Chesapeake Regulatory Consultants, Inc.
6837 Guilford Road
Clarksville, MD 21029-1632

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Robert G. Towers
Basil L. Copeland, Jr.
David E. Peterson

April 29, 2005

via eMail and US Mail
David A. Jacobson, Utility Analyst
South Dakota Public Utilities Commission
500 E. Capitol Avenue
Pierre, South Dakota 57501

RE: Report and Consulting Services Proposal
Montana-Dakota Utilities Co. (Gas rates)
SDPUC Docket No. NG05-002

Dear Dave:

Thank you for sending MDU's latest rate filing for our comments, suggestions and a proposal to assist Commission Staff. To that end, I have reviewed the filing statements and testimony and discussed the Company's cost of capital presentation with Basil Copeland.

Overview of the Filing

By letter dated March 23, 2005, MDU filed with the Commission an Application seeking an increase in rates for gas service in its East River Natural Gas System. The proposed rates were designed to increase its annual revenue from these customers by $849,745, which is described as a 12.8% increase (Statement O). However, because MDU's on-going purchased gas costs are recovered through an independent PGA and are not a component of the general rate increase now being proposed, the increase it proposes here is more appropriately viewed as an overall 65% increase in its existing base rate revenue (consisting of monthly Basic Service Charges and Distribution Delivery Charges) .

MDU's existing base rates were approved by the Commission in Docket No. NG93-003 and became effective on August 10, 1993 for application upon the commencement of gas service in the eleven communities constituting the East River system. The rates were based on projected service levels and estimated costs during the first ten years of operations and were approved as part of a settlement which also contained a statement of MDU's intent "for the foreseeable future to keep rates at or near the [approved] level..." (Settlement Agreement, Article IV).

MDU now serves about 5,800 customers in the eleven East River system communities, including 5,000 Residential, 800 Firm General Service and one Firm Contract customers (Statement O). Gas throughput is approximately 45% to Residential customers and 55% to commercial firm service users.

The revenue requirement determination filed in support of MDU's proposed rates is developed using an actual base year ended December 31, 2004 (Statement M, page 1), with numerous adjustments for purportedly "known and measurable changes that will occur by December, 2005" (Mulkern testimony, p. 2; Statement M, pages 3-4) to reflect a "pro forma" year 2004 (Stmt. M, page 5-6), ultimately labeled "Pro Forma 2005" (Stmt. N). Operating income adjustments were made to normalize the effects of weather on actual sales, to account for expected sales growth, and to reflect projected 2005 gas costs and related PGA revenues. Other adjustments are made to reflect budgeted payroll increases, benefits costs, and employee training expenses.

The estimated cost of plant additions expected to be in service by the end of 2005 are reflected as increases in rate base and depreciation expense. However, book depreciation expense is reduced to reflect the depreciation rates adopted for the Black Hills system in the 2004 settlement of Docket NG04-002.

The Company's analysis indicates that it incurred a net loss of $498,306 in 2004 resulting in a *negative* 7.097% rate of return on rate base (Statement M, p. 1). With the claimed adjustments to earnings and rate base the *negative* return is larger at 7.699% (Stmt. M, p. 5) and far below its claimed cost of capital of 9.921%, including a 12.25% return on common equity. To achieve a return equal to its claimed cost of capital would require a rate increase of $1.787 million in base rate revenue – more than double the amount requested. According to the Company's calculations, the proposed $849,745 rate increase will result in a return on rate base of a positive 0.68% and a return on equity of a *negative* 6.12%.

The 9.921% deemed to be an allowable return on rate base reflects Montana-Dakota Utilities Co.'s projected embedded debt and preferred stock costs and projected capital structure with equity reductions for unregulated subsidiaries (Stmt.

G). The 12.25% return on on common equity used to derive the 9.921% composite cost of capital has no analytical support.

Based on conclusions drawn from its analysis of service costs by customer class (Stmt. N), MDU recommends that the proposed 12.8% increase in combined base rate and PGA revenues be recovered as follows:

Residential	17.8% increase
Firm General Service	9.0% "
Firm Contract	No increase

(Stmt. O; Aberle Exhibit___(TAA-1)

If the Company were to propose rates reflecting its total claimed revenue requirement, the corresponding overall increase would be 27%, with increases of 43% and 14% respectively to the Residential and Firm General Service groups.

