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August 31, 2017

Via Electronic Filing and US Mail

OREGON PUBLIC UTILITY COMMISSION
ATTENTION: FILING CENTER
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**RE: Docket No. UM 1804–In the Matter of
NORTHWEST NATURAL GAS COMPANY dba NW NATURAL,
Application for Approval of Corporate Reorganization to Create a Holding Company**

Enclosed for filing is Staff Redacted Testimony in Support of Stipulation in UM 1804, together with a Certificate of Service and UM 1804 Service List.

Pages 7 to 9 and 13 to 14 has highly confidential information and the pages will be mailed to parties who have signed Modified Protective Order No 17-135.

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BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UM 1804

In the Matter of NORTHWEST NATURAL GAS COMPANY, Application for Approval of Corporate Reorganization to Create a Holding Company.

STAFF TESTIMONY IN SUPPORT OF STIPULATION

[REDACTED]

August 31, 2017

INTRODUCTION

Q. Please state your name and position.

A. My name is Matt Muldoon. I am a Senior Economist for the Public Utility Commission of Oregon (Commission or OPUC). My business address is 201 High Street SE, Suite 100, Salem, OR 97301.

Q. Are you the Matt Muldoon who previously offered reply testimony in this docket as Staff/100 and a witness qualification statement as Staff/101?

A. Yes.

Q. What is the purpose of this testimony?

A. Staff participated in the drafting of and supports the Joint Testimony in Support of Stipulation (JOINT TESTIMONY/100) filed in this docket. This particular testimony (Staff/200) explains why Staff supports the stipulation entered into by the parties (Stipulation) that was filed on August 11, 2017.

Q. Did you prepare new exhibits for this testimony?

A. No. However, Staff has jointly prepared the stipulated conditions that apply to NW Natural (Company) and its proposed holding company (HoldCo), and in many instances its affiliates, which were the result of multiple rounds of settlement negotiations between the parties. The stipulated conditions are found as Attachment A to the Stipulation filed on August 11, 2017.

Q. How is your testimony organized?

A. My testimony is organized as follows:

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I. OVERVIEW

Q. What is Staff's recommendation to the Commission?

A. Staff recommends that the Commission approve the Company's request to form a holding company (HoldCo) subject to the ring-fencing conditions stipulated to by all parties. With these conditions in place and adhered to by NW Natural and HoldCo, the restructuring provides a net benefit to NW Natural's customers and causes no harm to Oregonians.

Q. Are NW Natural customers held harmless both for the costs of planning and forming HoldCo, and the costs and potential negative results of future acquisitions by HoldCo?

A. Yes. NW Natural customers will be held harmless from any adverse rate impacts caused by NW Natural's rate of return, common equity, and long-term debt becoming more costly after the restructuring than they would be had NW Natural not reorganized. Further, HoldCo and NW Natural guarantee that NW Natural customers shall be held harmless if the reorganization or any subsequent HoldCo M&As cause a higher revenue requirement for NW Natural than had the reorganization not occurred.

Q. Under the stipulated conditions, will NW Natural's financial status be maintained to the extent that it will retain access to capital and maintain appropriate capitalization post-reorganization?

A. Yes. The parties have aligned incentives and flexibilities to reinforce the appropriate capitalization of NW Natural to prevent harm to NW Natural customers.

Q. Have you required that NW Natural prioritize the ability to issue first mortgage bonds (FMB) at low coupon rates in comparison to peer local gas distribution companies (LDC)?

A. Yes. Condition No. 4 ensures that the Company will maintain adequate interest coverage and make no other pledge of utility assets. In other words, the Company must maintain a pool of qualified assets adequate to meet requirements to issue FMB. This is important to ratepayers because FMB are highly rated and a lower cost form in which a utility can issue bonds with a maturity over one-year. FMB's save ratepayers significant interest cost as compared to unsecured debt.

Q. In the event that HoldCo encounters financial difficulty or even fails, is NW Natural protected from being drawn into a voluntary bankruptcy?

A. Yes. Oregon's strong, customary conditions to protect the utility from voluntary bankruptcy are included in the Stipulation. The bankruptcy-related conditions include a golden share to be held by an independent third-party. The golden share overrides all shares of all types of stock in the event of a

HoldCo bankruptcy. Further, the conditions also require a unanimous vote of the NW Natural board of directors, inclusive of an independent director, to voluntarily enter NW Natural into bankruptcy for the benefit of HoldCo.

