BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF SOUTH DAKOTA

IN THE MATTER OF THE APPLICATION OF NORTHERN STATES POWER COMPANY DBA XCEL ENERGY FOR AUTHORITY TO INCREASE ITS ELECTRIC RATES	))))	**XCEL ENERGY BRIEF** **EL11-019**

OVERVIEW

Northern States Power Company submits this Brief in support of its recommendations with respect to the remaining contested issues of: 1) the appropriate return on equity ("ROE") and capital structure; and 2) recovery of the Nobles Project ("Nobles") costs. We worked diligently with Staff and achieved settlement on all other issues in this case. Our decision to bring these contested issues forward for the Commission's review reflects our acknowledgement that these are very critical issues, the decisions on which will have very significant, long term implications on our business and our South Dakota customers. As such, it is appropriate to involve the Commission in full consideration of and decision on these issues. We are confident that the Commission will act to weigh the evidence on these issues and seek a just and reasonable outcome that balances the Company's needs and interests along with customers' interests.

We initially requested a $14.6 million increase. Since the time of the initial filing, the Company and Staff agreed to numerous adjustments and these adjustments were included in the Settlement Stipulation approved by the Commission in this docket. We have also modified our initial ROE request of 11.00 percent to 10.65 percent to reflect changes in market conditions. Our current request now before the Commission reflects an appropriate balancing of interests between ratepayers and investors and, with these adjustments in place, if the Commission accepts the Company's position on ROE, capital structure and Nobles, the Company's final request is reduced by approximately $2.6 million, to just under $12 million. At this level, our actual 2012 earned return will be no higher than 8.1 percent, a level far below what can be considered reasonable. If the Commission accepts Staff's position, the revenue deficiency would be reduced to $6.3 million and our actual 2012 earned return would fall to 6.3 percent, a level even further below what may be considered a reasonable rate of return. This fact is highly relevant to the Commission's balancing role, which includes seeking an outcome that will allow the Company a fair opportunity to achieve reasonable financial performance.

The 9 percent ROE recommendation of the Staff witness Mr. Basil Copeland would put South Dakota well below even the lowest group of other state-awarded ROEs in the nation, a position that does not reflect the balancing of customer and investor interests. As we explain later in the Brief, our position on ROE is well within the national norm and is appropriate for our current circumstances. We have provided evidence that the Nobles wind project is cost-effective for South Dakota customers. Our position on the Nobles wind project is to allow recovery of prudently incurred costs--a standard that the South Dakota Commission has applied for decades and one that reflects the benefits to South Dakota customers of the integrated NSP system.

In making its determination in this case, the Commission should recognize the practical outcomes in assessing how to achieve the balance it needs to apply. A decision that results in an earned ROE of 6.3 percent in the year that rates take effect (typically the high point in achieved returns) is not sustainable for the Company to remain an engine of economic development in this State nor would it be appropriate based on the evidence presented in this case.

DISCUSSION

I. Commission Standard

In determining just and reasonable rates, the Commission is to consider the public need for adequate, efficient, economical and reasonable service and the public utility's need for revenues sufficient to enable it to meet its cost of service and to earn a fair and reasonable return.[1] These regulatory standards create a framework under which both ratepayer and utility interests are properly balanced.

We recognize that we bear the burden of proof to show that our proposed rates are just and reasonable and we fully accept that burden.[2] As discussed in the following sections of this Brief, the testimony demonstrates that the Company proposed ROE is reasonable, the proposed capital structure is reasonable, and that the costs of Nobles satisfy the standard of SDCL § 49-34A-8 in that these costs are appropriate to provide: "adequate, efficient, economical, and reasonable service" for our South Dakota customers.

