*** PUBLIC VERSION ***

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF SOUTH DAKOTA

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

STAFF MEMORANDUM SUPPORTING SETTLEMENT STIPULATION

DOCKET NG11-003

Commission Staff (Staff) submits this Memorandum in support of the Settlement Stipulation of November 7, 2011, between Staff and NorthWestern Energy (NWE or Company) in the above-captioned matter.

BACKGROUND

On May 20, 2011, the Company filed an application with the Public Utilities Commission (Commission) seeking an increase in annual revenues of approximately $4,123,000 or 7.20 percent increase in rates for natural gas service to customers in its South Dakota retail service territory. NWE's proposed increase was based on an historic test year ended December 31, 2010, adjusted for what NWE believed to be known and measurable changes, a 10.90 % return on common equity, and a 8.68 % overall rate of return on rate base. NWE witnesses submitted testimony stating that the increase is needed to recover costs of doing business relative to natural gas service in South Dakota, including: (1) increased costs related to environmental remediation activities at the Aberdeen manufactured gas plant (MGP) site; (2) acquisition of the Milbank pipeline from Northern Natural Gas; and (3) the removal of the customer insurance refund related to the Huron MGP site that has been fully refunded to customers.

The Commission officially noticed NWE's filing on May 26, 2011, and set an intervention deadline of July 13, 2011. No petitions to intervene were filed. On June 17, 2011, the Commission issued an Order of Assessment of Filing Fee and Suspension of Imposition of Tariff. On September 9, 2011, the Commission received a petition from twenty-five customers requesting to suspend the proposed rate increase and to hold public hearings to determine if such a rate should be allowed. On September 30, 2011, the Commission issued an Order Granting the Petition to Hold a Public Hearing. On October 17, 2011, the Commission held a public hearing at the Scotland City Hall in Scotland, South Dakota, to hear customer's comments, concerns, and questions.

On September 8, 2011, after extensive discovery, Staff provided NWE a copy of its revenue requirement determination. Thereafter, Staff and NWE (jointly the Parties) held several settlement discussions in an effort to arrive at a mutually acceptable resolution of the issues presented in NWE's rate filing. Ultimately, the Parties reached a comprehensive agreement on NWE's overall revenue deficiency and other issues presented in the case including, but not limited to, class revenue responsibilities, rate design, and tariff concerns.

OVERVIEW OF SETTLEMENT

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

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

Staff and NWE agree NWE's revenue deficiency is $1,846,807 justifying an approximate 3.30% increase in present rates. The revenue requirement and supporting calculations described in this Memorandum and attachments depict Staff's positions regarding all components of NWE's South Dakota jurisdictional revenue requirement, including a reasonable return allowance on the Company's rate base investments.

STAFF OVERVIEW OF SETTLEMENT

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

Staff's determination of the settlement revenue requirement begins with December 31, 2010, South Dakota retail test year costs. Staff then adjusted the December 31, 2010, test year results for known and measurable post-test year changes. Staff Exhibit___ (BAM-1), Schedule 3 illustrates Staff's determination of NWE's pro-forma operating income under present rates. Staff Exhibit___ (BAM-2), Schedule 2 illustrates Staff's calculation of NWE's South Dakota retail rate base, and Staff Exhibit___ (BAM-1), Schedule 2 and Staff Exhibit___ (BAM-2), Schedule 1 summarizes the positions. Staff's calculation of NWE's revenue deficiency and total revenue requirement are shown on Staff Exhibit___ (BAM-1), Schedule 1.

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

RATE BASE

Average rate base – Both the Company and Staff arrived at a test year average rate base based on an average of the 13 month-end account balances, December 31, 2009, through December 31, 2010.

Vertex and Power Plan Software Systems - The Company proposed an adjustment to reflect two new computer software systems that were expected to be in-service after the end of the test year. The settlement revises the Company's adjustment to: 1. Remove the amounts related to the Vertex computer system as the software is not expected to be used and useful until November 2012; 2. Reflect actual costs in lieu of the Company's estimated costs; and 3. Recognize, as a rate base adjustment, the accumulated deferred income taxes related to the difference between book and tax depreciation. The net effect of these changes reduces rate base by approximately $339,000.

