Application: A.12-04-______

Exhibit No.: ______________

Witness: Kenneth Deremer

PREPARED DIRECT TESTIMONY OF
KENNETH DEREMER
ON BEHALF OF SAN DIEGO GAS & ELECTRIC COMPANY

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

APRIL 20, 2012

TABLE OF CONTENTS

I. INTRODUCTION 1

II. OBJECTIVES OF THE COST OF CAPITAL MECHANISM 1

III. CURRENT MECHANISM 3

A. Background 3

B. Current Cost of Capital Mechanism 4

IV. SDG&E’s Proposal 6

A. Experience with Cost of Capital Trigger Mechanism 6

B. Utility Bond versus U.S. Treasury Indices 6

C. CCM Measurement 8

D. Benefits of the CCM 9

E. Proposed CCM with Modification 10

V. SUMMARY AND CONCLUSION 12

VI. STATEMENT OF QUALIFICATIONS 14

APPENDIX A: Benchmark and Automatic Trigger Example 1-A

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
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24
25
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PREPARED DIRECT TESTIMONY OF
KENNETH DEREMER
ON BEHALF OF SAN DIEGO GAS & ELECTRIC COMPANY

I. INTRODUCTION

The purpose of my testimony is to address San Diego Gas & Electric Company's ("SDG&E's") current Cost of Capital Mechanism ("CCM"), which was adopted by the California Public Utilities Commission ("CPUC" or "Commission") in Decision ("D.") 08-05-035. The CCM automatically recalibrates SDG&E's authorized Return on Equity ("ROE") and overall Rate of Return ("ROR") on SDG&E's Commission-jurisdictional operations between cost of capital ("COC") proceedings, if the mechanism is triggered. This testimony describes the CCM's objectives, the history of its predecessor, the Market Indexed Capital Adjustment Mechanism ("MICAM"), the mechanics of the current CCM, and SDG&E's recommendation for the trigger mechanism going forward.

For the reasons stated in my testimony, SDG&E believes that the present CCM, with certain modifications described herein, should continue to be the basis for ROE and ROR adjustments between full COC proceedings.

II. OBJECTIVES OF THE COST OF CAPITAL MECHANISM

The CCM, and previously the MICAM, provides a formula that allows SDG&E to automatically adjust its revenue requirement based on utility bond rate changes in each year that SDG&E is not required to file a COC application. The mechanism was designed with several goals in mind. Specifically, the mechanism:

- Reduces the time and costs associated with annual COC proceedings;
- Provides objective results through readily available historical rates that eliminate the unreliability of interest rate forecasts;
- Is simple and transparent to apply;

1 - Does not produce frequent or abrupt changes; and
2 - Provides timely, transparent ratemaking information for numerous stakeholders.

3 Under the CCM, changes to SDG&E's return between COC proceedings is a function of
4 historical rates based on actual market data, thereby producing an objective outcome and
5 eliminating the need for interest rate projections and potential forecasting risk. The
6 Commission's initial MICAM decision, D.96-06-055 confirmed these objectives, pointing out
7 that they strike a balance between shareholder and ratepayer interests, adding:

> 8 [W]e explicitly state our intention to keep MICAM in place for an
> 9 extended period, so long as regulation of SDG&E's rates requires a
> 10 cost of capital input. This should provide greater likelihood of an
> 11 evening out of ratepayer and shareholder interests over time.[1]
> 12

13 SDG&E believes that MICAM's initial objectives are still worthwhile and that the
14 "extended period" for which it has been in place (in its native and then CCM format) has allowed
15 for their ongoing realization. SDG&E believes that an ongoing need exists for a COC trigger
16 mechanism and supports continuation of the uniform CCM for the California investor owned
17 electric utilities ("IOUs") adopted in D.08-05-035. SDG&E agrees with the Commission's
18 observations regarding the CCM effectively balancing the interests of shareholders and
19 ratepayers while simplifying and reducing COC proceedings, workload requirements and
20 regulatory costs:

> 21 This CCM streamlines the major energy utilities' cost of capital
> 22 process while providing greater predictability of the utilities' cost
> 23 of capital by eliminating the use of interest rate forecasts and
> 24 disputes concerning interest rate levels and trends, as well as
> 25 uncertainties associated with conflicting perceptions of financial
> 26 markets and the return requirements of investors. The CCM also
> 27 enables the utilities, interested parties, and Commission staff to
> 28 reduce and reallocate their respective workload requirements for
> 29 litigating annual cost of capital proceedings.[2]

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1 D.96-06-055, *mimeo*, p. 24.
2 D.08-05-035, *mimeo*, p.16.

