

STATE OF MINNESOTA
OFFICE OF ADMINISTRATIVE HEARINGS
FOR THE PUBLIC UTILITIES COMMISSION

In the Matter of the Application of
Minnesota Energy Resources Corporation
for Authority to Increase Rates for Natural
Gas Service in Minnesota

**SUMMARY OF TESTIMONY
AT THE PUBLIC HEARINGS,
FINDINGS OF FACT,
CONCLUSIONS AND
RECOMMENDATIONS**

This matter came on for public and evidentiary hearings before Administrative Law Judge Eric L. Lipman in January and February of 2009.

Public hearings were held in this matter in Rochester, Minnesota and Eagan, Minnesota on January 8, 2009. Additionally, a public hearing was held in Cloquet, Minnesota on January 12, 2009.

On February 3, 2009, an evidentiary hearing was held in the Large Hearing Room at the offices of the Minnesota Public Utilities Commission ("Commission"). The evidentiary hearing continued on a successive day and concluded on February 4, 2009.

Following the close of the evidentiary hearing, the parties submitted post-hearing submissions and reply briefs. The evidentiary hearing record closed on March 18, 2009.

The following persons noted their appearance:

Ann M. Seha, Michael J. Ahern and Sarah J. Kerbeshian, Dorsey & Whitney LLP, appeared on behalf of Minnesota Energy Resources Corporation ("MERC")

Karen Finstad Hammel and Julia E. Anderson, Assistant Attorneys General, appeared on behalf of the Minnesota Office of Energy Security ("OES").

William T. Stamets and Ronald M. Giteck, Assistant Attorneys General, appeared on behalf of the Minnesota Office of the Attorney General-Residential Utilities Division ("OAG-RUD").

Andrew P. Moratzka, Mackall, Crouse & Moore, appeared on behalf of ArcelorMittal USA, Hibbing Taconite Company, Northshore Mining Company, United

States Steel Corporation and United Taconite, LLC, (collectively known as the “Large Power Intervenors,” “LPI” or the “Taconites”).

Eric F. Swanson, Winthrop & Weinstine, appeared on behalf of Cornerstone Energy, Incorporated d/b/a Constellation New Energy--Gas Division, LLC (“Constellation”)

Robert Harding, Rates Analyst; Jerry Dasinger, Financial Analyst; and Stuart Mitchell, Rates Analyst; appeared on behalf of the Staff of the Minnesota Public Utilities Commission (the “Commission”).

STATEMENT OF ISSUES

MERC has requested an annual increase in its natural gas revenues of \$22,041,889. Of the total annual increase, \$18,416,621 is requested to increase natural gas rates for Peoples Natural Gas (“MERC-PNG”), and \$3,625,268 to increase natural gas rates for Northern Minnesota Utilities (“MERC-NMU”).

By way of a September 25, 2008 Notice and Order for Hearing, the Commission directed that an evidentiary record be established on this request. At the close of the evidentiary hearing the following matters remain in dispute.

- (1) Is the test year revenue increase sought by the Company reasonable or will it result in unreasonable and excessive earnings by the Company?
- (2) Is the rate design proposed by the Company, including proposed revisions to customer charges, reasonable?
- (3) Are the Company's proposed capital structure, cost of capital, and return on equity reasonable?
- (4) What is the appropriate return on equity (“ROE”)?
- (5) Based upon the appropriate return on equity, what is the appropriate overall rate of return (“ROR”)?
- (6) How should the revenue requirement be allocated to the customer classes?
- (7) Should the residential customer charge be increased, and if so, by how much?
- (8) Should the customer charge be approved as proposed for Small Volume Interruptible customers?

- (9) How should MERC account for rate case expenses if, after the close of the three-year amortization period, it has not yet filed a new rate case with the Commission?

SUMMARY OF TESTIMONY AT THE PUBLIC HEARINGS

Pursuant to Minn. R. 7829.1100, the Administrative Law Judge conducted public hearings on January 8 and January 12, 2009. The public hearings were held to elicit public comment regarding proposed rate increases.

Public hearings on MERC's proposed rate increase were held on January 8, 2009, at the Olmsted County Government Center in Rochester, Minnesota and at the Dakota County Vo-Tech College in Rosemount, Minnesota; and on January 12, 2009, at the Cloquet City Hall.

At the outset of the public hearings the Administrative Law Judge made introductory remarks, followed by short remarks from the Commission staff and David Kult, MERC's General Manager of Operations and Engineering. At each hearing, Mr. Kult briefly explained MERC's rate increase request and how it would likely affect the average residential customer. Following these presentations, members of the public and staff of OES and OAG-RUD offered testimony and dialogued with other participants at the hearing.¹

A summary of the testimony rendered at these evening hearings follows below:

Southern Minnesota Public Hearing – Rochester, Minnesota

At the public hearing in Rochester, Minnesota each of the five members of the public in attendance offered testimony for the hearing record.

Howard Wilson, a ratepayer from Rochester, Minnesota, expressed concern over the high percentage rates of increase associated with the monthly customer charge.²

Larry Smith, the Executive Director of Finance for Independent School District 535 – the Rochester Public Schools, detailed the impact that a rate increase would have upon the school system and the challenge that ISD 535 faces in providing cost-effective natural gas service to 32 different buildings.³

¹ See, Public Hearing Exhibits A, B, C and E.

² Rochester Public Hearing Transcript, at 17-18.

³ *Id.*, at 19-20.

Paul Weber, a ratepayer from Claremont, Minnesota, argued that the proposed rates of increase were unwarranted because of MERC's unsatisfactory methods of customer service.⁴

Raymond F. Schmitz, a ratepayer from Rochester, Minnesota, argued that these rates of increase in customer charges, and the proposed rates of return for the company, were at odds with the general under-performance of the economy and the prices that should be charged during a recession. Mr. Schmitz asserted that such rates of increase would be unduly burdensome to all classes of MERC customers.⁵

Philip Barton, a ratepayer from Rochester, Minnesota, argued that MERC should not be permitted to recover for costs incurred prior to its 2006 purchase of facilities from Aquila, Inc.⁶

Metropolitan Area Public Hearing – Eagan, Minnesota

At the public hearing in Eagan, Minnesota two of the five members of the public in attendance offered testimony for the hearing record.

Richard Dornfeld, a ratepayer from Rosemount, Minnesota, expressed concern over the higher percentage rates of increase for the residential class of customers in comparison to other customer classes.⁷

Jim Fischer, a ratepayer from Lakeville, Minnesota, expressed concern over the rate of proposed increase in comparison to the rise in the Consumer Price Index over the same period.⁸

Northern Minnesota Public Hearing – Cloquet, Minnesota

At the public hearing in Cloquet, Minnesota the sole member of the public in attendance offered testimony for the hearing record.

Jerry Moe, a ratepayer from Eveleth, Minnesota, expressed the view that any request for a rate increase at a time when there is general financial instability in the broader economy will be viewed with suspicion and anxiety.⁹

⁴ *Id.*, at 20-23.

⁵ *Id.*, at 23-33.

⁶ *Id.*, at 33-35.

⁷ Eagan Public Hearing Transcript, at 19-20; see also, Public Hearing Exhibit D.

⁸ Eagan Public Hearing Transcript, at 21-32.

⁹ Cloquet Public Hearing Transcript, at 25-26; see also, Cloquet Public Hearing Transcript at 8 – 26.

SUMMARY OF THE WRITTEN COMMENTS

In addition to the testimony and exhibits developed at the public hearing, thirteen ratepayers submitted written comments to the Administrative Law Judge before the close of the comment period on January 22, 2009. A summary of the written comments follows below:

David Bunker, a ratepayer from Bovey, Minnesota, expressed skepticism over the need for a natural gas rate increase at a time when oil and gasoline prices are falling and there is a general drop in prices throughout the economy.

Herbert Crow, a ratepayer from Chisholm, Minnesota, noting that his natural gas bills have doubled between 1997 and the present day, asserted that natural gas rates are sufficiently high enough.

Gilbert Eby, a ratepayer from North Branch, Minnesota, expressed the concern that as pensioners he and his wife are “pressed to the limits of our financial independence with the constant rise in the cost of living.”

Arlo Finney, a ratepayer from Farmington, Minnesota, argued that any increase in natural gas rates should be delayed as a sign that the company “is willing to share the burden of poor economic times.”

Donald W. Green, a ratepayer from Detroit Lakes, Minnesota, opposes the proposed rate increase on the grounds that it is not necessary and will “only aggravate the financial problems that exist for many people.”

Henry and Vivian Hentges, ratepayers from Saint Charles, Minnesota, argued that in poor economic times, MERC should cover any increased costs by reducing corporate salaries.

Deborah Herrick, a ratepayer from Worthington, Minnesota, does not believe the rate increase is justified when many ratepayers are doing their best to reduce the amount of energy that they consume.

Janet Lasch, a ratepayer from North Branch, Minnesota, opposed the requested increase in natural gas rates on the grounds that the applicant’s record of customer service is “very poor.”

Lois Paulson, a ratepayer from Park Rapids, Minnesota, expressed concern over the timing of a natural gas rate increase; noting both that oil and gasoline prices are falling and that there is a general downturn in the economy.

Bill Reid, a ratepayer from Chisholm, Minnesota, expressed skepticism over the need for the proposed increases, arguing that any increase in costs could be covered by reductions in corporate salaries and staffing.

Marilyn Theismann, a ratepayer from Rochester, Minnesota, expressed the view that the proposed rate increases “reflects a blatant disregard for consumers.”

Holly Wilson, the daughter of a ratepayer in Thief River Falls, Minnesota, expressed concern that an increase in natural gas rates cannot be met by elderly ratepayers on fixed incomes.

Robert M. Zeller, a ratepayer from Mantorville, Minnesota, urged the Commission to look closely at MERC executive compensation levels before approving the requested rate increase. Further, if a rate increase is needed, he urges that rates be raised for commercial classes of customers; on the grounds that business entities may deduct expenditures made for natural gas as a business expense.¹⁰

FINDINGS OF FACT

I. INTRODUCTION AND BACKGROUND.

A. The Applicant and its Application

1. MERC is a Delaware corporation and one of six subsidiary corporations of Integrys Energy Group, Inc. (“Integrys”). MERC is authorized to do business in Minnesota and its principal office is located in Rosemount, Minnesota.¹¹

2. MERC purchased the Minnesota assets of Aquila, Inc. in a sale approved by the Commission on June 1, 2006. The sale included two operating units – Aquila Networks-Peoples Natural Gas (now known as MERC-PNG) and Aquila Networks-Northern Minnesota Utilities (now known as MERC-NMU).¹²

3. Currently, MERC serves approximately 207,000 natural gas customers in 51 counties in Minnesota.¹³

4. MERC provides service to its Minnesota customers under the same rates, terms, and conditions that were established for Aquila, Inc. in that company’s last natural gas rate case – a set of rates that was effective on July 29, 2003.¹⁴

¹⁰ Each of the letters has been included in the docket of this proceeding. One additional letter arrived after the close of the comment period, and while included in the docket as a separate, late-filed exhibit, was not separately considered or summarized.