South Dakota Wheat Grower Contracts - In Dockets NG10-003, NG10-004, NG10-005, and NG10-006, the Commission approved contracts for four grain dryer customers. This adjustment annualizes the investments, costs and revenues associated with these customers during the test year. The settlement revises the Company's adjustment to: 1. Reflect the March 2011 plant balances to incorporate the credits for this project received from Northern Natural Gas that refunded the difference between estimated and final costs for its tap work; 2. Reduce plant balances by the plant amounts already included in the test year relating to these projects; and 3. Recognize, as a rate base adjustment, the accumulated deferred income taxes related to the difference between book and tax depreciation. The net effect of these changes reduces rate base by approximately $765,000.

Milbank Pipeline – In Docket NG11-001, the Commission "Ordered, that based on its findings that NorthWestern's cost of acquisition of the Milbank Line will be prudently incurred pursuant to SDCL 49-34A-19(3) and will provide benefits to its customers pursuant to SDCL 49-34A-19(4), the acquisition of the Milbank Line is approved in principle for inclusion in rate base on an acquisition cost basis to be determined at the time of the next general rate case." The Company requests the acquisition cost of the pipeline and two additional upgrades. The upgrades include rerouting one half mile of 6 inch high pressure transmission line identified as a High Consequence Area and updating multiple farm taps with new safety equipment.

The settlement revises the Company's adjustment to: 1. Reflect the actual costs of the HCA reroute; 2. Remove the amounts related to the farm tap upgrades as the work will not be completed during 2011; and 3. Recognize, as a rate base adjustment, the accumulated deferred income taxes related to the difference between book and tax depreciation. The net effect of these changes reduces rate base by approximately $385,000.

Working Capital Updates – The settlement reflects the most recent 13-month average for materials and supplies, propane inventory, prepayments, accumulated provision for injuries and damages, and accumulated provision for uncollectibles and the most recent

12-month average for natural gas storage. The net effect of these changes decreases rate base by approximately $300,000.

Freeman Acquisition Adjustment – The Settlement Stipulation approved in Docket NG07-013 prohibited NWE from recovering any gas plant acquisition adjustments for the Freeman/AMPI plant in future natural gas rate cases. The settlement removes the acquisition adjustment for the assets purchases from the city of Freeman. The adjustment reduces rate base by approximately $77,000.

Prairie Ethanol Depreciation - The Company proposed an adjustment to reflect the depreciation rate for the regulator station serving Prairie Ethanol, LLC, as approved in the contract by the Commission in Docket NG06-003. The settlement reflects depreciation expense as proposed by the Company, and adjusts accumulated depreciation to reflect the cumulative effect of 4 years of depreciation at the rate approved in the contract. The net effect of these changes reduces rate base by approximately $132,000.

Nekota Deferred PGA Costs – The settlement in Docket NG07-013 included deferred PGA costs from the Nekota pipeline using a five-year amortization period. Those costs would have been completely amortized on November 30, 2012, under that agreement. This settlement amortizes the remaining unrecovered costs over a three-year period with the average unamortized balance included as an addition to rate base. The adjustment increases rate base by approximately $37,000.

Rate Case Expense – The settlement reflects a three-year amortization of current rate case expense, and includes the average unamortized balance as an addition to rate base, increasing rate base by approximately $59,000.

Post-Test Year Plant Additions – During settlement discussions, the Company proposed an adjustment to include non-revenue producing plant placed in-service from January 2011 through August 2011. The settlement reflects the actual plant costs and associated depreciation and deferred taxes for these capital additions. The details for this adjustment can be found on Exhibit__(JPT-1), Schedule 10. The adjustment increases rate base by approximately $491,000.

