24 July 2017
Americas/United States
Equity Research
Electric Utilities

NorthWestern Energy (NWE)

COMPANY UPDATE

Downgrade to Underperform on Regulatory Risks

Rating	**(from NEUTRAL) UNDERPERFORM**
Price (21-Jul-17, US$)	61.77
Target price (US$)	(from 58.00) 60.00
52-week price range (US$)	63.78 - 54.09
Market cap (US$ m)	2,992

Target price is for 12 months.

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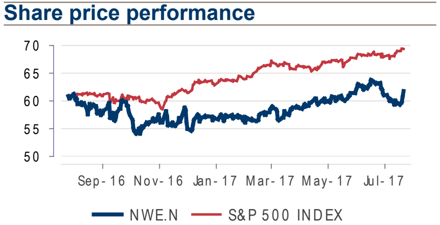
- **Downgrade to Underperform (in a note published earlier this morning).** We are downgrading NWE to Underperform (from Neutral) on increased Montana regulatory risk, with extra scrutiny over power cost recovery possibly leading to a full ratecase filing as early as Sept, earlier than the company would like (i.e., based on a 2016 Test Year). Oral arguments are set for 7/28 regarding a Notice of Commission Action requesting "a comprehensive electric supply revenue requirements case" by 9/30. Our meeting last week with regulators in San Diego (see our note, Electric Utilities: Commissioner Meeting Takeaways – 10 States) also leaves us with little confidence in the company's ability to win approvals for a $1.3B Electric Supply Resource Plan through 2029. Despite resetting our TP up $2 to $60 on higher peer P/Es, we see virtually no TR over the 12 months.
- **Estimates through 2019 are unchanged, but prospects for long-term growth look dimmer.** Our estimates remain unchanged at $3.40, $3.54, and $3.69 for FY2017-19, respectively, and already reflect a reduced capex forecast. We continue to assume ~9.5% earned ROEs but have increased the discount applied to peer 2018E P/E multiples to -1.5x from -0.5x previously to account for higher ratecase risk.
- **NWE's 7%-10% total return target (EPS + Dividend) under pressure.** After prior guidance to the low end based on "delayed" generation capex, the ability of the utility to return to the middle of the range is pressured by recent orders to treat utility ratebased generation on par with unregulated PPAs. Our estimates already assume the lower end with EPS growth of 4.4% through 2021 plus 3.5% dividend yield.
- **Estimates and Valuation**: Our estimates remain unchanged at $3.40, $3.54, and $3.69 for FY2017-19, respectively, vs consensus $3.41, $3.52, and $3.62. Our target price moves down $2 to $60 to reflect a -1.5x discount to peer electric 2018E P/E multiples (vs -0.5x previously).

Share price performance



On 21-Jul-2017 the S&P 500 INDEX closed at 2472.54
Daily Jul22, 2016 - Jul21, 2017, 07/22/16 = US$62.3

Quarterly EPS	Q1	Q2	Q3	Q4
2016A	1.01	0.65	0.68	0.96
2017E	1.13	0.64	0.69	0.94
2018E	-	-	-	-

Financial and valuation metrics

Year	12/16A	12/17E	12/18E	12/19E
EPS (CS adj.) (US$)	3.30	3.40	3.54	3.69
Prev. EPS (US$)	-	-	-	-
P/E (x)	18.7	18.2	17.4	16.8
P/E rel. (%)	89.6	96.1	103.2	109.4
EBITDA (US$ m)	416	444	463	480
EV/EBITDA (current)	12.3	11.5	11.0	10.6
Net debt (US$ m)	2,115	2,045	2,091	2,128
FFO/Interest	3.5	3.4	3.4	3.4
FFO/Total Debt	0.15	0.16	0.16	0.16

Number of shares (m)	48	BV/Share (Next Qtr., US$)	35
Net debt (Next Qtr., US$ m)	2,012	Dividend (current, US$)	2.1
Net debt/tot eq (Next Qtr., %)	117.7	Dividend yield (%)	3.33

Source: Company data, Thomson Reuters, Credit Suisse estimates

Target Price Update:

