

STATE OF IOWA
DEPARTMENT OF COMMERCE
UTILITIES DIVISION
BEFORE THE UTILITIES BOARD

IN RE:

BLACK HILLS/IOWA GAS UTILITY
COMPANY, LLC d/b/a BLACK HILLS
ENERGY

DOCKET NO. RPU-2010-0002

POST-HEARING BRIEF
AND
LATE-FILED EXHIBIT REQUESTED BY BOARD

On June 8, 2010, Black Hills/Iowa Gas Utility Company LLC, d/b/a Black Hills Energy ("*Black Hills Energy*" or "*Company*") filed its application requesting the Iowa Utilities Board ("*Board*") to approve on a permanent basis a proposed general increase in Black Hill Energy's rates and charges for natural gas utility service provided to its Iowa customers in the amount of \$4,684,141 on an annual basis. On July 7, 2010, the Board docketed the rate increase request as a formal contested case proceeding identified as Docket No. RPU-2010-0002.

Black Hills Energy subsequently executed a unanimous settlement agreement ("*Settlement*") with the Office of Consumer Advocate ("*OCA*") and Constellation New Energy – Gas Division, LLC, and on September 1, 2010, the parties to the Settlement filed the Settlement with the Board combined with a motion joint motion for approval of the Settlement "in its entirety without condition or modification." The Settlement states that its sole purpose is to resolve all issues in this docket and that all proposals, positions, and adjustments made or reflected in the Settlement, whether express or

implied, were made or obtained only through the spirit of compromise. The Settlement further states that certain substantive individual issues could not be satisfactorily resolved individually and that the parties had to make compromises to obtain a global settlement of all issues, The parties expressly agreed in the Settlement that it does not establish any regulatory principles or precedents. The Settlement expressly provides that it does not become effective “unless and until the Board enters an order approving [the Settlement] in its entirety without condition or modification.”

On October 12, 2010, the Board conducted a hearing for the purpose of spreading all pre-filed testimony on the record, admitting into evidence all pre-filed exhibits and allowing cross-examination of witnesses regarding the Settlement generally and the proposed Investment Recovery Mechanism (“IRM”) specifically. This brief addresses several questions raised by the Board at the October 12 hearing and several issues related to the IRM.

Responses to Board Questions

At the hearing Board member Hanson asked the Company to identify the average number of leaks per mile of bare steel pipe compared to coated pipe. *Tr. 212.* During 2009, Black Hills Energy experienced 49 non-excavation-related leaks on bare steel pipe, and 91 non-excavation-related leaks on coated steel pipe. When these figures are divided by the number of miles of pipe on Black Hills Energy’s Iowa system, the resulting statistics are 1.53 leaks per mile of bare steel main pipe, and 0.058 leaks per mile for coated pipe. In other words, bare steel pipe had over 26 times more leaks per mile than coated pipe.

Chairman Berntsen also requested a late-filed exhibit with a weather normalization calculation using the same methodology used in calculating the purchased gas adjustment for Black Hills Energy's annual PGA reconciliation filing. *Tr. 206*. The requested exhibit is attached and has been identified as Exhibit 3. It should be noted that the weather normalization calculation method used in the Settlement results in a slightly lower volumetric rate than the rate calculated using 30-year normals. Black Hills Energy urges the Board to recognize that the weather normalization calculation methodology used for the annual PGA reconciliation is distinct and unrelated to the calculation methodology made in a rate case. Any inaccuracies in the normalization calculations performed for the PGA are trued up annually, and therefore have no permanent impact on ratepayers or the Company. The normalization calculations performed in a rate case are used to establish billing determinants that result in permanent rates, and it could reasonably be argued that any inaccuracies create a permanent bias since, unlike the PGA reconciliation process, no true-up mechanism exists within the rate case process. In Docket No. RPU-08-2, Black Hills Energy's predecessor used Dr. Robert Livezey, a leading international expert on weather normals, to determine which calculation method would result in the most accurate normals. In that case, Dr. Livezey and Mr. Larry Loos explained the bias that had been built into Aquila's rates for years, and why a method other than 30-year normals was appropriate.¹² Black Hills Energy recognizes that the order approving

¹ Black Hills Energy asks the Board to take official notice of the weather-related testimony of Mr. Larry Loos and Dr. Robert Livezey in Docket No. RPU-08-2.

² Black Hills Energy proposed higher customer charges for each class that are based on the class cost of service study. The Company also proposed a lower volumetric rate. The goals for these changes were to match the rate design to the class cost of service study and to achieve approximately a 66% fixed

Black Hills Energy's settlement in Docket No. RPU-08-2 included a weather normalization adjustment based on 12-year normals, and that settlement in that case does not establish precedent for the Board or for any other party. However, nothing in the Board's rules require the use of 30-year normals for ratemaking purposes, and the mere fact that a different normalization process is used in the annual PGA reconciliation should not result in the rejection of the billing determinants used in this Settlement.³

Board member Hanson further requested the projected costs of unplanned leak response work. *Tr. 248-256*. It should be noted that Black Hills Energy's management has tripled its system integrity replacement budget since 2000, so it is unlikely that unplanned projects like road moves or bare steel replacement projects will exceed the annual integrity budget. The vast majority of integrity work (at least \$6 million annually) is outside the control of management. There is a difference between control over investments and the prudent management of safety-related investments within the context of a budget or plan.

Discussion of Issues

Regulatory lag has been and continues to be a problem for Black Hills Energy in Iowa, and the IRM⁴ is an appropriate mitigation measure. Black Hills Energy's safety-related integrity investments are a material factor in setting rates, and the IRM is an

margin recovery percentage in order to mitigate the impacts of declining usage per customer and abnormal weather.

