BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF SOUTH DAKOTA

IN THE MATTER OF THE APPLICATION OF NORTHWESTERN CORPORATION
DBA NORTHWESTERN ENERGY
FOR AUTHORITY TO INCREASE ITS ELECTRIC RATES

STAFF MEMORANDUM SUPPORTING
REVISED SETTLEMENT STIPULATION

DOCKET EL14-106

Commission Staff (Staff) submits this Memorandum in support of the Revised Settlement Stipulation (Stipulation) of October 16, 2015, between Staff, NorthWestern Energy (NorthWestern or Company), Industrial Intervenors, and Wal-Mart (jointly, the Parties) in the above-captioned matter.

BACKGROUND

NorthWestern last filed an electric rate case, Docket F-3367, in 1980. The rates as a result of this docket were effective in 1981. The settlement in Docket F-3367 allowed for limited increases during the moratorium period based on the Consumer Price Index. Although the Company could have filed for a full rate increase effective November 1, 1985, at the conclusion of the moratorium period, NorthWestern's rates were not adjusted again until September 1, 1987, when rates were reduced as a result of the Tax Reform Act of 1986. In 1998, base rates were adjusted to move all fuel costs out of base rates and into the fuel clause.

On December 19, 2014, the Company filed an application with the South Dakota Public Utilities Commission (Commission) requesting approval to increase rates for electric service to its customers in its South Dakota retail service territory by approximately $26.5 million annually or approximately 20.24%. A typical residential electric customer using 750 kWh per month would see an increase of $16.76 per month.

Some of the primary drivers discussed in NorthWestern's application are the addition of the Aberdeen peaker plant, federally required upgrades to the environmental controls at Big Stone, Coyote, and Neal Unit 4, NorthWestern's move to integrate with the Southwest Power Pool (SPP), and distribution and transmission upgrades, including the Yankton transmission project. NorthWestern's proposed increase was based on a historical test year ended September 30, 2014, adjusted for what NorthWestern believed to be known and measurable changes, a 10.00% return on common equity, and a 7.76% overall rate of return on rate base.

The Commission officially noticed NorthWestern's filing on December 24, 2014, and set an intervention deadline of February 6, 2015. On February 6, 2015, Toshiba America Business Solutions, Inc., Trail King

Industries, Inc., and Redfield Energy, LLC (collectively, the Industrial Intervenors) filed Petitions to Intervene. Wal-Mart Stores, Inc. (Wal-Mart) independently filed a Petition to Intervene. On January 8, 2015, the Commission issued an Order Assessing a Filing Fee and Suspending the Operation of Proposed Rates. On March 3, 2015, the Commission granted intervention to Industrial Intervenors and Wal-Mart.

On March 20, 2015, the Commission received a petition from twenty-seven NorthWestern customers requesting to suspend the proposed rate increase requested by NorthWestern and to hold a public hearing to determine if such a rate should be allowed or decreased. The Commission voted unanimously to hold a public hearing in Yankton, South Dakota. On May 14, 2015, the public hearing was held as ordered.

On May 29, 2015, NorthWestern filed a Notice of Intent to Implement Interim Electric Rates effective on and after July 1, 2015. On June 26, 2015, the Commission issued a Scheduling Order setting this matter for hearing on October 27-30, 2015.

Settlement discussions between Staff, NorthWestern, the Industrial Intervenors, and Wal-Mart commenced on August 25, 2015. Staff and NorthWestern arrived at a mutually acceptable resolution of the issues presented in NorthWestern's filing on August 25, 2015, and thereafter held additional discussions to work out the details. The Industrial Intervenors and Wal-Mart elected to not be parties to the settlement at that time.

On September 2, 2015, NorthWestern filed a letter proposing to suspend the procedural schedule to allow NorthWestern and the intervenors an opportunity to continue settlement discussions. All Parties consented to the proposed date changes and on September 10, 2015, the Commission issued an Order Amending Scheduling Order. On September 23, 2015, the Industrial Intervenors filed a letter stating all Parties agreed that the deadline for Staff and intervenors' testimony to be filed and served shall be extended to October 2, 2015, to allow the Parties to explore settlement and analyze information recently exchanged by the Parties. On September 24, 2015, NorthWestern and Staff jointly filed a Joint Motion for Approval of Settlement Stipulation, Settlement Stipulation, and Exhibits. On September 30, 2015, the Industrial Intervenors filed a letter stating the Industrial Intervenors reached an agreement in principle with NorthWestern and Staff and that Wal-Mart also agreed to this amended settlement. The letter also stated that amendments to the stipulation filed by Northwestern and Staff to reflect the agreement between the Parties were being prepared and that no testimony would be filed on October 2, 2015.

The Parties reached a comprehensive agreement on NorthWestern's overall revenue deficiency and other issues presented in this case including, but not limited to, class revenue responsibilities, rate design, and tariff concerns.

OVERVIEW OF SETTLEMENT

Staff based its revenue requirement determination on its comprehensive analysis of NorthWestern's filing and information obtained during discovery. Staff accepted some Company adjustments, made corrections where necessary, modified other adjustments, and rejected those that do not qualify as known and reasonably measurable. Lastly, Staff introduced new adjustments not reflected in NorthWestern's filed case.

Company, Intervenors, and Staff positions were discussed thoroughly at the settlement conference and subsequent discussions. As a result, some positions were modified and others were accepted where consensus was found. Ultimately, the Parties agreed on a comprehensive resolution of all issues. Staff believes the settlement is based on sound regulatory principles and avoids additional costly and unnecessary litigation.

STAFF ANALYSIS OF SETTLEMENT

Staff believes this settlement provides NorthWestern with an annual level of revenues relative to its current service costs that is fair, just, and reasonable. These settlement rates allow NorthWestern a reasonable opportunity to earn a return that is adequate to enable it to continue providing safe, adequate, and reliable service to its South Dakota retail customers.

