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August 3, 2006

via eMail and US Mail
David A. Jacobson, Utility Analyst
South Dakota Public Utilities Commission
500 E. Capitol Avenue
Pierre, South Dakota 57501

RE: Report and Consulting Services Proposal
Black Hills Power, Inc. - Proposed Increase in Electric Rates
SDPUC Docket No. EL06-019

Dear Dave:

Thank you for sending Black Hills' latest rate filing for our review and preparation of the following proposal. Basil Copeland has reviewed the Company's cost of capital evidence and I now have reviewed all of the other testimony, exhibits and filing statements.

Overview of the Filing

By letter dated June 30, 2006, Black Hills Power ("BHP" or "Company") filed with the Commission an Application seeking an increase in rates for electric service in South Dakota. The proposed rates were designed to increase its annual revenue from these customers by $9,593,688 representing an increase of 9.5% above the rates established, originally by a settlement of the Company's 1995 rate filing in Docket EL95-003 "freezing" the rates through 1999 and, subsequently, by a 1999 agreement that extended the freeze through 2004. In addition to the proposed increase in base rate revenue, BHP is proposing to implement various cost tracking mechanisms. These include a steam generating plant fuel adjustment clause, a wholesale (FERC-regulated) transmission cost tracker, and a Conditional Energy

Cost Adjustment ("CECA"). The CECA tracks, with a cost-sharing window, the cost of purchased power and oil and natural gas fuels used for power generation. For billing purposes the three trackers would appear as a single line item on customer bills. The proposed base rates and trackers would become effective for service rendered on and after January 1, 2007.

BHP, a wholly-owned subsidiary of Black Hills Corporation, is a vertically integrated electric utility providing retail electric service to about 2,600 customers in Wyoming and Montana combined in addition to the approximately 61,000 customers served in South Dakota at rates subject to the SDPUC's jurisdiction.[1] The Company also makes various sales for resale and short-term opportunity sales pursuant to agreements subject to the jurisdiction of the Federal Energy Regulatory Commission. (Statement Q)

The Company has significant transactions with affiliates, including (i) a long-standing arrangement for the purchase of substantial quantities of coal from Wyodak Resources Development Corporation (an indirect subsidiary of Black Hills Corporation via Black Hills Energy, Inc.)[2] and (ii) effective January 1, 2006, the sharing with other Black Hills Corporation subsidiaries of the cost of "administrative, management and support services" provided by the newly-established Black Hills Services ("Service Company"). (Theis testimony, p. 4)

The revenue requirement determination filed in support of BHP's proposed rates is developed using a "per books" base year ended December 31, 2005 (Statement M, page 1), with numerous pro forma adjustments to eliminate the effects of non-recurring events; to reflect fully the effects of changes that occurred during the base year; and to annualize purported "known and measurable" changes anticipated to occur prior to January 1, 2007, the proposed effective date of the filed rates. (Kilpatrick testimony, pp. 4-16). Adjustments to the base year average rate base are made to reflect the reclassification of non-jurisdictional transmission plant and to recognize post-base year investments, purportedly representing "non-revenue producing" plant. Operating income adjustments are made to eliminate abnormal costs associated with a base year outage at Neal Simpson II; to eliminate costs associated with power marketing activities; to annualize the effects of new employee positions and 2006 wage rate adjustments; to amortize the $550,000 estimated expense of this rate case; to eliminate costs incuured to buy-out key employee

[1] Statement N, p. 1, Allocation Factor 6.

[2] Exhibit MTT-1, Appendix A, pp. 1 and 9. See also, Statement R.

change of control agreements; to reflect higher overhead costs anticipated to be incurred under the new Service Company agreement; to reflect a 5-year amortization of anticipated Wyodak plant maintenance expenses; to eliminate certain advertising expenses; and to reflect proposed new depreciation rates. South Dakota jurisdictional rate base and operating income are determined by allocating total BHP costs between South Dakota, Montana and Wyoming. (Statement N)

The Company indicates that its South Dakota earned return on rate base was 9.62% in the base year 2005 (Statement N, p. 9) and that this return is expected to decrease to 6.62% as a result of the changes represented by its pro forma adjustments.(Statement N, Sch. N-1, p. 9). Based on its contention that a reasonable allowable return would be 9.83%, including an 11.75% return on common equity capital,[3] BHP purports to justify a South Dakota retail rate increase of $14.1 million (Ibid.), or 13.9% – approximately $4.5 million more than the proposed $9.6 million increase. The proposed $9.6 million adjustment represents an increase of 9.5% in South Dakota revenues at existing rates and, if applied to the claimed pro forma rate base and operating income, suggests an earned return on rate base of 8.80% and a 9.86% return on common equity.

