BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF SOUTH DAKOTA

IN THE MATTER OF THE APPLICATION OF OTTER TAIL POWER COMPANY
FOR AUTHORITY TO INCREASE ITS ELECTRIC RATES

STAFF MEMORANDUM SUPPORTING SETTLEMENT STIPULATION

DOCKET EL18-021

Commission Staff (Staff) submits this Memorandum in support of the Settlement Stipulation (Settlement) of February 15, 2019, between Staff and Otter Tail Power Company (OTP or the Company) (collectively referred to herein as "the Parties") in the above-captioned matter.

BACKGROUND

On April 20, 2018, the Company filed an application with the South Dakota Public Utilities Commission (Commission) seeking an increase in annual base rate revenues of approximately $5,978,109 for electric service to approximately 11,700 customers in its South Dakota retail service territory. OTP proposed to move the recovery of investment-related costs and related operating expenses from the Transmission Cost Recovery Rider (TCRR) and Environmental Cost Recovery Rider (ECRR) into base rates. This shift is responsible for $2,619,535 of the $5,978,109 revenue deficiency. The resulting proposed net annual revenue increase is $3,358,574, or approximately 10.10%. A typical residential electric customer using 927 kWh on an average monthly basis would see an increase of $11.29 per month under OTP's proposed rate design.

OTP also proposed to implement $2,386,538, or 7.17%, of its requested increase on an interim basis effective May 21, 2018, after 30 days had passed from the date of filing, with the full $3,358,574 net increase to become effective upon the Commission's final disposition in this case.

OTP also proposed an additional $629,107, or 1.72%, step increase to become effective January 1, 2020, to begin recovering the cost of its Merricourt Wind Project, which was projected to enter service later in 2019. A typical residential electric customer using 927 kWh would see an additional increase of $1.75 per month if OTP's proposed step increase is approved.

OTP's proposed requested revenue increase is based on a historic test year ended December 31, 2017, adjusted for what OTP claims are known and measurable changes, a 10.3% return on common equity, and a 7.96% overall rate of return on rate base. OTP witnesses submitted testimony stating that a revenue increase is needed at this time due to significant system investments made and increased operations and maintenance (O&M) costs incurred since OTP's last rate case, Docket EL10-011.

The Commission officially noticed OTP's filing on April 26, 2018, and set an intervention deadline of June 1, 2018. On May 16, 2018, the Commission issued an Order Suspending Operation of Proposed Rates; Order Assessing Filing Fee; Order Authorizing Consulting Contracts. Pursuant to this order, implementation of OTP's proposed rates was suspended for 180 days beyond April 20, 2018 and OTP's request to implement interim rates effective 30 days from the date of filing was denied. On June 28, 2018, Valley Queen Cheese Factory, Inc. filed a Petition to Intervene. The Commission issued an Order Granting Late Filed Intervention to Valley Queen Cheese Factory, Inc. (Valley Queen), on July 16, 2018. Valley Queen later indicated to Staff and OTP that it no longer wished to participate and therefore is not a party to this Settlement.

On September 17, 2018, OTP filed a Notice of Intent to Implement Interim Electric Service Rates for service provided on and after October 18, 2018, pursuant to SDCL 49-34A-17. OTP implemented interim rates based on its current rate design to recover the requested net annual revenue increase of $3,358,574, by applying the interim increase as a unique percentage applicable to each customer rate group, which resulted in an overall net increase of 10.10% across all customer classes. Interim rates are subject to refund pending a final order by the Commission in this proceeding.

Following extensive discovery, on January 7, 2019, Staff provided OTP a copy of its draft revenue requirement determination and related recommendations. Staff and OTP held discussions on January 14, 2019 to discuss Staff's revenue requirement determination and to commence settlement negotiations. Thereafter, Staff and OTP held additional settlement discussions in an effort to arrive at a mutually acceptable resolution of the issues presented in OTP's rate filing. Ultimately, the Parties reached an agreement on all issues presented in the case except return on equity. The issue of return on equity will be noticed for Commission consideration.

OVERVIEW OF SETTLEMENT

Staff's revenue requirement determination is based on comprehensive analyses of OTP's filing and information provided by OTP at Staff's request. Ultimately, Staff accepted some Company adjustments, made corrections to certain OTP's proposed adjustments, modified other adjustments, and rejected those that do not qualify as known and reasonably measurable. Lastly, Staff introduced several new adjustments that were not included in OTP's filed case.

The Company's and Staff's positions were discussed thoroughly at the settlement conferences. As a result, some of each party's positions were modified and others were accepted where consensus was found. Ultimately, the Parties agreed on a comprehensive resolution of all issues except return on equity. Such resolution is reflected in the Settlement. Staff believes the Settlement is grounded in sound regulatory principles and avoids additional, costly, and unnecessary litigation.

The Parties agree OTP's net revenue deficiency using Staff's litigation position for return on equity is $1,928,830, resulting in an approximate 5.80% net increase in retail revenue. The revenue requirement and supporting calculations described in this Memorandum and attachments depict Staff's positions on all components of OTP's South Dakota jurisdictional revenue requirement.

