South Dakota TCR Recovery Scenarios

I. Introduction and background

These reply comments are developed in response to a SD PUC staff request to model a scenario where 100% of large transmission projects are placed into ratebase.

OTP filed its request to establish a Transmission Cost Recovery (TCR) Rider in Docket No. EL10-015. In its TCR filing OTP proposed to leave large transmission projects identified in the MISO Attachment GG for OTP at the wholesale level. These projects would not be included in retail ratebase, but remain at the wholesale level. The MISO allocated costs associated with OTP retail load for these projects would be collected through MISO charges coming through the MISO Schedule 26 charge. Otter Tail would collect its revenue requirements for these transmission facilities through the MISO Schedule 26 revenue received from other utilities through MISO and from the MISO Schedule 26 charges allocated to SD retail customers. In other words, retail customers would not be credited with the wholesale revenue associated with Attachment GG transmission projects, as OTP would use that revenue to satisfy the revenue requirements associated with the transmission. Retail customers would only be responsible for the revenue requirements allocated to OTP retail load through the MISO process.

OTP chose to propose the TCR in this manner because there will be a large differential between the amount of transmission investment that could be justified by retail load responsibility and OTP's actual amount of transmission investment in these large regional projects. Placing such projects into ratebase would expose retail customers to potential financial risks of wholesale revenue. If changes are made to the applicable wholesale tariff or various FERC incentives that would reduce the wholesale revenue, retail customers would be liable to make up the difference if these projects are 100% included in ratebase.

SD staff has requested that OTP model placing all of the transmission investment into retail ratebase, and then crediting retail customers for the wholesale revenue received from MISO. This information will be used by PUC staff as they evaluate the various potential configurations of the TCR.

II. OTP Commentary associated with the PUC staff request to model all OTP's Regional Transmission investments into the TCR Rider revenue requirement calculation.

OTP believes that such an approach (placing 100% of MISO Attachment GG transmission projects into retail ratebase) would result in reasonable rates and recoveries over the long term, but the MISO recovery mechanisms appear likely to result in year-to-year Schedule 26 revenue variations, and therefore this approach may result in significant annual variations in the TCR Rider rate. Also, by increasing the amount of investment included in the TCR Rider, retail customers will have exposure to increased risks associated with these investments.

A. OTP's investments in and retail responsibility for the Regional Transmission Projects (CAPX 2020).

OTP's investments in these regional projects is larger than its retail load share of responsibility for the projects, therefore OTP's Schedule 26 revenues from the projects (which are based on the level of investment) exceeds OTP's Schedule 26 charges from the projects (which are based on OTP's load levels in MISO--and the particular MISO cost allocation methodology applicable to each project).

The difference between OTP's investment percentage and its retail responsibility for the projects is as follows:

	OTP Investment Percentage	OTP Retail Load Responsibility	Retail Responsibility for OTP Investment
Fargo line	13.20 percent	8.00 percent	60.61 percent
Bemidji line	20.00 percent	12.25 percent	61.25 percent

Under the proposal in OTP's Petition, OTP captured the revenues to support its level of investment by keeping the investments, the revenues and any associated risks outside the transmission project ratebase portion of the TCR Rider and retail rates. The TCR only includes the Schedule 26 cost allocation to OTP retail load. Under the alternative modeling requesting by PUC staff, the investments, revenues and risks are included in the TCR Rider and retail rates. Either method aligns the investments with the revenues to support the investment.

B. The Magnitude of OTP's Investment in these Regional Transmission Projects.

Because OTP is a relatively small utility, even though OTP has a minority interest in each project, the project investments are significant for OTP. OTP is expecting to invest approximately $150 million over the next five years in these regional projects—OTP's current rate base is only approximately $628 million, so if the non-retail portion of these investments were brought into retail TCR Rider rate base, it would reflect almost a 25% increase to OTP's total rate base. For this reason, if these investments are included in the calculation of TCR revenue requirements, they carry the potential for large magnitude interference with year-to-year TCR Rider rates.

