STATE OF SOUTH DAKOTA

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

Docket No. EL18-021

Post-Hearing Brief of Otter Tail Power Company

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I. INTRODUCTION

Otter Tail Power Company (Otter Tail) submits this Brief to address the appropriate Return on Equity (ROE) for Otter Tail. Otter Tail will also submit proposed Findings of Fact and Conclusions of Law.

South Dakota law expressly recognizes the constitutional requirements that the ROE must:

(1) Maintain confidence in the financial soundness of the utility;

(2) Maintain the utility's credit profile and allow it to attract capital; and

(3) Be commensurate with returns of other companies of comparable risk.[1]

South Dakota law also recognizes the need for a utility to "earn a fair and reasonable return,"[2] and the obligation of the Commission to "balance" the interests of customers and utilities.[3] Whether the return meets required standards rests on the "result" of the Commission's decision, based on consideration of "the facts … viewed as a whole."[4] Mechanical application of a single model that is not currently producing reasonable results cannot justify the Commission's selection of a utility's ROE.

Rather, whether an ROE meets applicable requirements depends on an assessment of whether the ROE is reasonable based on the facts of the case as a whole. Those facts show that Otter Tail has higher risks and superior performance as compared to other utilities, which justifies a higher ROE for Otter Tail than might be reasonable for other utilities.

Otter Tail's higher risks result from a combination of factors. Otter Tail is substantially smaller than other utilities, with substantially lower levels of institutional investment, and substantially lower trading volumes. Otter Tail is also making substantially larger capital

[1] Northwestern Pub. Serv. Co. v. Cities of Chamberlain, etc., 265 N.W.2d 867, 873-74 (S.D. 1978).
[2] SDCL 49-34A-8.
[3] In re Northwestern Pub. Serv. Co., 297 N.W.2d 462, 464 (S.D. 1980).
[4] Northwestern Pub. Serv., 265 N.W.2d at 872.

expenditures than other utilities. Otter Tail invested approximately $806 million between 2012 and 2017,[5] and plans to invest another $901 million between 2018 and 2022.[6]

Otter Tail has also provided superior performance for its customers. Otter Tail's South Dakota rates are significantly lower than those of other South Dakota investor owned utilities, and its customer satisfaction is among the highest in the nation. Otter Tail has a demonstrated history of managing its costs, both through project execution and infrequent rate case filings, to the concrete benefit of customers.

The combination of these risk and performance factors demonstrates Otter Tail should have an ROE in the range recommended by Mr. Robert Hevert. His ROE analysis and recommendation are sound, are well within the range of ROE awards across the country (which averaged 9.68 percent in 2018), and fully support an ROE of 10.00 percent or more.

In contrast, the ROE analysis and recommendation of Mr. Basil L. Copeland, Jr.:

(1) are the result of his unlawful goal of forcing a severe reduction in Otter Tail's market-to-book ratio, which would impair financial confidence in Otter Tail and its ability to raise capital; and

(2) are so far below ROE awards of other jurisdictions that a commensurate return could not be achieved.

Mr. Copeland's recommendations would result in approximately $1 billion in losses of market value for Otter Tail's shareholders (if adopted by all commissions that regulate Otter Tail),[7] which should disqualify Mr. Copeland's recommendations from further consideration. Adopting such a recommendation would also dramatically discourage investment in Otter Tail and other utilities doing business in South Dakota. For these reasons, the Commission should adopt an ROE for Otter Tail consistent with Mr. Hevert's recommendations.

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[5] Ex. OTP-5 at 12 (Gerhardson Direct); Ex. OTP-3 at 8 (Moug Direct).
[6] Ex. OTP-3 at 9 (Moug Direct); Ex. OTP-5 at 12 (Gerhardson Direct).
[7] Tr. at 134 (Moug).

II. ARGUMENT

A. The ROE must meet Constitutional minimum standards and be fair and reasonable under South Dakota statutes.

The Commission's ROE decision must satisfy constitutional minimums and statutory requirements. Mr. Copeland's recommendation that the Commission impose an ROE that forces a severe reduction of Otter Tail's market-to-book ratio satisfies neither standard. Reliance on mechanical application of an ROE model would also not fulfill the Commission's obligation to use reasoned judgment. Accordingly, the Commission should not adopt Mr. Copeland's approach or recommendation and should, instead, consider the record as a whole and establish an ROE that is fair and reasonable.[8]

The ROE determination begins with the constitutional principles that were established in *Hope* and *Bluefield* and were recognized by the South Dakota Supreme Court in *Northwestern Public Service Co*.[9] At a minimum, the ROE must: (1) maintain "confidence in the financial soundness" of the utility;[10] (2) be "commensurate with returns" earned by comparable companies;[11] and (3) allow the utility to maintain its credit profile and attract capital.[12]

In addition to satisfying constitutional minimums, the authorized ROE must also comply with South Dakota statutes, which require that Otter Tail be allowed to "earn a fair and reasonable return upon the value of its property."[13] Establishing a fair and reasonable return requires that the

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[8] SDCL 49-34A-8.
[9] Northwestern Pub. Serv., 265 N.W.2d at 873-74 ("In determining whether a rate is confiscatory, we start with the proposition [that] … [a] public utility is entitled to charge such rates as will permit it to earn a reasonable rate of return …." (citation omitted)).
[10] Northwestern Pub. Serv., 265 N.W.2d at 873 (quoting Bluefield Water Works & Improvement Co. v. Public Service Comm'n, 262 U.S. 679, 693 (1923)).
[11] Northwestern Pub. Serv., 265 N.W.2d at 873-74 (quoting Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944)).
[12] Northwestern Pub. Serv., 265 N.W.2d at 873-74 (quoting Hope, 320 U.S. at 603).
[13] SDCL 49-34A-8.

Commission balance the interest of the utility and customers – neither interest is to be predominant over the other, as the South Dakota Supreme Court has explained:

> The statutes place the responsibility on the PUC to balance the need of the utility for adequate revenue with the protection of the public from unjust or unreasonable rates. To this end, it is neither a consumer advocate nor a utility advocate.[14]

Adopting an ROE that has the effect of forcing a severe reduction in Otter Tail's market-to-book ratio, as Mr. Copeland recommends,[15] would violate these minimum standards and statutory directives.

B. The significance of Constitutional minimums and the fair and reasonable standard of South Dakota law is not lessened by the limited size of Otter Tail's South Dakota operations.

Mr. Copeland claims that that the impact of adopting his recommendation "is likely to be very small because South Dakota represents such a small proportion of OTP's service territory."[16] The inference of this statement seems to be that the size of Otter Tail's South Dakota operations lessens the significance of constitutional and statutory standards. To the contrary, there is no exception to the fair and reasonable standard for multi-jurisdictional utilities.[17] Regulatory commissions may not lawfully reduce a utility's earnings in their jurisdictions because of the utility's earnings in other jurisdictions.[18]

It also would not be "fair and reasonable" to reduce Otter Tail's earnings in South Dakota on the assumption that the missing earnings will be made up in other states because doing so

[14] In re Northwestern Pub. Serv. Co., 297 N.W.2d 462, 464 (S.D. 1980).
[15] Ex. S1 at 24 (Copeland Direct).
[16] Ex. S1 at 41 (Copeland Direct).
[17] Tr. at 188-189 (Gerhardson).
[18] *Minnesota Rate Cases*, 230 U.S. 352 (1913)

> Where the business of the [utility] is both interstate and intrastate, the question whether a scheme of maximum rates … for intrastate transportation affords a fair return, must be determined by considering separately the value of the property employed in the intrastate business ….

would, in effect, lead to subsidization of South Dakota customers by customers in other states.[19] Further, Mr. Copeland is also incorrect in claiming that any effect of the Commission's decision is "likely to be very small."[20] As Mr. Hevert explained, although "South Dakota is a small portion of [Otter Tail's] business:"

> [I]f we look at returns available elsewhere across the country, that type of return [the ROE recommended by Mr. Copeland] would be so noticeable, that I think it would get the attention of the financial community and not in a good way. [21]

Further, Mr. Moug also explained, Mr. Copeland's recommended ROE would result in approximately $1 billion of lost market capitalization if followed by all of Otter Tail's jurisdictions.[22]

C. The Commission must use its judgment based on consideration of all facts, and meeting that requirement depends on results, not mechanical use of any model.

The Commission has recognized that establishing a fair and reasonable return requires the exercise of "sound judgement" and "the overall results of the analysis."[23] The South Dakota Supreme Court has determined that the use of a "single formula" is not required and legality is determined based on whether "the method followed and the order entered when applied to the facts and viewed as a whole" produce an "unjust or arbitrary result."[24] Here, the record and facts viewed as a whole clearly indicate that a fair and reasonable return for Otter Tail is one that is not below

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[19] Tr. at 188-89 (Gerhardson) ("[I]f the idea that, hey, we can hit a low ROE because our impact on the company is going to be reduced only to 10 percent impact, I think that would actually strike at the very definition of what it means to be fair and reasonable.").
[20] Ex. S1 at 41 (Copeland Direct).
[21] Tr. at 80 (Hevert).
[22] Tr. at 134 (Moug) ("If the recommendations that Mr. Copeland was making as it related to market-to-book were followed by all of our jurisdictions, we would see a billion dollar reduction in our market capitalization ….").
[23] *In re Northern States Power Company*, Docket No. EL11-019, FINAL DECISION AND ORDER; NOTICE OF ENTRY at ¶ 8 (July 2, 2012).
[24] <u>Northwestern Pub. Serv.</u>, 265 N.W.2d at 872.

the mainstream of ROE awards available to other utilities, and one that recognizes OTP's unique risks and superior performance.

