

Prefiled Direct Testimony and Exhibits
Crystal D. Lail

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. EL23-_____

June 15, 2023

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Capital Structure Calculation

Exhibit__(CDL-1)

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Witness Information

Q. Please state your name and business address.

A. My name is Crystal D. Lail, and my business address is 3010 W. 69th Street, Sioux Falls, South Dakota 57108.

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

A. I am employed by NorthWestern Energy (“NorthWestern” or “Company”) as Vice President and Chief Financial Officer.

Q. Please provide a description of your relevant employment experience and other professional qualifications.

A. I have been with NorthWestern since January 2003. As Vice President and Chief Financial Officer, my primary responsibilities include the oversight of the finance organization, including accounting, financial planning and analysis, investor relations, reporting, enterprise risk management, tax, and treasury. This responsibility includes development and maintenance of internal controls to safeguard the financial assets of the Company.

Purpose of Testimony

Q. Please summarize your testimony.

A. NorthWestern has over the years successfully performed its role of providing safe and reliable service to customers at reasonable rates. We have operated in a cost-effective manner and maintained the required level of service through

1 repair and replacement of aging system assets, adoption of new technologies to
2 improve system efficiency, and expansion of capacity to support growth all while
3 protecting critical infrastructure from physical and cyber security threats. In order
4 to continue to achieve these goals, NorthWestern requires significant capital
5 investments and continuous access to financing to fund these investments.
6 Access to financing, both in terms of cost and availability, can only be optimized
7 if NorthWestern has a strong financial position. A lower cost of capital derived
8 from having a lower business and financial risk profile will benefit customers in
9 the form of reliable utility service at reasonable rates.

10
11 In this filing, my testimony discusses the capital structure, cost of debt, and cost
12 of equity requested by NorthWestern in this proceeding and makes the following
13 recommendations:

- 14 • The capital structure recommended is 49.50% debt and 50.50% equity;
- 15 • The cost of debt is 4.32%;
- 16 • The cost of equity is 10.70%; and
- 17 • The rate of return is 7.54%.

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

19
20 **Q. How does NorthWestern finance its investments and operations?**

21 **A.** Similar to other utilities, NorthWestern finances its investments and operations by
22 issuing debt (i.e. issuing secured long-term debt in the form of first mortgage
23 bonds and borrowing short-term from the revolving credit facilities) and equity

1 (i.e., offering shares of Company stock) and typically accesses the capital
2 markets on an annual basis. In order to fund continued investment in
3 infrastructure to serve customers in South Dakota at reasonable rates, access to
4 capital on reasonable terms is critical. It is therefore important for NorthWestern
5 to meet debt and equity investor expectations and maintain its current credit
6 ratings to continue to be able to obtain financing at competitive rates. It is
7 important that we receive timely recovery of the costs for investments and
8 operations as well as a reasonable overall cost of capital in order to be able to
9 maintain the ability to obtain financing at reasonable rates for customers.
10

11 **Q. What does the term “financial health” mean and how is it important to**
12 **NorthWestern in providing essential service?**

13 **A.** Financial health is critical to our ability to provide safe and reliable service at the
14 lowest cost possible because it impacts:

- 15 • Liquidity – ability to fund day-to-day operations such as energy supply
16 procurement and maintenance of our infrastructure without disruption or
17 restriction;
- 18 • Cost of capital – access to low interest rates for our debt and attractive price
19 for our common stock; and
- 20 • Credit availability – ability to do business with vendors under favorable terms.

21
22 Financial health refers to a company’s financial strength and its ability to attract
23 capital in varying economic conditions. A strong financial position, supported by

1 a balanced capital structure and stable cash flows, an appropriate return on
2 equity range relative to market conditions and risk, and the opportunity to earn
3 authorized returns, is critical to our ability to attract capital at a competitive cost in
4 various economic conditions. Ultimately, our financial position is foundational to
5 our obligation to provide affordable, safe, and reliable utility service to customers.
6 As a regulated utility, NorthWestern has a responsibility to provide safe and
7 reliable service to all customers, current and future, within its service territories.
8 This is a responsibility that remains in place no matter the state of the financial or
9 commodity markets and regardless of unexpected external events, such as major
10 storms, economic cycles, and even such unprecedented events as the recent
11 global pandemic.

