

Volume 2A

Direct Testimony and Supporting Schedules

Kevin G. Moug

Before the South Dakota Public Utilities Commission  
State of South Dakota

In the Matter of the Application of Otter Tail Power Company  
For Authority to Increase Rates for Electric Utility  
Service in South Dakota

Docket No. EL18-\_\_\_

Exhibit \_\_\_

**FINANCIAL SOUNDNESS, CAPITAL STRUCTURE  
AND COST OF CAPITAL**

Direct Testimony and Schedules of

**Kevin G. Moug**

April 20, 2018

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Schedule 1 – Qualifications, Duties and Responsibilities of Kevin G. Moug

Schedule 2 – Proposed Cost of Capital for 2017 Test Year

Schedule 3 – Effect of One-Notch Change in Credit Rating

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Schedule 6 – Common Equity for 2018 Forecast Year

Schedule 7 – Public and Non-Public Issuances of Common Equity by Otter Tail Corporation

1 **I. INTRODUCTION AND QUALIFICATIONS**

2 Q. PLEASE STATE YOUR NAME AND OCCUPATION.

3 A. My name is Kevin G. Moug. I am the Chief Financial Officer and Senior Vice  
4 President of Otter Tail Corporation and the Treasurer for Otter Tail Power Company  
5 (OTP). OTP is a wholly owned subsidiary of Otter Tail Corporation.

6

7 Q. PLEASE SUMMARIZE YOUR QUALIFICATIONS AND EXPERIENCE.

8 A. I have been Senior Vice President and Chief Financial Officer of Otter Tail  
9 Corporation since 2001. A copy of my resume is included as Exhibit \_\_\_(KGM-1),  
10 Schedule 1.

11 **II. PURPOSE AND OVERVIEW OF DIRECT TESTIMONY**

12 Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY?

13 A. The purpose of my Direct Testimony is to demonstrate the reasonableness of the  
14 capital structure, cost of Long-Term Debt (LTD), and the overall Rate of Return  
15 (ROR) to be used for OTP's 2017 Test Year. As I will explain, that capital structure is  
16 based on the OTP's 2018 projected capital structure. I will discuss the financial  
17 impacts and scope of OTP's recent capital expenditures and OTP's estimated future  
18 capital expenditures. I will also discuss the importance of the decisions of the South  
19 Dakota Public Utilities Commission (Commission) in this proceeding, including  
20 granting a reasonable Return on Equity (ROE), to: (1) maintaining OTP strong credit  
21 ratings; (2) the long-term cost of completing OTP's capital expenditures plans; and (3)  
22 OTP's ability to attract capital and provide service at a fair and reasonable cost.

23

24 Q. PLEASE PROVIDE A BRIEF OVERVIEW OF YOUR DIRECT TESTIMONY.

25 A. OTP's proposed capital structure, cost of LTD, and ROR are reasonable for the 2017  
26 Test Year and should be adopted for determining OTP's rates. OTP's proposed  
27 capital structure, cost of LTD, and ROR for the 2017 Test Year are based on the

1 forecast of OTP's 2018 capital structure, cost of LTD, and ROR. That forecast  
2 reflects the issuance of \$100 million of LTD in February 2018, which has the effects  
3 of reducing OTP's equity ratio, cost of LTD, and ROR below the levels that would  
4 have resulted from using OTP's actual equity ratio, cost of LTD, and ROR for 2017.  
5 As a result, OTP's approach provides a significant benefit to South Dakota customers.

6 OTP has been engaged in an extensive capital expenditure program, involving  
7 capital expenditures of approximately \$806 million from 2013 through 2017.<sup>1</sup> OTP  
8 required external sources of debt and equity capital to fund those investments, in  
9 addition to substantial amounts of internally generated equity. OTP's extensive  
10 capital expenditures plan is expected to continue from 2018 through 2022 with an  
11 additional approximately \$901 million of further capital expenditures by OTP in that  
12 5-year period.<sup>2</sup> Completion of OTP's capital expenditures plan will also require  
13 external sources of equity and debt capital in addition to internally generated cash flow  
14 from operations.

15 The Commission's decisions in this proceeding, including the Commission's  
16 decisions with respect to OTP's capital structure and ROE, may significantly affect  
17 investors' perceptions of OTP's regulatory environment, which has important  
18 implications for OTP's financial outlook and OTP's senior unsecured credit ratings.  
19 The credit ratings in effect when OTP places LTD to help finance the rest of its capital  
20 expenditures plan will affect OTP's cost of service for 10 to 30 years. As a result, the  
21 Commission's decisions in this proceeding may affect OTP's cost of service for a 10  
22 to 30-year period.

23  
24 Q. PLEASE SUMMARIZE OTP'S RECOMMENDED ROR, INCLUDING CAPITAL  
25 STRUCTURE, COST OF LTD, AND ROE.

26 A. OTP recommends an overall ROR of 7.96 percent. This ROR is based on the capital  
27 components and related costs summarized in Table 1 and shown on attached Exhibit

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<sup>1</sup> Otter Tail Corporation Form 10-K for year ended December 31, 2015, p 50 and Otter Tail Corporation Form 10-K for year ended December 31, 2017, p 49.

<sup>2</sup> Otter Tail Corporation Form 10-K for year ended December 31, 2017, p 49.



