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DEPARTMENT OF PUBLIC SERVICE REGULATION  
BEFORE THE MONTANA PUBLIC SERVICE COMMISSION  
OF THE STATE OF MONTANA

IN THE MATTER OF NorthWestern	)	
Energy's Application for Approval to	)	
Purchase and Operate PPL Montana's	)	REGULATORY DIVISION
Hydroelectric Facilities, for Approval of	)	
Inclusion of Generation Asset and Cost of	)	DOCKET NO. D2013.12.85
Service in Electricity Supply Rates, for	)	
Approval of Issuance of Securities to	)	
Complete the Purchase, and for Related	)	
Relief	)	

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**NorthWestern Energy's Post-Hearing Reply Brief**

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## **I. Introduction**

While the Montana Consumer Counsel (“MCC”) does not explicitly recommend that the Montana Public Service Commission (“Commission”) reject NorthWestern Energy’s (“NorthWestern”) Application to acquire the Hydros, it does so implicitly by advocating conditions that would terminate the transaction. From the MCC’s perspective, the short-term rate increase associated with the Hydros isn’t worth the transaction’s benefits. Therefore, the MCC advocates that NorthWestern remain in the market for its electricity supply resources for the indefinite future.

Remaining in the market for a large portion of electricity supply resources is a high-stakes gamble with customers’ dollars and is inconsistent with NorthWestern’s obligations under the law to plan for the long term. The MCC’s advocacy is short-sighted and would expose NorthWestern’s customers to avoidable and unacceptable risks. If the MCC’s guesses about future energy prices are wrong, NorthWestern’s customers remain overly exposed to volatile, escalating, and high energy prices just as they were from 2002-2008, when market prices jumped 112.9%, or in December 2013, when energy prices were, at times, 300% higher than in December 2012. Montana is part of a Pacific Northwest and larger western energy market and an unpredictable, unstable global economy. There is little – if anything – that the State of Montana can do to temper the effects of these markets and their dislocations on Montanans’ energy prices. If NorthWestern remains dependent on the market for a large portion of its energy supply resources, as it has since 2002 and as the MCC urges here, NorthWestern’s customers remain vulnerable and exposed to high and volatile energy prices.

In sharp contrast, NorthWestern focuses on the long term, from the perspectives of both the lowest cost and lowest risk to its customers. Under Original Cost Minus Depreciation (“OC-D”) ratemaking, the Hydros will depreciate over time, lowering their cost to customers. Therefore, for many, many years and far into the future, the Hydros will provide a relatively low and stably-priced energy resource to NorthWestern’s customers. Acquiring the Hydros means that NorthWestern will rely on the market for only 10% of its electricity supply; currently, 50% of NorthWestern’s electricity supply comes from the market. Owning or having under long-term contract 90% of its electricity supply resources (NorthWestern will own outright about 67% of its resources serving Montana) will enable NorthWestern to insulate its customers from rising and volatile market energy prices.<sup>1</sup> Ex. NWE-7 (Prefiled Direct Testimony of Joseph M. Stimatz), JMS-33 (2016, excluding Kerr). The Hydros will diversify NorthWestern’s electricity supply portfolio and, because the Hydros do not burn fuel or emit carbon, will further enable NorthWestern to shield customers from price increases from uncertainty in fuel prices and

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<sup>1</sup> In fact, just a few years ago, the MCC itself argued strongly that NorthWestern needed to get out of the market for precisely these reasons. *In the Matter of NorthWestern Energy’s December 2007 Electric Supply Procurement Plan*, Docket No. N2007.11.138, Comments of the Montana Consumer Counsel, p. 2. The MCC argued that:

NorthWestern must get off the market path as soon as possible, and it should have done so before now. Reliance on the market commits ratepayers to long term escalation and volatility as contracts expire and are replaced at the then current price and future market expectation. By contrast, acquisition of an owned resource fixes the path of at least part of the cost of power from that resource at OC-D, which declines over time, and permits the possibility of long term hedging or fixing of fuel cost risk.

Nowhere does the MCC explain what has changed since it made these comments to cause it to reverse its position.

environmental regulations.<sup>2</sup> And, given that loss of load probability is forecast to increase over the next decade – due to a variety of factors including coal plants in the Pacific Northwest closing (or other baseload capacity in the west being taken off line), giving rise to projected capacity shortages, the Hydros will aid NorthWestern in having an adequate and reliable source of capacity over the long term.

Moreover, the Hydros are demonstrably the best supply choice of any electricity supply alternative. On a risk-adjusted net present value (“NPV”) basis, the Hydros’ cost is approximately \$332 million *lower* than the cost of the next best alternative. In addition, because they are existing resources and there is no need for additional transmission facilities, the Hydros do not present any development risk.

For all of these reasons, NorthWestern believes that the Commission should approve NorthWestern’s acquisition of the Hydros. The choice between the MCC’s position and NorthWestern’s is obvious. The MCC’s focus is short-term and represents a gamble that energy prices will not rise; NorthWestern’s focus is rightly placed on the long term and on its ability to offer customers adequate, reliable, and stably priced electricity supply service over the long run. As recently as 2008, the MCC excoriated NorthWestern for not “getting off the market path” and urged that customers begin receiving the benefit of OC-D pricing.<sup>3</sup> NorthWestern agrees with the MCC’s prudent advice from that time.

To provide customers even more benefit from the transaction, however, NorthWestern proposed numerous adjustments to the Hydros’ revenue requirement. Together, these

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<sup>2</sup> As Brian Bird testified, the Hydros are like a “very long-term insurance policy.” July 11 Tr., 38:16-39:4.

<sup>3</sup> See Footnote 1, *infra*.

adjustments reduce the first-year revenue requirement by over \$11 million, from \$128,402,190 to \$117,149,256. In addition, NorthWestern proposed limits on the recovery of the Hydros' capital expenditures. July 17 Tr., 254:5-21 (CapEx proposal); July 18 Tr., 68:3-8. These voluntary adjustments are reflected in the following table:<sup>4</sup>

	NorthWestern Rev. Req.
NWE Original Hydros Revenue Requirement	\$128,402,190
NWE Rebuttal Adjustments:	
Hydros 50 Yr Depreciation Period	(\$4,401,890)
Removal of Kerr Dam Return On	(\$3,036,610)
Subtotal	(\$7,438,500)
NWE Rebuttal Hydros Revenue Requirement	\$120,963,690
NWE Hydros Adjustments:	
Hydros PPLM 2013 Actual Property Tax (PSC-352)	\$ (1,653,119)
ROE - 10%	
Debt - 4.00%	
Cap Structure - 52/48	
Overall Rate of Return - 6.88%:	\$ (2,161,315)
Subtotal	\$ (3,814,434)
Revenue Requirement after Rebuttal and Hearing	\$ 117,149,256
Net Hydros Original Revenue Requirement Reduction	\$ (11,252,934)

This transaction is a win for consumers. For all of these reasons, the Commission should approve the transaction. It enables NorthWestern to satisfy the Montana Legislature's mandate that NorthWestern "provide adequate and reliable electricity supply service at the lowest long-

<sup>4</sup> These adjustments were offered through prefiled and hearing testimony, including NorthWestern's Response to Hearing Provide No. 1, filed July 22, 2014, which demonstrated that customers would receive a benefit worth a net present value of approximately \$16.1 million with a 50-year depreciation life, using the capital structure and return on rate base included in NorthWestern's Rebuttal filing. *See generally* July 18 Tr., 59:1-61:18; July 11 Tr., 25:8-26:7; Ex. NWE-35 (Prefiled Rebuttal Testimony of Robert C. Rowe), pp. 11-14; Ex. NWE-12 (Prefiled Rebuttal Testimony of Brian B. Bird), p. 15; Ex. NWE-18 (Prefiled Rebuttal Testimony of Kendall G. Kliewer), pp. 2-3.

term total cost.” § 69-8-419(2)(a), MCA (2013). The benefits of the transaction far outweigh the costs, as customers obtain stably-priced electricity; a group of existing assets that do not require additional transmission construction; electricity generation resources that further diversify NorthWestern’s electricity supply portfolio; and generation resources that do not emit carbon and do not have fuel costs. As a result, this transaction is also the lowest-risk approach to meeting customers’ supply needs. § 69-8-419(2)(c), MCA (2013).

## **II. NorthWestern’s Valuation of the Hydros Uses the Best Available Information.**

NorthWestern asks the Commission to approve inclusion in rate base dedicated to serving customers all of the Hydros, except Kerr, at a value of \$870 million. In arms’ length negotiations with PPL Montana, LLC (“PPLM”), which was under no compulsion to sell, NorthWestern bargained for this price. Throughout a yearlong process, NorthWestern negotiated strongly on behalf of its customers. Several times, NorthWestern believed that the transaction was dead. In fact, during May of 2013, NorthWestern initiated a competitive solicitation to begin acquiring energy from the market. As set forth in Section II of its Brief, the MCC believes that NorthWestern is paying too much for the Hydros. MCC Brief, pp. 3-10. PPLM had previously rejected NorthWestern’s offer of \$740 million for the Hydros. Had NorthWestern made a lower offer, it may have been shut out of the process. NorthWestern’s analysis supported its bid. There is no evidence that any other potential purchaser would have offered less – or that any such bid would have been accepted. *See* July 15 Tr., 171:24-172:13. Long-standing regulatory principles require that if the transaction is consummated, the Commission must allow recovery of and return on NorthWestern’s investment of \$870 million.