II. ROE and Capital Structure

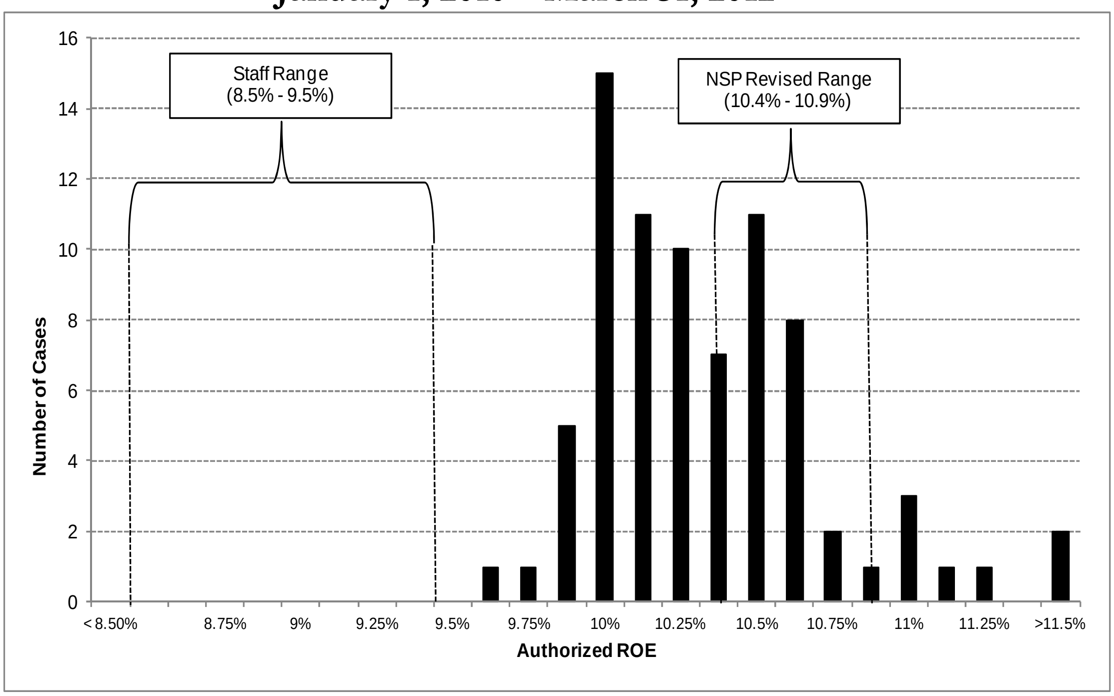
A reasonable ROE must be comparable to returns available from other investments of similar risk, and sufficient to attract capital.[3] The primary test for the adequacy of an allowed return turns on the results of the analysis rather

[1] SDCL § 49-34A-8.
[2] SDCL § 49-34A-8.4.
[3] *Northwestern Public Service v. Cities of Chamberlain, etc.,* 265 N.W.2d 867, 873 (S.D. 1978), quoting *Federal Power Commission v. Hope Natural Gas Co.,* 320 U.S. 591, 603 (1944).

than the steps taken during the analysis.[4] That is, the test focuses on whether the "total effect of the rate order [is] unreasonable."[5]

Thus, determining a reasonable ROE requires the exercise of the Commission's sound judgment. Our proposed 10.65 percent ROE meets the standard of comparability to returns from other investments, and thus the related standard of sufficiency to attract capital. This is supported by the following chart, which shows the results of 79 other regulatory ROE decisions from January 2010 to March 2012.

Authorized ROEs for Integrated Electric Utilities
January 1, 2010 – March 31, 2012[6]



The chart shows that the Company's proposed 10.65 percent is comparable to the returns authorized other integrated electric utilities, while even the top of Mr. Copeland's ROE range is far below any other authorized

4 *Hope Natural Gas Co.*, 320 U.S. at 602 (1944).
5 *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 310 (1989).
6 Coyne Rebuttal at 6; Source: Regulatory Research Associates.