¹¹ Ex. 16 at 3 (Cloinger Direct).

¹² See, *In the Matter of the Sale of Aquila, Inc.’s Minnesota Assets to Minnesota Energy Resources Corporation*, Docket No. G-007,011/M-05-1676, Order Approving Sale Subject to Conditions (June 1, 2006); and OES Exhibit 91, at 1 (St. Pierre Direct Testimony).

¹³ Ex. 16 at 3 (Cloinger Direct).

¹⁴ *In the Matter of a Petition by Peoples Natural Gas Company and Northern Minnesota Utilities, Divisions of UtiliCorp United Inc., for Authority to Increase Natural Gas Rates in Minnesota and to*

5. On July 31, 2008, MERC filed an application seeking an increase to its rate – its first following the June 1, 2006 sale of Aquila-PNG and Aquila-NMU.¹⁵

6. MERC’s application seeks an annual rate increase of \$18,416,621 for MERC-PNG and \$3,625,268 for MERC-NMU – for a combined total increase of \$22,041,889. In percentage terms, the proposed rate increases amount to a rise of 6.92 percent for MERC-PNG customers; a rise of 4.58 percent for MERC-NMU customers; and an overall percentage increase of 6.92 percent over current rates.¹⁶

7. Additionally, MERC’s application seeks a return on common equity of 11.25 percent.¹⁷

8. The Company’s application included proposed interim rate schedules that are based upon a 2008 test year and were adjusted for known and measurable changes. MERC also submitted a separate miscellaneous rate change filing seeking to restate the Base Cost of Gas for these interim rates.¹⁸

9. On August 1, 2008, the Commission issued a notice to potentially interested parties requesting comments on whether the Commission should accept the filing as substantially complete and whether it should refer the case to the Office of Administrative Hearings (“OAH”) for contested case proceedings.¹⁹

10. On August 11, 2008, the Office of Energy Security of the Minnesota Department of Commerce (“OES”) filed comments, recommending acceptance of the filing as complete and referring the case for contested case proceedings.²⁰

11. The Taconites also filed comments on August 11, 2008. The Taconites recommended a finding of exigent circumstances that would permit MERC to forgo collecting a portion of the interim rate revenue from large power customers. The Taconites asserted that a large interim rate increase qualified as an “exigent

Consolidate the Two Utilities, Docket No. G-007, 011/GR-00-951, Order Accepting and Adopting Settlement (July 29, 2003).

¹⁵ Ex. 16, at 3-4 (Cloninger Direct).

¹⁶ *Id.* at 9.

¹⁷ *Id.*

¹⁸ *In the Matter of the Petition of Minnesota Energy Resources Corporation for Approval of a New Base Cost of Gas to Coincide with the Implementation of Interim Rates*, MPUC Docket No. G-007,011/GR-08-835, MPUC Docket No. G-007,011/MR-08-836 (“Interim Rate Proceeding”).

¹⁹ *Comments on Filing, In the Matter of the Application of Minnesota Energy Resources Corporation for Authority to Increase Rates for Natural Gas Service in Minnesota*, MPUC Docket No. G-007,011/MR-08-835 (August 1, 2008).

²⁰ *Letter of Dale Lusti*, MPUC Docket No. G-007,011/MR-08-835 (August 11, 2008).

circumstance” because it would lead MERC’s industrial customers to bypass MERC’s system.²¹

12. MERC filed a letter on August 13, 2008, stating that it concurred with the recommendations of the OES and the Taconites and did not intend to file reply comments.²²

13. On September 11, 2008, the Commission met to consider all of these matters and whether to request parties to develop any specific matters in the rate case. On September 25, 2008 the Commission issued Orders in this case memorializing its September 11, 2008 determinations. The Commission found the rate case filing to be substantially complete; suspended the proposed rates pending a final decision on the merits of the rate case filing; and set an interim rate schedule.²³

14. In its September 25, 2008 *Order Setting Interim Rates*, the Commission authorized an annualized interim rate increase of \$19,836,777 (\$16,787,734 for MERC-PNG and \$3,049,043 for MERC-NMU), less than the amount requested by MERC (\$1,628,887 for MERC-PNG and \$576,225 for MERC-NMU) in order to maintain revenue neutrality of Conservation Improvement Program (“CIP”) costs.²⁴

15. In a related proceeding, the Commission set a new base cost of gas for interim rates.²⁵

16. Also on September 25, 2008, the Commission issued a *Notice and Order for Hearing*, referring the matter to the OAH for contested case proceedings. In its order, it directed the Office of Administrative Hearings to “specifically and thoroughly address” during the course of contested case proceedings, the following issues:

- (1) Is the test year revenue increase sought by the Company reasonable or will it result in unreasonable and excessive earnings by the Company?
- (2) Is the rate design proposed by the Company, including proposed revisions to customer charges, reasonable?
- (3) Are the Company's proposed capital structure, cost of capital, and return on equity reasonable?²⁶

²¹ *Initial Comments of Taconites*, MPUC Docket No. G-007,011/MR-08-835 (August 11, 2008).

²² *Letter of Michael J. Ahern*, MPUC Docket No. G-007,011/MR-08-835 (August 13, 2008).

²³ *Order Setting Interim Rates*, MPUC Docket No. G-007,011/MR-08-835 (September 25, 2008).

²⁴ *Id.* at 2.

²⁵ *Order Setting New Base Cost of Gas (Interim Rate Proceeding)*, G-007,011/MR-08-836 (September 25, 2008).

²⁶ *Notice and Order for Hearing*, MPUC Docket No. G-007,011/MR-08-835 at 5 (September 25, 2008).

17. The undersigned Administrative Law Judge held a prehearing conference on October 13, 2008. As provided in the *First and Second Prehearing Orders*, parties of right and intervenors includes the OES, the Residential and Small Business Utilities Division of the Office of the Attorney General (“OAG-RUD”), Cornerstone Energy, LLC d/b/a Constellation New Energy - Gas Division (referred to throughout this proceeding as “Cornerstone”), and the Taconites (ArcelorMittal USA, Hibbing Taconite Company, Northshore Mining Company, United States Steel Corporation and United Taconite, LLC).

18. On October 17, 2008, the undersigned issued a *Protective Order* to address the handling of non-public information during the proceedings.

19. A second prehearing conference was held by conference call on January 12, 2009, to review the progress of settlement negotiations.²⁷

20. As noted above, the evidentiary hearing in this matter was held February 3 and 4, 2009.

21. Prior to the commencement of hearing, the OES and MERC reached agreement on many of the issues through the normal course of resolution through pre-filed testimony. Other issues were resolved during the course of the evidentiary hearing. Among the accords reached between these parties were:

- a. Elements of the rate base;²⁸
- b. Exclusions from the rate base;²⁹
- c. Distribution plant adjustments to the rate base;³⁰
- d. Customer deposits adjustments to the rate base;³¹
- e. Construction Work in Progress accounting practice;³²
- f. Regulatory Asset and Liability adjustments;³³
- g. Cash Working Capital requirements;³⁴

²⁷ *Prehearing Conference Transcript*, OAH Docket No. 8-2500-17840-2 at 6 - 16 (January 12, 2009).

²⁸ Ex. 25 at 3 (Kyto Rebuttal); Ex. 91 at 10-11 (St. Pierre Direct).

²⁹ Ex. 25 at 4 (Kyto Rebuttal); Ex. 91 at 10-11 (St. Pierre Direct); Ex. 98 at 5 (St. Pierre Surrebuttal).

³⁰ Ex. 98 at 6 (St. Pierre Surrebuttal).

³¹ Ex. 25 at 5 (Kyto Rebuttal).

³² Ex. 25 at 13 (Kyto Rebuttal); Ex. 93 at 5 (Johnson Surrebuttal).

³³ Ex. 25 at 14 (Kyto Rebuttal) Ex. 84 at 16-19 (Johnson Direct).

- h. Rate base disallowances for service and main extensions;³⁵
- i. Service and main extension record-keeping requirements;³⁶
- j. Winter construction charges disallowances;³⁷
- k. Winter construction charges reporting;³⁸
- l. Cost allocation methods among utility and non-utility customers;³⁹
- m. Integrys business support, medical plan and dental plan costs;⁴⁰
- n. Depreciation rate and expense adjustments;⁴¹
- o. Interest synchronization on final adjustments;⁴²
- p. Adjustments to bad debt expenses;⁴³
- q. Adjustments to conservation improvement program revenues;⁴⁴
- r. Natural gas sales forecasting methods;⁴⁵
- s. Exclusion of unamortized rate case expenses;⁴⁶
- t. Allocating rate case expenses by a general allocation factor;⁴⁷

³⁴ Ex. 25 at 7 (Kyto Rebuttal); Ex. 98 at 10 (St. Pierre Surrebuttal).

³⁵ Ex. 94 at 21-24 (Minder Surrebuttal); Evidentiary Hearing Transcript, Vol. 1 at 147-48 (Kult).

³⁶ Ex. 29 at 15-16 (Kult Rebuttal); Ex. 94 at 36-37 (Minder Surrebuttal).

³⁷ Ex. 28 at 20-21 (Kult Direct).

³⁸ Ex. 29 at 6 (Kult Rebuttal) Ex. 85 at 68-69 (Minder Direct).

³⁹ Ex. 25 at 5-6 (Kyto Rebuttal); Ex. 91 at 17-19 (St. Pierre Direct).

⁴⁰ Ex. 25 at 6 (Kyto Rebuttal); Ex. 84 at 4-5 (Johnson Direct); Ex. 91 at 24-25 (St. Pierre Direct); Evidentiary Hearing Transcript, Vol. 1 at 194 (Walters)

⁴¹ Ex. 24 at 12-13 (Kyto Direct); Ex. 25 at 6 and 13 (Kyto Rebuttal); Ex. 91 at 26-27 (St. Pierre Direct); Ex. 98 at 8-9 (St. Pierre Surrebuttal).

⁴² Ex. 25 at 7 (Kyto Rebuttal), Ex. 98 at 9-10 (St. Pierre Surrebuttal).

⁴³ Ex. 24 at 18 (Kyto Direct); Ex. 25 at 8-9 (Kyto Rebuttal); Ex. 84 at 6-8 (Johnson Direct); Ex. 93 at 2-3 (Johnson Surrebuttal).

⁴⁴ Ex. 85 at 15-16 (Minder Direct).

⁴⁵ Ex. 82 at 9-20 and 26-29 (Heinen Direct); Ex. 25 at 16 (Kyto Rebuttal).

