BEFORE THE PUBLIC SERVICE COMMISSION OF NEBRASKA

IN THE MATTER OF THE APPLICATION OF BLACK HILLS NEBRASKA GAS UTILITY COMPANY, LLC D/B/A BLACK HILLS ENERGY FOR APPROVAL ITS GAS HEDGE AGREEMENT WITH BLACK HILLS UTILITY HOLDINGS, INC.	))))))	Application No. NG-0086

POST-HEARING BRIEF OF CONSTELLATION NEWENERGY-GAS DIVISION, LLC

Constellation NewEnergy-Gas Division, LLC ("CNEG") hereby submits the following post-hearing brief pursuant to the Order of the Commission and the Modified Procedural Schedule entered April 4, 2016, in this matter.

As set forth below, and as established at the recent hearing in this matter, the proposed Cost of Service Gas Program (the "COSG Program") as submitted by Black Hills Nebraska Gas Utility Co, LLC d/b/a Black Hills Energy ("Black Hills Nebraska"), unfairly shifts risk to ratepayers while guaranteeing recovery for the affiliates of Black Hills Nebraska. The proposal is non-transparent, unanswerable to market pressures or regulatory oversight, and rife with the potential for self-dealing. Accordingly, this Commission should deny Black Hills Nebraska's Application No. NG-0086 (the "Application") as it is not prudent, and otherwise proposes a scheme that is unjust, unreasonable and unduly preferential. *See* Neb. Rev. Stats. §§ 66-1809; 66-1854.

CNEG intervened in this matter because it believes the COSG Program presents serious implications to the competitive natural gas marketplace in Nebraska and elsewhere. CNEG particularly objects to the Application's attempt to create a quasi-regulated program where the affiliates of Black Hills Corporation ("BHC") enjoy guaranteed cost recovery while assuming little to no risk. *See* Ex. 302, Direct Testimony of Steve Sorenson, submitted February 16, 2016, at 11-15 ("Sorenson Direct"); Ex. 301, Direct Testimony of Stephen Bennett ("Bennett Direct"), submitted February 16, 2016, at 2-7. By its very terms, the COSG Program will provide BHC and its affiliates an unfair competitive advantage in the marketplace—essentially using Black Hills Nebraska's captive customer base on which it is guaranteed to profit. Subsidizing BHC's unregulated exploration and production efforts by guaranteeing that it earns a regulated return on its operations—whether or not it can deliver natural gas profitably—is unfair to competitive suppliers and not in the ratepayers' best interests. *See id.*[1]

Background

Under the COSG Program, Black Hills Utilities Holdings, Inc. ("BHUH"), would direct its newly created, unregulated subsidiary COSGCO to develop and acquire gas reserves to sell on the open market, not to Nebraska ratepayers. Ex. 101, Direct Testimony of Ivan Vancas ("Vancas Direct"), submitted September 30, 2015, at 14-15; Ex. 301, Bennett Direct, at 3-4. In conducting this business, COSGCO would utilize the services of another unregulated BHUH affiliate, Black Hills Exploration and Production, Inc. ("BHEP"), with respect to identification, development and operation of the wells. Ex. 101, Vancas Direct, at 16-17, 21.[2]

The COSG Program is governed by the COSG Agreement, which is between BHUH and the various utilities whose respective commissions approve the COSG Program. Ex. 101 Vancas Direct, at 29 & IV-1 (the "COSG Agreement"). Notably, the Commission is not a signatory to the COSG Agreement, nor does it have direct oversight of COSGCO. Rather, the Commission is

[1] CNEG believes the best way to serve customers is through competitive marketplaces, as this brings discipline into the market and encourages a low-price environment over the long term. ***Even if*** the COSG Program is able to provide customers an artificially low rate for any period of time—which is a very big "what if" as this Commission undoubtedly observed during the hearing—this will discourage competitors from entering and staying in the market. In short, the ability of the COSG Program to guarantee customer savings over the long term is beyond uncertain, and therefore not worth risking the harm to which this program will subject the competitive marketplace. Ex. 302, Sorenson Direct, at 11-15.

