STAFF MEMORANDUM REGARDING INTERIM RATES

TO: COMMISSIONERS AND ADVISORS

FROM: BRITTANY MEHLHAFF, PATRICK STEFFENSEN, ERIC PAULSON, JOSEPH REZAC, LORENA REICHERT, AND KRISTEN EDWARDS

RE: EL18-021 - In the Matter of the Application of Otter Tail Power Company for Authority to Increase Its Electric Rates

DATE: May 9, 2018

BACKGROUND

On April 20, 2018, the South Dakota Public Utilities Commission (Commission) received an Application for Authority to Increase Its Electric Rates (Application) from Otter Tail Power Company (OTP or Company) requesting authority to increase its rates in its South Dakota electric service territory. The Company is proposing a two-step increase to its base electric rates. The increases would be OTP's first increase to base rates in approximately eight years, when it was granted a 2.3 percent increase in docket EL10-011.

Step-One Increase

OTP proposes a two-step increase in this case, with the first step effective upon the Commission's final disposition in this case, which is projected to be in early 2019. The rate increase proposed for this first step is $3,358,547, or a 10.10 percent total bill increase, and the typical residential customer would see an increase of $11.29 per month under the rate design proposed by the Company. In Company Witness Bruce Gerhardson's Direct Testimony, OTP explains that roughly half of this requested increase is due to a 17 percent increase in net plant since EL10-011 and half due to a decrease in net operating income, net of the impacts of the Tax Cuts and Jobs Act.

Interim Rates

With this step-one increase, OTP is requesting interim rates effective once 30 days have passed from the date of filing, or May 21, 2018, pursuant to SDCL 49-34A-17. The Company has adjusted the proposed interim rates to remove any known and measurable changes that are included in the final step-one rate mentioned above but for which the changes will have not yet occurred during the interim rate period. This results in an adjusted increase of $2,386,538, or 7.17 percent, and will be subject to refund upon determination of the final step-one rates.

OTP also proposes to transfer all plant-in-service from its Transmission Cost Recovery Rider (TCRR) and Environmental Cost Recovery Rider (ECRR) to base rates as of the interim rate effective date, May 21, 2018. Thus, OTP has included interim rates for the TCRR and ECRR in its interim rate tariff filing. The

TCRR rate has been decreased to a $0.421 per kWh residential rate to recover a projected $1,170,601 revenue requirement for the May 21, 2018 through February 28, 2019 recovery period. The ECRR rate has been reduced to a $0.00075 per kWh credit to refund the $189,296 credit back to ratepayers during the interim rate period.

Step-Two Increase

The Company anticipates placing its Merricourt Project, a 150 MW wind energy generation facility near Merricourt, North Dakota, in service late 2019. Thus, OTP proposes a second step increase to be effective January 1, 2020 to facilitate recovery of this project. This results in a step-two increase of $629,107, or 1.72 percent.

STAFF ANALYSIS – INTERIM RATES

Pursuant to SDCL 49-34A-14, the Commission may, by order, suspend the operation of the proposed rate or practice. The suspension may not last longer than one hundred eighty days after the proposed rate or practice was filed. Staff notes the statute does not require the Commission suspend the proposed tariff, it merely allows the Commission to do so. The question becomes, are there unique circumstances that justify deviating from the general practice of this Commission? Staff provides its analysis of the current circumstances surrounding OTP's request for interim rates to provide the Commission with the facts necessary to make this decision.

Current Deficiency

The Company claims it had a $2.5 million revenue deficiency for the actual year ended December 31, 2017[1]. Staff has not completed an analysis of the 2017 actual year and therefore, Staff cannot agree or disagree with this amount at this time. However, Staff would likely calculate a lower revenue deficiency upon completion of such analysis. For instance, the Company included a 10.0% return on equity in its calculations, based on its last rate case settlement. Based on more recent rate cases, Staff anticipates its consultant will recommend a lower return on equity. There may be expenses Staff would recommend excluding as well, which would reduce the revenue deficiency.

Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act (TCJA) was effective January 1, 2018. The Commission's December 29, 2017 Order in Docket GE17-003 (TCJA Order), requires all rates impacted by federal income taxes be adjusted effective January 1, 2018, and are subject to refund or any other ratemaking treatment which ensures ratepayers receive the benefits of the tax change as of January 1, 2018, pending a determination of the impact of the TCJA. OTP made an adjustment to reflect the impact of the TCJA on its 2017 test year[2]. The Company calculated this impact on the revenue deficiency at $1,205,765, and included this adjustment in its proposed interim rates to be effective May 21, 2018.

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[1] Refer to Exhibit___(TAA-1), Schedule 3.
[2] Refer to Exhibit___(TAA-1), Schedule 5.

In his direct testimony, Mr. Gerhardson claims that the TCJA Order "serves as support that the Commission has previously authorized reasonable measures to prevent procedural lag in the setting of just and reasonable rates" and that it "serves as more than a regulatory precedent, too, given that it is intended to cover the same cost of service period as the period covered by OTP's interim rate request".[3]

While implementing interim rates on May 21, 2018, would get the tax savings to customers at an earlier date, the net impact proposed is an increase. Therefore, customers benefit by suspending the proposed increase, and ultimately any potential final increase[4], for the full suspension period allowed. Furthermore, per the terms of the TCJA Order, rates are subject to refund or any other ratemaking treatment which ensures ratepayers receive the benefit of the tax change as of January 1, 2018, pending a determination of the impact of the Act, regardless of when any non-tax related increase becomes effective. The TCJA is not noticed for Commission decision today. The TCJA should have no bearing on the Company's proposal for interim rates and any discussions regarding the TCJA should be left for later in this proceeding.

