BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF SOUTH DAKOTA

APPLICATION OF BLACK HILLS POWER, INC. FOR AN INCREASE IN ELECTRIC RATES	)))

DIRECT TESTIMONY OF GARNER M. ANDERSON

I. INTRODUCTION AND QUALIFICATIONS

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Garner M. Anderson. My business address is 625 Ninth Street, Rapid City, South Dakota, 57701.

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

A. I currently serve at Black Hills Corporation as Vice President and Treasurer. I am also the Treasurer for all of Black Hills Corporation's subsidiaries, including Black Hills Power, Inc.

Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS DOCKET?

A. I am appearing on behalf of Black Hills Power, Inc. ("Black Hills Power" or "Company"), a subsidiary of Black Hills Corporation.

Q. WOULD YOU BRIEFLY DESCRIBE YOUR DUTIES AND RESPONSIBILITIES IN YOUR CURRENT POSITION?

A. I am responsible for the Finance and Treasury Management functions at Black Hills Corporation and all of its subsidiaries. These functions include the short-term borrowing programs, such as bank credit lines, rating agency relationship management and long-term financial planning and capital strategies and optimization.

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

A. I have a BS in Business Administration from the University of South Dakota and an MBA in Finance from Arizona State University. I am also a Certified Public Accountant. I have been employed by Black Hills Corporation for over 18 years. I have served as Director of Treasury Services and Risk Manager for the company. I was appointed to my current position as Vice President and Treasurer in July 2003. Prior to working at Black Hills Corporation, I was employed in public accounting.

II. PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to support the recommended capital structure, the Company's estimated cost of short term debt of 5.09%, estimated cost of long term debt of 7.57%, the recommended cost of equity ~~ca~~pital of 11.75%, and the resulting weighted average cost of capital of 9.83% which Black Hills Power is requesting in this proceeding.

Q. MR. ANDERSON, ARE YOU SPONSORING ANY EXHIBITS?

A. Yes, I am. I am sponsoring Exhibit Nos. GMA-1, GMA-2 and GMA-3 which I will describe and refer to in my testimony.

Q. HAVE THE TESTIMONY AND EXHIBITS WHICH YOU ARE SPONSORING BEEN PREPARED BY YOU OR UNDER YOUR SUPERVISION?

A. Yes, they have.

III. FINANCIAL INTEGRITY

Q. PLEASE EXPLAIN FINANCIAL INTEGRITY.

A. Financial integrity is essential to maintain the Company's ability to access capital as needed at a reasonable cost, which in turn is critical to Black Hills Power's ability to satisfy its obligation to supply safe and reliable electric services. Financial integrity is described as the financial stability necessary to weather the peaks and valleys of business cycles, volatility in financial markets and interest rates, and unanticipated changes in operational requirements, all of which may strain an organization's ability to finance expenditures and provide quality service. A strong financial position provides the financial flexibility necessary to meet the ongoing demand for utility services.

Q. HOW DO INVESTORS EVALUATE A COMPANY'S FINANCIAL INTEGRITY?

A. Investors generally rely on nationally recognized credit rating services to evaluate a company's financial integrity and to inform them of the company's current financial position. The two most important nationally recognized credit rating services are Moody's Investors

Service ("Moody's") and Standard and Poor's ("S&P"). Currently, Black Hills Power's issuer rating is Baa2 and BBB- by Moody's and S&P, respectively; Black Hills Power's senior secured debt (first mortgage bonds) are respectively rated Baa1 and BBB.

Q. HOW DO RATING AGENCIES PERFORM THIS FUNCTION?

A. A company requesting a public credit rating provides a financial and operational overview to rating agencies for their analysis to obtain credit ratings for the company's securities. These agencies compare quantitative measures of a company's financial performance, as well as a qualitative assessment of the company's risks, to their guidelines to rate the company and determine the investment attributes of its debt securities. The credit ratings given by these agencies provide important information for investors reviewing the company as a potential investment.

Q. WHAT CRITERIA DO RATING AGENCIES USE IN EVALUATING A UTILITY?

A. As noted, the ratings evaluation process includes an analysis of both qualitative and quantitative factors. Moody's has provided the following overview of its general ratings methodology:

> "Moody's framework for rating regulated electric utilities is constructed around a number or credit risk factors rather than on any one particular metric such as a financial ratio.

