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BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION Complainant, v. NORTHWEST NATURAL GAS COMPANY, Respondent.	DOCKET UG-18___

NORTHWEST NATURAL GAS COMPANY

Direct Testimony of Brody J. Wilson

COST OF CAPITAL

Exh. BJW-1T

December 31, 2018

DIRECT TESTIMONY OF BRODY J. WILSON

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I. INTRODUCTION AND SUMMARY

Q. Please state your name, address and position.

A. My name is Brody Wilson. My business address is 220 NW Second Avenue, Portland, Oregon 97209. My current position at NW Natural is Vice President, Controller, Treasurer and Chief Accounting Officer.

Q. Please summarize your educational background and business experience?

A. I received a B.A. in accounting from George Fox University in 2001. From 2001 through 2012, I worked at PricewaterhouseCoopers, LLP, in the Power and Utilities Assurance practice. I joined NW Natural in 2012 as Accounting Director. In 2013, I was appointed as Controller and Chief Accounting Officer of NW Natural and its subsidiaries. In 2016, I was appointed Treasurer.

Q. Please summarize your testimony?

A. My testimony will discuss the Company's appropriate capital structure and overall rate of return, the cost of long-term debt, the cost of short-term debt and the Company's financing strategy and credit ratings. More specifically, my testimony will:

- Explain NW Natural's financing strategy; and
- Discuss the Company's current credit ratings and why it is important for the Company to maintain its current credit ratings.
- Present NW Natural's proposal to adopt a hypothetical capital structure of 49.5 percent common equity, 1 percent short-term debt and 49.5 percent long-term debt, with an overall rate of return (ROR) on rate base of 7.63 percent;

- Explain how I determined that the proposed capital structure is appropriate;
- Describe NW Natural's plan to maintain its targeted ratios of equity and debt at 50/50;
- Explain the calculation used for the Test Year short and long-term cost of debt;

II. FINANCING STRATEGY AND CREDIT RATINGS

Q. What is the Company's financing strategy?

A. The Company's financing strategy is to maintain a capital structure to support our strong credit ratings, which provides us optimal access to capital markets. We work to manage interest rate risk and secure low cost capital to fund utility growth and operations. To do this we focus on maintaining a strong balance sheet, focused on financing short-term obligations with short-term debt including commercial paper and to finance long-term assets of the Company through a balance of debt and equity financings.

Q. What is the Company's strategy for funding these ongoing capital expenditures?

A. To fund these ongoing capital expenditures, the Company seeks to maintain a strong capital structure and solid investment grade credit ratings. The Company targets a capital structure consisting of 50 percent common stock equity and 50 percent long-term debt with minimal reliance on short-term debt. The Company's short-term debt is not used to finance long-term assets but rather is used to fund seasonal working capital requirements. Achieving the target capital structure and maintaining sufficient liquidity are necessary to maintain attractive credit ratings and to have access to capital markets at reasonable rates. Over the last three years, the Company has averaged an equity ratio (excluding short-term debt) of 49.33 percent.

Q. What are NW Natural's current debt ratings?

A. The table below (Figure 1) shows the Company's current ratings for each type of debt security from Moody's Investor Service ("Moody's") and Standard and Poor's Ratings ("S&P"):.

	Moody's	S&P
Corporate	A3	A+
Secured	A1	AA-
Commercial Paper	P-2	A-1
Outlook	Negative	Stable

Figure 1

Q. How does NW Natural's "A" category debt rating benefit customers?

A. The Company's interest expense, and to a large extent the Company's access to capital during turbulent market conditions depends upon the debt ratings. If the Company's ratings were downgraded, the Company's interest expense would go up on future issuances. Additionally, lower credit ratings have a direct impact on financial terms the Company is able to negotiate from suppliers, and may limit access to capital markets. In summary, credit ratings affect our cost of debt and subsequently our cost of capital and customer rates.

Q. Please explain the implications of the credit ratings in terms of NW Natural's ability to access capital markets.

A. Generally speaking, companies with higher credit ratings will attract more investors, at better prices. Lower-rated companies may find it difficult to access capital, or potentially pay significantly more, especially in challenging capital market conditions. The capital market environment changes as macro business cycles move up and down, which creates tighter and looser access to capital. In order to ensure that the Company continues to have favorable pricing, or at times, access to capital markets during all market environments, it is imperative that the Company retains a strong credit rating.

Q. Are there other important factors that the rating agencies review in determining NW Natural's ratings?

A. Moody's and S&P rate the Company's debt based on their independent review of the Company's financial condition and credit metrics. Independent credit reviews consist of qualitative and quantitative metrics, such as, the regulatory environment and cash flow metrics. Although each rating agency has a slightly different methodology for analyzing credit risk, many of the key financial ratios are the same, or at least comparable.

