Black Hills Service Company

Cost Allocation Manual

EXHIBIT
BHP 41

Black Hills Service Company Cost Allocation Manual
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Introduction

The purpose of this cost allocation manual is to document the allocation processes of Black Hills Service Company, from recording the original transaction through the allocation of costs to Black Hills Corporation subsidiaries. Various topics to be addressed include the organization of the Service Company, the recording of transactions, calculating and assigning allocation factors, and recording and reconciling allocation transactions.

Black Hills Service Company (the Service Company) was formed on December 30, 2004, and was fully implemented and operational as of January 1, 2006. The Service Company was formed as required by the Public Utility Holding Company Act of 1935, which was administered by the Securities and Exchange Commission (SEC). Service companies were required of all registered holding companies under this law. Service companies coordinate corporate support functions and distribute costs to registered holding company subsidiaries using pre-defined allocation methodologies that had to be approved by the SEC.

Black Hills Corporation became a registered holding company at the end of 2004, and through a transition period and various amendments to the registered holding company filings, established the date of January 1, 2006 to fully implement the Service Company. In August of 2005, this law was repealed and replaced by the Public Utility Holding Company Act of 2005, which is administered by the Federal Energy Regulatory Commission (FERC). This new law was effective in February of 2006. Although certain administrative and reporting requirements changed as a result of the repeal, Black Hills Corporation did not change its implementation plan.

The Service Company is a wholly owned subsidiary of Black Hills Corporation (the Holding Company), and is a separate legal entity. The majority of operations and all employees were transferred out of the Holding Company on the effective date of implementation. The only transactions that remain at the Holding Company are transactions pertaining to long-term debt and related deferred finance costs, corporate credit facility and related deferred finance costs, and the administration of money pool transactions for both the utility money pool and the non-utility money pool. In addition, as will be discussed in greater detail later, certain corporate costs are allocated directly to the Holding Company. The most notable of these types of costs are corporate development project costs.

Service Company Organization

The Service Company is organized into operating departments based upon the services that those departments provide to Black Hills Corporation subsidiaries. Below is a list of each department, as well as a brief description of the services they provide.

Accounting Systems (1) – Maintains the corporate wide accounting systems of Black Hills Corporation, most notably the general ledger and financial statement preparation systems.

Accounts Payable (2) – Processes payments to vendors and prepares 1099s and applicable documentation for the majority of Black Hills Corporation subsidiaries.

Corporate Development (4) – Facilitates the development of the corporate strategy, prepares strategic plans, and evaluates potential business opportunities.

Corporate Governance (5) – Develops and enforces corporate governance policies and procedures in accordance with applicable laws and regulations. Provides oversight of compliance with Securities and Exchange Commission rules and regulations. Oversees the administrative duties to the Board of Directors.

Tax (6) – Prepares quarterly and annual tax provisions of all Black Hills Corporation subsidiaries. Maintains and reconciles all current and deferred income tax general ledger accounts. Prepares tax filings and ensures compliance with applicable laws and regulations. Oversees various tax planning projects.

Risk Management (7) – Provides risk management, risk evaluation, and risk analysis services. Provides support to the Executive Risk Committee.

Legal (8) – Provides legal services related to labor and employment law, litigation, contracts, rates and regulation, Securities and Exchange Commission compliance, environmental matters, real estate and other legal matters. Oversees the hiring and administration of external counsel. Provides legal support to various corporate development projects.

Environmental (9) – Establishes policies and procedures for compliance with environmental laws and regulations. Researches emerging environmental issues and monitors compliance with environmental requirements. Oversees environmental clean-up projects.

Executive Management (10) – Provides overall oversight of Black Hills Corporation subsidiaries. Guides the preparation of strategic plans and advises on potential corporate development opportunities. Provides the Board of Directors information for decision making purposes. Oversees communication with shareholders and the investor community.

Safety (11) – Develops and implements safety planning activities and provides employee safety education. Administers the corporate safety program. Assists with compliance with DOT, OSHA, and MSHA regulations.

Finance and Treasury (12) – Coordinates activities related to securities issuance, including maintaining relationships with financial institutions, cash management, debt compliance, investing activities and monitoring the capital markets. Oversees the administration of corporate pension and 401(k) plans.

Financial Reporting (13) – Oversees the corporate consolidation of subsidiary financial statements. Prepares monthly internal financial reports for management. Prepares quarterly and annual financial reports to the Securities and Exchange Commission. Researches emerging accounting issues and assists with the compliance of new accounting rules and regulations.

