Pre-filed Direct Testimony
Emilie T. Ng

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

In the Matter of the Application of
NorthWestern Energy Public Service Corporation, d/b/a NorthWestern Energy

For Authority to Increase Gas Utility Rates
in South Dakota

Docket No. NG24-_____

June 21, 2024

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Witness Information

Q. Please state your name and business address.

A. My name is Emilie T. Ng, 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 the Treasurer of NorthWestern Energy Public Service Corporation d/b/a NorthWestern Energy ("NorthWestern" or "Company").

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

A. I have been with NorthWestern since May 2002. As Treasurer, I am responsible for the areas of corporate finance, cash management, credit management, and bank and rating agency relations. Prior to joining NorthWestern, I held various positions in commercial and investment banking. I have a Masters of Business Administration degree from The University of Chicago.

Purpose of Testimony

Q. Please summarize your testimony.

A. My testimony discusses the capital structure, cost of debt, and cost of equity requested by NorthWestern in this proceeding and makes the following recommendations:

- The capital structure recommended is 46.87% debt and 53.13% equity;

- The cost of debt is 4.42%;
- The cost of equity is 10.70%; and
- The rate of return is 7.75%.

This summary is shown on Statement G Page 1 of 4.

My testimony also discusses the importance of having a financially-healthy utility.

Capital Structure

Q. Please summarize your specific recommendations for capital structure and overall rate of return.

A. I recommend approval of the proposed test year capital structure with 53.13% common equity and an overall rate of return of 7.75%, as shown below.

NorthWestern Energy Public Service Corp.

	Capital Structure	Rate	Weighted Rate
Debt to Book Capitalization			
Utility Long-Term Debt	46.87%	4.42%	2.07%
Utility Book Equity	53.13%	10.70%	5.68%
Rate of Return	100.00%		**7.75%**

Note: See Statement G page 1 of 4 for further details.

Q. Please describe the methodology used to calculate the capital structure recommended in this case.

A. NorthWestern reorganized into a holding company structure where its South Dakota and Nebraska ("SD/NE") jurisdictional utilities and the Montana jurisdictional utility became two stand-alone subsidiaries starting on January 1, 2024.[1] The filing reflects the book capitalization of the SD/NE subsidiary as of March 31, 2024, which is presented in its FERC Form 1/3-Q filing (see Statement G Page 1 of 4), capturing the holding company reorganization in the known and measurable period. This book capitalization is comprised of all the long-term debt secured by its assets and the proprietary capital (book equity) of NorthWestern. The ratio is calculated to be 46.87% debt and 53.13% equity.

Q. Please explain why the book capitalization as of March 31, 2024 accurately reflects the regulated capital structure.

A. Although the entity NorthWestern Energy Public Service Corporation existed as a legal entity as of December 31, 2023, the assets of the SD/NE utilities were not transferred until January 1, 2024 and the allocation of the capitalization for NorthWestern was completed during the first quarter of 2024. As such, the book capitalization of NorthWestern as of March 31, 2024 is a more accurate representation of the long-term capitalization of the SD/NE standalone utility subsidiary and thus, appropriate to use as the regulatory capital structure for this filing.

Q. How does this capital structure compare to the capital structure proposed by NorthWestern in the last rate review filed in South Dakota?

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[1] Docket GE22-002: Order approving corporate restructuring plan for NorthWestern Corporation pursuant to which (a) NorthWestern Corporation will transfer its public utility operations in South Dakota and Nebraska to a new entity, NorthWestern Energy Public Service Corporation, effective January 1, 2024; and (b) such new entity and NorthWestern Corporation will become wholly-owned subsidiaries of NorthWestern Energy Group, Inc.

A. In the 2023 South Dakota electric rate review, the proposed capital structure was 49.50% debt and 50.50% equity.

Cost of Debt

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

A. I used the total long-term debt secured by assets of the combined electric and natural gas utilities in South Dakota and Nebraska as of March 31, 2024, which was $520.0 million.

Q. Why is the unsecured revolving credit facility debt excluded from the calculation of the capital structure?

A. The unsecured revolving credit facility borrowings of $11 million as of March 31, 2024 is excluded from the capitalization calculation. These borrowings are generally used for ongoing working capital (e.g., energy supply purchases, construction work in process, dividends to parent, taxes, etc.) and therefore, not part of the long-term capitalization of the Company. Borrowings under the unsecured credit facility may be repaid using a combination of internally generated cash flows, equity issuances, and/or long-term debt issuances. Until such time that the unsecured revolving credit facility debt is refinanced as long-term secured debt, this portion of debt should not be considered permanent, long-term capital of the utility.

