DIRECT TESTIMONY
OF CRYSTAL D. LAIL
ON BEHALF OF NORTHWESTERN ENERGY

TABLE OF CONTENTS

Standard & Poor's Credit Opinion 12.19.2023	Exhibit CDL-4
Moody's Industry Outlook 9.13.2023	Exhibit CDL-5
Standard & Poor's Wildfire Article 11.29.2023	Exhibit CDL-6
Standard & Poor's Wildfire Article 11.9.2023	Exhibit CDL-7
EEI/AEE's Reaching for the Cloud February 2022	Exhibit CDL-8

Witness Information

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

A. My name is Crystal Lail. I am NorthWestern Corporation d/b/a NorthWestern Energy's ("NorthWestern" or "Company") 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 and have served as Chief Financial Officer since February 2021. 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 of Testimony

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to recommend approval of the proposed test year capital structure of 53.19% debt and 46.81% equity and overall rate of return of 7.49% for the electric and natural gas utilities. In support of this recommendation, I discuss why maintaining a financially healthy utility is integral to providing safe and reliable energy services to customers at reasonable rates. My testimony provides an overview of financial conditions, the environment in which we operate, and NorthWestern's overall financial health, including its credit ratings. I also describe how NorthWestern finances ongoing infrastructure investments, which support the capital structure and rate of return proposed in this filing. Finally, I address the financial impacts of wildfire risk from an investor and insurance perspective. The Direct Testimony of Adrien M. McKenzie provides additional detail related to the appropriate Return on Equity ("ROE"), based on our specific circumstances, together with an overview of the current state of the financial markets.

Q. How is your testimony organized?

A. I present my testimony in the following sections:

- Section I discusses the importance of a financially healthy utility to providing safe and reliable service, including impacts of the financial markets and NorthWestern's recent performance.

- Section II discusses NorthWestern's current credit ratings and credit evaluation criteria and our proposed Capital Structure, Cost of Debt, and Rate of Return ("ROR") for both the Electric Utility and Natural Gas Utility.
- Section III discusses how wildfire risk affects access to capital, credit ratings, and property and liability insurance costs.
- Section IV discusses proposed accounting treatment for technology costs.

Q. Why is NorthWestern filing this rate review?

A. NorthWestern continues to invest in its electric and natural gas systems. This rate review seeks to recover significant investments and update rates to reflect the following:

- Recovery of investments serving customers since the last rate review;
- Investment in Yellowstone County Generating Station ("YCGS");
- Wildfire mitigation efforts and escalating insurance costs;
- Effects of higher interest rate environment; and
- Higher operating costs due to inflation.

Q. How are current economic conditions affecting NorthWestern and utilities generally?

A. The post-pandemic operating environment has been challenging in several ways. First, inflationary pressures have significantly increased our operating costs, resource costs, and cost of materials. These pressures have amplified the effects of regulatory lag experienced by NorthWestern in terms of cost recovery. Second, the Federal Reserve, after aggressively increasing interest rates, has continued to hold rates higher in an attempt to bring inflation down to its 2% target, driving an increase in our overall cost of borrowing.

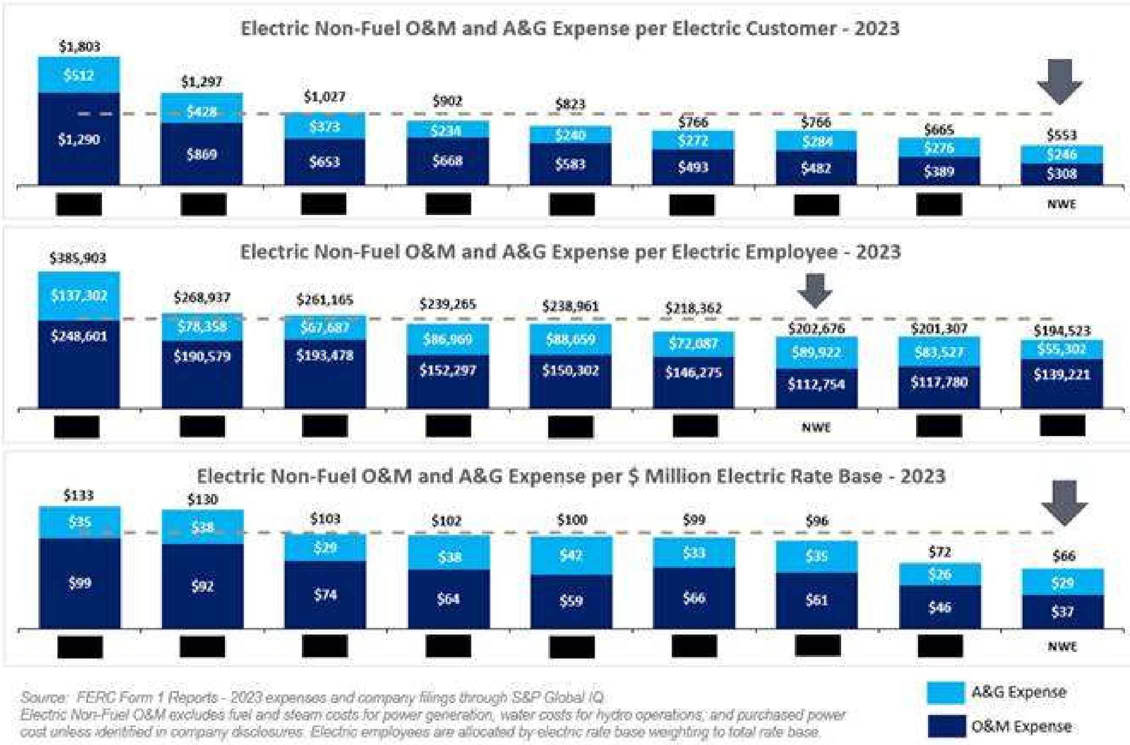
As a publicly traded utility, we have two primary sources of external capital: debt and equity investors. Utilities require ready access to capital markets in all types of economic environments. Our ability to attract new capital, especially equity capital, under reasonable terms is dependent on our ability to offer a risk/reward opportunity that is equal to or better than investors' other alternatives. We are competing for capital with not only other utilities but also with businesses in other sectors of the economy. The assessment of overall risk/reward of utility investments has shifted.

