

Direct Testimony and Exhibits
Brian G. Iverson

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

In the Matter of the Application of
Black Hills Power, Inc., a South Dakota Corporation

For Authority to Increase Rates
In South Dakota

Docket No. EL12-____

December 17, 2012

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Exhibit BGI - 2: List of Subsidiaries and Classification

Exhibit BGI - 3: Black Hills Power Historical Debt Structure

Exhibit BGI - 4: Black Hills Corporation Credit Ratings

1 **I. INTRODUCTION AND QUALIFICATIONS**

2 **Q. WHAT IS YOUR NAME AND BUSINESS ADDRESS?**

3 A. My name is Brian G. Iverson. My business address is 625 9th Street, Rapid City,
4 South Dakota 57709.

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

6 A. I am currently employed by Black Hills Corporation (“Black Hills Corporation”)
7 as Vice President and Treasurer.

8 **Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS APPLICATION?**

9 A. I am appearing on behalf of Black Hills Power, Inc. (“Company” or “Black Hills
10 Power”), a wholly-owned direct subsidiary of Black Hills Corporation.

11 **Q. PLEASE DESCRIBE YOUR DUTIES AND RESPONSIBILITIES IN YOUR
12 CURRENT POSITION.**

13 A. In my role, I am responsible for the financing activities of Black Hills Corporation
14 and its subsidiaries and affiliates, including Black Hills Power.

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

17 A. I have a B.S. degree in Accounting and a M.B.A. from the University of South
18 Dakota. I am a Certified Public Accountant (South Dakota). I also have a law
19 degree from the University of South Dakota.

20 I have been employed by Black Hills Corporation since 2004, working in various
21 positions within the legal, regulatory and resource planning areas. Prior to joining

1 Black Hills Corporation, I worked in the banking industry and in the private
2 practice of law, where I focused on business and financial transactions.

3 **II. PURPOSE OF TESTIMONY**

4 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

5 A. The purpose of my testimony is to support the following areas of the rate
6 application:

- 7 • Provide an overview and discuss the corporate structure of Black Hills
8 Corporation
- 9 • Discuss the Corporate Financial Integrity and Philosophy of Black Hills
10 Power
- 11 • Support Proposed Capital Structure of Black Hills Power
- 12 • Support Long Term Debt and Cost of Equity
- 13 • Discuss the Cost of Debt
- 14 • Support Weighted Average Cost of Capital

15 **Q. ARE YOU SPONSORING ANY EXHIBITS?**

16 A. Yes. I am sponsoring Exhibits BGI -1 to BGI – 4, which I will describe and refer
17 to in my testimony. The Exhibits attached to this testimony are as follows:

- 18 • **Exhibit BGI - 1:** Organizational Chart for Black Hills Corporation
- 19 • **Exhibit BGI - 2:** List of Subsidiaries and Classification
- 20 • **Exhibit BGI - 3:** Black Hills Power Historical Debt Structure
- 21 • **Exhibit BGI - 4:** Black Hills Corporation Credit Ratings

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

4 A. Yes.

5 **III. BLACK HILLS CORPORATION**

6 **Q. PLEASE PROVIDE A BRIEF DESCRIPTION OF BLACK HILLS**
7 **CORPORATION.**

8 A. Black Hills Corporation is a diversified energy company with a 129 year history
9 that is headquartered in Rapid City, South Dakota. Black Hills Corporation
10 operates as a “holding company” under the Public Utility Holding Company Act
11 of 2005. It operates principally in the United States with two major business
12 groups: 1) Utilities – which deliver retail electric and natural gas service, and 2)
13 Non-regulated Energy – which is involved in various wholesale energy businesses.

14 **Q. WHAT IS BLACK HILLS CORPORATION’S BUSINESS PHILOSOPHY?**

15 A. Black Hills Corporation is a strong, diversified energy company that holds itself to
16 a high standard of customer service and strives to provide safe, reliable and
17 affordable service to its customers. Black Hills Corporation and its subsidiaries
18 are active partners in the communities they serve and work diligently to be a
19 positive source of support within those communities.

