BEFORE
THE NORTH CAROLINA UTILITIES COMMISSION
DOCKET NO. E-2, SUB 1300

In the Matter of:	)	
	)	**DIRECT TESTIMONY OF**
Application of Duke Energy Progress, LLC	)	**KARL W. NEWLIN**
For Adjustments of Rates and Charges	)	**FOR DUKE ENERGY**
Applicable to Electric Service in North Carolina	)	**PROGRESS, LLC**
and Performance-Based Regulation	)	

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Karl W. Newlin. My business address is 400 South Tryon Street, Charlotte, North Carolina, 28202.

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

A. I am employed by Duke Energy Business Services, LLC ("DEBS") as Senior Vice President, Corporate Development and Treasurer. DEBS provides various administrative and other services to Duke Energy Progress, LLC, ("DEP," or the "Company") and other affiliated companies of Duke Energy Corporation ("Duke Energy").

Q. PLEASE SUMMARIZE YOUR EDUCATION AND PROFESSIONAL QUALIFICATIONS.

A. I graduated from Southern Methodist University with a Bachelor of Business Administration degree in 1991. I subsequently received a Master in Business Administration degree from UCLA's Anderson School of Management in 1998. I am also a Chartered Financial Analyst.

Q. PLEASE SUMMARIZE YOUR PROFESSIONAL EXPERIENCE.

A. In November 2018, I assumed the role of Senior Vice President, Corporate Development and Treasurer for Duke Energy. Previously, I served as Senior Vice President and Chief Commercial Officer for Duke Energy's natural gas business. In this role, I was responsible for gas commercial operations, which included supply, wholesale marketing, transportation and pipeline services, field customer service, sales and delivery, and business development. I was named to this position following Duke Energy's acquisition of Piedmont Natural Gas ("Piedmont") in October 2016.

I joined Piedmont in 2010 to manage its strategic planning functions, new business development activities and joint venture investments. In November 2011, I was appointed to the position of Chief Financial Officer, assuming responsibility for Piedmont's accounting, controller, finance, treasurer, investor relations, insurance, credit policy, risk management and state regulatory affairs areas. Prior to joining Piedmont, I served as Managing Director of Investment Banking for Merrill Lynch & Co. in its New York and Los Angeles offices.

Q. PLEASE DESCRIBE YOUR DUTIES AS SENIOR VICE PRESIDENT, CORPORATE DEVELOPMENT AND TREASURER.

A. In my role as Treasurer, I am responsible for treasury-related services to Duke Energy and its subsidiaries, including DEP. I monitor trends in the investment markets and maintain key relationships with debt investors, analysts, and financial institutions. Under my supervision, the Treasury Department arranges and executes all capital raising and liquidity transactions, including credit facilities and commercial paper, debt securities, preferred and hybrid securities, and common stock, as well as daily cash management for Duke Energy and its subsidiaries. My responsibilities include managing Duke Energy and its subsidiaries' credit ratings and interactions with the major credit rating agencies, commercial banks, and the capital markets. I am also responsible for liability management and long-term investments. As head of corporate development, I am responsible for the Company's corporate development activities, as well as mergers and acquisitions.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THIS COMMISSION OR OTHER STATE PUBLIC UTILITY COMMISSIONS?

A. Yes. I have testified before the North Carolina Utilities Commission on behalf of DEP, Duke Energy Carolinas, LLC ("DEC"), and Piedmont.

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

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

Q. PLEASE PROVIDE AN OVERVIEW OF YOUR TESTIMONY.

A. As detailed in my testimony, DEP 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. They will invest elsewhere if they feel 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 assure its financial strength and flexibility and ensure access to capital on reasonable terms.

The Company is making significant capital investments to provide cost-effective, safe, reliable, and increasingly cleaner 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.

