

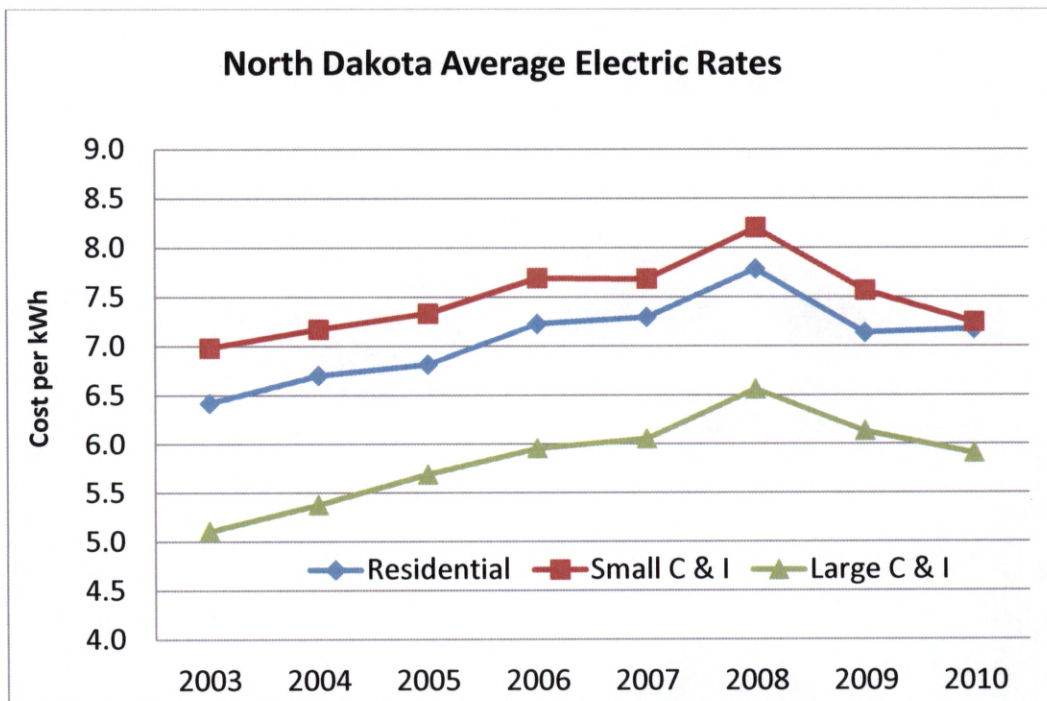
Memorandum

To: Commissioners
CC: PUD, Illona, Pete Biethon
From: Mike Diller
Date: April 27, 2012
Re: Close OTP's 2005 – 2011 Electric Annual Reports
(Case Nos. PU-06-180, PU-07-174, PU-08-190, PU-09-578, PU-10-146 & PU-11-159)

I have reviewed Otter Tail Power Company's Electric Annual Reports and recommend the above referenced cases be closed in accordance with commission policy 5-05-97. I am providing this to Pete Biethon in the event OTP would like to comment on my recommendation. After sufficient time has passed to receive comments, staff will prepare a motion to close the cases.

Rates

OTP Electric consumers have enjoyed a long period of stable "base" rates. Aside from OTP's 3.04% increase granted at the end of 2009, OTP's base rates have not increased since 1982. However, rates are also impacted by riders such as the cost of energy adjustment, renewable energy rider and the abandonment costs of Big Stone 2. The following chart takes into consideration all changes impacting rates by depicting total revenues divided by total kWh's sold for each customer class.



