UG-__ – Policy

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NORTHWEST NATURAL GAS COMPANY
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I. Introduction & Summary

Q. Please state your name, business address and position with the Company.

A. My name is Bruce R. DeBolt. I am Senior Vice President and Chief Financial Officer of Northwest Natural Gas Company ("NW Natural" or "company"). My educational background and experience appear at the end of this testimony.

Q. What are your responsibilities with NW Natural?

A. As Senior Vice President and CFO, I am a member of the senior management team reporting to the President and CEO. My responsibilities as chief financial officer of NW Natural include the financial planning, treasury, accounting, information services, budgeting, tax, business continuity and investor relations functions, among others. I participate on matters affecting the rates charged the company by its primary pipeline suppliers, Northwest Pipeline Corporation (a subsidiary of Williams Gas Pipelines West) and PG&E Gas Transmission - Northwest (formerly Pacific Gas Transmission Company).

Q. Have you testified previously before regulatory agencies on matters affecting natural gas rates?

A. Yes, I have presented testimony on natural gas ratemaking issues before the Washington Utilities & Transportation Commission (WUTC), the Oregon Public Utility Commission (OPUC), the Federal Energy Regulatory Commission (FERC) and the National Energy Board of Canada (NEB).

Q. What is the purpose of your testimony?

A. I am appearing as the company's witness on general policy issues. The purposes of my testimony are four-fold.

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First, my testimony presents background information on the company, including important facts about its operations and a summary of the company's experience since its last Washington general rate case in 2000.

Second, it explains the reasons for the company's filing for a general rate increase and outlines the financial results that will be realized from the increased rates which comprise this filing.

Third, it summarizes the main elements of the company's presentation in support of this filing.

Last, it addresses several specific adjustments or issues presented in the filing.

II. Background

Q. Please describe the business of Northwest Natural Gas Company.

A. The company is principally engaged in the distribution of natural gas. The company holds certificates from the WUTC granting it exclusive rights to serve portions of three Washington counties bordering the Columbia River. The OPUC has allocated to the company as its exclusive service area a major portion of western Oregon, including the Portland metropolitan area, most of the Willamette Valley and the coastal area from Astoria to Coos Bay. Gas service is provided in nine cities, together with neighboring communities, in three Washington counties, and in 95 cities, together with neighboring communities, in 16 Oregon counties.

At year-end 2002, the company had about 560,000 customers overall, including about 503,000 residential customers, 56,000 commercial customers and 550 industrial customers. In Washington, NW Natural serves about 47,100

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residential customers and 4,200 commercial customers as well as 44 industrial customers.

NW Natural serves its firm gas sales loads with a combination of on-system storage (40 percent of peak load), firm contract storage (12 percent of peak load), firm interstate transportation service (36 percent of peak load), recall arrangements with certain large transportation customers who release capacity to the company under defined conditions (10 percent) and a small percentage of production gas from the Mist field and other sources (2 percent).

NW Natural continues to be one of the fastest growing local gas distribution companies (LDCs) in the country, and the Vancouver area is our highest growth area. For a decade, the company has added customers at a rate of 3 percent to 6 percent annually, more than twice the national average. In Washington, the growth has been much more dramatic. Total customers more than tripled in the past 10 years, growing at a compound average growth rate of 13 percent. Total customers in Washington topped 50,000 in 2003.

NW Natural's fast-growing customer base means that the company has been experiencing increasing costs as well. Ordinarily, cost increases due to growth would translate into rate increases for customers. In recent years, however, the company has been able to avoid most non-gas cost rate increases through a combination of tight cost control and a "profitable growth" policy.

Q. Please describe the company's "profitable growth" policy.

A. Profitable growth means that the company focuses its investment decisions on serving those customers that pay their way, or (in other words) are "profitable."

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Adding customers profitably helps to avoid rate increases because the new customers do not cause additional costs to be borne by existing customers.