Milbank Pipeline Deferred Costs – In Docket NG11-001, the Commission "Ordered, that NorthWestern's establishment of a deferral or regulatory asset to account for and accrue that portion of the costs of the Milbank Line which are not assigned to large customers under Natural Gas Firm Transport Agreement contract with deviation rates but to NorthWestern's overall system, is approved, but a decision is not made at this time on the amount and treatment of this deferral or regulatory asset in NorthWestern's next general rate case, but is left for decision at the time of the next rate case." NWE proposed to amortize these costs over three years. The settlement revises the Company's adjustment to: 1. Reflect the actual costs of the HCA reroute and incorporate costs incurred during October 2011; 2. Remove the amounts related to the farm tap upgrades as the safety equipment did not serve customers from April 2011 through October 2011; 3. Recognize accumulated depreciation and accumulated deferred income taxes in the investment calculation; 4. Apply the rate of return reflected in this settlement; and 5.

Include the average unamortized balance as an addition to rate base. The net effect of these changes increases rate base by approximately $71,000.

Cash Working Capital – NWE's proposed rate base included a $78,484 allowance for cash working capital based on the results of a lead-lag study originally prepared for a rate proceeding in Montana. Staff carefully reviewed the Company's revenue and expense lead and lag day determinations and is in general agreement with them. Staff modified the Company's cash working capital calculation, however, to reflect the Staff's determination of pro forma operating expenses rather than those claimed by the Company, as is reflected in the Company's lead-lag analysis. This modification decreased the Company's cash working capital claim by $124,235.

In addition, the Company's filing overlooked three significant sources of working cash that are available to the Company. The Company acts as a transfer agent when it collects employee FICA, Federal Withholding and South Dakota Sales taxes and remits related receipts to the taxing authorities. During the holding period until the tax payments are made the Company has use of those funds for working capital purposes. Therefore, Staff made a rate base adjustment that reflects the working cash made available by the Company collecting employee FICA, Federal Withholding and South Dakota Sales taxes. This adjustment reduced rate base by $117,946.

OPERATING INCOME

Weather Normalization – The Company proposed an adjustment to normalize revenues and gas costs based on weather normalized volumes. The settlement revises the Company's adjustment to: 1. Reflect heating degree day (HDD) normals based on the thirty-year period, 1981-2010; 2. Normalize sales for weather sensitive rate schedules 81, 82, 84A, and 86A; 3. Determine base load use using the lowest consecutive three-month average; 4. Calculate the normalized temperature sensitive sales amount for each month using the ratio between the normal and actual HDDs for the corresponding month; 5. Utilize the actual and normal HDDs from the previous month to determine the weather normalization factor for Rate 86A to match test year revenues; and 6. Exclude property taxes and the released capacity/balancing surcharge as these costs are not weather sensitive. The details for this adjustment can be found on Exhibit_(BAM-3), Schedules 1 through 3. The net effect of these changes reduces operating revenues by approximately $1,378,000 and reduces operating expenses by approximately $1,083,000.

Late Payment Revenues - In prior cases, Staff has excluded late payment revenues from the revenue requirement formula because those revenues were used to compensate the utility for the cash working capital requirement arising from late paying customers. In those instances, the revenue lag days which were included in the lead-lag calculation did not include the effects of late-paying customers. This case is different. The revenue lag days included in the Company's lead-lag analysis includes the effects of late-paying customers. To exclude late payment revenues from the revenue requirement formula in addition to including the effects of late paying customers in the development of the revenue lag would double-count the working capital requirements of late paying customers. Therefore, it is necessary to include test year late payment revenues in the revenue requirement calculation in this case. The settlement revenue requirement determination includes the test year level of late payment revenue.

Advertising Expense - The Company proposed an adjustment to remove expenses for promotional and institutional advertising. The settlement accepts this adjustment and removes additional promotional advertising expenses, reducing operating expenses by approximately $1,000.

Association Dues Expense - The Company proposed an adjustment to remove dues paid to the Utility Shareholders of South Dakota. The settlement reflects this adjustment and removes the dues paid to organizations that were included in the Company's economic development plan. The adjustment reduces operating expenses by approximately $1,000.