The proposed distribution of the $849,745 assigns 64% of the increase to Residential customers and 36% to Firm General Service users while, according to the Company, its class cost of service study would support an 89% and 11% split. Apparently, this moderation of the cost analysis is proposed to minimize the impact of the increase on Residential users.

To implement the proposed rate changes, the Company proposes to replace the single East River rate schedule (Rate 66) with a Residential rate (retaining the Rate 66 identity) and a Firm General Service rate (denominated Rate 76). This change allows for separate Residential and Firm General Service Distribution Delivery Charges, providing the means by which the proposed allocation of the increase is accomplished. In addition to the single-step Distribution Delivery Charge, each rate schedule includes a Basic Service Charge, a Cost of Gas component and a Distribution Delivery Stabilization Mechanism (DDSM).

The Basic Service Charges are stated as a per day rate, to be applied to the number of days in each customer's billing period. Both the form of this rate component and the level of the proposed Basic Service Charges ($0.25 per day for Residential customers; $0.35 and $0.70 for small-meter and large-meter FGS customers) are the same as those approved in the settlement of MDU's Black Hills rate case, Docket NG04-004. However, the East River System Service Charges would replace much lower "Customer charges" in MDU's present rates; for example, the $0.25 per day rate proposed for Residential customers (equivalent to $7.50 for a

30-day billing period) would replace the presently-effective $2.00 per month Customer charge. The proposed DDSM is the same DDSM as was approved in Docket NG04-004.

Potential Issues and Division of Workload

MDU's filing raises issues similar to many of the issues which Staff dealt with in the 2004 (NG04-004) Black Hills filing. In this filing, revenue requirement issues relate to the numerous and necessarily speculative adjustments which the Company has made to reflect conditions anticipated by the end of 2005 – for example, adjustments to labor costs, benefit costs, communications expenses and new plant investment. The claim made for the cost of MDU's Supplemental Income Security Plan (SISP) costs, providing supplemental retirement benefits to "key employees", was examined and rejected by Staff in the Black Hills case.

On the other hand some costs are no longer at issue. MDU has adopted the depreciation rates which were agreed to in the Black Hills case settlement. Issues concerning possible income tax savings related to the filing of a consolidated tax return were examined by Staff in 2004 and found to support no adjustment. Although this situation may change over time, the addition of one year of tax filing experience does not justify a new investigation of the issue in this case.

The 12.25% return on equity reflected in the Company's claimed cost of capital is not supported by any analysis or testimony and, inexplicably, is much higher than the 11.0% ROE recommended by MDU's own witness in the Black Hills rate case. In that case, according to Staff's analysis of the rate settlement, the settlement rates reflected a 9.50% ROE. (Staff Memorandum Supporting Settlement Stipulation, p. 5)

The class cost allocations used to support the class-by-class distribution of the proposed increase and the proposed Basic Service Charges are distorted by classifying as "customer costs" a significant portion of costs related to distribution Mains. As in the recent and previous Black Hills cases, eliminating this bias in the allocations will shift cost responsibility away from Residential and other small users and onto the larger customers. Similarly, it will reduce the "customer costs" offered in support of the proposed Service Charges.

With precedent to guide the Staff on the recurring revenue requirement issues, it would be most efficient to have Staff review and develop positions on operating revenue and expenses, including sales adjustments for weather normalization and growth, labor and benefits costs, insurance, advertising, communications expenses as well as rate base adjustments for plant additions, etc. We would provide assistance to Staff as needed.

We propose to address the cost of capital, class cost allocation and rate design issues, with as much participation as possible by Staff.

Proposal

As you know, we have considerable experience with general rate increase requests by natural gas utilities. In addition to our participation in the recent (and earlier) MDU cases, MidAmerican and NWPS gas cases in South Dakota, we are presently engaged as consultants in gas and electric rate cases by the Colorado Consumer Counsel, the New Jersey Ratepayer Advocate and the West Virginia Consumer Advocate.

In this proceeding, we propose to assist the Staff as described above. Basil Copeland would analyze the cost of capital and capital structure issues. I would be responsible for any accounting issues that are delegated to me by your Staff, and the class cost of service and revenue distribution issues. Dave Peterson will be assisting me, as needed, in preparing the class cost of service and rate design studies.

We will prepare the necessary data requests to obtain the information needed for our analyses; review the Company's responses, and confer with their witnesses as necessary; and prepare testimony and supporting exhibits describing our analyses, and recommendations. As needed, we will assist Staff witnesses in developing issues on which they will testify. We will also assist Staff Counsel in preparing for hearing and with the preparation of post-trial briefs and other pleadings.

