

Prefiled Direct Testimony and Exhibits  
Brian B. Bird

Before the South Dakota Public Utilities Commission  
of the State of South Dakota

In the Matter of the Application of  
NorthWestern Corporation, d/b/a NorthWestern Energy

For Authority to Increase Electric Utility Rates  
in South Dakota

Docket No. EL14-\_\_\_\_\_

December 19, 2014

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## EXHIBITS

Capital Structure Calculation	Exhibit__(BBB-1)
National Average Authorized Return on Equity	Exhibit__(BBB-2)
RRA Report on Major Rate Case Decisions – January to September 2014 dated October 10, 2014	Exhibit__(BBB-3)

1 **Witness Information**

2 **Q. Please state your name and business address.**

3 **A.** My name is Brian B. Bird, and my business address is 3010 W. 69<sup>th</sup> Street,  
4 Sioux Falls, South Dakota 57108.

5  
6 **Q. By whom are you employed and in what capacity?**

7 **A.** I am employed by NorthWestern Energy (“NorthWestern” or “the Company”) as  
8 the Chief Financial Officer.

9  
10 **Q. How long have you been employed in your current position?**

11 **A.** I have been the Chief Financial Officer since December 2003.

12  
13 **Q. What are your responsibilities and duties in your current position?**

14 **A.** I am responsible for the areas of Accounting, Treasury, Tax, Financial Planning,  
15 Investor Relations, Internal Audit, and Business Technology.

16  
17 **Q. Please state your educational background and experience.**

18 **A.** I have 28 years of experience within the fields of corporate finance, treasury, tax,  
19 audit and accounting. I have an MBA – Finance from the University of  
20 Minnesota. I have a BBA from the University of Wisconsin – Eau Claire with a  
21 double major in Accounting and Finance. I also have my CPA certificate.

1 **Purpose of Testimony**

2 **Q. What is the purpose of your testimony?**

3 **A.** My testimony discusses the capital structure, cost of debt, and cost of equity  
4 requested by NorthWestern in this proceeding.  
5

6 **Q. What are your conclusions?**

7 **A.** The following is a summary of my conclusions regarding the overall cost of  
8 capital for the electric utility in South Dakota:

- 9 • The capital structure recommended is 46.4% debt and 53.6% equity;
- 10 • The cost of debt is 5.18%;
- 11 • The cost of equity is 10.00%; and
- 12 • The rate of return is 7.76%.

13 This summary is shown on Statement G, page 1 of 4.  
14

15 **Capital Structure**

16 **Q. Please describe the methodology used to calculate the capital structure**  
17 **recommended in this case.**

18 **A.** Consistent with the methodology used in NorthWestern's 2011 South Dakota  
19 natural gas rate case (Docket No. NG11-03), I derived the regulated capital  
20 structure using the total long-term debt and total rate base amounts associated  
21 with the company's South Dakota and Nebraska utility businesses. The equity  
22 amount is derived by deducting the total debt amount from the total rate base  
23 amount. Since none of the debt issued for the South Dakota/Nebraska utility

1 businesses is specifically assigned to either South Dakota or Nebraska or used  
2 solely for the electric utility or the natural gas utility, the capital structure of the  
3 combined South Dakota/Nebraska utility business should be representative of  
4 the capital structure of the South Dakota electric utility.

5  
6 **Q. Using this methodology, what capital structure are you proposing in this**  
7 **case?**

8 **A.** In this case, I used the total rate base amount for the combined utility of \$536.7  
9 million, which is comprised of the adjusted 13-month average rate base for the  
10 South Dakota electric utility of \$447.4 million (See Statement M page 1 of 1), the  
11 13-month average rate base for the South Dakota natural gas utility of \$63.6  
12 million, and the 13-month average rate base for the Nebraska natural gas utility  
13 of \$25.7 million for the period ending September 30, 2014. For the debt amount,  
14 I used the total debt associated with the South Dakota/Nebraska utility as of  
15 September 30, 2014 of \$219 million and added debt of \$30 million to reflect a  
16 planned debt issuance (to support capital expenditures to date for the South  
17 Dakota and Nebraska utilities) before the end of 2014 to derive a total debt  
18 amount of \$249 million (see Statement G, page 2 of 4). The capital structure  
19 calculated using these amounts is 46.4% debt and 53.6% equity and is the  
20 capital structure I am proposing in this case (see Exhibit\_\_(BBB-1.)

