BEFORE THE NEBRASKA PUBLIC SERVICE COMMISSION

IN THE MATTER OF BLACK HILLS/	)	
NEBRASKA GAS UTILITY COMPANY,	)	
LLC D/B/A BLACK HILLS ENERGY,	)	**DOCKET NO. NG_______**
OMAHA, SEEKING A GENERAL RATE	)	
INCREASE FOR BLACK HILLS ENERGY'S	)	
RATE AREAS ONE, TWO AND THREE	)	
(CONSOLIDATED)	)	

Direct Testimony of Robert Hollibaugh

Director – Tax

Accumulated Deferred Income Taxes included in Rate Base Calculation

December 1, 2009

Robert Hollibaugh
Director of Tax
625 Ninth St.
Rapid City, SD 57701

TABLE OF CONTENTS

EXHIBITS

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, POSITION, AND BUSINESS ADDRESS.

A. My name is Robert Hollibaugh, and my business address is 625 Ninth St., Rapid City, South Dakota 57701. I am employed by Black Hills Corporation as the Director of Tax. My responsibilities involve overseeing all tax related matters pertaining to the consolidated group that comprises Black Hills Corporation including those that affect Black Hills/Nebraska Gas Utility Company LLC d/b/a Black Hills Energy (hereinafter referred as "Black Hills Energy"). Additional responsibilities include providing rate case support with respect to tax related matters for all entities that comprise the regulated business segment of Black Hills Corporation.

Q. PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND EMPLOYMENT EXPERIENCE.

A. I graduated from the University of Nebraska – Kearney in 1980 with a bachelors of Science degree in business administration with an accounting emphasis. I am a Certified Public Accountant and a member of the American Institute of CPA's as well as the Taxation Committee of the Edison Electric Institute. Prior to joining Black Hills Corporation in 2005, I was employed by KPMG LLP as a senior tax manager from 2002 to 2005 with clients that were primarily in the utility and energy related industries. Such client responsibilities included tax planning, mergers and acquisitions, restructurings, controversy matters (e.g., IRS audit), and tax compliance. From 1996 to 2002, I was employed as an experienced tax manager for Arthur Andersen LLP with clients that were primarily in the utility and energy related industries. Client responsibilities were identical to my position at KPMG LLP. Prior to joining Arthur Andersen LLP, I was employed by NorthWestern Energy Corporation (f/k/a Northwestern Public Service Company) from 1980 to 1996 with responsibilities that were primarily tax related, but also included managerial duties in accounting and finance. As part of my tax related responsibilities, I provided support for rate case filings that included the development of all income tax related schedules.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to address the tax normalization rules as prescribed under the Internal Revenue Code of 1986 ("Code") and the regulations there under in support of the application of such authority in determining the appropriate level of Accumulated Deferred Income Taxes ("ADIT") used by Black Hills Energy in its calculation of rate base in this proceeding. In addition, I will discuss why the calculation is consistent with the requirements of the applicable "normalization" rules.

II. ACCUMULATED DEFERRED INCOME TAX BACKGROUND

Q. PLEASE EXPLAIN THE ISSUE RELATED TO THE COMPUTATION OF ADIT USED FOR RATEMAKING.

A. Code Section 167 provides a deduction for an allowance in the form of depreciation for the exhaustion, wear and tear of property used in a trade or business. Code Section 167 cross-references Code Section 168 for determining depreciation deductions for most property placed in service after 1980. Code Section 168 was added in 1981 as part of the Economic Recovery Tax Act (Pub.

L. No. 97-34) to provide for more liberal methods and shorter useful lives than previously allowed under Code Section 167. As a result of the Tax Reform Act of 1986 (Pub. L. No. 99-514), Code Section 168 was amended in the form of the Modified Accelerated Cost Recovery System (MACRS), which was intended to provide consistency for taxpayers with respect to methods and useful lives assigned in depreciating assets. MACRS generally applies to tangible property placed in service after 1986. Black Hills Energy has computed tax depreciation based on MACRS for the test period used in this proceeding in addition to its initial tax return as a member of the Black Hills Corporation consolidated group. Similarly, Aquila, Inc., as the prior owner of these assets, used MACRS in computing tax depreciation reported on its previously filed federal income tax returns. For both regulatory and financial reporting purposes, utilities generally use a straight-line method and longer useful life in determining depreciation expense. Consequently, different methods and useful lives will result in the creation of a temporary difference whereby annual depreciation for tax and financial reporting/regulatory purposes will not be the same. Such a temporary difference generates deferred income taxes that are required to be accounted for in accordance with Code Section 168 and the applicable regulations (i.e., normalization rules).

