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VIA ELECTRONIC FILING

December 14, 2009

Ms. Patricia Van Gerpen, Executive Director
South Dakota Public Utilities Commission
State Capitol Building
500 East Capitol Avenue
Pierre, SD 57501-5070

**RE: In the Matter of the Petition of Otter Tail Power Company Requesting Authority to Use Deferred Accounting for Costs Incurred During its Participation in the Big Stone II Project
Case No. EL09-_____**

Dear Ms. Van Gerpen:

Enclosed for filing is Otter Tail Power Company's Petition requesting authority to use deferred accounting until its next rate case for costs incurred during its participation in the Big Stone II project.

If you have any questions, please feel free to contact me at any time.

Sincerely,

/s/ Bruce Gerhardson

Bruce Gerhardson
Associate General Counsel
BG/dm

Enclosures

PUBLIC UTILITIES COMMISSION
STATE OF SOUTH DAKOTA

In the Matter of the Petition of Otter Tail Power
Company for Approval of Deferred Accounting
of Preconstruction Costs for Big Stone II

Docket No. EL09-_____

PETITION

Otter Tail Power Company (“OTP”) requests authority to use deferred accounting until its next rate case for costs incurred during its participation in the Big Stone II project. The Big Stone II project was a proposed multi-owner coal-fired generating plant to be located at the site of the existing Big Stone Generating Plant near Big Stone, South Dakota. At the time of its withdrawal, OTP had a 26.54% share of the project and a corresponding responsibility for shared project costs.¹

OTP worked on developing the project for several years. In June of 2005, OTP entered into project agreements with six other utilities for purposes of pursuing the project.² At that time, the participants applied for the necessary permits, began preliminary engineering work, and began other development work for the project. The South Dakota Public Utilities Commission (“Commission”) approved the project Site Permit in July 2006, the North Dakota Public Service Commission (“NDPSC”) issued an Advance Determination of Prudence for OTP’s participation in the project in July 2008, and the Minnesota Public Utilities Commission (“MPUC”) issued a Certificate of Need (“CON”) for the Big Stone II transmission lines in March 2009. OTP’s 2005

¹ Or more precisely 26.544622425% based on OTP’s proportion of committed off-take: 116MW of a total of 437 MW committed. OTP’s share of the project increased after Great River Energy (“GRE”) and Southern Minnesota Municipal Power Agency (“SMMPA”) withdrew from the project in September 2007. The project was permitted and engineered with an expected capacity between 500 and 550 MW, therefore, without new participants to make up for GRE and SMMPA, OTP’s share of off-take was larger than its requirements and its share of obligation exceeded its expected investment.

² Preliminary investigation of the feasibility of a second unit at the Big Stone site and other project activities had been undertaken before the project group agreements were finalized and executed.

Integrated Resource Plan, which specifically included the Big Stone II project, was approved by the MPUC in March 2009. The project also obtained a Water Allocation Permit, Air Permit, and other necessary permits, and completed a Federal Environmental Impact Statement for the project. During the time these permit proceedings were pending, OTP incurred approximately \$13.2 million for permitting, engineering and other development activities for the project.³

By fall of 2009, a combination of factors decreased OTP's need for the project and increased risks associated with the project and, therefore, OTP withdrew from participation. The combination of factors included: (a) significant changes to recent energy price forecasts that are expected to result in changes to OTP's next resource plan and resource adequacy requirements; (b) unprecedented financial market conditions and cost-recovery risks that made raising the large amount of necessary capital unreasonably costly; and (c) the risk that OTP could be required to either increase its share of the plant or participate in a smaller and less economic project if additional participants did not join in the project.⁴ OTP was one of five remaining participants when it discontinued participation in the project.⁵ The remaining participants later discontinued the project when the necessary additional participants did not join the project.

OTP's request to use deferred accounting for these project costs until its next rate case should be granted. Otter Tail currently expects it will file a rate case within the next twelve months. Denial of deferred accounting would cause OTP to reflect the approximately \$1.27 million South Dakota jurisdictional share of development costs as an expense on its financial reports for the current period even though the costs are expected to be reviewed for recovery and

³ The actual amount \$13,173,954.

