

**BEFORE THE PUBLIC UTILITIES COMMISSION  
OF THE STATE OF SOUTH DAKOTA**

<b>IN THE MATTER OF THE APPLICATION OF )</b>	<b>HEARING BRIEF</b>
<b>MIDAMERICAN ENERGY COMPANY FOR )</b>	
<b>AUTHORITY TO INCREASE RATES FOR )</b>	<b>NG98-011</b>
<b>NATURAL GAS SERVICE )</b>	

- I. The basics of a rate case procedure.
  - A. Ratemaking is a legislative process.

The South Dakota Supreme Court has held that ratemaking is a legislative process on several occasions.

Ratemaking is a legislative process, whether performed directly by the Legislature, or by an agency of its creation. Application of Northern States Power Co., 328 N.W.2d 852, 855 (S.D. 1983).

Even though ratemaking is a legislative process, it falls under the statutory definition of a contested case under South Dakota's Administrative Procedures Act, see SDCL 1-26-1(2):

"Contested case," a proceeding, including but not restricted to rate-making and licensing, in which the legal rights, duties, or privileges of a party are required by law to be determined by an agency after an opportunity for hearing but the term shall not include the proceedings relating to rule-making other than rate-making or student academic or disciplinary proceedings under the jurisdiction of the board of regents;

Contested cases require notice, SDCL 1-26-17; allow for intervention, SDCL 1-26-17.1; provide for the presentation of evidence including examining and cross-examination of witnesses, SDCL 1-26-18; are conducted according to rules of evidence, SDCL 1-26-19; allow for use of subpoenas, SDCL 1-26-19.1 and are subject to prohibition against ex parte contact, SDCL 1-26-26.

- B. Legislative criteria for determining gas and electric rates by the

Commission. 49-34A-8:

"The public utilities commission, in the exercise of its power under this chapter to determine just and reasonable rates for public utilities, shall give due consideration to the public need for adequate, efficient and reasonable service and to the need of the public utility for revenues sufficient to enable it to meet its total current cost of furnishing such service, including taxes and interest, and including adequate provision for depreciation of its utility property used and necessary in rendering service to the public, and to earn a fair and reasonable return upon the value of its property."

1. It was within the Commission's authority to defer ruling on part of a rate increase case until a contingent ruling was made by the Federal Energy Regulatory Commission (FERC). Carrying charges applicable during the deferral were analogous to funds used during construction and thus not repugnant to this section. Application of Northern States Power, supra, at 856 (S.D. 1983).

C. Burden of proof.

49-34A-11. The burden of proof to show that any rate filed is just and reasonable shall be upon the public utility filing same.

1. See also Application of Northwestern Public Service Company, 297 N.W.2d 462, 464 (S.D. 1980).

D. Statutory procedures.

Under § 49-34A-12, a utility must give notice of a change in rate. The notice to the Commission is to include statements of facts, expert opinions, substantiating documents and exhibits which support the requested change. The proposed effective date is also to

be stated. Customers are also to receive notice of the changed rate. The Commission may conduct a hearing as to whether the rates are just and reasonable, § 49-34A-13. Proposed rates may be suspended for up to 90 days and may go longer, not to exceed a year, if the Commission feels a longer period is necessary, §49-34A-14. However, if a proceeding has not been concluded six months after the rate change was filed, the utility may put it into effect, subject to a refund with interest, § 49-34A-17.

II. The principles involved in a ratemaking case.

A. As stated in Northwestern Public Service Company v. Cities of Chamberlain, et al., 265 N.W.2d 867, 874 (S.D. 1978) those general principles are:

1. ". . . the selection of an appropriate test period during which the utility's revenues, expenses, rate base and rate of return may be measured. The test period is usually a 12 month period."
2. The utility's rate base must be established ". . . which is its total investment in, or fair market value of, the used and useful property necessarily devoted to the rendering of regulated service."
  - a. "Once the rate base has been computed, with proper adjustments being made for the utility's operating expenses and revenues, all that remains is the last element, the setting of the allowable rate of return. . . ."
3. The rate of return is ". . .the percentage by which a utility's rate base is multiplied in order to determine the revenue needed to pay expenses and to acquire investment capital."
  - a. Stated another way, this "cost of service" *method* entails four steps:
    - "(1) Properly determine company's rate

base, i.e., investment devoted to public service;

- (2) determine a fair and reasonable rate of return;
- (3) multiply the base [(1) above] by the rate [(2) above]; and
- (4) add to company's cost of operations referred to above (including taxes and depreciation)."  
Application of Northwestern Public Service, supra, at 462.