If the Commission were to accept OTP's litigation position on the return on equity issue, the Parties agree that OTP's net revenue deficiency is $3,071,673, resulting in a 9.23% net increase in retail revenue. As further discussed below, the foregoing revenue requirement amounts are based on an estimated rate case expense. The Parties agree the ratemaking allowance for this expense will be updated following conclusion of the hearing. Further, it is the Parties intention that the final revenue requirement approved by the Commission reflect prudent, actual rate case expenses.

STAFF OVERVIEW OF SETTLEMENT

Staff's determination of the Settlement revenue requirement begins with OTP's total Company test year costs as allocated to the South Dakota retail jurisdiction for the test year ended December 31, 2017. Staff then adjusted test year results for post-test year known and measurable changes. Attachment 2b illustrates Staff's determination of OTP's *pro-forma* operating income under present rates, including Staff's litigation position on return on equity. Attachment 3b illustrates Staff's calculation of OTP's South Dakota retail rate base including Staff's litigation position on return on equity. Attachments 2a and 3a summarize Staff's positions on income and rate base, respectively. Attachment 1 supports Staff's determination of OTP's revenue deficiency and total revenue requirement, including Staff's litigation position on return on equity.

Attachment 20 presents Staff's determination of OTP's revenue deficiency and total revenue requirement with OTP's litigation position for return on equity. Attachment 21b illustrates Staff's determination of OTP's pro-forma operating income with OTP's litigation position on return on equity. Attachment 22b illustrates Staff's calculation of OTP's South Dakota retail rate base using OTP's litigation position on return on equity. Attachments 21a and 22a summarize the positions. The adjustments in yellow on Attachments 21b and 22b highlight the differences in the cost of service as a result of Staff's and OTP's litigation positions on return on equity.

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

REVENUE REQUIREMENT

Rate Base

Test Year Average Per Books –The Company's rate base reflects 13-month averages of plant and reserve balances, except for accumulated deferred income taxes, which average was calculated using a simple beginning and end-of-year average. Staff agrees with the 13-point average approach and therefore, accepted OTP's calculations in this respect. The Company's rate base started with total Company rate base balances, as reflected on its reported financial statements and as allocated to the South Dakota retail jurisdiction. From the "per books" amounts, OTP made certain adjustments[1] to reflect recognized regulatory ratemaking treatments and Commission decisions in prior dockets. Staff relied on OTP's adjusted per books amounts[2] as its starting point.

Next, the Parties made additional adjustments[3] where necessary and appropriate, as follows, to arrive at the pro forma or adjusted test year[4].

CISone Project – OTP's filing included a planned post-test year plant addition for the anticipated replacement of its 30-year-old, internally-constructed customer information system (CIS). OTP partnered with AAC Utility Partners to assist with a complex, 18-month selection process that had eight different departments create a list of over 4,000 functional requirements that were included as part of its request for proposals sent to approximately 50 vendors. OTP received 18 responses which were eventually narrowed down to four vendors that were brought in for system demonstrations. These on-site demonstrations resulted in the selection of Cayenta Utilities based on several variables including cost, system functionality, innovation, and flexibility.

OTP provided in testimony and discovery examples of the many benefits from this system upgrade, including ease of new or updated rate implementation, less reliance on CIS programmers and technicians, customer self-service, and cybersecurity. For example, according to OTP, cybersecurity efforts will be greatly enhanced as the Cayenta Utilities platform will allow for better customization, control, and monitoring over who can access information within CIS. OTP asserts that CIS will provide much greater protection of personal identification information with better login security and more detailed tracking of login history. Furthermore, OTP claims that the CISone platform will be a building block necessary for other technology OTP may need to employ in the future, such as mobile work management technologies, outage management technologies, and automated metering infrastructure. The CISone project, OTP claims, is a necessary first step in the advancement of these future technologies.

When OTP was preparing its testimony for this case, i.e., prior to its April 2018 filing, it was using a cost estimate for CISone that came from a project cost budget prepared in 2015. The total CISone project estimate at that time was approximately $15.8 million (total Company). OTP considered this budget reasonable given the information available at the time; however, as the project got closer and OTP began to understand the complexity of the project, this conservative number provided in 2015 became out of date. OTP now estimates the total project cost to be approximately $19.5 million (total

[1] OTP refers to these adjustments as "Traditional Adjustments".
[2] Staff's "per books" found on Attachment 3b, page 1, column b, are reflective of what OTP refers to as the "2017 Actual Year".
[3] OTP refers to these adjustments as "Test Year Adjustments".
[4] OTP refers to the pro forma adjusted test year as the "2017 Test Year".

Company). The Settlement provides, however, that only actual costs of approximately $17.4 million (total Company) incurred through December 31, 2018 will be included in OTP's revenue requirement at this time. Furthermore, the allowance for funds used during construction (AFUDC) that will be capitalized to the plant account (and included in the $17.4 million figure) will include AFUDC accrued only through October 31, 2018, as that is the month interim rates went into effect. Staff acknowledges that the Stipulation on this issue will include approximately three months of recovery before the CISone project went into service February 1, 2019. But this treatment will be more than offset by the approximately $2.1 million (total Company) in projected, final investment-related costs that are not included in the Settlement revenue requirement.

The Settlement treatment of the CISone project increases rate base to the actual costs described above resulting in an approximate $389,000 increase to rate base.