1 III. CURRENT MECHANISM

2 A. Background

3 In D.96-06-055, the Commission authorized the MICAM for SDG&E's ratemaking,
4 effective January 1, 1998. SDG&E used its authorized ROE, ROR, and capital structure for test
5 year ("TY") 1997 following the COC decision D.96-11-060.

6 The original MICAM decision scheduled a mid-course review and SDG&E submitted
7 Application (A.) 00-03-062 on March 29, 2000, supporting the MICAM's continuation and
8 seeking Commission clarification regarding benchmarking and capital-structure treatment.
9 D.03-09-008 adopted an all-party Settlement which continued the MICAM but (1) modified the
10 "off-ramp" provision;[3] (2) required SDG&E to file a full COC application every five years
11 absent a significant change in interest rates that would trigger an "off-ramp"; (3) changed the
12 mechanism's benchmark; and (4) authorized a one-time change to SDG&E's embedded debt cost
13 if certain events occurred.

14 The MICAM triggered in 2004, with notification to the Commission pursuant to Advice
15 Letter 1630-E /1479-G, changing the COC effective on January 1, 2005. On March 17, 2005,
16 the Commission issued D.05-03-023 regarding the post-test years associated with SDG&E's
17 2004 Cost of Service ("COS") proceeding. D.05-03-023 redefined the MICAM measurement
18 period as March through August (a change from its original April through September period),
19 effective in May 2005.

20 Ordering Paragraph 4 of D.05-12-043, establishing SDG&E's authorized rate of return
21 for TY 2006, provided SDG&E an option to file a TY 2007 COC application. Subsequently in
22 October 2006, the Commission granted SDG&E's Petition for Modification ("PFM") of D.05-

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[3] The "off-ramp" provision, which suspended the MICAM if triggered, would occur if the difference between the current six-month average "Aa" bond rate and SDG&E's benchmark exceeded an off-ramp of 260-basis points. SDG&E would file a complete COC application in the May following the off-ramp event.

12-043, authorizing SDG&E to defer its option to file its next application to May 2007 for test year 2008. SDG&E filed its TY 2008 Application and the Commission subsequently consolidated two other California IOUs into one proceeding, bifurcated into two phases. The second phase addressed the COC mechanisms, and in May 2008, the CPUC issued D.08-05-035, which established a uniform, multi-year COC mechanism for Southern California Edison Company ("SCE") and Pacific Gas & Electric Company ("PG&E"), and replaced SDG&E's MICAM.