Q. In what respects is the company subject to regulation as a utility?

A. NW Natural is subject to regulation with respect to, among other matters, rates, systems of accounts and issuance of securities by the WUTC and the OPUC. For the 12 months ended June 30, 2003, about 6.82 percent of the company's gas deliveries and 7.5 percent of its utility operating revenues were derived from Washington customers. The company is exempt from the provisions of the Natural Gas Act by order of the Federal Power Commission (now the FERC). The company is subject to regulation by the Securities and Exchange Commission with respect to the issuance of its securities for sale to the public.

The company's most recent general rate case in Washington, in 2000 (Docket No. UG-000073), authorized rates that were designed to produce a return on equity of 10.8 percent. The company's most recent general rate case in Oregon, concluded in August 2003 (OPUC Docket No. UG 152), authorized rates in that state designed to produce a return on common equity of 10.2 percent.

Q. Please describe the ownership of the company.

A. NW Natural had about 25.4 million shares of its common stock outstanding as of December 31, 2002. These shares were held by about 10,000 widely scattered shareholders. The company's most recent offering of common stock was in April 1998, when it sold 1,725,000 shares of common stock through a secondary public offering led by three underwriters. The company had made public offerings of common stock of comparable size in 1995, 1992 and 1989. The company also has an active dividend reinvestment program for current shareholders.

Typically, between 25 and 40 percent of the shares of common stock are held by institutions such as insurance companies, pension funds or mutual funds. Nearly half of the company's common stockholders are residents of Oregon and Washington.

Q. Please describe the significant developments since the company's last Washington general rate case which concluded in 2000.

A. The company's test year in Docket UG-000073 used recorded and adjusted financial results for the 12 months ended December 31, 1999.

As explained above, NW Natural continues to experience remarkable growth in its system, as well as continuing dramatic changes in its business and economic environment. In the interests of efficiency, and in the face of increasingly competitive conditions, NW Natural continues to become steadily more productive.

Q. How was NW Natural able to manage its costs over the past decade?

A. Total costs increase as customer additions and corresponding service requirements grow. Without any productivity gains, one would expect to see cost increases reflecting both the company's growth rate and the rate of inflation. NW Natural, however, focused its cost control efforts on achieving productivity, measured on a customer-per-utility-employee basis.

NW Natural has achieved significant productivity improvements in recent years. In 1991, NW Natural's 1,276 utility employees served 336,000 customers.

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In 2001 – a decade later – almost the same number of utility employees (1,284) served 541,000 customers. The customer-per-utility-employee ratio thus improved by 60 percent over the decade.

Q. How does NW Natural compare to other LDCs?

A. With respect to cost control, very favorably. The American Gas Association (AGA) periodically conducts a benchmarking survey comparing financial and operating statistics for more than 40 gas utilities. The AGA's study that was conducted in 2000 was reported with information from 1995 to 2000. NW Natural compared favorably to its LDC peers in such important measures as total O&M Expense per Customer, Customer Account Expense per Customer, General & Administrative (G&A) Expense per Customer and Transmission & Distribution Expense per Customer. With respect to these important cost measures, NW Natural has compared well against the average of the utilities reported by the AGA.

Q. Please describe NW Natural's capital investments over the past decade.

A. In the 10 years from 1993 through 2002, NW Natural made about $835 million in capital investments in its utility system. The bulk of these investments were for the gas mains and services required to add new customers to the system; for major and minor system improvements to improve service to existing customers; and for expansions of NW Natural's gas storage facilities. A standout example of a system improvement is that NW Natural now has completely replaced its low-pressure gas distribution system, including all remaining cast iron pipe. We invested in a new customer information system that went into service in 1997.

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And the continuing phased expansion of our on-system gas storage facilities (the Mist Gas Field and related pipeline) has served the growing firm peak requirements of our customers without the addition of more expensive pipeline firm transportation capacity.

Q. What do you conclude from the company's growth and cost patterns in recent years?

A. I believe the company has amply demonstrated during the past decade that it is capable of growing rapidly, improving its gas distribution system and increasing productivity. We are facing increasing costs, however, particularly in some discrete and identifiable areas that are: (1) beyond the company's ability to control, or (2) necessary, if the company is to be able to continue providing safe, reliable, adequate and cost-effective natural gas service to its customers in Washington.