1. ROE models provide useful starting points, but no model results are a substitute for the Commission's obligation to use its judgment to determine a just and reasonable ROE.

The Commission is not required to adopt the specific recommendations of any of the witnesses, and the Commission may not fail to consider and give appropriate weight to all testimony that has a reasonable basis. Doing so would not fulfill the Commission's duty to consider the "facts … viewed as a whole", as provided by the South Dakota Supreme Court.[25] The obligation to view the facts as a whole also applies to the Commission's selection of the ROE, and that approach requires the Commission to take into consideration all reasonable recommendations pertaining to the ROE.

While Mr. Copeland recommended focusing solely on the lowest ROE that meets constitutional minimums,[26] he also recognized: (1) the Commission could "adopt the middle" between Mr. Hevert's analyses and his analyses to set a "zone of reasonableness" for the Commission to determine Otter Tail's ROE; and (2) regulatory commissions often use this approach.[27] Mr. Copeland also recognizes that the while "methods" are involved: "[U]ltimately the concern is the end result, the outcome."[28] As a result, there is agreement that it is the *result* of the Commission's analysis, based on the evidentiary facts *as a whole,* which matters in evaluating the reasonableness of an ROE.

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[25] Northwestern Pub. Serv., 265 N.W.2d at 872.
[26] Ex. S1 at 24 (Copeland).
[27] Tr. at 120 (Copeland) ("[I]f you were to conclude that you found my testimony, my estimate, to be reasonable, that a reasonable mind would conclude the 8.25, and you found that a reasonable mind would conclude that it was 10.3, and therefore, you're going to adopt the middle of that, that's going to get upheld. That's going to satisfy, you know, the zone of reasonableness idea. And that's kind of often the way it's done.").
[28] Tr. at 111 (Copeland).

2. The DCF model is not producing reasonable ROE estimates under current market conditions, and it cannot be solely relied on to select an ROE.

Exclusive reliance on a mechanical application of the DCF model in this case would not be consistent with the exercise of sound judgment, and doing so would yield an unjust and arbitrary result. The DCF model is not producing reasonable ROE estimates under current market conditions and has not done so since 2014. While the DCF model may have provided reasonable estimates in the past, and it may do so again in the future, it is not doing so now. Whether the ROE is fair and reasonable and meets constitutional minimums will be determined based on current facts,[29] not the past or future.

A number of regulatory agencies have recently discussed the defects in the DCF model under current conditions. FERC has recently found that "in light of current investor behavior and capital market conditions, relying on the DCF methodology alone will not produce a just and reasonable ROE."[30] FERC has also recently noted that although it "previously relied solely on the DCF model to produce the evidentiary zone of reasonableness…", it is "…concerned that relying on that [DCF] methodology alone will not produce just and reasonable results."[31]

State commissions have made similar findings. For example, the North Carolina Commission recently considered the DCF analyses of the ROE witnesses (which ranged from 8.45 percent to 8.80 percent), and expressly found that "all of these DCF analyses in the current market produce unrealistically low results."[32]

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[29] Northwestern Pub. Serv., 265 N.W.2d at 872

[30] *Coakley v. Bangor Hydro-Elec. Co.*, 165 FERC ¶ 61,030 at ¶ 32 (2018) [*hereinafter Coakley*].

[31] *Coakley*, 165 FERC ¶ 61,030 at ¶ 30 (2018).

[32] *Duke Energy Carolinas, LLC*, North Carolina Utils. Comm'n Docket No. E-7, Sub 1146, ORDER ACCEPTING STIPULATION, DECIDING CONTESTED ISSUES, AND REQUIRING REVENUE REDUCTION at 62 (2018).

Other regulatory agencies have also concluded that reliance on a single mathematical model is not adequate for a subject as complex as determining the ROE. The Maryland Commission noted:

> [W]e are not willing to rule that there can be only one correct method for calculating an ROE. … *The subject is far too complex to reduce to a single mathematical formula.* [33]

The South Carolina Commission similarly noted that relying on a single model is "inconsistent with decisions reached by regulatory commissions over the past several years…."[34] The Commission should reach a similar conclusion regarding the DCF model in this case.

Considering a broad range of information is also consistent with how investors make decisions. FERC has noted that investors do not rely solely on the DCF model:

> While some investors may give some weight to a DCF analysis, it is clear that other investors place greater weight on one or more of the other methods … as well as taking other factors into account.[35]

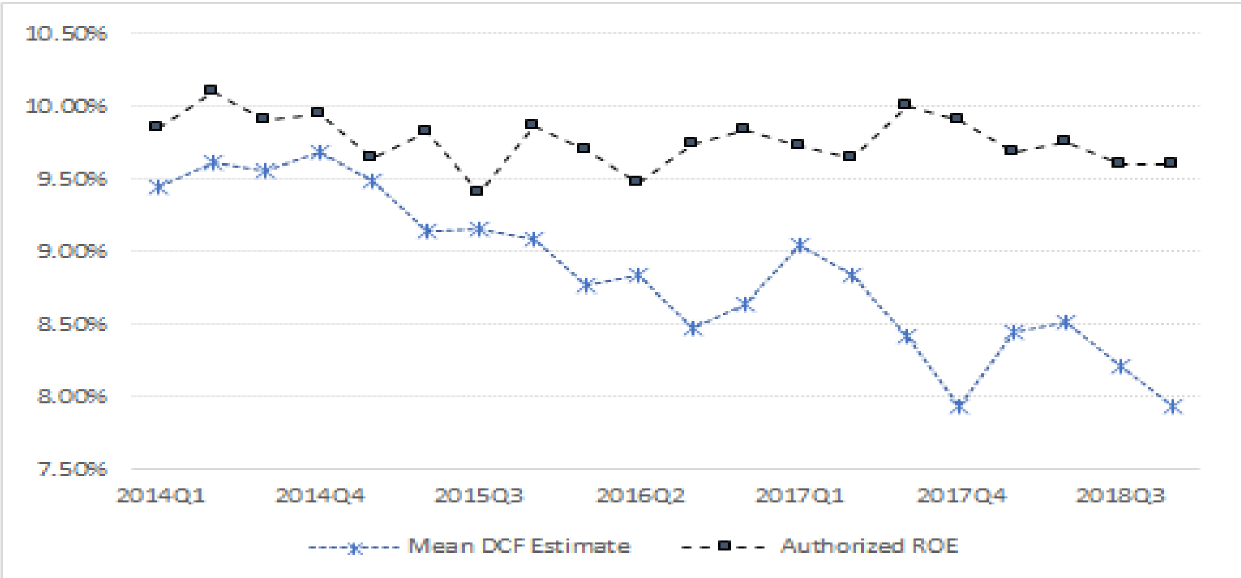
Investors consider "as much relevant data" as possible, including use of "multiple analytical approaches."[36] Applying the same approach used by investors essential because the ROE must be adequate to attract investment in the utility and maintain financial confidence in the utility. As a result, it would be inappropriate for the Commission to rely exclusively on the DCF or any other model in setting the ROE.

There is also substantial quantitative evidence that the DCF is not producing reasonable estimates *under current market conditions*. As shown in Figure 1 below, the differences between DCF model estimates and authorized ROEs were moderate and generally consistent through 2014 (which provides support for significant reliance on the DCF model through 2014). Since 2014,

[33] *Baltimore Gas and Electric*, Maryland Pub. Serv. Comm'n Order No. 87591 at 153. (2016) (emphasis added).
[34] *South Carolina Electric & Gas*, South Carolina Pub. Serv. Comm'n Order No. 2018-804 at 89 (2018).
[35] *Coakley*, 165 FERC ¶ 61,030 at ¶ 35 (2018).
[36] Ex. OTP-1 at 16 (Hevert Direct).

however, the gaps between authorized ROEs and DCF results are large and growing, so much so that in 2018, the differences were consistently over 100 basis points and exceeded 150 basis points by the 4th quarter of 2018.

Figure 1
Authorized ROEs vs. DCF Estimates[37]



This comparison shows regulatory agencies have recognized that the DCF model is producing results that are far below the actual cost of equity. In this context, following the DCF results will not meet the requirement for a comparable return since other commissions have recognized the defects in the DCF model.

D. Mr. Hevert's analysis supports an ROE of 10.00 percent or more for Otter Tail, reflecting Otter Tail's higher risk and superior performance.