21  
22 **Q. What other methodologies have you used to validate this proposed capital**  
23 **structure?**

1 **A.** I have used two other methodologies, as shown in Exhibit\_\_(BBB-1), to  
2 approximate the capital structure of the South Dakota electric utility:  
3 a) The consolidated capital structure of NorthWestern Corporation as of  
4 September 30, 2014 is 51.8% debt and 48.2% equity using the total long-  
5 term debt and the total shareholders' equity of the consolidated entity;  
6 b) The divisional capital structure of the South Dakota/Nebraska utility  
7 businesses is calculated to be 45.4% debt and 54.6% equity (pro forma  
8 for the \$30 million of planned debt issuance). Since the South  
9 Dakota/Nebraska jurisdictional debt is proportionally allocated to all three  
10 businesses, the book capitalization of the South Dakota/Nebraska division  
11 is representative of the book capitalization of the South Dakota electric  
12 utility.

13  
14 **Q. Please explain why you are not using the consolidated capital structure for  
15 NorthWestern as your proposed capital structure.**

16 **A.** Looking at the results of the different methods used to approximate the capital  
17 structure of the South Dakota electric utility and the fact that the book capital  
18 structure is relatively close to the debt to rate base capital structure, it is evident  
19 that the consolidated capital structure of NorthWestern Corporation overstates  
20 the leverage of its South Dakota electric utility business. NorthWestern's higher  
21 consolidated debt to capitalization ratio is a reflection of the company's  
22 significant investments in its Montana jurisdictional assets. In order to accurately  
23 represent the capital structure of the South Dakota electric utility business, I

1 believe the debt to rate base method is the most appropriate method to use for  
2 ratemaking purposes.

3  
4 **Q. Do you apply the same methodology in your rate filings in Montana?**

5 **A.** Yes. In our last Montana natural gas rate case (Docket No. D2012.9.94), we  
6 used a 52% debt to rate base as our capital structure.

7  
8 **Q. How does this capital structure compare to the capital structure proposed**  
9 **by NorthWestern in the last natural gas rate case filed in South Dakota?**

10 **A.** In the last natural gas rate case filed by NorthWestern in 2011, the proposed  
11 capital structure was 43.9% debt and 56.1% equity, slightly higher in terms of the  
12 equity component than the 46.4% debt and 53.6% equity proposed here.

13  
14 **Cost of Debt**

15 **Q. Please explain the debt amount used in calculating the capital structure**  
16 **presented in this case.**

17 **A.** For the long-term debt existing as of September 30, 2014, I used the total debt  
18 directly secured by assets of the combined electric and natural gas utilities in  
19 South Dakota and Nebraska, which was equal to \$219.0 million. Then, I added  
20 \$30 million of incremental long-term debt expected to be issued in December  
21 2014 for the combined utility businesses in South Dakota/Nebraska as a known  
22 and measurable change to the total long-term debt (see Statement G, page 2 of  
23 4.) The \$30 million of long-term debt is intended to support the capital growth of

1 the combined utility businesses in South Dakota/Nebraska and is the appropriate  
2 amount of debt that will allow NorthWestern to maintain its current conservative  
3 leverage structure for the South Dakota/Nebraska utilities.

4  
5 **Q. How did you determine the cost of debt?**

6 **A.** To derive the total annual cost of long-term debt, I added the annual interest cost  
7 and the annual amortization of debt discount and issuance expense associated  
8 with each debt component (see Statement G, page 2 of 4). I then divided the  
9 total annual cost of long-term debt by the pro forma long-term debt outstanding  
10 of \$249.0 million and determined a weighted average cost of long-term debt of  
11 5.18%.

