Docket No. UG-95____
Exhibit ____ (JDW-Testimony)
Witness: J. D. Wessling

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

GENERAL RATE APPLICATION
OF

CASCADE NATURAL GAS CORPORATION

DECEMBER 11, 1995

Prepared Direct Testimony of

J. D. Wessling

Cost of Capital & Capital Structure

WUTC UG-950326,
DOCKET NO. -951415
EXHIBIT # T-41
ADMIT W/D REJECT
☒ ☐ ☐

PREPARED TESTIMONY OF J.D. WESSLING

RE: EXHIBIT (JDW-1)

(Capital Structure)

Q. Please state your name and address for the record.

A. J. D. Wessling, 222 Fairview Avenue North, Seattle, Washington 98109.

Q. By whom are you employed?

A. I am employed by Cascade Natural Gas Corporation as Vice President - Finance.

Q. Please describe your education and employment background.

A. I graduated from St. Louis University in 1965 with a Bachelor of Science degree with a major in Accounting. After graduation I studied Finance at St. Louis University Graduate School and worked as an accountant for Ramsey Corporation. In 1968 I joined Arthur Andersen & Co. in St. Louis as a staff accountant. In 1972 I accepted a position with Associates Corporation of North America as a Zone Controller. While with Associates I was transferred to Los Angeles California to assume responsibility as controller of a newly acquired finance company. In 1974 I accepted an offer from Atlantic Richfield Company as a Senior Analyst in the Corporate Controller's Department. In 1975 I was promoted to the position of Controller, Treasurer, Secretary & Manager of Administration as well as a member of the board of directors of ARCO Pipe Line Company, a subsidiary of Atlantic Richfield. While with ARCO Pipe Line Company, I directed

CASCADE NATURAL GAS CORPORATION
222 FAIRVIEW AVENUE NORTH
SEATTLE, WASHINGTON 98109
(206) 624-3900

the development of the tariff rate for ARCO Pipe Line Company's 20% share of the Trans Alaska Pipeline and testified in support of the tariff calculation before the Federal Energy Regulatory Commission. I also submitted and testified in support of tariff rate adjustments in the state of Pennsylvania for ARCO Pipe Line Company. In 1978 I accepted an offer to transfer to the ARCO Petroleum Product Division of Atlantic Richfield as Manager of Policy and Internal Control. In 1981 I joined Simmons Oil Company in Phoenix, Arizona as Controller and one year later was appointed Senior Vice President and Chief Financial Officer. In 1984 I assumed the position of President and Chief Operating Officer. In 1986 I joined MicroAge, Inc. as Vice President and Chief Financial Officer and was instrumental in taking the Company public in 1987. In 1989 I joined Superx of Arizona as Vice President and Chief Financial Officer where my responsibilities were focused on restructuring the Company. I joined Cascade Natural Gas Corporation January 6, 1994 as Director - Finance, was elected Vice President - Finance February 1, 1995 and was elected Chief Financial Officer July 11, 1995. I am a Certified Public Accountant and a member of the American Institute of CPA's.

Q. Have you previously sponsored testimony before utility commissions?

A. Yes, before the Federal Energy Regulatory Commission and before the Pennsylvania Utility Commission.

Q. Do you sponsor exhibits as part in this filing?

A. Yes. I sponsor Exhibit (JDW-1), Schedules 1 through 6.

CASCADE NATURAL GAS CORPORATION
222 FAIRVIEW AVENUE NORTH
SEATTLE, WASHINGTON 98109
(206) 624-3900

Q. Were these exhibits prepared by you or under your supervision?

A. Yes they were.

Q. Please provide an overview of your exhibit and testimony.

A. The purpose of my testimony and exhibit is to recommend the appropriate capital structure for Cascade. To arrive at the recommended structure, I draw upon historic information as well as forward-looking information. I also provide recommendations on the cost of short-term debt, long-term debt and preferred stock. Additionally, I use a return on equity of 11.25% to arrive at a weighted cost of capital of 9.76% for Cascade at this time.

Q. Please begin by explaining Exhibit (JDW-1), Schedule 1.

A. Exhibit (JDW-1), Schedule 1, Target Cost of Capital, provides the target capital structure and cost of capital that Cascade considers the minimum to meet growth needs, customer needs and investor needs. My recommendation is for 5% short-term debt, 45% long-term debt, 5% preferred stock and 45% common equity. As a comparison, I have compiled on Schedule 6 of 6 common equity ratios of other gas distribution companies. Even with a 45% ratio, Cascade is significantly below the common equity ratio of many of its peers.