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5 PU-10-146 Filed 04/27/2012 Pages: 6
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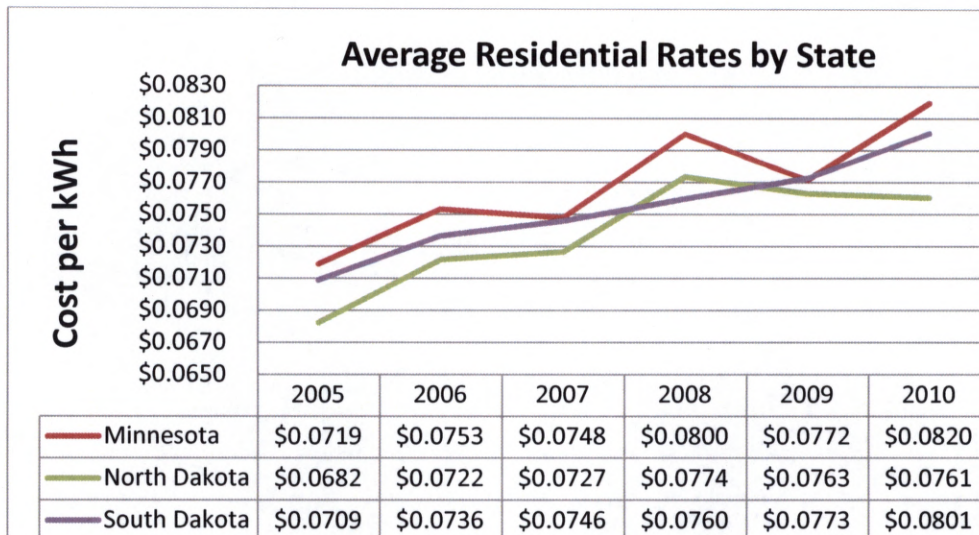
4 PU-09-578 Filed 04/27/2012 Pages: 6
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4 PU-08-190 Filed 04/27/2012 Pages: 6
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3 PU-07-174 Filed 04/27/2012 Pages: 6
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5 PU-06-180 Filed 04/27/2012 Pages: 6
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Another way to compare rates is to look at the average rates by state within the same company.



The following compares OTP's rates with other North Dakota retail suppliers.

North Dakota Public Service Commission
 Average Retail Price in North Dakota (cents/kWh)
 Total Revenues Divided by Total Sales as Reported to EIA

