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March 1, 2012

Mr. Darrell Nitschke
Director of Administration/Executive Secretary
North Dakota Public Service Commission
600 E Boulevard Ave, Dept. 408
Bismarck, ND 58505

**RE: In the Matter of Otter Tail Power Company's Request for Approval to Revise Its Energy Adjustment Rider to Include Emission Costs
Case No. PU-12-_____**

Dear Mr. Nitschke:

Otter Tail Power Company ("Otter Tail") hereby submits its application to the North Dakota Public Service Commission for approval of Otter Tail's request to revise its Energy Adjustment Rider to include certain specified costs for purchased emission allowances that may be necessary to comply with the Cross-State Air Pollution Rule promulgated by the Federal Environmental Protection Agency. Attachments 1 and 2 are redline and clean versions of Tariff Schedule 13.01, Energy Adjustment Rider. Otter Tail will separately show the cost of any allowances purchased in its monthly Energy Adjustment Rider filings.

Enclosed is an original and seven copies and a check for \$50.00 to cover the miscellaneous filing fee.

Please contact me at (218) 739-8607 or pbeithon@otpc.com with any questions you may have.

Sincerely,

/s/ PETE BEITHON
Pete Beithon
Manager Regulatory Recovery

wao
Enclosures
By electronic filing and UPS overnight

**STATE OF NORTH DAKOTA
BEFORE THE
NORTH DAKOTA PUBLIC SERVICE COMMISSION**

In the Matter of Otter Tail Power Company's
Request for Approval to Revise Its Energy
Adjustment Rider to Include Emission Costs

Case No. PU-12-_____

APPLICATION

I. INTRODUCTION

Otter Tail Power Company ("Otter Tail") hereby applies to the North Dakota Public Service Commission ("Commission") for approval to include in its Energy Adjustment Rider (commonly referred to as the fuel clause adjustment ("FCA")) certain specified costs for purchased emission allowances that may be necessary to comply with the Cross-State Air Pollution Rule ("CSAPR") promulgated by the Federal Environmental Protection Agency ("EPA").¹ The CSAPR creates a regime in which allowances are required for certain emissions and existing facilities are allowed allowances based on historic heat input. It applies to Otter Tail's two fossil fuel generating plants located in Minnesota: the Solway gas peaking plant and the Hoot Lake Plant ("HLP") units 2 and 3. Given the emission allowances allocated to Otter Tail's generating plants under CSAPR, it is expected that no additional allowances will be required to operate the Solway plant at historic levels. However, it is expected that additional CSAPR emission allowances will likely be required in order to have HLP units 2 and 3 available to serve Otter Tail's customers at the same levels as these units have operated in the recent past. FCA recovery of these emissions allowance costs will provide Otter Tail an opportunity to purchase CSAPR emission allowances to operate HLP when doing so will result in lower costs for customers than the cost of reducing HLP operations and purchasing replacement power.

¹ The rule was initially promulgated to take effect January 1, 2012, but in the course of litigation challenging the rule, it was stayed by the District of Columbia Circuit Court of Appeals. Oral arguments relating to that litigation are scheduled for April 13th in Washington DC. Otter Tail is not a party to that litigation.

II. GENERAL FILING INFORMATION

Pursuant to § 69-02-02-04 of the Commission's Rules of Practice and Procedure, the following information is provided.

A. Name, address, and telephone number of utility

Otter Tail Power Company
215 South Cascade Street
Fergus Falls, Minnesota 56538-0496
(218) 739-8200

B. Name, address, and telephone number of utility attorney

Bruce Gerhardson
Associate General Counsel
Otter Tail Power Company
215 South Cascade Street
PO Box 496
Fergus Falls, Minnesota 56538-0496
(218) 739-8475

C. Title of utility employee responsible for filing

Peter J. Beithon
Manager, Regulatory Recovery
Otter Tail Power Company
215 South Cascade Street
PO Box 496
Fergus Falls, Minnesota 56538-0496
(218) 739-8607

D. Date of filing and proposed effective date of rates

The date of this filing is March 1, 2012. Otter Tail proposes the requested revision to its Energy Adjustment Rider be effective for costs incurred beginning in 2012.