Figure 1: NWE – Sum of the Parts Valuation

		BASE CASE			
	2018 EPS	Prem / Disc	Effective P/E	Equity	Equity / Sh
Electric	$ 3.02	-1.5x	16.5x	$ 2,414	$ 49.76
Gas	$ 0.56	-1.5x	19.5x	$ 527	$ 10.86
Other	($ 0.03)	-1.5x	16.5x	($ 24)	($ 0.50)
Total EPS	**$ 3.54**			**$ 2,916**	**$ 60.00**
Diluted Shares Outstanding					48.5
Dividend					$ 2.10
Implied Yield					3.5%
Current Yield					3.4%
Implied P/E					16.9x
Prem / (Disc) To Group					(5.9%)
Upside/ (Downside) to Current Price					(2.9%)

Source: Company data, Credit Suisse estimates

YoY Walk:

Figure 2: NWE – 2Q17 YoY Earnings Walk

NWE Earnings Walk	EPS
2Q16 Adjusted EPS (Actual)	**$0.65**
Gross Margin Improvements	0.08
G&A Expense Increase	(0.01)
Property & Other Taxes	(0.02)
Depreciation & Depletion	(0.03)
Interest Expense	(0.00)
Other Income	0.01
Tax Loss	(0.01)
Other	(0.02)
2Q17 Adjusted EPS (CS Estimate)	**$0.64**
Consensus 2Q17 Adjusted EPS	$0.62
CS Shares Outstanding	*48*
FY 2017 EPS - CS	$3.40
FY 2017 EPS - Consensus	$3.41
FY 2017 EPS - Guidance	$3.30 - $3.50

Source: Company data, Credit Suisse estimates

- **Late-hour passage of HB 193 caught NWE by surprise and will likely lead to an early ratecase filing.** The new law allows the commission to alter the power supply cost mechanism and align it more with MDU's clause, including a 90%/10% sharing mechanism rather than the 100% pass through mechanism in effect now. The bill also shelters the Public Service Commission from lawsuits (e.g. NWE's suit regarding its disallowance of Colstrip fire costs) and prohibits the pass through of modelling and consultant costs through the fuel clause. During legislative debate, the bill gained some notoriety on this last point when Commissioner Kavulla cited a recent reimbursement for a sundry juice drink as an example of abuses under the current system. Although it had been tabled at one point, it appears that Kavulla was able to rally enough support from various groups toward the end of the legislative session to achieve passage.

- **NCA requests a filing by 9/30.** On 5/18, The Montana Public Service Commission (MPSC) issued a Notice of Commission Action (NCA) in connection with HB 193. The NCA directed NWE to provide supply cost information sufficient to allow the MPSC to implement, on an interim basis, one of three alternatives:
  - 1) a cost tracker with an initial base supply cost based on PowerSimm supply cost modeling for the time period July 1, 2017 to June 30, 2018;
  - 2) a cost tracker similar or identical to NWE's current tracker, established pursuant to Mont. Code Ann. 69-8-210(1), which could serve as a starting point for establishing a modified cost tracker; or
  - 3) any other cost tracker proposal that NWE thought would be workable and consistent with the intent of HB 193.
- **Rate filing this Fall more likely.** With the 2016 annual report filing showing a 9.6% earned ROE, NWE's transmission and distribution (T&D) assets generally earn lower, offsetting higher earnings for its supply assets and power cost recoveries. The MPSC's sole focus on reducing power cost recoveries may lead the company to conclude that it must file a full ratecase in September (under a 2016 Test Year) to ensure proper treatment of T&D. However, management has stated a preference for filing in 2018 under a 2017 Test Year as this would more accurately reflect ongoing costs and earnings.

- **For 2Q17, we forecast an in-line quarter at $0.64 vs consensus $0.62.** We see higher property taxes and depreciation offset by increased gross margin and cost cutting.

