

**BEFORE THE WASHINGTON
UTILITIES & TRANSPORTATION COMMISSION**

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,

Complainant,

v.

CASCADE NATURAL GAS,

Respondent.

DOCKET UG-200568

**RESPONSE TESTIMONY OF MARK E. GARRETT (MEG-1T)
ON BEHALF OF THE
WASHINGTON STATE OFFICE OF THE ATTORNEY GENERAL
PUBLIC COUNSEL UNIT**

EXHIBIT MEG-1T

November 19, 2020

DOCKET UG-200568

RESPONSE TESTIMONY OF MARK E. GARRETT

EXHIBIT MEG-1T

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Exhibit MEG-23	Cascade Response to UTC Staff Data Requests 26 and 27

I. WITNESS IDENTIFICATION AND PURPOSE OF TESTIMONY

1 **Q. Please state your name and business address.**

2 A. My name is Mark Garrett. I am the President of Garrett Group Consulting Inc., an
3 Oklahoma based firm specializing in public utility regulation, litigation, and consulting
4 services. My business address is 4028 Oakdale Farm Circle, Edmond, Oklahoma 73013.

5 **Q. Please describe your educational background and your professional experience
6 related to utility regulation.**

7 A. I am an attorney and a certified public accountant. I work as a consultant in the area of
8 public utility regulation. I received my bachelor's degree from the University of
9 Oklahoma and completed postgraduate hours at the Stephen F. Austin State University
10 and at the University of Texas at Arlington and Pan American. I received my juris
11 doctorate degree from Oklahoma City University Law School and was admitted to the
12 Oklahoma Bar in 1997. I am a Certified Public Accountant licensed in the States of Texas
13 and Oklahoma with a background in public accounting, private industry, and utility
14 regulation. In public accounting, as a staff auditor for a firm in Dallas, I primarily audited
15 financial institutions in Texas. In private industry, as controller for a mid-sized (\$300
16 million) corporation in Dallas, I managed the corporate accounting function, including
17 general ledger, accounts payable, financial reporting, audits, tax returns, budgets,
18 projections, and supervision of accounting personnel. In utility regulation, I served as an
19 auditor in the Public Utility Division of the Oklahoma Corporation Commission from
20 1991 to 1995. In that position, I managed the audits of major gas and electric utility
21 companies in Oklahoma. Before leaving the Oklahoma Commission I served as the
22 personal aide to Commissioner Bob Anthony. Since leaving the Commission, I have

1 worked on rate cases and other regulatory proceedings on behalf of various consumers
2 and consumer groups. I have provided testimony before the commissions in the states of
3 Alaska, Arizona, Arkansas, Colorado, Florida, Indiana, Massachusetts, Nevada,
4 Oklahoma, Texas, Utah, and Washington. My qualifications were accepted in each of
5 those states.

6 My clients primarily include large industrial customers, large gaming customers
7 in Nevada, large hospitals and hospital groups, universities, cities, large commercial
8 customers and solar industry interveners. I have also testified on behalf of commission
9 staffs and offices of attorneys general in the states of Indiana, Nevada, Oklahoma,
10 Washington, Florida and Utah. A more complete description of my education and
11 experience is provided in Exhibit MEG-2.

12 **Q. On whose behalf are you testifying?**

13 A. I am testifying on behalf of the Public Counsel Unit of the Washington Attorney
14 General's Office ("Public Counsel").

15 **Q. What is the purpose of your testimony in this proceeding?**

16 A. Garrett Group Consulting, Inc. has been engaged to review the general rate case filing of
17 Cascade Natural Gas Corporation ("Cascade" or "Company"), a wholly owned subsidiary
18 of MDU Resources Group, Inc. ("MDU Resources"), and to present recommendations
19 and ratemaking policy considerations related to the Company's proposed revenue
20 requirement and attrition adjustments for its electric and gas utilities. My testimony
21 presents Public Counsel's recommendations regarding the Company's revenue
22 requirement and attrition adjustment.

II. SUMMARY OF RECOMMENDATIONS

1 **Q. Please summarize the Company's requested rate increase and the revisions the**
2 **Company made after filing its original application.**

3 A. The Company is requesting an overall revenue increase of \$13,830,451, which is
4 approximately a 5.3% increase in rates.¹ The Company is proposing a capital structure of
5 50.4% equity and a return on that equity of 10.3%.² In response to the agreed to
6 procedural schedule, the Company submitted a supplemental filing in July 2020, that
7 recalculated its revenue deficiency based on an average of monthly averages (AMA) rate
8 base, rather than the end of period (EOP) rate base used in its original application.³ The
9 supplemental filing also updated sales volumes and revenue to reflect certain large
10 customers changing rate schedules and to correct a metering error.⁴ The Company's
11 supplemental filing resulted in a revenue deficiency of \$14,281,137. After its
12 supplemental filing, the Company recalculated its revenue requirement an additional time
13 to reflect the Company's new depreciation rates and to make additional corrections.⁵
14 These new depreciation rates reduced the Company's overall revenue requirement by
15 about \$1.022 million.⁶ My revenue requirement exhibits and recommendations utilize the

¹ See Direct Testimony of Nicole A. Kivisto, Exh. NAK-1T at 3:16-20.

