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 EL12-061

Commission Staff (Staff) submits this Memorandum in support of the Settlement Stipulation (Settlement) of September 6, 2013, between Staff and Black Hills Power Company (BHP or Company) in the above-captioned matter.

BACKGROUND

On December 17, 2012, 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 $13.7 million annually or approximately 9.94%. A typical residential electric customer using 650 kWh per month would see an increase of $7.11 per month.

BHP's proposed increase was based on a historic test year ending June 30, 2012, adjusted for what BHP believed to be known and measurable changes, a 10.25% return on common equity, and a 8.54% overall rate of return on rate base.

The Commission officially noticed BHP's filing on December 20, 2012, and set an intervention deadline of February 28, 2013. On January 15, 2013, a Petition to Intervene of GCC Dacotah, Inc., Rushmore Forest Products, Inc., Spearfish Forest Products, Inc., Pete Lien & Sons, Inc., and Rapid City Regional Hospital (collectively, Black Hills Industrial Intervenors or BHI) was filed. On January 17, 2013, the Commission issued an Order Assessing Filing Fee and Suspending Operation of Proposed Rates. On January 28, 2013, a Petition to Intervene of Regency Midwest Ventures Limited Partnership and Deadwood Resort, L.L.C. was filed. On January 29, 2013, a Petition to Intervene of Wal-Mart Stores, Inc. and Sam's West, Inc. (Walmart) was filed. On February 5, 2013, the Commission issued an Order Granting Intervention to Black Hills Industrial Intervenors. On February 15, 2013, the Commission issued an Order Granting Intervention to Wal-Mart Stores, Inc. and Sam's West, Inc. On February 28, 2013, the Commission issued an Order Denying Intervention without Prejudice denying intervention to Regency Midwest Ventures Limited Partnership and Deadwood Resort, L.L.C. On May 2, 2013, the Commission issued an Order for and Notice of Procedural Schedule and Hearing setting the matter for hearing on October 8-11, 2013. On May 2, 2013, BHP filed a Notice of Intent to Implement Interim Rates effective on and after June 16, 2013.

On May 23, 2013, BHP filed a Joint Motion for Approval of Settlement Agreement Between Black Hills Power and South Dakota Science and Technology Authority (SDSTA), Settlement Agreement Between BHP and SDSTA, Supplemental Motion for Approval of Settlement Agreement, Joint Motion for Approval of Settlement Agreement Between Black Hills Power and Menard, Inc. dba Midwest Manufacturing dba Dakota Panel (Dakota Panel), Settlement Agreement Between BHP and Dakota Panel, and Supplemental Motion for Approval of Settlement Agreement. On June 13, 2013, Staff filed its memorandum regarding the contracts with deviations. On June 24, 2013, the Commission issued an Order Conditionally Authorizing and Approving Implementation of Contracts with Deviations Rates on an Interim Basis.

Settlement discussions between Staff, BHP, BHI, and Walmart commenced on July 18, 2013. 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. On August 23, 2013, BHP filed a letter stating BHP, Staff, Walmart, and BHI agreed to suspend the procedural schedule to the extent that the testimony of Staff, Walmart, and BHI that was to be filed and served on or before August 23, 2013, must now be filed and served on or before August 26, 2013. On August 26, 2013, BHP filed a letter requesting that the procedural schedule in this case be suspended while the parties finalize the settlement documents for submission.

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 Party 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 costly and unnecessary litigation.

Staff and BHP agree BHP's revenue deficiency is approximately $8,831,464 justifying an approximate 6.39% increase in retail revenue. The 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 June 30, 2012, total Company test year costs and allocates total Company amounts to the South Dakota retail jurisdiction. Staff then adjusted the June 30, 2012, test year results for known and measurable post-test year changes. Staff Exhibit___(BAM-1), Schedule 3 illustrates Staff's determination of BHP's proforma 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 supports 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, June 30, 2011, through June 30, 2012.