III. Reasons for Filing

Q. Why has NW Natural filed this case?

A. NW Natural is filing this case particularly to address financial pressures from three directions: revenue loss due to declines in gas usage per customer; costs arising from additional facilities required to continue to provide reliable and safe service in Washington; and cost increases in other areas beyond the company's control. In addition, NW Natural is proposing a redesign of its industrial rates, a sales and revenue decoupling mechanism, and a new method to share revenues from NW Natural's interstate gas storage services to replace the method that expired last year.

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Q. What revenue requirement increase do the company's exhibits support?

A. As summarized in Kevin McVay's Test Period & Adjustments testimony, *Exhibit No. ____(KSM-1)*, the company's testimony and exhibits support the need for a $7.9 million annual revenue increase on a Washington-allocated basis. This increase is based on a test year ended June 30, 2003; an average rate base of about $111 million; a rate of return on rate base of 8.97 percent; a proposed equity ratio of 49.4 percent; and a proposed return on equity (ROE) of 11.0 percent.

Q. Please explain the impact of reduced usage per customer.

A. Over the past several years, gas usage per customer has been declining for several reasons including the response to higher and more volatile gas prices, more efficient appliances, customer conservation efforts and smaller house sizes. Since the last rate case in Washington, weather-normalized average use per residential customer per year has declined by approximately 160 therms per year.

Because NW Natural's fixed costs are recovered through volumetric charges, reduced usage per customer requires increased rates to allow for full recovery of the fixed costs of providing distribution services.

Q. What additional facilities is the company building to serve Washington customers and what impact do they have on the requested increase?

A. As explained in the Vancouver District Office testimony of Sandra K. Hart and Scott A. Milam (*see, Exhibit No. ____(SKH/SAM-1)*), the company is building a new district office in Vancouver. A new office has been needed for several years to meet the service requirements of the growing number of customers in Washington and to improve the company's ability to respond to emergencies.

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The immediate timing for development of the new district office is being driven by C-Tran's move to purchase the existing district office of the company for use as a regional transportation hub.

The new facility is estimated to cost $8 million, an amount that includes incremental costs resulting from Clark County's stringent site preparation requirements. The new facility will allow NW Natural to respond to almost all requirements of its Washington service territory with crews located in Washington rather than across the Columbia River in Oregon. It is designed to enable the company to meet the requirements of a growing service territory for years to come, and it will provide for better emergency response.

As explained in the Test Period & Adjustments testimony of Kevin McVay, *Exhibit No. ___(KSM-1), at Page 11, lines 14-17*, this new facility accounts for approximately $1.1 million of the company's overall increase in revenue requirement.

Q. What other major facilities is the company adding?

A. NW Natural's largest project overall is a major additional investment in its underground gas storage facilities and related pipelines. This project is covered in the South Mist Pipeline Extension testimony and exhibits of Charles E. Stinson, *Exhibit No. ___(CES-1)* and John A. Hanson, *Exhibit No. ___(JAH-1)*.

In this filing, NW Natural is proposing to incorporate into rates the next phase of its Mist storage development, the South Mist Pipeline Extension ("SMPE"). The first 11.7-mile segment of the SMPE is now nearing completion to be in service as of December 1, 2003, and the entire 62-mile project is expected to be completed and in service by October 1, 2004. The Washington-allocated portion of this facility adds approximately $800,000 to the revenue requirement increase (*see*, Kevin McVay's Test Period & Adjustments testimony, *Exhibit No. ___(KSM-1*).

Q. Describe the traditional business obligations for which costs have increased beyond NW Natural's ability to absorb them.

A. What I mean by "traditional business obligations" are those business functions that utilities must have in place but over which the company has little or no practical cost control. The cost pressures are particularly significant from three of these requirements: increased expense for the company's qualified pension plan in accordance with Statement of Financial Accounting Standard No. 87 (SFAS-87); increased employee health insurance expense; and increased costs of corporate liability insurance and other essential forms of business risk insurance.

