Application: A.12-04-015, et al.

Exhibit No.: ____________________

Witness: Sandra K. Hrna

PREPARED REBUTTAL TESTIMONY OF
SANDRA K. HRNA
ON BEHALF OF SAN DIEGO GAS & ELECTRIC COMPANY

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

AUGUST 29, 2012

TABLE OF CONTENTS

I. INTRODUCTION 1

II. FEA'S CAPITAL STRUCTURE RECOMMENDATIONS ARE MISGUIDED AND SHOULD BE REJECTED...2

A. Mr. Hill Uses Inconsistent Comparison Methodology, Resulting In Unreliable and Distorted Conclusions. 3

1. Mr. Hill Errs in Using Accrual Instead of Ratemaking Methodology. 3

2. FEA's Analysis Covers Too Short of a Time Period, Rendering Its Results Inaccurate. 4

B. Mr. Hill Incorrectly Implies that SDG&E Transferred Significant Capital to Sempra Energy Stockholders. 5

C. Mr. Hill Incorrectly Argues that SDG&E's Proposed Changes to Its Currently Authorized Capital Structure Are Expensive. 6

III. THE COMMISSION SHOULD IGNORE DRA's EXTRANEOUS COMMENTS ON DEBT EQUIVALENCE. 7

ATTACHMENT A

PREPARED REBUTTAL TESTIMONY OF
SANDRA K. HRNA
ON BEHALF OF SAN DIEGO GAS & ELECTRIC

I. INTRODUCTION

My Prepared Direct Testimony provided a forecast of SDG&E's embedded costs of long-term debt[1] and preferred stock for test year 2013, setting the embedded cost of debt and preferred stock at 5.09% and 6.35%, respectively. I also recommended a new authorized capital structure for SDG&E, specifically, 45.25% long-term debt, 2.75% preferred stock, and 52.00% common equity.

The main purpose of this rebuttal testimony is to address the testimony of Federal Executive Agencies (FEA), by its witness, Stephen G. Hill, which contests the Company's proposed capital structure. FEA does not contest the Company's embedded cost calculations. As shown below, FEA's methodology is flawed, resulting in inaccurate and incorrect recommendations that should be rejected.

Only FEA's direct testimony contested SDG&E's proposed capital structure. Both the Division of Ratepayer Advocates (DRA) and The Utility Reform Network (TURN) adopted and proposed no change to SDG&E's embedded cost calculations and proposed capital structure set forth in my direct testimony. Although DRA offers extraneous comments regarding debt equivalence (DE), DRA found SDG&E's recommended capital structure and embedded costs reasonable.[2] DE was not considered in and is irrelevant to DRA's recommendation, as DRA plainly states:

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[1] The terms "debt" and "long-term debt" are used interchangeably, unless specifically noted otherwise.

[2] DRA/Woolridge at 19-20.

Whereas DRA has accepted the capital structures for PG&E, SDG&E, SCE, and SCG, ***DRA does not accept that DE needs to be part of the determination of the appropriate capital structures for ratemaking purposes***.[3]

Because DRA did not consider DE in recommending adoption of SDG&E's capital structure, the Commission should fully disregard DRA's discussion of DE in adopting SDG&E's proposal. DRA's DE testimony is also misguided, and for the sake of correcting the record I explain below why the Commission should otherwise reject it.

II. FEA'S CAPITAL STRUCTURE RECOMMENDATIONS ARE MISGUIDED AND SHOULD BE REJECTED.

Mr. Hill proposes a ratemaking capital structure for SDG&E of 50.50% common equity, 2.75% preferred stock and 46.75% long-term debt.[4] The capital structure proposals of SDG&E and FEA are summarized in Table 1 below.