Test Year Plant In-Service Annualization – The Company proposed an adjustment to annualize test year non-revenue producing plant additions that occurred during the test year. The settlement determination revises the Company's adjustment to: 1) Remove the amounts related to the Southside Walmart and Stedheim Line Extension as these projects appear to be revenue producing; and 2) Recognize, as a rate base adjustment, the accumulated deferred income taxes related to the difference between book and tax depreciation. The net effect of these changes is to reduce rate base by approximately $2,770,000.

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 by April 1, 2013. The settlement determination revises the Company's adjustment to: 1) Reflect actual costs for completed plant additions as of June 15, 2013, as proposed after the initial filing; 2) Remove the amounts related to the Hansen Well Line Extension, Rocky Bluffs Apartments Line Extension, and Piedmont Reconductor as these projects appear to be revenue producing; 3) Remove the amounts related to the Energy Star Lighting projects as the savings resulting from these projects that are not reflected in the test year should off-set the costs of this investment; and 4) Reflect the accumulated deferred income taxes related to the 50% bonus depreciation for eligible projects which was extended through 2013. The net effect of these changes is to increase rate base by approximately $2,042,000.

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 allowance 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 and expense lead and lag-day determinations and is in agreement with the Company on them. Staff revised the Company's cash working capital calculation, however, to incorporate into the lead-lag analysis the impacts of Staff's recommended adjustments to pro forma operating expenses. This modification increased rate base by approximately $1,189,000.

Rate Case Expense – BHP proposed to amortize projected rate case costs for docket EL12-061 over three years and include two-thirds of that amount in rate base. The settlement reflects a three year amortization of $261,813 in actual costs as of July 2, 2013, for dockets EL12-061 and EL12-062 and includes one-half of that amount, or $130,907, in rate base, representing the average unamortized balance over the three year period. The net effect of these changes reduces rate base by approximately

$316,000. The settlement also establishes a tracker for the potential recovery of the residual costs associated with dockets EL12-061 and EL12-062 in BHP's next rate case filing.

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 Carry-forward – Tax deductions generated principally by "bonus" depreciation on recent plant additions have placed BHP in a tax loss position with respect to income taxes. When that occurs the Company is unable to use the deduction in the current tax year. Instead, the Company is allowed to carry forward the tax benefit to future tax years until the benefit has been fully utilized. The Settlement revenue requirement determination reflects the adjustments that are necessary to the accumulated deferred taxes reserve to properly reflect the NOL carry-forward. The result of recalculating this adjustment to reflect the effect of other adjustments incorporated in the settlement is to increase rate base by approximately $3,598,000.

Non-Utility Plant – The Company included Account 121, Non-Utility Plant, in rate base. The amount in this account consists entirely of a parcel of land which is not used for rate payers. The settlement removes the non-utility plant from rate base. The adjustment reduces rate base by approximately $5,000.

Working Capital Updates – The settlement reflects the most recent 13-month average for materials and supplies, fuel stocks, and prepayments. The net effect of these changes increases rate base by approximately $439,000.

Pre-Paid Expenses – BHP's original rate base presentation included an allowance for pre-paid expenses. Staff objected to this treatment because the payment lag for the related expense is already measured in the Company's lead-lag analysis. Therefore, including a separate rate base allowance for prepayments would double-count the working capital requirement for pre-paid expenses. The Settlement revenue requirement excludes BHP's originally proposed prepayment rate base allowance, reducing rate base by approximately $623,000.

Spare Transformer – BHP included in its rate base presentation the estimated cost of a spare transformer that it intends to purchase. When questioned about this item by Staff in discovery, the Company responded that its purchase of the transformer will be too far beyond the end of the test year to qualify as a known change adjustment. Therefore, the Settlement revenue requirement excludes the adjustment that was included in BHP's proposed rate base, reducing rate base by approximately $682,000.

