

Rebuttal Testimony
Laura McCarten

Before the South Dakota Public Utilities Commission
State of South Dakota

In the Matter of the Application of Northern States Power Company,
a Minnesota corporation
For Authority to Increase Rates for Electric Service in South Dakota

Docket No. EL11-019
Exhibit____(LM-2)

Earned Return

April 27, 2012

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I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Laura McCarten. I am Regional Vice President for Northern States Power Company, a Minnesota corporation (“NSP” or “the Company”) with electric and natural gas operations in South Dakota. My business address is 414 Nicollet Mall, Minneapolis, MN 55401.

Q. HAVE YOU PREVIOUSLY FILED DIRECT TESTIMONY AND SCHEDULES IN THIS PROCEEDING?

A. Yes, I have. I sponsored testimony providing: an overview of our rate case filing, summarizing the need for a general electric rate increase. I discussed infrastructure improvements, our efforts to manage costs in a challenging economic environment, and compliance with increasing regulatory requirements.

Q. WHAT IS THE PURPOSE OF THIS CURRENT TESTIMONY?

A. My purpose is to convey the actual result if the Commission were to adopt the recommendation of Mr. Basil L. Copeland, Jr. on Return on Equity (“ROE”), to explain why the Commission’s decision on ROE must reflect due consideration of this result, and to support an ROE decision that minimizes the obstacles for reasonable financial performance for the Company’s South Dakota electric operations.

II. EARNINGS AND REGULATORY LAG

Q. WHY IS THE ROE IN THIS CASE PARTICULARLY IMPORTANT TO THE COMPANY?

1 A. In the past 5 years, the Company has invested approximately \$5 billion in our
2 system and we are forecasting additional investments of approximately \$5.8
3 billion in the next 5 years (2011 through 2014). ROE has added importance in a
4 time of heavy investment, and the Company's actual earnings from its South
5 Dakota electric operations have been far below both reasonable levels and
6 authorized levels. As a result, the Commission's decision ROE decision in this
7 case will be seen as reflecting the level of support for those plans. NSP witness
8 James M. Coyne explains the regulatory compact under which a utility must
9 provide safe and reliable service and the returns allowed by regulators must be
10 fair in relation to comparable investments and allow the utility an opportunity to
11 maintain its financial health and obtain access to capital markets at a reasonable
12 cost. If the ROE does not meet these standards, the utility's financial health and
13 access to capital will be impaired, and its ratepayers will face higher long run
14 costs of capital. It is also clear from Mr. Coyne's Rebuttal Testimony that Mr.
15 Copeland's entire range of ROEs and his ROE recommendation is far below any
16 ROE that has been recently awarded to an electric utility in any other
17 jurisdiction. In this context, the Commission's ROE decision in this case takes
18 on added significance as a reflection of the Commission's position regarding
19 investments by the Company.

20
21 Q. WHAT IS THE COMPANY'S EXPECTED FINANCIAL PERFORMANCE UNDER MR.
22 COPELAND'S RECOMMENDED 9.0 PERCENT ROE?

23 A. If the Commission were to approve a ROE of 9.0% in this case, we project that
24 our actual 2012 earned ROE would be approximately 6.3%. This level of ROE
25 is not only much less than the 9.0% recommended by Mr. Copeland, it is far
26 below a reasonable level by any measure. This projected ROE level assumes we
27 are allowed full recovery of the Nobles Project (discussed in Mr. Alders' Rebuttal

1 Testimony), all elements of the proposed Settlement Stipulation (not yet finalized
2 by the Company and Commission Staff), and our assumed 2012 sales
3 projections.

4
5 Q. WHY THE LARGE DIFFERENCE BETWEEN THE PROJECTED ACTUAL AND ALLOWED
6 ROE?

