PUBLIC VERSION

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 EL14-026

Commission Staff (Staff) submits this Memorandum in support of the Settlement Stipulation (Settlement) of December 8, 2014, between Staff and Black Hills Power Company (BHP or Company) in the above-captioned matter.

BACKGROUND

On March 31, 2014, the Company filed an application with the South Dakota Public Utilities Commission (Commission) requesting approval to increase rates for electric service to customers in its South Dakota retail service territory by approximately $14.6 million annually or approximately 9.27%. A typical residential electric customer using 650 kWh per month would see an increase of $10.91 per month.

BHP's proposed increase was based on a historical test year ended September 30, 2013, adjusted for what BHP believed to be known and measurable changes, a 10.25% return on common equity, and a 8.48% overall rate of return on rate base.

The Commission officially noticed BHP's filing on April 3, 2014, and set an intervention deadline of June 6, 2014. On April 11, 2014, BHP filed revisions to certain pages originally filed in the application. On April 16, 2014, the Commission issued an Order Assessing Filing Fee. On June 6, 2014, a Petition to Intervene of GCC Dacotah, Inc., Pete Lien & Sons, Inc., Rushmore Forest Products, Inc., Spearfish Forest Products, Inc., Rapid City Regional Hospital, Inc., and Wharf Resources (U.S.A.), Inc. (collectively, Black Hills Industrial Intervenors or BHII) was filed. On June 6, 2014, Dakota Rural Action (DRA) also filed a Petition to Intervene. On June 26, 2014, the Commission issued an Order Granting Intervention to Black Hills Industrial Intervenors. On June 26, 2014, the Commission granted intervention to Dakota Rural Action subject to its filing an affidavit, which was filed on June 27, 2014. On September 3, 2014, BHP filed a Notice of Intent to Implement Interim Rates effective on and after October 1, 2014.

On September 4, 2014, BHP filed a Motion for Approval of Settlement Agreement, Confidential Settlement Agreement between Black Hills Power, Inc. and South Dakota Science and Technology Authority (SDSTA), including the associated Third Amendment to Electric Power Service Agreement between Black Hills Power, Inc. and SDSTA, and relevant exhibits. On September 10, 2014, Staff filed its memorandum regarding the Contracts with Deviations. On September 18, 2014, the Commission issued an Order Conditionally Authorizing and Approving Implementation of Contract with Deviations Rates on an Interim Basis.

Settlement discussions between Staff, BHP, BHII, and DRA commenced on October 28, 2014. 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 filing. Ultimately, the Parties reached a comprehensive agreement on BHP's overall revenue deficiency and other issues presented in this case including, but not limited to, class revenue responsibilities, rate design, and tariff concerns. BHII and DRA are not parties to the settlement. On December 9, 2014, BHP and Staff jointly filed a Joint Motion for Approval of Settlement Stipulation, Settlement Stipulation, and Exhibits. On December 12, 2014, the Commission issued a Scheduling Order setting this matter for hearing on January 27-29, 2015. On December 30, 2014, the Commission issued an Order for and Notice of Hearing.

BHII filed Direct Testimony and Exhibits of Lane Kollen and Direct Testimony and Exhibits of Stephen J. Baron on December 30, 2014. No testimony was filed by DRA. This Memorandum supports Staff's view of the settlement. Staff Witness Dave Peterson's direct testimony addresses specific items discussed in Mr. Kollen's testimony and Mr. Baron's testimony.

OVERVIEW OF SETTLEMENT

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

Company and Staff positions were discussed thoroughly at the settlement conferences. As a result, some positions were modified and others were accepted where consensus was found. Ultimately, the Parties agreed on a comprehensive resolution of all issues. Staff believes the settlement is based on sound regulatory principles and avoids additional costly and unnecessary litigation.

The Parties agree BHP's revenue deficiency is approximately $6,890,746, which results in an approximate 4.35% increase in retail revenue. This revenue requirement and supporting calculations described in this Memorandum and attachments depict Staff's positions regarding all components of BHP's South Dakota jurisdictional revenue requirement.

STAFF OVERVIEW OF SETTLEMENT

Staff's determination of the settlement revenue requirement begins with total Company test year costs for the twelve months ended September 30, 2013, and allocates those total Company amounts to the South Dakota retail jurisdiction. Staff then adjusted the September 30, 2013, test year results for known and measurable post-test year changes. Staff Exhibit___(BAM-1), Schedule 3 illustrates Staff's determination of BHP's *pro forma* operating income under present rates. Staff Exhibit___(BAM-2), Schedule 2 illustrates Staff's calculation of BHP's South Dakota retail rate base, and Staff Exhibit___(BAM-1), Schedule 2 and Staff Exhibit___(BAM-2), Schedule 1 summarize the positions. Staff Exhibit___(BAM-1), Schedule 1 summarizes Staff's determination of BHP's revenue deficiency and total revenue requirement collected through base rates.

The base revenue increase by rate schedule is shown on Staff Exhibit___(PJS-2), Schedule 1. Staff Exhibit___(PJS-2), Schedules 2-1 through 2-5 reflect the settlement base rates for each rate schedule. The comparison between present and settlement rates and resulting bill impacts for the Residential Service rate schedules is shown on Exhibit___(PJS-2), Schedule 3.

