**BEFORE THE NEBRASKA PUBLIC SERVICE COMMISSION**

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| **In the Matter of the Application of Black Hills/Nebraska Gas Utility Company, LLC, d/b/a Black Hills Energy, for Approval of its Cost of Service Gas Hedge Agreement With Black Hills Utility Holdings, Inc.** | ) ) ) ) | **Application No. NG-0086** |

# APPLICATION

Pursuant to Neb. Rev. Stats §§ 66-1808, 66-1854, *et seq*., other applicable statutes of the State Natural Gas Regulation Act, and orders issued by the Nebraska Public Service Commission ("Commission"), Black Hills/Nebraska Gas Utility, LLC, d/b/a Black Hills Energy ("Black Hills Nebraska" or "Company") seeks an order from the Commission: (1) authorizing the Company to enter into the Cost of Service Gas Hedge Agreement (the "COSG Agreement") with Black Hills Utility Holdings, Inc. ("BHUH"), (2) approving revised tariff sheets and authorizing the recovery of amounts incurred under the COSG Agreement from customers through the Company's purchased gas adjustment ("PGA") and annual cost adjustment ("ACA") clauses contained in the Company's tariffs; (3) approving the requested 50% hedge-participation level based on the Company's forecast annual firm gas demand or, in the alternative, a revised percentage that the Commission may determine; and (4) to the extent necessary, granting any waivers from affiliate rules or regulations or ring-fencing commitments, as the Commission deems applicable. In support of its Application, Black Hills Nebraska states as follows:

## BACKGROUND

### A. Background Regarding the Company and Black Hills

1. Black Hills Nebraska is a limited liability company organized under the laws of the State of Nebraska with its principal place of business in Nebraska at 1600 Windhoek Drive, Lincoln, Nebraska 66501-3008. Black Hills Nebraska is a direct, wholly owned subsidiary of BHUH. BHUH is a direct, wholly owned subsidiary of Black Hills Corporation ("BHC"). BHC serves approximately 765,000 electric and gas customers in the Midwest. BHC has been in the utility business for over 100 years and currently owns and operates electric utility businesses in South Dakota, Wyoming and Colorado and natural gas utility businesses in Wyoming, Nebraska, Nebraska, Iowa and Colorado. BHC has also been in the oil and gas exploration and production business for many years through its subsidiary, Black Hills Exploration and Development, Inc. ("BHEP").

2. Black Hills Nebraska holds appropriate certificates of convenience and necessity from this Commission to transact business as a natural gas public utility and is engaged in the purchase, transmission, sale and distribution of natural gas in the State of Nebraska in accordance with state laws and rules and regulations of this Commission. Black Hills Nebraska provides retail natural gas service to approximately 200,000 customers in Nebraska, including natural gas service to approximately 106 communities and other areas located in the eastern one-third of Nebraska.

### B. The Need for and Benefits of a Long-Term Hedging Program

3. To provide protection against short-term price volatility and to provide reliable gas service at reasonably stable prices, Black Hills Nebraska, with the assistance of BHUH's Gas Supply Services personnel, has for some time acquired natural gas from producers, marketers and counter-parties through a diversified portfolio approach that incorporates: (1) spot market

purchases, (2) short-term fixed price contracts and storage agreements, and (3) short-term financial hedges. The current percentage of Black Hills Nebraska' annual gas supply purchased through each of these methods is shown in Exhibit IV-2 to the direct testimony of Ivan Vancas. This diversified approach, while successful, is focused on short-term and seasonal hedging. As such, it does not provide protection against long-term increases in natural gas prices or price volatility beyond one or two years.

4. Historically, gas prices have been subject to substantial changes from month to month and year to year, based on supply and demand and other market factors. Exhibit RCL-1 and Figure 1 to the direct testimony of Richard C. Loomis demonstrates this volatility. Furthermore, while gas prices are currently at an historic low point relative to recent history, gas prices are anticipated to increase over the next two decades and experience periods of significant fluctuation. Specifically, to assess its long-term gas strategy and to understand the potential benefits of a long-term hedging program like the COSG Proposal, the Company, through BHUH, reviewed forecasts from well-accepted entities in the gas industry for the years 2016 to 2035 and created an average forecast based on the prices reflected in those forecasts. The resulting data shows that gas prices are estimated to rise from a low of $3.54/MMBtu in 2016 to a high of approximately $10.43/MMBtu in 2035. Table 1 in the direct testimony of Richard C. Loomis shows the annual average for each year in the average forecast.

5. In addition, BHUH retained Julia Ryan of Aether Advisors LLC ("Aether") to review that average forecast, the market trends, and the Company's diversified portfolio, and to assess whether changes should be made to the Company's current portfolio to protect customers against long-term price risks and market volatility. As set forth in more detail in her direct testimony, Ms. Ryan concurs that gas prices are likely to rise over the period covered by the average

forecast. She also concludes that, while the Company's current diversified portfolio approach has been effective in hedging against short-term price increases and volatility, the Company should incorporate a long-term hedging program and that it look to acquire reserves at a minimum of 35% of the portfolio with an objective of acquiring up to 50% of the portfolio.