Additionally, the Company must provide a non-consolidation opinion within 60 days of the Commission's decision in this case. Such an opinion would support the parties' conclusions that the stipulated conditions are sufficient such that a bankruptcy court would not order the substantive consolidation of the assets of NW Natural with those of HoldCo should HoldCo face bankruptcy.

Q. Does a net benefit result from the reorganization after consideration of the risks associated with formation of a holding company and a HoldCo business trajectory that may depart from NW Natural's interests?

A. Yes. The stipulated conditions create a common set of expectations for all parties to the Stipulation and NW Natural ratepayers in diverse and important ways. Given the controls agreed to by the parties, Staff expects the Company to focus first on the execution of utility business and service to customers, while also creating customer and investor value through HoldCo investments.

While a significant number of the stipulated conditions are crucial for ensuring no harm to ratepayers and Oregonians as a result of the reorganization, Staff did not consider those conditions to result in a net benefit alone. Further, because the comparator in this case is a continued prudent and well-managed NW Natural with top U.S. LDC credit ratings, the standard is demanding. In addition, the Company performs well in terms of safety and service quality, so Staff did not view continued excellence in these areas to result in a net benefit for customers.

Importantly however, the parties were able to reach agreement on key provisions that Staff believes provide a net benefit for NW Natural customers. For example, the stipulated conditions establish an equity floor that does not exist today, which also serves to alert the Commission of any deteriorating financial conditions, including any impairment to credit ratings, and restricts HoldCo from removing equity from the utility through the issuance of dividends. Additionally, the Company has agreed to provide a modest rate credit to customers in Condition 44 that provides an immediate financial benefit to ratepayers, and to capture potential cost savings from future M&As by HoldCo for NW Natural customers as specified in Condition 45.

Beyond the abovementioned benefits, broad access to information, including HoldCo's budget for five years post-reorganization (which allows the Commission to stay informed of HoldCo's corporate direction and intentions), and restrictive financial protection conditions give Staff confidence that Oregonians are adequately protected from potential harm. Moreover, ratepayers are assured of further cost reductions as talented officers, management, and key employees devote time to non-utility purposes due to the extensive cost allocation and affiliated interest conditions drafted by the parties. For example, one of the conditions requires employee, officer, director, agent, and attorney time to be tracked in hourly increments. Finally, the Company's support for low income, community engagement, and efficiency programs will be maintained.

Therefore, Staff finds that the conditions are properly designed to ensure NW Natural's continued financial strength and ready access to capital markets at reasonable rates. Further, NW Natural ratepayers are protected from an increase in cost of capital due to the reorganization, and the utility will not be dragged voluntarily into a HoldCo bankruptcy.

II. KEY ELEMENTS

A. Corporate Strategy and Objectives

Q. Has Staff reviewed the Company's corporate strategy and need for reorganization, inclusive of NW Natural's analysis underlying this strategy?

A. Yes. At first, the Company was reluctant to share its strategic process in terms of the types of investments it plans to use HoldCo to pursue and develop. Staff and intervenors felt this information was necessary to evaluate the risks and benefits of approval of a holding company structure, but also recognized that what HoldCo may be designed to pursue now could change dramatically in the future. After the filing of a modified protective order, NW Natural provided more detailed information to Staff and intervenors that assisted with Staff's review of the risks and benefits associated with HoldCo.

Q. From a finance prospective, is the Company's strategic process consistent with that of successful diversified companies?

A. Yes. The Company has **[BEGIN HIGHLY CONFIDENTIAL]** [redacted] **[END HIGHLY CONFIDENTIAL]** Based on this approach and related criteria provided in Staff's highly confidential reply testimony, Staff is comfortable with the Company's analysis and conclusions for growth at this time.

Q. Why does Staff think that reorganization (creation of HoldCo) is both timely and a good strategy for NW Natural customers?

A. **[BEGIN HIGHLY CONFIDENTIAL]** [redacted]

[redacted] **[END HIGHLY CONFIDENTIAL]**

The HoldCo growth strategy will likely satisfy investors (who initially are identical to the utility's investors) that there is good reason to expect a continued, consistently growing dividend stream into the future. This strategy works in harmony with ratepayer goals by avoiding an increase in rates to address what might otherwise be a higher cost of capital.

