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VIA E-FILE AND U.S. MAIL

June 23, 2010

Darrell Nitschke
Director of Administration/Executive Secretary
North Dakota Public Service Commission
State Capital
600 East Boulevard, Dept. 408
Bismarck, ND 58505-0480

RE: In the Matter of Otter Tail Power Company's 2010 Renewable Resource Cost Recovery Adjustment Factor Tariff NDPSC Case No. PU-10-18

Dear Mr. Nitschke:

Enclosed for filing please find an original and seven copies of Otter Tail Power Company's ("Otter Tail") Reply Comments in the above-referenced matter.

Also enclosed is a Certificate of Service. Copies will follow by U.S. mail.

Please refer all inquiries regarding this filing to Bruce Gerhardson at (218) 998-7108 or at bgerhardson@otpco.com.

Yours very truly,

Bruce Gerhardson
Associate General Counsel

Enclosures

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Reply Comments

Otter Tail Power Company

Bruce Gerhardson, Associate General Cnsl

STATE OF NORTH DAKOTA
PUBLIC SERVICE COMMISSION

In the Matter of Otter Tail Power Company's
2010 Renewable Resource Cost Recovery
Adjustment Factor Tariff

Case No. PU-10-18

OTTER TAIL POWER COMPANY REPLY COMMENTS

These Reply Comments respond to the Comments of the Large Industrial Group ("LIG"), filed in the above-referenced matter on May 12, 2010.

OTP confirms that it is continuing to discuss with the LIG the issues identified in the LIG's Comments. As reflected in these Reply Comments, three of the four issues raised by the LIG have been resolved. While OTP is hopeful that a settlement of all issues in dispute may be possible, a settlement has not yet been reached on the final issue. OTP will inform the Commission as soon as possible if a resolution is reached. OTP agrees with the LIG that the final issue remaining in dispute does not involve issues of material fact. Therefore, OTP agrees with the LIG that the final remaining issue can be resolved through an informal hearing (if not previously resolved by the parties).

A. Issues Discussed in the LIG's Comments.

The LIG discusses four issues in its Comments:

LIG Issue 1: Whether OTP should review the calculation of the North Dakota Investment Tax Credits ("ND ITC") associated with the Luverne Wind Project to determine if the project might qualify for a larger credit;

LIG Issue 2: Whether the ND ITC associated with the wind projects should be credited to the Rider as those credits are used on OTP's tax returns instead of amortizing them over the life of the projects—or, in the alternative, whether the unamortized balance of ND ITC should be reflected as a reduction to rate base;

LIG Issue 3: Whether OTP should continue to review the inter- and intra-class allocations for the Rider; and

LIG Issue 4: Whether OTP should provide information on the OTP website explaining the components of the Resource Adjustment line of customer bills.

B. OTP's Response to LIG's Issues.

OTP and the LIG have reached agreement on three of the four LIG Issues and are continuing to discuss whether they can reach agreement on the fourth issue. As explained herein, OTP has agreed to recalculate the ND ITC based on the total value of the Luverne Project (LIG Issue 1). OTP has also agreed it will continue to consider and discuss in future annual Rider filings the MISO capacity accreditation and any changes thereto, as that accreditation currently forms the basis for the inter- and intra-class allocations for the Rider (LIG Issue 3). OTP has also agreed it will make available on its Company website information on the components of the **Energy and Renewable adjustment** line of customer bills (LIG Issue 4).

For the reasons further explained herein, OTP does not, however, agree to pass through the ND ITC as the credit is received (LIG Issue 2). Instead, OTP has amortized the ND ITC and reflects any unamortized balance of the ND ITC as a reduction to rate base in the Rider, which the LIG suggests in its Comments as an acceptable treatment of the ND ITC. As referenced above, OTP is discussing the issue with LIG with the hopes of explaining how OTP's approach is consistent with the LIG's recommendation. If OTP's explanation does not resolve the issue for the LIG, this should be the only issue that requires resolution by the Commission.

B1. Response to LIG Issue 1: Calculation of ND ITC for Luverne.

OTP agrees with the LIG that the ND ITC should be calculated based on the gross amount of the Luverne Investment (the amount of the investment prior to application of the Federal Grant). OTP identified this issue previously, investigated it, and from that investigation concluded that the ND ITC should be increased to reflect 100 percent of the project costs, prior to the application of the Federal grant. The 2009 North Dakota tax return will be the first return that includes the calculation of this tax credit, because 2009 was the year the Luverne project was placed in service. OTP will reflect the effect of this increase of the credit in its Compliance filing and reduce its proposed 2010 RRA accordingly.

