**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF SOUTH DAKOTA**

**IN THE MATTER OF THE APPLICATION OF BLACK HILLS
POWER, INC. FOR AUTHORITY
TO INCREASE ITS ELECTRIC RATES**

**STAFF MEMORANDUM SUPPORTING
SETTLEMENT STIPULATION**

DOCKET EL09-018

Commission Staff (Staff) submits this Memorandum in support of the Settlement Stipulation of May 14, 2010, between Staff and Black Hills Power, Inc. (BHP or Company) in the above-captioned matter.

BACKGROUND

On September 30, 2009, the Company filed an application with the Public Utilities Commission (Commission) seeking an increase in annual revenues of approximately $32,000,000 or 26.6% for electric service to customers in its South Dakota retail service territory. The Company has also proposed rolling the test year fuel and purchased power costs collected through the Energy Cost Adjustment (ECA) into base rates. Under BHP's proposal, base rates would increase by approximately $38,800,000 or 34.2%, therefore, customer's bills would increase by approximately 34.2% for service on and after April 1, 2010.

The 34.2% rate increase exceeds the 26.6% revenue increase because the ECA mechanism lags a year behind when the actual costs are incurred. Unlike other investor owned electric utilities in South Dakota, BHP has an annual fuel clause. The ECA is a balancing account designed to recover or refund the variance between certain actual costs and those costs collected through base rates. The ECA that is effective from March 1, 2010, through February 28, 2011, recovers the fuel and purchased power costs that are incurred and not yet paid for by ratepayers in 2009. In order for the Company to recover its costs from 2009, the current ECA should remain in effect until February 28, 2011.

When the Company files its ECA in 2011, the 2010 fuel and purchased power costs will reflect the fuel costs incorporated in base rates approved in this rate case. The ECA should be lower in 2011, and if the ECA rate ends up to be 0 cents, the overall rate increase would have been approximately 26.6%.

BHP's proposed increase was based on a historic test year ending June 30, 2009, as adjusted for what BHP believes to be known and measurable changes, an 11.5% return on common equity, and a 9.27% rate of return on rate base. BHP witnesses submitted testimony stating that the increase is needed to offset the increased costs incurred by the

Company in providing service to its customers, including the addition of the Wygen III plant.

The Commission officially noticed BHP's filing on September 30, 2009, and set an intervention deadline of November 20, 2009. On November 3, 2009, the Commission issued an Order of Assessment of Filing Fee and Suspension of Imposition of Tariff. On December 3, 2009, the Commission issued its Order Granting Intervention, which granted intervention to Countertops, Inc., d/b/a Dakota Panel South Dakota, GCC Dacotah, Inc., Rushmore Forest Products, Inc., Sanford Underground Laboratory, Spearfish Forest Products, Inc., and Rapid City Regional Hospital, Inc. (collectively, Black Hills Industrial Interveners or BHII) and Lilias Jarding, Bobbie Handley, Carla Kock, and the South Dakota Peace and Justice Center (collectively, Residential Consumers Coalition or RCC). On December 7, 2009, the Commission issued an Order for and Notice of Procedural Schedule and Hearing. On January 28, 2010, the Commission issued an Order of Assessment of Additional Filing Fee for Staff to hire a consultant to review BHP's Integrated Resource Plan (IRP). On February 4, 2010, the Commission issued an Order for Continuance of Procedural Schedule and Hearing. On March 8, 2010, the Commission issued an Order for and Notice of Amended Procedural Schedule and Hearing. On March 1, 2010, the Commission received a request from the Company to implement interim rates on April 1, 2010, pursuant to SDCL 49-34A-17. On March 5 and March 8, 2010, the Commission received comments on the interim rate increase proposal from the BHII and the RCC collectively. On March 23, 2010, the Commission issued an Order Granting Request for Authority to Implement an Interim Rate Increase on April 1, 2010, Pursuant to SDCL 49-34A-17.

On or about January 22, 2010, BHP and BHII began settlement discussions. Those settlement discussions resulted in the BHP and BHII Confidential Settlement Agreement which is filed separately with the Commission. Staff was not a party to the settlement discussions between BHP and BHII and, thus, cannot provide any insight as to how that settlement was reached.

On March 29, 2010, Staff provided BHP a copy of its revenue deficiency determination. Thereafter, Staff and BHP (jointly the Parties) held several settlement discussions in an effort to arrive at a mutually acceptable resolution of the issues presented in BHP's rate filing. Additional information was exchanged between BHP and Staff and settlement discussions continued. Ultimately, the Parties reached a comprehensive agreement on BHP's overall revenue deficiency and other issues presented in the case including, but not limited to, class revenue responsibilities, rate design, and tariff concerns.

OVERVIEW OF SETTLEMENT

Staff based its revenue requirement determination on a comprehensive analysis of BHP's filing and on additional information obtained in discovery. Staff accepted some Company adjustments, made corrections where necessary, modified other adjustments using more recent actual data, and rejected those that did not qualify as known and reasonably measurable. Lastly, Staff introduced new adjustments not reflected in BHP's filed case.

Differences between the Company and Staff positions were discussed thoroughly at the settlement conferences. As a result of these discussions, each Party modified certain positions it had previously taken and each Party accepted certain positions of the other where common ground was found. Ultimately, the Parties were able to agree on a comprehensive resolution of the issues that Staff believes is based on sound regulatory principles and which avoids costly and unnecessary litigation.