Q. What has happened to the company's expense with respect to its pension plan?

A. In the case of pension expense, beginning January 1, 2003, NW Natural was required to adjust the assumptions it applies to its defined benefit pension plan by lowering the discount rate applicable to future obligations under the plan, and also lowering the expected earnings rate on plan assets. In both instances, the changes were required to reflect conditions in the capital markets as they have affected interest rates and stock and bond yields – in both cases downward. Our independent accountants concluded that our new assumptions were reasonable

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under the circumstances, in the course of their audit of the company's results of operations for 2002.

As a result of relatively high interest rates for much of the past decade and outstanding stock market performance, the plan was temporarily self-funding. The company was not required (or even permitted, under IRS rules) to make cash contributions to the plan for much of that decade. The amount of expense applicable to the pension plan that was calculated by our actuaries to be recorded in each year's income statement, pursuant to the requirements of SFAS 87, in several years actually was negative ("pension credits"). Now, however, lower interest rates mean that NW Natural has been required to reduce its assumed discount rate in calculating the value of its future pension liabilities. The declining stock market between 2000 and 2002 had a parallel impact on the asset side of the plan, reducing the value of the plan's securities holdings and indicating a reduced assumption for expected returns in future years. The higher plan liabilities and lower plan assets have combined to narrow the funded status of the plan, or even put the plan in a position of being under-funded, thereby substantially increasing the company's annual pension expense.

NW Natural expects the operations and maintenance (O&M) portion of its system annual SFAS 87 pension expense to be $3.9 million in 2003 and $4.3 million in 2004, up from $0.2 million in 2002. These amounts of pension *expense* are as compared to pension *credits* of $2.1 million in 2001, $3.0 million in 2000, $0.7 million in 1999 and $1.3 million in 1998. In NW Natural's last Washington rate case, pension credits were credited against operating expenses and resulted in a rate benefit to customers. In other words, our customers have directly benefited from the "self-funding" status of the plan during the years when that favorable condition applied.

This issue is discussed in more detail in the Total Compensation testimony and exhibits of Ms. Lea Anne Doolittle. *See, Exhibit No. ____(LAD-1)*. The test period pension expense forecast together with the cost of other benefit programs is included in the test period cost of service, as presented in the Test Period & Adjustments testimony and exhibits of Mr. McVay. *See, Exhibit No. ____(KSM-1).*

Q. What has happened in the area of health benefits?

A. In recent years, the company has experienced premium increases in the range of 11 to 25 percent per year for the health benefits it provides for employees. NW Natural's health benefit budget will grow from $11.9 million in 2002 to about $12.8 million in 2004. These increases are comparable to increases faced by other businesses of NW Natural's size and are consistent with national trends in the medical consumer price index.

Shareholders have already absorbed the sizable cost increases that have occurred since the company's last rate case. Employees also have absorbed a share, in the form of higher individual contributions to their cost of coverage or even some reductions in the scope of benefits. Nevertheless, health benefit expense continues to increase at a rapid rate. Health benefits are an area where the company cannot afford to offer less-than-competitive benefits if it expects to attract and retain a skilled and experienced workforce, so this is a cost of doing business the company cannot avoid.

This issue is also discussed in the testimony of Ms. Doolittle. An increment for health benefits expense is included and explained in the Test Period & Adjustments testimony of Mr. McVay. *See, Exhibit Nos. ____(KSM-1 and 4)* and *Exhibit No. ____(LAD-1).*

Q. What has happened in the area of business insurance?

A. Throughout the 1990s, companies like NW Natural benefited from a competitive market for insurance. The carriers were reducing premiums and offering new lines of coverage, to the point that the insurance market was flooded with products at very favorable rates. Business insurance tends to run in a cycle, however, and the opposite is true today. Now, due to high claims rates, corporate financial scandals, concerns over terrorism, and the fall of the equities markets, insurance companies are increasing rates, scaling back on coverage or simply refusing to underwrite. Utilities have been hit especially hard because of the financial scandals associated with some companies in the energy industry as well as their perceived vulnerability to attacks on physical infrastructure. An adjustment to include current levels of business insurance is included in *Exhibit No. ____(KSM-4).*

IV. Summary of Evidence

Q. What evidence is the company providing in support of its filing?

A. The company's filing is based on a test period ended June 30, 2003. After this policy testimony, Dr. Samuel C. Hadaway presents Return on Equity testimony (*see, Exhibit No. ____(SCH-1*) supporting the company's requested return on equity of 11.0 percent.

