MEMORANDUM

TO: COMMISSIONERS AND ADVISORS

FROM: BRIAN ROUNDS, KARA SEMMLER, RYAN SOYE, ROSS PEDERSEN, BRITTANY MEHLHAFF AND DAVID JACOBSON

SUBJECT: EL10-015 STAFF RECOMMENDATION

DATE: 11/16/11

On November 5, 2010 Otter Tail Power Company (OTP) petitioned the Commission to establish a Transmission Cost Recovery (TCR) Rider pursuant to SDCL 49-34A-25.1 through 25.4. OTP subsequently filed a corrected filing on December 21, 2010. With its filing, OTP requests to recover investments in new or modified projects that are not included in base rates as well as Schedule 26 charges that result from the Midwest Independent Transmission System Operator (MISO) tariff. The majority of OTP's request is not contentious, however the treatment of costs associated with large regional transmission projects in which OTP participates required much consideration. Staff's recommendation is outlined in the Stipulation and described below.

BACKGROUND

Traditionally, utilities in South Dakota built transmission to connect local generators to local loads, with connections between neighboring utilities being the only common exception. Once a utility determined a line was needed, it was built and placed into service. The line would be put in rate base, and the utility recovered its costs along with a rate of return. However, with the advent of utility participation in regional transmission organizations (RTOs) over the last decade, traditional ratemaking methods for regionally-beneficial transmission lines are no longer adequate for these participating utilities.

Of the six investor-owned utilities currently serving South Dakota, four are members of MISO. MISO is an RTO that manages a regional grid stretching from Montana to Ohio and provides open access transmission services along with many other functions. To manage such a large system, MISO undergoes its own transmission planning process (MTEP)[1], and new transmission lines are paid for through MISO's cost allocation methodology, as approved by FERC.

For a project that is not deemed eligible for cost-sharing through MTEP, costs are not allocated to other utilities, and the transmission owner pays for the line.[2] If a project is deemed to be eligible for cost-sharing through MTEP, MISO assigns costs to load serving entities (LSEs) based

[1] MISO Transmission Expansion Plan

[2] For projects that are not eligible for cost sharing, revenue requirements are recovered under Attachment O of the MISO Tariff

on the projected benefits of that line.[3] For example, a 345 kV line that is required for reliability, known as a Baseline Reliability Project (BRP), will have twenty percent of its costs allocated across all of MISO and eighty percent allocated to the local region based on a power flow analysis. For a 345 kV line that addresses regional public policy and provides reliability and economic value, known as a Multi Value Project (MVP), one hundred percent of its costs will be allocated across the entire region. The cost allocation methodology used by MISO attempts to spread project costs proportionally to their benefits.

As a member of MISO, OTP is responsible for a portion of the costs of all transmission lines eligible for cost-sharing, whether those lines are within its service territory or two states away. OTP sees those costs through monthly charges from MISO. These "Schedule 26 charges" are seen by OTP as expenses. They are passed on directly to the ratepayers, and OTP makes no direct return. Of course, these costs become credits for the utility that invested in the lines, which includes a FERC-approved return. The Schedule 26 charges are the basis of OTP's request in this docket.

TRANSMISSION COST RECOVERY (TCR) RIDER

In this filing, OTP proposes to recover specific transmission costs through an annually updated rider mechanism. Currently, they propose to only recover Schedule 26 costs through the rider. However, as they build or modify lines not eligible for MISO cost-sharing, they intend to utilize the recovery mechanism passed by the Legislature in 2006.[4] At the time of the initial filing OTP did not have any such projects expected to be constructed in the next five years.

The proposed TCR has separate treatments for the following three different types of transmission projects:

- **(1)** New or modified projects, ineligible for cost sharing through the MISO tariff;
- **(2)** MTEP-approved cost-shared projects that the company has no investment in; and
- **(3)** MTEP-approved cost-shared projects that the company has investment in.