For the purposes of preparing a cost estimate, I have assumed that two or three days will be required for participation in hearings in Pierre. As a practical matter, given the Company's decision to request less than half of the increase that it believes could be justified, I expect that Staff's analysis of the filing might lead to a settlement of the issues and that preparation of testimony and formal hearings may prove to be unnecessary. In that event, the cost of our services would be reduced.

We estimate that the cost of performing these services would amount to approximately $36,475, including out-of-pocket expenses. Of course we would bill only for time actually spent working on the assignment and for our actual out-of-pocket costs, principally for air fare for 2 man-trips to Pierre, per diem expenses in Pierre, long distance telephone, copier and courier services. Our estimate is derived as follows:

Tasks	Hours		
	Towers	Copeland	Peterson
• Analyze the filing, identify issues, discovery;	40	8	4
• Developing positions; preparation of testimony and exhibits, including coordination with other Staff witnesses;	40	40	24
• Review rebuttal testimony and preparation for hearing;	24	12	12
• Participation in hearing	24	16	-
• Assisting counsel with briefs	12	4	-
Total hours	140	80	40

Cost Summary

Fees: Towers	140 hrs. @ $135		$18,900
Copeland	80 hrs. @ $130		10,400
Peterson	40 hrs. @ $125		5,000
Out-of-pocket expenses:			
Air fare		$1,500	
Hotel		200	
Courier		125	
Data base charges			

for ROE analysis		250	
Other	100		
			2,175
Total cost			**$36,475**

Please let me know if you have any questions about my discussion of the issues, division of the workload between Staff and our firm or any other aspect of this report and proposal. We look forward to working with you again.

Sincerely,

Robert G. Towers
President

Attachment: Fee Schedule (April, 2004)

Chesapeake Regulatory Consultants, Inc.

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Robert G. Towers
Basil L. Copeland, Jr.
David E. Peterson

FEE SCHEDULE

		Hourly Rate
Robert G. Towers	Senior Consultant	$ 135.00
Basil L. Copeland, Jr.	Senior Economist	$ 130.00
David E. Peterson	Senior Consultant	$ 125.00

April 1, 2004

RECEIVED

MAY 2 5 2005

SOUTH DAKOTA PUBLIC UTILITIES COMMISSION

CONTRACT BETWEEN
CHESAPEAKE REGULATORY CONSULTANTS, INC. AND THE SOUTH DAKOTA PUBLIC UTILITIES COMMISSION

This Contract is entered into this ______ day of May, **2005**, between the **South Dakota Public Utilities Commission** (Commission) and Chesapeake Regulatory Consultants, Inc. (Contractor), of 6837 Guilford Road, Clarksville, Maryland 21029-1632. The terms and conditions are as follows:

1. <u>**Scope of Services**</u>: Contractor agrees to provide consulting services to the Staff of the Commission in the following Commission Docket: NG05-002, In the Matter of the Application of Montana-Dakota Utilities Co. for Authority to Increase Rates for Natural Gas Service.

Contractor agrees to assist Commission Staff in the preparation and presentation of testimony on behalf of Commission Staff in the above-referenced docket including: at hearings before the Commission; in settlement proceedings; and in the preparation of motions and briefs before the Commission. Contractor through its witness Robert G. Towers shall be responsible for: review and analysis of Montana-Dakota Utilities Co. (MDU) filings, preparation and receipt of data requests necessary to complete the analysis, preparation, filing and presentation of testimony and exhibits.

Contractor shall also be prepared to respond at hearings and during briefing to intervenors' submissions, if any, which address the issues which are the responsibility of Contractor. Specifically, Contractor Witness Robert G. Towers shall prepare, file, and present testimony and exhibits addressing class cost of service study issues, rate design, accounting issues that may arise, and possibly other issues delegated to Contractor by Commission Staff. Contractor shall provide general assistance on the filing when requested to do so by Commission Staff.

The scope and tasks to be performed shall be consistent with Contractor's proposal dated April 29, 2005, to Commission Staff. Contractor agrees to coordinate their filing with Commission Staff and as directed by Commission Staff, shall consult Commission Staff on requests for MDU data and other submissions or requests to MDU or intervenors. Contractor agrees to complete all tasks and filings within time frames as determined by Commission Staff.