Mr. Kevin S. McVay's Test Period & Adjustments testimony presents the state allocation methodology and the company's test period actual results and estimated results on the basis of the state allocation. *See, Exhibit No. ____(KSM-1)*. Mr. McVay also presents the derivation of the company's revenue requirement, which incorporates adjustments to the test year actuals and estimates. Also supporting the revenue requirement requested in this case is Dr. John A. Hanson's Load Forecast exhibit, *Exhibit No. ____(JAH-1)*, which provides a brief overview of the econometric analysis used to adjust, or normalize, Washington residential and commercial test-year sales volumes.

Ms. Lea Anne Doolittle's testimony, *Exhibit No. ____(LAD-1)*, discusses total compensation, including medical and pension costs.

Ms. Kimberly A. Heiting's testimony, *Exhibit No. ____(KAH-1)*, explains the company's requested advertising expenses.

Next, Dr. Francis P. Ferguson, in *Exhibit No. ____(FPF-1)*, presents the proposed spread of the revenue requirement generated by this filing across the company's rate schedules. Dr. Ferguson also describes the cost of service analysis and NW Natural's redesigned rates in his Cost of Service testimony, *Exhibit No. ____(FPF-1)*, and his Rate Redesign testimony, *Exhibit No. ____(FPF-1)*.

Exhibit No. ____(SKH/SAM-1) is the joint direct testimony of Ms. Sandra K. Hart and Mr. Scott A. Milam, who provide details of the company's new Vancouver District Office. Mr. Charles E. Stinson's testimony (*see, Exhibit*

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No. ____*(CES-1*) and Dr. John A. Hanson's testimony (*see, Exhibit No.* ____*(JAH-1*) explain the background of, and the need for, the company's South Mist Pipeline Extension.

In his Decoupling *Exhibit No.* ____*(JAH-1)*, Dr. John A. Hanson outlines the company's decoupling proposal, labeled DMN for Distribution Margin Normalization.

Last, in *Exhibit No.* ____*(CAM-1)*, Mr. C. Alex Miller presents the company's proposal for a new ratemaking treatment of NW Natural's interstate storage costs and revenues in his Storage Services testimony.

Q. What revenue requirement increase does the company's presentation support?

A. As summarized in Mr. McVay's Test Period & Adjustments testimony (*see, Exhibit No.* ____*(KSM-1*), the company's testimony and exhibits support the need for a revenue increase in Washington of $7.9 million per year. This increase reflects the use of a recorded test period, the 12 months ended June 30, 2003 as adjusted for known and measurable changes, a Washington-allocated rate base, and a proposed return on equity of 11.0 percent.

As Dr. Ferguson defines in his Rate Spread testimony (*see, Exhibit No.* ____*(FPF-1*), the revenue increase was spread first by applying the increase necessary to compensate for reduced usage per residential and commercial customer to the residential and commercial classes, then applying the remaining increase to all classes as an equal percentage increase in distribution margins. This produces increases in current rates, by sales category, averaging 16.0 percent for residential customers, 14.1 percent for commercial customers, 13.9 percent for industrial firm customers and 11.6 percent for industrial interruptible customers. The overall average rate increase across all classes of service is 15.0 percent.

Q. What earnings position will the increased revenues permit the company to achieve?

A. Based upon normalized operations for the 12 months ended June 30, 2003, reflecting all adjustments, NW Natural would have the opportunity to attain a rate of return on common equity of 11.0 percent on its Washington operations after a full year under the rates. Under the same assumptions, the equity return would be only about 2.06 percent without the requested rate increase.