Lobbying Expense - NWE proposed an adjustment to remove lobbying expense from the cost of service. The settlement accepts this adjustment.

Economic Development Expense - The Company proposed a $20,000 economic development plan to be split 50/50 between gas customers and shareholders. The settlement reflects a $30,000 economic development plan, inclusive of labor expenses, to be split 50/50 between ratepayers and shareholders. The adjustment reduces operating expenses by approximately $8,000.

Labor Expense – NWE proposed an adjustment to increase labor expense by 3% from test year amounts. The settlement accepts this adjustment because NWE provided support that showed its request was conservative.

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

Prairie Ethanol Depreciation - The Company proposed an adjustment to reflect the depreciation rate for the regulator station serving Prairie Ethanol, LLC, as approved in the contract by the Commission in Docket NG06-003. The settlement reflects depreciation expense as proposed by the Company.

Vertex and Power Plan Software Systems - The Company proposed an adjustment to reflect two new computer software systems that were expected to be in-service after the end of the test year. The settlement revises the Company's adjustments to: 1. Remove the amounts related to the Vertex computer system as the software is not expected to be used and useful until November 2012; 2. Reflect actual costs in lieu of the Company's estimated costs; and 3. Include an annual maintenance fee. The net effect of these changes is to reduce operating expenses by approximately $61,000.

Aberdeen MGP Clean-Up Costs - In NG07-013 the Commission approved rates designed to collect from ratepayers $1,425,400 annually for the Company's recovery of on-going costs incurred to remediate the site of the former Aberdeen manufactured gas plant. The Settlement Agreement required the Company to track the costs actually incurred during the period that the settlement rates are in effect and, at the end of this period, to credit ratepayers for any shortfall (below the ratemaking allowance) in the remediation expenditures. In its Application in this case, the Company requested an annual allowance of $2,800,000 based on a remediation plan and engineering estimates of the costs to be incurred during the year 2011. This required a $1,672,469 adjustment to the test year actual expense of $1,127,531.

Subsequent to the rate filing, the five-year remediation plan was reconsidered and, on July 14, 2011, a revised plan (but not the cost estimates) was approved by the South Dakota Department of Environment and Natural Resources. Based on the revised plan, the Company estimated that its 2011 costs would likely be $200,000 lower, or $2,600,000. Cost estimates were also developed for the remaining plan years, 2012 through 2015.

Staff's examination of the reports issued by the Company's engineers revealed that the cost estimates for the years 2011 through 2015 had been increased by "contingency allowances" equal to 25% of the specifically-identified engineering and construction costs. The settlement eliminates these allowances, reducing the expected 2011 costs by an additional $400,000 to $2,200,000 with corresponding reductions in the estimates for the remaining plan years. Staff determined that the average annual amount of the adjusted cost estimates for the five-year project period was $2,000,000.

The settlement establishes a $2 million cost allowance reduced further, to $1,739,886, by a five-year amortization of the cumulative over-collections[1] of $1.3 million that existed as of July 1, 2011, by operation of the NG07-013 rates[2]. This cost of service allowance resulted in adjustment to the test year actual expense of $612,355, replacing the Company's proposed $1,672,469 adjustment[3].

Huron MGP Insurance Refund – In the Settlement Stipulation approved in Docket NG07-013, NWE agreed to credit customers the amounts recovered from insurance companies, with carrying charges, related to the remediation of the Huron MGP site over a 36-month period. The allocated share of proceeds was refunded in full on November 30, 2010. The amortized refund was recorded as a regulatory credit in the test year, and this adjustment removes the amortization from the cost of service. The settlement accepts the adjustment.

Milbank Pipeline Deferred Costs – In Docket NG11-001, the Commission "Ordered, that NorthWestern's establishment of a deferral or regulatory asset to account for and accrue that portion of the costs of the Milbank Line which are not assigned to large

[1] The amount, including carrying charges, by which the ratemaking allowance in NG07-013, when applied to actual sales volumes, exceeded the remediation expenditures.