1 **Q. WHAT IS THE RELATIONSHIP BETWEEN BLACK HILLS**
2 **CORPORATION AND BLACK HILLS POWER?**

3 A. Black Hills Power is a wholly-owned subsidiary of Black Hills Corporation.
4 Black Hills Power is a component of Black Hills Corporation's Utilities Business
5 Segment. Attached as Exhibit BGI - 1 is the organizational chart for Black Hills
6 Corporation and its subsidiaries. Attached as Exhibit BGI - 2 is the listing of
7 subsidiaries and the classification of those subsidiaries into the two major business
8 groups - Utilities and Non-regulated Energy.

9 **Q. WHAT OTHER UTILITIES ARE OWNED BY BLACK HILLS**
10 **CORPORATION?**

11 A. In January 2005, Black Hills Corporation acquired Cheyenne Light, Fuel and
12 Power Company ("Cheyenne Light"), which provides both electric and natural gas
13 services. Cheyenne Light is a regulated utility and serves approximately 38,700
14 electric and 32,500 natural gas customers in Cheyenne, Wyoming, and parts of
15 Laramie County, Wyoming. In July 2008, Black Hills Corporation acquired the
16 natural gas assets of Aquila, Inc. in Nebraska, Kansas, Colorado and Iowa, and the
17 electric utility assets of Aquila, Inc. in Colorado. Those entities serve
18 approximately 523,000 natural gas customers in Nebraska, Kansas, Colorado and
19 Iowa and 92,000 electric customers in Colorado.

1 **IV. FINANCIAL INTEGRITY OF BLACK HILLS POWER**

2 **Q. PLEASE EXPLAIN THE CORPORATE FINANCE PHILOSOPHY OF**
3 **BLACK HILLS POWER.**

4 A. The corporate philosophy of Black Hills Power is the same philosophy established
5 by Black Hills Corporation. That corporate philosophy is that Black Hills Power
6 must maintain financial integrity and its ability to access capital as needed at a
7 reasonable cost. Financial integrity is critical to Black Hills Power's ability to
8 satisfy its obligation to supply safe and reliable electric services. Black Hills
9 Power defines financial integrity as the financial stability necessary to weather the
10 peaks and valleys of business cycles, volatility in financial markets and interest
11 rates, and unanticipated changes in operational requirements, all of which may
12 strain an organization's ability to finance expenditures and provide quality
13 service. A strong financial position provides the financial flexibility necessary to
14 meet the ongoing demand for utility services. Black Hills Power is conservative in
15 its financial philosophy and only takes on risk where appropriate and reasonable.
16 Even with a conservative corporate finance philosophy, no corporation is insulated
17 from market forces, credit crunches, and other financing difficulties that cannot be
18 foreseen or avoided. In those situations, Black Hills Power follows the guidelines
19 of prudence and reasonableness in evaluating its credit and financing options.

20 **Q. WHAT IS BLACK HILLS POWER'S CAPITAL STRUCTURE?**

21 A. Black Hills Power's expert witness, Dr. William Avera, provides in his testimony
22 a detailed analysis in support of the recommended capital structure. My testimony

1 supports the utilization of Black Hills Power's actual capital structure of 53.17
2 percent equity and 46.83 percent debt. It is important for Black Hills Power to
3 maintain this actual capital structure since it will be financing construction of the
4 Cheyenne Prairie Generating Station ("CPGS"). Maintaining Black Hills Power's
5 actual capital structure will support its credit worthiness and provide the Company
6 with reasonable access to the credit markets.

7 As a means of protecting its credit ratings, Black Hills Power generally maintains
8 and will continue to maintain a capitalization level (GAAP basis) of
9 approximately 45 to 48 percent debt and expects to continue this level of
10 capitalization in the future. Attached is Exhibit BGI - 3, which sets forth the
11 historical debt structure of Black Hills Power.

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

14 A. Dr. Avera will cover this topic in greater detail; however, investors generally rely
15 on nationally recognized credit rating services to evaluate a company's financial
16 integrity and to inform them of the company's current financial position. Three
17 nationally recognized credit rating services are Moody's Investors Service
18 ("Moody's"), Standard and Poor's ("S&P"), and Fitch Ratings ("Fitch"). As of
19 November 1, 2012, Black Hills Corporation is rated Baa3 by Moody's, BBB- by
20 S&P, and BBB- by Fitch. Black Hills Power is rated Baa2 by Moody's, BBB- by
21 S&P and BBB by Fitch and its senior secured debt is rated A3 by Moody's, BBB+
22 by S&P and A- by Fitch. Moody's and S&P rate Black Hills Corporation and

1 Black Hills Power with a “positive” outlook while Fitch rates both companies with
2 a “stable” outlook. Exhibit BGI - 4 shows key credit ratings for Black Hills
3 Corporation and Black Hills Power.

