

1 Montana Public Service Commission
2 Docket No. 2022.07.078
3 Electric and Natural Gas General Rate Review
4
5
6

7 PRE-FILED DIRECT TESTIMONY

8 OF CRYSTAL D. LAIL

9 ON BEHALF OF NORTHWESTERN ENERGY
10

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Witness Information

Q. Please identify yourself, your employer, and your job title.

A. My name is Crystal D. Lail. I am NorthWestern Energy’s (“NorthWestern” or “Company”) Vice President and Chief Financial Officer.

Q. Please provide a description of your relevant employment experience and other professional qualifications.

A. I have been with NorthWestern since January 2003. As Vice President and Chief Financial Officer, my primary responsibilities include the oversight of the finance organization, including accounting, financial planning and analysis, investor relations, reporting, enterprise risk management, tax, and treasury. This responsibility includes development and maintenance of internal controls to safeguard the financial assets of the Company.

Purpose and Summary of Testimony

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to discuss NorthWestern’s critical role in the energy infrastructure in Montana and why maintaining a financially healthy utility is integral to performing this role of providing safe and reliable energy services to customers at reasonable rates. My testimony also provides information on credit ratings and how we finance ongoing infrastructure investment that supports the capital structure and rate of

1 return proposed in this filing along with key proposals to support continued
2 financial strength and strong credit metrics.

3

4 **Q. How is your testimony organized?**

5 **A.** I present my testimony in the following sections:

- 6 • Section I discusses the importance of a financially healthy utility to
7 providing safe and reliable service, including impacts of the financial
8 markets and NorthWestern's recent performance.
- 9 • Section II explains how NorthWestern's proposals in this rate review
10 will assist in maintaining utility financial health and the importance of
11 the regulatory environment to the credit rating agencies' and investors'
12 perceptions of the regulatory risk and the ability to continue to invest in
13 critical infrastructure to serve customers. This section also includes a
14 discussion of the credit rating agencies' criteria and current credit
15 ratings and financial metrics.
- 16 • Section III provides our proposed Capital Structure, Cost of Debt, and
17 Rate of Return ("ROR") for both the Electric Utility and Natural Gas
18 Utility.

19

20 **Q. Please summarize your testimony.**

21 **A.** NorthWestern has over the years successfully performed its role of
22 providing safe and reliable service to customers at reasonable rates. We
23 have operated in a cost-effective manner and maintained the required

1 level of service through repair and replacement of aging system assets,
2 adoption of new technologies to improve system efficiency, and expansion
3 of capacity to support growth all while protecting critical infrastructure from
4 physical and cyber security threats. In order to continue to achieve these
5 goals, NorthWestern requires significant capital investments and
6 continuous access to financing to fund these investments. Access to
7 financing, both in terms of cost and availability, can only be optimized if
8 NorthWestern has a strong financial position. A lower cost of capital
9 derived from having a lower business and financial risk profile will benefit
10 customers in the form of reliable utility service at reasonable rates.

11
12 Although NorthWestern had been able to enjoy favorable financing terms
13 in the past, more recently, NorthWestern's credit ratings are at risk of
14 getting downgraded due to weak financial metrics. I believe there are
15 several factors contributing to this deterioration, including the inability to
16 recover costs closer to the time they are incurred. However, I also believe
17 there are ways to recover from this situation by implementing changes that
18 are constructive and reasonable.

19

20 In this filing, NorthWestern makes the following recommendations:

- 21 • A rate of return ("ROR") of 7.17% for the Montana electric and natural
22 gas utilities using a capital structure of 51.98% debt and 48.02% equity

1 and actual debt cost of 4.01% (except for Colstrip Unit 4, which has a
2 Return on Equity (“ROE”) of 10.0% and an overall ROR of 8.25%¹);

- 3 • The provision of an allowed ROE of 10.60% for both the Montana
4 electric and natural gas utilities based on the recommendation of
5 Adrien McKenzie, President of FINCAP, Inc., and as explained his pre-
6 filed direct testimony;
- 7 • Fully utilize adjustments for “Known and Measurable” capital
8 expenditures and expenses providing a suitable mechanism for the
9 timely recovery of prudently incurred costs and the opportunity to earn
10 our allowed ROR;
- 11 • Recovery of projected program costs for critical programs needed to
12 provide safe and reliable service (Wildfire and Cyber Security/BT); and
- 13 • A Reliability Rider for timely recovery of critical infrastructure
14 investments.
- 15 • A redesign of the current Power Costs and Credits Adjustment
16 Mechanism (“PCCAM”) and Fixed Cost Recovery Mechanism
17 (“FCRM”) pilot to allow these mechanisms to achieve their intended
18 purpose.

19
20 These financial elements are essential under any scenario or outcome of
21 this proceeding. But the importance of timely cost recovery to maintaining

¹ See Final Order No. 6925f, Dkt. No. D2008.6.69, ¶ 264 (Nov. 13, 2008).

1 a financially healthy utility and providing safe and reliable service to
2 customers cannot be overstated.

3

4 **Importance of a Financially Healthy Utility**
and Capital Market Conditions

5 **Q. How does NorthWestern finance its investments and operations?**

6 **A.** Similar to other utilities, NorthWestern finances its investments and
7 operations by issuing debt (i.e. issuing secured long-term debt in the form
8 of first mortgage bonds and borrowing short-term from the revolving credit
9 facilities) and equity (i.e., offering shares of Company stock) and typically
10 accesses the capital markets on an annual basis. In order to fund
11 continued investment in infrastructure to serve customers in Montana at
12 reasonable rates, access to capital on reasonable terms is critical. It is
13 therefore important for NorthWestern to meet debt and equity investor
14 expectations and maintain its current credit ratings to continue to be able
15 to obtain financing at competitive rates. It is important that we receive
16 timely recovery of the costs for investments and operations as well as a
17 reasonable overall cost of capital in order to be able to maintain the ability
18 to obtain financing at reasonable rates for customers.

19

20 **Q. What does the term “financial health” mean and how is it important**
21 **to NorthWestern in providing essential service?**

22 **A.** Financial health is critical to our ability to provide safe and reliable service
23 at the lowest cost possible because it impacts:

- 1 • Liquidity – ability to fund day-to-day operations such as energy supply
2 procurement and maintenance of our infrastructure without disruption
3 or restriction;
- 4 • Cost of capital – access to low interest rates for our debt and attractive
5 price for our common stock; and
- 6 • Credit availability – ability to do business with vendors under favorable
7 terms.

8

9 Financial health refers to a company’s financial strength and its ability to
10 attract capital in varying economic conditions. A strong financial position,
11 supported by a balanced capital structure and stable cash flows, an
12 appropriate ROE range relative to market conditions and risk, and the
13 opportunity to earn authorized returns, is critical to our ability to attract
14 capital at a competitive cost in various economic conditions. Ultimately,
15 our financial position is foundational to our obligation to provide affordable,
16 safe, and reliable utility service to customers. As a regulated utility,
17 NorthWestern has a responsibility to provide safe and reliable service to
18 all customers, current and future, within its service territories. This is a
19 responsibility that remains in place no matter the state of the financial or
20 commodity markets and regardless of unexpected external events, such
21 as major storms, economic cycles, and even such unprecedented events
22 as the recent global pandemic.

23

1 In times of depressed market conditions and constrained capital supply,
2 generally only financially strong utilities can attract capital under
3 reasonable terms, i.e., lower costs, providing those utilities with significant
4 and potentially critical flexibility. Operating without the flexibility afforded
5 through a strong financial position, (i.e., a strong capital structure, stable
6 cash flows, sufficient return expectations for investors, and sound
7 regulatory recovery mechanisms such as fuel and power cost recovery
8 mechanisms), would expose NorthWestern and our customers to
9 unwarranted and unnecessary financial risk, higher costs, and uncertainty.
10 Financial health ensures that the utility will have the flexibility to withstand
11 unanticipated macroeconomic events outside of its control and maintain
12 access to capital at reasonable costs.

13
14 Ultimately, weaker financial health at a utility increases the issued cost of
15 debt and the implied cost of equity, which increases the overall weighted
16 average cost of capital (“WACC”) and ultimately increases the financing
17 costs paid by customers. Strong financial health has the opposite effect,
18 which in turn provides a direct benefit to customers. Financial health and
19 strong credit ratings become even more important when the capital
20 markets are in distress and access to capital and liquidity can be critical to
21 the stable operations of the utility.

22

1 **Q. Please discuss recent financial market and macroeconomic**
2 **conditions that you consider important to considering in an**
3 **understanding of financial health.**

4 **A.** Financial health is always important and has been shown to be particularly
5 crucial as NorthWestern has navigated through periods of significant
6 economic and capital market uncertainty. The Great Recession of 2007-
7 2009 (“Great Recession”), the pandemic-driven recession following the
8 global outbreak of the coronavirus disease (“COVID-19”) in early 2020, the
9 market volatility and inflation of the last 12 months, and discrete events
10 like Winter Storm Uri have underscored the importance for NorthWestern
11 – as an essential service provider critical to virtually all aspects of daily
12 life, commerce, and government in the communities we serve – to have
13 uncompromised financial capabilities to be able to meet our customers’
14 needs in good times and bad.

15
16 After a 2003 bankruptcy, NorthWestern focused on regaining and
17 maintaining a strong financial position. This provided us with the ability to
18 access sufficient liquidity to react to adverse or unforeseen events in ways
19 that minimize negative consequences for our customers. NorthWestern’s
20 uninterrupted access to capital during periods of market turbulence is a
21 product of financial strength.

22

1 Capital access is important at all times, and a supportive regulatory
2 climate is crucial to supporting the need to access capital in the midst of
3 uncertain economic conditions. As noted by these recent examples,
4 favorable market conditions cannot be expected to persist in perpetuity.
5 When markets deteriorate, borrowing costs can increase and access to
6 capital may be limited. Given capital is a finite resource, investors choose
7 where to allocate funds and at what price.

8

9 **Q. Please further explain how the impacts of these recent examples of**
10 **financial market volatility underscores the importance of utility**
11 **financial health.**

12 **A.** The onset of the COVID-19 pandemic, beginning in the first quarter of
13 2020, precipitated both a liquidity crisis and overall financial market
14 volatility not seen since the Great Recession twelve years earlier. In fact,
15 the downturn in the national economy in terms of both increasing
16 unemployment and declining gross domestic product (GDP) were historic
17 in nature. While the economy took several months to deteriorate, the
18 financial markets reacted swiftly. The S&P 500 Index, a broad measure of
19 the U.S. equity market, had reached an all-time high on February 19,
20 2020. Within about one month, on March 23, 2020, it had fallen nearly
21 34%. Similarly, the S&P Midcap 400 Utilities Index comprised of 15 mid-
22 cap utilities in the U.S. hit an all-time high of 636.6 on February 18, 2020,
23 and by March 23 had fallen by more than 38% to 391.0, erasing more than

1 four years of gains. Clearly, during this turbulent time in the financial
2 markets, utility stocks were not viewed as the “safe haven” investment that
3 investors have historically considered them to be.