12  
13 **Q. What debt cost did you assume for the \$30 million of new debt anticipated  
14 in this filing?**

15 **A.** The all-in cost of debt assumed for the new \$30 million debt is 4.50%. This rate  
16 is based on NorthWestern's credit profile and current market conditions and  
17 assumes a 30-year secured financing in December 2014. The 4.50% rate is  
18 comprised of an implied forward 30-year Treasury rate at December 2014 as  
19 provided by investment bankers of 3.40% plus a credit spread in the range of  
20 1.05% to 1.25% and debt issuance expense amortization of 0.03%.

21 NorthWestern requests the right to update this rate based on the actual debt cost  
22 prior to finalizing this docket.

23



1 **Q. How is your cost of debt different from the cost of debt in your last filing?**

2 **A.** The cost of debt filed in our last South Dakota natural gas rate case in 2011 was  
3 5.83%, substantially higher than the 5.18% in this filing. The cost of debt filed in  
4 our last South Dakota electric rate case in 1980 was 8.46%.

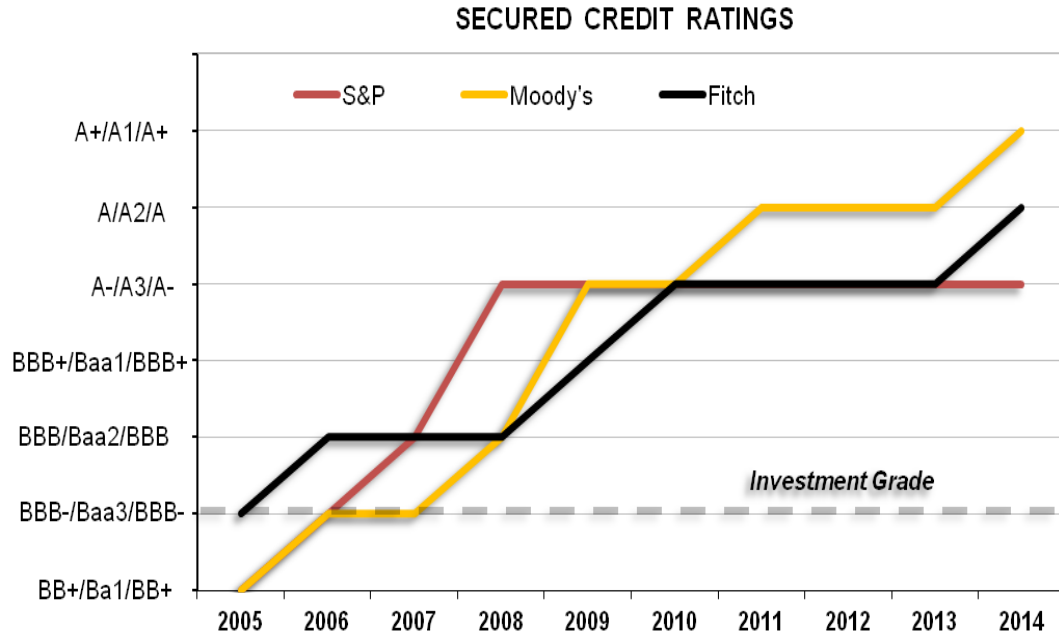
5  
6 **Q. How did NorthWestern reduce its cost of debt?**

7 **A.** Over the last ten years, NorthWestern has proactively accessed the debt  
8 markets to refinance its long-term debt at lower market rates. In May 2008, the  
9 Company refinanced \$55.0 million of South Dakota utility first mortgage bonds  
10 and reduced the interest rate on the bonds from 7.00% to 6.05%. In May 2010,  
11 the Company also refinanced \$64.0 million of South Dakota utility first mortgage  
12 bonds and reduced the interest rate on the bonds from 5.88% to 5.01%. In  
13 addition, NorthWestern was able to take advantage of the historically low interest  
14 rate environment in the last three years by issuing a total of \$100 million of debt  
15 with a weighted average maturity of 32 years at an average debt cost of 4.55%.