Utility equity capital is attractive in a low interest rate environment due to dividend yields and, historically, low relative risk. With higher interest rates, we are now competing essentially with the risk-free treasury rate, which has made utility dividends less attractive, and thus made utility equity capital more expensive. As a result of the higher interest rate environment, we have seen a downward trend in stock prices across the industry with utilities being the worst performing sector of the market in 2023. This is coupled with an increase in investor sensitivity to industry-related risks, especially wildfire risk for western utilities including NorthWestern, discussed further below. To attract capital, the Company must provide a return that compensates investors for the risk associated with their investment. These factors heighten the importance of the foundational elements of the regulatory compact and proposals that support financial health.

Q. Given concerns about affordability, how is NorthWestern continuing to manage its operating and maintenance ("O&M") costs relative to its peers?

A. As shown in Figure 1 below, NorthWestern continues to benchmark well against its peers when comparing our costs versus similar sized investor-owned peer utilities under three different cost normalizing methods.

Figure 1: Electric Non-Fuel O&M and A&G Expense



Q. Has NorthWestern continued to experience 'underearning', notwithstanding the final rates implemented on November 1, 2023 from the last rate review?

A. Yes. As shown in Figure 2 below, NorthWestern has not earned its authorized electric ROE from 2019 to 2023. As shown in Figure 3, NorthWestern also under-earned compared to our authorized natural gas ROE in 2020 to 2023.

Figure 2: Electric Earned versus Authorized

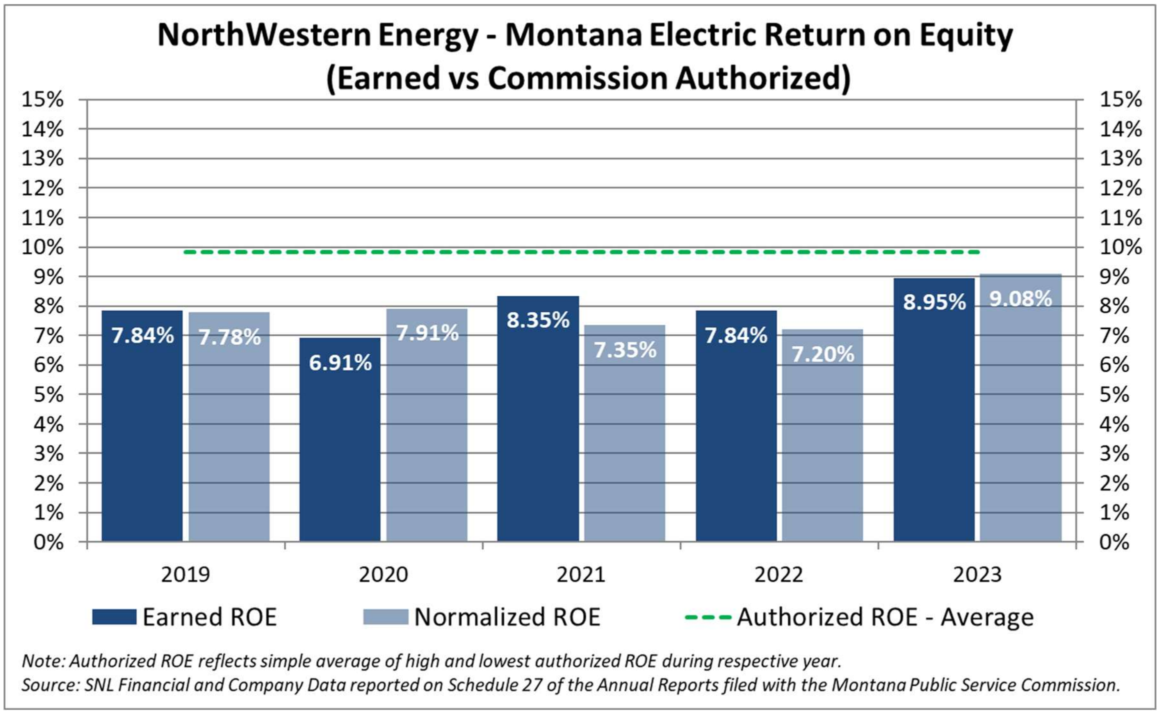
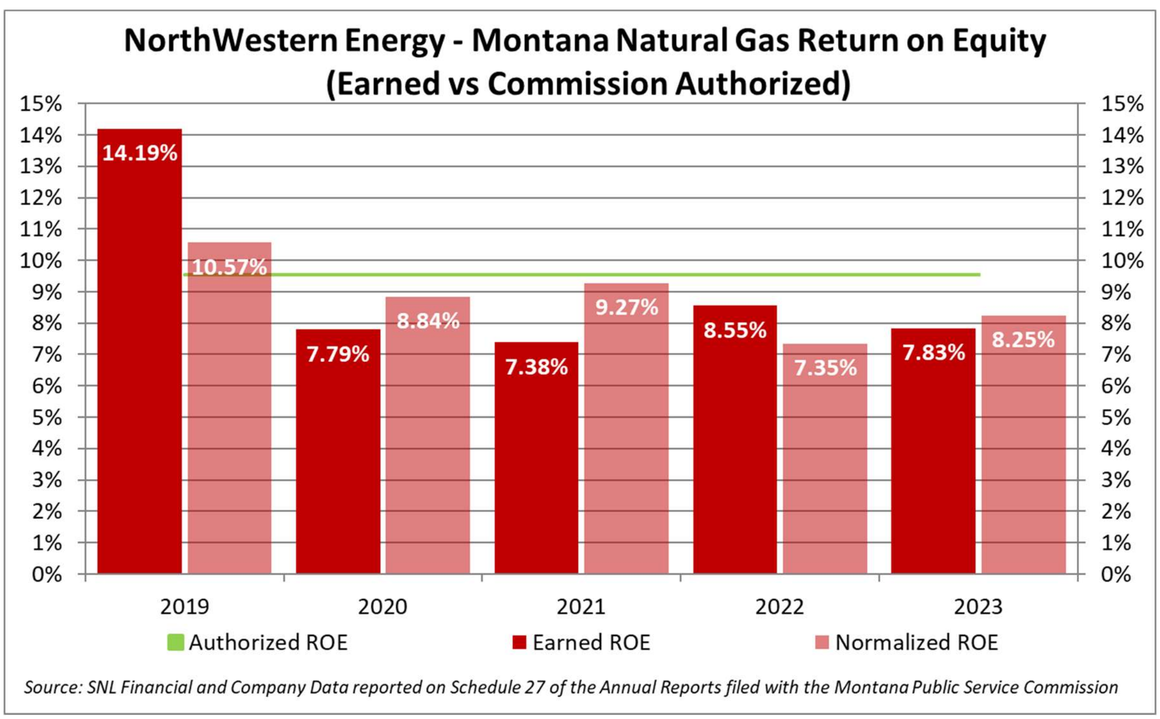