General Accounting (14) – Provides overall oversight for the maintenance of accounting records. Researches emerging accounting issues. Assists in the compliance of all accounting rules and regulations. Provides accounting support to the Service Company and the Holding Company.

Oversees the accumulation of subsidiary financial budgets and the consolidation of the corporate wide budget.

Human Resources (15) – Establishes and administers policies related to employment, compensation and benefits. Coordinates the bargaining strategy and labor agreements with union employees. Provides technical and professional development training and general HR support services. Oversees the self-insured medical benefits plans and provides support to the third party administrators of the plans.

Insurance (17) – Facilitates physical risk management strategies through the purchase and evaluation of various types of insurance coverage. Provides claims management services.

Internal Audit (18) – Reviews internal controls and procedures to ensure assets are safeguarded and transactions are properly authorized and recorded. Oversees the Sarbanes Oxley compliance efforts. Evaluates contract risks.

Investor Relations (19) – Provides communications to investors and the financial community. Assists in the preparation of the annual report.

Shareholder Services (20) – Provides various recordkeeping and administrative services related to shareholder services. Assists in the administration of equity-based compensation plans.

Payroll (21) – Processes payroll for all Black Hills Corporation subsidiaries including but not limited to time reporting, calculation of salaries and wages, payroll tax reporting and compliance reports.

Power Delivery Management (22) – Performs resource planning, power delivery management, strategic planning, and construction management for the corporation's power generation assets.

Regulatory Services – Electric (23) – Determines the regulatory strategy for the corporation's utility subsidiaries Black Hills Power, Cheyenne, Light Fuel and Power, and Black Hills Colorado Electric, including revenue requirements and rates for electric and gas customers. Coordinates the regulatory compliance requirements and maintains relationships with the regulatory bodies.

Utility Accounting (24) – Maintains the accounting records of the utility subsidiaries of the corporation. Assists in the compliance with regulatory accounting requirements. Prepares required filings with the Federal Energy Regulatory Commission and with applicable state commissions. Assists in the preparation of budgets for the utility subsidiaries of the corporation. Prepares various operating and financial reporting for utility management. Assists with the regulatory strategy for the utility subsidiaries.

Utility Asset Accounting (25) – Maintains the records for property, plant, and equipment of the utility subsidiaries of the corporation. Assists in the preparation of required filings with the Federal Energy Regulatory Commission and with applicable state commissions. Assists in the preparation of property tax returns for utility property. Assists in the preparation of various operating and financial reporting for utility management.

Generation Dispatch (26) – Performs resource planning for the electric utility subsidiaries. Oversees the operations of the Power Marketing group.

Records Management (27) – Administers and maintains the records retention policies and procedures of the corporation. Manages the Enterprise Content Management System.

Supply Chain (28) – Provides purchasing and strategic sourcing services. Manages contracts, including drafting, negotiating, reviewing, and interpreting contracts. Provides fleet management services. Provides oversight of the materials management functions for the utility subsidiaries.

Facilities Management (29) – Provides facility, construction, and real estate management services for corporate wide facilities. Supports disaster recovery and business continuation planning.

Communications (30) – Provides oversight to the corporate communications processes. Provides advertising and branding development for the companies within Black Hills Corporation. Responsible for media relations. Manages and tracks all contributions made on behalf of Black Hills and it subsidiaries, as well as Black Hills Corporation Foundation. Assists in the preparation of the annual report.

Regulatory & Governmental Affairs (31) – Monitors, reviews, and researches government legislation and acts as a liaison with legislators. Maintains relationships with local and state governmental bodies. Manages the company's lobbying strategy.

Information Technology Administration (32) – Provide guidance and strategic planning to the overall information technology operations. Provide liaison services between information technology departments and end users.

Information Technology Business Applications (33) – Manages, maintains, and supports the primary business applications of the company.

Information Technology Infrastructure Services (34) – Manages, maintains, and supports data center operations, infrastructure servers, storage, system software, enterprise architecture, and corporate databases.

Information Technology Telecommunications (35) – Manages and supports the data and VOIP telephony needs for the company, as well as wireless devices. Provides telecommunication expense management services.

Information Technology User Services (36) – Manages and supports field services, the help desk, and user integration.

Information Technology Security (37) – Manages and supports the systems that support physical security.

Information Technology Compliance (38) – Responsible for internal and external audit compliance, disaster recovery, change management and legal compliance.

Information Technology Governance (39) – Provides governance, planning, and strategic support to the information technology function.

