STAFF MEMORANDUM SUPPORTING SETTLEMENT STIPULATION

TO: COMMISSIONERS AND ADVISORS

FROM: BRITTANY MEHLHAFF, PATRICK STEFFENSEN, KRISTEN EDWARDS, AND AMANDA REISS

RE: DOCKET GE17-003 – IN THE MATTER OF STAFF'S REQUEST TO INVESTIGATE THE EFFECTS OF THE TAX CUTS AND JOBS ACT ON SOUTH DAKOTA UTILITIES

DATE: AUGUST 31, 2018

Commission Staff (Staff) submits this Memorandum in support of the August 31, 2018 Settlement Stipulation (Stipulation), between Staff and NorthWestern Corporation dba NorthWestern Energy (NorthWestern or the Company) in the above-captioned matter.

BACKGROUND

On December 20, 2017, the United States Congress passed the Tax Cuts and Jobs Act (TCJA), which was ultimately signed into law by the President on December 22, 2017. The TCJA impacts each tax paying utility's cost of service and all ratepayers. The TCJA contains provisions including, but not limited to, lowering the corporate tax rate from 35% to 21% effective January 1, 2018. The significant decrease in the tax rate and its resulting impact on utility costs and rates requires an investigation to ensure rates remain just and reasonable going forward after the enactment of the TCJA.

On December 21, 2017, Staff filed a "Motion Requesting Order Requiring Comments and Securing Tax Effects for Customers as of January 1, 2018" (Motion). In the Motion, Staff requested the Commission investigate the effect the TCJA has on South Dakota utilities and requested the Commission issue an order requiring utilities to submit comments on the effect the TCJA has on each utility. Additionally, Staff requested the Commission issue an order requiring that any adjustment to rates from the TCJA will be made effective January 1, 2018.

On December 29, 2017, the Commission issued its "Order Requiring Comments; Order Requiring Rates in Effect January 1, 2018, are Subject to Refund; Order Granting Intervention." On January 29, 2018, NorthWestern Energy submitted initial comments and on February 1, 2018, Black Hills Energy, Montana-Dakota Utilities Co., MidAmerican Energy, Xcel Energy, and Otter Tail Power Co. filed initial comments pursuant to the Commission's instructions. On April 3, 2018, NorthWestern filed additional comments. On August 31, 2018, Staff and NorthWestern (Parties) filed a "Joint Motion for Approval of Settlement Stipulation" and a "Settlement Stipulation" (Stipulation). A review of the terms of the Stipulation is provided below.

REVIEW OF THE STIPULATION

Staff worked with the Company to design a settlement that refunds the 2018 impacts of the TCJA, consistent with the Commission's order requiring any adjustment to rates be effective January 1, 2018, while incorporating alternative performance-based regulation and providing ongoing benefits to customers over the next two years.

2018 TCJA Refund

The Parties agree that the effects of the TCJA should be refunded to customers effective January 1, 2018 as required in the Commission's December 29, 2017 order. The Parties agree that NorthWestern should refund its natural gas and electric customers a total of $3.0 million for 2018. NorthWestern's current base rates will not change as a result of this settlement. The refund reflects a fair balancing of the Company's obligation to customers for 2018 regarding the TCJA impact, including the difference between the 35% corporate tax rate and the 21% corporate tax rate, and accumulated deferred tax balances.

The agreed upon refund amount for 2018, $3.0 million, will be posted in a single payment to customers' accounts no later than October 31, 2018. This refund is allocated between NorthWestern's natural gas and electric customers based on the ratio of the relative benefits computed from Staff's settlement cost of service models from the Company's most recent rate cases, adjusted for the impact of TCJA. The refund will be allocated to customer classes based on each class' share of the revenue allocation approved in EL14-106 and NG11-003. Customer refunds will be calculated based on each customer's most recent 12 months of sales available at the time of the refund, which is anticipated to be August 2017 through July 2018. No carrying charge will be applied to the 2018 refund amount, as a portion of the refund will be in the form of a prepayment. Refunds will be limited to active customers as of July 31, 2018. In the event customers have left NorthWestern's system after July 31, 2018 and prior to the refunds being issued, NorthWestern may end up with a small balance of remaining refund. Any remaining refund amount less than or equal to $5,000 will be written off. In the unlikely event the remaining refund amount is greater than $5,000, Staff with work with NorthWestern to determine an appropriate mechanism to refund additional amounts. There are likely to be a small number of customers who left the system prior to July 31, 2018 as well. Those customers also will not receive a refund. This avoids the Company having to incur costs to locate customers who are no longer active. It also avoids continual and economically inefficient true-ups to achieve a zero balance.

