BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF SOUTH DAKOTA

IN THE MATTER OF THE APPLICATION OF MONTANA-DAKOTA UTILITIES CO. FOR AUTHORITY TO INCREASE ITS NATURAL GAS RATES

STAFF MEMORANDUM SUPPORTING SETTLEMENT STIPULATION

DOCKET NG12-008

Commission Staff (Staff) submits this Memorandum in support of the Settlement Stipulation (Settlement) of October 24, 2013, between Staff and Montana-Dakota Utilities Company (MDU or Company) in the above-captioned matter.

BACKGROUND

On December 21, 2012, the Company filed an application with the South Dakota Public Utilities Commission (Commission) requesting approval to increase rates for natural gas delivery service to customers in its South Dakota retail service territory by approximately $1.5 million annually or approximately 3.3%. A typical residential customer in the Black Hills area using 75 dkt on an annual basis would see an average increase of approximately $3.00 per month while a typical residential customer in the East River area using 61 dkt on an annual basis would see an average decrease of approximately $1.10 per month (based on an average use of 75 dkt, an East River residential customer would see an average decrease of approximately $2.43 per month).

MDU's proposed increase was based on a historic test year ended June 30, 2012, adjusted for what MDU believed to be known and measurable changes, a 10.5% return on common equity, and an 8.101% overall rate of return on rate base.

The Commission officially noticed MDU's filing on December 28, 2012, and set an intervention deadline of February 22, 2013. On January 18, 2013, the Commission issued an Order of Assessment of Filing Fee and Suspension of Imposition of Tariff. On February 19, 2013, Federal Executive Agencies (FEA) filed a Petition to Intervene. On March 6, 2013, the Commission issued an Order granting intervention to FEA. The Commission received a Petition to Withdraw from FEA on April 19, 2013, and on May 10, 2013, the Commission issued an Order Granting Withdrawal.

On May 21, 2013, the Commission issued an Order for and Notice of Procedural Schedule and Hearing setting the matter for hearing on October 29-31, 2013. On June 19, 2013, MDU filed a Notice of Intent to Implement Interim Rates effective on and after July 22, 2013.

Settlement discussions between Staff and MDU commenced on September 12, 2013. On September 19, 2013, Staff filed a letter stating Staff and MDU agreed to modify the procedural schedule to delay the filing of Staff's testimony that was to be filed on September 27, 2013, until October 1, 2013. Staff filed testimony and exhibits supporting its case on October 1, 2013. Prior to Staff filing testimony and thereafter, Staff and MDU (jointly, the Parties) held several settlement discussions in an effort to arrive at a mutually acceptable resolution of the issues presented in MDU's filing. Ultimately, the Parties reached a comprehensive agreement on MDU's overall revenue deficiency and other issues presented in this case including, but not limited to, rate area consolidation, class revenue responsibilities, rate design, and tariff concerns.

On October 18, 2013, MDU filed a letter requesting that the procedural schedule in this case be suspended while the parties finalize the settlement documents for submission.

OVERVIEW OF SETTLEMENT

Staff's filed case on October 1, 2013, indicated an annual revenue decrease of approximately $1,393,000 would allow the Company to recover its ongoing costs and would allow MDU the opportunity to earn a reasonable and fair return on its South Dakota gas distribution investments. Company and staff positions were discussed thoroughly at the settlement conferences. As a result, some Party positions were modified and others were accepted where consensus was found. Ultimately, the Parties agreed on a comprehensive resolution of all issues. Staff believes the settlement is based on sound regulatory principles and avoids costly and unnecessary litigation.

Staff and MDU agree MDU's revenue deficiency is approximately $898,778 justifying an approximate 1.97% increase in retail revenue. The revenue requirement and supporting calculations described in this Memorandum and attachments depict Staff's positions regarding all components of MDU's South Dakota jurisdictional revenue requirement.

STAFF OVERVIEW OF SETTLEMENT

Staff Exhibit___ (BAM-16), Schedule 3 illustrates Staff's determination of MDU's pro-forma operating income under present rates. Staff Exhibit___ (BAM-17), Schedule 2 illustrates Staff's calculation of MDU's South Dakota retail rate base, and Staff Exhibit___ (BAM-16), Schedule 2 and Staff Exhibit___ (BAM-17), Schedule 1 summarize the positions. Staff Exhibit___ (BAM-16), Schedule 1 supports MDU's revenue deficiency and total revenue requirement collected through base rates.

Staff Exhibit___(PJS-3), Schedule 1 reflects the settlement base rates for each rate schedule and resulting revenue increases. The comparison between present and settlement rates and resulting bill impacts for several rate schedules is shown on Exhibit___(PJS-3), Schedule 2.

