

Update on rail issues at Otter Tail Power Company



April 21, 2006

Railroad History

- 1970's - Railroads in Financial Trouble
- 1980 - Railroads Deregulated (Staggers Act)
 - Market competition determines rates
 - Surface Transportation Board to ensure reasonable rates where no competition exists
- Dramatic Financial Turnaround
- 1976 there were 63 Class I RRs
- Today 4 Mega RRs
 - BNSF, Union Pacific, CSX, Norfolk Southern
 - Control more than 90 percent of the industry's revenue
 - Own over 90 percent of the U.S.'s track miles

Topics

- Railroad Industry
- Current Federal rail policy
- The STB process for rate relief
- Otter Tail's STB case
- Current coal supply situation at Big Stone Plant

Necessary relationship railroads and coal-fired electric generators

- 52 percent of the nation's electricity is generated from coal
- Most coal moves by rail to generating plants
- Utilities buy the coal at the "minemouth" then arrange for the transportation
- In our region two-thirds of the delivered price of coal is for transporting the coal to the generating plants

Federal Rail Policy

- Often generating plants are "captive" - they have access to only one railroad and no other viable option for transporting products
- Captive shippers pay rates that are significantly higher than the competitive rates available to shippers with more than one railroad providing service
- Rail rates are not filed with the STB and are not subject to prior-approval by the STB
- Railroads are exempt from anti-trust laws
- The Surface Transportation Board (STB) of the U.S. Department of Transportation is responsible for protecting captive rail customers from abuse of monopoly power

Rate Case Alternative

- Captive shipper options
 - Absorb increased costs
 - File rate case with STB
- Rate cases are complex, long, expensive
 - Generate over 700,000 pages of material
 - Take years to complete (2-5)
 - Cost millions of dollars (\$3-\$5)

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The STB Rate Reasonable Process

- Captive rail customers can petition STB to determine if a rate is "unreasonably high"
- Complainant must pay filing fee
- Complainant must prove rate exceeds 180 percent revenue to variable cost ratio
- Standard for when a rate is too high – "stand alone cost"

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Stand Alone Cost (\$AC) Calculation

"...a railroad may not charge a shipper more than what a hypothetical new, optimally-efficient carrier would need to charge the complaining shipper, if such a carrier were to design, build, and operate – with no legal or financial barriers to entry into or exit from the industry – a system to serve only that shipper and whatever group of traffic that shipper selects to be included in the traffic base."

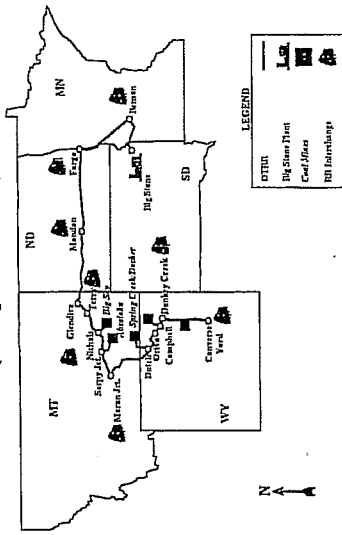
Surface Transportation Board Chairman Roger Nohar, in testimony before the Railroad Subcommittee of the House Transportation and Infrastructure Committee, March 31, 2004

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Otter Tail STB Case

- Filed our case in early 2002
- Prompted by a 38 percent increase to our rail transportation contract rate from 1999 to 2000
- STB issued its decision in January 2006

SCHEMATIC OF THE OTTER TAIL RAILROAD
(Excluding Glendive to Showden)



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Otter Tail Power Decision – Key Background

- Coal movement over medium density line from Powder River Basin (PRB) transported north and east by BNSF
- 2.2 million tons / year
- A 900-mile movement
- Tariff rate charged by BNSF (1Q02): \$ 13.49/ton
- Variable cost: approximately \$5.50 / ton
- Revenue to variable cost ratio: approximately 250 percent

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Otter Tail Decision – Key Elements

- Case dismissed for failure to prove unreasonableness, even though SAC analysis showed that rate was unreasonable
- OTP failed to show there was no "cross subsidy" of lighter-density lines under "Pennsylvania Power & Light (PPL) test"

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OTP SARR – “Stand Alone Cost” (without PPL test)

- BNSF Tariff rate (1Q02) = \$13.49/ton
- “Maximum reasonable rate (without PPL analysis)” (1Q02) = \$12.46/ton
- OTP won operating plan issues, investment and costs were based on OTP plan

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Cross subsidy test

- Any captive shipper with a low to medium density segment will find it extremely difficult to receive rate relief under the STB’s current philosophy

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Current coal supply situation at Big Stone Plant

- BNSF coal deliveries have not been sufficient to allow the plant to operate at full load and maintain normal 30-day emergency stockpile level since last year
- Increasing train cycle times are the cause
- Stockpile dropped to a 10-day supply in early March

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PPL Test

Is one segment “cross subsidizing” another?

“PPL” Test: If there is cross subsidy, case is dismissed

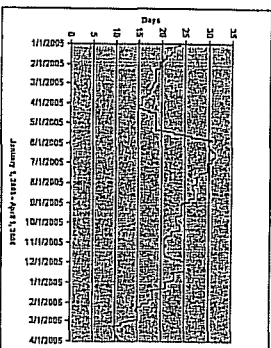
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Next steps

- We disagree with the STB decision in our case
- On March 27, 2006, Big Stone partners filed an appeal of the STB decision to the 8th Circuit Court of Appeals
- We expect a decision in our appeal within 18 months

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Historic daily stockpile levels at Big Stone Plant



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Drastic action required

- It is imperative that we build back the stockpile levels and return to full production in advance of the summer peak season for reliability reasons
- On March 11, 2006, Big Stone Plant implemented generation curtailments in an effort to build back the stockpile levels
- Generation was reduced to 70 percent of full load
- A month of generation curtailment at this level increased the stockpile by only 2 days
- On April 7, Big Stone Plant reduced its generation output to 45 percent of normal levels—stockpile as of April 13, 2006, is at 14 days

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Other options available

- Add a third train set
 - BNSF denied our request
- Add additional railcars to the existing two trains
 - Have not received a response from the BNSF on our February request to increase train size
- Trip-lease train sets
 - The coal supply issue is affecting everyone, trains are not available from the BNSF or from other utilities

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Drastic customer impacts

- Generation curtailments require purchasing replacement energy from the market
- Significant cost impacts to our customers—current curtailments cost an estimated \$3 million per month for the retail customers of the Big Stone Plant partners (OTP, NorthWestern Energy, and Montana-Dakota Utilities)

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Other options available

- Switch to Montana coal
 - Shorter haul
 - Higher sulfur coal
 - Existing fixed requirements contracts with Powder River Basin mines
 - Have committed to taking a limited number of trains of Montana coal as a stop-gap measure, but this is not a long-term solution

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