Mr. Hevert's analysis supports an ROE of 10.00 percent or more, especially taking into consideration Otter Tail's higher risk and superior performance.

Mr. Hevert used several quantitative models to estimate Otter Tail's cost of equity, which helps to quantify a range of investor expectations.[38] The 10.00 percent base of Mr. Hevert's ROE

[37] Ex. OTP-2 at 8 (Hevert Rebuttal).
[38] Ex. OTP-1 at 15 (Hevert Direct).

range and his 10.30 percent ROE recommendation are well within the range of these models, 'as shown in Table 1 below:

Table 1
Summary of Hevert Quantitative Analyses[39]

30-Day Constant Growth DCF	10.26% *
90-Day Constant Growth DCF	10.31% *
180-Day Constant Growth DCF	10.44% *
30-Day Multi-Stage DCF	9.22% *
90-Day Multi-Stage DCF	9.22% *
180-Day Multi-Stage DCF	9.31% *
CAPM Current 30-Year Treasury (3.03%) (Bloomberg Beta)	8.40% and 10.9%
CAPM Current 30-Year Treasury (3.03%) (Value Line Beta)	10.07% and 12.29%
CAPM Near Term Projected 30-Year Treasury (3.33%) (Bloomberg Beta)	8.70% and 12.39%
CAPM Near Term Projected 30-Year Treasury (3.33%) (Value Line Beta)	10.37% and 12.59%
Bond Yield + Risk Premium Current 30-Year Treasury (3.03%)	9.93%
Bond Yield + Risk Premium Near Term Projected 30-Year Treasury (3.33%)	9.98%
Bond Yield + Risk Premium Long Term Projected 30-Year Treasury (4.05%)	10.17%

** Mean High result, which is appropriate given Otter Tail's higher risk and superior performance*

These results support an ROE for Otter Tail of 10.00 percent or more, especially when Otter Tail's higher risk and superior performance are considered.[40]

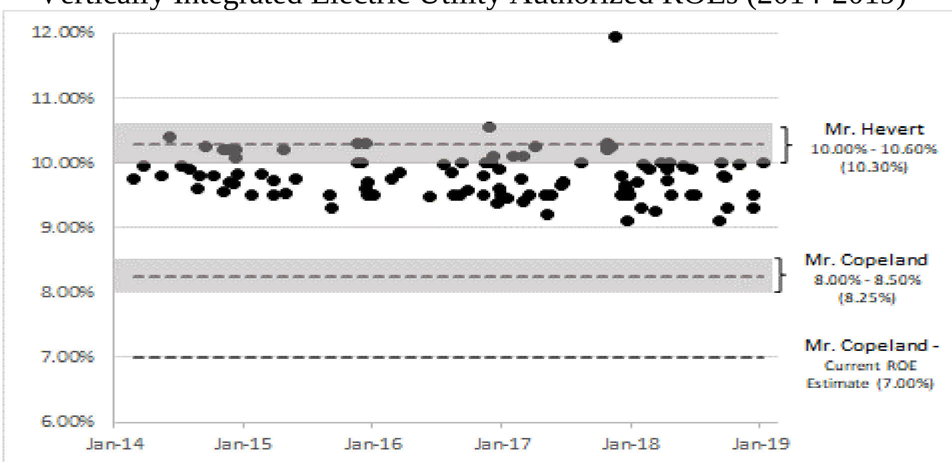
The reasonableness of Mr. Hevert's recommended ROE for Otter Tail is also supported by ROE awards to other utilities. ROEs authorized by other commissions are an important touchstone because Otter Tail must be allowed an ROE that is "commensurate with returns" earned by comparable companies.[41] ROEs authorized by other commissions are an obvious indicator of comparable returns[42] though, as discussed below, Otter Tail has *considerably higher risk* than most

[39] Ex. OTP-2 at 77 (Hevert Rebuttal).
[40] Ex. OTP-1 at 3-4 (Hevert Direct).
[41] Northwestern Pub. Serv., 265 N.W.2d at 873-74 (quoting Hope, 320 U.S. at 603).
[42] Ex. OTP-2 at 17-18 (Hevert); Tr. at 15 (Hevert).

other utilities. Other authorized ROEs also provide insight into how other commissions evaluate the factors at issue in this proceeding and what returns are available in other jurisdictions.[43] Thus, comparing the ROE recommendations of the witnesses to authorized ROEs provide a check on the constitutional requirement for a comparable return and a check on reasonableness.[44]

Mr. Hevert's ROE range and ROE recommendation are within the mainstream of ROE awards since 2014, while Mr. Copeland's ROE range and ROE recommendation are unreasonably low, as shown below:

Figure 2
Vertically Integrated Electric Utility Authorized ROEs (2014-2019)[45]



E. The record supports an ROE for OTP above the ROE for other utilities.

The cost of equity is the return investors require in compensation for the risk of investing in common stock,[46] and investors require higher returns for investing in utilities with higher risks.[47]

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[43] Ex. OTP-2 at 7 (Hevert Rebuttal).
[44] Northwestern Pub. Serv., 265 N.W.2d at 872 (requiring a reasonable result); SDCL 49-34A-8 (requiring a fair and reasonable return).
[45] Ex. OTP-2 at 6 (Hevert Rebuttal).
[46] Ex. OTP-1 at 7 (Hevert Direct).
[47] Ex. OTP-1 at 3 (Hevert Direct) ("The combination of [OTP's risk] factors indicates a heighted degree of business risk relative to the proxy companies, suggesting an ROE toward the upper end of the range to account for that greater risk.").

Otter Tail is riskier than other utilities, including other South Dakota utilities, which supports a higher cost of equity and ROE for Otter Tail.

South Dakota law also requires that the authorized ROE be "fair and reasonable."[48] As discussed below, Otter Tail has performed exceptionally, delivering substantial cost savings for customers and high-quality service. These factors are directly related to the "fair and reasonable" ROE for Otter Tail.[49] As a result of the combination of higher risk and superior performance, Otter Tail's ROE should be higher than the ROEs for average utilities and other South Dakota utilities.

1. Otter Tail faces higher risks than other utilities.

Otter Tail faces higher risks than other utilities, including other utilities providing service in South Dakota. These risks include Otter Tail's very large capital expenditures, small size, and Otter Tail Corporation's very low levels of institutional ownership and trading volume.

a) <u>Very High Capital Expenditures</u>

Higher levels of capital expenditures increase utility risk because "the additional pressure on cash flows associated with high levels of capital expenditures exerts corresponding pressure on credit metrics and, therefore, credit ratings."[50] Earning a return adequate to attract capital is of particular importance to a utility with high capital expenditures.[51]

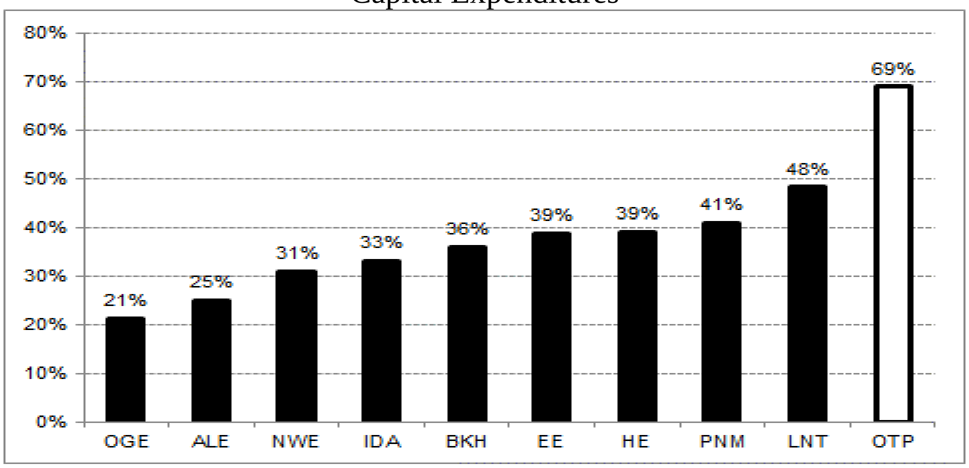
Otter Tail has been engaged in an extensive capital expenditure plan that is projected to continue over the next five years. From 2012 to 2017, Otter Tail invested approximately $806 million (OTP Total).[52] These capital expenditures required issuance of debt and equity and reinvestment of earnings.[53] OTP expects to invest an additional $901 million (OTP Total) between

[48] SDCL 49-34A-8.
[49] Ex. OTP-1 at 4 (Hevert Direct).
[50] Ex. OTP-1 at 37-38 (Hevert Direct).
[51] Ex. OTP-1 at 38 (Hevert Direct).
[52] Ex. OTP-3 at 8 (Moug Direct); Ex. OTP-5 at 12 (Gerhardson Direct).
[53] Ex. OTP-3 at 8 (Moug Direct).