Recent Commentary:

- **Is Montana once again sliding toward deregulation?** On June 22, the Montana Public Service Commission (MPSC) ordered to cap the length of NWE's long-term power contracts to a maximum 10 years, with a contracted price reopener at 5 years. While the order was primarily aimed at reducing the extraordinary length of Qualifying Facility (QF) contracts that have typically extended above-market rates to 25 years, the MPSC appeared to extend the policy much further, deciding "to apply this standard across the board, holding all energy projects, whether they are owned by the utility or independent developers, to the same standard. Vice-Chairman Travis Kavulla stressed, "What's good for the goose is good for the gander." Chairman Johnson agreed, stating "Our actions will help to mitigate the risk associated with relying on long-term price forecasts that are at best imperfect in the setting of rates customers pay for electricity." Commissioner Koopman: "It's not the role of the Commission to guarantee anyone's business success."
- **NWE suspends solicitation for gas assets in response.** In a follow-on decision on June 29, the MPSC authorized a shorter 10-year contract for an 80-MW solar farm, agreeing with Montana Consumer Counsel (MCC) that this helps "protect customers from the 'excessive risk' of long-term contracts." Regulators also voted to impose "symmetrical treatment" on other NWE resources, with the company responding by suspending its solicitation for new gas-fired assets under 20-year contracts (with a ratebase option to consider).

Figure 3: Montana Electric Supply Resource Plan (2015)

2015 Montana Electric Supply Resource Plan ($M, nominal overnight capital cost)	Cap (MW)	Year added	Project cost	Infrastructure cost	Total cost
3 Internal Combustion Engines	55	2019	$76.5	$22.0	$98.5
1 Internal Combustion Engine	18	2021	$26.5	$7.6	$34.1
1 Internal Combustion Engine	18	2024	$28.1	$8.1	$36.2
1 CCGT	348	2025	$593.9	$59.5	$653.4
1 Internal Combustion Engine & 1 Frame Combustion Turbine	171	2028	$254.2	$83.7	$337.9
1 Frame Combustion Turbine	79	2029	$103.9	$40.8	$144.7
Total			**$1,083.2**	**$221.7**	**$1,304.8**

Source: Company data

- **This adds pressure on NWE's 7%-10% total return target.** In our view, this latest regulatory turn raises questions as to the viability of NWE's plan for the addition of 689 MW of new ratebased capacity for ~$1.3B through 2029 that would bring the *ratebased* reserve margin about ~5% above the projected winter peak load from -28% currently, a figure that excludes contracted purchased power agreements (PPA). This 2015 Montana Electric Supply Resource Plan (MESRP) is intended to reduce customer dependence on PPAs with least-cost, lowest-risk resources, including the co-optimization of hydro, wind, and thermal capacity. Recall that in February, the company reduced expectations with a near-term forecast for the low-end of their prior 7%-10% long-term total return projection due to "recent regulatory headwinds" and "reduced and delayed" capital investment in generation assets within their 5-year capex plan through 2021. However, in the long run, management believes its negative reserve margin (excluding purchased power) will drive generation spending and, in turn, return the company to the middle of this guidance range, a prospect that depends on regulatory support for long-term price stability rather than a preference for deregulation of generation assets. See our 4/28 note "A Ratecase Runs Through It" and 2/21 "Swimming Against the Tide" for more detail.

Figure 4: NWE Capex Forecast (2017-21)

NWE Regulated Utility Capex Forecast, 2017E-2021E ($M)	2017E	2018E	2019E	2020E	2021E	Total
MT Electric	$207	$202	$230	$218	$216	$1,074
SD Electric	43	68	42	52	56	262
MT Gas	39	38	40	42	45	205
SD/NE Gas	9	12	6	8	8	43
Total	**$298**	**$321**	**$318**	**$321**	**$326**	**$1,583**
Prior	$324	$365	$389	$270		$1,657*

**Prior total is for the 2016-21 time period*

Source: Company data, Credit Suisse estimates

- **Deregulation was once considered an "unmitigated disaster".** These recent orders against long-term power contract lockups are consistent with Commissioner Kavulla's well-known preference for deregulated power markets and his 35-page dissent from the MPSC's 2014 approval of NWE's purchase and ratebasing of Talen's (formerly PP&L's) 439-MW hydro portfolio. Recall that this portfolio was once owned by NWE's predecessor Montana Power Corp but was eventually sold to PP&L and became a symbol of the state's previous flirtation with deregulation - an "unmitigated disaster" as coined by former Governor Schweitzer in 2007. At the time, the Governor complained that Montanans needed "protection from an out-of-state corporation that places profits above the economic health of this state and its people", which led to the passing of HB 25 in May 2007 to end deregulation and allow NWE to once again ratebase and construct its own generation assets.