[2] The General Manager of BHEP has indeed testified that in many cases, BHEP would act as the operator for acquisitions under the COSG Agreement. *See* Ex. 107, Direct Testimony of John Benton, submitted September 30, 2015 ("Benton Testimony"), at 19. For such work, BHEP would earn a fee, the payment of which would be part of the guaranteed costs for which ratepayers would be responsible under the COSG Program, as discussed further below. *See* COSG Agreement, at definition of "COSGCO OpEx;" May 2, 2016 Hearing Transcript, Benton Testimony, at 218.

simply asked to approve a methodology for charging Nebraska citizens (ratepayers) that is not in their best interest. Under the COSG Agreement, ratepayers would pay a hedge cost to BHUH in the event that COSGCO's actual return on equity (from the sale of gas on the open market) fails to come within 100 basis points of its allowed return on equity as set by the COSG Agreement. Ex. 101, Vancas Direct, at 23; COSG Agreement at 5.1. Ratepayers would only receive a hedge credit in the event COSGCO exceeds its allowed return on equity by 100 basis points.[3] *Id.*

Neither Black Hills Nebraska nor its affiliates have yet identified a property to be submitted under the COSG Program, but rather seek Commission pre-approval of the program structure itself. Ex. 101, Vancas Direct, at 20-21. Once BHEP identifies a property, however, the Commission will have only 60 days to reject any property submitted under the COSG Program. *See* COSG Agreement, at 4.2. Otherwise, any such property would be deemed a property under the terms of the COSG Agreement. *Id.* In this context, the Commission "opts in" by inaction. The failure to act within sixty (60) days under the current schematic of the plan allows the utility to proceed.

<u>Argument</u>

As set forth below, the Application should be denied, as Black Hills Nebraska has failed to establish that the COSG Program is prudent, as required by Nebraska Revised Statute Section 66-1854. The COSG Program fails the prudency test for any number of reasons, and many were explored at the recent hearing. Many of these concerns, however, can be boiled down to two primary objections to the Application: (1) the COSG Program unfairly shifts the risk of BHC

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[3] The Commission should immediately appreciate that this presents an accounting nightmare that will require the very best of forensic analysis to evaluate trade credits, costs, taxes, and administrative sharing that backs up charges levied against Nebraska ratepayers. As noted below, the accounting monitor proposed by Black Hills Nebraska will have a very limited role, and restricted powers and access to information, and is not up to the task of such an evaluation, particularly in light of the size of the proposed capital investment required for the COSG Program.

and its affiliates to ratepayers, and (2) the COSG Program, as proposed, lacks transparency and any reasonable likelihood or assurance of ratepayer benefit.

A. Shifting of Risk

To begin, creating a program with guaranteed cost recovery from well-head to burner tip unfairly shifts risk to Nebraska ratepayers. The Commission, of course, only has jurisdiction over Black Hills Nebraska, and not any other party to the COSG Agreement, nor any BHC affiliate such as BHEP, who will have significant involvement in the COSG Program. *See* Neb. Rev. Stat. § 66-1804; *see also* COSG Agreement at Preamble & Definition of "PUC." These other entities stand to make significant gains at the expense of ratepayers, regardless of the lack of any Commission power to oversee and regulate their actions.

