

Direct Testimony and Exhibit
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. EL14-___

March 31, 2014

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Exhibit

Exhibit BGI-1: Black Hills Power Historical Capital Structure QTD and
MTD 2011-2013

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 Service Company (“Service Company”),
7 and serve as Vice President and Treasurer of Black Hills Corporation (“BHC”)
8 and its subsidiaries.

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

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

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

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

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

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

21 I have been employed by BHC since 2004, working in various positions within the
22 legal, regulatory, resource planning, and finance areas. Prior to joining BHC, I

1 worked in the banking industry and in the private practice of law, where I focused
2 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 • Certify Books and Records of Black Hills Power
- 8 • Certify Use of Federal Energy Regulatory Commission (“FERC”) Uniform
9 System of Accounts for Black Hills Power
- 10 • Discuss Corporate Finance Philosophy of Black Hills Power
- 11 • Support Proposed Capital Structure of Black Hills Power
- 12 • Support Long Term Debt and Cost of Equity
- 13 • Discuss Debt Financing Activity
- 14 • Support Weighted Average Cost of Capital

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

16 A. Yes. I am sponsoring Exhibit BGI-1, which I will describe and refer to in my
17 testimony.

1 **Q. DOES YOUR DIRECT TESTIMONY SUPPORT ANY SPECIFIC**
2 **SCHEDULES THAT ARE PART OF THE COMPANY'S RATE**
3 **APPLICATION IN THIS PROCEEDING?**

4 A. Yes. My testimony supports the weighted average cost of capital schedules and
5 adjustments.

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

9 A. Yes.

10 **III. ACCOUNTING RECORDS**

11 **Q. ARE YOU FAMILIAR WITH THE BOOKS AND RECORDS OF BLACK**
12 **HILLS POWER AND THE MANNER IN WHICH THEY ARE KEPT?**

13 A. Yes. The financial statements and records have been prepared on the accrual basis
14 in conformity with Generally Accepted Accounting Principles ("GAAP") and in
15 accordance with accounting requirements of the Federal Energy Regulatory
16 Commission as set forth in its applicable Uniform System of Accounts.

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

18 **Q. PLEASE EXPLAIN THE CORPORATE FINANCE PHILOSOPHY OF**
19 **BLACK HILLS POWER.**

20 A. The corporate philosophy of Black Hills Power is the same philosophy established
21 by BHC. In particular, Black Hills Power must maintain financial integrity and its
22 ability to access capital as needed at a reasonable cost. Financial integrity is

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

14 **Q. WHAT IS BLACK HILLS POWER'S PRO FORMA CAPITAL**
15 **STRUCTURE?**

16 **A.** Black Hills Power's witness, Dr. William Avera, provides a detailed analysis in
17 support of the recommended capital structure in his testimony. However, my
18 testimony supports the pro forma capital structure for Black Hills Power of 53.32
19 percent equity and 46.68 percent debt.

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

3 A. Dr. Avera will cover this topic in greater detail; however, investors generally rely
4 on nationally recognized credit rating services to evaluate a company's financial
5 integrity and to inform them of the company's current financial position. Three
6 nationally recognized credit rating services are Moody's Investors Service
7 ("Moody's"), Standard and Poor's ("S&P"), and Fitch Ratings ("Fitch"). As of the
8 end of February 2014, Black Hills Power's senior secured debt is respectively
9 rated A1 by Moody's, A- by S&P, and A- by Fitch. Fitch rates Black Hills Power
10 with a "positive" outlook, and Moody's and S&P rate Black Hills Power as
11 "stable." As of the end of February 2014, BHC's senior secured debt is
12 respectively rated Baa1 by Moody's, BBB by S&P, and BBB by Fitch. Fitch rates
13 BHC with a "positive" outlook, and Moody's and S&P rate BHC as "stable."

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

15 A. The credit rating services issue guidelines that all companies must follow. In
16 general, a company must provide detailed financial and operational information to
17 rating agencies for their analysis before issuing credit ratings for the company's
18 securities. As noted below, these credit rating agencies compare quantitative
19 measures of a company's financial performance, as well as a qualitative
20 assessment of the company's risks (such as management, forecasts, and regulatory
21 climate), to their guidelines to rate the company and determine the investment
22 attributes of its debt securities. The credit ratings given by these agencies provide

1 important information to creditors, investors, vendors and counterparties regarding
2 the creditworthiness of BHC and Black Hills Power.

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

5 A. As noted by Dr. Avera, the ratings evaluation process includes an analysis of both
6 qualitative and quantitative factors. There are several steps in the ratings
7 evaluation process. For example, one step is to assess the extent of a “regulated”
8 company’s exposure to unregulated businesses. The strongest position is enjoyed
9 by those companies operating in a wholly regulated business. Another step in the
10 methodology is to assess the credit support that is gained from operating within a
11 particular regulatory framework. The rating agencies also consider the exact level
12 of risk posed by the business. These criteria and others established by the credit
13 rating agencies then lead to an overall assessment of the qualitative business risk
14 of the company’s activities.

15 As part of the quantitative assessment of a given entity, the rating agencies will
16 review numerous financial ratios of a given entity. Such ratios will be used to
17 review trends over various periods of time within a given entity, as well as to
18 provide comparisons among other companies in a given industry, or among
19 various industry averages.

20 For example, Moody’s has identified four areas that are considered most useful in
21 completing analysis of electric utility companies. They are as follows: (1)
22 Regulated Framework, (2) Ability to Recover Costs and Earn Returns, (3)

1 Diversification and (4) Financial Strength and Liquidity. By maintaining good
2 credit ratings, BHC and Black Hills Power achieve better credit terms and lower
3 cost of debt which directly benefit our customers.