New Depreciation Rates – The Company proposed adjustments to reflect the expense and rate base effects of new book depreciation rates that were made effective on a company-wide basis on January 1, 2018, pursuant to the Minnesota Public Utilities Commission's acceptance of the Company's 2017 Technical Update filing. OTP's 2017 Technical Update filing did not change any of the underlying estimates of service lives and salvage values for the Company's plant accounts. Those estimates remain the same as that adopted in the resolution of the Company's last general depreciation rate study. Rather, the 2017 Technical Update filing adjusts book depreciation rates only to reflect the year-by-year change in each account's remaining life. The Settlement accepts OTP's new depreciation rates adjustment.

Rate Case Expense – The Settlement reflects a four-year amortization of allowed rate case expense to spread these one-time costs over a reasonable period of time. The Settlement provides for the rate base inclusion of one-half of the amortizable costs in rate base, representing the average unamortized balance over the four-year period. The current estimated adjustment reduces rate base by approximately $193,000. For additional information on rate case expense see below under Operating Income.

Adjust ADIT for Tax Reform – The Company proposed an adjustment to reflect the changes in accumulated deferred income taxes (ADIT) associated with the Tax Cuts and Jobs Act (TCJA), arising from the difference between the estimated 2018 amounts before the tax rate change and 2018 amounts post-tax rate change. The Settlement revises OTP's original adjustment to reflect amounts based on the 2017 test year adjusted for the tax changes. This change reduces rate base by approximately $6,000.

Cash Working Capital – OTP's proposed rate base included an allowance for cash working capital based on a Company-prepared lead-lag study. A lead-lag study 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. This analysis also considers tax collections available, which the Company receives in advance of turning the related payments over to the taxing authorities. Staff carefully examined OTP's revenue lag and expense lead day determinations and made the following modifications to OTP's lead-lag analysis:

1. Removed Cost of Energy revenues because the related costs already receive a carrying charge in the fuel clause;
2. Included a separate expense lead for vacation pay and uncollectible accounts;
3. Included expense lead days for Federal Income Taxes, SD Gross Receipts Tax, and Interest on Long Term Debt
4. Revised revenue lag days to reflect automatic bill processing time and the number of days a bill is required to be paid before a late payment charge can be applied;
5. Revised SD Sales Tax expense days to incorporate revised revenue lag days;
6. Calculated a separate rate base deduction for tax collections available;
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 $1,740,000. This impact is subject to change based on the Commission's decision on return on equity.

Working Capital Updates – OTP's proposed rate base included allowances for materials and supplies, fuel stocks, prepayments, and customer advances using the 13-month test year average of those balances. The Settlement updates these average balances for the year ended December 31, 2018. The net effect of these changes increases rate base by approximately $317,000.

Special Deposits – The Company proposed an adjustment to the 13-month test year average balance for special deposits. OTP's adjustment removed extraordinary items, primarily deposits related to two large transmission projects. OTP found that it was not appropriate to include the amounts related to these projects because it was not normal for OTP to have those projects' balances in the special deposits account. The average balance in this account after the removal of the extraordinary amounts is the amount OTP will normally have in these accounts on an ongoing basis. The Settlement accepts OTP's adjustment to special deposits.

Changes in Allocation Factors – OTP's revenue requirement model relies on certain secondary jurisdictional allocation factors generated within the model (e.g., net plant in service). The Settlement incorporates the consequences of such jurisdictional allocation changes resulting from changes made to other elements of OTP's revenue requirement.

The net effect of the Settlement rate base adjustments reduces rate base by approximately $1,415,700. Based on Staff's recommended return on equity, this decreases the revenue requirement by approximately $122,000.

<u>Operating Income</u>

Per Books – The Company's South Dakota jurisdictional income statement started with total Company operating results, as reflected on its reported financial statements and as allocated to the South Dakota retail jurisdiction. From the "per books" amounts, OTP made certain adjustments[5] to revenues and

[5] OTP refers to these adjustments as "Traditional Adjustments".

expenses to reflect recognized regulatory ratemaking treatments and Commission decisions in prior dockets. Staff relied on OTP's adjusted per books amounts[6] as its starting point.

Next, the Parties made additional adjustments[7] where necessary and appropriate, as follows, to arrive at the pro forma or adjusted test year[8].

CISone Project – See the CISone rate base discussion above. Staff also notes that a ten-year depreciable life is appropriate for a project of this nature. The Settlement position for this adjustment increases the revenue requirement by approximately $39,000.

BSP II Amortization – In Docket EL10-011, the Commission approved recovery of costs associated with the canceled Big Stone II Plant. As a part of the Settlement in that docket, certain costs related to Big Stone II transmission facilities were removed from cost recovery due to the expectation that these costs would be recovered in MISO's transmission tariff along with other related transmission projects. In Docket EL13-007, the Company petitioned the Commission for authorization to use a deferred accounting treatment for the Big Stone II transmission-related project, since that project classification moved from active to cancelled. The BSP II Amortization Adjustment combines the remaining unamortized balances from Dockets EL10-011 and EL13-007 and sets the remaining amortization period to four years. The only change compared to OTP's originally filed position is the amortization period used. The Settlement revises the amortization period from two years and one month to four years to match the base rate moratorium period. . This adjustment decreases the revenue requirement by approximately $121,000.

