KeyBanc Capital Markets

Alert

July 10, 2017

Energy: Multi-Utilities

NYSE: NWE

NorthWestern Corporation

NWE - ALERT: Regulators Gone Wild?

Paul T. Ridzon / (216) 689-0270 / pridzon@key.com

John Barta / (216) 689-3386 / john_j_barta@key.com

We believe Montana regulation bears watching, particularly for NWE. Recent developments at the commission suggest commissioners (particularly free market advocate Commissioner Travis Kavula) may be leaning toward regulatory positions that could present challenges. Among the issues being discussed are moves to revisit PURPA contracts, to which Kavula is promoting the idea utility owned generation be subject to a reevaluation after five or 10 years. Additionally, related to the implementation of Montana Bill 193 (looks at recovery of supply costs), discussion has come up where the commission could look at earned returns of NWE's Montana generation assets (overearning) in isolation from the transmission and distribution assets (which are underearning). Kavula seems to be spearheading these efforts and is termed out after 2018. We also believe some of the proposed ideas run counter to legislative intent of the 2007 reregulation of generation and principle of leveling the field among Montana utilities with regard to supply cost recovery under Bill 193.

Recent Montana Regulatory Trends. We believe regulatory risk in Montana has been trending higher for NWE. We think the commission has been chipping away at the Company in an effort to have the Company file a rate case after adding the sizable hydro assets to rate base outside of a traditional rate case. We believe several recent developments should be monitored for the potential to further degrade the regulatory landscape.

Reexamination of PURPA QF Contracts Could Expand to Utility Generation. The Public Utility Regulatory Reform Act is a federal requirement that utilities must purchase power from small qualifying facilities (QFs) at the utilities' avoided cost, with significant deference to states around contract terms. With a flood of small renewables qualifying, many utilities are being required to sign contracts for power that is neither necessarily needed nor the optimal match for system needs. The Montana commission is looking at lowering the contract price and shortening terms of the contract from the typical 20-25 years to 5-10 years with a potential repricing after the initial term. Commissioner Kavula suggests a similar construct for future utility owned generation, which we view as a significant deviation from the traditional model of building a long-lived asset with assured recovery over the 30- to 40-year life of the plant.

Bill 193 Implementation Could Look at Other Issues. The recently enacted Bill 193 looks at the recovery of supply costs through tracker mechanisms. It was designed to put the utilities in the state on equal footing. NWE has historically been meaningfully short generation and had more straightforward recovery mechanism. As part of the process of studying how to implement this bill, the commission has discussed looking at NWE’s returns and has initiated a process to potentially do so. NWE will make its oral arguments on July 28, when we expect it to advocate for its previously announced plan to file a rate case in 2018. The commission is expected to render a decision sometime thereafter, with one outcome being that the commission could require NWE to file data (by September 30) with regard to returns at the supply segment. This is significant in that NWE’s generation assets are overearning, with transmission and distribution assets underearning (with blended returns slightly underearning).

Developments Concerning, but May Prove Challenging. We view these recent developments at the commission as concerning. NWE has a long-term plan to fill its short generation position with up to $1.3 billion of capital expenditures. Clearly, the higher risk of retroactive looks at generation asset prudence would likely cause NWE to rethink this capital. Additionally, the idea of cherry-picking asset classes to undergo effective rate cases is troublesome. However, we expect the implementation of these policy could face headwinds. The Montana legislature in 2007 specifically enacted legislation to encourage utility ownership of generation after Montana’s disastrous foray into deregulation. As such, we expect the legislature could weigh in on this matter. We also question whether the commission could prevent NWE from filing what would effectively be a full rate case, including its entire rate base, not just its generation portfolio, when it does file. Lastly, Commissioner Kavula is termed out after 2018. Given our view that he is driving much of the agenda, we think the rhetoric could die down after that time.

Disclosure Appendix

NorthWestern Corporation - NWE

We have managed or co-managed a public offering of securities for NorthWestern Corporation within the past 12 months.

NorthWestern Corporation is an investment banking client of ours.

We have received compensation for investment banking services from NorthWestern Corporation during the past 12 months.

We expect to receive or intend to seek compensation for investment banking services from NorthWestern Corporation within the next three months.