OPERATING INCOME

Wage Increase & Additional/Transferred Personnel – BHP's filing included several adjustments to test year payroll expenses. These adjustments included a forecasted 3.5 percent increase for non-union workers, a 3.0 percent increase for the Company's union workers, the transfer of several employees from the utility to the affiliate Black Hills Utility Holdings, one replacement employee and two additional employees. Staff carefully analyzed BHP's proposed pro forma payroll and found two areas of disagreement. First, the actual increase that was granted to non-union workers in March 2013 was 3.2 percent, not 3.5 percent as BHP originally forecasted. Second, one position had been eliminated post-test year. These two additional adjustments proposed by Staff are reflected in the Settlement revenue requirement. The net effect of these changes reduces operating expenses by approximately $80,000.

Intercompany Charges – Black Hills Service Company and Black Hills Utility Holdings – Certain centralized services, including executive, corporate governance, treasury, finance, human resources, and other services are provided to BHP by its corporate affiliates Black Hills Service Company and/or Black Hills Utility Holdings. BHP's filing included adjustments to test year charges from these two affiliates to reflect the Company's estimate of charges for twelve month period post-test year. Staff objected to these adjustments because forecasted operating costs for a future period do not meet the known and measurable standard for post-test year adjustments. During negotiations, BHP provided information showing the Company's actual billings from affiliates post-test year. Staff agreed to recognize the actual, known cost increases. Therefore, the Settlement revenue requirement reflects known post-test year cost increases in charges from affiliates. The net effect of these adjustments reduces the claimed operating expenses by approximately $54,000.

Employee Pension & Benefits Adjustment – BHP proposed an increase in employee benefits (pension, retiree healthcare and 401K) based on an estimate of the Company's expense for the twelve months ended June 30, 2012, provided by its independent actuary, Mercer. As it did with other projected expenses, Staff objected to the Company's reliance on cost projections rather than actual known changes. During settlement negotiations the Company provided its actual employee pension and benefit expenses for the twelve month period ended June 30, 2013. The Settlement revenue requirement includes BHP's actual employee benefits expense, rather than the forecasted increases that were included in the Company's original filing. The effect of this change reduces operating expenses by approximately $183,000.

Bad Debt Analysis – BHP proposed an adjustment to bad debt expenses based on a three year uncollectible rate average applied to the entire revenue amount. The settlement allows for an increase to bad debt expense based on a five year uncollectible rate average applied to retail revenues. The net effect of these changes reduces operating expenses by approximately $26,000.

Generation Dispatch & Scheduling – The Company's proposed adjustment updated 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 calendar year 2012 costs and adjusted the allocation to be based on the most recent GDEMA capacity resources. The result of Staff's revised allocation reduces jurisdictional operating expense by approximately $81,000.

Purchase Power Expense – The Company proposed an adjustment to increase purchased power costs to reflect 2013 contractual rates and the additional purchase power needed to meet customer needs due to the suspension of operations at the Ben French power plant. The settlement accepts this adjustment.

Generation Plant Overhaul Expenses – Found on Statement H, Schedule H-10, the Company proposed an adjustment to remove the generation plant overhaul expenses related to the Ben French power plant and Neil Simpson I power plant as both of these plants will be retired in March 2014 to comply with environmental standards. The proposed adjustment removed total test year generation overhaul expenses related to these plants and included the accrual reversal amortization, based on a seven year period. The settlement does not reflect such an adjustment in base rates but instead returns these amounts to customers over a three year period through the Energy Cost Adjustment (ECA). This ensures the Company will return the entire amount to customers. However, the effect of this adjustment is to increase base rate operating expenses by approximately $382,000.

Expense Elimination Adjustment – BHP proposed an adjustment to remove all costs associated with the abandoned Belle Fourche wind project and to remove advertising expenses that should not be recovered from ratepayers. The settlement accepts these adjustments and further removes additional advertising costs which do not provide for the provision of safe, adequate, and reliable electric service. The effect of this adjustment reduces operating expenses by approximately $1,000.