Staff's determination of the settlement revenue requirement begins with total Company test year costs for the twelve months ended September 30, 2014, and allocates those total Company amounts to the South Dakota retail jurisdiction. Staff then adjusted the September 30, 2014, test year results for known and measurable post-test year changes. Staff Exhibit___(PJS-1), Schedule 3 illustrates Staff's determination of NorthWestern's *pro forma* operating income under present rates. Staff Exhibit___(PJS-2), Schedule 2 illustrates Staff's calculation of NorthWestern's South Dakota retail rate base, and Staff Exhibit___(PJS-1), Schedule 2 and Staff Exhibit___(PJS-2), Schedule 1 summarize the positions. Staff Exhibit___(PJS-1), Schedule 1 summarizes Staff's determination of NorthWestern's revenue deficiency and total revenue requirement.

The increase summary by rate schedule is shown on Staff Exhibit___(EJP-2), Schedule 1. Staff Exhibit___(EJP-2), Schedules 2-1 through 2-7 reflect the settlement rates for each rate schedule. The comparison between present and settlement rates and resulting bill impacts for the Residential Service rate schedule is shown on Exhibit___(EJP-2), Schedule 3.

Unless otherwise noted, all of the changes discussed below are changes from the Company's filed position.

REVENUE REQUIREMENT

Rate Base

Average Rate Base – Both the Company and Staff arrived at a test year average rate base based on an average of the 13 month-end account balances, September 30, 2013, through September 30, 2014.

Normalizing Additions/Retirements During Test Year – The Company proposed an adjustment to annualize test year plant additions that were completed during the test year. The settlement determination revises the Company's adjustment to: 1) Remove the amounts related to portions of projects identified as revenue producing; 2) Reflect bonus depreciation through 2014; and 3) Use a 13-point average for accumulated depreciation and accumulated deferred income taxes. The net effect of these changes is to reduce rate base by approximately $469,000.

Depreciation Due to New Rates – The Company presented a current study of its depreciation accrual rates and adjusted test year depreciation expenses to reflect the rates recommended in the study. The settlement applies these rates to test year plant investments and all plant adjustments. Staff reviewed the Company's new depreciation study, focusing on the life estimates and decommissioning cost estimates used for its capital-intensive base load steam production plants, and concluded that the life extensions and decommissioning estimates for the Big Stone and Coyote plants approved by the Minnesota Commission and adopted by Otter Tail Power (a co-owner of the plants) are reasonable and properly reflected in the accrual rates proposed by NorthWestern. Additionally, the decommissioning costs are "brick and mortar" estimates containing no non-specific allowances for "contingencies". Similarly, the salvage estimates reflected in NorthWestern's accrual rates for its Neal plant are the estimates approved for that plant by the Iowa Utilities Board for the principal co-owner, MidAmerican Energy. Therefore, the settlement accepts the Company's proposed rate base adjustment associated with the new depreciation rates.

Post Test Year Additions/Retirements – NorthWestern proposed an adjustment to reflect plant investments expected to be used and useful prior to rates going into effect and requested the opportunity to true up this adjustment prior to finalizing this docket. The settlement determination revises the Company's adjustment to: 1) Reflect actual costs for completed projects through September 30, 2015; 2) Exclude all or portions of projects identified as revenue producing; 3) Reflect average accumulated depreciation and accumulated deferred income taxes; and 4) Reflect bonus depreciation through 2014. The net effect of these adjustments reduces rate base by approximately $5,654,000.

Staff's initial cost of service provided to the Company during settlement discussions included actual plant additions known through July 31, 2015.The Parties agreed to include additional non-revenue producing plant additions completed between August 1, 2015, and October 1, 2015, in rate base. However, these additional plant additions will not be included in rates until the in-service date of Big Stone Generating Station Air Quality Control System (Big Stone AQCS), which is discussed further below. The difference between the increase in rates including Big Stone AQCS and the additional plant additions and the increase in rates excluding Big Stone AQCS and the additional plant additions for the time period between July 1, 2015, and the in-service date of Big Stone AQCS will be refunded to customers through the calculation of the interim rate refund.

Cash Working Capital – NorthWestern's proposed rate base included an allowance for cash working capital based on a lead-lag analysis. A lead-lag analysis examines the timing of the Company's receipt of service revenues from customers in relation to the Company's payment of expenses to vendors and employees. Staff carefully examined NorthWestern's revenue lag and expense lead day determinations and made the following modifications:

1. Included a separate expense lead for vacation pay;
2. Included a separate expense lead for uncollectible accounts;
3. Included a separate expense lead for injuries and damages;
4. Revised the expense lead days for cost of fuel and purchased power, labor, other operating and maintenance, property taxes, and payroll taxes;
5. Revised the revenue lag days;

6. Calculated a separate rate base deduction for tax collections which the Company receives in advance of turning the related payments over to the taxing authorities; and
7. Revised expenses per day to incorporate into the lead-lag analysis the impacts of Staff's recommended adjustments to *pro forma* operating expenses.

These modifications decrease rate base by approximately $329,000.

Other Working Capital – The settlement reflects a more recent 13-month average for materials and supplies, fuel stocks, and customer deposits. This adjustment also removes the prepayments, accumulated provision for uncollectibles, and accumulated provision for injuries and damages balances from rate base, as these items have already been properly captured in the lead-lag study in the cash working capital adjustment. The net effect of these changes decreases rate base by approximately $4,069,000.

Rate Case Expense – The Company proposed to amortize projected rate case costs of $195,138 over a three year period and include the average unamortized amount of $97,569 in rate base. This settlement reflects a five year amortization of $390,409 in actual costs incurred as of August 13, 2015, as well as the inclusion of the average unamortized amount of $195,204 in rate base. The effect of this adjustment increases rate base by approximately $98,000.

South Dakota Field Inventory – The Company proposed a three year average of FERC Account 588. This account included costs related to a Field Inventory Study of the South Dakota electric distribution system completed as part of the InService implementation. Costs related to the Field Inventory Study totaled $899,096. The Company did not propose to include any of these costs in rate base. Staff proposed to amortize the study costs over a period of 10 years and include half of the study costs, $449,548, in rate base, representing the average unamortized balance of the study costs over the 10 year amortization period. The effect of this adjustment included in the settlement increases rate base by approximately $450,000.