4
5 Likewise, the expansive uncertainty surrounding the impacts related to
6 COVID-19 caused the short- and long-term debt capital markets to seize,
7 debt yields to spike, and investor demand for new issuances to contract.
8 Not only did debt investors take a pause, bank lenders were inundated
9 with requests for short-term financing such that they saw their lending
10 capacity deplete precipitously, causing them to turn away even their most
11 valued clients. NorthWestern itself experienced difficulty in obtaining a
12 \$100 million term loan during that time as only two of the eight banks we
13 work with were able to provide the financing at a reasonable price.
14 Nonetheless, NorthWestern was able to take action and access the capital
15 markets during this time to support continued investment in a period of
16 significant uncertainty.

17
18 NorthWestern’s financial strength enabled us to continue to have access
19 to financing during these extraordinarily turbulent times. Conditions in
20 financial markets only began to improve as the Federal Reserve took bold
21 and unprecedented actions to provide liquidity to the markets and
22 Congress began to signal its intent to provide fiscal stimulus to the overall
23 economy.

1 **Q. Describe how volatility and uncertainty in supply markets have**
2 **impacted NorthWestern and other utilities.**

3 **A.** There has been a significant change in the volatility of markets for electric
4 and natural gas supply. In 2021, NorthWestern's credit ratings supported
5 electric supply purchases of approximately \$190 million and natural gas
6 purchases of approximately \$64 million. Without good financial health,
7 NorthWestern would not have the access to credit necessary to purchase
8 supply in times of extreme market pricing. At the end of 2021,
9 NorthWestern's balance sheet supported over \$98 million of uncollected
10 supply costs procured to maintain service to customers. In the midst of
11 the February 2021 Winter Storm Uri, several utilities saw their supply
12 costs increase multifold and had to seek additional financing to cover
13 supply costs immediately, resulting in significant increases to debt on their
14 balance sheets. NorthWestern could have easily been one of them.
15 Thankfully, while it was not, the ability to obtain financing in a crucial time
16 to continue service and support the additional financial obligation is driven
17 by financial health.

18
19 **Q. What lessons have regulators and utilities learned from these types**
20 **of events driving financial and broader market uncertainty?**

21 **A.** The larger issue is being prepared for the inherent uncertainty and
22 volatility of economic conditions and the important foundation that a
23 financially healthy utility with a strong balance sheet provides. As

1 discussed previously, the COVID-19 pandemic's effect on markets was
2 unprecedented and was followed by similarly unprecedented
3 accommodative actions by the Federal Reserve and Congress – actions
4 that cannot be considered as ordinary. Absent these actions, this crisis
5 might have been much deeper and longer. NorthWestern must have the
6 continued financial strength to successfully address unforeseen financial
7 market disruptions and stress.

8

9 **Q. What are the significant factors contributing to overall financial**
10 **health that are important to stability and the ability to weather**
11 **changes in financial and other markets?**

12 **A.** The financial health of a regulated utility is largely a function of a
13 constructive regulatory environment. To maintain a strong financial
14 profile, a utility needs to have the opportunity to recover all prudently-
15 incurred costs in a timely manner, which includes not only the costs for
16 capital investments and operation and maintenance expenses, but also
17 the costs of servicing debt and providing a fair return for equity investors.
18 This is why balanced and consistent regulatory decisions, mechanisms
19 that facilitate timely recovery of costs, and a healthy capital structure are
20 vitally important to utilities, including NorthWestern.

21

22 **Q. How would you describe NorthWestern's current financial status?**

1 **A.** NorthWestern currently has a weaker financial performance than our peer
2 utilities. While NorthWestern’s credit ratings are investment grade, we
3 were downgraded by Fitch Ratings in March 2022, and until recently we
4 were on negative outlook with Moody’s Investors Service, as further
5 discussed below. In terms of the critical quantitative metric – ratio of cash
6 flow from operations to debt – our metric is below those of similar peer
7 utilities.

8

9 **Q. Does the current macroeconomic environment affect your views on
10 the imperative for financial health and balance sheet strength?**

11 **A.** Yes. The actions the Federal Reserve is contemplating in response to
12 macroeconomic trends, in particular the impacts of elevated inflation,
13 make the need for financial strength all the more acute. Inflation above a
14 nominal degree taking hold in an economy places enormous risk on
15 regulated utilities.

16

17 The Federal Reserve has signaled a greater willingness to continue to
18 raise interest rates and unwind some of the extraordinary measures it has
19 taken, such as expanding its balance sheet with purchases of financial
20 assets that have been the hallmark of more accommodative monetary
21 policy in the aftermath of the Great Recession. There is a significant
22 degree of macroeconomic uncertainty as the Federal Reserve attempts to
23 manage the worst inflation increases since the early 1980s. The

1 Consumer Price Index was up 8.6% in May 2022 versus one year ago.
2 According to S&P in its latest overview of credit conditions in the U.S.,² its
3 overall favorable view is clouded by a high risk of inflation: “As persistent
4 price pressures combine with continued supply constraints, investors
5 could soon demand significantly higher returns for the risks they’re
6 assuming because of fears of runaway inflation, escalating credit
7 concerns, or an unexpected adverse event”

8

9 **Q. Why is inflation viewed as particularly harmful to regulated utilities?**

10 **A.** Regulatory lag. As damaging as regulatory lag is under mildly inflationary
11 economic conditions, continued inflation at today’s levels would be
12 significantly detrimental to utility credit quality. Unregulated firms in
13 general have the ability to contemporaneously pass higher costs to
14 consumers. Utilities may be faced with situations where their costs
15 significantly diverge from the cost levels that rates are based upon,
16 leading to persistent and widening under-earning and cash flow declines.
17 If this coincides with a period of high capital spending, such as
18 NorthWestern is now experiencing with ever increasing capacity, safety,
19 and security demands, the inflationary pressures compound as spiraling
20 input costs combine with ongoing regulatory lag to outpace the ability of
21 the utility to accurately reflect the costs in rates.

² S&P, Global Credit Outlook 2022: Aftershocks, Future Shocks, and Transitions | Credit Conditions North America: As Recovery Rolls On, Inflation Risks Remain (Dec. 1, 2021), at 66.

1 The concern about inflation has also captured the attention of rating
2 agencies. For instance, S&P published a report in 2021 entitled “Will
3 Rising Inflation Threaten North American Investor-Owned Regulated
4 Utilities’ Credit Quality?” and answered in the affirmative.³

5
6 **Q. What factors do you think are affecting NorthWestern’s financial
7 performance and credit metrics?**

8 **A.** I believe the following factors are significant:

- 9 1. Inconsistent financial performance driven by lack of timely cost
10 recovery;
- 11 2. Persistent under-earning of our authorized returns and other cash-flow-
12 detrimental mechanisms driving lower credit metrics;
- 13 3. Higher risk due to more exposure to the electric power markets than
14 peers combined with the current design of our PCCAM; and
- 15 4. Lack of revenue adjustment mechanisms such as forward test year,
16 cost trackers, and a properly designed revenue decoupling
17 mechanism, the effects of which are exacerbated in an inflationary
18 period.

19

20 As discussed in the Pre-filed Direct Testimony of Jennifer Nelson, the use
21 of historic test years and the lack of full cost recovery of electric supply
22 costs through pass through recovery mechanisms or timeliness of capital

³ S&P, Will Rising Inflation Threaten North American Investor-Owned Regulated Utilities’ Credit Quality (July 20, 2021), at 5

1 cost recovery in Montana is more restrictive as compared to the
2 mechanisms available in other jurisdictions. This impacts the quality of a
3 company's access to both the debt and the equity markets as these
4 factors drive the company's risk profile. The higher the company's
5 perceived financial and business risks, the higher the return required by
6 investors. Investors' assessments of NorthWestern's risk profile is
7 affected by the factors noted above.

8

9 **Q. Has NorthWestern earned its authorized returns over the last five**
10 **years?**

11 **A.** No. A significant element to NorthWestern's financial health is the
12 opportunity to earn our authorized ROE. As shown in Figure 1 below,
13 NorthWestern significantly under-earned compared to our authorized
14 electric ROE from 2017 to 2021. As shown in Figure 2, NorthWestern
15 also under-earned compared to our authorized natural gas ROE in 2020
16 and 2021.

17

Figure 1: Electric Earned versus Authorized

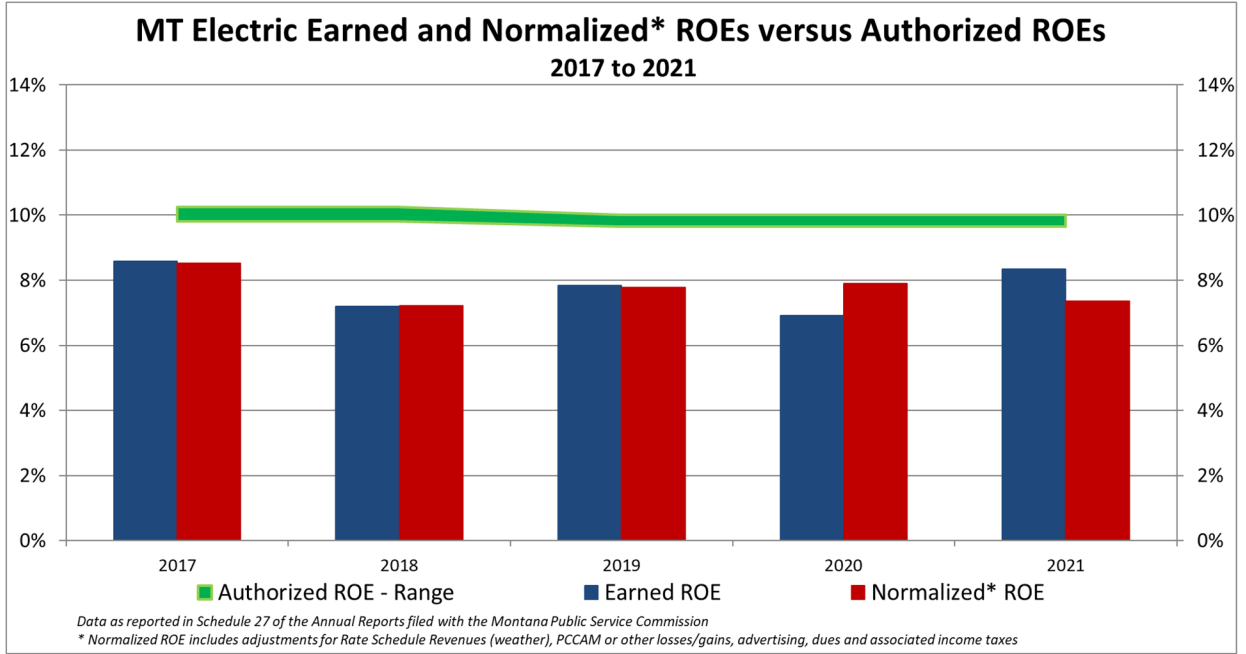
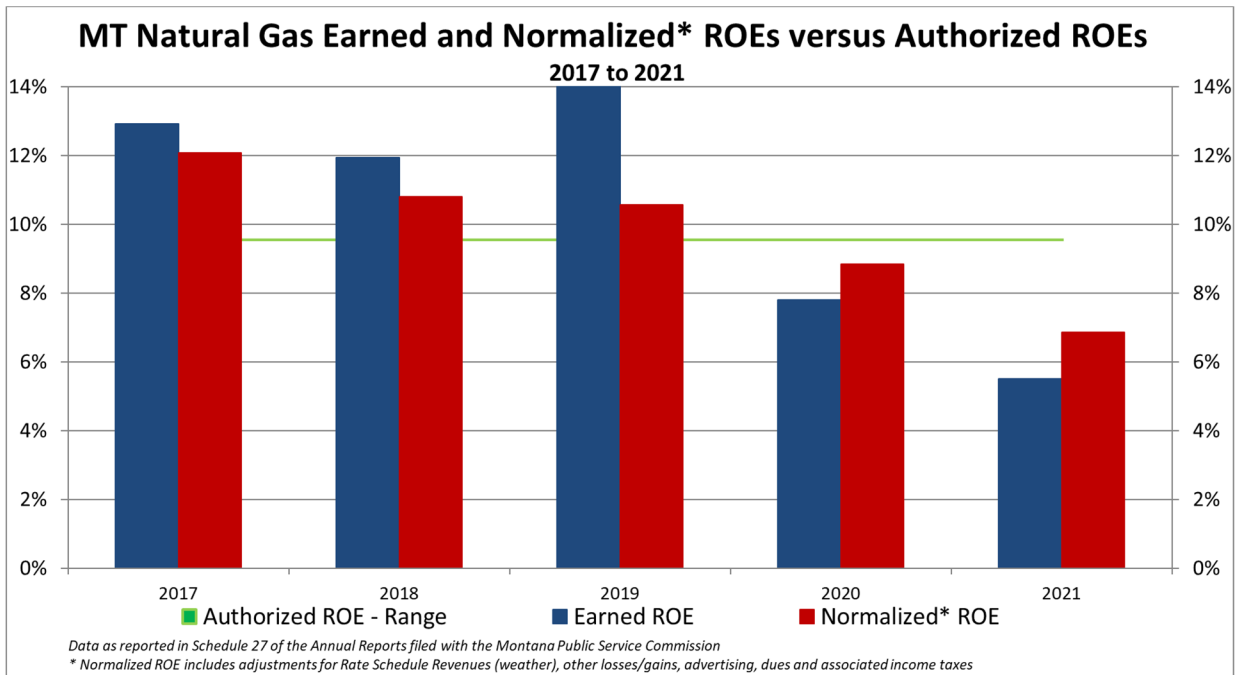