12
13 In times of depressed market conditions and constrained capital supply,
14 generally only financially strong utilities can attract capital under reasonable
15 terms, i.e., lower costs, providing those utilities with significant and potentially
16 critical flexibility. Operating without the flexibility afforded through a strong
17 financial position, (i.e., a strong capital structure, stable cash flows, sufficient
18 return expectations for investors, and sound regulatory recovery mechanisms
19 such as fuel and power cost recovery mechanisms), would expose NorthWestern
20 and our customers to unwarranted and unnecessary financial risk, higher costs,
21 and uncertainty. Financial health ensures that the utility will have the flexibility to
22 withstand unanticipated macroeconomic events outside of its control and
23 maintain access to capital at reasonable costs.

1 Ultimately, weaker financial health at a utility increases the issued cost of debt
2 and the implied cost of equity, which increases the overall weighted average cost
3 of capital (“WACC”) and ultimately increases the financing costs paid by
4 customers. Strong financial health has the opposite effect, which in turn provides
5 a direct benefit to customers. Financial health and strong credit ratings become
6 even more important when the capital markets are in distress and access to
7 capital and liquidity can be critical to the stable operations of the utility.

8
9 **Q. What are the significant factors contributing to overall financial health that**
10 **are important to stability and the ability to weather changes in financial and**
11 **other markets?**

12 **A.** The financial health of a regulated utility is largely a function of a constructive
13 regulatory environment. To maintain a strong financial profile, a utility needs to
14 have the opportunity to recover all prudently-incurred costs in a timely manner,
15 which includes not only the costs for capital investments and operation and
16 maintenance expenses, but also the costs of servicing debt and providing a fair
17 return for equity investors. This is why balanced and consistent regulatory
18 decisions, mechanisms that facilitate timely recovery of costs, and a healthy
19 capital structure are vitally important to utilities, including NorthWestern.

Capital Structure

20
21
22
23 **Q. Please summarize the key points in this section of your testimony.**

- 1 **A.** The most significant points I discuss include the following:
- 2 • The components of capital structure and rate of return have been determined
- 3 using accepted methodologies; and
- 4 • The proposed capital structure is consistent with the capital structure adopted
- 5 in the most recent electric general rate review.

6

7 **Q.** Please summarize your specific recommendations for capital structure and

8 overall rate of return.

9 **A.** I recommend approval of the proposed test year capital structure with 50.50%

10 common equity and an overall rate of return of 7.54%, as shown below.

<u>Debt/Book Capitalization</u>	<u>Adjusted</u>	<u>Percent of Capitalization</u>		
SD/NE Utility Debt	480,000,000	49.50%	4.32%	2.14%
SD/NE Utility Book Equity	489,721,075	50.50%	10.70%	5.40%
11 Total	969,721,075	100.00%		7.54%

12

13 **Q.** Please describe the methodology used to calculate the capital structure

14 recommended in this case.

15 **A.** NorthWestern is proposing to use the divisional capital structure of the South

16 Dakota/Nebraska (“SD/NE”) utility businesses which is comprised of the SD/NE

17 jurisdictional long-term debt and SD/NE jurisdictional propriety capital (book

18 equity) as presented in Statement A (page 2 of 2), adjusted to reflect \$61.0

19 million of SD/NE jurisdictional secured debt issued in March and May of 2023

20 (see Statement G, page 2 of 4) and \$44.4 million of increase in equity capital due

21 to the reclassification of intercompany payables to equity the amounts related to

1 deferred tax assets allocable to the SD/NE utility from the non-jurisdictional
2 division of NorthWestern Corporation, the consolidated entity. The ratio is
3 calculated to be 49.50% debt and 50.50% equity. Since the SD/NE jurisdictional
4 debt is proportionally allocated to all three businesses – SD Electric, SD Gas,
5 and Nebraska Gas, the book capitalization of the SD/NE division is
6 representative of the book capitalization of the South Dakota electric utility.
7

8 **Q. Please explain why using the divisional capital structure is the most**
9 **appropriate methodology to use.**

10 A. NorthWestern plans to reorganize into a holding company structure where the
11 SD/NE jurisdictional utility and the Montana jurisdictional utility will become
12 stand-alone subsidiaries. With that anticipated restructuring, the current
13 divisional capital structure of the SD/NE jurisdictional utility, adjusted to reflect
14 the transfer of the deferred tax assets to the respective jurisdictional utility, is an
15 accurate representation of the long-term capitalization of the to-be-formed SD/NE
16 utility subsidiary and thus, appropriate to use as the regulatory capital structure
17 for this filing.
18