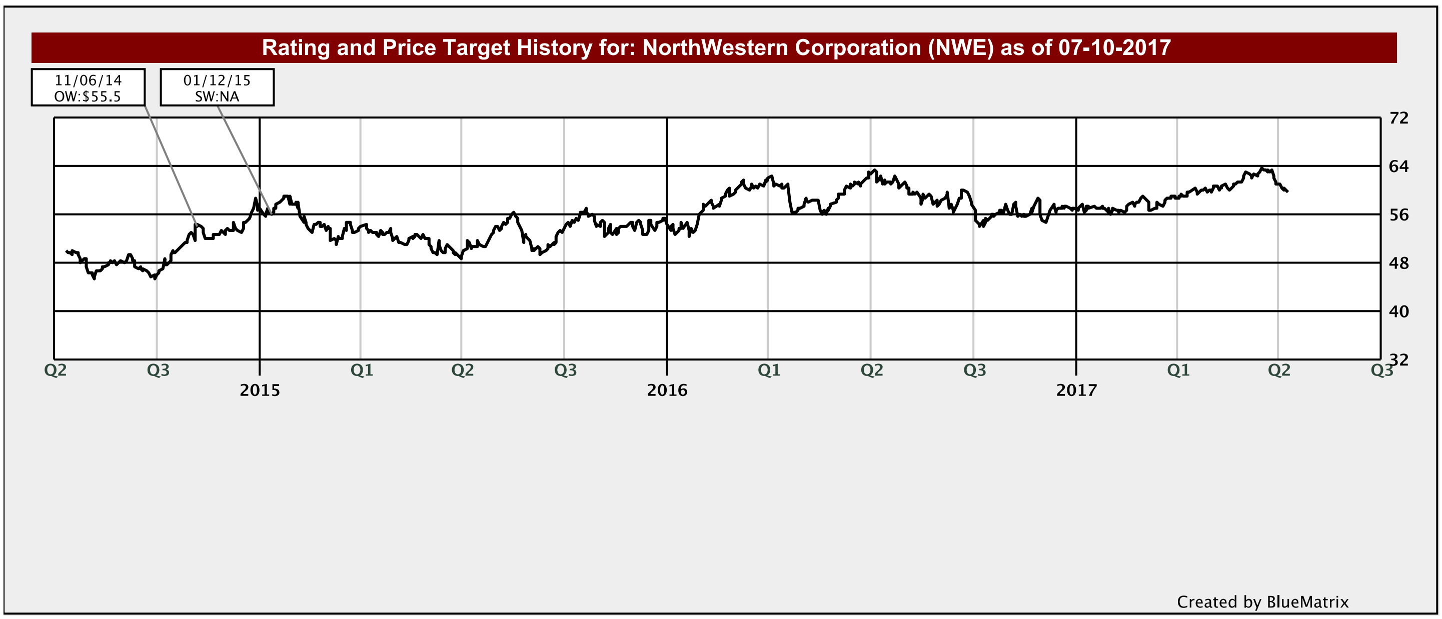
During the past 12 months, NorthWestern Corporation has been a client of the firm or its affiliates for non-securities related services.

As of the date of this report, we make a market in NorthWestern Corporation.

Reg A/C Certification

The research analyst(s) responsible for the preparation of this research report certifies that:(1) all the views expressed in this research report accurately reflect the research analyst's personal views about any and all of the subject securities or issuers; and (2) no part of the research analyst's compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the research analyst(s) in this research report.

Three-Year Rating and Price Target History



Rating Disclosures

Distribution of Ratings/IB Services Firmwide and by Sector

	KeyBanc Capital Markets		IB Serv/Past 12 Mos.	
Rating	**Count**	**Percent**	**Count**	**Percent**
Overweight [OW]	280	41.92	58	20.71
Sector Weight [SW]	376	56.29	53	14.10
Underweight [UW]	12	1.80	1	8.33

	Energy		IB Serv/Past 12 Mos.	
Rating	**Count**	**Percent**	**Count**	**Percent**
Overweight [OW]	28	45.90	20	71.43
Sector Weight [SW]	33	54.10	16	48.48
Underweight [UW]	0	0.00	0	0.00

Paul T. Ridzon (216) 689-0270 / pridzon@key.com

Rating System

Overweight - We expect the stock to outperform the analyst's coverage sector over the coming 6-12 months.

Sector Weight - We expect the stock to perform in line with the analyst's coverage sector over the coming 6-12 months.

Underweight - We expect the stock to underperform the analyst's coverage sector over the coming 6-12 months.

Other Disclosures

KeyBanc Capital Markets is a trade name under which corporate and investment banking products and services of KeyCorp and its subsidiaries, KeyBanc Capital Markets Inc., Member NYSE/FINRA/SIPC (“KBCMI”), and KeyBank National Association (“KeyBank N.A.”), are marketed.

KeyBanc Capital Markets Inc. (“KBCMI”) does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

This report has been prepared by KBCMI. The material contained herein is based on data from sources considered to be reliable; however, KBCMI does not guarantee or warrant the accuracy or completeness of the information. It is published for informational purposes only and should not be used as the primary basis of investment decisions. Neither the information nor any opinion expressed constitutes an offer, or the solicitation of an offer, to buy or sell any security. The opinions and estimates expressed reflect the current judgment of KBCMI and are subject to change without notice. This report may contain forward-looking statements, which involve risk and uncertainty. Actual results may differ significantly from the forward-looking statements. This report is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the specific needs of any person or entity.

No portion of an analyst’s compensation is based on a specific banking transaction; however, part of his/her compensation may be based upon overall firm revenue and profitability, of which investment banking is a component. Individuals associated with KBCMI (other than the research analyst(s) listed on page 1 of this research report) may have a position (long or short) in the securities covered in this research report and may make purchases and/or sales of those securities in the open market or otherwise without notice. As required by FINRA Rule 2241(C)(4)(A), financial interest, if any, by any research analysts listed on page 1 of this report will be disclosed in Important Disclosures, Company-specific regulatory disclosures located above in the Disclosure Appendix. KBCMI itself may have a position (long or short) in the securities covered in this research report and may make purchases and/or sales of those securities in the open market or otherwise without notice. As required by FINRA Rule 2241(C)(4)(F), if KBCMI, or its affiliates, beneficially own 1% or more of any class of common equity securities in the subject company(ies) in this research report, it will be disclosed in Important Disclosures, Company-specific regulatory disclosures located above in the Disclosures Appendix. This communication is intended solely for use by KBCMI clients. The recipient agrees not to forward or copy the information to any other person without the express written consent of KBCMI.

Paul T. Ridzon (216) 689-0270 / pridzon@key.com