B. Current Cost of Capital Mechanism

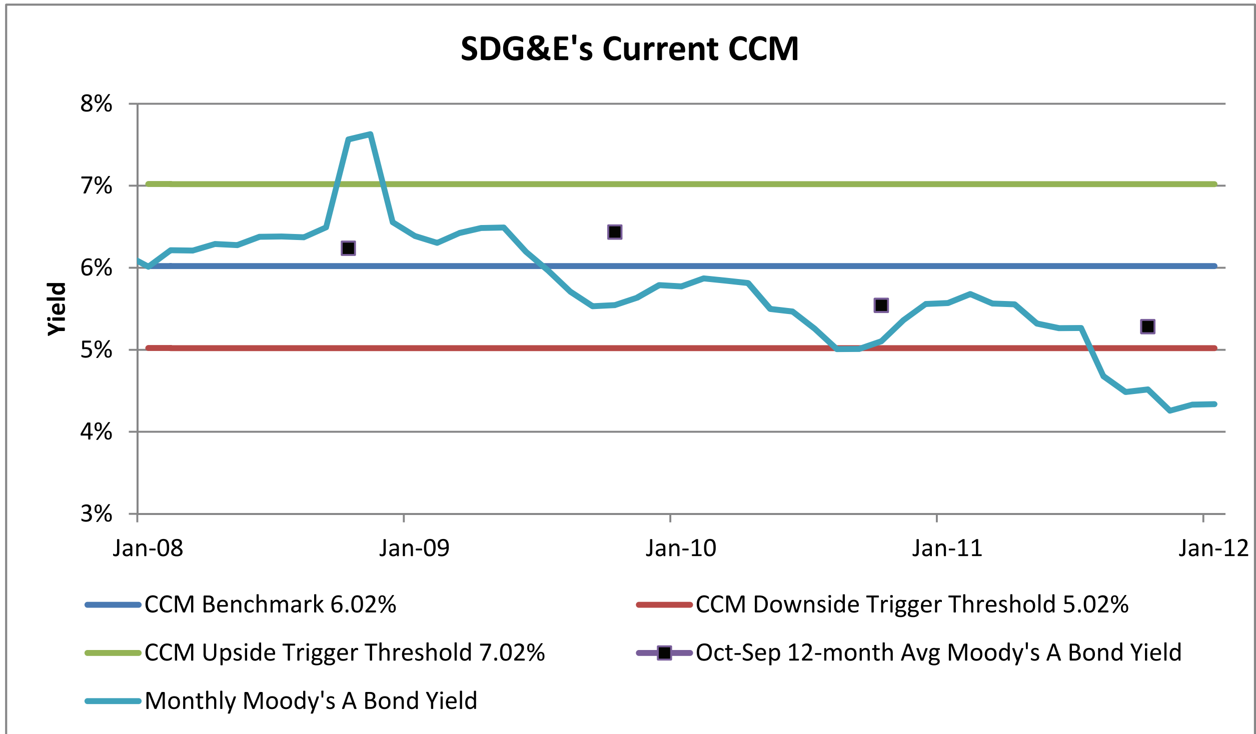
The current trigger mechanism requires a full COC application every third year. Between test years, if there is a significant change in the utility bond market during the measurement period, the ROE would automatically be adjusted through an October 15 advice letter, which would become effective on January 1 of the following year.

Specifically, as shown in Figure 1, a SDG&E trigger event occurs if the October through September twelve-month average of Moody's "A" rated utility bond yield changes more than 100 basis points higher or lower than the benchmark interest rate.[4] The benchmark represents either (a) the October through September average of "A" utility bond yields[5] from the year of SDG&E's most recent COC proceeding; or (b) the October through September average of the year the utility bond yield triggered an automatic adjustment. There is no provision for capital structure adjustment outside of the test year, but an adjustment may be permitted if credit ratings change in mid-cycle. The decision also allows an adjustment outside of the mechanism process if an extraordinary or catastrophic event occurs that has a material impact.

[4] Based on Moody's October 2006-September 2007 average of "A"-rated utility bond yields.

[5] Moody's utility index would be adjusted for a change in utility's credit rating. Moody's "A" utility bond interest rates is currently used given SDG&E's "A" credit rating.

1 **Figure 1**



2

3 If an automatic adjustment is triggered, the COC components are updated and a new ROR is
4 computed as follows:

5 1. The ROE is adjusted by one-half of the difference between the "A" utility bond
6 average and the benchmark.
7 2. The costs of long-term debt and preferred stock are updated to reflect actual
8 August month-end embedded costs in the trigger year, and forecasted interest
9 rates for variable long-term debt and new long-term debt and preferred stock
10 scheduled to be issued.
11 3. The authorized capital structure is not adjusted.
12 4. A Tier 2 advice letter is filed on October 15 of the trigger year to be effective
13 January 1 of the following year.
14 5. In any year where the 12-month October through September average Moody's
15 utility bond rates triggers an automatic ROE adjustment, that average becomes the
16 new benchmark.

IV. SDG&E'S PROPOSAL

A. Experience with Cost of Capital Trigger Mechanism

A COC trigger mechanism has successfully been in place for almost 15 years, excluding some interruption related to certain procedural matters.[6] The current CCM has been operational since the TY 2008 COC Decision.