Figure 2: Natural Gas Earned versus Authorized



1 **Q. Please explain how NorthWestern ‘under-earns’ when it is continuing**
2 **to make a profit.**

3 **A.** NorthWestern’s profit is a result of return on invested assets serving
4 customers. While we reflect a financial Net Income or ‘profit’ on our
5 income statements, the amount of profit falls short of the return on
6 invested assets expected based on the rate of return authorized for
7 NorthWestern, which is referred to as ‘under-earning’. As illustrated in the
8 above graphs, although NorthWestern recorded profits, the return on
9 equity based on these profits was below what the Company was
10 authorized to recover in rates from 2017 through 2021 in the electric
11 business and from 2020 to 2021 in the natural gas business (authorized
12 rates of return are the green lines in each graph). Investors expect that
13 regulated utilities have the opportunity to earn their authorized return and
14 will require lower cost of capital from those jurisdictions where there is a
15 consistent opportunity to achieve those earnings.

16

17 **Q. Is a utility’s ability to attract capital also affected by the ROEs that**
18 **are authorized for other utilities?**

19 **A.** Yes, utilities compete directly for capital with other investments of similar
20 risk, which include other natural gas and electric utilities. The ROE
21 awarded to a utility and ability to earn that ROE sends an important signal
22 to investors regarding whether there is regulatory support for financial
23 integrity, dividends, growth, and fair compensation for business and

1 financial risk. The cost of capital represents an opportunity cost to
2 investors. If higher returns are available for other investments of
3 comparable risk, investors have an incentive to direct their capital to those
4 investments. Thus, an authorized ROE that is not commensurate with
5 authorized ROEs for other natural gas and electric utilities and persistent
6 under-earning of that authorized amount can inhibit the utility's ability to
7 attract capital for investment, ultimately resulting in higher costs to
8 customers.

9

10 **Q. Despite NorthWestern's under-earning, does it continue to make**
11 **investments to meet customers' needs?**

12 **A.** Yes, since the last electric and natural gas general rate reviews,
13 NorthWestern has continued to invest to ensure safe and reliable service
14 for our customers, which is the primary driver of this application for rate
15 relief.

16

17 To maintain our continued commitment to safe and reliable service for our
18 customers, we have invested over \$835 million and \$267 million,
19 respectively, in the electric and natural gas systems towards enhancing
20 Montana's infrastructure while addressing critical capacity issues, since
21 our last rate reviews. Net rate base has increased by approximately \$453
22 million and \$143 million for electric and natural gas, respectively, since the

1 applicable test periods. These investments are the primary driver of the
2 requested electric and natural gas revenue requirements.

3

4 **Q. What are the financial implications of continuing to invest while**
5 **under-earning?**

6 **A.** The ratemaking process is premised on the principle that a utility must
7 have a reasonable opportunity to recover the return of, and the market-
8 required return on, its invested capital that it needed to ensure its ability to
9 provide essential service to its customers. Because utility operations are
10 capital intensive, regulatory decisions need to enable the utility to attract
11 capital at reasonable terms under a variety of economic and financial
12 market conditions; doing so balances the long-term interests of the utility
13 and its customers.

14

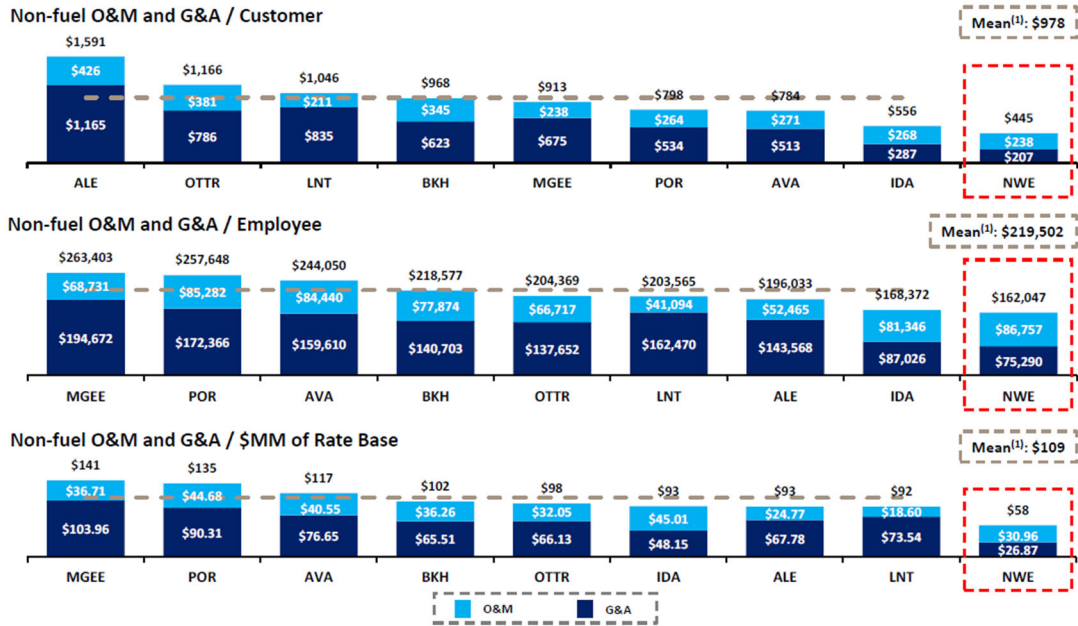
15 NorthWestern accesses the capital markets, debt and equity, to finance
16 ongoing infrastructure investment to maintain safe and reliable service to
17 customers. We compete for capital from investors who have the option to
18 invest in utilities in other jurisdictions. NorthWestern's performance
19 ultimately affects the availability and cost of needed capital as investor
20 dollars can go elsewhere and/or demand a higher price. Earned returns is
21 one of the key indicators that investors monitor, and they drive credit
22 metrics. Ultimately, financial performance drives cost of capital resulting
23 in costs to customers.

1 **Q. Given the critical need for investment in the electric and natural gas**
2 **systems that are driving this rate review, how is NorthWestern also**
3 **managing its operating and maintenance (“O&M”) costs as**
4 **compared to its peers?**

5 **A.** We compare extremely well. One of the reasons we have had customer
6 bills below the national average is due to the fact we have done an
7 excellent job containing costs. Figure 3 below reflects an independently
8 prepared analysis comparing our costs versus similar sized investor-
9 owned peer utilities under three different cost normalizing methods. In
10 each NorthWestern has the best cost ratio. In addition, this analysis
11 shows NorthWestern’s non-fuel O&M and administrative costs to be the
12 lowest in the group of peers.

Figure 3: Electric O&M and G&A Cost Structure vs. Peers

2021 Electric O&M and G&A Cost Structure vs. Peers



NorthWestern's non-fuel O&M and G&A costs are the lowest in its Peer Group

Source: Company filings and SNL.
 Note: O&M expense excludes fuel and steam costs for power generation, water costs for hydro generation, and purchased power costs.
 Customer count, employee count and rate base data reflect electric operations only.
 Employee data assumes total disclosed full-time and part-time employees allocated to the electric segment proportionally based on rate base. BKH employee count reflects disclosed electric segment employees and corporate employees allocated to the electric segment proportionally based on rate base, and excludes gas segment employees. OTTR employee count reflects disclosed Otter Tail Power employees and corporate employees, and excludes manufacturing and plastics segment employees.
 Rate base data assumes 2021 YE estimated rate base as disclosed by each company. POR 2021 YE rate base assumes latest authorized rate base (average, test year ending 12/2022), minus 50% of 2022E copex plus 50% of 2022E depreciation. MGEE and LNT 2021 YE rate base assumes average of disclosed average 2021 and average 2022 rate base estimates.
 (1) Mean excludes NWE.



