BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF SOUTH DAKOTA

IN THE MATTER OF THE APPLICATION OF OTTER TAIL POWER COMPANY FOR AUTHORITY TO INCREASE RATES FOR ELECTRIC SERVICE IN SOUTH DAKOTA

STAFF MEMORANDUM SUPPORTING SETTLEMENT STIPULATION

DOCKET EL10-011

Commission Staff (Staff) submits this Memorandum in support of the Settlement Stipulation of February 24, 2011, between Staff and Otter Tail Power Company (OTP or Company) in the above-captioned matter.

BACKGROUND

On August 20, 2010, the Company filed an application with the Public Utilities Commission (Commission) seeking an increase in annual revenues of approximately $2,756,000 or 9.96 percent increase in rates for electric service to customers in its South Dakota retail service territory. OTP's proposed increase was based on an historic test year ended December 31, 2009[1], adjusted for what OTP believes to be known and measurable changes, an 11.25 % return on common equity, and a 9.13 % overall rate of return on rate base. OTP witnesses submitted testimony stating that the increase is needed to recover: (1) additional rate base investments (including the addition of the Luverne wind farm) and associated depreciation expense; (2) Big Stone II development costs; and (3) significant increases in operating costs incurred by the Company in providing electric service to its customers.

The Commission officially noticed OTP's filing on August 26, 2010, and set an intervention deadline of October 8, 2010. No petitions to intervene were filed. On September 28, 2010, the Commission issued an Order of Assessment of Filing Fee and Suspension of Imposition of Tariff. On January 19, 2011, the Commission received a request from the Company to implement interim rates based on current rate design on February 17, 2011, pursuant to SDCL 49-34A-17. On January 27, 2011, Otter Tail filed an amended request to implement the interim rate increase at a level lower than the rate increase proposed in the initial application. On February 9, 2011, the Commission issued an Order Granting Request for Authority to Implement an Interim Rate Increase on February 17, 2011.

[1] By order dated June 16, 2010, the Commission granted OTP a waiver of ARSD 20:10:13:44, which allowed the Company to use a 2009 test year provided OTP's rate filing was made on or before August 31, 2010.

On January 4, 2011, after extensive discovery, Staff provided OTP a copy of its revenue requirement determination. Thereafter, Staff and OTP (jointly the Parties) held several settlement discussions in an effort to arrive at a mutually acceptable resolution of the issues presented in OTP's rate filing. Ultimately, the Parties reached an agreement on all issues presented in the case except the addition of the Luverne wind farm. The parties are unable to reach a resolution regarding the cost recovery of the Luverne wind farm and will notice this item for Commission consideration.

OVERVIEW OF SETTLEMENT

Staff based its revenue requirement determination on its comprehensive analysis of OTP'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 OTP'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 except the addition of the Luverne wind farm. Staff believes the settlement is based on sound regulatory principles.

Staff and OTP agree OTP's revenue surplus, excluding the addition of the Luverne wind farm, is $219,469 justifying an approximate 0.79% decrease in present rates. The revenue requirement and supporting calculations described in this Memorandum and attachments depict Staff's positions regarding all components of OTP's South Dakota jurisdictional revenue requirement, including a reasonable return allowance on common equity.

If the Commission determines the Luverne wind farm and its related costs are appropriate for rate recovery, Staff and OTP agree OTP's revenue deficiency is $642,572 justifying an approximate 2.32% increase in present rates.

STAFF OVERVIEW OF SETTLEMENT

Staff believes the settlement provides OTP with an annual level of revenues relative to its current service costs that is fair, just, and reasonable. These settlement rates allow OTP 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, 2009, total Company test year costs and allocates total Company amounts to the South Dakota retail jurisdiction. Staff then adjusted the December 31, 2009, test year results for known and measurable post-test year changes. Staff Exhibit___ (JPT-1), Schedule 3 illustrates Staff's determination of OTP's pro-forma operating income under present rates. Staff Exhibit___ (JPT-2), Schedule 2 illustrates Staff's calculation of OTP's South Dakota retail rate base, and Staff Exhibit___ (JPT-1), Schedule 2 and Staff Exhibit___

(JPT-2), Schedule 1 summarizes the positions. Staff's calculation of OTP's revenue surplus and total revenue requirement are shown on Staff Exhibit___ (JPT-1), Schedule 1.