Base Rate Moratorium

NorthWestern's comments filed in the docket show a need to file general rate cases for both natural gas and electric service by 2020. The Company supplied additional information with Staff regarding its forecasted revenue deficiencies for the upcoming years. The tables below provide NorthWestern's projected revenue deficiencies in 2018, 2019, and 2020, based on the 2018 TCJA refund and the Company retaining the TCJA benefits in 2019 and 2020.

The revenue deficiencies are estimated based on the Company's previously authorized returns on equity and traditional Staff and Commission ratemaking principles. The Company's calculations of these forecasted deficiencies began with 2017 actual earnings. NorthWestern normalized the 2017 results and used this as the basis for the 2018-2020 forecasts. The Company's normalized forecasts for 2018-2020 reflect adjustments similar to those agreed to in previous rate case settlements such as advertising, incentive compensation, and weather normalization. The Company also made conservative adjustments for each year including revenue growth, operating and maintenance expense inflation, and adjustments to rate base and depreciation for material plant additions planned to be in-service during this timeframe. The forecasts also reflect the 21% corporate tax rate.

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This information demonstrates that if NorthWestern was required to refund to customers the tax savings in 2019 and 2020, NorthWestern's forecasted revenue deficiency leads to an expectation it would file for a rate increase immediately, followed by another rate increase once additional on-going material investments in its system are in-service. The impact of the tax savings would be more than offset by the expected deficiency in each upcoming year and reasonable expectations are that the end result would be an increase in customer rates. By allowing NorthWestern to retain the TCJA benefits in 2019 and 2020, the Company is able to manage its costs and agree to a moratorium even though NorthWestern expects to still have a deficiency in those years.

Based on the information provided to Staff, the Parties agreed to a two-year rate moratorium, which ensures customer rates remain static rather than exposing customers to multiple rate increases over the next few years. The earliest NorthWestern can file a general rate case for either natural gas or electric service is June 30, 2020, for rates to become effective January 1, 2021. The Parties also agreed that NorthWestern may not seek recovery under any new rider mechanism during the moratorium period.

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Excess Accumulated Deferred Income Taxes

Due to the use of accelerated and bonus depreciation and tax normalization for rate purposes, the amount of taxes actually paid to the IRS by NorthWestern associated with protected plant has been much less than the taxes recovered from ratepayers. Prior to January 1, 2018, NorthWestern's accumulated deferred income tax (ADIT) balance had been accumulating at the 35% tax rate. Because the tax rate has now been reduced to 21%, NorthWestern now has an excess in its deferred tax reserve associated with protected plant that must be returned to ratepayers.

This settlement also establishes a method for returning these excess ADIT balances associated with protected plant[1] to ratepayers. The Parties agree that all excess protected plant-related ADIT will be

[1] Excess ADIT associated with protected plant refers to excess ADIT that the TCJA requires be normalized using the Average Rate Assumption Method (ARAM). Under ARAM, the utility cannot return to customers the excess in the deferred tax reserve that is protected until the year in which the book depreciation expense is more than the tax depreciation on the underlying assets. Utilities must follow ARAM for these protected assets in order to avoid a normalization violation. Therefore, ARAM must be used for ratemaking purposes.

amortized over the remaining book life of NorthWestern's plant using the Average Rate Assumption Method (ARAM), as required by the Internal Revenue Service.

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RECOMMENDATION

Staff recommends the Commission grant the Joint Motion for Approval of Settlement Stipulation and adopt the Settlement Stipulation without modification.

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