Unless otherwise noted, all of the changes discussed below are changes from the Company's 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, September 30, 2012, through September 30, 2013.

CPGS Plant Addition – BHP proposed an adjustment to increase plant in service for projected capital costs associated with the Cheyenne Prairie Generating Station (CPGS). The Company included in rate base the actual costs incurred as of December 31, 2013, and estimates of the remaining completion costs. The settlement determination revises the Company's adjustment to reflect actual costs as of October 31, 2014, and reasonably known and measurable changes after October 31, 2014. The settlement also reflects the associated accumulated deferred income taxes. The net effect of these changes is to reduce rate base by approximately $2,156,000.

Test Year Plant In Service Annualization – The Company proposed an adjustment to annualize test year non-revenue producing plant additions that were completed during the test year. The settlement determination revises the Company's adjustment to: 1) Remove the amounts related to eight projects that appear to be revenue producing; and 2) Reduce the amounts related to two projects for contributions made by CenturyLink. The settlement also includes accumulated deferred income taxes arising from these projects. The net effect of these changes is to reduce rate base by approximately $90,000.

Post-Test Year Plant Additions – The Company proposed an adjustment to increase South Dakota test year plant in service for projected non-revenue producing post-test year capital additions anticipated to be in service prior to October 1, 2014. The settlement determination revises the Company's adjustment to reflect actual costs for completed projects in-service as of November 6, 2014. The settlement also includes accumulated deferred income taxes on the post-test year plant additions that are reflected in rate base. The net effect of these changes is to increase rate base by approximately $423,000.

Ben French, Neil Simpson I, & Osage Retirements – BHP proposed an adjustment to remove from rate base the amounts related to the Ben French, Neil Simpson I, and Osage power plants that were retired on or before March 21, 2014, to comply with the Environmental Protection Agency (EPA) Area Source Rules. The settlement accepts this adjustment.

Accumulated Depreciation – The Company proposed an adjustment to increase accumulated depreciation (and thereby to reduce rate base) to reflect one-half of the annual depreciation expense associated with new assets and its new depreciation rates. The settlement revises the Company's adjustment to synchronize the depreciation reserve with the plant additions that are to be included in rate base and to reflect a depreciation rate of 2.98% for CPGS in lieu of the Company's proposed 3.29% rate. The net effect of these changes is to increase rate base by approximately $44,000.

Cash Working Capital – BHP's proposed rate base included an allowance for cash working capital based on a lead-lag analysis. A lead-lag analysis examines the timing of the Company's receipt of service revenues from customers in relation to the Company's payment of expenses to vendors and employees. The Company's cash working capital allowance also included a rate base deduction for tax collections which the Company receives in advance of turning the related payments over to the taxing authorities. Staff carefully examined BHP's revenue lag and expense lead day determinations and made the following modifications, which are consistent with Staff adjustments in prior rate cases:

1. Revised the expense lead days for net payroll, service/holding company charges, other operating and maintenance, FICA, federal income tax, gross receipts tax, federal withholding, and sales tax;
2. Included a separate expense lead for vacation pay;
3. Included a separate expense lead for incentive compensation;
4. Included a separate expense lead for uncollectible accounts expense;
5. Revised revenue lag days to remain consistent with past Staff practice and state statute, and to more accurately reflect the South Dakota jurisdictional revenue lag; and
6. Revised expenses per day to incorporate into the lead-lag analysis the impacts of Staff's recommended adjustments to *pro forma* operating expenses.

These modifications increase rate base by approximately $5,161,000.

Rate Case Expense – Rate case expense included in Docket EL12-061, which includes costs incurred for both Docket EL12-061 and EL12-062 as of July 2, 2013, was amortized over a three-year period beginning June 16, 2013. Interim rates in this case were put into effect on October 1, 2014, leaving approximately 20.5 months of cost recovery until the Docket EL12-061 rate case expenses are completely amortized. The settlement in EL12-061 established a tracker for the potential recovery of the residual costs associated with both dockets in BHP's next rate case filing.

BHP proposed recovery of projected rate case costs for EL14-026, the remaining unamortized rate case expense from EL12-061 and EL12-062, and the residual costs related to EL12-061 and EL12-062, all amortized over a three-year period. BHP also proposed an unamortized amount of $750,046 be included in rate base. The settlement reflects a three-year amortization of $212,861 in actual costs as of November 6, 2014, for docket EL14-026 and $412,797 in actual, unrecovered costs for EL12-061 and EL12-062, for a total amount of $625,657. One-half of the rate case costs, or $369,191, is included in rate base, representing the average unamortized balance over the three year period. The net effect of these changes reduces rate base by approximately $381,000. The settlement also establishes a tracking mechanism for the potential recovery of the residual costs, if any, associated with docket EL14-026 in BHP's next rate case.