Staff and BHP jointly and separately agree that BHP's revenue deficiency at this time is $22,002,926 justifying an approximate 19.36% increase in present rates (12.7% revenue increase). BHP and BHII settlement rates are reflected in Staff Exhibit___(JPT-4), Schedule 2-5 and their settlement agreement does not result in any changes to Staff's class revenue distribution. The revenue deficiency and supporting calculations described in this Memorandum and attachments depict Staff's positions regarding all components of BHP's South Dakota jurisdictional revenue requirement, including a reasonable return allowance on common equity.

STAFF OVERVIEW OF SETTLEMENT

Staff believes this settlement provides BHP with an annual level of revenues relative to its current service costs that is fair, just, and reasonable. These settlement rates allow BHP a reasonable opportunity to earn a return that is adequate to enable it to continue providing safe, adequate, and reliable service to its South Dakota retail customers. Staff's determination of the settlement revenue requirement begins with June 30, 2009, total Company test year costs and allocates total Company amounts to the South Dakota retail jurisdiction. It then adjusts the June 30, 2009, test year results for known and measurable post-test year changes. Staff Exhibit___ (JPT-1), Schedule 3 illustrates Staff's determination of BHP's pro-forma operating income under present rates. Staff Exhibit___ (JPT-2), Schedule 2 illustrates Staff's calculation of BHP's South Dakota retail rate base, and Staff Exhibit___ (JPT-1), Schedule 2 and Staff Exhibit___ (JPT-2), Schedule 1 summarizes these positions. Staff's calculation of BHP's revenue deficiency and total revenue requirement are shown on Staff Exhibit___ (JPT-1), Schedule 1. Unless otherwise noted, all of the changes discussed below are changes from the Company's initially filed position.

RATE BASE

Average rate base – Both the Company and Staff arrived at a test year average rate base based on an average of the 13 month-end account balances, June 30, 2008, through June 30, 2009.

Cash Working Capital – In determining its cash working capital requirement, BHP submitted a lead-lag study and separately took into consideration working capital available from certain taxes collected and held by the Company prior to submission to taxing authorities (Statement F, Schedule F-3). Staff adjusted the Company's lead-lag study by separating vacation expense from payroll expense and by separating uncollectible accounts expense from Other O & M because the expense lead days for vacation and uncollectible accounts expense have significantly different lead times than labor and Other O & M respectively. Certain non-jurisdictional taxes were removed by Staff from the expense lead calculation and Staff included Deferred Income taxes and Investment Tax Credit in its computation of expense lead. Staff determined BHP's revenue lag by utilizing a 20 day bill payment period which is the due date for customer billings, after which the Company may assess a late payment charge. Correspondingly, Staff removed late payment charges of approximately $149,000 from pro forma revenues thereby allowing the Company to be compensated for late paying customers. Staff modified BHP's calculation of working capital available from tax collections by omitting taxes collected from non-jurisdictional authorities and by reflecting statutory tax remittance dates. The result of Staff's revisions lowered BHP's South Dakota rate base by approximately $1,666,000.

Wygen III Plant Addition – BHP claimed the Wygen III plant would be completed by the proposed rate-effective date of April 1, 2010, and therefore, included in rate base the actual costs incurred at the time of the rate filing and estimates of the remaining completion costs. The settlement determination revises the Company's adjustment to: 1) Reflect actual costs as of March 31, 2010, in lieu of the Company's partially estimated costs; 2) Adjust the accumulated deferred income taxes related to the 50% bonus depreciation to reflect actual costs incurred in 2009 per the American Recovery and Reinvestment Act of 2009 in lieu of the Company's estimate; 3) Deduct one-half of the depreciation accrued in the first year of the plant's operation; 4) Reflect the accumulated deferred income taxes related to the difference between book and tax depreciation; and 5) Apply Staff witness Towers' recommended depreciation rate. The net effect of these changes is to reduce rate base by approximately $2,564,000.

Post-Test Year Plant Additions – The Company proposed to increase South Dakota test year plant in service for projected non-revenue producing post-test year capital additions anticipating that these plant additions would be in service by the conclusion of this proceeding. The settlement determination revises the Company's adjustment to: 1) Accept the completed plant additions as of February 2010 modified to reflect actual costs when placed in service; 2) Include work order 95707 for the replacement of a combustion turbine in the total Company amount of $3,220,506 that was proposed after the initial filing; 3) Include Wygen III shared assets in the total company amount of $2,439,047 that was completed by April 1, 2010; 4) Recognize, as a rate base adjustment, the accumulated deferred income taxes related to the difference between book and tax depreciation; 5) Reflect the accumulated deferred income taxes related to the 50% bonus depreciation for eligible projects per the American Recovery and Reinvestment Act of 2009; and 6) Allocate a portion of General plant additions to the non-jurisdictional Common Use System (CUS). The net effect of these changes is to reduce rate base by approximately $12,632,000.

Wygen III Materials and Supplies – The Company proposed an adjustment for Wygen III materials and supplies based on prices expected to be paid in 2009. The settlement determination revises the Company's adjustment by reflecting the actual dollars committed for executed spare parts orders in lieu of the Company's estimates and limited the amounts related to two packages of spare parts for the Wygen III turbine to 52% of their cost. The net effect of these changes is to reduce rate base by approximately $228,000.

