Solar Choice (“TASC”), and the Montana Large Customer Group (“LCG”). On September 8, 2015, the Commission issued *Procedural Order No. 7433*. The Commission issued *Order No. 7433d* denying MDU’s motion for interim rates on January 11, 2016. On January 13, 2016, the Commission issued a *Notice of Public Hearing*. On February 8, 2016, the parties filed a *Stipulation and Settlement Agreement* (“Stipulation”). On February 9, the Commission commenced a hearing in Glendive, Montana.

FINDINGS OF FACT**Ambiguity in the Stipulation**

3. A large amount of MDU’s proposed rate increase is driven by capital investments in new or existing generating facilities, which were made in the latter half of 2015. The Commission finds that the Stipulation is ambiguous on whether, if approved, the capital investments in new or existing generating facilities would be considered part of the rate base. The Stipulation articulates in relevant part that “[t]he cost of all the proposed plant additions are

included in these rates, but the Parties have not agreed to the specific level of costs included or the appropriate methodology for calculating level of costs—i.e., average vs. year-end or post-test year basis.” Stipulation and Settlement Agreement p. 4 (Feb. 8, 2016). The Commission finds that this provision is contradictory because it is not possible for “all” costs to be included in rates while “the specific level of costs” has not been arrived at.

I. RICE Units

4. MDU’s Reciprocating Internal Combustion Engine (“RICE”) units were declared commercially operational by MDU on December 31, 2015, the final day of the 12-month post-test year adjustment period. Hr’g Tr. pp. 300-302 (Feb. 9, 2016).

5. The record demonstrates that from that time until the hearing on this matter, the RICE units were not economically dispatched to provide energy to consumers. Tr. at 301-302. The record also reflects that the RICE units have not been certified by the wholesale market operator to provide capacity credits. Tr. at 280-282.

6. The Commission determines that the 2013 Integrated Resource Plan (“IRP”), does not, in fact, appear to support the construction of those units. This finding is evidenced by the results of MDU’s planning model which demonstrates that the RICE units would not be constructed under a scenario using the 80 percent Midwest Independent Transmission System Operator resource adequacy requirements currently in effect. *See In re MDU*, Dkt. N2013.9.66, 2013 IRP, Attachment C, pp. 17 and 20 (Sept. 16, 2013). The Commission further finds that MDU’s load growth forecast has declined substantially since that IRP was filed. Tr. at 77-78.

7. At hearing, when asked why units providing no economic energy and no capacity should nonetheless be included in rates, MDU witness Darcy Neigum argued that they were necessary to serve a load pocket in a transmission-constrained area of the oil patch. Tr. at 265-277. When asked where one could find support for the decision to construct this resource in the IRP, MDU offered Attachment H of the 2013 IRP and Page 13 of the 2013 IRP Main Report. Tr. at 279-281. The Commission finds that the documents contain only cursory statements describing the problem, and by themselves, do not justify the addition of a particular plant at a particular cost.

8. Additionally, there is evidence that other resources could provide capacity services more cost-effectively than the RICE units. MDU currently obtains capacity through its C Power demand response program for less than half the levelized cost of the RICE units. Tr. at

269-270. MDU has contracted with a third-party provider to achieve up to 25 MW of capacity through the C Power program, and to date MDU has acquired about 10-11 MW. Tr. at 230-231. Similarly, MDU's 2013 plan identified up to 10 MW of cost-effective capacity from a residential AC cycling program. Tr. at 228-229. MDU has yet to implement that program. Together, these demand-side programs are capable of providing up to 35 MW of capacity resource, almost twice the amount provided by the RICE units.

9. The Commission finds MDU did not adequately explain its slow progress in acquiring cost-effective demand-side capacity resources that may have deferred or substituted for the RICE units. Tr. at 270-271. The Commission is not persuaded that MDU could not have acquired additional cost effective demand-side capacity that would have displaced or deferred MDU's projected need for the RICE units.

