

SOUTHERN INDIANA GAS AND ELECTRIC COMPANY
d/b/a VECTREN ENERGY DELIVERY OF INDIANA, INC.
A CENTERPOINT ENERGY COMPANY
(VECTREN SOUTH)

IURC CAUSE NO. 45447

DIRECT TESTIMONY
OF
ROBERT B. MCRAE
VICE PRESIDENT AND TREASURER

ON

CAPITAL STRUCTURE AND COST OF DEBT

Glossary of Acronyms

CenterPoint	CenterPoint Energy, Inc.
Company	Southern Indiana Gas and Electric Company d/b/a Vectren Energy Delivery of Indiana, Inc.
FSA	Financial Services Agreement
IURC or Commission	Indiana Utility Regulatory Commission
Petitioner	Southern Indiana Gas and Electric Company d/b/a Vectren Energy Delivery of Indiana, Inc.
Service Company	CenterPoint Energy Service Company, LLC
Vectren	Southern Indiana Gas and Electric Company d/b/a Vectren Energy Delivery of Indiana, Inc.
Vectren North	Indiana Gas Company, Inc. d/b/a Vectren Energy Delivery of Indiana, Inc.
Vectren South	Southern Indiana Gas and Electric Company d/b/a Vectren Energy Delivery of Indiana, Inc.
Vectren Ohio	Vectren Energy Delivery of Ohio, Inc.
VUHI	Vectren Utility Holding Inc

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DIRECT TESTIMONY OF ROBERT B. MCRAE

1 **I. INTRODUCTION**

2

3 **Q. Please state your name and business address.**

4 A. My name is Robert Bruce McRae. My business address is 1111 Louisiana St,
5 Houston, TX 77002.

6

7 **Q. By whom are you employed?**

8 A. I am employed by CenterPoint Energy Service Company, LLC ("Service Company"),
9 a wholly-owned subsidiary of CenterPoint Energy, Inc. ("CenterPoint"). The Service
10 Company provides centralized support services to CenterPoint's operating units,
11 which includes Vectren Corporation ("Vectren"), a wholly-owned subsidiary of
12 CenterPoint.

13

14 **Q. On whose behalf are you testifying in this proceeding?**

15 A. I am testifying on behalf of Southern Indiana Gas and Electric Company d/b/a Vectren
16 Energy Delivery of Indiana, Inc. ("Petitioner", "Vectren South" or "the Company"),
17 which is a subsidiary of Vectren.

18

19 **Q. What is your role with respect to Petitioner Vectren South?**

20 A. I am Vice President and Treasurer for CenterPoint, the ultimate parent company of
21 Vectren South. I have the same role with two other utility subsidiaries of Vectren –
22 Indiana Gas Company, Inc. d/b/a Vectren Energy Delivery of Indiana, Inc. ("Vectren
23 North") and Vectren Energy Delivery of Ohio, Inc. ("Vectren Ohio").

1 **Q. Please describe your educational background.**

2 A. I have a Bachelor of Science in Management from Brigham Young University and a
3 Master of Business Administration from Indiana University's Kelley School of
4 Business.

5

6 **Q. Please describe your professional experience.**

7 A. I have been employed by CenterPoint since 2011 and have held various positions
8 within the company. From 2011 to 2012, I was a lead analyst in the Corporate Strategic
9 Planning group responsible for assisting various business units and functions with the
10 creation of their strategic plans. From 2012 to 2015 I was a manager in the Investor
11 Relations group where I was responsible for communicating financial, strategic, and
12 operational information to existing and prospective investors and research analysts.
13 Since 2015 I have worked in the Treasury group.

14

15 **Q. Provide some specific examples of activities you have undertaken during your
16 time in the Treasury department.**

17 A. I have managed the debt service and compliance of more than \$15 billion of external
18 debt, led 16 external bond offerings aggregating \$5.7 billion, led multiple transactions
19 regarding CenterPoint and its subsidiaries' \$5.1 billion credit agreements, co-led a \$5
20 billion Bridge facility syndication, among other things.

21

22 **Q. What are your present duties and responsibilities as Vice President and
23 Treasurer?**

24 A. I am responsible for all Treasury functions of CenterPoint and its subsidiaries,
25 including Vectren, the parent company of Vectren South. Treasury includes all short-

1 term and long-term financing, short-term investing, cash management, pension and
2 savings plan administration, banking relationships, and rating agency relationships. In
3 addition, I am responsible for the credit risk function of CenterPoint and CenterPoint
4 Energy Houston Electric, LLC.