i. Recovery of Costs and Monetization of Assets

The proposed COSG Program is set against the backdrop of BHC's desire to rescue its failing exploration and production entity, BHEP. BHEP has had difficulty selling its gas at a profitable price since 2010, and has been losing money for more than five years. *See* May 2, 2016 Hearing Transcript, Benton Testimony, at 211-212. BHEP currently holds 73,000 acres, with 2 trillion cubic feet of resource potential, in the Mancos Shale located in the Piceance Basin in Colorado. *Id.* at 224-225. It is no secret that BHC is highly motivated to monetize this asset, and BHEP has been evaluating it for use in the COSG Program. *Id.* at 208-210 & 225; *see* also Ex. 107 Bennett Direct at SB-1 ("Analyst Day Presentation"), at 9 & 60. It should also come to no surprise that BHEP's assets in the Mancos Shale conveniently meet the acquisition criteria for properties to be acquired under the COSG Agreement. *See* COSG Agreement at Ex. A; May 2, 2016 Hearing Transcript, Benton Testimony at 187-190. BHC further understands that it can eliminate drilling risks such as dry holes by selling these assets into the COSG Program. Bennett Direct at 9 & SB-2 ("Analyst Day Transcript") at 18-19.

BHC's CEO Brian Iverson, in fact, had the following exchange with an unidentified analyst on its October 8, 2015 Analyst Day call:

> *Unidentified Participant:* And what are the performance requirements for production, right? So, you guys go into agreement on (inaudible) approve the project. What is the performance on -- drilling performance on (inaudible) performance on (inaudible)?
>
> *Brian Iverson:* There are no restrictions on the agreement that we -- already met. So, basically, what you get into is, are you -- you know, it gets more of a prudency-type (ph) issue. You know, you identify the property, and you go out and you conduct a drilling program that you've identified -- your five-year drilling program. If you comply with that program and go along, that's what gets put into the program. So, you could have -- if you have a bad well, that's part of the process. You may have really good wells. They get the full benefit of the well.
>
> *Unidentified Participant:* So, that would all get loaded into the cost of the program.
>
> *Brian Iverson:* Right (ph).
>
> *Unidentified Participant:* So, the -- like, a bad well gets sucked in and spread out over everything else.
>
> *Brian Iverson:* Right.
>
> *Unidentified Participant:* So, you guys don't carry exposure to that.
>
> *Brian Iverson:* That's correct. So, what it gets to is, if you look at the returns of these kind of businesses, if you're taking that kind of risk, you're going to demand a higher than a utility return. So, what we've tried to do is look at this program and say, if you structure it this way, we're willing to accept that utility type of return on the program.

Ex. 301, Bennett Direct, at SB-2, pg. 18-19.

BHC's ability to shift risk to ratepayers is not limited to the monetization of the Mancos Shale assets. In fact, the entire program is designed so that BHC, through COSCGO, can recover a guaranteed return on equity for any property developed under the COSG Agreement. "[U]nlike the majority of natural gas suppliers selling on the open market, COSGCO would be guaranteed to recover its costs and receive a return on its reserve assets, regardless of the market price of gas." Ex. 301, Bennett Direct, at 3-4. The COSG Program allows this return by guaranteeing an allowed Return on Equity ("ROE") for COSGCO, which will be paid by ratepayers in the event that sales revenue of the gas sold on the open market does not cover COSGCO's costs and guaranteed return. *Id.*; *see also* COSG Agreement at 5.1 (addressing calculation of hedge cost). This type of guaranteed recovery is a remarkable shift from the type of activity that is normally granted a regulated return on equity (i.e. granting utilities a regulated ROE for distribution assets, in which it is logical to grant a monopoly status rather than having entities competing to install overlapping distribution networks). *See* Ex. 301, Bennett Direct, at 8. Further, the Commission has no power to review or approve the allowed ROE, which is subject to change each calendar year, but based on the average annual return on equity allowed in gas and electric utility rate cases nationwide. *See* COSG Agreement, at Definition of "Allowed ROE." Ultimately, the COSG Program allows COSGCO to receive this allowed ROE, on top of its operating expenses, without risking the loss of a single dollar of its own money.

COSGCO's costs, of course, are broadly defined, allowing it to recover various expenses, including those of other BHC affiliates, before the guaranteed ROE is even calculated. The COSG Agreement defines COSGCO's recoverable expenses as:

> COSGCO's expenses, calculated in accordance with GAAP, including ***without limitation*** the costs of management, attorneys, consultants, operating expenses, fees and charges paid to the operator, gathering, transportation, compression, line loss and unaccounted for gas costs, minimum daily quantity penalties, processing, marketing, royalties, depreciation, amortization and depletion (including accruals for future plugging, abandonment, and other anticipated asset retirement expenses calculated using engineering estimates and GAAP), Taxes, and direct charges from BHUH and its affiliates for time spent providing services for the benefit of COSGCO . . .