Staff believes the settlement provides MDU with an annual level of revenues relative to its service costs that is fair, just, and reasonable. These settlement rates allow MDU a reasonable opportunity to earn a return adequate for it to continue the provision of safe, adequate, and reliable service to its South Dakota retail natural gas customers.

As referenced in Table 1, Staff accepted certain Company adjustments in its filed testimony on October 1, 2013, that were based on sound regulatory theory and supported by MDU.

Table 1 – Staff Accepted Company Adjustments

Adjustment	Staff Witness	Staff Testimony Reference	Staff Exhibit Reference	MDU Witness	MDU Testimony Reference	MDU Statement Reference
Pierre Office Rental	Mehlhaff	12	BAM-1, Sch 3	Mulkern	8	H-1, pg. 8
Customer Guarantee	Mehlhaff	14	BAM-2, Sch 2	Mulkern	14-15	F-1, pg. 6
Postage	Steffensen	2-3	BAM-1, Sch 3	Mulkern	9	H-1, pg. 10
Other Tax Deductions	Peterson	6-7	BAM-1, Sch 3	Mulkern	12	K, p. 10
Elimination of Closing/Filing & Prior Period	Peterson	6-7	BAM-1, Sch 3	Mulkern	12	K, p. 12
Unamortized Gain/Loss on Debt	Peterson	6-7	BAM-2, Sch 2	Mulkern	14	K, p. 18
Deferred FAS 106 Costs	Peterson	6-7	BAM-2, Sch 2	Mulkern	14	K, p. 18
Deferred Taxes Normalization	Peterson	6-7	BAM-2, Sch 2	Mulkern	14	K, p. 18

For settlement purposes, the Company accepted certain adjustments recommended by Staff in its filed testimony. Table 2 provides a list of these adjustments with references to testimony and exhibits.

Table 2 – Company Accepted Staff Adjustments

Adjustment	Staff Witness	Staff Testimony Reference	Staff Exhibit Reference
Annualized Volumes	Mehlhaff	10	BAM-15
Other Operating Revenue	Mehlhaff	10-11	BAM-14
Vehicles & Work Equipment	Mehlhaff	11-12	BAM-9
Other Working Capital Updates	Mehlhaff	13-14	BAM-12
Customer Advances for Construction	Mehlhaff	14-15	BAM-13
Benefits	Peterson	11	BAM-1, Sch 3
Insurance	Peterson	11-12	BAM-1, Sch 3
Billings Landfill	Peterson	12-15	BAM-1, Sch 3; BAM-2, Sch 2
Advertising	Steffensen	3	PJS-1, Sch. 4
Industry Dues	Steffensen	3-4	PJS-1, Sch. 3
Regulatory Commission Expense	Steffensen	4	PJS-1, Sch. 2
Aviation Expense	Steffensen	5-6	PJS-1, Sch. 5
Mains Maintenance	Steffensen	6-7	PJS-1, Sch. 6

The differences between the Company's and Staff's positions were discussed thoroughly during settlement conferences, and further information and supporting documentation was supplied by the Company. As a result of these discussions, each party modified certain positions it had previously taken and accepted certain provisions of the other with the objective of reaching a comprehensive resolution of the issues based on sound regulatory principles, thus avoiding unnecessary litigation costs. Table 3 provides a summary of the changes made to Staff's filed case to reach a settlement.

Unless otherwise noted, all of the changes discussed below are changes from Staff's filed position.

Table 3 – Summary of Changes from Staff's Filed Case

	Change in Revenue Deficiency	Revenue Deficiency
Staff's Position as filed on 10/01/2013:		$(1,393,261)
Issues:		
Current Revenue	$(2,791)	
Weather Normalization	$485,843	
Cost of Gas	$371,956	
Labor	$266,581	
Company Consumption	$2	
Uncollectible Accounts	$7,089	
Depreciation	$288,967	
Interest Synchronization	$(41,946)	
Per Books Rate Base	$680,087	
Plant Additions	$35,546	
Cash Working Capital	$1,664	
Tax Collections Available	$(379)	
Interest on Customer Deposits	$4,212	
South Dakota Gross Receipts Tax	$3,433	
Rate of Return (Capital Structure & ROE)	$191,776	
Changes in Staff's Filed Position		$2,292,039
Settlement Position		**$898,778**

Current Revenue – After filing its testimony, Staff corrected rounding errors in the calculation of the current revenue adjustment. This correction reduced the revenue deficiency by approximately $2,791. The details regarding the corrected adjustment are found on Exhibit___(BAM-19). Staff also notes that correcting the misclassification of the Air Force Rate 641 revenues as gas-related revenues vs. distribution delivery charge revenues does not have the impact identified in Staff Witness Mehlhaff's testimony due to additional information provided regarding the Cost of Gas adjustment, as discussed below.