B2. Response to LIG Issue 2: Timing for Reflecting ND ITC in Rider Rates.

The LIG makes two alternative recommendations with respect to the timing for reflecting the ND ITC in Rider Rates. The LIG first recommends that the ND ITC should reduce the revenue requirements in each year the ITC is received (i.e. able to be used on OTP's North Dakota income tax returns). The LIG recommends, in the alternative, that if the ND ITC is to be amortized over the life of each project that the amount of ND ITC received but not yet amortized should be reflected as a reduction to rate base. The LIG's Comments fail to recognize, however, that OTP has calculated its Rider revenue requirements consistent with this alternative recommendation. For that reason, the LIG's assumption that OTP is able to earn on the unamortized balance is incorrect. In this response, OTP will first explain why the LIG's first recommendation (crediting revenue requirements at the ND ITC is received) would not be appropriate. The response will then explain how OTP's revenue requirement calculation is consistent with the LIG's alternative recommendation.

A. Crediting the ND ITC to revenue requirements as it is received would not be appropriate.

The North Dakota Investment Tax Credit (ND ITC) has been properly amortized over the life of the projects to which it applies, and altering that amortization to give all ND ITC benefits to the customers only in the years it is received would result in an unfair intergenerational transfer that would unfairly discriminate against future customers in favor of current customers. OTP's amortization of the ND ITC over the life of the projects is consistent with the purpose and application of the credit and consistent with the traditional ratemaking approach to such credits, and it does not result in OTP earning a return on the amount of ITC received but not yet applied to the Rider rate (as was claimed in the LIG's Comments).

For background, the ND ITC is a tax credit of 3 percent of the project investment that applies to OTP's North Dakota state tax obligations in each of the first five years after construction. The ITC can be carried forward if OTP does not have sufficient taxable earnings in those first five years. The purpose of the ND ITC is to incentivize investments in the state of North Dakota. It should be noted that because OTP is eligible for other tax credits, such as the Federal Production Tax Credit, the ND ITC for these projects is not useful to OTP in current tax years. Instead it will be carried forward for use in future years.

In support of its recommendation to reflect in rates the ND ITC as it is received, the LIG cites OTP's treatment of the Federal Production Tax Credit (PTC) in the Rider rate calculation; OTP is applying the Federal PTC as received pursuant to the Commission's Orders in Cases No. PU-08-742 & PU-06-466. However, the PTC is, as it sounds, a *production* credit based on annual renewable energy production in the first ten years—its purpose is to incentivize renewable energy production sooner rather than later. In contrast, the ND ITC is an *investment* tax credit intended to incentivize investment in North Dakota projects by reducing the cost of the projects built in North Dakota. Thus, the ND ITC is based on the value of the investment (not on energy production in any particular time frame). Because the investment to which the ND ITC applies is paid for by the OTP customers during the entire 25-year life of the projects, it would be inconsistent to give all the credit for the reduction in the cost of the project to only those customers who happen to pay for the early years of the investment's revenue requirements and none to the customers who pay the revenue requirements in the later years.

Also, the credit-as-received treatment of the PTC has some intergenerational impact (i.e. customers in the first ten years of the projects pay less because they receive all of the PTC, and customers in the last fifteen years pay more because they receive none of the PTC). It would be inappropriate to compound this effect by front-loading the benefit of the ND ITC.[1]

B. OTP's amortization of the ND ITC is consistent with the LIG's alternative recommendation.

The LIG makes an alternative recommendation that the unamortized balance of the ND ITC received by OTP should be applied to reduce rate base. This alternative is precisely what OTP does with the ITC—the unamortized balance is recognized as a reduction to the accumulated deferred income taxes in OTP's rate base.

