Witness OCS - 3D

BEFORE THE

PUBLIC SERVICE COMMISSION OF UTAH

IN THE MATTER OF THE JOINT NOTICE AND APPLICATION OF QUESTAR GAS COMPANY AND DOMINION RESOURCES, INC. OF PROPOSED MERGER OF QUESTAR CORPORATION AND DOMINION RESOURCES, INC.	))))))	**DOCKET NO. 16-057-01**

DIRECT TESTIMONY

AND EXHIBITS

OF

RICHARD A. BAUDINO

ON BEHALF OF THE

OFFICE OF CONSUMER SERVICES

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JULY 7, 2016

DIRECT TESTIMONY OF RICHARD A. BAUDINO

QUALIFICATIONS AND SUMMARY

Q. Please state your name and business address.

A. My name is Richard A. Baudino. My business address is J. Kennedy and Associates, Inc. ("Kennedy and Associates"), 570 Colonial Park Drive, Suite 305, Roswell, Georgia 30075.

Q. What is your occupation and by whom are you employed?

A. I am a consultant to Kennedy and Associates.

Q. Please describe your education and professional experience.

A. I received my Master of Arts degree with a major in Economics and a minor in Statistics from New Mexico State University in 1982. I also received my Bachelor of Arts Degree with majors in Economics and English from New Mexico State in 1979.

I began my professional career with the New Mexico Public Service Commission Staff in October 1982 and was employed there as a Utility Economist. During my employment with the Staff, my responsibilities included the analysis of a broad range of issues in the ratemaking field. Areas in which I testified included cost of service, rate of return, rate design, revenue requirements, analysis of sale/leasebacks of generating plants, utility finance issues, and generating plant phase-ins.

In October 1989, I joined the utility consulting firm of Kennedy and Associates as a Senior Consultant where my duties and responsibilities covered substantially the same areas as those during my tenure with the New Mexico Public Service Commission Staff. I became Manager in July 1992 and was named Director of Consulting in January 1995. Currently, I am a consultant with Kennedy and Associates.

Exhibit ____(RAB-1) summarizes my expert testimony experience.

Q. On whose behalf are you testifying?

A. I am testifying on behalf of the Utah Office of Consumer Services ("OCS").

Q. Please state the purpose of your testimony.

A. The purpose of my testimony is to address the credit quality and service quality risks to customers resulting from the proposed merger between Dominion Resources, Inc. ("Dominion") and Questar Gas Company ("Questar") and to present my conclusions and recommendations regarding certain customer protections in the form of conditions that should be ordered by the Public Service Commission of Utah ("Commission") if it approves the merger. The risks and conditions that I address are a subset of the risks and conditions that have been identified by the OCS and that are addressed more generally by OCS witness Mr. Lane Kollen.

Q. Please summarize your testimony.

A. Consistent with the Direct Testimony of OCS witness Mr. Kollen, I recommend that the Commission deny the proposed merger unless it imposes necessary conditions to protect ratepayers from adverse consequences in the areas of credit quality and service quality. I recommend that the Commission order the following conditions if it approves the proposed merger:

1. Questar Gas Company shall not pass through any increases in credit costs caused by the proposed merger. Credit Costs shall be defined as incremental costs of common equity, costs of new issuances of long-term debt, and costs of short-term debt due to any downgrading in corporate wide credit and/or utility-specific credit rating(s) within ten years after announcement of merger as well as the effects of any increases in common equity as a percentage of capitalization.
2. Questar Gas Company's cost of equity shall be determined using a comparable group gas utilities with A bond ratings regardless of whether Questar Gas Company is rated A or is downgraded.
3. Dominion shall continue to provide no less than the same access to short-term debt, commercial paper, and other liquidity that Questar currently has in place. Questar's total liquidity through its current arrangements is $750 million.
4. Questar Gas Company shall continue to comply with the Commission's service quality guidelines adopted in Docket No. 02-057-02. The Commission and Division of Public Utilities (DPU) will continue to monitor current service quality measures as reported by Questar Gas Company. The "Annual Goals" currently contained in Questar's customer satisfaction standards shall be changed to "Minimum Service Metrics". The Commission should also impose financial penalties if Dominion fails to achieve the Minimum Service Metrics.

<u>CREDIT QUALITY RISKS AND PROTECTIONS</u>

Q. Please describe how the applicants intend to finance the proposed merger.

A. Applicants witness Fred Wood described the proposed financing for the merger beginning on line 70 of his Direct Testimony. Initially, Dominion will rely on bridge and term loans with various financial institutions and its own credit facility. These resources are expected to provide the entire $4.4 billion needed to fund the exchange of Questar Corporation for cash. Mr. Wood further testified that Dominion plans to use the proceeds from permanent financings "to preclude the need for or replace any funds borrowed under these existing credit facility, bridge and term loan agreements."