The first step is to assess the extent of a "regulated" company's exposure to unregulated businesses. The strongest position is enjoyed by those companies operating in a wholly regulated business. However, the majority of the companies we consider in this sector have additional exposure to unregulated businesses, whether those are unregulated power generation or supply activities or non-electric unregulated businesses.

The second step in the methodology is to assess the credit support that is gained from operating within a particular regulatory framework. Moody's considers each regulatory system and assesses whether there is a high or low expectation of predictability in the system and whether operators can reasonably expect to recover their costs and investments through regulator-approved revenue increases.

The third step is to consider the exact level of risk posed by the unregulated business. Note that a relatively small, but high-risk, unregulated business has the capacity to cause a major credit deterioration for the entity as a whole.

This then leads to an overall assessment of the qualitative business risk of the company's activities."[1]

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[1] Moody's Investors Service "Rating Methodology: Global Regulated Electric Utilities," (October 2005).

As part of the quantitative assessment of a given entity, the rating agencies will review numerous financial ratios of a given entity. Such ratios will be used to review trends over various periods of time within a given entity, as well as to provide comparisons among other companies in given industry, or among various industry averages. Moody's has identified four primary ratios that are considered most useful in completing ratio analysis for electric companies. They are: 1) Debt/Capital, 2) Funds From Operations ("FFO") Interest Coverage, 3) FFO/Debt and 4) Retained Cashflow (FFO-dividends)/Debt. *Id.* at [1].

Moody's notes that, "However, the importance of ratio analysis can be overstated. No two companies look exactly alike from a qualitative assessment standpoint and each company we rate is constantly changing. It is impossible to assign an accurate credit rating on the basis of financial ratio analysis alone, even less so on the basis of any one ratio. Therefore, Moody's does not have any specific "hurdle rate" to explain which ratio will make the difference between any two rating categories." *Id.* at [1].

Q. HOW DOES BLACK HILLS POWER'S FINANCIAL INTEGRITY COMPARE TO THAT OF OTHER COMPANIES?

A. As mentioned above, Black Hills Power has an issuer credit rating of Baa2 and BBB-. In comparison to other entities in the utility sector, these ratings are slightly below average to below average. (Of the over 300 U.S. electric, water and gas utilities on which Standard &

Poor's provides long-term ratings, the percentage by ratings category are as follows: 3% AA; 26% A; 55% BBB; 16% BB or below.)[2] Of particular note is our BBB- rating from Standard & Poor's, which is on negative outlook. The rating outlook is the agency's assessment of the potential direction of a credit rating over the intermediate to longer term. (Each long-term credit rating is given a "Positive," "Stable," "Negative" or "Developing" outlook in addition to the overall rating. It is often an indication of the direction of future credit ratings changes.)

I believe the financial integrity of Black Hills is very sound; however, it has been my goal to improve our credit metrics to a level to provide for an improvement in our credit ratings, particularly with Standard & Poor's. In S&P's ratings hierarchy, the BBB- rating is the lowest investment grade level. Any downgrade from this level would be considered a change to a "junk," or a non-investment grade rating. If Black Hills Power's issuer rating were to be downgraded to a non-investment grade level, it would result in an increase in interest costs on future debt issuances, and could adversely impact our ability to access additional capital, whether debt or equity.

As part of our long-term objective to improve our credit rating and/or ratings outlook with Standard & Poor's, and to, at a minimum, maintain our existing credit rating level with Moody's, we have

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[2] Standard & Poor's, "Industry Report Card: U.S. Utilities See Strong Start in 2006, But Steam May Run Out," *Ratings Direct*, p.3 (April 21, 2006).

maintained a conservative debt to capitalization level (GAAP basis) of approximately 46%, as of December 31, 2005. As a means of protecting our credit ratings, we expect to continue to maintain this somewhat conservative level of capitalization in the future. Exhibit GMA-3 shows how Black Hills' key credit metrics compare to the suggested range for those ratings, as provided by Moody's. In general, the credit metrics are in the range of a Baa Medium rating, which is precisely where Moody's has rated Black Hills.

Q. HOW DOES THIS AFFECT THE RETURNS THAT EQUITY INVESTORS EXPECT?

A. Potential equity investors consider a company's degree of financial integrity when determining if they are willing to buy a company's common stock at a given price. As residual owners (i.e., they receive a return only after debt holders and preferred stock holders), equity holders are significantly concerned with financial integrity. Equity holders anticipate a return on their investment that is commensurate with their perception of the risk being taken by making that investment. The average U.S. electric utility rating is Baa1. Because Black Hills Power is a relatively small company in comparison to most U.S. utilities, and because of its lower than average credit ratings, equity investors view Black Hills Power as an above average risk and will have a correspondingly higher than average required return on equity.