- 1 **Rate Review Proposals' Relationship to Financial Health**
- 2 **Q. What is the significance of ratemaking-related financial metrics such**
- 3 **as ROE, equity ratio/capital structure, and timeliness and reliability**
- 4 **of cost recovery?**
- 5 **A. These ratemaking-related financial metrics – ROE, equity ratio/capital**
- 6 **structure, and timeliness and reliability of cost recovery – not only affect**
- 7 **NorthWestern's ability to continue to provide safe and reliable utility**
- 8 **services, they also affect investors' and credit rating agencies'**

1 assessments of NorthWestern's financial strength. I will address each
2 component in turn:

- 3 • First, the authorized ROE and capital structure affect NorthWestern's
4 earnings and cash flows, which directly affect its ability to fund capital
5 investment. In addition to credit ratings, investors also assess the
6 capital structure and ROE when making judgments about the
7 supportiveness of a regulatory jurisdiction. As such, the ROE and
8 capital structure combination is a powerful and effective
9 communication tool to underscore the interest of regulators in
10 supporting a utility's ability to attract low-cost financing to provide safe
11 and reliable utility services to customers.
- 12 • Second, the capital structure and authorized costs directly affect all key
13 credit metrics because total debt, operating cash flows, and interest
14 expense are all components of the primary credit metrics that rating
15 agencies analyze. The credit rating agencies also evaluate the relative
16 amounts of debt and equity in the capital structure to determine
17 whether a company is appropriately capitalized given its business risk
18 profile and to determine whether the company has the ability to make
19 interest payments, repay existing debt, and issue additional new debt
20 to fund its utility capital expenditures. The credit rating agencies are
21 very concerned with a company's ability to meet its short-term funding
22 needs under conditions of financial stress, and they factor in the debt

1 portfolio maturity schedule and other future obligations as part of their
2 assessments.

- 3 • Third, debt and equity investors expect a utility to be able to recover its
4 costs in a timely manner and to have a reasonable opportunity to earn
5 its authorized ROE. Investors and rating agencies track the decisions
6 of regulatory agencies relating to capital structure, cost of debt, ROE,
7 cost recovery, and forward-looking cost recovery mechanisms. They
8 categorize the various state regulatory environments in their
9 assessments of the relative risks of different utility investment
10 opportunities.
- 11 • Finally, investors prefer certainty and will demand a higher return for
12 what they perceive as greater risk. For regulated utilities, investors
13 prefer constructive, consistent, transparent, and predictable regulatory
14 environments because this reduces risk and enables investors to
15 generate predictable returns.

16
17 Investors' and credit rating agencies' assessments of NorthWestern's
18 financial strength not only dictate how well the Company can weather
19 uncertainties in the financial markets, they also have a direct impact on
20 customer rates as I will discuss in more detail later in my testimony.

1 **Q. Please further explain why the Montana Public Service**
2 **Commission’s (“Commission”) decisions are particularly important**
3 **to the debt and equity investor community’s perception of**
4 **NorthWestern’s business risk.**

5 **A.** The financial community carefully monitors the current and expected
6 financial condition of utilities and the regulatory frameworks in which they
7 operate. In that respect, the regulatory framework is one of the most
8 important factors in both debt and equity investors’ assessments of risk.
9 Credit rating agencies and investors also know that NorthWestern has
10 investments weighted heavily toward its electric business in Montana and
11 that our customers are concentrated in Montana, making Montana our
12 primary jurisdiction. Finally, rating agencies and debt and equity investors
13 know that the Commission is fully informed regarding ongoing
14 infrastructure investment plans through the various dockets before the
15 Commission. As a result, these agencies and investors will likely consider
16 the Commission’s decisions regarding the financial components of the
17 overall ROR and rates as a reflection of its level of support for
18 infrastructure investment in Montana. Therefore, the Commission’s
19 decisions have an important impact on NorthWestern’s ability to maintain
20 its financial health and allow us to attract low-cost capital to invest in
21 Montana’s infrastructure and continue to provide customers with
22 reasonable rates and reliable service.

23

1 **Q. Please explain how the Commission’s decisions ultimately affect**
2 **cost to customers.**

3 **A.** While the Commission’s decisions on cost recovery and allowed ROR
4 have a direct, near-term impact on costs to customers, decisions that
5 affect the financial health of the utility also have a long-term effect on
6 costs and service quality to customers. Allowing NorthWestern to recover
7 costs incurred to operate the utility and provide safe and reliable services
8 to customers in a timely manner ensures that the utility remains financially
9 healthy. Authorizing a reasonable ROR on NorthWestern’s investments in
10 utility assets preserves the Company’s access to financing at the lowest
11 cost available – similar to financing available to other companies of similar
12 investment risk profile. Both of these are in the best interest of
13 NorthWestern’s customers as greater long-term benefits can be derived
14 from a financially healthy utility in the form of lowering the overall cost of
15 doing business.

16
17 **Q. Does NorthWestern currently receive timely recovery of its costs?**

18 **A.** No, the use of a historic test year and delays in approval of interim rates,
19 in addition to lack of timely recovery mechanisms, result in customer rates
20 that do not reflect actual current costs of providing service to customers.

21
22

1 **Q. What proposals is NorthWestern making in this filing to address**
2 **more timely cost recovery?**

3 **A.** NorthWestern makes several proposals to address more timely cost
4 recovery, including:

- 5 1. Fuller utilization of “known and measurable” adjustments allowed
6 under current rules;
- 7 2. More forward-looking cost recovery for two critical service areas –
8 Wildfire Mitigation and Cyber Security/BT;
- 9 3. More timely cost recovery for critical reliability investments with a
10 proposed Reliability Rider;
- 11 4. A redesign of our PCCAM to better capture evolving market conditions
12 addressing the significant lag in cash flows; and
- 13 5. A redesign of our FCRM pilot to better address all customers and meet
14 the intended policy purpose of such a mechanism.

15

16 These proposals are discussed in further detail in the Pre-filed Direct
17 Testimony of Cynthia S. Fang.

18

19 **Q. How will these proposals support the financial health of**
20 **NorthWestern?**

21 **A.** The use of known and measurable adjustments as allowed by
22 Commission rule gives NorthWestern the ability to update certain
23 components of the filing through the end of 2022, including capital

1 structure, rate base items, and revenue and expense items. These known
2 and measurable adjustments are critical to establishing rates that are
3 reflective of the true and up-to-date cost of service, thereby ensuring that
4 NorthWestern generates enough revenues to cover its expenses and
5 demonstrate financial strength. In addition, by incorporating up-to-date
6 costs in the filing, the frequency of rate reviews in an inflationary
7 environment may be reduced.

8
9 The proposals to recover costs related to energy supply, wildfire mitigation
10 and cyber security/BT as well as a rider to cover reliability investments
11 would allow NorthWestern to maintain its current financial position by
12 supporting cash flows. By allowing the utility to recover these costs in a
13 timely manner, cash generated from operations is likely to be sufficient
14 and the need to finance cash shortfalls would be minimized.

15
16 Furthermore, a FCRM design that achieves its purpose of allowing the
17 utility an opportunity to recover as close to the Commission-authorized
18 revenue requirement as possible would contribute significantly to the
19 stability of operating cash flows.

20
21 Recognizing that debt is serviced with cash, not earnings, debt investors
22 are particularly concerned with mechanisms that do not improve cash flow
23 metrics, such as the current design of the PCCAM. To compensate

1 investors for such investments, deferred expenditures need to earn a
2 return or have immediate recovery. The proposals are focused on
3 maintaining stable and predictable cash flows from operations and
4 minimizing debt, which are critical in supporting the investment grade
5 credit ratings of NorthWestern.

6

7

Role of Credit Ratings

8 **Q. Please provide a summary of credit ratings.**

9 **A.** A credit rating measures credit risk, which is the ability and willingness of
10 an issuer to fulfill its financial obligations in full and on time. Put simply,
11 credit ratings measure the financial health of a company and the risk that
12 investors would not get paid back or earn a return on their investments.
13 Credit ratings help investors differentiate between companies who are
14 competing for the same investment dollars. The credit ratings assigned by
15 rating agencies indicate their opinions of a company's ability to meet its
16 financial obligations. Rating agencies' opinions are considered valuable
17 by potential investors because they represent independent, third-party
18 opinions that are based upon a consistent approach to the evaluation of a
19 company's risk over time. Ratings affect the number of interested
20 investors and the cost of a company's debt, and they offer important
21 insight into a company's investment risk in the past and future.

22

1 Utilities with higher credit ratings are associated with reduced risk, which,
2 in turn, attracts investors at a lower cost of debt and favorably positions
3 such utilities relative to lower-rated, comparable companies. Generally,
4 the stronger the company's credit ratings, the larger the pool of investors
5 willing to consider risking their money by investing in the company's debt
6 and the less the company will need to pay in fees and interest in order to
7 issue debt. Investment-grade credit ratings are crucial because the cost
8 of debt increases very rapidly – and the number of potential investors
9 decreases substantially – for those companies rated below investment
10 grade. The Commission recognized this point in Order No. 6685c, ¶ 32,
11 Docket No. D2005.5.87 (May 23, 2006), where it stated, "Investment
12 grade credit ratings can be instrumental in lowering the overall cost of
13 doing business, thus benefiting the customers."

14
15 Further, credit ratings take on greater importance when economic
16 conditions worsen and access to capital markets becomes more difficult
17 as discussed earlier related to recent market events. As credit availability
18 tightens, investors become increasingly more selective regarding which
19 companies qualify for their investment dollars. Therefore, lower credit
20 ratings reduce or eliminate access to capital markets and significantly
21 increase the cost of capital during times of market distress.

22

1 **Q. To continue to support investments in its Montana utility and deliver**
2 **service at just and reasonable rates, is NorthWestern able to access**
3 **financing at the lowest cost available to a utility of its size and**
4 **financial position?**

5 **A.** No. NorthWestern benefitted from an improving credit ratings trend from
6 2004 to 2016. However, given credit ratings downgrades since then and
7 poor stock price performance, I am concerned that NorthWestern no
8 longer has access to the lowest-cost financing available to a utility of its
9 size and financial position.

10

11 **Q. What are NorthWestern’s current credit ratings with all three rating**
12 **agencies?**

13 **A.** NorthWestern’s current credit ratings are shown below:

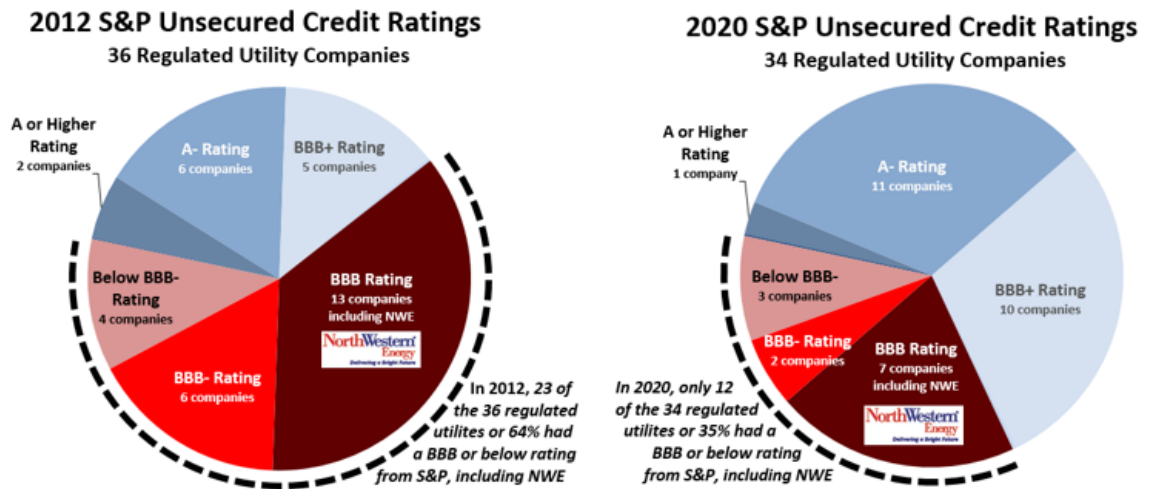
	Senior Secured Rating	Senior Unsecured Rating	Outlook
Fitch	A-	BBB+	Stable
Moody’s	A3	Baa2	Stable
S&P	A-	BBB	Stable

14 **Q. Are these ratings considered strong?**

15 **A.** No. Though still investment grade, NorthWestern’s credit ratings are only
16 two notches from being non-investment grade. As shown in the 2020
17 graphic in Figure 4 below, NorthWestern’s credit ratings by Standard and
18 Poor’s Global Ratings (“S&P”) are currently already in the bottom third of
19 the 34 Edison Electric Institute (“EEI”) regulated electric utilities rated by it.
20 In fact, if we are downgraded by S&P, we would be in the lowest category

1 of utilities at BBB- or lower unsecured rating with less than 15% of the EEI
 2 regulated electric utilities in that category. Figure 4 below shows that most
 3 utilities since 2012 improved their S&P credit ratings while NorthWestern's
 4 S&P credit ratings have remained the same.