B. The test year.

"The test-year concept is designed to produce a measure of a regulated utility's earnings for a known period of time, to enable the regulatory body to make an accurate prediction of revenues and expenses in the reasonably near future. Based upon the evidence presented, the regulatory body undertakes a reasoned exercise of its discretion in altering test-year data to reflect changes of known magnitude occurring subsequent to the test year." Northwestern v. Cities of Chamberlain, et al., supra, at 878, citing Northwestern Bell Telephone Co. v. State, 253 N.W.2d 815, 822 (MN 1977).

1. "Adjustments are made for changes that will occur in the utility's revenues and expenses within a reasonable time following the close of the test year." Northwestern v. Cities of Chamberlain, et al., supra, at 874.
  - a. But see SDCL 49-34A-19 which, in part, states: "The Commission may take into consideration the reasonable income and expenses that will be forthcoming in a period of twenty-four months in advance of the test year."

C. Rate base.

". . .the ratemaking body must determine the proper rate base, that is, the value of the property owned by the utility which is used and useful in providing service to the public. This is the figure upon which the investors in a utility are entitled to earn a return." Northwestern v. Cities of Chamberlain et al., supra, at 874.

#### 1. AFUDC/CWIP

The South Dakota Supreme Court in addressing rate base issues has adopted language that states:

There will be no need in the computation of rate base to include the value of (assets) not presently in use unless the time for using them is so near that they may be said, at least by analogy, to have the quality of working capital. Application of Northwestern, supra, at 466.

A company is typically permitted to be compensated for an asset as part of its base when it is actually in use, when it is actually placed in service. Application of Northwestern Bell Telephone Co., 98 N.W.2d 170 (S.D. 1959). During the construction of an asset, the company may capitalize funds used during construction (AFUDC). Contrasting this to the concept of construction works in progress (CWIP), the Supreme Court said:

The capitalization of AFUDC matches the cost reflected in utility rates with the benefits concurrently received by rate payers, whereas inclusion of CWIP in the base would require current ratepayers to pay for construction that will result in service in the future. Application of Northwestern, supra, at 465.

AFUDC is calculated by determining "a rate representing the estimated cost of capital calculated from the weighted costs of the various capital components, i.e., common equity, stocks, bonds, etc., which rate is then multiplied by the investment in construction work, thus arriving at the AFUDC to be capitalized," Application of Northwestern, supra at 467.

Construction related expense is treated for income tax deduction purposes in two ways, normalized or flow-through. "Under normalized treatment the cost-of-debt component in the AFUDC rate is calculated net-of-tax deduction for interest. This is a lower rate which in effect passes the benefit of the tax deduction to ratepayers over the life of the newly constructed property." In the flow-through treatment, the interest deduction is used in calculating income tax expense which is included in the cost of service which reduces that component, Application of Northwestern, Id.

a. In electric ratemaking there is a statutory provision for a rate stability plan where the utility plans major capital additions or new power purchases that allows a phase-in of rate increases prior to those capital expenditures or new power purchases, see SDCL 49-34A-73 through 49-34A-76.

#### D. Rate of return.

Citing Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 603, 64 S.Ct. 281, 288, 88 L.Ed. 333, 345 in Northwestern, supra, at 873, the South Dakota Supreme Court held:

From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of business. These include service on debt and dividends on the stock. (citations omitted) By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

1. The Commission in setting rates for utilities is to give consideration to utilities earning a fair and reasonable return on the value of its property, see SDCL 49-34A-8.

#### III. Setting rates.

The Commission may disallow unreasonable profit due to sales of materials or sales to the utility by a company affiliated with the utility, see SDCL 49-34A-19.2.

The Commission is not bound by any single formula in fixing rates ". . .so long as the method followed and the order entered when applied to the facts and viewed as a whole do not produce an unjust or arbitrary result." Northwestern Public Service v. Cities of Chamberlain, et al., supra, at 872; see also Application of Montana-Dakota Utility Company, 278 N.W.2d 189, 191 (S.D. 1979). The Supreme Court has indicated that it is ". . .more concerned with the result which is reached than the method employed, Application of Montana-Dakota, supra, citing Application of Northwestern Bell Telephone Co., 98 N.W.2d 170 (S.D. 1959).

A decision of the Commission must be consistent with the law and not clearly erroneous in light of the entire evidence in the record, SDCL 1-26-36.