Transmission Plant (Common Use System or CUS) – Most of the Company's transmission assets are segregated from the other utility assets because they are regulated by FERC and the Company is obligated to pay for its transmission service under the Joint Open Access Transmission Tariff. The Company has removed the applicable transmission plant and related expenses and revenues from the South Dakota cost of service. The settlement accepts these adjustments with minor modifications. Since Staff's case starts with the South Dakota jurisdiction, Staff's case does not have a specific adjustment for the removal of the CUS plant and related expenses and revenues.

Test Year Plant Annualization – The Company proposed an adjustment to annualize test year non-revenue producing plant additions that occurred during the test year. The settlement determination revises the Company's adjustment to: 1) Accept the Company's revised calculation of the annualization of non-revenue producing plant additions that properly annualizes the projects that moved from Account 107 (Construction work in progress) to the Completed Construction Account 106; 2) Reflect the accumulated deferred income taxes related to the difference between book and tax depreciation; 3) Reflect the accumulated deferred income taxes related to the 50% bonus depreciation for eligible projects per the American Recovery and Reinvestment Act of 2008 and 2009; and 4) Allocate a portion of General plant additions to the non-jurisdictional common use transmission system. The net effect of these changes is to increase rate base by approximately $4,281,000.

Test Year Accumulated Depreciation Adjustment – The Company proposed changes in depreciation rates based on analyses of plant retirement experience to the end of 2009, including plant removal costs and salvage values, prospective retirement dates for generating units, and, for mass property accounts, actuarial analysis of plant mortality characteristics. Also, refer to the discussion regarding Depreciation Rates under Operating Income. The settlement determination revises the Company's adjustments by revising the depreciation rate for the Wyodak, Osage, and Kirk Plant acquisition adjustments from 3.11% to 2.00% and removing CUS accumulated depreciation. The net effect of these changes is to reduce rate base by approximately $43,000.

Rate Case Expense – The settlement revenue requirement reflects a three-year amortization of allowed rate case expenses to spread these one-time costs over a reasonable period of time. Although BHP requested rate base treatment for two-thirds of the unamortized balance, the settlement includes one-half of the amortized costs, representing the average unamortized balance over the three-year period. This decreases rate base by approximately $62,000.

Renewable Energy Credits – The Company proposed to include the revenues from the sale of renewable energy credits in the calculation of the power marketing net income in the Conditional Energy Cost Adjustment (CECA). The settlement determination credits 90% of the share of margin generated by the sale of renewable energy credits in the determination of the fuel and purchased power adjustment beginning April 1, 2010, consistent with the Commission's decision in EL09-029 regarding Xcel Energy's proposal on the sale of renewable energy credits and also amortizes over three years the retail customers share of revenues related to the sale of renewable energy credits that occurred prior to April 1, 2010, with one-half of the South Dakota allocated share as a reduction to rate base. The net effect of this adjustment is to reduce rate base by approximately $14,000.

Amortization of Kirk Plant Reserve – See discussion of this issue under Operating Income. The Kirk Plant depreciation reserve was deducted from rate base by BHP. The settlement reduces this deduction by one-half of the annual amortization of the reserve balance reflected in Operating Income. The net effect of this change is to increase rate base by approximately $37,000.

Changes In Allocation Factors – Staff accepts the adjustment reflecting the changes in the jurisdictional cost of service that occurred post test year. The primary driver of the changes was the removal of the City of Gillette from the cost of service and pro forma adjustments. The adjustment updates the historic test year amounts allocated to South Dakota based on the pro forma allocation factors on Schedule N-1, Page 2.

Working Capital Updates – The settlement determination reflects the most recent 13-month average rate base allowances for materials and supplies, fuel stocks, prepayments, and customer advances. Amounts related to federal and state income taxes were excluded from prepayments. The net effect of these changes is to decrease rate base by approximately $906,000.

Flow-Through Tax Treatment for Repair Allowance – Staff's rate base adjustment removes the deferred tax balance that BHP had accumulated by normalizing tax benefits associated with an expanded tax deduction relating to repair expenditures that the IRS now permits BHP to claim. This issue is discussed more fully in the Operating Income section. The net effect of this change is to increase rate base by approximately $1,005,000.

Incentive Compensation – BHP included costs related to six Black Hills Power incentive plans and, in addition, an allocated portion of incentive compensation paid by Black Hills Service Company. The settlement removes financial based incentive payments that were included in the capitalized labor costs for plant. Shareholders are the overwhelming beneficiaries of incentive plans that promote the financial performance of the Company and therefore should be responsible for the cost of such compensation. This decreases rate base by approximately $116,000.

OPERATING INCOME

Corrections to Test Year – The Company proposed an adjustment to correct the account misclassification of CUS transmission revenue from rent from electric property and other (initial filing) to revenue - CUS system. Also see discussion on Transmission Plant (Common Use System or CUS). The settlement determination accepts this adjustment which reduces South Dakota other operating revenues by approximately $499,000.

Rate Case Expense – BHP proposed to amortize estimated rate case expenses over the next three years. The settlement includes actual costs incurred to date, amortizes the expense over three years, and reduces the amortized expense by the amount of rate case expense currently included in rates. The net effect of these changes is to reduce operating expenses by approximately $152,000.