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

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

7 If Black Hills Power's credit metrics are weak, that will impact its ability to obtain
8 short and long-term financing, the cost of such financing, and vendor payment
9 terms, including collateral requirements. Black Hills Power has its own credit
10 rating, and is able to issue first mortgage bonds. Additionally, Black Hills Power
11 also has access to short-term capital through BHC, its parent company. Black
12 Hills Power's financial integrity is an important factor in supporting BHC's
13 investment grade credit rating.

14 As a means of protecting its credit ratings, Black Hills Power generally maintains
15 and will continue to maintain a capitalization level (GAAP basis) of
16 approximately 45 to 48% debt and expects to continue this level of capitalization
17 in the future.

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

20 A. For a company to attract equity capital, the potential investor must believe that the
21 company will earn a return that exceeds the cost of capital. If a company earns
22 less than its cost of capital, value is destroyed for the shareholders, and

1 consequently, the ability to raise additional capital for future projects declines.
2 The components of cost of capital include both cost of debt and the cost of equity.
3 The cost of equity is impacted by a number of factors, including the risk premium
4 investors expect above the long-term U.S. Treasury Rates, the market risk of the
5 company, the industry risk premium, the size of market capitalization, and the
6 ratio of debt to total capitalization. Black Hills Power believes that its cost of
7 equity capital is 10.25% and therefore is requesting rates to support that return. If
8 Black Hills Power earns less than 10.25% on its equity capital component, its
9 shareholders will not meet their return expectations, and consequently, access to
10 capital markets will be diminished. I believe the philosophy of Black Hills Power
11 is consistent with the opinion of Dr. Avera.

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

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

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

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

1 Hills Power. In addition, as noted above, credit ratings impact vendor payments,
2 including collateral requirements.

3 **V. CAPITAL STRUCTURE**

4 **Q. WHAT IS THE CAPITAL STRUCTURE PROPOSED FOR BLACK HILLS**
5 **POWER?**

6 A. The Company proposes a capital structure of 53.32 percent equity and 46.68
7 percent debt.

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

10 A. This capital structure is appropriate because it is not only the actual capital
11 structure of Black Hills Power, but it is also appropriate for the financial position
12 and relative size of Black Hills Power to support utility operations, to serve its
13 customers with the appropriate capacity, for replacement and expansion of assets
14 used to provide power, to maintain liquidity, and to attract cost effective sources
15 of capital for refinancing plant improvement and growth. Black Hills Power
16 issues debt in its own name and maintains a separate capital structure. Thus, a
17 capital structure of 53.32% equity and 46.68% debt structure for Black Hills
18 Power should be approved in this proceeding.

1 **Q. IS THE CAPITAL STRUCTURE PROPOSED FOR BLACK HILLS**
2 **POWER CONSISTENT WITH ITS HISTORICAL CAPITAL**
3 **STRUCTURE?**

4 A. Yes. Exhibit BGI-1 sets forth the capital structure for Black Hills Power for the
5 period of March 2011 to December 2013. As shown on this Exhibit, the
6 percentage of debt of Black Hills Power has been less than 47 percent for each of
7 the years shown on the Exhibit. In the prior rate case, my direct testimony
8 included a similar schedule dating back to 2010 which verified that the percentage
9 of debt for Black Hills Power has consistently been less than 47%. Thus, applying
10 a capital structure of 53.32% equity and 46.68% debt represents the actual capital
11 structure that Black Hills Power has used for a number of years.

12 **Q. ARE THERE PLANS TO ISSUE ANY NEW DEBT FOR BLACK HILLS**
13 **POWER?**

14 A. Yes. During 2014, new bonds will be issued to help finance the anticipated costs
15 related to Cheyenne Prairie Generating Station ("CPGS"). Black Hills Power will
16 own approximately 42 percent of this new \$222 million, 132 MW gas-fired
17 generating plant. Cheyenne Light, Fuel and Power Company will own
18 approximately 58 percent of CPGS. Black Hills Power anticipates adding
19 approximately \$50 million of long-term financing for Black Hills Power's portion
20 of the costs of this new generating plant and other plant additions. The cost of that
21 new debt is currently calculated at an all-in cost of debt of 5.67 percent.

1 **VI. COST OF DEBT**

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

3 A. The pro forma cost of debt for Black Hills Power is 6.45 percent, which is lower
4 than the test period cost of debt of 6.57 percent as interest rates on our new
5 financing are expected at a lower cost than our current fixed rate bonds (Series
6 AE, Series AF and Series 2004 Campbell County).

7 **Q. HOW MUCH LONG-TERM DEBT DOES BLACK HILLS POWER HAVE**
8 **OUTSTANDING?**

9 A. Black Hills Power has \$270,055,000 of existing long-term debt outstanding as of
10 December 30, 2013.

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

13 A. The average cost of long-term debt is determined by taking the weighted average
14 of the amount of the individual debt issue components and their respective interest
15 rates (adjusted for issuance costs), along with the estimated cost of the new long-
16 term financing for CPGS.

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

19 A. The weighted average cost of capital requested for Black Hills Power incorporates
20 the cost of equity of 10.25 percent, the weighted average cost of debt of 6.45
21 percent, and a capital structure of 53.32 percent equity and 46.68 percent debt

1 financing. This calculation results in a weighted average cost of capital of 8.48
2 percent.

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

4 **A. Yes.**