⁴⁶ Ex. 84 at 10-12 (Johnson Direct); Ex. 25 at 13 (Kyto Rebuttal).

⁴⁷ Ex. 93 at 7-8 (Johnson Surrebuttal); Evidentiary Hearing Transcript, Vol. 1 at 60 (Kyto).

- u. Adjustments to the rate of annual expense;⁴⁸
- v. Adjustments to advertising expenses;⁴⁹
- w. Conservation improvement program tracker account methods and amortization period;⁵⁰
- x. Conservation cost recovery methods;⁵¹
- y. Filing and recovery methods for conservation improvement program costs in the test year;⁵² and,
- z. Tariff changes regarding:
 - i. Small volume balancing;⁵³
 - ii. Telemetry requirements;⁵⁴
 - iii. Returned check practice;⁵⁵
 - iv. Reconnection practice;⁵⁶
 - v. Usage data request practice;⁵⁷
 - vi. Winter construction and “abnormal circumstance” practice;⁵⁸
 - vii. Connections to non-primary space heating customers;⁵⁹ and,
 - viii. Waiver of Contribution in Aid of Construction practice.⁶⁰

⁴⁸ Ex. 93 at 5-6 (Johnson Surrebuttal).

⁴⁹ Ex. 25 at 14 (Kyto Rebuttal); Ex. 85 at 21-22 (Minder Direct).

⁵⁰ Ex. 26 at 4-8 (Gunn Direct), Ex. 85 at 4-10 (Minder Direct).

⁵¹ Ex. 26 at 9-12 (Gunn Direct); Ex. 85 at 10-17 (Minder Direct); Evidentiary Hearing Transcript Vol. 2B at 64-65 (Minder).

⁵² Ex. 26 at 5 (Gunn Direct); Ex. 27 at 4-7 (Gunn Rebuttal); Ex. 27 Rebuttal Exhibits SAG-01 and SAG-02; Ex. 85 at 6-7 (Minder Direct); Ex. 94 at 5-6 and 11 (Minder Surrebuttal).

⁵³ Ex. 2 (Proposed Final Tariffs); Ex. 94 at 13-15 (Minder Surrebuttal).

⁵⁴ Ex. 37 at 40 (Walters Direct); Ex. 85 at 24-29 (Minder Direct); Ex. 39 at 11 (Walters Rebuttal).

⁵⁵ Ex. 39 at 11 (Walters Rebuttal); Ex. 85 at 29-30 (Minder Direct).

⁵⁶ Ex. 37 at 43-45 (Walters Direct); Ex. 85 at 30-33 (Minder Direct); Ex. 87, Attachment No. BJM-11.

⁵⁷ Ex. 37 at 46 (Walters Direct); Ex. 85 at 33-34 (Minder Direct); Ex. 87, Attachment No. BJM-11.

⁵⁸ Ex. 39 at 12-15 (Walters Rebuttal); Ex. 94 at 16-17 (Minder Surrebuttal).

⁵⁹ Ex. 37 at 47-48 (Walters Direct); Ex. 85 at 69-70 (Minder Direct).

⁶⁰ Ex. 39 at 15-17 (Walters Rebuttal); Ex. 85 at 73-74 (Minder Direct); Ex. 94 at 18-20 (Minder Surrebuttal); Evidentiary Hearing Transcript, Vol. 1 at 194 (Walters).

The undersigned finds that these agreed-upon adjustments, tariff revisions, accounting practices and recordkeeping requirements are all reasonable and urges their adoption by the Commission.

II. GENERAL PRINCIPLES

22. A reasonable rate enables a public utility not only to recover its operating expenses, depreciation, and taxes, but also allows it to compete for funds in capital markets.⁶¹ The rate of return should be sufficient to cover operating expenses – including debt service and dividends on stock – and continued assurance in the utility’s ability to maintain credit and attract capital.⁶²

23. A just and reasonable return should be similar to returns on investments in other businesses having corresponding risk.⁶³

24. The determination of reasonableness involves a balancing of consumer and utility interests. Assuring a fair rate of return must be balanced against the rate-paying public’s interest in rates that are just and reasonable. Minnesota law requires that any doubt as to reasonableness of proposed rates must be resolved in favor of the consumer.⁶⁴

25. In carrying out its statutory responsibilities, the Commission has announced the following principles for rate design:

- (A) Rates should be designed to provide the Company a reasonable opportunity to recover all prudently incurred costs, including costs of attracting capital. These rates, when matched to test-year customer counts and sales projections, should allow the Company a reasonable opportunity to collect its revenue requirement.
- (B) Rates should be designed to promote an efficient use of resources. As such, they should reflect the costs that classes of customers impose upon the system.
- (C) Rates and conditions of service should provide a reasonable continuity with the past. Rate-design changes should be reasonable and, to the extent possible, gradual to prevent drastic impacts on existing customers.

⁶¹ See, *Bluefield Waterworks & Improvement Co. v. Public Serv. Comm’n of West Virginia*, 262 U.S. 679 (1923).

⁶² See, *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1994).

⁶³ *Id.* at 603.

⁶⁴ See, Minn. Stat. § 216B.03 (2008).

(D) Rates should be understandable and easy to administer.⁶⁵

26. Setting the rates at or near the embedded cost to serve each customer class serves the public interest in assuring that adequate price signals are sent to customers who receive service.⁶⁶

27. MERC bears the burden to prove by a fair preponderance of the evidence, that it is just and reasonable that it should recover from ratepayers the costs of its claimed expenses.⁶⁷

III. COST OF CAPITAL

28. In its rate-setting orders, the Commission has balanced the interests of ratepayers and utilities. A reasonable rate enables an investor-owned utility to recover its operating expenses, depreciation, and taxes, as well as compete for funds in capital markets. Allowing a fair and reasonable return upon the utility's investment in property used to provide the utility service is a factor in setting just and reasonable rates. This return on investment in property is commonly referred to as return on equity or ROE.”

29. For publicly-traded companies, the Return on Equity is determined by the actual performance of that company's stock in the marketplace. Because MERC securities are not publicly traded, however, it is necessary to establish the ROE figure for MERC by other means. The Commission has historically relied upon the Discounted Cash Flow (“DCF”) analysis to derive ROE for rate cases. This is the most widely accepted model and one that has been used consistently as a starting point for establishing the cost of equity in public utility cases before the Commission.⁶⁸

30. The Discounted Cash Flow model provides an Return on Equity estimate that meets the *Hope* and *Bluefield* criteria for a fair return;⁶⁹ it produces data that are commensurate with the returns that are being earned on other investments with equivalent risks; and it effectively estimates a rate of return that is sufficient to enable the utility to attract capital, maintain its credit rating and assure its financial integrity.⁷⁰

⁶⁵ See, *In the Matter of a Petition by Great Plains Natural Gas Company, A Division of MDU Resources Group, Inc., for Authority to Increase Natural Gas Rates in Minnesota*, Findings of Fact, Conclusions of Law and Recommendation, OAH Docket No. 7-2500-17721 at 14-15 (2006) (MPUC Docket No. G-004/GR-04-1487) (<http://www.oah.state.mn.us/aljBase/250017721.rt.rcl.htm>).

⁶⁶ Minn. Stat. § 216B.03 (2008); Ex. 90 at 4.

⁶⁷ Minn. Stat. § 216B.016 (4) (2008).

⁶⁸ See, Ex. 80 at 7 (Griffing Direct).

⁶⁹ See, *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1994); *Bluefield Waterworks & Improvement Co. v. Public Serv. Comm'n of West Virginia*, 262 U.S. 679 (1923).

⁷⁰ Ex. 80 at 58 (Griffing Direct).

A. MERC Capital Structure

31. MERC is a subsidiary corporation of Integrys, Energy Group, Inc. (“Integrys”). Integrys issues debt on behalf of its subsidiaries. Under this arrangement, MERC had \$102,646,935 of debt at the time of its application.⁷¹ MERC is financed with a combination of long-term debt, short-term debt and common equity.⁷²

32. In its application, MERC submitted two separate capital structures – “Permanent Capital” and “Total Capital.”⁷³

33. MERC’s Total Capital incorporated two adjustments to Permanent Capital. One of these proposed adjustments is for customer deposits in the amount of \$374,371 and is labeled “Other Interest Bearing Balance Sheet Items.” The other proposed adjustment includes non-utility expenditures, MERC’s CIP expenditures and plant disallowances in the amount of \$5,871,457, and is denominated “Capital Structure Adjustments.”⁷⁴

34. OES complained that MERC’s capital adjustments decrease the weighted cost of total capital by 0.2511 percent, thus affecting its rate of return; and that no other regulated Minnesota utility adjusted its rate of return in this way.⁷⁵

35. MERC witness, Lisa Gast, CPA, responded to this concern in her Rebuttal Testimony by submitting revised schedules updating MERC’s capital structure, cost of capital, and required rate of return for the 2008 proposed test year for actual results through November 2008.⁷⁶ MERC’s revised Schedule D-1 incorporates the OES’s recommendations and does not make adjustments to Permanent Capital.⁷⁷

36. MERC’s rebuttal testimony reflects Dr. Griffing’s recommendation to use what MERC termed “Permanent Capital” as its proposed capital structure.⁷⁸ The OES agrees with MERC’s capital structure proposal as modified by Ms. Gast in her Rebuttal Testimony.⁷⁹ Ms. Gast’s updated recommendation for MERC’s capital structure is:

⁷¹ Ex. 21, Rebuttal Exhibit LJG-1, Schedule D-1.

⁷² Ex. 80 at 40 (Griffing Direct).

⁷³ *Id.* at 39.

⁷⁴ *Id.*; Ex. 20, Attachment LJG-2, Schedule D-1.

⁷⁵ Ex. 91 at 12-13 (St. Pierre Direct).

⁷⁶ Ex. 20, Attachment LJG-1, Schedule D-1 through D-5.

⁷⁷ *See*, Ex. 22 at 2.

⁷⁸ Ex. 21 at 1-2 (Gast Surrebuttal); Ex. 80 at 39 (Griffing Direct).

⁷⁹ Ex. 99 at 12 (Griffing Surrebuttal).

<u>Component</u>	<u>Ratio (%)</u>
Long-Term Debt	43.42%
Short-Term Debt	7.81%
<u>Common Equity</u>	<u>48.77%</u>
Total	100% ⁸⁰

37. No other party commented upon, or proposed an alternative to, the capital structure agreed upon by the OES and MERC.

38. MERC’s revised proposed capital structure set forth above and included in Ms. Gast’s Rebuttal Testimony schedules is reasonable.⁸¹ MERC has demonstrated that its proposed capital structure reflects the actual financial transactions of its business.

39. OES and MERC agree on the appropriate capital structure and the cost of both long-term and short-term debt. However, as detailed below, there is a significant difference in the recommended Returns on Equity.