Q. PLEASE EXPLAIN THE INTERNAL REVENUE SERVICE NORMALIZATION REQUIREMENT.

A. To understand the Internal Revenue Service (IRS) normalization requirement, it is helpful to begin with some background information. The background information presented by this testimony is not intended to present legal opinion, but instead is intended to support that Black Hills Energy is aware of the legal holdings and legislative development that has occurred in the past and is relevant to Black Hills Energy's application of such normalization requirements in this rate proceeding. To that end, Black Hills Energy's review of applicable tax code history leads it to understand that Congress enacted accelerated depreciation in 1954 as a means to promote and encourage economic expansion. Accelerated depreciation provides for the deferral of taxes that a company would otherwise be required to pay. Congress perceived this deferral of taxes as an interest free loan, which was intended to be used by companies for capital investment and expansion in an effort to stimulate the post World War II economy. Normalization of accelerated depreciation was designed to be a reflection in the ratemaking process of the tax benefit commensurate with the level of depreciation expense being recovered from customers. That is to say, the deferred income taxes created by the use of accelerated depreciation should be accounted for by using the accrual method of accounting.

Q. HOW DID REGULATORY BODIES TREAT ACCELERATED DEPRECIATION AFTER CONGRESS ENACTED IT IN 1954?

A. Initially, regulators had two choices. They could choose either a Flow-through method or a Normalization method.

Q. COULD YOU EXPLAIN THESE TWO METHODS OF HANDLING ACCELERATED DEPRECIATION?

A. Yes. The Flow-through method was designed to be a reflection in the regulatory process of a tax benefit commensurate with the level of depreciation expense being deducted on the utility's income tax return. Thus, regulators allowed the company to collect in its cost of service for tax expense only what it actually paid. In the early years of an asset's useful life, lower income taxes resulted from the benefit of accelerated depreciation that was allowed to "flow-through" to the utility's customers. Under this method, future customers will incur a higher tax bill because while accelerated depreciation results in lower taxes in the early years, ultimately these lower taxes will be paid to IRS in the later years of an asset's useful life when less depreciation can be claimed for tax purposes.

Q. PLEASE EXPLAIN THE OTHER METHOD KNOWN AS "NORMALIZATION".

A. The Normalization method was designed to be a reflection in the ratemaking process of the tax benefit commensurate with the level of depreciation expense being recovered from customers. In other words, income tax expense reflected in cost of service is based on the amount of tax the utility would have paid had its taxes been calculated using the straight line method of depreciation and a longer useful life. Under this method, the utility collects from its customers more in taxes than it pays the IRS during the early years of an asset's useful life. The income tax effect of the book/tax temporary difference is recorded in a deferred tax account as prescribed by inter-period tax allocation (i.e., accrual) method of accounting. Deferred taxes reverse in the later years of an asset's life when the utility will pay higher taxes to IRS than it collects from its customers in rates.

Q. UNDER THE NORMALIZATION METHOD, IS IT CORRECT TO SAY THAT THE UTILITY RETAINS THE IRS "LOAN"?

A. No. Under the Normalization method, the utility does not keep the full base of the IRS "loan" because the amount of ADIT is deducted from rate base resulting in a lower revenue requirement and, consequently, reduced rates for customers. However, the utility does have unrestricted use of the funds to allow it to reinvest in the form of additional plant facilities. The deduction of ADIT from rate base in later years decreases as previously deferred taxes are repaid to IRS.

Q. WHICH METHOD DID REGULATORS USE, THE FLOW-THROUGH METHOD OR THE NORMALIZATION METHOD?

A. Subsequent to when Congress introduced accelerated depreciation, regulatory agencies were not consistent with respect to rate treatment. Regulators handled accelerated depreciation differently, depending upon how they viewed accelerated depreciation and whether the benefits of this "loan" should accrue to customers or to the utility. In addition, it depended upon the regulator's view of the need to match income tax expense reflected in cost of service to the amount of taxes paid by the utility.