⁴ OTP's share of Big Stone II costs was estimated at about \$400 million. However, without the addition of other project participants, OTP's expected share of costs in a similarly sized project would have increased to approximately \$500 million or more. For purposes of illustrating the magnitude of the investment, OTP's total rate base as of the end of 2008 was approximately \$575 million.

⁵ Two Big Stone II Participants, GRE and SMMPA, withdrew from the project previously.

amortization over a period of years in the Company's next rate case. Additionally, as a consequence of this accounting treatment, denial of deferred accounting would also require the Company to accelerate that rate case filing.

I. General Filing Information

Otter Tail provides the following general filing information:

A. Name, Address, and Telephone Number of Utility.

Otter Tail Power Company
215 South Cascade Street
P.O. Box 496
Fergus Falls, MN 56538-0496
Telephone: (218) 739-8200

B. Name, Address, and Telephone Number of Utility Attorney.

Bruce Gerhardson
Associate General Counsel
Otter Tail Power Company
215 South Cascade Street
P.O. Box 496
Fergus Falls, MN 56538-0496
Telephone: (218) 998-7108

C. Date of Filing.

This Petition is being filed on December 14, 2009.

D. Controlling Statute for Time in Processing the Filing.

There is no set period for a Commission decision on the Petition.

E. Title of Utility Employee Responsible for Filing.

Bruce Gerhardson
Associate General Counsel
Otter Tail Power Company
215 South Cascade Street
P.O. Box 496
Fergus Falls, MN 56538-0496
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F. Service List.

Otter Tail requests that the following persons be placed on the Commission's official service list for this matter and that any trade secret comments, request, or information be provided to the following on behalf of Otter Tail:

Bruce Gerhardson
Associate General Counsel
Otter Tail Power Company
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II. Otter Tail Should Be Allowed, In Its Next Rate Case To Recover Prudently Incurred Preconstruction Costs And Investments.

OTP is not seeking a final determination of its right to recover its preconstruction costs in this proceeding. OTP will seek recovery of these costs in its next rate case, and is requesting by this Petition the authority to use deferred accounting for the costs until then. However, while OTP is not seeking recovery in this proceeding, it is appropriate to include in this Petition at least a preliminary discussion of the recoverability of these costs. In its next rate case, OTP will demonstrate that it was prudent for OTP to participate in the project, that its decision to withdraw was reasonable, and that the specific costs for which recovery is requested were necessary and reasonable.

Under South Dakota law and the law in nearly all other states, public policy supports recovery of prudently incurred preconstruction costs and investments associated with abandoned plant projects. South Dakota utilities have been allowed to recover their prudently incurred costs associated with abandoned plants in at least three cases: *Re Black Hills Power and Light*

Company, the Osage Plant abandonment;⁶ *Re Northern States Power Company*, the Sibley plant site abandonment,⁷ and *In the Matter of the Application of Northern States Power Company*.⁸

The Washington Supreme Court, in *Power v. Utilities & Transp. Comm'n*,⁹ cataloged the regulatory and court decisions involving abandoned plants (as of 1985) and found that:

Approximately 100 state regulatory agencies in some 33 jurisdictions have faced the question of how to allocate the burden of costs associated with abandonment of power plant projects. As the Supreme Judicial Court of Massachusetts summarized in *Attorney Gen. v. Department of Pub. Utils.*, 390 Mass. 208, 455 N.E. 2d 414, 422 (1983):

A substantial majority of the public utility regulatory agencies that have considered the question have permitted a utility to recover all or some portion of the prudently incurred costs of a nuclear power plant reasonably abandoned before completion.