2018 and 2022,[54] including the Astoria Station Project, the Big Stone Area Transmission (BSAT) Ellendale and Lake Norden Area Transmission Projects, all located in South Dakota.[55] Completing this capital expenditures plan will also require issuance of equity and debt capital, in addition to reinvesting earnings.[56]

Otter Tail's projected capital expenditures are 68.92 percent of its net plant for 2018-2022, which is higher than utilities analyzed by Mr. Hevert and Mr. Copeland as shown below:

Figure 3
Capital Expenditures



Otter Tail's significantly higher rate of investment supports a higher ROE for Otter Tail.

b) Very Small Size

Smaller size leads to two types of increased risk: (1) liquidity risk (*i.e.*, the risk of not being able to sell one's shares in a timely manner due to the relatively thin market for the securities); and (2) fundamental business risks.[57] Investors require a "size premium" to account for these increased risks.[58]

[54] Ex. OTP-3 at 9 (Moug Direct); Ex. OTP-1 at 36 (Hevert Direct).
[55] Ex. OTP-5 at 5 (Gerhardson Direct).
[56] Ex. OTP-3 at 2 (Moug Direct).
[57] Ex. OTP-1 at 40 (Hevert Direct).
[58] Ex. OTP-1 at 42 (Hevert Direct).

Otter Tail is significantly smaller than other investor owned utilities, including other investor owned utilities in South Dakota. Otter Tail serves only 132,000 total customers across a service area the size of Wisconsin.[59] Otter Tail's implied market capitalization is approximately 2.00 percent of the median level of the utilities analyzed by Mr. Hevert and Mr. Copeland, and approximately 4.00 percent of the smallest of those companies.[60] Otter Tail Corporation (Otter Tail's parent) is the second smallest publicly traded investor owned utility in the United States,[61] and its total market capitalization is 1/10th the size of the average publicly traded investor owned utility.[62] Otter Tail Corporation's market capitalization is significantly lower than the market capitalization of any of the utilities analyzed by Mr. Hevert and Mr. Copeland,[63] and is lower than the market capitalization of any utility serving South Dakota.[64]

c) <u>Very Low Institutional Ownership</u>

Equity investors perceive low levels of institutional ownership as a risk. Institutional investors provide capital-intensive utilities an efficient source of capital and a source of liquidity. Companies with lower levels of institutional ownership are at a competitive disadvantage because of diminished access to efficient sources of equity capital and diminished market liquidity. Investors require higher returns from utilities with low levels of institutional ownership in view of this competitive disadvantage and liquidity risk.[65]

Otter Tail Corporation has a very low level of institutional ownership compared to other utilities, including other utilities serving South Dakota. Otter Tail Corporation has 43.10 percent

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[59] Ex. OTP-5 at 10 (Gerhardson Direct).
[60] Ex. OTP-1 at 40 (Hevert Direct).
[61] Ex. OTP-3 at 4 (Moug Direct)
[62] Ex. OTP-3 at 4 (Moug Direct).
[63] Ex. OTP-1 at 40 (Hevert Direct).
[64] Ex. OTP-3 at 4-5 (Moug Direct). Otter Tail Corporation's $1.67 billion market capitalization well below Northwestern's market capitalization of $2.54 billion, Black Hill's market capitalization of $2.79 billion, MDU's market capitalization of $5.3 billion, and Xcel Energy's market capitalization of $21.95 billion.
[65] Ex. OTP-1 at 45-46 (Hevert Direct).

institutional ownership, which is far below the 81.22 percent average institutional ownership level of utilities analyzed by Mr. Hevert and Mr. Copeland, and well below the level of institutional ownership levels of Black Hills (99.03 percent) Northwestern (99.56 percent), Xcel Energy (74.51 percent), and MDU (64.77 percent).[66]

d) Low Trading Volume

Low trading volume increases the risk that investors (especially institutional investors) may have difficulty selling positions without adversely affecting the market price of shares. Investors require a higher return – a liquidity premium – to account for this risk.[67] The Commission should reflect such a premium when establishing the ROE for Otter Tail.

Otter Tail Corporation has very low trading volumes. From 2013 to 2018, Otter Tail Corporation's average daily trading volume was approximately 18 percent of the average daily trading volume of the utilities analyzed by Mr. Hevert and Mr. Copeland[68] and 3 percent of Xcel Energy's, 10 percent of MDU's, 24 percent of Black Hills's, and 29 percent of Northwestern's trading volumes.[69]

2. Otter Tail also provides superior performance.

Otter Tail also provides superior performance as demonstrated by its low rates, successful completion of major projects, and infrequent rate cases, while providing excellent service.

a) Very Low Rates

Otter Tail's rates are low despite its small size and large, sparsely populated service area, and substantial capital investments. Since 2011, Otter Tail's rates have been the second lowest among South Dakota utilities and well below the national average.[70]

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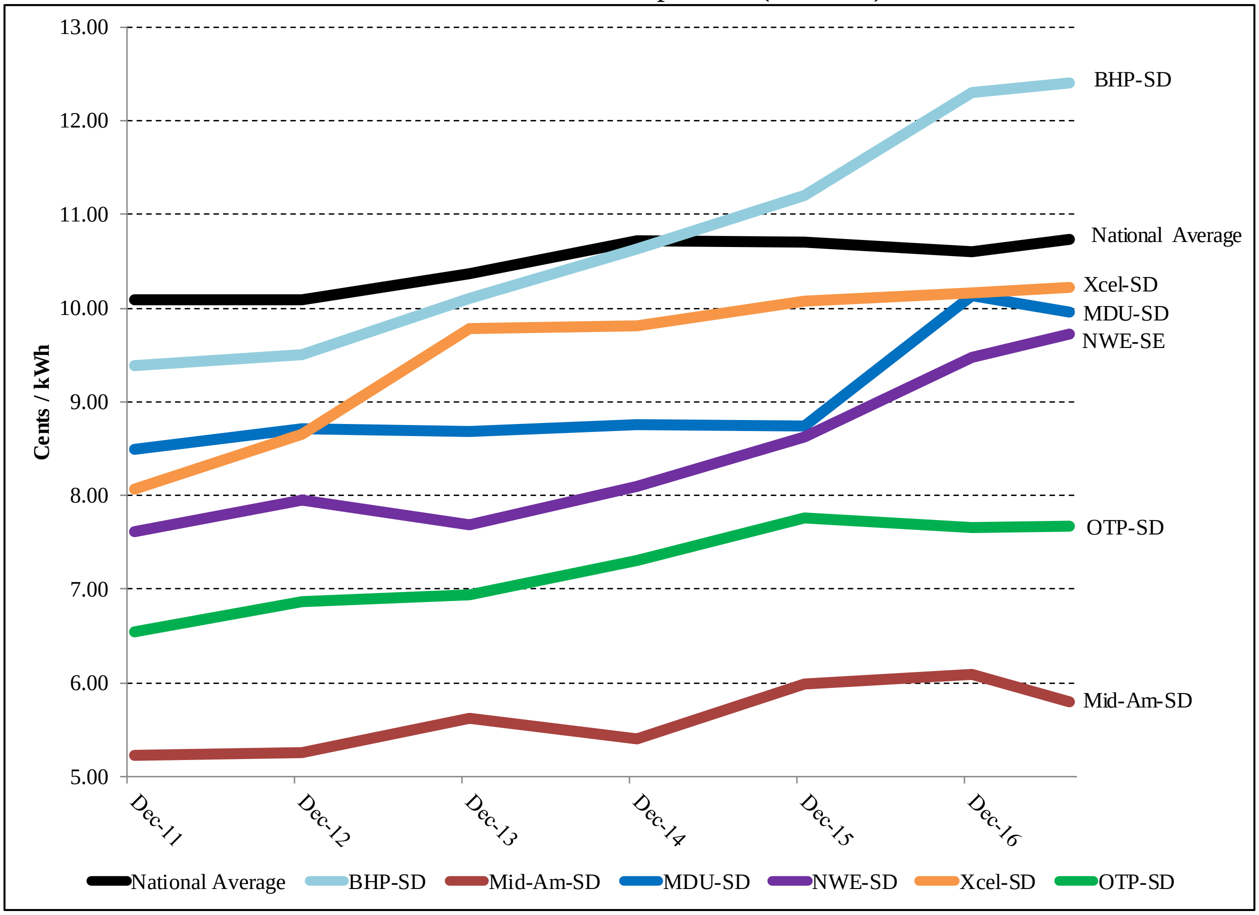
[66] Ex. OTP-1 at 45-46 (Hevert Direct).
[67] Ex. OTP-1 at 46 (Hevert Direct).
[68] Ex. OTP-1 at 46 (Hevert Direct).
[69] Ex. OTP-1 at 47 (Hevert Direct).
[70] Ex. OTP-5 at 14-15 (Gerhardson Direct).

