BEFORE THE NEBRASKA PUBLIC SERVICE COMMISSION

IN THE MATTER OF THE APPLICATION	**)**	
OF BLACK HILLS NEBRASKA GAS, LLC, D/B/A	**)**	
BLACK HILLS ENERGY, RAPID CITY, SOUTH	**)**	**APPLICATION NO. NG-109**
DAKOTA, SEEKING APPROVAL OF A GENERAL	**)**	
RATE INCREASE	**)**	

DIRECT TESTIMONY OF

JUSTIN W. KLAPPERICH

ON BEHALF OF

BLACK HILLS NEBRASKA GAS, LLC

June 1, 2020

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EXHIBITS

DIRECT TESTIMONY OF JUSTIN W. KLAPPERICH

I. INTRODUCTION AND BACKGROUND

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Justin W. Klapperich. My business address is 7001 Mount Rushmore Rd, Rapid City, South Dakota 57701.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by Black Hills Service Company, LLC ("BHSC"), a wholly owned subsidiary of Black Hills Corporation ("BHC"). I am the Director of Tax.

Q. ON WHOSE BEHALF ARE YOU TESTIFYING?

A. I am testifying on behalf of Black Hills Nebraska Gas, LLC. ("BH Nebraska Gas" or the "Company"). BH Nebraska Gas is the natural gas utility resulting from the recent consolidation of the Nebraska gas utility assets and operations of BHC's Nebraska gas utility subsidiaries, Black Hills/Nebraska Gas Utility Company, LLC ("BH Gas Utility") and Black Hills Nebraska Gas Distribution, LLC. ("BH Gas Distribution").

II. STATEMENT OF QUALIFICATIONS

Q. WHAT ARE YOUR DUTIES AND RESPONSIBILITIES IN YOUR CURRENT POSITION?

A. I am responsible for tax accounting, regulatory, and planning matters pertaining to BHC and its subsidiaries, including those activities that affect the Company. Additional responsibilities include providing rate review support with respect to tax-related matters for all entities that comprise the regulated business segment of BHC. In a former role with the Company, I was co-leader of the acquisition and integration of SourceGas Distribution ("SourceGas Acquisition") approved in Commission Application No. NG-0084. In that role I was responsible for synergy execution and tracking as part of the integration of SourceGas Distribution and BH Gas Utility.

Q. WOULD YOU PLEASE OUTLINE YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND?

A. My education, employments history, and professional experience are provided in Exhibit No. JWK-1.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE NEBRASKA PUBLIC SERVICE COMMISSION ("COMMISSION")?

A. No. I have testified before the Wyoming, Colorado and Arkansas Commissions, on various matters.

III. PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to discuss the following items:

(1) accumulated deferred income taxes ("ADIT");

(2) the Company's implementation of the Tax Cuts and Jobs Act of 2017 ("TCJA") including the accounting for excess deferred income taxes ("EDIT") in compliance with Commission's Application Nos. NG-0095-PI-213, NG-0095.2, NG-0095.3 (TCJA);

(3) the tax consequences associated with the consolidation approved in Application No. NG-100 (Tariff Consolidation); and

(4) a Transition Report ("Synergy Savings Report") required in Application No. NG - 0084 (Source Gas Acquisition).

The Synergy Savings Report identifies synergy savings resulting from the SourceGas Acquisition, and how those synergies have benefited and will continue to benefit BH Nebraska Gas customers. The Synergy Savings Report filed with this general rate review application satisfies the requirement established in Commission Application No. NG-0084 (SourceGas Acquisition).

Q. ARE YOU SPONSORING ANY ATTACHMENTS?

A. Yes. I am sponsoring the following exhibits:

Exhibit No. JWK-1 provides my education, employment history and professional experience.

Confidential Exhibit No. JWK-2 is the SourceGas Acquisition Application No. NG-0084 required Synergy Savings Report; and

Confidential Exhibit No. JWK-3 is a SourceGas Acquisition Application No. NG-0084 Supplement to Synergy Savings Report.

Q. DOES YOUR DIRECT TESTIMONY SUPPORT ANY SPECIFIC SCHEDULES THAT ARE PART OF THE COMPANY'S FILING IN THIS PROCEEDING?

A. Yes. My testimony supports Statement K of Application Exhibit 1, Section 2 (i.e., Revenue Requirement Study), which provides the calculation of federal and state income tax expense included in determining the cost of service. My direct testimony also supports Schedules M-1 and M-2 of the Revenue Requirement Study, which provides the calculation of ADIT and EDIT included in the Test Period rate base, as well as the appropriate adjustments to ADIT in determining rate base. I also support the Revenue Requirement Study Schedules M and Statement K, which show the ADIT and EDIT amortizations[1].