It is our estimate that the cost of equity capital is 11.75%, based on the evaluation (with which we concur) conducted by William E. Avera and outlined in his testimony.

Q. HOW DO THE RATINGS AFFECT THE COMPANY'S ABILITY TO ISSUE DEBT?

A. The ratings affect a company's ability to issue debt in a couple of ways. First, the lower the rating the greater the risk premium required from those willing to invest in a company, and second, a low rating also limits the number of potential investors interested in a company's debt which reduces the market for the company's debt. Both of these circumstances tend to increase the overall cost of debt to a company.

Q. WHY IS THIS IMPORTANT TO BLACK HILLS POWER?

A. Access to capital is important to provide additional funds for expansion of plant and the potential acquisition of additional generation for Black Hills Power.

V. CAPITAL STRUCTURE

Q. WHAT IS THE CAPITAL STRUCTURE YOU ARE PROPOSING FOR BLACK HILLS POWER?

A. I propose a capital structure of 54.3% common stock equity and 45.7% debt.

Q. HOW DOES THIS CAPITAL STRUCTURE COMPARE TO OTHERS IN THE INDUSTRY?

A. Based on the most recently available company-specific data published by Moody's, it is within the range of those of other U.S. vertically integrated electric utilities having the same credit rating as Black Hills Power (the ratings group were those utilities with a Baa1 Sr. Debt rating). The range was from 35% equity as a percent of total capital to 60% equity as a percent of total capital; the average was 50%.[3]

Q. WHY IS THIS CAPITAL STRUCTURE APPROPRIATE FOR BLACK HILLS POWER?

A. This capital structure is appropriate because of the financial position and relative small size of Black Hills Power and the need to lower the risk profile in order to improve credit ratings and to attract cost effective sources of capital for plant improvement and growth.

VI. COST OF CAPITAL

Q. WHAT IS THE COST OF DEBT FOR BLACK HILLS POWER?

A. The cost of debt for Black Hills Power is 7.54%.

Q. HOW DID YOU DETERMINE THE COST OF DEBT FOR BLACK HILLS POWER?

A. Exhibits GMA-1 and GMA-2 present the method used to determine the cost of debt. Essentially, it is a calculation of the weighted average cost of outstanding debt.

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[3] Moody's Investors Service "Moody's Sourcebook, Power and Energy Company" (October 2004) at xliv.

Black Hills Power has $157.2 million of existing long-term debt outstanding as of December 31, 2005. Exhibit GMA-2 provides a detail schedule of the individual issues and respective interest rates and amount of long-term debt outstanding as of December 31, 2005. The average cost of long-term debt is determined by taking the weighted average of the amount of the individual debt issue components and their respective interest rates (adjusted for issuance costs). In addition, Black Hills Power had $1.8 million of notes payable to related parties as of December 31, 2005, at a rate of 5.09%.

The overall cost of debt calculation is thus determined by taking the weighted average of 1) the amount and average cost of long-term debt and 2) the amount and cost of notes payable to associated companies.

Q. WHAT IS YOUR OUTLOOK FOR INTEREST RATES?

A. My outlook for interest rates is during the 2006-2008 period is that the ten-year Treasury bond yield will increase from the current rate of approximately 5.2% to a rate somewhere between 5.3% to 6.3%.

Q. WHAT ARE OTHER OPTIONS FOR FINANCING BLACK HILLS POWER'S CAPITAL NEEDS?

A. A portion of preferred stock financing would be an alternative for Black Hills Power's capital structure, although given Black Hills Power's relatively small size I feel such an issue would not be a very efficient form of financing. In addition, Black Hills Power has not historically used preferred stock as a source of new capital. We have found it to be more cost-effective to issue debt and common stock to meet our capital funding needs.

Q. WHAT IS THE WEIGHTED AVERAGE COST OF CAPITAL REQUESTED FOR BLACK HILLS POWER?

A. The weighted average cost of capital requested for Black Hills Power incorporates the cost of equity of 11.75%, the weighted average embedded cost of debt of 7.54%, and a capital structure of 54.3% equity and 45.7% debt financing. This calculation results in a weighted average cost of capital of 9.83%. The result is presented in Exhibit GMA-1.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.