| Rank | Power Suppliers | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|------|------------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| 1 | City of Hope | 5.59 | 9.05 | 5.03 | 5.45 | 4.65 | 5.18 | 5.89 |
| 2 | City of Sharon | 5.67 | 5.56 | 6.32 | 7.36 | 8.27 | 6.81 | 6.07 |
| 3 | City of Hillsboro | 4.51 | 4.65 | 5.14 | 5.13 | 5.72 | 6.36 | 6.32 |
| 4 | City of Valley City | 4.52 | 4.57 | 5.06 | 5.30 | 5.72 | 5.97 | 6.39 |
| 5 | City of Lakota | 4.25 | 4.26 | 5.14 | 5.13 | 5.67 | 6.29 | 6.54 |
| 6 | City of Maddock | 6.76 | 6.08 | 6.67 | 6.85 | 6.07 | 6.00 | 6.83 |
| 7 | Roughrider Electric Cooperative | | | | 7.06 | 5.32 | 6.21 | 6.96 |
| 8 | McKenzie Electric Coop Inc | 5.83 | 5.67 | 6.04 | 7.28 | 6.22 | 6.18 | 7.06 |
| 9 | City of Cavalier | 5.14 | 5.74 | 5.74 | 6.27 | 6.79 | 7.40 | 7.16 |
| 10 | Mountrail-Williams Elec Coop | 6.47 | 6.26 | 6.16 | 6.06 | 6.49 | 6.73 | 7.17 |
| 11 | Lower Yellowstone R E A, Inc | 7.94 | 7.80 | 7.36 | 7.01 | 6.34 | 7.22 | 7.28 |
| 12 | Slope Electric Coop Inc | 4.62 | 4.50 | 4.35 | 4.82 | 4.59 | 5.67 | 7.28 |
| 13 | North Central Elec Coop, Inc | 6.44 | 6.47 | 6.53 | 6.48 | 6.89 | 7.22 | 7.30 |
| 14 | City of Northwood | 5.88 | 6.34 | 6.82 | 7.52 | 7.07 | 7.47 | 7.49 |
| 15 | Northern Plains Electric Coop | 6.15 | 6.24 | 6.25 | 6.30 | 6.44 | 6.87 | 7.53 |
| 16 | Sheridan Electric Coop, Inc | 8.29 | 8.39 | 8.22 | 8.04 | 7.72 | 8.57 | 7.61 |
| 17 | Montana-Dakota Utilities Co | 6.55 | 6.47 | 6.83 | 6.66 | 7.35 | 6.83 | 7.71 |
| 18 | Otter Tail Power Co | 6.19 | 6.66 | 6.72 | 5.40 | 7.16 | 6.90 | 7.72 |
| 19 | Dakota Valley Elec Coop Inc | 5.08 | 5.13 | 5.08 | 5.09 | 5.24 | 5.84 | 8.00 |
| 20 | Northern States Power Co | 5.69 | 6.44 | 6.46 | 6.58 | 7.33 | 7.14 | 8.14 |
| 21 | Capital Electric Coop, Inc | 7.12 | 7.00 | 6.96 | 7.01 | 7.02 | 7.37 | 8.16 |
| 22 | City of Stanton | 5.74 | 5.54 | 5.76 | 5.56 | 5.83 | 6.30 | 8.18 |
| 23 | Nodak Electric Coop Inc | 5.39 | 5.70 | 5.46 | 5.64 | 5.69 | 6.23 | 8.37 |
| 24 | Burke-Divide Electric Coop Inc | 7.36 | 7.37 | 7.37 | 7.99 | 8.52 | 8.88 | 8.39 |
| 25 | Grafton City of | 5.17 | 5.29 | 5.29 | 5.71 | 6.54 | 6.92 | 8.44 |
| 26 | Verendrye Electric Coop Inc | 5.76 | 5.71 | 5.70 | 5.81 | 6.05 | 6.46 | 8.44 |
| 27 | City of Park River | 5.92 | 6.04 | 6.31 | 6.78 | 6.74 | 7.69 | 8.58 |
| 28 | Traverse Electric Coop, Inc | 7.84 | 7.52 | 7.93 | 8.11 | 8.14 | 8.83 | 8.78 |
| 29 | Cass County Electric Coop Inc | 6.14 | 6.29 | 6.45 | 6.70 | 6.71 | 7.20 | 9.29 |
| 30 | City of Riverdale | 5.65 | 5.84 | 6.46 | 5.39 | 4.15 | 8.05 | 9.54 |
| 31 | McLean Electric Coop, Inc | 7.37 | 7.37 | 7.53 | 6.12 | 6.60 | 7.17 | 9.55 |
| 32 | Cavalier Rural Elec Coop, Inc | 7.19 | 7.60 | 8.07 | 8.54 | 8.61 | 8.33 | 9.63 |
| 33 | KEM Electric Coop Inc | 8.15 | 7.98 | 7.95 | 7.82 | 8.69 | 8.58 | 9.86 |
| 34 | Goldenwest Electric Coop, Inc | 8.77 | 8.57 | 8.30 | 8.23 | 8.27 | 8.71 | 10.49 |
| 35 | Mor-Gran-Sou Electric Coop Inc | 7.48 | 7.51 | 8.18 | 8.25 | 9.42 | 10.55 | 11.96 |
| 36 | Oliver-Mercer Elec Coop Inc | 5.78 | 5.66 | 5.44 | | | | |
| 37 | West Plains Electric Coop Inc | 6.24 | 6.20 | 5.61 | 5.74 | | | |

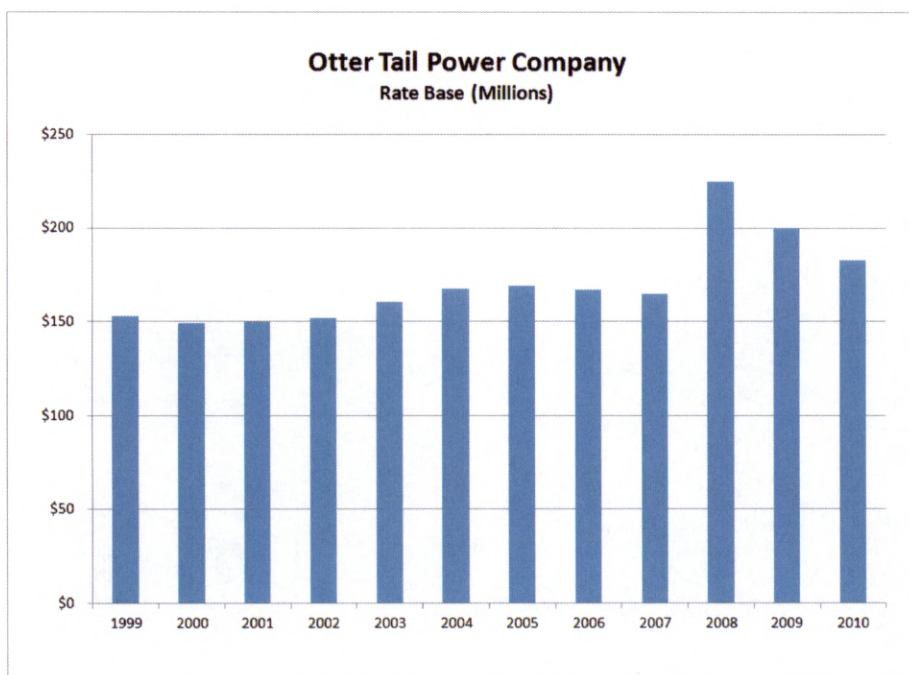
As you can see, OTP was 21st out of 36 reporting electric providers in North Dakota in 2004. Based on the most recent available year end data from the US Energy Information Administration, OTP has improved to the 18th position out of 35 reporting and just behind Montana-Dakota Utilities Co.