## **A. DCF Analysis.**

The MCC argues that NorthWestern's valuation incorporates speculative assumptions that would impose a high degree of risk on NorthWestern's customers. MCC Brief, pp. 3-8. The evidence demonstrates otherwise. The MCC focuses on NorthWestern's discounted cash flow ("DCF") analysis as the basis of the MCC's evaluation to the exclusion of NorthWestern's full comprehensive analysis and even misrepresents the results of the DCF analysis. MCC states, "When asked how NWE determined a value for the Hydros, NWE witness Bird explained that the Company had developed a DCF analysis to take into account operating costs and revenues that a merchant power producer, as a competing bidder, might expect" and cites to page 14 of Ex. NWE-11 (Prefiled Direct Testimony of Brian B. Bird). MCC Brief, p. 3. The MCC statement is incomplete and distorted. Brian Bird's complete answer to the question posed at page 14 of his testimony includes far more than a single DCF analysis:

It immediately determined that there were two competing factors that needed to be considered in the analysis. First, the price had to be sufficient to entice PPL to sell the Hydros to NorthWestern. Second, NorthWestern considered the impact on customers' bills, which maintained pressure to ensure that the price we bid was not too high.

With that as a backdrop, NorthWestern developed three models to ultimately help determine a price and its impact on customer bills. First, Energy Supply performed a [DCF] analysis (the DCF Analysis Model) taking into consideration all the costs of operating the Hydros and the revenues that a merchant power producer would expect based upon market price curves, and discounting those cash flows back determined a price. Second, Finance ran a 30-year revenue requirements model (the Long-Term 30-Year Revenue Requirement Model), which utilized some of those same inputs, as well as others, to determine what this acquisition would cost customers in total. Third, Regulatory Affairs ran the revenue requirement information from the long-term model through a cost of service or standard test period revenue requirement model (the First-Year Rate Impact Model) to determine the initial impact on customers' bills. More detail on these models is presented in the Prefiled Direct Testimonies of Joseph M. Stimatz, Travis E. Meyer, and Patrick J. DiFronzo, (respectively the "Stimatz", "Meyer" or

“DiFronzo Direct Testimony”). NorthWestern also engaged a financial advisor, Credit Suisse, in September 2012 to help with this analysis.

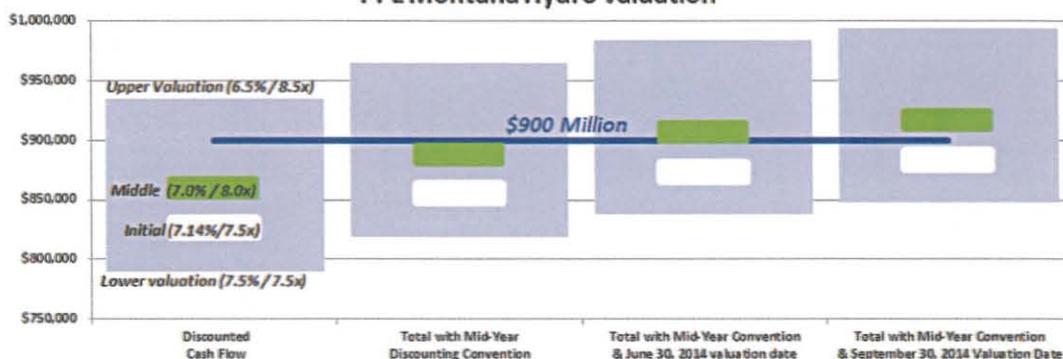
Ex. NWE-11 (Prefiled Direct Testimony of Brian B. Bird), pp. BBB-14 – BBB-15.

In addition, the MCC repeatedly misrepresents that NorthWestern’s DCF analysis resulted in a value of \$826 million. The following statements are examples:

1. “A net present value (NPV) calculation of the resulting stream of cash flows initially resulted in a value of \$826 million, although NWE decided to increase its bid to \$900 million in an effort to foreclose any competitive bidders.”
2. “NWE’s assertion in its Brief, p. 21, that the ‘initial DCF value . . . was \$883 million . . . not the \$826 million’ is simply inconsistent with the record.”
3. “This value was developed at some later point in the process of justifying this bid.”

MCC Brief, pp. 3-4; footnote 2. In these statements, the MCC misrepresents the evidentiary record and ignores Brian Bird’s testimony. Mr. Bird described the adjustments to the DCF Analysis Model that NorthWestern made prior to determining its bid. Ex. NWE-11 (Prefiled Direct Testimony of Brian B. Bird), pp. BBB-16 – BBB-18. He testified, “When those changes are considered the initial valuation goes from \$826 million to \$883 million.” Ex. NWE-11 (Prefiled Direct Testimony of Brian B. Bird), pp. BBB-17 – BBB-18. The following graphic demonstrates that at all times as NorthWestern evaluated its bid for all of the Hydros (including Kerr) \$900 million is within its DCF analysis range. The graphic, provided as part of Ex. NWE-11 (Exhibit \_\_ (BBB-3)), also illustrates that using conservative assumptions, the initial DCF value was \$883 million.

### PPL Montana Hydro Valuation



	Pre A&G DCF	Discounted Cash Flow	Mid-Year Convention of NPV rather than Year End Convention	Total with Mid-Year Discounting Convention	June 30, 2014 rather than December 31, 2013 Valuation Date	Total with Mid-Year Convention & June 30, 2014 valuation date	September 30, 2014 rather than June 30, 2014 Valuation Date	Total with Mid-Year Convention & September 30, 2014 Valuation Date
Upper DCF Valuation 6.5% Discount Rate 8.5x EBITDA Terminal Value	\$1,009,217	\$935,164	\$29,914	\$965,078	\$19,364	\$984,442	\$9,912	\$994,354
<b>Mustang Bid</b>		<b>\$900,000</b>		<b>\$900,000</b>		<b>\$900,000</b>		<b>\$900,000</b>
Middle DCF Valuation 7.0% Discount Rate 8.0x EBITDA Terminal Value	\$929,714	\$858,781	\$29,549	\$888,330	\$19,045	\$907,375	\$9,765	\$917,140
Initial DCF Valuation 7.14% Discount Rate 7.5x EBITDA Terminal Value	\$895,974	\$825,879	\$28,976	\$854,855	\$18,468	\$873,322	\$9,474	\$882,797
Lower DCF Valuation 7.5% Discount Rate 7.5x EBITDA Terminal Value	\$858,311	\$790,305	\$29,101	\$819,406	\$18,638	\$838,044	\$9,573	\$847,618

### 1. Projected Electricity Market Prices.

The MCC claims that NorthWestern’s forecast market prices are too high and that these high projections lead to an inflated value for the Hydros. The MCC attributes these allegedly too high prices to NorthWestern’s inclusion of carbon costs in the projections of rates for 2021 and beyond. The MCC is wrong when it asserts that NorthWestern’s forecast market prices are too high.

NorthWestern’s projected market prices, including the impacts of carbon regulation, are reasonable and comparable to other projections. Joe Stimatz showed that NorthWestern’s

projected market prices are generally lower than the Northwest Power & Conservation Council's forecast prices and PPLM's projected net realized prices. Ex. NWE-10 (Prefiled Rebuttal Testimony of Joseph M. Stimatz), pp. JMS-5 – JMS-6. Other analysis in this docket confirmed the reasonableness of NorthWestern's long-term price projections. The Commission's consultant, Evergreen Economics, opined, "NWE's forecast of electricity prices appears reasonable when compared with other, publicly available, forecasts." Ex. PSC-4, p. 11.

## **2. Carbon Costs are Reasonable.**

The MCC asserts that, "It is extremely speculative that carbon regulation will impose costs to such an extent." MCC Brief, p. 5. The MCC's claim is unsubstantiated and contradicted by the evidentiary record, which shows that NorthWestern's estimates of carbon costs are conservative and consistent with industry practice. John Hines testified that NorthWestern's carbon values "are substantially lower than the values used by other utilities." Ex. NWE-3 (Prefiled Rebuttal Testimony of John D. Hines), p. JDH-17. Mr. Hines presented a chart showing that NorthWestern's estimated carbon costs are from \$8.60/tonne to \$26.66/tonne below the average of other Pacific Northwest utilities. *Id.* Mr. Hines also pointed out that NorthWestern's projected carbon costs in the 2013 Electricity Supply Resource Procurement Plan and this docket are, on a levelized basis, less than half of the carbon costs projected in NorthWestern's 2011 Plan. July 8 Tr., 153:23-154:2. The Commission's consultant, Evergreen Economics reported, "NWE's modeling assumption that carbon taxation will occur in the United States by 2021, while not a foregone conclusion, may be increasingly likely." Ex. PSC-4, p. 12. Evergreen Economics also stated, "NWE's carbon price assumptions are in line with internal carbon pricing used by other investor-owned utilities (IOUs) for operational and planning purposes." *Id.* Dr. Power testified, "NWE's projected mean carbon prices are 'in the middle of

the pack' but towards the lower end of the 28 other utilities on which the Synapse report<sup>5</sup> focused." Ex. HRC-1, p. 11. Only the MCC asserts that NorthWestern's projected carbon costs are speculative or extreme. The MCC offers no evidence other than Dr. Wilson's opinions. Those opinions ignore the evidence in the record and Dr. Power's recognition that "carbon regulation in one form or another seems certain." *Id.* at p. 8.

### **3. Capital Expenditures.**

The MCC argues that NorthWestern has underestimated future capital expenditures leading to an overvaluation of the Hydros. The MCC states, "The Company assumed that annual capital expenditures starting in 2018 will be \$8.5 million escalated at 2.5%. In contrast, PPL's own budgeted expenditures over the next five years average \$11.6 million per year." MCC Brief, p. 6. The MCC mixes PPL Corporation's ("PPL") short-term budgets and NorthWestern's long-term forecasts to create a false impression. NorthWestern's projections for 2014-2017 average \$11 million per year; PPL's budgets for the same period average \$10.6 million per year. The fallacy of the MCC's argument is illustrated by comparing the three capital expenditure forecasts that are available in this docket – NorthWestern's (from Ex. NWE-7 (Prefiled Direct Testimony of Joseph M. Stimatz), Exhibit \_\_ (JMS-1)); HDR Engineering's (from Ex. NWE-29 (Prefiled Additional Issues Testimony of Rick Miller), Exhibit \_\_ (RM-1)); and PPL Corporation's (from response to Data Request PSC-001, Confidential Information Memorandum – Hydro Facilities, p. 60 of 66). The table below shows each of these by year.