Big Stone AQCS Project – As part of its Post Test Year Additions/Retirements adjustment, NorthWestern proposed to include estimated costs of the Big Stone AQCS in rate base. Given the significance of the project, Staff chose to list this adjustment separately in its cost of service model. While Staff agrees with including Big Stone AQCS in rate base, given it is a significant capital addition that will be placed in service after the implementation of interim rates, Staff felt it was inappropriate to include Big Stone AQCS costs in rates as of the interim rate implementation date. The Parties agreed to include the revenue requirement associated with this project in rates when the Big Stone AQCS is placed in service, expected to be December 1, 2015.

The difference between the increase in rates including Big Stone AQCS and the additional plant additions and the increase in rates excluding Big Stone AQCS and the additional plant additions for the time period between July 1, 2015, and the in-service date of Big Stone AQCS will be refunded to customers through the calculation of the interim rate refund.

The costs associated with Big Stone AQCS included in final rates results in a decrease in rate base of approximately $1,467,000 compared to the amount included in the Company's filing. The capital costs included for Big Stone AQCS are based on actual costs through September 30, 2015, and forecasted costs for October and November 2015. The amount included in rates should be well under what the final project costs are. NorthWestern agrees to provide a report of actual final costs for Big Stone AQCS once final costs are known, which will likely be mid-2016.

Beethoven Wind – On July 23, 2015, NorthWestern announced that it had entered into an agreement to purchase Beethoven Wind, an 80 megawatt wind facility located near Tripp, South Dakota. NorthWestern's customers were already obligated to pay for Beethoven through the Delivered Cost of Fuel adjustment since Beethoven was a PURPA qualifying facility (QF) selling its output to NorthWestern pursuant to two QF contracts in which NorthWestern was legally obligated to enter. Following the announcement of the acquisition in lieu of continuing the energy purchase agreements, Staff asked NorthWestern to further explain the benefits of acquiring the plant versus purchasing energy under the contracts and to provide all information necessary to include the costs of the project in base rates.[1] The Company provided information supporting the acquisition from both a final perspective and an operational perspective. The Parties estimate that NorthWestern's customers will save approximately $44 million ($25 million net present value (NPV)) over the next 20 years as compared to continuing to purchase energy under the existing QF contracts[2].

While the acquisition of Beethoven was not known at the time the rate case was filed and was not included in the Company's application, Staff believes it is most efficient and cost-effective for ratepayers to include the investment in base rates as part of this current rate case rather than necessitating NorthWestern to immediately file another rate case to recover the Beethoven costs. Since the Company can no longer book the QF costs to the Delivered Cost of Fuel adjustment as of the transaction closing date of September 25, 2015, and NorthWestern has already begun crediting the Production Tax Credits (PTCs) and QF savings to customers through the Delivered Cost of Fuel adjustment[3], a need for timely recovery of the investment in base rates is necessary. Inclusion of the Beethoven costs in base rates as a result of this rate case mitigates the need for another rate case and associated litigation costs. Including Beethoven in base rates is merely a shift of cost recovery from one item on customers' bills to another. As noted above, this shift in cost recovery is anticipated to save customers approximately $44 million over the next 20 years.

As shown on page 6 of the Stipulation, the Beethoven QF contracts' first year rates resulted in a revenue requirement of approximately $8.3 million. However, the price of the contracts quickly escalated. Under a traditional cost of service revenue requirement calculation, the relationship is reversed, in that the revenue requirement is highest in the first year and decreases over time as the asset depreciates. Under a traditional cost of service calculation, the estimated Beethoven revenue requirement for the first year

[1] See Exhibit 2 to the Revised Settlement Stipulation.
[2] See Revised Settlement Stipulation, page 5.
[3] See Docket EL15-033.

is approximately $10.8 million. This amount decreases through year 10, increases again in year 11 due to the expiration of the PTCs, and then decreases again as the asset continues to depreciate.

In order to mitigate the impact of transferring the Beethoven costs from the Delivered Cost of Fuel adjustment to base rates, the Parties agreed to a levelized cost of service for the first three years. This results in a revenue requirement of approximately $9.0 million for each of the first three years. The following table compares the Beethoven cost of service for the first three years under the 3 year levelized cost of service included in the settlement and a traditional cost of service.

Comparison of 3 Year Levelized Cost of Service vs. Traditional Cost of Service

		NWE Owned (7.24% RoR) 3 Year Levelized then Annual Cost of Service		NWE Owned (7.24% RoR) Traditional Annual Cost of Service		Variance 3 Year Levelized Greater (Less) than Traditional	
Year		$/MWH	Revenue	$/MWH	Revenue	$/MWH	Revenue
1	2016	$27.52	$9.0	$32.97	$10.8	-$5.45	($1.8)
2	2017	$27.52	$9.0	$27.09	$8.9	$0.44	$0.1
3	2018	$27.52	$9.0	$21.73	$7.1	$5.80	$1.9

However, this table does not depict the fact that the revenue requirement the Company is allowed to recover remains the same until the Company applies for another rate increase. If the Company did not file additional rate cases each year, the revenue requirement associated with Beethoven would remain at $10.8 million each year under standard ratemaking practice. Thus, the most important difference of the levelized rate is to not “lock-in” for several years the first year revenue requirement of $10.8 million versus $9.0 million levelized cost. The Commission has used a levelization methodology in previous cases when it made sense to use the levelized format instead of the usual rate base methodology.

The Beethoven Wind adjustment based on the three year levelized cost of service increases rate base by approximately $121,236,000.

In order to shift from the levelized cost of service to a traditional cost of service following year 3, on or before October 1, 2018, NorthWestern will either file a full rate case or adjust the amount in base rates for Beethoven to the cost of service calculated based on actual year 3 revenue requirements adjusted for known and measurable changes. At the same time, NorthWestern will adjust the authorized revenue requirement for Beethoven for any differences between operations and maintenance expenses incurred in the operation of Beethoven and the estimated amounts used in establishing the amount in base rates. The net amount over collected or under collected from customers between October 1, 2015, and September 30, 2018, will be refunded or billed to customers as a one-time separate line item amount on customer bills. This assures the O&M expenses included now in rates will eventually be adjusted to ensure no current over-recovery.