Cost of Service

Rates are designed to cover the cost of providing electric service. The cost of providing electric service includes 3 primary components including rate base, cost of capital and operating expenses.

Rate Base

OTP's investments in wind generation facilities in 2008 (Langdon and Ashtabula) and 2009 (Luverne) have caused an increase above recent rate base levels. You will note however that the rate base has fallen fairly quickly since then due to the favorable tax laws and grants of the federal and state governments. In the future, new and upgraded transmission facilities and environmental upgrades to coal generation facilities will continue to put pressure on rate base.

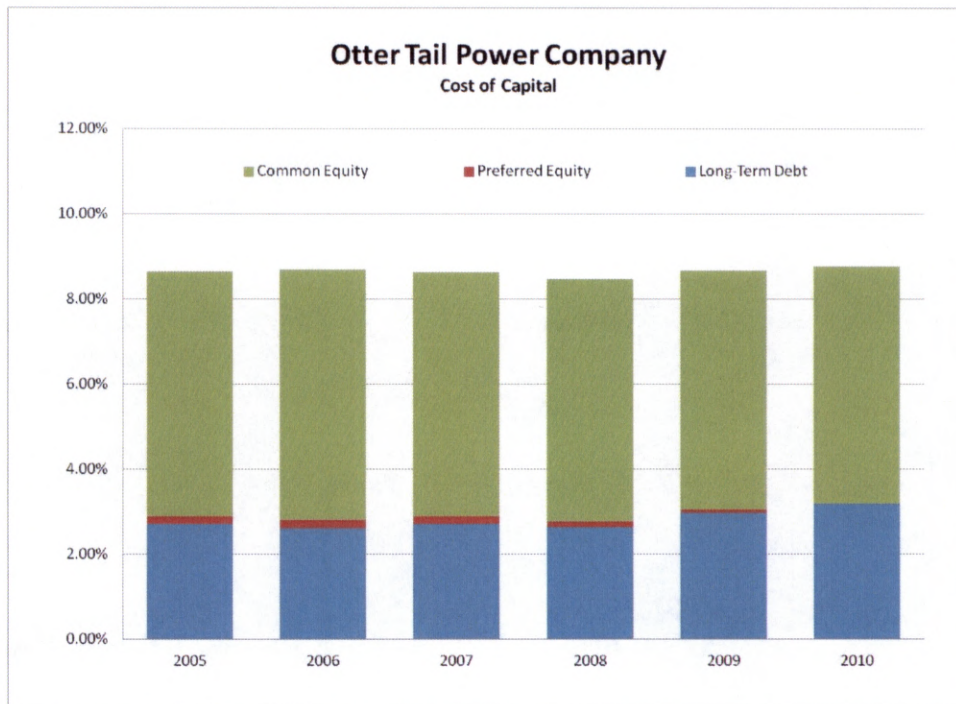


Following is a summary of the specific components of rate base.