Figure 3: Natural Gas Earned versus Authorized



Earned returns is one of the key indicators that investors and credit rating agencies monitor. While we reflect a financial Net Income or 'profit' on our income statements, the amount falls short of the return investors expect on invested assets based on the rate of return authorized for NorthWestern, which is referred to as under-earning. This continued under-earning is driven by investment in the systems in excess of depreciation to serve customers, inflationary cost increases, higher interest rates, and regulatory lag.

Q. What proposals, in addition to the foundational elements of ROE and capital structure, is NorthWestern making in this filing to support overall financial health?

A. Key proposals include:

1. Cost recovery of YCGS that includes a Bridge Rate Proposal to address the recovery of the investment in YCGS between the in-service date and final rates in this rate review and end of period rate base reflecting the full cost of the facility;
2. Balancing Accounts for the recovery of costs incurred between rate reviews in the critical areas of Wildfire Mitigation and Colstrip Compliance; and
3. Capitalization of Business Technology Costs with a Balancing Account.

These proposals are discussed in further detail in the Regulatory Priorities Testimony of Cynthia S. Fang.

Importance of a Financially Healthy Utility

Q. Please explain how NorthWestern finances its investments and operations, and how financial health affects its ability to obtain this financing.

A. NorthWestern finances its investments and operations by issuing debt (issuing secured long-term debt in the form of first mortgage bonds and borrowing short-term from revolving credit facilities) and equity (offering shares of Company stock). NorthWestern's unsecured credit facility provides access to critical liquidity for working capital including market supply purchases and the financing of plant investments until long-term debt is issued. NorthWestern accesses the capital markets frequently, and NorthWestern's financial health drives its ability to obtain this financing at reasonable rates, which impacts NorthWestern's ability to serve our customers.

NorthWestern's financial health is foundational to its ability to provide reliable, affordable, and sustainable energy services to its customers. This obligation exists no matter the state of the financial or capital markets and regardless of unexpected external events, such as major storms, economic cycles, wildfire events, geopolitical uncertainty, and unprecedented events such as the global pandemic. As noted above, the post-pandemic economic environment and assessment of utility risk/reward have shifted since our last rate review filed two years ago.

Financial health refers to a company's financial strength and its ability to attract capital in varying economic conditions. A strong financial position includes a balanced capital structure and stable cash flows, an appropriate ROE range relative to market conditions and risk, and the opportunity to earn authorized returns. These elements are critical to the utility's ability to attract capital at a competitive cost in various economic conditions.

Financially strong utilities attract capital under reasonable terms, even in times of depressed market conditions and constrained capital supply, providing those utilities flexibility to meet their obligations to their customers at lower costs. Weaker financial health at a utility increases the issued cost of debt and the implied cost of equity, which increases the overall weighted average cost of capital and ultimately increases the financing costs paid by customers. Financial health and strong credit ratings become even more important when the capital markets are in distress and access to capital and liquidity can be critical to the stable operations of the utility.

Q. How does NorthWestern's regulatory environment affect its financial health?

A. The financial health of a regulated utility largely depends on its regulatory environment. To maintain a strong financial profile, a utility needs to have the opportunity to timely recover all prudently-incurred costs, which includes not only the costs for capital investments and operation and maintenance expenses, but also the costs of servicing debt and providing a fair return for equity investors. As discussed below in more detail on our current credit ratings, the qualitative assessment of the regulatory environment is a critical component to the credit rating agencies' assessment of a utility's credit quality. This is why balanced and consistent regulatory decisions, mechanisms that facilitate timely recovery of costs, and a healthy capital structure are critical to utilities, including NorthWestern.

Q. How does the construction of a large plant such as YCGS impact the financial health of NorthWestern?

A. Construction of a large project such as YCGS requires significant balance sheet support. Costs incurred during construction are primarily financed with our unsecured credit facility. During the construction period of this facility, interest rates increased substantially with current rates at approximately 6.5%. NorthWestern has recorded Allowance for Funds used During Construction ("AFUDC"), which provides some offset to these interest costs. However, AFUDC is non-cash and therefore the impact during construction of approximately $300 million in costs is a detriment to our quantitative credit metrics until we begin recovering the costs of the facility.

Q. Describe the importance of YCGS recovery, including the bridge rate and end of period rate base, in supporting NorthWestern's financial health?

A. As discussed above, carryng the costs of construction of the YCGS facility have negatively impacted NorthWestern's quantitative credit metrics. The bridge rate proposal addresses this by reducing regulatory lag with an effective date of the bridge rate on October 1, 2024. While this rate review is being conducted, this aligns that recovery with when customers are receiving the value of the facility and is credit supportive as it begins to reverse the negative quantitative credit impacts. Full recovery of the facility in the ultimate rate review outcome, which is reflected in the end of period rate base amount, is also critical to NorthWestern's financial health as using an average of the rate base would not allow NorthWestern the reasonable opportunity to earn the allowed return and cover costs of the facility.