Weather Normalization – After filing its testimony, Staff corrected rounding errors and an incorrect modeling link in its calculation of the weather normalization adjustment. These corrections increased the revenue deficiency by approximately $485,843. The details regarding the corrected adjustment are found on Exhibit___(BAM-21).

Cost of Gas – Staff's filed case assumed per books cost of gas expense was equal to per books gas-related revenues, thus creating equal offsetting adjustments to the cost of gas expense and the gas-related revenues adjusted in the current revenue adjustment. During settlement discussions, MDU explained per books gas-related revenues do not equal per books cost of gas expense due to the lag in the PGA. Correcting this misunderstanding increased the revenue deficiency by approximately $371,956. The details regarding this corrected adjustment are found on Exhibit___(BAM-20).

Labor – MDU's filed case included the Company's three-year average level of incentive compensation payouts. As described in Staff Witness Peterson's testimony, the Company's incentive compensation plans each require that MDU achieve a minimum or threshold level of corporate earnings before it distributes any performance-related payouts, regardless if other financial, safety, or operational individual and team goals are met. Thus, Staff's filed case eliminated all incentive compensation costs. For settlement purposes, Staff allowed rate recovery for those portions of the Company's incentive payouts that were not related to achieving financial goals. This treatment is consistent with the Staff's treatment in incentive compensation costs in previous South Dakota rate cases. The agreed-upon settlement adjustment removed one-third of MDU's originally claimed incentive compensation costs. This change increased the revenue deficiency by approximately $266,581. This adjustment is shown on Exhibit___(DEP-8).

Depreciation – Staff Witness Pous disagreed with MDU's proposed net salvage for Distribution Plant Accounts 376, 380, and 381 and Common Plant Account 390 and MDU's proposed lives for Distribution Mains (Account 376) and Common Plant Structures and Improvements (Account 390). For settlement purposes, the Parties agreed to use Staff Witness Pous' recommended net salvage for Distribution Plant Accounts 376, 380, and 381 and Common Plant Account 390 and the Company's proposed lives on Distribution Mains (Account 376) and Common Plant Structures and Improvements (Account 390). Staff agreed to accept the Company's proposed lives as reasonable for settlement purposes since the majority of the differences between Staff's and MDU's proposed depreciation expense was related to net salvage. The resulting depreciation rates are found under paragraph 4 of the Elements of the Settlement Stipulation. The revised depreciation adjustment also includes the depreciation impact of changes to plant-in-service incorporated in the settlement. The net effect of these changes increased the revenue deficiency by approximately $288,967. The details regarding the resulting depreciation adjustment are found on Exhibit___(BAM-23).

Per Books Rate Base – The settlement revises the per books accumulated reserve for depreciation for general and common plant to correct typographical errors in Staff's calculation of the 13-point averages. The settlement also reflects a change in the allocation of customer deposits from the total SD Utility amount to the SD Gas amount. The Parties agreed an allocation based on the interest on customer deposits was more appropriate than an allocation based on revenues. The net effect of these changes increases the revenue deficiency by approximately $680,087. The details regarding the revised adjustment are found on Exhibit___(BAM-18).

Plant Additions – Staff's filed case included recovery for non-revenue producing plant additions that were completed and placed in service prior to interim rates going into effect. All other plant additions proposed in MDU's adjustment were excluded from Staff's case. One such plant addition Staff excluded was the new Pierre office and warehouse building, as construction was completed after July 22, 2013 (the date interim rates went into effect). However, Staff's case also accepted MDU's proposed adjustment to remove the test year rent expense for the Pierre office and warehouse as MDU will no longer incur this expense due to the construction of the new building. The Parties agreed including the adjustment to remove rent expense but excluding the adjustment for the new building created a mismatch. Since the plant addition went into service on July 26, 2013, just days after interim rates went into effect, Staff felt it was reasonable to include the Pierre office and warehouse in the plant addition adjustment. The adjustment to include the Pierre office and warehouse building in plant-in-service and the associated adjustments to accumulated deferred income taxes and property taxes increased the revenue deficiency by approximately $35,546. The details regarding the revised post-test year plant additions adjustment are found on Exhibit___(BAM-25). The related depreciation and accumulated depreciation amounts are included with Staff's depreciation adjustment using pro forma plant and settlement depreciation rates found on Exhibit___(BAM-23).

Interest on Customer Deposits – Staff's filed case included MDU held customer deposits as a deduction to rate base. MDU expressed its concern regarding Staff's position in that it did not recognize the interest that MDU pays on such deposits, as this expense is recorded below-the-line. Staff agreed and the settlement determination includes the interest expense that MDU pays on customer deposits. This adjustment increased the revenue deficiency by approximately $4,212. This adjustment is found on Exhibit___(BAM-16), page 5, column aa.