The tables below display Moody's and Standard and Poor's benchmark and NW Natural's, as a consolidated company, over the Test Year (Oct/17 to Sep/18) results.

Ratio	Moody's "A" Benchmark	NW Natural's 2018 TY Results	Comment
Pre-tax Interest Coverage	4.5x to 6.0x	4.5x	Within rating band
Debt Leverage	40%-50%	54.4%	Slightly Unfavorable
FFO to Debt	19% to 27%	14.5%	Slightly Unfavorable
Retained Cash Flow	15% to 23%	10.1%	Slightly Unfavorable

Ratio	S&P "A"	NW Natural's	

	Benchmark	2018 TY Forecast	Comment
FFO/Debt	13% - 23%	14.8%	Within rating band
Debt/EBITDA (x)	3x – 4x	4.8x	Slightly Unfavorable
CFO/Debt	12%-20%	16.3%	Within rating band

FFO = Funds From Operations
EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization
CFO = Cash Flow from Operations

Q. Have NW Natural's credit ratings changed since the Commission issued its order in the Company's 2008 rate case?

A. Yes, both rating agencies have made changes since the 2008 rate case. Standard and Poor's upgraded the Company's senior secured long-term debt rating from A+ to AA- in March 2013. The reason for the upgrade was due to a change in Standard and Poor's recovery methodology on senior bonds secured by utility real property. NW Natural's recovery rating changed from 1 to 1.5, which aligns with an AA- or better rating. No other changes were made by Standard and Poor's.

Moody's has made two changes since our last rate case. The first change occurred in December of 2012 when Moody's changed the Company's outlook from Stable to Negative and downgraded our short-term debt rating from P-1 to P-2. The reasons Moody's cited for the change in outlook were continued weakness in financial metrics and expectation of further deterioration, the Company's outcome in its 2012 OPUC rate case, negative impact on cash flows from elevated capital expenditures, and stable dividend policy. The reasons cited for the change in short-term rating were primarily due to the change in outlook and alignment with other A3-rated issuers in the utility sector. The second change occurred in February of 2014 when Moody's changed the outlook from Negative to Stable. This change was the result of a more favorable view of U.S. regulation, and the strong support that Oregon regulation offers NW Natural. The third change occurred in February 2018 when Moody's changed the outlook from Stable to Negative. Moody's stated in their release that NW Natural's negative outlook reflects the potential for cash leakage due to newly signed US tax law and the possibility of CFO pre-working capital (WC) to debt falling below 16percent on a sustainable basis. Moody's goes on to note that NW Natural's current financial profile reflects CFO pre-WC to debt around 19percent through the twelve months ended September 30, 2017. We had expected a reduction of this metric over the next two years, but now the additional impact of tax reform could reduce this metric to below 16percent.

The latest Rating Agency credit reports can be found in Exh. BJW-2 and Exh. BJW-3 for Moody's and S&P, respectively. Historical ratings for each Rating Agency are displayed below in figure 2 and 3.

S&P Credit Rating History

	Status as of	Review Date												
Rating Type	1/1/2010	1/25/2010	6/16/2010	12/13/2010	6/29/2011	12/20/2011	6/6/2012	3/12/2013	11/4/2013	5/9/2014	9/17/2014	9/15/2015	8/4/2016	6/21/2017
Outlook	Stable	Stable	Stable	Stable	Stable	Stable	Stable	Stable	Stable	Stable	Stable	Stable	Stable	Stable
Senior Secured LT Debt	AA-	AA-	A+	A+	A+	A+	A+	AA-	AA-	AA-	AA-	AA-	AA-	AA-
Corporate Credit Rating	AA-	A+	A+	A+	A+	A+	A+	A+	A+	A+	A+	A+	A+	A+
Short-Term	A-1+	A-1	A-1	A-1	A-1	A-1	A-1	A-1	A-1	A-1	A-1	A-1	A-1	A-1

Figure 2

Moody's Credit Rating History

Rating Type	Status as of 1/1/2010	Review Date 11/17/2010	3/16/2012	12/19/2012	1/4/2013	2/18/2014	2/18/2015	2/15/2016	2/24/2017	2/1/2018
Outlook	Stable	Stable	Stable	Negative	Negative	Stable	Stable	Stable	Stable	Negative
Senior Secured LT Debt	A1	A1	A1	A1	A1	A1	A1	A1	A1	A1
Corporate Credit Rating	A3	A3	A3	A3	A3	A3	A3	A3	A3	A3
Short-Term	P-1	P-1	P-1	P-2	P-2	P-2	P-2	P-2	P-2	P-2

Figure 3

Q. Please describe the impact of TCJA on the Company's credit ratings and access to capital.

A. As described in the Direct Testimony of Sean Borgerson, the Company proposes to pass the benefits of the Tax Cuts and Jobs Act ("TCJA") back to customers in this rate case. In this regard, we view the TCJA positively; however, there are also significant challenges created by the TCJA that must be addressed for NW Natural customers to benefit from the tax changes over the long term. The most important challenge is to ensure that the Company maintains the ability to readily access the capital markets at favorable rates. The Company experiences diminished cash flow as a direct result of passing the benefits of tax reform to customers. The reduction of available cash from operations is driven by a combination of the following: (i) the amortization of excess deferred tax benefits; and (ii) slower depreciation under the MACRS depreciation for future capital investments in the absence of bonus depreciation.