[1] See BH Nebraska Gas Application Exhibit No. 1, Section 2 (Revenue Requirement Study).

IV. ACCUMULATED DEFERRED INCOME TAXES

Q. WHAT ARE ACCUMULATED DEFERRED INCOME TAXES ("ADIT")?

A. ADIT is the cumulative amount of deferred taxes resulting from differences in timing of recognizing income and expenses for regulatory book versus tax purposes. Those differences are tracked and recorded in a deferred tax asset or deferred tax liability and calculated in accordance with Generally Accepted Accounting Principles ("GAAP") based upon the tax rate in effect at the time it is recorded. ADIT represents a reserve on the utility's financial statements for the future tax obligations to federal and state governments.

Q. WHAT GIVES RISE TO ADIT?

A. In the computation of income taxes, Internal Revenue Code of 1986 ("IRC" or "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 consistent rules for taxpayers with respect to methods and useful lives assigned in depreciating assets. MACRS generally applies to tangible property placed in service after 1986. BH Nebraska Gas has computed tax depreciation based on MACRS for the plant balances included in the Revenue Requirement Study used in this proceeding. For both regulatory and financial reporting purposes, utilities generally use a straight-line method and longer useful life in determining depreciation expense. 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. These temporary differences in turn create book/tax timing differences between income tax expense computed for the year (i.e. under the accounting principal requiring "matching" of tax expense with the pre-tax earnings generated in the period) and the income taxes actually paid. Such a temporary difference generates deferred income taxes that are recorded, cumulatively, in an ADIT account, as prescribed by the inter-period tax allocation method of accounting[2] and the applicable Treasury regulations that set forth the normalization rules.

Q. HOW ARE THE NORMALIZATION RULES APPLIED IN THE CONTEXT OF UTILITY RATEMAKING?

A. The normalization method spreads out, or normalizes, the tax benefit associated with depreciation expense to match the depreciation being used in setting rates. Treasury Regulations Section 1.167(l)-1(h)[3] 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, if the regulatory agency uses straight-line depreciation in setting rates, a utility that uses accelerated depreciation for tax purposes must use the straight-line method of depreciation (i.e., the straight-line method and estimated useful life

[2] This accounting is described in General Instruction No. 16 of the FERC Uniform System of Accounts, 18 C.F.R. Part 101, "Comprehensive Inter-period Income Tax Allocation."
[3] 26 CFR§1.167(l)-1 (2014).

used in calculating annual book depreciation expense) in computing its income tax expense for purposes of determining the cost of service for ratemaking purposes. The Treasury 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 an ADIT account.

Under this method, the utility recovers in its rates more in income taxes than it actually incurs during the early years of an asset's useful life resulting in an increase in deferred taxes. Deferred income taxes decrease in the later years of an asset's life when the utility will pay higher taxes than it is permitted to recover from its customers in rates. 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 rate base reduction represents the notion that ADIT, which represents taxes incurred but not yet paid to the government, is a source of capital for the utility. Specifically, the capital is the pre-tax cash flow that is allowed to be retained and reinvested in the utility instead of being remitted to the government in the form of tax payments. Because the government does not charge interest on future tax liabilities, the capital is cost-free (sometimes referred to as an interest-free loan from the government.) By reducing rate base, only the portion of rate base financed with debt and equity, rather than ADIT, is subject to the return on investment equation in setting rates.

Q. WHAT IS THE IMPACT IF A COMPANY DOES NOT CONFORM TO THE NORMALIZATION REQUIREMENTS?

A. Failure to comply with the normalization requirements results in a utility's tax liability for a given year increasing by the amount which it reduced its excess tax reserve in excess of the amount permitted under the normalization rules. In addition, the utility becomes ineligible to deduct accelerated depreciation for federal income tax purposes and instead may only deduct the lesser amount of depreciation expense for regulatory reporting purposes. Lastly, the TCJA signed into law on December 22, 2017, implemented a significant tax penalty for failure to comply with the normalization rules. Both consequences would adversely impact both the utility and its customers.