Q. DID THE APPROACH OF ALLOWING REGULATORS TO CHOOSE CHANGE?

A. Yes. Ultimately, Congress became concerned that "flow-through" decisions by regulators resulted in a "doubling of the Government's loss of revenue, from the use of accelerated methods of depreciation for tax purposes." H.R. Rep. No. 91-413 (1986), reprinted in 1969 U.S.C.C.A.N. 1645, 1782.

Congress reasoned,

> This is because the flow-through of the tax reduction reduces the rates charged to customers, which in turn reduces the utility's taxable income and therefore reduces its income tax. This second level of tax reduction is passed on to the utility's customers, with the same effect.

Q. HOW DID CONGRESS ADDRESS THE CONCERN RELATED TO FLOW- THROUGH TREATMENT BY REGULATORS?

A. In the Tax Reform Act of 1969 (Pub. L. No. 91-172), Congress enacted Section 451 that added Section 167(l) to the Code. This provision essentially provided that if a taxpayer is claiming accelerated depreciation and is not normalizing the resulting deferred taxes, then it must use the straight line method and generally longer useful life (i.e., book method) when determining its depreciation expense for federal income tax purposes. At one point, Congress considered no longer permitting utilities to use accelerated depreciation. However, Congress believed that precluding regulated utilities from using accelerated depreciation would place them at an unfair competitive disadvantage both in terms of pricing with respect to the sale of their products and services and their ability to attract capital in the form of bondholders and equity investors. The legislative history reflected Congressional intent to remove the regulatory agency's ability to require flow-through of deferred taxes. As stated in the legislative history, beginning on page 1,783 and thereafter, regulatory agencies "will be permitted to in effect force the taxpayer to straight line depreciation by not permitting normalization. The regulatory agency will not, in such cases, be permitted to require flow through of deferred taxes." Thus, Congress took away a regulatory agency's ability to require flow-through of deferred taxes by removing the utilities' ability to use accelerated depreciation in the event the regulator mandated the flow-through method.

Q. DID CONGRESS ENACT ACCELERATED DEPRECIATION LEGISLATION THAT WAS INTENDED TO BENEFIT BOTH THE UTILITY AND ITS CUSTOMERS?

A. Yes. The Tax Reform Act of 1969 was at issue in a case that went to the United States Supreme Court. The case involved Texas Gas Transmission Corp.'s request for permission from the Federal Power Commission to use accelerated depreciation and normalization with respect to its post-1969 expansion property. The citation to the case is Federal Power Comm'n v. Memphis Light, Gas & Water Div., 41 U.S. 464, 93 S. Ct. 1723 (1973).

Among the relevant guidance to Black Hills Energy from that case is that the U.S. Supreme Court opinion discussed how accelerated depreciation was beneficial for both the customers and the company. For example, on page 465 of the case the Supreme Court made the following statement:

[Accelerated depreciation with] normalization in computing the tax allowance for rate purposes . . . offers more hope for stability of rates for its customers and more assurance that the company can earn its fair rate of return without future rate increases. Further benefits of normalization are that it will improve the company's before tax coverage of interest, thereby enhancing the quality of its securities, and that it will help alleviate present day cash shortages.

III. ECONOMIC RECOVERY ACT OF 1981 IMPACT ON BLACK HILLS ENERGY

Q. ARE THERE ANY ADDITIONAL SIGNIFICANT LEGISLATIVE CHANGES RELATED TO TAX NORMALIZATION?

A. Yes. There are two other significant developments in tax law that affected tax normalization: (1) the Economic Recovery Tax Act of 1981 and (2) the normalization Regulations as originally issued by the U. S. Treasury.

Q. COULD YOU EXPLAIN HOW BLACK HILLS ENERGY UNDERSTANDS THE ECONOMIC RECOVERY TAX ACT OF 1981 ACT AND U.S. TREASURY REGULATIONS AS THEY RELATE TO NORMALIZATION?

