PUBLIC VERSION

STAFF MEMORANDUM SUPPORTING SETTLEMENT STIPULATION

TO: COMMISSIONERS AND ADVISORS

FROM: KRISTEN EDWARDS, JON THURBER, BRITTANY MEHLHAFF, AND PATRICK STEFFENSEN

RE: DOCKET EL17-006 – IN THE MATTER OF THE APPLICATION OF BLACK HILLS POWER, INC. DBA BLACK HILLS ENERGY FOR APPROVAL OF 2017 TRANSMISSION FACILITY ADJUSTMENT

DOCKET EL17-008 – IN THE MATTER OF THE APPLICATION OF BLACK HILLS POWER, INC. DBA BLACK HILLS ENERGY FOR APPROVAL OF ITS 2017 ENVIRONMENTAL IMPROVEMENT ADJUSTMENT

DATE: June 9, 2017

Commission Staff (Staff) submits this Memorandum in support of the Settlement Stipulation (Stipulation) of June 9, 2017, between Staff and Black Hills Power, Inc. dba Black Hills Energy (BHE or Company) in the above-captioned matters.

BACKGROUND

On February 15, 2017, BHE filed an application for approval of its 2017 Transmission Facility Adjustment (TFA). The Commission assigned this filing as Docket EL17-006. The Company requested the annual rate adjustment allowed under SDCL 49-34A-25.3 for the costs associated with transmission investments previously approved for recovery. The Company did not request recoveries for additional projects. BHE requested approval of its annual true-up of TFA revenue requirement from April 15, 2016, through May 31, 2017, as approved in Docket EL16-005, and the forecasted recovery of TFA revenue requirements from June 1, 2017, through May 31, 2018.

BHE also filed an application for approval of its 2017 Environmental Improvement Adjustment (EIA) on February 15, 2017. The Commission assigned this filing as Docket EL17-008. The Company requested the annual rate adjustment allowed under SDCL 49-34A-99 for the costs associated with environmental improvements previously approved for recovery. The Company did not request recoveries for additional projects. BHE requested approval of its annual true-up of EIA revenue requirement from April 15, 2016, through May 31, 2017, as approved in Docket EL16-006, and the forecasted recovery of EIA revenue requirements from June 1, 2017, through May 31, 2018.

The Commission officially noticed BHE's filings on February 16, 2017, and set an intervention date of March 3, 2017. No interventions were filed in either docket.

Pursuant to the Settlement Stipulation in Docket EL15-008 and the Amendment to Settlement Stipulation in Docket EL14-013, the Company is required to submit a report of its South Dakota jurisdictional financial condition for the preceding calendar year by February 15th of each year, as long as the Company is receiving revenue from either the EIA or TFA. Staff believes the report is necessary to monitor the Company's earnings and the potential effect of adding the TFA and EIA to its South Dakota tariff. In accordance with this requirement, on February 15, 2017, BHE provided Staff its 2016 Annual

Report of South Dakota Jurisdictional Financial Condition (Annual Report). On February 23, 2017, BHE filed the Annual Report in Dockets EL17-006 and EL17-008.

On March 1, 2017, the Commission issued in both EL17-006 and EL17-008 an Order Assessing Filing Fee and on March 29, 2017, the Commission issued in both dockets an Order Suspending Operation of Rate Schedule, thereby suspending the operation of the proposed EIA and TFA rates for 180 days beyond February 15, 2017.

STAFF'S ANALYSIS AND SETTLEMENT RESOLUTIONS

Staff conducted a comprehensive review of BHE's filings in these dockets and obtained additional information through discovery. As further discussed below, Staff's analysis in these dockets focused on review of the Annual Report and addressing the Company's earnings level consistent with the public interest. This review assists Staff in determining the need for and appropriateness of requested riders.

Staff and BHE (jointly the Parties) positions were discussed thoroughly at numerous settlement conferences. As a result, some party positions were modified and others were accepted where consensus was found. The Parties ultimately arrived at a mutually acceptable resolution of all issues. Staff believes the settlement is based on sound regulatory principles and avoids costly litigation.