As mentioned earlier, SDG&E believes that the COC trigger has historically worked according to design and has indeed achieved its original objectives. First, it has dampened precipitous interest-rate movements. Between 1998 and 2000, the "Aa" utility bond yield rose almost 115 basis points and then fell about 90 basis points between 2000 and 2002. During this time, however, the MICAM did not trigger. Only after the "Aa" yield had fallen over 200 basis points between 2000 and 2004 did MICAM adjust SDG&E's ROE automatically. Since then and even following the 2007 COC proceeding where the CCM benchmark was changed to the single "A" utility bond, the CCM has not triggered. This provides evidence that the mechanism in fact is responsive to longer-term trends, rather than short-term volatility.

B. Utility Bond versus U.S. Treasury Indices

The Commission found in the 2008 consolidated COC Phase 2 decision, D.08-05-035, that utility bond yields are better indicators of a utility's costs of capital than Treasury bond yields. The Decision states:

> The purpose of an interest rate benchmark is to gauge changes in interest rates that also indicate changes in the equity costs of utilities. U.S. Treasuries are more sensitive to economic changes

[6] Conceptually speaking, CCMs would not be applicable the year preceding a COC test year. The Commission decision authorizing the cost of capital for a particular test year would supersede a change associated with a trigger event from the preceding year (that would normally be implemented the following January). For SDG&E, shortly after the mechanism became operational, it was deferred for a year by SDG&E's mandated participation in the TY 1999 "unbundling" proceeding (A.98-05-019). Three years later, the MICAM was not applicable due to SDG&E's participation in the TY 2003 COC proceeding (A.02-05-026). The mechanism also would not have been applicable in 2005 and 2007 due to TY 2006 and 2008 COC applications (A.05-05-012 and A.07-05-007).

> and risks in the international capital markets than utility bonds because they are bought and sold globally. However, U.S. utility bonds are generally affected less than Treasuries as a result of major shifts of international capital because a majority of U.S. utility bonds are traded within the U.S. Consistent with our use of utility bond interest rates in ROE, PBR, and MICAM proceedings and desire to use an index that more likely correlates and moves with utility industry risk, utility bonds should be adopted for the CCM index.[7]

A utility bond index that tracks changes in both the general level of interest rates as well as changes in utility risk, such as the Moody's "single-A" utility bond index, represents a more reasonable metric for SDG&E's CCM than does the use of Treasury rates. Treasury securities reflect the risk-free treasury rate, which does not correlate consistently with the utility industry and SDG&E-specific risk.

In fact, SoCalGas' trigger mechanism is based on 30-year Treasury bond yields, which has led to various instances of decoupling from utility bond yields over the past decade. Most recently, SoCalGas filed a PFM in 2009,[8] seeking authority for an immediate one-year suspension of its MICAM to prevent an inappropriate downward adjustment to its authorized ROE due to the decoupling of the 30-year Treasury bond rate and Utility bond rates. During this time, Treasury bond yields were experiencing significant declines while overall utility bond rates were increasing. SDG&E concurs with SoCalGas' assertion in the PFM that the changing global economy and tightening credit markets impacted the appropriateness of the 30-year Treasury bond yields index as a trigger mechanism. The PFM explained that, unlike the typical macroeconomic forces that drive Treasury bond yields, the Federal Reserve Board's (or "Fed's") reactionary stop-gap measures caused a drastic divergence between utility bond yields and Treasury bond yields.

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[7] D.08-05-035, *mimeo*, pp. 12-13.
[8] Petition to Modify D.97-07-054 filed in A.95-06-002 on April 7, 2009.

As further explained in the PFM:[9]

- Treasury bond yields are highly sensitive to changes in international economic conditions, whereas the U.S. utilities' cost of equity is not.
- Since U.S. Treasuries are considered to be the safest investment in the world, investors across the world tend to flock to investments in U.S. Treasuries at times of widespread global economic turmoil. In such periods of turmoil, the required return on riskier investments such as utility bonds and stocks increases while the yield on U.S. Treasury bonds declines.
- Yields on U.S. Treasury bonds are highly sensitive to efforts by the Fed to stimulate the economy.