Questar Corporation and its subsidiaries' existing indebtedness, which total $1.7 billion as of December 31, 2015, will remain outstanding at Questar Corporation, Questar Gas, and Questar Pipeline, all of which will become direct or indirect subsidiaries of Dominion.

The Applicants provided additional information about the merger financing on page 19 of their presentation at the Utah Technical Conference dated April 28, 2016. Please refer to Exhibit ____(RAB-2) for the referenced page from this presentation. The contemplated permanent financing after closing the proposed merger transaction will consist of $1.45 billion of Dominion senior notes, $1.25 billion of Mandatory Convertible securities, $0.50 billion of Dominion equity, and $1.20 million of Master Limited Partnership drop proceeds.

Q. Have the major bond rating agencies responded to the proposed merger?

A. Yes. The Applicants provided rating agency reports from Fitch, Standard and Poor's ("S&P"), and Moody's that addressed the proposed merger with the attendant effects on Dominion's and Questar's ratings outlooks. Mr. Wood summarized the Applicants' credit and bond ratings and the ratings outlooks on pages 5 and 6 of his Direct Testimony.

Dominion's credit rating was lowered from A- to BBB+ by S&P after the merger announcement. S&P's rating outlook for Dominion is now stable. Fitch affirmed Dominion's Issuer Default Rating of BBB+. Moody's affirmed Dominion's corporate credit rating of Baa2.

Questar Corporation currently has an A credit rating from S&P. Questar Gas has an A2 rating from Moody's and an A rating from S&P. After the merger announcement, Questar Corporation's ratings were put on a review for downgrade from Moody's and were placed on a negative credit watch from S&P. Questar Gas' credit rating was affirmed by Moody's but was placed on a negative credit watch from S&P.

Q. What were the reasons expressed by S&P with respect to the credit rating outlook for Questar as a result of the proposed merger?

A. As Mr. Wood noted in his Direct Testimony, the negative outlook is associated with S&P's use of a group rating methodology for Questar once it becomes part of the Dominion corporate family. S&P stated that it expected to view Questar as "core to Dominion and therefore Questar's issuer credit rating would be aligned with Dominion's ‘BBB+’ group credit profile". S&P went on to state the following:

> The ratings on Questar, QGC, and QPC are on CreditWatch with negative implications, reflecting the prospect for a two-notch downgrade of Questar's issuer credit rating to 'BBB+' due to the company's agreement to be acquired by DRI. We expect to resolve the CreditWatch listing by the date of the transaction's closing, which could be by year-end 2016.
>
> We could lower our ratings on Questar, QGC, and QPC to align them with our ratings on DRI. (Joint Application, Exhibit 1.14, page 9 of 12)

Q. Mr. Baudino, what is your conclusion with respect to the credit risks for Questar from the proposed merger?

A. S&P's comments with respect to the negative outlook for Questar suggest that Questar Gas may lose it's A credit rating once the merger is completed. This would be due to the way that S&P employs its group rating methodology. Such a downgrading would be the direct result of the merger and Dominion's lower credit quality.

Q. If Questar Gas lost its A rating from S&P, is it possible that the Company's cost of capital would increase?

A. Yes. With a lower credit rating Questar Gas could face an increased cost of debt and equity. BBB-rated debt costs are higher than A-rated debt cost. For example, the Mergent Bond Record showed that the May 2016 yield on Baa public utility bonds was 4.60% compared to the A-rated public utility bond yield of 3.93%, a difference of 67 basis points.

In addition, since BBB/Baa rated utilities are perceived as riskier than A/A rated companies by investors, the required return on equity would also be higher. Thus, if Questar Gas is downgraded by S&P, the cost of equity would likely increase as well.

Q. Given the risk of downgrading and the attendant increase in the cost of capital for Questar, do you recommend that the Commission include measures to protect Utah ratepayers in the event that Questar's credit ratings are lowered due to the proposed merger?

A. Yes. I recommend that the Commission condition its approval of the proposed merger such that neither Questar nor Dominion may pass through to Utah customers any increases in the cost of debt and/or equity that result from the proposed merger. Absent such a condition with attendant credit protection measures, the Commission should deny the proposed merger.