Staff Exhibit___(JPT-4), Schedule 1 supports the revenue deficiency and total revenue requirement with the Luverne wind farm included. Staff Exhibit___ (JPT-4), Schedule 3 illustrates Staff's determination of OTP's pro-forma operating income with all costs related to the Luverne wind farm. Staff Exhibit___ (JPT-5), Schedule 2 illustrates Staff's calculation of OTP's South Dakota retail rate base with the Luverne wind farm investment. Staff Exhibit___ (JPT-4), Schedule 2 and Staff Exhibit___ (JPT-5), Schedule 1 summarizes the positions.

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, 2008, through December 31, 2009.

Test Year Plant Annualizations and Post-Test Year Plant Additions - The Company proposed adjustments to annualize test year non-revenue producing plant additions that occurred during the test year and for projected post-test year non-revenue producing capital additions, anticipating that these plant additions would be in service by the conclusion of this proceeding, increasing rate base by approximately $1,481,000. The settlement revises the Company's adjustments to: 1. Remove the amounts related to the income producing Ladish Sub Work and the Casselton Ethanol Plant Substation; 2. Reflect actual costs in lieu of the Company's estimated costs; 3. Allocate the Gwinner Capacitor Bank on the transmission function; 4. Recognize, as a rate base adjustment, the accumulated deferred income taxes related to the difference between book and tax depreciation; and 5. Reflect the accumulated deferred income taxes related to the 50% bonus depreciation for eligible projects per the American Recovery and Reinvestment Act. The net effect of these changes reduces rate base by approximately $303,000.

Big Stone Plant II Costs - In Docket EL09-024 the Commission approved the Company's petition for deferred accounting treatment of the cancelled Big Stone II project costs. The Company proposed an adjustment to amortize the deferred Big Stone II costs over five years with the net unamortized balance of 4/5 of the total deferred amount included in rate base. The settlement revises the Company's adjustment to: 1. Remove from cost recovery in this case the costs related to Big Stone II transmission facilities because OTP expects these costs will be included in MISO transmission tariff recoveries; 2. Amortize the remaining costs over ten years; 3. Include one-half of the amortizable costs, representing the average unamortized balance over the ten-year period in rate base; and 4. Track the recovery of costs so that the Company neither over recovers nor under recovers these costs. The net effect of these changes reduces rate base by approximately $509,000.

Transmission Plant Transfer - The Company proposed an adjustment to reclassify transmission plant to distribution plant or production plant based on a Boundary Guideline Study ordered by the Minnesota Public Utilities Commission. The settlement accepts the adjustment.

Depreciation to Reflect 2010 Rates - The Company proposed an adjustment to reflect the depreciation rates effective January 1, 2010, as certified by the Minnesota Public Utilities Commission based on the Company's 2009 Technical Update filing. The settlement accepts the adjustment.

Special Deposits - The Company proposed an adjustment to special deposits. The proposal removes extraordinary items, mainly the amounts related to the proceeds received from financing related to the Luverne wind investment. The settlement reflects the most recent 13 month average with the extraordinary items removed. The adjustment reduces rate base by approximately $24,000.

Remove Unamortized Holding Company & Rate Case Expense from EL08-030 - The Company included the unamortized portion of rate case expense and holding company expense from its previous rate case in Docket EL08-030. The settlement removes these deferred assets from the test year. The settlement stipulation approved by the Commission in Docket EL08-030 did not establish a true-up mechanism for these expenses. The net effect of these changes reduces rate base by approximately $194,000.

Rate Case Expense and Holding Company Expense – The settlement reflects a three-year amortization of allowed rate case expense and holding company expense to spread these one-time costs over a reasonable period of time. Although OTP did not request rate base treatment for the unamortized balances, the settlement includes one-half of the amortizable costs, representing the average unamortized balance over the three-year period. The net effect of these changes increases rate base by approximately $115,000.