19 **Q. Please explain why it is appropriate to increase the equity capital of the**
20 **SD/NE jurisdictional utility by the \$44.4 million to reflect the reclassification**
21 **of certain intercompany payables to equity.**

22 A. Certain deferred tax assets in the books of the SD/NE jurisdictional utility are
23 recorded as an allocation from the non-jurisdictional division of NorthWestern

1 Corporation as an intercompany payable. When the process of reorganization to
2 a holding company structure is completed, this intercompany payable will be
3 converted to equity capital provided by the non-jurisdictional division. As such, it
4 is appropriate to increase the equity capital of the SD/NE jurisdictional utility by
5 the \$44.4 million to reflect the permanent allocation of the deferred tax assets to
6 the SD/NE utility.

7
8 **Q. What other methodologies have you used to validate this proposed capital**
9 **structure?**

10 **A.** I used two data points to validate this proposed capital structure:

- 11 • First, I looked at the consolidated capital structure of NorthWestern
12 Corporation as of December 31, 2022. Using the total long-term secured
13 debt and the total shareholders' equity of the consolidated entity, adjusted
14 for \$300 million of total secured debt issued in 2023, the consolidated
15 capital structure is 48.09% debt and 51.91% equity. This is shown on
16 Exhibit_(CDL-1).
- 17 • Second, I looked at the average capital structure of the operating
18 companies of the proxy group used by our return on equity ("ROE")
19 witness, Adrien McKenzie of FINCAP, Inc., which is shown on Exhibit
20 AMM-4 page 2-3 of 3. The average capital structure of this group is 48%
21 debt and 52% equity (which included 0.2% of preferred stock).

1 **Q. The methodologies you mentioned above both show capital structures with**
2 **equity components of approximately 52%. Please explain why the capital**
3 **structure you are proposing has a lower equity component of 50.50%.**

4 **A.** The proposed capital structure includes \$61 million of debt issued in 2023,
5 which is beyond the test period but included as a known and measurable
6 change in this filing. This incremental debt is intended to cover capital
7 investments planned for 2023, and the assets and associated earnings from
8 these investments have yet to materialize in the equity capital for the SD/NE
9 jurisdictional utility. As such, the capital structure proposed in this case
10 understates the equity component of the long-term capitalization of the utility.
11

12 **Q. How does this capital structure compare to the capital structure proposed**
13 **by NorthWestern in the last electric rate case filed in South Dakota?**

14 **A.** In the 2014 electric rate case, the proposed capital structure was 46.4% debt and
15 53.6% equity, thus the proposed structure reflects a higher usage of debt since
16 the last case and resulting lower equity component.
17

18 **Cost of Debt**

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

21 **A.** Long-term debt as of December 31, 2022, reflects the total debt directly secured
22 by assets of the combined electric and natural gas utilities in South Dakota and
23 Nebraska, which was equal to \$419.0 million. Then, I added \$61 million of

1 incremental long-term debt issued in March and May of 2023 to support
2 investments in the combined utility businesses in South Dakota/ Nebraska as a
3 known and measurable change to the total long-term debt (see Statement G,
4 page 2 of 4.)

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

7 **A.** To derive the total annual cost of long-term debt, the annual interest cost is
8 added to the annual amortization of debt discount and issuance expense
9 associated with each debt component (see Statement G, page 2 of 4). This
10 amount is then divided by the total annual cost of long-term debt by the long-term
11 debt outstanding of \$480.0 million, determining a weighted average cost of long-
12 term debt of 4.32%.

13
14 **Q. How is your cost of debt different from the cost of debt in your last filing?**

15 **A.** The cost of debt filed in our last South Dakota electric rate case in 2014 was
16 5.14%, substantially higher than the 4.32% in this filing, resulting in a lower cost
17 for customers.

18
19 **Cost of Equity**

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

21 **A.** I relied on the analysis performed by Adrien McKenzie of FINCAP, Inc., which is
22 explained in his prefiled direct testimony. Mr. McKenzie's analysis shows a
23 range of reasonableness for return on equity ("ROE") – using an electric utilities

1 only proxy group and a low-risk non-utility firms proxy group – to be 10.2% to
2 11.2%, with a midpoint of the range of 10.7%, inclusive of common equity
3 flotation cost. I agree with Mr. McKenzie’s analysis and recommend using an
4 ROE of 10.7%.