ANNUAL REPORT

In recent years, the regulatory framework in South Dakota has changed with the addition of several riders and other regulatory mechanisms. BHE has taken advantage of all available riders which allow a guaranteed recovery on certain investments and costs. The Company has also requested establishment and recovery of regulatory assets in recent years. Regulatory assets allow the Company to defer costs to its balance sheet and request recovery at a later time. In the past when all the Company had were base rates and the Energy Cost Adjustment, Staff was comfortable allowing the Company to manage its costs between rate cases and know that in some years the Company would likely under-earn and other years the Company would likely over-earn. However, given that the addition of riders and regulatory assets can enhance the Company's earnings through single issue ratemaking, Staff believes it is necessary to monitor the Company's earnings to ensure these additional mechanisms are necessary for the Company to earn a fair return. Staff monitors the Company's earnings through review of the Annual Report submitted in the EIA and TFA pursuant to the settlement agreements between the Parties.

The initial Annual Report filed in February, 2017 stated an earned return on equity (ROE) of **[Begin Confidential] [End Confidential]** for the Black Hills Power South Dakota Jurisdiction for the year ended December 31, 2016. **[Begin Confidential] [End Confidential].**

Staff engaged in a review to verify the accuracy of the reported return. Staff's analysis identified a number of adjustments that should be made to the Annual Report. Staff engaged in four sets of discovery to address Staff's concerns.

On April 11, 2017, the Company submitted to Staff in response to data requests an Updated Annual Report of South Dakota Jurisdictional Financial Condition. BHE filed this report in the dockets on June 9, 2017. The Updated Annual Report of South Dakota Jurisdictional Financial Condition demonstrates an earned ROE of **[Begin Confidential] [End Confidential]**. Staff believes this revised report is a materially accurate representation of the Company's 2016 South Dakota earnings. Confidential Exhibit A –

Reconciliation attached to this memorandum provides a reconciliation of the adjustments made to the initial Annual Report and reflected in the Updated Annual Report of South Dakota Jurisdictional Financial Condition.

EIA AND TFA REVENUE REQUIREMENTS

[Begin Confidential] [End Confidential] Staff determined the Company did not need the EIA and TFA mechanisms to earn a fair return as the Company would have earned an approximate **[Begin Confidential] [End Confidential]** ROE without the mechanisms. The revenues collected through base rates are currently sufficient to recover the capital costs associated with EIA and TFA investments and earn a reasonable return. The proposed revenue requirements in Dockets EL17-006 and EL17-008 for June 1, 2017 through May 31, 2018 were $269,141 and $398,317, respectively. The Company agreed to forgo recovery of the EIA and TFA revenue requirements after May 31, 2017. The Company estimates the EIA and TFA recoveries forgone during the moratorium period, as further explained below, to be approximately $3.0 million.

Since the rates proposed by the Company to be effective June 1, 2017, were suspended by the Commission, the rates effective June 1, 2016 will continue to be charged until the Stipulation is approved by the Commission. The Parties request approval of the Stipulation prior to July 1, 2017. This is expected to result in an over-collection in the balancing account for the EIA and an under-collection for the TFA.

The Company agrees to forgo recovery of the TFA under-collection balance and the TFA rates will be set to zero on July 1, 2017. The EIA balance will be refunded to customers over a six-month period beginning July 1, 2017, through refund rates determined based on the expected over-collection balance and estimated sales. Since the refund rates are based on estimates, the Company will track the EIA balance and discontinue the refund rates once the entire balance has been refunded to customers. This may be before or after the calculated six-month period. Once the balance is refunded, the EIA rates will be set to $0.00. BHE will submit a compliance filing, including the final tariff sheet, to inform the Commission the refund process is complete. Staff believes this refund plan is the most adequate and efficient way to fully return the over-collection to customers.

VEGETATION MANAGEMENT REGULATORY ASSET

[Begin Confidential] [End Confidential] Staff next focused on review of the Vegetation Management Regulatory Asset (VMRA) to which expenses were reclassified to the balance sheet for future recovery during 2016.