Patient Protection and Affordable Care Act – OTP claimed the recently enacted health care reform legislation will end a favorable tax treatment accorded Medicare Part D prescription drug subsidies beginning in 2013. In prior years, the IRS allowed companies to exclude the Medicare subsidy from income. Because these are tax deductions to be recognized in future years, OTP accumulated a deferred tax asset (a regulatory asset – promised to be paid in the future) that was included in OTP's South Dakota rate base. Elimination of the deduction beginning in the 2013 tax year requires OTP to write-off the deferred tax asset. As a result, OTP proposed an adjustment to reduce its South Dakota rate base to reflect the write-off of the regulatory asset previously recorded. The settlement accepts this adjustment.

In addition, OTP proposed an adjustment to test year income taxes and accumulated deferred income taxes to recognize the elimination of the deduction that will occur in 2013. The settlement does not reflect this adjustment. The adjustment increases rate base by approximately $81,000.

Wind Removal and Wind In - The Company proposed an adjustment to remove all costs related to the Langdon Wind Energy Center, the Ashtabula Wind Energy Project, and the Luverne wind farm to start with a "clean" rate base and operating income statement from the actual test year (Wind Removal). The Company then proposed an adjustment to include the 2010 projected wind-related costs for these three wind farms (Wind In). The wind removal adjustment represents a full year of costs for the Langdon Wind Energy Center and the Ashtabula Wind Energy project and partial costs for the Luverne wind farm (in-service September 2009). The settlement does not reflect either of these adjustments. The net effect of these adjustments reduces rate base by approximately $1,417,000.

Luverne Wind Farm - The settlement removes all actual test year costs related to the Luverne wind farm. The adjustment is necessary because the parties are unable to reach a resolution regarding the ratemaking treatment for the facility. The adjustment reduces rate base by approximately $1,407,000. However, as noted above, the parties have agreed to the additional adjustments that are required if the Commission should decide that Luverne wind farm costs are to be recovered.

Changes In Allocations Due To Effect Of Test Year Adjustments – OTP's revenue requirement model relies on certain secondary allocation factors generated within the model (e.g., net plant in service). The settlement incorporates the consequences of such allocation changes caused by other elements of the settlement.

Cash Working Capital - To determine its cash working capital requirement, the Company submitted a lead-lag study and separately considered working capital available from certain taxes collected and held by the Company prior to tax submission. The settlement modifies OTP's cash working capital claim by: 1. Inclusion of net payment leads and lags for preferred stock dividends, interest on long term debt, depreciation expense, investment tax credit and deferred income taxes; 2. Modification of lead days to reflect statutory payment dates rather than actual payment dates; 3. Recognition of the payment lags associated with South Dakota sales tax related to the revenue deficiency, employee FICA and federal withholding taxes; and 4. Separation of vacation expense from labor and associated payroll expenses and separation of uncollectible accounts from all other O & M expense because the expense lead days for vacation and uncollectible expense have significantly different lead times than labor and other O & M respectively. The net effect of these changes reduces rate base by approximately $338,000.

BSP Capitalized Adjustment – The settlement removes the Big Stone Capitalized Costs from the test year. These costs were completely amortized in May 2010 and do not reflect normal, on-going conditions. The adjustment decreases rate base by approximately $3,000.

Working Capital Updates - The settlement reflects the most recent 13-month average rate base allowances for materials and supplies, fuel stocks, prepayments and customer advances as well as the rate base deductions for the reserves for injuries and damages and uncollectibles. The settlement also reflects inclusion of the most recent 13-month average FAS 87 - prepaid pension expense in the approximate amount of $726,000 which the Company proposed after the initial filing. The net effect of these changes increases rate base by approximately $613,000.

Cable & Conductor Long Term Agreement - The settlement reflects savings related to the rebid of OTP's cable and conductor long term agreement based on 2009 usage and costs. The adjustment reduces rate base by approximately $40,000.

Test Year Flow-Through Repair Allowance Deduction – For financial reporting purposes, utilities are required to capitalize certain repair expenditures and to depreciate the related costs over the remaining lives of the repaired facilities. In 2009, OTP requested and received permission from the IRS to expense certain repair expenditures for tax purposes. As a result the Company claimed a current tax deduction for the costs of the repairs, which results in a reduction in OTP's income tax liability for 2009 and beyond.