C. The Alternative Proposal's Potential Impact on Retail Transmission Rates over the life of the projects.

The alternative proposal calculates a TCR Rider retail revenue requirement for all of OTP's CAPX investments, and then the Schedule 26 revenues received from MISO for the projects are applied as a credit that reduces the annual retail TCR Rider revenue requirement.

The Schedule 26 revenue potentially offsets not only the OTP portion of the allocated retail load costs, but also the Schedule 26 charges related to other MISO members' regional transmission investments. While this 2011 result makes it appear promising that moving all project costs and revenues into the TCR Rider may be beneficial for OTP's retail customers, OTP wants to make sure that the Commission is aware that these short-run results are not representative of what is expected over the life of the projects.

OTP expects that in some years MISO revenues will be more than the retail transmission revenue requirements. It appears this may be the case generally during the early period of project construction due to the way the MISO tariff works. In later years, however, it is expected that the MISO revenues may be less than the retail transmission revenue requirements. Whether the number and magnitude of positive years will outweigh the number and magnitude of negative years, OTP cannot say.

The projects have very long lives, and OTP expects that there will be significant rate making differences between the MISO and retail rate mechanisms that could affect the revenue received from these investments from year to year over the lives of the projects. OTP also expects that the MISO rate mechanism will evolve, as it has already been revised at least twice since OTP's 2010 Schedule 26 rate was approved.

Currently the MISO recovery mechanism is different from the TCR Rider retail mechanism in that it incorporates the costs of taxes, O&M and other costs using a formulaic methodology based on the Company's overall transmission investments and costs. Those formulaic costs are later trued up based on updated formulae. The MISO recovery mechanism also treats deferred taxes very differently than do traditional retail recovery mechanisms such as used in the TCR Rider. These differences and the true-up mechanisms used by the MISO recovery mechanisms are already resulting in significant timing and other differences from the retail rate calculation. For example, OTP recovered significantly more Schedule 26 revenue than it expected in 2010, and the true-up for that recovery will be reflected as a credit to revenues (a reduction) of approximately $500,000 in 2012. The potential for true-up adjustments for annual recoveries appears to be most significant during the construction period due to weather and other construction variables that can shift costs from one year to another.

Despite the numerous differences between the MISO tariff and retail recovery (i.e. the TCR Rider) OTP believes that either method will result in just and reasonable rates and recoveries over the life of the projects. As indicated above, however, OTP expects there will likely be significant differences in the Schedule 26 revenues received from year to year, and therefore, whatever approach is used, it will be essential that the same approach be used throughout the life of the projects. If for example, the alternative approach was used in years where Schedule 26 revenues were more than the retail revenue requirement, but not in years where Schedule 26 revenues were less than the retail revenue requirement, OTP would not be able to adequately recover its costs for the investments. So, while either approach may be adequate for recovery over the life of a project, it would not be appropriate to move the costs and revenues associated with the investments in and out of retail from year to year.

For these reasons, OTP believes that either the original OTP approach or the alternative approach can work for these investments. However, because OTP's investment percentage

exceeds its retail responsibility for the investments, OTP offers an alternative proposal that might better align the retail level of investment with retail customers' obligations for these investments.

D. OTP Alternative Proposal (Split the Pie) that would use investments up to OTP's retail obligation, leaving the investment over the retail obligation in a separate "FERC jurisdiction" outside of the retail revenue requirement.