Power Marketing Adjustment – BHP's adjustment to remove power marketing expenses from the base rate regulated cost of service is found on Statement H, Schedule H-12. The revenue adjustment found in Statement I, page 1, removes the corresponding power marketing revenues from the base rate cost of service. The settlement accepts both adjustments.

Rate Case Expense – BHP proposed to amortize projected rate case costs for docket EL12-061 over three years. The settlement allows a three year amortization of $261,813 in actual costs as of July 2, 2013, for dockets EL12-061 and EL12-062. The net effect of these changes reduces operating expenses by approximately $136,000. The settlement also establishes a tracker for the potential recovery of the residual costs associated with dockets EL12-061 and EL12-062 in BHP's next rate case filing.

Ben French O&M Adjustment – The Company proposed an adjustment to remove the operating and maintenance expenses related to the Ben French power plant operations. The settlement revises this adjustment to reflect actual costs during the test year in lieu of the budgeted amounts proposed by the Company. The net effect of this adjustment reduces operating expenses by approximately $160,000.

Coal Price Adjustment – BHP's proposed coal price adjustment was based on the projected 2013 coal costs and coal consumption based on a four year average, excluding months with plant outages. The proposed adjustment also removed coal costs and transport costs related to the Ben French power plant, as Ben French suspended operations. The settlement reflects 1) acceptance of the removal of coal costs and transport costs related to Ben French; 2) BHP's actual 2012 average cost of coal as reflected in its annual ECA filing in lieu of the budgeted costs; and 3) coal consumption based on average coal usage by plant over the time period based on the major maintenance cycle for each plant. The average coal consumption takes into account the lower usage during the outage years and normalizes the amount of tons used by plant. The net effect of these changes increases operating expenses by approximately $890,000.

Severance Expense Adjustment – BHP proposed an adjustment to remove all severance payments from the test year. The settlement accepts this adjustment.

Capacity Reserve Adjustment – BHP proposed an adjustment to remove the spinning reserve sales included in the test year due to suspended operations at the Ben French power plant. The settlement accepts this adjustment.

Remove Energy Costs & Revenues – The Company proposed an adjustment on Statement H, column q, to remove all energy related costs. The associated revenue was also removed in Statement I. All energy related costs will be recovered through the (ECA). The Company's expense adjustment also removed re-agent expenses since these are costs are proposed to be recovered through the ECA. The settlement accepts these adjustments, revised to reflect the effect of other adjustments that were revised as part of this settlement. The net effect of these changes reduces operating revenues by approximately $147,000 and reduces operating expenses by approximately $882,000.

Contract Sales Adjustment – The Company proposed an adjustment to reflect an increase in revenues from the Municipal Energy Agency of Nebraska (MEAN) that was expected to occur in 2013. The settlement revises this adjustment to reflect the actual MEAN contract pricing in effect for 2013. The adjustment reduces operating revenues by approximately $277,000.

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.

Remove Reserve Capacity Agreement Revenue – The Company proposed an adjustment to remove the test year revenues associated with the Reserve Capacity Integration Agreement since this agreement expired on June 30, 2012. The settlement accepts this adjustment.

Miscellaneous Service Revenue – The Company proposed to increase the charges for reconnection of service which has been disconnected for non-payment. The settlement 1) accepts the Company's adjustment to increase the reconnection charge during business hours from $15.00 to $30.00; 2) revises the adjustment to increase the reconnection charge for 5:00 pm – 10:00 pm from $30.00 to $60.00 in lieu of the Company's proposal of $100.00; and 3) revises the adjustment to maintain the reconnection charge for overnights, weekends, and holidays at $60.00 as opposed to the Company's proposed charge of $100.00. The Company desires to move away from the three tiered approach as all other Black Hills Corporation utilities use a two tiered approach and the cost to the Company to perform reconnections after hours does not vary based on weekday, overnights, or weekends. Staff believes these adjustments gradually move towards costs and facilitate the move to a two-tiered approach while not increasing any one charge more than twice the existing charge. The net effect of these changes reduces operating revenues by approximately $4,000.