E. Statutory authority

Approval of this Application is requested under the general authority granted to the Commission in N.D.C.C. § 49-02. The FCA is administered under North Dakota Rules § 69-09-02-39.

F. Other requirements of North Dakota Rules § 69-02-02-04

Articles of Incorporation: A certified copy of Otter Tail's Articles of Incorporation is on file with the Commission, as is an original certificate of good standing.

III. DESCRIPTION AND PURPOSE OF FILING

In this Application Otter Tail requests approval of a variance to North Dakota Rules § 69-09-02-39 to permit inclusion in its Energy Adjustment Rider of certain specified costs for purchased emission allowances that may be necessary to comply with the CSAPR issued by the Federal EPA on and after January 1, 2012. FCA recovery of these emissions allowance costs will provide Otter Tail with an opportunity purchase CSAPR emission allowances necessary to operate HLP when doing so will result in lower costs for customers than the cost of reducing HLP operations and purchasing replacement power.

The number of emission allowances that Otter Tail may need to purchase is directly related to the number of tons of coal burned by the generating plant. Therefore, the cost of these emission allowances becomes part of the cost of fuel burned.

There are a number of uncertainties surrounding this new regulation. Several states and entities have begun legal challenges, which have resulted in a stay of the rule. Oral arguments on the rule are scheduled for April 13th. As discussed below, the availability and cost of emission allowances are not known with certainty. If allowances cannot be obtained, it is estimated the output of HLP units 2 and 3 may be reduced by as much as 60 percent.

After the rule becomes effective and throughout the compliance process, Otter Tail will evaluate the lowest cost options for its customers. These options might include purchasing additional allowances or reducing plant output and purchasing replacement energy in the market. Otter Tail is making this request for cost recovery to allow it greater flexibility to meet compliance requirements in a way that is the lowest cost for its customers and in the public interest.

A. Background

1. Otter Tail's Minnesota generating plants

Otter Tail operates two fossil fuel generating plants in Minnesota: a 47 MW gas peaking plant (Solway plant) built in 2003 and located at Solway, Minnesota, near Bemidji, and the Hoot Lake (HLP) coal plant at Fergus Falls, Minnesota. HLP consists of two operating units: 59 MW unit 2 built in 1959 and 85 MW unit 3 built in 1964. HLP unit 1 was retired and removed from commercial operation in 2005.

2. New Federal emission regulations

In August 2011 the Federal EPA finalized CSAPR. CSAPR further regulates sulfur dioxide (“SO₂”) and nitrogen dioxide (“NO_x”) emissions from fossil fuel fired power plants located in the eastern portion of the United States. The Rule establishes two new types of SO₂ allowances (“Group 1” and “Group 2”) and two new types of NO_x allowances (“annual” and “ozone”). Minnesota is classified as a “Group 2” SO₂ state (along with 6 other states) and an “annual” NO_x state (along with 22 other states). North Dakota and South Dakota are not included in CSAPR. Therefore, Otter Tail's Coyote Generating Station in North Dakota, and the Big Stone Plant in South Dakota are not impacted by this new rule.

The final CSAPR was published on August 8, 2011, and was to be effective October 7, 2011, for generating plant operations on and after January 1, 2012. Generating units were allocated allowances in late October 2011. In the course of litigation challenging the rule, it was stayed by the District of Columbia Circuit Court of Appeals. Had the rule not been stayed, compliance would have been determined in early 2013 based on 2012 emissions. Because of the stay, implementation and compliance dates are unknown at the time of this filing.