Although the PFM was denied,[10] the Commission did previously acknowledge that the use of 30-year Treasury bond yields as a benchmark may be flawed in D.03-01-008.[11] Therefore, the current use of utility bond rates remains most appropriate.

C. CCM Measurement

SDG&E has used the 100-basis point dead band for its MICAM and current CCM since 1998 and continues to recommend this range. The size of the dead band, combined with the measurement period, influences how often the adjustment mechanism will be activated, and therefore it is important to strike a reasonable balance between triggering too often and not triggering enough. Choosing a dead band and/or measurement period that is too sensitive to interest rates would be disruptive, while having a dead band and/or measurement period that is too wide could potentially prevent a trigger when it would be appropriate for one to occur.

[9] *Id.*, Declaration of Gary H. Hayes, p. i.

[10] *See* D.09-07-033.

[11] In D.03-01-008, in which the Commission denied SoCalGas' Petition to suspend MICAM, the Commission observed that "[u]se of 30-year Treasury Bonds as a benchmark may be flawed." D.03-01-008, *mimeo*, p. 4.

SDG&E's current mechanism uses a 100-basis point dead band under a 12-month average measurement period, which the Commission has found to be the best combination that "mitigates volatility of interest rates."[12]

D. Benefits of the CCM

The CCM's simple, transparent nature has met with positive reaction from various stakeholders. With the complexity of processing utility applications and the Commission's desire to ease the burden of issuing year-end decisions, creating a transparent market-based mechanism eases the burden in terms of time, cost and demands placed upon the resources of the Commission. Credit agencies and investment banks, who regularly evaluate the financial condition of the utilities, have indicated their preference for the automatic rate-setting mechanism, since it provides greater clarity and transparency in understanding changes to a utility's ROE versus the uncertainty of trying to predict the outcome of a fully litigated COC proceeding on an annual basis. The Commission has echoed these sentiments in its own COC decisions over time, observing, for example, that "[o]ur consistent practice has been to moderate changes in interest rates relative to changes in ROE in order to increase the stability of ROE over time."[13]

SDG&E's ratepayers benefit from a trigger mechanism that was established to maintain fair and reasonable capital costs and ROEs. Shareholders and ratepayers alike share in the burden and benefit of market changes, while eliminating the burden of full COC applications. Lastly, the Commission's resources, as well as SDG&E's, are better deployed in CCM/MICAM years. A typical COC proceeding will demand many resources for the better part of a calendar year. Providing an effective COC mechanism allows the Commission to commit resources to

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[12] D.08-05-035, *mimeo*, p. 12.
[13] D.96-11-060, *mimeo*, p. 16.

other critical regulatory proceedings, including general rate cases, renewable energy and electric commodity ("ERRA") compliance, and gas cost allocation ("TCAP"). Fortunately, the MICAM and current CCM have provided an effective way to adjust the COC without the need for annual full proceedings.

In sum, the historic MICAM and the current CCM have met the original objectives. The mechanism is simple, utilizes readily available historical information, does not produce frequent or abrupt changes, provides timely and transparent ratemaking information for numerous stakeholders, and allows the Commission (as well as the Company) to better deploy valuable resources.

E. Proposed CCM with Modification

SDG&E proposes to continue utilizing the currently authorized CCM (as described in section III), but slightly modified to include an off-ramp provision as employed in prior SDG&E MICAMs. SDG&E believes that between full COC proceedings occurring every third year, the combination of a 12-month measurement period and 100-basis point dead band provides a level of stability that strikes a balance between triggering too often and triggering too infrequently. A trigger event would occur if the October through September twelve-month average of Moody's "A"-rated utility bond yield changes more than 100 basis points higher or lower than the benchmark interest rate. The initial benchmark would represent the October 2011 through September 2012 average of "A"-rated utility bond yields.[14] The proposed mechanism would continue to:

- Utilize Moody's utility bond rating as the appropriate benchmark (as described in detail above). The benchmark will remain in effect until the earlier of a trigger event or the conclusion of the three-year COC period.