Cascade is currently rated BBB+ by Standard & Poors (S & P) even though at the moment, based on 1994 results and capital structure, we do not qualify for this rating. We intend to increase existing common equity to achieve a structure consistent with a BBB+ rating, but we must first finalize this rate case.

CASCADE NATURAL GAS CORPORATION
222 FAIRVIEW AVENUE NORTH
SEATTLE, WASHINGTON 98109
(206) 624-3900

Furthermore, it is Cascade's objective to achieve a rating of A. To achieve an A rating, S & P, among other qualitative and quantitative measures, expects a Company to maintain a level of debt to total capital in the range of 42% to 52%. Cascade's target capital structure results in short and long-term debt of 50% which is on the high side of the range.

Another very important quantitative factor in achieving an "A" rating is the fixed charge coverage; and the key to an acceptable fixed charge coverage is a stable level of earnings. S & P considers a fixed charge coverage ratio of 2.0 to 3.25 to be acceptable for a "BBB" rating and coverage of 3.0 to 4.25 for an "A" rating. At December 31, 1994, Cascade's coverage ratio was 2.07, near the lower end of the acceptable range for "BBB". These factors are all interdependent.

We are convinced that an "A" rating from S & P will be beneficial to Cascade and its customers. For example, Cascade's new short-term credit agreement has tier pricing. At our current S & P rating of "BBB+," our all-in cost of borrowing is .4375 over the London Interbank Borrowing Rate (LIBOR). If our rating were to improve to "A," the all-in cost would be .375 over LIBOR. The same is true of the facility fee, which is .125% at our present rating vs. .10% if we achieve an "A" rating. Another factor to keep in mind is, accessible debt and equity markets generally expand as the rating rises, very important during periods of tight money.

The first step toward our goal of an "A" rating is recognition by the Washington Utility and Transportation Commission (Commission) of the benefit of an "A" rating. By so doing, the efforts of Cascade will be perceived in the debt and equity markets as consistent with the views and policies of

CASCADE NATURAL GAS CORPORATION
222 FAIRVIEW AVENUE NORTH
SEATTLE, WASHINGTON 98109
(206) 624-3900

the Commission. The actual achievement of an "A" rating will require improvement in the fixed charge coverage and an increase in the equity component of the capital structure.

Q. Please refer to Exhibit (JDW-1), Schedule 2, page 1 and describe this schedule.

A. Exhibit (JDW-1), Schedule 2, page 1 is a comparison of the Cascade capital structure at December 31, 1994; an average of the capital structure for the years 1994 and 1993; a structure from June 1993 with the high equity component; and a target capital structure. The structure at December 31, 1994 had the lowest equity component during the 1993-94 period. This information is presented as a comparison of historic capital structure ratios experienced by Cascade. It is clear from this comparison that the capital structure at December 31, 1994 is not a structure that Cascade normally maintains.

The capital structure proposed is what I refer to as a target. The target structure takes into account expected forecasted events in the near term. This is not the target structure for an "A" rating.

Q. Why are you presenting a target capital structure?

A. Our capital structure at December 31, 1994 is not indicative of the capital structure Cascade expects and it is not the capital structure to maintain if we expect to continue as a BBB+ rated company. To achieve these goals, we expect our capital structure to consist of 45% to 50% common equity.

Q. If you expect your capital structure to be at 45% to 50% common equity, why is it at 41.88% common equity at December 31, 1994?

CASCADE NATURAL GAS CORPORATION
222 FAIRVIEW AVENUE NORTH
SEATTLE, WASHINGTON 98109
(206) 624-3900

A. The capital structure at a particular point in time may vary from the parameters identified as acceptable due to overall economic conditions as well as the markets for debt and equity and the capital needs of the Company. In October of 1994 Cascade issued $18,000,000 of additional medium-term notes which satisfied the need for capital at the time. We could have elected to issue equity in October 1994, in which case we would have had a common equity ratio of slightly over 50%. We chose to issue the medium- term notes because the market conditions were favorable at the time and the fact that the notes were already registered with the S.E.C. made the debt issue much simpler and less expensive.