10. Based upon the above evidence and analysis, the Commission finds that MDU has not demonstrated that the RICE units are used and useful.

II. Environmental Upgrades

11. Two significant upgrades at the Big Stone and Lewis and Clark coal-fired generating plants were made in anticipation of the South Dakota State Implementation Plan for Regional Haze ("SIP") and the federal Mercury and Air Toxics Standard ("MATS"), respectively.

12. According to MDU's 2011 IRP, the SIP requirement for the Big Stone upgrade becomes enforceable only after the adjusted test period of this rate case. *See In re MDU*, Dkt. N2011.8.70, 2011 IRP, Attachment H, p. 13 (Aug. 15, 2011). MATS, meanwhile, requires compliance by April 16, 2016. *See* Dkt. N2013.9.66, 2013 IRP, Attachment G, p. 5; *see also* Late Filed Ex. 1 (March 4, 2016).

13. The Commission sympathizes with the utility's exposure to environmental regulations that the Commission believes are unjustified. However, MDU has conceded that the return authorized by a regulatory commission for a utility that owns coal assets is, in part, compensation for the risks of owning and operating those plants. The Commission finds that environmental regulation is one such risk. Ex. MDU-11, pp. 9-11.

14. In this case, the Commission determines that the pollution control systems are operational, or used. The Commission also finds that based on modeling conducted within the IRPs and the pollution control equipment's testing, these capital additions, while not presently

useful, likely will prove to be useful during the time when rates are in effect, but is unable to definitively reach a conclusion at this time.

III. RICE Units and Environmental Upgrades Inclusion in Rate Base

15. If the Commission were to read the Stipulation's provision cited above in such a way as to require the addition of all major plant additions to rate base, the Commission would not approve it. *Supra* ¶ 3.

16. Nicole Kivisto, MDU's CEO, testified that she believes that the four major projects are all used and useful. Tr. at 84. However, she testified first that the Stipulation, if approved, does not require the Commission to ascertain the value of the property in question by its original cost or by any other methodology. Tr. at 80. Furthermore, counsel for LCG maintained that the provision was intended to ensure that, fuel costs that are actually offset by the addition of the Thunder Spirit wind farm, are not included in the company's tracking mechanism for fuel and purchased power, which LCG's customer is subject to. Tr. at 477-478.

17. The Commission determines that the Stipulation does not require the Commission to conclude whether the major plant additions MDU has presented in this docket should be entered into rate base. Furthermore, no specific finding regarding the used and usefulness of the RICE Units and the environmental upgrades is necessary to find the stipulated rates just and reasonable. Therefore, this Order makes no such findings. The Commission may investigate whether the RICE units and the Lewis and Clark and Big Stone environmental upgrades are actually used and useful in a future rate case.

Return on Equity

18. The Commission's last ordered return on common equity ("ROE") for MDU's electric operations was established at 10.25 percent. *See In re MDU*, Dkt. 2007.7.79, Order 6846f (April 23, 2008). Capital markets have changed dramatically since that time, and the cost of debt, in particular, is at historic lows. Under such circumstances, the Commission finds that it is sound regulatory practice to provide MDU guidance regarding a reasonable ROE range.

19. Each party submitted studies of the cost of capital in this docket. Parties disagreed over methodology and results, including whether to award a premium to MDU because of the firm's risk relative to a proxy group of utilities. *See* Direct Test. J. Stephen Gaske p. 13 (June 25, 2015); *see also* Direct Test. Michael P. Gorman pp. 51-52 (Nov. 20, 2015). The parties also disagreed as to whether to rely on a discounted cash flow ("DCF") model that incorporates a

quarterly dividend payment adjustment and a flotation cost adjustment (Direct Test. John W. Wilson p. 12 (Nov. 20, 2015), Direct Test. Gorman at 49-51), and whether to rely on the risk-premium model and/or the capital asset pricing model (CAPM) as evidence of the reasonable cost of capital. *See* Rebuttal Test. J. Stephen Gaske pp. 20-24 (Jan. 14, 2016).