New Depreciation Rates – See the new depreciation rates discussion above under rate base. The Settlement accepts OTP's new depreciation rates adjustment.

Weather Normalization – The Company proposed an amendment to test year revenues and expenses to reflect normal weather conditions. Staff raised concerns about the methodology that OTP utilized to develop the weather normalization adjustment. Subsequently, the Company filed Supplemental Testimony and Exhibits revising its original weather normalization adjustment. After careful analysis, Staff concluded that challenging the adjustment on methodological grounds would not result in a lower adjustment or benefit to ratepayers. The Settlement accepts OTP's revised weather normalization adjustment outcome as filed in the supplemental testimony.

Revenue Normalization – The Company proposed an adjustment to remove billing corrections related to prior periods and to include billing adjustments related to 2017 that occurred in 2018. The adjustments also include the fuel costs associated with the bill adjusted kWh. Staff accepted these out of period adjustments.

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[6] Staff's "per books" found on Attachment 2b, page 1, column b, are reflective of what OTP refers to as the "2017 Actual Year".

[7] OTP refers to these adjustments as "Test Year Adjustments".

[8] OTP refers to the pro forma adjusted test year as the "2017 Test Year".

Wages, KPA, and Management Incentive – This adjustment is comprised of three separate Company-proposed adjustments: Wages, Key Performance Award (KPA), and Management Incentive Compensation. The following paragraphs discuss each adjustment in detail.

The Company proposed to increase 2017 test year wages expense by annualizing the December 2017 wage amounts and by applying OTP's 2018 wage increases only to the months in 2018 following the effective date of the wage increase. The Settlement annualizes 2017 test year wages by applying the actual 2017 wage increases to the months in 2017 prior to the wage increase and provides an entire year effect of the 2018 wage increase. This calculation is consistent with the calculation used in prior OTP wage adjustments and similar previously Commission approved wage adjustments. Moreover, Staff believes the approach that is reflected in the Settlement is more representative of current wages and is an appropriate level of wages to include in the cost of service since no additional wage increases will be included in base rates over four years because of the agreed-upon rate moratorium discussed below. Finally, this adjustment calculates an increase in payroll tax which corresponds to the increase in wages. This adjustment increases the revenue requirement by approximately $181,000.

OTP proposed an adjustment to reflect a five-year average payout, based on the years 2013 through 2017, for payouts made under its key performance award incentive compensation plan. The Settlement reverses that part of the Company's proposed adjustment that allocated 20.7 percent of the adjustment to construction labor and another 2.3 percent of the adjustment to below-the-line labor, since the KPA does not apply to these types of labor expense. The Settlement also includes a payroll tax expense in the five-year average, since payroll tax is included in the per books figures. It is important to note the Company provided discovery responses and documentation that demonstrated there are no incentives in the KPA plan paid based strictly on financial criteria such as earnings per share or net income. This adjustment decreases the revenue requirement by approximately $6,000.

OTP proposed two separate adjustments relating to its management incentive compensation expense[9]. The first adjustment[10] removed all amounts over a 25 percent cap on individual employee incentives based on 2017 compensation levels in the management incentive plan, the plan for the president, and the corporate bonuses plan. The second Company-proposed adjustment[11] reflects a five-year average payout, again based on the years 2013 through 2017, for only the management incentive plan and the plan for the president. The Settlement reverses that part of the Company-proposed test year adjustment relating to the allocation of 20.7 percent of the adjustment as construction labor and another 2.3 percent of the adjustment as below-the-line labor, because the management incentive plan and the plan for the president do not apply to these types of labor expense. The Settlement also adjusts to a five-year average, based on the years 2013 through 2017, for corporate bonuses in addition to the

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[9] Management Incentive Compensation has three different categories in these adjustments: Management Incentive, the Plan for the President, and Corporate Bonuses

[10] OTP classified this adjustment as a "traditional adjustment" and had therefore already been applied to the amounts included in Staff's "per books".

[11] OTP classified this adjustment as a "test year adjustment".

management incentive plan and plan for the president. Next, the Settlement removes from all plans any incentives that were awarded based on financial criteria in lieu of removal based on a 25 percent cap. Finally, the Settlement also includes payroll taxes in the five-year average, since the per books amount also includes payroll taxes. This adjustment decreases the revenue requirement by approximately $65,000.

In total, the adjustments to wages, the KPA plan, the management incentive, the plan for the president, and corporate bonuses increase the revenue requirement by approximately $110,000.

Medical/Dental and FAS 87, 106, and 112 Expense – OTP proposed an adjustment to reflect a proposed 2018 medical and dental benefits expense and actual 2018 expenses for FAS 87, 106, and 112. Staff accepted OTP's adjustments to FAS 87 and 106 expense; however, the Settlement updated medical and dental benefits expense to the actual 2018 expense. For the FAS 112 expense, the Settlement reflects a five-year average, based on the years 2014 through 2018, because this account experiences volatile, year-by-year fluctuations in the expense and neither 2017 nor 2018 are indicative of ongoing FAS 112 costs. Staff also notes that Mr. Wasberg testified that OTP has made significant changes to control retirement benefit costs, including eliminating participation in the pension plan in 2006 for non-union employees, in 2008 for Coyote union employees, and in 2010 for other union employees. This adjustment decreases the revenue requirement by approximately $45,000.

