

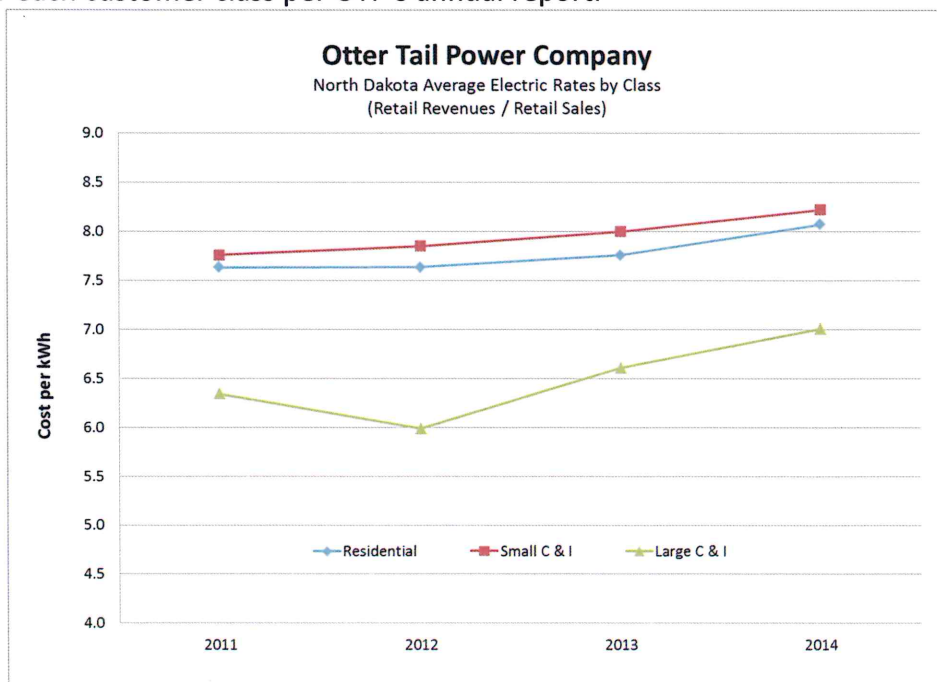
Memorandum

To: Darrell Nitschke, Executive Secretary
CC: PUD, Illona, Stuart Tommerdahl
From: Mike Diller *Mike Diller*
Date: January 5, 2016
Re: Close OTP's 2011 – 2015 Electric Annual Reports
(Case Nos. PU-12-170, PU-13-201, PU-14-246, PU-14-754)

I have reviewed Otter Tail Power Company's (OTP) Electric Annual Reports and recommend the above referenced cases be closed in accordance with commission policy 5-05-97. I am providing this to Stuart Tommerdahl 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's 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, Big Stone 2 abandonment costs, transmission cost recovery and environmental cost riders. The cost increases have been offset by low cost purchased market energy, lower cost of capital requirements and increased margins. The following chart takes into consideration all changes impacting rates by depicting total revenues divided by total kWh's sold for each customer class per OTP's annual report.



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

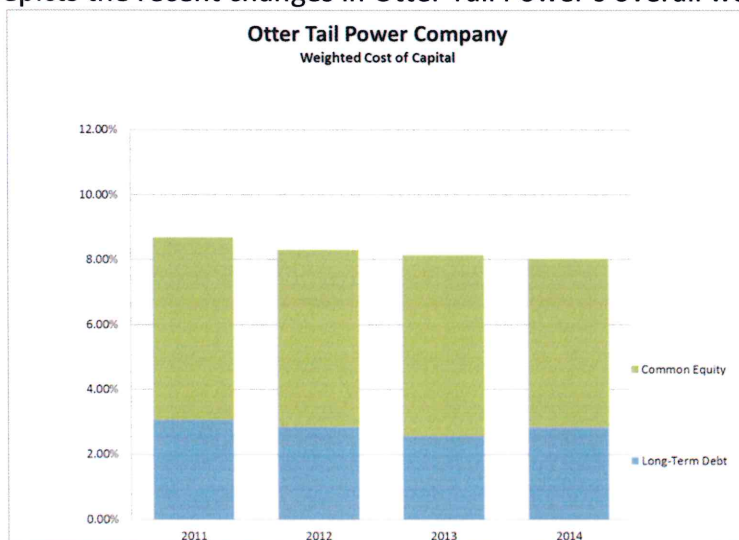
Following is a summary of the specific components of rate base.

Rate Base:	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
Plant in Service	\$573,590	\$596,136	\$615,001	\$638,267
Accumulated Depreciation	(233,022)	(244,288)	(260,249)	(275,334)
Net Plant	\$340,568	\$351,848	\$354,752	\$362,933
Plant Held for Future Use	13	13	13	13
Construction Work in Progress	3,904	10,014	38,551	70,458
Material and Supplies	7,061	7,066	7,518	7,910
Fuel Stocks	4,388	4,513	4,110	3,787
Prepayments	(11,861)	(14,185)	(14,129)	(10,707)
Customer Advances	(217)	(209)	(252)	(357)
Cash Working Capital	1,823	3,164	3,344	3,358
Accum. Deferred Income Taxes	(85,843)	(89,833)	(98,612)	(102,740)
Total Rate Base	\$259,836	\$272,391	\$295,295	\$334,655

As you can see above, net plant has remained relatively flat and accumulated deferred income taxes continue to grow offsetting the small growth in net plant. A significant increase can be noted in Construction Work in Progress which is primarily due to the environmental upgrades occurring at the Big Stone coal generation facility coupled with significant transmission investments. The environmental upgrades were completed in 2015, so the next annual report will show a large increase in rate base. The environmental upgrade costs are covered by an environmental rider so its completion alone will not drive the need for a rate increase.