As with regulatory agencies, the substantial majority of courts that have considered the matter have also allowed utilities to recover abandoned plant costs, prudently incurred, as operating expenses or as expenses which could otherwise be amortized.¹⁰

In *Attorney Gen. v. Department of Pub. Utils.*,¹¹ the Massachusetts Supreme Court explained the overarching policy issue as follows:

If the company now absorbs the Pilgrim II [nuclear power plant] loss, regulatory policies and the returns they dictate, appear to us to be inadequate to compensate investors for the new level of risk. Investors who are inadequately compensated do not remain investors for long. The adverse financial consequences which flow from such circumstances are, in our opinion, inevitable and devastating. The company goes to great lengths in describing how earnings will indefinitely be depressed, stock prices will tumble, bond ratings will collapse, and future capital, if available at all, will be prohibitively priced. Stripped of hyperbole, this assessment remains accurate enough to cause us great pause. The Disdain of the financial markets for this company will be formidable, and that disdain can only mean that eventually the customers of the company will pay a high price in terms

⁶ Docket No. F-3389.

⁷ Docket No. F-3062.

⁸ Order Approving Stipulation and Agreement, Docket No. F-3422 (April 15, 1983).

⁹ 711 P.2d 319 (1985).

¹⁰ *Pacific Power & Light Co. v. Public Serv. Comm'n*, 677 P.2d 799 (Wyo. 1984); and *Citizens Action Coalition of Ind., Inc. V. Northern Ind. Pub. Ser. Co.*, 472 N.E. 2d 938 (Ind. Ct. App. 1984).

¹¹ 390 Mass 208, 455 N.E.2d 422 (1983).

of both extravagant compensation for new capital and an unavoidable service deterioration reflecting the scarcity of reasonably priced capital. In a very real sense, what we face today is not the question, who should bear the cost of Pilgrim II. It is, rather, when should those costs be faced.

Based on public policy considerations, prudently incurred costs associated with a reasonably abandoned plant project are recoverable in rates and, therefore, it is appropriate to use deferred accounting for those costs until they can be included in rates.

With respect to the issue of whether OTP was prudent in participating in the Big Stone II project, not only has the Commission made findings of prudence in the Order granting a Site Permit for the Project, the NDPSC and the MPUC also approved OTP's participation in the Project.

The Commission's Order Granting the Project a Site Permit (July 21, 2006),¹² while noting that it was not making a determination of prudence for the purpose of future ratemaking proceedings, made the following findings in support of providing a site permit for Big Stone II¹³:

¶ 38. Based on OTP's resource planning, Big Stone Unit II is shown to be a least cost baseload resource for the OTP system

¶ 77. If Big Stone Unit II does not become operational, the owners have scarce alternative resources from which to obtain energy, they are faced with increased risk and cost, and there is no single next best resource alternative or other baseload project from which to obtain the needed energy. ...

In North Dakota, OTP's participation in the Big Stone II Plant was reviewed by the NDPSC in *Otter Tail Corporation Advance Determination of Prudence Determination*, Case No. PU-06-481. In its Findings of Fact, Conclusions of Law, and Order (August 27, 2008), the NDPSC made the following findings when it granted OTP an Advance Determination of Prudence for the project:

¹³ *In the Matter of the Application of Otter Tail Power Company and Others for Certification of Transmission Facilities in Western Minnesota*, Docket No. E-017, ET-6131, ET-6130, ET-6144, ET06135, ET-10/CN 05-619, Order Granting Certificate of Need With Conditions (March 17, 2009) ("CON Order").

Finding 30. The Commission finds that . . . Otter Tail . . . [has] a need for additional electric system resources to ensure reliable electric service to customers.

Finding 139. The Commission finds that it is reasonable and prudent to construct a baseload generating facility at the Big Stone site.