Based on Staff's review of discovery responses from NW Natural, **[BEGIN HIGHLY CONFIDENTIAL]** [redacted]

[redacted] **[END HIGHLY CONFIDENTIAL]** In other words, the stipulated conditions provide a better fit for utility and HoldCo decision-making and for customers because they are comprehensive, strong, and integrated, and also allow flexibility for growth of the consolidated entity.

Further, the stipulated conditions ensure better and more comprehensive access to information for the Commission, ready to be supplemented by explanations from HoldCo and NW Natural's officers and subject matter experts on request. Due to the stringent conditions stipulated by the parties, HoldCo cannot readily extract the utility's wealth, pledge its assets, or impair its credit ratings by paying early special dividends. These initially were primary concerns for Staff as expressed in reply testimony, but have been alleviated with the stipulated conditions. Further, the Company also agreed to new stipulated financial warning controls that are not now present. Together, the stipulated conditions form a tough set of interlocking conditions that provide adequate protections against harm, as well as new protections and benefits for customers not present today.

Q. Is Staff concerned that HoldCo's board of directors and growth strategy could change, and if so, how do the stipulated conditions protect customers?

A. HoldCo's board and strategy could change in the future, but Staff is no longer concerned about this possibility due to the strength of the 50 stipulated conditions agreed to by the parties. The stipulated conditions offer clarity of expected requirements regarding access to information, pricing with affiliates, and allocation of HoldCo-related costs. Further, the conditions offer strong protections against voluntary HoldCo bankruptcy negatively affecting NW Natural should HoldCo's strategy not prove successful and durable. Most importantly to Staff, the conditions create robust and layered financial controls to maintain the financial stability of the utility and ensure that proper capitalization is not sacrificed for HoldCo endeavors. Staff also notes the important preventative measures agreed to by the Company that work to promote the exercise of proactive measures taken in a timely manner to manage credit ratings and equity levels, rather than trying to fix the problem *after* it has occurred.

Further, NW Natural must continue to maintain separate credit ratings and meet all the criteria required to issue first mortgage bonds, a low cost, long-term financing method available to utilities. Additionally, HoldCo and NW Natural jointly guarantee that ratepayers will be held harmless with respect to rate of return, common equity, and long-term debt becoming more costly after the restructuring than had NW Natural not reorganized.

Finally, should HoldCo pivot to riskier pursuits with more volatile returns, the stipulated conditions would serve as guard rails to protect NW Natural from harmful levels of equity extraction through dividend issuances up to the parent. For example, Condition 9 restricts dividend issuance depending on the level of equity comprising NW Natural's capital structure. This provision wears lightly under conservative management, but tightens if NW Natural's capitalization begins to drop. Further, Staff and intervenors did not like the prospect of seeing drops in NW Natural credit ratings and conditions that address concerns only after the fact. Thus, as discussed above, the parties agreed to conditions requiring notification and plans by NW Natural to restore its credit ratings.

For example, if NW Natural common equity falls below 44 percent of capital structure (or is reasonably likely to fall below 44 percent) as determined on a preceding or projected thirteen month average, NW Natural must explain why within five days, and provide the Commission a restoration plan within 30 days, triggering periodic reporting thereafter. Additionally, if the Company's credit ratings drop below investment grade, the utility cannot issue dividends to HoldCo. While the utility maintains A-ratings, it has the greatest flexibility regarding capital structure. If ratings drop from A to BBB+ for S&P or Baa1 for Moody's, that flexibility is ratcheted back regarding capital structure, with further ratcheting if ratings continue to drop.

Under a different interlocking condition, the utility must notify the Commission by providing a calendar weeks' notice before transferring five percent of NW Natural's retained earnings. If there is even an intention to move 10 percent of retained earnings out of the NW Natural over a six-month period, the Commission must receive advance notification. This notification is designed to prevent stealthy raiding of the utility's resources. Any special cash dividend or distribution beyond regular quarterly dividends must be announced to the Commission at least 30 days in advance before declaring such a dividend.

In sum, the parties have crafted interwoven credit rating and capital structure conditions that Staff is confident will protect ratepayers by preserving the utility's financial stability as future M&As are executed by HoldCo.