B. Return on Equity – Rate of Return

40. As a wholly owned subsidiary of Integrys, MERC has no publicly traded common stock.⁸² Although Integrys common stock is traded publicly, MERC’s regulated local distribution company (“LDC”) segment only accounts for approximately 11.4 percent of the parent company’s earnings available to shareholders. As such, it was the view of OES analysts that MERC’s operations represented too little of Integrys’ earnings, for the parent company’s Return on Equity and Rate of Return to serve as an appropriate proxy in the assignment of an ROR and ROE for MERC.⁸³

1. Discounted Cash Flow Analysis and Comparable Groups.

41. MERC and the OES each proposed a rate for Return on Equity. In developing their proposals, MERC and OES each began their respective calculations with the Discounted Cash Flow analysis.

42. The DCF method uses the current dividend yield and the expected growth rate of this yield to determine a rate of return that is sufficient to induce investment. The Discounted Cash Flow analysis is derived from a formula for determining the net present value, or price per share, of a share of stock.⁸⁴

⁸⁰ Ex. 21, Rebuttal Exhibit LJG-1, Schedule D-1.

⁸¹ See, *id.*

⁸² Ex. 21 at 1-2 (Gast Rebuttal).

⁸³ Ex. 80 at 9 (Griffing Direct).

⁸⁴ *Id.* at 7.

43. The DCF model uses three inputs – dividends, market equity prices and growth rates. The first two inputs are market-based and follow from marketplace decisions of both the companies and their investors with respect to the value of equity shares. Growth rate data are drawn from independent experts. Because of the types of data that are used in the formula, the Discounted Cash Flow minimizes the opportunities for analyst decision-making and judgment to influence the computation of the Return on Equity.⁸⁵

44. Although the OES and MERC each employed the DCF analysis, there were some differences in the groups of companies selected for comparison and other variables, between the sets of calculations – variations that produced different results.

45. As part of their respective Discounted Cash Flow analyses, OES and MERC drew data from a set of comparable companies which each believed represented a similar set of investment risks as MERC. Because MERC common stock is not publicly traded, reference to the data from these other firms provides a basis to calibrate an appropriate Return on Equity. OES refers to its collection of similar firms the “Comparison Group,” whereas MERC titled its selections the “Gas Group.”⁸⁶ From the data drawn from the set of comparison companies, the Discounted Cash Flow computations follow from a fixed formula.

46. OES and MERC agree upon seven of the companies that should be included in the DCF comparison group – and disagree as to three others. A side-by-side listing of the respective proposals appears below.

<u>OES Comparison Group</u>	<u>MERC Gas Group</u>
(a) AGL Resources, Inc.	(a) AGL Resources, Inc.
(b) Laclede Group, Inc.	(b) Laclede Group, Inc.
(c) New Jersey Resources Corp.	(c) New Jersey Resources Corp.
(d) Northwest Natural Gas	(d) Northwest Natural Gas
(e) Piedmont Natural Gas Co.	(e) Piedmont Natural Gas Co.
(f) South Jersey Industries, Inc.	(f) South Jersey Industries, Inc.
(g) WGL Holdings, Inc.	(g) WGL Holdings, Inc.
(h) (NOT INCLUDED BY OES)	(h) Atmos Energy Group;

⁸⁵ *Id.* at 57.

⁸⁶ *Id.* at 9; Ex. 22, Attachment PRM-1, Schedule 9 at 1.

(i) (NOT INCLUDED BY OES)	(i) NICOR, Inc.
(j) Southwest Gas	(j) (NOT INCLUDED BY MERC). ⁸⁷

47. The OES's expert, Dr. Marlon F. Griffing, sought to develop a comparison group of publicly traded companies operating within the Standard Industrial Classification Code 4924 – signifying “Natural Gas Distribution.” Dr. Griffing sought companies that are: based in the United States; publicly traded; currently paying dividends; have positive growth-rate projections from expert analysts; not expected to merge into or be acquired by another company; have a Standard and Poors bond rating between AA- and BBB-; and have at least 60 percent of net income (or another earnings indicator) from regulated local distribution operations.⁸⁸

48. Dr. Griffing excluded Atmos Energy from his Comparison Group because it did not have at least 60 percent of its net income from local distribution operations. Dr. Griffing excluded NICOR, Inc. from his comparison group because its Standard & Poors bond rating of “AA” fell outside of the “AA-” to “BBB-” range that he ordinarily uses.⁸⁹

49. Mr. Moul sought to develop a comparison group of companies by beginning first with the gas utilities listed in the basic service of *Value Line* and excluding those firms whose size and business operations make them too dissimilar to MERC. Additionally, Mr. Moul excluded Southwest Gas from his comparison group “due to its location.”⁹⁰

50. While many of the companies listed in the Comparison Group are likewise included in the Gas Group, the eight firms in Dr. Griffing’s Comparison group more closely approximate the regulatory environments, operations and investment risk presented by MERC than do the nine firms in the Gas Group.⁹¹

51. To determine an ROE, both Dr. Griffing and Mr. Moul examined earnings growth rate projections and used inputs from three reporting services: Value Line Investment Survey (“Value Line”), Yahoo! Finance and Zacks Investment Research (“Zacks”). Likewise, the experts both used similar dividend-yield equations and sources for dividend inputs.⁹² While both Mr. Moul and Dr. Griffing used the Discounted Cash Flow model, as detailed below, they differ in their application of this technique when developing Return on Equity recommendations.

⁸⁷ Ex. 22, Attachment PRM-1, Schedule 2 at 2.

⁸⁸ Ex. 80 at 9-13 (Griffing Direct).

⁸⁹ *Id.* at 47-48.

⁹⁰ Ex. 22 at 4 (Moul Direct); Ex. 80 at 48 (Griffing Direct).

⁹¹ Ex. 80, at 9-26 (Griffing Direct).

⁹² *Id.* at 45.

2. OES Return on Equity and Rate of Return Recommendations

52. Relying upon the Commission's earlier acceptance, in other proceedings, of the "constant-growth" DCF method, Dr. Griffing used this DCF method in his analysis. The constant growth method assumes that dividends (D) are received at the end of each year; the annual growth rate of dividends (g) is constant to infinity; and the discount rate for dividends (k) is constant to infinity.⁹³

53. Dr. Griffing used data from a 30-day period between September 16 and October 15, 2008 to calculate dividend yields. As he explained, this period includes enough trading days to dampen short-term aberrations in the capital markets and was close in time to the then most recently published growth estimates preceding the due date for the filing of direct testimony in this proceeding.⁹⁴

54. In his Direct Testimony, Dr. Griffing recommended a Return on Equity range between 8.53 percent and 11.47 percent with a midpoint of 9.93 percent.⁹⁵

55. Noting that no clear pattern was evident in recent share prices of the companies of the "Comparison Group" and the "Gas Group," Dr. Griffing discounted the effect of the recent turmoil in the financial markets on the assignment of an appropriate Return on Equity. Dr. Griffing asserts that during the period that Mr. Moul used for his DCF analysis, five of the ten companies that are listed in the two groups showed share price increases and five showed share price decreases.⁹⁶

56. In his Surrebuttal Testimony, and relying upon updated company report and annualized dividend data gleaned after the due date for the filing of direct testimony in this proceeding, Dr. Griffing recommended a Return on Equity range between 8.89 percent and 11.66 percent with a midpoint of 10.21 percent.⁹⁷

57. The Return on Equity range reflects the differences among various expert forecasts used in the calculation of a Return on Equity. Forecasters differ as to the

⁹³ *Id.* at 7-8. The equation form of the constant-growth DCF model is:

$$k = \frac{D_1}{P_0} + g$$

In this equation, D_1 is the annual dividend one year from the present, P_0 is the growth rate of the dividend, and k is the discount rate and also is the fair rate of return for equity.

⁹⁴ See, Ex. 80 at 28 (Griffing Direct); Ex. 81, Attachment MFG-6, Schedule 1 at 1-5, Schedule 2 at 1-11, Schedule 3 at 1-10 and Schedule 4 at 1-10.

⁹⁵ Ex. 80 at 32 (Griffing Direct).

⁹⁶ *Id.*, at 29 (Griffing Direct)

⁹⁷ See, Ex. 99 at 4, 5 and 11; Ex. 100, Attachment MFG-S-3 at 1-51 and Attachment MFG-S-2 at 1-5; Ex. 101 Attachment MFG-S-4, Schedule 1.

impact that future interest-rate changes, rates of economic growth and regulatory changes will have upon companies in the Comparison Group.⁹⁸

58. As a check upon the reasonableness of the Return on Equity calculations that followed from his Discounted Cash Flow analysis, Dr. Griffing also undertook a Capital Asset Pricing Model (“CAPM”) analysis. The CAPM computes a cost of equity by determining the systematic risk of an investment – called “the Beta” – by subtracting a “risk-free rate of return” from the total return on the market of equities.⁹⁹

59. Dr. Griffing began his analysis by selecting the average yield on a 20-Year Treasury bond for September 16 - October 15 to represent his riskless asset rate. Dr. Griffing reasoned that these longer-term bonds were less volatile than shorter-term intermediate Treasury bonds; and therefore were more appropriate for use in a CAPM analysis. Dr. Griffing used the average beta of the eight companies in his Comparison Group from the September 12, 2008 *Value Line Investment Survey*, which is 0.81. For the risk-premium component of the analysis, Dr. Griffing used the 6.5 percent value from Ibbotson Associates’ annual yearbook.¹⁰⁰

60. Dr. Griffing’s CAPM analysis yielded a Return on Equity of 9.59 percent.¹⁰¹ This rate is within the overall range of his DCF analysis and is close to the 9.93 percent midpoint of this range.

61. Dr. Griffing updated his CAPM analysis in his Surrebuttal Testimony. The outcome of his updated CAPM analysis is 7.80 percent, which is outside the low end of his updated Return on Equity range of between 8.89 percent and 11.66 percent. Concluding that this result demonstrated that the CAPM can produce unreliable results, Dr. Griffing adjusted the inputs to his CAPM analysis using data provided by Mr. Moul to incorporate a forecast market risk premium. By adding the forecast market risk premium for the Standard & Poors Composite 500, to the historical market risk premium used in his CAPM analysis, Dr. Griffing obtained a Return on Equity result of 9.35 percent. 9.35 percent is inside the low end of the Return on Equity range of his Discounted Cash Flow results.¹⁰²

62. Dr. Griffing also assessed the reasonableness of his updated DCF result against the *Public Utilities Fortnightly* annual Return on Equity survey. The most recent of these surveys was published in the November 2008 issue and covers the period between September 1, 2007 and August 31, 2008. Dr. Griffing found 28 cases for natural gas-only Local Distribution Companies within the survey. The mean Return on

⁹⁸ Ex. 80 at 33-34 (Griffing Direct).