[14] Moody's "A"-rated utility bond interest rate is currently used given SDG&E's "A" credit rating.

- Continue the effective CCM trigger for the proposed three-year COC period. A three-year term provides a balance between not having a full proceeding every year, but having one often enough to review for significant changes or impacts to SDG&E.
- Continue a plus/minus 100 basis point dead band. Setting too high a threshold would prevent an adjustment during a period of significant capital market changes, and a low threshold might cause frequent ROE adjustments based on moderate interest movement rather than longer term interest rate trends.
- Measure a 12-month average of utility bond yields for the period of October 1 through September 30.
- Continue the 50% adjustment to ROE of total change to utility bond index when CCM exceeds 100 basis point trigger.
- Update the costs of long-term debt and preferred stock when a trigger occurs to reflect actual August month-end embedded costs in the trigger year and forecasted interest rates for variable long-term debt, new long-term debt, and preferred stock scheduled to be issued.
- Retain the currently authorized capital structure, but allow the company to file a capital structure adjustment application in the event of a change to credit rating.
- File an Advice letter on October 15 of the trigger year to implement trigger provisions effective January 1 of the following year.
- Allow a COC application outside of the CCM process if an extraordinary or catastrophic event materially impacts COC or capital structure and affects the company differently than the overall financial markets.

In addition to the current measures, SDG&E believes that utilizing an off-ramp provision provides a safeguard that protects against extreme changes in interest rates and also provides the Commission latitude to suspend the mechanism. Prior to adopting the current CCM, the

Commission had consistently authorized an off-ramp provision in the event extreme interest rate changes impaired the integrity of the MICAM.[15] As noted above, the Commission's consistent practice has been to moderate changes in ROE relative to changes in interest rates in order to increase the stability of SDG&E's ROE over time. The off-ramp proposal is intended to apply where events could cause extreme impacts to the utility bond index (and, in turn, SDG&E's ROE) due to unique economic conditions such as hyperinflation, significant impacts to the domestic or global financial markets, or unusual utility industry-specific events. SDG&E proposes to have the option to invoke an off-ramp provision should the Single "A" Utility Bonds move by more than 250 basis points from the benchmark (upwards or downwards) during the October through September 12-month average time frame. If this were to occur, SDG&E could, at its discretion, notify the Commission's Executive Director that it is suspending the trigger mechanism, and that it will subsequently file an application with the Commission to request, at a minimum, a full review of the CCM trigger event, and potentially a review of its overall COC. If SDG&E does not invoke the off-ramp provision in the event of a greater than 250-basis point trigger, SDG&E will follow the specific guidelines of the CCM trigger and file the compliance advice letter addressing the full impacts to its COC resulting from the trigger mechanism.

V. SUMMARY AND CONCLUSION

As my foregoing testimony explains, SDG&E has been operating successfully under a COC trigger mechanism for almost 15 years. SDG&E believes that its current CCM, which utilizes the Moody's Utility Bond rate, is most appropriate to approximate the movements in

[15] When the MICAM was first employed in 1998, D.96-06-055 implemented an off-ramp provision such that for a year in which the difference between the current six-month average and the benchmark exceeded 400 basis points, the MICAM process would be "abated" in the following year. The settlement agreement later adopted in D.03-09-008 modified the MICAM off-ramp to trigger a COC proceeding rather than a MICAM adjustment. The settlement replaced the 400 basis point off-ramp with a 260 basis point off-ramp and permitted a complete re-examination of COC if needed. The Commission concluded that "a 260 basis point off-ramp trigger promotes the public interest because it is more sensitive to significant economic changes than the current off-ramp." D.03-09-008, *mimeo*, p. 5.

1 SDG&E’s capital costs. The features inherent in the CCM at present strike the appropriate
2 balance of ROE stability against significant changes in the utility industry and financial markets
3 between COC proceedings. Consequently, SDG&E proposes to continue the CCM, with certain
4 modifications described in this testimony.
5 This concludes my prepared testimony.

