Cause No. 46038

FILED
April 4, 2024
INDIANA UTILITY
REGULATORY COMMISSION

On Behalf of Petitioner,
DUKE ENERGY INDIANA, LLC

VERIFIED DIRECT TESTIMONY OF CHRISTOPHER R. BAUER

Petitioner's Exhibit 9

April 4, 2024

DIRECT TESTIMONY OF CHRISTOPHER R. BAUER
DIRECTOR, CORPORATE FINANCE AND ASSISTANT TREASURER
DUKE ENERGY BUSINESS SERVICES, LLC
ON BEHALF OF DUKE ENERGY INDIANA, LLC
BEFORE THE INDIANA UTILITY REGULATORY COMMISSION

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Christopher R. Bauer. My business address is 525 South Tryon Street, Charlotte, North Carolina.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by Duke Energy Business Services, LLC ("DEBS") as Director, Corporate Finance and Assistant Treasurer. I am also the Assistant Treasurer of Duke Energy Indiana, LLC ("Duke Energy Indiana" or the "Company"). DEBS provides various administrative and other services to Duke Energy Indiana and other affiliated companies of Duke Energy Corporation ("Duke Energy").

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND.

A. I received a Bachelor of Arts degree from Flagler College in 2003 and a Master of Business Administration from the University of North Florida in 2004.

Q. PLEASE SUMMARIZE YOUR PROFESSIONAL EXPERIENCE.

A. From 2004 to 2010, I worked in Deloitte's Audit and Enterprise Risk Services unit, providing financial statement and internal control services across various industries. In 2010, I joined Duke Energy as a Lead Audit Consultant in the Internal Audit department. In 2015, I moved to Duke Energy's Investor Relations group where I served as a manager responsible for communicating the company's strategic, operating and financing plan to debt and equity investors and external stakeholders. In 2017, I moved to the Treasury department and served as both a Treasury Director and the Director of Credit & Capital Markets before assuming my current role in early 2021. I am a licensed Certified Public Accountant in the state of Florida.

Q. PLEASE DESCRIBE YOUR DUTIES AS DIRECTOR, CORPORATE FINANCE AND ASSISTANT TREASURER.

A. I am responsible for financing the operations of Duke Energy and its subsidiary utilities. This includes the issuance of new debt and equity securities and obtaining other sources of external funds. My responsibilities also include financial risk management of interest rate exposure for Duke Energy and its regulated utilities. Additionally, I maintain relationships with Duke Energy's commercial banks, the fixed income investor community, and the credit rating agencies.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. My testimony will address Duke Energy Indiana's financial objectives, capital structure, and cost of capital. I will also discuss the current credit ratings and forecasted capital needs of Duke Energy Indiana. Throughout my testimony, I will emphasize the importance of Duke Energy Indiana's continued ability to meet its financial objectives.

Q. PLEASE PROVIDE AN OVERVIEW OF YOUR TESTIMONY.

A. As detailed in my testimony, Duke Energy Indiana faces substantial capital needs over the next several years. The Company competes for capital in the open market and must appeal to debt and Duke Energy's equity investors to attract the capital it needs. As Dr. Roger Morin, a leading expert on utility finance, indicates, "[t]he … prices of debt capital and equity capital are set by supply and demand, and both are influenced by the relationship between the risk and return expected for those securities and the risks expected from the overall menu of available securities." Morin, Roger A., *Modern Regulatory Finance* (PUR Books LLC 2021), at 27.

Investors have a variety of investment opportunities available to them and require a return commensurate with the risk they incur. Investors are less likely to invest if they feel the expected return does not fairly compensate for the perceived risk of the investment. Investors will invest elsewhere if they anticipate the expected return provided by a company is inadequate, and lower credit quality weakens a company's attractiveness as an investment opportunity relative to companies with higher credit quality and similar return profiles. For this reason, it is critically important that the Company maintain strong investment-grade credit quality to provide financial strength and flexibility and to ensure access to capital on reasonable terms.

The Company is making significant capital investments to provide cost effective, safe, reliable, and environmentally compliant electric service to its customers well into the future. The Company's proposed rate increase will allow it to recover prudently incurred costs, compete in the capital markets for needed capital, and preserve its financial standing with both equity and debt investors, as well as the credit rating agencies, to the long-term benefit of customers.