TABLE 1 – CAPITAL STRUCTURE PROPOSALS

	SDG&E	FEA
Long-Term Debt	45.25%	46.75%
Preferred Stock	2.75%	2.75%
Common Equity	52.00%	50.50%

In making his recommendation, Mr. Hill does not contest reducing the Company's authorized preferred stock level from its current authorized level of 5.75% to 2.75%. However, Mr. Hill rejects the Company's proposal to maintain its currently authorized debt level at 45.25%, and proposes "that the percentage reduction each company seeks in its use of preferred stock be split evenly between equity and debt,"[5] which results in an authorized debt level of

3 DRA/Woolridge at 21 (emphasis added).

4 FEA/Hill at 87-88.

5 FEA/Hill at 87.

46.75% and common equity level of 50.50%. Mr. Hill's proposed "even split" of preferred stock to debt and equity is arbitrary and lacking in empirical or analytical support. SDG&E makes the following observations regarding Mr. Hill's recommendation:

A. Mr. Hill Uses Inconsistent Comparison Methodology, Resulting In Unreliable and Distorted Conclusions.

In proposing a capital structure which increases the company's authorized long-term debt level, Mr. Hill states that, "[g]iven that the Companies current financial position puts them very near the top of the industry, and that they have achieved that lofty status with more cost-effective capital structures that utilized less common equity than the amount requested by SDG&E and SCG."[6] These conclusions are based on flawed assumptions. Mr. Hill's inconsistent comparison methodology results in unreliable and distorted conclusions, as shown below. SDG&E has actually used significantly more common equity than its CPUC authorized common equity capital structure of 49% over this cost of capital cycle (not less), as reflected below.

1. Mr. Hill Errs in Using Accrual Instead of Ratemaking Methodology.

Mr. Hill incorrectly asserts that "SDG&E's average capital structure over the last five quarters is comprised of 48.60% common equity, 1.04% preferred stock and 50.37% long-term debt."[7] In reality, on average, SDG&E's actual ratemaking common equity, preferred, and debt percentages are 51.71%, 1.13%, and 47.16%, respectively. Attachment A compares the capital structure for ratemaking purposes and the accrual-based method used by Mr. Hill.

SDG&E's customer rates are set upon the authorized ratemaking capital structure set by the CPUC. However, Mr. Hill mistakenly used an accrual-based (unadjusted SEC Financials) method to derive his capitalization percentages to estimate ratemaking capital structure. The

[6] FEA/Hill at 87.

[7] FEA/Hill at 82.

ratemaking capital structure computation excludes certain accrual-based amounts on the SEC financial statements. For instance, adjustments for Variable Interest Entities (VIEs) must be made to determine ratemaking capital structure. Once the authorized capital structure is approved, the utility must manage to the CPUC ratemaking method – not to an accrual-based method. Furthermore, Mr. Hill makes another mistake in computing SDG&E's ratemaking capital structure with the inclusion of short-term debt.[8] Neither SDG&E's currently authorized capital structure nor its recommended capital structure include short term debt.[9]

2. FEA's Analysis Covers Too Short of a Time Period, Rendering Its Results Inaccurate.

The SDG&E capital structure analysis conducted by Mr. Hill used the most recent five quarter ends, instead of using the full analysis period from the last Cost of Capital (1st Quarter 2008 through 1st Quarter 2012). In the 1998 Holding Company Decision, the CPUC mandated SDG&E to:

> ...maintain balanced capital structures consistent with that determined to be reasonable for each of them by the Commission…[u]tilities' equity shall be retained such that the Commission's adopted capital structure for each shall be maintained…on average over the period the capital structure is in effect for ratemaking purposes. (D.98-03-073, Attachment B, p. 8.)

Comparing SDG&E's actual ratemaking capital structure for March 2008 through March 2012 (the complete time period from SDG&E's last Cost of Capital decision), the capital structure components have averaged 53.36% for common stock equity, 1.47% for preferred stock equity and 45.17% for long-term debt. Mr. Hill is inaccurate in asserting that "[b]y using less equity

[8] FEA/Hill, Schedule 10 at 3.