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<sup>5</sup> The Synapse report is "2013 Carbon Dioxide Price Forecast," November 2013 (with 2014 corrections), Patrick Luckow, et al., Synapse Energy Economics.

**Estimated Capital Expenditures (Million\$)**

<u>Year</u>	<u>NorthWestern</u>	<u>HDR</u>	<u>PPL</u>
2014	12.8	13.6	12.5
2015	10.0	11.4	8.8
2016	9.2	8.0	9.1
2017	12.0	12.5	12.1
2018	8.5	7.8	8.5
2019	8.7	8.7	8.7
2020	8.9	7.3	9.0
2021	9.2	7.2	9.2
2022	9.4	9.9	9.4
2023	9.6	8.8	9.6
2024	9.9	10.0	9.9
2025	10.1	8.0	10.1
2026	10.4	11	10.4
2027	10.6	8.7	10.6
2028	10.9	8.6	10.9
2029	11.2	10.1	11.2
2030	11.4	7.9	11.5
2031	11.7	7.9	11.8
2032	12.0	6.0	12.0

As the table shows, NorthWestern’s forecast capital expenditures are not artificially low<sup>6</sup>. In fact, they are generally higher than a professional engineering firm’s independent estimate and in line with the current owner’s estimate. Furthermore, as reflected by the hearing testimony and the chart on page 5, NorthWestern has offered to forgo seeking recovery on any capital expenditure greater than its forecast through 2020, subject to certain limited conditions. This in

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<sup>6</sup> NorthWestern’s decision with respect to appropriate levels of capital expenditures for environmental related issues was recently significantly substantiated. In the course of establishing a CapEx budget for the Hydros, NorthWestern decided not to include monies to address a possible listing of the Arctic grayling as an Endangered Species “because they relate to less certain, potential future environmental liabilities.” See Response to PSC-080(a). On August 20, 2014, the United States Fish and Wildlife Service announced that listing of the Arctic grayling under the Endangered Species Act was not warranted at this time. See Federal Register, Vol. 79, No. 161 (August 20, 2014) ([http://www.fws.gov/mountain-prairie/species/fish/grayling/12monthfinding/federal\\_register\\_2014-19353.pdf](http://www.fws.gov/mountain-prairie/species/fish/grayling/12monthfinding/federal_register_2014-19353.pdf)).

effect guarantees that customers are not at risk during this period without extending the limitation too far into the future. The MCC would require NorthWestern to go further and to guarantee that it would not ask its customers to pay for any capital expenditures during the life of the Hydros that exceed the current projections. Action by the Commission to implement the MCC's suggestion is contrary to regulatory practice and could have unintended, negative consequences. The MCC recommends providing a "zone of acceptability" for \$7 million to \$10 million of capital expenditures each year. This zone of acceptability could lead to either under-investment or to over-investment. Chairman Gallagher recognized these problems when he posed the following series of questions to Dr. Wilson:

- Q. Do I understand your suggestion correctly, however, that we set a ceiling and floor, or a zone of acceptability and that a future CapEx on average exceeds 10 million, adjusted by the two percent, that it is summarily disallowed. And that if it comes in under 7 million, the floor that NorthWestern reaps the benefit of that circumstance? . . .
- Q. I'm concerned about how that might be practically applied in an order in this document. Are you suggesting that we literally disapprove and pre-approve future CapEx, as much as 30 years into the future, in this particular order? . . .
- Q. I have a couple of concerns, besides the legal ones that might be raised with that. But let me ask you how to – call them my concerns. And I'm always preaching to my fellow commissioners about somebody is always being trained. Either we're training our companies and practitioners or they're training us. But I'm concerned that, that particular proposal might be modifying the behavior of NorthWestern Energy in a way to maximize that? For example, they might be inclined to gold plate these facilities over the course of time and spending right up to the 10 million average per year, even though it's not really necessary. . . .
- Q. Well, I'm glad you said that, because that's the other end of my concern, is that – given \$7 million, on an escalating basis, of automatic pre-approved CapEx over the next ten years might induce NorthWestern Energy to go with the band-aiding bailing-wire approach on these facilities, keeping them running on a shoestring, but adding the unused CapEx in the profits for shareholders.

July 15 Tr., 175:23 – 178:2.

Furthermore, as Mr. Stimatz testified, even if NorthWestern has underestimated capital expenditures for every year by 30%, and the Commission allows recovery of the increased expenditures, a portfolio including the Hydros remains superior to alternatives by nearly \$300 million. Ex. NWE-9 (Prefiled Additional Issues Testimony of Joseph M. Stimatz), p. JMS-4 – JMS-5. Travis E. Meyer presented tables that demonstrated the minimal effect on long-term revenue requirements of the most negative scenario. *See* Ex. NWE-16 (Prefiled Additional Issues Testimony of Travis E. Meyer), pp. TEM-4 – TEM-7.

#### **4. Terminal Value.**

The MCC complains about the reliability of NorthWestern's estimate of terminal value. MCC Brief, pp. 7-8. In testimony, Dr. Wilson suggested that the terminal value should be zero. *See* Ex. MCC-2 (Prefiled Additional Issues Response Testimony of John W. Wilson), p. 10 (adjusting terminal value to \$0 on an NPV basis to increase the cost of the Hydros). The terminal value represents the value of the cash flows from the Hydros that would occur after the end of the 20-year DCF analysis. Ahmad Masud discussed terminal value in response to Data Request PSC-345(a). He stated:

The use of estimated terminal value for generation assets, including hydro assets at the end of a forecast period, is very standard practice in estimating the valuation range for such assets if the subject assets are deemed to have useful economic life beyond the projected cash flow forecast. Terminal value is a proxy for future cash flow beyond the forecast period and is an important aspect of valuation for assets with very long useful lives such as the hydro assets. The use of observable and publicly available EBITDA multiples based on comparable companies or comparable acquisitions, if available, is also standard and acceptable practice in valuation of assets and is not mixing models.

As discussed in my Prefiled Direct Testimony and my Prefiled Rebuttal testimony, Credit Suisse used multiple approaches in estimating the terminal

value of the Hydro Assets given that there were no comparable publicly traded companies with exactly similar assets. One of those approaches was to apply an observable EBITDA multiple for IPPs. The average 2014E EBITDA for the IPPs was 10.5x. The average 2014 E EBITDA of “Clean generation IPP comps” was 11.9x (page 15 of AM Exhibit 1). Credit Suisse also considered a long-term IPP trading history on a 1 year forward EV/EBITDA multiples basis which showed a long-term average multiple of 7.4x. Based on this available information, Credit Suisse used a range of 7.5x – 8.5x as exit terminal multiples in our DCF analysis even though the then-current spot trading multiples were significantly higher as discussed above.

The forecast period for the DCF analysis is 20 years. Ex. NWE-7 (Prefiled Direct Testimony of Joseph M. Stimatz), Exhibit \_\_ (JMS-1). The Hydros will generate electricity and provide value to the supply portfolio well beyond 20 years. No one contested that the Hydros have economic useful lives beyond 20 years. The MCC recommended that the Hydros be depreciated at 2.0% per year implying a useful economic life of 50 years. Ex. MCC-3 (Prefiled Direct Testimony of Albert E. Clark), pp. 10-11. Although Credit Suisse used a range of 7.5 - 8.5 times EBITDA, in preparing its bid for the Hydros, NorthWestern used the lowest multiple, 7.5 times EBITDA. Ex. NWE-11 (Prefiled Direct Testimony of Brian B. Bird), p BBB-17.

To respond to this credible and supported analysis, Dr. Wilson states:

Also, despite the continued aging of these plants over the next twenty years and the assumption of diminished capital expenditures for their refurbishment, renovation and repair over that period, NWE’s DCF analysis assumes that plants will have a terminal value (i.e., could be sold for) \$1.1 billion in 2033. While I place little importance on such distant speculation, this one is worth noting, both because of its doubtful plausibility and because it is a critical factor in NWE’s DCF market value estimate, accounting for \$270 million of the Company’s \$826 valuation.

Ex. MCC-1 (Prefiled Direct Testimony of John W. Wilson), p. 38. Dr. Wilson offers no analysis, no basis for his opinion, and no critique of Ahmad Masud’s reasoned explanation as to the standard practice of including and calculating terminal value. In addition to not critiquing Mr. Masud’s explanations, at hearing, the MCC did not ask Mr.

Masud a single question about the terminal value, its calculation, or determination of the multiples. *See* July 11 Tr., 109:11 – 128:1 (Cross-Examination of Mr. Masud by Ms. Tranel).

There is no evidence, other than Dr. Wilson’s unsupported, unfounded opinion that the terminal value is less than that included in NorthWestern’s analysis. The Hydros will be only 40% depreciated at the end of 20 years. Over \$200 million of new capital expenditures is forecasted or already made for 2013 through 2032. NorthWestern’s estimate of terminal value is correct and comports with standard valuation practice.

