Volume 2A

Testimony and Schedules of Witnesses:

Kevin Moug

Financial Soundness
Capital Structure
Cost of Capital

Before the South Dakota Public Utilities Commission

State of South Dakota

In the Matter of the Application of Otter Tail Corporation
d/b/a Otter Tail Power Company
For Authority to Increase Rates for Electric Utility
Service in South Dakota

Docket No. EL08 ___

Exhibit___

FINANCIAL SOUNDNESS, CAPITAL STRUCTURE AND COST OF CAPITAL

Direct Testimony and Schedules of
Kevin G. Moug

October 31, 2008

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I. INTRODUCTION AND QUALIFICATIONS

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Kevin G. Moug. My business address is 4334 18th Avenue SW, Suite 200, Fargo ND 58103.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am the Chief Financial Officer of Otter Tail Corporation ("OTC"). Otter Tail Power Company ("OTP") is currently an operating division of OTC.

Q. WHO ARE YOU TESTIFYING FOR?

A. I am testifying on behalf of OTP.

Q. HAVE YOU INCLUDED A DESCRIPTION OF YOUR EDUCATIONAL AND EMPLOYMENT EXPERIENCE?

A. Yes, a description of my educational and employment experience is included as Exhibit___(KGM-1), Schedule 1.

Q. WERE YOUR SCHEDULES PREPARED BY YOU OR UNDER YOUR SUPERVISION?

Yes.

II. PURPOSE OF TESTIMONY

Q. WHAT ARE THE PURPOSES OF YOUR DIRECT TESTIMONY?

A. The purposes of my Direct Testimony are to discuss financial issues that have important implications for the overall financial soundness of OTP and our ability to complete OTP's substantial investment plans. I will address the capital structure and associated cost of financing for OTP's electric utility operations. I will also discuss the relationship between the substantial investment plans of OTP and its financial soundness, including a discussion of the impact of decisions by the South Dakota Public Utilities Commission (the "Commission") on those plans.

Q. PLEASE SUMMARIZE YOUR TESTIMONY AND YOUR RECOMMENDATIONS TO THE COMMISSION.

A. OTP recommends an overall cost of capital of 8.89 percent. This cost of capital is based on: (i) OTP's thirteen month average divisional capital structure for 2007, consisting of 40.3 percent long term debt, 2.8 percent short term debt, 3.6 percent preferred stock, and 53.3 percent common equity; and (ii) OTP's costs of long-term debt, short-term debt, and preferred stock; and (iii) an 11.25 percent return on equity ("ROE"), which is explained in the Direct Testimony of Mr. Robert B. Hevert. Exhibit___ (KGM-1). Schedule 2, and the following table, provide a summary of OTP's capital structure and the costs of the components of its proposed capital structure.

	Amount	Percentage of Total Capitalization	Cost of Capital	Weighted Cost of Capital
Long-Term Debt	$173,571,466	40.3%	6.33%	2.55%
Short-Term Debt	12,154,247	2.8%	5.85%	0.16%
Long-Term and Short-Term Debt	$185,725,713	43.1%	6.30%	2.72%
Preferred Stock	15,500,000	3.6%	4.75%	0.17%
Common Equity	229,633,133	53.3%	11.25%	6.00%
Total Capitalization	$430,858,846	100.0%		8.89%

The use of OTP's divisional capital structure and recommended ROE provides the foundation for OTP's financial soundness and for the accomplishment of its investment objectives. The proposed capital structure will also remain appropriate for ratemaking purposes in the event that a holding company structure is formed, as we have proposed in Case No EL08-025.

Q. HOW IS THE BALANCE OF YOUR TESTIMONY ORGANIZED?

A. First, I will explain our recommended capital structure, including costs of debt and preferred stock, and discuss how that capital structure relates to OTC. Second, I will discuss the financial requirements needed to accomplish OTP's overall investment plan, and the importance of maintaining OTP's financial soundness to the accomplishment of that investment plan. Third, I will address the formation of a holding company, including an explanation of why our proposed capital structure and cost of capital remain appropriate for this rate case.