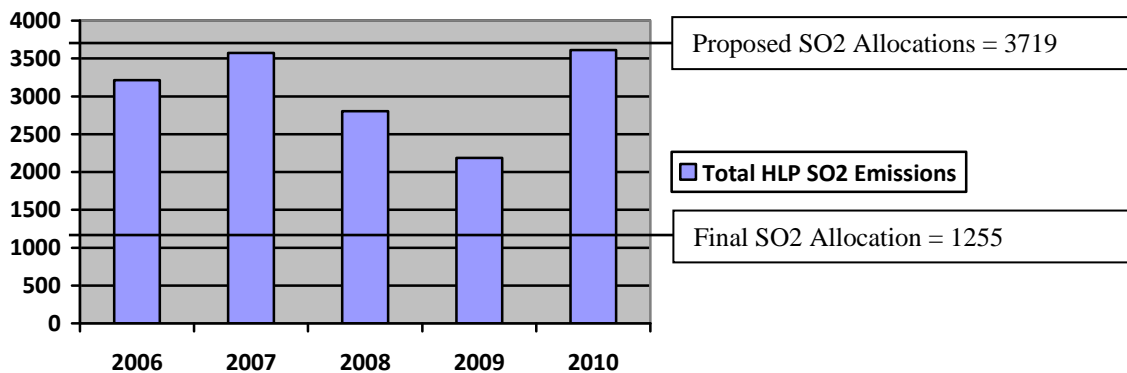
Other important information regarding the CSAPR rule includes the following:

- The new rules do not rely on Title IV allowances used for the Acid Rain Program (ARP); however, sources will still be required to hold the ARP allowances and comply with all requirements of that program.

- The rule sets an allowance budget for each state, and then allocations are made from the state budget to each affected unit within the state. Allocations are made based on the ratio of the unit’s historical heat input to the state’s historical heat input. Adjustments are then made to ensure that sources do not receive more allowances than their historical maximum emissions. This allocation methodology is in contrast to the originally proposed Transport Rule for Group 2 that allocated allowances based on a unit’s projected future actual emissions. The significance to HLP of this change in allocation methodology is explained below.
- If an affected unit does not have enough allowances, the unit can obtain allowances on the open market. However, a Group 2 SO₂ unit can only use Group 2 SO₂ allowances. Any extra allowances remaining at the end of the year can be banked for use in future years.

It should be noted that initially, prior to publication, the EPA draft CSAPR did not appear to impact Otter Tail—based on Otter Tail’s evaluation of the earlier CSAPR drafts, all of Otter Tail's generating plants would be able to meet the new requirements under normal operating conditions and by using the allowances allocated pursuant to the rule as originally proposed. Therefore, operations would have been able to continue as before without purchasing additional emission allowances. However, when the final CSAPR rule was ultimately published in the Federal Register, it had been revised such that Otter Tail’s HLP units 2 and 3 were unlikely to be able to meet the new requirements at normal operating levels without the purchase of SO₂ emission allowances beyond those allocated to the company.

The chart below illustrates the magnitude of the difference between the proposed and final emission allowances under the rule.



3. Potential impact of CSAPR

SO₂

Under the CSAPR, generating units that do not have enough allowances can obtain allowances on the open market. The CSAPR designates Minnesota as one of seven states classified as Group 2 for SO₂. The CSAPR allows a utility located in a Group 2 state only to purchase allowances from other Group 2 states. A liquid market has not yet been established for these allowances. In the case of SO₂ allowances, there is some indication that the Group 2 states in total will not have enough allowances available; therefore, the market price is difficult to predict. The EPA modeling suggests a market price of \$600/ton. Applying this price to the average shortfall for HLP would result in the cost of annual purchases of over \$1 million, about 40 percent of which would be allocated to North Dakota.

The following illustrates historical shortfalls based on the final HLP SO₂ allocations.

Year	Total HLP SO₂ Emissions (tons)	Final HLP SO₂ Allocation (tons)	Theoretical SO₂ Allowance Shortfall (based on final allocation)
2010	3610	1255	(2355)
2009	2187	1255	(932)
2008	2802	1255	(1547)
2007	3574	1255	(2319)
2006	3215	1255	(1960)

NO_x

Based on the CSAPR NO_x allowance allocations provided for in the rule, HLP will be close to being able to operate within its allowance budget without making additional NO_x allowance purchases. The EPA modeling suggests an estimated market price of \$500/ton. The highest level of NO_x emissions at HLP in the last 5 years happened in 2007. Applying the EPA modeled costs and assuming HLP has a year similar to 2007, OTP would have to purchase approximately 150 annual NO_x allowances for an estimated total cost of around \$75,000. The table below shows total historical

HLP NOx emissions that were recalculated based on anticipated achievable 2012 emissions.