**B. Comparable Transactions.**

The MCC complains that NorthWestern’s use of comparable hydroelectric transactions is flawed because the four individual hydro assets used were “significantly different than the Montana hydro assets.” MCC Brief, p. 9. The MCC misunderstands or misstates asset valuation and how the comparable transactions were used. Valuation is estimating what something is worth. There are three general approaches: income or DCF, comparable transactions or relative value, and replacement or cost to build. NorthWestern used all three approaches. Notwithstanding that the Hydros are a portfolio of assets on both sides of the Continental Divide, the MCC asserts that five assets that are hydro portfolio assets “are not capable of direct comparison with the Montana Hydros.” MCC Brief, pp. 8-9.

The comparables showed what other parties were willing to pay for hydroelectric assets (as either a portfolio or an individual development) on a per kW basis. The range of values in the marketplace is \$1,184/kW to \$3,220/kW. Ex. NWE-13 (Prefiled Direct Testimony of Ahmad Masud), AM Exhibit 1, p. 18 of 26. Only one of the comparable values was below \$1,500/kW. *Id.* Credit Suisse used a narrower range, \$1,650/kW to \$2,150/kW, to estimate the

value of the Hydros. *Id.* Credit Suisse did not attempt to place a value on individual developments. Rather, recognizing the differences in the comparables, Credit Suisse chose a conservative, narrow range to apply to the portfolio of Hydros.

In his rebuttal testimony, Mr. Masud discussed a transaction involving the Safe Harbor facility that occurred after NorthWestern's valuation of the Hydros. Ex. NWE-14 (Prefiled Rebuttal Testimony of Ahmad Masud), pp. AM-4 – AM-5. Safe Harbor is significant because it further validates the current value of hydro assets. The value of the Safe Harbor transaction was \$2,182/kW, which is above the range that Credit Suisse used to value the Hydros. The Safe Harbor value is nearly 10% higher on a kW basis than the value NorthWestern is paying for the Hydros and that it is asking to put into rate base.

In addition, the MCC questions the comparability of the Tapoco transaction because the last dam was built in 1957 and because it included 86 miles of transmission line and 14,400 acres of land. MCC Brief, p. 9. The MCC did not establish any value for the transmission line or even establish the condition and sufficiency of it. Nor did the MCC establish any value for the land. Moreover, the newest of the Hydros dams is comparable in age to the newest of the Tapoco dams. Cochrane was completed in 1958; Thompson Falls was expanded in 1992; and the Rainbow facility was fully redeveloped in the last few years. Ex. NWE-20 (Prefiled Direct Testimony of William T. Rhoads), Exhibit\_\_ (WTR-4).

### **III. NorthWestern's Stochastic Modeling is Correct.**

NorthWestern's stochastic modeling demonstrates that the 30-year NPV of the Hydros portfolio is \$332 million less costly than the next best alternative and \$376 million less costly, on a risk adjusted basis, than relying on the market for needs other than current resources. Ex. NWE-2 (Prefiled Supplemental Testimony of John D. Hines), p. JDH-6. The MCC claims that

NorthWestern's stochastic results are biased in favor of the Hydros "because they incorporate substantial risks for the alternative of market purchases, but exclude risks for the Company's assumed low Hydros capital expenditure levels." MCC Brief, p. 10 (citing MCC-1, 28:10 to 29:11). The MCC argues that market price risk has declined and "market prices are expected to remain less volatile." MCC Brief, p. 12 (citing MCC-2, 11:18 to 12:16). In the cited testimony, Dr. Wilson asserts, "To assume that electric market prices in the foreseeable future will return to the levels and volatility that was experienced in the 2004-2008 period would be a mistake." Ex. MCC-2 (Prefiled Additional Issues Response Testimony of John W. Wilson), p. 12. This statement inaccurately assumes, without any evidence, that the market prices in 2004-2008 were more volatile and that the PowerSimm model uses volatility solely from the 2004-2008 period. PowerSimm uses historical volatility from a broader timeframe than just 2004-2008. The price volatility in PowerSimm has been validated. Ascend Analytics has compared current volatility of Mid-C On Peak and Off Peak spot prices with that from the narrow period discussed by Dr. Wilson and found that volatility has not diminished. While Dr. Wilson does not identify the "foreseeable future," given the remainder of his advocacy, it can only be a short-term view to no later than 2020. NorthWestern must plan and evaluate resources using the long-term.

The MCC complains that NorthWestern did not model the uncertainties of capital expenditures. MCC Brief, pp. 10-11. The MCC bases this complaint on the erroneous contention, discussed above, that NorthWestern used an unreasonably low projection of capital expenditures and ignores industry practice. As Dr. Gary Dorris testified:

Unanticipated capital improvement or maintenance costs pose a risk for any potential physical resource, but, following industry standard practice, are not included in the stochastic model's risk assessment for any resources under consideration by NorthWestern. A review of the planning entity documents, (mainly Northwest regional utility Integrated Resource Plans) cited by

NorthWestern in their review of regional carbon price forecasts indicates that no other utility includes any explicit representation of capital upkeep or maintenance cost risks in assessing the comparative costs of different resources. (*See* Exhibit GD-1).

Ex. NWE-4 (Prefiled Rebuttal Testimony of Gary W. Dorris), p. GWD-22. Dr. Dorris also testified, “the magnitude of the impact [of unanticipated capital costs] is likely inconsequential when compared to other, higher-magnitude cost risks (e.g. carbon and market price risks).” *Id.*

#### **IV. The Proposed Conditions are Unreasonable and Unacceptable.**

In Section IV of its Brief, the MCC urges the Commission, should it approve NorthWestern’s Application, to impose three conditions. MCC Brief, pp. 12-15. The basis of the MCC’s request is that the “large and immediate rate increase that would result from the proposed acquisition could be avoided by pursuing the ‘current’ market-based scenario.”<sup>7</sup> MCC Brief, p. 12. The MCC’s three proposed conditions should be seen for what they are: conditions so commercially unreasonable that NorthWestern would be required to walk away from the transaction. Ex. NWE-12 (Prefiled Rebuttal Testimony of Brian B. Bird) p. BBB-11; Ex. NWE-36 (Prefiled Rebuttal Testimony of Robert C. Rowe) pp. RCR-1 – RCR-4 and RCR-10; July 11 Tr., 24:16-25:5; July 18 Tr., 60:19-62:15. This would leave NorthWestern dependent on the market for 50% of its Montana customers’ electricity supply needs, which is, of course, the MCC’s preferred outcome in this docket, as current electricity prices are low and the MCC does not believe the long-term benefits of NorthWestern’s proposed transaction are worth the short-term price increase.

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<sup>7</sup> The evidence shows that the expected monthly increase in rates, for an average residential customer, is \$4.66.

As set forth below, the Commission should reject the MCC's three proposed conditions. They lack any sound public policy foundation, are not based on the facts, or are radical and punitive. Moreover, as discussed elsewhere in this brief, NorthWestern has proposed adjustments that reduce the revenue requirement by over \$11 million, enabling customers to benefit even more from the transaction.

The MCC's first condition concerns alternative proposals for "hypothetical carbon adders" by which NorthWestern would either treat alleged carbon-related revenues as customer-contributed capital until actual carbon-related costs are incurred, or treat alleged carbon-related revenues as interim and refundable. The basis of these alternative proposals is the assertion that customers are being asked to pay a "carbon tax" in their rates. The MCC's assertion is flatly incorrect and ignores the evidentiary record on this issue. There is no carbon tax in the proposed Hydros revenue requirement or rates, and the MCC cannot and has not identified one. Ex. NWE-10 (Prefiled Rebuttal Testimony of Joseph M. Stimatz), pp. JMS-7 – JMS-8; July 17 Tr., 226:9-12; July 9 Tr., 190:14-17. The Commission need only analyze Patrick DiFronzo's testimony and exhibits detailing the revenue requirement's components to correctly conclude that a carbon tax is not among them. See Ex. NWE-31 (Prefiled Direct Testimony of Patrick J. DiFronzo) and Ex. NWE-32 (Prefiled Rebuttal Testimony of Patrick J. DiFronzo). In fact, there could be none – the Hydros do not emit carbon.<sup>8</sup>

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<sup>8</sup> Tradition has it that when Lord Cornwallis surrendered at Yorktown in 1781 the British played *The World Turned Upside Down*. MCC turns the world of carbon risk upside down. NorthWestern proposes to acquire the Hydros to give its customers a measure of protection from future carbon risk, not to impose carbon costs on them. Indeed, any non-utility owner of the Hydros (including the current owner) would receive a windfall benefit from carbon regulation: the ability to charge a market price increased by the direct and indirect effects of carbon regulation while not incurring the costs of carbon regulation. With NorthWestern's ownership

The MCC's assertion that there is a carbon adder is based on NorthWestern's DCF model that provided an indication of the Hydros' market value; that valuation concluded that a merchant buyer could easily pay \$883 million for the Hydros. *See* pp. 8-9, *supra*. The DCF analysis was just one of the three models that NorthWestern developed in determining its ultimate bid price. NorthWestern also used advice from its financial advisor, Credit Suisse, including Credit Suisse's discounted cash flow analysis; comparable asset analyses; and the cost of new build opportunities analysis. The DCF valuation is not a revenue requirement, and the DCF model's components are not part of the NorthWestern revenue requirement.

The MCC ignores this evidence. While the MCC claims that ratepayers will pay "nearly \$400 million in excess charges" due to carbon costs, the record demonstrates that this claim has no factual basis as there are simply no carbon taxes or carbon costs in the proposed customer rates. Therefore, the Commission should reject any proposed conditions relating to them.

The second condition concerns alternative proposals for capping NorthWestern's recovery of capital expenditures. The MCC's proposals are extreme and not grounded on any reasonable public policy; as Dr. Wilson testified, his approach locks in CapEx as much as 30 years into the future.<sup>9</sup> However, solely in an effort to reduce customer risk, NorthWestern itself

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and OC-D regulation, NorthWestern's customers receive the specific benefit of protection from carbon-related costs for these assets, along with the general benefit of depreciation.