Figure 4: S&P ratings

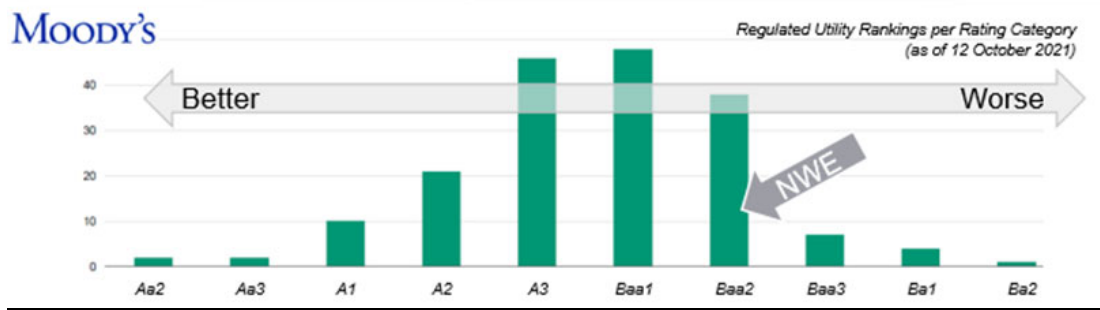


Source: Edison Electric Institute (EEI) 2016 and 2020 Financial Review Reports

5 Furthermore, based on Moody's latest industry report dated November 4,
 6 2021 (see Exhibit CDL-3), as shown in Figure 5, NorthWestern is in the
 7 bottom 21% of the 68 vertically integrated utility companies that it rates.
 8 Any credit ratings downgrade would exacerbate that situation and put
 9 NorthWestern in the lowest category of utilities at Baa3 unsecured rating
 10 with less than 7% of utilities in that category.

11

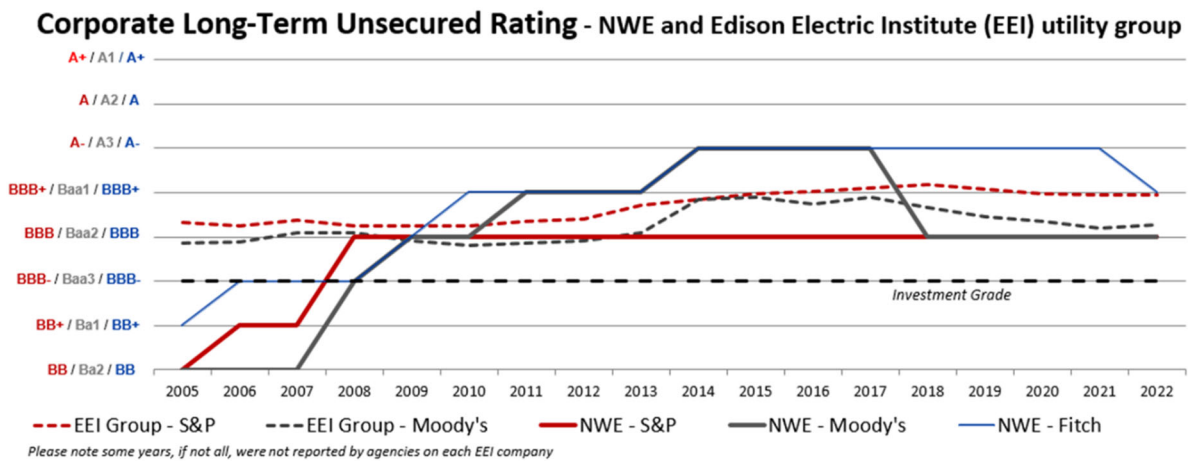
Figure 5: Moody's



Source: Moody's approach to utility credit ratings presented to the MPSC dated October 2021

1 NorthWestern once enjoyed strong, upward trending credit ratings. As
 2 shown below in Figure 6, from 2005 to 2014, the Company's credit ratings
 3 had improved steadily and, from 2014 to 2016, had reached levels that
 4 were on par with average utility credit ratings.

Figure 6: NorthWestern Credit Ratings History



5 By strengthening its balance sheet and cash flows as a result of
 6 constructive regulatory outcomes, the Company was able to support a
 7 steady improvement in its credit ratings to that of similar peers by 2014,
 8 thereby lowering its borrowing costs through lower credit-adjusted pricing

1 and obtaining attractive pricing on equity issuances. However, following
2 that time period, the growth of cash flows fell behind the growth of debt
3 issued to support ongoing infrastructure investments, resulting in weaker
4 credit metrics and, in 2017, NorthWestern's credit ratings began to
5 weaken.

6

7 **Q. Why has NorthWestern's cash flow not grown at the same pace as**
8 **the Company's level of investment in the utility business?**

9 **A.** In addition to our inability to earn our authorized returns, additional cash
10 specific issues have contributed to our reduced cash flow metrics,
11 including:

- 12 • Use of a historic test year with a 13-month rate base average;
- 13 • Length of time between general rate review filings;
- 14 • Use of depreciation rates as a tool in settlement of the last electric
15 filing, which reduced the ultimate amount of cash in rates;
- 16 • Persistent lag in the recovery of energy supply costs without a return
17 compensating for increased debt costs;
- 18 • Implementation of the Tax Cuts and Jobs Act reduced tax-related
19 recoveries from customers; and
- 20 • Lack of credit-supporting regulatory mechanisms, including capital cost
21 riders, projected/forward-looking test years, and other adjustment
22 clauses such as those present in other utilities. See Mr. McKenzie's
23 Exhibit AMM-3.

1 **Q. What financial considerations drive credit analysis?**

2 **A.** Credit analysis focuses on cash flow. Credit analysts strive to understand
3 the cash flow dynamics of a company's financial results because servicing
4 debt requires cash, not just earnings. A recent example of this is the
5 effect of tax reform on utilities, which placed downward pressure on utility
6 ratings because of its negative cash flow impact despite relatively neutral
7 earnings implications. The primary measure that rating agencies use for
8 most cash flow metrics is cash from operations (CFO) or some derivation
9 of it. The other major element of financial risk to a credit analyst is the
10 total amount of debt or debt-like obligations (also referred to as imputed or
11 off-balance sheet debt) on the issuer's balance sheet. Items that the
12 rating agencies regard as debt-like adjustments include lease liabilities,
13 long-term power purchase obligations, pension obligations, and asset-
14 retirement obligations.

15

16 **Q. What quantitative credit metric are the rating agencies most focused**
17 **on?**

18 **A.** The primary financial metric evaluated by the major credit rating agencies
19 includes some version of cash flow to debt coverage. The ratio of funds
20 from operations or cash from operations to total debt (FFO/Total Debt or
21 CFO/Debt), commonly known as Funds from Operation ("FFO") to Debt, is
22 a primary measure. This metric is a direct measure of a company's ability
23 to pay its debt obligations with the cash flow it generates. For S&P, this

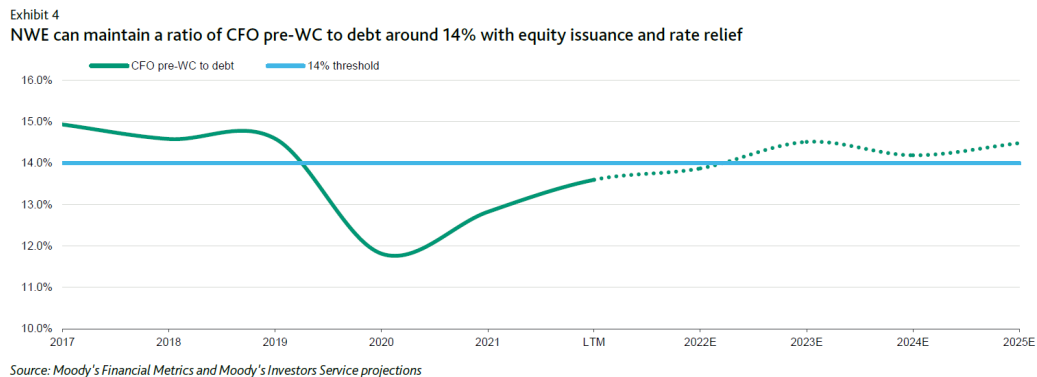
1 metric is called FFO/Debt and FFO is calculated based on earnings before
2 interest, taxes, depreciation, and amortization expenses (“EBITDA”) less
3 cash interest expense and taxes. For Moody’s, this metric is called Cash
4 Flow from Operations before changes in working capital to Debt (“CFO
5 pre-WC/Debt”). For Fitch, this metric is called FFO-adjusted leverage and
6 it is the ratio of total debt to cash flow from operations before working
7 capital changes (FFO) plus interest expense. In summary, the rating
8 agencies focus on the amount of cash a company generates from
9 operations relative to the amount of debt it has to support.

10

11 **Q. What were NorthWestern’s FFO/Debt ratios in the last five years and**
12 **what are the expected ratios?**

13 **A.** NorthWestern’s FFO/Debt equivalent metrics for the last five years and
14 projected for the next four years as calculated and published by Moody’s
15 (see Exhibit CDL-4) are reflected below in Figure 7. The projected metric
16 below assumes rate relief in both 2023 and 2025 in line with rate base
17 growth.

Figure 7: FFO / Debt



1 **Q. How does NorthWestern's current FFO / Debt ratio compare to that of**
2 **its peers?**

3 **A.** According to the industry report published by Moody's dated November 4,
4 2021 (Exhibit CDL-3), NorthWestern ranks 60th among the 68 operating
5 utility companies rated by Moody's in terms of CFO pre-Working
6 Capital/Debt ratio, also an FFO/Debt equivalent metric.