Leap Year Adjustment – The Company proposed an adjustment to eliminate one day of February sales due to the test year being a leap year. The settlement accepts the adjustment to kWh sales and revenues, excluding the adjustment to energy efficiency revenues as these revenues are removed from the test year, and also removes associated fleet fuel and labor expenses. The net effect of these changes increases operating revenues by approximately $3,000 and reduces operating expenses by approximately $23,000.

Pole Attachment Revenue – The Company proposed an adjustment to reduce operating revenues due to a decrease in pole attachment revenues as the formula for charging pole attachment rates has been changed by the Federal Communications Commission. The settlement updates the revenue amount based on the actual amount of revenue billed and collected in 2013. The effect of this change reduces operating revenues by approximately $2,000.

Difference in Billing Determinants – BHP proposed an adjustment to reconcile the per book kWh energy sales and billing revenue from the Company's general ledger and billing system as compared to the summary of the monthly test year billing determinants for the billing system. The settlement accepts this adjustment.

Special Contract Rate Annualization – BHP provides service to certain customers under special contracts which previously have been approved by the Commission. Those contracts contain a provision for a rate increase effective April 1, 2013. Therefore, BHP proposed an adjustment in its rate filing to increase test year sales revenue by $190,182 to reflect the impact of the post-test year rate increase for the special contract customers on test year revenues. Staff accepted BHP's revenue annualization adjustment for special contract customers and the adjustment is reflected in the Settlement revenue requirement.

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

Test Year Plant Annualization – The Company proposed an adjustment to annualize test year non-revenue producing plant additions that occurred during the test year. The settlement determination revises the Company's adjustment to: 1) Remove the amounts related to the Southside Walmart and Stedheim Line Extension as these projects appear to be revenue producing; 2) Reflect the associated effect on depreciation expense; and 3) Reflect the associated effect on property taxes. The net effect of these changes is to increase operating expenses by approximately $647,000.

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 by April 1, 2013. The settlement determination revises the Company's adjustment to: 1) Reflect actual costs for completed plant additions as of June 30, 2013, as proposed after the initial filing; 2) Remove the amounts related to the Hansen Well Line Extension, Rocky Bluffs Apartments Line Extension, and Piedmont Re-conductor as these projects appear to be revenue producing; 3) Remove the amounts related to the Energy Star Lighting projects as the savings resulting from these projects that are not reflected in the test year should off-set the costs of this investment; 4) Reflect the associated effect on depreciation expense; and 5) Reflect the associated effect on property taxes. The net effect of these changes is to reduce operating expenses by approximately $685,000.

Service Company Charges – Blended Ratio – Black Hills Service Company provides centralized corporate services to BHP and other affiliates. Many of the charges for these centralized services cannot be directly billed to the users because they are common costs. There is no direct method for billing most common costs. Rather, the Service Company has developed a "blended ratio" which is used to allocate certain common costs among all affiliates. The blended ratio equally weights three different general ratios: Gross Margin, Asset costs, and Payroll Dollars. The Service Company affiliates, however, do not include the parent company, Black Hills Corporation, in the blended ratio. Rather, the Service Company affiliates arbitrarily assign five percent of the common costs that are allocated among the affiliates using the blended ratio to the parent company.

Staff objected to this approach. Instead, Staff recommended that metrics for the parent company be included in the calculation of the blended ratio. This approach re-allocates more costs to the parent and fewer costs to the affiliates, including BHP. Therefore, Staff recommended a reduction in test year affiliate charges to reflect the re-allocation of common costs to the corporate parent. During settlement discussions, the Company proposed to include half of this adjustment and Staff agreed for settlement purposes. The result of this adjustment reduces operating expenses by approximately $21,000.