OTP's filing reflected the "normalization" treatment of the tax/book timing difference created when OTP was allowed to expense repair costs for income tax purposes. (OTP is still required to capitalize the repair costs for financial reporting purposes.) Under the normalization treatment, the reduction in OTP's income taxes currently payable is reversed for ratemaking purposes, through the creation of an allowance for deferred income taxes. The process of recording deferred income taxes, in effect, spreads the tax reduction that OTP received in 2009 over the remaining lives of the repaired facilities.

The settlement reflects the "flow-through" treatment which passes on to South Dakota ratepayers, in 2009, the tax benefit OTP received by claiming the tax deduction on its 2009 tax return. That is, under the settlement flow-through treatment, South Dakota ratepayers receive an immediate benefit from OTP's tax deduction rather than waiting to receive the benefit over the remaining lives of the repaired facilities. The adjustment increases rate base by approximately $305,000.

Change in Allocation Factors Due to Effect of Removing Luverne - The settlement reflects minor changes in the per books and pro forma allocation factors due to the removal of all actual test year costs related to the Luverne wind farm. The net effect of this adjustment reduces rate base by approximately $5,000.

OPERATING INCOME

Test Year Plant Annualizations and Post-Test Year Plant Additions - The Company proposed adjustments to annualize test year non-revenue producing plant additions that occurred during the test year and for projected post-test year non-revenue producing capital additions, anticipating that these plant additions would be in service by the conclusion of this proceeding. The settlement revises the Company's adjustments to: 1. Remove the amounts related to the income producing Ladish Sub Work and the Casselton Ethanol Plant Substation; 2. Reflect actual costs in lieu of the Company's estimated costs; 3. Allocate the Gwinner Capacitor Bank on the transmission function; 4. Recognize, as a rate base adjustment, the accumulated deferred income taxes related to the difference between book and tax depreciation; and 5. Reflect the accumulated deferred income taxes related to the 50% bonus depreciation for eligible projects per the American Recovery and Reinvestment Act. The net effect of these changes reduces operating expenses by approximately $3,000.

Big Stone Plant II Costs - In Docket EL09-024 the Commission approved the Company's petition for deferred accounting treatment of the cancelled Big Stone II project costs. The Company's proposed adjustment amortizes the deferred Big Stone II costs over five years with the net unamortized balance of 4/5 of the total deferred amount included in rate base. The settlement revises the Company's adjustment to: 1. Remove from cost recovery in this case the costs related to Big Stone II transmission facilities because OTP expects these costs will be included in MISO transmission tariff recoveries; 2. Amortize the remaining costs over ten years; 3. Include one half of the amortizable costs, representing the average unamortized balance over the ten year period in rate base; and 4. Track the recovery of costs so that the Company neither over recovers nor under recovers these costs. The net effect of the changes reduces operating expenses by approximately $152,000.

Interest Synchronization - The settlement synchronizes the tax deduction for interest expense with the long-term debt interest portion of the capital structure and rate base.

Transmission Plant Transfer - The Company proposed an adjustment to reclassify transmission plant to distribution plant or production plant based on a Boundary Guideline Study ordered by the Minnesota Public Utilities Commission. The settlement accepts the adjustment.

Depreciation to Reflect 2010 Rates - The Company proposed an adjustment to reflect the depreciation rates effective January 1, 2010, as certified by the Minnesota Public Utilities Commission based on the Company's 2009 Technical Update filing. The settlement accepts the adjustment.

Weather Normalization – The Company agreed to withdraw its proposed adjustment.

Retail Revenue Normalization – The Company proposed an adjustment to annualize the effect of the rate increase made effective during the test period. The current rates were implemented in July 2009 from its previous rate case in Docket EL08-030. The adjustment recalculated the revenue from January 2009 through June 2009 by applying current rates and recalculated the fuel clause for 2009. The adjustment also removes billing corrections related to prior periods and includes billing adjustments related to 2009 that occurred in 2010. The settlement accepts the adjustment.