1 **III. DESCRIPTION OF OTP AND OTTER TAIL CORPORATION**

2 Q. PLEASE PROVIDE A SUMMARY DESCRIPTION OF OTP AND OTTER TAIL  
3 CORPORATION.

4 A. OTP is a wholly owned subsidiary of Otter Tail Corporation and is a separate legal  
5 entity from Otter Tail Corporation. OTP issues its own LTD and has its own credit  
6 facility with banks that provide OTP's short-term borrowings. Otter Tail Corporation  
7 owns all of OTP's outstanding common stock. There are no loans outstanding  
8 between OTP and Otter Tail Corporation. Otter Tail Corporation is publicly held and  
9 traded on the NASDAQ. OTP is Otter Tail Corporation's only utility operating  
10 company.

11  
12 Q. HOW DOES OTTER TAIL CORPORATION COMPARE IN SIZE TO OTHER  
13 ELECTRIC UTILITIES?

14 A. Otter Tail Corporation is the second smallest publicly traded investor owned utility in  
15 the United States,<sup>3</sup> and it is much smaller than the average of publicly traded investor  
16 owned utilities. Otter Tail Corporation's total market capitalization is \$1.67 billion<sup>4</sup>  
17 while the average total market capitalization of publicly traded investor owned utilities  
18 is \$16.7 billion.<sup>5</sup> Otter Tail Corporation is also the smallest publicly traded investor  
19 owned utilities doing business in South Dakota, including Northwestern Energy  
20 NWE) with market capitalization of \$2.54 billion<sup>6</sup>, Black Hills (BKH) with market  
21 capitalization of \$2.79 billion<sup>7</sup>, Montana-Dakota Utilities (MDU) with market

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<sup>3</sup>[http://www.eei.org/resourcesandmedia/industrydataanalysis/industryfinancialanalysis/QtrlyFinancialUpdates/Documents/QFU\\_Stock/2017\\_Q4\\_Stock\\_Performance.pdf](http://www.eei.org/resourcesandmedia/industrydataanalysis/industryfinancialanalysis/QtrlyFinancialUpdates/Documents/QFU_Stock/2017_Q4_Stock_Performance.pdf).

<sup>4</sup><http://www.nasdaq.com/symbol/ottr> 3-12-18.

<sup>5</sup> EEI 2017 Stock Performance, Q4 2017 Financial Update, total industry \$720,427 million divided by 43 utilities [http://www.eei.org/resourcesandmedia/industrydataanalysis/industryfinancialanalysis/QtrlyFinancialUpdates/Documents/QFU\\_Stock/2017\\_Q4\\_Stock\\_Performance.pdf](http://www.eei.org/resourcesandmedia/industrydataanalysis/industryfinancialanalysis/QtrlyFinancialUpdates/Documents/QFU_Stock/2017_Q4_Stock_Performance.pdf).

<sup>6</sup><http://www.nasdaq.com/symbol/NWE> 3-12-18.

<sup>7</sup><http://www.nasdaq.com/symbol/BKH> 3-12-18.

1 capitalization of \$5.3 billion<sup>8</sup> and Xcel Energy (XE) with market capitalization of  
2 \$21.95 billion.<sup>9</sup>

3  
4 Q. HOW DOES OTTER TAIL CORPORATION'S COMMON STOCK OWNERSHIP  
5 PROFILE COMPARE TO OTHER ELECTRIC UTILITIES?

6 A. Otter Tail Corporation also has a level of institutional ownership of its common stock  
7 which is substantially lower than the average institutional ownership of the electric  
8 utilities in the comparable group of OTP witness Mr. Robert B. Hevert, and lower than  
9 all other investor owned utilities providing electric service in South Dakota.

10  
11 Q. DOES OTTER TAIL CORPORATION'S LOWER LEVEL OF INSTITUTIONAL  
12 OWNERSHIP HAVE AN EFFECT ON OTP'S COST OF EQUITY?

13 A. Yes. As Mr. Hevert explains in his Direct Testimony, institutional investors are an  
14 important and efficient source of equity capital. Otter Tail Corporation's significantly  
15 lower level of institutional common stock ownership indicates there is a lower level of  
16 equity capital available (from institutional demand) to Otter Tail Corporation and  
17 OTP, with lower demand leading to a higher cost of equity for OTP.

18  
19 Q. HOW DOES OTTER TAIL CORPORATION'S AVERAGE DAILY TRADING  
20 VOLUME COMPARE TO OTHER ELECTRIC UTILITIES?

21 A. Otter Tail Corporation daily trading volume of approximately 100,000 shares per day  
22 is far below the average daily trading volume of Mr. Hevert's comparable group and  
23 the levels of NWE, BKH, MDU and XE, as described in Mr. Hevert's Direct  
24 Testimony.

25  
26 Q. IS THIS LOWER TRADING VOLUME RELATED TO LIQUIDITY RISK AND  
27 LOWER INSTITUTIONAL OWNERSHIP?

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<sup>8</sup> <http://www.nasdaq.com/symbol/mdu> 3-12-18.

<sup>9</sup> <http://www.nasdaq.com/symbol/xel> 3-12-18.