Overhead/Depreciation/Miscellaneous (98) – Accounts for the majority of employee benefit costs that make up the overhead rate. Accounts for depreciation of fixed assets. Accounts for small, miscellaneous items not associated with a specific department.

Direct Costs versus Indirect Costs

A key issue in distributing Service Company costs is distinguishing between direct costs and indirect costs. The account coding will change depending on whether the cost is a direct or indirect cost. Below is a summary of each of these types of costs and examples of these costs.

Direct costs are those costs that are specifically associated with an identified subsidiary or group of identified subsidiaries. This means that it is known exactly to which subsidiary or group of subsidiaries these costs relate. Here are some examples:

- A Payroll Processor is processing the payroll for Enserco. The labor costs incurred in processing payroll are specifically associated with an identified subsidiary. Therefore, this would be a direct cost.
- An Internal Auditor travels to Golden to complete audits for Enserco and Black Hills Exploration and Production. The time associated with completing the audits would be charged to each company based on the time worked for each specific company project. The travel expenses could either be coded to each company based on time worked or coded using a combination of spreading those charges equally and charging costs specifically to one of the companies each day worked. For example, one meal to Enserco, the next meal to BHEP, etc.
- The Human Resources department incurs costs to bring an employment candidate on-site to Gillette for an interview with Wyodak. These travel costs incurred in bringing the employee in for the interview are specifically associated with an identified subsidiary. Therefore, this would be a direct cost.
- A Help Desk technician orders a replacement computer monitor for an employee at Black Hills Power. This hardware cost incurred is specifically associated with an identified subsidiary. Therefore, this would be a direct cost.

Indirect costs are those costs that are not associated with an identified subsidiary. This means that the costs indirectly support all companies or directly support the operation of the Service Company. In other words, costs that would be directly charged to the Service Company using the definition and examples above would be classified as indirect costs. Here are some examples:

- A Payroll Processor attends training on year-end payroll updates. The labor costs incurred in attending this training are not specifically associated with an identified subsidiary. Therefore, this would be an indirect cost.

- The Internal Audit department is completing a BHC consolidated financial statement audit. Since all entities indirectly affect the financial statements of BHC consolidated, this charge would be considered an indirect cost.
- An Environmental representative wishes to take Paid-Time-Off (PTO). This charge can not be directly attributable to any specifically identified company; therefore, this charge would be considered an indirect cost.
- A Help Desk technician orders a replacement computer monitor for an employee of the Service Company. This hardware cost incurred is specifically associated with the Service Company. Therefore, this would be an indirect cost.

It is important that when determining if a cost is a direct cost or an indirect cost to consider two things. (1) Can the costs be substantiated that are coded to a specific company or group of companies and (2) Can it be substantiated that a utility-based entity is not subsidizing the operations of non-utility based company with the time and expenses that have been charged to them. As can be seen from above, a certain level of judgment will be involved when deciding whether a particular cost should be directly charged or indirectly allocated.

There are certain costs that will always be considered direct or indirect costs, no matter the circumstances. Below is a list of significant Service Company expenses that follow these rules:

Always considered direct costs:

- Capitalized costs for non-BHSC projects (including capitalized labor)
- Corporate development project costs
- Corporate development department costs
- Retiree healthcare costs

Always considered indirect costs:

- PTO and Holiday labor (they are included as a component of overhead)
- Corporate-wide bonuses and other similar methods of compensation that are included as a component of overhead
- Payroll taxes and 401(k) match expenses (they are included as components of overhead)
- Short or long-term disability expenses
- Board of Directors' fees and expenses
- General Office rent
- Depreciation
- Directors' and officers' insurance
- Investor relations expenses
- Shareholder expenses
- Intercompany interest expense and income

Transaction Coding

In addition to the normal general ledger software, the Service Company also utilizes the Project Tracking software system. Project Tracking allows for the accumulation and tracking of all

Service Company income statement transactions. In addition, the system also handles the distribution of both direct and indirect costs to Black Hills Corporation subsidiaries.

All income statement transactions will use the coding as described below. The coding is comprised of four separate fields, each representing an important characteristic of the underlying transaction. Balance sheet transactions may either use this coding as well, or they may be recorded directly to the balance sheet, depending on the nature of the transaction.

Location -- Cost Center -- Work Order -- Cost Code

Location:

- Three (3) character numeric field.
- The location field is used to identify the account code as either a direct cost or an indirect cost.
- If the cost is a direct cost, the location field will be populated using the location code for the company being directly charged. For example, the location code for Enserco is 017, the location code for BHEP is 025, and the location code for BHP is 005.
- If the cost is an indirect cost, the location field will be populated using the location code of 999. Remember, indirect costs also include costs directly related to the Service Company.