Operating Income

Various Revenue – The Company proposed to increase fees for non-sufficient funds (returned checks), after hours connections, after hours reconnections for Did Not Pay (DNP), business hours connections, and business hours reconnections for DNP. The settlement reflects a lower than proposed fee amount for after hours connections and after hours reconnections for DNP. Staff also used the average number of occurrences over a three calendar year period of 2012 through 2014 for each fee in its revenue adjustment. The table below represents the current, company proposed, and settlement fee amounts. The Company also proposed to add back lost revenues due to the Option L discounts received by certain customers. In the test year the Company had customers on both the Option L 4% discount and customers on the Option L 8% discount. This settlement accepts the Option L Revenue adjustment portion. The effect of this adjustment decreases revenues by approximately $31,000.

	Current	Proposed	Settlement
Tampering Fee	-	100.00	100.00
NSF Revenue	15.00	30.00	30.00
After Hours Connections	15.00	150.00	65.00
After Hours Reconnects for DNP	69.00	150.00	75.00
Business Hours Connections	10.00	20.00	20.00
Business Hours Reconnects for DNP	49.00	60.00	60.00

Basin & MRES Capacity – The Company proposed an adjustment to normalize NorthWestern's capacity costs by the four-year average (2015-2018) of the contracted capacity with Basin Electric Power Cooperative (Basin) and Missouri River Energy Services (MRES). Staff accepted this adjustment, but corrected a value used in NorthWestern's calculation. This correction is included in the settlement and increases operating expense by approximately $12,000.

Labor – NorthWestern proposed this adjustment to recognize the contracted union salary increases of 3% in 2015 and 2016 as well as estimated non-union increases of 3% in 2015 and 2016. Staff's adjustment accepts the contracted increases for the union work force; however, this adjustment revises the non-union 2015 increase to the actual amount of 3.34% and removes the 2016 increase, as it is not known at this time. Staff's labor adjustment also removes the $30,189 in labor costs NorthWestern proposed to remove through the lobbying adjustment. This adjustment revises the calculation to remove the test year labor associated with lobbying before the percent increase is applied. Also, staff has reviewed salary studies which indicate NorthWestern's pay increases are in line with industry averages. Staff's modifications to the labor adjustment decrease operating expense by approximately $182,000.

Payroll Taxes – NorthWestern proposed corresponding adjustments to recognize the 2015 and 2016 pay increases as they pertain to Social Security, Medicare, Federal Unemployment Tax, and State Unemployment Tax contributions. Staff agreed the pay increases would have a similar impact on payroll tax expense, but made the following modifications:

1. Revised the two-year pro-forma increase to match the percent increase calculated in the labor adjustment, which used an actual 2015 non-union increase and removed the 2016 non-union increase;
2. Reduced the Social Security adjustment by the percentage of NorthWestern's labor expense that is not subject to Social Security contributions, as Social Security has an earnings cap; and

3. Removed the adjustments for Federal Unemployment Tax and State Unemployment Tax, as wages subject to these taxes are capped at $7,000 and $15,000, respectively.

These modifications decrease operating expense by approximately $17,000.

401K Expense – NorthWestern proposed a corresponding adjustment to recognize the 2015 and 2016 pay increases as they pertain to 401k contributions. Staff agreed the pay increases would have a similar impact on 401k expense, but made the following modifications:

1. Revised the two-year pro-forma increase to match the increase calculated in the labor adjustment, which used an actual 2015 non-union increase and removed the 2016 non-union increase;
2. Reduced the elective 401k contribution percentage from an estimated 4 percent to an actual 3.77 percent; and
3. Increased the non-elective 401k contribution percentage from an estimated 5 percent to an actual 5.79 percent.

It should also be noted that NorthWestern discontinued their defined benefit plan for new hires, while grandfathering existing employees, effective October 3, 2008, for non-union employees and December 31, 2009, for union employees. Staff's modifications to the Company's 401K adjustment decrease operating expense by approximately $11,000.

Advertising – NorthWestern proposed an adjustment to remove promotional advertising expenses that should not be recovered from ratepayers. The settlement accepted this adjustment and further removed additional advertising costs which do not provide for the provision of safe, adequate, and reliable electric service for South Dakota ratepayers. Additional expenses removed include promotional contests, state fair sponsorships, and tree planting events. The effect of this adjustment reduced operating expenses by approximately $27,000.

Economic Development – The Company proposed to include 50% of all economic development expenses in the test year. The Company also proposed to file an annual report and budget for Commission review and approval by March 30 of each year, beginning March 30, 2016. The settlement reflects a $70,000 economic development plan to be split 50/50 between shareholders and rate payers. The Company must file an annual report and budget for Commission review and approval by March 31 of each year, beginning March 31, 2016. The effect of this adjustment decreases operating expenses by approximately $16,000.

South Dakota Field Inventory – The Company proposed a three year average of FERC Account 588. Test year amounts for this account included costs related to a Field Inventory Study of the South Dakota electric distribution system completed as part of the InService implementation. Costs related to the Field Inventory study totaled $899,096. This settlement reflects a five year average of FERC Account 588 less the Field Inventory Study costs since the Field Inventory Study is a nonrecurring expense. The settlement also amortizes the Field Inventory Study costs of $899,096 over a 10 year period, resulting in an annual cost of $89,910 included in the cost of service. Staff proposed a 10 year amortization period to align with the expected useful life of the new CIS system, of which InService is a part of. The effect of this adjustment decreases operating expenses by approximately $240,000.

SPP O&M Adjustment – The Company proposed an adjustment to reflect ongoing operations and maintenance costs associated with joining SouthWest Power Pool (SPP). The settlement revises this adjustment to reflect the actual salaries and accompanying benefits and payroll taxes associated with two new employee positions and the actual contract costs for services provided by a third party assisting NorthWestern with marketing and settlements in the SPP market. The effect of this adjustment decreases operating expenses by approximately $90,000.