Credit Ratings

Q. What is an investment grade credit rating?

A. A rating of at least BBB- from Fitch Ratings ("Fitch") and Standard & Poors Financial Services LLC ("S&P") and Baa3 from Moody's Investors Service, Inc. ("Moody's") are considered to be investment grade ratings.

Investment grade debt can be held by a larger base of investors and generally has a lower interest rate because it is considered less risky than debt that is rated below investment grade. A common colloquialism for bonds below investment grade is “junk bonds.” Companies whose debt is rated below investment grade may not be able to access necessary capital in capital-constrained market conditions, except possibly under onerous terms and conditions, and typically pay a higher cost of capital.

Q. What are NorthWestern’s current credit ratings?

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

The most recent published credit rating reports from each rating agency are provided as Exhibits CDL-2 to 4.

Q. What factors do the rating agencies consider when they assign credit ratings to a utility?

A. The rating agencies each take into account factors including the regulatory environment in which the utility operates, the utility’s ability to recover its costs and earn its allowed return on a timely and consistent basis, its level of diversification, and its financial strength. The agencies use various quantitative metrics to measure a utility’s financial strength, with the key financial metric being the FFO (Funds from Operation) to Debt ratio.

Q. How is NorthWestern's regulatory environment considered in the rating agencies' credit rating assessment?

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

With Moody's, regulatory framework and ability to recover costs and earn returns account for 50% of its scoring model, with the other half being a combination of diversification and financial strength. With S&P, regulatory advantage[1] is the most heavily weighted factor (60%) used in assessing a utility's business risk profile. Finally, with Fitch, fully regulated utilities are assigned a base rating of A as an industry, with further modifications for a company-specific rating based on regulatory framework (timely cost recovery, degree of transparency and predictability, mechanisms available to stabilize cash flow, and presence of regulatory measures to protect

[1] 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.

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

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

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

Q. Will the recovery of YCGS help preserve the credit ratings of NorthWestern?

A. As discussed above, the full recovery of YCGS is critical to improving the quantitative credit metrics and therefore, financial health of NorthWestern. In fact, NorthWestern's current credit ratings are supported by the assumption that YCGS will be recovered in rates after it reaches commercial operation. As mentioned in the most recent Moody's credit report on NorthWestern (Exhibit CDL-3), "*As a result of the rate case and the pending commercial operation of its new Yellowstone generation plant (a roughly $275 million, 175 megawatt natural gas-fired electric generation plant), Moody's expects NWC's financial metrics to improve, such that its ratio of cash flow from operations before changes in working capital (CFO pre-WC) to debt will be around 15% in the next 12-18 months, up from the 12%-13%*" (page 2). Our Fitch ratings also assumes that YCGS has legislative and regulatory support, and therefore, recovery of the plant is a reasonable expectation. The Fitch credit opinion (Exhibit CDL-2) states "*Fitch believes Yellowstone has support in Montana's legislature, ….. with the senate having passed SB557 and SB971, two bills that supports the company's position to complete the project*" (page 5). Failure to obtain rate recovery of the YCGS plant would put NorthWestern's credit ratings at risk not only due to the quantitative impacts of weak credit metrics, but also the qualitative assessment of the lack of regulatory support.

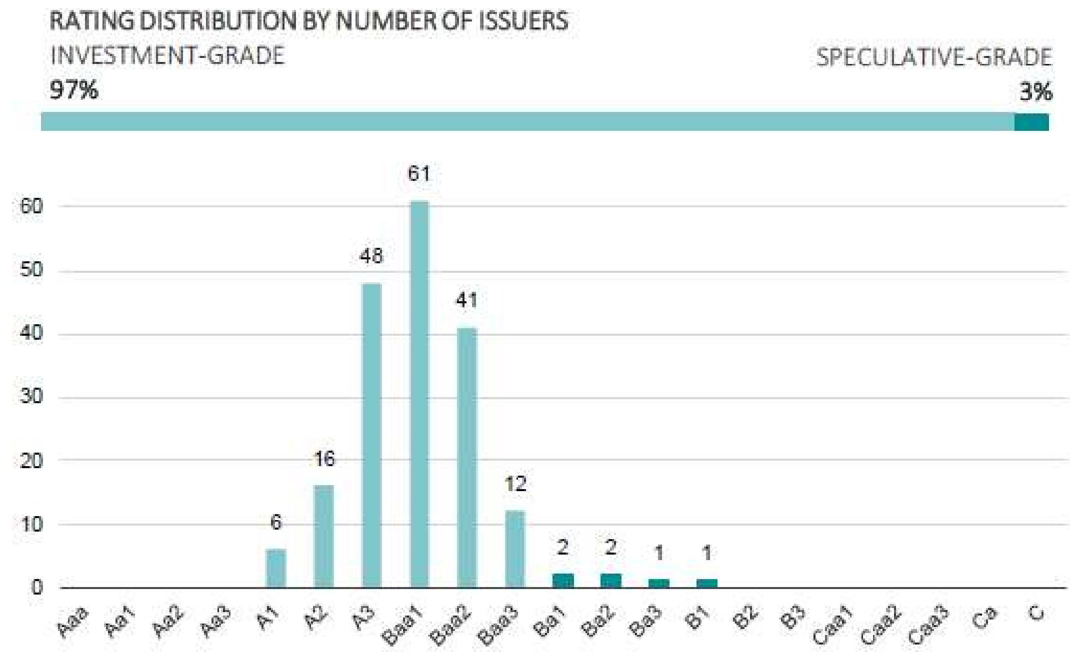
Q. **Does a utility's credit rating provide an indication of the financial health of the company?**

A. Yes, it does. A credit rating is an assessment by a credit rating agency that provides that agency's independent view of a company's creditworthiness, considering multiple factors as discussed above. Generally, companies with stronger financial health are considered lower risk and have higher credit ratings.