As discussed above, OTP did not have any type (1) projects budgeted in the next five years. Type (2) projects are ongoing throughout MISO and OTP receives monthly charges from MISO through Schedule 26 to pay for those. OTP asks to recover all of these costs. Currently, OTP has some investment in type (3) projects, including the CapX Twin Cities to Fargo 345 kV line and the CapX Bemidji to Grand Rapids line. OTP requests to eventually place the costs of all three types of projects into a TCR rider that the Commission would review and reconcile annually.

TYPE (1) PROJECTS

At the present time, OTP does not intend to recover the costs of any new or modified, non-MISO-jurisdictional projects in the proposed TCR rider. Staff is concerned about its ability to conduct a full prudence review on such investments outside of a rate case, and more so believes

[3] For projects that are eligible for cost sharing, revenue requirements and recovery mechanisms are specified under Attachment FF, Attachment GG, and Schedule 26 of the MISO Tariff.
[4] SDCL §49-34A-25.1 through 25.4

such a policy could be misconstrued as pre-approval. Because no projects are planned at this time, Staff recommends the Commission need not specifically address the questions of whether type (1) project costs should be recoverable through the TCR. When such a project is planned, the Company can make a new request, either in a rate case or the TCR, and the Commission can specifically consider the request.

TYPE (2) PROJECTS

Expenses incurred by OTP as a result of MISO's cost allocation methods are considered by Staff to be a cost of MISO membership. In the cases where OTP is not an investor in the projects, Staff agrees these expenses should be passed through the TCR rider.

TYPE (3) PROJECTS

OTP earns a FERC-approved rate of return on MTEP-approved projects that it participates in, and OTP's participation in such projects typically goes beyond its retail responsibility. As a result, Commission treatment of type (3) projects is much more complex. OTP's original proposal was to leave these projects in the non-retail jurisdiction and simply pass Schedule 26 charges through the rider. By not including them in the retail rate base, OTP shields the ratepayers from the risk of recouping their investment through the MISO tariff, but also currently earns a higher FERC return, which is then passed on to ratepayers.

In a previous case with Xcel, the Commission approved the opposite, in which all transmission investment was placed into rate base using a South Dakota return. With this approach, Schedule 26 revenues, including wholesale transmission revenues not associated with South Dakota retail service, are credited to the retail revenue requirement. The upside of this approach is that FERC returns are currently higher than South Dakota returns, meaning ratepayers benefit from the difference. The downside to this approach is that ratepayers take on the risks of under-recovering wholesale costs, large swings in investment timing and recovery, and/or decreasing FERC returns. OTP's situation is different than the previous Xcel case as the OTP transmission investment level is much greater than the retail load obligation of the investment.

OTP insisted that both approaches would provide reasonable rates over the long term but proposed a third method that limits risk to South Dakota ratepayers while still garnering some of the benefits. A hybrid approach the parties have termed the "split method" would only allocate the retail portion of regional transmission projects to the TCR as determined by MISO, based on retail load obligations. Additionally, the TCR would be credited with the MISO tariff revenue for the South Dakota retail allocated share of regional transmission projects.

In an attempt to provide clarity to the arguments above, Staff offers the following discussion of the 3 proposed methods:

<u>Method 1: Original Filing – Complete Federal Jurisdiction</u>

OTP's original filing proposed leaving projects eligible for MISO cost allocation at the non-retail level. As a result, these projects would not be included in the South Dakota retail rate base.

Rather, the costs associated with these projects would be collected through MISO Schedule 26 charges. In other words, OTP would collect its revenue requirements for these facilities through the MISO Schedule 26 revenue. This Schedule 26 revenue includes revenue from other utilities in MISO as well as the Schedule 26 charges allocated to OTP's retail customers. The South Dakota retail customer responsibility is relatively low and includes only portions of these projects attributable to South Dakota retail use. South Dakota retail customers, under this method, are only responsible for the revenue requirements allocated to OTP's retail load through the MISO process.

