STAFF MEMORANDUM SUPPORTING SETTLEMENT STIPULATION

TO: COMMISSIONERS AND ADVISORS

FROM: BRITTANY MEHLHAFF, PATRICK STEFFENSEN, AND KRISTEN EDWARDS

RE: DOCKET EL18-029 – IN THE MATTER OF THE APPLICATION OF BLACK HILLS POWER INC., DBA BLACK HILLS ENERGY FOR APPROVAL OF ITS TAX CUT AND JOBS ACT PROPOSAL

DATE: AUGUST 28, 2018

Commission Staff (Staff) submits this Memorandum in support of the August 28, 2018 Settlement Stipulation (Stipulation), between Staff and Black Hills Power Inc., dba Black Hills Energy (Black Hills Energy or the Company) in the above-captioned matter.

BACKGROUND

On December 20, 2017, the United States Congress passed the Tax Cuts and Jobs Act (TCJA), which was ultimately signed into law by the President on December 22, 2017. The TCJA impacts each tax paying utility's cost of service and all ratepayers. The TCJA contains provisions including, but not limited to, lowering the corporate tax rate from 35% to 21% effective January 1, 2018. The significant decrease in the tax rate and its resulting impact on utility costs and rates requires an investigation to ensure rates remain just and reasonable going forward after the enactment of the TCJA.

On December 21, 2017, in Docket GE17-003, Staff filed a "Motion Requesting Order Requiring Comments and Securing Tax Effects for Customers as of January 1, 2018" (Motion). In the Motion, Staff requested the Commission investigate the effect the TCJA has on South Dakota utilities and requested the Commission issue an order requiring utilities to submit comments on the effect the TCJA has on each utility. Additionally, Staff requested the Commission issue an order requiring that any adjustment to rates from the TCJA will be made effective January 1, 2018.

On December 29, 2017, the Commission issued its "Order Requiring Comments; Order Requiring Rates in Effect January 1, 2018, are Subject to Refund; Order Granting Intervention." On January 29, 2018, NorthWestern Energy submitted initial comments and on February 1, 2018, Black Hills Energy, Montana-Dakota Utilities Co., MidAmerican Energy, Xcel Energy, and Otter Tail Power Co. filed initial comments pursuant to the Commission's instructions.

On June 29, 2018 Black Hills Energy filed, in Docket EL18-029, a proposal to refund the 2018 TCJA customer benefit to ratepayers, reduce base rates effective January 1, 2019 for future TCJA tax expense reductions, and revise base rate customer charges. On August 28, 2018, Staff and Black Hills Energy (Parties) filed a "Joint Motion for Approval of Settlement Stipulation" and a "Settlement Stipulation" (Stipulation). A review of the terms of the Stipulation is provided below.

REVIEW OF THE STIPULATION

Staff worked with the Company to design a settlement that refunds the 2018 impacts of the TCJA, consistent with the Commission's order requiring any adjustment to rates be effective January 1, 2018, reduces rates effective January 1, 2019 for future TCJA tax expense reductions, and revises the base rate customer charges.

2018 TCJA Refund

The Parties agree that the effects of the TCJA should be refunded to customers effective January 1, 2018 as required in the Commission's December 29, 2017 order. The Parties agree that Black Hills Energy should refund its electric customers a total of $7.67 million for 2018. The refund reflects a fair balancing of the Company's obligation to customers for 2018 regarding the TCJA impact, including the difference between the 35% corporate tax rate and the 21% corporate tax rate, and accumulated deferred tax balances.

The agreed upon refund amount for 2018, $7.67 million, will be posted in a single payment to customers' accounts no later than October 2018. This refund is allocated to customer classes based on each class' share of the revenue allocation approved in EL14-026. Customer refunds will be calculated based on each customer's most recent 12 months of sales available at the time of the refund, which is anticipated to be August 2017 through July 2018. No carrying charge will be applied to the 2018 refund amount, as a portion of the refund will be in the form of a prepayment. Refunds will be limited to active customers as of July 31, 2018.