Q. HAS OTP PROVIDED THE REQUIRED STATEMENT AND SCHEDULES OF THE ACTUAL AND PROPOSED 2007 AVERAGE CAPITAL STRUCTURES AND COSTS OF CAPITAL?

A. Yes. Statement G and Schedules G1 through G4 have been provided and are being sponsored by Mr. Peter Beithon. Exhibit___(KGM-1), Schedule 2, attached to my testimony is a summary of the capital structures in this case. Details and supporting calculations are included with the work papers for the cost of service studies in Volume 4A.

III. CAPITAL STRUCTURE AND COST OF DEBT

Q. PLEASE SUMMARIZE OTP'S CAPITAL STRUCTURE AND COSTS.

A. OTP is currently a separate operating division of OTC and was throughout the 2007 Test Year. OTP's electric utility operations and investments are financed with a combination of long-term debt, short-term debt, preferred stock and common equity, which comprise OTP's capital structure. OTP's 2007 Test Year capital structure is set forth on Exhibit___(KGM-1), Schedule 2, and reflects the amount and costs of the capital used to finance the investments and operations of OTP. OTP's cost of capital is based on its separate 2007 average divisional capital structure, consisting of 40.3 percent long-term debt, 2.8 percent short-term debt, 3.6 percent preferred stock, and

53.3 percent common equity. It is also based on OTP's costs of long-term debt, short-term debt, and preferred stock, and an 11.25 percent ROE.

Long-Term Debt

Q. WHAT IS THE AMOUNT AND COST OF OTP'S LONG-TERM DEBT IN THE PROPOSED CAPITAL STRUCTURE?

A. The amount of OTP's long term debt in the capital structure is $173.6 million and the cost of long-term debt is 6.33 percent, as shown on Exhibit___(KGM-1), Schedule 2.

Q. HOW WERE THE AMOUNT AND THE COST OF OTP'S LONG-TERM DEBT CALCULATED?

A. The amount and cost of OTP's long-term debt were calculated on the basis of the 13-month average beginning December 31, 2006 and ending December 31, 2007.

Q. HOW IS LONG TERM DEBT ASSIGNED TO OTP?

A. The portfolio of long-term debt that has been assigned to OTP reflects application of several factors. Some debt has been issued expressly for utility purposes and may have restrictions that limit usage to utility purposes. Other debt issued by OTC is not related to utility operations and is, accordingly, excluded from the OTP-utility long-term debt portfolio. Debt is assigned to OTP-utility in the year in which it is issued by OTC and remains assigned to OTP thereafter.

Short-Term Debt

Q. WHAT ARE OTP'S SHORT-TERM DEBT AND ASSOCIATED COSTS?

A. The short-term debt of $12.2 million and cost of 5.85 percent were based on the average of daily outstanding balances for the 2007 Actual Year.

Preferred Stock

Q. IS THERE A COMPONENT OF PREFERRED STOCK IN OTP'S CAPITAL STRUCTURE?

A. Yes. OTP's capital structure includes $15.5 million of Preferred Stock at a cost of 4.75 percent.

Common Equity

Q. HOW WAS THE AMOUNT AND PERCENTAGE OF OTP'S TEST YEAR COMMON EQUITY DETERMINED?

A. The $229.6 million and 53.3 percent of OTP's common equity were based on a 13-month average from December 31, 2006 through December 31, 2007.

Q. ARE COSTS INCURRED IN CONNECTION WITH ISSUING COMMON STOCK?

A. Yes. When common stock is issued to the public, the corporation issuing the stock incurs costs in the process of issuance, including underwriter discounts, audit, legal, printing and listing fees and other expenses of issuance. When these issuance costs (also known as "flotation costs") are incurred, they reduce the net proceeds received by the corporation issuing the stock. Flotation costs are not an "expense" and they are not reflected in the annual income statement of the issuing corporation. When newly issued equity is allocated to OTP, the portion of the issuance costs related to that equity is allocated to OTP.