Location -- **Cost Center** -- Work Order -- Cost Code

Cost Center:

- Two (2) character numeric field.
- The cost center field is used to identify the department in which the costs originated.
- Each employee will use his or her department's unique cost center code when completing the account coding for costs they are initiating. If completing the account code on behalf of another individual, you would use that individual's department's cost center code. For example, if an administrative assistant is responsible for initiating invoices for a variety of cost centers, the account coding would include the cost centers for those departments and not the administrative assistant's cost center.
- For the most part, when completing a timesheet or coding an invoice, the cost center you use will always be the same. The major exception is when coding on behalf of others.
- Examples of cost center codes include 21 for Payroll, 15 for Human Resources, and 17 for Insurance.

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Location   Cost Center   **Work Order**   Cost Code

Work Order:

- Five (5) character numeric field.
- The work order field is used to identify the specific nature of the costs incurred. In essence, a work order is a cost pool to accumulate similar costs.
- Work orders can be used to track various types of costs required by departments or employees. For example, the Payroll department might have a work order to track costs for Payroll Processing, the Human Resources department might have a work order to track costs of Hiring/Recruiting, and the IT department might have a work order to track costs of providing IT User Support.
- For departmental budget-to-actual comparisons, it is important to use work orders to which your departments has budget dollars assigned. This will require communication with your department supervisor so that the correct work orders are used. The exception to this rule will be special projects that arise during the year.

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Location   Cost Center   Work Order   **Cost Code**

Cost Code:

- Two (2) character numeric field.
- The cost code field is used to identify the general nature of the costs incurred. The cost code is loosely equivalent to financial statement expense accounts.
- For instance, when a Payroll Processor is processing payroll and codes her timesheet, she will use cost code 31, for Labor-A&G. When the HR department codes travel costs for visiting other BHC sites, they may use costs code for Travel-Airfare (37), Lodging (07), and Meals (04).

To further understand how the account coding string is completed for each transaction, please see the following examples:

- An Accounts Payable processor processes an A/P check run for Wyodak and needs to code her time. This would be a direct charge because it is specifically associated with an identified subsidiary. The location code for Wyodak is 019, so that would be the first piece of the coding string. The Accounts Payable processor is part of the Accounts Payable department, whose cost center is 02. This department has a work order for Processing A/P Runs, and that work order number of 30005. Lastly, the processor is coding her timesheet, so a cost code of 31 would be used, which relates to Labor A&G.

- Here's how the completed string would look:

019	--	02	--	30005	--	31
Location		Cost Center		Work Order		Cost Code

- A non-company specific invoice is received for external financial statement audit fees. This would be an indirect cost because it is not associated with a specific company. Therefore, the location would be 999. This invoice would be initiated for payment by the General Accounting department, with a cost center of 14. The work order for Financial Statement Audits is 30125. Lastly, the cost code would be 10, for Audit Fees. Here's the string:

999	--	14	--	30125	--	10
Location		Cost Center		Work Order		Cost Code

- The Human Resources department incurs various consulting costs on changes to employee benefit plans. The location would be 999 because these costs are not associated with a specific company. Cost center 15 would be used for the Human Resources department. This department has work order 30168 for Human Resources Benefit Services. The cost code for Consulting/Professional Fees is 09. The coding string is:

999	--	15	--	30168	--	09
Location		Cost Center		Work Order		Cost Code

Recording Transactions to the General Ledger/Chart of Accounts

All Service Company income statement transactions must run through a Project Tracking account coding string. Project Tracking, however, is a separate system from the General Ledger. All transactions that are recorded through Project Tracking are simultaneously recorded to the General Ledger through a process referred to as "FERC-ing."

All work orders must be assigned a "FERC" relationship. All transactions that are recorded to that work order will be recorded to a General Ledger account based on the "FERC" relationship that is set-up. The work order, along with the cost center and cost code, decides which General Ledger account the transaction will hit. The location field will not have an impact on the General Ledger.

As new work orders are established, "FERC" relationships must also be established for all potential combinations of cost centers, work orders, and cost codes. Normally, for Service Company transactions, the key driver to the General Ledger is the cost code. The general rule is that all transactions recorded to the same cost code will be recorded to the same General Ledger account. There may be occasions where this general rule does not hold true, and in these cases, the work order will also help designate the General Ledger account used. For Service Company transactions, the cost center rarely affects the General Ledger account used, meaning that any transactions recorded to a work order/cost code combination will be recorded to the same General Ledger account no matter what cost center is used in the account coding string. However, the system does require that the "FERC" relationship include cost center, along with the work order and cost code.