A. Yes. For example, Black Hills Energy's review and understanding of the Economic Recovery Act of 1981 Act ("1981 Act") is that the 1981 Act required normalization by regulators as a condition for accelerated depreciation by public utilities for qualified property placed in service after December 31, 1980. S. Rep. No. 97-144 (1981), reprinted in 1981 U.S.C.C.A.N. 105, 161. Similar to Congress's objective in 1954, Black Hills Energy believes that the purpose of the 1981 amendment was to provide an investment stimulus that was viewed as essential for economic expansion. Congress considered accelerated depreciation as a way of spurring investment and encouraging businesses to replace old machinery and equipment with modern and more efficient assets that reflected the latest technology. Page 152 of the legislation explains that passage of the 1981 Act was an attempt by Congress to restructure the system of determining tax depreciation has a way to stimulate capital formation, increase productivity and improve the nation's competitiveness in international trade.

Congress was also trying to simplify the depreciation rules. For example, it is clear to Black Hills Energy from reading the legislative history of the 1981 Act that Congress viewed "deferred taxes" as an interest-free loan to the utility. See page 149 for more detail. That section of the legislative history notes that the utility is able to use funds that otherwise would have to be obtained by borrowing or raising equity capital. Thus, as Black Hills Energy understands it, Congress did not want to allow accelerated depreciation unless the regulatory body used the normalization method to account for it. This explains the provision in the 1981 Act that states the amount of capital to be deducted from rate base must not exceed the amount of deferred taxes recorded on the books with respect to accelerated depreciation in order to be in compliance with tax normalization. Id.

The Treasury Regulations provided additional guidance with respect to the law enacted in the Tax Reform Act of 1969 that defined the normalization method of accounting. For example, they provide that the reserve established for public utility property should reflect the total amount of tax deferral resulting from the use of different depreciation methods for tax and ratemaking purposes. The Regulations also require that the ADIT balance be used as a reduction to the utility's rate base and must be determined by reference to the same historical period as used for determining ratemaking tax expense. The utility may use historical or projected data in calculating these two amounts, but they must be done consistently. In addition, the Regulations provide that in the case of a taxable sale of utility property, pre-disposition ADIT is no longer available to the seller or the buyer to reduce rate base or to be treated as source of zero-cost capital. Lastly, the Regulations describe the consequences to the utility if found in violation of the normalization rules.

Q. WITH THAT BACKGROUND, PLEASE EXPLAIN BLACK HILLS ENERGY'S UNDERSTANDING OF THE IRS NORMALIZATION RULE.

A. Black Hills Energy understands that the normalization method of accounting as prescribed under Treasury Regulations Section 1.167(l)-1(h) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the actual tax liability. In other words, a utility that uses accelerated depreciation must use the straight-line method of depreciation (i.e., the straight-line method and estimated useful life used in calculating annual book depreciation expense) in computing its income tax expense for purposes of determining cost of service for ratemaking purposes. The Regulations further require the utility to calculate the annual tax effect of this book/tax temporary difference and record the increase or decrease on its books and records in a deferred tax account. Additionally, the Regulations require that the ADIT balance be used as a reduction to the utility's rate base and must be determined by reference to the same historical period as used for determining ratemaking tax expense. The utility may use historical or projected data in calculating these two amounts, but they must be done consistently.

IV. AQUILA TRANSACTION AND FUTURE ADIT

Q. WHAT ARE THE CONSEQUENCES TO BLACK HILLS ENERGY IF THE IRS DETERMINED THAT A VIOLATION OF THE TAX NORMALIZATION RULES OCCURRED IN THIS RATE PROCEEDING?

A. As stated above, Black Hills Energy believes that Congress originally enacted the normalization rules to ensure that the capital formation benefits of accelerated depreciation be retained by the utility and for ratepayers to benefit from lower rates through the reduction to rate base. The intent behind the normalization rules is to prevent regulators from passing the tax benefits of accelerated depreciation to ratepayers by reducing the income tax allowance used in developing cost of service. The normalization rules dictate that accelerated depreciation determined under Code Section 168 does not apply to any utility property if the taxpayer does not use the normalization method of accounting. Tax normalization rules also require that the ADIT reserve be reduced to reflect any asset retirement. Thus, when a utility that owns public utility property that it has depreciated using an accelerated method for tax purposes sells public utility assets, it is required by the normalization rules to remove all applicable deferred federal income taxes to reflect the disposition of such assets. However, if a regulator requires the utility to continue to carry an ADIT balance on its books when that ADIT balance has been eliminated, the utility would be in violation of the normalization rules and precluded from using accelerated depreciation in current and future years. Thus, the utility would not get the benefit of tax deferral from accelerated depreciation and the cost free capital associated with this book/tax temporary difference.