Q. HAS COMMON STOCK BEEN RECENTLY ISSUED?

A. Yes. The Company completed a $155 million common stock offering in September 2008. A portion of the net proceeds from the equity offering were used to finance the construction of the Ashtabula Wind Center. This is a regulated rate base investment in which OTP will own 32 wind turbines rated at 1.5 megawatts each.

Q. IS IT PROBABLE THAT ADDITIONAL COMMON STOCK WILL BE ISSUED IN CONNECTION WITH OTP'S INVESTMENT PLANS?

A. Yes. As further explained by Mr. Brause, OTP's investment plans show that the substantial increases in investments that began in the 2007 Test Year will continue for the next five years. These investment plans will substantially increase the need for equity at OTP, and make a further common equity issuance probable.

Q. PLEASE BRIEFLY DESCRIBE THE OWNERS OF OTC'S COMMON STOCK.

A. Our ownership mix consists of 57 percent individual investors and 43 percent institutional investors. By contrast, according to Edison Electric Institute ("EEI"), the average for other electric utilities ownership mix is 34 percent individual investors and 66 percent institutional investors. Based on information about our registered common stock owners, we know we have a substantial concentration of common stock owners in South Dakota (3 percent), Minnesota (44 percent), and North Dakota (13 percent). While these percentages do not reflect the distribution of total share ownership, we do conclude that we have a concentration of individual ("retail") ownership among persons who are within our service region and that we are, in a significant sense, locally owned.

<u>Capital Structure</u>

Q. DOES OTP MAINTAIN A SEPARATE DIVISIONAL CAPITAL STRUCTURE?

A. Yes.

Q. WHEN WAS OTP'S DIVISIONAL CAPITAL STRUCTURE ESTABLISHED?

A. OTP's separate divisional capital structure was established in 1997, and it has been maintained on a separate basis since that time.

Q. DOES OTC SUPPLY CAPITAL TO OTP?

A. Yes. As a division of OTC, OTP receives all of its capital through OTC. OTP's capital structure reflects the capital that has been used to fund the operations and investments in OTP's electric utility operations.

Q. IS OTP'S DIVISIONAL CAPITAL STRUCTURE APPROPRIATE FOR THE CALCULATION OF OTP'S RATE OF RETURN?

A. Yes. The OTP capital structure is appropriate for several reasons:

1. The OTP divisional capital structure reflects the capital that has provided financing for OTP's electric utility operations and properties;
2. The OTP divisional capital structure is supported by the need for capital resources to fulfill OTP's substantial investment plans for its electric utility operations; and
3 The OTP capital structure is similar to the capital structures of other electric generation and distribution companies, as Mr. Hevert explains in his Direct Testimony.

Q. WHAT FACTORS DOES OTP'S CAPITAL STRUCTURE REFLECT?

A. The OTP capital structure reflects the combination of several factors, including: (i) the common equity, debt, and preferred stock, that had been used to finance the OTP electric utility operations; (ii) OTP earnings and capital contributions by OTC, which increase the common equity of OTP; (iii) the funding of dividends on preferred stock and a portion of the dividends on common equity, which decreases the common equity of OTP; and (iv) the goal of maintaining a capital structure for OTP that is appropriate for an electric utility.

Q. IS THE OTP CAPITAL STRUCTURE USED IN THE MANAGEMENT OF OTP?

A. Yes. The OTP capital structure provides the foundation for evaluation of the financial performance of OTP and is used for management of OTP.

Q. HOW DOES OTP'S TEST YEAR COMMON EQUITY RATIO COMPARE TO OTHER ELECTRIC UTILITIES?

A. As Mr. Hevert explains, OTP's proposed equity ratio is appropriate in relation to the equity ratios of his comparable companies.