The Company has presented a class cost of service study ("CCOSS") for the South Dakota jurisdiction but has elected to spread the proposed rate increase "across-the-board" by assigning a 9.5% increase to all classes. (Application, Section 3, p. 1). However, the unit charges within the rate schedules are not uniform and include much larger increases in the fixed monthly Customer Charges. For example, the proposed Residential Customer Charge of $9.00 is 20% higher than the existing $7.50 charge. Similarly, the General Service (non-Total Electric) Customer Charge would be increased by 16%, from $9.50 to $11.00.

Potential Issues and Division of Workload

BHP's filing raises issues similar to those which Staff has dealt with in most other general rate filings – the development of a revenue requirement determination based on actual experience but reflecting a myriad of adjustments purported to reflect known and measurable changes. Each of the major adjustments needs to be evaluated to determine its validity and to assess whether or not it maintains the balance of test year sales levels, operations productivity, price levels and

[3] Exhibit GMA-1.

investments. Adjustments here that are not routinely encountered include the requested changes in depreciation rates and the cost changes emanating from BHP's new Service Company agreement.

And, of course, additional adjustments might be required. For example, while BHP calculates its Federal income tax liablity as if it were a single, stand-alone taxpayer taxed at the corporate rate of 35% of its own "taxable income", the fact is that it is but one member of a group of corporations controlled by Black Hills Corporation that files a single consolidated tax return. The parent company itself had a tax loss in 2004 (the year for which data have been provided in Statement K, Sch. K-3) and it controls other corporations with tax losses in that year. The result of these conditions is that, in 2004, the consolidated group incurred a tax liability (before eliminations) of $1.4 million while BHP, the regulated utility was assigned a Federal income tax liability of $5.7 million (Statement K, Sch. K-3).[4] In other cases, we have recommended an adjustment to recognize consolidated tax savings if such savings are a recurring phenomenon.

The proposed changes in depreciation rates purport to be based on a comprehensive study of historical retirement experience, plant removal costs and gross salvage and engineering judgment and, for "unit property" (e.g. generating units) forecasted retirement dates and expected pre-retirement additions. Supporting data for these determinations has not been provided in the filing – particularly for the mass property accounts[5] – and therefore cannot be evaluated at this time.

The Service Company agreement and, in particular, the manner by which corporate administrative (etc.) costs are allocated among the various entities served (including the parent company) require a detailed review; it is not sufficient to assert merely that the costs allocated are actual costs. The Company also should be required to explain why this new intra-company cost sharing arrangement should result in increased costs to BHP.

The 11.75% return on equity reflected in the Company's claimed cost of capital purports to be supported by various measures of equity costs including earnings of comparable companies and, for proxy company groups, various DCF,

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[4] The Company asserts, but does not explain, that there will be no tax savings in 2005 as a result of the consolidated return. (Statement K, Sch. K-3. Fn.)

[5] See LWL Exhibit "Report on Depreciation Accrual Rates", pp. 22-23. Only summary data is provided for Unit property (Ibid., pp. A-1 and all following pages).

Risk Premium, Realized returns, and Capital Asset Pricing Model analyses. (Avera testimony, p. 50). By contrast our on-going analysis of equity costs for combination gas and electric utilities suggests a range extending below 9.0%. Considering BHP's proposals to insulate itself from its most onerous and unpredictable cost changes (via the three adjustment clauses), the claimed 11.75% equity cost is greatly exaggerated.

The South Dakota class cost of service study (CCOSS) presented in Statement O, Sch. 0-1 suggests that there should be a slightly larger-than-average rate increase to the Residential class and a slightly smaller-than-average increase to Small General Service customers (see the "Percent Increases" purportedly justified shown on line 8019). However, these differences are not so great as to mandate opposing the Company's across-the-board increase – particularly in light of two circumstances. First, much of the load data used to develop the CCOSS is "borrowed" from other companies and is not necessarily reflective of the characteristics of BHP's customers. Second, if indeed the Company is requesting less than the increase that could be justified by Commission standards (a condition that has not yet been demonstrated), the proposed increase for any class may not exceed its share of the justified cost of service.