<sup>9</sup> *See* July 15 Tr., 176:7-13:

Q. (Chairman Gallagher): I'm concerned about how that might be practically applied in an order in this docket. Are you suggesting that we literally disapprove and pre-approval future CapEx, as much as 30 years into the future, in this particular order?

A. (Dr. Wilson) Yes, in order to protect consumers. Yes, I do.

made a proposal that the Commission should consider. Under NorthWestern's proposal, put forward by NorthWestern's CEO, Bob Rowe:

- a. Hydros Capital Expenditures incurred in the normal course of business allowable for cost recovery would be capped at \$58.1 million, through 2020, which is NorthWestern's forecasted Hydros-related capital expenditure budget.
- b. Except as noted in Item c. below, Hydros Capital Expenditures greater than \$58.1 million during this period would not be allowed the recovery of a return on, but will be allowed recovery of a return of (depreciation expense)
- c. Recovery of a Return on and Return of Hydros Capital Expenditures that are the result of Extraordinary Events and/or unknown Regulatory or Environmental Regulations may be requested by NorthWestern as part of future general rate filings.

July 17 Tr., 254:5-21.

These adjustments reflect NorthWestern's effort to address customer impacts, while also honoring the concern raised by Chairman Gallagher about the risks of locking in investment levels too far in advance.<sup>10</sup>

The MCC's final requested condition concerns net negative salvage for the Hydros. The MCC claims that NorthWestern has "assumed zero decommissioning costs as the result of a large terminal value, and that assumption has formed part of the basis for the purchase price that

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<sup>10</sup> The preapproval statute also provides explicitly that future Commissions have the ability to review ongoing investments and expenditures: See § 69-8-421(9), MCA (2013). It provides:

Nothing limits the commission's ability to subsequently, in any future rate proceeding, inquire into the manner in which the public utility has managed, dispatched, operated, or maintained any resource or managed any power purchase agreement as part of its overall resource portfolio. The commission may subsequently disallow rate recovery for the costs that result from the failure of a public utility to reasonably manage, dispatch, operate, maintain, or administer electricity supply resources in a manner consistent with 69-3-201, 69-8-419, and commission rules.

will be included in rate base.” MCC Brief, p. 15. The MCC’s recommendation should be rejected as there is no sound factual or public policy basis for it.

The MCC’s statement in its Brief is incorrect. NorthWestern assumed zero decommissioning costs for the first 20-year period solely because NorthWestern expects the Hydros to operate well beyond 20 years. That assumption has nothing to do with the terminal value. The DCF model uses explicit estimates of cash flows for some finite period, plus a terminal value in the last year of the analysis that represents cash flows in all periods beyond that. Here, revenues, expenses, and capital expenditures were explicitly estimated for 20 years. There are no decommissioning costs in those years because, if approved, the Hydros will provide Montana customers cost-based power for generations longer.

The terminal value reflects future cash flows, both positive and negative, after the forecast period and is estimated using a market multiple. There is no explicit estimate of the cash flows on a line-by-line basis because the costs are so far out into the future. For that reason, there is no explicit decommissioning cost in the terminal value.<sup>11</sup>

In his testimony, Mr. Stimatz recommends that at some distant future date, if NorthWestern determines that decommissioning of one or more of the Hydros is appropriate, a future Commission will determine the prudence of that decision and the costs. That is the appropriate regulatory approach and one that the Electric Utility Industry Generation Reintegration Act (“Generation Reintegration Act”) process explicitly envisions. Title 69, Chapter 8, MCA (2013). For these reasons, the MCC’s recommendation should be rejected.

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<sup>11</sup> And, as Mr. Stimatz testified, “[i]f we [NorthWestern] had any decommissioning, it would have been 50, or 60, or 100 years out in the future, and the effect on present value would be minimal.” July 9 Tr., 195:2-4.

**V. Return on Equity and Capital Structure: NorthWestern's proposals are appropriate because they ensure that NorthWestern's financial integrity and credit worthiness are maintained.**

In an attempt to justify its proposed 9% return on equity ("ROE") and a 45/55 capital structure, the MCC's Brief puts forth an argument which is premised on the concept that the Hydros' transaction is low-risk to NorthWestern. MCC Brief, pp. 15-16. As is discussed below in detail, the MCC's argument should be rejected. As was explained several times at the hearing, the Hydros will have the same risk as any other asset in NorthWestern's portfolio beginning on the first day NorthWestern owns them. July 10 Tr., 194:2-8; 195:21-25 – 196:1-3. Thus, the risk of operating a utility and investing in long-lived assets will apply to the Hydros. The approval provided by Montana law does not eliminate these risks. NorthWestern has put forth substantial, credible evidence demonstrating that a 10% ROE and a 48/52 capital structure are appropriate for these assets and will, as required by law, result in just and reasonable rates for NorthWestern's customers. NorthWestern has proposed an ROE that is (1) conservative and, as a result, mindful of customer impacts; (2) comparable to other utilities; and (3) consistent with the capital market evidence.

**A. An ROE that is too low will result in harm to both NorthWestern and its customers.**

The Commission's job is to determine the appropriate and reasonable ROE for utility rate-based assets. In setting an ROE, "the Commission has an opportunity to show that it recognizes the importance of continuity and a balanced regulatory regime." Ex. NWE-34 (Prefiled Rebuttal Testimony of Adrien M. McKenzie), p. AMM-7. "The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and

enable it to raise the money necessary for the proper discharge of its public duties.” *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia, et al.*, 262 U.S. 679, 693, 43 S.Ct. 675, 679 (1923). Thus, “the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks.” *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603, 64 S.Ct. 281, 288 (1944). Investors “will react if the ROE is set too low.” July 17 Tr., 65:4-5. A recent example of this was when Florida Power and Light received a “very negative rate order” and subsequently “had a severe decline in their stock price as a result.” July 17 Tr., 65:15-20. Thus, if an ROE is set too low, a utility will not be able to attract necessary capital especially when “[t]he competition for capital is intense.” Ex. NWE-34 (Prefiled Rebuttal Testimony of Adrien M. McKenzie) p. AMM-4. As the Commission is aware, “utilities struggle to earn their ROE on a regular basis throughout the industry.” July 17 Tr., 37:13-15. If the utility is unable to attract capital at reasonable terms, it may have to fund transactions with more debt issuance. As is discussed below, more debt issuance in turn can negatively affect the credit worthiness of the utility. Lower credit ratings result in higher debt costs, which ultimately are passed on to customers. This situation highlights the importance of setting an ROE at the appropriate level. Customers benefit when investors have confidence in a regulatory process that is stable and constructive. Ex. NWE-34 (Prefiled Rebuttal Testimony of Adrien M. McKenzie) p. AMM-8 (“The challenging capital market environment over the last few years highlights the benefits of stability in the ROE, and changing course from the path of financial strength would be extremely short-sighted.”).

In an attempt to justify Dr. Wilson’s recommended ROE of 9%, the MCC suggests that the higher approved ROEs for NorthWestern’s other rate-based assets will pull the Hydros’ ROE

upward if the Commission approves an ROE of 9%. MCC Brief, p. 15. In reality, a low Hydro ROE, representing one-third of NorthWestern's electric rate base, will pull down the authorized ROE on all of NorthWestern's other rate-based assets. In fact, if the transaction closes, the Hydros will be such a large percent of the Montana electric rate base, that a low ROE will have a disproportionate impact.

The MCC then suggests that an ROE in the 8%-9% range is even more appropriate in order to lower NorthWestern's overall ROE. This is unreasonable and punitive. This is not a company-wide rate case, and the only assets at issue are the Hydros. There is no evidentiary or public policy basis for concluding that an appropriate ROE is 8%-9% in order to lower NorthWestern's overall ROE. Adopting the MCC's proposed 9% ROE would ratify its short-sightedness concerning this transaction.

**1. Preapproval does not make NorthWestern's risk profile different from peer utilities.**

The MCC suggests that this transaction is less risky and thereby justifies a lower ROE because NorthWestern has a preapproval mechanism established by the Generation Reintegration Act. MCC Brief, p. 16. This argument must be rejected. The regulatory framework, which includes provisions for preapproval and other adjustment mechanisms, is a key consideration in the risk evaluation of credit rating agencies and others in the investment community. Ex. NWE-34 (Prefiled Rebuttal Testimony of Adrien M. McKenzie) pp. AMM-6 – AMM-7. In this case, preapproval, or any unrelated tracker mechanism, does not make a utility less risky as it relates to determining the appropriate ROE. July 17 Tr., 71:15-25 – 72:1-3. Concerning pre-approval and

cost recovery mechanisms, NorthWestern is no different from the utilities included in the proxy group of the DCF Cost of Equity model.<sup>12</sup> NorthWestern's witness, Adrien McKenzie, testified:

Well, in response to discussion that I've heard from the Commissioners and questions that were posed to other witnesses, I went and looked at the 10K reports for all the companies in the proxy group to get an idea of what tracker mechanisms and adjustment mechanisms that they operate under that they report to investors.

And basically found that all of the companies benefit from fuel or power cost recovery mechanisms. In fact, I found only one instance, the case of Kansas Power & Light Company in Missouri, which does not operate under any kind of a fuel adjustment mechanism.

Ten of the companies have revenue decoupling mechanisms available at least in one of their jurisdictions. Nine of them operate under infrastructure tracking mechanisms **which allow them to recover plant investment without going through a rate case proceeding**. Seven of the companies operate under environmental or emissions cost adjustment clauses. Some of them, like the example I gave of Kentucky Utilities, are extremely significant. And others, like Minnesota Power, benefit from a pre-approval process. They just in fact in January of this year received pre-approval for \$345 million associated with Bison 4 wind project which is earning a return of 10.38 percent.