More illustrative of normal debt and equity ratios are the averages presented on Schedule 2, page 2. The 1993 averages on Schedule 2, page 2 consist of 46.38% equity and the 1994 averages consist of 44.77% equity, including the low level of equity at the end of the year. These averages for each year are the average of the monthly averages.

Q. Going back to Schedule 1, please explain the short-term debt cost of 6.82%?

A. I refer you to Schedule 3 which provides the detail for the 6.82% rate. Line 1, column b is the amount of short-term debt that would typically be outstanding. The source of these funds is credit lines with major banks. Currently most short-term borrowing is from Preferred Funding Inc.(PFI). The PFI Facility, is a low cost source of short term borrowing guaranteed by our committed lines of credit. PFI is a fund managed by Merrill Lynch Money Markets Inc. which issues commercial paper and loans the money to worthy credits as referred by participating banks. The rates are approximate rates for

CASCADE NATURAL GAS CORPORATION
222 FAIRVIEW AVENUE NORTH
SEATTLE, WASHINGTON 98109
(206) 624-3900

commercial paper with an add-on generally at a lower rate than available from other sources for short-term funds.

Schedule 3 includes interest charges and the various fees that are part of the arrangements with banks. The basic costs are the interest cost, a facility fee, an agent's fee and an arrangement fee. These fees are based on proposals from two banks with which we currently deal. Arrangement fees would include the banks' costs of structuring the facility. A significant part of these costs is generally legal fees.

Q. Please explain the long-term cost rate on line 2 of Schedule 1.

A. Long-term debt details are presented on Schedule 4. This Schedule identifies the specific long-term debt issues, which total $100,000,000 at December 31, 1994. All debt, beyond one year, was and is in the form of Medium-Term Notes (MTNs), issuance of which was approved by the WUTC, Order UG-920737.

Q. Please define Medium-Term Notes.

A. MTNs are notes much like Commercial paper but with maturities ranging from nine months to forty years. The issuer, Cascade, files a registration statement with the SEC, commonly referred to as a *shelf registration*, for the notes to be offered at various times with different maturities and rates tailored to specific financing needs. MTNs give the issuer flexibility in raising cash by arranging for long-term debt issues only as needed, in the amounts needed. In addition, the shelf

CASCADE NATURAL GAS CORPORATION
222 FAIRVIEW AVENUE NORTH
SEATTLE, WASHINGTON 98109
(206) 624-3900

registration saves financing costs as the issuer does not need to keep filing separate registrations for new issues.

Q. On Schedule 5, please explain in detail the MTN effective rates in column (c) starting at line 2.

A. The first issue is for $22 million with a nominal interest rate of 7.32% which matures in 2004. Associated with this issue were the following costs:

	Amount
Agent's fee	$ 137,500
Call premium on redemption of 10.15% Senior Notes due 2003	2,782,512
Agent's fees for refinancing Sr. Notes	67,800
Unamortized debt expense on Sr. Notes	771,206
General issuance costs	56,330
	$ 3,815,348

The total costs of $3,815,348 are deducted from the principal amount of $22,000,000 to arrive at the net proceeds or cash inflow of $18,184,652 at the initiation of this debt or period 0. Cash outflows are semi-annual interest payments until period 24 when the original principal amount plus interest for the period is paid. With this stream of cash flows the internal rate of return (IRR) calculates to 9.8105%.

Q. How does this IRR compare to the IRR of the 10.15% Senior Notes due 2003?

CASCADE NATURAL GAS CORPORATION
222 FAIRVIEW AVENUE NORTH
SEATTLE, WASHINGTON 98109
(206) 624-3900

A. An analysis was prepared and filed with the Commission June 29, 1993 with the Company's application for an order authorizing the issuance of up to $100,000,000 of Medium-Term Notes. Exhibit "L-3" of that application illustrates the economics on an IRR basis. The IRR on the 10.15% Senior Notes due 2003 was 11.765%. Based on all the costs associated with a refinancing, including the cost of early redemption of the 10.15% Senior Notes, it was determined that an IRR of 11.649% with an interest rate up to 9.40% would result in lower costs to Cascade. As stated above, the actual IRR is 9.8105%.