20. MDU relies largely on coal-fired resources, which face significant environmental regulation risks. Whether that increases the company's overall risk is a matter of dispute. The Commission's ratemaking treatment of coal-related upgrades requires some measure of risk to be shared between customers and the utility. *Supra* ¶¶ 13-14. The reward should be commensurate with that risk.

21. Other utilities in the proxy group also rely heavily on coal-fired generation. The risk of owning these assets is internalized in their DCF results, although differences may exist between jurisdictions' ratemaking treatment of environmental upgrades.

22. MDU contended that its small size and relatively undiversified service territory makes it more risky and therefore it should command a higher reward. However, many of the proxy companies are an amalgamation of small utilities. The proxy group's dividend and growth forecasts in the DCF results may incorporate all or some portion of those risks. Tr. at 147-48. The Commission finds that adding an *ex post* risk premium adjustment to the DCF results would result in double-counting those risks. Direct Test. Gorman at 51-52.

23. MDU utilized a risk premium of 60 basis points above the median, while other parties used none. In consideration of the risks that MDU identified, the Commission is only persuaded that they may be real, but that much of that risk is likely captured in the DCF results.

24. To its DCF results, MDU added a 3.5 percent adjustment for flotation costs, or the cost of issuing new common equity. MDU's Schedule 2 Exhibit JSG-2 shows that the flotation costs incurred with 51 new common stock issues by electric companies from January 2005 through November 2014 averaged 3.37 percent. The LCG argued that the flotation cost adjustment for MDU is not based on known and measurable costs for MDU and should be rejected.

25. In addition, the LCG argued that there is no clear understanding of how actual flotation costs were treated by MDU in past ratemaking. If those flotation costs were amortized as an expense within the cost of service, then these costs have already been recovered, and allowing a return on equity adjustment would mean double recovery of the flotation costs. The

MCC argued that in the case of common equity, the great preponderance of equity growth for electric utilities, including MDU, is retained earnings and not new public stock issuances.

26. The Commission agrees with the intervenors' testimony and finds that it would be inappropriate to add a hypothetical flotation cost to the DCF results. Removing those flotation costs from MDU's ROE recommendation ($10.0/1.035 = 9.66$ percent) reduces the recommendation by 34 basis points.

27. MDU relies on a Quarterly Dividend Yield DCF analysis where the return is equal to:

$$\frac{D_0(1 + 0.625g)}{P} + g$$

LCG believes the quarterly compounding of dividends overstates the actual likely yield, resulting in an unreasonable upward bias in the DCF results. Data Resp. PSC-082 (Dec. 22, 2015). The Commission agrees and would discount the use of this model, in favor of other DCF models. Removing the quarterly dividend adjustment to the dividend yield in MDU's DCF models reduces MDU's recommended ROE for the group of 12 electric proxy companies by approximately 13 basis points.

28. When flotation costs and the quarterly dividend adjustment to dividend yield are removed from the Basic DCF Model of MDU, the median result is 8.93 percent. The Commission has in this Order suggested that environmental compliance costs may not be eligible for rate-base treatment until the emissions standards for which purpose they were constructed are actually in effect. This treatment represents an alignment of customer and utility incentives, but the Commission is conscious that it also represents a potentially larger risk than other coal-owning utilities in the proxy group.

29. The Commission, as discussed above, finds that a small-size premium is already incorporated within the DCF results. Therefore, assuming an adjustment commensurate to MDU's risk, but somewhat less than what MDU has suggested, a reasonable ROE would range from 9.0 percent to 9.5 percent, or an approximately 0 to 50 basis point addition to reasonable DCF results, attributable to the degree of risk that environmental upgrades may be required.