[9] Although FEA does not actually make a recommendation on whether to include short-term debt in the overall cost of capital proposal, Mr. Hill incorrectly shows short-term debt amounts averaging $313 million over the five quarters on Schedule 10, page 3 of his testimony. In SDG&E's response to FEA-SDG&E DR 02-7, SDG&E provided a monthly detail of short-term debt over the same five quarter ends that Mr. Hill has referenced in his testimony. SDG&E's average short-term debt (month-end balances) is less than $8 million for these 15 months.

and more debt to finance its operations, SDG&E has been capitalizing its operations more cost-effectively than it would if it had been employing the capital structure it request in this proceeding."[10] In comparing SDG&E's actual ratemaking capital structure results against its CPUC-authorized capital structure, SDG&E's actual CPUC common equity percentage has averaged 53.36%, which is 4.36% above its authorized common equity percentage. It should also be noted that during this time period, SDG&E issued approximately $1.9 billion of long-term debt, taking advantage of historical low financing costs for the benefit of the ratepayer in the longer term. This amount of debt is double the total long-term debt at year-end 2007. This large amount of debt has a downward impact on SDG&E's common equity ratio. SDG&E balances the capital structure to offset the large amount of debt, either by retaining cash flow from operations or by equity infusions from its parent company, Sempra Energy.

B. Mr. Hill Incorrectly Implies that SDG&E Transferred Significant Capital to Sempra Energy Stockholders.

Mr. Hill argues that "Sempra raised its dividends earlier this year by 25%. By any standard, that is an enormous dividend increase and represents a transfer of significant capital to the Company's stockholders."[11] The dividend policy of the parent company, Sempra Energy, is not relevant in determining the appropriate capital structure for SDG&E; moreover, it does not support Mr. Hill's position, as the size and timing of dividends are not solely dependent on the utility's business. As mentioned in an earlier point, due to the anticipated large capital expenditure levels, SDG&E has capitalized at a higher common equity ratio than authorized. The costs of the higher than authorized common equity ratio are not recoverable in rates. Furthermore, Mr. Hill apparently did not validate the amount and frequency of dividends paid by

[10] FEA/Hill at 82.

[11] FEA/Hill testimony at 87.

SDG&E to Sempra Energy. Due to SDG&E's large capital program, its dividend plans have been suspended for several recent years. In fact, SDG&E has received more common equity inflows from its parent than it has provided in dividends since 2008. While SDG&E paid $150 million of common stock dividends in 2009, SDG&E received $200 million of common equity from Sempra in 2011. SDG&E has been a $50 million net beneficiary of capital from Sempra Energy for the current Cost of Capital cycle of 2008 – 2012. No common stock dividends were paid by SDG&E in 2008, 2010, 2011 and 2012. SDG&E provided no significant capital to its parent company during these years. This factual reality stands in stark contrast to Mr. Hill's claims.

C. Mr. Hill Incorrectly Argues that SDG&E's Proposed Changes to Its Currently Authorized Capital Structure Are Expensive.[12]

When viewed in isolation, leaving all else unchanged, an increase in a utility's authorized common equity level will increase rates in the short term. Although the common equity component is a higher cost financing source, SDG&E's overall capital structure recommendation is consistent with SDG&E's and the Commission's desires to adopt capital structures that prudently and proactively help sustain SDG&E's strong credit profile over the long-term. SDG&E's embedded cost of debt has been reduced by almost 10% (see my testimony and recommendation to decrease SDG&E's current authorized cost of debt from 5.62% to 5.09%) during this cost of capital cycle, which is a significant and recurring long-term ratepayer benefit. Moreover, SDG&E has accomplished this during a period of historical financial market volatility (2008) and financial crisis. It is evident that SDG&E's strong credit profile and prudent, proactive management of its credit profile has contributed to these benefits. SDG&E's

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[12] *See* FEA/Hill testimony at 86.

1 recommended capital structure supports SDG&E's strong credit profile during a period of high
2 capital expenditure outflows and expected continued market volatility. Mr. Hill makes a short-
3 term and misguided argument which does not take into consideration the long-term benefits to
4 ratepayers of SDG&E's proposed capital structure.

