

Memorandum

To: Darrel Nitschke, Director of Administration
CC: Commissioners, Legal Division, Bruce Gerhardson
From: Mike Diller *MRD*
Date: September 5, 2008
Re: Holding Company Structure Application (PU-08-292)

Staff agrees with Otter Tail Corporation's proposal to form a new holding company. The commission and its staff have had many discussions about "ring fencing" or the idea of protecting utility assets and operations from the potential failures of unregulated business activities within the same corporation. This proposal will remove Otter Tail Power Company (OTP) as a division of Otter Tail Corporation and include it as a first tier subsidiary of the new holding company.

The reorganization will create legal separation from the parent company and result in a more secure utility operation. The legal separation will allow for OTP to issue its own long-term debt; maintain its own capital structure; protect OTP and its ratepayers from non-regulated financial risks; and will make the allocation of corporate wide services and costs easier to track and review. Staff recommends approval.

Other Considerations

While staff is recommending approval of the application, it recognizes that there are issues that will need to be addressed in Otter Tail's next rate increase application. For instance, what is the appropriate cost of capital after restructuring is complete? Should we be concerned about double leveraging or the idea that a holding company can borrow money at one rate and then capitalize it as higher cost equity capital at the utility subsidiary level? Because the utilities capital structure can be easily altered through dividend payments to the holding company or equity infusions from the holding company, what is the appropriate capital structure?

Staff is pleased with Otter Tail's commitment to giving ratepayers full consideration of its low cost preferred stock even though it will now be booked at the holding company level. The issuance of preferred stock originated with the utility business and should be considered, at least theoretically, as part of the utility capital structure in future rate proceedings.

Staff is not opposed to a 5 year amortization of reorganization costs, beginning with the close of the transaction, as long as the costs are allocated across the entire corporation and not born solely by the electric ratepayers. It could be argued that the creation of a holding company is only necessary because of the Company's diversification into unregulated activities and therefore no costs should be assigned to ratepayers. It could also be argued that most of the benefits of forming a holding company now accrue to the benefit of electric ratepayers. Staff's recommendation takes into consideration both arguments and recommends a company-wide allocation of reorganization costs. Staff recommends that the Company explain why this transaction costs \$1.1 million and disclose how the costs will be allocated to its electric operations.

Last, staff does not believe that OTP needs to provide customer notification to its North Dakota ratepayers. The change in corporate structure will not affect rates or the regulation of Otter Tail Power Company. Accordingly, staff counsel Annette Bendish concludes:

I recognize the reference to "merger" in the filing but, it is my opinion that this isn't a merger in the true sense of the word as used in 69-02-04-01 that would require customer notice. The application submitted to the Commission is an application to form a new holding company and the change will be relatively seamless to customers. I am concerned that if bill inserts are used it will cause unnecessary alarm to customers. I agree that a notice of opportunity for hearing would be adequate in this situation.