Rate Case Expense Amortization – OTP proposed to amortize its original estimate of rate case expenses over the next three years. The Settlement amortizes rate case expenses over the next four years to match the agreed-upon base rate moratorium period. Rate case expenses presently reflected in the Settlement are based on actual expenses incurred to date and on an estimate of expenses through resolution of the non-settled return on equity issue, including both Staff and Company estimates. The Settlement specifies that rate case expense shall be adjusted to reflect prudent, actual expenses incurred through the resolution of the return on equity issue. The current estimated adjustment reduces the revenue requirement by approximately $51,000. Staff notes that it has not vetted the estimates provided by the Company at this time. The estimates are included to provide the Commission a representation of the amount of expenses that may be incurred and ultimately requested by OTP for recovery.

Storm Damages – The Company proposed an adjustment to normalize storm repair expenses based on the five-year average of actual expenses. The Settlement accepts OTP's storm damages adjustment.

Removal of Production Tax Credits (PTCs) – The Company received PTCs during the test year for its Ashtabula and Langdon wind projects, but the PTCs have since expired due to the ten-year sunset provision. The Company proposed an adjustment to remove the expired PTCs from the test year. The Settlement accepts this adjustment.

Plant Outage Normalization – OTP performs major plant overhauls during planned outages on its Coyote Station and Big Stone plants every three years; however, neither plant's three-year cycle included a major plant outage during the 2017 test year. Thus, OTP proposed an adjustment to include in rates one-third of the cost of actual 2016 Coyote major outage costs and one-third of the projected 2018 Big Stone major outage costs. During discovery, Staff learned that while there were not any major plant outage costs during the 2017 test year, there was a higher level of maintenance expenses associated with minor plant outages, since more minor maintenance activities are performed during the years there are no major plant outages. Therefore, the Settlement reflects a three-year average, based on the years 2016 through 2018, of actual total plant outage costs for Big Stone and Coyote Station. This three-year average will accurately reflect one-third the actual cost of the 2016 Coyote major outage, one-third the actual cost of the 2018 Big Stone major outage, and an average level of minor plant outages at the two plants. Since the Settlement uses actual 2018 outage costs in the three-year average, OTP's projected Big Stone major outage costs of $2,533,300 (total Company) used in its initial adjustment was replaced with the actual 2018 major outage costs of $3,264,119 (total Company). This may seem like a large increase from what OTP initially projected, but Staff notes that the last major outage at Big Stone, in 2015, cost OTP $4,252,869 (total Company). Considering the increase from the conservative estimates used by OTP in its initial proposal coupled with the nearly offsetting three-year average for minor plant outage costs, this adjustment increases the revenue requirement by only approximately $1,000.

TCRR Revenue Removal – The Company proposed to remove certain test year revenues collected through the TCRR because the related costs associated with specific projects, going forward, will be recovered in base rates. This revenue was removed from the test year in order to calculate the impact on the base rate deficiency. However, this adjustment does not result in a significant change to customers' overall bills given the corresponding reduction in the TCRR charge. While this adjustment increases the base revenue deficiency, the impact is reversed when determining the net revenue deficiency on Attachment 1. The Settlement accepts this adjustment.

ECRR Revenue Removal – The Company proposed an adjustment to remove test year revenues collected through the ECRR because the related costs, going forward, will be recovered in base rates. This revenue was removed from the test year in order to calculate the impact on the base rate deficiency. However, this adjustment does not result in a significant change to customers' overall bills given the corresponding reduction in the ECRR charge. While this adjustment increases the base revenue deficiency, the impact is reversed when determining the net revenue deficiency on Attachment 1. The Settlement accepts this adjustment.

Adjust Deferred Tax for Tax Reform – The Company proposed an adjustment to reflect the changes in deferred tax expense associated with the TCJA. OTP's adjustment is comprised of the amortization of excess accumulated deferred income taxes (EDIT) and the change to deferred taxes as a result of changing the corporate tax rate from 35% to 21%. The company provided that approximately $4.3 million (total Company) was due to the amortization of EDIT based on an average life of property of 25 years. Therefore, approximately $4.0 million (total Company) is related to the change in tax rate.

The Company's adjustment assumes the Average Rate Assumption method (ARAM) for all EDIT. The ARAM must be used for protected assets to avoid IRS normalization violations. Attachment 10 determines the EDIT adjustment associated with protected assets based on the 25-year average life of property, based on the information available. However, OTP will use the actual ARAM for book purposes in accordance with IRS regulations. The Settlement reflects a 4-year amortization period for the EDIT associated with non-protected assets. This amortization period returns the balance to customers more quickly and ensures the balance will be completely amortized by the time rates are effective in OTP's next rate case. This adjustment reduces the revenue requirement by approximately $57,000.

Association Dues – The Settlement removes association dues costs associated with lobbying and various other activities that are not essential for the provision of safe, adequate, and reliable electric service for South Dakota ratepayers. This adjustment reduces the revenue requirement by approximately $11,000.