Figure 4
South Dakota Rate Comparison (All bills)[71]



In 2017, Otter Tail Corporation was the fourth lowest price provider among all utility parent companies nationwide.[72]

b) Under-Budget Completion of Large Projects

Otter Tail has executed large projects well, which helps Otter Tail to maintain low rates to the benefit of its South Dakota customers. The Big Stone Plant Air Quality Control System (AQCS) Project was the single largest investment ever made by Otter Tail. The AQCS Project was put into commercial operation more than $125 million under budget.[73] The cost savings were

[71] Ex. OTP-5 at 15 (Gerhardson Direct).
[72] Ex. OTP-5 at 16 (Gerhardson Direct).
[73] Ex. OTP-7 at 10 (Phinney Direct); Ex. OTP-5 at 15 (Gerhardson Direct).

driven in large measure by Otter Tail taking on the duties of construction management for the project.[74]

Otter Tail's under budget completion of the AQCS Project reduced the 2017 Test Year South Dakota revenue deficiency by approximately $0.8 million, a dollar-for-dollar saving for South Dakota customers. Those saving will continue to benefit South Dakota customers for many years. The cost savings for Otter Tail's approximately 12,000 South Dakota customers will total approximately $15.5 million over the life of the AQCS Project, with a net present value of $7.0 million.[75]

Otter Tail also completed the Hoot Lake Plant Mercury and Air Toxics Standards (MATS) $2.8 million (28 percent) below the total original project budget.[76]

c) <u>Infrequent Rate Cases</u>

Otter Tail files infrequent rate cases. Otter Tail's last South Dakota rate case was filed on August 20, 2010. Since that time:

- Xcel Energy has filed *three* rate cases;
- Black Hills Power has filed *two* rate cases;
- MidAmerican has filed *two* rate cases;
- Northwestern has field *two* rate cases; and
- Montana-Dakota Utilities (MDU) has filed *three* rate cases.[77]

Otter Tail's infrequent rate case filings reflect Otter Tail's control of costs on behalf of its customers and Otter Tail's sensitivity to the fact that rate cases are a significant expense borne by customers.[78]

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[74] Ex. OTP-7 at 8 (Phinney Direct); Tr. at 172-173 (Gerhardson).
[75] Ex. OTP-6 at 11 (Gerhardson Direct).
[76] Ex. OTP-8 at 7 (Tommerdahl Direct); Ex. OTP-7 at 13-14 (Phinney Direct).
[77] Ex. OTP-6 at 12 (Gerhardson Rebuttal).
[78] Ex. OTP-5 at 6 (Gerhardson Direct). In explaining OTP's decisions on rate case filings, Mr. Gerhardson testified:

> we've got … something under 12,000 customers in South Dakota and if we, let's say, had $600,000 of costs, each customer's paying an awful lot for a rate case. So when we haven't had a rate case for eight or nine years and the implication is that's on us, I will say it made me bristle a little bit.

d) Very High Levels of Customer Satisfaction

These operational successes have resulted in extremely satisfied customers. Over the last three years, Otter Tail was recognized as one of the top three utilities in customer satisfaction among the Midwest midsize utilities in the JD Power Electric Utility Residential Customer Satisfaction Study.[79] Otter Tail has also achieved very high customer satisfaction scores as measured by the American Customer Satisfaction Index[80] and by Bellomy Research. Since 2012, over 90 percent of Otter Tail's residential and commercial customers have rated Overall Quality of Service as "Very Good" or "Excellent."[81]

Otter Tail's excellent customer service has also been recognized by the Edison Electric Institute (EEI), a nation-wide association of investor-owned utilities. In 2017, EEI presented Otter Tail with the Emergency Recovery Award for its outstanding restoration after a snow and ice storm hit Otter Tail's territory on Christmas Day, 2016, leading to loss of power to more than 4,000 residences in South Dakota and 2,200 residences in North Dakota.[82]

3. The combination of Otter Tail's higher risks and superior performance should be considered when setting its ROE.

Otter Tail is decidedly not a utility of average risk or average performance. Otter Tail has higher risks than comparable utilities in several areas.[83] Investors require higher returns in

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> That's a good thing. And we will endeavor -- we will endeavor to not to have rate cases frequently if we can avoid.

Tr. at 181-82 (Gerhardson).

[79] Ex. OTP-5 at 17 (Gerhardson Direct).

[80] Ex. OTP-5 at 17-18 (Gerhardson Direct). ACSI compares Otter Tail's customer satisfaction ratings with the ratings of the top electric and gas investor-owned utilities in the country. Otter Tail's 2016 score for customer satisfaction was 84 out of 100, well above all classes of utilities, when each is considered as a group. Otter Tail scored high in every key driver measured by ACSI including satisfaction, meeting customer expectations, quality, perceived value, customer loyalty, reliability, and service restoration. Ex. OTP-5 at 17-18 (Gerhardson Direct).

[81] Ex. OTP-5 at 18-19 (Gerhardson Direct).

[82] Ex. OTP-5 at 19 (Gerhardson Direct).

[83] *See* Section II.D.1.

exchange for accepting the kind of risks associated with Otter Tail,[84] and accounting for Otter Tail's higher risk is required by constitutional standards.[85]

The South Dakota statutory requirement that Otter Tail's ROE be "fair and reasonable" also requires consideration of Otter Tail's higher risk and superior performance. Otter Tail has delivered for customers: the extraordinary performance on Otter Tail's capital projects has reduced Otter Tail's rate request and will save customers money for decades. That performance is consistent with Otter Tail's overall ability to maintain very low rates despite the challenge of being a small utility serving a very large, sparsely populated service territory. Recognizing this kind of performance through a higher authorized ROE is entirely consistent with sound regulatory practice and the concept of a "fair and reasonable" return.[86]

Otter Tail's higher risks and superior performance fully justify an ROE in the range recommended by Mr. Hevert.

4. Customers will not be harmed by awarding an ROE for OTP that recognizes its higher risks and superior performance.

Establishing Otter Tail's ROE is not a "zero-sum" contest between customers and shareholders. Setting a fair and reasonable ROE will benefit customers by maintaining Otter Tail's financial strength, which will allow it to continue to perform exceptionally. Further, Otter Tail's customers will still pay very low rates if the Commission authorizes an ROE in the range recommended by Mr. Hevert.

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[84] Ex. OTP-1 at 3 (Hevert Direct) ("The combination of [OTP's risk] factors indicates a heighted degree of business risk relative to the proxy companies, suggesting an ROE toward the upper end of the range to account for that greater risk.").

[85] Northwestern Pub. Serv., 265 N.W.2d at 873-74 (quoting Hope, 320 U.S. at 603 for the requirement that ROE be "commensurate with returns" earned by comparable companies).

[86] Ex. OTP-1 at 50-51 (Hevert Direct); SDCL 49-34A-8.

As discussed above, the ROE must satisfy constitutional minimums of instilling "confidence in the financial soundness of the utility,"[87] and allow the utility to maintain its credit profile and attract capital.[88] Meeting these requirements directly benefits customers. Financial strength affects a utility's ability to provide safe and reliable service.[89] Financially strong utilities can attract capital at more favorable rates, thereby saving money for customers,[90] and are able to generate internal earnings, which Otter Tail has used, and will continue use, to fund capital expenditures to provide service to customers.[91]

Further, as shown in Figure 5 below, Otter Tail customers will continue to have very low rates even with an ROE of 10.30 percent.

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[87] Northwestern Pub. Serv., 265 N.W.2d at 873 (quoting Bluefield, 262 U.S. at 693).

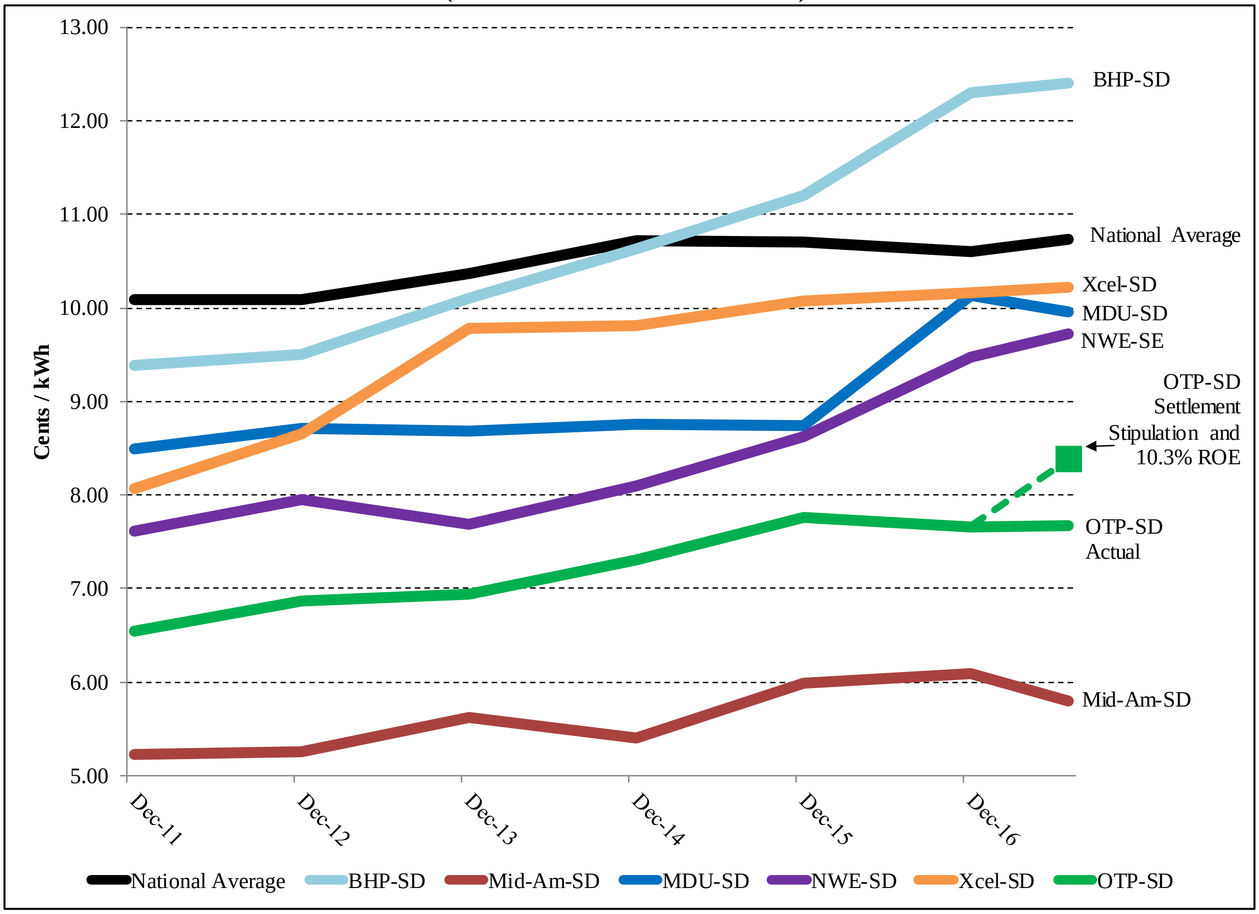
[88] Northwestern Pub. Serv., 265 N.W.2d at 873-74 (quoting Hope, 320 U.S. at 603).