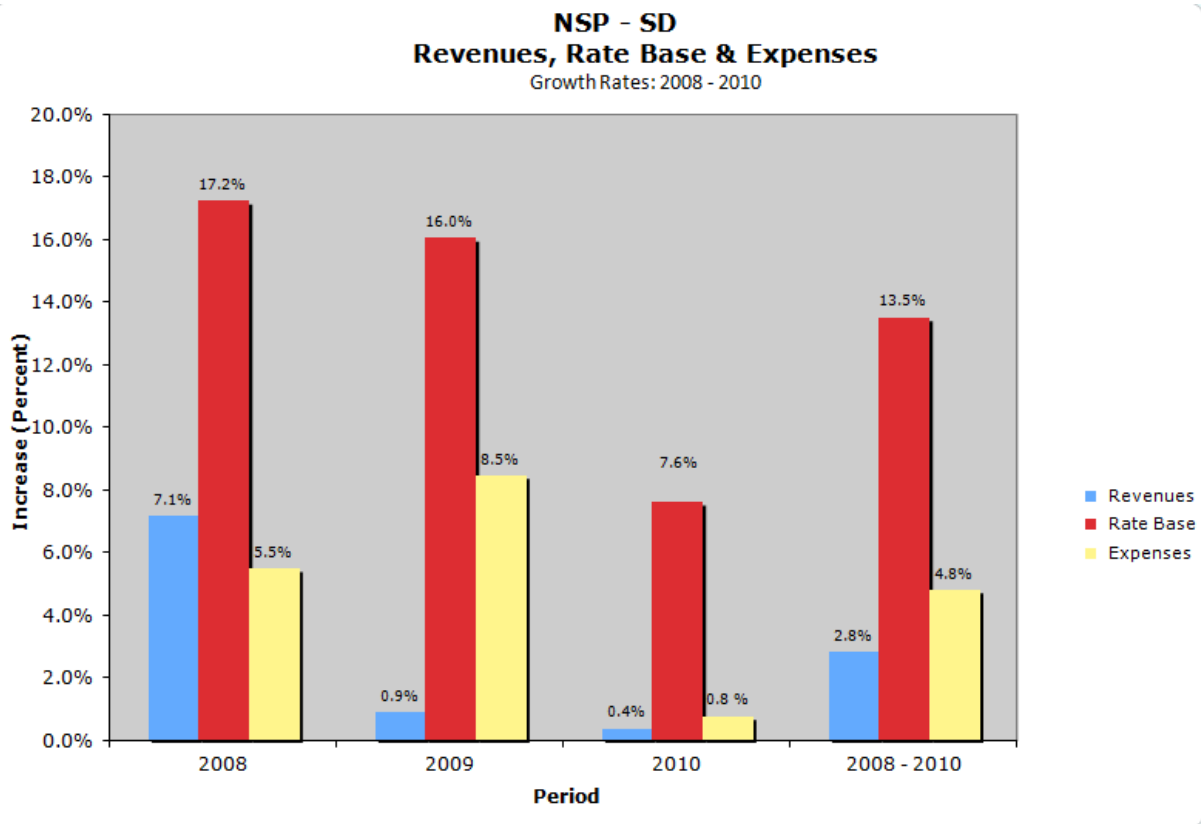
7 A. A confluence of factors has created this situation. One significant factor is South
8 Dakota's use of a historic test year, which builds in a significant delay between
9 the time that an investment is made and the time when we are able to obtain the
10 rate levels needed to recover the costs of those investments. During a time of
11 very substantial investments, as we are now in, the time lag between when the
12 investments are made and the time when the costs are included in rates causes an
13 ongoing under-recovery of costs and significant ongoing reductions in earnings.
14 In the past, when investments were at a lower level, the use of a historic test year
15 did not result in such a severe gap between costs and revenues, and hence
16 earnings. However, other factors, explained below, have exacerbated the
17 situation for this rate case, at this time. These factors include:

- 18 i. Significant increases in investment necessary to meet customers' needs,
19 both on a system-wide level and to our local South Dakota service area;
- 20 ii. Near-flat sales levels, which has all but eliminated sales growth as an
21 offset to the revenue and earnings gaps;
- 22 iii. The extended length of time this case has experienced; and
- 23 iv. Our inability to completely update to actual costs through 2011.

24
25 Q. WHAT IS THE SIGNIFICANCE OF NSP'S CURRENT AND PROJECTED LEVELS OF
26 INVESTMENTS?

1 A. As explained in our original filing, we are making necessary investments to
2 maintain, improve and replace infrastructure on our system in order to maintain
3 safe and reliable service to our customers. The investments we have made and
4 are continuing to make in our local distribution facilities and system are
5 increasing our rate base to such a level that it is consistently growing at a much
6 faster pace than can be offset by any revenue increases resulting from customer
7 usage (without rate increases). Our capital investments are being driven by
8 infrastructure needs, not by increasing usage levels. I present in the following
9 chart a comparison of the growth of our revenues, rate base and expenses from
10 2008 through the 2010 test year.

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14 As shown in this chart, the growth in rate base in each of the years 2008-2010
15 greatly exceeds the growth rate in revenues for those years. Rate base has grown

1 by 13.5% over this period, while annual revenues have grown by only 2.8%. This
2 data makes clear how our large capital investment needs contribute to the
3 Company' ongoing earnings deficiencies.