1 A. Yes. The lower trading volume creates a challenge for an institutional investor's  
2 ability to acquire or sell the large blocks of stock that are typically held by an  
3 institutional investor. This has an adverse effect on liquidity for owners of Otter Tail  
4 Corporation common stock and implications for OTP's cost of equity, as Mr. Hevert  
5 also explains.

#### 6 **IV. OTP CAPITAL STRUCTURE AND EQUITY RATIO**

7 Q. HOW DID OTP DETERMINE ITS PROPOSED CAPITAL STRUCTURE?

8 A. OTP's proposed capital structure for its 2017 Test Year is based on the 13 month  
9 average of OTP's 2018 forecast capital structure.

10

11 Q. WHY IS OTP PROPOSING THE USE OF A 2018 FORECAST CAPITAL  
12 STRUCTURE FOR A 2017 HISTORICAL TEST YEAR?

13 A. OTP is proposing the use of its 13-month average 2018 forecast capital structure  
14 because of a significant change that occurred in February 2018. In February, OTP  
15 issued \$100 million of LTD at a rate of 4.07 percent. This LTD was issued to provide  
16 long term financing for major capital expenditures that have been and are being placed  
17 in service.

18

19 Q. HOW DOES THE USE OF THE 2018 FORECAST CAPITAL STRUCTURE  
20 AFFECT RATES?

21 A. The use of the 2018 forecast capital structure added \$100 million to OTP's long term  
22 debt, which reduced its equity ratio by approximately 3.4 percent from the 2017  
23 historic 13-month average (on a test year basis), and reduced the average cost of LTD  
24 by approximately 28 basis points from the 2017 historic 13-month average. Thus, the  
25 use of the 2018 forecast capital structure and cost of LTD provides substantial benefits  
26 to South Dakota customers, reducing the 2017 Test Year revenue requirement by  
27 approximately \$317,000.

28

1 Q. HOW DOES OTP'S PROPOSED 53.1 PERCENT EQUITY RATIO COMPARE TO  
2 EQUITY RATIOS OF MR. HEVERT'S COMPARABLE GROUP COMPANIES?

3 A. As Mr. Hevert explains, OTP's equity ratio is well within the range of the equity ratios  
4 of companies in his comparable group. Mr. Hevert notes the mean equity ratio from  
5 the operating utilities in his comparable group is 51.61 percent, the median equity ratio  
6 is 52.80 percent, and the range is from 44.86 percent to 57.42 percent. OTP's  
7 proposed 53.1 percent equity ratio is well within that range.

8

9 Q. DO OTP'S CAPITAL STRUCTURE AND EQUITY RATIO PROVIDE OTHER  
10 CUSTOMER BENEFITS?

11 A. Yes. OTP's capital structure and equity ratio have also contributed to OTP's ability to  
12 simultaneously finance its significant capital expenditures at reasonable costs,<sup>10</sup> and  
13 reduce its cost of LTD. We also expect that OTP's capital structure and equity ratio  
14 will facilitate OTP's completion of its capital expenditures over the next 5 years. All  
15 of these result in benefits to OTP customers.

16

17 Q. IS A REDUCTION IN OTP'S EXPENSES AND RATES (RESULTING FROM  
18 FEDERAL INCOME TAX REFORM) A FACTOR THAT AFFECTS THE  
19 REASONABLENESS OF OTP'S CAPITAL STRUCTURE AND EQUITY RATIO?

20 A. As explained in Mr. Hevert's Direct Testimony, a reduction in OTP's expenses and  
21 rates to reflect OTP's reduced federal income tax is the type of result that the rating  
22 agencies have characterized as a credit negative event which has an effect on both the  
23 cost of equity and reasonableness of the capital structure.

24

25 Q. IS OTP PROPOSING AN INCREASE IN ITS EQUITY RATIO AS A RESULT OF  
26 FEDERAL INCOME TAX REFORM?

27 A. No. OTP does believe, however, that federal income tax reform provides further  
28 substantial support for the reasonableness of OTP's proposed 53.1 percent equity ratio

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<sup>10</sup> Otter Tail Corporation 2016 Form 10(K), p. 50.

1 **V. OTP RECENT CAPITAL EXPENDITURES AND ONGOING**  
2 **CAPITAL EXPENDITURES PLANS**

3 Q. PLEASE SUMMARIZE OTP'S RECENT CAPITAL EXPENDITURES.

4 A. OTP's capital expenditures increased significantly in 2012 and have remained very  
5 substantial since then as shown on Table 2 below:

6  
7  
8

**Table 2**  
OTP Capital Expenditures 2012 – 2017 <sup>11</sup>

<b>Year</b>	<b>Capital Expenditure (\$ millions)</b>
2012	\$102
2013	\$150
2014	\$149
2015	\$136
2016	\$150
2017	\$119
Total	\$806
Average	\$134

9

10 OTP witness Mr. Bruce Gerhardson provides further information regarding the various  
11 projects that were included in these capital expenditures.

12

13 Q. HOW DO THESE PRIOR EXPENDITURES COMPARE TO OTP'S NET PLANT  
14 IN SERVICE WHEN THEY BEGAN?

15 A. OTP's net electric plant in service as of December 31, 2011 was approximately \$922  
16 million.<sup>12</sup> OTP's \$806 million investment during 2012-2017 represented  
17 approximately 99 percent of its net electric plant as of December 31, 2011.