Q. WHAT ARE DEP'S FINANCIAL OBJECTIVES?

A. Financial strength and access to capital are necessary for DEP to provide cost-effective, safe, and reliable service to its customers. The Company, at all times, 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% common equity for DEP 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 DEP'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 DEP must be able to finance its needs throughout such periods. Strong investment-grade credit ratings provide DEP 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 in the Company's Application and by Witness LaWanda Jiggetts, DEP is requesting a traditional base rate increase of approximately 5.7%, equating to an increase in pre-tax revenue requirement of approximately $219.1 million excluding the impact of the refund of certain tax benefits. The Company is also requesting a multi-year rate plan ("MYRP") in this proceeding. Layering in capital projects associated with the MYRP, as discussed by Witness Kathryn

Taylor, adds an additional pre-tax revenue requirement for each Rate Year. The incremental revenue requirement for each Rate Year includes costs for a set of capital investments, net of operating benefits, associated with the Company's proposed capital spending projects to be placed in service during the Rate Year for each year. As further detailed in Witness Taylor's testimony, the overall base rate revenue requirement increase is $334.3 million, $485.1 million, and $623.5 million in Rate Year 1, 2, and 3, respectively. The proposed capitalization in this request is comprised of 47% debt and 53% equity.

In addition, the requested increase reflects, in part, an increase in the Company's cost of equity capital from the level approved by the Commission in the Company's last general rate case. The testimony of the Company's Return on Equity ("ROE") Witness, Dr. Robert Morin, indicates that the Company's cost of equity capital is 10.2%, based upon his quantitative and qualitative analyses.

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 providing 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 DEP'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 DEP's credit rating.

Many qualitative and quantitative factors go into this assessment. Qualitative aspects may include DEP'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 DEP 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. 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 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 its 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.

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

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

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 somewhat 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). DEP'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. S&P revised its outlook to "Stable" from "Negative" on January 26, 2021, following the one-notch downgrade to the issuer credit rating of Duke Energy Corporation and its subsidiaries. The downgrade followed the coal ash settlement between DEP, DEC, and other parties. S&P stated in its January 26, 2021, Duke Energy Corporation report that "although the settlement resolves several complex issues related to coal ash, the lack of a full recovery of its costs and the reduced ROE on its future coal ash remediation demonstrates a modest increase in business risk and somewhat erodes its forward-looking financial measures." [1]

[1] *See* S&P Global Ratings, Research Update "Duke Energy Corp. And Subsidiaries Downgraded To 'BBB+' On Coal Ash settlement, Outlook Stable," January 26, 2021 ("January 2021 Duke Energy Corporation Report").

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

A. The rating agencies believe DEP operates in a generally constructive regulatory environment that supports long-term credit quality, and view the Company's position within the Duke Energy corporate family as credit supportive. However, the rating agencies have identified several challenges the Company faces in maintaining its credit ratings. In March 2022, 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.[2]

- Regulatory Lag: Moody's is particularly focused on downward pressure on financial metrics due to regulatory lag, including in the recovery of coal ash basin closure costs.
- Capital Expenditures: Moody's notes elevated capital expenditures to modernize the electric grid and meet environmental compliance requirements, including coal ash basin closure and remediation, will maintain pressure on credit metrics.
- Environmental Considerations: DEP has a higher carbon transition risk profile, as a result of its current generation portfolio, than that of transmission and distribution-only companies. The Company is also exposed to physical climate risks due to the location of its service territory along the Atlantic coastline and the propensity for severe storms.

[2] *See* Moody's Investors Service, Credit Opinion, "Duke Energy Progress, LLC – Update to Credit Analysis," March 24, 2022 ("March 2022 DEP Report").

In addition to the risks identified by Moody's above, S&P, in its May 2022 research update, states that regulatory risks in South Carolina persists following the 2019 rate case order denying recovery of certain coal ash costs, which was affirmed by the South Carolina Supreme Court.[3] As indicated previously in my testimony, S&P also viewed the coal ash settlement in North Carolina as negative for the Company's credit quality and, as a result, revised its assessment of the regulatory environment in North Carolina downward from most credit supportive to highly credit supportive.

Q. WHAT IS DEP'S PROPOSED CAPITAL STRUCTURE?

A. As mentioned earlier in this testimony, DEP's proposed capital structure is 47% long-term debt and 53% equity. The Company believes this proposed capital structure is optimal for DEP, as it introduces an appropriate amount of risk due to leverage while minimizing the weighted average cost of capital to customers. Approval of the proposed capital structure will help DEP maintain its credit quality. This level is also consistent with the Company's target credit ratings for DEP.