5

6 **Q. Have you ever testified before any state regulatory commission?**

7 A. Yes. Although I have not testified before the Indiana Utility Regulatory Commission
8 ("IURC" or "the Commission"), I have testified on behalf of CenterPoint Energy
9 Houston Electric, LLC in dockets 48226 and 49421 and on behalf of CenterPoint
10 Energy Minnesota Gas in dockets G-008/GR-17-285 and G-008/GR-19-524.

11

12 **Q. What is the purpose of your testimony in this proceeding?**

13 A. My testimony will provide an overview of the components of Vectren South's capital
14 structure and its weighted average cost of capital.

15

16 **Q. Are you sponsoring any attachments in this proceeding?**

17 A. Yes. I am sponsoring the following attachments in this proceeding:

- 18 • The D Schedules of Petitioner's Exhibit No. 18, Capital Structure and Cost of
19 Capital

20

21 **Q. Were these schedules prepared by you or under your supervision?**

22 A. Yes, they were.

23

24

1 **II. CAPITAL STRUCTURE**

2

3 **Q. What topics do you discuss in this section of your testimony?**

4 A. In this part of my testimony I explain the importance of establishing a capital structure
5 that will help preserve the financial integrity of the Company, thereby allowing it to
6 maintain access to capital on reasonable terms in all market conditions. Next, I
7 describe the Company's projected capital structure for the test year and I explain why
8 that capital structure is reasonable.

9

10 **Q. What does the phrase "capital structure" mean in the context of utility**
11 **ratemaking?**

12 A. "Capital structure" refers to the percentages of debt and equity used to finance the
13 assets and perform the operations necessary to provide service to customers. The
14 primary sources of capital to finance long-term assets of the Company are long-term
15 debt and common equity. Capital structure is typically expressed in terms of the ratio
16 of a particular type of capital to total capital. Thus, for example, a utility with a total
17 capitalization of \$1 billion, long-term debt of \$450 million, and common equity of \$550
18 million would have a capital structure composed of 45% long-term debt and 55%
19 common equity.

20

21 **Q. Are there other capital structure components other than investor provided debt**
22 **and equity used to determine Vectren South's requested capital structure?**

23 A. Yes. In addition to investor provided debt and equity, there are several additional
24 components included in the regulatory capital structure calculation such as customer
25 deposits, accumulated deferred income taxes, prepaid pension and investment tax

1 credits. Petitioner's Exhibit No. 18, Schedule D-1 details all of the components used
2 to calculate the Company's requested capital structure.

3

4 **Q. Why does a utility finance its assets and operations with different types of**
5 **capital?**

6 A. A utility typically uses different types of capital because the various elements of capital
7 have different risks, and, hence, different costs. Debt is less risky than equity because
8 debt holders are senior to equity holders in terms of having a claim on the utility's
9 assets, and for that reason debt is generally cheaper than equity. Additionally, income
10 tax deductibility of interest expense, in contrast with the non-deductibility of most types
11 of cash dividends, further reduces the after-tax cost of debt capital. As a utility
12 increases the proportion of debt in its capital structure, however, lenders increasingly
13 demand higher returns to offset the risk of default. Utilities and other companies
14 therefore try to strike a balance that will provide dependable access to capital in a cost-
15 effective manner.

16

17 **Q. What is the forecasted capital structure for this case?**

18 A. Table RBM-1 below details the Company's forecasted capital structure.

19

Table RBM-1

Long-Term Debt	37.86%
Preferred Stock	0.00%
Common Equity	47.20%
Cost Free Capital	14.42%
Other Capital	0.52%
Total Capital	100.00%

1 **Q. What investor provided capital structure is reflected in the Company's**
2 **forecasted capital structure?**

3 A. As is detailed in workpapers to Petitioner's Exhibit No. 18, D Schedules, WPD D-1.1,
4 the investor provided capital structure consists of 44.51% long-term debt and 55.49%
5 common equity. This reflects a projected capital structure and will be updated to actual
6 as of June 30, 2021 for Phase 1 rates, and actual as of December 31, 2021 for Phase
7 2 rates, as discussed by Petitioner's Witness Angie M. Bell.

8

9 **Q. Does the Company directly issue equity into the external capital markets?**

10 A. No, the sources of the equity on the Company's balance sheet are: (1) equity
11 contributions from Vectren Utility Holdings, Inc ("VUHI"); and (2) retained earnings
12 from operations. The Company may make periodic dividend payments to VUHI to
13 ensure that the Company's equity ratio remains within a reasonable range, and VUHI
14 may make equity contributions to the Company for the same purpose. VUHI, in turn,
15 obtains equity financing ultimately from CenterPoint.

16

17 **Q. Does the Company issue debt into the external capital markets?**

18 A. Occasionally, the Company does issue debt in the public or private debt capital
19 markets, however the majority of its debt capital is issued to VUHI. Historically, only
20 tax-exempt financing related to qualifying environmental expenditures has been
21 issued to external debt capital markets.