6. Based on Ms. Ryan's analysis and for other reasons set forth in the supporting testimony, Black Hills Nebraska has concluded that, to minimize customers' exposure to the volatility of gas market prices, to provide long-term price stability, and to provide an opportunity for customers to pay less than market prices over the long term, it is prudent for the Company to pursue a long-term hedging program for a portion of its gas portfolio. Specifically, the Company has determined that it is advisable to enter into the COSG Agreement with BHUH and other utility companies in several states and to hedge a portion of its forecast annual firm demand for natural gas under the Cost of Service Gas Program (the "COSG Program"). This program is being submitted for commission approval in the following states: Colorado, Iowa, Kansas, Nebraska, South Dakota, and Wyoming.

### C. The COSG Program and the COSG Agreement

7. In general terms, under the COSG Agreement (which is attached as Exhibit IV-1 to the direct testimony of Ivan Vancas), Black Hills Nebraska would commit to BHUH to acquire up to 50% of its forecast annual firm demand each year (the "Hedge Quantity"), for the term of the COSG Agreement. Based on that commitment, BHUH would, through a wholly owned subsidiary that would be established ("COSGCO"), bring to the Commission for approval gas reserves that would be purchased (if approved). The reserves would not be purchased with any funds or credit of Black Hills Nebraska. COSGCO would acquire the reserves either through a cash acquisition or the funding of drilling costs for new gas wells.

8. Under the acquisition criteria set forth in the COSG Agreement, the target reserves would consist of fields with proven gas reserves and an operating history, demonstrating drilling and operating costs. The reserves would also be located in fields with established gathering and processing capabilities and connections to interstate pipelines, or in fields for which production and transportation costs can be reliably estimated to minimize risk. To protect customers, for an acquisition to be submitted to the Commission under the COSG Program, the estimated cost of acquiring, developing, and producing the acquired reserves would have to be, on a net present value basis, at a cost anticipated to be less than the long-term market price gas forecast, such that the acquisition and development would be reasonably anticipated to save the Black Hills Nebraska' customers money over the term of the COSG Program.

9. To provide oversight of the COSG Program, BHUH would retain, subject to Commission approval, an independent hydrocarbon monitor (the "Hydrocarbon Monitor"). The Hydrocarbon Monitor would assess any proposed acquisition and initial drilling plan and provide a written recommendation regarding whether the acquisition or drilling plan satisfies the criteria of the COSG Agreement. In addition, the Hydrocarbon Monitor would assess every five years future drilling plans and provide a written recommendation regarding whether those plans satisfy the criteria in the COSG Agreement. In addition, BHUH would retain, subject to Commission approval, an independent accounting monitor (the "Accounting Monitor"). The Accounting Monitor would conduct annual assessments of the COSG Program as provided by the COSG Agreement and provide an assurance report of its findings to the Commission.

10. Under the terms of the COSG Agreement, BHUH would determine a revenue requirement under the COSG Program based on the actual cost per MMBtu for production operating expenses (including overhead paid to the field operator, O&M, gathering, processing costs, taxes

and royalty payments), plus a return on equity ("ROE") for capital used to acquire the reserves, drill the wells and construct any required infrastructure. The acquisition would be accounted for and the revenue requirement would be calculated using a capital structure based on 40% debt, 60% equity. The "Allowed Return on Equity" under the COSG Program would be the average annual ROE on all gas and electric utility rate cases for the calendar year as reported by Regulatory Research Associates, *provided* that if there are fewer than 20 gas and electric utility rate cases reported for a calendar year, then the allowed ROE for that calendar year will be the average of (i) the annual ROE on equity in all gas and electric utility rate cases for that calendar year, and (ii) the annual ROE in all gas and electric utility rate cases for the prior calendar year, as reported by Regulatory Research Associates.

11. After acquiring the reserves, COSGCO would produce natural gas and any associated liquids. For tax and other reasons explained in more detail in the supporting testimony, unless otherwise approved by the parties to the COSG Agreement, Black Hills Nebraska would not receive the gas produced from the reserves. Rather, that gas would be sold to third parties, and BHUH would purchase the Hedge Quantity for the Company from the spot market just as it currently does. However, if the actual ROE under the COSG Program is more than 100 basis points over the Allowed ROE during that month, then Black Hills Nebraska' customers would receive a "Hedge Credit" for that month through the PGA/ACA clauses in the Company's tariffs, effectively reducing the cost of gas for customers in that month. By contrast, if the Allowed ROE under the COSG Program exceeds the actual ROE by more than 100 basis points, Black Hills Nebraska would be charged a "Hedge Cost" to make up for the difference, which amount would be passed on to Black Hills Nebraska' customers that month through the PGA/ACA clauses in the Company's tariffs.