- **"Excited to return ownership to the utility"** It must be noted that the prior deregulation period from 1997-2007 began with $245M of stranded cost recovery in 2002 and was followed by rising power and gas prices that ultimately led to the HB 25 "re-regulation" bill in 2007. In the order approving the 2014 return of the hydro portfolio to NWE, Commissioner Koopman even remarked that "Looking at the proposed hydro acquisition from a generalized perspective these past nine months, it was quite natural to get excited over the prospects of these 11 dams returning to the ownership of a Montana-regulated utility. All the obvious attributes that were asserted then, remained equally valid at our moment of decision, and were buttressed by a general (albeit not unanimous) public enthusiasm for the purchase, expressed through 17 listening sessions and many hundreds of letters, phone calls, and e-mails." Further supporting the decision to ratebase was the prospect (then higher probability) of a carbon price on fossil generation, with the order citing "If the opportunity to acquire the Hydroelectric Facilities were lost due to such conditions, customers would face more expensive alternative energy supply resources. The Commission finds that the risks … are outweighed by the overall benefits of the proposed acquisition."

- **Always a step behind? Low gas and power prices have once again turned sentiment against long-term generation assets.** The change in sentiment back toward deregulation since 2007 appears to be driven by sustained reductions in gas and power pricing since then, largely as a result of massive shale gas/oil discoveries in the US. While we see the rationale behind regulatory impatience with imperfect long-term price forecasts used to justify long-duration contracts and asset purchases, our general impression is that the time to lock in long-term pricing is when the curve is low. As such, the MPSC's preference for deregulation and short-term contracts at a time of historic low prices makes little sense to us.
- **Is this legal?** Historically speaking, the choice to untether customer bills from long-term regulatory stability has been the province of state legislatures rather than regulatory commissions. These latest orders seeking "symmetry" for utilities would appear to be inconsistent with both HB 25 as well as other national precedents. It is unclear at this time how the company and other parties, including consumer groups, will respond.

The following commentary comes from our meetings at the NARUC Summer Policy Conference in San Diego on July 17:

- **Skeptical of a coming capacity "crunch".** Commissioner Kavulla noted that projections for a regional capacity shortage are largely based on coal retirements in neighboring states (e.g., Colstrip). These projections would appear to him to represent an economic paradox, with coal retirements based on being uneconomic while at the same time the projection for a capacity shortage would seem to imply that these plants are indeed necessary and therefore should be economic over longer-run cycles. His view is that the region is fundamentally oversupplied, providing inexpensive opportunities for consumers through at least 2025.
- **Let demand meet supply.** Kavulla entered into the regulatory arena with a key fundamental belief: that utility customers are uniquely positioned to be captured into long-term, out-of-market rate structures, perhaps analogous to an above market rate on a 30-year mortgage loan. As such, Commercial and Industrial (C&I) customers have been gravitating toward relatively short 3-year energy PPAs (renewables and gas-fired) because they are cheaper than utility rates based on long-term ratebased assets. In this view, the best way to avoid a future capacity shortage is to rely on the inherent cyclical volatility of the energy-only market to motivate C&I customers into signing longer-term energy contracts that lock in cheaper prices. Although Residential customers are not eligible for choice in the state, Kavulla believes that C&I contracts are enough to incentivize adequate new supply going forward (or at least to keep existing plants from retiring). Undoubtedly, saving regional coal plants from an early and to some, unjust extinction in the absence of a Clean Power Plan is one of the underlying goals here.