5 III. THE COMMISSION SHOULD IGNORE DRA'S EXTRANEOUS COMMENTS 6 ON DEBT EQUIVALENCE.

7 Despite the acceptance of the utilities' proposed capital structures, DRA expresses
8 disagreement with the companies' positions on DE and its role in the determination of the
9 appropriate capital structures for ratemaking purposes.[13] As previously noted, DRA's DE
10 discussion should be rejected in full because DRA did not consider DE in reaching its
11 recommendation to adopt SDG&E's capital structure. For sake of an accurate record, however, I
12 explain below why DRA's DE discussion is incorrect.[14] The following addresses DRA's
13 comments on DE:

14 1. Since DE is not recognized as debt on a company's financial statements (per
15 Generally Accepted Accounting Principles or "GAAP"), DRA believes that DE is only a
16 concept rating agencies consider and should be excluded from determining the
17 appropriate cost of capital. However, one of the main purposes of conducting DE
18 analysis is to determine the impact for which credit agencies adjust when determining
19 key credit metrics and associated credit ratings. It is irrelevant that DE is not recognized
20 as debt for GAAP purposes. Standard & Poor's (S&P) considers long term fixed financial
21 obligations as debt and DE constitutes the largest rating agency adjustment to the debt

[13] *See* DRA/Woolridge at 20-23.

[14] My prepared direct testimony, at pages 9-15 and Appendix B fully discuss DE background, methodology, applicability, calculations, and credit ratio analysis.

1 ratio of SDG&E. Therefore, DE is highly relevant when determining utilities' financial
2 soundness and support of investment-grade credit ratings.
3 2. DRA criticizes the risk factor used by rating agencies, stating that "S&P does not
4 indicate how the risk factor is determined…given the methodology for imputing debt
5 from PPAs, the risk factor is extremely important, but it is also based on unpublished,
6 subjective factors."[15] This merely continues DRA's criticism of credit agencies'
7 methodology when determining credit metrics. This is irrelevant to the fact that credit
8 agencies have long used this methodology to determine their credit analysis. The
9 Commission should not discount the importance of maintaining healthy credit ratings to
10 maintain lower costs for ratepayers in the long term, as further explained in Dr. Morin's
11 testimony.
12 3. DRA states that PPAs mitigate risks by shifting construction and operating risks
13 to the power supplier and that risk to the utility is that of recovering fixed financial
14 obligations in rates. SDG&E does not refute that PPAs may mitigate some risks
15 associated with construction or operating costs. However, PPAs also bring with it a fixed
16 long term obligation that is viewed by rating agencies as debt. Through its Long Term
17 Procurement Plan and RPS goals, SDG&E has executed PPAs that involve long-term
18 financial commitments translating into $1.6 billion of debt equivalence over the cost of
19 capital term. SDG&E's anticipated $1.6 billion of debt equivalence is not yet reflected in
20 credit analyst reports, but is expected to be realized and taken into consideration during
21 the cost of capital term. In the 2011 Standard & Poor's credit report, SDG&E's DE was
22 reflected at only $182 million, which is $1.4 billion less than the total expected growth

[15] DRA/Woolridge at 20-23.