VI. STATEMENT OF QUALIFICATIONS

My name is Kenneth J. Deremer, and my business address is 8330 Century Park Court, San Diego, California 92123. I am currently employed by SDG&E as the Director of Financial Planning, Budgets and Claims. My current responsibilities include the development, implementation and analysis of SDG&E's annual and multi-year financial planning and budget process. I assumed my current position in May 2011. Prior to this, I served as the Director of Financial Analysis & Assistant Treasurer beginning January 2009, where my responsibilities included overseeing the development, analysis, and implementation of financing strategies, revenue requirements, regulatory accounts, and cost recovery mechanisms for SDG&E and SoCalGas. Previously, I was the Director of Tariffs and Regulatory Accounts beginning May 2007, where my responsibilities included the implementation and oversight of the utilities' tariffs and regulatory accounts, and the preparation of testimony in various regulatory proceedings, including the General Rate Case. I also served as the Regulatory Accounts Manager beginning April 2002. In that position, I managed the process for implementing and maintaining regulatory accounts, including serving testimony in ERRA proceedings.

I have been employed by SDG&E and Sempra Energy since 1991. In addition to my work experience described above, I worked from 1999 through 2002 as a Regulatory Tariff Administrator and held various positions in the Financial Reporting Department.

I received a Bachelors of Science in Business Administration from the University of California, Riverside in June 1987. I also received a Masters in Business Administration, with an emphasis in Finance, from the University of California, Riverside in December 1989. I have previously testified before this Commission.

APPENDIX A: Benchmark and Automatic Trigger Example

For illustrative purposes the benchmark interest rate proposed using 2010-2011 data is shown in Table 1 (this will be replaced with updated rates at the time of the final Commission decision in this proceeding).[16] The benchmark for 2010 – 2011 would equal 5.28% (Moody's October 2010 through September 2011 average of Moody's A-rated utility bond yield). This benchmark would remain in effect until the earlier of a trigger event or the conclusion of the proposed three-year COC period. If the average A-rated utility bond yield for a future October through September period moves below 4.28% or above 6.28%, an automatic adjustment would be triggered.

Table 1:
SDG&E CCM – Illustrative Benchmark for 2011

Monthly average Moody's A utility bond yields:

Month	Yield
October	5.10%
November	5.37%
December	5.56%
January	5.57%
February	5.68%
March	5.56%
April	5.55%
May	5.32%
June	5.26%
July	5.26%
August	4.69%
September	4.48%
Average	5.28%

To illustrate the process of reflecting a CCM trigger event, first assume SDG&E's authorized ROE is 11.0%. Suppose a trigger event occurs in October 2013, where the 12-month October 2012 through September 2013 Moody's A bond average is 6.38% (a 110 basis-point increase from the benchmark). The upward trigger event would cause a 55

[16] The final benchmark would be determined by the October 2011 through September 2012 measurement period and reflected in the compliance advice letter to implement the final COC decision.

1 basis point adjustment to SDG&E's authorized ROE from 11.0% to 11.55%. The
2 October 2012 through September 2013 average of 6.38% would become the new
3 benchmark level. The resulting ROR would be based on the newly set ROE and updated
4 actual August month-end embedded costs of long-term debt and preferred stock, but there
5 would be no change to the authorized capital structure.

6 Now suppose the inverse: a trigger event occurs where the 12-month average is
7 4.18% (a 110 basis point decrease from the benchmark). The downward trigger event
8 would cause a 55 basis point decrease to SDG&E's authorized ROE from 11.0% to
9 10.45%. The October 2012 through September 2013 average of 4.18% would become
10 the new benchmark level. The resulting ROR would be based on this newly set ROE and
11 updated actual August month-end embedded costs of long-term debt and preferred stock,
12 but there would be no change to the authorized capital structure.

13 In each of the examples discussed, SDG&E would file a Tier 2 Advice Letter
14 informing the Commission of the CCM trigger event, including all necessary calculations
15 to determine the trigger, adjusted cost of capital levels, and associated rate-impacts.
16 Customer rates would reflect the new cost of capital levels the following January,
17 consistent with current practices.