COSG Agreement, at Definition of "COSGCO OpEx (emphasis added). As discussed in more detail in the following section, the Commission has no audit rights and very little insight with respect to determining whether, in fact, any such costs were properly accrued. Moreover, while the Applicant's witnesses testified that BHC affiliates would provide such services "at cost," this is not true in all areas. For example, the Applicant has proposed to utilize BHEP in the role of operator in many instances. As admitted by John Benton, BHEP would charge for such services utilizing some version of a standard form operating agreement, and in the event BHEP entered into a joint operating agreement with COSCGO (which is allowed under the COSG Program), it would retain a portion of the natural gas for itself, as well as some or all of the other derivatives. *See* May 2, 2016 Hearing Transcript, Benton Testimony, at 218-219.

ii. Black Hills Nebraska's Inability to Withdraw from Agreement

If the COSG Program fails to result in lower consumer prices, it is very difficult for the Commission to direct Black Hills Nebraska to terminate its involvement in the COSG Program. As stated in Section 6.2 of the COSG Agreement, in the event a utility is ordered to terminate its involvement in the COSG Program, all remaining utilities must first approve the sale of certain assets that are "functionally equivalent to the terminating Utility's Percentage Share for the calendar year," and if "if no third party(ies) is willing to purchase such interest, the terminating Utility shall remain bound to this COSG Agreement until the end of the Term." In other words, no utility, including Black Hills Nebraska, is allowed out of the Agreement until (1) all remaining utilities approve the potential sale of assets equaling that utility's participation percentage ***and*** (2) a third party actually agrees to purchase such an asset. Otherwise, the utility is locked into the agreement until the wells on each property acquired under the agreement have been plugged and abandoned. This essentially means that the Commission could be locked in for 20 to 30 years. *See* May 2, 2016 Hearing Transcript, Vancas Testimony, at 94.

iii. Colorado's Rejection of the COSG Agreement

Lastly, the risk to Nebraska ratepayers is amplified by the decision of the Colorado Public Utilities Commission ("CPUC") to reject the COSG Program. The CPUC, upon considering a motion to dismiss filed by the Colorado Office of Consumer Counsel, unanimously voted to dismiss Black Hills/Colorado Gas Utility Company LP's COSG Program application in Colorado Public Utilities Commission Proceeding No. 15-0867G. Indeed, the CPUC found that "[t]he limited information Black Hills did provide indicates that ratepayers would see a significant rate increase in the early years of the program and that Black Hills would immediately enjoy what amounts to a guaranteed profit margin. Any benefits to ratepayers will be delayed and are questionable because they are based on the speculative long-term forecast of increased market gas prices." *See In the Matter of the Application of Black Hills/Colorado Electric Utility Company, LP*, Colo. Pub. Util. Comm., Proceeding No. 15A-0867G, Decision No. 15A-0868E (April 27, 2016).[4] Not only does this decision verify the concerns of the many parties opposed to the COSG Program, but Colorado's refusal to participate in the program eliminates 26% of the Applicant's proposed participation level, and therefore increases the percentage of participation of any remaining entity by over 50%. *See* COSG Agreement at Ex. C, Percentage Share and Hedge Target.

B. Lack of Transparency

Coupled with the shifting of BHC's various risks from shareholders to ratepayers is the lack of transparency in the proposed COSG Program. Notably, the proposed monitors lack adequate power and independence to properly oversee COSGCO's acquisitions and the many inter-company transactions noted above. Furthermore, the Applicant has failed to establish that the COSG Program will, in fact, benefit consumers.