Labor Expense – April & November Annual Increases – The Company proposed to increase test year labor expense by annualizing wage increases that occurred during the test year, increases that occurred in 2010, and increases expected to occur in 2011. The settlement annualizes wage and salary increases that became effective during the test year and reflects known salary increases granted after the end of the test year. The Coyote Station union employees received a 4.0% increase on September 1, 2009, and September 1, 2010. This contract was negotiated in 2008, prior to the current economic crisis. The collective bargaining agreements with the other four unions resulted in a 2.0% increase on November 1, 2009, and a 2.9% increase on November 1, 2010. Non-union employees received no increase in 2009, and a 3.0% increase on April 1, 2010. Executive employees received no increase in 2009, and a 2.4% increase on April 1, 2010. All increases were supported by studies of salaries paid by other reasonably comparable companies.

The settlement determination excludes all wage increases projected to be implemented in 2011. The net effect of these changes is to reduce operating expenses by approximately $35,000.

KPA Incentive Compensation – OTP proposed an adjustment to reflect a five-year average, 2005 through 2009, payout for key performance incentive compensation. The settlement normalizes costs based on actual payouts for performance indicators other than financial for the period of 2006 through 2009. Shareholders are the primary beneficiaries of incentive plans that promote the financial performance of the Company and therefore should be responsible for the cost of such compensation. The 2005 payout occurred under a different KPA incentive plan and is excluded from the multi-year average. The net effect of these changes reduces operating expenses by approximately $14,000.

Employee Benefits Medical/Dental – The Company proposed an adjustment to increase employee medical and dental expense based on its projection of costs in 2011. The settlement reflects a corresponding adjustment based on actual costs from 10/1/09 through 9/30/10. The adjustment reduces operating expenses by approximately $147,000.

FAS 87 Pension Costs – OTP proposed an adjustment to FAS 87 pension costs based on projected pension expenses for 2011. The settlement reflects OTP's actual pension costs for 2010 rather than OTP's estimate of 2011 pension costs. The adjustment reduces operating expenses by approximately $183,000.

FAS 106 & 112 Benefits – Similar to its request regarding pensions, OTP proposed adjustments to FAS 106 and 112 costs based on projected expenses for 2011. The settlement reflects OTP's actual 2010 FAS 106 costs and the most recent five-year average for FAS 112 costs because the 2010 amount was not typical of ongoing costs. The net effect of these changes increases operating expenses by approximately $4,000.

Holding Company Formation Costs – In Docket EL08-025, the Commission approved OTP's request to form a new holding company to comply with SDCL 49-34A-107. OTP proposed to amortize, over a five-year period, additional formation costs incurred since the amount approved in its last rate case in Docket EL08-030. The settlement allows the additional cost incurred to complete the reorganization, amortizes the expense over three years, and reduces the amortized expense by the amount of holding company formation costs currently included in rates. The net effect of these changes reduces operating expenses by approximately $2,000.

Amortized Rate Case Expense - OTP proposed to amortize estimated rate case expenses over the next three years. The settlement includes actual costs incurred to date, amortizes the expense over three years, and reduces the amortized expense by the amount of rate case expense currently included in rates. The net effect of these changes reduces operating expenses by approximately $47,000.

Patient Protection and Affordable Care Act – OTP claimed the recently enacted health care reform legislation will end a favorable tax treatment accorded Medicare Part D prescription drug subsidies beginning in 2013. In prior years, the IRS allowed companies to exclude the Medicare subsidy from income. Because these are tax deductions to be recognized in future years, OTP accumulated a deferred tax asset (a regulatory asset – promised to be paid in the future) that was included in OTP's South Dakota rate base. Elimination of the deduction beginning in the 2013 tax year requires OTP to write-off the deferred tax asset. As a result, OTP proposed an adjustment to reduce its South Dakota rate base to reflect the write-off of the regulatory asset previously recorded. The settlement accepts this adjustment.

In addition, OTP proposed an adjustment to test year income taxes and accumulated deferred income taxes to recognize the elimination of the deduction that will occur in 2013. The settlement does not reflect this adjustment. The net effect of this change decreases deferred taxes by approximately $81,000.

Vegetation Maintenance Cycle – OTP proposed an adjustment based on the Company's 2010 budget for vegetation maintenance expenses. The settlement accepts this adjustment with the condition expenses remain at or above the South Dakota 2010 budget amount of $287,728, on average, for the period rates are in effect. If the average is below the South Dakota test year amount at the time OTP files its next application for a rate increase, OTP will make an adjustment to reflect this commitment.

