Chesapeake Regulatory Consultants, Inc

1698 Saefern Way
Annapolis, MD 21401-6529

Phone: 410.849.3210
eMail: rgtsbs@comcast.net

Robert G. Towers
Basil L. Copeland, Jr.
David E. Peterson

December 17, 2009

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

RE: Report and Consulting Services Proposal
Black Hills Power, Inc. - Application to Increase Electric Rates in South Dakota
SDPUC Docket No. EL09-018

Dear Dave and Bob:

Thank you for sending Black Hills' rate filing and for the opportunity to submit the following report and proposal. We would be pleased to assist your Staff in analyzing the Application and preparing recommendations to present to the Commission. Basil Copeland has reviewed the Company's cost of capital evidence and Dave Peterson and I have reviewed the testimony, exhibits and filing statements pertaining to all other aspects of the Company's requests.

Overview of the Filing

By letter dated September 29, 2009, Black Hills Power, Inc. ("BHP", "Black Hills" or "the Company") filed with the Commission an Application seeking to increase its rates for electric service to its approximately 64,100 customers in South Dakota. The proposed rates were designed to increase its annual revenue from these customers by about $32 million, or 26.6% above sales revenues at presently-effective rates during a test year ended June 30, 2009. The Company's present rates became effective pursuant to the Commission's December 29, 2006 Order approving a settlement of a rate filing in Docket EL06-019.

Black Hills attributes the need for rate relief at this time to all plant investments made and expense increases incurred since its last rate filing but primarily to the advent of its Wygen III generating station. Wygen III is expected to be completed and in service by April 1, 2010 and the increase in electric service rates is proposed to coincide with the actual in-service date (but not earlier than March 1).

The proposed rates are based on a revenue requirement developed from a June 30, 2009 test year, adjusted for cost level and operational changes that are claimed to be known and measurable. New depreciation rates are proposed for existing plant and are generally lower than existing rates. The claimed 9.27% return on the test year average net investment rate base reflects the Company's test year cost of debt, adjusted for a projected new $180 million issuance, a pro forma "appropriate" capital structure with 52% common equity, and a return on equity of 11.50%.

Although Black Hills presents a class cost of service study indicating that rates for Large Industrial and General Service customers should receive a larger than average increase (McFadden, p. 14), the Company proposes the same percentage increase in revenues from all classes and, in general, for the unit charges in each rate schedule. Revenues now derived from the Company's fuel adjustment charges (the Steam Plant Fuel Cost Adjustment, or "SPFCA", and the Conditional Energy Cost Adjustment, or "CECA") are rolled into base rates and new bases are established for the adjustment clauses. Also, a new "stacking" methodology is proposed for the CECA to insure that power purchases made for regulated retail customers (e.g. wind generation purchases made to satisfy what is said to be the South Dakota portfolio objective of ten percent wind by 2015) are billed to these customers. (Sargent, pp. 19-20) Other clarifications to CECA involve the refunding of cost savings, the inclusion of potential revenues from the sale of emissions allowances or renewable energy credits and to make clear that new governmental mandates (such as carbon taxes) are recoverable in the SPFCA.

Black Hills Power, Inc. ("BHP") is a subsidiary of Black Hills Corporation, a holding company registered initially under PUHCA 1935. Affiliates having transactions with BHP include Black Hills Service Company, providing business services to BHP and other affiliates, Utility Holding, providing customer service, billing and information technology services to BHP and other affiliates, and Wyodak Resources Development Corporation, supplier of coal to all of BHP's coal-fired generating facilities at prices based on a cost of service formula. In addition, BHP charges for services it provides to affiliates. (Cleberg, pp. 5-10; Ohlmacher, pp. 4-8).

Potential Issues and Division of Workload

The Application raises many issues similar to those which Staff has dealt with in other general rate filings, including the recent (on-going) NSP filing – the development of a revenue requirement based on recent actual experience adjusted significantly for purported "known and measurable" changes, including post-test year actual and projected routine new investments in purportedly non-income producing plant, various labor and other expense increases and, in this case, the substantial investment and operating expenses related to the yet-to-be activated Wygen III generating unit. The Company's support for each of the major adjustments should be examined, including a comparison of estimated capital investments with actual post-test year investments to date and an assessment made of whether or not the adjustments maintain the necessary balance among other elements of the revenue requirements equation, e.g. test year sales levels and operational productivity. For example, the Wygen III unit, which is constructed to satisfy load growth, will not be operational before the Spring of 2010 (and was originally targeted for completion in June of 2010) yet test year sales levels are those experienced during the year ended June 30, 2009. Indeed, the advent of Wygen III, resulting in its "lumpiness" effect on revenue requirements (caused by unnecessarily large margins of capacity in excess of customer demands in the early years of operation) acknowledged by the Company (Tietgen, p. 9) is likely to be a central issue in this case. On the other hand, the Company will emphasize that its Resource Plan has been reviewed by the Wyoming Commission and that a Certificate of public need has been issued by Wyoming for Wygen III. Also, the plant is expected to be completed at a cost that is measurably under budget. Still, a phase-in of the plant's costs and/or enhancements of ratepayer benefits from opportunity sales might be appropriate.