July 17 Tr., 72:5-25 – 73:1-8 (emphasis added).

In evaluating the reasonableness of NorthWestern's 10% requested ROE, it is not sufficient merely to conclude that preapproval moderates what would otherwise be an untenable level of risks. This is because a fair ROE is not determined in a vacuum. It is based on the returns that investors require from other utilities of comparable risk. MCC has presented no evidence to support its position that preapproval leads to a demonstrable distinction in the investment risks of NorthWestern, *relative to other electric utilities*. Because the risk measures of the proxy companies are comparable to NorthWestern, and because these risk measures consider the impact of regulatory adjustment mechanisms, there is no basis for MCC's

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<sup>12</sup> In fact, investment reports have noted that certain NorthWestern cost recovery mechanisms are less comprehensive than other utilities. July 17 Tr., 68:7-11.

unsupported view that preapproval distinguishes NorthWestern's risks from others in the industry or warrants consideration in evaluating NorthWestern's 10% ROE request.

Just as importantly, circumstances in the electric utility industry throughout the country have also evolved. As stated above, it is not sufficient to assert that preapproval lessens the exposure associated with a major asset acquisition to justify an adjustment to the ROE. In response to risks in the industry, to manage those risks for all stakeholders, and in an effort to preserve utilities' opportunity actually to earn a fair ROE, commissions and legislatures across the country have instituted a wide range of cost recovery mechanisms. The preapproval provision of the Generation Reintegration Act was adopted as part of a comprehensive response to the tragic error of supply deregulation for smaller customers. However, it is consistent with this larger industry-wide trend. It does not diminish NorthWestern's investment risks in comparison to other electric utilities or justify any adjustment to NorthWestern's ROE as proposed by the MCC. *See also* July 11 Tr., 43:4-15, 56:15-58:12, 61:3-17 (Bird testimony on ROE and preapproval).

The MCC cites two Commission decisions for support of its statement that "preapproval shifts risks away from the shareholders and investors to the ratepayers." MCC Brief, p. 16 (citing to Docket No. 88.6.15, Order No. 5360d ("Order 5360d") and Docket No. D2001.10.144, Order No. 6382d ("Order 6382d")). First, it must be noted that the law has changed significantly since the first cited decision was issued approximately 25 years ago. In 1989, when the Commission issued Order 5360d, there was no preapproval statute and it was nearly a decade before supply deregulation. In 2002, when the Commission issued Order 6382d, the utility landscape was different in that there was still no preapproval statute, but deregulation had occurred. Then in 2007, to address the failure of deregulation, which had the effect of requiring

customers to be served solely by the market, the Montana Legislature extended preapproval as part of a comprehensive and balanced approach to reintegrating electric supply into utility operations, creating a mechanism for the Commission to comprehensively evaluate asset acquisitions before customers were asked to pay for them. § 69-8-421(1), MCA (2013). With the passage of HB 25 in 2007 (the Generation Reintegration Act), the utility landscape significantly changed and preapproval was provided for in law.<sup>13</sup> The Act was meant to rebuild a portfolio of cost-based electric generation. Thus, the Commission’s historical criticisms of such regulatory constructs, especially in the context of approving expenses such as supply contracts, are just not relevant.<sup>14</sup>

Second, the MCC’s reliance on these two old decisions and its argument on this issue are misplaced. These decisions dealt with requests from the Montana Power Company, and subsequently NorthWestern, for the Commission to preapprove power purchase expenses. *See* Order 5360d, ¶ 306; *see also* Order 6382d, pp. 12-14. The decisions do not address preapproval and its relationship to the determination of appropriate ROEs for assets that the utility proposes to rate base and dedicate to customers. In fact, Order 6382d clearly *does not* stand for the

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<sup>13</sup> The Commission supported HB 25. It is troubling that the Montana Consumer Counsel, a Constitutional Office responsible to a Committee of the same Legislature that passed the Generation Reintegration Act, is so harshly opposed to a law that is such a basic part of the regulatory framework it helps implement.

<sup>14</sup> The MCC’s opposition to the preapproval statute is nonsensical for a variety of additional reasons. For example, NorthWestern is required by law to obtain Commission approval to finance the transaction, as requested in this application. FERC requires a Montana Commission approval before it will approve financing. And, as explained by Rowe, even without pre-approval major generation additions likely would come before the Commission sometime before they are dedicated to serve customers – just as is the case here. Finally, it would be fundamentally unworkable to finance the purchase, acquire the assets, operate them as assets unregulated by the Montana Commission (but requiring certain FERC approvals), and subsequently (perhaps a year or so later) receive Commission approval to dedicate the assets to serve customers at OC-D. July 17 Tr., 254:22-256:8; July 18 Tr., 12:10-13:9.

proposition for which the MCC cites it. As the Commission stated in that same Order, “Preapproval of rate base treatment for utility capital investment is another matter, not at issue and not discussed here.” See Docket No. D2001.10.144, Order No. 6382d, p. 13, n. 15. Thus, these decisions are not relevant to the issues and therefore should not guide the Commission in this case.

**2. NorthWestern is not in the cherry-picking business.**

The MCC alleges that NorthWestern “arbitrarily excluded the lowest one-third of the values” when it conducted the discounted cash flow (“DCF”) analysis for determining an appropriate ROE for the Hydros. MCC Brief, p. 18. The evidence demonstrates that this allegation is false. NorthWestern’s exclusion of certain values was (1) well-reasoned and (2) consistent with regulatory findings.

Mr. McKenzie explained the rationale for excluding certain values. Low values were analyzed in light of the fundamental risk-return tradeoff and thus results that were “implausibly low or high should be eliminated.” Ex. NWE-34 (Prefiled Rebuttal Testimony of Adrien M. McKenzie) p. AMM-12. Investors expect greater returns when investing in utility common stock versus long-term bonds. *Id.* Exhibit NWE-4, page 3, attached to the response to Data Request PSC-007(b), provides the results of the DCF earnings growth percentages for utilities in the proxy group. At the time the DCF analysis was completed, “Moody’s reported that monthly yields on triple-B bonds averaged 5.17%.” *Id.*, at AMM-13. Therefore, given the risk-return principle, investors would expect a rate of return “substantially higher” than 5.17% to hold utility common stock. *Id.* In addition to looking at the monthly triple-B bond yields at the time of the analysis, it is important to consider future events that may affect these values. “Investors do not anticipate that these low interest rates will continue.” *Id.* As such, IHS Global and Energy

Information Administration forecasts imply that triple-B bond yields will be approximately 6.7% over the period of 2014 through 2018. *Id.*, at AMM-14 – AMM-15.

The MCC attacks NorthWestern’s analysis by arguing that NorthWestern’s witness, Adrien McKenzie, believes that even if the methodology used in the DCF analysis may be skewed, the end results are justified because they are “more important than the particular method used.” MCC Brief, p. 19 (citing to July 17 Tr., 27:17-20). The MCC’s assertion takes Mr. McKenzie’s words out of context. Mr. McKenzie was responding to a question from staff attorney, Jeremiah Langston, regarding the *Bluefield* and *Hope* decisions and if those cases endorsed a specific methodology for determining an appropriate ROE.

Q. [JEREMIAH LANGSTON]: And would you agree that those decisions [*Bluefield* and *Hope*] did not endorse a specific method for estimating the cost of equity?

A. [ADRIEN MCKENZIE]: Yes, I would agree with that. In fact, quite the opposite. They emphasize that the end result of the process is really what’s most important and not a particular method that’s used.

July 17 Tr., 27:14-20. Essentially, this testimony stands for the proposition that no one method, whether it is DCF, Empirical CAPM, Risk Premium, Expected Earnings Approach, is the only right method. Instead, what matters is that the final approved rate of return is a rate that attracts capital necessary to maintain the financial health of the utility. This statement and the underlying concept do not suggest that NorthWestern’s DCF analysis lacked support or was an unaccepted methodology.

Moreover, while the MCC’s Brief focuses on the DCF model, it ignores the results of other methods presented by NorthWestern, which clearly demonstrate the reasonableness of its requested 10.0% ROE. The Federal Energy Regulatory Commission (“FERC”) recently acknowledged that DCF results are downward biased in today’s capital market conditions and

concluded that the very same risk premium, CAPM, and expected earnings approaches presented in NorthWestern's evidence should be considered in evaluating a fair ROE within the DCF range. *Martha Coakley, et al. v. Bangor Hydro-Electric Co., et al.*, 147 FERC ¶ 61,234, ¶¶ 146 and 147 (June 2014). MCC ignores the implications of this evidence.

Regulators have consistently eliminated outlying values. Elimination of values that fail to pass fundamental tests of reasonableness and economic logic has been regularly accepted by FERC. *See Bangor Hydro-Electric Co.*, 117 FERC ¶ 61,129 (2006), rehearing granted in part by *Bangor Hydro*, 122 FERC ¶ 61,265 (2008); *see also Southern California Edison Co.*, 92 FERC ¶ 61,070 (2000); *Pioneer Transmission, LLC*, 126 FERC ¶ 61,281, 62,606 (2009). More recently, FERC found that "it is reasonable to exclude any company whose low-end ROE fails to exceed the average bond yield by about 100 basis points or more." *Southern California Edison Company*, 131 FERC ¶ 61,020, 61,140 (2010), rev'd on other grounds, 147 FERC ¶ 61,240 (2014). This finding was rationalized in that it "gives the [FERC] flexibility to exclude from the proxy group companies whose low-end ROE is somewhat above the average bond yield, but is still sufficiently low that an investor would consider the stock to yield essentially the same return as debt." *Id.* (internal quotations omitted). Additionally, FERC has recognized that current capital market conditions are anomalous, which leads to understated DCF results and therefore justifies moving to the upper end of the DCF range, even AFTER excluding low-end outliers. *Martha Coakley, et al. v. Bangor Hydro-Electric Co., et al.*, 147 FERC ¶ 61,234, ¶¶ 41, 123, 142, and 144-145 (June 2014).