1 level during the 2013 to 2016 time period. This 767% expected increase in DE may soon
2 be imputed and could result in a downside credit adjustment for SDG&E. Moreover,
3 while Moody's regards Commission-approved risk reduction measures positively, they
4 also view other characteristics of PPAs that may negatively affect utilities' credit.[16] DRA
5 neglects to mention that Moody's considers the pass-through of costs as one of several
6 factors in determining whether to include PPAs as fixed debt obligations. Moody's is
7 only one of three major rating agencies that cover SDG&E, and they all use a risk factor
8 for utilities with PPAs (as DRA acknowledges).[17]
9 4. DRA claims that since metrics are only used as guidelines to credit agencies, there
10 should be very little weight given to strict interpretations associated with credit ratios.
11 However, the Commission has acknowledged that DE can affect utility credit ratios,
12 ratings, and capital structure.[18] My direct testimony outlines SDG&E's debt equivalence
13 for existing, approved, and filed PPAs within the cost of capital term. The currently
14 published DE figure per S&P's June 2011 report shows $182M for existing PPAs. It is
15 important to stress that SDG&E expects nearly 10 times this amount – over $1.6 billion –
16 of DE for executed contracts over the cost of capital term and to be reflected in future
17 rating agency reports. The credit ratio analysis following S&P methodology, as outlined
18 in my testimony, clearly demonstrates that with expected PPA debt equivalence, the
19 financial ratios move toward a more highly leveraged position. These PPAs will continue
20 to impact SDG&E's credit profile negatively going forward.

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[16] Moody's Investors Service Rating Methodology: Global Regulated Electric Utilities, March 2005.

[17] *See* DRA/Woolridge at 20-21.

[18] *See* D.05-12-043 pp. 8, 43.

1 5. DRA states that DE should be discounted because there is no regulatory
2 consensus on how to deal with DE issues. SDG&E concurs that there is no consensus on
3 how to deal with issues in the power supply procurement process and in setting the
4 overall cost of capital for a public utility. However, the fact that other state utility
5 commissions may treat DE differently would not mitigate this very real downside credit
6 risk factor for SDG&E. DE has already been recognized by the Commission as a real
7 cost and risk factor; therefore, DRA's claims regarding these real costs are contrary to
8 both the Commission's perspective and S&P's and other credit rating agencies'
9 documented treatment of DE.
10 This concludes my prepared rebuttal testimony.

ATTACHMENT A

Capital Structure – CPUC Ratemaking vs. FEA Accrual Based

SAN DIEGO GAS & ELECTRIC TOTAL CAPITALIZATION Amount (000,000)	Actual 3/31/2011	Actual 6/30/2011	Actual 9/30/2011	Actual 12/31/2011	Actual 3/31/2012	Average
CPUC Ratemaking Method						
COMMON EQUITY	$3,398	$3,469	$3,582	$3,740	$3,845	$3,607
PREFERRED STOCK	79	79	79	79	79	79
LONG-TERM DEBT	2,928	2,928	3,279	3,529	3,779	3,289
SUBTOTAL	$6,404	$6,476	$6,939	$7,347	$7,703	$6,974
CPUC Ratemaking Percentage						
COMMON EQUITY %	53.06%	53.57%	51.62%	50.90%	49.92%	51.71%
PREFERRED %	1.23%	1.21%	1.13%	1.07%	1.02%	1.13%
LONG-TERM DEBT %	45.72%	45.22%	47.25%	48.03%	49.06%	47.16%
	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
FEA Accrual Based Method						
COMMON EQUITY	$3,516	$3,557	$3,673	$3,841	$3,952	$3,708
PREFERRED STOCK	79	79	79	79	79	79
LONG-TERM DEBT	3,493	3,489	3,832	4,077	4,322	3,843
SHORT-TERM DEBT	269	269	346	375	305	313
SUBTOTAL	$7,357	$7,394	$7,930	$8,372	$8,658	$7,942
FEA Percentage Excluding Short Term Debt						
COMMON EQUITY %	49.60%	49.92%	48.43%	48.03%	47.31%	48.60%
PREFERRED %	1.11%	1.11%	1.04%	0.99%	0.95%	1.04%
LONG-TERM DEBT %	49.28%	48.97%	50.53%	50.98%	51.74%	50.37%
	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
CPUC Ratemaking vs. Accrual Differences						
COMMON EQUITY %	3.45%	3.65%	3.19%	2.87%	2.60%	3.11%
PREFERRED %	0.11%	0.10%	0.09%	0.08%	0.07%	0.09%
LONG-TERM DEBT %	-3.56%	-3.75%	-3.28%	-2.95%	-2.68%	-3.21%