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|--------------------------|------------------|------------------|------------------|------------------|------------------|------------------|
| Plant in Service | \$372,329 | \$372,386 | \$382,742 | \$450,702 | \$520,856 | \$553,633 |
| Accumulated Depreciation | (175,240) | (181,930) | (188,379) | (189,466) | (202,328) | (217,581) |
| Net Plant in Service | \$197,089 | \$190,456 | \$194,363 | \$261,236 | \$318,528 | \$336,052 |
| Deferred Income Taxes | (31,645) | (29,502) | (30,838) | (39,235) | (65,893) | (87,789) |
| Other Rate Base Items | 3,623 | 6,070 | 1,546 | 2,618 | 12,110 | 317 |
| Total Rate Base | \$169,067 | \$167,024 | \$165,071 | \$224,619 | \$264,745 | \$248,580 |

Cost of Capital

Assuming a 10.75% cost of equity rate last approved by the commission, the following chart depicts the recent changes in Otter Tail Power's overall weighted cost of capital.



As can be noted above, the overall cost of capital has remained fairly constant over the past several years. Note that preferred equity was moved to the corporate level when Otter Tail Power Company became a subsidiary of the newly formed holding company of Otter Tail Corporation, effective July 1, 2009, and therefore preferred equity is no longer included in the capital structure of the utility company.

Because both entities would begin receiving their own debt ratings, Staff agreed with the formation of the holding company as it would likely improve the debt rating of Otter Tail Power Company and therefore lower the cost of future debt. According to Otter Tail's recently published 2011 annual report to stockholders, Otter Tail Power Company does enjoy a better senior unsecured debt rating than does Otter Tail Corporation. However, the ratings are quite low for both the holding company and Otter Tail Power possibly negating some of the anticipated benefits.

The company issued utility debt to replace the preferred stock that was moved to the holding company level. The issued debt rate was higher than the preferred equity but interest expense is deductible for tax purposes whereas preferred equity dividends are not. Therefore, after giving consideration to the tax impact, ratepayers were unaffected by the transaction.

Overall, staff remains concerned with the debt ratings of both the utility operations and the holding company given the large capital expenditures expected to take place over the next few

years. While separate ratings now exist between regulated and non-regulated, equity for these expansions will come from the holding company.

Net Income

Following is a summary of Otter Tail Power's net income for the past 6 years:

| <u>Description</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>2010</u> |
|------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Total Operating Revenues | \$158,348 | \$117,078 | \$121,095 | \$132,109 | \$128,282 | \$128,672 |
| Production | 94,978 | 54,865 | 62,107 | 59,686 | 52,450 | 52,494 |
| Gross Margins | \$63,370 | \$62,213 | \$58,988 | \$72,423 | \$75,832 | \$76,178 |
| Transmission | 3,020 | 3,891 | 4,108 | 4,341 | 4,414 | 4,839 |
| Distribution | 5,243 | 5,734 | 6,462 | 6,580 | 6,395 | 7,056 |
| Customer Accounting | 3,937 | 4,201 | 4,545 | 4,776 | 4,873 | 5,101 |
| Cust. Service and Info. Exp. | 1,089 | 1,143 | 1,153 | 1,236 | 999 | 998 |
| Sales Expense | 655 | 611 | 629 | 549 | 486 | 542 |
| Admin. and General | 14,152 | 13,066 | 12,294 | 12,969 | 13,100 | 13,550 |
| Charitable Contributions | 0 | 0 | 0 | 0 | 0 | 0 |
| Depreciation Expense | 9,637 | 10,042 | 10,157 | 12,326 | 14,645 | 16,202 |
| General Taxes | 4,130 | 3,780 | 3,711 | 3,613 | 3,653 | 3,924 |
| Net Income Before Taxes | \$21,507 | \$19,745 | \$15,929 | \$26,033 | \$27,267 | \$23,966 |
| Income Tax | 5,137 | 5,583 | 4,046 | 5,946 | 2,957 | 2,886 |
| Net Income | \$16,370 | \$14,162 | \$11,883 | \$20,087 | \$24,310 | \$21,080 |