16  
17 **Q. How else has NorthWestern improved its financial position since the last  
18 rate case?**

19 **A.** NorthWestern's lower debt cost is not entirely driven by the current lower interest  
20 rate environment. By strengthening its balance sheet and cash flows, the  
21 Company was able to support a steady improvement in its credit ratings, thereby  
22 lowering its borrowing costs through lower credit spreads. Below is a chart

1 showing the improvement in the Company's credit ratings in the last 10 years,  
 2 and now at credit ratings on par with average utility credit ratings.



<u>Agency</u>	<u>Secured</u>	<u>Unsecured</u>	<u>Outlook</u>
Standard & Poor's	A-	BBB	Stable
Moody's Investor Services	A1	A3	Stable
Fitch Ratings	A	A-	Stable

3 In addition, from 2012 through early 2014, NorthWestern was able to raise \$100  
 4 million of equity through an equity dribble program. An equity dribble program  
 5 allows a company to raise equity capital opportunistically by selling small  
 6 amounts of shares into the market on an as-needed basis and at certain prices.  
 7 The Company was also able to grow its business by making strategic  
 8 investments in regulated businesses. All of these contributed to the  
 9 improvement in credit ratings as shown above.

1 **Q. How will the lower debt cost benefit customers?**

2 **A.** Every dollar saved in debt cost is a direct benefit to ratepayers. As a percentage  
3 of customer bill, debt cost is now only 6.8% of a customer's total bill (based on  
4 the current filing) versus 20.2% in 1981. The combination of a lower interest rate  
5 environment, an improved credit profile, and proactive debt management has  
6 provided this benefit to customers.

7

8 **Cost of Equity**

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

10 **A.** I relied on the analysis performed by Adrien McKenzie of FINCAP, LLC, which is  
11 explained in his prefiled direct testimony. Mr. McKenzie's analysis shows a  
12 range of reasonableness for return on equity ("ROE") – using an electric utilities  
13 only proxy group and a low-risk non-utility firms proxy group – to be 9.7% to  
14 11.3%, with a midpoint of the range of 10.64%, inclusive of flotation cost. I agree  
15 with Mr. McKenzie's analysis and recommend using an ROE of 10.00% in  
16 calculating NorthWestern's rate of return.

17

18 **Q. Do you believe that Mr. McKenzie's recommended ROE of 10.64% is fair  
19 and reasonable?**

20 **A.** Yes.

21

1 **Q. Please explain why you are proposing a 10.0% ROE, which is below Mr.**  
2 **McKenzie's recommended ROE of 10.64%, for NorthWestern's electric**  
3 **utility operations.**

4 **A.** While we have made significant capital investments in our South Dakota electric  
5 utility operations for the purpose of providing clean and reliable energy to our  
6 customers, we are also cognizant of the rate impact these investments will have  
7 on our customers. As such, I am proposing a 10.0% ROE in this filing mainly to  
8 help minimize the rate increase impact to our customers. The 10.0% ROE is still  
9 within the range of reasonableness for ROEs based on Mr. McKenzie's analysis,  
10 though on the low end of the range.

11  
12 **Q. How does the 10.00% cost of equity proposed in this case compare to**  
13 **ROEs authorized in recent rate cases?**

14 **A.** The 10.00% ROE proposed herein is conservative compared to the following  
15 benchmarks:

16 • Based on information from SNL Financial, from January 2010 to  
17 September 2014, an average of 47 electric rate cases per year have been  
18 finalized with an average authorized ROE of 10.16% and an average of  
19 26 natural gas rate cases per year have been finalized with an average  
20 authorized ROE of 9.85%. The average difference between electric and  
21 natural gas authorized ROEs was 31 basis points. Please refer to  
22 Exhibit\_\_(BBB-2) for the supporting data.