Q. PLEASE DESCRIBE THE TRANSACTION THAT RESULTED IN BLACK HILLS ENERGY ACQUIRING UTILITY ASSETS FROM AQUILA, INC.

A. Black Hills/ Nebraska Gas Utility Company, LLC is a limited liability company that was formed in 2008 and is a direct wholly owned entity of Black Hills Utility Holdings, Inc. (BHUH). In turn, BHUH is a direct wholly owned subsidiary of Black Hills Corporation. In July 2008, BHUH acquired the natural gas utility assets of Aquila, Inc. including the properties that comprised the natural gas distribution system serving customers located in Nebraska. Upon acquisition by BHUH, such assets and certain assumed liabilities were immediately contributed to the newly formed Black Hills/Nebraska Gas Utility Company LLC, which is treated as a disregarded entity for federal income tax purposes.

Q. WHAT WERE THE TAX CONSEQUENCES TO THE SELLER WITH THE ASSET SALE AS DESCRIBED ABOVE?

A. The transaction was treated as an asset sale for federal income tax purposes. Accordingly, the sale was recognized as a taxable transaction resulting in a reportable event for Aquila, Inc. (Aquila). Under the Code, gain or loss is determined by the amount realized reduced by the seller's adjusted tax basis in the asset sold and is reported by the seller under Code Section 1001.

In addition, Aquila has an obligation under the normalization rules. When a utility owns public utility property that it has depreciated using an accelerated method for tax purposes sells such assets, it is required by the normalization rules to reduce its accumulated deferred tax reserve to reflect the disposition. Accordingly, the ADIT balance associated with the sold assets should be removed from the seller's regulatory books since the interest free loan has become payable to IRS. The buyer takes a new tax basis in the acquired utility assets that reflects the purchase price consideration paid. In the instant case, Black Hills Energy's new tax basis in the assets was based on the net book value of such assets resulting in an increase in tax basis (i.e., step-up) since such net book value would be greater than Aquila's adjusted tax basis.

Q. WHAT IS THE SIGNIFICANCE OF THE STEP-UP IN TAX BASIS OF THE UTILITY PROPERTY ACQUIRED BY BLACK HILLS ENERGY?

A. As a result of the acquisition by Black Hills Energy, the ADIT balance on Aquila's regulatory books was removed in recognition of the sale of its utility assets. Consequently, the purchased assets were recorded on Black Hills Energy's books with a zero beginning balance in the deferred tax account, Account No. 282. The transaction was treated as an asset purchase with Black Hills Energy's tax basis of the acquired assets having increased from what was Aquila's adjusted tax basis for the assets immediately prior to the acquisition. Such tax basis would be equal to the acquired cost, which for regulatory purposes was determined to be equal to the remaining net book value of the depreciable plant on the date of the transaction. Because the new tax basis established for Black Hills Energy's depreciable assets exceeds Aquila's prior remaining adjusted tax basis, Black Hills Energy will recognize greater tax depreciation expense in the future that should generate an ADIT liability in the early years of the assets' depreciable lives.

Q. IS THERE ANOTHER REASON WHY BLACK HILLS ENERGY WILL RECOGNIZE ANNUAL INCREASES TO ADIT ABOVE WHAT AQUILA WOULD HAVE GENERATED ON AN ANNUAL BASIS?

A. Yes. In addition to the higher tax basis, Black Hills Energy will be able to depreciate the balance at an accelerated rate due to the use of MACRS. MACRS establishes a depreciable life of 15 years for a majority of the acquired assets. MACRS depreciation rates in the early years use accelerated rates that decrease in each succeeding year. As a result, Black Hills Energy will recognize more tax depreciation and accordingly higher annual deferred tax amounts than would have been recorded by Aquila had the transaction not occurred.