² *Id.*

³ See Order 3 Prehearing Conference Order, App. B (Jul. 13, 2020).

⁴ See Order 3 Prehearing Conference Order, App. B, n.2 (Jul. 13, 2020).

⁵ See Mark E. Garrett, Exh. MEG-17, Cascade response to UTC Staff Data Request 127. Public Counsel is filing Exhibit MEG-17 so that Public Counsel may address Cascade's updated depreciation rates and the associated impact to the revenue requirement request in this general rate case. As of the filing date of this testimony, Cascade has not submitted a filing to incorporate the new depreciation rates into this general rate case.

⁶ See Exhs. MEG-8 and MEG-17.

1 Company's supplemental filing which shows a revenue deficiency of \$14,281,137. I also
2 include an adjustment to incorporate the Company's new depreciation rates.

3 **Q. Please summarize the rate impact of Public Counsel's recommendations.**

4 A. Public Counsel's witnesses recommend several adjustments which result in an overall
5 recommended rate *decrease* of \$1.619 million, as shown in the table below.

Table 1: Summary of Public Counsel's Recommendations (Millions) ⁷	
	Total
Total Increase Requested	\$14.281
Public Counsel's Proposed Adjustment to Requested Increase	\$(16.681)
Recommended Increase (Decrease)	\$(2.400)

6 Public Counsel recommends the following:

- 7 • The Company's authorized rate of return should be set at 6.83%.
- 8 • An adjustment is recommended to remove post-test year plant additions
9 and plant-related costs.
- 10 • An adjustment is recommended to remove post-test year wage increases
11 and related costs for 2021.
- 12 • An adjustment is recommended to normalize short-term incentive
13 compensation costs to target levels.
- 14 • An adjustment is proposed to remove 50% of directors' fees.

⁷ See Exh. MEG-4.

III. POST TEST YEAR PLANT ADDITIONS

1 **Q. Please describe Cascade's requested rate increase for plant and plant-related costs.**

2 A. Cascade's filing uses an historical test year ending December 31, 2019. The Company
3 proposes one set of adjustments to restate test year plant and related costs to their *end of*
4 *period* (EOP) balances. The Company then proposes another set of post-test year pro
5 forma adjustments to project the test year EOP balances out another year to
6 December 31, 2020, for certain plant that the Company expects to be in service by that
7 date. The rate base impact of these pro forma adjustments adds another \$65 million to
8 rate base.⁸

9 **Q. What is the rate impact of the post-test year additions?**

10 A. The revenue requirement impact of adding the post-test year plant additions to rate base
11 is about \$6 million.⁹ The revenue requirement impact for associated depreciation, taxes
12 and revenue growth is about \$2.8 million according to the Company.¹⁰ This means the
13 total rate increase requested for these post-test year plant estimates is about \$8.8
14 million,¹¹ or about 64% of the Company's requested rate increase.¹²

15 **Q. What portion of these post-test year projected plant costs were actually in service**
16 **and available for review when interveners filed testimony in this case?**

⁸ See Direct Testimony of Maryalice C. Peters, Exh. MCP-1T at 7:23.

⁹ See Exh. MEG-3, Summary (64,780,798 x 9.340% = 6,060,451).

¹⁰ See Peters, Exh. MCP-1T at 7:21-23.

¹¹ Calculated as follows: [\$6 million + \$2.8 million = \$8.8 million].

¹² Calculated as follows: [\$8.8 / \$13.8 = 64%].

1 A. The balance of these post-test year plant additions at September 30, 2020, was
2 \$10,321,227.¹³ The revenue requirement associated with this plant would be
3 approximately \$1.4 million,¹⁴ which represents a full rate base return on the balance plus
4 depreciation expense. This number would be lower if revenue growth was added into the
5 calculation.