Q. How could these challenges impact the Company's credit rating?

A. A decrease in cash flows will weaken credit metrics and increase financial pressures on the Company. A strong equity to debt capital structure is critical to the financial health and stability of the Company. One critical credit metric for utilities is the FFO-to-debt ratio. This ratio is measured by the following formula:

$$\textbf{FFO-to-Debt Ratio} = \frac{\textit{Cash Flow from Operations (excluding working capital changes)}}{\textit{Total Debt (including long and short term debt)}}$$

When the tax benefits from the TCJA flow to customers, this reduces the numerator in the equation (i.e. cash flows).

Q. Have the Company's rating agencies taken action in response to the Company's weaker credit metrics?

A Yes. On January 19, 2018, Moody's issued a press release noting it had changed the rating outlooks to negative from stable for 24 regulated utilities and utility holding companies. On February 1, 2018, they followed up with a specific opinion on NW Natural that confirmed the change in outlook to negative. Both the press release and the opinion issued were specific as to the reason being directly related to the impact or potential impact that tax reform may have on the companies listed in the press release and as previously noted its impact on the Company. The report can be found in Exh. BJW-2.

Q. What can the Company do to mitigate this negative impact of the TCJA?

A. In the Moody's opinion, they site the impact of rate cases for the Company and how tax reform is addressed through regulation being an important consideration for whether or not the Company is downgraded or is able to retain its existing ratings. Ultimately, it is our opinion that both agencies are focused on the Company's cash flow metrics being weak for its ratings level and improved cash flow metrics being important to the Company's ability to retain its ratings. Therefore, the Company's main mitigating strategy is to improve cash flows. This includes looking at our regulatory capital structures and increasing the equity level returns to ensure we are able to earn a return that is reflective of our capital structure and our cost to operate.

As described above, maintaining strong credit ratings are important for NW Natural and our customers because they lead to significant savings for customers over time, which could be eroded if the Company is downgraded. A downgrade would lead to an immediate increase in the cost of all sources of borrowing: long-term debt issuances including refinancing, commercial paper, and bank credit. Such an increase in borrowing cost can be far more pronounced in times of market stress like what was seen during the 2008 financial crisis.

III. RECOMMENDED CAPITAL STRUCTURE AND RATE OF RETURN

Q. What is NW Natural's current Commission-authorized ratemaking capital structure and overall ROR?

A. In the Company's last general rate case (Order 04 in Docket UG 080546), the Commission adopted the following capital structure, capital costs and overall ROR:

NW NATURAL'S CAPITAL STRUCTURE AND RATE OF RETURN
ORDER 04, DOCKET UG-080546

Component	Ratio	Cost	Weighted Cost
Long-term Debt	44.23%	6.796%	3.0%
Short-term Debt	5.03%	5.280%	0.3%
Common Equity	50.74%	10.100%	5.1%
Total	**100%**		**8.4%**

Q. What is NW Natural's recommended capital structure for ratemaking purposes in this proceeding?

A. NW Natural is requesting the adoption of a hypothetical capital structure of 49.5 percent equity, 1.00 percent short-term debt and 49.5 percent long-term debt with an overall rate of return (ROR) on rate base of 7.622 percent. The ROR is based upon a 2.186 percent and 5.066 percent embedded cost of debt for short-term and long-term, respectively, as well as a 10.3 percent cost of equity. The following table presents the proposed capital structure along with the calculation of the Company's ROR for the test year:

Component	Ratio	Cost	Weighted Cost
Long-term Debt	49.5%	5.066%	2.508%
Short-term Debt	1.00%	2.186%	0.022%
Common Equity	49.5%	10.30%	5.099%
Total	**100%**		**7.628%**

Q. How did NW Natural derive the proposed capital structure for this proceeding?

A. The proposed capital structure is an adjustment to the Company's actual capital structure during the Test Year, based on a 13 month average of monthly averages (AMA) for the year ended September 30, 2018. The Company's actual capital structure for this period is 46.6 percent Equity, 50.47percent Long-Term Debt, and 2.93percent Short-Term Debt.