4 **Q. HOW DO RATING AGENCIES PERFORM THIS FUNCTION?**

5 A. The credit rating services issue guidelines that all companies must follow. Those
6 credit rating services generally require a company to provide detailed financial and
7 operational information to rating agencies for their analysis before issuing credit
8 ratings for the company’s securities. As noted below, these credit rating agencies
9 compare quantitative measures of a company’s financial performance, as well as a
10 qualitative assessment of the company’s risks (such as management, forecasts, and
11 regulatory climate), to their guidelines to rate the company and determine the
12 investment attributes of its debt securities. The credit ratings given by these
13 agencies provide important information to creditors, investors, vendors and
14 counterparties regarding the creditworthiness of Black Hills Corporation and
15 Black Hills Power.

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

18 A. As noted by Dr. Avera, the ratings evaluation process includes an analysis of both
19 qualitative and quantitative factors. The strongest position is enjoyed by those
20 companies operating in a wholly regulated business, such as Black Hills Power. A
21 significant factor in the methodology is to assess the credit support that is gained
22 from operating within a particular regulatory framework and the supportiveness of

1 decisions arising from the regulatory body. In evaluating whether a regulatory
2 body supports utilities, considerations include such items as timely decision
3 making, pass-throughs, and fair return on equity (ROE) determinations, and an
4 opportunity for utilities to earn those ROEs. The rating agencies also consider the
5 exact level of risk posed by the business. These criteria and others established by
6 the credit rating agencies then lead to an overall assessment of the qualitative
7 business risk of the company's activities.

8 As part of the quantitative assessment of a given entity, the rating agencies will
9 review numerous financial ratios of a given entity. Such ratios will be used to
10 review trends over various periods of time within a given entity, as well as to
11 provide comparisons among other companies in a given industry, or among
12 various industry averages.

13 For example, Moody's has identified four areas that are considered most useful in
14 completing analysis for electric utility companies. They are as follows: (1)
15 Regulated Framework, (2) Ability to Recover Costs and Earn Returns, (3)
16 Diversification and (4) Financial Strength and Liquidity. Other rating agencies
17 have their own methodologies, but have similar areas of analysis. By maintaining
18 good credit ratings, Black Hills Power achieves better credit terms and lower cost
19 of debt, which directly benefits our customers

20 **Q. WHAT IS THE FINANCIAL CONDITION OF BLACK HILLS POWER?**

21 A. The financial integrity of Black Hills Power is sound. The goal of Black Hills
22 Power is to maintain and, if possible, improve its credit metrics.

1 If Black Hills Power's credit rating is downgraded, that will impact its ability to
2 obtain short and long-term financing, the cost of such financing, and vendor
3 payment terms, including collateral requirements. Black Hills Power's financial
4 integrity is an important factor in supporting Black Hills Corporation's investment
5 grade credit rating.

6 **Q. HOW DOES THIS FINANCE PHILOSOPHY AFFECT THE RETURNS**
7 **THAT EQUITY INVESTORS EXPECT?**

8 A. For a company to attract equity capital, the potential investor must believe that the
9 company will earn a return that exceeds the cost of capital. If a company earns
10 less than its cost of capital, value is destroyed for the shareholders, and
11 consequently, the ability to raise additional capital for future projects declines.
12 The components of cost of capital include both cost of debt and the cost of equity.
13 The cost of equity is impacted by a number of factors, including the risk premium
14 investors expect above the long-term U.S. Treasury Rates, the market risk of the
15 company, the industry risk premium, the size of market capitalization, and the
16 ratio of debt to total capitalization. The market meltdown in the fourth quarter of
17 2008 increased the risk premium investors need to attract capital, which increased
18 the cost of equity for all companies, including Black Hills Power. Black Hills
19 Power believes that its cost of equity capital is 10.25 percent and therefore is
20 requesting rates to support that return. If Black Hills Power earns less than 10.25
21 percent on its current equity capital component, its shareholders will not meet their
22 return expectations, and consequently, access to capital markets will be

1 diminished. As I previously noted, it is of particular importance that Black Hills
2 Power maintain reasonable access to capital markets since it will be financing the
3 construction of CPGS. I believe the philosophy of Black Hills Power is consistent
4 with the opinion of Dr. Avera.