OTP explained in its May 17, 2011 filing why it chose to propose the TCR in this manner. Specifically, it did so "because there will be a large differential between the amount of transmission investment for which retail load has responsibility and the amount Otter Tail is investing in these large regional transmission projects. Allocating all of this investment into the retail ratebase would expose retail customers to potential financial risks associated with the investments, including primarily the risk that the FERC jurisdictional revenues may not be sufficient to off-set the retail revenue requirements if the projects are placed into the retail ratebase." In other words, OTP can depend on revenues from the MISO load-serving members to provide some or a majority of the revenue requirements. Under Method 1, there is little risk placed on South Dakota retail customers.

Staff appreciates OTP may choose not to rate base transmission that is arguably wholesale, or FERC jurisdictional. In addition, from a policy perspective the type of transmission being built is not strictly intended to serve retail load. With that said, Staff also recognizes under this method South Dakota retail customers will pay the higher FERC rate of return for their share of the regional transmission facilities.

Method 2: Complete Retail Treatment

The second possibility explored by staff is nearly the opposite of what Otter Tail originally filed. Specifically, Staff looked at the possibility of placing all transmission investment into rate base. In this case, the retail revenue requirement would be credited with 100% of the MISO Schedule 26 revenue associated with the transmission investment. Although the economics of this scenario are most appealing, it also places the most risk of wholesale revenue insufficiency upon OTP's retail customers.

Ratepayers will see the most economic benefit, although possibly short-term, from this option. As previously described, the FERC return is currently greater than the South Dakota return. Under this scenario then, since all transmission projects are included (not just those that serve the retail load), South Dakota ratepayers will capture the benefits that result from the positive difference between the South Dakota and FERC returns. To explain further, for the portion of projects that South Dakota ratepayers are responsible, they would end up paying the lower South Dakota rate of return, but for the rest of the projects, they would receive the net difference between the South Dakota and FERC returns. In some cases, this could have the potential of making the TCR rider a credit on customer bills.

Along with the economic benefit, however, comes risk. Should the MISO cost allocation method change or the FERC return become lower than the South Dakota return, South Dakota ratepayers will be directly affected. Additionally, there might be significant delays between MISO expenses and credits, and if SD ratepayers are a carrying a disproportionate amount of those costs, the accompanying swings in the TCR could be substantial. It may not be sound retail regulatory policy to include non-retail jurisdictional transmission facilities simply because it results in a financial benefit at the present time. In sum, because all regional projects are included in the South Dakota revenue requirement, should the revenue stream change or go away, our ratepayers would be responsible to meet that revenue requirement. South Dakota ratepayers would ultimately bear the risk of paying for all transmission projects, even those not attributed to retail service.

Method 3: Separation of Retail and Non-Retail

As a hybrid of the extremes above, OTP suggested allocating the investment into state and FERC jurisdictions on a percent-of-responsibility basis. The portion of the transmission built and used for retail purposes under this scenario is rate based with the South Dakota rate of return. As a result, South Dakota ratepayers are only responsible for the revenue requirement associated with the portion of the line used for retail service. In addition, South Dakota ratepayers receive the benefit of the Schedule 26 wholesale revenues associated with the retail load portion of the transmission investment. These wholesale revenues offset their Schedule 26 costs, leaving ratepayers simply paying for their retail transmission at the SD rate of return.

Staff believes this method is in line with the traditional ratemaking philosophy typically employed by this commission. The portion of transmission allocated to South Dakota ratepayers would be in sync with their costs. Furthermore, the risks associated with this option would be limited to the transmission associated with OTP's South Dakota retail responsibility.