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

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. Achieving an approved

[3] *See* S&P Global Ratings, "Duke Energy Progress LLC," May 4, 2022 ("May 2022 DEP Report").

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 and DEP will manage its capital structure within a reasonable range of this base. As of December 31, 2021, DEP' capital structure was 46.1% long-term debt and 53.9% equity.

Q. WHAT IS DEP'S COST OF EQUITY?

A. Witness Morin, who has separately filed testimony, indicates that the Company's cost of equity is 10.2%, and the Company supports Dr. Morin's analysis.

Q. WHAT ROLE DO EQUITY INVESTORS PLAY IN THE FINANCING OF DEP, 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. DEP compensates equity investors for the risk of their investment in Duke Energy 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 DEP 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 DOES 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. High 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 produces lower earnings and cash flows, lowers credit quality, and may limit financial flexibility. As mentioned in my testimony above, the coal ash settlement in North Carolina, including lower authorized returns and the inability to fully recover prudently incurred costs, were highlighted in S&P's Rating Action Rationale supporting their downgrade for Duke Energy and its subsidiaries in January 2021[4].

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

A. Yes. DEP's equity component, as requested 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, DEP is in a period of significant capital investment necessary to provide cost-effective, safe, 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 IS DEP'S AVERAGE COST OF LONG-TERM DEBT?

A. DEP's weighted average cost of long-term debt as of the end of the test year (December 31, 2021) was 3.71%. The 3.70% cost of long-term debt used to compute the Company's requested 7.15% weighted average cost of capital was updated as of June 30, 2022. Over the last several years, DEP has been taking advantage of low interest rates, steadily decreasing the weighted average cost

[4] *See* January 2021 Duke Energy Corporation Report.

of long-term debt as older bonds are replaced with new, lower cost, issuances. The Company will update the average cost of long-term debt throughout the proceeding.

Q. WHAT ARE DEP'S CAPITAL REQUIREMENTS OVER THE NEXT FIVE YEARS?

A. DEP faces substantial capital needs over the next several years to comply with environmental requirements, refurbish, replace and upgrade aging infrastructure; construct or acquire needed generation resources; strengthen and modernize our energy grid; and satisfy its debt maturities. The Company's total capital requirements, including MYRP projects, for the next five years (2022-2026) are projected to be approximately $13.6 billion. This amount consists of approximately $12.3 billion in projected capital expenditures and approximately $1.3 billion in debt retirements.

Q. HOW WILL DEP'S CAPITAL REQUIREMENTS BE FUNDED?

A. DEP's capital requirements, including MYRP projects, are expected to be funded from internal cash generation, the issuance of debt, and equity funding from Duke Energy, as needed.

Q. WHAT IS DEP'S FINANCING PLAN FOR THE CAPITAL SPENDING PROJECTS FOR EACH YEAR OF THE MYRP (PBR FILING REQUIREMENT R1-17(B)D SUB-PART I)?

A. As noted above, Duke Energy Progress will finance projects under the MYRP in the same manner it finances all of its capital needs, while maintaining the Company's capital structure within a reasonable range of its regulatory approved capital structure. To achieve market efficiencies and obtain the most economical terms available, DEP will generally finance all of its external capital needs for a given year, including capital spending projects included in the MYRP, in a single long-term debt offering. DEP issues long term debt securities (5 to 30 years) in the US institutional debt markets, which is an efficient market for financing the Company's capital projects. While DEP may and has in the past accessed the bank market for shorter term, floating rate securities, these financing decisions and processes would not change based on a MYRP.

Q. DO YOU SUPPORT THE COMPANY'S ACCOUNTING REQUEST RELATED TO COAL ASH BASIN CLOSURE COSTS?

A. Yes. I worked with Witness Jiggetts to evaluate the credit metric impacts of joining a contemporaneous cost recovery mechanism with the Company's existing "spend-defer-recover" mechanism for future coal ash basin closure costs. As shown in Exhibit 5 to Witness Jiggetts' testimony, implementing a contemporaneous recovery mechanism would have a negative impact on the Company's FFO/Debt credit metric while also increasing customer bills. Therefore, it is in the best interest of the customers and the Company to continue the accounting deferral treatment of environmental compliance costs.

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

A. Yes.