4
5 Q. PLEASE EXPLAIN BRIEFLY HOW THE OTHER FACTORS YOU NOTED CONTRIBUTE
6 TO THE LARGE GAP BETWEEN ALLOWED AND ACTUAL ROE IN 2012:

7 A. Weak sales levels contribute to the gap in 2012, which is unlike some prior years.
8 Prior to 2008, sales growth in our South Dakota jurisdiction had been quite
9 robust, even while other areas of our NSPM service region were growing much
10 more slowly. This strong South Dakota growth provided offsetting revenue to
11 help cover growing costs to serve customers. We experienced significantly
12 reduced sales in 2008 and 2009 because of the economic downturn. While sales
13 improved somewhat in 2010, sales in 2011 increased only slightly over 2010 and
14 clearly will not be able to offset the increased cost of service to customers.
15 Expectations are not much different for 2012.

16
17 Further, compounding the problem for 2012 is the extended period during
18 which this case has been in process. While it was helpful to be able to
19 implement interim rates (subject to refund) beginning in January 2012, the
20 passage of time since filing this case has brought us to having another historic
21 year completed for 2011. Although that year was complete, we were unable to
22 update our costs to fully reflect actual results for 2011, leading to an additional
23 12 month gap between our costs in 2012 and our rates based on 2010 levels.
24 Without being able to update this current case for all of 2011 actual experience, it
25 will be necessary for us to prepare another rate case immediately.

26

1 Q. IN LIGHT OF THESE FACTORS, IS THERE ANYTHING THAT CAN BE DONE IN THIS
2 DOCKET TO PROVIDE THE COMPANY A REALISTIC OPPORTUNITY TO EARN A
3 REASONABLE ROE?

4 A. The only factor the Commission can influence in this docket to affect the
5 Company's actual 2012 earning opportunity is the authorized ROE. The
6 Commission can, and should, reduce the imbalance these circumstances created
7 by authorizing a higher ROE than Mr. Copeland's recommended level of 9.0 %.
8 While a higher ROE cannot eliminate the earnings deficiencies, a reasonable
9 ROE will at least mitigate the severe deficiency and will also show that there is
10 support for our investments in our electric system. To illustrate, if the
11 Commission authorized an ROE at the top end of our recommended range, we
12 still will not earn anywhere close to that allowed ROE in 2012. We would earn
13 approximately 8.1% at our recommended 10.65% ROE.

14
15 Q. IS THERE ANY RISK OF OVER-EARNING AS A RESULT OF THE ROE IN THIS CASE?

16 A. No. The other factors noted above will still act to depress actual 2012 earnings
17 to a level well below whatever level the Commission authorizes in this rate case.
18 There is virtually no chance of actually earning the authorized return for the
19 foreseeable future let alone earning over-earning in our South Dakota
20 jurisdiction.

21
22 Q. WITH THE CONTINUED HIGH LEVELS OF CAPITAL INVESTMENTS AND PROJECTED
23 SLOW SALES GROWTH OVER THE NEXT FEW YEARS, DO YOU SEE ANY
24 OPPORTUNITY TO BE CREATIVE IN THE APPROACH TO RATEMAKING GOING
25 FORWARD?

26 A. Yes, I certainly do. New legislation was recently passed, with the support and
27 guidance of the Commission, to allow for an even more forward look for

1 ratemaking than is the current practice, and we have started thinking about the
2 implementation of a Phase-in Rate Plan in the near future. Looking ahead, we
3 are interested in working with the Commission and other stakeholders to create a
4 constructive, sustainable framework, one which we can both be confident will
5 provide the Company a fair chance to earn the ROE you authorize.

6
7 **III. CONCLUSION AND RECOMMENDATIONS**

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9 Q. PLEASE SUMMARIZE YOUR CONCLUSIONS AND RECOMMENDATIONS.

10 A. The Company has made and continues to make very substantial investments in
11 its system, including its South Dakota electric operations. As we have shown, as
12 a result of circumstances outside its control, the Company will not earn a
13 reasonable return from its South Dakota electric operations no matter what ROE
14 is awarded. In light of this reality, and in keeping with that aspect of the
15 regulatory compact that recognizes the reasonable needs of the utility, we
16 respectfully urge the Commission act to limit the Company's certain severe
17 under-earning in 2012 by authorizing an ROE in the higher end of the range of
18 reasonableness defined by the Company's witness. Such a decision by the
19 Commission in this case would limit the level of under-earning and would signal
20 the Commission's level of support for further investment.

21
22 Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

23 A. Yes it does.

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