As to the design of tariff rates, the Company should be required to explain its justification for the larger-than-average increase in monthly Service Charges. Typically Staff has determined that such charges are supported by overstated "customer costs" as determined in the CCOSS.[6] Eliminating this bias in the allocations shifts costs away from Residential and other small users and onto the larger customers. Similarly, it reduces the "customer costs" used to support higher Service Charges.

Another potential issue relates to the allocation of BHP's system costs among the three states by a method which differs from the method used for the South Dakota class cost allocation. The validity of using two different methods should be investigated.

The need for and proper operation and application of the proposed adjustment clauses require a comprehensive review.

With precedent to guide the Staff on the recurring revenue requirement

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[6] Correction of overstated "customer costs" in the CCOSS would also diminish the difference between the "justified" increase to Residential and other customer groups.

issues, it would be most efficient to have Staff review and develop positions on the recurring operating revenue and expense adjustments and rate base adjustments for plant additions and working capital. We would provide assistance to Staff in defining and developing positions on these issues, as needed.

We propose to address the cost of capital, depreciation rate and consolidated tax return issues discussed above. Together with Staff we would review the new Service Company agreement and its implementation and the operation of the proposed cost trackers and we would be prepared to testify on any changes to be recommended. In addition, we would review the Company's CCOSS and make recommendations on the spread of any rate increase and the propriety of the monthly Service Charges. All of our activities would be carried out with as much participation as possible by Staff.

Proposal

As you know, we have considerable experience with general rate increase requests by electric and gas utilities including experience with the types of issues that we have identified here. In addition to our participation with Staff in the more than thirty formal rate proceedings since 1976, we are presently engaged by the Colorado Consumer Counsel, the New Jersey Rate Counsel (formerly "Ratepayer Advocate") and the Staff of the Delaware Public Service Commission as consultants in gas, electric and water rate cases before the regulatory commissions in those states.

In this proceeding, we propose to assist the Staff as described above. Basil Copeland would analyze and testify on the cost of capital and capital structure issues. I would be responsible for any accounting issues that are delegated to me by your Staff, the depreciation rate and Service Company issues, the jurisdictional and class cost of service determination, and our review of the adjustment clauses. Dave Peterson has considerable experience with service company issues and jurisdictional and class cost allocations and would assist me, as needed, with those issues.

We will prepare the necessary data requests to obtain the information needed for our analyses; review the Company's responses, and confer with their witnesses as necessary; and prepare testimony and supporting exhibits describing our analyses, and recommendations. As needed, we will assist Staff witnesses in developing issues on which they will testify. We will also assist Staff Counsel in preparing for hearing and with the preparation of post-trial briefs and other pleadings.

For the purposes of preparing a cost estimate, I have assumed that two or three days will be required for participation in hearings in Pierre. As a practical matter, given the Company's decision to request a significantly smaller increase than it believes is justified, it is possible that Staff's analysis of the filing might lead to a settlement of at least the rate level issues and that preparation of testimony and formal hearings on these issues would be avoided. In that event, it is likely that the cost of our services would be reduced.

We estimate that the cost of performing these services would amount to approximately $54,865 including out-of-pocket expenses. Of course we would bill only for time actually spent working on the assignment and for our actual out-of-pocket costs, principally for air fare for 2 man-trips to Pierre, per diem expenses in Pierre, long distance telephone, copier and courier services. Our estimate is derived as follows:

Tasks	Hours		
	Towers	Copeland	Peterson
• Analyze the filing, identify issues, discovery;	60	8	30
• Developing positions; preparation of testimony and exhibits, including coordination with other Staff witnesses;	72	40	40
• Review rebuttal testimony and preparation for hearing;	40	12	24
• Participation in hearing	32	16	-
• Assisting counsel with briefs	20	4	-
Total hours	224	80	94

Cost Summary

Fees: Towers	224 hrs. @ $135		$30,240
Copeland	80 hrs. @ $130		10,400
Peterson	94 hrs. @ $125		11,750
Out-of-pocket expenses:			
Air fare		$1,800	
Hotel		200	
Courier		125	
Data base charges for ROE analysis		250	
Other		100	
			2,475
Total cost			**$54,865**

Please let me know if you have any questions about my discussion of the issues, division of the workload between Staff and our firm or any other aspect of this report and proposal. We look forward to working with you again.

Sincerely,

Robert G. Towers
President

Attachment: Fee Schedule (January 2006)

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FEE SCHEDULE

		Hourly Rate
Robert G. Towers	Senior Consultant	$ 135.00
Basil L. Copeland, Jr.	Senior Economist	$ 130.00
David E. Peterson	Senior Consultant	$ 125.00

January 1, 2006