Decommissioning Regulatory Asset – The Neil Simpson I, Ben French, and Osage coal-fired power plants are subject to the Environmental Protection Agency (EPA)'s National Emission Standards for Hazardous Air Pollutants for Area Sources: Industrial, Commercial, and Institutional Boilers (Area Source Rules). After evaluating the options, BHP concluded the most cost effective plan to comply with these rules was to retire Neil Simpson I, Osage, and Ben French by the compliance deadline of March 21, 2014. The decommissioning process began in 2014 and is estimated to be completed by September 2015. In

Docket EL13-036, the Commission issued an order authorizing BHP to transfer the remaining plant balance for the soon to be decommissioned plants into a regulatory asset account.

In this docket, BHP proposed to amortize the estimated costs associated with the retirement and decommissioning of these three generating plants over five years and include the unamortized balance at the end of Year One, or four-fifths of the costs, in rate base. The settlement removes all contingencies that had been included in BHP's decommissioning estimates, revises the amount included for obsolete inventory to agree with the amount removed from working capital, amortizes the regulatory asset over ten years, and includes the average unamortized balance over the first three years in rate base. The net effect of these changes is to decrease rate base by approximately $1,806,000.

Storm Atlas Regulatory Asset – Winter Storm Atlas (Atlas) occurred October 3-5, 2013, causing the worst outages in BHP's 130-year history. Heavy snow and high winds, combined with fully leafed trees, caused significant damage to BHP facilities and left as many as 41,800 customers without power. Repairing this widespread damage far exceeded BHP's normal storm-related costs. In Docket EL13-036, the Commission issued an order allowing BHP to use deferred accounting for costs incurred as a result of Atlas.

In this docket, BHP proposed to include actual costs through December 31, 2013 arising from Atlas, as well as costs through the end of February 2014. The Company also proposed to include costs for a system-wide line inspection driven by Atlas. BHP proposed to amortize these costs over five years and to include the unamortized balance at the end of Year One, or four-fifths of the costs, in rate base. The settlement reflects actual, final Atlas-related costs (excluding employee bonuses) and actual system inspection costs through September 30, 2014, and reflects only the incremental internal labor costs associated with the system inspection. The settlement amortizes the regulatory asset over ten years and includes the average unamortized balance over the first three years in rate base. The net effect of these changes is to decrease rate base by approximately $1,566,000.

Tax Return True-up – BHP's proposed test year allowance for income taxes included "true-up" adjustments to eliminate certain tax events that were recorded during the test year but which were related to periods prior to the test year. It is important to purge from test year operating results for transactions that relate to periods outside of the test year. Therefore, Staff accepts BHP's Tax Return True-up adjustments. Those adjustments are included in the Settlement revenue requirement determination.

NOL Adjustment – Over the past several years, bonus depreciation previously approved by Congress significantly increased BHP's annual tax deductions. The increased deductions, however, exceeded BHP's income resulting in a tax loss. Because of the tax loss position, BHP was not able to utilize all of its allowable deductions in the year they were earned. It had recorded deferred taxes relating to these tax deductions, nevertheless. The accumulated deferred taxes are used as an offset to BHP's rate base. Therefore, it was necessary to adjust BHP's rate base to reflect the unused tax deductions. BHP will now be able to utilize more of its previously unused tax deductions given the revenue increase agreed to by the Parties. The impact of this greater utilization of tax deductions on BHP's rate base has been reflected in the settlement revenue requirement. The result of recalculating this adjustment to reflect the effect of other adjustments incorporated in the settlement is to increase rate base by approximately $641,000.

Other Working Capital – BHP proposed this rate base adjustment to accurately reflect recent investments in a spare transformer for Neil Simpson II, in spare fan motors at the Neil Simpson Complex, in critical spare parts at Cheyenne Prairie Generating Station, and in a new coal stockpile at the Neil Simpson Complex, while removing the test year inventories at the recently retired Ben French, Neil Simpson I, and Osage generating units. The settlement accepts this adjustment while modifying for actual costs and reflecting a more recent 13-month average for materials and supplies, fuel stocks, and customer advances. These modifications increase rate base by approximately $969,000.

69 kV LIDAR Surveying Project – BHP proposed this adjustment to recover Light Detection and Ranging (LIDAR) project costs on its 69 kV system. This survey provided BHP with electronic modeling data to verify proper ground clearances were met and help streamline their vegetation management efforts. The project cost is shared with the joint owners of the transmission system, and BHP proposed to amortize costs associated with the project over five years and to include the unamortized balance, or four-fifths of the cost, in rate base. The settlement reflects a reduction for accumulated deferred income taxes associated with the project, an update to actual project costs and actual contributions from joint owners, and includes the average unamortized balance, or one-half of the cost, in rate base. The result of Staff's revisions reduces rate base by approximately $399,000.

Customer Service Model – This Staff proposed adjustment reflects the rate base reduction for BHP's customer service model changes. With the Belle Fourche and Newell customer service and electric operation service centers being consolidated and moved to Spearfish and Sturgis, respectively, the Newell office is no longer needed. Removing the remaining amounts associated with the Newell office reduces rate base by approximately $9,000.

Sturgis Office & Operations Center – BHP built a new service center in Sturgis to consolidate operations and business offices into one location in the northern hills. As a result, the two existing facilities in Sturgis will be closed. The settlement removes the amounts related to these two facilities as they are no longer needed. This adjustment reduces rate base by approximately $308,000.