Summary Comparison of Methods Used to Allocate Type (3) Projects

	Method 1	Method 2	Method 3
Treatment	All MISO cost-shared project investment out of SD rate base	All MISO cost-shared project investment in SD rate base	Only the portion of MISO cost-shared project investment that SD ratepayers are responsible for in rate base
Benefits	No risk of under-recovering the wholesale revenue requirement	SD ratepayers pay the SD return on their share of costs, and receive the difference between FERC and SD returns on the rest[5]	SD ratepayers pay the SD return on their share of costs, no risk of under-recovering the wholesale revenue requirement associated with the rest
Detriments	SD ratepayers pay the FERC return on all wholesale transmission costs	Risk of under-recovering the wholesale revenue requirement	Risk of under-recovering the wholesale revenue requirement associated with their share of the cost, and SD ratepayers don't receive the difference between FERC and SD returns on the rest

[5] Of course, claiming this as a benefit assumes the FERC return will continue to be larger than the SD return.

Staff agrees that Method 3, as offered by OTP, is the best option. Although placing all transmission costs into rate base would be the most beneficial to ratepayers at this time, there is an amount of risk associated with that method. Furthermore, Staff believes taking advantage of this current benefit would be undeserved, and that the methodology used should be independent of the FERC return's relation to the South Dakota return.

RATE OF RETURN

OTP's original filing did not include the need to set an appropriate rate of return. However, the inclusion of a portion of regional transmission costs into rate base (as Staff recommends with Method 3 above) would require the Commission to determine an appropriate return. As a result OTP has proposed using the rate of return approved in the most recent rate case, docket EL10-011. Staff contends that the rider mechanism created herein provides the utility with a guaranteed recovery of costs that the utility would otherwise only be given the opportunity to recover in a general rate case. As a result, Staff believes that such a reduction in recovery risk should be accompanied with a reduction in the utility's return on equity. OTP argues this reduction should be offset by (1) the benefits gained by ratepayers as a result of the difference in the FERC and South Dakota returns; and (2) the retraction of FERC's incentive for OTP to voluntarily[6] invest in regional transmission lines. Staff dismisses the first argument on the basis that those benefits are subject to change and commensurate with the additional risk taken on by ratepayers. However, Staff agrees with the second argument. If OTP chose not to participate in these projects, SD ratepayers would pay the higher FERC return without choice. Thus, Staff believes offsetting the prior mentioned reduction as an incentive to participate in such projects is reasonable, and stipulates to OTP's originally proposed rate of return.

UPDATE TO INCLUDE 2012 COSTS

OTP's initial filing sought recovery of costs to be incurred in 2011 with an effective date of March 1, 2011. Since this date has passed, the Company filed an update on September 26, 2011, to establish rates to be in effect November 1, 2011 through December 31, 2012. This filing includes actual data through August 2011 and incorporates 2012 projected costs. Staff agrees with OTP that establishing TCR rates to be effective through 2012 benefits the Company, Staff, and customers. As the November 1, 2011 date has passed, Staff and the Company agree rates should be effective December 1, 2011 through December 31, 2012. The Company will make a filing in late 2012 to establish new rates to be effective in 2013.

CLASS ALLOCATION AND RATE DESIGN

The Company proposed allocating the revenue requirement to customer classes based on the transmission demand allocation factor, D2, from OTP's most recent rate case at the time of the filing, Docket EL08-030. Since the filing of this TCR docket, the Company's most recent rate case, Docket EL10-011, was completed, and the allocation of the TCR revenue requirement was revised to reflect the transmission demand allocation factor from Docket EL10-011. OTP also

[6] OTP's participation in regional transmission projects is voluntary, and the FERC rate is meant to incentivize their participation.

proposed to implement both a demand charge and an energy charge for the large general service class and an energy rate only for the remaining retail rate classes. Staff supports the Company's proposal.

The net effect of the changes outlined in this memo is an estimated 2011 and 2012 revenue requirement of $616,351. *The revised TCR rates for the respective customer classes to be* effective December 1, 2011 are:

Class	¢/kWh	$/kW
Large General Service	0.083	0.072
Controlled Service	0.020	N/A
Lighting	0.108	N/A
All Other Service	0.180	N/A

RECOMMENDATION

Staff recommends the Commission approve the Stipulation for the reasons stated above.