Q. From a financial perspective, is NWN's decision to pursue forming a holding company timely?

A. Yes. Staff believes that now is a timely opportunity for NW Natural to reorganize. Currently, U.S. gas and electric utility stock prices are very high, reflecting strong global demand. According to Bloomberg, small-capitalization stand-alone utilities like NW Natural, Avista, and Portland General Electric are acquisition targets whose stock prices are now commanding a further premium over peer utilities.[1]

However, with current high demand for haven securities with characteristics like NW Natural's steady U.S. dollar-denominated cash flows, NW Natural or HoldCo can float equity or issue new long-term debt at low-cost and high flexibility or when the Company draws down on funds. In other words, at this time financial market conditions are conducive to restructuring at low cost and risk to the Company and its ratepayers.

NW Natural's exceptionally high credit ratings and consistent quarterly dividend have attracted a solid following of money managers and market analysts. The Company's restructure would meet their needs and

[1] Please see the Bloomberg analysis, "Foreign Capital Adds Avista to Growing List of U.S. Utility Buys" dated August 9, 2016.

expectations this year. Based on market conditions and the Company's current financial profile from an investor, market analyst, or money manager perspective, this is the ideal time for the Company to restructure in order to address concerns summarized in Staff's highly confidential testimony at least cost and risk.

Q. Could NW Natural wait for a ripe acquisition target and restructure at that time if necessary?

A. Perhaps. However, based on Staff's review of the Company's highly confidential testimony in this case and highly confidential discovery responses, waiting is not ideal.

[BEGIN HIGHLY CONFIDENTIAL] [redacted]

[redacted] **[END HIGHLY CONFIDENTIAL]**

Q. Why are NW Natural ratepayers better off if NW Natural is allowed to form HoldCo as opposed to another entity acquiring NW Natural?

A. Staff suspects that companies that would seek to acquire NW Natural would very likely have a different company culture and lesser focus on Oregon and Oregon customers. The NW Natural management team has a proven track record for Oregon customers and some of the stipulated conditions preserve this track. For example, Condition 37 commits that NW Natural's corporate headquarters will remain in Oregon and HoldCo will not move its headquarters out of Oregon without prior Commission approval.

B. Cost of HoldCo Formation and Future Acquisitions

Q. Are ratepayers held harmless for the costs of HoldCo formation and future HoldCo acquisitions?

A. Yes. The interlocking stipulated conditions work together in multiple ways to identify costs not appropriate for ratepayers to bear. For example, Condition 21 provides for the tracking of HoldCo and future M&A planning, legal, and formation work. This dovetails with Conditions 17 and 18 to exclude such costs where appropriate. Further, Condition 48 clarifies that HoldCo and investors will bear the costs of goodwill and incremental executive costs associated with future M&A activity. Multiple conditions contain provisions that hold ratepayers harmless for higher cost of capital and costs associated with non-regulated activities such as future HoldCo M&As.

C. Preservation of Financial Status and Access to Capital

Q. Do the stipulated conditions prioritize NW Natural's ability to attract capital in the short- and long-term?

A. Yes. The stipulated conditions balance NW Natural's corporate finance flexibility with performance from a utility ratepayer perspective. When NW Natural can obtain low cost credit facilities and borrow at attractive rates in comparison to NW Natural's current abilities, then NW Natural has greater flexibility in capital structure and issuance of dividends, which is what HoldCo seeks. This alignment incentivizes HoldCo to continue current best management practices with regard to the utility's financial structure. Importantly, if access to capital becomes impaired, Condition 9 restricts financial flexibility. For this reason, the greatest flexibility of 44 percent common equity (determined on a preceding or projected thirteen month average) associated with the highest credit ratings is also the equity floor below which NW Natural cannot issue dividends.

Q. What if HoldCo decision-making or acquisitions result in a higher cost of capital for NW Natural?

A. Under Condition 6, HoldCo and NW Natural guarantee that customers will be held harmless from any adverse rate impacts caused by NW Natural's rate of return, common equity, and long-term debt becoming more costly than had NW Natural not reorganized. For the first seven years post restructuring, NW Natural agrees to bear the burden to show that costs of debt and equity are no more expensive than had NW Natural not reorganized.

Q. How does NW Natural's proposed restructure, subject to the stipulated conditions, compare to a leveraged buyout of NW Natural?