Timing of Rate Case Filings

The Company is the only one with the knowledge of when it will be in a deficit and can time its rate case accordingly. Thus, the Company could have filed on November 20, 2017 rather than April 20, 2018 to have an effective date of May 21, 2018. Staff finds it difficult to support the regulatory lag argument from the utility's perspective when the lag from the Commission perspective is the amount of time since the company's last filing, in this case eight years. Staff believes the legislature gave the Commission authority to suspend rates up to 180 days, for good reason. While we can debate the reasons, the fact remains the Company can choose the timing of its filing and this option to suspend rates for 180 days should remain, absent compelling circumstances otherwise.

Standards for Granting Interim Rate Relief

The Company has not provided any support that interim rates are needed or that by not allowing interim rates to be effective May 21, 2018, the Company and its customers will be harmed.

In an electric rate case filing made by Montana-Dakota Utilities Company (MDU) on December 22, 1980, Docket F-3370, Commission Staff recommended interim rate relief be granted only upon a showing by the utility that it would be unable to finance needed construction in the absence of interim relief. To satisfy that standard, the utility must show:

1. Its anticipated construction expenditures are prudent (i.e., that they represent expenditures for plant required to continue providing safe, adequate, and reliable utility service),
2. The construction expenditures cannot be met with internally generated funds, short-term borrowings and/or new common equity capital obtained on reasonable terms, and

[3] Gerhardson Direct, page 9.
[4] Staff has not yet completed a review of the rate case to determine whether an increase is justified.

3. The construction expenditures required to be financed with new preferred stock and/or long-term debt cannot be financed by those means because of restrictive provisions in the Company's charter, indenture, etc. barring the issuance of such securities.

By order dated February 20, 1981, the Commission denied interim relief to MDU. Staff believes this should still be the bar a utility needs to reach to show its need for special interim rate relief. Staff does not believe OTP is in a position of financial distress that requires interim rate relief sooner than 180 days.

Furthermore, the circumstances surrounding MDU's request for interim relief appear to be quite different than the environment OTP is operating in today. MDU was in the process of constructing the Coyote Generating Station, a major utility asset. In addition, the financial markets were in a much different place than today. During MDU's test year ended June 30, 1980, the U.S. prime interest rate ranged from 11.5 percent to 20.0 percent and the CPI inflation rate ranged from 11.26 percent to 14.76 percent. In December 1980, when MDU made its request for interim rate relief, the U.S. prime interest rate reached a record high of 21.5 percent and the CPI inflation rate was 12.52 percent. This is a stark difference from the economic environment of today where the current U.S. prime interest rate is 4.75 percent[5] and the CPI interest rate is 2.36 percent[6]. Given the Commission found it inappropriate to grant MDU's request for interim rate relief in 1980, a utility would have to be in severe financial distress to consider granting interim rate relief today.

Rider Recovery Moving to Base Rates

One positive aspect of an earlier implementation of interim rates, on May 21, 2018, is that certain costs currently being recovered in the Environmental Cost Recovery Rider (ECRR) and Transmission Cost Recovery Rider (TCRR) would be transferred from rider recovery to base rate recovery at an earlier date. This simply means there would be five less months of dollar-for-dollar, guaranteed recovery of the costs associated with the environment-related and transmission-related projects described in Company Witness Bryce Haugen's Direct Testimony. Staff does not believe this benefit outweighs the benefit of suspending the interim rate implementation date to October 21, 2018.

Proposed Interim Rates Under 180 Day Suspension In Lieu of May 21, 2018 Interim Rates

Mr. Gerhardson further states in his Direct Testimony, that if the Commission suspends the proposed increase, it would be the proposed final rates, or 10.10 percent, which would go into effect once 180 days have passed from the filing date. The Company has communicated to Staff that the primary driver from the 7.17 percent increase if interim rates are effective May 21, 2018, to the final 10.10 percent increase, is the customer information system, or CISone, project described in Company Witness Stuart Tommerdahl's Direct Testimony. The Company also conveyed to Staff that the project will be in-service by the time the interim rates would go into effect October 21, 2018. Therefore, while an earlier interim rate effective date would provide the Company five additional months of recovery at the 7.17 percent

[5] May 4, 2018
[6] March 2018

increase amount, it would also decrease recovery from the 10.10 percent increase amount to the 7.17 percent increase amount from October 21, 2018 to the date final rates are put into effect, as late as April 20, 2019. Staff would also note that the 7.17 percent and 10.10 percent increases used in this analysis are Company-proposed increases, and it is likely final rates determined would be less. The possibility of savings associated with up to 6 months of rates at a 7.17 percent increase versus a 10.10 percent increase do not outweigh the increased costs associated with 5 months of rates at a 7.17 percent increase versus a 0.00 percent increase.

RECOMMENDATION

For the reasons stated above, Staff recommends the Commission deny the Company's request to implement interim rates effective May 21, 2018. In lieu of granting this request, Staff recommends the Commission suspend the imposition of the tariff for 180 days beyond April 20, 2018. If the Commission does grant the Company's request to implement interim rates effective May 21, 2018, Staff recommends the Commission's order specify that the facts and circumstances surrounding the Commission's determination are unique to this docket.

Staff also recommends the Commission assess a filing fee to account for actual expenses incurred form the date of the filing, not to exceed $250,000, and give the Executive Director authority to enter into consulting contracts as necessary.