In Minnesota, OTP's participation was closely scrutinized by the MPUC in an extensive CON proceeding¹³ and in OTP's integrated resource plan ("IRP") proceeding.¹⁴ In both proceedings, the MPUC found that it would be prudent for the Company to participate in Big Stone II. In the CON Order, the MPUC found:

[T]hat applicants have appropriately considered alternative resources of electricity and the record demonstrates that the Big Stone II proposal is likely the least expensive option, even when environmental costs are considered.¹⁵

[T]hat, under a broad range of reasonable scenarios and subject to reasonable conditions, the Big Stone II proposal is more cost-effective than other alternatives.¹⁶

[T]he Big Stone II proposal is at least as reasonable and prudent as any other alternative demonstrated by a preponderance of the evidence in the record.¹⁷

In the IRP Order, the MPUC approved OTP's selection of Big Stone II as an appropriate resource to meet customer demand:

Based on a review of the record, the Commission will approve Otter Tail's revised resource plan as outlined in and supported by Otter Tail's January 3, 2008 supplemental filing. By developing a plan to meet the levels of customer demand predicted [by] its July 1, 2007 forecasts Otter Tail has demonstrated that this plan can be expected to maintain the adequacy and reliability of its service. Through selecting the least cost manner of fulfilling that demand, Otter Tail has demonstrated that its plan can be expected to keep customers' bills and Otter Tail's rates as low as practicable given regulatory and other constraints. Through granting appropriate weight to externalities, Otter Tail has demonstrated that its

¹³ *In the Matter of the Application of Otter Tail Power Company and Others for Certification of Transmission Facilities in Western Minnesota*, Docket No. E-017, ET-6131, ET-6130, ET-6144, ET06135, ET-10/CN 05-619, Order Granting Certificate of Need With Conditions (March 17, 2009) ("CON Order").

¹⁴ *In the Matter of Otter Tail Power Company's 2005 Integrated Resource Plan*, Order Approving Resource Plan, Docket No. E-017/RP-05-968 ("IRP Order").

¹⁵ *Id.* at 25.

¹⁶ *Id.* at 32.

¹⁷ *Id.*

plan can be expected to minimize adverse socioeconomic effects and adverse effects upon the environment. And by considering a range of alternatives Otter Tail has demonstrated that its plan can be expected to enhance Otter Tail's ability to respond to changes in the financial, social, and technological factors affecting its operations, and limit the risk of harm to Otter Tail and its customers from financial, social, and technological factors beyond Otter Tail's control.¹⁸

In sum, three separate utility Commissions have issued four final Orders, each based on an extensive record from contested case proceedings. Each of those Orders concludes that it was prudent for OTP to pursue the Big Stone II project, and each of those Orders makes numerous specific findings on the scope and character of plant technology and the nature of the transmission facilities.¹⁹ All of the costs OTP seeks to defer in this request were incurred in furtherance of and in compliance with the findings of those Orders.

OTP's decision to withdraw from the Big Stone II project was also reasonable. The project agreements required OTP to make a final decision on September 11, 2009, that would have committed OTP to continued participation through financing, construction, and operation of the project. Circumstances existing at that point in time, however, made it unreasonable for OTP to irrevocably commit to its continued participation in the project.

OTP's decision to participate in Big Stone II in 2005 and continuing into 2008 was based on circumstances significantly different from those OTP faced in September 2009. The confluence of factors that made it reasonable for OTP to withdraw from the project included:

- Significant unanticipated changes to long-term forecasts for on-peak and off-peak energy prices and changes in projected customer demand, which are expected to impact OTP's next resource plan and resulting resource adequacy requirements. The changes include forecasts of energy prices in the 2012 to 2024 time frame that are 40% to 50% lower than

¹⁸ *In the Matter of Otter Tail Power Company's 2005 Integrated Resource Plan*, Order Approving Resource Plan, Docket No. E-017/RP-05-968.

¹⁹ In the interest of brevity, the majority of the specific findings on these subjects have not been cited in this Request.

previous forecasts. OTP expects to complete an updated Integrated Resource Plan (“IRP”) by July 1, 2010 and expects that these forecast changes will impact the resource additions recommended in that IRP.

- Unprecedented financial market conditions brought on by the broad economic downturn, which made raising the necessary capital unreasonably risky and potentially more costly. These conditions have resulted in a lending market in which it has grown increasingly difficult to find debt financing at a reasonable cost, especially for such a large project, with increasing uncertainties; these conditions have also resulted in an equity market that has significantly driven up the cost of raising equity capital.
- The risk that additional partners would not join the project, leaving OTP responsible for a larger share of the project costs. Two participants had previously withdrawn, and reasonable efforts to find replacement participants were unsuccessful, increasing OTP’s share of project costs substantially.
- The growing uncertainty in the direction of federal climate-change legislation and the Environmental Protection Agency’s intent to regulate CO₂.
- Uncertainty surrounding adequate and timely cost recovery.
- Uncertainty due to protracted appellate processes.