V. <u>Specific Issues and Adjustments</u>

Q. Do you have other testimony of a policy nature?

A. Yes. This portion of my testimony describes other issues of policy, some of which are not addressed elsewhere in the filing.

A. <u>Capital Structure, Cost of Debt and Return on Equity.</u>

Q. What is the company proposing that the Commission authorize as a return on equity and a return on rate base?

A. I directed Mr. McVay to calculate a Washington revenue requirement based upon a return on common equity of 11.0 percent as supported in the testimony and exhibits of Dr. Hadaway. In translating that return into a return on rate base, I further directed Mr. McVay to use the company's capital structure at June 30, 2003, including the pro forma redemptions of certain long-term term debt and preferred securities after that date and their replacement with new securities at assumed costs consistent with market conditions and traditional accounting treatment. As shown in Mr. McVay's Test Period & Adjustments testimony, *Exhibit No. ____(KSM-1)*, those values generate a return on rate base of 8.97 percent.

Q. Is the company's actual capital structure reasonable for use in determining a return on rate base?

A. In my opinion it is, with some pro forma adjustments to reflect a refinancing that will reduce the company's cost of capital.

The company's actual capital structure at June 30, 2003 (including the short-term debt balance on that date) included 49.7 percent total debt and 49.6 percent common equity. I know from discussions with Standard & Poor's and Moody's Investors Service, the two leading debt rating agencies, that both of these rating agencies consider NW Natural's total debt ratio still to be higher than what would be desirable for an A-rated gas utility, and its interest coverage ratios to be lower. The company has maintained its "A" rating on secured long-term debt from S&P and Fitch in recent years and an "A2" rating from Moody's. I believe our success in maintaining these ratings to date stands on the strength of our demonstrated ability to maintain a conservative capital structure with adequate common equity and to earn acceptable returns from new customers in a context of rapid customer growth.

The company wants to maintain its "A" rating on secured long-term debt and its equivalent ratings (A1/P-1) on commercial paper. Our costs of capital will be lower in the long run, to the benefit of our customers, if we can do so. It would

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contribute to the security of the company's debt ratings and its ability to attract debt capital at a reasonable cost if its actual capital structure were recognized as reasonable for ratemaking purposes.

Q. What capital structure and capital costs are you proposing for use in establishing rates?

A. The following table presents the company's capital structure for the test period and the resulting overall rate of return. NW Natural is requesting an overall rate of return on rate base of 8.97 percent.

Test Year Capital Structure

	% of Capital	Cost	Weighted Cost
Long-Term Debt	49.3%	7.13%	3.52%
Short-Term Debt	1.3%	1.42%	0.02%
Preferred Equity	0.0%	- - %	0.00%
Common Equity	49.4%	11.00%	5.43%
TOTAL	100.00%		**8.97%**

Q. Please explain the derivation of the amount and embedded cost of long-term debt in the company's capital structure, and the amount of preferred stock.

A. As shown in the portion of my exhibit relating to the cost of debt, *Exhibit No. ____(BRD-2, p. 2)* , the company's embedded cost of long-term debt as of June 30, 2003, is 7.13 percent. The amount and cost of debt in the capital structure include pro forma adjustments to reflect the redemption of $35 million of higher-cost debt during the third quarter of 2003 and its replacement with $40 million of refinancing debt. The capital structure also includes adjustments to reflect the redemption of $7.5 million of preferred stock in November 2003 and its replacement with $10 million of refinancing debt. The latter redemption took the balance of preferred stock in the company's capital structure to zero, so the embedded cost of preferred stock should not be an issue in this case.

Q. How did you calculate the cost of long-term debt for the test period?

A. Pages 1 and 2 of *Exhibit No. ____(BRD-2)* are two separate calculations of NW Natural's cost of long-term debt outstanding at June 30, 2003. Page 1 represents the actual costs of long-term debt, including the costs of the Medium Term Notes (MTNs) that were redeemed in the third quarter of 2003, while page 2 removes the redeemed MTNs but includes the estimated amounts and costs of refinancing issues on a pro forma basis (the pro forma). In the pro forma presentation, we have included refinancing issues assuming current market interest rates, defined as an estimate of the benchmark rate for U.S. Treasury securities plus an estimated spread for a single A-rated corporate note.