30. The Commission considers the capital asset pricing model ("CAPM") and risk-premium evidence to be a check on DCF results, because of the potentially self-referential nature of the latter model. The DCF proxy group is a collection of regulated firms whose earnings are driven by regulatory ROE awards, which in turn are set by regulators' assessments of what other

regulated firms are earning. This circularity is almost inevitable in the use of DCF. The Commission finds that the CAPM results in the LCG's testimony, which it regards as the most credible, supports a 9.0 percent to 9.5 percent ROE.

31. The Commission finds that a ROE in the range of 9.0 percent to 9.5 percent is supported by substantial record evidence. The Stipulation is silent on this matter, and the Commission recognizes that market conditions could change by the time another rate case filing is made. For the purpose of implementing the provisions of Mont. Admin. R. 38.5.506(2)(b), the Commission concludes that an ROE in the range of 9.0 percent to 9.5 percent is a more reasonable starting point than the 10.25 percent authorized in Order 6486f. *See* Dkt. D2007.7.79, Order 6486f (April 23, 2008).

Reasonableness of the Stipulation

32. In its initial application, MDU requested an annual revenue increase of \$11,755,752. It later revised its request in rebuttal testimony to \$9,774,133 to reflect adjustments identified during the course of the proceedings to that point in time. The Stipulation offered by the parties would result in an overall annual revenue increase of \$7.4 million, phased in over a two-year period as follows: An annual revenue increase of \$3 million would occur on April 1, 2016, and an additional annual revenue increase of \$4.4 million would occur on April 1, 2017. The \$4.4 million increase effective April 1, 2017 would be subject to adjustment based on the difference between MDU's actual 2015 net transmission service expense of \$1,268,269 and its actual 2016 net transmission expense, but the adjustment would not be more than \$338,143, positive or negative.

33. In assessing whether approval of the Stipulation would be in the public interest and lead to just and reasonable rates, the Commission balanced its concerns, expressed above, regarding whether certain of MDU's proposed plant additions are actually used and useful in providing service to customers. Absent the Stipulation, it is possible to envision a range of decision scenarios for resolving this matter. Some of those scenarios lead to an overall revenue increase lower than the stipulated \$7.4 million, others to a slightly higher overall revenue increase.

34. Most importantly, however, the Commission's evaluation of a range of possible decision scenarios, and the relative merits of those scenarios, suggests that the Stipulation's overall \$7.4 million increase, phased in over a two year period, combined with the agreement by

MDU not to file a subsequent rate increase request before April 1, 2017, represents a reasonable outcome and produces just and reasonable rates for MDU's customers. Although the Commission questions whether certain of MDU's proposed plant additions are currently actually used and useful, evidence suggests that over time the environmental upgrades will likely become used and useful. Scenarios that exclude MDU's proposed RICE units and upgrades to Lewis & Clark and Big Stone, but resolve other contested issues on which this decision does not opine in favor of MDU, suggest that the stipulated outcome is within a zone of reasonable outcomes, particularly given the phased revenue increase.

35. The Commission observes that the allocation of revenues in the stipulation may result in a disproportionately large increase to one customer class that already provides a return to MDU which exceeds the system average rate of return. At hearing, the LCG presented an alternative allocation of revenues in Exhibit LCG-7 to rectify the issue. Tr. at 434-439. All parties agreed to support the allocation of revenues presented in Exhibit LCG-7.

36. The stipulated allocation of the revenue increase among the customer classes contained in Exhibit LCG-7 falls within the range of outcomes shown by the parties' various cost studies. There are no universally accepted utility cost of service methods and plausible arguments underlie many of the methods the parties applied in this case. Exhibit LCG-7 appears to reflect a degree of rate moderation, as no customer class would receive an increase greater than 1.5 times the system average increase. Again, an assessment of possible decision scenarios suggests that the stipulated revenue allocation contained in Exhibit LCG-7 falls within a zone of reasonable allocation alternatives and is fair to all classes. The Commission approves the stipulation while adopting the allocation of revenues presented in Exhibit LCG-7.