22

23 **Q. Are there any forecasted debt issuances included in Vectren South's investor**
24 **provided capital structure during the test year?**

25 A. There is a \$125 million note planned for issuance in 2021. \$55 million of that issuance

1 will be used to refinance maturing debt and the remainder will be incremental long-
2 term debt that is used to term out short-term borrowing and invest in capital
3 expenditures. Additionally, although not a part of the test year, \$81 million of
4 previously issued VUHI notes will be loaned to Vectren South in November 2020 and
5 reported to the Commission in accordance with Cause No. 45170 reporting
6 requirements.

7

8 **Q. You testified earlier that the Company's investor provided capital structure**
9 **includes 55.49% common equity. Why is that percentage reasonable and**
10 **appropriate?**

11 A. The projected common equity ratio of 55.49% as of the end of the test year is
12 reasonable for several reasons. First, it is consistent with equity ratios found to be
13 reasonable for other utilities within Indiana in recent Commission orders. Second, it is
14 reasonable as compared to the equity ratios of the Company's proxy group, as
15 presented by Petitioner's Witness Ann E. Bulkley. Finally, this is consistent with
16 current financing authority as approved in Cause No. 45170 for Vectren South.

17

18 **Q. You testified that a 55.49% equity ratio is consistent with equity ratios found by**
19 **the Commission to be reasonable for other utilities. What findings are you**
20 **referring to?**

21 A. The IURC issued an order in the Duke Energy rate case (Cause No. 45253) on June
22 29, 2020 which included an investor provided equity ratio of 53%. Additionally, the
23 IURC issued an order approving a settlement in the NIPSCO electric rate case (Cause
24 No. 45159) on December 4, 2019 which included an investor provided equity ratio of
25 57% and an order approving a settlement in the NIPSCO gas rate case (Cause No.

1 44988) on September 19, 2018 which included an investor provided equity ratio of
2 56.02% at the end of the test year in that case. Given that the equity ratio being
3 requested in this case is within the range of these recent orders, the request is
4 reasonable.

5

6 **Q. Your second reason for testifying that a 55.49% equity ratio is reasonable is that**
7 **it is reasonably comparable to the equity ratios of the Company's proxy group.**
8 **Has the Company provided an analysis comparing its proposed equity ratio to**
9 **the equity ratios of the proxy group companies?**

10 A. Petitioner's Witness Bulkley's direct testimony demonstrates that equity ratios of the
11 proxy group range from 50.03% to 66.58% with an average of 58.88%. As Petitioner's
12 Witness Bulkley states, this demonstrates that Vectren South's projected equity ratio
13 of 55.49% is near the average equity ratio for the utility operating subsidiaries of the
14 proxy groups."

15

16 **Q. You testified earlier that the Company is requesting approval of a capital**
17 **structure containing 44.51% long-term debt. Is that debt ratio reasonable?**

18 A. Yes. That long-term debt ratio reflects projected long-term debt issuances during the
19 test year. See Petitioner's Exhibit No. 18, Schedule D-1. The determination of the cost
20 of debt associated with those projected issuances is discussed below.

21

22

23 **III. COST OF CAPITAL**

24

25 **Q. What topics do you discuss in this section of your testimony?**

1 A. I discuss the components of the Company's weighted average cost of capital.

2

3 **Q. What is the Company's requested weighted average cost of capital?**

4 A. The Company's requested weighted average cost of capital is 6.18%.

5

6 **Q. What is the weighted cost of the long-term debt portion of Vectren South's**
7 **capital structure?**

8 A. As shown in Petitioner's Exhibit No. 18, Schedule D-1, Vectren South's forecasted
9 weighted average cost of long-term debt as of the end of the test year is 3.59%. The
10 details used to calculate this cost of long-term debt are shown in Petitioner's Exhibit
11 No. 18, Schedule D-2. This cost rate reflects the carrying value of the long term debt,
12 which reflects the unamortized issuance costs.

13

14 **Q. Previously you had mentioned that one source of debt capital was intercompany**
15 **notes between VUHI and the Company. How are the interest rates for those**
16 **notes determined?**

17 A. The interest on the intercompany notes between VUHI and the Company is governed
18 by the Financial Services Agreement ("FSA") each entity entered into as of December
19 31, 2011. Per the FSA, "interest shall be charged on the unpaid outstanding balance
20 ... at a rate per annum equal to the rate paid and to be paid by Lender with respect to
21 the borrowings it made in order to provide funds to Borrower hereunder." For example,
22 if VUHI borrows \$100 million at a rate of 4.0%, any intercompany notes put in place
23 between VUHI and the Company associated with that \$100 million borrowing would
24 carry the same 4.0% interest rate.