Q. Can you comment on how NorthWestern's current credit ratings compare to other utilities?

A. NorthWestern's credit ratings are two notches above the threshold for being non-investment grade. Based on Moody's latest industry report dated September 7, 2023 (see Exhibit CDL-5), as shown in Figure 4, NorthWestern is in the bottom 31% of the 190 holding companies and operating subsidiaries that it rates at Baa2. Any credit ratings downgrades would put NorthWestern in the lowest category of utilities at Baa3, with less than 10% of utilities in that category. While a credit rating of Baa3 (one notch below our current rating of Baa2) is still considered investment grade, it would not be optimal as a downgrade from that rating due to an unexpected event, or series of events, would result in a credit rating that is below investment grade.

Figure 4: Moody's Utility Industry Report



Includes holding companies and operating subsidiaries.
Source: Moody's Investors Service

Q. Should the Commission consider rating agencies' assessment of regulatory risk when deciding the outcome of this proceeding?

A. Yes. Credit rating agencies have emphasized the importance of balanced, consistent, and constructive outcomes in utility rate proceedings. Such regulatory outcomes convey to the rating agencies and the investment community the credit-positive relationships between utilities and commissions, which in turn may lower the perceived risk for external investors and result in lower debt and equity costs to the benefit of customers.

Q. Please describe the probable effects of a lower credit rating on cost of capital.

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

Equity investors also look at credit ratings. Because the income available to common equity holders is subordinate to debt obligations, the weakening of a company's creditworthiness also increases the cost of equity. Ultimately, customers of the higher-rated utility benefit from lower capital costs.

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

A. Just as lower ratings are associated with higher borrowing costs in the debt markets, higher risk associated with a lower credit rating translates into a higher required ROE (cost of equity). This higher ROE warranted by the higher risk profile would result in higher rates to customers. Other things being equal, the reduction in valuation suggested by lower stock prices also implies a higher discount rate, or cost of equity capital.

Capital Structure, Cost of Debt, and Rate of Return

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

A. I recommend approval of the proposed test year capital structure with 46.81% common equity and overall rates of return of 7.49% for the electric and natural gas utilities, as shown in Figure 5 below.

Figure 5: Capital Structure and Rate of Return

	Capital Structure	Rate	Weighted Rate
Long-term Debt	53.19%	4.57%	2.43%
Derived Equity	46.81%	10.80%	5.06%
Rate of Return	100.00%		**7.49%**

* Except for Colstrip Unit 4 which will have a rate of return of 8.25%.
Note: See Statement F - ROR for further details

The proposed capital structure and overall costs of capital are reasonable and largely similar to the ones applied to rates for over a decade. The proposed capital structure is also within the range of capital structures for other utility operating companies in Mr. McKenzie's proxy group of 37.9% to 62.7% equity component (see Exhibit AMM-4 Page 2 of 3). The recommended capital structure will continue to support NorthWestern's financial integrity as demonstrated through strong bond ratings and lower costs of debt, while also enabling continued capital investments in the utility infrastructure.

Q. Please describe the importance of the determination of a reasonable authorized ROE.

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

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

A. The combination of persistently high inflation, a higher for longer interest rate environment, and the dramatic shifts in market conditions all contribute to an expectation of increased market risk and an increase in the ROE required by investors. It is essential that the Commission consider these factors in determining an appropriate forward-looking ROE. Inflation and interest rates have remained elevated. Because there is a strong historical inverse correlation between interest rates and the share prices of utility stocks (share prices of utility stocks typically fall when interest rates rise), utilities were the worst performing sector in 2023 and it is reasonable to expect that investors' required ROEs for utility companies will also continue to increase.

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

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

Capital Structure

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

A. Consistent with past filings,[2] NorthWestern is proposing the use of debt/rate base to determine the capital structure. Total Montana utility average test year rate base with adjustment for known and measurable changes is reflected as total capitalization. Then, equity is derived by deducting the total Montana jurisdictional long-term debt from the Montana

---

[2] The Commission determined that the use of rate base to derive capitalization is the preferred method for calculating the Company's capital structure for ratemaking purposes in Docket No. D2007.7.82, and has implicitly accepted this methodology with the approval of settlements with capital structures derived using this methodology in Docket Nos. D2012.9.94, D2016.9.68, 2018.02.012, and 2022.07.078.

utility average rate base amount. Using this methodology, NorthWestern's capital structure in this filing is 53.19% debt and 46.81% equity.

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

A. The rate base amount used as a proxy for capitalization is $3.90 billion. This amount represents the average test year rate base amount with adjustments for known and measurable changes for the Montana electric and natural gas utilities, excluding the estimated rate base related to YCGS of $300 million and the $19.4 million of rate base reduction agreed to in the Stipulation Agreement in Docket No. D2007.7.82. This calculation is shown on Exhibit CDL-1.

Q. Please explain why you excluded the $19.4 million of rate base reduction ordered in the Stipulation Agreement in Docket No. D2007.7.82 when calculating the capitalization of the Montana Total Utility.

A. The $19.4 million (amortized from the original $38.8 million) rate base reduction was part of the negotiated settlement between the Montana Consumer Counsel and NorthWestern in Docket No. D2007.7.82, and, among other things, it effectively reduced the amount of NorthWestern's revenue requirement in future rate reviews. Therefore, the reduction in revenue requirement resulting from this adjustment results in a lower return <u>on</u> rate base.

Q. Is the exclusion of this stipulated rate base reduction consistent with past Commission orders?

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

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

A. Debt in this calculation reflects Montana jurisdictional secured long-term debt, which is specifically secured by either the electric utility assets or the natural gas utility assets. As of December 31, 2023, Montana Total Utility debt was $2.0 billion. For this filing, we incorporated the $175 million of debt issuance in March of 2024 as a known and measurable change. This debt issuance resulted in a net debt increase of $75 million since the proceeds were used to refinance $100 million of debt that matured in March of 2024. Statement F provides the debt details.