ROE. There is no plausible explanation for such a divergence. Stated simply, if Mr. Copeland's recommendation is right either: (i) all other regulatory agencies must be very wrong in their approach to ROE; or (ii) the Company's electric operations in South Dakota must have a significantly lower risk than any other jurisdiction. There is no support for either of those hypothetical explanations. Similarly, there is no support for the conclusion that conditions in 2012 justify such a departure from the norm. In 2012, there have been 13 regulatory decisions awarding ROEs. The average of those 13 decisions was 10.15 percent, with a range of 9.80 percent to 10.50 percent.[7]

The large discrepancy in recommended ROE comes down to primarily one aspect of the ROE analysis, the appropriate growth rate. As a result, the Commission's role in finding the right answer is more straightforward than if there were a large number of differences.[8] Further, we believe the Commission will agree that we have the more reasonable approach in principle and in terms of outcome.

As the Commission weighs which data to consider, it is helpful to keep in mind what ROE experts are trying to do. The ROE is the aggregate of investors' perceived expectation of a market return that allows them to elect a particular investment over another. Because the growth component of the Discounted Cash Flow ("DCF") model is not observable, the Commission

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[7] See Coyne Surrebuttal at 3, Ex. __ (JMC-2), Schedule 1. To put this in a local context, in December 2011 and in 2012, four sister jurisdictions within Xcel Energy received ROE awards of 10.40 percent (NSP-Wisconsin); 10.40 percent (NSP-Minnesota ND); 10.37 percent (NSP-Minnesota MN); and 10.00 percent Public Service of Colorado. While South Dakota remains a smaller jurisdiction within the Xcel Energy Company, its share of the deficiency is growing to the point where that deficiency is very noticeable even as part of this large system.

[8] A much smaller difference relates to inclusion of flotation costs in the Company's analysis. Flotation costs for stock issuances are like the costs of issuing debt in that they are not fully recovered in the year of a stock issuance but rather over a long term. Dane Direct at 21-23. As a result, debt issuance and flotation costs should be recovered even if there is no debt or stock issuance in the test year. Recovery of flotation costs is even more appropriate for the Company as a result of its ongoing, very substantial investments.

must exercise judgment in determining investor expectations of growth. We determined the growth rate based solely on forecast earnings growth. This approach is appropriate for three basic reasons: 1) investors look to earnings growth as the fundamental source of long term growth; 2) earnings growth data is the only consensus data that is widely available to investors; and 3) the use of earnings growth is supported by research.[9]

In contrast, Mr. Copeland's growth rate is skewed downwards as the result of giving 3/4ths weighting to the book value, dividend and "% Retained to Common Equity" growth rates, none of which are appropriate inputs to estimating growth rates when attempting to measure investor expectations. These inputs are not appropriate because: 1) they are not reported by most analysts, making it unlikely they are relied upon by investors; 2) they are more influenced by short run management decisions, thus overlooking the long run perspective; and 3) they ignore the potential of growth from stock issuances (in the case of the Percentage retained for Common Equity).[10]

In addition, the capital structure used by Mr. Copeland does not match the test year. We compute the capital structure and the rate base with consistent and matching data using a 13-month average because the capital structure provides the funding for and is directly connected to the rate base.[11] In contrast, Mr. Copeland relies on mismatched data by using a year-end 2010 capital structure and a 13-month average rate base.

Although not directly related to the numeric analysis, Mr. Copeland also presented a discussion of spreads between equity returns and yields on Treasuries that is worth addressing. While we acknowledge that it seems less than intuitive that costs of equity have remained relatively high compared to

[9] Coyne Rebuttal at 15-16; Coyne Surrebuttal at 5.
[10] *Id.* at 15-17.
[11] *Id.* at 42-43.

substantially lower interest rates, understanding why is important in reaching the right balance on ROE. Mr. Copeland did not address the fact that the turbulent and volatile economic conditions that have persisted since September 2008 have led to artificially low interest rates due to policy initiatives by the Federal Reserve, as well as the fact that many investors are now far more reluctant or unwilling to invest in equities and have instead sought the safety of Treasuries. These factors have increased relative demand for Treasuries and have led to an increase from the historic spreads between Treasury yields and equity returns. In striking the right balance on ROE, it is important to take into account that the risk inherent in equity investments has become less attractive, and this is what has driven the increase in the spread between equity returns and Treasury yields.