OTP has expended approximately \$13.2 million participating in the Big Stone II Project. The South Dakota jurisdictional share of these costs is 9.64% or \$1,269,688 dollars.²⁰ The costs are more fully described in Attachment A, but fall generally into the following cost categories: Engineering, project development, permitting, legal, other expenditures, and Allowance for Funds Used During Construction (AFUDC). OTP has excluded from this request any costs that it has

²⁰ This jurisdictional allocation percentage is a composite of the E1 and D1 allocators set in OTP’s last general rate case.

incurred for land in which it continues to have a property title interest, and it has excluded any internal and labor-related costs that are being recovered in current rates. For example, OTP incurred costs for certain easements relating to the project and OTP has a continuing real property right in those easements. Therefore, the costs for those easements have been reflected in Otter Tail's property accounts and are not included in this deferral request. Additionally, OTP reviewed the internal labor costs included in this request and verified that they were excluded from the 2007 test year used in OTP's most recent rate case (Docket No. EL08-742) as they were being accounted for as Construction Work in Progress ("CWIP") along with the other project costs.

While OTP believes the numerous findings on prudence cited above, combined with the factors supporting OTP's later withdrawal, demonstrate that the costs should be recoverable, OTP also agrees that the Commission will decide the reasonableness of the costs at a later date, in the context of a future rate case. In that future case, the prudence of the costs and the reasonableness of allowing their recovery in rates will be reviewed and determined, along with determining the appropriate rate recovery methodology (e.g. amortization period, etc.).

III. Deferred Accounting Is Appropriate

The need for deferred accounting for costs incurred on abandoned utility projects is a consequence of the change in the accounting treatment for those costs upon the abandonment. Prior to abandonment, the project development costs are capitalized as CWIP typically over multiple years. In OTP's most recent rate case, Big Stone II project-related costs were excluded from the 2007 test year — those costs were accumulating in the CWIP account and, therefore, were not reflected in the revenue requirement either as an expense or as an investment included in rate base.

Upon OTP's withdrawal from the project, absent deferred accounting, all costs for permitting, project management, legal fees and other costs that had accumulated over the several years of OTP's involvement in the project would be expensed in the current period. Through the use of deferred accounting, the financial status quo can be preserved until OTP's next rate case so that the Company's financial statements are not dramatically and unreasonably impacted prior to a Commission decision whether the costs should be included in rates. If the Company were required, for financial reporting purposes, to write off approximately \$1.27 million because deferral was not granted, it would have a very material negative impact on earnings in the current period. Then, if the costs are later authorized for recovery in the next rate case, that would cause a dramatic increase to earnings in that period. This volatile swing in earnings from negative to positive and its likely affect on stock prices, the cost of debt, shareholder and lender confidence and the negative impact on the availability of additional capital cannot be understated.

The Commission has previously allowed deferred accounting when necessary to allow a utility to obtain full recovery its costs. In this case, as explained above, OTP has not previously recovered any of the costs for which it is requesting deferral. In addition, the Commission just recently approved new retail rates in Docket No. EL08-742 that do not include any of the Big Stone II preconstruction costs and investments. For these reasons the use of deferred accounting should be granted.

IV. Conclusion.

Otter Tail should be authorized to use deferred accounting until Otter Tail's next rate case.