Bad Debt – NorthWestern proposed an adjustment to decrease bad debt expense based on a three year uncollectible rate average applied to adjusted retail revenues. The settlement revises this adjustment based on the following modifications:

1. Revised to a five year uncollectible rate average using the years ending September 30, 2009 through 2013;
2. Removed the year ending September 30, 2014, from the average due to NorthWestern implementing a new customer information system during September 2013 which caused billing delays and an extraordinarily large amount of bad debt expense during this time period; and
3. Corrected NorthWestern's uncollectible rate calculation to use the average net write offs divided by the average billed revenue as opposed to dividing by the total billed revenue amount.

These modifications increase operating expense by approximately $34,000.

Spousal Travel on Aircraft – NorthWestern proposed an adjustment to remove expenses related to spouses riding on NorthWestern's airplane to attend the National Lineman's Rodeo. Staff has removed all expenses related to the National Lineman's Rodeo trip as Staff feels expenses associated with this trip should not be paid by ratepayers. The effect of this adjustment reduces operating expenses by approximately $1,000.

Rate Case Expense – The Company proposed to amortize projected rate case costs of $195,138 over a three year period and include the average unamortized amount in rate base. This settlement reflects a five year amortization of $390,409 in actual costs incurred as of August 13, 2015. The effect of this adjustment increases operating expenses by approximately $13,000.

Lobbying – NorthWestern proposed an adjustment to remove all hotel, meals, mileage and labor expense related to lobbying. As discussed above, Staff removed the lobbying related labor as part of the labor adjustment. Thus, to avoid double counting, Staff did not include the lobbying related labor expense removal as part of the lobbying adjustment. Staff also updated mileage expense related to lobbying. The settlement reflects Staff's adjustment. The effect of this adjustment increases operating expense by approximately $29,000.

Depreciation Due to New Rates –The settlement accepts this adjustment based on the discussion above under Rate Base.

Interest Synchronization – The settlement synchronizes the tax deduction for interest expense with the weighted cost of long-term debt and the historic test year rate base as adjusted for known and measurable changes.

Carrying Charge – The Company proposed an adjustment to remove the recorded interest income from customers calculated on under-collected tracker balances as it is not guaranteed or known for any periods beyond the test year. The settlement accepts this adjustment.

Storm Damage – The settlement normalizes storm damage expenses to reflect a five year average using the period from October 1, 2009 through September 30, 2014. The effect of this adjustment increases operating expenses by approximately $102,000.

Vegetation Management – The settlement normalizes vegetation management expenses to reflect a five year average using the period from October 1, 2009, through September 30, 2014. The effect of this adjustment increases operating expenses by approximately $105,000.

Severance Expense – Staff proposed an adjustment to the severance expense included in the test year. This settlement reflects a five year average of severance expenses from 10/1/2009 through 9/30/2014. As shown on Exhibit___(EPJ-1) Schedule 5, severance expense has the tendency to be very volatile, ranging from $0 to $39,267 at the South Dakota level. The effect of this adjustment increases operating expenses by approximately $7,000.

Claims & Injury Compensation – Staff proposed an adjustment to the claims and injury compensation expense included in the test year. This settlement reflects a five year average of claims and injury compensation expenses from 1/1/2010 through 12/31/2014. As seen on the adjustment exhibit, claims and injury compensation has shown a tendency to show significant volatility with expenses ranging from $508,444 to $949,337. The effect of this adjustment increases operating expenses by approximately $44,000.

Remove Armour Rent Expense – Included in the settlement test year plant normalization adjustment are costs associated with a new storage facility in Armour, South Dakota. In response to Staff's data request, NorthWestern agreed an adjustment should be made to remove the expense associated with renting a storage shed in Armour that will no longer be rented. This adjustment reduces operating expense by approximately $1,000.

Remove Asset Based Margins – The settlement removes asset based margins from the test year as Staff proposed future asset based margins flow through the delivered cost of fuel adjustment. Since the test year margins were negative, meaning expenses were greater than revenues, this adjustment reduces operating expense by approximately $84,000.

Remove Reagent Costs – The settlement removes Neal 4 reagent expense from the test year, which is attributed to the new environmental equipment that was placed in service in December 2013. On April 6, 2015, Docket EL15-009, NorthWestern received approval to collect reagent costs through its fuel tracker. The O&M costs should be removed from the test year as they will be collected through the tracker. This removal decreases operating expense by approximately $169,000.

Transmission Structure Maintenance Reclassification – The settlement removes cost incorrectly charged to FERC account 569 during the test year. A reclassification journal entry subsequent to the test year was made to move the dollars to a CWIP project; thus, these dollars should be removed from the test year. This removal decreases operating expense by approximately $2,000.

Association Dues – Staff proposed an adjustment to the association dues expense included in the test year. This settlement removes association dues costs related to lobbying and other various activities that do not provide for the provision of safe, adequate, and reliable electric service for South Dakota ratepayers. The effect of this adjustment decreases operating expenses by approximately $83,000.

Miscellaneous Expense – Staff proposed an adjustment to miscellaneous expenses included in the test year. This settlement removes two expenses related to incentive compensation that were included in the test year. During discovery, Staff found that the company had inadvertently included these costs related to director and officer incentive compensation in the test year. The effect of this adjustment decreases operating expenses by approximately $72,000.

Demand Side Management – NorthWestern and Staff discovered the 30% lost margin factor revenue was booked to the test year. This adjustment removes the lost margin revenue. All other revenues and expenses related to demand side management were left out of the test year. The effect of this adjustment decreases operating revenues by approximately $1,000.

Depreciation Due to Normalizing Additions/Retirements During Test Year – Refer to the discussion above under Rate Base. The net effect of these changes increases depreciation expense by approximately $15,000.

Depreciation Due to Post Test Year Additions/Retirements – Refer to the discussion above under Rate Base. The net effect of these changes increases depreciation expense by approximately $115,000.

Depreciation Due to Big Stone – Refer to the discussion above under Rate Base. The revisions to this adjustment decreases depreciation expense by approximately $72,000.