The Service Company uses the Federal Energy Regulatory Commission's Uniform System of Accounts, as required by the Public Utility Holding Company Act of 2005. This chart of accounts prescribes which accounts are to be used for specific types of transactions. Because this is the same chart of accounts that a public utility uses, there are several groups of accounts that are not applicable to a service company. On the income statement, the primary group of accounts that is used is the Administrative and General Expenses account group.

Timekeeping

All Service Company employees are required to complete a timesheet for each two week pay period, whether they are an employee paid hourly or an employee paid a salary. Timesheets are due by 10:00 a.m. on Monday following the end of the pay period every other Sunday. Timesheets of all hourly employees must be approved by their supervisor. Timesheets of salaried employee are not required to be approved by their supervisor, but it is encouraged.

Timesheets are completed using a web-based program. Employees must complete the coding string, as previously discussed, for each time record. The timesheet will default the cost code field to the cost code for administrative and general labor, and the employee can skip the completion of this field. The only other allowable cost code on the timesheet is the cost code for capitalized labor. However, if the employee's activities can be capitalized, the employee will need to manually complete the cost code field. In addition, a pay code must also be designated for each time record. The pay code designates the time as such classifications as regular time, overtime, holiday time, or paid time off.

Employees are encouraged to enter their time in one half hour increments, although they may use smaller increments if they so choose. Employees are also encouraged to keep their timesheets updated on a regular basis, so that they don't have to enter two weeks worth of time on the last day of the pay period. It is best if they enter their time on a daily basis.

Overhead

Certain benefits that are provided to employees become an inherent cost of labor. To account for these benefits and allow for them to be charged to the appropriate subsidiary, they become part of an overhead rate that is added on to each payroll dollar. The Service Company utilizes two different overhead rates. A general overhead rate is added on to all payroll dollars, while a supplemental overhead rate is added on to payroll dollars of executive officers only. The supplemental overhead rate is necessary because certain benefits are limited to executive officers, and including those benefits in an overhead rate for all employees would not fairly distribute benefit costs.

As payroll is processed, overhead is calculated on the payroll dollars and follow the same location, cost center, and work order as the labor was coded to on the timesheet. The one difference is the cost code. Normal labor is coded to cost code 31, while capitalized labor is coded to cost code 39. Normal labor overhead is then coded to cost code 32, while capitalized labor overhead is coded to cost code 40. The General Ledger impact is that salary expense is grossed up for overhead, with a corresponding credit entry to Labor Overhead Offset, which is a contra expense account. This means the net impact to the income statement will be zero. The one exception is capitalized labor overhead, which is added to capitalized labor on the balance sheet, with the offset recorded as a credit to the income statement, thereby reducing overall expenses.

The overhead rates are calculated at the beginning of the year based upon budgeted benefit expenses and budgeted labor. These rates are loaded into Project Tracking and used for payroll processing throughout the year. Adjustments to the rates may be made during the year if material changes occur or are expected to occur to employee benefits. Below is a list of components of the overhead rates:

General overhead:

- PTO and Holiday pay
- FICA, FUTA, and SUTA taxes
- Medical/health benefits for active employees
- Pension accruals for the defined benefit plan
- Retiree healthcare accruals
- Gainshare/results compensation bonus accruals
- Short-term incentive plan bonus accruals for non-officers
- Stock option expense

Supplemental overhead:

- Restricted stock expense
- Non-qualified pension accruals (PEP and SERP)
- Short-term incentive plan bonus accruals for officers
- Performance plan bonus accruals

At the end of each month, overhead calculated on payroll using the overhead rates must be trued up against actual employee benefit costs. The purpose for this true-up is due to the fact that the Service Company's income statement must net to zero, meaning there can be no net income or net loss remaining at the Service Company. Overhead calculated on payroll is based on an estimated rate and budgeted benefits, so differences between actual benefits will be inherent to this process. The two main reasons for the difference is the employee benefit costs differ from the budget, or that payroll differs from budget. After the difference is calculated and reviewed for reasonableness, it is recorded to a separate work order, which is used only to track the overhead true-up adjustments, and indirectly allocated to Black Hills Corporation subsidiaries.