Wage Increase – The Company proposed to increase test year labor expense and associated payroll taxes by 3.5% using an average of union negotiated wage increases and expected non-union salary increases. The settlement annualizes wage and salary increases that became effective during the test year and reflects known salary increases granted after the end of the test year. Union employees received, on average, a 2% increase on April 1, 2009, that was negotiated in the collective bargaining agreement. Non-union employees received, on average, a 2.03% increase on April 1, 2009, and a 2.58% increase on April 1, 2010. The increases were supported by studies of salaries paid by other reasonably comparable companies. The net effect of these changes is to reduce operating expenses by approximately $113,000.

Additional Employees – The Company proposed adjustment included estimated salary and benefit expenses for nine positions, four unfilled positions at the end of the test year and five new positions to be created after the end of the test year which are necessary to provide service to customers. The settlement determination reflects actual salaries for three new positions that were filled to meet the workforce needs driven by the expansion at the Neil Simpson Energy Complex; i.e., Wygen III. The benefit expense was derived using a loaded benefit rate based on actual expenses with known and measurable adjustments. Six positions were not included for the following reasons: 1) Three positions were not filled and do not qualify as known and measurable adjustments; 2) Two positions were replacement positions with the costs already included in the test year; and 3) One position was a maintenance trainer position that Staff could not reasonably quantify the reduction in contracted maintenance expense. The net effect of these changes is to reduce operating expenses by approximately $619,000.

Inter-company Transaction Adjustment – The settlement determination accepts BHP's proposed Inter-company Transaction adjustment, which annualizes certain known changes in the Company's costs paid to the affiliate service company, Black Hills Service Company. In the Service Company Charges adjustment, however, Staff took issue with the manner in which certain service company overhead charges are assigned to the corporate parent, Black Hills Corporation. See discussion on Service Company Charges.

Wygen III O&M – BHP estimated annual O&M expenses based on actual expenses at its similar Neil Simpson II Plant. The settlement determination reflects these estimates and revises the property insurance expense from $250,000 to $224,260 to reflect the actual premium in lieu of the Company's estimate. The net effect of this change is to reduce operating expenses by approximately $12,000.

Wygen III Forecasted Coal Cost – BHP estimated the quantity of coal to be burned at Wygen III and priced this tonnage using its forecast of the "Statement R" price per ton to be paid to Wyodak Resources in 2010. The settlement determination reflects BHP's estimated tonnage priced at the actual 2009 Statement R average price. The net effect of this adjustment is to reduce operating expenses by approximately $133,000.

Purchase Power and Natural Gas Expense – The Company proposed an adjustment to decrease purchased power and natural gas costs for peak loads and other needs based on normal 12 month operations with Wygen III as part of the generation portfolio. The settlement determination accepts this adjustment.

Wygen III Miscellaneous Service Revenues – The Company proposed an adjustment to increase miscellaneous service revenues for MDU and a third party's service contracts and use of common assets in accordance with the ownership documents for Wygen III. See discussion on Wygen III Shared Facilities Asset Fee. The settlement determination accepts this adjustment.

Generation Dispatch and Scheduling – Because BHP centrally schedules and dispatches generation for its jurisdictional retail provision of service and other parties, and because MDU's 25% ownership and Gillette's 23% ownership of Wygen III would have not yet been included in a test year allocation of scheduling and dispatch costs, the Company's Statement H, Schedule H-8, details an adjustment providing for such an allocation. Staff generally agreed with the allocation but replaced the budgeted costs used by BHP with actual calendar year 2009 costs. The Company stated that dispatch costs would not increase due to the operation of Wygen III. The result of Staff's revised allocation reduces jurisdictional operating expense by approximately $2,000.

Generation Plant Overhaul Expense Without Wygen III – The Company is requesting approval for the creation of a regulatory liability for each steam plant for periodic major turbine maintenance expenses. A predetermined amount, based on historical experience and estimates, would be accrued as an annual expense and after the maintenance work is performed, the actual expense would be applied against the accrued amount and any differences would be recognized in the income statement. By establishing this regulatory liability for major maintenance, the income statement is normalized for these large projects and better reflects the ongoing operations of the Company. The settlement determination accepts the Company's proposal but revises the Company's adjustment by replacing the Company's estimate for the Wyodak plant with the actual costs of the most recent, 2006 overhaul and for Wygen III adjusts the Company's full-cost request to reflect only its 52 % ownership share of the plant. The net effect of these changes is to increase operating expenses by approximately $19,000.

Transmission Expense – The Company's adjustment is based on a projected 2010 CUS (FERC jurisdiction) transmission rate for the Company. The settlement determination modifies the Company's adjustment to reflect the current FERC approved rate in lieu of the estimated rate and removes the CUS load dispatch labor increase reflected in the labor adjustment. The net effect of these changes is to reduce operating expenses by approximately $108,000.

Power Marketing Adjustment – BHP's adjustment to remove Power Marketing expenses from the base rate regulated cost of service is found on Statement H, Schedule H-12. The Revenue adjustment found in Statement I, page 1, removes the corresponding Power Marketing Revenues from the base rate cost of service. Staff has accepted the expenses removed in Statement H and the revenues removed in Statement I.