Q. YOU TESTIFIED ABOVE THAT ON THE DATE OF SALE THE SELLER WOULD HAVE A DEFERRED TAX BALANCE OF ZERO FOR TAX PURPOSES. WILL BLACK HILLS ENERGY ALSO HAVE A DEFERRED TAX BALANCE OF ZERO?

A. Yes. Black Hills Energy has a 'fresh start' with respect to calculating tax depreciation expense and the resulting ADIT. Thus, its financial records and regulatory books will reflect a zero beginning balance with respect to deferred taxes.

Q. DO BLACK HILLS ENERGY'S REGULATORY BOOKS ALSO BEGIN WITH A ZERO BALANCE IN THE RESERVE FOR DEPRECIATION?

A. No. The original cost and the accumulated depreciation reserve for ratemaking purposes and accordingly for Black Hills Energy's regulatory books remain consistent with the original cost and reserve for depreciation reflected on the books of Aquila prior to the acquisition.

Q. WHAT ARE THE REGULATORY AND TAX IMPLICATIONS IF A REGULATOR DOES NOT COMPLY WITH THE TAX NORMALIZATION RULES?

A. As stated above, Black Hills Energy asserts that the normalization rules as prescribed in the Code and applicable regulations there under dictate the regulatory treatment of deferred income tax expense and the associated ADIT. Black Hills Energy believes that the Code further provides that accelerated depreciation determined under Section 168 does not apply to any public utility property if the taxpayer does not use a tax normalization method of accounting. Thus, Black Hills Energy appropriately follows the rule of law that a utility cannot use accelerated methods of depreciation for qualified property if it does not comply with the normalization rules.

In essence, the normalization rules require a utility to maintain an ADIT account for the tax effect of the difference between regulatory book depreciation and accelerated tax depreciation. The ADIT recorded on the utility's regulatory books must be maintained in accordance with the normalization rules. The Code further requires that the ADIT balance be maintained in accordance with Code Section 168 and that such balance be used in the determination of rate base. Thus, as Black Hills Energy understands applicable law, if the Nebraska Commission were to require a flow-through of tax benefits either directly or indirectly to customers or use the prior owner's ADIT balance in the computation of rate base or cost of capital, this act would cause a violation of IRS regulations and Black Hills Energy would be prevented from computing accelerated depreciation pursuant to Code Section 168. As a result, Black Hills Energy's customers would pay higher rates in the early years of an asset's depreciable life due to the increase in rate base caused by the loss of ADIT that would have otherwise been created by accelerated tax depreciation. Consequently, Black Hills Energy may need to go to the debt and/or equity markets to raise additional capital since it could no longer rely on the source of funds in the form of deferred taxes generated from the use of accelerated tax depreciation.

Q. PLEASE IDENTIFY THE SPECIFIC CODE REFERENCE THAT PRESCRIBES THE METHOD USED TO DETERMINE TAX DEPRECIATION IF THE IRS DETERMINES THAT A VIOLATION OF THE NORMALIZATION RULES HAS OCCURRED.

Black Hills Energy notes that a specific reference is Internal Revenue Code: Section 168(i) (9) (C), which provides in part:

> Public Utility Property Which Does Not Meet Normalization Rules- In the case of any public utility property to which this section does not apply by reason of subsection (f)(2), the allowance for depreciation under section 167 (a) shall be the amount computed using the method and periods referred to in subparagraph (A)(i).

Subparagraph (A) (i) of Section 168 (i) (9) provides, in part:

> The taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use

> the method of depreciation with respect to such property that is no shorter than the method and period used to compute its depreciation expense for such purposes;
>
> Thus, the Code restricts tax depreciation to the utility's regulatory depreciation method (i.e., straight line and longer useful life) when there is a normalization violation.

Q. ARE THERE ANY IRS RULINGS IN WHICH A REGULATED UTILITY INVOLVED IN A SALE OF ASSETS WOULD HAVE BEEN DETERMINED TO BE A NORMALIZATION VIOLATION?