⁹⁹ Ex. 22 at 40 (Moul Direct).

¹⁰⁰ Ex. 80 at 34-38 (Griffing Direct); and Ex. 81, Attachment MFG-8, Schedule 3.

¹⁰¹ See, Ex. 81, Attachment MFG-8, Schedule 4.

¹⁰² Dr. Griffing used Mr. Moul’s November 30, 2008 values as the OES does not have access to the First Call data that Mr. Moul uses for his analysis. Ex. 99 at 7, n. 2 (Griffing Surrebuttal).

Equity award for the 28 companies is 10.36 percent. The median award is 10.20 percent. Seventeen awards are 10.20 percent or lower. The mean of Dr. Griffing’s updated DCF analysis is 10.21 percent, one basis point higher than the median Return on Equity of the companies in the *Public Utilities Fortnightly* survey and 15 basis points lower than the mean Return on Equity of all 28 companies.¹⁰³

63. Calculation of the overall allowable Rate of Return is derived by multiplying each capital structure component by the cost of that component and then adding the various results together for a total. Dr. Griffing’s recommended 10.21 percent Return on Equity results, when combined with rates for other component costs, results in a Rate of Return of 7.98 percent:

Component	Ratio (%)	Cost Rate	Weighted Average Cost
Long-Term Debt	43.42%	6.28%	2.73%
Short-Term Debt	7.81%	3.45%	0.27%
Common Equity	48.77%	10.21%	4.98%
Total	100%		7.98%. ¹⁰⁴

3. MERC Return on Equity and Rate of Return Recommendation

64. In his Direct Testimony, Mr. Moul recommended a Return on Equity of 11.25 percent.¹⁰⁵

65. In his Rebuttal Testimony, Mr. Moul updated this recommendation to urge a Return on Equity of 11.75 percent. This recommendation blends results from a Discounted Cash Flow analysis, a “Risk Premium” analysis and a Capital Asset Pricing Model analysis.¹⁰⁶

66. While Mr. Moul’s Discounted Cash Flow analysis results in a Return on Equity estimate of 10.04 percent, this initial figure is adjusted; as Mr. Moul argues, to better reflect the actual risk of MERC’s equities. Noting that the market values of equity for the companies in the MERC Gas Group exceed the book values of this equity, he argues that the Return on Equity calculation that is produced by an unadjusted Discounted Cash Flow analysis understates the actual degree of risk. In his recommendation, therefore, Mr. Moul urges application of a “leverage adjustment.”¹⁰⁷

¹⁰³ Ex. 99 at 10-12 (Griffing Surrebuttal).

¹⁰⁴ *Id.* at 13 and 20.

¹⁰⁵ Ex. 22 at 6 (Moul Direct).

¹⁰⁶ Ex. 23 at 4-5 (Moul Rebuttal).

¹⁰⁷ Ex. 22 at 19 and Appendix E (Moul Direct).

67. Likewise, Mr. Moul's Capital Asset Pricing Model analysis includes a leverage adjustment to his beta value. Argues Mr. Moul: "To develop a CAPM cost rate applicable to a book value capital structure, the *Value Line* (market value) betas have been unleveraged and releveraged for the book value common equity ratios using the [Robert S.] Hamada formula."¹⁰⁸

68. Mr. Moul also includes a size adjustment of 0.92 percent in his CAPM analysis. Mr. Moul argues that because of MERC's relatively smaller size, when compared to like local distribution companies, both the risk of investment in MERC, and the rates of return it must offer investors, increases.¹⁰⁹

69. Testing his synthesized Return on Equity recommendation, Mr. Moul employed a Comparable Earnings analysis. He used both historically-realized returns and forecasted returns for non-utility companies over a ten-year period. The historical median rate of return for these companies was 13.90 percent and the forecasted return was 12.00 percent, with a combined average of 12.95 percent. Like the CAPM and Risk-premium approaches, the results of Comparable Earnings analyses are influenced by analyst judgment.¹¹⁰

70. Combining MERC's capital structure with the Return on Equity derived from Mr. Moul's analysis, MERC concluded that the overall cost of capital was 11.75 percent. This figure follows from Mr. Moul's analytical methods when his original calculations, which used data from May of 2008, are updated with data from October of 2008.¹¹¹

71. While MERC argues with genuine force that its comparatively small size makes it more difficult to attract investment capital than companies in either the "Comparison Group" or the "Gas Group,"¹¹² its proposed methods of accounting for these challenges have not been recognized previously by the Commission and they invite more risk of analyst manipulation than does the Discounted Cash Flow method.¹¹³

¹⁰⁸ Ex. 22 at 41-42; Ex. 23 (PRM-2), Sch. 1; see also, Ex. 80 at 54-55 (Griffing Direct); Ex. 81, Attachment MFG-8, Schedule 2 and Schedule 5; Ex. 99 at 8-9 (Griffing Surrebuttal).

¹⁰⁹ Ex. 22 at 43-44 (Moul Direct).

¹¹⁰ See, Ex. 22 at 46-48 (Moul Direct); Ex. 80 at 57 (Griffing Direct).

¹¹¹ Ex. 22 at 1-2 and 5-7 (Mould Direct); Ex. 23 at 4-5 (Moul Rebuttal).

¹¹² Compare generally, Ex. 99 at 16 - 19 (Griffing Surrebuttal).

¹¹³ See, Ex. 80 at 57 (Griffing Direct); compare generally, *In the Matter of a Petition by Peoples Natural Gas Company and Northern Minnesota Utilities, Divisions of UtiliCorp United, Inc. for Authority to Increase Natural Gas Rates in Minnesota*, Order Accepting and Adopting Settlement, Docket No. G007,011/GR-00-951 (July 29, 2003) (the Commission rejected an early settlement amongst the parties in the predecessor rate case, in part, on the grounds that the proposed adjustments "were based upon a cost-justification model that ... had not been examined and approved in any Commission proceeding").

72. Dr. Griffing's Discounted Cash Flow analysis is firm evidence that a Return on Equity of 10.21 percent will be sufficient to attract investment capital. His additional calculations using this method with MERC's Gas Group further emphasize the reasonableness of his Return on Equity recommendation.¹¹⁴

73. Twenty seven of the twenty eight awards reported in the November 2008 *Public Utilities Fortnightly* Return on Equity survey were 11.20 percent or lower.¹¹⁵

74. By using the OES' proposed capital structure and Dr. Griffing's updated Discounted Cash Flow analysis, it is clear that the allowable Rate of Return is 7.98 percent, which reflects the OES's recommended Return on Equity of 10.21 percent.¹¹⁶

IV. TEST YEAR REVENUE, EXPENSES AND OPERATING INCOME

75. When setting rates, the Commission will consider those revenues and expenses shown by the Applicant to be reasonably representative of ongoing operations and incurred during its projected test year.¹¹⁷

76. Use of the year ending on December 31, 2008, as the projected test year for determining MERC's revenue requirement is reasonable.¹¹⁸

77. The OES' proposed adjustments to the test year sales and revenue are reasonable.¹¹⁹

78. At the close of the evidentiary hearing on February 4, 2009, a single expense issue remained unresolved between OES and MERC. The parties agree upon the proper allocation of rate case expenses to non-regulated activities and an amortization period for the rate case expenses. The parties do not fully agree on an appropriate method of accounting for, and later recovery of, rate case expenses.

79. MERC proposed a three-year amortization period for its rate case expenses. It argues that this is a reasonable time-period based upon its estimate of the timing of its next application for a rate increase. MERC states that, overall, companies in the natural gas industry are undertaking rate cases more frequently than in years past; and that a three-year amortization period is consistent with the current cycle of rate-case filings.¹²⁰

¹¹⁴ Ex. 99 at 5 (Griffing Surrebuttal); Ex. 101, Attachment MFG-S-4, Schedule 2.

¹¹⁵ Ex. 99 at 11 (Griffing Surrebuttal).

¹¹⁶ *Id.* at 13.

¹¹⁷ *Notice and Order for Hearing*, MPUC Docket No. G-007,011/MR-08-835 at 5 (September 25, 2008).

¹¹⁸ Ex. 24 (Kyto Direct).

¹¹⁹ Ex. 82 at 9-32 (Heinen Direct); Ex. 25 at 16 (Kyto Rebuttal).

¹²⁰ Ex. 24 at 21-22 (Kyto Direct).

80. While OES accepts as reasonable MERC's proposal to amortize its rate case expenses over a three-year period, without a substantial history of rate filing activity by MERC, OES is not confident of its prediction that MERC will return to the Commission with another rate application in three years time. It expresses the concern that, without other safeguards, MERC will over-collect significant rate-making expenses after the three-year amortization period. OES proposes that MERC segregate through deferred accounting rate-case expenses after the three-year amortization period.¹²¹

81. MERC's request for current rate case expenses in this matter is appropriate, the total of which should be amortized over a three-year period. Further, establishing a deferred accounting account to track any monthly recovery of rate case expense after the three-year amortization period expires is reasonable.

82. The OES recommendation that rate case expenses after the expiration of the three-year amortization period be credited against the revenue requirement in MERC's next rate case does not constitute single-issue ratemaking.

83. The OES recommendation that rate case expenses after the expiration of the three-year amortization period be credited against the revenue requirement in MERC's next rate case is reasonable.

V. REVENUE REQUIREMENTS - GROSS REVENUE DEFICIENCY

84. The record in this matter shows that under the current rates MERC will experience a substantial revenue shortfall. MERC is entitled to recover this revenue shortfall through an adjustment of its natural gas distribution rates.

85. With the adjustments to rate base and test year operating expenses and revenues agreed to by OES and MERC (either in prefiled testimony or during the evidentiary hearing), the one remaining factor influencing the gross revenue deficiency is the cost of common equity.¹²²

86. Using the OES's recommended cost of equity of 10.21 percent and the resultant rate of return of 7.98 percent, the undersigned finds that the gross revenue deficiency for MERC-PNG is approximately \$13,646,056 and the gross revenue deficiency for MERC-NMU is approximately \$1,885,474.¹²³

87. These numbers are approximate because it is anticipated that the parties will submit final gross revenue deficiency calculations for each MERC subunit as part of the process of the presentment and review of this Report and the final rate determination by the Commission.

¹²¹ Ex. 84, at 9 (Johnson Direct).

¹²² See generally, *MERC Reply Brief*, at 1-2.

¹²³ See, Ex. 98 at 19 (St. Pierre Surrebuttal); Ex. 98, Attachments MAS-S-2 and MAS-S-10.