IV. INVESTMENT PLANS AND FUTURE CAPITAL REQUIREMENTS

Q. PLEASE DESCRIBE OTP'S ANTICIPATED CAPITAL EXPENDITURES.

A. As Mr. Brause explains, the investment plans for OTP have increased dramatically. Investments were approximately $25 million in 2004, $30 million in 2005, and $35 million in 2006, an average of $30 million per year. In contrast, in 2007 OTP invested $126 million, including our investment in the Langdon Wind Project. As noted in our September 24, 2008 Prospectus Supplement, we also expect to invest approximately $121 in the Ashtabula Wind Center. As reflected in OTC's June 30, 2008 Form 10-Q, it is anticipated that investments for OTP for the 5-year period of 2008-2012 will be approximately $880 million, which would be an average of over $175 million per year. These investments include approximately $336 million for Big Stone II, $121 million of the Ashtabula Wind Center, and $67 million for CapX 2020 transmission projects. As explained by Mr. Brause, even if OTP's participation in Big Stone II changes, a similar, if not costlier, base load generation investment will be required.

Q. WILL THE AUTHORIZED ROE AND CAPITAL STRUCTURE IN THIS PROCEEDING HAVE AN IMPACT ON THE ABILITY OF OTP TO ACHIEVE ITS INVESTMENT PLANS?

A. Yes. The ROE and capital structure authorized in this proceeding will have a substantial impact on our ability to carry out OTP's 5-year investment plan in two important ways. First, the ROE and capital structure will have a direct impact on the level of earnings authorized by the Commission. That level of earnings will, in turn, directly impact our ability to fund capital investment with internally generated funds.

Second, the ROE and capital structure authorized in this proceeding will have a significant effect on the perceptions of investors. These perceptions will have a substantial impact on both the availability and the cost of the capital needed to carry out OTP's investment plans. Investors are very aware of a utility's regulatory environment and the authorized ROE and capital structure are significant elements of that regulatory environment. The reaction of investors is likely to be heightened by the combination of: (i) the fact that OTP has not requested a general rate increase since 1987; and (ii) the scale of the OTP investment plan, particularly in contrast to its historic investment levels.

Q. WHAT ARE OTC'S CURRENT SENIOR UNSECURED CREDIT RATINGS

A. Moody's Investors Services maintains an A3 rating, with a negative outlook. This rating was just reaffirmed by Moody's in September 2008. Standard and Poor's ("S&P) maintains a BBB- rating, with a stable outlook. This rating was issued in September 2008 as well. The previous rating by S&P was BBB+, with a negative outlook.

Q. WHY DID S&P INITIATE A DOWNGRADE OF OTC'S SENIOR UNSECURED CREDIT RATING?

A. OTC's credit profile reflects the combination its regulated electric utility business and the non-electric businesses. The non-electric businesses are considered to have higher risk, given the unregulated nature of these businesses. The lowering of the S&P rating relates to OTC's growing non-electric businesses which are considered to have a higher degree of earnings and cash flow volatility than OTP. Also, S&P believes these businesses will be under greater pressure given current economic conditions. Another factor noted by S&P is the large construction program being undertaken by OTP. The financial effect of OTP's construction program will ultimately depend on external financing and the level of regulatory support during and after construction. S&P has concerns that cost overruns or construction delays could result in declining financial measures. In fact, our plan to form a holding company was undertaken, in large part, to enable OTP to obtain separate (and higher) debt ratings than OTC. We anticipate that, after the formation of a holding company, OTP will have the ability to obtain such separate credit ratings and believe that those ratings may be higher than OTC's debt ratings.

Q. DOES THIS DOWNGRADE IMPACT THE SOUTH DAKOTA RATE CASE?

A. No. The requested cost of capital and regulated return on equity are not impacted by this downgrade. The costs of long term debt, short term debt, and preferred stock are based on embedded, historical costs, not on current debt ratings. Thus, there is no effect on those costs. The ROE is forward looking and based on a comparable group, not on OTP or OTC specifically. Thus, there is no effect on the ROE.