Normalized Storm Repair Expense – The Company proposed an adjustment to normalize storm repair expenses based on the five-year average of actual Company experience. The settlement accepts this adjustment.

Reduction in Capacity Costs - The Company proposed an adjustment to reflect the costs of purchase capacity agreements for the upcoming years at prices lower than were incurred in the test year. The settlement revises the Company's adjustment to reflect the actual contract price for one agreement in lieu of an average capacity cost. The adjustment reduces operating expenses by approximately $1,000.

Schedule 26 Expenses Collected in Transmission Rider - The Company proposed an adjustment to remove the MISO Schedule 26 costs from the test year and filed to recover those costs in Docket EL10-015, In The Matter Of The Petition Of Otter Tail Power Company To Establish A Transmission Cost Recovery Tariff. The settlement accepts this adjustment.

Remove Minor Affiliate Transactions – The Company proposed an adjustment to remove affiliate transaction costs from the test year. The settlement accepts this adjustment.

Wind Removal and Wind In – The Company proposed an adjustment to remove all costs related to the Langdon Wind Energy Center, the Ashtabula Wind Energy Project, and the Luverne wind farm to start with a "clean" rate base and operating income statement from the actual test year (Wind Removal). The Company then proposed an adjustment to include the 2010 projected wind-related costs for these three wind farms (Wind In). The wind removal adjustment represents a full year of costs for the Langdon Wind Energy Center and the Ashtabula Wind Energy project and partial costs for the Luverne wind farm (in-service September 2009). The settlement does not reflect either of these adjustments. The net effect of these adjustments reduces operating expenses by approximately $1,045,014.

Luverne Wind Farm - The settlement removes all actual test year costs related to the Luverne wind farm. The adjustment is necessary because the parties are unable to reach a resolution regarding the ratemaking treatment for the facility. The adjustment reduces operating expenses by approximately $111,000. However, as noted above, the parties have agreed to the additional adjustments that are required if the Commission should decide that Luverne wind farm costs are to be recovered.

Change in Allocation Factors Due to Effect of Removing Luverne - The settlement reflects minor changes in the per books and pro forma allocation factors due to the removal of all actual test year costs related to the Luverne wind farm. The adjustment increases operating expenses by approximately $1,000.

Changes In Allocation Factors Due To Effect Of Test Year Adjustments - OTP proposed an adjustment to synchronize the secondary allocation factors, mainly net plant in service, with the Company's proposed other adjustments to rate base and operating income. The settlement recognizes the need for and therefore reflects such synchronizing adjustments.

Economic Development – The settlement removes one-half of the South Dakota economic development expense from the test year. The economic development expense primarily covers the labor cost of one employee whose time is allocated between Minnesota and South Dakota. This adjustment shares the expense equally between ratepayers and shareholders. The adjustment reduces operating expenses by approximately $11,000.

Advertising – The settlement removes all expenses for promotional advertisements and safety advertisements not related to electric safety. The adjustment reduces operating expenses by approximately $3,000.

Association Dues – The settlement eliminates approximately $1,000 in dues paid to organizations which promote social and economic development activities.

BSP Capitalized Items – The settlement removes the tax-related Schedule M amortization related to the Big Stone Capitalized Costs that were fully amortized. The adjustment reduces operating expenses by approximately $2,000.

Asset Based Margins - The settlement eliminates all revenues and expenses related to asset based sales from the test year. As a result, no amount of asset based margins will be reflected in base rates. One hundred percent of the South Dakota jurisdictional share of asset based margins will be credited to the fuel adjustment clause rider. The adjustment reduces other electric revenues by approximately $1,081,000 and production expense by approximately $832,000.

Emission Allowances - The settlement removes the gain on the sale of emission allowances from the test year. One hundred percent of the South Dakota jurisdictional share of the gain on the sale of emission allowances will be credited to the fuel adjustment clause rider. The adjustment reduces other electric revenue by approximately $2,000.