Wages & Salaries – BHP's filing included several adjustments to test year payroll expenses, including employee additions. The settlement includes a rate base adjustment associated with one-half of the amount of annual employee salaries charged to capital projects. This adjustment increases rate base by approximately $79,000.

Other Rate Base Reductions – The Company's filing included *pro forma* rate base reduction for: 1) the flow-through of the income tax benefit associated with the repairs deduction that should not be included in rate base; 2) deferred taxes and federal effect of the state NOL that should be removed from rate base since South Dakota does not impose a state income tax; 3) deferred tax liability associated with regulatory asset – unit of property account that should not be included in rate base since the amount in the regulatory asset – unit of property is not included in rate base; and 4) the addition of accumulated deferred income tax associated with the plant that is allocated to BHP from BHSC and BHUH because the assets allocated to BHP are included in rate base. The settlement accepts this adjustment.

OPERATING INCOME

Wages & Salaries – BHP's filing included several adjustments to test year payroll expenses. These adjustments included 1) using 01/28/2014 annualized payroll as a starting point as it was the most recent payroll at the time BHP completed its adjustment; 2) removing the labor costs associated with Neil Simpson I plant personnel who will have part of their time charged to power plants not owned by BHP at the Neil Simpson Complex; 3) a 2014 union wage increase of 3.25%, a 2014 non-union wage increase of 3.50%, a partial year of a 3.5% 2015 union wage increase, and a partial year of a 3.5% 2015 non-union increase; 5) adding the costs associated with open vacancies and additional employees needed for operations; and 6) removing costs associated with employee eliminations.

Staff agreed with the Company's adjustment, except for the amounts included for the 2014 non-union and 2015 union and non-union wage increases and employee additions. The settlement revises the Company's adjustment to 1) reflect a 2014 non-union wage increase of 3.25% in lieu of the Company's proposed budgeted 3.5%; 2) reflect a full year of the 2015 union wage increase of 3.25% in lieu of the Company's proposed partial year of a projected 3.5% wage increase; 3) reflect a full year of the 2015 non-union wage increase of 3.0% in lieu of the Company's proposed partial year of a projected 3.5% wage increase; and 4) reflect employee additions for actual employees hired, including only the portion of employee salaries charged to O&M and adjusting the salaries for the 2015 wage increases. This adjustment reduces operating expenses by approximately $130,000.

Black Hills Corp. / Black Hills Utility Holdings Intercompany Charges – BHP proposed a $2.3 million adjustment to total company test year expenses for charges billed to it from Black Hills Utility Holdings (BHUH) (Adjustment H-5). Staff objected to this adjustment because it did not reflect a known and measurable change in BHP's costs; rather, it was merely BHP's estimate of future costs. Consistent with the Parties' treatment of other operating expenses, including expenses billed to BHP by BHSC, the Parties agreed to recognize known changes in billed costs by the service company through August 31, 2014. That is, the rate case allowance for service company billings reflect BHP's actual costs for the twelve months ended August 31, 2014, excluding amounts associated with vegetation management and reflecting an annualization for customer records and collection expenses associated with a change in allocation factors. The *pro forma* utility holdings costs also reflect an annualization of wage increases for both 2014 and 2015. The effect of these changes is to increase South Dakota operating expenses by approximately $527,000.

Employee Pension & Benefits Adjustment – BHP proposed a $334,319 total company adjustment to test year employee benefits expenses (Adjustment H-6). Within this adjustment, BHP normalized its test year pension expense by averaging the annual expense over the past five years. This normalization adjustment reduced the test year pension expense by $508,454 on a total company level. Staff agreed to BHP's pension expense normalization adjustment if it is to be applied consistently in future rate cases. Staff disagreed with the remainder of BHP's proposed employee benefits adjustment because it is based on estimated future costs rather than known cost changes. The settlement reflects known post-test year changes in employee benefits costs rather than BHP's estimates. It also reflects a normalized level of pension costs based on a five-year average of BHP's actual pension expense. The effect of these changes is to reduce South Dakota operating expenses by approximately $289,000.

Bad Debt Analysis – BHP proposed an adjustment to decrease bad debt expenses based on a three year uncollectible rate average. The settlement decreases bad debt expense based on a five year uncollectible rate average applied to retail revenues. The net effect of this change increases jurisdictional operating expense by approximately $6,000.

Generation Dispatch & Scheduling – BHP proposed an adjustment to update costs for generation dispatch and scheduling in accordance with the Generation Dispatch and Energy Management

Agreement (GDEMA) which allocates costs to the parties contracting for services based on total capacity of each company. Staff generally agreed with the adjustment but replaced the budgeted costs used by BHP with actual year-end August 2014 costs, while allowing known and measurable increases to labor and labor overhead. Staff also corrected errors to the capacities provided for Black Hills Power and Black Hills/Colorado Electric. The result of Staff's revisions reduces jurisdictional operating expense by approximately $106,000.