5 **Q. HOW DO THE CREDIT RATING AGENCIES AFFECT THE**
6 **COMPANY'S ABILITY TO ISSUE DEBT?**

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

13 **Q. WHY IS THIS IMPORTANT TO BLACK HILLS POWER?**

14 A. Access to capital is important to refinancing and for expansion of plant and the
15 potential acquisition of additional generation for Black Hills Power. In addition,
16 as noted above, credit ratings impact vendor payments, including collateral
17 requirements.

1 V. CAPITAL STRUCTURE

2 **Q. WHAT IS THE CAPITAL STRUCTURE PROPOSED FOR BLACK HILLS**
3 **POWER?**

4 A. The Company proposes a capital structure of 53.17 percent common stock equity
5 and 46.83 percent debt. The capital structure proposed is the same capital structure
6 the Company is operating at as of June 30, 2012.

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

9 A. As Dr. Avera testifies, this capital structure is appropriate because of the financial
10 position and relative size of Black Hills Power to support utility operations, to
11 serve its customers with the appropriate capacity, for replacement and expansion
12 of assets used to provide power, to maintain liquidity, and to attract cost effective
13 sources of capital for refinancing plant improvement and growth.

14 **Q. IS THE CAPITAL STRUCTURE PROPOSED FOR BLACK HILLS**
15 **POWER CONSISTENT WITH ITS HISTORICAL CAPITAL**
16 **STRUCTURE?**

17 A. Yes. First, the capital structure proposed for Black Hills Power is its present
18 capital structure. Second, the capital structure proposed for Black Hills Power is
19 consistent with its historical capital structure as set forth in Exhibit BGI – 3. As
20 shown on this Exhibit, the percentage of debt of Black Hills Power has been less
21 than 46.8 percent since March of 2011.

1 **VI. COST OF DEBT/ROE**

2 **Q. WHAT IS BLACK HILLS POWER REQUESTING FOR A RETURN ON**
3 **EQUITY (ROE) AND WHY?**

4 A. Black Hills Power is requesting a ROE of 10.25 percent. Dr. Avera's
5 recommendation is that Black Hills Power be authorized a fair ROE in the range
6 of 10.2% to 11.4%. Black Hills Power's requested ROE of 10.25% is at the lower
7 end of the range recommended by Dr. Avera. Black Hills Power purposely
8 selected a conservative ROE at the lower end of Dr. Avera's range because the
9 Company is cognizant of the difficulties faced by some of its customers in today's
10 economy. There are, however, significant financial risks in the capital markets,
11 including the European crises, potential tax policy changes (including changes in
12 investor return expectations should federal income taxes on corporate dividends
13 increase), monetary policy matters, unemployment and the slow growing
14 economy. If Black Hills Power earns less than 10.25% on its equity capital
15 component, its access to capital markets will be diminished, which will adversely
16 affect both its customers, because the Company's cost of capital will be more
17 costly, and its shareholders, who will not meet their return expectations.

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

19 A. The pro forma cost of debt for Black Hills Power is 6.59 percent. This reflects the
20 actual cost after adjusting for bonds that were retired during the test year, which
21 lowered the pro forma cost of debt by ten basis points.

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

3 A. Black Hills Power has a projected \$270 million of existing long-term debt
4 outstanding as of June 30, 2012, based on actual debt.

5 The average cost of long-term debt is determined by taking the weighted average
6 of the amount of the individual debt issue components and their respective interest
7 rates (adjusted for issuance costs). Reference is made to Statement G, page 3 in
8 the revenue requirement model.

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

11 A. The weighted average cost of capital requested for Black Hills Power incorporates
12 the cost of equity of 10.25 percent, the weighted average embedded cost of debt of
13 6.59 percent, and a capital structure of 53.17 percent equity and 46.83 percent debt
14 financing. This calculation results in a weighted average cost of capital of 8.54
15 percent. The result is presented in Statement G, page 1.

16 **Q. DOES THAT CONCLUDE YOUR DIRECT TESTIMONY?**

17 A. Yes.