Ancillary Service Market - In Docket EL08-035 the Commission allowed the pass-through of MISO ASM charges and revenues through Xcel's fuel clause rider. The settlement removes the revenues and costs related to the MISO ancillary service market transactions from the test year. As a result, one hundred percent of South Dakota margins will be credited to the fuel adjustment clause rider. The net effect of this adjustment increases operating expenses by approximately $27,000.

Spousal Travel – The settlement removes travel related expenses of employee spouses in the amount of approximately $1,000.

Aircraft Expense Related to Lobbying – The settlement removes aircraft expenses for travel related to lobbying in the amount of approximately $1,000.

MISO Attachment O Revenue - The settlement reflects additional revenue the Company will receive related to the annualized 2009 transmission plant additions and the post-test year transmission plant additions included in the pro forma test year. The adjustment increases other operating revenues by approximately $10,000.

Purchase Card Program - The settlement reflects a rebate the Company received from the bank regarding its spending volume on a purchase card program. The adjustment reduces operating expenses by approximately $2,000.

Management Incentive Compensation – OTP included actual costs related to the 2009 payout level, plus some carryover from 2008, adjusted to remove any amounts over a 25 percent cap on individual employee incentives based on 2009 compensation levels. The settlement normalizes costs based on actual payouts for performance indicators other than financial for the period of 2005 through 2009. Shareholders are the primary beneficiaries of incentive plans that promote the financial performance of the Company and therefore should be responsible for the cost of such compensation. The net effect of these changes reduces operating expenses by approximately $25,000.

Test Year Flow-Through Repair Allowance Deduction - For financial reporting purposes, utilities are required to capitalize certain repair expenditures and to depreciate the related costs over the remaining lives of the repaired facilities. In 2009, OTP requested and received permission from the IRS to expense certain repair expenditures for tax purposes. As a result the Company claimed a current tax deduction for the costs of the repairs, which results in a reduction in OTP's income tax liability for 2009 and beyond.

OTP's filing reflected the "normalization" treatment of the tax/book timing difference created when OTP was allowed to expense repair costs for income tax purposes. (OTP is still required to capitalize the repair costs for financial reporting purposes.) Under the normalization treatment, the reduction in OTP's income taxes currently payable is reversed for ratemaking purposes, through the creation of an allowance for deferred income taxes. The process of recording deferred income taxes, in effect, spreads the tax reduction that OTP received in 2009 over the remaining lives of the repaired facilities.

The settlement reflects the "flow-through" treatment which passes on to South Dakota ratepayers, in 2009, the tax benefit OTP received by claiming the tax deduction on its 2009 tax return. That is, under the settlement flow-through treatment, South Dakota ratepayers receive an immediate benefit from OTP's tax deduction rather than waiting to receive the benefit over the remaining lives of the repaired facilities. The adjustment reduces operating expenses by approximately $305,000.

Remove Fuel Adjustment Clause Revenue and Expense - Currently the Company has a two-part factor to recover pertinent fuel clause adjustment expenses via base rates and through the monthly fuel clause adjustment. The settlement removes all applicable revenues and costs allowed for recovery in the fuel adjustment clause from the cost of service and allows the Company to recover all applicable revenues and costs through the one-part fuel adjustment cost factor. The net effect of these changes reduces retail revenues by approximately $10,358,000 and operating expenses by the same amount.

Renewable Energy Credits - In Dockets EL09-029 (Xcel) and EL09-018 (BHP) the Commission ordered ninety percent of the South Dakota state jurisdictional share of revenues generated by the sale of renewable energy credits shall be credited to customers through the fuel adjustment clause. The settlement reflects this same treatment. It also reflects that ninety percent of the 2010 South Dakota renewable energy credits revenue shall be credited to the fuel adjustment clause in 2011 in the amount of approximately $49,000.

COST OF CAPITAL AND RATE OF RETURN

OTP's proposed rate increase was established to produce a 9.13% rate of return on its claimed rate base. The 9.13% rate of return reflected a capital structure consisting of 53.2% common equity capital and 46.8% long term debt. The structure is derived from its experience in 2009 following the July 1 creation of the Otter Tail Corporation holding company and represents OTP's prospective capitalization. Application of an adjusted post-reorganization embedded long-term debt cost of 6.71% and a claimed common equity return of 11.25% to the capital structure yielded the proposed 9.13% overall rate of return on rate base. Staff's assessment of the settlement reflects an 8.50% rate of return on average rate base, derived from ***Begin Confidential End Confidential***

RATE DESIGN ISSUES

The parties agree in principle on all issues regarding rate design and the class revenue distribution. Tariffs will be filed with the Commission after a decision is rendered on the Luverne wind farm. Staff concurred with the changes made by OTP for all rate schedules except for Farm Service, General Service – 20 kW and greater, and Large General Service. The settlement position reached between Staff and OTP will be discussed below.