Q. How could the Commission implement the credit risk protection that you recommend?

A. In the event of credit rating downgrades for Questar wherein the rating agency cites the merger as a factor in the downgrade, I recommend the Commission implement the following conditions:

1. For new long-term debt issued by Questar and/or Dominion on behalf of Questar, the Commission should use the lower of (1) an imputed debt cost with a rating equal to the rating before the downgrade, or (2) the actual debt cost. For Questar, the current bond rating is A/A from S&P and Moody's.
2. For all short-term debt, the Commission should use the lower of (1) an imputed A-rated debt cost, or (2) the actual debt cost, whichever is lower.

3. Questar's return on equity should be based on a comparison group of A-rated gas utilities.

Utah ratepayers must be protected from any resulting higher cost of debt that results from the proposed merger. Tying the cost of any new debt to the lower of actual debt cost or the pre-merger debt rating cost ensures adequate and reasonable protection for ratepayers.

This is also true for any increases in Questar's cost of equity resulting from a rating downgrade from the merger. If, for example, Questar's credit rating were lowered to BBB/Baa from its current A/A rating, the cost of equity would also rise as investors would consider Questar a higher risk company and, in turn, require a higher cost of equity. Utah ratepayers must be protected from this adverse outcome. Imputing a cost of equity based on A/A rated utilities would provide such a protection.

Q. Should this protection be extended to short-term debt cost?

A. Yes. After the closing, Questar Gas Company will obtain its short term financing through the Dominion credit facility and other Dominion sources of capital instead of through Questar Corporations' credit facility and other sources of capital. A credit downgrade of Dominion could affect the cost of short-term borrowing for Questar Gas. For example, Dominion has $4.5 billion of commercial paper, letters of credit, and additional capacity available under credit facilities as of December 31, 2015. Dominion's credit facilities and short-term debt are described on page 51 of its 2015 10-K Report that was included as Exhibit 1.10 in the Applicants' Joint Application. If the cost of borrowings under these credit facilities is negatively affected from bond downgrades, ratepayers should be protected from any such increased costs.

Q. Turning to short-term debt, what changes will the proposed merger cause with respect to Questar's access to short-term debt and other liquidity?

A. On page 12, lines 298 through 300 of his Direct Testimony Mr. Wood testified that Questar "will continue to benefit from access to the commercial paper market in the same manner that it currently utilizes to finance short-term capital needs on a cost-advantaged and efficient basis." Mr. Wood further testified that Dominion Questar Corporation would provide liquidity to Questar Gas "for seasonal working capital and other needs in a manner consistent with Questar Corporation's past practice."

Q. Please describe Questar's current liquidity resources.

A. Questar's 2015 10-K Report described its short-term financing capabilities on page 42 as follows:

Questar issues commercial paper to meet short-term financing requirements. The commercial-paper program is supported by revolving credit facilities with various banks that provides back-up credit liquidity. Credit commitments under the revolving credit facilities totaled $500 million under the multi-year credit facility and $250 million under the 364-day facility at December 31, 2015, with no amounts borrowed. The credit facilities expire upon a change of control such as the proposed Merger with Dominion Resources. However, the Company has amended its credit facilities to extend through the closing of the proposed Merger with Dominion Resources. Commercial paper outstanding amounted to $457.6 million at December 31, 2015, compared with $347.0 million a year earlier. Availability under the revolving credit facilities is reduced by outstanding commercial paper amounts, resulting in net availability under the facilities of $292.4 million at December 31, 2015. Under the facilities, consolidated funded debt cannot exceed 70% of consolidated capitalization.

In summary, Questar has a total of $750 million of short-term debt and credit facilities to meet short-term financing requirements, which include working capital.

Q. What is your recommendation with respect to assuring that Questar continues to have adequate access to needed liquidity, including working capital needs, if the Commission approves the proposed merger?

A. I recommend that the Commission order Dominion to provide Questar no less than the same access to liquidity it currently has under its existing short-term debt and commercial paper arrangements, which currently stands at $750 million. Questar and its customers must be assured that Questar will have sufficient access to liquidity after the merger with Dominion is consummated.

Q. Did the Applicants propose any consumer protections with respect to the cost of capital as part of their Application in this case?