Allocation Factors

As previously stated, Service Company costs are either directly charged to a subsidiary, or indirectly allocated when the cost is not associated with a specific subsidiary. Indirect costs are allocated out using one of several pre-defined allocation factors. Each cost center has been assigned one of these allocation factors. All indirect costs of that cost center are then allocated using that factor. When determining which allocation factor should be assigned to each cost center, a factor was selected based on the specific cost driver of that cost center. For instance, the expenses incurred by the Human Resources department are primarily related to their support of all company employees. In this example, the cost driver for the Human Resources department indirect costs is employees. Therefore, their indirect costs will be allocated based upon the Employee ratio.

For certain cost centers, a specific cost driver may not be clearly identifiable or the driver may not be cost efficient to compute on a continuing basis. In these instances, a three-pronged general allocation factor is used, which is referred to as the Blended ratio. This ratio equally weights three different general ratios: Gross Margin, Asset Cost (limited to PP&E), and Payroll Dollars. These factors were chosen to be included in the Blended ratio because they best allocate costs based on the diverse nature of BHC operations.

In addition, some cost centers utilize a Holding Company Blended ratio. The difference between the Blended Ratio and the Holding Company Blended ratio is that the Holding Company Blended Ratio allocates a percentage of costs to BHC Holding Company. For example, the Corporate Governance department will allocate indirect costs using the Holding Company Blended ratio because certain costs incurred, such as New York Stock Exchange fees and Board of Directors costs, relate to both the Holding Company and the subsidiary companies. It should also be noted that Corporate Development costs will be directly charged to the Holding Company and will not be allocated to the subsidiaries.

One additional item to note is that health care costs are allocated differently due to the self-insurance pool. Black Hills Corporation has chosen to pool all health care costs and spread the risk amongst all subsidiaries equally. The exceptions are Cheyenne Light, Fuel and Power and the Aquila companies, which have their own health care plans that are substantially different than Black Hills Corporation's health care plan. As a result, these companies do not pool their costs with BHC, but rather pay directly all medical costs incurred. All other medical costs of BHC are paid by the Service Company and allocated to subsidiaries based on employee counts.

The following is a list of all allocations factors, including a brief description of the factor, the basis for the calculation of the factor, and the cost centers to which that factor has been assigned. Any asset factors and employee count factors are calculated as of period-end dates, while revenue and expense factors are calculated for twelve months ended as of period-end dates.

> *Asset Cost Ratio* – Based on the total cost of assets as of December 31 for the prior year, the numerator of which is for an applicable BHC subsidiary and the denominator of which is for all applicable BHC subsidiaries. Assets are limited to property, plant, and equipment, and include construction or work in process. Assets are also reported at their

FERC value, meaning that assets for the utility subsidiaries will not include any eliminations that are done to bring their FERC financial statements into compliance with GAAP. FERC requires that acquired fixed assets be recorded at their gross value with accumulated depreciation, while GAAP requires that acquired fixed assets be recorded at their net value. An elimination journal entry is used to eliminate the gross-up for preparation of GAAP financial statements, but this elimination journal entry is not factored into the calculation of the Asset Cost Ratio.

The Environmental cost center utilizes this ratio, and it is a component in both the Blended Ratio and the Holding Company Blended Ratio.

Gross Margin Ratio – Based on the total gross margin for the prior year ending December 31, the numerator of which is for an applicable BHC subsidiary and the denominator of which is for all applicable BHC subsidiaries. Gross margin is defined as revenue less cost of sales. Certain intercompany transaction may be excluded from gross margin if they would not have occurred if the revenue relationship was with a third party instead of a related party.

No cost centers utilize this ratio, but it is a component in both the Blended Ratio and the Holding Company Blended Ratio.

Payroll $ Ratio – Based on the total payroll $ for the prior year ending December 31, the numerator of which is for an applicable BHC subsidiary and the denominator of which is for all applicable BHC subsidiaries. Payroll $ include all bonuses and compensation paid to employees, but do not include items that are only included on an employee's W-2 for gross-up and income tax purposes, such as life insurance premiums over $50,000.

No cost centers utilize this ratio, but it is a component in both the Blended Ratio and the Holding Company Blended Ratio.

Blended Ratio – A composite ratio comprised of an average of the Asset Cost Ratio, the Payroll $ Ratio, and the Gross Margin Ratio. These factors are equally weighted. This factor is sometimes referred to as the general allocation factor.