[2] The settlement rates in this case, if approved by the Commission, will not become effective until December 1, 2011.

[3] Any difference between the $1.3 million over-collection under the NG07-013 rates as of July 1, 2011, and the over-collection existing when the settlement rates in this case become effective will be carried forward and credited to ratepayers through the prospective tracking of the new rate allowance and actual costs.

customers under Natural Gas Firm Transport Agreement contract with deviation rates but to NorthWestern's overall system, is approved, but a decision is not made at this time on the amount and treatment of this deferral or regulatory asset in NorthWestern's next general rate case, but is left for decision at the time of the next rate case." NWE proposed to amortize these costs over three years. The settlement revises the Company's adjustment to: 1. Reflect the actual costs of the HCA reroute and incorporate costs incurred during October 2011; 2. Remove the amounts related to the farm tap upgrades as the safety equipment did not serve customers from April 2011 through October 2011; 3. Recognize accumulated depreciation and accumulated deferred income taxes in the investment calculation; 4. Apply the rate of return reflected in this settlement; and 5. Include the average unamortized balance as an addition to rate base. The net effect of these changes reduces operating expenses by approximately $6,000.

South Dakota Wheat Grower Contracts - In Dockets NG10-003, NG10-004, NG10-005, and NG10-006, the Commission approved contracts for four grain dryer customers. The take-or-pay distribution revenue requested in this adjustment was approved in Docket NG11-005. This adjustment annualizes the investments, costs and revenues associated with these customers during the test year. The settlement revises the Company's adjustment to: 1. Reflect the March 2011 plant balances to incorporate the credits for this project received from Northern Natural Gas that refunded the difference between estimated and final costs for its tap work; 2. Reduce plant balances by the plant amounts already included in the test year relating to these projects; and 3. Reflect the customer charge revenue that was not included in the test year; 4. Reduce distribution revenue by the revenue already included in the test year; 5. Apply the 2010 effective property tax rate in lieu of a historical average; and 6. Use the 2010 O&M rate per foot instead of the 2008 rate. The net effect of these changes reduces operating expenses by approximately $19,000 and reduces operating revenues by approximately $40,000.

Milbank Pipeline – In Docket NG11-001, the Commission "Ordered, that based on its findings that NorthWestern's cost of acquisition of the Milbank Line will be prudently incurred pursuant to SDCL 49-34A-19(3) and will provide benefits to its customers pursuant to SDCL 49-34A-19(4), the acquisition of the Milbank Line is approved in principle for inclusion in rate base on an acquisition cost basis to be determined at the time of the next general rate case." The settlement revises the Company's adjustment to: 1. Reflect the actual costs of HCA reroute; 2. Remove the amounts related to the farm tap upgrades as the work will not be completed during 2011; 3. Includes interruptible revenue for POET Big Stone; and 4. Apply the 2010 effective property tax rate in lieu of a historical average. The net effect of these changes reduces operating expenses by approximately $38,000 and increases operating revenues by approximately $102,000.

NNG Farm Taps – The settlement accepts NWE's estimates of annual incremental O&M expenses associated with acquiring the NNG farm taps because the estimates were based on recent actual expenses incurred in serving these customers.

Tampering Fee – The Company proposed a new $100 tampering fee for instances in which a disconnected customer reconnects their own service, but failed to make a corresponding adjustment to test year revenues. The settlement reflects such an adjustment, increasing operating revenues by approximately $1,000.

Freeman Acquisition Adjustment – The Settlement Stipulation approved in Docket NG07-013 prohibited NWE from recovering any gas plant acquisition adjustments for the Freeman/AMPI plant in future natural gas rate cases. The settlement eliminates the amortization expense associated with the acquisition adjustment for the assets purchases from the city of Freeman. The adjustment reduces operating expenses by approximately $2,000.

Discontinued Non-regulated Services - The settlement removes the expenses, net of revenue, related to non-regulated services that NWE does not intend to continue after 2011. The Company indicated that it does not plan to install or repair customer owned gas pipes or equipment. NWE only intends fulfill its meter reading contract with the city of Chamberlain, SD, and its existing maintenance contracts with the cities it serves. The adjustment reduces operating expenses by approximately $20,000.