Q. DOES THE COMPANY'S FILING COMPLY WITH THE NORMALIZATION REQUIREMENTS?

A. Yes.

V. <u>STATUS OF TCJA IMPLEMENTATION</u>

Q. WHAT IS THE TCJA AND WHAT DOES IT CHANGE THAT AFFECTS THE COST OF SERVICE FOR BH NEBRASKA GAS?

A. The TCJA amended the IRC in several ways with key provisions that will affect customer rates. The primary changes impacting regulated natural gas utilities resulting from the TCJA are as follows:

1. The Federal Income Tax rate for C corporations ("FIT Rate") changed from 35% to 21% effective January 1, 2018;

2. "Bonus" tax depreciation is no longer available for public utility property placed in service after December 31, 2017;

3. As a result of the FIT Rate change, Accounting Standard Codification ("ASC") 740 required the revaluation of the ADIT accounts as of December 31, 2017; and

4. For regulated entities, the FIT Rate change results in the creation of an account associated with the revaluation of these ADIT items to be included in rate base (EDIT) that will be amortized and *returned* to customers in the form of a regulatory liability. In some instances, the ADIT item revalued was a deferred tax asset. In this instance, just as the reduction in tax rate reduces future tax liabilities, so too does a lower tax rate degrade the value of a future tax asset. When this occurs, deficient deferred income taxes or "DDIT" is created which represents an amount to be *collected* from customers as a regulatory asset. In this proceeding, however, the amount to be returned to customers (EDIT) is greater than the amount to be collected from customers (DDIT) resulting in a net EDIT regulatory liability balance to be returned to customers.

Q. PLEASE EXPLAIN THE REVALUATION OF ADIT NECESSITATED BY THE FIT RATE CHANGE UNDER THE TCJA.

A. As a result of the TCJA, the ADIT must be revalued to reflect the future value of the tax obligations resulting from book-tax timing differences based on the lower tax rate. For non-regulated entities, the revaluation of ADIT results in deferred tax expense or benefit in the period of enactment that is allocated to income from continuing operations. However, regulated entities are required by their regulators to return through future rates the portion of deferred taxes recovered from customers based on the higher pre-TCJA tax rates. These deferred taxes to be returned to customers, or EDIT, are recorded as a regulatory liability in the period of enactment.

As an example of the revaluation, consider an expense recognized on the books of $100 that is not able to be recognized for income tax purposes until the following year which results in a timing difference of $100 and an ADIT balance of $35 prior to the law change, calculated as the timing difference times the federal tax rate ($100 * 35%). The new 21% FIT Rate would require the reduction of the ADIT to $21, again calculated as the timing difference times the federal tax rate ($100 * 21%). The $14 ($35 - $21) change is removed from the ADIT account and placed in the new regulatory liability or EDIT account. The revalued ADIT balance reflects the amount the Company is expected to pay for future income tax expense and the EDIT balance reflects the amount originally booked as future income tax expense but, due to the FIT rate change, is converted to an obligation to refund customers' prior period overcollection of deferred taxes. In order to pass all $14 to customers, rates must be reduced by a pre-tax (i.e. grossed up) amount of $17.72 so that the after-tax reduction to rates equals $14 ($17.72 x 79% = $14). The ADIT balances represent both deferred tax assets and deferred tax liabilities. The net EDIT (i.e. all EDIT net of all DDIT) balances must be returned to BH Nebraska Gas' customers and BH Nebraska Gas will return the net EDIT; however, in doing so, BH Nebraska Gas must adhere to the timing rules and other requirements under the TCJA and the IRC.

Q. WHAT IMPACT DOES THE TCJA HAVE ON RATE BASE IN THIS PROCEEDING?

A. The revaluation of ADIT, in and of itself, has no impact on the rate base in this proceeding. As a result of the TCJA, the deferred tax assets (DTAs) included in FERC Account 190 in rate base were revalued from the former 35% FIT Rate to the new 21% FIT Rate. The reduction to this DTA was reclassified to a regulatory asset for DDIT (also included in rate base) which resulted in no net effect on rate base. In a similar fashion, the deferred tax liabilities (DTLs) included as a reduction to rate base in FERC Accounts 282 and 283, for example, were revalued via a reclassification to EDIT regulatory liability (also a reduction to rate base) which resulted in no net effect on rate base. Put another way, net liabilities for future income taxes that were previously due to the federal government (pre-TCJA) are now due to customers (post-TCJA) because customers funded the ADIT reserve account.

Q. PLEASE DESCRIBE THE EXCESS DEFERRED FEDERAL INCOME TAX COMPONENTS AND RESTRICTIONS ON THE TIMING OF RETURNING TO OR COLLECTING FROM CUSTOMERS IN THE FORM OF AMORTIZATION.