II. <u>FINANCIAL OBJECTIVES</u>

Q. WHAT ARE DUKE ENERGY INDIANA'S FINANCIAL OBJECTIVES?

A. Financial strength and access to capital are necessary for Duke Energy Indiana to provide cost-effective, safe, environmentally compliant, and reliable service to its customers. The Company always seeks to maintain its financial strength and flexibility, including its strong investment-grade credit ratings, ensuring reliable access to capital on reasonable terms. Specific objectives that support financial strength and flexibility include: (a) maintaining at least 53 percent common equity for Duke Energy Indiana on a financial capitalization basis; (b) ensuring timely recovery of prudently incurred costs; (c) maintaining sufficient cash flows to meet obligations; and (d) maintaining a sufficient return on equity to fairly compensate shareholders for their invested capital. The ability to attract capital (both debt and equity) on reasonable terms is vitally important to the Company and its customers, and each of these specific objectives helps the Company both to maintain its investment-grade credit ratings and to meet its overall financial objectives.

Q. DO DUKE ENERGY INDIANA'S CUSTOMERS BENEFIT FROM THE COMPANY'S STRONG CREDIT RATINGS?

A. Yes. To ensure reliable and cost-effective service, and to fulfill its obligations to serve customers, the Company must continuously plan and execute major capital projects. This is the nature of regulated, capital-intensive industries like electric and gas utilities. The Company must be able to operate and maintain its business without interruption and refinance maturing debt on time, regardless of financial market conditions. The financial markets can experience periods of volatility, and Duke Energy Indiana must be able to finance its needs throughout such periods. Strong investment-grade credit ratings provide

Duke Energy Indiana with greater access to the capital markets on reasonable terms during such periods of volatility.

Q. WHAT RATEMAKING TREATMENT IS BEING REQUESTED IN THIS PROCEEDING AND HOW WILL THE COMPANY'S FINANCIAL OBJECTIVES BE IMPACTED?

A. As explained by Company witness Ms. Graft, Duke Energy Indiana is requesting an overall rate increase of approximately 16.2% percent, equating to an increase in pre-tax revenue requirement of approximately $491.5 million after both Step 1 and Step 2 increases.

This requested rate relief is premised, in part, on a forecasted capital structure of 47 percent debt and 53 percent equity. It is also based on a forecasted cost of debt of 4.87 percent, and a forecasted cost of equity of 10.5 percent, as discussed in the testimony of Company witnesses Mr. McKenzie and Mr. Pinegar. My testimony explains and supports the capital structure and cost of debt.

Approval of the Company's request in this case will support its financial objectives by allowing timely recovery of its investments in plant and equipment, providing sufficient cash flows to fund necessary capital expenditures and service debt, and will provide a fair and reasonable return to equity investors.

Q. PLEASE EXPLAIN CREDIT QUALITY AND CREDIT RATINGS, AND HOW THEY ARE DETERMINED.

A. Credit quality (or creditworthiness) is a term used to describe a company's overall financial health and its willingness and ability to repay all financial obligations in full and on time. An assessment of Duke Energy Indiana's creditworthiness is performed by two major credit rating agencies, Standard & Poor's ("S&P") and Moody's Investors Service ("Moody's"), and results in Duke Energy Indiana's credit rating.

Many qualitative and quantitative factors go into this assessment. Qualitative aspects may include Duke Energy Indiana's regulatory climate, its track record for delivering on its commitments, the strength of its management team, its operating performance, and the economic vitality and customer profile of its service area. Quantitative measures are primarily based on operating cash flow and focus on the level at which Duke Energy Indiana maintains debt leverage in relation to its generation of cash and its ability to meet its fixed obligations (interest expense in particular) based on internally generated cash. The percentage of debt to total capital is another example of a quantitative measure. Creditors and credit rating agencies view both qualitative and quantitative factors in the aggregate when assessing the credit quality of a company.

Q. WHAT IS THE ROLE OF REGULATION IN THE DETERMINATION OF THE FINANCIAL STRENGTH OF A UTILITY COMPANY?

A. Investors, investment analysts, and credit rating agencies regard constructive regulation as one of the most important factors in assessing a utility company's financial strength. The regulatory environment is comprised of two important factors, the regulatory framework and the predictability and consistency of decision making. These stakeholders want to be confident that the Company operates in a stable regulatory environment that will allow the Company to recover prudently incurred costs and earn a reasonable return on investments necessary to meet the demand, reliability, service, and environmental requirements of its customers and service area.