A. Yes. Black Hills Energy is aware of an IRS ruling related to regulated utilities, which has a bearing on its actions related to this rate proceeding. For example, in Private Letter Ruling (PLR) 9447009 issued in 1994, the IRS ruled there would be a normalization violation if, subsequent to the date of the acquisition and deemed sale of assets of a natural gas transmission company, the natural gas company's rate base was reduced for the balance in the reserve for the ADIT attributable to accelerated depreciation on public utility property before the acquisition date. Its parent sold the company to a buyer in a transaction whereby an election pursuant to Code Section 338(h) (10) was made. Such a transaction, although structured as a stock sale, was treated as an asset sale by the seller and buyer for tax purposes. The IRS ruled that because of the deemed sale of the seller's assets, the seller's ADIT balance ceased to exist and had to be removed from the seller's regulated books of account and could not be flowed through to customers. Further, the IRS ruled that a normalization violation would occur if the seller's ADIT balance that existed before the acquisition was used to reduce the buyer's rate base post-transaction either directly or indirectly. Although a PLR is not cited here as legal precedent, it does provide Black Hills Energy and other taxpayers with guidance as to how the IRS would view similarly structured transactions such as the Aquila/Black Hills Energy transaction.

V. FERC ADIT IN ACQUSITIONS

Q. HOW DOES THE FEDERAL ENERGY REGULATORY COMMISSION'S UNIFORM SYSTEM OF ACCOUNTS ADDRESS THE ACQUISITION OF ASSETS WITH RESPECT TO ADIT?

A. The tax effect of book/tax temporary differences related to plant investment is recorded in Federal Energy Regulatory Commission ("FERC") Account No. 282. With respect to the Regulations, Part 201, Account No. 282, Part D, the FERC specifically restricts the use of Account No. 282 to the purpose for which the account was established. Deferred income tax recorded in Account No. 282 must represent the tax liability associated with the recognition of book/tax temporary differences. Further, the regulations specifically restrict transferring any balance to retained earnings or making any other use thereof, except as provided by instructions to Account No. 282. The instructions state, in part, that: "Upon the disposition by sale, exchange, transfer, abandonment or premature retirement of plant on which there is a related balance herein, this account shall be charged with an amount equal to the related income tax expense, if any, arising from such disposition . . . ."

Thus, the FERC's Uniform System of Account rules recognize that upon an asset sale, the seller's ADIT balance is extinguished since the deferred taxes become due and payable by the seller at the time of the transaction.

Q. ARE THE PROCEDURES USED BY BLACK HILLS ENERGY IN THE COMPUTATION OF ADIT RECORDED IN ACCOUNT NO. 282 TO BE USED IN THE COMPUTATION OF RATE BASE IN THIS PROCEEDING IN COMPLIANCE WITH THE NORMALIZATION RULES?

A. Yes. Black Hills Energy has implemented the appropriate policies and procedures to properly reflect on its books and records an ADIT balance that is fully compliant with the requirements of the IRS normalization rules and FERC Uniform System of Accounts.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

BEFORE THE NEBRASKA PUBLIC SERVICE COMMISSION

IN THE MATTER OF BLACK HILLS/ NEBRASKA GAS UTILITY COMPANY, LLC D/B/A BLACK HILLS ENERGY, OMAHA, SEEKING A GENERAL RATE INCREASE FOR BLACK HILLS ENERGY'S RATE AREAS ONE, TWO AND THREE (CONSOLIDATED)	**)**	**DOCKET NO. NG______**

VERIFICATION

STATE OF SOUTH DAKOTA)
) ss.
COUNTY OF PENNINGTON)

Robert Hollibaugh, of lawful age, being first duly sworn, deposes and says that he is the Director of Tax for Black Hills Corporation, that he has read the foregoing testimony on behalf of Black Hills/Nebraska Gas Utility Company, LLC d/b/a Black Hills Energy, knows the contents thereof, and that the statements and allegations therein contained, including the information provided herewith pursuant to the State Natural Gas Regulation Act, are true to the best of his information, knowledge, and belief.

Robert Hollibaugh

SUBSCRIBED AND SWORN TO before me this 23rd day of November, 2009.

Lynn E. Brown
Notary Public
My Commission Expires 6-27-2012

SEAL LYNN E. BROWN NOTARY PUBLIC State of South Dakota SEAL