As mentioned earlier, BHP receives corporate services from three affiliates and itself provides services to affiliates. Some service costs purport to be directly assigned while others are allocated. The process for assignments and the methods of allocation should be reviewed for reasonableness as well as the claimed pro forma level of these costs (Kilpatrick, pp. 17 and 13).

The 11.50% return on equity ("ROE") reflected in the Company's claimed cost of capital purports to be supported by various measures of equity costs of a "proxy group" of comparable companies, including alternative DCF, Capital Asset Pricing Model and "expected earnings" analyses. (see Avera, p. 58). Mr. Avera's conclusions contrast with our on-going analyses of equity costs for electric utilities indicating a range of costs extending well below 10.0%. Furthermore, to arrive at the requested rate of return on rate base, the proposed ROE is applied to a capital structure that reflects a hypothetical equity component (52%) that exceeds the Company's pro forma equity ratio.

The Company's proposal to increase class service rates by an across-the-board uniform percentage is at odds with its class cost of service study which suggests that this approach requires Residential customers to subsidize Industrial and Large General Service users. Although the CCOSS appears to be sound in principle, it is likely to be challenged by industrial/large general service customer intervenors if there is an effort to reallocate the proposed revenue distribution. Proposed changes in the SPFCA and CECA need to be clarified and better understood.

Proposal

As you know, we have considerable experience with general rate increase requests by electric and gas utilities including experience with the types of issues that we have identified here. In addition to our participation with the South Dakota Staff in more than thirty formal rate proceedings since 1976, we presently have contracts with the Colorado Consumer Counsel and New Jersey Rate Counsel as consultants in gas, electric and water rate cases before the regulatory commissions in those and other states. We also serve as rate consultants to municipalities, municipal utilities and industrial groups that are consumers of utility services.

In this case, with precedent to guide the Staff on many of the recurring revenue requirement issues, including the rate base adjustments for plant additions and working capital, it would be most efficient to have Staff review and develop positions on these adjustments. We would provide assistance to Staff in defining and developing positions on these issues, as needed. In fact, all of our activities are proposed to be carried out with as much participation as possible by your Staff.

We offer Basil L. Copeland, Jr. to analyze and testify on the cost of capital and capital structure issues. David E. Peterson and I would be responsible for accounting issues that are delegated to us by Staff, depreciation rates, corporate expenses and tax issues and the jurisdictional and class cost of service (CCOSS) determinations. We would also expect to actively assist your Staff with other rate design issues. In all instances, our efforts would be to assist the Staff in developing the issue and, where necessary, to present our own testimony. We anticipate that testimony required from CRC would be presented by Basil Copeland and David Peterson.

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

For the purposes of preparing a cost estimate, I have assumed that two or three man-days will be required for participation at hearings in Pierre.

We estimate that the cost of performing these services would amount to approximately $66,525, including out-of-pocket expenses. Of course we would bill only for time actually spent working on the assignment and for our actual out-of-pocket costs, principally air fare for two man-trips to Pierre, per diem expenses in Pierre, copier and courier services. Our estimate is derived as follows:

Tasks	Hours		
	Towers	Copeland	Peterson
• Analyze the filing, identify issues, discovery;	50	24	60
• Developing positions; preparation of testimony and exhibits, including coordination with other witnesses;	40	42	50
• Review rebuttal testimony and preparation for hearing;	20	18	20
• Participation in hearing; and	4	8	24
• Assisting counsel with briefs.	16	8	16
Total hours	130	100	170

<u>Cost Summary</u>

Fees:	Towers	130 hrs. @ $160		$20,800
	Copeland	100 hrs. @ $160		16,000
	Peterson	170 hrs. @ $160		27,200
	Total fees			64,000
Out-of-pocket expenses:				
	Air fare		$1,800	
	Hotel		300	
	Courier		125	
	Data base charges for ROE analysis		200	
	Other		100	
				2,525
Total cost				**$66,525**

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

Sincerely,

Robert G. Towers
President

Attachment: Fee Schedule (January 2009)

Chesapeake Regulatory Consultants, Inc.

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Annapolis, MD 21401-6529

Phone: 410.849.3210
Email: rgtsbs@comcast.net

Robert G. Towers
Basil L. Copeland, Jr.
501.851.8619
David E. Peterson
410.286.0503

FEE SCHEDULE

		Hourly Rate
Robert G. Towers Annapolis, MD	Senior Consultant	$ 160.00
Basil L. Copeland, Jr. Maumelle, AR	Senior Economist	$ 160.00
David E. Peterson Dunkirk, MD	Senior Consultant	$ 160.00

January 1, 2009