37. The stipulated rate design would maintain existing customer charges for the residential and small general rate service classes, consistent with the MCC's recommendations in this case. The Commission finds that this is a reasonable approach because it maximizes customers' ability to reduce bill impacts through demand-side actions. For the remaining rate classes, the stipulation would increase each tariffed rate element by an equal percentage, maintaining the existing rate relationships established by the Commission in a prior case. *See In re MDU*, Dkt. D2010.8.82, Order 7115d (Aug. 2, 2011). Absent more specific class cost of service determinations and a more thorough consideration of marginal cost information than occurred in this case, this approach is reasonable.

Finalization of Tracking Adjustments

38. In the Stipulation, MDU states that it has “filed Applications for authority to implement a fuel and purchased power cost tracking adjustments under Rate 58” and that the Commission “has issued Interim Rate Orders” but “has not issued final orders.” Stip. at 6. Further, MDU asserts that the parties “agree that the Commission should issue final rate orders for these pending fuel and purchased power cost tracking adjustments under Rate 58.” *Id.* The Commission agrees that it should finalize the fuel and purchased power cost tracking adjustments under Rate 58. Subsequent to this Order, the Commission will issue final orders approving the pending power cost tracking adjustments on a final basis.

CONCLUSIONS OF LAW

39. A “public utility” includes a private corporation “that owns, operates, or controls any plant or equipment... for the production, delivery, or furnishing” of power to other persons. Mont. Code Ann. § 69-3-101 (2015). As a private corporation that provides electric service within Montana, MDU is a “public utility.”

40. The Commission is “invested with full power of supervision, regulation, and control” of public utilities. *Id.* § 69-3-102.

41. The Commission may “do all things necessary and convenient” in the exercise of its powers. *Id.* § 69-3-103(1). The Commission may “regulate the mode and manner of all investigations and hearings of public utilities” before it. *Id.* § 69-3-103(2)(c).

42. As a public utility, MDU is required to furnish reasonably adequate service at just and reasonable rates. *Id.* § 69-3-201 (“every unjust and unreasonable charge is prohibited and declared unlawful.”)

43. Every public utility must file schedules with the Commission showing “all rates, tolls, and charges which it has established and which are in force at the time for any service performed by it within the state or for any service in connection therewith...” *Id.* § 69-3-301(1).

44. Other than rate schedules that adjust certain state and local taxes and fees, a public utility may not change any rate schedule except as approved by the Commission or upon the passage of nine months. *Id.* § 69-3-302.

45. “The commission may, in its discretion, investigate and ascertain the value of the property of each public utility actually used and useful for the convenience of the public.” *Id.* § 69-3-109.

46. Before the Commission approves a rate increase, “or before any change may become effective due to the passage of nine months,” the Commission must provide notice of the proposed change and announce a hearing on the matter. *Id.* § 69-3-303(1).

ORDER

IT IS HEREBY ORDERED THAT:

47. The Stipulation submitted by MDU, the MCC, and the LCG is hereby APPROVED;

48. As outlined in the Stipulation, MDU is authorized to collect an additional \$7.4 million dollars, phased in over a two-year period, with an annual revenue increase of \$3 million to occur on April 1, 2016, and an additional annual revenue increase of \$4.4 million to occur on April 1, 2017;

49. The \$4.4 million increase effective April 1, 2017 is subject to adjustment based on the difference between MDU’s actual 2015 net transmission service expense of \$1,268,269 and its actual 2016 net transmission expense, but the adjustment will not be more than \$338,143, positive or negative;

50. The Commission’s approval of the Stipulation includes the adoption of the allocation of revenues presented in Exhibit LCG-7;

51. The Commission will issue final orders approving the pending power cost tracking adjustments under Rate 58 on a final basis;

52. The Stipulation does not require the Commission to conclude whether the major plant additions are entered into rate base;