[4] The Commission will also appreciate that, very recently, the Florida Supreme Court rejected a similar cost of service gas arrangement involving Florida Power and Light ("FPL"), finding it particularly problematic that FPL was guaranteed a profit on its capital investment in wells while ratepayers were to bear all production risks. *See Citizens of the State of Florida v. Graham*, No. SC15-95, __ So. 3d. __, 2016 WL 2908155 (May 19, 2016) (finding that the project in question "is a guaranteed capital investment for FPL; it is not a hedge to stabilize fuel costs"). Black Hills Nebraska has cited the FPL venture as an exemplar program. Ex. 101, Vancas Direct, at 12-13.

i. The Limited Power and Usefulness of the Proposed Monitors

To start, while the Applicant has pointed to the proposed hydrocarbon and accounting monitors as providing some level of protection to ratepayers, the monitors have limited duties, powers and independence. They also have limited access to information. The COSG Agreement only affords these monitors, and the Commission, access to "BHUH and COSCGO's books, accounts, and records regarding the Properties and this COSG Agreement." COSG Agreement, at § 2.3. The monitors and Commission are not entitled to see the books and records of BHEP and other unregulated Black Hills affiliates, and will see only the costs charged by these entities to COSGCO. *See* May 2, 2016 Hearing Transcript, Vancas Testimony, at 107.

Furthermore, with respect to any analysis done by the monitors as described in the COSG Agreement, the information provided to these monitors is all supplied by BHUH, and there is no requirement of any independent investigation by the monitors themselves.[5] For example, BHUH provides the hydrocarbon monitor a specified list of information for any proposed acquisition under the COSG Agreement, with which the monitor then has ten (10) days to issue a report stating whether the acquisition meets the "Acquisition Criteria" set forth in the agreement. *See* COSG Agreement, at §§ 4.2, 4.3 and Ex. A. In other words, the hydrocarbon monitor's role is limited by the COSG Agreement to merely reviewing data and making a determination that the property in question meets the very acquisition criteria that was developed by the Applicant. It is hard to imagine that the hydrocarbon monitor's role is anything more than a rubber stamp on proposed acquisitions submitted to the Commission. The same can be said of the accounting monitor, whose only role is to provide "an assurance report regarding the accuracy of BHUH's calculations under [the] COSG Agreement" that are stated in BHUH's annual report. *Id.* at

[5] The Commission will appreciate that, while Company witnesses testified that the Agreement did not explicitly restrict monitors from looking at outside sources, the COSG Agreement requires no independent research or audit by the monitors themselves. *See, e.g.* Hearing Transcript, May 3, 2016, Testimony of Aaron Carr, at 347-348.

§§ 2.1 & 5.5. There are no remedies for miscalculations or any provision stating what the Commission may actually do with the accounting monitor's report. *See* May 3, 2016 Hearing Transcript, Kilpatrick Testimony, at 270. Overall, the lack of required oversight is particularly concerning given that COSGCO's investment base is predicted to be in the range of half a billion dollars if the COSG Program has full participation by all utilities as sought by Black Hills Nebraska and its affiliates. *See* May 2, 2016 Hearing Transcript, Vancas Testimony, at 98-99.

ii. Lack of Support for Ratepayer Savings

A further transparency problem with the Application is the fact that the proposed acquisition criteria relies on uncertain forecasts and data, and the prospect of ratepayers actually saving money, as opposed to paying hedge costs to COSGCO, is beyond speculative. The problem with the Applicant's proposed modeling for evaluating acquisitions has been pointed out by a number of witnesses, including CNEG witnesses Stephen Bennett and Andrew Bushra. As stated by Stephen Bennett, "[t]he main conclusion that can be drawn from the model . . . is that the NPV analysis of customer costs or savings from the reserve asset is highly dependent on the input and assumptions and forecasts. As such, the uncertainty inherent in those assumptions and forecasts will impact the accuracy of the model, its outputs and the assessment of whether the natural gas reserve will provide any economic benefit to the customers who are ultimately being asked to take on the risk of the COSG Program." Ex. 301 Bennett Direct, at 15. Mr. Bushra, by examining a number of the forecasting assumptions in the Applicants' model, similarly determined that the model's ability to predict a hedge credit is highly sensitive to the accuracy of the forecasts and data put into the model. *See, gen.* Ex. 300, Direct Testimony of Andrew Bushra, Submitted February 16, 2016. These concerns were echoed by the Christensen Associates report that was commissioned by Commission Staff, which concluded that "Black Hills Nebraska has not convincingly demonstrated . . . that the acquisition of gas properties by