7
8 **Q. Is NorthWestern at risk of getting downgraded as a result?**

9 **A.** Yes. In March of 2021, Moody's put NorthWestern on Negative outlook.
10 In March of 2022, Fitch downgraded our credit ratings from A- to BBB+
11 (unsecured rating) and A to A- (secured ratings). In May of 2022, Moody's
12 revised its Negative outlook to Stable after NorthWestern issued \$500
13 million of equity, a substantial amount representing roughly 16% of
14 NorthWestern's market capitalization, to preserve current ratings. Based
15 on reports from all three rating agencies, NorthWestern's credit ratings

1 could be downgraded based on continued weakness in credit metrics and
2 further negative outcomes from regulatory proceedings.

3

4 **Q. How can NorthWestern's credit ratings with Moody's be at risk when**
5 **the outlook was recently revised to Stable from Negative?**

6 **A.** Moody's revised its outlook on NorthWestern to Stable due to several
7 reasons:

- 8 • When companies are put on a Negative or Positive outlook, Moody's
9 cadence is to resolve these types of outlooks within a 12-18 month
10 timeframe and decide whether the credit ratings have to be
11 downgraded (if Negative outlook), upgraded (if Positive outlook), or
12 kept the same (either Negative or Positive outlook). Once the ratings
13 action has been determined, the outlook is usually restored to Stable.
14 In NorthWestern's case, the Negative outlook had been in place for
15 almost 14 months. Given that there is no pending event that could be
16 a catalyst for further changes in the Company's credit risk assessment
17 within the ensuing four months, Moody's found it appropriate to take
18 NorthWestern off the Negative outlook given the improvement in the
19 FFO/Debt equivalent metric closer to 14% based on first quarter 2022
20 financial results largely driven by the sizable equity issuance in 2021;
- 21 • Moody's forecasted NorthWestern's FFO/Debt to be at or slightly
22 above 14%, the threshold for maintaining current ratings, for the next
23 three years assuming rate relief in both 2023 and 2025;

- 1 • NorthWestern’s strong commitment to preserving current ratings as
2 demonstrated through the issuance of a sizable amount of equity
3 (\$500 million).

4
5 However, as further described in the Moody’s press release dated May 11,
6 2022 (see Exhibit CDL-7), NorthWestern’s credit ratings continue to be at
7 risk of getting downgraded due to the uncertainty regarding the outcome
8 of this rate review. The report stated:

9 The outcome will be a material driver of the company's
10 financial profile in 2H 2023 and beyond. We estimate that
11 the combination of equity issuance and higher rates in 2023
12 will still leave little flexibility above NWE's 14% financial
13 metric threshold that we have cited could lead to a
14 downgrade from its Baa2 rating if not met. As a result, the
15 rate case outcome will likely have an important incremental
16 impact on credit, depending on the parameters of the
17 ultimate order.

18
19 Furthermore, in Moody’s latest credit opinion (Exhibit CDL-4), the analyst
20 stated:

21 While the equity issuance will bring greater stability to the
22 company’s credit profile over the next 12 months, NWE’s
23 longer-term financial and credit trajectory will be heavily
24 influenced by the results of an upcoming rate case filing in
25 Montana.

26
27 In other words, Moody’s Stable outlook on NorthWestern is predicated on
28 assumptions that rate increases in 2023 and 2025 would support the 14%
29 FFO/Debt metric threshold. As detailed further in the report,
30 NorthWestern’s credit ratings could be downgraded if “the outcome of
31 NWE’s Montana rate case results in CFO pre-WC to debt below 14%.”

1 **Q. Should NorthWestern issue more equity to avoid being downgraded?**

2 **A.** No. While issuing more equity would result in fewer debt issuances, thus
3 improving the FFO/Debt metric by reducing the denominator, it will cause
4 NorthWestern's capital structure to have a higher equity component. A
5 higher equity component in the capital structure will result in a higher cost
6 of capital (since cost of equity is higher than cost of debt) and ultimately
7 translate to higher costs to customers. Furthermore, as described by Mr.
8 McKenzie, NorthWestern's current capital structure is already in line with
9 other utility operating companies in the proxy group. As such, the
10 weakness in NorthWestern's FFO/Debt metric lies not in the level of debt,
11 but in the level of cash flows. Finally, if NorthWestern issues more equity,
12 this will have the effect of reducing the debt component in the capital
13 structure while not significantly improving the FFO/Debt ratio. As
14 illustrated in Figure 8 below, reducing debt by \$100 has the same effect
15 on the FFO/Debt metric as increasing FFO by \$15. In other words, an
16 improvement in our cash flows (FFO) will have a more material impact to
17 our credit metrics than reducing debt.

Figure 8: Illustration of FFO and Debt Impact on FFO/Debt

		<u>Opt 1:</u>		<u>Opt 2:</u>	
		<u>Decrease</u>		<u>Increase</u>	
		<u>Adj</u>	<u>Debt</u>	<u>Adj</u>	<u>FFO</u>
FFO	340		340	15	355
Debt	2,429	(100)	2,329		2,429
FFO/Debt	14.0%		14.6%		14.6%

1 **Q. How important is a utility's regulatory environment to the rating**
2 **agencies' credit rating assessments?**

3 **A.** When evaluating regulated utilities, the most important qualitative factor
4 that all three rating agencies consider is the regulatory environment in
5 which the utility operates. The credit ratings agencies focus on the basic
6 regulatory framework, including (1) the legal foundation for utility
7 regulation, (2) the ratemaking policies and procedures that determine how
8 well the utility is afforded the opportunity to earn a reasonable return with
9 reasonable cash flow, and (3) the history of regulatory behavior by
10 commissions applying those laws, policies, and procedures. Then, they
11 examine the mechanics of regulation, particularly the rate-setting process.

12
13 With Moody's, regulatory framework and ability to recover costs and earn
14 returns account for 50% of their scoring model, with the other half being a
15 combination of diversification and financial strength. With S&P, regulatory
16 advantage⁴ is the most heavily weighted factor (60%) used in assessing a
17 utility's business risk profile. With Fitch, fully regulated utilities are
18 assigned a base rating of A as an industry, with further modifications for
19 company-specific rating based on regulatory framework (timely cost
20 recovery, degree of transparency and predictability, mechanisms available
21 to stabilize cash flow, and presence of regulatory measures to protect

⁴ S&P assesses regulatory advantage by determining how regulatory stability, efficiency of tariff-setting procedures, financial stability, and regulatory independence protect a utility's credit quality and its ability to recover its costs and earn a timely return.

1 creditors), market and franchise, asset base and operations, and
2 commodity exposure.

3

4 To further illustrate this, Moody's most recent report (Exhibit CDL-4) states
5 on page 4, "As a regulated vertically integrated electric and gas utility, one
6 of NWE's primary credit drivers is the degree of support that the
7 company receives from regulators. Roughly 80% of NWE's operations are
8 regulated by the MPSC, making it the most important regulatory
9 jurisdiction from a credit perspective." In S&P's most recent report (Exhibit
10 CDL-5) on page 2, the agency indicated that "assumption of sustained
11 operating cash flow, through the effective management of regulatory risk
12 and the execution of its planned cost-control initiatives, is important for
13 NorthWestern to earn its authorized returns and maintain steady cash
14 flows, which are fundamental to our forecast". In Fitch's latest report
15 (Exhibit CDL-6) on page 3, Fitch described NorthWestern's business risk
16 profile as

17 ...weaker than that of peers Xcel Energy Inc. (BBB+/Stable),
18 MDU Resources Group, Inc. (BBB+/Stable), and Black Hills
19 Corporation (BBB+/Stable). All three have greater regulatory
20 diversification than NWE which has greater exposure to
21 Montana, which Fitch considers as having a challenging
22 regulatory environment. MDU's Montana operations has not
23 faced similar regulatory challenges. Xcel and Black Hills
24 have significant operations in Colorado under a regulatory
25 framework that Fitch considers to be more constructive than
26 Montana's.
27

28 **Q. What other considerations are important in determining regulatory**
29 **risk?**

1 **A.** Credit rating agencies also place high value on transparency,
2 predictability, and consistency in regulatory outcomes. Utilities fund
3 capital expenditures primarily with long-dated maturities to match the long-
4 lived assets. Credit rating agencies regard fixed income investors (who
5 extend credit over long periods) as their primary audience and strive to
6 rate long-term debt as accurately as possible. Utility investors value
7 ratings that are stable and accurate. Regulatory frameworks and
8 practices that are viewed as constructive, transparent, consistent, and
9 predictable allow rating agencies to more accurately project future cash
10 flows and debt leverage and will result in a better business risk profile.
11 This predictability offers creditors the ability to accurately assess risk over
12 most of the debt's tenor and the company the ability to manage its
13 business activities and capital program for the long-term benefit of
14 customers. All of these benefits should help drive better pricing for debt
15 issuances, resulting in lower debt costs for customers.

16
17 **Q. Should the Commission consider regulatory risk when deciding the
18 outcome of this proceeding?**

19 **A.** Yes. Credit rating agencies have emphasized the importance of
20 balanced, consistent, and constructive outcomes in utility rate
21 proceedings. Such regulatory outcomes convey to the rating agencies
22 and the investment community the credit-positive relationships between
23 utilities and commissions, which in turn may lower the perceived risk for

1 external investors and result in lower debt and equity costs to the benefit
2 of customers.

3

4 **Q. Will the ROE and capital structure determinations in this proceeding**
5 **carry the same degree of importance to the rating agencies as they**
6 **have in the past?**

7 **A.** No. The ROE and capital structure decisions in this proceeding will attract
8 more attention than they would in a typical rate review. NorthWestern has
9 earned returns that are sub-par, as evidenced by its weaker cash flow
10 metrics, in the opinion of the rating agencies, so restoring its ability to earn
11 returns that can support its current ratings will be a major consideration in
12 future ratings decisions by the rating agencies. Further, the core issue
13 discussed above behind weak credit metrics – the cash-flow shortfalls – is
14 often remedied through credit supportive mechanisms and higher equity
15 ratios. Credit supportive mechanisms and a strong capital structure that is
16 specifically targeted to alleviate cash-flow problems would signal to the
17 rating agencies that supporting credit quality is a shared goal of
18 NorthWestern and its regulators.

19

20 **Q. How are the risk of Power Purchase Agreements (“PPA”) regarded**
21 **by credit rating agencies?**

22 **A.** While the rating agencies recognize that PPAs can mitigate some risks, on
23 balance, they mostly view PPAs as risk-additive for vertically-integrated

1 electric utilities. S&P explicitly adjusts reported financial information to
2 account for the added risk of PPA obligations when they are “very
3 material,”⁵ and in fact they do so for NorthWestern.

4

5 **Q. What are the implications of PPA obligations to NorthWestern’s**
6 **credit profile?**

7 **A.** Since the fixed, long-term obligation that most PPAs impose on a utility act
8 as a damper on credit profile, either qualitatively or quantitatively or both,
9 actions to counteract that effect are necessary to preserve credit quality
10 and ratings. For NorthWestern, as we are less vertically integrated (more
11 in the market for electric supply purchases than our peers), we are
12 considered higher risk in this area.