A. There are two general components to the TCJA EDIT balances. The first component is the balance subject to the income tax normalization requirements of the TCJA ("Protected EDIT"), while the second component consists of the balance not subject to the normalization requirements ("Non-Protected EDIT"). The TCJA specifically requires that EDIT associated with the accelerated depreciation of property be normalized into customer rates in a highly prescriptive manner referred to as the average rate assumption method ("ARAM").[4] This EDIT is referred to as "Protected EDIT." ARAM specifies that the utility cannot return to customers any of the EDIT that is protected under the TCJA until the year in which the book depreciation expense is more than the tax depreciation on the underlying assets. In this fashion, the return of EDIT to customers matches the period in which previously deferred taxes associated with fixed assets become payable. Once this occurs,

[4]"ARAM" or "Average Rate Assumption Method" is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in its regulated books of account which gave rise to the reserve for deferred taxes. Under such method, during the time period in which the timing differences for the property reverse, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying- (i) the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property as of the beginning of the period in question, by (ii) the amount of the timing differences which reverse during such period.

the utility begins to record the associated amount under ARAM at a rate no faster than the remaining book life of that asset. The Non-Protected EDIT may be treated by the Commission like any other regulatory asset or liability in the rate setting process.

Q. PLEASE DESCRIBE THE TWO SUB-COMPONENTS OF NON-PROTECTED TCJA EDIT.

A. The first sub-component is the Non-Protected EDIT related to book-tax basis differences for fixed assets ("Plant EDIT"). The second sub-component is the Non-Protected EDIT created by miscellaneous temporary timing differences not related to fixed assets ("Non-Plant EDIT").

Q PLEASE DESCRIBE THE COMPONENTS OF THE NEBRASKA GAS TCJA EDIT AND RECOMMENDED DISPOSITION TO CUSTOMERS.

A. The EDIT Balance of BH Nebraska Gas consists of Protected EDIT and Non-Protected EDIT differences as summarized in the table that follows:

			EDIT Regulatory (Asset)/Liability Balances			
Category	Yr	Date	BH NEBRASKA GAS UTILITY CO LLC	BH GAS DIST NEBRASKA	NGU NE	REF
PROTECTED PROPERTY RB	2020	AprHTD	14,633,621	6,130,143	20,763,764	A
NON-PROTECTED PROPERTY RB_PT	2020	AprHTD	4,033,928	902,913	4,936,841	B
PROTECTED NOL RB	2020	AprHTD	-	(3,722,221)	(3,722,221)	A
NON-PROTECTED NP RB	2020	AprHTD	(1,025,610)	(1,146,967)	(2,172,577)	B
NON-PROTECED PROPERTY RB_OTH	2020	AprHTD	(1,248,200)	(68,164)	(1,316,364)	B
NON-REFUNDED ARAM	2020	AprHTD	2,999,541	50,411	3,049,953	B
	2020	AprHTD	19,393,281	2,146,114	21,539,395	
		Recapitulation:				
		Subtotal Protected	14,633,621	2,407,922	17,041,542	SUM A'S
		Non-Protected	4,759,660	(261,808)	4,497,852	SUM B's
		Total TCJA Balance	19,393,281	2,146,114	21,539,395	

The Protected EDIT is subject to the normalization rules and is required to be returned to customers under the ARAM method. The current estimate of the Protected EDIT of BH Nebraska Gas is an amount owed to customers of $17.04 million. This balance is the net of Protected Property EDIT of $20.76 million and Protected Net Operating Loss (“NOL”) DDIT of $(3.72) million. The Company proposes reflecting annual ARAM amortizations of Protected Plant EDIT regulatory liabilities as satisfaction of Protected NOL DDIT regulatory asset until such time as the regulatory asset is satisfied. Using historical data, the annual ARAM amortization is trending at approximately $1 million. At this pace, the $3.72 million NOL DDIT regulatory asset balance is anticipated to be fully satisfied via ARAM amortizations of Protected Plant EDIT regulatory liabilities in approximately four years. Because the protected ARAM amortizations are anticipated to satisfy a regulatory asset in the next four years, no protected amortizations are reflected in Schedule K of the Revenue Requirement Study in this proceeding.

The Non-Protected EDIT of BH Nebraska Gas consists of three components: plant (i.e. rate base) related, non-plant related, and unrefunded amortizations that have already occurred under the ARAM method with deferred accounting/tracking applied. The Non-Protected EDIT is a net regulatory liability to be returned to customers of $4.49 million. BH Nebraska Gas proposes to return the total net Non-Protected EDIT to customers as a one-time bill credit at the time final just and reasonable rates are made effective under this proceeding. Utilizing this approach, the unprotected regulatory liabilities will be returned to customers expediently and the need for future tracking of the non-protected items is alleviated. This testimony and the treatment of the EDIT satisfies the commitments made by BH Nebraska Gas in the TCJA Application Nos. NG-0095.2 and NG-0095.3.