[89] Ex. S1 at 6 (Copeland Direct) ("If the allowed rate of return on equity is significantly below the market cost of equity the impairment of the firm's financial integrity undermines its ability to render safe and reliable service."); Tr. at 178 (Gerhardson) ("[I]f our market cap dropped by a billion dollars, we would have a desperate financial situation. We'd have to manage, and it would most certainly affect our ability to perform as we have.").

[90] Ex. OTP-3 at 12-14, 17 (Moug Direct); Tr. at 142 (Moug).

[91] Ex. OTP-3 at 11 (Moug Direct) ("[T]he ROE … will have a direct impact on … OTP's authorized earnings. [A]uthorized earnings will, in turn, directly impact OTP's ability to fund capital expenditures with internally generated retained earnings. …OTP has reinvested almost 80 percent of its earnings in the 2012-2017 period ….Previously authorized ROEs … have had a significant effect on … internally generated retained earnings, which have been a significant source of funding for OTP's capital expenditures and are expected to remain a significant source of funding for the remainder of OTP's capital expenditures plan.").

Figure 5
South Dakota Rate Comparison[92]
(All Bills Data 2011 – 2017)



As a result, the Commission can have confidence that authorizing an ROE up to 10.30 percent would fairly protect customers' interests, especially because such an award would recognize unique aspects of Otter Tail's risks and superior performance (which has kept rates low).

[92] Ex OTP-5 at 15 (Gerhardson Direct); Staff Memorandum Supporting Settlement Stipulation, Attachment 20 (SD Electric Revenue Requirement – OTP ROE). Attachment 20 identifies present 2017 Test Year Retail Revenue of $30,658,393 and Rider Roll-In Revenue of $2,619,535, for total present revenues of $33,277,928. At Otter Tail's proposed 10.3% ROE and reflecting the Settlement Stipulation, the overall revenue increase would be $3,071,673, or 9.23%. Otter Tail's July 2017 All Bills rate was 7.67 cents / kWh: 7.67 cents / kWh multiplied by 1+9.23% equals 8.38 cents / kWh.

F. Mr. Copeland's goal of reducing market-to-book ratios makes his analysis unreliable and would severely harm customers of all South Dakota utilities.

Mr. Copeland's overriding goal is to force a reduction in the market-to-book ratio of Otter Tail (and all utilities). This goal clearly had a direct effect on his recommendation. No other utility commission in the country has implemented such a policy, as demonstrated by utility market-to-book ratios persistently exceeding levels Mr. Copeland deems appropriate.[93] Further, there is no quantitative or analytical basis for Mr. Copeland's market-to-book recommendation.[94] These factors alone would support the Commission rejecting Mr. Copeland's recommendation.

More importantly, however, adopting Mr. Copeland's policy goal would cause severe harm to Otter Tail investors, discouraging investment in Otter Tail and other utilities doing business in South Dakota, all to the detriment of South Dakota customers. The harm to all utilities doing business in South Dakota would be enhanced by the fact that the Commission would be the only regulatory commission in the United States to adopt such a policy, which would provide strong incentives to investors to avoid an investment in utilities doing business in South Dakota. Ultimately, the harm to Otter Tail shareholders and customers and the constitutional and statutory violations that would result from following Mr. Copeland *require* that his position be rejected.

1. Adopting Mr. Copeland's recommendations would cause approximately $1 billion of lost market capitalization and severely undermine financial confidence in Otter Tail and its ability to attract capital.

The ROE established in this case must maintain "confidence in the financial soundness of the utility,"[95] and allow the utility to maintain its credit profile and attract capital.[96] Mr. Copeland's recommended range of 8.00 to 8.50 percent would violate these minimum requirements.

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[93] Ex. S1 at 20-21 (Copeland Direct); Ex. OTP-2 at 41 (Hevert Rebuttal).
[94] Tr. at 104-110 (Copeland).
[95] Northwestern Pub. Serv., 265 N.W.2d at 873 (quoting Bluefield, 262 U.S. at 693).
[96] Northwestern Pub. Serv., 265 N.W.2d at 873-74 (quoting Hope, 320 U.S. at 603).

Mr. Copeland's recommendation is intended to radically reduce utility market-to-book ratios:

> While I think that the Commission should move OTP's allowed rate of return on equity toward a market-to-book ratio of no more than 1.25, I recognize that it would not be prudent to do this all at once. My recommended rate of return of 8.25 percent is adequate to support a market-to-book ratio of 1.37 at the present time.[97]

Mr. Copeland recognizes that doing so would impose "capital losses" on current [Otter Tail] investors, but recommends that the Commission give no consideration to those losses:[98]

> There is no valid argument here that this is somehow "unfair" to investors. … [T]he mere existence of capital losses for investors does not impact the balancing of competing interests calculus at all.[99]

Mr. Copeland attempts to justify his position because the "class of investors" obtained what he regards as "excess returns"[100] in prior years:

> [F]or investors as a class, losses as market-to-book ratios get pushed back down to where they ought to be are simply a "refund" of the excess returns, which they should not have received in the first place. [101]

Even if Mr. Copeland's rationale of recovering excess returns from prior years was legal and sound, it would not apply in this case because Otter Tail has not earned its overall regulated rate of return in South Dakota.[102] This means that any increases in *market* prices for Otter Tail investors are not the result of South Dakota operations and provide no justification for any decision by the Commission.

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[97] Ex. S1 at 4 (Copeland Direct).

[98] Ex. S1 at 41 (Copeland Direct) ("I should address the concern always raised in a situation like this of the capital losses that would be experienced by investors from this decline in market-to-book ratio.").

[99] Ex. S1 at 41 (Copeland Direct).

[100] Mr. Copeland's intent to recoup "excess earnings" from prior years also violates the fundamental test year concept of rate-setting, which excludes income and expense from outside of the test year.

[101] Ex. S1 at 41 (Copeland Direct).

[102] Ex. OTP-6 at 7 (Gerhardson Rebuttal). Table 1 in Mr. Gerhardson's Rebuttal Testimony shows overall rate of return, *i.e.* cost of debt and authorized ROE. Since: (1) debt is paid before equity and (2) the actual overall rate of return is below the authorized rate of return, one can conclude Otter Tail has not achieved its authorized South Dakota ROE for several years.

Perhaps even more important, the impacts of adopting Mr. Copeland's recommendations would be catastrophic. Mr. Moug determined that adopting a 1.25 market-to-book ratio would cause approximately $1 billion in losses:

> If the recommendations that Mr. Copeland was making as it related to market-to-book were followed by all of our jurisdictions, we would see a billion dollar reduction in our market capitalization …. [103]

Mr. Moug verified his calculation.[104] Mr. Copeland's immediate recommendation of an 8.25 percent ROE and market-to-book ratio of 1.37 for Otter Tail[105] would cause similar losses.[106]

Further, the harm to Otter Tail and its investors and customers would not be limited to capital losses. Rather, as Mr. Moug explained, Otter Tail would experience severe harm to its ability to raise equity and to its cost of equity:

> [I]f we had to then raise equity at $23 a share compared to $49 a share, we would have to double the amount of shares that we would have to raise to cover the amount of dollars needed …. So … the cost of that equity would go up as a result of the significant dilution that would occur ….

These are extremely serious concerns for Otter Tail investors and customers, given Otter Tail's plan to finance $901 million of 2018-2022 capital expenditure through a balanced mix of equity and debt.[107]

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[103] Tr. at 134 (Moug).
[104] Tr. at 134 (Moug).

> Our current stock price today is floating around the $49.50 a share. Assuming a market-to-book of 1.25 would put the stock price at $23.63 a share. And we have approximately 40 million shares outstanding. And so that's where that number [$1 billion] comes from.

Mr. Moug's calculation reflects a market loss of $25.87 per share ($49.50 - $23.63) x 40 million shares = $1.035 billion.
[105] Ex. S1 at 4 (Copeland Direct) ("My recommended rate of return of 8.25 percent is adequate to support a market-to-book ratio of 1.37 at the present time.").
[106] A market-to-book ratio of 1.25 would result in a stock price of $23.63. Based on that relationship (1.25 market-to-book / $23.63 stock price), a market-to-book ratio of 1.37 would equal a stock price of $25.90. The calculation is as follows: 1.25/23.63 = 1.37/x, where x = (23.63*1.37)/1.25. A market loss of $23.60 per share ($49.50 - $25.90) x 40 million shares = $944 million.
[107] Ex. OTP-3 at 20 (Moug Direct).

Mr. Copeland's recommendations for Otter Tail's ROE are also far below the mainstream of ROEs awarded by other regulatory Commissions and below the ROEs approved by the Commission for other South Dakota utilities. These gaps would violate the minimum requirement established in *Hope* and adopted by the South Dakota Supreme Court that the ROE be "commensurate with returns" earned by comparable companies.[108] It would also violate the "fair and reasonable" standard of SDCL 49-34A-8.

The failure to meet the requirement for a comparable return is clear. First, Mr. Copeland's ROE recommendations are lower than any ROE awarded to any vertically integrated electric utility in the United States since at least 1980.[109] Second, as shown in Figure 2, above, Mr. Copeland's ROE recommendations are materially lower than any ROE authorized in the recent past (i.e. since 2014). Third, Mr. Copeland's recommended ROE is 125 basis points below the most recent ROE's authorized by the Commission.[110] An ROE that was far below other authorized ROEs cannot meet either the comparable return requirement or fair and reasonable standard of SDCL 49-34A-8, especially given Otter Tail's higher risk and superior performance, as discussed above.

2. Adopting an unreasonably low ROE for Otter Tail would cause equity capital to move away from Otter Tail and other South Dakota utilities.

The destructiveness of Mr. Copeland's recommendations would extend beyond Otter Tail and this case. Both investors and rating agencies will evaluate the Commission's decision. Following Mr. Copeland's recommendation would make South Dakota an extreme outlier among jurisdictions across the country, decreasing investors' willingness to invest in South Dakota utilities and increasing regulatory risk associated with South Dakota. While these may not be matters of concern for Mr. Copeland, the Commission can and should avoid these consequences.

[108] Northwestern Pub. Serv., 265 N.W.2d at 873-74 (quoting Hope, 320 U.S. at 603).
[109] Ex. OTP-2 at 5 (Hevert Rebuttal).
[110] Ex. OTP-6 at 7-8 (Gerhardson Rebuttal).

Utilities compete against each other for investment capital and investors face no barriers to where they invest. Mr. Hevert explained the ability of investors to move their investments to jurisdictions with more favorable policies:

> Investors have many options available to them and will allocate their capital based on expected risks and returns associated with those alternatives. … [I]f a company in a given jurisdiction is authorized a significantly lower ROE than a company of equivalent risk is authorized in another jurisdiction, capital will flow from the lower return to the higher return.[111]

Mr. Hevert confirmed this effect during the evidentiary hearing:

> [I]f a regulatory Commission were to adopt such an approach and to reduce the authorized return below those available from other comparable risk utilities equity investors can and will invest in jurisdictions that do not adopt such a restrictive approach. [112]

No other utility commission in the United States has adopted a goal of reducing utility market-to-book ratios or an ROE anywhere near as low as 8.25 percent. If the Commission were to do so, it would put Otter Tail and other South Dakota utilities at a competitive disadvantage when seeking investment capital.[113]

Mr. Copeland claimed that investors are indifferent to ROE awards, relying on a theoretical argument.[114] Contrary to this implausible claim, Mr. Moug explained that, in reality, investors compare ROEs as means of comparing alternative utility investments and utility jurisdictions:

> I would [tell] you that the return on equity becomes the head line number that everybody looks at. … They gravitate towards what was the allowed ROE, how does that compare with the national average, how does that compare with other jurisdictions that the utility does business in if they're in other jurisdictions.[115]

Mr. Moug also explained that awarded ROEs are important to investors because investors use awarded ROEs to determine if a utility can deliver projected earnings:

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[111] Ex. OTP-1 at 5 (Hevert Direct).
[112] Tr. at 19 (Hevert).
[113] Ex. OTP-1 at 18 (Moug Direct).
[114] Tr. at 98-100 (Copeland).
[115] Tr. at 144-145 (Moug).

> What investors do is they will look at that rate base growth. They will take that rate base, multiply it times the equity piece that is in the cap structure … and then they take that times the ROE the utility is granted and that gives them a very good idea of what the earnings profile of the utility is on a go forward basis.[116]

Mr. Hevert also explained the importance of authorized returns to investors:

> [W]hen you look at the fact that investors have finite capital to invest and they have to allocate that capital to get the best risk adjusted return, they certainly are going to look at this type of data. They're going to look at the returns authorized elsewhere as they think about where to allocate their capital.[117]

Mr. Hevert also explained how a very low ROE would affect investors:

> [A]s a practical matter I think you really have to consider whether reducing return by 140, 150 basis points relative to alternatives will enable the company to attract the capital it needs to continue investing in South Dakota.[118]

Investors clearly will have a negative reaction if the Commission were to follow Mr. Copeland's recommendations.

Following Mr. Copeland's recommendations would also harm the perception of the South Dakota regulatory environment. An unreasonably low ROE for Otter Tail would be have a heightened effect on the market because it would clearly signal a lack of support by the Commission in the context of Otter Tail's large investments and superior performance, as Mr. Moug explained:

> An ROE for OTP below the national mainstream or below the authorized ROE of other utilities in South Dakota would send more pronounced signals because of the context of this case. OTP has made, and is making, extensive investments in South Dakota, providing exceptionally high-quality service and cost savings over many years, and filing very infrequent general rate cases in South Dakota. Lack of support for those results would be particularly unsettling.[119]

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[116] Tr. at 145 (Moug).
[117] Tr. at 83 (Hevert).
[118] Tr. at 84 (Hevert).
[119] Ex. OTP-4 at 2 (Moug Rebuttal).

Adverse rate case results caused a reduction in rating agency outlook for a Minnesota utility[120] and most recently an actual reduction in that utility's debt ratings.[121]

Finally, an unreasonably low ROE cannot be justified by the fact that South Dakota represents only a small part of Otter Tail's total utility business.[122] The market's adverse reaction would not be eliminated by the limited scope of Otter Tail's business in South Dakota, as Mr. Hevert explained:

> I agree that South Dakota's a small portion of the company's business, but it certainly in my view would signal an element of regulatory risk to investors that would be very very important to them, regardless of the utility.[123]

Thus, the small portion of Otter Tail's business in South Dakota does not eliminate or justify the severe adverse effects of an unreasonable low ROE.

G. Mr. Copeland's recommendations should not be given any weight, but even if it were given the same weight as Mr. Hevert's recommendations, the result would be an ROE of at least 9.75 percent.

As discussed above, Mr. Copeland's analysis and recommendation do not satisfy constitutional, statutory and reasonableness requirements and therefore should not be given any weight in this case. But even if the Commission were to find both Mr. Copeland and Mr. Hevert are credible witnesses and give Mr. Copeland's recommendations the same weight as Mr.

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[120] Ex. OTP-3 at 11-12 (Moug Direct):

> The effect of rate case and ROE decisions is demonstrated … by … Moody's which changed its ratings outlook on ALLETE from Stable to Negative. Moody's noted the combined effects of the recent Minnesota Power rate case decision … and the reduced cash flow … from the recent federal tax reform. …
>
> Moody's also not[ed] that; "The MPUC reduced MP's allowed ROE to 9.25% from the requested 10.25%, below the national average of about 9.6%."

[121] Moody's followed with a one-notch downgrade of Minnesota Power on March 29, 2019. *In re Minnesota Power*, MN PUC Docket No. E015/GR-16-664, March 29, 2019 Letter of David. R. Moeller (Mar. 29, 2019), *available at* https://www.edockets.state.mn.us/EFiling/edockets/searchDocuments.do?method=showPoup&documentId={B007CB69-0000-CF17-AE16-08945BE13A97}&documentTitle=20193-151515-01. The Commission may take notice of the one-notch downgrade of Minnesota Power on March 29, 2019 pursuant to S.D.C.L § 1-26-19, which applies to this contested case proceeding. S.D. Admin. R. § 20:10:01:15.