Normalized Output for Power Marketing Coal Costs – The adjustment filed by the Company to remove fuel costs related to power marketing is found on Statement H, Schedule H-14. BHP utilized a four year average (2005 - 2008) of coal consumption at the three coal plants providing power marketing generation and the projected price of coal. Staff revised the Company's adjustment to reflect a five year average of coal consumption, including 2009 consumption, and utilized the actual 2009 cost of coal, resulting in an increase in operating expense allocated to South Dakota jurisdictional operations of approximately $193,000.

Coal Price Adjustment – BHP based their pro forma annual coal cost on a four year average (2005 - 2008) of consumption at its coal fired generating plants and projected 2010 coal costs. Staff revised this calculation to reflect a five year average of consumption, including 2009 consumption, and BHP's actual 2009 average cost of coal as reflected in its annual Energy Cost Adjustment filing in Docket EL10-001. The result of Staff's revisions reduced BHP's operating expenses by approximately $578,000.

Depreciation Rates – BHP proposed changes in depreciation rates based on analyses of plant retirement experience to the end of 2009, including plant removal costs and salvage values, prospective retirement dates for generating units, and, for mass property accounts, actuarial analyses of plant mortality characteristics. Depreciation accrual rates were developed using the remaining life method to eliminate the effects of any excess or deficiency in past accruals over the plant's service life. The methodology is the same as that used in its previous rate case, Docket EL06-019. Staff accepted the accrual rates developed by BHP except for the 2.72% rate proposed for Wygen III, based on an assumed life span of 45 years.

For Wygen III, Staff proposed an accrual rate of 2.35% predicated on a 50-year life span. The settlement determination reflects this change.

The settlement determination also revises the depreciation rate for the Wyodak, Osage and Kirk Plant acquisition adjustments from 3.11% to 2.00%.

Test Year Depreciation Expense – See discussion of Depreciation Rates. The settlement determination also reflects the removal of depreciation expenses related to the common use transmission system. The net effect of these changes is to increase operating expenses by approximately $82,000.

Wygen III Depreciation, Overhaul and Property Tax Expense – See discussion of Depreciation Rates for Wygen III depreciation expense allowance and Generation Plant Overhaul Expense Without Wygen III for the overhaul expense allowance. The net effect of these changes is to reduce operating expenses by approximately $364,000.

Operating Revenue Adjustment – Statement I, page 2 of the Company's initial filing adjusts operating revenues to reflect changes to contractual sales made to Montana-Dakota Utilities Co. and the Municipal Energy Agency of Nebraska. As these changes are known and measurable, they are accepted by Staff. The settlement determination accepts this adjustment.

Energy Cost Adjustment Revenue Adjustment – In the process of resetting base rates to include a more current fuel cost level, an adjustment was made by BHP to reduce Energy Cost Adjustment Revenues as they will subsequently be recovered in base rates (Statement I, page1). The settlement determination accepts this adjustment.

Lawsuit and Severance Payment Adjustment – The South Dakota portion of the lawsuit and severance payments included in the South Dakota test year are approximately $1,000 and approximately $17,000 respectively. Because these expenses are nonrecurring, staff made an adjustment to remove both of these expenses from the cost of service and the settlement determination reflects this.

Interest Synchronization and Statement K Adjustment – The settlement determination accepts the Company's adjustments for Federal income tax adjustments for AFUDC equity and AFUDC capitalized and synchronizes the tax deduction for interest on debt with an adjusted net investment rate base and the rate of return. The net effect of these adjustments is to increase federal income taxes by approximately $255,000.

Workers Compensation – The Company's filing did not adjust test year workers compensation expense. The settlement normalizes these expenses by removing a non-recurring claim and adjusting the test year amount to reflect the 5 year average from 2004 through 2008. The net effect of these changes is to reduce operating expenses by approximately $1,402,000.

Industry Association Dues and Lobbying Expense – Staff proposed and the Company accepted two adjustments for the partial removal of industry association dues and lobbying expense. Staff believes these expenses are for the benefit of shareholders and not necessary in providing safe, adequate, and reliable service. The result of these two adjustments decreases South Dakota operating expenses by approximately $47,000.

Economic Development Expense – The Company included approximately $53,000 for South Dakota economic development expenses. Staff disallowed this amount because the Company does not have an economic development plan approved by the Commission which would benefit shareholders as well as ratepayers; therefore, the settlement determination reflects this adjustment.

Advertising Expense – Staff adjusted advertising expenses to remove costs not related to safety, energy conservation, and consumer education. The settlement determination accepts this adjustment of approximately $266,000.

Pension Expense – BHP included approximately $1,915,000 in the test year cost of service representing total company contributions to fund its defined benefit pension plan. Staff learned through data requests that actual total company pension expense for the test year was approximately $1,831,000. Staff allowed the actual expense incurred which after allocation to the South Dakota jurisdiction resulted in a reduction of pension expense of approximately $75,000.

Removal of Demand Side Management – In recognition of the complexity of Demand Side Management (DSM) programs and the Commission's previous actions to create a separate rider for DSM expense recovery through independent dockets, Staff proposed to remove the test year DSM expenses of approximately $280,000 from the cost of service. The settlement determination accepts this adjustment.