VI. RATE DESIGN

A. Background on the Existing Rate Structure

88. MERC's natural gas rate structure consists of rates designed to recover wholesale (commodity and demand) costs; fixed customer costs; and costs to deliver the wholesale gas to customers. The customer charge and delivery rate constitute the delivery charge portion of a customer's bill.¹²⁴

89. Under Minnesota law, the wholesale cost to MERC for the natural gas that is sold to customers is passed through to customers without additional markup. In Minnesota, the costs of providing natural gas service and the utility's authorized rate of return are recovered through the delivery charge.¹²⁵

90. For Residential customers, the costs of providing natural gas service and the utility's authorized rate of return are recovered through customer charges or through a volumetric distribution charge. To the extent that customer charges do not recover the full cost of connecting a customer to, and maintaining the customer on the distribution system (including such costs as ongoing metering, billing, customer service and maintenance), the costs associated with these services will be recovered through a volumetric charge.

91. The customer charge is the amount paid monthly by any customer that is connected to MERC's gas distribution system. This charge is paid independently of gas usage. The basic customer charges were set most recently in 2003 and vary by customer class.¹²⁶

92. The delivery rate is calculated by multiplying the therms in the natural gas that is purchased by an established rate. Customary rate design practice includes allocating a portion of the projected revenue requirement to the basic charge and the remainder to the delivery rate.¹²⁷

93. Among the services provided by MERC to its customers are sales service and transportation service. Under sales service, customers rely on MERC-PNG's or MERC-NMU's regulated utility to obtain gas and arrange for transportation of that gas to the customer.¹²⁸

94. Under transportation service, customers acquire their own gas supplies through an unregulated gas supplier and arrange for delivery to a Town Border Station

¹²⁴ See generally, Eagan Public Hearing Transcript, at 25-29 (Remarks of Dasinger).

¹²⁵ See generally, Minn. Stat. § 216B.016 (7); Minn. R. 7825.2700 (2) (2007); Exs. 13 – 15.

¹²⁶ Evidentiary Hearing Transcript, Volume 1 at 19 (Cloninger Testimony).

¹²⁷ Compare generally, Ex. 97 at 6 (Peirce Surrebuttal); Ex. 97, Attachment SLP-16.

¹²⁸ Ex. 90 at 6 (Peirce Direct).

(TBS). From Town Border Stations, MERC-PNG's and MERC-NMU's distribution system is used to transport the gas to various customers. Transportation customers typically bear more responsibility for balancing and nominating gas supplies than do sales customers.¹²⁹

95. Both sales and transportation customers may elect to take "firm" or "interruptible" service. Firm service is typically not subject to curtailment and is priced to include the costs of providing a reliable source of supply. Service to customers who subscribe to interruptible tariffs can be order to curtail their use for a time as may be needed in order to maintain overall system reliability.¹³⁰

96. Regardless of where customers obtain gas supplies – from MERC or some other supplier – all customers who use MERC's distribution system must pay for the transportation of natural gas. Indeed, a key principle of effective rate design is that the cost of transportation to a particular customer be uniform among, and not a basis of competition between, MERC and other potential suppliers of natural gas.¹³¹

97. This transportation component is strictly regulated under Minnesota state law because the distribution of natural gas is considered a "natural monopoly." Rates for these services include, at a minimum, the incremental cost of transporting natural gas through the distribution system, along with providing metering, billing and other customer services.¹³²

98. MERC proposed to increase the monthly Transportation Administration Fee from the current level of \$150.00 to \$170.00 per metered account for all transportation customers.¹³³

99. Constellation objects to MERC's proposal to increase the Transportation Administration Fee for small volume transportation customers and proposed that the fee be reduced to \$50.00 per month for small volume transportation customers.¹³⁴

100. The undersigned concludes that MERC's proposed increase to the transportation administration fee is supported by the Class Cost of Service study¹³⁵ and recommends that the transportation administration charge be increased to \$170.00 per month per metered account for all transportation customers and that the Commission adopt MERC's proposal to require all small volume transportation customers to install telemetry.

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *Id.* at 7.

¹³² *Id.*

¹³³ Ex. 34 at 2 (Hoffman Malueg Rebuttal).

¹³⁴ Exs. 61 and 62; Evidentiary Hearing Transcript, Volume 2A at 53-57 (Haubensak Testimony).

¹³⁵ See, Ex. 34 at 8-9 (Hoffman Malueg Rebuttal).

B. MERC's Class Cost of Service Study

101. In order to establish an estimated cost of service for the various customer classes and individual components of cost within each customer class, MERC began, as required by rule, with a Class Cost of Service Study ("CCOSS").¹³⁶

102. The objective of a Class Cost of Service Study should be to identify, as accurately as possible, which customer class is responsible for each cost incurred by the utility that is providing the service. A Class Cost of Service Study should reflect cost causality, with no other factors influencing the study.¹³⁷

103. As part of its application, MERC submitted a fully distributed embedded cost study that apportions its historic as well as ongoing costs.¹³⁸

104. MERC was the only party to submit a Class Cost of Service Study in this proceeding.

C. Revenue Apportionment

105. MERC's revenue apportionment proposals was designed to move customer classes towards their cost of service and to move the rates that are assessed by MERC-PNG and MERC-MNU closer together. MERC hopes to further consolidate the rate areas of these formerly separate utilities.¹³⁹

106. In very general terms, MERC's rate proposals for MERC-PNG and MERC-NMU share a number of the same features. MERC proposes keeping residential rates below the cost of service, although urging a movement of residential rates closer to the actual cost of service. In addition, within the general service class, MERC's proposes to set rates for the larger commercial and industrial general service customers at higher than the cost of service, while smaller commercial and industrial customers would be below the cost of service. Likewise, interruptible and transportation customers generally would continue to pay rates that are set above their cost of service.¹⁴⁰

107. To the extent that MERC-PNG's and MERC-NMU's non-general service customers can use alternative energy sources (such as propane, or No. 2, or No. 6 fuel oil) to replace natural gas, each utility must be sensitive to the prices of those alternatives in crafting rates for its customers. Unlike electric utilities which have assigned exclusive service territories, there are no assigned service areas for natural

¹³⁶ Ex. 32 at 2-5; *see also*, Minn. R. 7825.4300 (2007).

¹³⁷ Ex. 89 at 3 (Ouanes Direct).

¹³⁸ Ex. 32 at 5, 8 and 9 (Hoffman Malueg Direct); Ex. 89 at 5 and 9 (Ouanes Direct). The entire CCOSS results for MERC-PNG and MERC-NMU are presented in Ex. 7, Information Requirements Document 15.

¹³⁹ Ex. 37 at at 9-10.

¹⁴⁰ Ex. 37 at 32-34 (Walters Direct).

gas utilities. However, some non-general service customers may be able to bypass a utility's system altogether.¹⁴¹

108. MERC proposed a small increase to the distribution charge for the Super Large Volume (SLV) customer class, from \$0.0040 to \$0.0042 per therm. MERC limited the proposed rate increase for this class due to concern that any additional increases in this rate class would make MERC offerings noncompetitive and result in SLV customers bypassing MERC's system entirely. MERC asserts that once bypass occurs, it is difficult to regain these customers. So as to avoid losing the support of the super large volume customers toward common costs on the system, MERC proposes to shield this class from some of the effects of increased costs of service.¹⁴²

109. Similarly, out of concerns over potential customer bypass, MERC proposes to hold the distribution charge for MERC-NMU's SLV Interruptible Transport rate class flat.¹⁴³

110. The OES reviewed MERC's proposed revenue apportionment to SLV customers to determine whether the proposed rates are covering the incremental cost of serving them.¹⁴⁴ MERC's response to OES Information Request No. 310 indicated that incremental costs are being covered, and, thus, the OES concluded that MERC's proposed revenue apportionment to the SLV customers is reasonable.¹⁴⁵

111. The OES reviewed MERC's proposed revenue apportionment, and the rationale offered by MERC for the proposed apportionment, and determined that the apportionment was reasonable.¹⁴⁶

112. Further, OES concluded that the customer classes that are furthest from cost are being moved slightly closer to cost than other customer classes, without shifting the burden significantly to those classes of customers which are apportioned revenue responsibility above their allocated costs.¹⁴⁷

113. No other party filed testimony on the revenue apportionment in this case.

114. The undersigned concludes that MERC supported its use of fully distributed embedded Class Cost of Services Study and that its study should be used as a basis for revenue apportionment and rate design.

¹⁴¹ Ex. 90 at 8.

¹⁴² Ex. 37 at 25 and 29.

¹⁴³ Ex. 2 at Sheet No. 6.20 (Proposed Final Tariffs – Redline); Ex. 37 at 25; Ex. 37, Attachment GJW-1, Schedule 2, Page 2 of 2.

¹⁴⁴ Ex. 90 at 13-14 (Peirce Direct); *compare generally*, Minnesota Statute § 216B.163 (4)(1) (2008).

¹⁴⁵ See, Ex. 90 at 15 and Attachment SLP-5 (Peirce Direct).

¹⁴⁶ Ex. 90 at 13-16 (for MERC-PNG), 19-20 (for MERC-NMU) (Peirce Direct).

¹⁴⁷ Ex. 90 at 16.

115. Based upon the agreed upon resolution between MERC and the OES of certain financial issues, it is predicted that the gross revenue deficiency will be less than what MERC originally requested.¹⁴⁸

116. In the event of a determination that MERC receives a smaller revenue requirement than applied for in this case, OES recommended that rates for the Super Large Volume customers for MERC-PNG and MERC-NMU be held constant, and that the decreased revenue requirement be apportioned proportionately to the remaining customer classes. MERC agreed with this approach.¹⁴⁹

117. Historically and in MERC's current proposal, the rates established for the Super Large Volume customer classes have reflected concerns over both recovering the cost of service while attempting to prevent bypass of MERC's natural gas system by these customers. As a result, it is reasonable for the Commission to consider the SLV rate class separately when passing upon potential reductions to a revenue apportionment so to meet a later lower revenue requirement.

118. The OES's proposed revenue apportionment with proportionately reduced amounts for all but the Super Large Volume customer class is reasonable, and strikes the best balance between the various rate design principles used by the Commission. The amount apportioned to Super Large Volume class should be kept as initially requested by MERC.

119. The record includes a recommended revenue apportionment as to which all parties have had the opportunity to submit pre-filed Rebuttal Testimony and test through cross-examination. This recommendation is reasonable for all customer classes and should be accepted.¹⁵⁰

D. Residential Customer Charge

120. The residential customer's bill includes three elements—the commodity charge for natural gas, the volumetric distribution charge and the customer charge.

121. Currently, MERC-NMU's residential customer charge is set at \$5.50 per month and MERC-PNG's is set at \$6.50 per month. MERC proposes to charge both MERC-NMU and MERC-PNG residential customers a \$9.00 per month customer charge. As with other features of its rate application, MERC asserts that its proposal is intended to move customer charges for the residential classes closer to the actual cost

¹⁴⁸ Evidentiary Hearing Transcript, Volume 1 at 199 (Walters).