An additional reasonableness check on the ROE analysis is that the Company does not have any expectation that it can, under the current regulatory framework, earn its authorized return. Company witness Ms. Laura McCarten's Rebuttal testimony shows that the Company has experienced inadequate returns in prior years, and will also experience a return deficiency in 2012.[12] The Company projects no more than an 8.1 percent return for 2012, even with a 10.65 percent ROE and Commission approval of full recovery of Nobles costs. Consequently, the Company will not achieve a reasonable ROE in 2012, even under the best of circumstances.

If the Commission selects the ROE proposed by Mr. Copeland and adopts Staff's Nobles adjustment, the Company's actual earned ROE for 2012 would be 6.3 percent at best, compounding the issues associated with the current regulatory framework that cannot be addressed in this proceeding. We

[12] McCarten Direct at 14-15 (showing an actual ROE (adjusted for normal weather) of 4.23% for 2009 and 2.64% for 2010) and McCarten Rebuttal at 2 showing an actual ROE (adjusted for normal weather) of 6.3% for 2012 at a 9% authorized ROE and 8.1% for 2012 at a 10.65% authorized ROE). By comparison, our weighted cost of long term debt is 6.13%. *See* Coyne Rebuttal at 5.

urge the Commission view the evidence in the record with a common sense approach to assessing reasonableness in this case. An earned return on equity coming out of a rate case that is almost equal to our weighted cost of debt (6.13 percent) will not be sufficient to attract capital. Mr. Coyne's rebuttal testimony explains the negative impact on earnings caused by a combination of: (i) substantial new annual investments; (ii) historic test years and the resulting regulatory lag; and (iii) prior low authorized returns.[13] The harm from an ROE that is not reasonably comparable (and is therefore insufficient to attract capital) would be compounded by the very substantial investments being made by the Company.[14]

The Company has been and will continue to be making significant investments in our generation, transmission and distribution infrastructure.[15] These substantial annual investments heighten the adverse effect of the timing lag inherent in the use of historic test years because rates never catch-up to investment levels. While these effects cannot be resolved in this case, it is appropriate for the Commission to acknowledge these factors when making its decision on a reasonable ROE. The Company is a long-term business and has been an important asset to the State's overall economy, and we believe the Commission will seek an outcome that treats customers fairly but does not hamper the Company's ability to attract investment in the State.

We are confident that this Commission understands the need for a utility to earn a return comparable to other utilities in order to foster continued investment in reliable electric service. While the financial differences between the Company and Staff's position on ROE are great, the reasons for that difference are limited and we believe that all of the evidence taken together

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[13] Coyne Rebuttal at 7-10.
[14] McCarten Direct at 5.
[15] *Id.*

would suggest an ROE at or very near the Company's recommended return.

III. Nobles

The question presented on Nobles is whether it is a prudent, economical, efficient, and reasonable and necessary resource to serve our South Dakota customers.[16] The evidence demonstrates that Nobles is a cost-effective resource for our customers and the Commission should grant cost recovery of the Nobles investment in this case. While we disagree with Staff's analysis that the test for cost recovery is only whether a resource is least-cost, the Commission does not need to consider the issue with respect to Nobles since the evidence in the record supports that Nobles is a least-cost resource and therefore qualifies for cost recovery even based on that limited standard.

Three separate analyses each support finding Nobles to be a cost-effective source of energy for our customers. Before selecting Nobles, we conducted two Strategist models; a very conservative model, and a model that better reflects the standalone value of Nobles. The conservative model ignored that Nobles would be the next wind project added to the Company's generation portfolio and instead assumed that 2000 MW of additional wind was added ahead of Nobles and the result of this assumption led to disagreement among the parties.

In reality, Nobles is being added before 2000 MW of future wind generation. When evaluated on a standalone basis as the next unit of wind generation to be added, Nobles shows between $4 million and $80 million in savings to our customers, reflecting a range between zero to $17 per ton cost for carbon.[17] The more realistic, incremental modeling reflects the true

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[16] SDCL §49-34A-8.4.