Important considerations of a strong regulatory framework include the allowed rate of return, the cash quality of earnings, the timely recovery of capital investments, the stability of earnings, and the strength of the utility's capital structure. Positive consideration is also given for utilities operating in states where the regulatory process is streamlined, the time lag in capital investment recovery is minimized through cost recovery mechanisms such as riders and trackers, and outcomes are equitably balanced between customers and investors. Further considerations that demonstrate a strong regulatory environment include the track record of regulatory decisions in terms of consistency, predictability, and supportiveness.

Q. HOW ARE DUKE ENERGY INDIANA'S OUTSTANDING SECURITIES CURRENTLY RATED BY THE CREDIT RATING AGENCIES?

A. As of the date of this testimony, Duke Energy Indiana's outstanding debt is rated as follows:

Table 1:

Rating Agency	S&P	Moody's
Issuer / Corporate Credit Rating	BBB+	A2
Senior Secured	A	Aa3
Outlook	Stable	Stable

Obligations carrying a credit rating in the "A" category are considered strong, investment-grade securities subject to low credit risk for the investor. "A" rated debt is presumed to be susceptible to changes in circumstances and economic conditions;

however, the debt issuer's capacity to meet its financial commitments is considered strong. By contrast, ratings in the "BBB" category are considered adequate and have less assurance of access to the capital markets in challenging market conditions. AA and Aa category ratings for S&P and Moody's, respectively, are stronger than A ratings.

S&P may also modify its ratings with the use of a plus or minus sign to further indicate the relative standing within a major rating category. An "A+" credit rating is at the higher end of the "A" credit rating category and an "A-" is at the lower end of the category. Moody's credit rating assignments use the numbers "1," "2," and "3," with the numbers "1" and "3" analogous to a "+" and "-," respectively. For example, Moody's credit ratings of "A2" and "A3" would be analogous to "A" and "A-" credit ratings at S&P, respectively.

The ratings outlook assesses the potential direction of a long-term credit rating over an intermediate term (typically six months to two years). Duke Energy Indiana's "Stable" outlook at S&P and Moody's means that those credit ratings are not likely to change at this time; however, a change in outlook or rating could occur if the Company experiences a change in its qualitative or quantitative credit quality. S&P utilizes a family rating methodology, whereby the credit rating and outlook of the parent company, Duke Energy Corporation, is applied to each of the parent's subsidiaries.

Q. WHAT STRENGTHS AND WEAKNESSES HAVE THE CREDIT RATING AGENCIES IDENTIFIED WITH RESPECT TO DUKE ENERGY INDIANA?

A. The rating agencies believe Duke Energy Indiana operates in a generally constructive regulatory environment that supports long-term credit quality. In particular, Duke Energy

Indiana's authorized rider and tracker mechanisms allow for timely recovery of expenditures for purchased power and energy efficiency costs, as well as recovery and a return on investments for infrastructure integrity improvements and environmental compliance. Filing for base rate increases using a forward-looking test period is also viewed favorably by the rating agencies. However, the rating agencies have identified a number of challenges the Company faces in maintaining its credit ratings. In June 2023, Moody's identified several factors that could adversely impact the Company's financial metrics (specifically, cash flow coverage ratios), which, in turn, could affect its ratings:[1]

- A decline in the credit supportiveness of the utility's regulatory framework: Moody's identifies the current regulatory environment and suite of cost recovery mechanisms as credit supportive. Changes to this environment could potentially pressure the credit profile of the Company.
- Regulatory Lag: This refers to the delayed recovery on investments the Company makes between rate cases and how this puts pressure on credit metrics. Moody's cites regulatory lag in recovery of environmental and coal ash compliance costs and grid modernization investments as a credit challenge for the Company, particularly during periods of elevated capital expenditures.
- Elevated Carbon Transition Risk: Moody's also points to Duke Energy Indiana's elevated carbon transition risk within the regulated utility sector because of its relatively high coal generation ownership.

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[1] *See* Moody's Investors Service, Credit Opinion, "Duke Energy Indiana, LLC" June 30, 2023 ("June 2023 DE Indiana Report").