6 **Q. Did Cascade invoke the Commission’s policy statement in Docket U-160531 that**
7 **addresses projected cost increases in the rate-effective period?**

8 A. No. The Company “decided not to propose a mechanism at this time due to the
9 uncertainty related to the COVID-19 global pandemic and related impacts to the
10 Company’s capital projects planning.”¹⁵

11 **Q. Has this Commission expressed concerns about using projected future levels of**
12 **expense and capital expenditures rather than historical costs as the basis for setting**
13 **rates?**

14 A. Yes. In its order for Avista’s 2015 rate case (Dockets UE-150204 and UG-150205), the
15 Commission stated:

16 [We] are concerned about authorizing a practice that simply projects future
17 levels of expense and capital expenditures that may, as multiple
18 commenters point out, “become a ‘self-fulfilling prophecy’ where there is
19 an incentive for rates of capital expenditure to be driven by an effort to
20 match earlier projections.”¹⁶

¹³ See Exh. MEG-5, Plant in Service; and see Exh. MEG-22, Cascade 2nd Revised Supplemental Response to UTC Staff Data Request 92, with Attachment.

¹⁴ Calculated as follows: [(\$10.3 x 9.34%) + (\$10.3 x 4%) = \$1.4 million].

¹⁵ See Kivisto, Exh. NAK-1T at 5:7–10.

¹⁶ *Wash. Utils. & Transp. Comm’n v. Avista Corp.* Dockets UE-150204 & UG-150205, Order No. 5 at 44.

1 The Commission has also expressly rejected using a future test year approach to
2 ratemaking.¹⁷ Cascade’s requested rate increase in this case, as described above, is based
3 upon cost projections into future periods. This request for a substantial rate increase
4 based on projected future levels of expenditures is a cause for concern.¹⁸

5 **Q. Do you agree with the Commission’s concern regarding projected cost increases?**

6 A. Yes. Since utilities “make money” based upon the level of capital they invest (rate base)
7 their natural incentive is to spend more money. If a utility is then allowed to project its
8 expenditure levels, it will most certainly achieve those levels, especially if those levels
9 are already embedded in rates.

10 **Q. Do you agree with the Company not using the Commission’s policy statement issued**
11 **in Docket U-160531 to project cost increases into the rate-effective period (which**
12 **would be 2021)?**

13 A. Yes. I agree with the Company that, with COVID-19 uncertainties, now is not the time to
14 be projecting cost increases into the future for the purpose of increasing rates even
15 further. However, I would note that although the Company is not projecting cost
16 increases into the rate-effective period (2021), it is projecting costs out one year (2020). I
17 think the same concerns about COVID-19 that make cost projections into 2021 difficult
18 apply also to 2020. Moreover, the Commission’s policy statement for projected cost
19 increases provided various protections for ratepayers such as prudence reviews and

¹⁷ *WUTC v. Pacific Power & Light Co.*, Docket UE-140762, Order 08, ¶ 8 (Mar. 25, 2015); *WUTC v. Puget Sound Energy*, Dockets UE-111048 and UG-111049, Order 08, ¶¶ 96-98 (May 7, 2012).

¹⁸ *WUTC v. Avista Corp.*, Dockets UE-160228 and UG-160229, Order 06, ¶ 68 (Dec. 15, 2016) (Avista’s results in recent years appears to be the realization of the Commission’s earlier expressed concern that authorizing a practice that simply projects future levels of expense and capital expenditures may become a self-fulfilling prophecy where capital expenditures are driven by an effort to match earlier projections.).

1 offsetting cost adjustments, which are not fully provided for under the Company’s
2 approach in this case for 2020 projections. For example, although the Company included
3 some offsetting adjustments for its requested plant increases through 2020, such as
4 accumulated deferred income tax (ADIT) and accumulated depreciation directly related
5 to those additions, it did not address the \$27 million in depreciation recoveries during
6 2020 for existing plant that will directly reduce rate base during the year.¹⁹ Some portion,
7 if not all, of that \$27 million would be used to offset the 2020 pro forma plant additions.
8 The Company cannot simply ignore this important rate base offset. In other words, the
9 Company cannot include only costs that will increase rate base for 2020, such as plant
10 additions, but ignore reductions to rate base that occur over the same period of time, such
11 as depreciation recoveries.

12 **Q. What rationale did the Company provide for projecting out one year for post-test**
13 **year plant additions?**

14 A. Primarily, the Company indicates it is seeking to avoid the “progressive and deleterious
15 impacts of regulatory lag.”²⁰

16 **Q. Do you agree with the Company concerns regarding the “progressive and**
17 **deleterious” impacts of regulatory lag?**

18 A. No. Regulatory lag is the time between rate cases, in effect, it is the “lag” that occurs
19 from the time a utility’s rates are set in one rate case until their rates are re-set in the next
20 case. Regulatory lag provides multiple ratemaking benefits within the regulatory scheme.
21 First, regulatory lag provides a natural incentive for the utility to control costs between

¹⁹ See Exh. MEG-5, Plant in Service.

²⁰ See Kivisto, Exh. NAK-1T at 4:17–5:14.