¹⁴⁹ Ex. 39 at 2 (Walters Rebuttal); Ex. 90 at 16 and 20 (Peirce Direct); Evidentiary Hearing Transcript, Volume 1 at 215-18 (Walters Testimony).

¹⁵⁰ Ex. 90 at 16-17 (Peirce Direct); Evidentiary Hearing Transcript, Volume 2B at 84-132 (Peirce Testimony).

of service and to facilitate a future consolidation of the rate schedules between MERC-PNG and MERC-NMU.¹⁵¹

122. MERC’s incremental analysis shows that the proposed residential customer charge of \$9.00 per month does not recover the incremental, customer classified costs.¹⁵²

123. The residential customer charge has not been increased in the eight years since Aquila’s rate case in Docket No. G007,011/GR-00-951.¹⁵³

124. The Consumer Price Index for Urban Consumers has increased 24.79% between the 2000 test year and 2008.¹⁵⁴

125. MERC asserts that the current and proposed customer charges are below the cost of service and the recoveries are supported by the Class Cost of Service Study:

	Current Customer Charge	Proposed Customer Charge	Customer Charge Justified by the CCOSS
MERC-PNG (GS-1, GS-4, and GS-5)	\$6.50	\$9.00	\$25.47
MERC-NMU (GS-NMU)	\$5.50	\$9.00	\$29.11 ¹⁵⁵

Because the customer charges are below the customer cost, MERC argues that these costs are shifted to distribution charges, and that as a result, customers with higher than average usage pay more than their proportionate share of these costs. MERC maintains that this shifting of costs constitutes an intra-class subsidy that is inconsistent with the provisions of Minn. Stat. §§ 216B.03 and 216B.07.¹⁵⁶

126. As Ms. Peirce of OES elegantly summarized in her testimony, “[i]mplicit in the argument to keep customer charges low is that it is appropriate to ask Customer A to pay some of the fixed costs of serving Customer B.”¹⁵⁷

¹⁵¹ Ex. 37 at 9-10 (Walters Direct); Ex. 90 at 20 (Peirce Direct).

¹⁵² Ex. 36 at 20 (Hoffman Malueg Surrebuttal); Ex. 36, Attachment JCHM-2.

¹⁵³ Ex. 39, Walters Rebuttal at 7.

¹⁵⁴ Ex. 16 at 6 (Cloinger Direct).

¹⁵⁵ Ex. 37 at 11 (Walters Direct).

¹⁵⁶ Ex. 40 at 5-6 (Walters Surrebuttal); Ex. 97 at 5 (Peirce Surrebuttal); see *a/so*, Minn. Stat. § 216B.03 (“Rates shall not be unreasonably preferential, unreasonably prejudicial, or discriminatory, but shall be sufficient, equitable, and consistent in application to a class of customers”); Minn. Stat. § 216B.07 (“[n]o public utility shall, as to rates or service, make or grant any unreasonable preference or advantage to any person or subject any person to any unreasonable prejudice or advantage”).

¹⁵⁷ Ex. 97 at 5 (Peirce Surrebuttal).

127. The amount of intra-class subsidization from customers within the residential customer class is not based upon an ability to pay. For example, Ms. Peirce predicts that the result of maintaining the fixed customer charge below the actual cost of services is that some lower-income residential customers, who have high winter usage, will pay for costs through volumetric charges that they do not impose on the system.¹⁵⁸

128. While acknowledging the appropriateness of moving customer charges closer to actual costs, OES prefers a set of more modest increases, and extending the subsidies from other customer classes as an “interim step toward consolidating the rate structures.”¹⁵⁹ It initially urged a residential customer charge of \$7.50 for MERC-PNG and \$7.00 for MERC-NMU – and then later proposed that a residential customer charge of \$7.25 be set for both companies.¹⁶⁰

129. The OAG-RUD claimed that MERC’s cost support does not provide a basis for an increase in the residential customer charge. OAG-RUD argued that the residential customer charges for MERC-PNG and MERC-NMU should not increase.¹⁶¹

130. The OAG-RUD also took issue with relying too heavily on the CCROSS as the basis for cost allocation or as a revenue recovery tool. Its view was that the Commission can more accurately determine whether a subsidy for a class exists by comparing marginal costs for providing a specific service with the rate charged.¹⁶²

131. As detailed more fully in the Memorandum that follows below, MERC has demonstrated that an increase in the residential customer charge from \$5.50 for MERC-NMU and \$6.50 for MERC-PNG to \$9.00 per month for each company is reasonable and appropriate. MERC has demonstrated that the proposed increases in the residential customer charge appropriately assigns costs to that class, while avoiding ratepayer confusion, disincentives to conservation and significant rate shock. Additionally, the proposed customer charges will likely result in a more uniform set of winter and summer utility bills; send more accurate price signals to customers by bringing their rates closer to the true cost of service; and provide incrementally more stable cash flows to the utility.¹⁶³

¹⁵⁸ Ex. 90 at 22-23 (Peirce Direct); see also, Ex. 70 at 10 (Lindell Rebuttal); Ex. 97 at 5-7 (Peirce Surrebuttal).

¹⁵⁹ Ex. 90 at 21 (Peirce Direct).

¹⁶⁰ Ex. 97 at 2 (Peirce Surrebuttal).

¹⁶¹ *OAG-RUD Reply Brief*, at 2-3.

¹⁶² *Id.* at 7-8.

¹⁶³ Ex. 37 at 12-16 (Walters Direct); Ex. 40 at 2 (Walters Surrebuttal).

132. In the view of the Administrative Law Judge, the claim that an increase in the residential customer charge of (up to and including) \$3.50 per month will have the tendency to “confuse and alienate” customers is overstated.¹⁶⁴

VII. CONSERVATION IMPROVEMENT PROGRAM

133. MERC proposed to include certain 2007 year-end Conservation Improvement Program (“CIP”) tracker account balances and certain Demand Side Management (“DSM”) financial incentives in test year CIP expenses. MERC proposes to recover these expenses through the Conservation Cost Recovery Charge (“CCRC”), which is a feature of both MERC-PNG’s and MERC-NMU’s base rates.¹⁶⁵

134. MERC’s allocation of its approved Conservation Improvement Plan expenses and Conservation Cost Recovery Charge is appropriate.

135. MERC requested Commission approval of the CIP tracker account balances and the Demand Side Management incentives parallel filings submitted in MPUC Dockets Nos. G011/M-08-843 and G007/M-08-844.¹⁶⁶

136. For MERC-PNG, MERC proposed a 2007 year end CIP tracker account balance of \$2,764,463 and 2006 and 2007 DSM financial incentives of \$491,706 and \$468,445, respectively.¹⁶⁷

137. For MERC-NMU, MERC proposed a 2007 year end CIP tracker account balance of \$866,744 and 2006 and 2007 DSM financial incentives of \$39,113 and \$69,179, respectively.¹⁶⁸

138. On December 17, 2008, the OES submitted comments in Docket Nos. G011/M-08-843 and G007/M-08-844. For MERC-PNG, the OES recommended adjustments to the 2007 CIP tracker account, which resulted in a year-end 2007 balance of \$2,715,561 – rather than the proposed year-end 2007 balance of \$2,764,463 – a difference of \$48,902.¹⁶⁹

139. Similarly, for MERC-NMU, the OES recommended adjustments to the 2006 and 2007 CIP tracker accounts, which resulted in a year-end 2007 balance of

¹⁶⁴ Compare generally, *In the Matter of an Application by Northern States Power Company, a Minnesota Corporation and Wholly Owned Subsidiary of Xcel Energy, Inc., for Authority to Increase Rates for Natural Gas Service in Minnesota*, Docket No. G-002/GR-06-1429 at 42 (September 10, 2007) (The Commission retains an \$8.00 per month residential customer charge).

¹⁶⁵ Ex. 26 at 4 (Gunn Direct); Ex. 85 at 4-5 (Minder Direct).

¹⁶⁶ Ex. 26 at 5-6.

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*

¹⁶⁹ Ex. 94 at 2-3 (Minder Surrebuttal).

\$825,033 – rather than the proposed year-end 2007 balance of \$866,745 – a difference of \$41,712.¹⁷⁰

140. The OES's recommended adjustments for MERC-PNG and MERC NMU included a recommended disallowance of their proposed 2007 DSM financial incentives in Docket Nos. G011/M-08-843 and G007/M-08-844. MERC was also not able to reconcile two different CIP expenses for 2006 and 2007 for MERC-PNG and MERC-NMU that were reported in the CIP tracker accounts in Docket Nos. G011/M-08-843 and G007/M-08-844 and the CIP status reports in Docket Nos. G011/CIP-04-816.03 and G007/CIP-04-815.03, respectively. Thus, the OES recommended including in the CIP tracker accounts the CIP expense amounts that were previously approved by the Director of the OES in MERC's status reports dockets. In addition, MERC did not correctly calculate its year-end 2006 CIP tracker account balances for MERC-PNG and MERC-NMU in Docket Nos. G011/M-08-843 and G007/M-08-844, respectively.¹⁷¹

141. On January 7, 2009, MERC responded in Rebuttal Testimony by proposing a two-track procedural approach for determining the levels of CIP tracker account balances and DSM financial incentives to include in test year CIP expenses for MERC-PNG and MERC-NMU. Each track would be dependant upon the timing of the Commission's determinations in MPUC Docket Nos. G011/M-08-843 and G007/M-08-844 in relation to its determinations in this docket.¹⁷²

142. If the Commission does not make determinations in Docket Nos. G011/M-08-843 and G007/M-08-844 prior to a determination on final rates in the present docket, MERC proposed to use the CIP tracker account balances and DSM financial incentives for 2006 and 2007 proposed by the OES in Docket Nos. G011/M-08-843 and G007/M-08-844 to calculate deferred CIP expenses for the test year. MERC also proposed to include in test year CIP expenses 2005 DSM financial incentives for MERC-PNG and MERC-NMU of \$380,631 and \$116,415, respectively. These DSM financial incentives were previously approved by the Commission in Docket Nos. G011/M-06-823 and G007/M-06-822, but were inadvertently not included for recovery by MERC. In addition, MERC proposed that it be ordered to recover any difference between the CIP tracker balances and DSM financial incentives included in test year CIP expenses in this proceeding and those ultimately approved by the Commission in Docket Nos. G007/M-08-844 and G011/M-08-843. This set of arrangements would form "Track One."¹⁷³

143. If the Commission makes determinations in Docket Nos. G011/M-08-843 and G007/M-08-844 prior to a determination on final rates in the present docket, however, MERC proposed that the approved 2007 year-end CIP tracker account balances and DSM financial incentives for 2005, 2006, and 2007 be included in test

¹⁷⁰ *Id.*

¹⁷¹ Ex. 94 at 5-6 (Minder Surrebuttal); Evidentiary Hearing Transcript, Volume 2B at 62-66 and 68 (Minder).