For these reasons, NorthWestern's DCF analysis eliminated values from 2.0% to 7.4% because "these values provide no meaningful guidance as to the returns investors require from utility common stocks and should be excluded." Ex. NWE-34 (Prefiled Rebuttal Testimony of

Adrien M. McKenzie) p. AMM-15. The abundance of evidence regarding why NorthWestern eliminated certain values demonstrates that the analysis was not arbitrary and was well supported by regulatory precedents. Additionally, NorthWestern's proposed 10% ROE is lower than the current average ROEs authorized by utility commissions during the first three quarters of 2013. Ex. NWE-11 (Prefiled Direct Testimony of Brian B. Bird) Exhibit \_\_ (BBB-4), p. 3 (Average authorized ROE was 10.09%).

In fact, what is arbitrary is Dr. Wilson's decision simply to eliminate any value below 6.0% without any reasoning or analysis to support this recommendation. *See* Ex. MCC-1 (Prefiled Direct Testimony of John W. Wilson) Exhibit \_\_ (JW-5), p. 3. Dr. Wilson's decision to restrict his low-end cutoff to only values that fall below 6.0% is even inconsistent with prior testimony he provided to the Commission on setting appropriate ROEs. In Docket No. D2009.9.129, Dr. Wilson testified that it was sometimes "appropriate to exclude outliers in evaluating [DCF] results" and that it was therefore appropriate to exclude values "that are either 300 basis points (i.e., 3.0%) above or below NorthWestern's currently allowed equity return." *In the Matter of NorthWestern Energy's Application for Approval for Authority to Establish Increased Natural Gas and Electric Delivery Service Rates*, Docket No. D2009.9.129, Direct Testimony of John W. Wilson, at p. 21. If Dr. Wilson had applied this same logic to the DCF results in this case, he would have excluded all values below 7.0%. This would increase Dr. Wilson's excluded values by 10 resulting in 23 excluded values or 1/5 of the values. Notwithstanding the inconsistency in his position, Dr. Wilson's 300 basis points figure fails to adequately address concerns of investors as is discussed above with respect to expected common stock returns. It would appear that 300 basis points is a randomly selected number not based on bond yields or

any other capital market evidence. Given Dr. Wilson’s inconsistency and apparent failure to ascertain what is reasonable to an investor, the MCC’s 9% ROE proposal should be rejected.

**B. The MCC’s capital structure proposal would potentially move NorthWestern toward unfavorable credit ratings thereby harming customers.**

The MCC proposes that the Hydros’ capital structure should be comprised of 55% debt and 45% equity. The only support for the MCC’s proposal is that if NorthWestern issues a level of debt at the top of range suggested by it, such issuance results “in a debt component close to 55%.” MCC Brief, p. 21. The evidence, however, demonstrates that NorthWestern does not intend to issue \$500 million in debt to finance the Hydros transaction. NorthWestern’s testimony succinctly states that “NorthWestern expects to finance the \$870 million related to this transaction with about \$400 million in equity and about \$450 million in debt, with the remainder in cash flows produced by the business from September 2013...to June 2014.” Ex. NWE-12 (Prefiled Rebuttal Testimony of Brian B. Bird) p. BBB-9. The following illustrates the percentages resulting from the financing of the Hydros transaction.

<b>Capital raise related to Hydro</b>				
Equity for Hydro Transaction	\$	400	million	46.0%
Cash from operations from Sept 2013 - June 2014	\$	20	million	2.3%
Debt for Hydro Transaction	\$	450	million	51.7%
<hr/>				
Rate base without Kerr Dam	\$	870	million	100.0%

*Id.* The MCC’s proposal also fails to recognize the cash that will be used by NorthWestern to finance this transaction. The percentages in the table are clearly in line with NorthWestern’s proposed capital structure of 52% debt and 48% equity.

Notwithstanding the lack of support for the MCC's proposed capital structure, if the Commission approves the MCC's proposal, NorthWestern, and ultimately its customers, will be subject to higher debt costs. *See* Response to Data Request PSC-057. A higher percentage of debt is viewed negatively by rating agencies and will therefore harm NorthWestern's credit worthiness. *Id.* A lower credit rating results in higher debt costs. NorthWestern is already more highly leveraged than its peers. *See* Updated Attachment to Data Request PSC-057 (average reported debt to total capitalization for peer utilities in 2013 was 50.32%). In fact, due to NorthWestern's short-term debt issuances, 52% debt is already "at the high end of [NorthWestern's] range." July 11 Tr., 30:15-20 ("At year end, that number, it usually swings from 53 to 55 percent during the year, on a consolidated basis."). NorthWestern's Chief Financial Officer, Brian Bird, testifies that 52% is the appropriate number in this case as "[i]t's dangerous to push it more than that." *Id.*, at 31:14. Therefore, NorthWestern has provided credible, substantial evidence to support its proposal that the capital structure for the Hydros should be set at 52% debt and 48% equity.

**VI. Acquisition of the Hydros promotes the Legislature's mandate that NorthWestern provide adequate and reliable electricity supply service at the lowest long-term total cost.**

In Section V of its Brief, the MCC makes clear its view that NorthWestern should continue to rely on the market instead of acquiring the Hydros because current electricity market prices are low. MCC Brief, pp. 22-25. That short-term view, which likely forever eliminates the Hydros from serving NorthWestern's customers at OC-D rates, also exposes customers indefinitely to uncontrollable electricity prices. As the evidence demonstrated, there is no other electricity generation alternative that NorthWestern could acquire that has the Hydros' positive attributes, low relative risks and lowest cost. The MCC's position goes to the heart of this case:

Should the Commission take the short-term view, spurred by current low energy prices, or should the Commission take the long-term view, as called for by Montana law, recognizing that approving the Hydros transaction will enable NorthWestern to provide a stable energy supply at a stable price for generations to come, regardless of regional and global market conditions?

The law requires NorthWestern to acquire supply resources that satisfy long-term objectives. Specifically, Montana law requires NorthWestern to “provide adequate and reliable electricity supply service at the *lowest long-term total cost*.” § 69-8-419(2)(a), MCA (2013) (emphasis added). To adopt the MCC’s short-term position would be contrary to the Legislature’s mandate to focus on the long term. It would also be contrary to the Consumer Counsel’s sound advice in its 2008 Comments on NorthWestern’s 2007 Electricity Supply Procurement Plan that called for NorthWestern to get out of the market as soon as possible because “reliance on the market commits ratepayers to long term escalation and volatility.”<sup>15</sup>

The evidence demonstrates that acquisition of the Hydros satisfies these objectives. First, NorthWestern demonstrated that it requires additional generation resources in order to ensure that it can provide both “adequate” and “reliable” electricity supply service. Ex. NWE-1 (Prefiled Direct Testimony of John D. Hines), p. JDH-40. The MCC did not dispute NorthWestern’s position that the Hydros would enable it to provide both “adequate” and “reliable” energy supply service or the evidence in support of it.

Second, NorthWestern provided extensive testimony and evidence showing customers’ exposure to volatile electricity prices if NorthWestern does not own its supply resources. To this end, NorthWestern demonstrated that when it was entirely depending on the market from 2002-

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<sup>15</sup> See footnote 1, *supra*.

2008, customer rates increased 112.9%. Ex. NWE-3 (Prefiled Rebuttal Testimony of John D. Hines) p. JDH-8. Even in December of 2013, daily prices at the Mid-C trading hub were, at times, about 300 percent higher than just the previous December. *Id.*, at JDH-21-22.

The MCC challenges the significance of this evidence, asserting that the 2002-2008 time period was unusual as deregulation was ending, and that “there is no reason to believe” that these unique conditions will be repeated. MCC Brief, p. 23. The MCC also argues that sudden price spikes should not be a concern because customers do not pay rates on a daily price basis, and that customers can always sign up for budget billing in order to avoid a future unexpected price increase.

These arguments are deeply flawed. Just because the *specific* market events that caused Montana electricity prices to rise between 2002-2008 may not be repeated does not mean that electricity prices will not rise or become more volatile. (“It can’t happen again” thinking is often prelude to a tumble.) Market events and dislocations will continue to occur; they simply will be caused by factors different from those specifically associated with the 2002-2008 timeframe.<sup>16</sup>

Montana is part of a Pacific Northwest and western energy market and an unpredictable global

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<sup>16</sup> The MCC recognized the anomalies in the current circumstances. Chairman Gallagher asked:  
**Q.** Would you agree with me that an anomalous bubble of circumstances that we’re in make it difficult – make is additionally difficult for us to make decisions based on historic and traditional analytical patterns, and when I talk about a anomalous bubble, I talked about the policy such as the federal reserves quantitative easement, easing its affect on interest rates, the fracking and horizontal drilling revolution and its affect on gas rates, the climate control policy, that all of these have created an environment that make it challenging for us to rely on market fundamentals as we analyze this?

Dr Wilson responded:

**A. True.**

July 15 Tr., 174:6-19.

economy, and neither the State of Montana, nor NorthWestern, can materially control these larger market forces and their impacts on Montana electricity prices.<sup>17</sup> From the risk management perspective required by law, the near-term opportunities of lower market prices will be dwarfed by the long-term risks of higher market prices. § 69-8-419(2), MCA (2013).