Energy Cost Adjustment Expense Elimination – The Company proposed an adjustment to remove all costs that are collected through the Energy Cost Adjustment (ECA) from the test year. The settlement accepts this adjustment.

Neil Simpson Complex Shared Facilities – BHP proposed an adjustment to update revenues and expenses for shared facilities in accordance with the Neil Simpson Complex Shared Facilities Agreement which allocates revenues and expenses to the parties based on net capacity of each company. Staff generally agreed with the adjustment but replaced the budgeted costs used by BHP with actual costs. The result of Staff's revisions reduces jurisdictional operating expense by approximately $74,000 and reduces jurisdictional operating revenue by approximately $136,000.

Removal of Unallowed Advertising – BHP proposed an adjustment to remove advertising expenses that should not be recovered from ratepayers. The settlement accepts this adjustment and further removes additional advertising costs which do not contribute to the provision of safe, adequate, and reliable electric service for South Dakota ratepayers. The effect of this adjustment reduces operating expenses by approximately $4,000.

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 rates. The settlement revises the expense adjustment to correct the labor-bonus costs removed and accepts the revenue adjustment. The effect of this adjustment reduces operating expenses by approximately $9,000.

Rate Case Expense – Rate case expense included in Docket EL12-061 (consisting of costs related to Docket EL12-061 and EL12-062) was amortized over a three-year period beginning June 16, 2013. Interim rates in this case were put into effect on October 1, 2014, leaving approximately 20.5 months of cost recovery until the expenses are completely amortized. The settlement in EL12-061 established a tracker for the potential recovery of the residual costs associated with both dockets in BHP's next rate case filing.

BHP proposed recovery of projected rate case costs for EL14-026, the remaining unamortized rate case expense from EL12-061 and EL12-062, and the residual costs related to EL12-061 and EL12-062, amortized over a three-year period. The settlement reflects a three-year amortization of $212,861 in actual costs as of November 6, 2014 for docket EL14-026 and $412,797 in actual, unrecovered amounts for EL12-061 and EL12-062, for a total three-year amortization allowance of $625,657. The net effect of these changes is a reduction in operating expenses by approximately $188,000. The settlement also establishes a tracking mechanism for the potential recovery of the residual costs associated with docket EL14-026 in the next rate case filing.

Vegetation Management Expense – BHP proposed to adjust its test year vegetation management expenses to reflect the amount approved in the stipulation in Docket EL12-061. The settlement accepts this adjustment with a slight modification which updates the allocator to conform to what BHP filed in its Statement N. The result of Staff's revision increases jurisdictional operating expense by approximately $1,000.

CPGS O&M – The Company proposed an adjustment to reflect projected operation and maintenance expense for CPGS during a normal year. The settlement reflects the Company's proposed adjustment, less reagent costs which are recovered through the ECA. This adjustment reduces operating expenses by approximately $28,000.

Ben French Severance Expense – BHP proposed an adjustment to remove the employee severance expense associated with the Ben French plant. The settlement accepts this adjustment.

Neil Simpson Complex Common Steam Allocation – BHP proposed an adjustment to update costs for the operation and maintenance of Neil Simpson Complex common steam facilities where BHP is responsible for costs relating to the capacity associated with Neil Simpson II and its ownership percentage of Wygen III. Staff generally agreed with the adjustment but replaced the budgeted costs used by BHP with actual year end August 2014 costs, while allowing known and measurable increases to labor and benefits. Staff also corrected errors in the capacity shares provided for Black Hills Power and MDU, City of Gillette & Other. The result of Staff's revisions reduces jurisdictional operating expense by approximately $243,000.

Ben French, Osage, & Neil Simpson I O&M Elimination – BHP proposed an adjustment to remove the test year operating and maintenance expenses related to the Ben French, Neil Simpson I, and Osage power plants that were retired on or before March 21, 2014, to comply with the Environmental Protection Agency (EPA) Area Source Rules. The settlement accepts this adjustment.

Future Track Workforce Development – BHP proposed a $721,861 total company expense adjustment (Adjustment H-19) to implement its eight-year Future Track Workforce Development Program. Included in the Company's proposal was a request to defer as a regulatory asset for future recovery all costs associated with the program that exceed the amount included in base rates.

Staff objected to the Company's proposal, both as to the expense to be included in base rates and to BHP's proposal to defer expenses in the future. The Parties agreed to reflect in rates BHP's actual costs for newly hired employees under the Future Track program, without deferrals. The effect of this change is to decrease South Dakota operating expenses by approximately $344,000. The settlement also eliminates the annual reporting requirements proposed in BHP's filing.

69 kV LIDAR Surveying Project – BHP proposed this adjustment to recover Light Detection and Ranging (LIDAR) project costs on its 69 kV system. This survey provided BHP with electronic modeling data to verify proper ground clearances were met and help streamline their vegetation management efforts. The project cost is shared with the joint owners of the transmission system. BHP's share is amortized over five years to correspond with the expected frequency of the survey. Staff's adjustment reflects actual costs of the survey and actual contributions from the joint owners. The result of Staff's revision reduces jurisdictional operating expense by approximately $66,000.

