BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

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IN THE MATTER OF THE REQUEST	§	**Docket No. 19-057-13**
OF DOMINION ENERGY UTAH FOR	§	**Surrebuttal Testimony**
APPROVAL OF A VOLUNTARY	§	**of Daniel J. Lawton**
RESOURCE DECISION TO	§	**For the Utah Office of Consumer**
CONSTRUCT AN LNG FACILITY	§	**Services**
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September 23, 2019

REDACTED VERSION

SURREBUTTAL TESTIMONY OF
DANIEL J. LAWTON

SECTION I: INTRODUCTION/BACKGROUND/SUMMARY

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Daniel J. Lawton. My business address is 12600 Hill Country Boulevard, Suite R-275, Austin, Texas 78738.

Q. DID YOU PREVIOUSLY FILE DIRECT TESTIMONY IN THIS DOCKET?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. I address issues raised by Dominion Energy Utah ("DEU" or "Company") witness Mendenhall in his rebuttal testimony regarding the evaluation of supply reliability RFP bid alternatives and debt imputation along with financial metrics.

Q. IN HIS REBUTTAL TESTIMONY MR. MENDENHALL CONTINUES TO ASSERT THAT NET PRESENT VALUE ("NPV") OF LEASE PAYMENTS WILL IMPACT RATING AGENCY FINANCIAL METRIC EVALUATIONS OF THE COMPANY AND THEREFORE RFP BID EVALUATIONS – DO YOU AGREE?

A. No. Mr. Mendenhall acknowledges that new accounting rules regarding leases, ASC 842, do not create new or different financial metric impacts for the Company.[1] Moreover, no new or additional costs or capital structure impacts are

[1] See Rebuttal Testimony K. Mendenhall at 1, lines 9 – 11.

created for ratemaking purposes by the implementation of ASC 842. Quite simply ASC 842 has no new impact on this proceeding.

Q. BRIEFLY EXPLAIN THE IMPACT OF THE IMPLEMENTATION OF ASC 842?

A. One key change is that leases will now be capitalized and as such reported on the corporate balance sheets. The change in balance sheet reporting does not change any costs or earnings, but does impact some financial statement financial metrics or ratios. Given that financial ratios are indicators of a company's financial health and are relied on by rating agencies and lenders it is important to consider the impacts of ASC 842 on financial metrics.

Keeping in mind that ASC 842 does not impact revenues, costs, debt, or earnings one can evaluate the impact of ASC 842 on key financial metrics. First, Return on Equity (ROE) is not impacted. ROE is calculated as net income divided by equity. Second, the debt to equity relationship is unchanged. Although the lease liability is added to the balance sheet, the lease obligation is considered an "other" liability not debt. Given no change in the debt level, the debt to equity level does not change. Third, "earnings before interest taxes, depreciation, and amortization" (EBITDA) does not change as none of the elements of EBITDA are impacted by the ASC 842 requirements.[2] Again, it is important to note that rating agencies have for years adjusted financial metrics (both interest expense and debt levels) for the impact of lease arrangements.

Q. WHAT FINANCIAL METRICS ARE TYPICALLY EVALUATED BY RATING AGENCIES?

A. Table 1 below is a summary of typical financial metrics considered by Moody's in the evaluation of credit strength and quality.

[2] Financial measures such as EBITDA, Funds From Operations ("FFO"), and Cash Flow From Operations ("CFO") are similar financial metric measures.

TABLE 1[3]

MOODY'S FINANCIAL RISK INDICATIVE RATIOS: LOW BUSINESS RISK GRID

RATING	CFO/DEBT (%)	CFO/INTEREST (x)	DEBT CAPITAL (%)
Aaa	$\geq \mathbf{34}\%$	$\geq \mathbf{8.0}x$	**≤29%**
Aa	**23 - 34**	**6.0 – 8.0**	**29 - 40**
A	**15 - 23**	**4.5 – 6.0**	**40 - 50**
Baa	**7 - 15**	**3.0 – 4.5**	**50 - 59**

Table 1 above reflects the Moody's matrix of financial metrics for various bond ratings based on the combination of business risks and financial risks.

While ASC 842 has no impact on this case, credit rating agencies such as Standard & Poor's (S&P"), Moody's, and Fitch have for years considered lease and other similar financial transactions in formulating company specific financial metrics.

Q. WHY DOES MR. MENDENHALL CONTINUE TO ASSERT THAT IMPUTED DEBT IS NECESSARY IN THE EVALUATION OF RFP ALTERNATIVE PROPOSALS IN THIS CASE?

A. While ASC 842 has no new impact on this case, credit rating agencies such as Standard & Poor's (S&P"), Moody's, and Fitch do consider lease arrangements and other similar financial transactions as debt like financial obligations. I addressed this issue in my earlier filed direct testimony.