Late Payment Revenues – Consistent with Staff's prior treatment of late payment revenues in cash working capital, the Settlement removes late payment revenues received during the test year from OTP's revenue requirement and reduces the retail revenue lag days[12] to account for the removal of late payment revenues. Staff's adjustment increases the revenue requirement by approximately $96,000.

Employee Gifts and Recognition – The Settlement removes employee recognition and gift expense not related to service awards or longevity recognition. This adjustment decreases the revenue requirement by approximately $3,000.

Charitable Administration Removal – Staff requested the Company identify its expenses included in the cost of service for administration of OTP's charitable contributions. In response to the request, the Company removed all charitable administration expenses in its Supplemental Filing. The Settlement accepts this removal of charitable administration expenses. The adjustment reduces the revenue requirement by approximately $7,000.

Interest Synchronization – The Settlement properly synchronizes the tax deduction for interest expense with the weighted cost of long-term debt and the test year rate base as adjusted for known and measurable changes. This adjustment increases the revenue requirement by approximately $94,000. This impact is subject to change based on the Commission's decision on return on equity.

Vegetation Management – The Settlement normalizes vegetation management expense using a five-year average of actual expense for the years 2014 through 2018, because the expense fluctuates considerably from year-to-year. Further, OTP is on a five-year tree trimming cycle. The adjustment reduces the revenue requirement by approximately $26,000.

Provision for Potential FERC Penalty – At the end of 2017, OTP believed that there was the potential for a FERC penalty based on the information known at the time. Therefore, the Company established on its

[12] Refer to Cash Working Capital adjustment.

books an accrual for the anticipated penalty. The accrual, however, was reversed in the second quarter of 2018, as FERC did not assess a penalty. Staff proposed an adjustment to remove the test year accrual. The adjustment reduces the revenue requirement by approximately $9,000.

Advertising Expense – The Settlement removes the costs for advertising that is not essential for the provision of safe, adequate, and reliable electric service. The adjustment reduces the revenue requirement by approximately $4,000.

Structure Expense – Staff proposed and the Settlement reflects an adjustment to normalize FERC Account 552, Structures Expense, using a five-year average of actual expense for the years 2013 through 2017, because the 2017 expense was abnormally high due to two fuel tanks that were resurfaced and painted in that year. Labor and benefits costs were not included in this adjustment. The adjustment reduces the revenue requirement by approximately $6,000.

Changes in Allocation Factors – OTP's revenue requirement model relies on certain secondary jurisdictional allocation factors generated within the model (e.g., net plant in service). The Settlement incorporates the consequences of such jurisdictional allocation changes caused by other elements of the Settlement and reflects such synchronizing adjustments.

Based on Staff's recommended return on equity, the net result of the Settlement operating income adjustments reduces the revenue requirement by approximately $90,500.

Cost of Capital and Rate of Return

OTP requested an overall rate of return of 7.96% using a capital structure consisting of 53.1 percent common equity and 46.9 percent long-term debt. The embedded cost of long-term debt was 5.3 percent and the requested rate of return on equity is 10.3 percent. Staff's analysis initially challenged all three components of the overall rate of return. However, the Parties were able to come to an agreement for settlement purposes regarding capital structure and the embedded cost of debt. The Parties agree to a capital structure of 52.92 percent equity and 47.08 percent long-term debt, and an embedded cost of debt of 5.22 percent. The figures accepted for capital structure and cost of debt were determined in a manner consistent with what was decided by the Commission in Docket EL11-019[13]. The Parties were unable to reach an agreement on return on equity. A hearing will be held regarding return on equity on March 26-28, 2019.

Attachment 19 reflects the rate of return derived based on the agreed-upon capital structure and embedded cost of debt and a return on equity of 8.25% as recommended by Staff's witness Basil L. Copeland Jr. The resulting rate of return based on Staff's return on equity recommendation is 6.83%. Attachment 26 reflects the rate of return derived based on the agreed-upon capital structure and

[13] Docket EL11-019 (Northern States Power Company dba Xcel Energy) is the most recent docket where the Commission decided rate of return (including capital structure, cost of debt, and return on equity) as a result of an evidentiary hearing.

embedded cost of debt and a return on equity of 10.3% as recommended by OTP's witness Robert B. Hevert. The resulting rate of return based on OTP's return on equity recommendation is 7.91%.

Revenue Deficiency

As shown on Attachment 1, Staff's determination of the adjusted average rate base is $83,489,251. Multiplying the adjusted average rate base by Staff's recommended rate of return of 6.83% results in a required operating income of $5,072,316. When compared to the operating income with present rates, the income deficiency is $3,587,827, and after applying the gross revenue conversion factor to add additional income taxes made necessary by the increase, the revenue deficiency is $4,541,553. Adding the gross receipts tax amount of $6,812 to the revenue deficiency results in a total base rate revenue deficiency of $4,548,365. After recognizing the portion of the base rate deficiency occurring because of the rider projects rolling into base rates, the net revenue deficiency is $1,928,830.

Attachment 20 details the revenue deficiency calculation based on OTP's recommended rate of return. The net revenue deficiency resulting from the Settlement and OTP's recommended return on equity is $3,071,673.

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.