³ Black Hills Energy believes that no precedent exists to require use of 30-year normals for rate setting purposes, but if the Board concludes that 30-year normals are appropriate, the Company is willing to recalculate the rate design model using the billing determinants resulting from use of 30-year normals. It should be noted, however, that this exercise could result in higher General Service rates. See *Tr. 262-263*.

⁴ It should be noted that Black Hills Energy made several changes to the proposed mechanism in this case to address the concerns noted in the Board staff's "Gold Memo" in Docket No. RPU-08-2, including elimination of General Plant and Vehicles and a lower rate of return on eligible assets

important solution to mitigating regulatory lag and rate shock. Black Hills Energy and the other parties in this docket, within the context of the Settlement, deem the IRM to be a just and reasonable automatic adjustment mechanism, and urge the Board to approve the Settlement in its entirety, including the IRM, without modification.

1. Regulatory lag has been and continues to be a problem for Black Hills Energy in Iowa, and the IRM is an appropriate mitigation mechanism.

Although regulatory lag was not a make-or-break issue in the past, the present confluence of slow or no growth, reduced consumption, and increases in system replacement needs and operating costs have significantly magnified the financial impact of regulatory lag.⁵ As Black Hills Energy pointed out in Exhibit TLP-5, the delay in recovery inherent in the IRM (e.g., surcharge recovery of 2011 investment costs will not begin until March 2012) shows that the IRM will not completely eliminate regulatory lag. However, the IRM will reduce regulatory lag from what it is today and, if approved as proposed, should achieve an appreciable reduction.

2. Black Hills Energy's safety-related integrity investments are a material factor in setting rates, and the IRM is a reasonable and appropriate measure for mitigating regulatory lag.

Black Hills Energy plans to invest \$8 million per year on system integrity investments. *Tr. 199.* The Company's proposed rate base in this case was approximately \$110 million (*Section C, Schedule 1, p. 1*) and the Company experienced

⁵ As far as the corporation's Iowa operations are concerned, the expectation is that Black Hills Energy's Iowa operations will continue to experience very limited customer growth and modest declines in usage per customer, resulting from efficiency gains in appliances and housing stock as well as our own aggressive efforts to promote our Board-approved energy efficiency programs, and difficulty consistently earning the Board-ordered allowed rate of return on equity capital for the foreseeable future. This is primarily due to a combination of regulatory lag, the need for ongoing and substantial Iowa capital additions, O&M costs escalating at the rate of inflation, and the limited customer growth and declining use per customer mentioned above. *Tr. 178.*

net income of approximately \$6.9 million in 2009 (*Form IG-1, p. 114.1*). If the Company does not file a rate case until 2013, that case would include approximately \$24 million in non-revenue producing system integrity investments, based on the Company's capital spending budget.⁶ System integrity investments are material to Black Hills Energy, because the cost of capital and depreciation on the investments planned before the Company's next case will equal almost half the Company's 2009 net income. The IRM would gradually increase rates and mitigate the earnings impact caused by the delay in return on/of these investments.

3. The Settlement should be approved in its entirety, including the IRM, without modification.

In order to approve a settlement, the Board must find that the Settlement is reasonable in light of the whole record, consistent with law, and in the public interest. 199 IAC 7.18. In a recent decision applying this rule the Board stated that "(w)hile the Settlement may not decide each issue the way the Board would in a contested hearing, the Board, viewing the Settlement as a whole, will find it to be reasonable, in the public interest, and not contrary to any law." "Order Approving Settlement and System Coordination and Operating Agreement," *In re Interstate Power and Light Company*, Docket Nos. RPU-076-5, SPU-00-10, at 8 (IUB Feb. 6, 2008).

The Board should view the Settlement as a whole and from that perspective determine that the Settlement, including the proposed IRM mechanism, is reasonable in light of the whole record, consistent with law, and in the public interest. Based on that determination, the Board should approve the settlement in its entirety, including the

⁶ Black Hills Energy calculates that a \$24 million increase in rate base would result in a \$3.3 million increase in the revenue deficiency, assuming all other factors are unchanged. The Company's 2009 net income reported to the Board on Form IG-1 was \$6.9 million.

IRM, without condition or modification even if the Settlement does not decide each issue the way the Board would in a contested case hearing.

The IRM proposed in this proceeding as part of a global settlement of the rate proceeding and agreed to by all the parties is just, reasonable and in the public interest. It is as an effective mechanism to help limit the effects of regulatory lag, while providing consumers more stability and predictability of rates, and reduces the potential for ratepayer hardship and public controversy that could result from accumulating and deferring the recovery of integrity investments to general rate cases.

The protections afforded by the proposed IRM protect the Board and Black Hills Energy's ratepayers – imposing a dollar-amount cap on the level of expenditures, limiting expenditures to integrity (non-growth, non-revenue-producing) investments only, requiring Black Hills Energy to present its budget to address the potential integrity investments prior to the year of investment, providing for an annual reconciliation, and limiting recovery to investments actually placed in service -- provide assurance that Black Hills Energy cannot earn an inappropriate return on the eligible investments. The Settlement process is one of give and take to reach a global settlement that has terms and results that are acceptable to the parties. It is the contention of the parties, through the submission of the Settlement, that taken as a whole, the Settlement is just and reasonable and should be approved.

Conclusion

For the foregoing reasons, the Board should view the unanimous Settlement submitted in this docket as a whole and from that perspective determine that the Settlement, including the proposed IRM mechanism, is reasonable in light of the whole

record, consistent with the law, and in the public interest, and should accordingly approve the Settlement in its entirety and without condition or modification even if the Settlement does not decide each issue the way the Board would in a contested case hearing.

Dated October 26, 2010.

Respectfully submitted,

BLACK HILLS/IOWA GAS UTILITY, LLC
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