Booked to Billed Revenue Adjustment – Staff proposed an adjustment to the actual revenues booked during the test year to account for the variance between booked revenues and billed revenues in the test year. The reason for the booked and billed revenue differences is because of situations where there are pro-rated billing cycles, account close outs, meter misreads, and out-of-period adjustments that ultimately affect the amount of revenues booked by the Company versus the revenues billed. The Company did not make such an adjustment to the cost of service, but rather accounted for this difference in the rate design step. NorthWestern used a booked to billed revenue ratio to determine the proposed revenues to base its proposed rates on. In an effort to be more transparent, Staff proposed a test year revenue adjustment increasing test year revenues to the billed revenue amount at current rates, thus eliminating the need for the booked to billed revenue ratio in rate design. The billed revenues were determined based on the test year billing determinants for each rate element multiplied by the tariff rates in effect during the test year. This adjustment increases operating revenues by approximately $69,000.

Incentive Compensation – NorthWestern offers its officers, managers, and employees opportunities to earn incentive compensation in addition to their base salaries and wages. The Company offers these opportunities under three separate plans: the Long-Term Incentives Plan; the Employee Incentive Compensation Plan; and the Retirement Savings Plan Incentive Match. NorthWestern Energy – South Dakota Electric expensed a total of $1,169,151 under these programs for the test year ended September 30, 2014.

In prior South Dakota gas and electric rate cases, stipulations recommended by Staff which eliminated incentive compensation expenses that were awarded based on achieving financial targets were approved by the Commission. In the instant proceeding, Staff proposed, and NorthWestern agreed, to exclude $858,508 from incentive compensation recoverable through rates. This is the amount that was awarded during the test year for achieving financial performance targets. The treatment reflected in the settlement in this proceeding is consistent with Staff's and the Commission's treatment of incentive compensation expenses in all recent prior electric and gas proceedings.

Beethoven Wind – Refer to the discussion above under Rate Base. This adjustment includes increases to operation and maintenance expense, depreciation expense, property taxes, and a credit for PTCs. In total, this adjustment decreases operating expenses by approximately $2,846,000.

Point to Point Revenues – Upon its entrance into SPP on October 1, 2015, NorthWestern must convert its point to point transmission customers on its lower voltage transmission system to a distribution service due to classifications of transmission assets in SPP. These customers will be charged for their use of higher voltage transmission lines through SPP and will be charged by NorthWestern for their use of lower voltage transmission lines (considered distribution lines by SPP and FERC). Currently, these customers are charged by NorthWestern for use of all transmission lines pursuant to NorthWestern's FERC Open Access Transmission Tariff (OATT).

Since the lower voltage transmission lines are classified as distribution and thus state jurisdictional, the settlement includes a new rate schedule in NorthWestern's South Dakota tariff to address the rates to be charged to these customers by NorthWestern. All current point to point customers using NorthWestern's lower voltage transmission lines will be charged pursuant to this new tariff, excluding two municipal electric utilities. Since these two municipal electric utilities are not end-use customers, the rates NorthWestern charges these other utilities for use of their transmission lines is not state jurisdictional, but must remain FERC jurisdictional. However, the rates charged to these two municipal electric utilities will be determined in the same manner as the South Dakota tariff rates.

The test year included point to point revenues associated with higher voltage and lower voltage transmission lines. Since NorthWestern will no longer directly charge these customers for their use of the higher voltage transmission lines, ongoing point to point revenues will be less. The settlement reflects this difference and updates the revenues associated with the lower voltage transmission lines pursuant to the new South Dakota rate schedule and the FERC tariff associated with the two municipal electric utilities. This adjustment reduces operating revenues by approximately $197,000.

Income Tax Adjustment – The Company's filing included pro forma adjustments to income tax for true-up items and tax adjustments for temporary differences. The settlement accepts this adjustment.

Cost of Capital and Rate of Return

NorthWestern requested a 7.76 percent overall rate of return using a capital structure of 46.39 percent long-term debt and 53.61 percent common equity. The embedded cost of debt was 5.18 percent, and the requested rate of return on equity was 10.00 percent. Staff's analysis initially challenged all three components of the overall rate of return: (1) the capital structure, (2) the embedded cost of debt, and (3) the required return on equity.

[Begin Confidential] [redacted]

[redacted]

[redacted]

[redacted] **[End Confidential]**, the settlement overall rate of return is 7.24 percent.

Revenue Deficiency

As shown on Exhibit___(PJS-1), Schedule 1, Staff's determination of the adjusted average rate base is $557,307,014. Multiplying the adjusted average rate base by the settlement rate of return of 7.237%, results in a required operating income of $40,332,309. When compared to the operating income with present rates, the income deficiency is $18,975,549, and after applying the gross revenue conversion factor to add additional income taxes made necessary by the increase, the revenue deficiency is $29,193,152.

NorthWestern proposed an adjustment to reflect a gross receipts tax rate of .15% on their pro-forma revenues. Staff's adjustment reflects the changes made to pro-forma revenues and uses the current gross receipts tax rate of .14%. These revisions increase the revenue deficiency by approximately $1,000. Adding the gross receipts tax amount of $40,870 to the revenue deficiency results in a total revenue deficiency of $29,234,022.

Normally the revenue deficiency would only affect base rates. However, the revenue deficiency amount of $29,234,022 represents neither the impact to base rates nor the total impact to customers, due to the Beethoven Wind adjustment, which essentially moves costs from the Delivered Cost of Fuel tracker to base rates, both of which appear on customers' bills. The revenue deficiency calculated in Staff's cost of service model includes adjustments for alternative annual wind tax and PTCs. While these items are part of the Beethoven Wind revenue requirement, the alternative annual wind tax and PTCs will flow through the Ad Valorem tracker and Delivered Cost of Fuel tracker, respectively, instead of base rates. To calculate the impact to base rates, Staff reversed the impact of these items and added that to the $29.2 million revenue deficiency, resulting in a base rate increase of $40,687,309[4].