Class Cost Allocation/Spread of the Increase

OTP's filed case included a class cost of service study (CCOSS). A CCOSS is useful in assigning revenue responsibility to the rate classes that OTP serves and in designing rates within each class. Staff objected to OTP's use of the minimum distribution system approach to allocate a significant portion of its distribution system (i.e. conductors and transformers) among the rate classes. Under the minimum distribution system approach, the theoretical cost of a hypothetical distribution system composed solely of minimum sized components is allocated among the classes based on the relative number of customers within each rate class. Doing so results in far too many costs being allocated to the Residential class. As a result, OTP recommended assigning a greater-than-average percentage increase to the Residential class.

On the other hand, Staff contends that the distribution facilities in question are designed and built to serve customers' maximum loads and, therefore, should be allocated on a demand basis. Staff's approach indicates the Residential class should receive a less-than-average percentage increase when compared to the overall average percentage increase.

To resolve this issue, Staff proposed, and OTP agreed to increase revenues by a uniform percentage increase across all classes. This approach preserves the relative revenue-to-cost differentials between rate classes that were established in OTP's last electric rate case, Docket EL10-011, and represents a reasonable middle ground between the results indicated in OTP's CCOSS using the minimum distribution system approach and Staff's CCOSS approach. The percentage increases resulting from the Settlement are more favorable to the Residential class than under OTP's original proposed spread of the increase, which is consistent with Staff's rejection of the minimum distribution system approach to allocate distribution facilities. The Company also agrees to study Staff's approach to class cost of service, which is an alternative to the Minimum Distribution System Study, when it files its next rate case.

Rate Design

Residential Customer Charge – OTP's current residential customer charge is $8.00. OTP claimed that its marginal cost study supported its proposed residential customer charge of $15.23. Regardless of any cost support, gradualism and customer impact alone dictate a modification to OTP's proposed increase. In addition, Staff's analysis of the Company's underlying embedded cost of service indicated a much different result than OTP's. In fact, Staff concluded that the existing monthly customer service charges already exceed what Staff believes is a reasonable allocation of customer-related costs and that no increase in the monthly customer charge is justified at this time strictly based on the cost analysis[14]. However, for settlement purposes, the Parties agreed to increase the residential customer charge to $10.00.

OTHER ISSUES

Phase-in Rider – The Company proposed a step increase to be effective January 1, 2020, to recover the cost of the Merricourt Wind Project (Merricourt), which was expected to be in-service by the end of 2019. Merricourt is a 150 MW wind farm that will be located near Merricourt, North Dakota, consisting of 75 two-MW Vestas V110 wind turbine generators and the associated infrastructure. The Company projects its annual energy output to be approximately 666,000 MWh, with a capacity factor of 50.7%. During settlement discussions, OTP revealed that Merricourt is now expected to be placed in service well after the end of 2019. Since this project will no longer meet the known and measurable 24-month rule outlined in ARSD 20:10:13:44, the Parties sought a different solution.

OTP plans to construct an approximate 250 MW simple-cycle natural gas fired energy conversion facility known as the Astoria Station Project (Astoria). Since Astoria would not qualify as a known and measurable adjustment in this case, OTP did not propose to include the costs in rates at this time. However, given the significant costs associated with an investment of this nature, a rate case to recover the costs associated with Astoria in the near future was most likely inevitable. Given OTP's planned investment in the Astoria Station, expected to be in-service by the end of 2020, in addition to the Merricourt investment, the Parties agree that OTP may file for the establishment of a phase-in rate plan under SDCL 49-34A-73 through 78, seeking recovery of Merricourt and Astoria construction work in progress and continuing once the projects are in-service and until the time the Company files its next

[14] Staff notes that its customer charge analysis is impacted by rate of return. Based on Staff's recommended return on equity, OTP's existing monthly customer charge exceeds the cost of service by $0.25. Incorporating OTP's recommended return on equity shows that OTP's existing monthly customer charge also covers the costs included in Staff's embedded residential customer cost analysis.

rate case. This approach provides OTP the opportunity to recover costs associated with the two capital projects while avoiding multiple rate cases. At the same time however, Staff reserves the right to review project costs for prudence and to comment on the mechanics of the phase-in rider.

Staff also negotiated two important adjustments that will help offset the revenue requirements associated with Merricourt and Astoria:

- Material New Load Adjustment: The phase-in rate plan will also include an adjustment reflecting the net benefit of the additional load in the Lake Norden area, including corresponding updates to jurisdictional allocation factors resulting from the increased load to South Dakota. Staff believes such an adjustment is necessary to reflect such a significant addition to OTP's load which is anticipated to begin occurring just months after the final change in base rates are effective in this case. This adjustment will commence with the effective date of the phase-in rates. The adjustment will be estimated based on anticipated increased customer sales compared to the pro forma test year sales in this rate case and will be true-up based on actual sales each year.
- Hoot Lake Retirement Adjustment: The phase-in rate plan will also include an adjustment to reflect the net savings associated with the Hoot Lake plant retirement, which is scheduled for retirement in May of 2021. The adjustment will be based on the Hoot Lake costs that are authorized to be recovered through base rates. Given some costs will phase out over a period of time and may not be known with certainty at the time of retirement, this adjustment will also be subject to true-up.