18

19 Q. HOW HAS OTP PROVIDED LONG-TERM FUNDING FOR ITS 2012-2017  
20 CAPITAL EXPENDITURES?

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<sup>11</sup> Otter Tail Corporation Form 10-K for year ended December 31, 2014, p 50 and Otter Tail Corporation Form 10-K for year ended December 31, 2016, p 49.

<sup>12</sup> Otter Tail Corporation, 2011 Form 10-K, p. 115.

1 A. OTP provided long-term funding for its \$806 million of capital expenditures in 2012-  
2 2017 with a combination of approximately \$250 million of LTD issued by OTP  
3 (including the February 2018 issuance), earnings retained by OTP, and equity  
4 infusions from Otter Tail Corporation. Earnings retained by OTP and equity infusions  
5 from Otter Tail Corporation increased OTP's equity balance from \$330 million at year  
6 end 2011 to \$558 million at year end 2017. From 2012-2017, almost 80 percent of  
7 OTP's net income has been reinvested, either as retained earnings or added infusions  
8 of equity from Otter Tail Corporation. These equity reinvestments provided needed  
9 funding for OTP's capital expenditures and were also needed essential to maintain a  
10 balance of debt and equity and a balanced capital structure for OTP.

11  
12 Q. HAVE OTP'S CAPITAL EXPENDITURES AND RELATED FUNDING BEEN A  
13 SIGNIFICANT PART OF OTTER TAIL CORPORATION'S STRATEGY?

14 A. Yes. OTP is Otter Tail Corporation's largest business, and Otter Tail Corporation has  
15 focused on OTP within Otter Tail Corporation's two platforms, electric and  
16 manufacturing. That focus on OTP has been successful, but \$901 million of planned  
17 capital expenditures for OTP remains for the four-year period of 2018-2022, as shown  
18 in Table 3 below:<sup>13</sup>

19 **Table 3**  
20 Projected OTP Capital Expenditures 2018 – 2021<sup>14</sup>

<b>Year</b>	<b>Capital Expenditure (\$ millions)</b>
2018	\$95
2019	\$382
2020	\$185
2021	\$145
2022	\$94
Total	\$901
Average	\$180

21  

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<sup>13</sup> Otter Tail Corporation Form 10-K for year ended December 31, 2016, p 49.

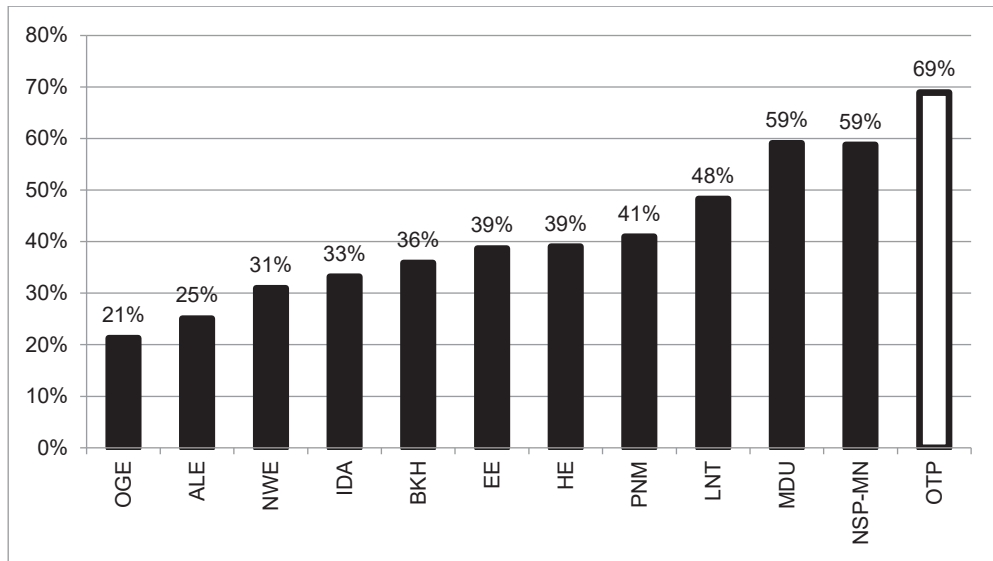
<sup>14</sup> Otter Tail Corporation Form 10-K for year ended December 31, 2014, p 50 and Otter Tail Corporation Form 10-K for year ended December 31, 2016, p 49.

1 Q. HOW DO THESE CAPITAL EXPENDITURES COMPARE TO OTHER  
2 UTILITIES?

3 A. As Mr. Hevert notes in his Direct Testimony, OTP's planned capital expenditure level  
4 is far higher than any other company in his proxy group, as shown in Chart 1:

5  
6  
7  
8  
9

**Chart 1:**  
Comparison of OTP and Hevert Comparable Group  
Planned Capital Expenditures  
(As a percentage of net plant)



10

11 As Mr. Hevert also notes, OTP's projected 69 percent capital expenditures level as a  
12 percentage of its net plant is also significantly higher than all publicly traded investor  
13 owned utilities in South Dakota, including XEL (at 59 percent), MDU (at 59 percent),  
14 NWE (at 31 percent), and BKH (at 36 percent).<sup>15</sup>

15

16 Q. WILL THE ROE AND CAPITAL STRUCTURE AUTHORIZED IN THIS  
17 PROCEEDING HAVE AN EFFECT ON FINANCING OF OTP'S CAPITAL  
18 EXPENDITURE PLANS?