[17] *Id.* at 16. At the $17/ton for carbon regulation costs used by the Company in its analysis, the savings are $80 million. In its analysis of potential carbon costs, the Company assumed $17 per ton because that is the middle of the range identified by the experts in a Minnesota Commission

position of Nobles in dispatch and the impact of adding Nobles at the time the decision was made. The modeling done under the "real life" scenario in which Nobles operates shows Nobles as displacing energy from the higher-cost units it actually displaces and, as a consequence, that Nobles is a cost-effective resource.[18] While we acknowledge that this additional modeling which turns the economic analysis from a slight cost to a benefit was not identified earlier in this proceeding, the facts underlying the appropriate incremental analysis are accurate and should provide significant comfort to this Commission that the Nobles resource met the traditional cost effectiveness test.

We also compared the cost of Nobles against forecasts of the cost of obtaining the energy from the MISO market. Using market forecasts available at the time of the selection of Nobles demonstrates that obtaining an equivalent amount of energy from the MISO market would have been \$3.05/MWh more expensive.[19] This MISO market price reflects the effect of high gas prices on the market price for energy at the time Nobles was selected. This evaluation, in combination with the Strategist modeling addressed by Mr. Alders, demonstrates that Nobles was the right resource to serve our customers' energy needs.[20]

We believe that, in balancing the interests of customers and investors, the Commission should also recognize that the Company conducts its resource

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proceeding to determine that precise issue. MPUC Docket No. E999/CI-93-583. In addition, at the time we made the decision to invest in Nobles, there was active legislation in Congress to implement carbon regulation and the long range cost being discussed at that time was in the \$12 to \$21 range. In any case, even assuming a \$0/ton cost of carbon shows a \$4 million savings for our customers as a result of the Nobles addition.

[18] As Mr. Alders' testimony shows, even if Nobles were the last unit of wind added to meet all of our States' renewable energy requirements, Nobles would still be very cost competitive – within 0.11 percent, approximately \$64 million in PVRR, of the no-build alternative. Alders Rebuttal at 14.

[19] *Id.* at 18.

[20] While market prices may have changed in the years since Nobles was selected due to unexpected falling gas prices, the Commission evaluates a resource selection based on the information available at the time the decision was made. *In re Black Hills Power,* Docket No. EL09-018 (August 11, 2010) at pp. 24-25.

planning based on system needs. Rather than picking and choosing certain resources to serve certain loads, we determine needs based on a forecast of the number of customers and MWh sales on a system basis. It is appropriate to consider the benefits to South Dakota of being served using an integrated generation and transmission system when evaluating whether the standards for cost recovery have been satisfied; and the consequences if resources were instead provided to South Dakota on a standalone basis. A large integrated system allows us to: a) reduce the total amount of generating resources used to reliably serve customers; b) diversify the fleet of generating resources required to meet our customers' needs, lowering costs and risks; and c) lower costs by spreading costs over a substantially larger customer base.[21]

Minnesota does have a different renewable energy standard than South Dakota; the Company is required to comply with the state laws in each of the states in which it operates, and state laws that result in costs being incurred by a utility are a cost of providing service recoverable pursuant to SDCL § 49-34A-8.[22] The Company carefully evaluates resources necessary to meet the goals and objectives of the states in which we operate and we make investments that are demonstrated to be in the best interests of all of our customers. The Company has proceeded to comply with these goals and requirements because doing so results in both the achievement of the policy goals of the States in which we provide service and provides cost-effective resources for our customers.

In addition to being a cost-effective energy resource, Nobles provides further value to our South Dakota customers that they would not receive if the

[21] Alders Rebuttal at 24-25, with a more detailed discussion of each benefit at 25-31.

[22] Consider for example, property taxes on generation facilities. Those property taxes are a direct reflection of state legislative and local government policies on how best to fund government. As a cost of owning the generation used in our integrated system to provide service in South Dakota, property taxes from each state are properly allocated to South Dakota customers.