This 2018 refund amount of $7.67 million is determined based on the cost of service used in Black Hills Energy's last rate case, Docket EL14-026, adjusted to use a tax rate of 21 percent in place of the 35 percent rate. The 2018 refund also reflects offsetting excess accumulated deferred income tax effects.

Due to the use of accelerated and bonus depreciation and tax normalization for rate purposes, the amount of taxes actually paid to the IRS by Black Hills Energy associated with protected plant has been much less than the taxes recovered from ratepayers. Prior to January 1, 2018, Black Hills Energy's accumulated deferred income tax (ADIT) balance had been accumulating at the 35% tax rate. Because the tax rate has now been reduced to 21%, Black Hills Energy now has an excess in its deferred tax reserve associated with protected plant that must be returned to ratepayers.

This settlement also establishes a method for returning these excess ADIT balances associated with protected plant[1] to ratepayers. The Parties agree that all excess protected plant-related ADIT will be amortized over the remaining book life of Black Hills Energy's plant using the Average Rate Assumption

[1] Excess ADIT associated with protected plant refers to excess ADIT that the TCJA requires be normalized using the Average Rate Assumption Method (ARAM). Under ARAM, the utility cannot return to customers the excess in the deferred tax reserve that is protected until the year in which the book depreciation expense is more than the tax depreciation on the underlying assets. Utilities must follow ARAM for these protected assets in order to avoid a normalization violation. Therefore, ARAM must be used for ratemaking purposes.

Method (ARAM), as required by the Internal Revenue Service. The 2018 refund amount associated with this protected plant balance is approximately $1.3 million.

Black Hills Energy also has a net regulatory asset associated with non-protected plant[2]. The Parties agree that Black Hills Energy will amortize this $1.3 million deferred tax asset over one year, materially offsetting the 2018 refund of the protected plant amortization. Staff believes a one-year amortization of this deferred tax asset is appropriate in this situation given Black Hills is re-setting its base rates effective January 1, 2019 due to the effects of the TCJA. This eliminates any remaining deferred tax asset balance as of the dates new rates are in effect.

Base Rate Reduction

The Parties agree that the effects of the TCJA beyond January 1, 2019 should be given back to customers in the form a permanent reduction in base rates. This reduction equals the $7.67 million difference in base rates determined by applying the 21 percent tax rate in place of the 35 percent tax rate coupled with the approximate $1.3 million continued amortization of protected plant using ARAM for a total of an $8.97 million reduction in base rates effective January 1, 2019. Black Hills Energy will make a compliance filing in December 2018 to true-up the estimated excess accumulated deferred income tax to the actual, known amount.

Customer Charges

Black Hills Energy proposes a rate design strategy consistent with the rate design approved in its last rate case, Docket EL14-026, except for a proposed increase in customer charges. The increased customer charges, including an increase in the residential customer charge from $9.25 per month to $12.00 per month, is intended to begin to eliminate cross-subsidies among customers in the same rate schedule. Staff's cost-based customer charge analysis completed in Docket EL14-026 supports the Company's proposed $12.00 residential customer charge. Since Black Hills Energy has not experienced a huge increase in customers since that time, Staff believes this analysis remains accurate and therefore Staff supports the Company's rate design proposal. While this increase in customer charge is greater than Staff has supported in past rate cases, given the length of time between the Company's last rate case and the end of its current moratorium, Staff believes a larger increase is appropriate in an attempt to eliminate at least a portion of cross-subsidization within rate schedules.

RECOMMENDATION

Staff recommends the Commission grant the Joint Motion for Approval of Settlement Stipulation and adopt the Settlement Stipulation without modification.

[2] The Commission has discretion on the amortization of a regulatory asset or liability associated with non-protected plant for ratemaking purposes.