In his rebuttal testimony at pages 2 – 3 Mr. Mendenhall calculates the net present

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[3] Moody's Investor Services,"Ratings Methodology," Regulated Electric and Gas Utilities at 22 (June 23, 2017)

value (“NPV”) of an RFP alternative proposal’s lease payment and adds the entirety of this amount as additional debt in the Company’s capital structure. Mr. Mendenhall then proceeds to estimate the impact of this added debt on the Funds From Operations divided by debt (“FFO/Debt”) financial metric. The added debt causes the FFO/Debt metric to decrease from 18% to **HIGHLY CONFIDENTIAL BEGINS** [redacted] **HIGHLY CONFIDENTIAL ENDS**. Mr. Mendenhall then concludes that DEU bonds would suffer a downgrade if the FFO/Debt financial metric decreased to his estimated level.[4] Mr. Mendenhall further concludes that if the capital structure were rebalanced with the addition of equity to offset the imputed debt, the FFO/Debt metric would increase from **HIGHLY CONFIDENTIAL BEGINS** [redacted] **HIGHLY CONFIDENTIAL ENDS** avoiding a potential downgrade to the Company’s bonds.[5] The net result of Mr. Mendenhall’s debt imputation and subsequent capital structure rebalancing with equity results in adding costs to the RFP alternatives. Bottom line, some of the RFP alternatives end up as more costly and uncompetitive proposals.

Q. DO YOU AGREE WITH MR. MENDENHALL’S ANALYSIS AND/OR CONCLUSIONS?

A. No. Mr. Mendenhall’s analysis is flawed in that he fails to take into account typical risk factors rating agencies employ in evaluating lease type transactions and imputed debt. Rating agencies such as S&P apply risk factors to the calculated NPV of the lease payment stream. While risk factors range from 0% to 100%, they generally fall in the 25% to 50% range.[6] For utilities, such risk factors are generally tied to the probability of recovery of the lease payments from ratepayers. The higher the probability of recovery, the lower the risk factor. Mr. Mendenhall did not consider any risk factor and assumed the worst-case scenario at 100% of the

[4] See Rebuttal Testimony of K. Mendenhall at page 3, lines 47 – 48.
[5] See Rebuttal Testimony of K. Mendenhall at page 3, lines 60 – 61.
[6] Standard & Poor’s Methodology For Imputing Debt For U.S. Utilities’ Power Purchase Agreements. (May 2007) at 3. www.standardandpoors.com/ratingsdirect

imputed debt NPV calculation. If one were to employ a conservative 50% risk factor then the FFO/Debt financial metric calculation becomes **HIGHLY CONFIDENTIAL BEGINS** [redacted] **HIGHLY CONFIDENTIAL ENDS,** a level that Mr. Mendenhall acknowledges avoids a downgrade.[7]

Q. DO YOU HAVE ADDITIONAL COMMENTS REGARDING DEU'S ALLEGATION THAT A BOND DOWNGRADE WOULD RESULT FROM DEU ACCEPTING AN RFP BID'S LEASE PROPOSAL?

A. Yes. First, Mr. Mendenhall has presented no evidence to support a downgrade and the facts support the opposite conclusion of no downgrade. I pointed out above, Mr. Mendenhall failed to consider any risk factors in his calculation. But even accepting Mr. Mendenhall's results as correct (which they are not) a review of Table 1 above, Moody's guidelines for CFO/Debt metrics, indicates a range of 15% to 23% of indicative ratios for a firm in the A rating category. Further, the S&P range for the (FFO/Debt) metric for a firm of medial volatility is in the 13% - 23% range. There clearly is no threat to financial integrity or DEU's current bond rating based on the facts in this case. This 13 – 23 percent range is supported by looking at current peer risk company comparisons by Moody's for CFO/Debt.[8] Similarly situated "A" rated peer group gas utilities have CFO/Debt metrics similar to the Company.

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. The bottom line is that there are no new guidelines regarding rating agencies adjusting company financial metrics for lease type transactions. Moreover, the impact of the potential leases in this case would not threaten the Company's financial integrity. Furthermore, as stated by Mr. Mendenhall, imputed debt does not impact regulatory calculations.[9] Rating agency debt imputation for lease and lease-type transactions has been occurring for years and I agree with Mr.

[7] See Rebuttal testimony K. Mendenhall at page 3 lines 60 - 61.
[8] Moody's Investor Services, Credit Opinion, "Questar Gas Company" (January 30, 2019) at page 7.
[9] Response to OCS 2.14, see Direct testimony D. Lawton at lines 144 – 145.

Mendenhall that it does not change utility revenue requirements or rate considerations. The Commission should remove the imputed debt cost adder from the Company's RFP bid quantitative analysis.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.