1 rate cases. If overall net costs decrease between rate cases, the utility keeps the additional
2 profits. If, on the other hand, there is a net increase in overall costs, the utility pays the
3 difference. However, the cost-control incentives created by regulatory lag are only part of
4 the picture. The fact that regulated utilities accept the risk of regulatory lag is one of the
5 main reasons that utilities are awarded a return on equity (ROE) above the level of a
6 “risk-free” capital. In other words, without the risk of regulatory lag, a utility’s authorized
7 ROE should be set much closer to a risk-free rate of return, much lower than the current
8 authorized returns.

9 For example, if regulators were able to re-set a utility’s rates to recover all
10 prudently incurred costs on shorter time frames than currently exist between rate cases,
11 such as on an annual, monthly, weekly or daily basis, the utility’s rate of return would be
12 driven lower and lower with each iteration. Utilities often complain about regulatory lag,
13 but at the same time continue to press for higher rates of return on their investments.
14 Utilities cannot have it both ways. The existence of regulatory lag enables utilities to
15 assume a degree of risk, and to manage that risk by controlling costs between rate cases.
16 As discussed above, utilities have an incentive to take steps to decrease overall net costs
17 between rate cases to maximize profits. If utilities fail to do so, they will not be able to
18 achieve their authorized rates of return. This is not typically a situation that regulators
19 should strive to eliminate. It is an intentional part of the regulatory paradigm. A utility is
20 compensated for assuming the risk of regulatory lag, and it is enabled to reap the rewards
21 of fully achieving those returns if they effectively control costs. The bottom line is,
22 Cascade should not be awarded a full return on equity comparable to the returns of other

1 utilities if it is not willing to take on the same risks of regulatory lag that these other
2 utilities are willing to assume.

3 Regulatory lag also serves as a disincentive to overcapitalize, or “gold-plate” the
4 system. A utility is less likely to make unnecessarily large capital additions if it will have
5 to bear the costs of these additions for the period of regulatory lag.

6 **Q. Are you concerned that Cascade may have to file multiple rate cases with its current
7 capital expenditure plans?**

8 A. No. A utility should file multiple rate cases during a period of increased capital
9 expansion. This provides the Commission with ample opportunities to evaluate the
10 reasonableness of the utility’s expenditures during this period as they progress.

11 **Q. Did the Company file the traditional average of monthly averages (AMA) rate base
12 in its initial application?**

13 A. No. The Company filed an end of period (EOP) rate base for December 31, 2019, the end
14 of the test year, and a series of pro forma adjustments to *project* an EOP rate base for
15 December 31, 2020, for certain plant additions it expects will be completed and in service
16 by that time.²¹ As a result of not filing the traditional AMA rate base, the Company
17 agreed to provide a supplemental filing on an AMA basis, which was filed in July 2020.²²
18 Staff also requested, in UTC Staff Data Requests 26 and 27, that the Company provide its
19 AMA data and calculations.²³

²¹ The post-test year updates are not comprehensive, and do not include significant reductions to rate base such as the increase in accumulated depreciation and ADIT on the 2019 EOP plant in service.

²² See Order 3 Prehearing Conference Order, App. B, n.2 (Jul. 13, 2020). The supplemental filing provided the test year on an AMA basis. The Company then adjusted to an EOP basis.

²³ See Exh. MEG-23, Cascade Response to Public Counsel Data Requests 26 and 27.

1 **Q. What was the rate impact of adjusting the Company's AMA rate base to the EOP?**

2 A. The revenue requirement impact of moving to an EOP rate base from an AMA rate base
3 was about \$2.2 million.²⁴ And then, as pointed out before, the impact of moving from the
4 EOP rate base to the projected December 2020 pro forma rate bases was an additional
5 \$8.8 million.

6 **Q. What do you recommend?**

7 A. I recommend that the Commission reject the Company's projected pro forma plant
8 additions through December 2020 in the amount of an additional \$64 million. As of
9 September 2020, only about \$10 million of these projected additions were actually in
10 service.²⁵ I recommend instead that, as a middle ground, the Commission allow Cascade
11 to use an EOP rate base in this case, rather than the traditional AMA approach. I show
12 later in this testimony how this increase is fully offset with adjustments going the other
13 way, such as lower depreciation rates and lower cost of capital. Nevertheless, this
14 approach does provide the Company with a full rate base return on all of its invested
15 capital at test year end. If the Commission decides to go beyond the test year for plant
16 additions, in my opinion, it should not go beyond the \$10 million added by September
17 2020, since this is the latest date interveners could review and verify these asset
18 additions.

²⁴ This is the difference in the original and supplemental adjustments R-4 net of the pre-tax operating income adjustments. $\$4.3\text{M} - \$1.7\text{M} = \$2.6\text{M}$, $\$1.6\text{M} + \$0.4\text{M} - \$1.3\text{M} - \$0.3\text{M} = \$0.4\text{M}$, and $\$2.6\text{M} - \$0.4\text{M} = \$2.2\text{M}$.