- Cash Flow from Operations (pre-working capital)/Debt levels falling below 22% on a sustained basis: This important metric used by Moody's measures the cash generating ability of a utility compared to its total debt. A higher percentage gives creditors and investors greater confidence that the utility is generating adequate cash flows to meet its financial obligations and debt service costs.

Q. WHAT IS THE CURRENT RATINGS OUTLOOK FOR U.S. REGULATED UTILITIES?

A. In its May 18, 2023 report, S&P revised their outlook for North American Regulated Utilities to stable from negative. S&P states that "our reassessment of the sector follows three years in which downgrades significantly outpaced upgrades," and "we expect future downgrades and upgrades will be more balanced over the next two years." However, S&P also notes that "[s]ignificant risks for the industry remain, including inflation, record levels of capital spending, and the practice of many companies to operate with minimal financial cushion from their downgrade thresholds." [2]

Moody's revised its sector outlook from negative to stable in its September 7, 2023 Outlook report. Moody's stable outlook is due, in part, to a more supportive U.S. regulatory environment than anticipated for utilities and lower financial and cost recovery risks due to abating natural gas prices and inflation. Like S&P, Moody's notes that many risks remain for the industry, including higher interest rates and elevated capital spending

[2] *See* S&P Global Ratings, Research, "The Outlook For North American Regulated Utilities Turns Stable" May 18, 2023 ("May 2023 S&P Report").

to reduce carbon emissions and improve system reliability and resilience. Lastly, Moody's states "[w]e would consider changing our outlook to negative if there is a sustained decline in regulatory support for timely cost recovery, capital markets access becomes less certain or the availability of bank credit facilities becomes constrained, or if sector FFO-to-debt dips materially below 14% in 2024 and beyond."[3]

III. CAPITAL STRUCTURE AND COST OF CAPITAL

Q. WHAT ARE DUKE ENERGY INDIANA'S CURRENT AND FORECASTED FINANCIAL CAPITAL STRUCTURES?

A. Duke Energy Indiana's current (as of August 31, 2023) financial capital structure is 47.6 percent long-term debt and 52.4 percent equity. Duke Energy Indiana's capital structure is forecasted to be 47 percent long-term debt and 53 percent equity at the end of 2025 (the end of the Forward-Looking Test Period). This forecasted capital structure is consistent with the Company's target capital structure of 47 percent long-term debt and 53 percent equity for Duke Energy Indiana as it introduces an appropriate amount of risk due to leverage while minimizing the weighted average cost of capital to customers. Use of the forecasted capital structure in setting Duke Energy Indiana's rates will help Duke Energy Indiana maintain its credit quality. This level is also consistent with the Company's target credit metrics needed to support its current credit ratings.

Q. DOES THE ACTUAL FINANCIAL CAPITAL STRUCTURE VARY OVER TIME?

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[3] *See* Moody's Investor Service, Outlook, "Outlook turns stable on low natural gas prices and credit-supportive regulation" September 7, 2023 ("September 2023 Moody's Report").

A. Yes, it does. The specific debt/equity ratio will vary over time, depending on a variety of factors, including, among other things, the timing and size of capital investments and payments of large invoices, debt issuances, seasonality of earnings, and dividend payments to the parent company. Maintaining a regulatory capital structure of 47/53 is consistent with the Company's financial objectives and overall plan to maintain its ability to finance operations at rates favorable for customers. Duke Energy Indiana manages its capital structure within a reasonable range of this base.

Q. WHAT IS DUKE ENERGY INDIANA'S COST OF EQUITY?

A. Company witness Mr. McKenzie, who has separately filed testimony, indicates that the Company's cost of equity is 10.8 percent. Though the Company supports Mr. McKenzie's analysis, for rate mitigation purposes, the Company is proposing an authorized return on equity of 10.5 percent, as discussed by Company witness Mr. Pinegar.

Q. WHAT ROLE DO EQUITY INVESTORS PLAY IN THE FINANCING OF DUKE ENERGY INDIANA, AND HOW WILL THE OUTCOME OF THIS CASE IMPACT THESE INVESTORS?