It appears that the LIG's misunderstanding on this point (that OTP's method results in a reduction to rate base) that leads the LIG to incorrectly conclude in its comments that OTP is "unfairly earn[ing] a return on the difference [between the amount of the ITC reflected on tax returns and the amount reflected in current rates]." OTP is not earning a return on the difference between the annual ND ITC amount received and the amount of the annual amortization. In

[1] In fact, it is this front-loading of the PTC for the Langdon and Ashtabula projects that led to the LIG's comment about why there is a less significant drop in the Luverne revenue requirements in the early years compared to the Langdon and Ashtabula projects. The Langdon and Ashtabula projects are crediting the PTC in the first ten years and are therefore showing reduced revenue requirements in those years, but the revenue requirements will jump in the eleventh year, when the PTC no longer applies to the production from those projects. The Luverne project received the Federal grant instead of the PTC and that was applied as a reduction to the total cost of the investment, therefore there is no significant step-up of revenue requirements at any point during the life of that project.

addition to the amortization of the ND ITC over the life of the projects, OTP establishes a corresponding deferred tax liability that off-sets any rate base differences so that OTP is only earning its return on its actual investment and not on any difference between the ND ITC received and the amount of the amortization.

OTP believes this explanation should satisfy the LIG's concern of OTP's amortization approach, and, as referenced above, it is OTP's hope that the explanation will result in an agreement on this final disputed issue. If it does not, OTP requests that the Commission accept OTP's use of the traditional accounting for these ITCs. Altering the traditionally accepted method would result in an inappropriate intergenerational transfer (in plain English, it would transfer all benefit of the ITC to the customers in the first years to the detriment of customers paying for the project in the later years).

B3. Response to LIG Issue 3: Agreement to Continue Discussion on the Basis for Inter- and Intra-class Allocations for the Rider.

The rate design for the Rider uses a demand and energy charge for Large General Service customers and an energy charge for all other customers based on MISO's capacity accreditation for wind resources. Currently MISO accredits wind capacity at an 8 percent of nameplate. This accreditation is a reduction of MISO's initial accreditation of wind at 20 per cent capacity. It is OTP's understanding that MISO continues to study the appropriate amount of capacity to accredit wind resources in its footprint. OTP has heard that MISO may move from a footprint-wide accreditation study, to a location-by-location study methodology, that could affect the amount of capacity accreditation given to OTP's wind projects. OTP believes that a location-specific approach may be beneficial to OTP's projects given that OTP's projects have much higher availability then wind projects cited in most regions of the MISO footprint. Therefore, OTP agrees with the LIG that its demand/energy allocation factors for renewable should continue to be monitored. Fundamentally, we believe that matching the Rider allocation factors to the capacity accreditation of the generation projects is an appropriate rate design methodology, but given that the industries approach to accreditation is evolving, it will be appropriate to keep the Commission and parties such as the LIG informed of future developments. OTP will do so in its annual Rider Rate filings.

B4. Response to LIG Issue 4: Information on OTP Website to explain components of Energy and Renewable Adjustment Line Item on Customer Bills

OTP agrees that there is value in providing information explaining the rate components of OTP's Energy and Renewable Adjustment billing line item. OTP's current Energy and Renewable Adjustment line is an aggregate of two authorized rates: (1) the Energy Adjustment Rider ("FCA") rate; and (2) the Renewable Rider ("RRA") rate. The RRA is set annually. The FCA changes monthly. OTP agrees that it will be useful to make information on these rates available to customers on the OTP website and to provide other information to explain the resource adjustment line on their bills.

I. Conclusion.

As explained in these Reply Comments, OTP agrees with the LIG on the following three issues: 1) the ND ITC should be calculated based on the gross amount of the Luverne Investment (the amount of the investment prior to application of the Federal Grant); 2) OTP will continue to provide information in future annual filings on capacity accreditation for wind projects; and 3) OTP will make information available to customers on the OTP website to explain the components of the resource adjustment line on their bills. OTP does not agree that any adjustment should be made to its amortization of the ND ITC.

OTP requests that the Commission issue an Order approving OTP's 2010 RRA consistent with these Reply Comments. OTP will file a compliance filing to reflect a recalculation of the RRA consistent with the Commission's Order and taking into account the anticipated implementation for the 2010 RRA (OTP used April 1, 2010 as its anticipated implementation date in the original filing). OTP believes September 1, 2010 will be a reasonable implementation date.

Dated: June 23, 2010

Respectfully Submitted,

OTTER TAIL POWER COMPANY

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CERTIFICATE OF SERVICE

In the Matter of Otter Tail Power Company's
2010 Renewable Resource Cost Recovery
Adjustment Factor Tariff

Case No. PU-10-18

Diane Merz certifies that on the 23rd day of June, 2010, she served a true and correct copy of the attached **Otter Tail Power Company Reply Comments** by e-mailing and U.S. Mail, addressed to the following:

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