²⁵ See Exh. MEG-5, Plant in Service; and see Exh. MEG-22, Cascade 2nd Revised Supplemental Response to UTC Staff Data Request 92.

IV. POST TEST YEAR WAGE INCREASES

1 **Q. Please discuss the Company's proposed adjustment to payroll expense.**

2 A. The Company made two adjustments to payroll expense. The first adjustment, R-5,
3 restated the test year wages to reflect pay increases granted during the test year.²⁶ The
4 second adjustment, P2, adds wage increases for the post-test year periods 2020 and 2021
5 for bargaining employees, non-bargaining employees, and MDU employee payroll
6 allocated to CNG. The bargaining payroll expense was increased three percent for each of
7 the two years and the non-bargaining and MDU payroll expenses were each increased by
8 four percent for each of the two years.²⁷ The first restating adjustment increased the
9 revenue requirement by \$90,769 and the second pro forma adjustment increased the
10 revenue requirement by an additional \$2,114,702.²⁸

11 **Q. Do you agree with the Company's pro forma adjustment?**

12 A. No. The projected increases for 2020 and 2021 are unsupported and go well beyond the
13 end of the test year. Moreover, the Company has not accounted for normal offsetting
14 events such as employee turnover that tends to mitigate the increases from blanket pay
15 increases. In other words, a four percent pay raise will not cause a four percent increase
16 in payroll expense as there are too many other factors involved in overall payroll costs.

17 **Q. Please discuss the first issue – that the pro forma pay raises go well beyond the end**
18 **of the test year.**

19 A. The Company's proposal to include wage increases through 2021 amounts to piecemeal

²⁶ See Peters, Exh. MCP-1T at 6:7–8.

²⁷ See Peters, Exh. MCP-1T at 6:16–7:7.

²⁸ See Peters, Exh. MCP-5.

1 or single-issue ratemaking, where potential cost increases in one area of the revenue
2 requirement are quantified and included – such as increases from pay raises – but
3 potential decreases in other areas are ignored – such as decreases from lower debt costs,
4 depreciation recoveries, or increased revenues. The traditional ratemaking formula
5 followed in most every jurisdiction, including Washington, synchronizes all components
6 of the revenue requirement formula – including rate base, cost of capital, revenues, and
7 expenses – at one point in time: the test year. It is considered objectionable by most
8 regulators for a utility to go beyond the test year to include one cost component that tends
9 to increase rates, without updating all of the other components of the formula as well.

10 **Q. Are there other reasons to reject the proposed payroll increases that go two years**
11 **beyond the test year?**

12 A. Yes. The Company chose not to propose any sort of mechanism in this case in response
13 to the Commission’s policy statement in Docket U-190531 regarding the inclusion of
14 property in rates that becomes used and useful during the rate-effective period, which
15 would be 2021. Specifically, the Company stated:

16 While the Company truly appreciates the Commission’s approach and
17 recommendations in the policy statement, Cascade has decided not to
18 propose a mechanism at this time due to the uncertainty related to the
19 COVID-19 global pandemic and related impacts to the Company’s capital
20 projects planning. Cascade will reevaluate the possibility of making a
21 proposal in its next general rate case.²⁹

22 I agree with the Company that this is not the time to seek rate increases associated with a
23 projected future test year for plant in service, but I think the same rationale applies for
24 operating expenses such as payroll. If the Company is refraining from using a future test

²⁹ See Kivisto, Exh. NAK-1T at 5:7–11.

1 year for rate base, it should do the same for payroll costs.

2 **Q. Please address your second concern that a four percent pay raise will not generally**
3 **cause a four percent increase in payroll expense.**

4 A. I tested the payroll costs for the period after the 2020 pay increases went into effect using
5 payroll data provided in response to Public Counsel Data Requests 52 and 53.³⁰ I found
6 that the non-bargaining employees' base pay did not increase at the four percent rate used
7 by CNG to annualize its payroll costs. I found instead that exempt payroll expense
8 increased by 2.6% for exempt employees and by 2.2% for non-exempt employees. I did
9 not find the same type of problem for the bargaining employees whose raises were set at
10 three percent.

11 **Q. What is your recommendation for the payroll increases proposed by the Company?**

12 A. I recommend that the pay increases set for all employees at the three percent level, and
13 that only one additional year of increases be allowed. This provides the full three percent
14 negotiated by the bargaining employees and limits the raises for non-bargaining
15 employees to levels closer to the pay levels actually attained.

16 **Q. What is the amount of the payroll cost adjustment you recommend?**

17 A. I recommend that the payroll expense increase requested by the Company be reduced by
18 \$1,122,728 to limit the 2020 pay increases to three percent, and to exclude the 2021 pay
19 increases, which extend two years beyond the test year.