[122] Ex. S1 at 41 (Copeland).

[123] Tr. at 80-81 (Hevert).

Hevert's, the resulting fair and reasonable ROE (*i.e.* one that reflects OTP's unique risks and superior performance) would be at least 9.75 percent.

During the evidentiary hearing, Mr. Copeland acknowledged that the Commission could consider both his analysis and that of Mr. Hevert if the Commission found both "to be reasonable." One way to do so would be to use Mr. Hevert's and Mr. Copeland's ROE ranges to select a starting point within a "zone of reasonableness" [124] from which to evaluate the effect of Otter Tail's higher risk and superior performance.

Mr. Hevert's and Mr. Copeland's ROE ranges support a starting point of 9.25 percent to 9.30 percent in two ways. Using the top of Mr. Copeland's range (8.50 percent) and the bottom of Mr. Hevert's range (10.00 percent) produces a *narrow* range based on a combination of their analyses, which has a midpoint of 9.25 percent. Using the top of Mr. Hevert's range (10.60 percent) and the bottom of Mr. Copeland's range (8.00 percent) produces a *wider range* based on a combination of their analyses, which has a midpoint of 9.30 percent.

These 9.25 percent to 9.30 percent midpoints would be representive of an ROE *for a utility of average risk and average performance.* The Commission's approval of ROEs for other South Dakota utilities also supports 9.25 percent as an appropriate starting point before consideration of Otter Tail's higher risks and superior performance. The analysis would then need to account for those factors. As discussed in Section II.D, it is clear that Otter Tail faces higher risks and delivers significantly better performance than other utilities.

While no witness identified a specific value for each of Otter Tail's higher risk and superior performance factors, Otter Tail submits that the cumulative effect of those factors cannot be less

[124] *See* Tr. at 120 (Copeland) ("[I]f you were to conclude that you found my testimony, my estimate, to be reasonable, that a reasonable mind would conclude the 8.25, and you found that a reasonable mind would conclude that it was 10.3, and therefore, you're going to adopt the middle of that, that's going to get upheld. That's going to satisfy, you know, the zone of reasonableness idea. And that's kind of often the way it's done.")

than 50 basis points. Consideration of only *one* aspect of Otter Tail's superior performance – the under-budget completion of the Big Stone AQCS Project – supports that conclusion.

Otter Tail's under budget completion of the Big Stone AQCS Project saved Otter Tail's South Dakota customers approximately $0.8 million in the 2017 Test Year.[125] Those savings will continue for many years.

An arithmetic calculation shows that the approximately $800,000 customers' savings is equivalent to approximately 143 basis points of ROE.[126] This means that the award of an ROE 50 basis points higher than the ROE for an average risk, average performing utility would represent a sharing with Otter Tail shareholders of approximately 35 percent of the 2017 Test Year Big Stone AQCS Project savings.[127] The other approximately 65 percent of savings would be provided to customers.

This sharing of savings demonstrates that a 50 basis point overall increase in Otter Tail's ROE is fully justified by a single performance factor without consideration of any risk factors or other performance factors. As a result, an increase of 50 basis points for the combination of Otter Tail's higher risk and superior performance is conservative approach.

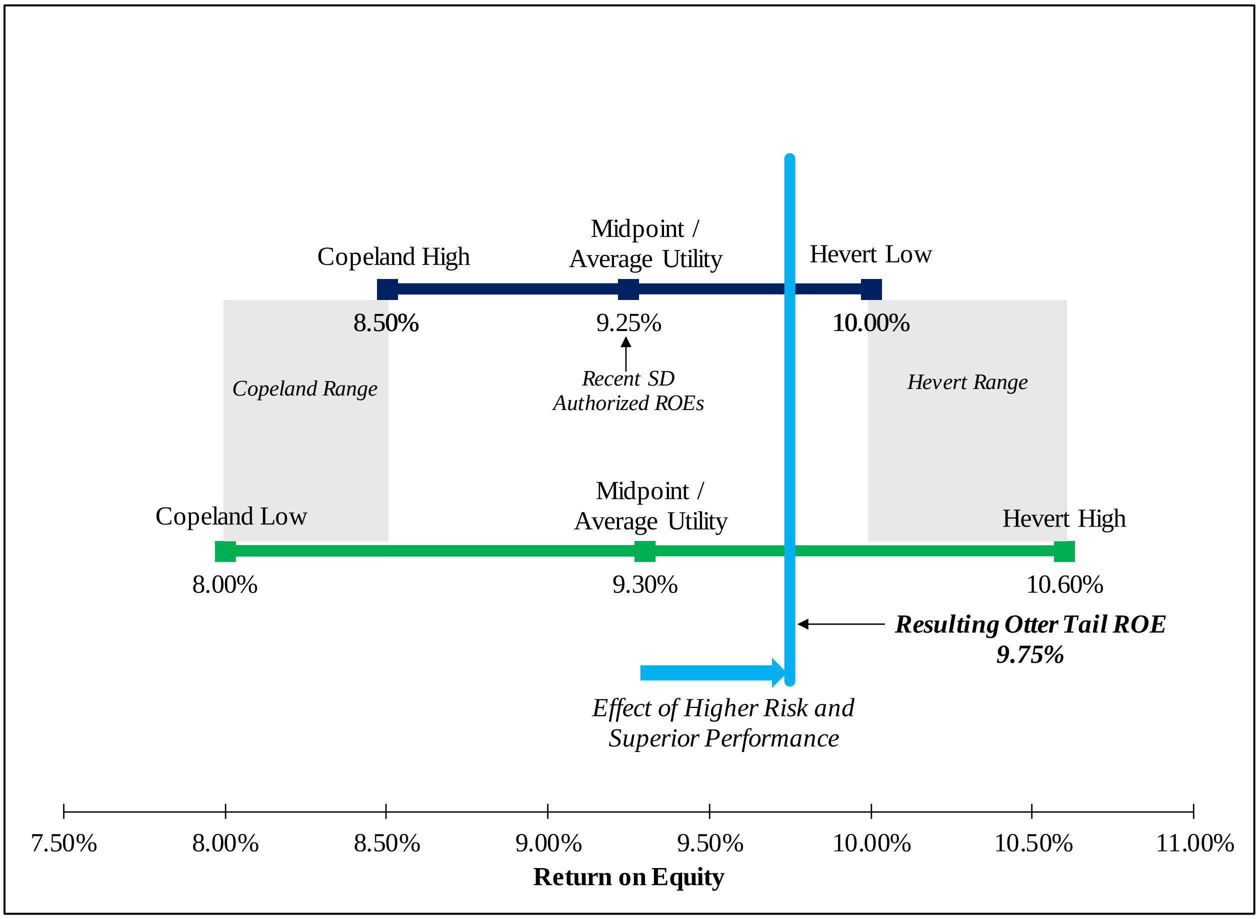
Accordingly, if the Commission were to give equal weight to Mr. Hevert's and Mr. Copeland's analyses and ranges Otter Tail's ROE should be at least 9.75 percent, as shown below:

[125] Ex. OTP-6 at 11 (Gerhardson Rebuttal).

[126] Attachment 1 to Staff's February 21, 2019 Memorandum Supporting Settlement Stipulation identified the revenue requirement associated with Mr. Copeland's recommended 8.25% ROE to be $35,206,758. Attachment 20 to Staff's February 21, 2019 Memorandum Supporting Settlement Stipulation identified the revenue requirement associated with Mr. Hevert's recommended 10.30% ROE to be $36,349,601. The only difference between the two positions is the recommended ROE, which means that the entire revenue difference between the two positions is the result of the difference between the ROE positions. The revenue difference is $1,142,843 ($36,349,601 - $35,206,758). The difference between the two ROE positions is 205 basis points (10.30% - 8.25%). The result is that every basis point is equivalent to approximately $5,575 ($1,142,843 / 205 basis points). The $800,000 savings / $5,575 per basis point = 143.5 basis points.

[127] 50 basis points / 143.5 basis points = 35%.

Figure 6
Effect of ROE Data and Otter Tail Risk and Performance Factors



While Mr. Copeland's recommendations should not be given and significant weight (as explained above), giving his ROE recommendations equal weight with Mr. Hevert's ROE recommendations would lead to an ROE of at least 9.75 percent for Otter Tail, after giving Otter Tail's higher risks and superior performance even a conservative value of 50 basis points. Accordingly, the fair and reasonable ROE for Otter tail, based consideration of the entire record, is at least 9.75 percent.

III. CONCLUSION

South Dakota law requires the Commission to consider the record as a whole and exercise its reasoned judgment when determining the ROE for Otter Tail. The record establishes that Otter

Tail has higher risks, while providing superior performance, including lower rates than other utilities doing business in South Dakota. These factors fully justify an ROE for Otter Tail of 10.00 percent or more as recommended by Mr. Hevert. Even if Mr. Copeland's recommendations are given equal weight with Mr. Hevert's, the ROE for Otter Tail should be at least 9.75 percent in light of those higher risks and superior performance.

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