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

A. The unsecured revolving credit facility borrowings have consistently been excluded from the approved capital structure, including in Docket Nos. 2022.07.078, 2018.02.012, D2016.9.68, and D2013.12.85. This precedent continues to be supported by the fact that our secured debt is used for long-term financing and is secured by utility rate-based assets, while the unsecured revolving credit facility debt is used to fund temporary financing needs, which, in our case, includes cash needs related to energy supply purchases, property taxes, construction work in progress, dividends, and other working capital items. This is even more relevant in NorthWestern's case because the rate base amount is being used as the proxy for capitalization (i.e., the denominator of the capital structure calculation). To include the unsecured revolving credit facility borrowings in the capitalization calculation would overstate the amount of debt used to finance that very rate base that is the subject of this regulatory filing.

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

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

A. Consistent with the methodology used in prior dockets and as explained earlier in my testimony on why rate base is used as a proxy for total capitalization, equity is derived by deducting the Montana Total Utility long-term debt from the Montana Total Utility rate base $3.90 billion total rate base less $2.07 billion of long-term debt, which equals $1.83 billion of derived equity. The resulting capital structure is 53.19% debt and 46.81% equity.

Q. Has NorthWestern's capital structure changed materially since the latest rate review?

A. No, it has not. In NorthWestern's 2022 electric and natural gas rate review, the capital structure proposed and accepted was 51.98% debt and 48.02% equity.

Cost of Debt

Q. How did you calculate the cost of debt?

A. For all the debt secured by the Montana electric and natural gas utility assets, the cost of long-term debt is determined by adding the annual interest cost, the annual amortization of debt discount, and the issuance expense associated with each debt component, which is then divided by the long-term debt balance, resulting in a cost of long-term debt of 4.57% (see Statement F).

Q. How does this cost of debt compare to the cost of debt filed in the previous rate review?

A. The cost of debt of 4.57% is higher than the 4.01% filed in the last rate review. As explained earlier in my testimony, due to the higher interest rate environment that we are in, the cost of debt to finance our investments has increased significantly.

Cost of Equity

Q. How did you determine the cost of equity?

A. The cost of equity relies on the analysis performed by Mr. McKenzie, which he explains in his direct testimony. Mr. McKenzie's analysis shows a range of reasonableness of ROE for a proxy group of electric and natural gas utilities of 10.30% to 11.30%, with an estimated mid-point of 10.8%. I agree with Mr. McKenzie's assessment and have used the recommended 10.80% in calculating NorthWestern's proposed ROR.

Q. What is the significance of ratemaking-related financial metrics such as ROE, equity ratio/capital structure, and timeliness and reliability of cost recovery?

A. These ratemaking-related financial metrics – ROE, equity ratio/capital structure, and timeliness and reliability of cost recovery – not only affect NorthWestern's ability to continue to provide safe and reliable utility services, they also affect investors' and credit rating agencies' assessments of NorthWestern's financial strength. I will address each component in turn:

- First, the authorized ROE and capital structure affect NorthWestern's earnings and cash flows, which directly affect its ability to fund capital investment. Together with credit ratings, investors also assess the capital structure and ROE when making judgments about the supportiveness of a regulatory jurisdiction. Thus, the ROE and capital structure combination is a powerful and effective communication tool to underscore the interest of regulators in supporting a utility's ability to attract low-cost financing to provide safe and reliable utility services to customers.
- Second, the capital structure and authorized costs directly affect all key credit metrics because total debt, operating cash flows, and interest expense are all components of the primary credit metrics that rating agencies analyze. The credit rating agencies also evaluate the relative amounts of debt and equity in the capital structure to determine whether a company is appropriately capitalized given its business risk profile and to determine whether the company can make interest payments, repay existing debt, and issue additional new debt to fund

its utility capital expenditures. The credit rating agencies are very concerned with a company's ability to meet its short-term funding needs under conditions of financial stress, and they factor in the debt portfolio maturity schedule and other future obligations as part of their assessments.

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

<u>Wildfire Risk and Impacts on Access to Capital and Insurance</u>

Q. Can you please explain why wildfire risk is a significant risk for utilities?

A. Wildfires present risk to lives and property, risk to utility system infrastructure, and financial liability risk. Utilities, including Pacific Gas and Electric Co., Hawaiian Electric, and PacifiCorp, have been impacted by catastrophic wildfire events, leading to significant financial liabilities for those entities. Like other utilities, NorthWestern is committed to reducing wildfire risk for the safety of our customers and the communities we serve.

Due to recent losses by utilities, credit rating agencies and debt and equity investors are focused on implications of this risk. This focus includes assessments around operating practices, financial exposure including litigation construct, and insurance coverage. Wildfire risk impacts investors' decisions about whether to purchase debt and equity securities and is a factor in how the credit rating agencies are assessing risk of each utility. Equity analysts have also heightened their scrutiny of authorized ROEs and the ability to earn those returns with overall regulatory outcomes. The expectations for the required return, and thus the cost of equity capital, have increased given this environment.

Q. What are the credit implications of wildfire risk for utility companies?

A. S&P describes its concerns around increased wildfire risk in a recent article titled, "North American Wildfire Risks Could Spark Ratings Pressure

For Governments And Power Utilities, Absent Planning And Preparation," provided as Exhibit CDL-6. The article describes how "*strong financial management and balance sheets could help stabilize credit fundamentals*" (page 11), and also how "*in combination with other wildfire risk management strategies, maintaining or increasing property and liability insurance coverage can reduce a utility's financial exposure to physical risks*" (page 15).

S&P also issued a report titled, "A Storm is Brewing – Extreme Weather Events Pressure North American Utilities' Credit Quality," provided as Exhibit CDL-7. This report highlights the importance of cost recovery capabilities for utilities' credit quality:

> However, when the costs become unusually large, regulatory lag--the timing difference between when a utility incurs costs and when it's recovered from ratepayers--increases, the balance sheet leverages, and utilities have even experienced significant disallowances that weaken credit quality. In these instances, we believe the industry hasn't contained the credit risk and the industry is short of protective credit capabilities. As such we believe it's important for the IOU industry to significantly increase and broaden recovery capabilities. Exhibit CDL-7 at 13.