- 1           • Based on a report published by the Regulatory Research Associates on  
2           Major Rate Case Decisions (included in Exhibit\_\_(BBB-3)), the average  
3           ROE authorized for electric utilities in the first three quarters of 2014 was  
4           10%; and
- 5           • Based on electric rate cases recently filed with the South Dakota Public  
6           Utilities Commission (“SDPUC”), NorthWestern’s proposed ROE of  
7           10.00% is below the filed electric ROEs from the other utilities in this  
8           jurisdiction. More importantly, this conservative ROE of 10.0% would  
9           result in one of the lowest RORs currently filed with the SDPUC. In fact, it  
10          would be the lowest of all currently filed RORs if all South Dakota utilities  
11          used fixed-rate (i.e., non-floating) long-term debt, which we believe is the  
12          prudent thing to do in this historically low long-term interest rate  
13          environment.

<u>COMPANY</u>	<u>Docket No.</u>	<u>Date Filed</u>	<u>RoE</u>	<u>RoR</u>	<u>Cap Structure Debt/Equity</u>
Black Hills Power	EL14-026	3/31/2014	10.25%	8.48%	46.7%/53.3%
Xcel	EL14-058	6/23/2014	10.25%	7.84%	46.1%/53.9%
MidAm	EL14-072	8/4/2014	10.70%	7.59%*	49.2%/50.8%
NorthWestern		To be filed	10.00%	7.76%	46.6%/53.4%

\*Mid-American’s low ROR is a result of a low overall cost of debt driven by the company’s use of floating-rate debt. The use of floating-rate debt may provide the benefit of low debt cost in the near term. However, such interest rate structure exposes customers to potential interest rate hikes in the future and, therefore, may impact the company’s ability to provide long-term rate stability to customers.

14   **Q.   What is your view of an authorized ROE that is below 10%?**

15   **A.**   I believe a low ROE, especially one that is below the market average, has a  
16          number of potential negative implications:

- First, utilities are currently living in an era of high capital investments due to environmental compliance requirements and the need to improve system integrity and reliability. As such, the competition for capital is intense. A utility with a low authorized ROE would be deemed to be a less desirable investment compared to another utility with a higher authorized ROE, all else being equal;
- A low authorized ROE may give the perception of a “difficult regulatory environment”, which in turn may affect both debt and equity capital costs;
- A low authorized ROE amplifies the effects of regulatory lag and forces a utility to require more frequent rate cases to catch up on the lag; and finally,
- A low authorized ROE could lessen the utility’s incentive to invest in this jurisdiction versus the other states in which it operates.

### Rate of Return

**Q. How did you determine the overall cost of capital required for the electric utility in South Dakota?**

**A.** The overall cost of capital required for the electric utility in South Dakota is derived from the cost of long-term debt and cost of equity appropriate for the utility, weighted by the percentage of debt and equity in the proposed capital structure. The calculation of the weighted average cost of capital is shown on Statement G, page 1 of 4. As indicated on the statement, the weighted average cost of capital (rate of return) is 7.76%.

1 **Q. How does your proposed rate of return of 7.76% compare to recent**  
2 **authorized rates of return for utilities in South Dakota?**

3 **A.** The following table shows that, due to our low debt costs and lower requested  
4 cost of equity, NorthWestern's filed rate of return is in line with rates of return  
5 authorized for other utilities in South Dakota in recent rate cases (2013 through  
6 today):

	Docket No.	Filed Cost of Debt	Filed Common Equity/ Total Capitalization	<b>Authorized Rate of Return</b>
Black Hills Power (Electric)	EL12-061	6.59%	53.2%	<b>7.93%</b>
Northern States Power (Electric)	EL12-046	6.12%	52.9%	<b>7.78%</b>
Montana-Dakota Utilities (Natural Gas)	NG12-008	5.68%	52.8%	<b>7.60%</b>
NorthWestern Energy (Electric)	To be filed	5.18%	53.6%	<b>7.76%</b>

7 Furthermore, the 7.76% ROR requested in this application is below the current  
8 authorized ROR for our South Dakota gas utility operations of 7.79%.

9

10 **Q. Does this conclude your testimony?**

11 **A.** Yes, it does.