Q. Why has NW Natural proposed a hypothetical capital structure?

A. We have a proposed a hypothetical capital structure for two important reasons. First, NW Natural's target capital structure has historically been, and continues to be, 50 percent equity and 50 percent long-term debt with minimal reliance on short term financing. There is a natural fluctuation in our capital structure on a temporary basis over time. These fluctuations do not, however, represent a meaningful departure from our targeted capital structure. For example, over the last 24 months, NW Natural has seen a range of 49.7 percent to 45.0 percent equity. Although short term debt has remained quite low, certain months increase in order to maintain adequate cash flows to mitigate timing in receivables and cash outflows. Within the last twelve months, NW Natural's short term debt has ranged from zero to $105 million.

Additionally, NW Natural has requested an adjustment to its capital structure to respond to negative impacts of the TCJA. As mentioned previously, the decreases in cash flows will weaken credit metrics and increase financial pressures on the Company. A strong equity to debt capital structure is critical to the financial health and stability of the Company. If the Company's financial metrics continue to decline, namely the FFO-to-debt ratio, it is very likely that our rating agencies will downgrade our credit ratings. To rebalance the ratio and counter the impact of reduced cash flows, the Company can increase the numerator in the FFO-to-debt ratio by shifting the Company's regulatory capital structure away from debt. The Company's proposed capital structure increases the equity level, and makes small reductions to Long-Term Debt and Short-Term Debt. This adjustment will help to protect the Company's strong credit ratings, which will benefit our customers in the long term.

Q. How does NW Natural's proposed utility capital structure compare with the natural gas peer group?

A. The Company's proposed capital structure is similar to the equity to capital ratio of our peer group identified by Dr. Villadsen in the Company's Return on Equity Testimony Exh. BV-1T. The average equity to capital ratio of our full sample peer group is 49 percent (excluding short term debt).

IV. COMMON EQUITY

Q. Did NW Natural issue common equity shares through a public offering on November 16, 2016?

A. Yes. The Company issued 1,012,000 shares of common stock, with total net proceeds of $52.8 million. The timing and amount issued were based on financial forecasts for the purpose of maintaining our equity exposure within a target range. The amount of proceeds from this offering were added to the general funds of NW Natural and used for corporate purposes, primarily to fund, in part, NW Natural's ongoing utility construction program and for general corporate purposes.

Q. Does the Company have any preferred stock?

A. The Company retired its last remaining portion of preferred stock in 2005. The Company has no plans at this time to issue preferred stock.

Q. What is NW Natural's plan to maintain the target utility common equity ratio over the next few years?

A. The Company's plan includes taking a number of steps. In addition to the expected increase in common equity due to retained earnings growth each year, the Company intends to: (1) continue issuing new shares of common stock to investors through its ongoing Dividend Reinvestment and Optional Cash Payment Plan; and (2) sell new common shares to investors through public offerings, as needed.

V. LONG-TERM DEBT AND SHORT-TERM DEBT

Q. How was the cost of long-term debt calculated for the Test Year?

A. Exh. BJW-4 presents the details of the Company's long-term debt outstanding ($814.7 million as of September 30, 2018) and the corresponding weighted average cost (5.066 percent) for the Test Year. The cost of long-term debt includes only existing debt at the end of the Test Year. The weighted average cost of long-term debt was calculated by multiplying the debt outstanding, by the average cost for each debt issue.

Column "T" of Exh. BJW-4 shows the annualized expense of each individual issue in terms of an effective interest rate, which represents the total cost of issue, including coupon rate, premiums or discounts, underwriter's commissions, gains and losses on interest rate hedges, and other expenses related to the issue such as legal fees and unamortized debt discounts and early redemption premiums assigned to refunding issues. Unamortized debt discounts and early redemption premiums from previously outstanding debt issues are added to the new debt issuance because the Company was able to achieve a lower annualized cost of debt due to net present value savings from the early redemption.

Q. How was the cost of short-term debt calculated for the Test Year?

A. Short-term debt was calculated in a similar manner to long-term debt. Exh. BJW-5 presents the Company's short-term debt outstanding ($100.5 million as of September 30, 2018) and the corresponding weighted average cost (2.186 percent) for the Test Year. The weighted average cost of short-term debt was calculated by multiplying the commercial paper outstanding by its average cost for each debt issue.

Q. Do you expect this level of short-term debt to continue?

A. No. As mentioned above, short term debt arises when timing differences of working capital (largely receivables and payables) create a need for cash. The commercial paper market provides a great source of liquidity to meet these short term cash needs. Within the last twelve months, NW Natural's short term debt has ranged from zero to $105 million.

Q. Does this conclude your testimony?

A. Yes.

VI. LIST OF EXHIBITS