Q. How is wildfire risk addressed in this filing?

A. The Direct Testimony of Jason C. Merkel describes the operational activities and measures being taken to address this risk. Ms. Fang's testimony addresses our proposal for timely recovery of wildfire mitigation costs, including operational costs and insurance costs, through a balancing account. The recovery of these costs is critical to credit quality and ongoing financial health of NorthWestern. To continue to attract capital on reasonable terms, the Company must provide a return that compensates investors for the risk associated with their investment.

Q. Is purchasing insurance for losses and claims related to wildfires necessary and prudent?

A. Yes. Utilities have for many years purchased property and liability insurance to protect against a variety of losses, including loss from wildfires. Property insurance provides coverage for damage to certain utility infrastructure caused by a wildfire. Liability insurance provides coverage for losses incurred as a result of liability claims brought against the company. These costs are reflected in the cost of service component of the revenue requirement.

Q. How is the changing assessment of wildfire risk changing the insurance market for wildfire-related coverage?

A. The market for insurance coverage for utilities is experiencing significant changes, with recent events and resulting losses making it more difficult and expensive for utilities to obtain liability coverage for wildfire losses. Due to the large claims associated with wildfires in California from 2007 – 2022, several insurance companies have stopped offering wildfire liability coverage for California utilities. As the western U.S. has seen more wildfires outside of California, the markets have tightened further. In early

2024, Energy Insurance Mutual ("EIM"), a mutually owned excess liability insurance carrier for utilities and the energy services industry, announced a blanket policy affecting all utility liability renewals in 2024. Beginning this year, EIM is limiting its capacity, resulting in a lower limit of availability of $50 million for Montana from $100 million, while adding an incremental surcharge for less coverage. Other insurance companies are also limiting or not offering coverage for wildfire-related losses in certain states or altogether. Even when coverage is available, costs have increased substantially, even since 2023. S&P's recent report highlights,

> *…in recent years, insurance companies have experienced underwriting losses in property lines, driven by a combination of higher inflation increasing repair costs and more severe weather-related events. Insurers have responded by raising rates and reducing their exposure to residential and commercial property risks in areas exposed to natural catastrophes. This has led to higher insurance premiums and deductibles for policy holders--paying more for less coverage.*" Exhibit CDL-7 at 14-15.

Q. What impact has this had on NorthWestern's insurance coverage for wildfire?

A. NorthWestern's experience with the renewal of its liability policy, which includes coverage for wildfire-related losses, mirrors the experience of the broader utility industry. Certain of NorthWestern's insurance carriers are reducing the coverage they previously provided due to the implementation of blanket policies that affect all their utility clients. Specifically, NorthWestern's liability policy that expired June 30, 2024, included $100 million of coverage from EIM; this coverage is being reduced to $50 million effective with the liability policy renewal on July 1, 2024. Other insurance companies are deciding to offer coverage on a case-by-case basis, taking into account factors like the inherent risk of wildfire in a region due to historical wind speeds and drought conditions, the average property values in the utility's service territory, an assessment of litigation risk, and the robustness of the utility's wildfire mitigation plans and programs. We have worked closely with our underwriters to convey NorthWestern's focus on wildfire mitigation over the last decade and continuing efforts, which has helped to support the availability of insurance coverage, albeit at a higher cost. Future renewals are also expected to be elevated.

Q. Please provide the basis of the cost of property and liability coverage NorthWestern used in the revenue requirements.

A. NorthWestern renews its policies each year on July 1. The test period has been adjusted to include an expected increase of over 200% in total premium, reflecting an industry reset of premiums and coverage effective July 1, 2024. The known and measurable adjustment is included in the Direct Testimony of Elaine A. Rich.

Q. How do NorthWestern's customers benefit from adequate insurance coverage? Are those benefits worth the cost?

A. Obtaining adequate insurance coverage is important for NorthWestern and its customers. NorthWestern's 2024 Wildfire Mitigation Plan identifies the ongoing work to reduce risk of ignition by NorthWestern's infrastructure. However, the risk of a wildfire, just like other risks, cannot be reduced to zero. Insurance protects the Company and its customers in the event a wildfire does occur. As seen with recent wildfires in other states, judgments for claims of liability against the utility can be substantial, even if the cause of the wildfire is contested or not definitive, or the imprudence of the utility is alleged but not proven. Such claims without insurance could be catastrophic for the utility and its customers.

Having adequate insurance coverage is also necessary for NorthWestern to maintain strong credit ratings and be able to attract capital and maintain necessary liquidity. The absence of adequate insurance would greatly increase the credit rating agencies' view of NorthWestern's business risk, which would put substantial pressure on our credit ratings and likely prompt the rating agencies to raise the downgrade thresholds associated with our credit metrics. In maintaining access to capital in all environments, without adequate insurance, banks and debt investors may be less willing to lend to NorthWestern. Insurance coverage is not only a prudent but a necessary cost that allows NorthWestern to continue to invest in its system for the benefit of its customers without dramatically increasing its cost of capital.

Q. Please describe how NorthWestern's proposed Wildfire Balancing Account will work.

A. NorthWestern is proposing to defer incremental wildfire mitigation and insurance costs in the Wildfire Balancing account. The proposal would specifically authorize NorthWestern to include incremental operation and capital costs in the Balancing Account and will be adjusted on a monthly basis consistent with actual eligible costs. As described in Ms. Fang's testimony, an annual filing will be made to update rates. In order to determine the rate impact, a two-year amortization period is proposed consistent with recovery of amounts deferred from the last rate proceeding.

<u>BT Accounting Treatment</u>

Q. What specific Business Technology ("BT") costs is NorthWestern asking for a change in accounting treatment for in this case?

A. NorthWestern is asking for the ability to capitalize costs that are currently expensed associated with cloud computing, Software as a Service ("SaaS"), and subscriptions for technology related to utility operations on a going forward basis, including the incremental amount in a BT Balancing Account. As discussed in the Direct Testimony of Jeanne M. Vold, the use of cloud-based products or applications, SaaS, and subscriptions will continue to grow over time as software vendors move away from offering on premise (On-Prem) solutions. Please refer to Ms. Vold's testimony for further discussion of cloud computing, SaaS, and subscriptions and the difference between these models and traditional On-Prem solutions.