20 **Q. Is there a related payroll tax adjustment?**

21 A. Yes. The reduction in pro forma payroll expense will reduce related payroll taxes in the
22 amount of \$85,889. These adjustments can be seen at Exhibit MEG-6.

³⁰ See Exhs. MEG-14 and MEG-15.

V. ANNUAL INCENTIVE COMPENSATION EXPENSE

1 **Q. Are the Company’s annual incentive compensation plans discussed in the**
2 **Company’s direct testimony?**

3 A. There is limited discussion of the incentive compensation plans in the Company’s direct
4 testimony. Company witness Maryalice C. Peters indicates that the Company has
5 included an “Executive Incentives” adjustment,³¹ and provides a workpaper which
6 quantifies the incentive compensation amounts paid during the 2019 test year.³²
7 However, the Company does not discuss its benchmarking process or provide any other
8 evidence that the incentive compensation included in its revenue requirement is
9 reasonable or market-based.

10 In its application, Company included total incentive compensation of \$3,062,654,
11 which the Company then adjusted by \$1,230,735 to remove incentive compensation paid
12 to its executives.³³ Subsequently, the Company made a correcting entry in order to reflect
13 “an updated calculation for Washington incentives that was inadvertently not filed.”³⁴
14 According to the Company, the actual amount of incentives accrued in 2019 for
15 Washington operations was \$2,890,621, which is pulled from the general ledger accounts
16 for incentive/bonus expenses.³⁵ The revised adjustment to remove Executive Incentive
17 compensation is \$1,162,983. The Company indicated that this adjustment removes all of

³¹ See Peters, Exh. MCP-1T at 6:9–11.

³² See Peters Workpaper, MCP WP-1.13.

³³ *Id.*

³⁴ See Exh. MEG-12, Cascade Response to UTC Staff Data Request 4.

³⁵ *Id.*

1 its long-term and short-term executive incentive compensation costs.³⁶ In response to
 2 Public Counsel Data Request 43, the Company provided the following detailed
 3 information on the updated incentive compensation amounts:³⁷

Originally filed:

MDUR Exec Incentive Plan	\$ 722,274.82
MDUR Employee Incentive Plan	\$ 362,995.47
MDU Exec Incentive Plan	\$ 473,325.53
MDU Employee Incentive Plan	\$ 387,024.02
IGC Exec Incentive Plan	\$ 35,135.07
CNG Direct Employee Incentive Plan	\$ 389,056.37
CNG Allocated Employee Incentive Plan	\$ 692,843.03
	\$ 3,062,654.31
Total WA Executive Incentives	\$ 1,230,735.42
Remove Executive Incentives	\$ (1,230,735.42)

Should have been:

MDUR Exec Incentive Plan	\$ 722,274.82
MDUR Employee Incentive Plan	\$ 362,995.47
MDU Exec Incentive Plan	\$ 405,573.38
MDU Employee Incentive Plan	\$ 454,776.17
IGC Exec Incentive Plan	\$ 35,135.07
CNG Direct Employee Incentive Plan	\$ 389,056.37
CNG Allocated Employee Incentive Plan	\$ 520,810.11
	\$ 2,890,621.39
Total WA Executive Incentives	\$ 1,162,983.27
Remove Executive Incentives	\$ (1,162,983.27)

4 Q. **Have you reviewed the Company’s annual incentive compensation plans?**

5 A. Yes. There the Company’s plans are provided as attachments in response to UTC Staff
 6 Data Request 5.³⁸ The Company’s incentive compensation awards are based on multiple
 7 formal written plans which include financial performance funding targets, as well as

³⁶ See Exh. MEG-16, Cascade Response to Public Counsel Data Request 40.

³⁷ See Exh. MEG-13, Cascade Response to Public Counsel Data Request 43 at 2.

³⁸ See Exh. MEG-19C, Cascade Response to UTC Staff Data Request 5, with Confidential Attachments.

1 O&M expense goals, operational goals, and cyber security goals.³⁹ The Company's plan
2 overview is designed to pay employee incentive compensation at various levels based on
3 the achievement of pre-established goals. Specifically, the Plan states:

4 The two items used to determine the incentive compensation award for each
5 eligible participant are:

6
7 1. **Funding of awards:** A financial performance target will be used in
8 determining whether or not a payout under the Plan will be made and what
9 level of payout is possible. If the minimum target is not achieved, no payout
10 is possible. See Addendum A for the specific financial measure for each
11 individual Company.