Test Year Plant Annualization – The Company proposed an adjustment to annualize test year non-revenue producing plant additions that occurred during the test year. The settlement determination revises the Company's adjustment to: 1) Accept the Company's revised calculation of the annualization of non-revenue producing plant additions that properly annualizes the projects that moved from Account 107 (Construction work in progress) to the Completed Construction Account 106; 2) Reflect the accumulated deferred income taxes related to the difference between book and tax depreciation; 3) Reflect the accumulated deferred income taxes related to the 50% bonus depreciation for eligible projects per the American Recovery and Reinvestment Act of 2008 and 2009; and 4) Allocate a portion of General plant additions to the non-jurisdictional common use transmission system. The net effect of these changes is to increase operating income by $6,000.

Post-Test Year Plant Additions – The Company proposed to increase South Dakota test year plant in service for projected non-revenue producing post-test year capital additions, anticipating that these plant additions would be in service by the conclusion of this proceeding. The settlement determination revises the Company's adjustment to: 1) Accept the completed plant additions as of February 2010 modified to reflect actual costs when placed in service; 2) Include work order 95707 for the replacement of a combustion turbine in the total Company amount of $3,220,506 that was proposed after the initial filing; 3) Include Wygen III shared assets in the total company amount of $2,439,047 that was completed by April 1, 2010; 4) Recognize, as a rate base adjustment, the accumulated deferred income taxes related to the difference between book and tax depreciation; 5) Reflect the accumulated deferred income taxes related to the 50% bonus depreciation for eligible projects per the American Recovery and Reinvestment Act of 2009; and 6) Allocate a portion of General plant additions to the non-jurisdictional common use system. The net effect of these changes is to reduce operating income by $931,000.

Late Payment Charge Revenue – See discussion on Cash Working Capital (Rate Base).

Incentive Compensation – BHP included costs related to six Black Hills Power incentive plans and, in addition, an allocated portion of incentive compensation paid by Black Hills Service Company. The settlement determination removes financial based incentive payments from the test year benefit expenses. Shareholders are the overwhelming beneficiaries of incentive plans that promote the financial performance of the Company and therefore should be responsible for the cost of such compensation. This reduced operating expenses by approximately $794,000.

Changes In Allocation Factors – BHP proposed an adjustment which modifies the jurisdictional allocation factors, mainly the removal of the City of Gillette from the cost of service, with the Company's proposed other adjustments to rate base and operating income. The settlement determination recognizes the need for and therefore reflects such synchronizing adjustments.

Industrial Revenue Adjustment – The settlement determination annualizes the effect of the rate increase for industrial customers made effective during the test period. That is, Staff's adjustment properly calculates pro forma revenues for the Industrial Class as if the rates had been in effect for the entire test period. This adjustment was not included in BHP's original filing. The effect of these changes increases retail revenues by approximately $65,000.

Renewable Energy Credits – The Company proposed to include the revenues from the sale of renewable energy credits in the calculation of the power marketing net income in the Conditional Energy Cost Adjustment (CECA). The settlement determination credits 90% of the share of margin generated by the sale of renewable energy credits in the determination of the fuel and purchased power adjustment beginning April 1, 2010, consistent with the Commission's decision in EL09-029 regarding Xcel Energy's proposal on the sale of renewable energy credits and also amortizes over three years the retail customers share of revenues related to the sale of renewable energy credits that occurred prior to April 1, 2010, with one-half of the South Dakota allocated share as a reduction to rate base. The net effect of this adjustment is to increase other operating revenues by approximately $9,000.

Flow-Through Tax Treatment for Repair Allowance – Prior to 2008, BHP was required to capitalize for financial reporting and for tax purposes certain repair expenditures. In 2008, BHP received permission from the IRS to claim the repair expenditures as a deduction on its tax return. Because accounting conventions still require BHP to capitalize the repair expenditures for book reporting purposes, a timing difference is created between when the expense is recognized for tax purposes and when it is expensed for financial reporting purposes. In BHP's filing, the tax effect of the resulting timing difference has been "normalized." Under tax normalization, current ratepayers are denied the benefit of the tax deduction that BHP received. Rather, that benefit is spread out over many years. Because repair expenditures are a normal and recurring cost for BHP, i.e., new timing differences for the repair allowance are being created each year, Staff recommends that the tax benefit that BHP receives by claiming the repair allowance deduction be "flowed-through" to current ratepayers in the form of a reduced income tax expense allowance. Staff's adjustment reduces BHP's claimed provision for deferred taxes by approximately $1,005,000. Staff also eliminated the related deferred tax balance from BHP's proposed rate base. This increased rate base by approximately $1,005,000.

Service Company Charges – At the end of 2004, Black Hills Corporation established a separate service company, Black Hills Service Company (BHSC), to provide shared corporate, administrative, management, and support services to BHP and all other corporate affiliates. BHSC bills BHP and all other affiliates for service provided pursuant to a Service Agreement and the terms of its Cost Allocation Manual. The Cost Allocation Manual sets forth the procedures and formulae that are to be used to allocate unattributable (i.e., costs that cannot be billed directly to the entity requesting the service) among the affiliates. Under the terms of the Cost Allocation Manual, the corporate parent, Black Hills Corporation was assigned only 5% of the costs of certain shared services. The remaining 95% is to be allocated among the affiliates by using the average of three measures of relative size for each affiliate (assets, payroll, and gross margin). Staff believes that this approach assigns too few costs to the parent company, the result of which is that too many costs are allocated to BHP and the other affiliates. Staff proposed to include the parent company's assets, payroll, and gross margin in the calculation of the allocation formula rather than arbitrarily assigning only 5% of the total to the parent company. Staff's proposed allocation method increases the parent company's share of certain corporate overhead costs from 5% to 12.54%. This, in turn, reduces BHP's share of those overhead costs by approximately $105,000.