In Docket EL12-061 the Commission approved establishment of the VMRA, effective April 1, 2013. Expenditures above the amount included in base rates were re-classed as a regulatory asset and a rate of return carrying charge was calculated on a monthly basis and included in the VMRA balance. BHE intended to trim the entire distribution system during the five-year plan period (April 1, 2013 through March 31, 2018) associated with the VMRA. The entire right-of-way clearance was reclaimed as of March 31, 2017, ahead of schedule. In Docket EL17-021, the Company proposes that future expenditures for vegetation management should not be considered a regulatory asset and requests approval to end the VMRA.

The current balance in the VMRA account as of March 31, 2017, is $13,821,096, which excludes the return on equity component in accordance with accounting rules[1]. **[Begin Confidential] [End Confidential]**. The Company agrees to amortize the VMRA balance over a six-year period beginning July 1, 2017. BHE will not seek recovery of the VMRA balance during the moratorium period, which is discussed in more detail below. **[Begin Confidential] [End Confidential]** Staff agreed it was reasonable to amortize the VMRA balance over a six-year period, consistent with the moratorium period. This reduces the Company's earnings by **[Begin Confidential] [End Confidential]** per year during the six-year period.

FUTURE EARNINGS LEVELS

[Begin Confidential] [End Confidential]

Staff's preferred option for addressing future earnings was to work with the Company to explore alternative performance-based regulation, which is what the settlement is designed to do. The settlement includes several aspects designed to protect ratepayer interests and provide ongoing benefits to customers over the next several years. Each of these items is discussed more thoroughly below.

Rate Moratorium – The Parties agree that BHE shall not file any rate application for an increase in base rates which would go into effect prior to July 1, 2023. Furthermore, the Company will not file for an increase in rates for the EIA, TFA, or phase in rate plans pursuant to SDCL 49-34A-73 during this six-year moratorium period. The rate moratorium does not apply to the Energy Cost Adjustments or the Energy Efficiency Solutions Adjustment. As further described in the stipulation, the moratorium will remain in effect unless the Commission enters an order declaring that the Company is entitled to relief from the moratorium as a result of an extraordinary event. Unlike previous rate case stipulations which have specifically defined an extraordinary event, this settlement requires BHE to prove to the Commission why it is entitled to such relief. Staff can challenge any evidence presented by the Company in such a proceeding. The Commission can also issue an Order to Show Cause at any time during this moratorium period.

The six-year moratorium provides stable rates for customers for a significant amount of time. In fact, given BHE's current base rates were effective October 1, 2014, customer rates will remain stable for nearly nine years. This is a significant benefit for customers since BHE has filed rate cases every two to three years since 2006.

[Begin Confidential] [End Confidential]

Jurisdictional Earnings Reports – Although the Company's agreement to end recoveries through the EIA and TFA eliminates its obligation to provide jurisdictional annual earnings reports pursuant to the Settlement Stipulation in Docket EL15-008 and the Amendment to Settlement Stipulation in Docket EL14-013, BHE has agreed to continue providing such reports so Staff and the Commission can monitor the Company's earnings during the moratorium period.

To ensure proper reporting and avoid disagreement regarding how the normalized report should be prepared, the Parties agreed on certain parameters upon which the report will be prepared. These

[1] Including the return on equity component would result in a balance of $14,793,656.

parameters are detailed in the Stipulation. These understandings should allow for efficient review of the report each year.

BHE will file the jurisdictional earnings report for the previous calendar year on or before May 1st of each year during the moratorium period, beginning with the 2017 report being filed no later than May 1, 2018. The report will be filed as a confidential compliance filing in either the EIA or TFA.