Company Consumption, Uncollectible Accounts, Interest Synchronization, Cash Working Capital, Tax Collections Available, and South Dakota Gross Receipts Tax – The Company accepted Staff's method of determining company consumption, uncollectible accounts, interest synchronization, cash working capital, tax collections available, and South Dakota gross receipts tax. While the Parties agreed with the specific method for these adjustments, the precise revenue requirement value of each adjustment needed to be recalculated to reflect other adjustments to rate base, operating income, and rate of return incorporated in the settlement. The net result of these changes reduced the revenue deficiency by approximately $30,137.

Rate of Return – The Company requested an overall rate of return of 8.101 percent, using a capital structure of 50.708 percent common equity, 2.063 percent preferred stock, 9.529 percent short term debt and 37.700 percent long term debt, with cost rates of 6.846 percent for long term debt, 1.060 percent for short term debt, 4.583 percent for preferred stock, and a requested return on common equity of 10.500 percent. At the time of filing, the Company's capital ratios and cost rates were *pro forma* June 30, 2013. Staff filed testimony supporting an overall rate of return of 7.23 percent, using a capital structure of 47.872 percent common equity, 2.128 percent preferred stock and 50.000 percent debt, with cost rates of 5.934 percent for debt (a composite of long and short term debt), 4.585 percent for preferred stock, and an 8.700 percent return on common equity. Staff's cost rates for debt and preferred stock were based on an updated Statement G reflecting *actual* capital ratios and costs for June 30, 2013. The overall rate of return accepted in settlement is 7.60 percent, using a **[Begin Confidential]** [redacted]

[redacted] **[End Confidential]**

Spread of the Increase – The results of the class cost of service study indicated that returns earned from the Residential and Large Interruptible (including the Air Force Base) were far below the returns earned in the other rate classes. Therefore, the Parties agreed to apportion the total increase between the Residential and Large Interruptible rate classes by increasing overall revenue in each class by 3.3%. Due to rate consolidation between the MDU's Black Hills and East River service territories (which Staff agreed to), however, the revenue requirement for the Black Hills Residential class will increase approximately 4.3% and the revenue requirement for the East River Residential class will decrease 4.1%. Because there are considerably more customers in the Black Hills service territory, the weighted average increase for the Residential class is 3.3%.

Rate Design – MDU initially proposed to increase its Basic Service Charge to $0.30 per day for Residential customers. Staff initially recommended no change in the Basic Service Charge primarily due to the revenue excess it initially calculated. Mr. Peterson, however, determined that an appropriate cost-based rate for the Basic Service Charge is not more than $0.28 per day for Residential customers. Therefore, for settlement purposes, the Parties agreed to increase the Basic Service Charge to $0.28 per day for Residential service.

Rate Consolidation – The settlement reflects the consolidation of MDU's Black Hills and East River service territories. Please refer to Staff Witness Peterson's testimony regarding Staff's acceptance of the consolidation.

OTHER ISSUES

Margin Sharing – The settlement reflects MDU's proposal to adopt a net margin sharing plan for sales to grain dryers. Because sales to grain dryers are highly variable and unpredictable each season, including such sales in base rates is problematic. Under the agreed-upon margin sharing plan, MDU will return to South Dakota customers 90 percent of net margins (revenues minus the cost of gas) earned on all sales to grain dryers through the periodic PGA.

Billings Landfill – Staff recommended an adjustment to MDU's proposed cost of service to exclude the Company's operating expenses and return on investment in gas production facilities at the Billings, Montana landfill. Rather, Staff recommended that the Company be allowed to recover its Billings Landfill production-related costs in MDU's monthly PGA, where the amount to be recovered was to be capped at $6.701 per dekatherm. In settlement, the Parties agreed to the cost recovery structure for Billings Landfill production costs that Staff recommended and further agreed to cap cost recovery at MDU's average cost of gas. The weighted average cost of gas for the twelve months ending June 30, 2013 was **[Begin Confidential]** [redacted] **[End Confidential]**.

Implementation of Rates – The tariffs shown on Exhibit A attached to the Stipulation are proposed to be implemented for service rendered on or after December 1, 2013. Customer bills will be prorated so that usage prior to that date is billed at the previous rates and usage on and after that date is billed at the new rates.

Interim Rate Refund – Interim rates were implemented on July 22, 2013. Approval of the Stipulation will authorize a rate increase less than the interim rate level. The Company agrees to refund customers the difference between interim rates and new rates collected, during the period July 22 through November 30, 2013, with interest. The Company will file a separate proposal for the interim rate refund following Commission approval of the Settlement.