Nekota Deferred PGA Costs – The settlement in Docket NG07-013 included deferred PGA costs from the Nekota pipeline using a five-year amortization period. Those costs would have been completely amortized on November 30, 2012, under that agreement. This settlement amortizes the remaining unrecovered costs over a three-year period. The adjustment reduces operating expenses by approximately $49,000.

Regulatory Debits/Credits – The settlement corrects a historical test year error in FERC Account 407. A detailed breakdown of the entries in this account did not agree with the amount included in the filing. The adjustment reduces operating expenses by approximately $126,000.

Spousal Travel – The settlement removes aircraft expenses for non-business related passengers in the amount of approximately $1,000.

Rate Case Expense – The settlement reflects a three-year amortization of current rate case expense. The adjustment reduces operating expenses by approximately $13,000.

Incentive Compensation – The settlement removes payouts for achieving financial performance measures. Shareholders are the overwhelming beneficiaries of incentive plans that promote the financial performance of the Company and therefore should be responsible for the cost of such compensation. The adjustment reduces operating expenses by approximately $54,000.

Repairs Tax Credit – Previously, NWE capitalized certain repair costs for both financial reporting purposes and for tax reporting purposes. More recently, however, NWE was granted permission by the IRS to deduct as a current year's expense those repair costs in the year in which they are incurred. The different treatments of these repair costs for financial reporting and for tax reporting creates a timing difference. NWE proposed in its filing to flow-through to South Dakota ratepayers the tax benefit of the repair allowance deduction in the year in which the expenses were incurred. NWE's alternative treatment would have been to "normalize" the tax benefit by spreading out the tax savings over a number of years into the future.

The repair expense deduction is a continuously recurring and slowly reversing timing difference. That is, NWE can expect to incur similar expenses every year. Thus, Staff agrees with the flow-through approach. The flow-through treatment is a benefit to South Dakota ratepayers in that it reduces the ratemaking allowance for income taxes in the year in which the deduction is claimed rather than over a number of years into the future. The only adjustment that Staff's revenue requirement exhibit reflects for this issue is that Staff replaces NWE's original estimate of the tax benefit for the test year with the actual tax benefit, which was not known at the time the Company filed its case. The settlement reduces NWE's originally claimed tax deduction by approximately $84,000.

Stock Based Compensation – NWE's claimed South Dakota operating expenses include $79,075 for stock based compensation paid to NWE executives during the test year. Staff believes that the Company's stockholders are the primary beneficiaries when financial performances goals are met so as to trigger awards for incentive compensation in the form of shares of stock. Since stockholders are the primary beneficiaries, South Dakota ratepayers should not have to pay the stock based compensation expense. Therefore, the settlement revenue requirement excludes the $79,075 of test year stock based compensation expense.

Gas Production Structure Maintenance – The settlement normalizes the expense in FERC Account 741 based on a five year average. The expense in this account can be cyclical and fluctuate widely from year to year. From 2009 to 2010, the expense increased 258%. The adjustment reduces operating expenses by approximately $33,000.

2012 Union Contract – During settlement discussions, the Company proposed an adjustment to labor, payroll taxes, and benefit expenses to reflect a recently negotiated union contract. Effective January 1, 2012, union employees will receive a 2.75% wage increase. A corresponding adjustment to payroll taxes and the 401K match was also included. The details for this adjustment can be found on Exhibit__(JPT-1), Schedule 9. The adjustment increases operating expenses by approximately $85,000.

Post-Test Year Plant Additions – During settlement discussions, the Company proposed an adjustment to include non-revenue producing plant placed in-service from January 2011 through August 2011. The settlement reflects the annualized depreciation expense associated with these capital additions. The details for this adjustment can be found on Exhibit__(JPT-1), Schedule 10. The adjustment increases operating expenses by approximately $29,000.