Amortization of Kirk Plant Reserve – BHP had on its books at the end of the test year a depreciation reserve related to the already-retired Kirk Generating Plant. Because the reserve balance represented amounts recovered to compensate the Company for the Kirk Plant investment and retirement-related costs and because it was determined that all of these costs have been fully recovered, Staff recommended an amortization of the reserve balance, reducing depreciation expense over a period of three years by approximately $73,000 per year.

Wygen III Shared Facilities Asset Fee – The settlement determination includes the Wygen III shared facilities in the post-test year non-revenue producing plant additions. The Company receives reimbursement for these facilities through a shared capital asset fee from MDU and other parties that utilize the facilities and credits the revenues to miscellaneous service revenues in the cost of service. This adjustment reflects the additional revenues that will be received via the shared capital asset fee agreement that is not already reflected in the cost of service. The net effect of this adjustment is to increase other operating revenue by approximately $25,000.

Employee Picnic – BHP included approximately $3,000 in South Dakota test year amounts for expenses related to an employee picnic. Staff removed this amount in its entirety because this type of expense is not necessary in providing safe, adequate, and reliable electric service. This adjustment is reflected in the settlement determination.

COST OF CAPITAL AND RATE OF RETURN

The Company's proposed rate increase was established to produce a 9.27% rate of return on its determination of an average rate base. The 9.27% rate of return reflected a proforma objective capital structure, a 6.85% cost of actual and projected long term debt and a claimed return of 11.5% on common equity capital. Staff's assessment of the settlement determination uses an 8.26% rate of return on average rate base. BHP provided the actual cost of its projected debt issue and an update of its actual capital structure. The Settlement Stipulation provides an 8.26% ROR on rate base ***Begin Confidential**

End Confidential***

BALANCING OF RATEPAYER AND UTILITY INTERESTS DURING A TRANSITIONAL PERIOD

Recognizing that the driving force in BHP's request for significant rate relief in this proceeding was the addition of a new unit, Wygen III, to the Company's generation fleet, Staff examined both the Company's planning for this unit and the rate consequences of its placement into service. In its rate filing, BHP acknowledged the "lumpiness" effect on rates of a major new block of generation but, nevertheless, requested immediate, full cost recovery for Wygen III.

Staff explored both the efficacy of the decision to build Wygen III and the alternatives for the recognition of its costs and benefits in retail rates. To assist Staff, the Commission retained a consultant with expertise in power supply resource planning who, after examining BHP's underlying "2007 Integrated Resource Plan" and later forecasts, concluded that, while the 2007 IRP analysis, in his view, gave insufficient consideration to a number of Wygen III alternatives, potentially understated certain risks created with the Wygen III alternative and wrongly evaluated the combined systems of BHP and CLF&P, rather than BHP alone, observed that the introduction of the Wygen III:

(a) will provide the additional capacity (including reserve margin) needed by BHP to serve the projected combined requirements of its wholesale and South Dakota retail customers in 2010 and

(b) will provide the additional capacity (including reserves) needed by BHP to serve the projected requirements of South Dakota retail customers alone in mid-2013.

Moreover, Staff noted that Wygen III is expected immediately to provide operating efficiencies that will accrue to BHP's retail customers.

It is Staff's position that the issues raised by its IRP consultant should be addressed directly and fully in future IRP's undertaken by BHP but that criticism's of the Company's 2007 IRP should not be used alone to treat Wygen III as if it does not exist or, equally important, to withhold from ratepayers the benefits that it is expected to produce.

The Settlement Stipulation between BHP and Staff contains commitments by BHP to address in future IRPs the IRP issues raised by Staff in this proceeding.

In addition, the Settlement Stipulation contains several elements, the purpose of which is to insure that the benefits from Wygen III accrue to South Dakota ratepayers, including:

(a) Wygen III is expected to provide the lowest cost system generation, a benefit that will be assigned to Retail customers, flowing to them by operation of the Fuel and Purchased Power Adjustment clause,

(b) *Sixty-five percent (65%)* of *pre-tax* Power Marketing Income (PMI) (the opportunities for which are expected to be enhanced with Wygen III) *will be* credited to Retail ratepayers. Previously only a sliding scale percentage of *after-tax* PMI *could be* credited to ratepayers; a credit was applied only if (and to the extent thereof) there was an increase above the base cost in Fuel and Purchased Power costs, and

(c) A minimum PMI credit of $2 million will apply regardless of the actual level of PMI and irrespective of changes in Fuel and Purchased Power costs.