13

14 A standard pathway for restoring the credit profile is to strengthen the
15 mechanism by which these costs are recovered, which we are proposing
16 in this case related to the PCCAM. Also, while not asking for it in this
17 case, allowing a return to be earned on PPAs would be another effective
18 tool to promote ratings stability. The rating agencies would view that
19 favorably, as well as the signal that it would send that preserving utility
20 credit quality is a crucial piece of the state’s overall effort to modernize its
21 energy economy.

22

⁵ S&P, Guidance | Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments (June 7, 2021), ¶ 190.

1 **Q. Please describe the probable impacts of a lower credit rating on cost**
2 **of capital.**

3 **A.** Long-term debt is priced based on the underlying benchmark Treasury
4 rate plus a credit-adjusted spread, which is primarily based on
5 NorthWestern's credit rating and investors' perceptions of the Company.
6 In general, the lower the credit rating, the higher the credit-adjusted
7 spread, which is used to derive the interest rate on the debt. Issuing debt
8 at a higher rate will increase the cost of long-term debt, which is ultimately
9 paid by customers.

10

11 Equity investors also look at credit ratings. Because the income available
12 to common equity holders is subordinate to debt obligations, the
13 weakening of a company's creditworthiness also increases the cost of
14 equity. Ultimately, customers of the higher-rated utility benefit from the
15 lower capital costs as these costs are ultimately borne by them.

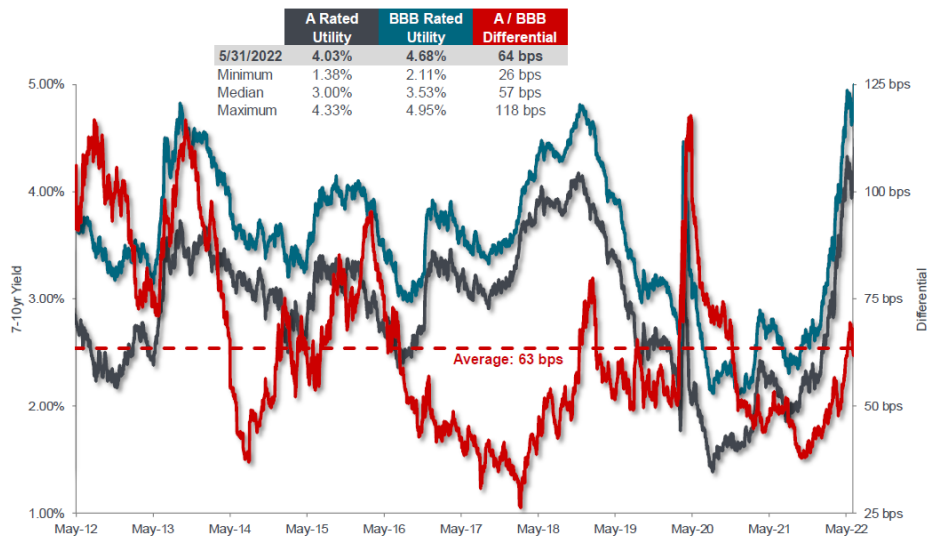
16

17 **Q. Do credit spreads differ based on credit ratings?**

18 **A.** Yes. Lower credit ratings are seen as riskier and therefore investors
19 demand a higher credit spread, or interest rate on the debt. The lower our
20 credit ratings, the higher the credit spread necessary to entice investors to
21 invest in our debt. A downgrade of NorthWestern's unsecured debt
22 ratings by one notch to BBB- (S&P) or Baa3 (Moody's) means its secured
23 ratings would fall into the BBB/Baa range. Either of these downgrades

1 would have a significant impact on the Company’s borrowing costs. As
 2 depicted in Figure 9 below, the credit spread differential between A-
 3 category utility bonds and BBB-category utility bonds has been as high as
 4 118 basis points (“bps”) and averaged 63 bps, with a median differential of
 5 57 bps over the last ten years. More importantly, as illustrated below,
 6 during times of financial turmoil such as in the early months of the COVID-
 7 19 pandemic (March to June 2020), the credit spread differential tends to
 8 be more pronounced.

Figure 9: Credit Spread



Sources: Bloomberg, MorganMarkets, KBCM

9 Additionally, as depicted above, the credit spreads of BBB rated utility
 10 companies are historically wider than those of A rated utility companies,
 11 especially in times of market volatility. If NorthWestern applied this 63 bps
 12 differential in credit spreads to the debt it issued in the last five years, this
 13 credit spread differential would have increased the cost of debt in this filing

1 from 4.01% to 4.23%, which is equal to \$3.8 million of additional debt cost
2 per year ultimately paid by customers.

3

4 Furthermore, a one-notch rating downgrade would have a pronounced
5 effect for NorthWestern, considering that ratings towards the bottom of the
6 investment grade scale imply reduced financial flexibility and would offer
7 no "cushion" in the event of potential dislocations in the financial markets
8 (e.g., extreme widening of the pricing differential between A-rated and
9 BBB-rated debt securities, investors switching to risk-off assets, significant
10 volatility in the stock market, etc.) or other unforeseen events.

11

12 **Q. How would a lower credit rating affect the equity portion of**
13 **NorthWestern's capital structure?**

14 **A.** In order to preserve our credit ratings, we would need to issue equity
15 instead of debt to fund investments and minimize debt issuances in the
16 future. This approach would have the effect of increasing the equity
17 portion of our regulatory capital structure. This higher equity component
18 would ultimately increase customer costs because equity is more
19 expensive than debt. The sizable equity issuance (\$500 million) that we
20 executed in 2021 was necessary to avoid a downgrade to our credit
21 ratings.

22

1 **Q. How would a lower credit rating affect NorthWestern's cost of**
2 **equity?**

3 **A.** Just as lower ratings are associated with higher borrowing costs in the
4 debt markets, higher risk associated with a lower credit rating translates
5 into a higher required return on equity (cost of equity). This higher ROE
6 warranted by the higher risk profile would result in higher rates to
7 customers.

8
9 In addition, if NorthWestern were forced to continue to significantly
10 rebalance its capital structure by issuing more equity in lieu of debt in an
11 effort to maintain the Company's existing credit ratings, this would also
12 lead to higher costs to customers through a higher WACC. Other things
13 being equal, the reduction in valuation suggested by lower stock prices
14 also implies a higher discount rate, or cost of equity capital.

15

16 **Q. What is the significance of this rate review to how investors and**
17 **credit rating agencies will evaluate NorthWestern's financial risk?**

18 **A.** The outcome of this rate review will affect the investors' and rating
19 agencies' evaluations of both the business risks and the credit risks of
20 NorthWestern. Investors and credit rating agencies will use the outcome
21 of the rate review to update their financial projections and credit metrics to
22 determine whether NorthWestern will be able to service its existing debt
23 obligations and will have the flexibility to take on incremental debt to

1 finance its operations and fund further investments in the business. In
2 general, the more downward pressure there is on cash flow to debt
3 metrics and credit ratings, the more upward pressure there is to cost of
4 capital to the utility and its customers as debt and equity investors require
5 a higher rate of return to compensate them for the higher assessed
6 business and credit risks.

7

8 **Capital Structure, Cost of Debt, and Rate of Return**

9 **Q. Please summarize the key points in this section of your testimony.**

10 **A.** The most significant points I discuss include the following:

- 11 • The components of capital structure and rate of return have been
12 determined using the same methodology that has been used in prior
13 rate reviews;
- 14 • The methodology of using rate base to derive the equity component of
15 the capital structure has also been used in prior rate reviews;
- 16 • Unsecured revolving credit facility debt is appropriately excluded from
17 capital structure consistent with prior rate reviews; and
- 18 • The proposed capital structure is consistent with the capital structure
19 adopted in the most recent electric general rate review Docket No.
20 2018.02.012 for the Montana electric utility.

21

22 **Q. Please summarize your specific recommendations for capital**
23 **structure and overall rate of return.**

1 **A.** I recommend approval of the proposed test year capital structure with
 2 48.02% common equity and an overall rate of return of 7.17% for both the
 3 electric and natural gas utilities, as shown in Figure 10 below.

Figure 10: Capital Structure and Rate of Return

	Capital Structure	Rate	Weighted Rate
Long-term Debt	51.98%	4.01%	2.08%
Derived Equity	<u>48.02%</u>	10.60%	<u>5.09%</u>
Rate of Return	100.00%		<u><u>7.17%</u></u>

* Except for Colstrip Unit 4 which will have a rate of return of 8.25%.

Note: See Exhibit CDL-1 for further details

4 The proposed capital structure and overall costs of capital are reasonable
 5 and largely similar to the ones applied to rates for over a decade. The
 6 proposed capital structure is in line with capital structures of other utility
 7 operating companies in Mr. McKenzie’s proxy group (see Exhibit AMM-
 8 14). The recommended capital structure will continue to support
 9 NorthWestern’s financial integrity as demonstrated through strong bond
 10 ratings and lower costs of debt, while simultaneously enabling continued
 11 substantial capital investments in the utility infrastructure.

12
 13 **Q. Please describe the importance of the determination of a reasonable**
 14 **authorized ROE.**

1 **A.** The Commission's order in this proceeding should provide the opportunity
2 to earn an ROE that is: (1) adequate to attract capital at reasonable terms
3 under a variety of economic and financial market conditions over the
4 period of time that its investment will be recovered; (2) sufficient to
5 reasonably ensure its financial integrity; and (3) commensurate with
6 returns on investments in enterprises with similar risk. Providing the
7 opportunity to earn a market-based cost of capital supports the financial
8 integrity, which is in the interest of both customers and shareholders.

9

10 **Q. What effect do current and prospective market conditions have on**
11 **the cost of equity?**

12 **A.** The combination of persistently high inflation, the Federal Reserve's
13 changes in monetary policy, and the dramatic shifts in market conditions
14 all contribute to an expectation of increased market risk and an increase in
15 the ROE required by investors. It is essential that these factors be
16 considered in determining an appropriate forward-looking ROE. Inflation is
17 currently at the highest level experienced in approximately 40 years.
18 Interest rates, which have increased significantly from pandemic-related
19 lows in 2020, are expected to continue to increase in direct response to
20 the Federal Reserve's use of monetary policy to address inflation.
21 Because there is a strong historical inverse correlation between interest
22 rates and the share prices of utility stocks (share prices of utility stocks
23 typically fall when interest rates rise), it is reasonable to expect that

1 investors' required ROEs for utility companies will also continue to
2 increase. Therefore, ROE estimates based solely on current market
3 conditions will understate the ROE required by investors during the future
4 period that the rates determined in this proceeding will be in effect.

5
6 **Q. Is the proposed capital structure and return on equity applied to all
7 assets?**

8 **A.** No. In Docket No. D2008.6.69 (Order No. 6925f), the Commission
9 determined that the revenue requirement for the life of Colstrip Unit 4
10 should be based on a 10% ROE, 6.5% cost of debt, and a 50/50 capital
11 structure, which results in a ROR of 8.25%.