The pro forma presentation of the cost of debt includes, as part of the costs of the two projected new series of MTNs, allocations of the redemption premiums and unamortized costs relating to the issues redeemed. *Exhibit No. ____ (BRD-3)*. The redemption premiums and unamortized costs are shown on *Exhibit No. ____ (BRD-4).* The costs from the 7.50%, 7.52% and 7.25% Series of MTNs are allocated to the pro forma 6.25% Series of MTNs due 2023 ($40,000,000), while the costs from the $7.125 Series of Redeemable Preferred Stock are allocated to the pro forma 5.15% Series of MTNs. *See, Exhibit No. ____ (BRD-5, pp. 1 – 4).*

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Q. Please provide the details of the long-term redemptions, and explain why they are in the public interest.

A. NW Natural has exercised optional redemption provisions on three issues of MTNs and one issue of redeemable preferred stock as follows:

- the $4,000,000 principal amount outstanding on the 7.50% Series of Secured MTNs due June 30, 2023 was redeemed at 103.75% of its principal amount on July 1, 2003;
- the $11,000,000 principal amount outstanding on the 7.52% Series of Secured MTNs due June 30, 2023 was redeemed at 103.76% of its principal amount on July 1, 2003;
- the $20,000,000 principal amount of the 7.25% Series of Secured MTNs due August 18, 2023 was redeemed at 103.65% of its principal amount on August 18, 2003; and
- the remaining $7,500,000 principal amount (75,000 shares) of the $7.125 Series of Redeemable Preferred Stock, which had annual sinking fund requirements through 2013, was redeemed at 102.375% of its stated value of $100 per share on November 14, 2003.

Based on current market conditions, NW Natural believes it will be able to refinance these early redemptions of debt and preferred stock at lower rates, thereby enabling the company to reduce its cost of debt and overall cost of capital.

Exhibit No. ____(BRD-5, pp. 1 – 3) represent the redemption analyses for the 7.50%, 7.52% and 7.25% Series of MTNs, showing estimated gross savings of $850,000, $2,380,400 and $3,270,000, respectively, and net present value savings of $202,456, $579,677 and $486,323, respectively. Aggregate gross and net present value savings for redemptions on the three issues of MTNs are estimated at $6,500,400 and $1,268,456, respectively. In each of these three analyses the company assumed a yield of 5.25 percent on the benchmark U.S. Treasury 30-year bond, plus a spread of 100 basis points. The company intends to re-finance these early redemptions with new issuances of MTNs with 20-year maturities, matching the remaining life of the securities redeemed. The reason the company used a 30-year benchmark rate rather than a 20-year benchmark is because the bond market prices 20-year corporate issues off the 30-year Treasury benchmark. There is no equivalent 20-year benchmark U.S. Treasury rate.

NW Natural believes the redemption of the preferred stock will also reduce the company's cost of capital. *Exhibit No. ____(BRD-5, p. 4)* is a redemption analysis for the $7.125 Series of Redeemable Preferred Stock showing present value savings of $1,743,868, including tax savings, assuming a spread of 90 basis points. In this analysis, the company assumed that the refinancing issue would be a 10-year MTN, and assumed a yield of 4.25 percent on the benchmark U.S. Treasury 10-year note.

The financing plan described above is consistent with NW Natural's objectives to maintain a capital structure containing 45 to 50 percent long-term debt and 45 to 50 percent common equity, and to maintain strong investment grade credit ratings.

In NW Natural's pro forma cost of debt, the effect of the refinancing is that the weighted average cost of capital was reduced from 9.04 percent to 8.97

percent, including no changes in the common equity account balance as of June 30, 2003. *Exhibit No. ____(BRD-6)* shows the company's weighted average cost of capital. The first table (Table A) shows the cost of capital before the redemptions and refinancings. The second table (Table B) shows the cost of capital on a pro forma basis after the redemptions and re-financings. We submit that the refinancing is in the public interest because the company will have succeeded in reducing its cost of capital, to the benefit of its customers, without damaging its credit quality.