Cost of Capital

Assuming a 10.75% cost of equity rate last approved by the commission in 2009, the following chart depicts the recent changes in Otter Tail Power's overall weighted cost of capital.



The overall cost of capital has remained fairly constant over the past years with a slight downward trend.

Net Income

Following is a summary of Otter Tail Power's net income:

<u>Description</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
Total Operating Revenues	\$134,679	\$139,028	\$145,922	\$158,910
Production	54,506	55,522	58,469	65,140
Gross Margins	\$80,173	\$83,506	\$87,453	\$93,770
Change in Margins	\$3,995	\$3,333	\$3,947	\$6,317
Transmission	5,496	7,117	8,884	10,807 [↗]
Distribution	6,773	7,129	7,545	7,556
Customer Accounting	5,078	5,432	5,848	5,820
Cust. Service and Info. Exp.	1,102	1,193	1,156	1,107
Sales Expense	167	141	158	119
Admin. and General	13,264	13,410	16,195 [↗]	17,012
Depreciation Expense	17,907	18,560	19,204	18,339
General Taxes	4,331	4,494	4,675	5,085
Sub-total (Lines 5-12)	\$54,118	\$57,476	\$63,665	\$65,845
Net Income before IT	\$26,055	\$26,030	\$23,788	\$27,925
Income Tax	2,076 [↘]	1,668 [↘]	1,370	2,083
Net Income	\$23,979	\$24,362	\$22,418	\$25,842

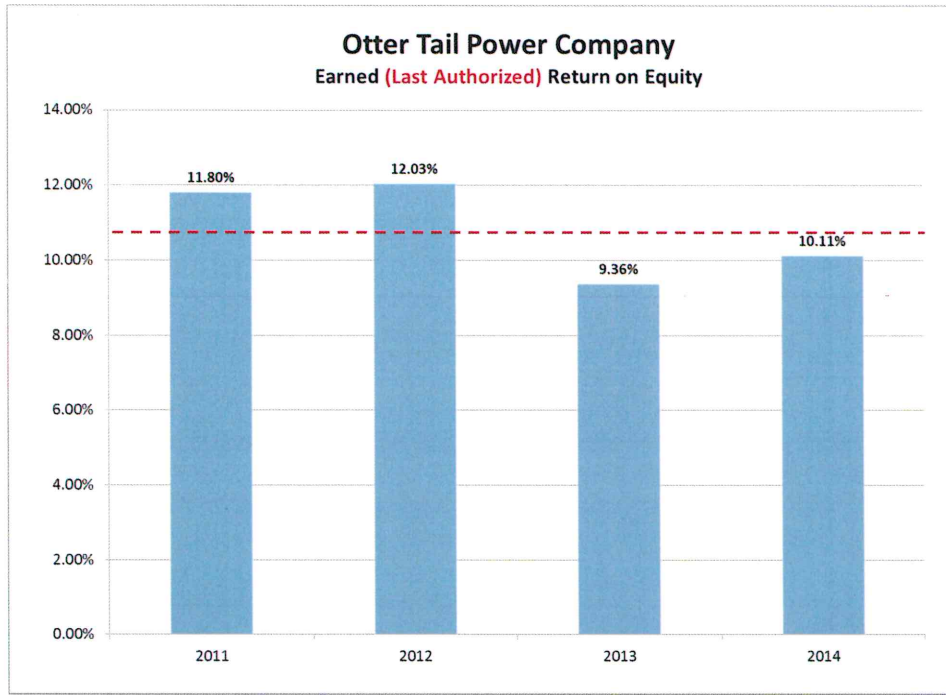
The increased margins continue to provide sufficient earnings despite increased expense levels. Transmission expenses have nearly doubled since 2011 primarily due to increased allocation of MISO transmission costs including significant pass-through costs associated with multi-value projects constructed across the MISO region for improved reliability and deliverability. Administrative and General Expense increased significantly in 2013 as a result of the holding company selling several subsidiary companies resulting in a higher allocation of corporate costs to its utility operations. Other A&G cost increases include Office Supplies, Risk Insurance and Employee Pensions and Benefits.

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 of 10.75%.

	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
Rate Base	\$259,836	\$272,391	\$295,295	\$334,655
Cost of Capital	8.68%	8.30%	8.15%	8.03%
Return Required	\$22,553	\$22,596	\$24,052	\$26,886
Net Income ²	23,979	24,362	22,418	25,842
Return Excess (Deficiency)	\$1,426	\$1,766	(\$1,634)	(\$1,044)
Income Tax Factor ¹	1.6220	1.6220	1.6115	1.6115
Revenue Excess (Deficiency)	\$2,312	\$2,865	(\$2,634)	(\$1,683)

As can be noted, OTP generated earnings in excess of 10.75% in 2011 and 2012 followed by two years of earning less than 10.75%. Overall, OTP's rates appear to be providing the Company with a reasonable return on its investment in North Dakota. Following is a chart of the earned return on stockholder equity.



Administrative Matter

In response to staff's requests for information pertaining to income taxes, OTP found that it had made a mistake in calculating income taxes for 2011 and 2012. Therefore, the 2011 and 2012 annual reports on file do not accurately reflect earnings. Therefore, staff will augment the annual report case files for 2011 and 2012 so that future referencing of earnings will be accurate. This report contains the corrected tax calculations.