12

13 Capital Structure

14 **Q. Please explain the calculation of capital structure that you presented
15 above.**

16 **A.** Consistent with past filings, NorthWestern is proposing debt/rate base to
17 determine the capital structure. Total Montana utility average rate base
18 with adjustment for known and measurable changes is reflected as total
19 capitalization. Then, equity is derived by deducting the total Montana
20 jurisdictional long-term debt from the Montana utility average rate base
21 amount. Using this methodology, NorthWestern's capital structure in this
22 filing is 51.98% debt and 48.02% equity.

23

1 **Q. Is this methodology of using debt and rate base to derive capital**
2 **structure consistent with past Commission orders?**

3 **A.** Yes. In Docket No. D2007.7.82, the Commission determined that the use
4 of rate base to derive capitalization is the preferred method for calculating
5 the Company's capital structure for ratemaking purposes. Paragraphs 72
6 and 73 of Order No. 6852f stated that:

7 For regulatory purposes, the PSC evaluated NWE's
8 regulated Montana capital structure using Montana regulated
9 assets and liabilities to derive the Montana regulated equity.
10 This information was provided in NWE Exhibit 11. The
11 Montana NWE regulated electric and gas rate base is \$931
12 million; long-term debt totals \$481 million; and, as a result,
13 equity is \$450 million. This derives a Montana regulated
14 capital structure of 52 percent debt and 48 percent equity,
15 which is a capital structure close to NWE's consolidated
16 capital structure and one that does **not** include goodwill.
17 (emphasis in original)

18
19 NorthWestern has consistently used the rate base of the Montana utility
20 and the debt associated with the Montana utility to derive the capital
21 structure for ratemaking purposes. In recent dockets, the Commission
22 has implicitly accepted this methodology, including in Docket Nos.
23 D2012.9.94, D2016.9.68, and 2018.02.012, where the Commission
24 approved settlements with capital structures as proposed by
25 NorthWestern.

26

27 **Q. Please explain the rate base amount used in calculating the capital**
28 **structure.**

1 **A.** The rate base amount used in this filing is \$3.39 billion. This amount
2 represents the average rate base amount with adjustments for known and
3 measurable changes for the Montana electric and natural gas utilities
4 presented in this filing, and as described in the Pre-filed Direct Testimony
5 of Jeffery B. Berzina. This total rate base amount excludes the \$22.0
6 million rate base reduction agreed to in the Stipulation Agreement in
7 Docket No. D2007.7.82. This calculation is shown on Exhibit CDL-2.

8

9 **Q. Please explain why you excluded the \$22.0 million of rate base**
10 **reduction ordered in the Stipulation Agreement in Docket No.**
11 **D2007.7.82 when calculating the capitalization of the Montana Total**
12 **Utility.**

13 **A.** The \$22.0 million (amortized from the original \$38.8 million) rate base
14 reduction was part of the negotiated settlement between the Montana
15 Consumer Counsel and NorthWestern in Docket No. D2007.7.82, and,
16 among other things, it effectively reduced the amount of NorthWestern's
17 revenue requirement in future rate reviews. Paragraph 86 of Order No.
18 6852f states that:

19 The Stipulation specifies the regulatory accounting treatment
20 for capital expenditures for improvements and updates to
21 existing electric transmission and distribution and natural gas
22 transmission, distribution and storage facilities. For each of
23 the years 2008 and 2009, \$19.4 million will be deducted from
24 gross plant, and the depreciation reserve associated with
25 that plant will be deducted from the total depreciation
26 reserve for ratemaking purposes. This \$38.8 million
27 reduction in rate base has a net present value to ratepayers

1 of approximately \$31 million based on a discount rate of 8
2 percent. The associated depreciation expense will be
3 included in cost of service. These investments will be
4 allocated two-thirds to electric delivery service and one-third
5 to natural gas delivery service.
6

7 Therefore, the reduction in revenue requirement resulting from this
8 adjustment results in a lower return on rate base. However, because the
9 rate base amount is also used to determine the capital structure of the
10 utility for regulatory purposes, to artificially reduce the total capitalization of
11 the Company without proportionally reducing the debt causes the
12 calculated capital structure to have a higher debt to rate base ratio or a
13 thinner equity layer. This thinner equity layer reduces the rate of return
14 calculated, thus further reducing the revenue requirement calculated, an
15 unintended consequence of the benefits that were intended by the
16 Stipulation. As such, the Property, Plant, and Equipment (“PP&E”)
17 adjustment should not be applied when calculating rate base to determine
18 capitalization.
19

20 Most importantly, capitalization is often defined as the total debt and total
21 equity used by a business to finance its assets; hence, the use of rate
22 base assets as a proxy for determining a utility’s capitalization is
23 reasonable. The capitalization used in this filing should represent the total
24 capital deployed by NorthWestern to invest in Montana infrastructure; in
25 this case, this is the Montana Total Utility rate base amount without the
26 negotiated PP&E reduction prescribed by the Stipulation. In other words,

1 the \$22.0 million of PP&E are real assets, which were capitalized using
2 debt and equity and are therefore part of the total capitalization of the
3 Montana Total Utility. To exclude these assets from the use of rate base
4 as capitalization would result in understating the capitalization of the
5 Montana Total Utility. Furthermore, in order to maintain the integrity of the
6 capital structure calculation, if the \$22.0 million of PP&E is not included in
7 rate base, then the debt allocated to these assets should not be included
8 in the total debt amount either (i.e., if the denominator does not include the
9 \$22.0 million of assets, neither should the numerator include the debt
10 allocated to these assets).

11

12 **Q. Is the exclusion of this stipulated reduction to PP&E in calculating**
13 **rate base as a proxy for capitalization consistent with past**
14 **Commission orders?**

15 **A.** Yes. In Docket No. D2007.7.82, Order No. 6852f, the Commission
16 determined that the rate base amount to be used as a proxy for
17 capitalization was \$931 million which excluded the stipulated reduction to
18 PP&E, which at the time was \$38.8 million. Consistent with the use of rate
19 base to determine capitalization, the Commission has accepted this
20 exclusion in subsequent dockets.

21

22 **Q. How did you determine the debt amount used in the calculation of**
23 **the capital structure?**

1 **A.** Debt in this calculation reflects Montana jurisdictional secured long-term
2 debt, which is specifically secured by either the electric utility assets or the
3 natural gas utility assets. As of December 31, 2021, Montana Total Utility
4 debt was \$1.76 billion. Statement F provides the debt details. We have
5 not proposed a known and measurable adjustment to the Montana debt
6 amount as we do not expect to issue additional long-term debt in 2022.

7
8 **Q. Why is unsecured revolving credit facility debt excluded from the
9 calculation of the capital structure?**

10 **A.** The unsecured revolving credit facility borrowings have consistently been
11 excluded from the approved capital structure, including in Docket Nos.
12 2018.02.012, D2016.9.68, and D2013.12.85. This precedent is consistent
13 with the fact that our secured long-term debt is used for long-term
14 financing and is secured by utility rate-based assets while unsecured
15 revolving credit facility debt is used to fund temporary financing needs,
16 which, in our case, includes cash needs related to energy supply
17 purchases, property taxes, construction work in progress, dividends, and
18 other working capital items for all of NorthWestern's jurisdictions. This is
19 even more relevant in NorthWestern's case because the rate base amount
20 is being used as the proxy for capitalization (i.e., the denominator of the
21 capital structure calculation). To include the unsecured revolving credit
22 facility borrowings in the capitalization calculation would overstate the

1 amount of debt used to finance that very rate base that is the subject of
2 this regulatory filing.

3

4 Furthermore, unsecured revolving credit facility debt is paid down using a
5 combination of internally generated cash flow, equity issuances, and/or
6 long-term debt issuances. As such, until such unsecured revolving credit
7 facility debt is refinanced as long-term secured debt, this portion of debt
8 should not be considered permanent, long-term capital of the utility.

9

10 **Q. Please explain how the equity amount used in this filing is**
11 **calculated.**

12 **A.** Consistent with the methodology used in prior dockets and as explained
13 earlier in my testimony on why rate base is used as a proxy for total
14 capitalization, equity is derived by deducting the Montana Total Utility
15 long-term debt from the Montana Total Utility rate base \$3.39 billion total
16 rate base less \$1.76 billion of long-term debt, which equals \$1.63 billion of
17 derived equity. The resulting capital structure is 51.98% debt and 48.02%
18 equity.

19

20 **Q. Has NorthWestern's capital structure changed materially over time?**

21 **A.** No, it has not. In NorthWestern's 2018 electric rate review, the parties
22 agreed to a capital structure consisting of 50.62% long-term debt and
23 49.38% equity. The capital structure in the 2016 natural gas rate review

1 was 53.21% long-term debt and 46.79% equity. The capital structure in
2 the 2012 natural gas rate review was 52.35% long-term debt and 47.65%
3 equity.

4

5 Cost of Debt

6 **Q. How did you calculate the cost of debt?**

7 **A.** For all the debt secured by the Montana electric and natural gas utility
8 assets, the cost of long-term debt is determined by adding the annual
9 interest cost, the annual amortization of debt discount, and the issuance
10 expense associated with each debt component, which is then divided by
11 the long-term debt balance, resulting in a cost of long-term debt of 4.01%
12 (see Statement F).

13

14 **Q. How does this cost of debt compare to the cost of debt filed in
15 previous rate reviews?**

16 **A.** The cost of debt of 4.01% is lower than the cost of debt filed in the last
17 several general rate reviews (4.26% in Docket No. 2018.02.012; 4.67% in
18 Docket No. D2016.9.68; 5.37% in Docket No. D2012.9.94; 5.76% in
19 Docket No. D2009.9.129; and 5.76% in Docket No. D2007.7.82).

20

21

1 Cost of Equity

2 **Q. How did you determine the cost of equity?**

3 **A.** The cost of equity relies upon the analysis performed by Mr. McKenzie,
4 which he explains in his pre-filed direct testimony. Mr. McKenzie's
5 analysis shows a range of reasonableness of ROE for a combined electric
6 and natural gas utility of 9.70% to 11.00%, with an estimated mid-point of
7 10.35%, plus a 0.25% risk adjustment, for a recommended ROE for
8 NorthWestern of 10.60%. I agree with Mr. McKenzie's assessment and
9 have used the recommended 10.60% in calculating NorthWestern's
10 proposed ROR. Although the Commission may allow an increment of up
11 to 2% added to the rate of return for Demand-Side Management ("DSM")
12 programs, NorthWestern does not request that additional increment in this
13 docket.⁶ Mr. Berzina provides more details on NorthWestern's request to
14 include DSM in rate base.

15

16 **Q. Does this complete your testimony?**

17 **A.** Yes, it does.

18

VERIFICATION

This Pre-filed Direct Testimony of Crystal D. Lail is true and accurate to the best of my knowledge, information, and belief.

/s/ Crystal D. Lail
Crystal D. Lail

⁶ See Montana Code Annotated § 69-3-712.