¹⁷² Ex. 94 at 11-13 (Minder Surrebuttal).

¹⁷³ Ex. 27 at 4-5 (Gunn Rebuttal).

year CIP expenses in the general rate case. This set of alternative arrangements would form "Track Two."¹⁷⁴

144. On January 22, 2009, the OES agreed in Surrebuttal Testimony with MERC's two-track procedural approach.¹⁷⁵

145. The undersigned concludes that MERC's two-track approach for the recovery of Conservation Improvement Program tracker account balances and Demand Side Management incentives, is consistent with the Commission's prior practice and yet does not prejudice or presume to foretell the decisions that the Commission will in Docket Nos. G011/M-08-843 and G007/M-08-844.

Based on the foregoing Findings, the Administrative Law judge makes the following:

CONCLUSIONS

1. The Minnesota Public Utilities Commission and the Administrative Law Judge have jurisdiction over the subject matter of this proceeding pursuant to Minnesota Statutes §§ 14.50, 216B.08 and 216B.16.

2. In the absence of competition, government regulation has been used to approximate the results that would be achieved in a competitive environment. Minnesota Statutes §§ 216B.03 and 216B.07 require rates to be reasonable and not unreasonably discriminatory.

3. Modifying MERC's natural gas rates in the manner described in the Findings and Conclusions above results in just and reasonable rates that are in the public interest as those terms are used Minn. Stat. § 216B.11.

4. The rate finally ordered by the Commission should be compared to the interim rate set in the Commission's September 25, 2008 Order Setting Interim Rates, and a refund be ordered to the extent that the interim rate exceeds the final rate, subject to any true-up ordered regarding any particular expense.

5. Any Finding that is more appropriately designated as a Conclusion is hereby adopted as a Conclusion.

RECOMMENDATION

Based upon the foregoing Findings and Conclusions, IT IS RECOMMENDED that the Minnesota Public Utilities Commission determine that:

¹⁷⁴ *Id*; see also, Evidentiary Hearing Transcript, Volume 1 at 123-124 (Gunn).

¹⁷⁵ Ex. 94 at 4 and 7-13 (Minder Surrebuttal).

1. MERC is entitled to increase gross annual revenues in the manner and in an amount consistent with the terms of this Order.

2. Within 30 days of the service date of this Order, MERC shall file with the Commission for its review and approval, and serve on all parties in this proceeding, revised schedules of rates and charges reflecting the revenue requirement for annual periods beginning with the effective date of the new rates, and the rate design decisions contained herein. MERC shall include proposed customer notices explaining the final rates. Parties shall have 14 days to comment.

3. If the Commission orders an Interim Rate Refund, within 30 days of the service date of this Order, MERC shall file with the Commission for its review and approval, and serve upon all parties in this proceeding, a proposed plan for refunding to all customers, with interest, the revenue collected during the Interim Rate period in excess of the amount authorized herein. Parties shall have 14 days to comment.

4. The matters set forth in these Findings and Conclusions should govern the mathematical and computational aspects of the Findings and Conclusions. Any computations found to be in conflict with the items expressed should be adjusted to conform to the body of this Report.

Dated: April 17, 2009.

/s/ Eric L. Lipman
ERIC L. LIPMAN
Administrative Law Judge

NOTICE

Notice is hereby given that pursuant to Minn. Stat. § 14.61, and the Rules of Practice of the Minnesota Public Utilities Commission (“Commission”) and the Office of Administrative Hearings, exceptions to this Report, if any, by any party adversely affected must be filed according to the schedule which the Commission will announce. Exceptions must be specific and stated and numbered separately. Proposed Findings of Fact, Conclusions and Order should be included, and copies there of shall be served upon all parties. Oral argument before a majority of the Commission will be permitted to all parties adversely affected by the Administrative Law Judge’s recommendation who request such argument. Such request must accompany the filed exceptions or reply (if any), and shall be filed with the e-docket system, or an original and 15 copies of each document should be filed with the Commission.

The Commission will make the final determination of the matter after the expiration of the period for filing exceptions, or after oral argument, if such is requested and had in the matter.

Further notice is hereby given that the Commission may, at its own discretion, accept or reject the Administrative Law Judge’s recommendation and that said recommendation has no legal effect unless expressly adopted by the Commission as its final order.

MEMORANDUM

While the record in this case includes a complex array of cost and revenue data, the disputes between the parties can be quickly summarized: As to one or another feature of MERC's rate proposal, each party comes forward requesting special relief from the Commission's familiar methods, in the hopes of obtaining benefits for particular companies or classes of customers.

In this vein, for example, MERC argues that notwithstanding a long-history of using an unmodified Discounted Cash Flow analysis, the Commission should employ a set of analyst-developed adjustments to make MERC's equities more attractive to investors. While MERC argues with genuine force that its comparatively small size makes it more difficult to attract investment capital than companies in either the "Comparison Group" or the "Gas Group," its proposed methods of accounting for these challenges have not been recognized previously by the Commission and they invite more risk of analyst manipulation than does the Discounted Cash Flow method. Without clear guidance that the types of adjustments undertaken by Mr. Moul are acceptable to the Commission, and are not overly susceptible to analyst manipulation, such enhancements to the DCF method are disfavored.

For a different set of beneficiaries, OES and OAG-RUD argue that the Commission should intervene to keep the monthly charge to residential customers artificially low for the indefinite future. OES and OAG-RUD urge this result so as to avoid "rate shock" to residential customers. While it is true that 20 of MERC's 207,000 customers submitted testimony opposing any residential rate increase, in the view of the Administrative Law Judge, the claim that an increase in the residential customer charge of up to and including \$3.50 per month will have the tendency to "confuse and alienate" a large number of customers, is overstated. This is particularly true because the monthly charge represents a relatively small portion of the average residential customer's annualized natural gas bill and MERC's proposal includes a corresponding average per therm rate reduction for residential customers.¹⁷⁶

Indeed, the more likely possibility is that the alternatives urged by OES and OAG-RUD would be more shocking to residential customers. OES and OAG-RUD recommend that comparatively larger shares of fixed costs be shifted to distribution charges, such that customers with higher than average usage would continue to pay more than their proportionate share of these costs. "Implicit in the argument to keep customer charges low," Ms. Peirce of OES reminds us, "is that it is appropriate to ask Customer A to pay some of the fixed costs of serving Customer B."¹⁷⁷ Because there is genuine doubt that any of the twenty commentators who opposed a residential rate increase, would prefer the system of higher average costs per therm and cross-subsidizing their neighbor's utility bills, as argued by OES and OAG-RUD, the

¹⁷⁶ Ex. 37 at 13-14 (Walters Direct); Ex. 38, Schedules 10 and 11.

¹⁷⁷ Ex. 97 at 5 (Peirce Surrebuttal); see *also*, Ex. 90 at 22-23 (Peirce Direct); Ex. 97 at 6-7 (Peirce Surrebuttal).

predictions of “rate shock” are of limited guidance. The alternatives that OES and OAG-RUD recommend for residential customers are worse.

Moreover, to the extent that any rates which have the tendency to “shock customers” follow from long lag times between ratemaking petitions, all of the participants in the ratemaking process (the Applicants, OES, OAG-RUD, Intervenors, OAH, the Commission, the Minnesota Legislature and the public) bear some share of responsibility. As the record in this comparatively simple case bears out, the ratemaking process (particularly for companies whose stock is not publicly traded) is a very resource-intensive and costly enterprise.¹⁷⁸ Even in those instances in which the rate case expenses are fully recoverable at a later date, sensible applicants will approach with genuine caution the prospect of undertaking a new rate case because the staff impacts upon employees can be so grueling.

Thus, while guarding against potential “rate shock” is an important part of the Commission’s analysis, it should be viewed as one factor in the context of a much broader regulatory environment. A countervailing concern to “shocking” residential customers is that even bringing a narrow set of ratemaking matters to a decision is a costly, difficult and complex undertaking.¹⁷⁹

On balance, MERC’s requested increases in the monthly charges for residential customers are consistent with the actual costs of service and are reasonable.

The Taconites come forward to argue that to the extent that there is smaller revenue deficiency for MERC than was earlier projected, they should share equally in any later re-apportionment of the revenue requirements. Because the rates for MERC’s SLV customers will increase at a far smaller rate than other classes, and MERC-PNG’s SLV rates are now set below the cost of service,¹⁸⁰ these arguments are not well taken. In the view of the Administrative Law Judge, to the extent that MERC’s revenue requirements are later re-apportioned, the customer classes that are furthest from cost should be moved closer to cost, provided that other customer classes are not “apportioned revenue responsibility above their allocated costs.”¹⁸¹

In its application, MERC proposes to raise the Transportation Administration Fee from \$150 to \$170. Constellation urges a 66 percent reduction in the current fee for small volume transportation customers like it. Because MERC’s requested increase reflects the reasonable monthly costs of administering MERC’s transportation tariff for

¹⁷⁸ Compare generally, Ex. 25 at 12 (Kyto Rebuttal).

¹⁷⁹ Compare also, Eagan Public Hearing Transcript, at 31-32 (a ratepayer from Lakeville, Minnesota wonders why a utility that faced increases costs would wait to file a petition to increase its rates); Ex. 93 at 10 (OES Financial Analyst Mark A. Johnson notes the possibility that MERC may file a new rate case within three years, but, because he is not an official of MERC, cannot confidently predict how the company will assess the costs and benefits of a follow-on filing).

¹⁸⁰ Evidentiary Hearing Transcript, Volume 2B at 122-23 (Peirce).

¹⁸¹ Ex. 90 at 16 (Peirce Direct).

each metered account; these costs are not related to amount of gas that is consumed by the gas customer; and the Commission set this fee at \$150 per month for all classes of MERC customers in 2000; the fee reduction requested by Constellation is unwarranted.

With one exception, the Administrative Law Judge has recommended the results that follow from the familiar formulas over special adjustments for particular interests.

The one exception is with respect to MERC's request that the rate of increase for the class of Super Large Volume customers be held far lower than would otherwise be indicated by the Class Cost of Service Study. Presumably, if given its druthers, MERC would much prefer to assign the Super Large Volume customers rates which match the true costs of providing the service to these companies; but it refrains from urging this result out of concern over customer bypass and the resulting impact that bypass might have upon revenues for the entire system. In the view of the Administrative Law Judge, this rationale has special persuasive force because it is not an example of a party's preferred result being urged over an opposing party's competing interests.

The Commission is best guided by the methods it has followed in the past – which, in this case, can be found in twin pillars of OES's updated Discounted Cash Flow analysis and MERC's Class Cost of Service Study. With these tools, the Commission is well equipped to promote the efficient use of resources, a reasonable rate of return for regulated companies and the adoption of rates that are fair and reasonable for all classes of customers.

E. L. L.