It is understood and agreed that the role of Commission Staff, and in turn the role of the Contractor, shall be to advocate the public interest as Commission Staff views that public interest.

2. <u>**Maximum Reimbursement:**</u> The Commission agrees to reimburse the Contractor for satisfactory completion of Contractor's services in an amount not to exceed Thirty-six thousand four hundred and seventy five dollars and no cents

($36,475). Services shall be paid for on the basis of time actually spent working on the case and for actual out-of-pocket costs at rates consistent with Contractor's proposal to Commission Staff dated April 29, 2005, which is incorporated by reference into this document.

If the Contractor desires to increase the maximum reimbursement under this paragraph, Contractor must notify the South Dakota Public Utilities Commission Executive Director in writing not less than thirty (30) days before monthly billings reach the maximum reimbursement. The Commission reserves the right to deny any request for an increase and may hold the Contractor to the maximum reimbursement in the original contract or amendment.

3. **Reimbursement:** The Commission agrees to reimburse the Contractor upon satisfactory progress toward completion of the tasks outlined in Paragraph 1 of this Contract. Payment up to the amount specified in the Maximum Reimbursement paragraph herein shall be made in monthly installments and shall be based on the monthly financial report as described herein. A copy of the Contractor's hourly fee schedule is appended to this Contract as Exhibit A, which is hereby incorporated herein and will remain effective throughout the term of this Contract.

A monthly financial report shall be submitted by the Contractor which shall include the nature of the work performed, the hours worked by and charges for Contractor's out-of-pocket expenses. Receipts for such expenses shall be available to the Commission upon request. This information is for the express purpose of internal auditing by the Commission. When requesting payment, the time period or phase of service covered will be indicated on the face of the voucher.

The Contractor may not receive progress payments more frequently than monthly. Progress payments shall be based on services rendered and no payment may be made in advance of services rendered. It is agreed that the Commission may withhold ten percent of each progress payment until the satisfactory completion of the contract. Invoices for services rendered shall be sent to the South Dakota Public Utilities Commission, Deputy Executive Director, State Capitol Building, 500 East Capitol Avenue, Pierre, South Dakota 57501, within ten (10) days of the calendar month billed.

4. **Consideration:** The consideration to be paid the Contractor as provided herein shall be in compensation for all Contractor's services incurred in the performance hereof.

5. **Change in Scope of Services:** If the scope of services under this Contract is modified to require additional work not herein contemplated and such modification

is approved by the parties herein prior to performance and a written amendment to this Contract is drawn identifying the approved changes, an authorization of additional funds will be made by the Commission and the maximum amount will be appropriately increased.

6. <u>Indemnity</u>: The Contractor agrees to indemnify, defend and hold harmless the State, its officers, agents and employees from any and all claims and losses accruing or resulting to any and all contractors, subcontractors, material men, laborers and any other person, firm or corporation furnishing or supplying work, services, materials or supplies in connection with the performance of this Contract and from any and all claims and losses accruing or resulting to any person, firm or corporation who may be injured or damaged by the Contractor in the performance of this Contract.

7. <u>Independent Contractor</u>: The Contractor and the agents of the Contractor in performance of this Contract shall act in an independent capacity and not as officers, employees or agents of the Commission.

8. <u>Contract Not Assignable</u>: This Contract is not assignable by the Contractor, either in whole or in part, without the written consent of the Commission.

9. <u>Alteration and Oral Agreements</u>: No alteration or variation of the terms of this Contract shall be valid unless made in writing and signed by the parties hereto. No oral understanding or agreement not incorporated herein may be binding on any of the parties hereto.

10. <u>Interpretation of Inconsistencies</u>: In the interpretation of this Contract, any inconsistencies between the terms hereof and the attachments shall be resolved in favor of the terms hereof.

11. <u>Subcontracts</u>: Contractor shall submit any subcontracts which he proposes to enter into to the Commission for its prior written approval before the Contractor enters into the same. No work may be subcontracted without the prior approval of the Commission. Upon the termination of any subcontract, the Commission shall be notified immediately.

12. <u>Retention of Contractor's Records</u>: The Contractor shall retain all records relating to direct expenses reimbursed to the Contractor hereunder and to hours of employment on this Contract by any employee of Contractor for which the Commission is billed. Such records shall be maintained for a period of three years after termination of this Contract and shall be available for inspection at any reasonable time by personnel authorized therefore by the State of South Dakota.