Cost centers that utilize this ratio include Accounting Systems, Accounts Payable, General Accounting, Insurance, Internal Audit, Legal, Risk Management, Tax, Communications, Regulatory & Governmental Affairs, Records Management, Supply Chain, Information Technology Administration, Information Technology Business Applications, Information Technology Infrastructure Services, Information Technology Telecommunications, Information Technology User Services, Information Technology Security, Information Technology Compliance, Information Technology Governance, Facilities Management, and Overhead / Depreciation / Miscellaneous.

Holding Company Blended Ratio – 5% of costs allocated to the Holding Company, with the remaining 95% of costs allocated using a composite ratio comprised of an average of the Asset Cost Ratio, the Payroll $ Ratio, and the Gross Margin Ratio. These factors are equally weighted.

Cost centers that utilize this ratio include Corporate Governance, Executive Management, Finance and Treasury, Financial Reporting, Investor Relations, and Shareholder Services.

In addition, directors and officer's insurance expense incurred through the Insurance cost center is allocated using the Holding Company Blended Ratio, as well as strategic planning costs of the Corporate Development cost center.

Employee Ratio – Based on the number of employees at the end of the prior year ending December 31, the numerator of which is for an applicable BHC subsidiary and the denominator of which is for all applicable BHC subsidiaries.

Cost centers that utilize this ratio include Payroll, Safety, and Human Resources.

Holding Company Employee Ratio – Based on the number of employees at the end of the prior year ending December 31, the numerator of which is for an applicable BHC subsidiary and the denominator of which is for all applicable BHC subsidiaries, but excluding Cheyenne Light Fuel & Power and the Aquila companies.

This ratio is used to allocate health and medical costs from the BHC self-insurance pool. CLFP and the Aquila companies maintain their own self-insurance pools for which their benefits are substantially different than the benefits offered by the BHC self-insurance pool. As a result, CLFP and Aquila companies health and medical costs are not administered and allocated through the BHC self-insurance pool, but are paid directly by CLFP and the Aquila companies, respectively.

Power Generation Capacity Ratio – Based on the total power generation capacity at the end of the prior year ending December 31, the numerator of which is for an applicable BHC subsidiary and the denominator of which is for all applicable BHC subsidiaries. Power generation includes only capacity in service and does not include capacity under construction.

The Power Delivery Management cost center utilizes this ratio.

Utility Asset Cost Ratio – Based on the total cost of utility assets as of December 31 for the prior year, the numerator of which is for an applicable BHC utility subsidiary and the denominator of which is for all applicable BHC utility subsidiaries. Utility assets are limited to property, plant, and equipment, and include construction or work in process. Assets are also reported at their FERC value, meaning that assets for the utility subsidiaries will not include any eliminations that are done to bring their FERC financial statements into compliance with GAAP. FERC requires that acquired fixed assets be recorded at their gross value with accumulated depreciation, while GAAP requires that acquired fixed assets be recorded at their net value. An elimination journal entry is used to eliminate the gross-up for preparation of GAAP financial statements, but this elimination journal entry is not factored into the calculation of the Utility Asset Cost Ratio.

The Utility Asset Accounting cost center utilizes this ratio, and it is a component in the Utility Blended Ratio

Utility Gross Margin Ratio – Based on the total utility gross margin for the prior year ending December 31, the numerator of which is for an applicable BHC utility subsidiary and the denominator of which is for all applicable BHC utility subsidiaries. Utility gross margin is defined as revenue less cost of sales. Certain intercompany transaction may be excluded from utility gross margin if they would not have occurred if the revenue relationship was with a third party instead of a related party.

No cost centers utilize this ratio, but it is a component in the Utility Blended Ratio.

Utility Payroll $ Ratio – Based on the total utility payroll $ for the prior year ending December 31, the numerator of which is for an applicable BHC utility subsidiary and the denominator of which is for all applicable BHC utility subsidiaries. Utility payroll $ include all bonuses and compensation paid to employees, but do not include items that are only included on an employee's W-2 for gross-up and income tax purposes, such as life insurance premiums over $50,000.

No cost centers utilize this ratio, but it is a component in the Utility Blended Ratio.

Utility Blended Ratio – A composite ratio comprised of an average of the Utility Asset Cost Ratio, the Utility Payroll $ Ratio, and the Utility Gross Margin Ratio. These factors are equally weighted.

The Utility Accounting cost center utilizes this ratio. The Regulatory Services – Electric and Generation Dispatch cost centers also utilize this ratio, but costs are allocated only to electric utilities of Black Hills Corporation.