Incentive Compensation – Officers and employees of BHP and its affiliate Service Company are eligible to receive incentive compensation awards if certain financial, operating, or safety goals are met. The Company believes that putting a portion of an employee's total compensation "at risk" motivates employees to achieve corporate, safety and operating goals. BHP requested rate recognition for all incentive compensation awards that were paid during the test year.

As it has in many prior rate cases, Staff objected to including in rates all of the incentive compensation awards. Specifically, Staff objects to include incentive compensation awards that are tied to officers and/or employees achieving financial goals. Staff believes that the Company's stockholders are the primary beneficiaries when financial performance targets are achieved. Stockholders rather than ratepayers should pay for financial performance-related incentive compensation awards. Staff's position of excluding incentive compensation awards that were based on achieving financial targets is reflected in the Settlement revenue requirement. This adjustment reduced test year payroll expenses by approximately $1,110,000.

Demand Side Management – The settlement removes approximately $61,000 in demand side management related costs. Demand side management costs are currently being recovered through a separate rider and need to be removed to avoid double recovery.

Charitable Contributions – The settlement removes approximately $8,000 in charitable contributions.

Economic Development – The settlement removes approximately $89,000 in economic development related costs, included labor, meals, and transportation related costs. BHP understands they should file a plan by January 1, 2014, to seek approval by the Commission where ratepayers and shareholders share in the benefits and costs of the plan. BHP can then seek recovery of these economic development related costs in their next rate case.

Association Dues – The settlement removes approximately $131,000 in association dues costs associated with economic development, lobbying, and other activities which do not provide for the provision of safe, adequate, and reliable electrical service.

Storm Damage – The settlement normalizes storm damage costs to a five year average of costs, reducing operating expenses by approximately $33,000.

Workers Compensation – During discovery, BHP proposed an adjustment to normalize workers compensation costs to a five year average of these costs. The settlement accepts this adjustment, increasing operating expenses by approximately $146,000.

Vegetation Management – During settlement discussions, the Company proposed to increase vegetation management expense based on actual costs incurred for the twelve months ending June 30, 2013. The most recent vegetation management costs are more reflective of current operational expenses at the time rates are going into effect. This adjustment increases operating expenses by approximately $329,000.

COST OF CAPITAL AND RATE OF RETURN

The Company requested an overall rate of return of 8.54 percent, using a capital structure of 53.17 percent equity and 46.83 percent long term debt, with cost rates for debt and equity of 6.59% and 10.25%, respectively. The settlement reflects an overall rate of return of 7.93%, using a **[Begin Confidential]** [redacted] **[End Confidential]**

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.

Distribution of the Increase – BHP performed a class cost of service study. In a class cost of service study the utility's investments and costs are allocated and/or assigned to the various service classifications. From this, revenue requirements for each rate class can be determined. Based on the results of the Company's class cost study it was determined that the Residential and Lighting Service classes were contributing more than an equitable share of revenues to the Company's overall return and that the General Service, General Service – Large and Industrial Contract classes were not contributing enough revenue to the Company's overall return. In order to bring each class closer to the system-wide rate of return, BHP proposed a spread of the increase that resulted in a lower-than-average percentage increase for the Residential and Street Lighting classes and higher-than-average percentage increase for the remaining classes.

Staff carefully reviewed and analyzed BHP's class cost allocation procedures. Staff determined that those procedures represent a fair and equitable allocation of the Company's revenue requirement based on cost causation of each rate classification. Therefore, Staff accepted BHP's proposed spread of the increase among the rate classes. Because the Settlement results in a lower overall rate increase than what the Company originally proposed, the spread of the increase that BHP initially proposed had to be scaled back proportionally to each rate class to reflect the same relative spread of the increase that BHP initially proposed. This scaled back procedure is the rate spread that is reflected in the Settlement.

Rate Design Changes – BHP proposed increases to all customer charges. Staff had concerns that these charges exceed the cost of service and proposed to limit the customer charge increases to the percentage increase for each class as indicated in the class cost of service. The settlement reflects Staff's proposal.