COSGCO will provide net benefits to retail gas consumers in Nebraska." *See* Ex. 4, Christensen Associates Report, at 19.

The Applicants' own witnesses, in fact, confirm the problems associated with relying on long-term forecasts. When cross-examined on his forecasting model, Applicant witness Aaron Carr admitted the prediction of hedge credits under the model depended on long-term price forecasts for natural gas, which are inherently unreliable:

> Q. But the point is that the prediction of a hedge credit is dependent on these numbers being accurate correct?
>
> A. ***I don't know that any forecast at the end of the day is going to be accurate.*** There are the long term market price forecasts that we picked and proposed to use as part of this for comparison purposes, yes.

Hearing Transcript, Testimony of Aaron Carr, at 346 (emphasis added).

Even under the hypothetical model provided by the Applicant—the forecasting in which is admittedly inaccurate—ratepayers would not earn a hedge credit until 2020. *Id.* at 345. Under that hypothetical scenario, for ratepayers to even begin earning the hedge credit predicted in the model in 2020, the natural gas price would need to be in the range of $5.28 per MMBTU. *Id.* For that to occur, the price of gas would need to consistently rise over 250 to 300% in the next four years. *See* May 3, 2016 Hearing Transcript, Testimony of Michael McGarry, at 408 (stating that the natural gas price for June, 2016 according to NYMEX, is $2.05); Ex. 311, EIA-Henry Hub Natural Gas Spot Price (listing the spot price of gas as of March, 2016 at $1.73 per mcf). Gas prices have only exceeded $5.00 once since 2010, and only then for a brief period (not the sustained price as what is apparently considered and predicted in the model). *See* Ex. 103, Direct Testimony of Chuck Loomis at 4, Fig. 1; Ex. 106, Direct Testimony of Aaron Carr, at AC-2 (the "Carr Model"), at page 6 of 13, line 68.

In short, predicting whether ratepayers will receive a hedge credit is a risky proposition, and relies on long-term forecasts that are, by their nature, unreliable. Indeed, the inaccuracy of these forecasts is established by the testimony of the Applicant and its own model. It is for this reason, apparently, that the Applicant has shifted to arguing that the proposed COSG Program can result in less volatility, rather than overall lower prices. *See* Ex. 227, Response to DR Request No. PA-22. However, the proposed COSG Program does not lock ratepayers into any set price, and even if it could, it is questionable what, if any, benefit that would be to consumers. *See* May 3, 2016 Hearing Transcript, Testimony of Michael McGarry, at 407 & 412. Furthermore, Black Hills Nebraska has failed to establish with any reasonable certainty that there is sufficient anticipated future market volatility to warrant approval of the COSG Program based on that stated goal.

Conclusion

The proposed COSG Program is a risky venture for Nebraska ratepayers, and the ability of this Commission to cease the utility's involvement, or to oversee the actions of the various unregulated BHC affiliates, is beyond difficult. Ultimately, the Commission must see this program for what it is—a means by which BHC affiliates seek to monetize assets and earn a return on equity at the risk of ratepayers. For these reasons, and those stated above and at the recent hearing, the Commission should reject the Application.

Respectfully submitted this 6th day of June 2016.

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CERTIFICATE OF SERVICE

I hereby certify that on June 6, 2016, the foregoing Post-Hearing Brief of Constellation NewEnergy-Gas Division, LLC was served by delivering copies thereof to the individuals/entities below, by e-mail and/or United States mail:

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