5
6 **Q. How does the 10.7% cost of equity proposed in this case compare to ROEs
7 proposed in recent rate cases in South Dakota?**

8 **A.** The 10.7% ROE proposed is in line and in fact, slightly conservative compared to
9 recent rate cases filed with the Commission.

<u>COMPANY</u>	<u>Docket No.</u>	<u>Date Filed</u>	<u>ROE</u>	<u>ROR</u>	<u>Cap Structure Debt/Equity</u>
Xcel	EL22-017	June 2022	10.75%	7.65%	46.99%/53.01%
MidAm	NG22-005	May 2022	10.75%	7.604%	46.67%/53.33%
NorthWestern		June 2023	10.70%	7.54%	49.50%/50.50%

10 **Q. Please describe the importance of the determination of a reasonable
11 authorized ROE.**

12 **A.** The outcome in this proceeding should provide NorthWestern the opportunity to
13 earn an ROE that is: (1) adequate to attract capital at reasonable terms under a
14 variety of economic and financial market conditions over the period of time that
15 its investment will be recovered; (2) sufficient to reasonably ensure its financial
16 integrity; and (3) commensurate with returns on investments in enterprises with
17 similar risk. Providing the opportunity to earn a market-based cost of capital
18 supports the financial integrity, which is in the interest of both customers and
19 shareholders.

1 **Q. What effect do current and prospective market conditions have on the cost**
2 **of equity?**

3 **A.** The combination of persistently high inflation, the Federal Reserve's changes in
4 monetary policy, and the dramatic shifts in market conditions all contribute to an
5 expectation of increased market risk and an increase in the ROE required by
6 investors. It is essential that these factors be considered in determining an
7 appropriate forward-looking ROE. Inflation is currently at the highest level
8 experienced in approximately 40 years. Interest rates, which have increased
9 significantly from pandemic-related lows in 2020, are expected to continue to
10 increase in direct response to the Federal Reserve's use of monetary policy to
11 address inflation. Because there is a strong historical inverse correlation
12 between interest rates and the share prices of utility stocks (share prices of utility
13 stocks typically fall when interest rates rise), it is reasonable to expect that
14 investors' required ROEs for utility companies will also continue to increase.
15 Therefore, ROE estimates based solely on current market conditions will
16 understate the ROE required by investors during the future period that the rates
17 determined in this proceeding will be in effect.

18
19 **Q. Is a utility's ability to attract capital also affected by the ROEs that are**
20 **authorized for other utilities?**

21 **A.** Yes, utilities compete directly for capital with other investments of similar risk,
22 which include other natural gas and electric utilities. The ROE awarded to a
23 utility and ability to earn that ROE sends an important signal to investors

1 regarding whether there is regulatory support for financial integrity, dividends,
2 growth, and fair compensation for business and financial risk. The cost of capital
3 represents an opportunity cost to investors. If higher returns are available for
4 other investments of comparable risk, investors have an incentive to direct their
5 capital to those investments. Thus, an authorized ROE that is not commensurate
6 with authorized ROEs for other natural gas and electric utilities and persistent
7 under-earning of that authorized amount can inhibit the utility's ability to attract
8 capital for investment, ultimately resulting in higher costs to customers.

9 10 Rate of Return

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

13 **A.** The overall cost of capital required for the electric utility in South Dakota is
14 derived from the cost of long-term debt and cost of equity appropriate for the
15 utility, weighted by the percentage of debt and equity in the proposed capital
16 structure. The calculation of the weighted average cost of capital is shown on
17 Statement G, page 1 of 4. As indicated on the statement and summarized earlier
18 in my testimony, the weighted average cost of capital (rate of return or ROR) is
19 7.54%.

20
21 **Q. How does the proposed ROR compare to the current authorized ROR for**
22 **the electric utility?**

1 **A.** This rate of return is only slightly higher than the current authorized ROR for the
2 SD Electric Utility of 7.24%, despite the higher returns required by investors
3 given increased risks associated with the unprecedented hike in inflation, higher
4 interest rates, and persistent market instability as described in detail in Mr.
5 McKenzie's testimony. To reiterate Mr. McKenzie's analysis, failure to allow
6 NorthWestern to earn a rate of return commensurate to comparable risks in the
7 market would result in jeopardizing the financial integrity of the utility and its
8 ability to attract the necessary capital to continue to provide safe and reliable
9 service to its customers.

10

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

12 **A.** Yes, it does.