Reconnection Charges – The Company proposed to increase the charges for reconnection of service which has been disconnected for non-payment. The settlement reflects a charge of $30.00 for reconnections during business hours, $60.00 for reconnections outside of normal business hours. Staff believes these adjustments gradually move towards costs while not increasing any one charge more than twice the existing charge. Staff also recommends the Company maintain their normal business hours at 8:00 am to 5:00 pm as opposed to the Company's proposal of 8:00 am to 4:00 pm for purposes of making customer connections and reconnections. Staff further recommends the Company list the reconnection charge for outside of business hours in the tariff. These changes have been reflected in the tariffs attached to the Settlement.

OTHER ISSUES

Vegetation Management Regulatory Asset – BHP requested the Commission approve an accounting order regarding vegetation management whereby the Company is allowed to treat its South Dakota expenditures for vegetation management that exceed the amount included in the test year, $1,412,177, as a regulatory asset. The Company requested the accounting order for vegetation management due to the increased vegetation management expense that BHP expects to incur due to the mountain pine beetle infestation. BHP states the increased amount over the typical costs has long term benefits and is thus best treated as an asset to be amortized over a longer period of time. Customers should benefit from this treatment as the recovery of these additional expenses will be delayed to a time when other increases have stabilized.

Staff and the Company agree to the establishment of the vegetation management regulatory asset, effective April 1, 2013, as proposed by the Company, modified to reflect the increased vegetation management expenses included in base rates as a result of this settlement and to ensure that if actual annual expenses are less than $1,741,509, the vegetation management regulatory asset will be reduced.

Transmission Facility Cost Recovery Tariff – The Company proposed to establish a new Transmission Facility Adjustment tariff (TFA) for cost recovery of investment in transmission facilities as allowed per SDCL 49-34A-25.1 through 25.4. Staff and the Company agree to such a tariff, with the understanding that the establishment of the TFA tariff does not determine future project eligibility or the mechanics of the revenue requirement calculations. These determinations will be made upon a future filing made by the Company for approval to recover project costs through the TFA tariff.

Energy Cost Adjustment – The Company proposed the following adjustments to its ECA clauses, the Fuel and Purchased Power Adjustment (FPPA) and the Transmission Cost Adjustment (TCA): 1) collect the base FPP and TCA costs through the FPPA and TCA, respectively, effective April 1, 2013, instead of in base rates; 2) include re-agents (including lime, lime freight, ammonia and chemicals) in the FPP costs; and 3) remove the SD Surplus Energy Phase-out. Staff and the Company agree to such changes. The base FPP and TCA costs were collected through the FPPA and TCA beginning on June 16, 2013, with the implementation of interim rates. Staff and the Company agree the re-agents recovered through the FPPA will exclude re-agents costs recovered through the Environmental Improvement Adjustment.

Implementation of Rates – The tariffs shown on Exhibit 1 attached to the Settlement are proposed to be implemented for service rendered on or after October 1, 2013. Customer bills will be prorated so that usage prior to that date is billed at the previous rates and usage on and after that date is billed at the new rates.

Interim Rate Refund – Interim rates were implemented on June 16, 2013. 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 collected, during the period June 16 through September 30, 2013. 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.

Contracts with Deviations – On May 23, 2013, BHP filed contracts with deviations between BHP and SDSTA and between BHP and Dakota Panel. The Commission approved these contracts 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 these contracts with deviations may now be finally approved by the Commission, without condition.

BHP has also entered into a settlement agreement with BHI, which will result in contracts with deviations. Staff was not involved in these negotiations, but has reviewed a draft settlement agreement and proposed rates.

Rates resulting from Staff's settlement with BHP have been designed based on the class cost of service revenue responsibility to ensure that the reduction in revenue due to the contracts with deviations with SDSTA, Dakota Panel, and BHI is borne by BHP's shareholders, not other customers.

RECOMMENDATION

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