Customer Service Model Adjustment – This adjustment reflects the cost reductions BHP achieved as a result of their customer service model changes. The Belle Fourche and Newell customer service and electric operation services centers were consolidated and moved to Spearfish and Sturgis, respectively. This adjustment removes the salaries and benefits of three customer service representatives and eliminates Belle Fourche and Newell facility costs. The settlement also removes further costs associated with telephone, janitorial labor, and depreciation expense. The result of Staff's revision reduces jurisdictional operating expense by approximately $7,000.

Remove City of Gillette – BHP proposed an adjustment to remove the City of Gillette revenue as it relates to replacement energy. The associated costs are removed as part of the Power Marketing adjustment. The settlement accepts this adjustment.

Unbilled Revenue and Provision for Rate Refunds – Unbilled Revenue reflects an accounting accrual made each month to reflect a portion of the current month usage which is billed in the following month. These accrual entries are reversed out the following month. Provision for Rate Refunds reflects the balance related to interim rates in Dockets EL12-061 and EL12-062. These adjustments remove the entire per books amounts from these two accounts to reflect normal levels. The settlement accepts these adjustments.

Removal of Energy Cost Revenue – The Company proposed an adjustment to remove revenue associated with the ECA as associated energy costs were also removed from the test year. The settlement accepts this adjustment.

PIPR Rate Annualization – The test year revenues contain only a portion of the Phase In Plan Rate revenues established in Docket EL12-062. This known and measurable adjustment is needed to reflect the proper level of revenue and properly match what customers were paying at the end of the test year, thus reducing the revenue deficiency. The settlement accepts this adjustment.

Weather Normalization – BHP's filing contained a weather normalization adjustment of ($644,705). Staff undertook an independent weather normalization analysis and concluded that an adjustment of ($264,403) would be appropriate. Staff's adjustment updated BHP's data to reflect the latest NOAA weather normals for the thirty year base period 1981-2010. Staff also included June in the analysis of cooling load sensitivity, and measured sensitivity in absolute value as a departure from normal, rather than relative variation from monthly normals. Sensitivity was based on regression coefficients correlating usage with departure from normal. BHP accepted Staff's adjustment for settlement purposes. The effect of these changes increases operating revenues by approximately $380,000.

Industrial Contract Service Accrual – BHP proposed this known and measurable adjustment to properly match revenues with test year usage for three of their industrial customers on contract rates. The settlement accepts this adjustment.

EL12-061 Rate Increase Annualization – The test year revenues are based on the rates established in Docket EL09-018; however, rates were changed in Docket EL12-061, effective October 1, 2013. This is a known and measurable change to test year operating results. BHP proposed this adjustment to reflect the proper level of revenue to be received from customers based on the recently approved rates. The settlement accepts this adjustment.

Interest Synchronization – The settlement synchronizes the tax deduction for interest expense with the weighted cost of long-term debt and the historical test year rate base as adjusted for known and measurable changes.

Depreciation Expense – In its March 31, 2014 rate filing, BHP claimed a total company depreciation expense allowance of $3,035,046 related to the Cheyenne Prairie Generating Station based on the then-estimated $92,250,624 total company plant investment at its expected in-service date of October 1, 2014. The expense allowance reflected a composite depreciation accrual rate of 3.29% that assumed a 35-year life span for the plant, allowances for retirements of plant components during the life span and an estimate of removal costs amounting to 4% of the plant investment at the time of its retirement.

The settlement reduces the CPGS depreciation allowance by $349,819 to $2,685,227, on a total company level, to reflect BHP's agreed-upon actual investment in the plant and a composite depreciation accrual rate of 2.98%. The 2.98% composite rate was derived by extending the assumed life span of CPGS from 35 years to a more realistic 40 years judging by life estimates made by other utilities for combined cycle generating units. Other parameters reflected in the 2.98% rate (interim retirements and removal costs) are consistent with the parameters reflected in BHP's existing depreciation accrual rates for its other generating facilities.

The settlement further revises the Company's depreciation adjustment to reflect the effect of the other plant adjustments included in the settlement. The net effect of these changes is to decrease South Dakota jurisdictional operating expenses by approximately $87,000.

Decommissioning Regulatory Asset – The Neil Simpson I, Ben French, and Osage coal-fired power plants are subject to the EPA's National Emission Standards for Hazardous Air Pollutants for Area Sources: Industrial, Commercial, and Institutional Boilers (Area Source Rules). After evaluating the options, BHP concluded the most cost effective plan to comply with these rules was to retire Neil Simpson I, Osage, and Ben French by the compliance deadline of March 21, 2014. The decommissioning process began in 2014 and is estimated to be completed by September 2015. In Docket EL13-036, the Commission issued an order authorizing BHP to transfer the remaining plant balance for the soon to be decommissioned plants to a regulatory asset.

In this docket, BHP proposed to amortize the estimated costs associated with the retirement and decommissioning of Neil Simpson I, Ben French, and Osage over five years. The settlement removes all contingencies, revises the amount included for obsolete inventory to agree with the amount removed from working capital, and amortizes the regulatory asset over ten years, reducing the annual South Dakota amortization expense by approximately $1,651,000. BHP may track the actual costs incurred and seek recovery, in a future rate case, of decommissioning costs not recovered from customers.