---

<sup>15</sup> Hevert Direct Testimony, Section VI, *Capital Expenditures*.

1 A. Yes. The ROE and capital structure authorized in this proceeding will have a  
2 substantial impact on OTP's financing of its capital expenditures plan in two  
3 important ways. First, the ROE and capital structure will have a direct impact on the  
4 level of OTP's authorized earnings. The level of authorized earnings will, in turn,  
5 directly impact OTP's ability to fund capital expenditures with internally generated  
6 retained earnings.

7 As I explained, OTP has reinvested almost 80 percent of its earnings in the  
8 2012-2017 period of its previous substantial capital expenditures. Previously  
9 authorized ROEs have had a significant effect on the availability of these internally  
10 generated retained earnings, which have been a significant source of funding for  
11 OTP's capital expenditures and are expected to remain a significant source of funding  
12 for the remainder of OTP's capital expenditures plan.

13 The authorized ROE and capital structure will have a significant effect on the  
14 perceptions of rating agencies and investors, which is likely to be heightened by the  
15 scale of the OTP capital expenditures plan and the general recognition that federal  
16 income tax reform will have negative effects on utilities and the resulting uncertainty  
17 for utilities. These perceptions could have a substantial impact on credit ratings and  
18 the availability and external debt and equity capital that will be needed to complete  
19 OTP's capital expenditures plans. Later in my Direct Testimony, I will also discuss  
20 plans for issuance of new LTD and external sources of equity in the 2018-2022 time  
21 period during which OTP will be completing its capital expenditures plan.

22  
23 Q. DO RATE CASE AND ROE DECISIONS AFFECT CREDIT RATING AGENCY  
24 EVALUATION OF UTILITIES?

25 A. Yes. The effect of rate case and ROE decisions is demonstrated in the February 20,  
26 2018 action by Moody's Investor Services (Moody's) which changed its ratings  
27 outlook on ALLETE from Stable to Negative. Moody's noted the combined effects of  
28 the recent Minnesota Power rate case decision of the Minnesota Public Utilities  
29 Commission (MPUC) and the reduced cash flow anticipated from the recent federal  
30 tax reform. Moody's noted the rate case decision was likely to negatively affect

1 financial metrics and also was seen as an indication of a deterioration of Minnesota  
2 Power’s regulatory environment, noting that the “rate case outcome also points to a  
3 less constructive regulatory relationship between MP and the MPUC.”

4 In a February 8, 2018 Issuer Comment, Moody’s also discussed the negative  
5 effects of the MPUC rate case decision, noting that; “The MPUC reduced MP’s  
6 allowed ROE to 9.25% from the requested 10.25%, below the national average of  
7 about 9.6%.”

## 8 **VI. OTP’S CREDIT RATINGS AND COST OF BORROWING**

9 Q. ARE CREDIT RATINGS IMPORTANT TO OTP?

10 A. Credit ratings are particularly important to OTP now while OTP is completing its  
11 capital expenditures program. As I will explain, completion of that plan will require  
12 OTP to issue additional LTD in order to complete the plan, and the interest rates at  
13 which OTP issues its LTD will continue to affect costs for many years into the future.  
14 OTP’s credit ratings have a direct effect on the interest rates for OTP’s LTD.

15  
16 Q. HOW DOES OTP ARRANGE ITS LTD FINANCING?

17 A. OTP raises the LTD needed for financing its operations, including its capital  
18 expenditures, through private placements with institutional investors rather than  
19 through public issuances of LTD. OTP uses private placements because the size of its  
20 debt offerings attracts better interest in the private placement market from fixed  
21 income investors as well as not incurring the added costs of issuing public debt and  
22 having to incur an additional borrowing cost for a small size premium that would exist  
23 in the public debt market. OTP’s private placements of LTD are for terms of 10 to 30  
24 years.

25  
26 Q. DOES OTP’S USE OF PRIVATE PLACEMENTS FOR LTD MAKE CREDIT  
27 RATINGS UNIMPORTANT TO OTP AND OTP’S CUSTOMERS?

28 A. No. Credit ratings remain very important to OTP and OTP customers because  
29 institutional investors use these ratings, along with their own analysis, in making

1 decisions regarding whether to invest in OTP's LTD debt and the interest rate to  
2 require in order to make an investment in OTP's LTD.

3  
4 Q. WHAT ARE OTP'S CURRENT CREDIT RATINGS?

5 A. OTP's current credit ratings are set out in Table 4 below:

6  
7 **Table 4**  
8 OTP Credit Ratings<sup>16</sup>

	Moody's	Fitch	S&P
Corporate Credit/Long term issuer Default Rating	A3	BBB	BBB
Senior Unsecured Rating	N.A.	BBB+	BBB
Outlook	Stable	Stable	Positive

9  
10 The "Positive" outlook from S&P reflects a change in outlook from Stable on August  
11 21, 2017.<sup>17</sup>

12  
13 Q. HAVE YOU ESTIMATED THE EFFECTS ON LTD INTEREST RATES OF A  
14 ONE-NOTCH CHANGE IN OTP'S CREDIT RATING?