25

1 **Q. Vectren South's external debt has typically been issued at a lower cost than the**
2 **intercompany notes it receives from VUHI. Why is that?**

3 A. The cost differential is based on several factors. First, most of Vectren South's external
4 notes are tax-exempt municipal bonds which traditionally have a lower coupon as a
5 result of their tax-exempt status. Second, Vectren South's external bonds are secured
6 by a mortgage. A secured note is viewed as less risky as compared to an unsecured
7 note, therefore the interest rate required by an investor is less. Third, the stand-alone
8 credit rating of the Company's external bonds is of higher quality than that of VUHI.
9 And lastly, many of the Vectren South issued notes are variable rate notes, meaning
10 the interest rate changes on a monthly basis. When interest rates are low, the interest
11 expense of those notes is decreased as well; however, if interest rates rise, the interest
12 expense will also increase. Currently, interest rates are very low and therefore have a
13 cost advantage over fixed rate notes at VUHI that may have been issued when interest
14 rates were higher.

15
16 **Q. Earlier in your testimony you mentioned that there was an expected debt**
17 **issuance planned for the test year. What is the interest rate assumed for that**
18 **issuance and what is the impact to the cost of long-term debt?**

19 A. The \$125 million planned issuance during the test year assumes a coupon of 2.81%
20 which is very favorable as compared to the \$55 million note that is maturing in 2021
21 which has an interest rate of 4.67%. Also, the \$81 million of notes that will be allocated
22 from VUHI to Vectren South will carry coupons of 3.42% on \$40 million and 1.21% on
23 the remaining \$41 million. These low coupons are included in the proposed cost of
24 long-term debt and have the effect of lowering the cost of debt to the proposed 3.59%.

25

1 **Q. What was the cost of equity used to calculate the Company's proposed cost of**
2 **capital?**

3 A. The cost of equity used in the determination of the overall cost of capital was 10.15%.
4 Details regarding the cost of equity estimate can be found in Petitioner's Witness
5 Bulkley's direct testimony.

6

7 **Q. Are there other capital structure components for purposes of determining**
8 **Vectren South's cost of capital?**

9 A. Yes. As mentioned earlier, Petitioner's Exhibit No. 18, Schedule D-1 and the
10 supporting workpapers contain a listing of those components and their proposed
11 weighted average interest rates. That schedule includes customer deposits at a 4.22%
12 weighted average interest rate and investment tax credits at a rate of 7.23%.

13

14 **Q. Are there any cost-free components included in Vectren South's proposed cost**
15 **of capital?**

16 A. Yes. Accumulated deferred income taxes, customer advances for construction, OPEB,
17 and prepaid pension were included at zero cost. Accumulated deferred income taxes
18 are addressed by Petitioner's Witness Brenda L. Musser. Customer advances for
19 construction are discussed by Petitioner's Witness Bell.

20

21 **Q. What is the prepaid pension asset and why is it included in the capital structure?**

22 A. The prepaid pension asset is the difference between the cumulative contributions to
23 the pension fund and the cumulative accruals of pension expense. In other words,
24 these are amounts that have been paid into the pension fund in excess of cumulative
25 pension expense. Once amounts are contributed to the fund, the Company no longer

1 has access to these amounts – they must remain in the fund. The prepaid pension
2 asset provides a benefit to customers in that it serves to reduce pension expense that
3 would otherwise be accrued and recovered in rates. I understand that in Indiana there
4 have been two recognized methods for including the value of the prepaid pension
5 asset in ratemaking: some utilities have included the prepaid pension asset in rate
6 base, and other utilities have included the prepaid pension asset in the capital structure
7 as an offset to zero cost capital. Both methods have been accepted by this
8 Commission. We have elected to include the prepaid pension asset in the capital
9 structure.

10

11 **Q. You also mentioned OPEB. What is that and why is it in the capital structure?**

12 A. This results from the adoption of Financial Accounting Standards No. 106 nearly thirty
13 years ago, which requires that postretirement benefits other than pensions be reflected
14 on an accrual basis. The difference between the accrued expense under generally
15 accepted accounting principles and the amount that is paid out on a pay-as-you-go
16 basis is reflected either as a rate base offset or as a component of zero cost capital.
17 The Company has historically reflected it as zero cost capital. This treatment is the
18 mirror image of the treatment of the prepaid pension asset, and so the OPEB zero cost
19 capital is an offset to the prepaid pension asset in the capital structure.

20

21 **IV. CONCLUSION**

22

23 **Q. Does this conclude your prepared direct testimony?**

24 A. Yes, it does.

VERIFICATION

I, Robert B. McRae, affirm under the penalties of perjury that the forgoing representations of fact in my Direct Testimony are true to the best of my knowledge, information and belief.



Robert B. McRae

Dated: October 30, 2020