Storm Atlas Regulatory Asset – BHP proposed to include its actual Atlas-related costs through December 31, 2013, and its estimated costs through the end of February 2014. The Company also proposed to include costs for a system-wide line inspection necessitated by Atlas. BHP proposed to amortize these costs over five years. The settlement reflects actual, final Atlas-related costs (excluding employee bonuses) and actual system inspection costs through September 30, 2014, and reflects only incremental internal labor costs associated with the system inspection. The settlement amortizes the regulatory asset over ten years. The net effect of these changes is to reduce the annual South Dakota amortization expense by approximately $512,000.

Charitable Contributions – The settlement removes approximately $16,000 in charitable contributions.

Storm Damage – The settlement normalizes storm damage costs to a five-year average. As Atlas was the only major storm event in 2013 and its costs are recovered in a separate adjustment, this normalization adjustment would need to include $0.00 for the 2013 expense, and Staff was concerned that using $0.00 would not reflect an accurate value of normal storm damage expense. Thus, Staff chose the 2008 through 2012 timeframe for this adjustment and increased operating expense by approximately $31,000.

Incentive Compensation – BHP's proposed revenue requirement included approximately $3.8 million for incentive compensation, including amounts billed from the affiliate service company. For settlement purposes, the Parties agreed that incentive compensation paid for achieving financial performance goals will be excluded from BHP's South Dakota revenue requirement. This adjustment reduces South Dakota operating expenses by approximately $666,000.

Economic Development – The Company proposed 100% recovery of economic development expenses included in the test year. The settlement reflects a $100,000 economic development plan, inclusive of labor, to be split 50/50 between shareholders and ratepayers. The adjustment reduces operating expenses by approximately $27,000.

Association Dues – The settlement removes approximately $6,000 in association dues costs associated with donations, lobbying, and various other activities that do not provide for the provision of safe, adequate, and reliable electric service for South Dakota ratepayers.

Custer to Hot Springs Cooperatives Revenues – BHP has a joint ownership agreement with Rushmore Electric and its two members, Black Hills Electric Cooperative and Butte Electric Cooperative, for the co-owned portions of the 69 kV sub-transmission system. Rushmore Electric Power Cooperative, on behalf of itself and its members, pays BHP a monthly fee to ensure that customers of all parties are fairly and accurately responsible for their use of the jointly owned facilities. The settlement includes an adjustment to account for the additional annual revenues BHP will receive associated with the Custer to Hot Springs line. The effect of this adjustment is to increase operating revenues by approximately $90,000.

Workers Compensation – During discovery, BHP proposed an adjustment to normalize workers compensation costs to a five-year average of the costs. The settlement accepts this adjustment, increasing operating expenses by approximately $172,000.

Black Hills Corp./ Black Hills Service Co. Intercompany Charges – BHP's filed case included test year expenses billed to it by its affiliate service company, approximately $20.4 million, without adjustment. Consistent with the parties' treatment of other operating expenses, including expenses billed to BHP by BHUH, the Parties agreed to recognize known changes in billed costs by the service company through August 31, 2014. That is, the rate case allowance for service company billings reflect BHP's actual costs for the twelve months ended August 31, 2014, except for property insurance which is BHP's actual costs for the year October 2014 through September 2015. The pro forma service company costs also reflect an annualization of wage increases for both 2014 and 2015. The net effect of these changes is to increase South Dakota operating expenses by approximately $1,132,000.

Income Tax Adjustment – The Company's filing included pro forma adjustments to income tax for true-up items and items that are not part of the regulated operations of BHP that should therefore not be included in the computation of federal income tax. The settlement accepts this adjustment.

COST OF CAPITAL AND RATE OF RETURN

BHP's initial filing sought an overall rate of return of 8.48 percent, which included an embedded debt cost of 6.45 percent and a capital structure of 53.32 percent equity and 46.68 percent debt. The requested rate of return on equity was 10.25 percent. Staff's analysis initially challenged all three components of the overall rate of return: (1) embedded cost of debt, (2) the capital structure, and (3) the required return on equity.

[Begin Confidential] [redacted]

[redacted]

[redacted]

[redacted]

[redacted] **[End Confidential]**, the settlement overall rate of return is 7.76 percent.

RATE DESIGN ISSUES

The parties agree in principle on all issues regarding rate design and the class revenue distribution. The settlement position reached between Staff and BHP is discussed below.

Class Cost of Service/Spread of the Increase – BHP's filed case included a class cost of service study ("CCOSS"). A CCOSS is useful in assigning revenue responsibility to each rate class that BHP serves in

South Dakota and in designing rates within each class. The allocation methods reflected in BHP's CCOSS are basically the same as those that were reflected in previous CCOSS studies filed by BHP and accepted by Staff and the Commission. In this proceeding, however, BHP introduced the results of a new customer load study based primarily on data obtained from the Company's new AMI meters. The new load data was used in developing the class demand allocation factors used in the CCOSS. The new load data incorporated into the CCOSS indicated that base rates for two of the five customers classes should be increased significantly (Residential – 19.26% and General Service Large/Industrial Contract – 15.44%); base rates to the Water Pumping/Irrigation class should be increased by a small amount (3.45%); and base rates for the remaining two classes should be decreased (General Service – 6.37% and Lighting Service – 15.74%). Rather than implementing these indicated rate changes, BHP proposed a rate moderation plan to avoid adverse rate impacts to the Residential and General Service Large/Industrial Contract customers. Under BHP's moderation plan, no class is to pay less than 75 percent of the system-wide percentage increase and no class is to pay more than 120 percent of the system-wide percentage increase.