15 A. Yes. Based on recent history, a one-notch change by Moody's (from OTP's current  
16 A3 rating to Baa1) would lead to a 25 to 40 basis point change in interest rates, with  
17 an increase in the Credit Rating reducing interest rates and a decrease in the Credit  
18 Rating increasing interest rates. This change in interest rates would not apply to LTD  
19 that is now outstanding but would apply to LTD that would be placed when the change  
20 in the Credit Rating became effective.

21  
22 Q. WOULD A CREDIT RATING CHANGE ALSO HAVE AN EFFECT ON THE  
23 COSTS OF OTP'S SHORT TERM DEBT?

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<sup>16</sup> Moody's August 9, 2017 Credit Opinion for OTP (Moody's 2017); Fitch, August 17, 2017 (Fitch 2017); S&P August 21, 2017 Ratings for OTP and Otter Tail Corporation (S&P 2017).

<sup>17</sup> S&P 2017, p. 1.



1 A. Yes. OTP's STD credit agreement contains a defined pricing grid. A one notch  
2 downgrade in OTP's credit ratings would result in higher short-term borrowing costs  
3 of 25 basis points under the current credit agreement.  
4

5 Q. DOES OTP PLAN TO ISSUE LTD DURING THE 2018-2022 TIME PERIOD IN  
6 ORDER TO COMPLETE ITS CAPITAL EXPENDITURE PLAN?

7 A. Yes. OTP plans to finance its estimated \$901 million of capital expenditures in the  
8 2018-2022 timeframe with a balanced mix of equity and debt, including OTP retained  
9 earnings and equity infusions from Otter Tail Corporation, including the results of  
10 common stock issuances.  
11

12 Q. HAVE YOU ESTIMATED THE POTENTIAL EFFECTS ON OTP'S INTEREST  
13 EXPENSES IF THERE IS A RATING CHANGE?

14 A. Yes. Table 5 below summarizes the effects on OTP total interest expenses per \$200  
15 million of LTD that may be issued if there is a one-notch downgrade and interest rates  
16 increase by 25 and 40 basis points, with that LTD outstanding from 10 years to 30  
17 years. Those calculations are shown on Exhibit \_\_\_(KGM-2), Schedule 3.  
18

19 **Table 5**  
20 Effect of 25 basis point interest rate increase on  
21 \$200 million issuance of LTD

	<b>OTP Total @ 25 basis points</b>	<b>OTP Total @ 40 basis points</b>
Annual increase	\$500,000	\$800,000
Cumulative increase over 10 years	\$5,000,000	\$8,000,000
Cumulative increase over 20 years	\$10,000,000	\$16,000,000
Cumulative increase over 30 years	\$15,000,000	\$24,000,000

22  
23 Q. WILL THE CHANGE IN THE COST OF THIS ADDITIONAL LTD AFFECT  
24 LONG TERM COSTS OF SERVICE?

25 A. Yes. The terms of newly issued debt are expected to range from 10 to 30 years. As a  
26 result, these costs will remain part of the costs of service for a substantial period of  
27 time.

1 **VII. EFFECTS OF OTP’S BUSINESS AND FINANCIAL RISKS ON ITS**  
2 **CREDIT RATINGS**

3 Q. DO RATING AGENCIES CONSIDER BOTH BUSINESS RISKS AND  
4 FINANCIAL METRICS IN ESTABLISHING A UTILITY’S CREDIT RATINGS?

5 A. Yes. Credit rating agencies assess, and assign ratings to, both a utility’s: (1) Business  
6 Risk; and (2) Financial Risk when making rating determinations. A utility’s Financial  
7 Risk is based on credit metrics. Business Risk and Financial Risk are considered  
8 together when a credit rating agency determines a utility’s credit rating and each  
9 category of risk affects the level of risk that the rating agency requires of the other  
10 category in order to maintain a given rating. For example, the required Financial Risk  
11 becomes more stringent (i.e. the credit metrics must be better) to maintain a given  
12 credit rating as the utility’s Business Risk rating decreases (indicating higher level  
13 business risk).

14  
15 Q. WHAT ARE THE COMPONENTS THAT ARE CONSIDERED IN DETERMINING  
16 A UTILITY’S BUSINESS RISK?

17 A. A utility’s business risk considers a number of factors, including: (1) the regulatory  
18 environment in which the utility provides service, including the timing and ability to  
19 recover investment; (2) the risk of environmental and other changes that may affect  
20 the utility’s costs and ability to provide service; (3) the size and diversity of a utility’s  
21 customer base; and (4) the economic strength of the utility’s service area. Because a  
22 utility’s ability to set rates and recover its costs is so dependent on cost of service  
23 regulation, a utility’s regulatory environment is a key element of its business risk  
24 rating. The scope of a utility’s investments is also a very significant factor in  
25 assessing a utility’s risk.