The following OTP alternative approach (Split the Pie) will align the retail portion of these investments with the retail revenue requirement calculations. This OTP alternative approach will:

(1) provide a more transparent review of the investments required to serve retail than would simply passing the Schedule 26 charges for OTP's investments through to retail customers;

(2) mitigate the potential for retail customers to pay a FERC-authorized rate of return for the OTP retail portion of OTP's investment in regional facilities instead of paying the SDPUC-authorized rate of return;

Separating the retail and non-retail portions of these regional projects by including in the TCR Rider just the retail portion of the investments, and applying the retail proportion of Schedule 26 revenues as a credit to the TCR Rider to serve as an off-set to Schedule 26 charges would help to insulate retail customers from the entire wholesale revenue risk. This approach would also mitigate the potential for large differences between the retail revenue requirement and the Schedule 26 revenues from year to year. The Split the Pie approach would limit retail customers exposure to risks associated with the investments to the level associated with OTP's provision of retail service.

One area of risk at the wholesale revenue level is the incentives put in place by FERC to encourage investment in transmission. One of these incentives is the ability to collect a formulaic O&M revenue stream on CWIP. This is currently allowed, but OTP believes that it is an incentive that will be removed in the near future. Due to the construction of the CAPX

projects this year and in the next few years, the loss of this incentive has a significant impact in the wholesale revenue stream.

III. New Modeling Results

Included are the results from four different scenarios. The scenarios begin with the information that was submitted in the Supplemental Response to IR SD-PUC-01-08, and then adjustments are made as described below. The four scenarios include:

- 100% inclusion of the CAPX transmission projects in the TCR, with full credit for all MISO Schedule 26 wholesale revenues received. The FERC O&M incentive on CWIP is included.
- 100% inclusion of the CAPX transmission projects in the TCR, with full credit for all wholesale revenues received. Wholesale revenues have been reduced by the amount of the FERC O&M incentive on CWIP, and Schedule 26 expenses have been reduced by the amount of FERC O&M incentive allocated to OTP retail customers.
- This is a Split the Pie scenario that includes the CAPX transmission projects in the TCR up to the investment level justified by OTP retail load. Any excess OTP investment is left at the wholesale level. MISO Schedule 26 revenues have been pro-rated based on the split between wholesale and retail investment. The FERC O&M incentive on CWIP is included.
- This is a Split the Pie scenario that includes the CAPX transmission projects in the TCR up to the investment level justified by OTP retail load. Any excess OTP investment is left at the wholesale level. MISO Schedule 26 revenues have been pro-rated based on the split between wholesale and retail investment. The impact of the FERC O&M incentive on CWIP has been removed, meaning that MISO Schedule 26 revenues are decreased and that MISO Schedule 26 expenses allocated to OTP retail customers have been reduced.

IV. Conclusion

These scenarios, combined with the information provided in the Supplemental Response to IR SD-PUC-01-08, provide the range of expected TCR rates with the varying degrees of revenue requirements risk to retail customers. The following should be noted:

- The data provided in the Supplemental Response to IR SD-PUC-01-08 has the highest TCR rate to retail customers, but also has zero wholesale risk for the customers. The elimination of the FERC O&M incentive of CWIP would have not have an impact on retail customers and neither would other changes to the wholesale revenue tariff. Retail customers would pay their allocated costs based on the MISO tariff, at a FERC approved rate of return.
- The 100% CAPX projects in the TCR scenario has the highest degree of wholesale revenue risk to retail customers, but also provides the greatest opportunity for retail customers to benefit from the wholesale revenue. OTP's investment in the transmission projects at a level higher than justified by retail load impact would be new territory in the regulatory arena. This scenario allows retail customers to pay transmission costs at a state authorized rate of return rather than a FERC authorized rate of return.
- The Split the Pie scenario is between the two scenarios listed above. It would allow retail customers to pay for their retail load obligation portion of the projects at a state approved rate of return. This would also create some risk exposure to retail customers through the wholesale tariff revenue received on that portion of the investment. The transmission investment above the level justified by the retail load would be kept separate and not create risk for the retail customers.

OTP believes that any of these scenarios will provide the necessary return and revenue requirements over the long-term, and any of these alternatives is acceptable. Once a methodology is selected, however, it would not be acceptable to be changing the methodology in the future as economics change and wholesale tariff changes are made.

Please call me or contact me with any questions or to discuss this information.

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