V. FORMATION OF HOLDING COMPANY

Q. HAS OTC COMPLETED THE FORMATION OF THE HOLDING COMPANY?

A. No. OTC has not yet obtained all necessary regulatory approvals, and the formation of the holding company would not occur prior to April 1, 2009 in any event.

Q IS THE IMPLEMENTATION OF A HOLDING COMPANY CONSISENT WITH OTC'S AND OTP'S LONG-RUN FINANCIAL STRATEGIES?

A. Yes. OTC has had a long run financial strategy of enhancing the financial separation of OTP from the unregulated operations of OTC. In fact, that strategy has been a primary financial objective of OTC that began with the establishment of a separate divisional capital structure in 1997, was expanded with the separation of the corporate group in 2001, and is being completed with the formation of the holding company.

Q. DOES THE COMMISSION NEED TO DETERMINE THE CAPITAL STRUCTURE OF A NEW OTP SUBSIDIARY IN THIS PROCEEDING?

A. No. This proceeding is concerned with the appropriate capital structure and cost of capital for ratemaking based on the 2007 Test Year. The OTP capital structure that is implemented after formation of the holding company will remain subject to

Commission review and oversight, and OTC and OTP will provide full information regarding the capital structures for OTP and any new holding company.

VI. CONCLUSION

Q. CAN YOU PLEASE SUMMARIZE YOUR CONCLUSIONS?

A. Yes. I recommend the Commission approve a capital structure consisting of 53.3 percent equity, an ROE of 11.25 percent and an overall rate of return of 8.89 percent.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

KEVIN G. MOUG

EMPLOYMENT

2001-PRESENT Otter Tail Corporation Fargo, ND
Chief Financial Officer

1996-PRESENT Varistar Corporation Fargo, ND
Chief Financial Officer & Treasurer

1993-1996 Advance Dental Management Mondovi, WI
Chief Financial Officer

1981-1993 Deloitte & Touche Minneapolis, MN
Senior Manager – Middle Market Practice

EDUCATION

- Bachelor of Science in Business Administration University of North Dakota

INDUSTRY CERTIFICATIONS

- Certified Public Accountant

PROFESSIONAL AFFILIATIONS

- American Institute of Certified Public Accountants Member
- Financial Executive International Member
- US Bank Advisory Board Board Member
- Minn-Kota Chapter of American Red Cross Board of Directors
- Innovis Health Board of Directors

Otter Tail Corporation d/b/a OTTER TAIL POWER COMPANY
Electric Utility - State of South Dakota

RATE OF RETURN COST OF CAPITAL SCHEDULE

Docket No. EL08-____
Exhibit___(KGM-1)
Financial Information
Schedule 2

	(A)	(B)	(C)	(D)
Capitalization:	Amount	Percent of Total Capitalization	Cost of Capital	Weighted Cost of Capital
2007 ACTUAL YEAR				
Long-Term Debt	$173,571,466	40.3%	6.33%	2.55%
Short-Term Debt	12,154,247	2.8%	5.85%	0.17%
Long-Term and Short-Term Debt	$185,725,713	43.1%	6.30%	2.72%
Preferred Stock	15,500,000	3.6%	4.75%	0.17%
Common Equity	229,633,133	53.3%	4.51%	2.40%
Total Capitalization	$430,858,846	100.0%		5.29%
2007 TEST YEAR				
Long-Term Debt	$173,571,466	40.3%	6.33%	2.55%
Short-Term Debt	12,154,247	2.8%	5.85%	0.16%
Long-Term and Short-Term Debt	$185,725,713	43.1%	6.30%	2.72%
Preferred Stock	15,500,000	3.6%	4.75%	0.17%
Common Equity	229,633,133	53.3%	11.25%	6.00%
Total Capitalization	$430,858,846	100.0%		8.89%

All are based on 13-month average balances.

Details in JCOSS W/P D-1 through D-3