NorthWestern can, however, protect its customers from these market risks if it can own or control a substantial majority of its electricity supply needs. This is, in fact, why the MCC so strongly called for NorthWestern in March 2008 to get out of the market.<sup>18</sup>

In acquiring the Hydros, NorthWestern seeks to accomplish precisely what the MCC advocated in its 2008 Comments. Acquisition of the Hydros enables NorthWestern to significantly get out of the market at light load and control that risk for customers. As NorthWestern witness Joe Stimatz testified, “Once we make an investment in the Hydros .... that market risk is no longer there for that portion of our portfolio.” July 9 Tr., 185:13-17. In addition, acquisition of the Hydros enables NorthWestern to fix the path of at least part of the cost of power from that resource at OC-D, which declines over time. As NorthWestern witness Bob Rowe testified, “And what we are doing, what we’re trying to do, is start over right now. Start that OC minus D clock again. And for assets that, just like this capitol building, will be around for another 100 years.” July 17 Tr., 225:24-226:3.

The MCC’s assumption that prices will not significantly increase in the future, or that price spikes will not occur because the market events and dislocations that took place from 2002-

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<sup>17</sup> A high level review of just some known risks that will affect electricity price and supply include the closure of the Boardman coal plant in Oregon; the closure of the Centralia plant in Washington State; the shuttering of Corette in Montana; proposed greenhouse gas regulations, and other environmental regulations such as Regional Haze and the Mercury and Air Toxics Standards (MATs). July 8 Tr., 188:7-192:16.

<sup>18</sup> See footnote 1, *supra*.

2008 are unlikely to be replicated, is unreasonable, irresponsible, and factually unsubstantiated. It is the same magical thinking that led to the policy disasters of supply deregulation. The energy forecasts in this record reflect a rise in electricity prices (Ex. NWE-1, p. 35, Graph 5; Ex. NWE-10, p. 6) , and no one can predict precisely what specific circumstances may affect energy prices in the future.<sup>19</sup> Approving this transaction will enable NorthWestern to protect its customers from regional and global market dislocations, public policy decisions in Washington D.C., Washington State,<sup>20</sup> or in other states, price spikes, and large price increases. In so doing, the acquisition significantly benefits customers and also enables NorthWestern to meet its obligation to provide adequate and reliable electricity supply service at the lowest long-term total cost.

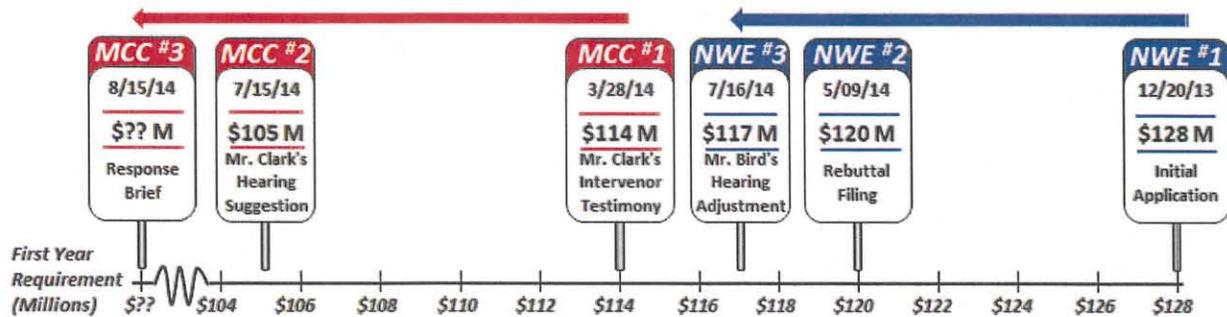
**VII. NorthWestern’s requested first-year revenue requirement is reasonable.**

The MCC complains that NorthWestern has reduced its requested revenue requirement from \$128,402,190 to \$120,963,690 to \$117,149,257. MCC Brief, pp. 25-28. This criticism is perplexing. NorthWestern was accommodating the MCC’s concerns. Now, it appears that the MCC is moving its recommended revenue requirement down from \$114,597,373. MCC Brief, pp. 27-28 (Mr. Clark’s “recommended revenue requirement would be substantially reduced, in line with NWE’s reductions.”).

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<sup>19</sup> Indeed, this is why the Commission has urged and NorthWestern has adopted a robust scenario process to inform its supply planning and decision-making.

<sup>20</sup> See Washington Governor Inslee’s Executive Order 14-04, Ex. NWE-3 (Prefiled Rebuttal Testimony of John D. Hines).



In describing NorthWestern’s reduction to \$117 million, the MCC states, “This most recent reduction was the result of two additional adjustments. The first of these live testimony changes is a reduction in assumed debt cost from 4.5% to 4.0%. The second is use of actual PPLM property tax expense. Both of these latter changes are unreliable.” MCC Brief, pp. 25-26.

The MCC asserts that NorthWestern “is not proposing to fix its debt cost at 4%, regardless of actual cost.” MCC Brief, p. 26. This is not true. NorthWestern’s CEO Bob Rowe testified, “If the Commission said go lock in 4 percent debt, we can get the 4 percent. It would be a combination of shorter and longer tenure I think for the reasons we discussed.” July 18 Tr., 34:16-19. He also stated, “We could lock in a blending at 4 percent. We could go longer. We could go out a full 30 years. I’ll look for direction from the Commission. And as soon as we have that direction, we have the ability to go out and do it.” *Id.*, 35:20-25. Contrary to the MCC’s assertion, NorthWestern did offer to blend the maturities of its debt to lock in 4.0% debt cost.

The MCC also argues, “The proposed property tax adjustment has similarly little, if any, permanent effect.” MCC Brief, p. 26. The MCC’s analysis of this adjustment is incorrect. NorthWestern offered to accept the proposed property tax amount for 2015 even if its actual property taxes are higher. If NorthWestern’s original estimate of what property taxes will be is correct, by accepting PPLM’s actual property tax level for 2015, NorthWestern has permanently

forgone \$1.7 million. NorthWestern committed to not requesting a true-up of the Hydros revenue requirement to actual taxes outside of a rate case. To the extent that NorthWestern recovers increased taxes for 2016 and beyond through its property tax tracker, NorthWestern is forgoing recovery of 40% of the increase permanently (because the tracker statute only allows recovery of 60% of a shortfall). Based on the current estimates, the difference is approximately \$665,000 per year in property taxes that NorthWestern will pay but not recover in rates. The MCC's argument about the effect of income tax deductibility is the justification for the adjustment but it does not reflect the actual effect.<sup>21</sup> This is a permanent and significant concession by NorthWestern.

### VIII. Conclusion

The extensive record and the myriad arguments touch on nearly every aspect of utility regulation and service to customers. However, the details can obscure the big picture. In its Post-Hearing Brief ("HRC Brief"), Human Resource Council District XI and Natural Resources Defense Council ("HRC") remind the Commission to avoid not seeing "the forest for the trees."

HRC Brief, p. 1. HRC reminds us all:

In this proceeding, due to the proposal's importance, the extent of the analysis that NWE performed, the voluminous record and, not to be overlooked, the nature of the arguments in opposition, there is the possibility that the big picture will be obscured in a fog of details and evidence.

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<sup>21</sup> NorthWestern is not seeking to relitigate the property tax tracker issue. However, the following simplified example shows that the property tax tracker does not make a utility whole.

	BASE YEAR	INCREASED TAX YEAR
Revenue	5,000	5,300
Expenses Other than Property Tax	2,500	2,500
Property Tax	1,000	1,500
Income	1,500	1,300
Income Tax	600	520
Return	900	780

*Id.*

The big picture is that NorthWestern must take action to secure electricity supply resources and has brought forth the lowest cost, lowest risk alternative. Furthermore, NorthWestern has proposed a rate of return (“ROR”) of 6.88%. To NorthWestern’s knowledge, this is the lowest ROR for any Commission-regulated electric or natural gas utility since 1980.

As Mr. Bird testified at the hearing:

For instance, when you look at authorized ROEs, and I encourage you to do that for our peers, I’d also look at rates of return. Spion Kop is 7 percent. I believe it’s the lowest printed ROR in this state. I can tell you that if the debt cost adjustment that I talked about, if we could raise our debt at 4 percent, our ROR on this transaction would be 6.88 percent. And so I don’t think we’ve seen a 7 percent ROR. And that’s a fantastic cost of money for our customers.

July 11 Tr., 63:3-11.

Approval of NorthWestern’s acquisition of the Hydros is in the public interest. Without the Commission’s approval, NorthWestern cannot purchase this lowest cost, lowest risk resource. Acquisition of the Hydros is consistent with NorthWestern’s obligation to provide reasonable adequate service at just and reasonable rates, the statutory objectives for electricity supply resource planning and procurement, and the Commission’s administrative rules.

NorthWestern has worked to address the legitimate concerns of the MCC. As the HRC correctly stated:

No decision is without risk. Here, however, NWE’s effort to reduce reliance on the regional electricity market and to provide its customers with a reasonably-priced and stable source of supply, which once again will be regulated by this Commission, calls out for a finding that the benefits of the acquisition outweigh its cost and risk.

HRC Brief, p. 12.

For the foregoing reasons, NorthWestern respectfully requests that the Commission approve the Application and grant the relief requested.

Respectfully submitted this 25th day of August, 2014.

NORTHWESTERN ENERGY

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**CERTIFICATE OF SERVICE**

I hereby certify that a copy of NorthWestern Energy's Post-Hearing Reply Brief in Docket No. D2013.12.85 has been hand delivered to The Montana Public Service Commission and The Montana Consumer Counsel. A copy has been e-filed on the MPSC website. It will be mailed to the most recent service list in this Docket by first class mail. It will also be emailed to the counsel of record.

Date: August 25, 2014



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