Spread of the Increase – OTP prepared a South Dakota jurisdictional and a class cost of service study. The class cost of service study showed the return earned from the General Service and Large General Service rate classes are higher than from the other rate classes, including the Residential and Farm classes. Ordinarily, such a result indicates a somewhat larger than average increase for the Residential and Farm Service rate classes. Due to, however, the inherent uncertain nature of all class cost studies, the load data upon which they rely and the legitimate goal of gradualism in rate design, OTP proposed to moderate the increases to the Residential and Farm classes. The settlement does not adopt all of the results embodied in OTP's class cost study. Rather, it reflects a proportional scaling back of OTP's proposed class rate increases to maintain the moderation approach reflected in OTP's filed rates. See Exhibit A and Exhibit B attached to the Settlement Stipulation.

Farm Service – OTP proposed to increase the customer charge by $5.00 from $8.00 to $13.00. While the cost analysis performed by the Company supports this increase, the settlement reflects a $1.00 increase to $9.00. Staff supports moderate increases to the monthly service charge to allow customers to adapt.

General Service – 20 kW and greater – OTP proposed a new seasonal demand charge for this schedule. In its last rate case, OTP added a new facilities charge. Staff has concerns the combination of a facilities charge and a demand charge may cause customer confusion, and it would be simpler to have either a facilities charge or a demand charge. The settlement adds a seasonal demand charge and eliminates the facilities charge.

Large General Service – OTP proposed to increase the winter demand charge by approximately 115% to $6.13 per kW for secondary customers. Prior to the last rate case, Docket EL08-030, the demand charge was $7.05 per kW for the first 100 kW of demand and $5.15 per kW for the excess. In Docket EL08-030, the winter demand charge was reduced to $2.85 per kW. OTP now proposed a winter demand charge of $6.13. Staff has concerns regarding rate stability as customers could have modified their usage based on those price signals provided less than two years ago. The settlement reflects a winter demand charge of $4.63, cutting the increase in half.

Rate Schedules & Bill Impacts – The rate schedules reflecting settlement rates without the Luverne wind farm are on Exhibit_(BAM-2), Schedule 2-1 through Schedule 2-10. The comparison between present and settlement rates for the residential service and farm service rate schedules is shown on Exhibit_(BAM-2), Schedule 3.

The rate schedules reflecting settlement rates with the Luverne wind farm included are on Exhibit_(BAM-3), Schedule 2-1 through Schedule 2-10. The additional revenue needed to recover the costs of the Luverne wind farm is mainly collected through the energy charges of each rate schedule. Customer charges, facility charges, and demand charges are set at the same level as the rates without the Luverne wind farm.

OTHER ISSUES

Vegetation Management – Commission Staff concurs with OTP's requested recovery of expenses for vegetation management with the provision expenses remain at or above the South Dakota 2010 budgeted amount of $287,728, on average, for the period rates are in effect. If the average is below the South Dakota test year amount at the time OTP files its next application for an increase in rates, OTP will make an adjustment to reflect this commitment.

Big Stone II Tracking Mechanism – The Settlement Stipulation amortizes the cancelled Big Stone II plant costs over ten years; includes one-half of the amortizable costs, representing the average unamortized balance over the ten-year period in rate base; and implements a tracking mechanism for the recovery of costs so that the Company neither over recovers nor under recovers these costs. The South Dakota annual amortization expense is $100,332 and the amount included in rate base is $501,662.

Renewable Energy Credit 2010 Revenue - Ninety percent of the South Dakota 2010 renewable energy credits revenue shall be credited to the fuel adjustment clause rider in the month following the Commission's approval of the Settlement Stipulation in the amount of $49,070.