- **Entire Montana PSC is on the same page.** Kavulla estimated that his fellow commissioners were in agreement with him and that they were all just as focused on supporting non-ratebased supply options.
- **What do we think?** Our discussion was totally in-line with recent decisions from the Montana PSC to put utility generation decision making on equal footing with other unregulated supply options (see our 7/6 note Montana Drops a Goose Egg). We come away with concern for NWE's coming power cost recovery tracker treatment this summer and the prospect for an earlier-than-expected ratecase filing later this Fall. We are also concerned about prospects for NWE's long-term Montana Electric Supply Resource Plan (MESRP). We do not disagree that in any open market where supply and demand are free to meet each other; there will always be a price that makes the market. However, a reliance on energy markets alone is a recipe for extreme price volatility that will be politically unpalatable, especially without 100% retail choice for all customers (Residential included) when the current supply glut begins to clear in the mid-2020s. With a commodity considered as fundamentally necessary to daily life as electricity, price volatility is typically solved with price caps that effectively cheat new generation investors of returns they are owed under prior market structures. For this reason, volatile energy markets have never been friendly environments to raise low-cost financing for large capital-intensive generation projects. Hence more established energy markets such as PJM, New England and MISO moved on to parallel capacity market structures many years ago to encourage long-term plant financing and reduce energy price volatility (and are now moving further with reforms to ensure the adequacy of ancillary services and baseload supply). As Montana moves closer to deregulation once again without retail choice and without a capacity market, we see an increased probability of shortages, price caps, and a potentially destabilized grid down the road.

1Q Earnings Report – A Ratecase Runs Through It

Companies Mentioned *(Price as of 21-Jul-2017)*
NorthWestern Energy (NWE.N, $61.77, UNDERPERFORM, TP $60.0)

Disclosure Appendix

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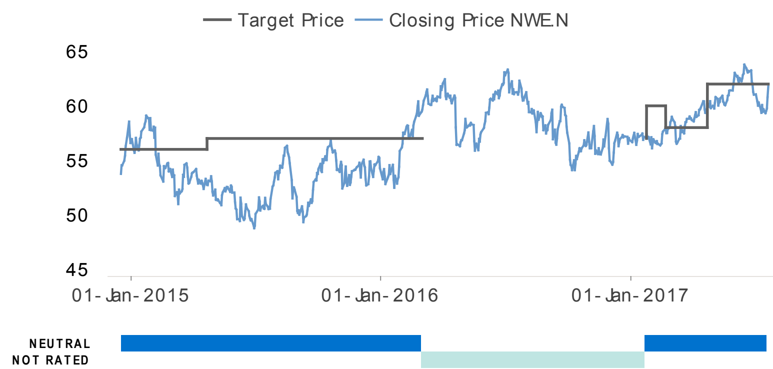
I, Michael Weinstein, certify that (1) the views expressed in this report accurately reflect my personal views about all of the subject companies and securities and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

3-Year Price and Rating History for NorthWestern Energy (NWE.N)

NWE.N Date	Closing Price (US$)	Target Price (US$)	Rating
17-Dec-14	53.74	56.00	N *
22-Apr-15	52.73	57.00	
02-Mar-16	59.66		NR
24-Jan-17	57.38	60.00	N *
21-Feb-17	57.94	58.00	
23-Apr-17	59.54	62.00	

** Asterisk signifies initiation or assumption of coverage.*



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Restricted	2%	

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Target Price and Rating
Valuation Methodology and Risks: (12 months) for NorthWestern Energy (NWE.N)

Method: We arrive at NWE's $60 target price using the traditional P/E multiple framework which applies a P/E multiple to our 2018 earnings estimate. Given its clean business model, a clear rate base growth trajectory and dividend yield that is in-line with the group, we believe NWE should be trading at a discount to the group's P/E multiple to account for the increased regulatory risk in Montana. Applying the group's P/E multiple with a 1.5x discount across the business to reflect the worsening regulatory situation in Montana to arrive at a 16.5x multiple which we apply to a 2018 EPS estimate for the electric segment and a 19.5x group P/E multiple to the gas segment's 2018 EPS estimate, we arrive at a target price of $60 for NWE. Our Neutral rating reflects a forecasted total return in line with the group average.

Risk: Risks to our $60 target price and the Neutral rating for NWE are 1) approval of a potential decoupling mechanism to deal with lost load 2) regulatory approval to add gas reserves to ratebase and add newbuild generation units to ratebase, particularly in Montana and 3) changes in the regulatory environment in Nebraska, Montana or South Dakota

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