12 2. **Goals:** Achievement of pre-established goals will determine what
13 portions of funded awards are paid out. See details in Addendum A.⁴⁰

14 The Company's Plan includes a separate Addendum A, in four parts, that details the
15 distinct financial measures and goals for each individual Company. The financial targets
16 and goals for the employees of the MDU Resources Group, Inc., are set forth in
17 Addendum A.1 and A.2,⁴¹ which has been designated as confidential. The financial
18 targets and goals established for employees in MDU Utilities Group are set forth in
19 Addendum A.3 and A.4.⁴²

³⁹ See Exh. MEG-19C, Cascade Response to UTC Staff Data Request 5, Attachment, Non-Executive 2019 Short-term Incentive Plan, at 1-2.

⁴⁰ See Exh. MEG-19C, Cascade Response to Data Request 5, Attachment, Non-Executive 2019 Short-term Incentive Plan, at 2.

⁴¹ See Exh. MEG-20C, Cascade Response to Public Counsel Data Request 42, Confidential Attachment Addendum A.1—which applies to MDU Resources Group employees in Pay Grades 29-38 and Confidential Attachment Addendum A.2—which applies to MDU Resources Group employees in Pay Grades 39-42.

⁴² See Exh. MEG-20C, Cascade Confidential Response to Public Counsel Data Request 42, Confidential Attachment Addendum A.3—for MDU Utilities Group employees in Pay Grades 29-38 and Confidential Attachment Addendum A.4—for MDU Utilities Group employees in Pay Grades 39-42.

1 **Q. Do you agree with the Company's adjustment to remove its executive incentive**
2 **compensation from its revenue requirement?**

3 A. Yes. According to the Company's updated data, it removed \$1,162,983 of incentive
4 compensation expense, which reflects the amounts the Company awarded to its
5 executives and officers positions, and represents 40% of the total incentive compensation
6 awarded in the test year.⁴³ My review of the Company's plan shows that all components
7 of the plans are based on both financial and operational goals. The Company has not
8 presented specific evidence that the incentive compensation amounts paid are market-
9 based, however the stated goals in the Company's plan appear to benefit both
10 shareholders and ratepayers. Therefore, the Company's removal of a portion of its
11 incentive compensation from revenue requirement is an appropriate step that will
12 implement a *sharing* of these costs between shareholders and ratepayers.

13 **Q. Is an additional adjustment needed to normalize the test year incentive**
14 **compensation costs?**

15 A. Yes. The Company's test year incentive compensation payout is significantly higher than
16 its stated target level for short term incentives. With incentive compensation, it is
17 standard practice to normalize test year levels to target levels. The target level for
18 incentives is the best estimate of the anticipated ongoing level for these costs. More
19 importantly, target level approximates market price before adjusting for financially based
20 incentives. As such, target level is a starting point—*i.e.*, the highest level that should be

⁴³ Executive incentive compensation is 40% of total incentive compensation ($\$1,162,983/\$2,890,621 = 40\%$).

1 included in rates. Then, after that, any further adjustment, or disallowance, related to the
2 reasonableness of the costs for ratemaking purposes can be made.

3 **Q. How does the Company’s test year incentive compensation payout compare with**
4 **incentive compensation paid in prior years?**

5 A. The Company’s incentive compensation awards for the 2019 test year are significantly
6 higher than in the amounts awarded prior years, as shown in the table below:

Comparison of Test Year Incentive Compensation to Prior Five Years

	Test Year - 2019	2014	2015	2016	2017	2018	5-Year Average
MDUR Exec Incentive Plan*	722,275	312,058	261,949	435,280	458,645	500,170	393,621
MDUR Employee Incentive Plan	362,995	142,364	197,611	141,909	219,421	186,859	177,633
MDU Exec Incentive Plan*	405,573	13,777	240,248	275,850	235,739	322,812	217,685
MDU Employee Incentive Plan	454,776	409,901	67,884	237,039	140,835	156,033	202,338
IGC Exec Incentive Plan*	35,135	38,513	0	46,716	118,904	27,102	46,247
CNG Exec Incentive Plan*	-	56,540	568	60,949	120,112	44,306	56,495
CNG Direct Employee Incentive Plan	389,056	166,403	90,982	196,587	317,681	240,472	202,425
CNG Allocated Employee Incentive Plan	520,810	543,656	120,245	371,600	792,819	321,850	430,034
Total Incentive Compensation	2,890,621	1,683,212	979,487	1,765,931	2,404,155	1,799,605	1,726,478
Less: Sum of Executive Incentive Plans *	1,162,983	420,889	502,765	818,796	933,400	894,390	714,048
Non-Executive Incentives	1,727,638	1,262,324	476,722	947,135	1,470,755	905,215	1,012,430

7 After its adjustment to remove its Executive Incentives, the Company seeks to recover
8 the remaining \$1,727,638 in rates.⁴⁴ However, the Company’s average incentive
9 compensation for the prior five years (2014–2018) is \$1,012,430. This indicates that a
10 normalization adjustment is required. The five-year average is also comparable to the
11 Company’s stated target level for short-term incentive compensation for the test year,
12 which is \$1,101,969.⁴⁵ Therefore, an additional adjustment, in the amount of \$625,669, is
13 needed to reduce the short-term incentive compensation in the revenue requirement.