Q. How did you determine the cost of debt?

A. To derive the total annual cost of long-term debt, the annual interest cost is added to the annual amortization of debt discount and issuance expense associated with each debt component (see Statement G page 1 of 4). This total annual cost of long-term debt amount is then divided by the long-term debt outstanding of $520.0 million, determining a weighted average cost of long-term debt of 4.42%.

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

A. The cost of debt filed in our last South Dakota rate review in 2023 was 4.32%, slightly lower than the 4.42% in this filing. As interest rates have reached all-time highs in recent years, recent debt issuances by the Company have come at a higher cost resulting in a higher overall cost of debt for the utility.

Cost of Equity

Q. How did you determine the cost of equity?

A. I relied on the analysis performed by Adrien McKenzie of FINCAP, Inc., which is explained in his direct testimony. Mr. McKenzie's analysis shows a range of reasonableness for return on equity ("ROE") – using a natural gas utilities proxy group and a low-risk non-utility firms proxy group – to be 10.2% to 11.2%, with a midpoint of the range of 10.7%. I agree with Mr. McKenzie's analysis and recommend using an ROE of 10.7%.

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

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

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

A. The combination of sustained higher long-term interest rates, significant capital investments required by the utility sector, and uncertainty posed by de-carbonization policies all contribute to an expectation of increased market risk and an increase in the ROE required by investors when investing in utilities. It is essential that these factors be considered in determining an appropriate forward-looking ROE. Inflation recently reached the highest level experienced in approximately 40 years. Interest rates, which have increased significantly from pandemic-related lows in 2020, are expected to continue to remain high as the Federal Reserve uses monetary policy to address inflation. Because there is a strong historical inverse correlation between interest rates and the share prices of utility stocks (share prices of utility stocks typically fall when interest rates rise), it is reasonable to expect that investors' required ROEs for utility companies will also continue to increase.

<u>Rate of Return</u>

Q. How did you determine the overall cost of capital required for the natural gas utility in South Dakota?

A. The overall cost of capital required for the natural gas utility in South Dakota is derived from the cost of long-term debt and cost of equity appropriate for the utility, weighted by the percentage of debt and equity in the proposed capital structure. The calculation of the weighted average cost of capital is shown on Statement G Page 1 of 4. As indicated on Statement G and summarized earlier in my testimony, the weighted average cost of capital (rate of return or "ROR") is 7.75%.

Q. How does the proposed ROR compare to the current authorized ROR for the South Dakota natural gas utility?

A. This rate of return is slightly lower than the current authorized ROR for the South Dakota natural gas utility of 7.79%, despite the higher returns required by investors given increased risks associated with the unprecedented hike in inflation, higher interest rates, and persistent market instability as described in detail in Mr. McKenzie's testimony. To reiterate Mr. McKenzie's analysis, failure to allow NorthWestern to earn a rate of return commensurate to comparable risks in the market would result in jeopardizing the financial integrity of the utility and its ability to attract the necessary capital to continue to provide safe and reliable service to its customers.

Utility Financial Health

Q. How does NorthWestern finance its investments and operations?

A. Similar to other utilities, NorthWestern finances its investments and operations by using its internally generated cash flows and by issuing debt (i.e. issuing secured long-term debt in the form of first mortgage bonds and borrowing short-term from the revolving credit facilities) and equity (i.e., offering shares of Company stock). In order to fund continued investment in infrastructure to serve customers in South Dakota at reasonable rates, access to capital on reasonable terms is critical.

Q. How does NorthWestern ensure that it maintains access to these financing options at reasonable rates?

A. In order to ensure access to financing at competitive rates for customers, it is important for NorthWestern to meet debt and equity investors expectations by maintaining a financially-healthy utility. A financially-healthy utility is one that receives timely recovery of its costs of operations and investments as well as a reasonable overall rate of return.

Q. How is financial health important to NorthWestern in providing essential service?

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

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

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

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

On top of its negative effect on financial flexibility, weaker financial health at a utility increases its issued cost of debt and cost of equity, which increases the overall weighted average cost of capital for the utility that is ultimately borne by its customers.

Q. What are the significant factors contributing to overall financial health of a utility?

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

Q. Does this complete your pre-filed direct testimony?

A. Yes, it does.