53. The Commission makes no determination as to the used and usefulness of the RICE units and the environmental upgrades;

54. An ROE in the range of 9.0 percent to 9.5 percent is supported by substantial record evidence;

55. The revenue increase outlined in the Stipulation is just and reasonable;

56. MDU shall adhere to and implement all provisions of the Stipulation;

57. These rates are effective for service rendered on or after April 1, 2016.

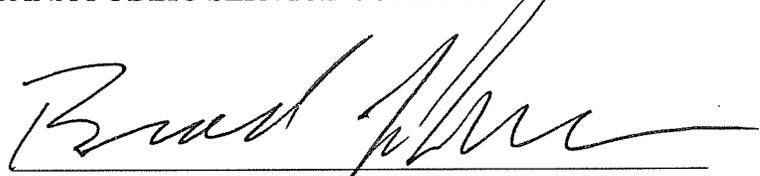
On March 11, 2016, Commissioner Bushman moved to APPROVE the Stipulation, with the

modification in Exhibit LCG-7, and with supporting language as to the reasonableness of the Stipulation. Commissioner Lake seconded the motion, which failed 2 to 3, Commissioners Johnson, Kavulla, and Koopman dissenting.

Commissioner Kavulla moved to APPROVE the draft Order subject to changes as discussed, substantive edits, and circulation to Commissioners. Commissioner Koopman seconded the motion which passed 4 to 1, Commissioner Bushman dissenting.

DONE AND DATED this the 11th day of March 2016 by a vote of 4 to 1. Commissioner Bushman dissenting.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION



BRAD JOHNSON, Chairman



TRAVIS KAVULLA, Vice Chairman



KIRK BUSHMAN, Commissioner (dissenting)



ROGER KOOPMAN, Commissioner



BOB LAKE, Commissioner

ATTEST:



Aleisha Solem
Commission Secretary

(SEAL)



Service Date: March 25, 2016

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DISSENTING OPINION OF COMMISSIONER KIRK BUSHMAN

The Commission's order lacks due process, it draws conclusions that are best left for future Commissions when the issues are ripe and the facts of the day are known, and it contradicts its own findings of fact that are not supported by a proper evidentiary record.

Days before the start of the Montana-Dakota Utilities electric rate case hearing in Glendive, Montana, the Public Service Commission received a stipulation from the parties involved in the docket. At this time the Commission chose to continue with a contested hearing even though the parties had submitted a stipulation. The result was an incomplete evidentiary record that lacked the parties' cross-examination of the witnesses and evidence.

The Commission in its final order presents findings of fact that are only supported by the Commission's own analysis. Although this analysis is sufficient and valid in determining whether the stipulation is reasonable and in the public interest, it lacks due process and is arbitrary and capricious regarding the findings of fact listed in the order. The Commission erred by continuing a contested hearing even after parties had presented the stipulation. The Commission would have been better served by suspending the contested docket and continuing the hearing solely on the stipulation. The Commission's options were then one of two choices: 1) approve the stipulation with analysis supporting the prudence & public interest; or 2) deny the stipulation and proceed to a contested hearing, allowing all parties to address the issues that concerned the Commission.

In addition to the lack of due process, the Commission's order contradicts itself. The facts listed in the order seem to support a denial of the stipulation. However, in the conclusion

the Commission approves the stipulation. The process by which the Commission does this demonstrates a departure from their proper quasi-judicial role to one of advocacy, where they draw conclusions regarding used and useful, as well as return on equity, in an attempt to guide future Commissions.

It is my opinion that the Commission should have accepted the stipulation with an explanation of analysis that demonstrated prudence and public interest.

Therefore, I respectfully DISSENT from the Order,

A handwritten signature in black ink, appearing to read "Kirk Bushman". The signature is written in a cursive, somewhat stylized font. It is positioned above a horizontal line.

Kirk Bushman, Commissioner (dissenting)