A. In the aforementioned April 28, 2016 presentation, the Applicants outlined a number of so-called "ring fencing" provisions for Questar on page 18. Please refer to Exhibit ____(RAB-2) for this page. With respect to cost of capital protections, the Applicants proposed the following:

- Maintain status as a standalone issuer of long-term debt
- Maintain current debt and equity capital ratios
- Maintain credit metrics that support strong investment-grade credit ratings
- Maintain issuer credit ratings from independent credit rating agencies

Q. What is ring fencing and what is the purpose of ring fencing?

A. In this case, ring fencing refers to protections provided to a regulated utility company that shield that company from risks from its affiliates and/or parent company. These risks may take the form of operational risks and credit risks. A primary goal of ring fencing is to protect the regulated utility company from harm due to the financial risk, including bankruptcy risk, of its affiliates and/or parent company. Ring fencing also protects the regulated utility from having its assets depleted or compromised by an affiliate. Ring fencing also ensures that customers are not harmed from the results of corporate restructurings, such as the costs that are or may be incurred due to the transaction proposed in this proceeding.

Q. Are the Applicants' proposed ring fencing provisions for cost of capital sufficient for Commission approval of the merger?

A. No. The Applicants' ring fencing provisions are not specific enough and do not go far enough to protect Utah ratepayers. Tying cost of capital protections to Questar's credit and bond ratings before the merger announcement is critical to protect ratepayers from the adverse consequences of a downgrade of Questar's debt securities.

I do agree that the Commission should maintain the currently approved debt and equity ratios for Questar. It is my understanding that Questar will be filing a rate case soon and the Commission should order that its decision on the ratemaking capital structure for Questar in that docket be maintained after the proposed merger is completed.

I also agree with Dominion's commitment to maintain Questar's status as a standalone issuer of debt.

With respect to Dominion's commitment to maintain issuer credit ratings, it appears that there is a strong likelihood that S&P will downgrade Questar's credit rating as a result of the proposed merger. Thus, this stated commitment from Dominion likely cannot be upheld without the additional protections that I recommend.

Q. Are you aware of credit quality protections that were part of other merger proceedings before the Commission?

A. Yes. In Docket No. 98-2035-04 the Commission Report and Order dated November 23, 1999 approved a Stipulation among the parties to that case as part of its approval of a merger between Scottish Power PLC and PacifiCorp. Among other things, the Commission's Report and Order provided the following on page 8:

Financial Issues. Applicants agree that any reduction in the cost of capital will be reflected in rates in Utah, but any increase in the cost of capital of electric operations of PacifiCorp that is a direct result of the merger will be borne by shareholders (Condition 25). Applicants also agree that a hypothetical capital structure based on A-rated electric utilities comparable to PacifiCorp should be used to determine the correct cost of capital for ratemaking purposes (Condition 19). In addition, Applicants agree to maintain separate long-term debt (Condition 21) and to apply to the Commission for approval of debt issuances (Condition 22).

In Docket No. 05-035-54 the Commission's Report and Order dated June 5, 2006 adopted a Stipulation as part of its approval for a merger between PacifiCorp and MidAmerican Energy Holdings Company. Paragraph 21 of that Stipulation provided for the following:

21) MEHC and PacifiCorp, in future Commission proceedings, will not seek a higher cost of capital than that which PacifiCorp would have sought if the transaction had not occurred. Specifically, no capital financing costs should increase by virtue of the fact that PacifiCorp was acquired by MEHC.

SERVICE QUALITY ISSUES AND PROTECTIONS

Q. Does the Commission currently monitor the quality of service for Questar?

A. Yes. Questar currently files annual Customer Satisfaction Standards ("CSS") reports on a variety of service quality indices with the Commission. This comprehensive set of service quality standards resulted from a Settlement agreed to by members of the Service Standards Task Force in Docket No. 02-057-02. The Applicants included the 2015 CSS report as Exhibit 2.2 attached to the Joint Application.

Q. What are the service quality measures reported by Questar in its CSS reports?

A. Questar's CSS reports cover a broad range of customer service and satisfaction components in the following general areas:

- Overall impression of Questar Gas Company
- Customer care
- Customer affairs
- Service Calls - Ask-A-Tech
- Service Calls
- Billing

Each component within the broad areas listed above have Annual Goals associated with performance. Please refer to Exhibit ____(RAB-3) for a summary of the customer service and satisfaction Annual Goals and Questar's annual performance associated with each service quality goal for the years 2010 through 2015.

Q. How has Questar performed with respect to the Annual Goals contained in the CSS reports?

A. With three exceptions, Questar has met or exceeded every one of the Annual Goals for each service quality component for the six-year period shown in Exhibit ____(RAB-3). I highlighted the three instances in which Questar did not meet the Annual Goals.

Q. Did the applicants submit testimony with respect to the effect of the proposed merger on Questar's service quality?

A. Applicants' witness Diane Leopold addressed customer service beginning on page 13 of her Direct Testimony. Ms. Leopold testified at lines 330 through 331 that Dominion "intends to maintain Dominion Questar Gas' customer service at or better than current levels and will strive for continued improvements thereto."