26

1 Q. HAVE THE RATING AGENCIES ADDRESSED THE LARGE SCOPE OF OTP'S  
2 CAPITAL EXPENDITURES?

3 A. Yes. Moody's, Fitch, and S&P have each explicitly recognized the large scope of  
4 OTP's capital expenditure program. Based on information for 2017-2021, Moody's  
5 has noted "OTP's current five-year capital investment program is approximately \$862  
6 million."<sup>18</sup> Fitch similarly noted the "Large capex program at OTP totaling \$862  
7 million through 2021."<sup>19</sup> S&P stated it could revise the outlook downward from  
8 positive to stable "if rising capital spending continues without adequate and timely  
9 recovery of costs."<sup>20</sup> Rating agencies (and the capital markets) are particularly aware  
10 of the need for regulatory decisions that support the recovery of capital expenditures  
11 during periods of substantial expenditures

12  
13 Q. HAVE THE RATING AGENCIES ADDRESSED THE RELATIONSHIP OF  
14 REGULATORY DECISIONS TO OTP'S CAPEX PROGRAM?

15 A. Yes. The importance and connection of supportive regulatory decisions to OTP's  
16 capital expenditures plan has been explicitly discussed. Moody's recently said:

17 OTP's rating outlook reflects Moody's expectation that the regulatory  
18 environments for OTP remain credit supportive and that OTP will  
19 continue to produce predictable and stable cash flows.

20 \*\*\*

21 For OTP, a rating downgrade is possible if its regulatory support wanes  
22 and becomes less credit supportive such that regulatory lag increases or  
23 cost recovery is negatively affected.<sup>21</sup>

24  
25 Fitch has similarly said:

26 Otter Tail Power's (OTP) Stable Outlook reflects that regulated nature  
27 of its electric utility operations and a balanced regulatory environment  
28 across its three state jurisdictions .....<sup>22</sup>

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18 Moody's 2017, p. 4.

19 Fitch 2017, p. 4.

20 S&P 2017, p. 2.

21 Moody's 2017, pp 1, 2.

22 Fitch 2017, p 2.

1 S&P has noted the Positive outlook may not lead to an upgrade of the credit  
2 rating:

3 [I]f rising capital spending continues without adequate and timely  
4 recovery of costs.”<sup>23</sup>  
5

6 Q. HOW IMPORTANT ARE REGULATORY AND COST RECOVERY IN  
7 RELATION TO FINANCIAL METRICS IN DETERMINING OTP’S RATINGS?

8 A. Regulatory and cost recovery appear to be as important as financial metrics in  
9 determining OTP’s credit ratings. Exhibit \_\_ (KGM-1), Schedule 4 is a copy of  
10 Moody’s Rating Factors for OTP from the August 9, 2017 Credit Opinion for OTP.  
11 The August 9, 2017 Credit Opinion shows the four factors Moody’s considered in its  
12 rating decisions for OTP along with the weightings given to each. Regulatory  
13 Framework was weighted 25 percent. Ability to Recover Costs and Earn Returns  
14 (which reflect regulation) was weighted 25 percent. Diversification was weighted 10  
15 percent. Financial Strength was weighted 40 percent.<sup>24</sup> The impact of regulation and  
16 resulting ability to recover costs and earn returns accounted for 50 percent of the  
17 ratings.  
18

19 Q. WILL THE ROE AUTHORIZED IN THIS PROCEEDING BE IMPORTANT TO  
20 OTP’S CREDIT RATINGS, INVESTORS, AND COST OF CAPITAL?

21 A. Yes. While ROE is certainly not the only factor considered in the evaluation of a rate  
22 case or a potential investment in a utility doing business in a particular state, it is easy  
23 for rating agencies and investors to identify and compare ROEs to expectations and to  
24 ROEs from other jurisdictions. The ROEs are also regarded as an indicator of  
25 regulatory support or the lack of support, as the Moody’s action and Issuer Comment  
26 pertaining to Minnesota Power demonstrate. Moody’s also recently noted “A rating  
27 upgrade could be considered if OTP’s regulatory environments improved materially,  
28 further shortening regulatory lag and improving rates and returns.”<sup>25</sup>

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<sup>23</sup> S&P 2017, p. 2.

<sup>24</sup> Moody’s 2017, p. 5.

<sup>25</sup> Moody’s 2017, p. 2.

1 Q. IS OTP'S CAPITAL STRUCTURE IMPORTANT TO OTP'S RATING AGENCIES,  
2 INVESTORS, AND COST OF CAPITAL?

3 A. Yes. A utility's capital structure provides the long-term structural foundation for the  
4 financing required to support its operations and capital investment plans. It is  
5 particularly important when a utility is making significant capital expenditures, as  
6 reflected in Fitch's recent Rating Report noting that:

7 Fitch expects ... that future funding needs will be met by a balanced mix  
8 of debt and equity and that [Otter Tail Corporation] will downstream  
9 additional equity as needed to support the balanced capital structure.<sup>26</sup>  
10

11 Q. WHAT IS YOUR CONCLUSION?

12 A. When a utility is engaged in an extensive capital expenditure program, a decision in a  
13 single rate case can have adverse effects that last long beyond the term of the rates set  
14 in that case. This is true in the case of OTP at this time, which continues to be  
15 engaged in an extensive capital expenditure program that will involve capital  
16 expenditures of approximately \$901 million in the 2018-2022 timeframe. As a result,  
17 OTP requests the Commission take these facts into consideration when determining  
18 where to set the ROE for OTP within the range of reasonable ROEs.