A. If a leveraged buyout of NW Natural by a third-party were to occur, NW Natural could be disadvantaged in both the short- and long-term because it could be merged into a family of companies with lower bond ratings and relatively greater debt. Leveraged buyouts also often tend to lean on revolving credit facilities (which are like a large credit card) that are not suitable for long-term obligations. Further, leveraged buyouts are risky because they have historically employed large amounts of unsecured debt to purchase the target firm's equity. That particular approach and structure puts severe cash flow strains on the acquired target firm so as to allow the acquiring holding company to make fixed principle and interest debt payments. Heavy debt financing would add significant risk to NW Natural. Staff does note, however, that the above-described scenario would be subject to Commission review and approval, just as this proposal to restructure triggered ORS 757.511.

Nonetheless, Staff supports the stipulated conditions for the proposed restructure that incent continued NW Natural financial excellence, while protecting ratepayers if NW Natural's access to or cost of capital is impaired to a level that Staff and intervenors find concerning to the health of the utility. Further, NW Natural must notify the Commission not after it has failed, but rather, if its financial strength should start to slip, NW Natural must offer the Commission a thoughtful proposed remedy early enough for the remedy to be effective. Thus, HoldCo's success hinges on it prioritizing the financial health of the utility, which alleviates Staff's concern that utility management and service would be neglected as a result of the restructuring.

Q. In recent years, leveraged buyout companies have given themselves large early special dividends as a way to lower the risk of their investment. Do the stipulated conditions include warnings to the Commission to flag large movements of cash or the intention to make future large distributions out of NW Natural?

A. Yes. Condition 10 serves as the Commission's alarm bell if HoldCo were to consider transferring wealth on a large scale out of NW Natural to HoldCo.

D. Access to Information and People

Q. Do the stipulated conditions make sure that NW Natural maintains its own books and records with audit trails and sufficient detail to field information requests and audits?

A. Yes. The Company will also make board of director and rating agency information available as it pertains to NW Natural. This is in addition to the condition that NW Natural maintain separate utility books and records.

Q. Will these records be locally accessible in Oregon?

A. Yes. Conditions 14, 28, and 29 address these concerns.

Q. When it would be beneficial for the Commission to have HoldCo or NW Natural officers, directors, or subject matter experts appear before the Commission, do both HoldCo and NW Natural agree to make these persons available?

A. Yes, upon Commission request. Condition 30 captures this agreement.

E. Net Benefit

Q. Why are NW Natural customers better off under HoldCo, subject to the stipulated ring-fencing conditions, than they would be without the reorganization?

A. The stipulated ring-fencing conditions create strong controls not present today that cause NW Natural (and HoldCo after reorganization) to continue to perform to a high standard. The controls will become part of the decision-making at HoldCo, not just NW Natural, and are tied to critical functions that affect NW Natural and its customers. Essentially, the stipulated conditions require that the management and board of directors of both companies orient their decision-making to the NW Natural perspective—providing safe and reliable utility service at reasonable rates. Staff is confident that these 50 controls offer a package of protections that prevent harm to utility customers and Oregonians, as well as a net benefit, appropriate to the facts and circumstances of this case.

The stipulated conditions are designed to work together as a package of protections to be effective not just in the preferred future that NW Natural currently targets for HoldCo, but also in a myriad of other situations that HoldCo may pivot to. The robust ring-fencing conditions arrived at through thoughtful discussions among the parties will help NW Natural and HoldCo's management stay oriented to high-quality utility performance that has served ratepayers well in recent years.

III. CONCLUSION

Q. What is Staff's recommendation regarding NW Natural's application to reorganize into a holding company structure?

A. Staff recommends that the Commission approve the formation of HoldCo subject to the stipulated ring-fencing conditions provided as Attachment A to the Stipulation.

Q. Does this conclude your testimony in support of the Stipulation?

A. Yes.

UM 1804-SERVICE LIST

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CERTIFICATE OF SERVICE

UM 1804

I certify that I have, this day, served the foregoing document upon all parties of record in this proceeding by delivering a copy in person or by mailing a copy properly addressed with first class postage prepaid, or by electronic mail pursuant to OAR 860-001-0180, to the following parties or attorneys of parties.

Dated this 31st day of August, 2017 at Salem, Oregon

Kay Barnes

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