Q. HOW DOES THE COMPANY PROPOSE TO DESIGN THE RATE REDUCTION ASSOCIATED WITH FLOWING BACK EDIT REGULATORY LIABILITIES?

A. The determination of TCJA EDIT was made prior to the legal entity consolidation of BH Gas Utility and BH Gas Distribution. Accordingly, the Company proposes to return EDIT to BH Gas Utility and BH Gas Distribution customers on a per customer basis in a pro rata manner in accordance with how the EDIT was collected from those customers.

VI. TAX IMPLICATIONS ASSOCIATED WITH THE CONSOLIDATION

Q. PLEASE DESCRIBE THE CONSOLIDATION OF NEBRASKA GAS UTILITIES.

A. The consolidation is part of a larger jurisdictional simplification project, which is a legal and commercial realignment of BHC's subsidiaries intended to simplify the overall corporate structure. The consolidation became effective on January 1, 2020 through a series of internal transactions to move all the gas utility assets and associated liabilities of BH Gas Distribution into BH Gas Utility and then rename the consolidated legal entity BH Nebraska Gas.

Q. ARE CUSTOMERS OF BH NEBRASKA GAS AFFECTED FROM A TAX PERSPECTIVE BY THE CONSOLIDATION APPROVED IN APPLICATION NO. NG-100?

A. No. All corporate restructuring steps qualify as tax-free reorganizations under the Internal Revenue Code, which ensures there are no adverse tax implications to the customers of BH Nebraska Gas as a result of the Commission's approval of the consolidation in Application No. NG-100.

VII. TRANSITION REPORT (A/K/A "SYNERGY SAVINGS REPORT")

Q. DID THE COMMISSION ESTABLISH A TRANSITION REPORT REQUIREMENT PURSUANT TO THE JOINT STIPULATION AND SETTLEMENT AGREEMENT IN APPLICATION NO. NG-0084?

A. Yes. The Commission's January 26, 2016 Order at page 15 and Paragraph 26 of the Settlement Agreement requires BH Nebraska Gas (formerly BH Gas Utility) to submit a confidential report to the Public Advocate and Commission detailing the costs eliminated as a result of the transaction ("Transition Report" or "Synergy Savings Report").

Confidential Exhibit Nos. JWK-2 and JWK-3 present the Company's Synergy Savings Report and a supplement to the Synergy Savings Report, which satisfies the Commission's Application No. NG-0084 Transition Report requirement. The Synergy Savings Report compares the cost structure of BH Gas Distribution under SourceGas ownership (as escalated to a current-year view) by major FERC account rollups to the cost structure of the same operation within BH Nebraska Gas under BHC ownership. The difference between the two cost structures illustrates cost eliminations by major FERC account. Confidential Exhibit JWK-3 supplements the report by including savings related to capitalized costs. As noted above, the savings identified in these confidential exhibits are already reflected in the Revenue Requirement Study supported by Mr. Clevinger.

Q. PLEASE DISCUSS SYNERGY SAVINGS IN THE CONTEXT OF UTILITY ACQUISITIONS?

A. Synergies generally refer to cost savings or costs avoided as a result of the combination of two businesses in an acquisition. From a regulatory cost of service perspective, the cash cost savings or avoidances may be reductions to capital and/or operating and maintenance expenses in the hands of the combined organization as compared to the cost structure of the two stand-alone businesses before the transaction.

Q. ARE THE COST REDUCTIONS ACHIEVED THROUGH THE SOURCEGAS ACQUISITION INTEGRATION EFFORTS REFLECTED IN THE REVENUE REQUIREMENT DEVELOPED IN THIS PROCEEDING?

A. Yes. The vast majority of the SourceGas Acquisition integration was accomplished by the end of 2017. Therefore, the synergy savings achieved following the acquisition are reflected in the revenue requirement analysis performed by Mr. Clevinger.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

STATE OF NEBRASKA)

) SS

COUNTY OF LANCASTER)

I, Justin W. Kapperich, being first duly sworn on oath, depose and state that I am the witness identified in the foregoing prepared testimony and I am familiar with its contents, and that the facts set forth are true to the best of my knowledge, information and belief.

Justin W. Klapperich

Subscribed and sworn to before me this 27th day of May, 2020.

(SEAL)

GENERAL NOTARY - State of Nebraska
CHRISTINA L. ELLIS
My Comm. Exp. July 4, 2022

Notary Public

My Commission Expires: