

Memo

To: Darrell Nitschke, Executive Secretary

From: Mike Diller, Director of Economic Regulation



Date: June 7, 2016

**Re: Big Stone & Hoot Lake Environmental Cost Recovery Rider
Otter Tail Power Company, Case No. PU-16-148
For June 22, 2016 Regular Agenda**

Brief History of Case

On May 9, 2012, Case No. PU-11-165, the commission granted Otter Tail Power Company (Otter Tail) an Advanced Determination of Prudence (ADP) for the Air Quality Control System (AQCS) at the Big Stone Plant except for the portion regarding the deployment of Selective Catalytic Reduction Technology (SCR) for the removal of nitrogen oxides. The total project cost including SCR was estimated to be \$489 million. Otter Tail owns 53.9% of the Big Stone Plant and is therefore responsible for 53.9% of the total project costs.

On December 18, 2013, Case No. PU-13-84, the commission approved the first Environmental Cost Recovery (ECR) rider for the Big Stone AQCS in accordance with North Dakota's law (49-05-04.2) providing for cost recovery of federal environmental mandates including costs for SCR amounting to a 4.319% surcharge on customers' bills effective January 1, 2014. The total estimated project cost was revised downward to \$405 million due to redesign efforts, reuse of existing plant, favorable market conditions, internal management of the project, and budget reductions for contingencies.

On July 15, 2014, Case No. PU-14-142, the commission approved Otter Tail's first update to the ECR rider increasing it to a 7.531% surcharge on customers' bills effective August 1, 2014 and further reduced the total estimated project cost to \$384 million. The actual costs incurred through February 2014 were \$175 million with a projected balance at the end of June 2015 of \$353 million.

On June 17, 2015, Case No. PU-15-131, the commission approved Otter Tail second update to the ECR rider for the Big Stone AQCS plus additional costs related to the Mercury and Air Toxics Standards (MATS) project at its Hoot Lake Plant. The rider increased to 9.193% of customers' bills effective July 1, 2016. The actual costs January 2015 were \$277 million with a projected balance at the end of June 2016 of \$384 million.

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Public Service Commission Staff

Mike Diller

On March 31, 2016, Otter Tail requested to update its ECR rider. The Big Stone AQCS became operational in December, 2015 and the Hoot Lake Mercury and Air Toxics Standards (MATS) project has been in-service since October, 2014. The proposed ECR rider decreases the current rider from 9.193% to 7.904% of customers' bills effective July 1, 2016. The rider is based on estimated costs through June 2017 which will be trued up to actuals during the next rider.

Recommendation

Staff has reviewed the application and recommends approval of the proposed rate.

The Notice of Opportunity for Hearing requires that comments and requests for hearing must be received by June 21, 2016. No comments or requests for hearing have been made to date. Absent the filing of legitimate concerns or requests for hearing, staff will include a motion for commission consideration on the June 22, 2016 agenda to approve Otter Tail's application to revise its ECR Rider tariff.

Impact to Customers

The proposed rider in this proceeding will decrease the average monthly residential bill by \$1.19 for customers using 1,000 kWh.

Otter Tail continues its "percent-of-bill" method of recovery resulting in a requested surcharge of 7.904% on most of the electric bill components. The rate surcharge does not apply to certain rider charges as described in the tariff such as the Energy Adjustment Rider, Renewable Resource Rider and the Transmission Cost Recovery Rider to avoid assessing a rider on a rider.

Attachment 2 of Otter Tail's application summarizes the revenue requirements associated with AQCS and the MATS project at the Hoot Lake Plant. Attachment 6 of Otter Tail's application divides the total estimated revenue requirements by estimated revenues to arrive at a percentage of revenue rate increase necessary to recover these costs. Any differences in estimated costs or revenues will be rectified through the tracker in next year's filing.

Review

The AQCS project was deemed completed and operational by December 2015 but finish-up costs will continue through 2016. Once all the costs are in, staff will conduct a review of the final costs. Staff understands that a review of costs for reasonableness and prudence is separate and apart from the granting of ADP. Any adjustments resulting from that final review will be factored into the final cost of the project for cost recovery.

The MATS project at Hoot Lake power plant has been completed for less than \$7 million compared to the original estimate of \$10 million and will allow the plant to continue operating until 2020.

Because the AQCS project was completed in 2015, it qualifies for 50% bonus depreciation for tax purposes in the first year of operation. The book depreciation charged to customers each year is approximately 3%. The large difference between tax and book depreciation allows Otter Tail to defer paying income taxes and is referred to as Accumulated Deferred Income Taxes or ADIT. The ADIT balance is an offset to rate base to recognize that customers have paid income taxes that Otter Tail can defer paying to taxing authorities. This method of accounting credits customers for the cash they have contributed for income taxes but not yet paid by Otter Tail. As a result of Otter Tail being able to claim bonus depreciation for tax purposes, revenue requirements for the ECR Rider are \$1.7 million less for the projected year ending 2016 than without claiming bonus depreciation. The value of bonus depreciation will diminish over time as book depreciation catches up with tax depreciation but will remain a value to customers throughout the life of the plant.

The primary differences between last year's ECR rider and this year's rider includes a reduction in revenue requirements for the Big Stone AQCS of \$774,156 and a reduction in the annual true-up adjustment of \$1,081,564. The reduction in AQCS revenue requirements is a result of lower projected expenses, lower projected plant investment and a higher ADIT balance due to bonus depreciation. The swing in true-up costs from a positive \$327,575 in last year's filing to a negative true-up adjustment of \$753,989 was caused largely by book depreciation originally projected to begin in November, 2015, for the AQCS but actually did not begin until January, 2016, and the large rate base offset of ADIT not anticipated in last year's filing.

Return on Equity (ROE)

Based on 2015 operating results, Otter Tail agreed to reduce its ROE from 10.75% to 10.5% as well as its jurisdictional energy allocation factor in its recent annual rate update for its Renewable Resource Cost Recovery Adjustment, Case No. PU-16-14. Otter Tail is unwilling to make similar adjustments in this filing because actual sales through April, 2016 are down 6% compared to last year due to the unusually mild first half of the 2016 winter season and expects to earn less than 10.5% ROE for 2016. Staff agrees that the winter months were very mild and recognizes that Otter Tail carries a heavier heating load than its more urban counterparts. Therefore, staff recommends approval of the rider as is and will continue to monitor earnings annually as well as through Otter Tail's various rider mechanisms.