Also, the Settlement Stipulation includes provisions that limit the additional fixed costs imposed on ratepayers by the Wygen III investment, including:

(a) A depreciation rate of 2.35% is used for Wygen III reflecting a 50-year life span and calculated without consideration of future additional major investments, reducing BHP's claimed operating expense by about $462,000. BHP had proposed a rate of 2.72% based on a 45-year life span and considering assumed future major expenditures,

(b) During the three year transition period, from 2010 (when Wygen III capacity will be needed to meet the combined requirements of BHP's wholesale and retail loads) and 2013 (when Wygen III capacity is expected to be needed to serve retail loads alone) the Company's rates will reflect a ratepayer cost-mitigating "SD Surplus Energy Credit" of $2.5 million in Year 1 (the twelve month period ending March 2011), $2.25 million in Year 2 and $2.0 million in Year 3, and

(c) A three-year moratorium prohibiting BHP from filing any application for an increase in base rates that would become effective prior to April 1, 2013, unless the Company experiences an "Extraordinary Event" as defined in the Settlement Stipulation.

AUTOMATIC ADJUSTMENT CLAUSES

BHP proposed clarifying the Energy Cost Adjustment in anticipation of carbon tax legislation to ensure that costs related to governmental impositions on generation plants can be recovered through both the Steam Plant Fuel Cost Adjustment (SPFCA) and the Conditional Energy Cost Adjustment (CECA) as those costs relate to fuel. Staff's recommendation and the Settlement Stipulation provide that the Company's proposed language not be included in the CECA and SPFCA at this time but that, if and when any new governmental impositions are imposed, the Company be allowed to file such a proposal, either individually or with the other five rate regulated utilities, demonstrating that the costs are allowable under SDCL 49-34A-25 and justifying the costs to be recovered.

In addition, a change in the stacking methodology for generation resources is proposed, whereby wind resources will serve load first and be paid for first by customers. To ensure economic dispatch of other resources, BHP will treat renewable energy as zero cost energy for purpose of dispatch and the associated energy will be the first resource attributed to serving load.

Staff and BHP agree to the Company's use of two adjustment clauses including the Transmission Cost Adjustment (TCA) and Fuel and Purchased Power Adjustment (FPPA) which combines the current Steam Plant Fuel Cost Adjustment and the Conditional Energy Cost Adjustment as set forth in the Settlement Stipulation Exhibits.

RATE DESIGN ISSUES

The revenue increase by rate schedule is shown on Staff Exhibit___ (JPT-4), Schedule 1, with the current rate design and settlement determination rate design structural changes shown on Staff Exhibit___ (JPT-4), Schedules 2-1 to 2-5.

Spread of the Increase – BHP prepared a South Dakota jurisdictional and a class cost of service study. The class cost study showed that the return earned from the Large General Service and Industrial class is less than the returns earned from the Residential, Small General Service and Lighting classes. In spite of this finding, BHP proposed to increase each class's revenue by a uniform percentage amount. Given the inherent uncertain nature of all class cost studies and the load data upon which the results rely and the legitimate ratemaking goal of gradualism in rate design, Staff proposed to move the Large General Service and Industrial rate class half-way to its indicated cost of service level. Staff expects that the Large General Service and Industrial rate class will be brought up to its full cost of service level in future rate cases. See Exhibit 1 attached to the Settlement Stipulation.

Rate Design Changes – BHP proposed to apply the percentage increase indicated in the class cost of service to each rate component equally. Under this proposal, all customers within a customer class will receive approximately the same increase in their power costs. The Commission approved the current rate design in 2006, Docket EL06-019. Increasing each rate component by the same percentage is appealing from a rate continuity and customer acceptance perspective. Staff viewed this approach as reasonable, and the settlement increased each rate component by the percentage increase indicated in the spread of the increase with the exception of the monthly service charges discussed below.

Monthly Service Charge – BHP's proposed rates reflected a uniform percentage increase for essentially all charges. This method, however, results in monthly service charges for the Residential and Small.General Service classes that far exceed Staff's cost of service and, further, would make BHP's monthly service charges the highest in the State among the six rate regulated electric utilities. Based on Staff's cost of service analyses for the customer cost function, we proposed a $0.25 (3.1%) per month increase in the Residential monthly service charge and a $1.00 (10%) increase in the monthly service charge for Small General Service customers.

Bill Impacts – The comparison between present and settlement rates for the residential service rate schedule is shown on Staff Exhibit_(JPT-4), Schedule 3.

OTHER ISSUES

Vegetation Management – Commission Staff concurs with BHP's requested recovery of expenses for vegetation management with the provision that expenses remain at or above the South Dakota per books amount of $1,064,963, on average, for the period rates are in effect. If the average is below the South Dakota test year amount at the time that BHP files its next application for an increase in rates, BHP will make an adjustment to reflect this commitment.

Interim Rates Subject to Refund – Staff and BHP agree that the revised rate schedules shall be implemented for service rendered on and after April 1, 2010, with bills prorated so that usage prior to April 1, 2010, is billed at the previous rates and usage on and after April 1, 2010, is billed at the new rates subject to refund, with interest, pursuant to the Commission Order Granting Request for Authority to Implement an Interim Rate Increase on April 1, 2010, Pursuant to SDCL 49-34A-17, dated March 23, 2010.

MORATORIUM

The Parties agree that BHP shall not file any rate application for an increase in base rates which would go into effect prior to April 1, 2013; provided, this restriction would not prevent BHP from filing for a rate increase to take effect prior to April 1, 2013, if BHP's cost of service is expected to increase due to an "Extraordinary Event", as defined in the Settlement Stipulation.