⁴⁴ Short-Term incentives compensation amounts after Executive Incentives are removed (\$2,890,621 - \$1,162,983 = \$1,727,638).

⁴⁵ See Exh. MEG-18, Cascade Responses to Public Counsel Data Requests 44 and 46.

1 **Q. Do your recommendations result in a reasonable sharing of the incentive**
2 **compensation costs?**

3 A. Yes. Because the Company's plan contains both financial and operational targets and
4 goals, a sharing of the reasonable incentive compensation costs between shareholders and
5 ratepayers is appropriate. I recommend: (1) that the Commission accept the Company's
6 adjustment to remove Executive Incentive compensation and (2) that the Commission
7 require an additional adjustment to normalize the test year levels to the Company's stated
8 2019 target levels. The adjustment to normalize annual incentive expense in the amount
9 of \$625,669 is shown in Exhibit MEG-7.

VI. BOARD OF DIRECTORS COMPENSATION SHARING ADJUSTMENT

10 **Q. What is the issue with respect to director's compensation?**

11 A. Officers and directors of any corporation have legal, fiduciary duties of loyalty and care
12 to the corporation itself and not to the customers of the company. These individuals are
13 required by law to put the interests of the company first. Undoubtedly, the interests of the
14 company and the interests of the customer are not always the same, and at times, can be
15 quite divergent. This natural divergence of interests creates a situation where not every
16 compensation cost is presumed to be a necessary cost of providing utility service. Instead,
17 a sharing of director compensation costs would recognize the fact that the costs of
18 director fees provide a benefit to both shareholder and the ratepayers alike.

19 **Q. Are you involved in other cases where the commission requires a sharing of director**
20 **compensation?**

21 A. Yes. Earlier this year, I was involved in a general rate case involving Southwest Gas
22 ("SWG") before the Public Utility Commission of Nevada, which has a policy of sharing

1 board of director costs. In the last SWG rate case, the Nevada commission ordered that
2 the cost of the BOD compensation be shared equally between ratepayers and
3 shareholders.

4 The Commission accepts Staffs proposal to disallow 50 percent of the BOD
5 compensation costs in order to share the costs equally between ratepayers and
6 shareholders. The Commission finds that the evidence on the record supports
7 benefits to both ratepayers and shareholders. A competent BOD provides value
8 to SWG through increased earning and market value, while ratepayers benefit
9 from safe, reliable service. Accordingly, it is appropriate that the costs be
10 shared between shareholders and ratepayers.⁴⁶

11 **Q. How is your adjustment calculated?**

12 A. According to Cascade's response to AWEC Data Request 50, Attachment, Cascade
13 included \$350,370 in its revenue requirement for directors' fees.⁴⁷ My proposed
14 adjustment allocates this amount evenly between ratepayers and shareholders. The
15 amount of this adjustment is \$175,185 for Washington. This adjustment is set forth at
16 Exhibit MEG-10.

VII. RECOMMENDATIONS OF OTHER PUBLIC COUNSEL WITNESSES

17 **Q. Please describe the recommendations of other witnesses testifying on behalf of Public**
18 **Counsel that are incorporated in your revenue requirement calculations.**

19 A. My revenue requirement calculations incorporate the cost of capital recommendations of
20 Dr. Randall J. Woolridge, PhD. In his testimony in this proceeding Dr. Woolridge
21 recommends an overall rate of return of 6.83%. This return includes a recommended

⁴⁶ See *Application of Southwest Gas Corp. for authority to increase its retail natural gas utility service rates and to reset the Gas Infrastructure Replacement Rates for Southern and Northern Nevada*, Docket No. 18-05031, Modified Order ¶ 420 (Nev. P.U.C. Feb. 15, 2019).

⁴⁷ See Exh. MEG-21, Cascade's Response to AWEC Data Request 50, with Attachment.

1 return on equity of 9.00%, and a cost of debt of 4.74%. Dr. Woolridge recommends a
2 capital structure consisting of 49.1% equity.

VIII. CONCLUSION

3 **Q. To the extent that you do not address a specific item or adjustment, should that be**
4 **construed to mean that you agree with the Company's proposal for that item?**

5 A. No. Exclusion from my testimony of any specific adjustments or amounts proposed by
6 the Company does not indicate my approval of those adjustments or amounts, but rather
7 that the scope of my testimony is limited to the specific items addressed herein.

8 **Q. Does this conclude your testimony at this time?**

9 A. Yes, it does.