A. Equity investors provide the foundation of a company's capitalization by providing significant amounts of capital, for which an appropriate economic return is required. Duke Energy Indiana compensates equity investors for the risk of their investment by targeting fair and adequate returns, a stable dividend, and earnings growth - these are all necessary to preserve access to equity capital. Returns to equity investors are realized only after all operating expenses and fixed payment obligations (including debt principal and interest) of the business have been paid. Because equity investors are the last to receive surplus earnings and cash flows, their investment involves significantly more risk. For this reason, equity investors require a higher return for their investment. Equity investors expect utilities like Duke Energy Indiana to recover their prudently incurred costs and earn a fair and reasonable return for their investors. The Company's proposal in this proceeding supports this investor requirement.

Q. WHAT EFFECT DO CAPITAL STRUCTURE AND RETURN ON EQUITY HAVE ON CREDIT QUALITY?

A. Capital structure and return on equity are important components of credit quality. As mentioned in the previous answer, the greater the equity component of capitalization, the safer the returns are to debt investors, which translates into higher credit quality and lower borrowing costs. In addition, the allowed return on equity is a key component in the generation of earnings and cash flows. An adequate return on equity helps ensure equity investors receive fair compensation for their investment while also helping to protect the interests of debt investors. A strong capital structure and an adequate return on equity provide balance sheet protection and cash flow generation to support high credit quality. Strong credit quality creates financial flexibility by providing more readily available access to the capital markets on reasonable terms, and ultimately lower debt financing costs. Conversely, a weak capital structure and an inadequate allowed return on equity produce lower earnings and cash flows, lowers credit quality, and may limit financial flexibility.

Q. DO YOU BELIEVE THAT DUKE ENERGY INDIANA'S CAPITAL STRUCTURE HAS AN ADEQUATE EQUITY COMPONENT TO ENABLE DUKE ENERGY INDIANA TO ACHIEVE THE COMPANY'S FINANCIAL STRENGTH AND CREDIT QUALITY OBJECTIVES?

A. Yes. Duke Energy Indiana's equity component, as reflected in this case, enables it to maintain current credit ratings and financial strength and flexibility. This level of equity enables the Company to tolerate different business cycles while also providing more confidence to the Company's lenders and bondholders. Like many utilities, Duke Energy Indiana is in a period of significant capital investment necessary to provide cost-effective, safe, environmentally compliant, and reliable service to its customers in a time of rising costs, lower load growth, and rapidly evolving state and federal requirements. The magnitude of its capital requirements dictates the need for a strong equity component of the Company's capital structure to ensure access to capital funding at reasonable terms.

Q. WHAT ARE DUKE ENERGY INDIANA'S CURRENT AND FORECASTED AVERAGE COSTS OF LONG-TERM DEBT?

A. Duke Energy Indiana's current (as of August 31, 2023) weighted average cost of long-term debt is 4.83%. Duke Energy Indiana's weighted average cost of long-term debt is forecasted to be 4.87% at the end of 2025 (the end of the Forward-Looking Test Period).

Q. WHAT ARE DUKE ENERGY INDIANA'S PROJECTED CAPITAL REQUIREMENTS OVER THE NEXT FIVE YEARS?

A. Duke Energy Indiana faces substantial capital needs over the next several years to satisfy debt maturities, comply with environmental requirements, refurbish, replace and upgrade aging infrastructure, construct or acquire needed generation resources, strengthen and modernize the energy grid, continue to invest in energy efficiency, and to satisfy its debt maturities.

Q. HOW WILL DUKE ENERGY INDIANA'S CAPITAL REQUIREMENTS BE FUNDED?

A. Duke Energy Indiana's capital requirements are expected to be funded from internal cash generation, the issuance of debt, and equity funding.

IV. CONCLUSION

Q. DID YOU PROVIDE COMPANY WITNESS MR. RUTLEDGE WITH 2025 FINANCIAL FORECAST ASSUMPTIONS (CAPITAL STRUCTURE AND COST OF DEBT) FOR HIS USE IN PREPARING THE 2025 DUKE ENERGY INDIANA FORECAST?

A. Yes, I did.

Q. DOES THIS CONCLUDE YOUR PRE-FILED DIRECT TESTIMONY?

A. Yes.

Cause No. 46038

VERIFICATION

I hereby verify under the penalties of perjury that the foregoing representations are true to the best of my knowledge, information and belief.

Signed:______________________________ Dated: April 4, 2024
Chris Bauer