In the event BHE's earnings over the moratorium period materialize to a level unanticipated at this time, Staff can request the Commission initiate a proceeding to investigate the Company's rates. The Commission is free to investigate upon its own motion as well. **[Begin Confidential] [End Confidential]**

Power Marketing Margin Guarantee – The Company's fuel and purchased power adjustment includes a sharing mechanism associated with power marketing. The power marketing operating income credit, which reduces the fuel and purchased power adjustment recovery, is currently guaranteed at a minimum of $1 million each year. The Company agrees to increase this minimum by $1 million, bringing the total annual power marketing operating income credit minimum to $2 million. The additional $1 million credit will be guaranteed from April 1, 2017 through March 31, 2023, providing a total guarantee to customers of approximately $6 million.

Capital Projects – The Parties agree a minimum of $10 million of capital spending planned for the 2020-2021 timeframe shall be accelerated so projects are placed in service prior to December 31, 2019. The increased spending must provide a direct benefit to South Dakota retail customers. The Stipulation includes a list of potential projects including 69KV line projects, new distribution substations, and distribution substation transformer projects. This list may be modified with agreement between the Parties. While the list of potential projects includes distribution projects, acceleration of such projects may be waived if the Company prudently adds a Company-owned generation project of 10MW or greater to its resource mix prior to December 31, 2019.

[Begin Confidential] [End Confidential] Additionally, the capital acceleration will benefit customers by increasing reliability and commencing depreciation prior to the Company's next rate case, resulting in a lower impact to rates at that time.

Other Regulatory Asset Amortization – The Parties agree that the regulatory asset balances related to rate case expenses incurred after settlement of Docket EL14-026, decommissioning, and Winter Storm Atlas will be fully amortized over the moratorium period. Amortizing these regulatory asset balances over the moratorium period ensures that, barring an extraordinary event where the Company is allowed to file for an increase in rates, the Company will not seek an increase in rates related to these balances.

Pursuant to the Settlement Stipulation in Docket EL14-026, the decommissioning and Winter Storm Atlas regulatory assets were to be amortized over a 10-year period beginning October 1, 2014 and ending September 30, 2024. Accelerating the amortizations to be completed by June 30, 2023 shortens the amortization period from 10 years to 8.75 years. This acceleration expenses costs during the moratorium period that would otherwise be remaining for potential recovery in a rate case as early as July 1, 2023, providing savings to customers and reducing the Company's returns during the six-year moratorium period by approximately **[Begin Confidential] [End Confidential]**, or approximately **[Begin Confidential] [End Confidential]** each year.

Rate case expense incurred at the time of the settlement in Docket EL14-026 were amortized and recovered through base rates over three years. This amount will be fully amortized as of September 30, 2017. However, following the calculation of rates pursuant to the settlement between Staff and the Company in Docket EL14-026, the Company incurred additional expenses due to the hearing and appeals to the circuit court and supreme court. These additional expenses of **[Begin Confidential] [End Confidential]** would be deferred until the next rate case when the Company would seek recovery. Amortizing these additional rate case expenses during the moratorium period reduces the Company's returns during the moratorium period by approximately **[Begin Confidential] [End Confidential]** per year and eliminates recovery of such expenses in a future rate case (unless a rate increase is allowed due to an extraordinary event).

Vegetation Management Activities and Reporting – BHE will continue to maintain a four to five-year vegetation management cycle. The Company will file a non-docketed vegetation management report by May 1st of each year during the moratorium period so that Staff and the Commission may monitor the Company's vegetation management activities.

No Recovery of EIA/TFA Filing Fees – The Company agrees it will not request recovery of the filing fees assessed by the Commission in Dockets EL17-006 and EL17-008 in any future rate applications.

RECOMMENDATION

The settlement results in significant savings to customers throughout the six-year moratorium period. **[Begin Confidential] [End Confidential]**

In addition to these quantifiable benefits during the moratorium period, the settlement also allows for stable rates, monitoring of earnings and vegetation management activities, and lower rate impacts in the future due to accelerated distribution projects and no recovery of EIA and TFA filing fees.

Staff recommends the Commission grant the Joint Motion for Approval of Settlement Stipulation and adopt the Stipulation without modification, including the attached tariff sheets, with an effective date of July 1, 2017.