Q. Please provide the details of the company's assumptions with respect to the new debt issues.

A. The long-term debt schedule on *Exhibit No. ____(BRD-3)* includes details on the $40 million issue proposed for November 2003, with an estimated coupon rate of 6.25 percent, an underwriter's commission of $300,000, and total expenses of $3,056,850 including redemption premiums and unamortized debt costs from the three MTN issues that were redeemed. The effective cost (*i.e.*, the "cost of money") for this new issue is calculated at 7.038 percent compared to the 7.335 percent, 8.964 percent and 8.987 percent cost assigned to the three MTN issues that were redeemed. The latter three issues have been removed from the long-term debt schedule. The details of the new issue are on line 28 of the Exhibit.

The long-term debt schedule also shows on line 29 a new $10 million issue proposed for November 2003, with an estimated coupon rate of 5.15 percent, an underwriter's commission of $62,500, and total expenses of $204,125 including the premium from the optional redemption of the $7.125 Series of

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Redeemable Preferred Stock. There were no unamortized costs remaining from the $7.125 Series of Preferred Stock.

Q. How did you determine the amount and cost of short-term debt in the ratemaking capital structure?

A. *Exhibit No.* **____***(BRD-7)* shows that the company's 13-month average balance of short-term debt outstanding was $13,087,840 at June 30, 2003, and the corresponding average interest rate was 1.42 percent. The 13-month average balance was calculated by multiplying the monthly commercial paper borrowing average by the corresponding number of days for each month, then adding the resulting balances together and dividing that number ("total balance") by 365 days. The average interest rate was calculated by first multiplying the monthly commercial paper borrowing average by the corresponding number of days for each month, then multiplying that result by the average interest rate for the month, and then adding the resulting balances from each month and dividing by the "total balance."

B. Distribution Margin Normalization – Decoupling.

Q. Please explain the company's decoupling proposal called Distribution Margin Normalization (DMN).

A. The DMN mechanism would establish a Use Balancing Account (UBA). Each month, the company would compare the actual average use of residential and commercial customers to the expected average use that was determined for these customers in the last rate case. If there is a difference, the difference in therms times the applicable distribution margin would be booked to the UBA as a collection or a refund. Distribution margin is the weighted energy rate applicable to each class less the Weighted Average Cost of Gas and less the average cost of purchased demand associated with firm transportation. The company would either refund to or collect from residential and commercial customers the net balance in the account at the end of the 12-month deferral period in June of each year. The refunds or surcharges would be applied as temporary rate increments in amounts intended to amortize the balance over 12 months, just as other deferred accounts are administered during the amortization period beginning in October of each year.

The company does not propose that all customers be included in the DMN mechanism. We do not include industrial customers because these customers' loads vary from month to month and from year to year, for reasons that are often unrelated to weather or commodity prices. Also, it would not be clear which customer group would bear responsibility for usage deviations in the industrial group. The company is willing to continue living with the risks these markets entail, without decoupling them.

The company also proposes not to include residential and commercial customers who are new to the system since the end of the rate case test year. That is to say, residential and commercial customers who joined the system after June 30, 2003 will not be included in the "normalized" group of customers. The company would exclude these customers for two reasons. First, we prefer to eliminate controversy about what usage levels to assume for these customers.

Second, we want to preserve the company's incentive to invest capital prudently when bringing new customers onto the system.

VI. Qualifications

Q. Please state your educational background and experience.

A. I received an A.B. from Princeton University in 1969. Subsequently, I attended the Stanford Law School and the Stanford Graduate School of Business, and received the J.D. and M.B.A. degrees in 1973. From 1974 through 1980, I was an assistant attorney general for the State of Oregon. I joined NW Natural as associate counsel in February 1980 and was elected Vice President and General Counsel on June 1, 1983. I was elected to the position of Senior Vice President, Finance, and Chief Financial Officer on March 1, 1990.

Q. Does this conclude your direct testimony on these issues?

A. Yes, it does.