Dated: December 14, 2009

By: /s/ Bruce Gerhardson

Bruce Gerhardson

Associate General Counsel

OTTER TAIL POWER COMPANY

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**Otter Tail Power Company
Big Stone II Development Costs
For Period February 1, 2005 through November 30, 2009**

1	Engineering, procurement and construction management	\$1,473,546
2	Project development team (including labor)	\$3,531,343
3	Permitting and environmental impact statement	\$2,528,093
4	Legal	\$3,109,769
5	Other expenditures	\$1,255,091
6	Credit from participants that previously withdrew	-\$725,479
7	AFUDC	\$2,001,590
BIG STONE II PROJECT DEFERRAL REQUEST		\$13,173,954

Ownership percentages:

OTP paid 19.33% of joint project costs through September 2007, the date when GRE and SMMPA withdrew. OTP funded 26.54% from September 2007 through its withdrawal on September 11, 2009. OTP's share of joint project costs were assigned on a composite percentage basis because of changes in ownership percentages over the life of the project.

Descriptions for breakdown categories:

- 1 **ENGINEERING, PROCUREMENT AND CONSTRUCTION MANAGEMENT:** The plant project's engineering, procurement and construction manager designed and specified the electric generating plant, solicited/evaluated six equipment bid packages in 2006, produced three major cost estimate renditions, performed a coal drying assessment, geotechnical investigation and ultra-supercritical study, and provided testimony at regulatory proceedings. Includes the cost of transmission studies conducted to determine the impact the proposed generator has on the transmission system and the upgrades to allow the generator to interconnect and deliver energy to the transmission system, and preliminary engineering efforts to determine proposed structure types and potential substation layouts.
- 2 **PROJECT DEVELOPMENT TEAM (INCLUDING LABOR):** Includes Otter Tail generation project labor; staff expenses such as meals, lodging, travel; and payments to several independent contractors. The project development team provided assistance for project engineering, permitting, communications and financing efforts. Transmission project management time spent on permitting, engineering, environmental, land or other specifically detailed tasks were included in those specific categories. General transmission staff project management time not specifically assigned to other categories is included here. Internal labor costs and expenses included in this filing were excluded from the test year expenses used in OTP's rate case.
- 3 **PERMITTING AND ENVIRONMENTAL IMPACT STATEMENT:** External costs associated with efforts to obtain the Federal EIS and the following permits: MN CON and route, SD site, PSD air, solid waste, water, and groundwater permits. Permitting activities include development of permits, filing fees and hearing expenses. Excludes all outside attorney fees that are included in #4 legal. Plant permitting related internal labor costs that are included in #2 project development. Transmission permitting costs presented here include outside consultants and internal labor and expenses to support these efforts.

**Otter Tail Power Company
Big Stone II Development Costs
For Period February 1, 2005 through November 30, 2009**

- 4 **LEGAL:** Payments to outside legal firms for generation and transmission activities. Includes work on the project agreements including the Participation Agreement, O&M Services Agreement, Joint Facilities Agreement, Trust Agreement, Interconnection and Transmission Upgrade Allocation Agreement, and Blanket Easement Agreement. Includes outside counsel charges related to financing, new participants and equipment contracts. Also includes external attorney fees for obtaining permits including MN CON and route, SD site, solid waste, water, groundwater and PSD air permits.

- 5 **OTHER:**
PLANT: Includes groundwater tolerance testing costs, insurance premiums and broker fees, communications expenses, scrubber evaluation costs, SD use tax payments, credits for SD tax rebates. Includes payments for property easements, options and purchases, mineral and water rights, as well as property tax payments, and other miscellaneous charges net of lease revenues. Includes property purchases committed and obligated prior to withdrawing from the project.
TRANSMISSION: Expenses related to survey permission, easement options and easement acquisition including easement payments, labor and expenses and various other miscellaneous charges.
EXCLUDES any costs for property rights for which OTP continues to have a title interest.

- 6 **CREDIT FROM PARTICIPANTS THAT PREVIOUSLY WITHDREW:** When GRE and SMMPA withdrew from the project in September 2007 they forfeited their trust fund balances and paid exit payments in accordance with the project agreements. The dollars shown here are OTP's 26.54% share of GRE and SMMPA exit payments and trust fund balances when they withdrew from the project.

- 7 **AFUDC:** Allowance for funds used during construction on OTP's CWIP investment for the period February 1, 2005 to August 31, 2009.