## 19 **VIII. COMPONENTS OF OTP'S PROPOSED CAPITAL STRUCTURE**

20 Q. WHAT ARE THE COMPONENTS OF OTP'S CAPITAL STRUCTURE?

21 A. OTP's capital structure consists of LTD, STD and common equity.

### 22 **A. LONG-TERM DEBT**

23 Q. WHAT IS THE AMOUNT AND COST OF OTP'S LTD IN THE PROPOSED  
24 CAPITAL STRUCTURE FOR THE 2017 TEST YEAR?

25 A. The 13-month average of OTP's LTD for the 2018 forecast year that is proposed for  
26 use in the 2017 Test Year is \$492.7 million and the cost of LTD is 5.30 percent, as  
27 shown on Exhibit \_\_\_ (KGM-1), Schedule 5.

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<sup>26</sup> Fitch 2017, p.3.

1 Q. HOW DO THE AMOUNT AND THE COST OF OTP'S LTD IN THE CURRENT  
2 RATE CASE COMPARE TO OTP'S LAST RATE CASE?

3 A. Since OTP's last rate case, LTD has increased by approximately \$196.5 million and  
4 the cost has decreased by approximately 151 basis points as shown in Table 6 below:

5

6

7

8

**Table 6**  
OTP LTD 2008 Rate Case and Current Case  
(\$ millions)

	2008 Rate Case	Current Rate Case	Difference
Amount	\$296.2	\$492.7	\$196.5
Cost	6.81%	5.30%	(1.51)%

9

10 **B. COMMON EQUITY**

11 Q. WHAT IS THE AMOUNT OF OTP'S 2018 FORECAST COMMON EQUITY AND  
12 HOW WAS IT DETERMINED?

13 A. OTP's common equity of \$562.3 million reflects the average of 13 month-end  
14 expected equity balances from December 2017 through December 2018 as shown on  
15 Exhibit\_\_\_ (KGM-1), Schedule 6. Since that schedule was prepared, Otter Tail  
16 Corporation has made a \$10 million equity infusion into OTP. OTP does not  
17 anticipate increasing the proposed 53.1 percent equity ratio as a result of that equity  
18 infusion or other possible equity infusions by Otter Tail Corporation.

19

20 Q. HAS OTTER TAIL CORPORATION RECENTLY ISSUED COMMON STOCK?

21 A. Yes. Otter Tail Corporation has had follow on offerings of its common stock since  
22 2004 and 2008. Otter Tail Corporation also issued common stock during the 2014-  
23 2017 timeframe using its "At the Market Program," its Dividend Reinvestment Plan  
24 (DRIP), and its Employee Stock Purchase Plan (ESPP). All of these common stock  
25 issuances are included on Exhibit \_\_\_KGM-1), Schedule 7.

26

1 Q. ARE THERE COSTS OF ISSUING COMMON STOCK?

2 A. Yes. When common stock is issued, the corporation issuing the stock incurs costs in  
3 the process of issuance, including underwriter discounts, audit, legal, printing and  
4 listing fees, and other expenses of issuance. When these issuance costs (also known as  
5 “flotation costs”) are incurred, they reduce the net proceeds received by the  
6 corporation issuing the stock (under generally accepted accounting principles).  
7 Flotation costs are comparable to the issuance costs for LTD. The flotation costs  
8 associated with Otter Tail Corporation’s common stock issuances are identified in  
9 Exhibit\_\_KGM-1), Schedule 7, which Mr. Hevert used to determine the flotation  
10 cost adjustment. All of these flotation costs were treated as a reduction in proceeds  
11 and reflected on the balance sheet and not expensed, which is the standard practice  
12 with all flotation costs.

13

14 Q. WERE THESE 2014-2017 COMMON STOCK ISSUANCES BY OTTER TAIL  
15 CORPORATION RELATED TO OTP’S CAPITAL EXPENDITURES?

16 A. Yes. These Otter Tail Corporation common stock issuances were directly related to  
17 OTP’s prior capital expenditures, its current capital expenditures and its planned  
18 future capital expenditures.

19

20 Q. PLEASE SUMMARIZE OTTER TAIL CORPORATION’S PLANNED COMMON  
21 STOCK ISSUANCES.

22 A. As I noted earlier, OTP plans to finance its estimated \$901 million of capital  
23 expenditures in the 2018-2022 timeframe with a balanced mix of equity and debt,  
24 including OTP retained earnings and equity infusions from Otter Tail Corporation,  
25 including the results of common stock issuances. These common stock issuances by  
26 Otter Tail Corporation are expected to include issuances under its At-the-Market  
27 (ATM) program, its Dividend Reinvestment Plan (DRIP) and its Employee Stock  
28 Purchase Plan (ESPP) during the 2018 - 2022 timeframe.

29

1 Q. ARE THE 2014-2017 AND PLANNED COMMON STOCK ISSUANCES  
2 DIRECTLY RELATED TO OTP'S INVESTMENT PLANS?

3 A. Yes. The 2014-2017 common stock issuances and planned issuances of common  
4 stock by Otter Tail Corporation during the 2018 – 2022 timeframe are directly related  
5 to the current and planned capital expenditures for OTP.

6 **XI. CONCLUSION**

7 Q. CAN YOU PLEASE SUMMARIZE YOUR CONCLUSIONS?

8 A. Yes. I recommend the Commission approve a capital structure for the 2017 Test Year  
9 including 53.10 percent equity, a 10.30 percent ROE, and an ROR of 7.96 percent.

10

11 Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

12 A. Yes, it does.