Without agreeing specifically with either the results of the CCOSS or BHP's underlying new load research results, the Parties agreed to accept BHP's proposed rate moderation plan by implementing a 75% to 120% percent collar around the system-wide percentage increase. Under this approach, the following class increases result:

Settlement Class Revenue Increases

Class	Percent Increase
Residential	5.04%
General Service	3.46%
General Service Large/Industrial Contract	4.55%
Water Pumping/Irrigation	3.11%
Lighting Service	3.45%
Total	**4.35%**

Rate Design (Residential Customer Service Charge) – BHP's currently effective monthly customer service charge for the Residential class is $8.75. BHP proposed to increase the present rate to $10.00. In settlement, the parties agreed to increase the Residential monthly customer service charge to $9.25. This represents a 5.71 percent increase in that charge, which is within the range agreed to among the parties for the Residential class as a whole. Staff also believes that a $9.25 monthly service charge is supported by the underlying costs to serve Residential customers.

OTHER ISSUES

Economic Development – The settlement reflects a $100,000 economic development plan, inclusive of labor, to be split 50/50 between shareholders and ratepayers. Under the terms of the settlement the following conditions apply:

- $100,000 total paid equally by ratepayers ($50,000) and shareholders ($50,000);

- Expenses shall include but not be limited to, all South Dakota labor, expenses and monetary contributions deemed to be a benefit to economic development in the BHP South Dakota electric territory;
- On an annual basis, no later than March 1 of each year, BHP will submit for the Commission's approval a filing that describes the actual cost, design and individual benefits of each cost to BHP's Economic Development programs in the previous calendar year and the projected cost, design and individual benefits of each cost to BHP's Economic Development programs in the current calendar year;
- The Commission may determine that some of the programs are not appropriate for purposes of 50% rate recovery;
- If the remaining programs cost less than $100,000 at the end of a program year, the unspent costs shall be "carried over" into the next program year for Commission approval of expenditure or refund; and
- No carry-over shall occur for any amounts spent annually in excess of $100,000.

Energy Cost Adjustment – The Company proposed the following change to the Fuel and Purchased Power Adjustment (FPPA), which is a component of the ECA: 1) to include any difference in ad valorem or property taxes from what is reflected in base rates; 2) to credit 100% of the Company's wholesale contract revenue on October 1, 2014, as agreed to in Docket No. EL12-062; 3) to eliminate the power marketing credit minimum; and 4) to recover 100% of the costs related to short-term planning reserve capacity purchases and sales. Staff agreed with items 1, 2, and 4, but took issue with the elimination of the power marketing credit minimum. The Parties agreed for settlement purposes to reduce the power marketing credit minimum from $2 million to $1 million and increase the power marketing sharing from 65% to 70%.

Major Maintenance Accrual – BHP requested approval of a modification to the major maintenance account to expense a portion of the plant overhaul costs each year based on a plant's planned maintenance cycle. In Docket EL09-018, the settlement allowed BHP to establish a major maintenance account and a regulatory liability for steam plant maintenance and a 7-year cycle was established. The work previously done during the seven year overhaul is now split into two overhauls. There is no change in the existing accrual at this time. The settlement defines major maintenance for steam plants as the expenses incurred during the period of time when a steam turbine generator is opened for maintenance.

Implementation of Rates – The tariffs shown on Exhibit 1 attached to the Settlement are to be implemented for service rendered on or after March 1, 2015. Customer bills will be prorated so that usage prior to October 1, 2014, is billed at BHP's previously effective rates (i.e., the base rate in effect immediately prior to the interim rates implemented on October 1, 2014), and usage on and after October 1, 2014, is to be billed at the new rates established by the settlement.

Interim Rate Refund – Interim rates were implemented on October 1, 2014. Approval of the Settlement will authorize a rate increase less than the interim rate level. The Company agrees to refund customers the difference between interim rates and new rates established by the settlement for usage during the period October 1, 2014 through February 28, 2015. As part of the refund, BHP will include interest, calculated by applying a 7% annual interest to the average refund balance for each month that interim revenues were collected. The Company's Interim Rate Refund Plan is attached to the Settlement as Exhibit 3.

Contract with Deviations – On September 4, 2014, BHP filed a Contract with Deviations between BHP and SDSTA. The Commission approved this Contract with Deviations on an interim basis. Now that the cost of service and class cost of service study review is complete, Staff and BHP agree the Contract with Deviations may now be finally approved by the Commission, without condition.

RECOMMENDATION

Staff recommends the Commission approve the Settlement for the reasons stated above.