Commission were to deny cost recovery of all or a portion of the costs of Nobles. Those benefits (e.g. free energy, renewable energy credits (RECs), production tax credits (PTCs), and bonus depreciation) should be reallocated to those jurisdictions that fully participated in paying Nobles costs. Based on the cost of replacement energy, reallocated PTCs, replacement capacity costs and reallocated RECs, those lost benefits would be worth $681,000 in 2012; increasing to $828,000 in 2015; and $991,000 in 2020.[23] In addition, $180,000 of the $600,000 bonus tax depreciation (spread over the next several years) would not be allocated to South Dakota. Consequently, the lost benefits are greater than Ms. Maini's proposed disallowance of $612,000. Again we are confident that the Commission recognizes that a fair and balanced regulatory scheme means that it cannot keep the benefits that are directly associated with disallowed costs. These facts further support finding that Nobles is cost effective.

In addition, all Nobles investment costs were prudent. There is no basis for limiting Nobles cost recovery to the level of preconstruction cost estimates presented by the Company to the Minnesota Commission when the Company sought approval of a Minnesota special rate rider to recover Nobles costs.[24] Under Ms. Maini's recommendation, the Company's requested cost recovery would be reduced by $113,000. However, these incremental actual costs were a necessary and reasonable cost of bringing the project on line. The costs used in Strategist modeling were the developer's costs and did not include the associated costs of payments to landowners, compensation for crop damage, sales tax, builders risk insurance, transmission interconnection, and similar items. The exclusion of these costs would not have affected the selection of

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[23] Alders Surrebuttal at 11-12.

[24] The Minnesota Commission approved recovery of Nobles costs in its order in MPUC Docket No. E002/GR-10-971.

Nobles because these same costs would have been incurred by competing projects and the magnitude of the costs, approximately 2 percent of total project costs, did not change the cost-effectiveness of the project. Because the costs were necessary and prudent, the Company is entitled to recover them.

Finally, the Commission's standard for reviewing and approving cost recovery is whether the investment was prudent, economical and efficient and reasonable and necessary to provide service.[25] The facts demonstrate that the selection of Nobles satisfies the prudent, efficient, economical and reasonable and necessary to provide service requirements of the statute.

CONCLUSION

The Commission's decisions on these issues are of fundamental importance to the financial health of the Company. Simply adopting the Staff's positions would upset the balancing of investors' and customers' interests that the Commission is tasked with achieving. The evidence in this case and the ratemaking principles that guide the Commission in setting rates support a 10.65 percent ROE and a 13-month average capital structure. These components lead to an overall rate of return of 8.52 percent. Use of Staff's point estimate ROE or even the upper end of Staff's range will put the Company's ROE below even the bottom of the range of recent awards granted to similarly situated utilities and make our current underearning situation even more pronounced compared to our peers.

Similarly the evidence in this case and the ratemaking principles that guide the Commission justify allowing full cost recovery for Nobles. Our decision to move forward with Nobles was based on the fact that it would provide a cost-effective energy resource for the system. Our South Dakota

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[25] SDCL § 49-34A-8.4.

customers benefit from both Nobles and from participation in the Company's integrated system and undoing the integrated system would necessarily assign away benefits from South Dakota that it is not contributing toward. Finally, the small difference between final project costs and the estimate at the point of the regulatory review, roughly 2 percent, is not unusual for a large construction project and is not the basis for a disallowance.

The Company has worked hard to resolve issues with Staff where it could. The issues of ROE, capital structure and Nobles recovery are of the magnitude that will have significant consequences for the Company. In both cases, our positions are well within the zone of reasonableness, consistent with the Commission's standard ratemaking principles, fully supported by the evidence in the record, and consistent with the Commission's balancing of interests between ratepayers and shareholders. We ask that the Commission recognize this by approving our proposed ROE, capital structure, and full cost recovery for Nobles.

Respectfully submitted this 6th day of June, 2012,

By:

/s/

Kari L. Valley
Assistant General Counsel
Northern States Power Company
414 Nicollet Mall, 5th Floor
Minneapolis, MN 55401
(612) 215-4526