12. Explained in simpler terms, under the COSG Program, a portion of the Company's customers' gas costs, instead of being dependent upon uncertain spot market prices, would be roughly pegged to the production cost of gas, which is more stable. The current environment, where prices are below reserve replacement costs in many cases, provides a prime opportunity to acquire reserves that would serve as the long-term physical hedge under the COSG Program. Once reserves are acquired at today's low prices, the cost of production is unlikely to be as variable as the market price of gas. As such, by acquiring a percentage of its gas supply at the physical hedge price as calculated under the COSG Agreement, Black Hills Nebraska anticipates that it will stabilize the gas prices paid by the Black Hills Nebraska' customers over the long term, minimize customers' exposure to market volatility, and provide savings to customers over the life of the COSG Agreement.

**INTRODUCTION OF WITNESSES SUPPORTING THE APPLICATION**

13. In support of its application, Black Hills Nebraska is submitting the testimony of the following witnesses, which is incorporated herein by reference:

a. Mr. Ivan Vancas: Mr. Vancas introduces each of the witnesses who are providing testimony in support of this Application and identifies the topics on which they will testify. He also explains what the Company is seeking through its Application, the manner in which the Company currently procures natural gas for its customers, and describes the purpose and reasons for a long-term hedge program like the COSG Program. He also addresses how the COSG Program is designed to provide long-term price stability to customers with reasonably anticipated savings for customers over the life of the program. In addition, he describes how the program will operate and explains the terms of the COSG Agreement. Finally, he discussed certain ring-fencing protections and explains how the

COSG Program is consistent with those protections.

b. Mr. John Benton: Mr. Benton describes the gas exploration and production industry, including the common structures used for acquiring gas reserves and the types of production costs incurred in gas exploration and production. His testimony also discusses BHEP, its history and expertise in acquiring and developing shale and tight gas reserves, and its advisory and other potential roles in the COSG Program.

c. Ms. Julia Ryan (Aether Advisors LLC): Ms. Ryan's testimony discusses Aether's review of the Company's gas portfolio strategy. She also explains her recommendations regarding actions the Company should consider taking to include long-term hedging mechanisms. Finally, she explains how the COSG Program, as proposed, is consistent with that objective.

d. Mr. Richard C. Loomis: Mr. Loomis explains BHUH's and the Black Hills Nebraska' current hedging practices, explains how the Contract will mesh with those hedging practices, identifies the limitations of long-term financial hedging options, and describes the forecast used by the Company to assess the prospective savings to customers generated by the long term physical gas hedge under the COSG Agreement with BHUH.

d. Mr. T. Aaron Carr: Mr. Carr describes the Commission's oversight of the COSG Program as well as the customer protections incorporated into the COSG Agreement and the COSG Program design. Specifically, he discusses (i) the guidelines for future acquisitions and drilling plans, (ii) reviews of those acquisitions and plans, (iii) the retention of independent accounting and hydrocarbon monitors, and (iv) the other COSG Program protections for customers. Finally, he explains a hypothetical model used by the Company as a tool to evaluate the costs and benefits of the COSG Program as compared with those that would result from the continued purchase of gas at the prices in the long-term spot market forecast.

e. Mr. Christopher Kilpatrick: Mr. Kilpatrick's testimony discusses accounting and regulatory issues related to the COSG Program, including, how "Hedge Credits" and "Hedge Costs" are forecast and calculated; how investment base, expenses, revenues, and return on equity are calculated; how forecast and actual costs will be accounted for, trued-up and adjusted as necessary; and how tariff sheets will be modified in light of the COSG Program and how costs incurred by Black Hills Nebraska under the COSG Agreement would be recovered through the Company's existing PGA and ACA clauses in its tariffs.

f. Mr. Adrien McKenzie (FINCAP, Inc.): Mr. McKenzie discusses the capital structure of the COSG Program and the basis for and reasonableness of the requested return on equity.

## EXHIBITS

All exhibits related to this Application are attached to the testimony of the witnesses supporting the Application.

## CONCLUSION

WHEREFORE, Black Hills Nebraska requests the Commission issue an order: (1) authorizing the Company to enter into the COSG Agreement with BHUH, (2) approving revised tariff sheets and authorizing the recovery of amounts incurred under the COSG Agreement from customers through the Company's PGA and ACA; (3) approving the requested 50% hedge-participation level based on the Company's forecast annual firm gas demand or, in the alternative, a revised percentage that the Commission may determine; and (4) to the extent necessary, granting any waivers from affiliate rules or regulations or ring-fencing commitments, as the Commission deems applicable.

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## Certificate of Service

I hereby certify that a copy of the above and foregoing was mailed, postage prepaid, this 30th day of September, 2015, addressed to:

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