The phase-in rate plan will use the return on equity determined in this proceeding. While the projects are under construction, the rate of return will include the weighted average cost of debt calculated at year-end levels, including short-term debt costs, and the equity ratio calculated at year-end levels. Once the projects are in-service the weighted average cost of long-term debt calculated at year-end levels will be used.

Staff also secured additional benefits for customers regarding the Merricourt wind project. The phase-in plan will reflect PTCs based on Merricourt's actual production. However, if OTP has not filed a rate case to be effective by October 1, 2022, the phase-in plan will reflect PTCs for the Merricourt wind project based on a capacity factor of 50.7% until the time of the Company's next rate case. PTCs are highly dependent on the capacity factor. The Settlement recognizes that during the start-up period, the project may not reach the expected capacity factor but also locks in the expected capacity factor effective October 1, 2022, for the benefit of customers consistent with the adjustment initially proposed for the step increase.

Rate Moratorium – In conjunction with the rate phase-in plan, OTP agreed to a base rate moratorium. This moratorium provides benefits to customers by delaying a base rate increase for other costs that may increase in the next few years, instead of adding to the increased bills customers will have due to the Merricourt and Astoria investments. Merricourt and Astoria are expected to be placed in service by December 31, 2020. Under this expected scenario, the Company agrees to not file a rate case before

April 1, 2022 based on a 2021 test year. This results in a 4-year base rate moratorium. However, if either Merricourt or Astoria are not in service by December 31, 2020, the Company will not file a rate case until the test year reflects twelve months in-service for both projects. This ensures the Company and Staff will have at least a full year of historical operating costs to consider when setting rates in the next rate case.

Economic Development Rider & Super Large General Service – OTP proposed to implement two new rate schedules associated with large customers. OTP's Economic Development Rate (EDR) rider is designed to attract new customer load that provides net benefits to ratepayers. The Super Large General Service (SLGS) rate schedule is designed to attract new large loads with high load factors that provide net benefits to ratepayers. Although different schedules, the EDR and SLGS tariff sheets have many similarities. Staff proposed revisions to the Company's proposed tariffs, primarily regarding the "Commission-Approved Process" section. Staff requested the Company remove the language requiring pre-approval of a rate formula. Staff agrees to review the rate formula when requested but also wishes to make clear that such review does not preclude Commission review and approval of the resulting rate. The Company must also file the executed electric service agreement as a contract with deviations for Commission approval. Staff also suggested a change to the first item under "Terms and Conditions" to remove language indicating the goal of the calculation was to establish a floor price. OTP agrees to Staff's suggested changes.

Residential Time of Day Pilot – OTP's application included a Residential Time of Day Service Pilot rate schedule. OTP proposes the pilot run for two years. Participation in the pilot program will be voluntary and limited to 50 residential customers. OTP hopes to learn from the customers participating in the pilot before expanding the time of day rate structure as a permanent rate offering. Staff supports the Company's pilot approach. However, Staff recommended a lower customer charge be implemented similar to the lower customer charge recommended for regular residential service. The Settlement reflects a Residential Time of Day Pilot Customer Charge of $15.00.

General Service Rules & Rate Application – Staff took issue with two changes OTP proposed to its general service rules and rate application sections of its tariff.

1. Disconnection Notice - Under the Company's proposed change, customers who seek reconnection would need to bring their accounts current and pay a reconnection fee. Currently, the disconnect amount due and a reconnection fee are needed to be reconnected. Staff disagreed with requiring the total amount due because it appeared that not all notice periods for bills would be observed. Under the Settlement, this proposed change will not be implemented.

2. Assisting Customers in Rate Selection – The Settlement language replaces the "will endeavor to assist" language with "will assist" and more closely aligns with tariff language to that of other companies' tariffs.

Final Tariffs – The Parties agree that OTP will submit final tariffs for Commission approval after the Commission renders a final decision. The tariffs will reflect the rates resulting from the revenue requirement determined by this Settlement and the Commission's decision on return on equity, as well as the tariff terms and conditions agreed to per this Settlement.

Interim Rate Refund – Interim rates were implemented effective October 18, 2018. If the Commission ultimately approves a rate increase less than the interim rate level, the Company agrees to refund to customers the difference between interim rates and new rates established by the Settlement for usage during the period October 18, 2018, through the effective date of final rates. As part of the refund, OTP will include interest, calculated by applying a 7% annual interest to the average refund balance for each month that interim revenues were collected. OTP will file a separate interim rate refund plan.

Tax Cuts and Jobs Act – The Parties agree this rate case fully addresses the Company's obligations regarding the TCJA in Docket GE17-003. The adjustments described above ensure rates are developed based on the 21% federal corporate tax rate and the appropriate excess deferred income taxes are returned to customers. Such adjustments are effective upon the date interim rates went into effect. No adjustment or refund was required for the time period prior to the commencement of interim rates due to the unique financial position of the Company in relation to how its base rates were set in Docket EL10-011. Specifically, the Company's base rates included significant PTCs. Adjusting the rates determined in Docket EL10-011 to reflect the 21% tax rate would have resulted in an increase, or surcharge, to customers. The Settlement appropriately addresses the TCJA. No further actions are required in Docket GE17-003, other than to close the docket with respect to OTP.

RECOMMENDATION

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