Prior to purchasing Beethoven Wind, NorthWestern was obligated to purchase the power through two QF contracts. Thus, customers began paying for Beethoven Wind through the Delivered Cost of Fuel adjustment earlier this year. Based on the QF contracts, the first full year of costs customers would have paid through the Delivered Cost of Fuel adjustment is $8,314,709. Therefore, to determine the net impact to ratepayers, this reduction in the Delivered Cost of Fuel tracker should also be recognized to determine the net effect, positive or negative, on ratepayers. In total, the base rate increase combined with the PTCs, alternative annual wind tax, and QF contracts savings, results in a net impact to ratepayers of $20,919,313, as shown in the table below. This increase amount is primarily related to NorthWestern's original filed rate case subsequently lowered by Staff adjustments. The Beethoven purchase is included in the number as is the reduction in the delivered cost of fuel tracker and continued recognition of the ad valorem tracker.

Base Rate Increase	$ 40,687,309
Beethoven Production Tax Credits to Delivered Cost of Fuel	$(11,839,372)
Beethoven Alternative Annual Wind Tax in Ad Valorem Tracker	$ 386,085
Staff's Calculated Revenue Deficiency	$ 29,234,022
QF Contracts Savings to Delivered Cost of Fuel	$ (8,314,709)
Net Impact to Ratepayers	**$ 20,919,313**

As noted in the table on page 5 of the Stipulation, the portion of the net impact to ratepayers attributable to Beethoven is $704,108. Staff and NorthWestern recognize that the addition of the

[4] See Exhibit___(PJS-1), Schedule 1, lines 14, 15, and 16.

Beethoven Wind farm to NorthWestern's generation mix will have an impact on other fuel and purchased power expenses. However, it is virtually impossible to quantify how the addition of Beethoven Wind generation will affect the level of these expenses that will be replaced by Beethoven Wind and is even more difficult to quantify such an adjustment based on the test year since Beethoven Wind only recently became operational and was not operational during the test year. Such an adjustment involves too many unknown variables such as how and when the wind blows and what the market is doing every hour of every day. However, the impact to other fuel and purchased power will occur whether NorthWestern owns Beethoven or purchases the energy pursuant to QF contracts. Therefore, the net impact to ratepayers attributable to Beethoven is best measured at $704,108, regardless of any offset to existing fuel and purchased power. Furthermore, any impact on fuel and purchased power expenses will automatically flow through the Delivered Cost of Fuel adjustment. In order to ensure customers receive the benefit of the reduction in fuel and purchases power expenses at the same time the new base rates go into effect, the Parties agree to adjust the Delivered Cost of Fuel adjustment to reflect the estimated $8.3 million reduction as of the effective date of final rates. The adjustment is calculated by dividing the $8.3 million by test year kWh to arrive at the reduction to the Delivered Cost of Fuel adjustment of $0.00524 per kWh. This pro forma adjustment to the Delivered Cost of Fuel adjustment will reduce the lag customers would experience otherwise since the Delivered Cost of Fuel adjustment is based on the last twelve months of actual costs. The estimated $8.3 million reduction will be trued-up based on actual costs through the tracker account.

As shown on Exhibit___(BAM-6), the base rate increase of $40,687,309 is a 30.06% increase to retail revenues. When the impact of the PTCs and the QF Contracts Savings to the Delivered Cost of Fuel adjustment, a total of $(20,154,081), and the Beethoven Alternative Annual Wind Tax in the Ad Valorem Tracker are included, the net impact to ratepayers of $20,919,313 is an increase of 15.45% to retail revenues. In summary, the bottom line impact to customers' bills on average is an increase of 15.45%.

RATE DESIGN ISSUES

The Parties agree in principle on all issues regarding rate design and the class revenue distribution. The settlement position reached between the Parties is discussed below.

<u>Class Cost Allocation/Spread of the Increase</u>

Included in NorthWestern's rate increase filing is a class cost of service study ("CCOSS") that was prepared by an outside consultant, Mr. Gary L. Goble. A CCOSS is intended to assign and allocate the Company's revenues, expenses, and investments to the various customer classes served by the Company. The primary goal of a CCOSS is to determine whether each class is contributing its fair share to the Company's overall revenue requirement, as measured by class rates of return under existing rates.

Staff carefully reviewed NorthWestern's CCOSS and the resulting class rates of return. Any CCOSS relies heavily on professional judgment when it comes to selecting the appropriate class allocation factors and cost determinants. On the whole, however, and without specifically accepting or adopting any particular cost allocation method or procedure contained in the Company's CCOSS, Staff judged the Company's CCOSS to be fair and reasonable in this instance.

The results of the Company's CCOSS indicated a significant imbalance between the rate classes relative to each class's indicated revenue responsibility. In general, the Residential, Irrigation, and Lighting classes are achieving class rates of return that are lower than the Company's overall earned return. Correspondingly, the returns earned by the remaining Commercial and Industrial classes exceed the Company's overall earned return. Ideally, all else being equal, each class should yield a return that is at or near the Company's overall earned return. But, in this instance, all else are not equal. The imbalance that now exists is not something that sprouted up overnight. The imbalance is likely to have been occurring over many years; perhaps even before the Company's rates effective in 1981 were designed as a part of the Company's most recent rate case. Moreover, correcting the imbalance at this time will result in untenable rate impacts on the Residential customers, particularly the low volume Residential customers. Since it is impractical and unwise to attempt to correct the imbalance in one shot at this time, NorthWestern proposed a rate impact moderation plan. Under the Company's proposed moderation plan, the revenue increase is apportioned to each class on a relatively uniform percentage basis, with the Commercial and Industrial rate class receiving slightly less than the average increase. This slight unevenness in the spread of the increase is a measured step in the movement towards cost based rates for each class. For the purpose of this proceeding, Staff accepted the Company's rate moderation approach and applied it to the lower revenue requirement reflected in the settlement. This resulted in the following class increases:

Revenue Class	Increase	Percent
Residential	$ 8,771,217	16.42%
Irrigation	$ 27,917	15.37%
Commercial	$ 2,693,675	16.91%
Commercial and Industrial	$ 8,907,613	14.12%
Municipal	$ 118,211	17.31%
Lighting	$ 400,681	19.19%
Total Retail	**$ 20,919,313**	**15.45%**

Consolidation of Rate Classes

The Company proposed consolidating the Residential Rate 15 customers into the Residential Rate 14, and the Company also proposed to consolidate the Irrigation Rate 18 customers into the Irrigation Rate 16. Staff agreed with the consolidation of the Rate 18 customers into Rate 16 but did not agree with the consolidation of the Rate 15 customers into Rate 14.