Year	Total HLP NOx Emissions (tons)	Final HLP NOx Allocations (tons)	Theoretical NOx Allowance Shortfall
2010	891	847	(44)
2009	611	847	236
2008	815	847	32
2007	1031	847	(184)
2006	916	847	(69)

Estimated Customer Impacts – Financial Impacts

Based on the information above, it is anticipated there will be some impact of the rule for HLP SO2 emissions, while the impact for HLP NOx emissions will likely be immaterial. These emission costs will apply to all of Otter Tail’s North Dakota customers subject to FCA. Based on current estimates, the potential monthly impact for an average residential using 1,000 kWh per month may range from \$0 to \$0.36 and the impact on all other customers using an average of 8,000 kWh per month may range from \$0 to \$2.40 per month these estimates, of course, depend on the amount of credits purchased, the price and market conditions for purchased power and allowances.

IV. REQUEST FOR VARIANCE FROM NORTH DAKOTA RULE

As explained above, the number of emission allowances that Otter Tail may need to purchase for its HLP is directly related to the number of tons of coal burned at the plant, and therefore, the cost of these emissions becomes a cost of the fuel for that plant. Nevertheless, Otter Tail requests a rule variance to ensure that this treatment of these costs is not inconsistent with a technical reading of the rules.

North Dakota Rules § 69-09-02-39, subp. 4, provides that energy costs are the cost of: "fuel consumed in the utility's own plants and the utility's share of fossil and nuclear fuel consumed in jointly owned or leased plants."

North Dakota Rules § 69-09-02-39, subp. 7, further describes the cost of fuel: "The cost of fuel other than nuclear may include only those items listed in Account 151

of the Uniform System of Accounts for Public Utilities and Licensees." The FERC's Uniform System of Accounts requires the inventory of emission allowances to be carried in account 158.1 Allowance Inventory with changes expensed to account 509 Allowances. Therefore, while the cost of newly acquired emission allowances can reasonably be viewed as a "cost of fossil fuel," the references to specific FERC accounts included in North Dakota Rules were promulgated before this EPA regime could have been contemplated. Therefore, a rule variance is appropriate in this circumstance.

North Dakota Rules § 69-09-02-39, subp. 10, provides that "[i]f a particular circumstance prevents the use of a standard or its use would result in an undue burden, the commission may for good cause shown, permit deviation from a standard." Based upon this authority and for these reasons, Otter Tail requests that the Commission also allow a deviation from the accounting for energy costs as defined in North Dakota Rules § 69-09-02-39 in order to include such emission costs.

V. CUSTOMER NOTIFICATION.

Otter Tail has begun serving notice of this filing on customers.

VI. REVISION TO OTTER TAIL'S ENERGY ADJUSTMENT RIDER

In order to have a clear description of the costs included in its FCA, Otter Tail recommends the following addition to paragraph 1 of its Energy Adjustment Rider, Section 13.01 of its Rate Book:

The average cost of energy shall be determined as follows:

1. The cost of fuel, as recorded in Account 151, used in the Company's generating plants, and the cost of emission allowances purchased after January 1, 2012, necessary for the Company to operate its generating plants in compliance with the Cross-State Air Pollution Rule. Energy from the Company's hydro generating plants shall be included at zero cost.

Attachments 1 and 2 are redline and clean versions of Tariff Schedule 13.01, Energy Adjustment Rider. Otter Tail will separately show the cost of any allowances purchased in its monthly FCA reports.

VII. CONCLUSION

Otter Tail respectfully requests the Commission approve the requested revision to its Energy Adjustment Rider as described herein effective for costs incurred beginning in 2012.

Dated: March 1, 2012

Respectfully Submitted,

OTTER TAIL POWER COMPANY

By: /s/ PETER J. BEITHON
Peter J. Beithon
Manager, Regulatory Recovery
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218-739-8607

By: /s/ BRUCE GERHARDSON
Bruce Gerhardson
Associate General Counsel
Otter Tail Power Company
215 South Cascade Street
PO Box 496
Fergus Falls, MN 56538-0496
218-739-8475



Fergus Falls, Minnesota

ENERGY ADJUSTMENT RIDER

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There shall be added to or deducted from the monthly bill the amount per kilowatt-hour (rounded to the nearest 0.001¢) that the average cost of energy is above or below 2.8030¢ per kilowatt-hour. The average cost of energy per kilowatt-hour for the current period shall be calculated from data covering actual costs from the most recent four-month period as follows:

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Energy costs from actual months 1, 2, 3, and 4 plus unrecovered (or less over recovered) prior cumulative energy costs divided by retail sales for actual months 1, 2, 3, and 4 equals the cost of energy adjustment for month 6.