Changing Allocation Factors

Allocation factors are set at the first of the year, based upon financial information from the prior year ending December 31st. Assets, utility assets, employee counts, and power generation capacity are based on values as of the previous period ending December 31st. Gross margin, utility gross margin, payroll $, and utility payroll $ are based on values for the 12 months ended December 31st.

Certain events may occur during the year that are deemed to be significant to Black Hills Corporation that will require corresponding adjustments made to the allocation factors. Examples of these types of events include acquisitions, divestitures, new generation, significant staffing changes or new, significant revenue streams.

When these events occur, indirect allocation factors will be adjusted. When adjusting allocation factors, it is the policy of the Service Company to not recalculate all allocation factors. Rather, allocations factors will be adjusted with pro forma changes. For example, if an acquisition occurs during the middle of the year, pro forma values will be loaded. Asset values at the time of the acquisition would be used, as well as pro forma gross margin and payroll $ for a 12 month period. It should be noted that estimations may be required, especially when significant additions or changes are expected as a result of the acquisition.

It should also be noted that asset values, gross margin, and payroll $ for the other companies will not be changed. However, the ratios will change because the base against which the ratios are calculated will change. Subsidiary companies would see decreased ratio values with acquisitions, and increased ratio values with divestitures. Changes will be effective as of the beginning of the month, and will apply to all transactions for the month. Access to the tables for indirect allocation factors and the assignment of these factors to cost centers is restricted to only appropriate personnel.

Any changes to indirect allocation factors are initiated by one member of the allocations staff and reviewed by another member of the allocations staff. All changes are documented in memo format, with the supporting documentation maintained. Allocation factors loaded into the system are reviewed by someone other than who input the factors into the system.

Subsidiary Payment for Direct and Indirect Charges

It is the policy of the Service Company to initiate the subsidiary payments for direct and allocated charges. The reason for this is to prevent the subsidiaries from protesting charges and withholding payment. All payments for direct and allocated charges must be remitted to the Service Company by the end of the following month. To initiate payment, the Service Company prepares payment authorizations, with appropriate back-up, and provides them directly to the accounts payable departments of the subsidiary companies. These payment authorizations may then be approved according to subsidiary payment approval policies. The Service Company will monitor payments received during the month to ensure that all subsidiary companies make payment in a timely manner.

Executive Risk Committee Costs

The Executive Risk Committee exists to provide risk management support to certain BHC subsidiaries that provide the largest risk exposure. The Committee normally meets once a month. The majority of the Service Company costs incurred in relation to the Committee are labor and overhead costs. Due to the diverse make-up of this committee, it was not feasible to design an allocation factor to distribute these costs fairly to the appropriate business units. As a result, a manual allocation is performed each month.

All Service Company employees who participate on this Committee are instructed to code their costs to Location 999 as an indirect cost and to work order 30177. It was decided that the Committee primarily supports Enserco, while also providing ancillary support to BHEP and BHP (due to its power marketing transactions). As a result, it was determined that 80% of the

Committee's costs should be distributed to Enserco, 10% to BHEP, and 10% to BHP. These percentages were approved by the BHC CEO. These percentages are applied against total Committee costs incurred by the Service Company to determine each company's share. After all costs for the month have been incurred, they are distributed to business units with a manual journal entry that credits the costs out of Location 999 and to the locations for Enserco, BHEP, and BHP.

Allocating Fixed Assets

The Service Company maintains certain fixed assets that are used by and benefit all Black Hills Corporation subsidiaries. These fixed assets primarily consist of computer hardware and software that form the corporate-wide information technology network. Because these fixed assets support all Black Hills Corporation subsidiaries, they are allocated to the subsidiaries monthly as part of the month-end close process, along with the allocation of these assets' accumulated depreciation.

After all fixed asset and depreciation journal entries and reconciliations for month-end are completed, a manual journal entry is prepared to allocate the fixed assets and accumulated depreciation. This journal entry debits fixed assets and credits accumulated depreciation on the general ledger of each subsidiary, and credits fixed assets and debits accumulated depreciation at the Service Company. This journal entry is set to auto-reverse so that balances will be restored to the Service Company as of the first of the following month. This allows fixed asset additions, dispositions, and depreciation to be managed at the Service Company, with only ending balances allocated to the subsidiaries. As a result of this auto-reverse process, the subsidiaries will carry a payable back to the Service Company and will not be required to relieve the payable with cash.

Allocated assets and accumulated depreciation are maintained in separate general ledger accounts at the subsidiary level so that they aren't intermingled with regular subsidiary fixed assets, and for ease of reconciliation. Fixed assets are allocated using the Blended Ratio.