13. **Relationship of Commission Staff and Contractor:** Commission Staff will be permitted to work side-by-side with Contractor's Staff to the extent and under conditions that may be directed by the Executive Director of the Commission.

14. **Contractor Responsible for Performance of Services:** Contractor will not be permitted to utilize Commission personnel for the performance of services which are the responsibility of Contractor, unless such utilization is previously agreed to in writing by the Executive Director and any appropriate adjustment in price is made. No charge will be made to Contractor for the services of Commission employees while performing coordinating or monitoring functions.

15. **Disclosure and Confidentiality:** The Contractor will not disclose data or disseminate the contents of any final or preliminary report or testimony, in any form, in regard to this Contract without express written consent of the Commission. Permission to disclose information on one occasion shall not authorize Contractor to further disclose such information or disseminate the same on any other occasion.

If requested by the Commission, the Contractor shall require each of its employees or officers who will be involved in the performance of this Contract to agree to the above terms in a form to be approved by the Commission and shall supply the Commission with evidence thereof.

Each subcontract shall contain provisions similar to the foregoing, related to the confidentiality of data and non-disclosure of the same.

16. **Data is Property of the Commission:** Data developed for this Contract shall become the property of the Commission. It shall not be disclosed without the permission of the Executive Director. Each final report submitted shall also become the property of the Commission and shall not be disclosed except in such manner and time as the Executive Director may direct.

17. **Amendment:** The timing for the performance of the tasks and items contained herein, the total contract price, the date for completion of the Contract, as well as, all other terms not specifically accepted may only be altered by formal written amendment of this Contract.

18. **Waiver:** No waiver of any breach of this Contract shall be held to be a waiver of any other or subsequent breach. All remedies afforded in this Contract shall be taken and construed as cumulative; that is, in addition to every other remedy provided therein or by law. The failure of the Commission to enforce, at any time, any of the provisions of the Contract shall in no way be construed to be a waiver of such provisions, nor in any way affect the validity of this Contract or any part thereof, or the right of the Commission to hereinafter enforce each and every such provision.

19. **Time is Critical:** Time is of the essence in this Contract. In the event Contractor

shall fail to perform the agreements on its part to be performed at the time fixed for performance of such respective agreements by the terms of this Contract or by any extension, the Commission may, at its election, terminate the Contract. Such termination shall be in addition to and not in lieu of any other legal remedies provided by this Contract or by law.

20. **Breach of Contract:** In the event of any breach of this Contract, the Commission may, without any prejudice to any of its other legal remedies, terminate this Contract in accordance with the provisions of the Termination paragraph of this Contract.

21. **Duration of Contract:** Unless otherwise specifically provided by the terms of this Contract or by amendment thereof, the duration of this Contract shall be one year from the contract date.

22. **Termination:** The Commission may terminate this Contract, should Contractor fail to perform the covenants herein contained at the time and in the manner herein provided, upon five days written notice to the Contractor. In such event, the Commission shall pay the Contractor only the reasonable value of the services theretofore rendered by the Contractor as may be agreed upon by the parties or determined by a court of law. In the event of such termination, the Commission may proceed with the work in any manner deemed proper by the Commission. The Commission's cost of securing substituted performance shall be deducted from any sum due the Contractor under this Contract, with the balance, if any, to be paid the Contractor upon demand.

23. **Payments Include All Taxes:** Payments to be made to the Contractor, as specified herein, shall include all taxes of any description, federal, state and municipal assessed against the Contractor by reason of this Contract.

24. **Workers' Compensation Insurance:** The Contractor hereby warrants that it carries workers' compensation insurance for all of its employees who will be engaged in the performance of this Contract and agrees to furnish to the Commission satisfactory evidence thereof at any time the Commission may request.

25. **South Dakota Law Controlling:** It is expressly understood and agreed that this Contract shall be governed by the laws of the State of South Dakota, both as to interpretation and performance. Otherwise, as specified herein, no document or communications passing between the parties hereto shall be deemed a part of this Contract.

APPROVED AS TO FORM:

Sara B. Greff, Assistant Attorney General DATE

COMMISSION:

GARY HANSON Chairman	ROBERT K. SAHR Commissioner	DUSTIN M. JOHNSON Commissioner

CONTRACTOR:

By:

Robert G. Towers, President
Chesapeake Regulatory Consultants, Inc.

5/24/05
Date