

NorthWestern Energy (NWE)

COMPANY UPDATE

Montana Drops a Goose Egg

Rating	NEUTRAL
Price (05-Jul-17, US\$)	60.42
Target price (US\$)	62.00
52-week price range (US\$)	63.78 - 54.09
Market cap (US\$ m)	2,927

Target price is for 12 months.

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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).

NWE's 7%-10% total return target 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 these orders. Our estimates and TP remain unchanged for now, which already assume the lower end with EPS growth of 4.4% through 2021 plus 3.5% dividend yield. We reiterate our Neutral rating. Risks include further regulatory deterioration, execution of capital plans, and a coming ratecase filing.

Share price performance



On 05-Jul-2017 the S&P 500 INDEX closed at 2432.54
Daily Jul05, 2016 - Jul05, 2017, 07/05/16 = US\$63.33

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)	18.3	17.8	17.1	16.4
P/E rel. (%)	87.6	94.0	101.0	107.0
EBITDA (US\$ m)	416	444	463	480
EV/EBITDA (current)	12.1	11.4	10.9	10.5
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			35
Net debt (Next Qtr., US\$ m)	2,012			2.1
Net debt/tot eq (Next Qtr., %)	117.7			3.39

Source: Company data, Thomson Reuters, Credit Suisse estimates

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Figure 1: 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 2: 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.
- **From our [6/25 Weekly note](#): Montana PSC to NWE: "Hit the Books."** In Montana, the Public Service Commission (PSC) has opened a docket to create minimum requirements for Northwestern (NWE) to study the impact of customer generation with net metering; this was mandated under House Bill 219 (HB 219) which was signed into law this past session. On June 16th, the MPSC issue a notice to seek public comment by July 7th for its proposals for minimum requirements to include in the study. The study will only apply to NWE as they have the most net-metered customers; MDU will be exempt as they only have 4 net-metered customers in the state. The study will need to be completed by April 1, 2018 and will be used to create requirements for net metered customers, including whether a separate rate class is needed for customer generators, the new requirements will be established in NWE's next general electric rate case. Montana law currently limits capacity for systems connecting to NWE's system at 50kW; overall customer generator capacity currently stands at 5.6MWs in the state.

Companies Mentioned (Price as of 05-Jul-2017)

MDU Rsrcs Group (MDU.N, \$26.19)
NorthWestern Energy (NWE.N, \$60.42, NEUTRAL, TP \$62.0)

Disclosure Appendix

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

NWE.N	Closing Price	Target Price	
Date	(US\$)	(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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Target Price and Rating

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

Method: We arrive at NWE's \$62 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 the group's P/E multiple with a slight discount to account for the increased regulatory risk in Montana. Applying the group's P/E multiple with a 0.5x discount across the business to reflect the worsening regulatory situation in Montana to arrive at a 17.0x multiple which we apply to a 2018 EPS estimate for the electric segment and a 20.0x group P/E multiple to the gas segment's 2018 EPS estimate, we arrive at a target price of \$62 for NWE. Our Neutral rating reflects a forecasted total return in line with the group average.

Risk: Risks to our \$62 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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