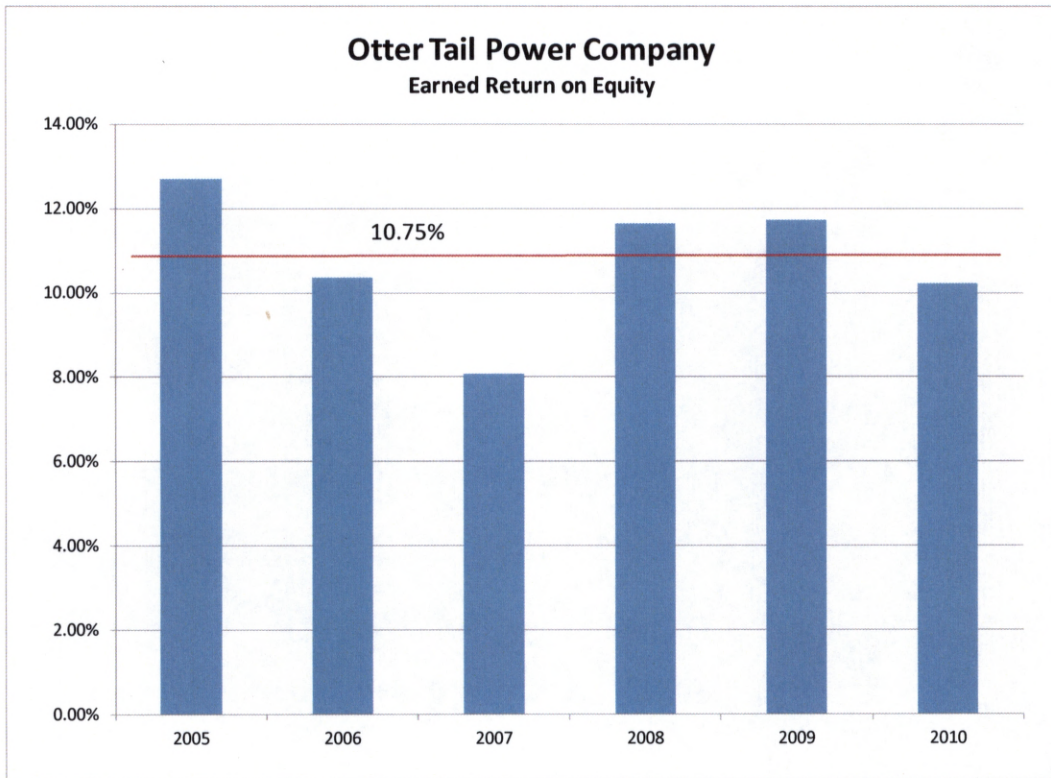
Operating Revenues and Production costs are reviewed together in a Gross Margin analysis to wash out the larger pass through costs of fuel and market power purchases. A new level of gross margins begins in 2008 and forward due primarily to the wind rider and the rate increase granted in 2009.

You can also note a significant increase in depreciation expense which is directly related to the three new wind farms brought on line in 2008 and 2009. Similarly related to the wind farms is a significant reduction in income tax expense during the past two years as a percentage of income due to favorable tax treatments of such facilities.

Revenue Deficiency

The following revenue deficiency calculation provides a summary of the primary rate components and an overall view of the financial health of Otter Tail Power Company in terms of earning its authorized return. I have assumed the last authorized return on equity of 10.75% for this presentation.

| | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>2010</u> |
|-----------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Rate Base | \$169,067 | \$167,024 | \$165,071 | \$224,619 | \$264,745 | \$248,580 |
| Cost of Capital | 8.64% | 8.69% | 8.62% | 8.47% | 8.67% | 8.76% |
| Return Required | \$14,608 | \$14,512 | \$14,223 | \$19,016 | \$22,956 | \$21,765 |
| Net Income | 16,370 | 14,162 | 11,883 | 20,087 | 24,310 | 21,080 |
| Return Excess (Deficiency) | \$1,762 | (\$350) | (\$2,340) | \$1,071 | \$1,354 | (\$685) |
| Income Tax Factor 1/ | 1.654 | 1.654 | 1.645 | 1.645 | 1.644 | 1.644 |
| Revenue Excess (Deficiency) | \$2,914 | (\$578) | (\$3,849) | \$1,762 | \$2,226 | (\$1,126) |



Recommendation to Close Cases

Staff has reviewed the 2005 through 2010 annual reports and recommends the cases be closed. During this time period, a rate increase application was filed in 2009 which has been heard and ordered on by the commission. The review conducted during the rate case along with this filing is sufficient to recommend closing these annual reports.