

1 Minnesota. I have a BBA from the University of Wisconsin – Eau Claire with a
2 double major in Accounting and Finance. I also have my CPA certificate.

3
4 **Q. What is the purpose of your testimony?**

5 A. My testimony will discuss the capital structure, cost of debt, and cost of equity
6 requested by NorthWestern in this proceeding.

7
8 **Q. What are your conclusions?**

9 A. The following is a summary of my conclusions regarding the overall cost of
10 capital for the Gas utility in South Dakota:

- 11 • The capital structure recommended is 43.9% debt and 56.1% equity;
- 12 • The cost of debt is 5.83%;
- 13 • The cost of equity is 10.90%;
- 14 • The rate of return is 8.68%;

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

16
17 **Q. What is the Company's proposed capital structure?**

18 A. The Company is proposing to use a capital structure of 43.9% debt and 56.1%
19 equity, which is based on the South Dakota gas utility rate base and debt
20 allocable to the South Dakota gas utility business. The South Dakota gas rate
21 base I have used is \$59.7 million, which represents the adjusted 13-month
22 average rate base at December 31, 2010. For the debt allocable to the South
23 Dakota gas utility, I started with the total South Dakota and Nebraska
24 jurisdictional debt which are directly secured by the physical assets of the electric
25 and gas utilities in South Dakota and Nebraska. The total debt identified was
26 \$119.0 million as of December 31, 2010 (see Statement G, Page 2 of 4). I then
27 allocated debt to the South Dakota electric utility, the South Dakota gas utility
28 and the Nebraska gas utility businesses proportionately based on their
29 respective rate base amounts. The debt allocable to the South Dakota gas utility
30 business is \$26.2 million. This calculation is shown on Exhibit BBB-1.

1 The equity for the South Dakota gas utility business is derived by deducting the
2 debt allocated to the South Dakota gas utility business (\$26.2 million) from the
3 South Dakota gas utility rate base (\$59.7 million). The derived equity amount is
4 \$33.5 million. The 43.9% debt and 56.1% equity, therefore, represents the
5 capital structure specific to the South Dakota gas utility business. This
6 calculation is shown on Exhibit BBB-1.

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

10 A. I have used two other methodologies to support the capital structure appropriate
11 for this filing:

12 a) Consolidated capital structure of NorthWestern Corporation as of the end of
13 the test year, which is calculated to be 52.6% debt and 47.4% equity using the
14 total long-term debt (excluding short-term borrowings under the corporate
15 revolver) and the total shareholders' equity of the consolidated entity;

16 b) The divisional capital structure of the South Dakota/Nebraska Electric and
17 gas utility businesses, which is calculated to be 33.6% debt and 66.4% equity.
18 Since the South Dakota/Nebraska jurisdictional debt is proportionally allocated to
19 all three businesses, the book capitalization of the South Dakota/Nebraska
20 division is representative of the book capitalization of the gas utility of South
21 Dakota.

22
23 **Q. Please explain why you are not using the consolidated capital structure for
24 NorthWestern as your proposed capital structure?**

25 A. Looking at the results of the different methods used to approximate the capital
26 structure of the South Dakota gas utility, it is evident that the consolidated capital
27 structure of NorthWestern Corporation overstates the leverage of the South
28 Dakota gas utility business. NorthWestern's higher consolidated debt to
29 capitalization ratio is a reflection of the company's recent investments in the
30 Colstrip generation assets and the Dave Gates Generation Station (f/k/a Mill
31 Creek Generation Station), both of which are in the Montana jurisdiction. In

1 order to accurately represent the capital structure of the South Dakota gas utility
2 business, I believe the debt to rate base method is the most appropriate method.
3

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

5 A. For the long-term debt existing as of December 31, 2010, I used the total debt
6 that are directly secured by assets of the combined electric and natural gas
7 utilities in South Dakota and Nebraska of \$119.0 million (see Statement G, Page
8 2 of 4).
9

10 To derive the total annual cost of long-term debt, I added the annual interest cost
11 and the annual amortization of debt discount and issuance expense associated
12 with each debt component (see Statement G, Page 2 of 4). By dividing the total
13 annual cost of long-term debt by the long-term debt outstanding of \$119.0
14 million, I determined a weighted average cost of long-term debt of 5.83%.
15

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

17 A. The cost of debt in our last rate case filing in 2007 was 6.57%, substantially
18 higher than the 5.83% in this filing.
19

20 **Q. How did NorthWestern reduce its cost of debt?**

21 A. Over the last five years, NorthWestern has proactively accessed the debt
22 markets to refinance its long-term debt at lower market rates. In May 2008, the
23 Company refinanced \$55.0 million of South Dakota utility first mortgage bonds
24 and reduced the interest rate on the bonds from 7.00% to 6.05%. In May 2010,
25 the Company also refinanced \$64.0 million of South Dakota utility first mortgage
26 bonds and reduced the interest rate on the bonds from 5.88% to 5.01%.
27

28 **Q. What is your proposed cost of equity?**

29 A. I am proposing a cost of equity of 10.9%, which is based on the analysis
30 performed by Dr. William E. Avera. Dr. Avera's analysis shows a range of
31 reasonableness for ROE using three proxy groups, namely: gas utilities only,

1 combined electric and gas distribution utilities, and non-utilities of 10.2% to
2 11.6%. We recommend using 10.9%, which is in the middle of the range.
3

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

6 A. The overall cost of capital required for the gas utility in South Dakota is derived
7 from the cost of long-term debt and cost of equity appropriate for the utility
8 weighted by the percentage of debt and equity in the proposed capital structure.
9 The calculation of the weighted average cost of capital is shown on Statement G,
10 Page 1 of 4. As indicated on the statement, the weighted average cost of capital
11 is 8.68%.

12
13 **Q. How does your proposed rate of return of 8.68% compare to recent**
14 **authorized rate of returns for utilities in South Dakota?**

15 A. The following table shows that, due to our low debt costs and lower requested
16 cost of equity, our filed rate of return is in line with rates of return authorized for
17 other utilities in South Dakota in recent rate cases:

| | Filed Return on Equity | Filed Cost of Debt | Filed Common Equity/ Total Capitalization | Filed Rate of Return | Authorized Rate of Return |
|-------------------------------------|------------------------------|--------------------------|-------------------------------------------------|----------------------------|---------------------------------|
| Black Hills Power (Electric) | 11.50% | 6.85% | 52.0% | 9.27% | 8.26% |
| Northern States Power (Electric) | 11.25% | 6.64% | 51.6% | 9.02% | 8.32% |
| Otter Tail Power (Electric) | 11.25% | 6.71% | 53.2% | 9.13% | 8.50% |
| NorthWestern Energy (Gas) | 10.90% | 5.83% | 56.1% | 8.68% | n.a. |

18
19 **Q. Does this complete your prepared direct testimony?**

20 A. Yes, it does.