As filed in the Company's application, Rate 15 customers were proposed to have an increase in base rates significantly greater than 1.5 times the overall class increase. However, Staff discovered that in the original filing, the proposed Rate 15 rates did not agree with the proposed Rate 14 rates. Since the Company proposed to consolidate Rate 15 into Rate 14, the proposed rates should be the same. After updating the rates to equal the proposed Rate 14 rates, the revised proposed increase was still significantly greater than 1.5 times the overall increase. Staff believed a proposed consolidation with an increase significantly over 1.5 times the overall class increase would be too significant at this time and that a more gradual consolidation approach should be looked at over time versus an all in one step. The Company agreed to forgo the consolidation of Rate 15 into Rate 14 in this case.

Also proposed in the Company's application, Rate 18 customers were set to receive an increase in base rates reflecting a level close to the overall class. However, Staff again discovered that in the original filing, the proposed Rate 18 rates did not agree with the proposed Rate 16 rates for on-peak energy. After updating the on-peak rates to match the proposed Rate 16 rates, the revised proposed increase was below the overall class average. Staff believes consolidating Rate 18 into Rate 16 is acceptable in this case.

Rate Design

Residential Customer Charge – NorthWestern's currently effective Residential Service Rates 10 and 11 presently include a $5.00 per month Customer Charge. With the present rate filing NorthWestern requests that the monthly Customer Charge be increased to $9.00.

NorthWestern's presently effective $5.00 per month Residential Customer Charge is among the lowest, if not the lowest, in the State. Staff also recognizes that an increase in the Customer Charge is appropriate at this time if rates are to be moved closer to the indicated cost of service. However, as with the spread of the increase, increasing the Customer Charge to the indicated cost of service will result in an adverse rate impact, particularly on low usage Residential customers. Therefore, as a step in the direction of cost-based rates, the Commission Staff recommended a $1.00 per month increase in the Residential Customer Charge, which Northwestern accepted.

OTHER ISSUES

Economic Development – The settlement reflects a $70,000 economic development plan to be split 50/50 between shareholders and rate payers. Under the terms of the settlement, the following conditions apply:

- $70,000 total paid equally by ratepayers ($35,000) and shareholders ($35,000)
- Expenses shall include but not be limited to, all South Dakota expenses and monetary contributions deemed to be a benefit to economic development in the NorthWestern Energy South Dakota electric territory.
- On an annual basis, no later than March 31 of each year, NorthWestern will submit with the Commission for approval a filing which describes the actual cost, design and benefits of each cost to NorthWestern's Economic Development programs in the previous calendar year and the projected cost, design and benefits of each cost to NorthWestern's Economic Development programs in the current calendar year.
- The Commission may determine that some of the programs are not appropriate for purposes of 50% rate recovery.
- If the remaining programs cost less than $70,000 at the end of a program year, the unspent costs shall be "carried over" into the next program year for Commission approval of expenditure or other efficient method as the Commission determines to be appropriate.
- No carry over shall occur for amounts spent annually in excess of $70,000.

Southwest Power Pool – Upon NorthWestern joining SPP, all revenues from the sale of energy and all expenses from purchases of energy through SPP will be included in the Delivered Cost of Fuel Adjustment clause. Furthermore, the current Delivered Cost of Energy Adjustment will be maintained to accomplish recovery of transmission-related costs imposed on NorthWestern by SPP. Transmission-related revenue will also be credited to customers through the Delivered Cost of Energy Adjustment.

Asset and Non-Asset Based Margins – Customers will be credited 100% of asset based margins through the Delivered Cost of Fuel Adjustment clause. If NorthWestern engages in non-asset based margin activities in the future, any positive non-asset based margins will be shared with customers (70% to shareholders; 30% to customers) through the Delivered Cost of Fuel Adjustment clause. Any negative non-asset based margins will be 100% responsibility of shareholders.

Rate Moratorium – The Parties agree that NorthWestern shall not file any rate application for an increase in base rates which would go into effect prior to July 1, 2018, subject to the occurrence of certain extraordinary events.

Implementation of Rates – The tariffs shown on Exhibit 3 attached to the Stipulation are proposed to be implemented for service rendered on and after the Big Stone AQCS in-service date, expected to be December 1, 2015. The Environmental Protection Agency (EPA) requires 30 days' notice prior to the Big Stone AQCS going in service thus NorthWestern will know the exact in service date in time to implement rates coincident with the in-service date. Customer bills will be prorated so that usage prior to that date is billed at the previous rates and usage on and after that date is billed at the new rates.

Interim Rate Refund – Interim rates were implemented on July 1, 2015. Approval of the Settlement will authorize a rate increase less than the interim rate level. The Company agrees to refund customers the difference between interim rates and new rates established by the settlement for usage during the period July 1, 2015, through the effective date of final rates. As part of the refund, NorthWestern will include interest, calculated by applying a 7% annual interest to the average refund balance for each month that interim revenues were collected. Also, as discussed above, the Interim Rate Refund calculation will include a refund of the difference between the increase in rates including Big Stone AQCS and the additional plant additions and the increase in rates excluding Big Stone AQCS and the additional plant additions for the time period between July 1, 2015, and the in-service date of Big Stone AQCS. The revenue requirement of Beethoven will be implemented in rates as of its closing date of September 25, 2015. This will also be part of the interim rate refund calculation. NorthWestern will separately file an Interim Rate Refund Plan prior to Commission consideration for approval of the settlement, which will explain the calculations in more detail.

RECOMMENDATION

For the reasons stated above, Staff recommends the Commission grant the Joint Motion for Approval of Revised Settlement Stipulation and adopt the Stipulation without modification.