Q. Let us now return to Exhibit (JDW-1), Schedule 4 and please explain lines 3 - 14.

A. The MTNs on line 3 were issued September 4, 1992 and were used to retire the existing 10.125% Debentures due 2007. The costs related to this issue were:

	Amount
Agents' fees for sale of notes	$ 105,000
Call premium on redemption of 10.125% Debentures	680,790
Unamortized debt expense on 10.125% Debentures	534,027
General MTN issuance costs	35,846
	$ 1,355,663

The IRR on the 10.125% Debentures was 10.821%, substantially higher than the MTNs with the call premium and other costs.

Schedule 4, lines 4, 5 & 6, column (c) are the effective rates for three MTNs. These Notes were issued to reduce short-term debt requirements. The effective rate reflects the nominal interest rate

CASCADE NATURAL GAS CORPORATION
222 FAIRVIEW AVENUE NORTH
SEATTLE, WASHINGTON 98109
(206) 624-3900

plus total up-front issuance costs of $231,450 for the three issues. The resulting IRR of 9.12% was calculated the same as the previously discussed MTN issues.

Lines 7, 8 & 9, column (c) are the effective rates for these three series of MTNs. The costs related to these issues were:

	Amount
Agent's fees for sale of notes	$ 180,000
Call premium on 9.875% Debentures	1,083,850
Unamortized debt discount on 9.875%	900,162
Carry-forward costs on retired 10.5% Senior Subordinated Debentures	120,315
Carry-forward costs on retired 12.75% Debentures	1,232,834
General	61,450
	$ 3,578,611

Schedule 4, line 10 through 14 column (c) are the effective rates for 5 MTNs which were issued to reduce short-term debt requirements.

As can be seen from Schedule 4, all of Cascade's long-term debt is medium-term note issues.

Q. What is the accounting treatment for all the costs associated with these refinancings?

A. All the associated costs are amortized over the years outstanding of the related debt issue. If a debt issue is retired early, the unamortized costs are carried forward to a specific replacement issue along with any additional costs. This is consistent with FERC accounting options for these types

CASCADE NATURAL GAS CORPORATION
222 FAIRVIEW AVENUE NORTH
SEATTLE, WASHINGTON 98109
(206) 624-3900

of costs as explained in paragraph 20,028 of the Accounting and Reporting Requirements for Natural Gas Companies, attached as a worksheet.

Q. Please explain the next section on your Exhibit JDW -1, Schedule 1, line 3, identified as Preferred Stock.

A. Senior Preferred Stock is shown in detail on Schedule 5 with $7,217,737 outstanding at December 31, 1994 and an expected outstanding of $14,329,967 after issuance of a proposed $7,500,000.

Q. Please discuss the effective rates for the preferred stock.

A. The $.55 Senior Preferred Series A, B & C have been outstanding since 1960 and are being retired through regular annual retirements. The effective rates are the nominal rates plus the costs to issue.

Line 5 is the 7.85% Preferred issuance which was approved by the WUTC, Order No. UG-911283, dated November 13, 1991. Costs associated with this issue were $125,583. These costs were for placement fees in the amount of $75,000, legal fees of $43,868, expenses of the agent of $6,375 and miscellaneous of $340. These costs are considered in the calculation of the IRR of 8.21%.

Because of the Company's current capital ratios it would not be prudent to issue additional debt. However, the amount of preferred stock outstanding does allow for an additional amount of preferred. I have forecasted a preferred issue of $7,500,00 with a coupon or dividend rate of 6.45%. The rate after adding issuance costs is assumed to be 6.61%. This information is the result of proceeding to issue preferred stock in November, 1995 with A. G. Edwards as agent for

CASCADE NATURAL GAS CORPORATION
222 FAIRVIEW AVENUE NORTH
SEATTLE, WASHINGTON 98109
(206) 624-3900

Cascade. The issue will be a private placement with one institution which we expect to close by the end of December, 1995. It is important to note that the preferred rate for a company rated "A" by S & P would command a dividend rate of 6.10% and an annualized all-in cost of approximately 6.20%. This represents a reduced annual cost of a little over $38,000 on just this one issue of $7,500,000 which again highlights the benefits of achieving an "A" rating.

Q. Does this conclude your testimony?

A. Yes it does.

CASCADE NATURAL GAS CORPORATION
222 FAIRVIEW AVENUE NORTH
SEATTLE, WASHINGTON 98109
(206) 624-3900