Q. Are cloud, SaaS and subscription costs eligible to be capitalized?

A. Cloud-based and subscription costs are typically expensed unless they qualify as a capital lease. If the SaaS software includes an identifiable cost associated with a license, then that cost may be eligible to be capitalized. In making this determination, it must also be demonstrated that: (1) a contractual right to take possession of the software at any time may occur without significant penalty or loss in functionality; and (2) it is feasible to run the software on the company' s own hardware or contract with another party to do so. Additionally, certain costs, such as implementation and development costs, may be eligible to be capitalized as well. Determining whether a SaaS-type contract contains a license can be difficult, however, as many of these do not contain the level of detail necessary to reasonably make that determination. In those situations, none of the costs under the SaaS-type contract would be capitalized, despite the similarity of the economics to On-Prem contracts that would indicate that a capital component would exist.

Q. Please describe NorthWestern's proposed accounting treatment for cloud computing, SaaS, and subscription costs.

A. NorthWestern is proposing to establish a BT Balancing Account for amounts incremental to amounts included in the revenue requirement in this case that are incurred for third-party cloud computing, SaaS, and subscription costs that are not eligible for capitalization under current accounting rules. We are proposing to use the percentage for capitalization reflective of the typical capital portion of On-Prem technology consistent with our past experience. The proposed accounting treatment is designed to allow for consistent treatment with an On-Prem technology by applying consistent capitalization and including these costs in the BT Balancing Account. The proposed accounting treatment is designed to allow for the capitalization and recovery through the BT Balancing Account what would be the capital portion of third-party costs.

Q. Do NorthWestern's requested rates in this case reflect this proposed accounting treatment?

A. NorthWestern is proposing the above accounting treatment on a prospective basis, beginning with the effective date of rates as a result of this proceeding.

Q. What is the baseline level of cloud computing, SaaS, and subscription costs in this case?

A. Ms. Vold's testimony addresses the baseline level of cloud computing, SaaS, and subscription costs included in this case in the base revenue requirement.

Q. How much of NorthWestern's costs for On-Prem software have been capitalized in the past?

A. The average O&M percentage of NorthWestern's On-Prem software costs is approximately 20%, with approximately 80% capital percentage.

Q. Why is NorthWestern proposing this accounting treatment and balancing account?

A. Ms. Vold's testimony addresses the change in how software is licensed and sold and ultimately the significant increases in technology needed to provide safe, reliable service to customers. The accounting treatment differences drive disparate outcomes between the treatment of comparable On-Prem and cloud, SaaS and subscription based technologies, despite similarities in economics. This proposal is meant to provide a consistent decision-making approach with the same capital versus expense treatment regardless of whether the solution is cloud-based, SaaS, or subscription versus an on On-Prem solution. Moreover, the changes in pricing model of these technologies make it very difficult to determine identifiable license costs, resulting in increased potential for these costs to be recorded as O&M expense as opposed to capital as would occur with On-Prem. Ms. Vold's testimony also addresses the increases in technology costs needed to continue to provide safe, reliable service to customers. It is for these reasons NorthWestern is requesting capitalization with a balancing account.

Q. Please describe industry support for capitalization and how other state commissions have addressed this issue.

A. The proposed accounting is supported by the National Association of Regulatory Commissioners ("NARUC") and the electric trade association Edison Electric Institute ("EEI"). In November 2016, NARUC adopted a resolution in which they encouraged state utility commissions to allow utility companies to include cloud-based software investments in rate base and earn a return on those investments. In February 2022, EEI and Advanced Energy Economy issued a white paper on the accounting treatment of cloud-based costs titled "Reaching for the Cloud: Solutions for Regulatory Parity for Cloud Services for Utilities". This white paper provided as Exhibit CDL-8 discusses the differences in accounting treatment between On-Prem solutions and cloud services and notes:

> For utilities, use of cloud computing represents a more difficult choice, as accounting standards and traditional cost-of-service regulation interact to create adverse financial impacts for utilities that are out of line with the potential greater cost efficiencies and benefits that cloud computing can provide to utility customers." (page 19)

The white paper also provides supporting details regarding state commissions that have addressed the disparity in treatment through a variety of approaches (pages 20-22).

Q. How would the capitalization with the BT Balancing Account work under this proposal?

A. The proposed accounting treatment would specifically authorize NorthWestern to capitalize approximately 80% of these costs, which would make them consistent with the accounting treatment of On-Prem technology. These costs would be capitalized with a return using the approved ROR in this case. The BT Balancing Account will be adjusted on a monthly basis consistent with actual eligible costs, reflecting amounts that would have been capitalized if they were for On-Prem. As described in Ms. Fang's testimony, an annual filing will be made to update rates. In order to determine the rate impact, a five-year amortization period is proposed consistent with general software depreciation lives.

Conclusion

Q. Please summarize your testimony.

A. In this filing, NorthWestern makes the following recommendations:

- An ROR of 7.49% for the Montana Total Utility using a capital structure of 53.19% debt and 46.81% equity, actual debt cost of 4.57%, and a proposed ROE of 10.80%, based on the recommendation of Adrien McKenzie, President of FINCAP, Inc., and as explained in his direct testimony (except for Colstrip Unit 4, which has an ROE of 10.0% and an overall ROR of 8.25%[3]);

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

- Recovery of the YCGS generation facility in a timely manner that reflects the values of services customers receive, which is critical to NorthWestern's financial health;
- Recovery of costs of wildfire mitigation and adequate insurance, which are critical to protect NorthWestern and its customers in the event of a wildfire and are credit supportive, which in turn allows access to capital at lower costs for customers.
- Approval of capitalization of certain technology costs to support the adoption of technologies critical to serve customers.

Q. Does this complete your direct testimony?

A. Yes, it does.

<u>Verification</u>

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

<u>/s/ Crystal D. Lail</u>
Crystal D. Lail