Q. How does Dominion intend to maintain or improve Questar's customer service after the merger?

A. The OCS asked Dominion to explain how Dominion intended to maintain customer service after the merger in its Data Request 2.67. The Applicants' response is included in my Exhibit ____(RAB-4). In its response, the Applicants stated that Dominion "plans to continue to monitor and evaluate the customer service standards and metrics currently approved by the Utah Public Service Commission."

Q. Is it enough for Dominion to simply "monitor and evaluate" the customer service standards currently in place for Questar?

A. No. Dominion should be held to a higher standard of performance than a simple monitoring and evaluating of current performance goals.

Utah ratepayers must be assured that Questar's current customer satisfaction performance will not deteriorate after the proposed merger is completed. The risk for customers post-merger is that customer service could decline if Dominion were to reduce staffing levels in an effort to cut its costs and pass the savings on to shareholders. The DPU, OCS (when it was previously known as The Committee), and the other parties worked to carefully construct a suite of customer satisfaction goals in order to assure Utah ratepayers excellent levels of service from Questar. That commitment must be carried forward by Dominion and continue to be monitored by the Commission.

Q. How should the Commission ensure that Questar's service quality and satisfaction does not decline if it approves the proposed merger?

A. First, I recommend that the Commission order Dominion to continue its commitment to the currently effective CSS reporting requirements for Questar. In this regard, I further recommend that Dominion be required to submit reports quarterly, rather than annually. Questar had been filing quarterly CSS reports until 2014, when the Commission allowed Questar to file annual reports. If the Commission approves the merger, it would be prudent and reasonable to return to quarterly reporting for Dominion Questar so that the

Commission and DPU can closely and regularly monitor the impact of the merger on the CSS standards established by the Commission in Docket 02-057-02.

Second, I recommend that the "Annual Goals" for each service criterion in the CSS report be renamed "Minimum Service Metrics". Simply having a goal to shoot for is insufficient incentive for Dominion to maintain service quality and satisfaction for Utah customers after the merger. The currently effective Annual Goals must now be considered minimum achievable service metrics to which Dominion must adhere. Dominion should be required by the Commission to maintain these minimum service metrics.

Third, the Commission should assess penalties against Dominion for failing to achieve the Minimum Service Metrics.

Q. Please explain why the Commission should assess penalties against Dominion for failing to maintain Minimum Service Metrics.

A. Dominion should have a strong financial disincentive to allow customer service and satisfaction to decline after the merger. Instituting a penalty for lack of performance will provide an additional inducement for Dominion not to cut back on service quality to Utah ratepayers after completion of the proposed merger.

Q. What is your recommendation with respect to penalties for failing to achieve the Minimum Service Metrics?

A. I recommend that the Commission assess Dominion a $200,000 penalty for failure to achieve one or more of the individual CSS Minimum Service Metrics within each of the six categories of customer satisfaction metrics of the CSS reports.

The penalty would work in the following manner. Within the Customer Care category, if Dominion failed to achieve one of more of the individual performance metrics, the Commission would assess a $200,000 penalty. The recommended penalty would work in a similar fashion for each of the other categories. If, for example, Dominion failed to achieve one or more of the performance metrics in the Service Calls category in addition to the failure to achieve performance metrics in the Customer Care category, then the Commission would assess a total penalty of $400,000.

Penalties would be based on Dominion's performance over a calendar year. Penalties for a particular calendar should then be flowed back to Questar's customers in the following year as a 1-month credit to customer bills and allocated based on dekatherm ("dth") consumption to all customers. Across the six customer satisfaction categories, the maximum total penalty amount would be $1.2 million per year.

Q. Has the Commission approved penalties for lack of customer service quality in prior cases?

A. Yes. In the aforementioned Docket 98-2035-04 the Commission-approved Stipulation included penalties associated with certain customer service guarantees from PacifiCorp. Please refer to Exhibit ____(RAB-5), which includes the customer service standards, performance metrics, and penalties that were contained in an attachment to the Stipulation.

In the aforementioned Docket No. 05-035-04, MidAmerican Energy Holdings Company and PacifiCorp agreed to continue the customer service guarantees and performance standards after its acquisition of PacifiCorp. This agreement was attached to the Commission's Report and Order dated June 5, 2006. Please refer to Exhibit ____(RAB-6) for the relevant page from this agreement.

Q. Does this complete your testimony?

A. Yes.