The applicable adjustment will be applied effective on any billing dated on or after the first day of each calendar month. The average cost of energy shall be determined as follows:

1. The cost of fossil fuel, as recorded in Account 151, used in the Company's generating plants and the cost of emission allowances purchased after January 1, 2012 necessary for the Company to operate its generating plants in compliance with the Cross-State Air Pollution Rule. Energy from the Company's hydro generating plants shall be included at zero cost.
2. The energy cost of purchased power included in Account 555 when such energy is purchased on an economic dispatch basis, exclusive of capacity or demand charges. This includes but is not limited to net costs linked to the utility's load serving obligation, associated with participation in wholesale electric energy markets operated by Regional Transmission Organizations, Independent System Operators or similar entities that have received Federal Energy Regulatory Commission approval to operate the energy markets. All Midwest Independent System Operator ("MISO") Energy and Ancillary service market charges and credits relating to retail sales and asset based sales, specifically including (but not limited to) Schedule 16 and 17 charges and credits shall be included in the calculation.
3. The actual identifiable fossil and nuclear fuel costs associated with energy purchased for reasons other than identified in 2 above.

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NORTH DAKOTA PUBLIC
SERVICE COMMISSION
2009, in North Dakota

Case No. PU-0812-862

Approved by order dated November 25, 2009

~~Bernadeen Brutlag~~ Thomas R. Brause

~~Services~~ Vice President, Administration

EFFECTIVE with bills rendered on
and after December 1,

APPROVED:

Manager, Regulatory



Fergus Falls, Minnesota

North Dakota, Section 13.01
ELECTRIC RATE SCHEDULE

Energy Adjustment Rider

Page 2 of 3

~~Fifteenth~~ ~~Fourteenth~~ Revision

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- 4. The net energy cost of energy purchases from a renewable energy source, including hydropower, wood, windpower, and biomass.

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NORTH DAKOTA PUBLIC
SERVICE COMMISSION
~~2009~~, in North Dakota

Case No. PU-~~0812-862~~ ___

Approved by order dated _____ ~~November 25, 2009~~

~~Bernadeen Brutlag~~ Thomas R. Brause

~~Services~~ Vice President, Administration

EFFECTIVE with bills rendered on
and after _____ ~~December 1,~~

APPROVED:

~~Manager, Regulatory~~



Fergus Falls, Minnesota

ENERGY ADJUSTMENT RIDER

There shall be added to or deducted from the monthly bill the amount per kilowatt-hour (rounded to the nearest 0.001¢) that the average cost of energy is above or below 2.8030¢ per kilowatt-hour. The average cost of energy per kilowatt-hour for the current period shall be calculated from data covering actual costs from the most recent four-month period as follows:

Energy costs from actual months 1, 2, 3, and 4 plus unrecovered (or less over recovered) prior cumulative energy costs divided by retail sales for actual months 1, 2, 3, and 4 equals the cost of energy adjustment for month 6.

The applicable adjustment will be applied effective on any billing dated on or after the first day of each calendar month. The average cost of energy shall be determined as follows:

1. The cost of fossil fuel, as recorded in Account 151, used in the Company's generating plants and the cost of emission allowances purchased after January 1, 2012 necessary for the Company to operate its generating plants in compliance with the Cross-State Air Pollution Rule. Energy from the Company's hydro generating plants shall be included at zero cost. C
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3. The actual identifiable fossil and nuclear fuel costs associated with energy purchased for reasons other than identified in 2 above.
4. The net energy cost of energy purchases from a renewable energy source, including hydropower, wood, windpower, and biomass.

NORTH DAKOTA PUBLIC
SERVICE COMMISSION
Case No. PU-12-____
Approved by order dated _____

EFFECTIVE with bills rendered on
and after _____, in North Dakota

APPROVED: Thomas R. Brause
Vice President, Administration