Contract with Deviations Revenue Adjustment – The Company proposed an adjustment to transportation revenues to: 1. Reflect the minimum annual obligation for four contract customers whose test year usage were below their obligations; 2. Remove the amortization of a customer rate buydown that will be fully amortized by February 2012; and 3. Remove a 2009 minimum obligation payment that was recorded in 2010. The settlement accepts this adjustment.

COST OF CAPITAL AND RATE OF RETURN

NWE's proposed rate increase was designed to produce an 8.86 percent rate of return on its claimed rate base. This rate of return reflected a requested return on common equity of 10.90 percent, embedded debt costs of 5.83 percent, and a capital structure comprised of 43.87 percent long term debt and 56.13 percent common equity (see Statement G, p. 1, column (e)). Staff's assessment of the settlement yields a 7.79 percent rate of return on average rate base, derived using ***Begin Confidential

End Confidential***

RATE DESIGN ISSUES

The parties agree in principle on all issues regarding rate design and the class revenue distribution. Staff concurred with the changes made by NWE for all rate schedules except for Residential Service. The settlement position reached between Staff and NWE is discussed below.

Spread of the Increase – NWE's filing in this docket included an embedded class cost of service study. NWE's study showed that present rates in the Residential and Large Commercial/Industrial Option A classes were generating rates of return somewhat below the rates of return being generated in the other rate classes. NWE's originally proposed class rate increases were designed to equalize the rates of return for all classes.

Staff carefully reviewed NWE's class cost of service study. With minor exceptions, Staff believes that NWE's allocation procedures fairly allocate cost responsibility to the various rate classes. Staff also agrees with the general proposition that, barring overriding concerns that are not present in this proceeding, equalized class rates of return result in just and reasonable rates. Therefore, Staff did not oppose distributing the increase among the rate classes so as to equalize class rates of return in this proceeding, as originally proposed by NWE. In order to equalize class rates of return, revenue increases in the Residential and in the Large Commercial/Industrial Option A rate classes are slightly greater than the overall system-wide average percentage increase, as shown in Exhibit A.

As was approved by the Commission in Docket NG07-013, the Settlement Agreement in this proceeding reflects a distribution of Aberdeen MGP remediation revenue requirements among the rate classes in the same proportion as the overall revenue increase is distributed to each rate class.

Residential Service – NWE proposed to increase the customer charge by $2.00 from $7.00 to $9.00. While the cost analysis performed by the Company supports this increase, the settlement reflects a $1.00 increase to $8.00. Staff supports moderate increases to the monthly service charge to allow customers to adapt.

Rate Schedules & Bill Impacts – The rate schedules reflecting settlement rates are found on Exhibit_(BAM-5), Schedule 2-1 through Schedule 2-5. The comparison between present and settlement rates for the residential service, small commercial service, and commercial and industrial firm service (option A) rate schedules is shown on Exhibit_(BAM-5), Schedule 3.

OTHER ISSUES

Economic Development – The Company has agreed to provide an annual report and budget to the Commission for review and approval by March 31st of each year, beginning on March 31, 2012. If NWE spends less than $30,000 in 2012 or any subsequent year, the Company agrees to refund 50 cents of each dollar less than $30,000 to customers through a credit to bills or other efficient method as the Commission determines to be appropriate.

Aberdeen MGP Clean-up Costs – The Parties agree to track the recoveries of actual annual expenditures, net of recoveries, so the Company neither over recovers nor under recovers these costs. Beginning on January 31, 2013, and for every year thereafter, the Company will report on the clean-up costs and recoveries, and compare the actual work completed during the reporting period to the schedule provided in response to data request 5-8. Staff reserves the right to review clean-up costs for prudency.

Moratorium - The Parties agree that NWE shall not file any rate application for an increase in base rates which would go into effect prior to December 1, 2013; provided, this restriction would not prevent NWE from filing for a rate increase to take effect prior to December 1, 2013, if NWE's cost of service is expected to increase due to an "Extraordinary Event", as defined in the Settlement Stipulation.